APPENDIX 2

REPORT OF THE INVESTMENT ADVISER
PREPARED FOR

Dorset County Pension Fund

Pension Fund Investment Committee

On March 1st 2016

Investment Outlook

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Dorset County Council Pension Fund

February 2016

Report of the Investment Adviser

Investment Outlook

We are back in the middle of a serious market correction caused by a loss of collective investor nerve since the turn of the New Year with doubts over the sustainability of global growth, the continuing malaise in emerging markets, the volatility of oil prices and now fears over the banks.

This followed on from a fourth quarter 2015 which showed a strong recovery in equities from the 10% sell off in the summer months. The search for safe assets means that gilts have recovered after their fourth quarter retreat. Sterling too has recovered somewhat from the heavy selling against the dollar last year.

There is something of a fear factor at present and a disconnect from the reality of the global economy although there are plenty of reasons to expect volatility and that it will continue this year. Global economic growth is indeed slowing, led by emerging markets like China, but we are far from heading into recession. A market recovery could be anticipated, helped as ever by supportive central banks.

Economy

Global growth is probably slowing to around 3%. Leading the pack are the UK and US, The UK is typical of the scale of downward adjustment to forecasts with consensus now around 2.25% against 2.5%.The US has at last raised interest rates by 0.25% but clearly the Fed does not feel the domestic economy is strong enough for it to move much more for now. The European economies are gaining a little traction but are showing no acceleration from the 1-1.5% level. Japan is similar with the central bank actually moving to negative short term rates to stimulate an economy that seems to be losing faith in "Abe-nomics".

That all suggests the global economy will enjoy its fifth year of weak economic growth, supported by exceptionally low interest rates and free from inflation worries. Lower oil prices unquestionably help consumer incomes and spending but investment spending remains low reflecting weak business confidence while, unusually, world trade growth has slowed right down so exports suffer. To a large extent, this reflects the problems of the emerging markets and the fall off in commodity exports but also in manufactured goods.

The Bank of England has signalled that it is unlikely to raise interest rates this year, another change in the signals .With CPI remaining close to 1% for the year and wages growth slowing, surprisingly, there is no urgent reason to tighten. .Brexit will of course be the big issue in the months ahead and poses a significant potential risks. Consensus is that a vote to leave would be negative for UK equities, gilts and sterling though much of the effect on equities and sterling could be priced in at current levels. Either way, a period of uncertainty will cap recovery.

A word on emerging markets which in a sense have been the tail that wagged the dog in recent months. The slowing is undeniable, their currencies remain under pressure while there are increasing concerns about rising debt levels and mismatched foreign currency debt, China is struggling to avert too sharp a slowdown and rebalance its economy from investment to consumption. The jury must be out as to whether it succeeds. Emerging markets are going to follow not lead the global economy with consequent implications for commodity prices. Oil remains down to the Saudis and whether they can afford to continue maximising output.

Markets

Last year was a poor year for investors with UK equities and gilts producing -1% and 1% respectively while global equities did better at 4%, helped by sterling's fall of 6% against the dollar. The fourth quarter rallied, up 4% in UK equities and 8% in global. For the second year running therefore, the UK lagged global markets. Exceptionally, the FTSE 250 Index of mid-cap stocks rose 11%. The stand out asset class yet again was UK commercial property with a total return in the mid- teens.

Markets have become too dependent on the lower for longer policy of the central banks and expect them to respond immediately market sentiment takes a bashing as in the current quarter. Already, Yellen and Carney have amended their guidance on rates while the ECB and Japanese central bank have indicated potential action. Likewise, expectations on global growth were perhaps too high so an adjustment phase to market views is sensible .However, there are dangers it could go too far and at the time of writing, a certain panic has set in, notably with the major sell-off in European bank shares.

Geopolitical risk has also increased while the fragility of oil prices refocuses market attention away from the benign effects on consumer spending to the adverse effects on energy companies and their lenders. Credit markets suffer in parallel. Our more parochial concern over Brexit has been overshadowed by these global issues. Emerging market fears began the unwinding of the bull market story for developed markets but in the current nervous state, a wider set of concerns have come along

Major bear markets are usually an anticipation of global recession or, occasionally like 2008, reflect a financial shock. It is hard to see recession around the corner while banks should be better prepared to withstand major credit events which involve bad debts, whether from emerging market companies or oil and gas companies. One concern of course is whether the central banks themselves have enough firepower left at current low rates to provide that support.

Accordingly, while there are stressed players at present and lots of concerns, markets will probably settle down and accept that the slow growth story remains intact still even if it is not as exciting as markets would like. From today's levels, though, one cannot have much confidence in much more than low single digit returns from equities for the year. That should probably bet the return from bonds as government bond yields are more likely to rise than fall while corporate bond spreads might narrow slightly as bankruptcy fears recede.

Property

The UK commercial property market remains buoyant if somewhat overvalued, with the exception of some sectors like retail. Returns the year as a whole are some 14-15%, well ahead of other asset classes.

The occupancy market is firm with rents rising outside the retail sector and the strength has extended across most regions. There is no sign yet of the predicted sell-off in City or West End though a no vote in the referendum might see some overseas selling.

Yields in commercial property must be near their lows now but with rental growth and attractive yields, this year could still see property being the best returning asset class again.

We have delegated the task of tactical asset allocation to our Diversified Growth manager who times moves across markets according to short term tactical views and is judged as to how he produces returns over and above a cash benchmark. Hedge funds do a similar thing but at a greater fee and we no longer have exposure to them

As indicated last time, alternatives like private equity and infrastructure dance to a different tune and are both illiquid assets where we have to commit for a long time. Private equity is a geared equity play where we should expect higher returns over time than quoted equities while infrastructure is also a long term investment where we are attempting to achieve a positive return in real terms

Asset Allocation

The Dorset scheme retains a good exposure to risk seeking assets like equities and property while half of the bond assets are designed to hedge out liability risk, i.e. inflation risk. Alternative assets can be regarded as diversifying assets such as diversified growth funds and as defensive quasi-liability matching assets such as infrastructure.

A rise in bond yields will challenge markets at some stage but the scheme has a reasonably diversified investment strategy which will provide some protection while the liability hedge, covering part of the inflation exposure, will provide some protection against an eventual rise in inflation.

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