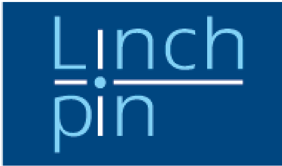
Appendix A



Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **3rd June 2019**

Introduction

1. As there are several new members to this committee, I start by summarising my view of the Fund's position today. I then give a brief commentary on markets. I finish by setting out recommendations for the Committee; as new members may wish to bed themselves in before taking any major decisions, these are direction pointers more than items needing urgent action.

2. Teesside Pension Fund's primary purpose in law is to receive contributions, and to administer and invest them in a way which will result in members receiving them on time and in full. In investing the funds, there is a requirement to take advice, which is why you hire independent advisers.

3. The actuary values the fund every three years and sets a return target which, if achieved, should result in a successful outcome. She also provides a snapshot of the fund's solvency: i.e. the funding ratio, which was 100% at March 2016. However, this depends on many assumptions, some of which (eg. investment returns in the future) are heroic, others of which (eg. longevity, salary increases) will certainly turn out to be wrong. The Fund is already collecting contributions for pensions which may not be drawn down for nearly 100 years. When making decisions it is essential to look to the long-term, and not to let short-term considerations or emotions dominate.

4. The Fund has historically had the bulk of its investments in equities, i.e. shares in companies. This is because, unlike most other investment assets (eg. property, fixed income), companies grow over time and, as importantly, deliver shareholders growing cashflow streams in the form of dividends. Equities have performed particularly well over the past ten years and, as a result, the Fund's funding ratio today is likely in the 110% to 120% range.

5. Equities can at times fall dramatically in value; most recently, in Q4 2018, US equities fell almost 25%. Although the Fund has a long-term investment horizon, such volatility is in fact undesirable for many reasons. The Fund therefore invests some money in other assets to provide protection. Historically the default 'protection' assets have been government and corporate bonds. These are currently expensive, and the Fund largely diversifies today through commercial property and cash.

6. Under "pooling" this Committee will retain responsibility for strategic asset allocation (ie. how much to invest in each high-level asset class). Investment implementation will increasingly move to Borders to Coast PP, the pool this Fund has established with 11 others. In practice this Committee's role will be to ensure i) that the pool provides what the Fund needs, ii) effective governance to ensure remedies if things go wrong, and iii) appropriate allocation between the Pool's sub-funds.

7. Finally, as the fund is relatively mature, the cashflow shortfall (contributions minus expenditure) was around £57m last year. The investment portfolio needs to deliver sufficient income in the future to avoid having to sell assets to fund this deficit, which is likely to increase. **Apart from this point, the Fund is in a relatively healthy financial position.**

Market commentary

8. In March I said that the US Federal Reserve (aka"**the Fed**"), America's central bank and an important influence on the world's markets, had abandoned its previous path of raising rates, which gave a major positive signal to markets. I suggested this change of course reduced the risk of a US recession and that equities, albeit expensive by historic standards, would likely trade sideways.

9. **Three months later it seems to me clear that Fed's shift has longer term positive implications for world markets.** To explain why, I go back to the period after the Global Financial Crisis in 2008/9, when the Fed and other world central banks' priority was to avert first a financial collapse and then global recession. They kept monetary policy loose - known as printing money or Quantitative Easing ("**QE**"). The excess money tended to go to financial assets, which is why the price of many 'investments', from real estate through prestige cars to shares and bonds has risen in this period.

10. Over the last two years concerns about rising inflation led the Fed to reverse that policy by contracting its balance sheet. US rates rose to 2.5%, in contrast to near zero rates in Europe, Japan, and the UK, and by Q4 2018 investors (myself included) started to fear that a US recession would result from the Fed's tighter stance. The change of tack in January suggests **a return to some form of QE, which significantly reduces the risk in all markets**. In particular, it lowers the likelihood of economic recession and is a signal that the Fed's no. 1 worry is no longer inflation.

11. Elsewhere the developed world seems to be edging closer to the Japanese model of very low growth and low inflation. I said last time that a broader recession in Europe is looking more likely and my view has not changed. BREXIT is not helpful, but I would be wary of any commentator suggesting that any outcome is disastrous: ultimately Britain's prosperity depends on larger factors, such as the path of globalisation and capitalism, and of course geo-politics.

Portfolio commentary and recommendations

12. The monetary background described above suggests that, even if equities are expensive, **the probability of a prolonged bear market (as opposed to a sharp dip) is now lower.** It is not all good news, however. Bond yields are likely to continue to fall, which will increase the valuation of liabilities.

13. **Given the current healthy funding position, I suggest that this Committee's priority over the next year should be how best to protect this.** In particular:
    - Do members wish to reduce risk (ie. maximise likelihood of pensions being paid) or maintain it (ie. increase the likelihood of being able in future to reduce contributions)?
    - Is the current 80% Growth/20% Protection split appropriate?
    - Should assets other than bonds and cash be considered within the Protection bucket?
    - Should we consider a third bucket to ensure investments deliver sufficient cash to cover the cashflow deficit (approx. 1.6% of AUM) resulting from the relative maturity of the Fund?
    - Should the Fund be looking at other ways to protect its position?

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