Appendix 2

AllenbridgeEpic
INVESTMENT ADVISERS

REPORT OF THE INVESTMENT ADVISER
PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

on September 9th 2013

Investment Outlook

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Appendix 2

Dorset County Council Pension Fund
SEPTEMBER 2013
Report of the Investment Adviser

Investment Outlook

Summary

"Sell in May and go away" is an old stock market saying that proved apposite again this year but only for a short time. We have warned in the last two reports that the main threat to more bullish markets was the risk of the Federal Reserve withdrawing from its QE policy of buying bonds which could drive up bond yields and unnerve markets. That is precisely what happened when Mr Bernanke made his statement over tapering which led to considerable uncertainty but perhaps markets soon realised they had overreacted and rallied back to earlier peak levels,

Closer to home, the UK economy appears to be picking up though that has not deterred Mr Carney, the new Governor, from introducing his new policy of forward guidance . This suggests base rates will stay at current levels for up to three years until unemployment falls back to 7%, a radical change of approach though inflation targeting still remains important. Markets have had some difficulty interpreting this however

Underwriting the resilience of risk assets has been increasing signs of global economic recovery, led by the US and Japan. In their different ways, Europe and China pose questions still but markets seems to feel risks are diminishing .

Economy

The Fed has had to clarify its approach over tapering, ie bringing QE to an end. This is likely to go in stages which would start with a reduction in the monthly bond buyback programme, that could start as early as September, followed by cessation of bond purchases and eventually selling bonds back to the public. Evidence of an improving economy led by the consumer continues to grow with the revived housing market the clearest driver behind better sentiment.

In the UK, Mr Carney acknowledges some improvement in the economy, not least with a 0.6% Q2 GNP growth figure, but believes we are far from what he calls" escape velocity". This is why the Bank believes it will take until 2016 before unemployment falls from 7.8% to 7.0%, his condition for considering a rise in base rates. There are three so- called "knockouts" or caveats to the new policy: that CPI inflation does not exceed 2.5% on a medium term forecast; that inflationary expectations remain stable ; and that there is no threat to financial stability from continuing loose monetary policy. The policy is therefore more ambiguous than expected.

Europe does appear to be bottoming out, perhaps six months after the UK with a modest rise of 0.2% in Q2 GNP and improving survey data. Germany is growing modestly and clearly southern Europe is a long way from gaining traction but the declines in output have perhaps come to an end. Normality seems to have returned to the financial system though banks remain under pressure to raise capital and address the issue of loan provisions.

In Japan, the economy is certainly growing and at a rate of 2-3% ,well ahead of recent trend . A key uncertainty is whether the government honours a commitment to raise the sales tax early next year as a contribution to reducing the bloated budget deficit, which might choke off recovery. China appears to have removed concerns that growth could slow below the 7.5% mark on the latest numbers but after some years of 10% growth this slowdown continues to impact commodity prices and commodity exporters like Australia and Brazil..

In currency markets, emerging market currencies have been weak regardless of whether they are perceived commodity plays as emerging markets reel from a succession of internal and external problems, one of which has been the rally in the dollar. This was initially quite pronounced when it was thought interest rates would rise with the tapering of QE but the dollar has now lost momentum. Sterling has been range bound but surprisingly went higher on the Bank's guidance as markets reasoned that there were still enough triggers for interest rates to rise. However, many FX analysts now expect the pound to weaken against the dollar as the US-UK interest rate gap widens out in favour of the US.

Markets

There was a pronounced shift upwards in government bond yields in Q2 , led by the US as markets factored in a rise in interest rates as a result of the end of QE, As a result , returns from bonds were negative in the quarter , including investment grade corporate bonds , In the UK, if the curve up to ten years is excluded, the market was discounting a rise in gilt yields. The change of Bank of England tack might suggest this was misplaced suggesting gilt yields should fall. In the event, this has not yet happened as markets are unsure what it all means. In any event, it is hard to be positive on bonds as yields are still below fair value. Index linked yields remain negative or zero, offering little value while inflationary expectations remain over 3% . Corporate bond spreads may narrow in as the economy recovers but the duration risk suggests returns from credit will be unappetising for some time.

Equity returns were broadly flat in Q2 after a strongQ1 with the UK slightly down while other advanced markets were mostly positive. The main concern has been emerging markets which fell some 7% in sterling terms and are negative for the year to date. The rally in most markets in June and July leaves markets in a good state as we write in mid – August.

How to read equity markets after this interesting round trip.? Clearly, against bonds, equities remain attractively priced and in absolute terms valuations are far from stretched. The US is probably more stretched than most while emerging market valuations have fallen back. There is some concern that in the US earnings growth is slowing markedly as profit margins are at such highs while P/E s have risen from 13 to 16 in the course of the year, indicating at least fair value. However, as bull markets mature, equities can keep rising through multiple expansion, ie P/E ratios rise as markets get uprated . Market momentum is certainly still positive while confidence in the economy appears to be recovering strongly. This could mean positive sentiment could move markets higher even if earnings growth is no longer providing support.

The US usually provides leadership to the rest of the world though most markets would have more underlying support from earnings recovery, eg Europe or valuation, eg emerging markets.

The latter are of course a mixed bag and recent volatility could continue for a while though the long term story remains attractive. Best guess then is that markets move higher later in the year

after the current consolidation , barring unforeseen market shocks. This is consistent with our previous advice and the correction we anticipated is now, hopefully, behind us.

Property

The property market is certainly showing signs of life with confidence moving to the regions from central London which has outperformed the rest of the country for some time, helped by foreign buying. Capital values appear to have stopped falling so that the running yield of 6% now looks a good annual target. Medium term targets are if anything slightly more bullish and there is certainly scope for some revaluation of secondary properties where yields have widened out so far..

Alternatives

This year has been a better one for hedge funds with the average hedge fund return for the first half of the year up by some 4.5%. While June was negative, most months have been modestly accretive. Interestingly, there is no longer much divergence between fund of funds and single strategy managers, which has been a problem for the last two years. Diversified growth fund managers are keeping up . Alternatives have of course lagged equities this year and since the crash but are used as an insurance against further market corrections.

Asset Allocation

We have agreed not to make any strategic asset allocation changes until after the formal valuation, which has led to the deferment of the review of alternatives. Generally speaking, the outlook for equities and property, so-called growth or real assets, looks better than bonds or so-called defensive assets in the short to medium term. While private sector schemes would be derisking into the equity market rally, we are not under compulsion to do so. The main strategic decision would seem to be whether we diversify our growth assets further by switching more out of equities into alternatives and whether the mix of alternatives is optimal.

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