ASSET MANAGEMENT

DORSET COUNTY PENSION FUND

Quarterly Report 30 September 2019

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PORTFOLIO REVIEW

Fund performance objective

The fund objective is to outperform the benchmark by 0.5% per annum net of the standard management fees.

Fund asset allocation

Fund & benchmark index	Fund allocation (%)
RLPPC Over Five Year Corporate Bond Fund Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.	100.0

Portfolio value

	Portfolio total (£m)
30 September 2019	**230.37**
30 June 2019	220.28
Change over the quarter	10.09
Net cash inflow (outflow)	0.00

Executive summary

Performance

- The Fund gave a gross return of 4.58% over the quarter, bringing the 12 month return to 13.38%.
- Sterling investment grade credit underperformed UK government debt in the third quarter; respective all-maturities returns were 3.68% and 6.20%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 4bps to 1.29% by the end of the period.
- The fund underperformed the corresponding index, with positive effects from our underweight in supranationals offset by stock selection within structured bonds.

The economy and bond markets

- Global economic growth remained weak in the third quarter and US-China trade tensions escalated further with retaliatory tariffs between the countries. While consumer data remained relatively resilient, business surveys implied a weak, albeit not recessionary, global economy. There was significant and widespread easing of monetary policy alongside a smattering of fiscal stimulus announcements. The US and UK yield curves both inverted, implying that perceived future growth prospects were sufficiently limited as to warrant little concern about future inflation.
- Survey data suggested that UK economic growth is worsening, with PMI survey data consistent with a modestly shrinking economy, though hard data painted a more positive picture. Retail sales, consumer confidence and the labour market remained robust. Real pay growth was strong, around 2% year-on-year, and employment continued to grow. On the other hand, business investment was weak, Brexit and the global backdrop weighed on business sentiment, and signs of a pick-up in domestically-driven inflation remained elusive. The government announced a substantial fiscal boost for the year ahead, as well as additional spending on Brexit preparations.
- Continuing their positive trajectory from the first half of the year, valuations in government bond markets moved to unprecedented levels in the third quarter, as central banks reacted to deteriorating economic growth globally. Having kept interest rates unchanged at 2.25% since the start of the year, the US Federal Reserve cut them twice over the quarter to 1.75%. The European Central Bank (ECB) also cut its deposit rate to an all-time low of -0.5% and committed to purchasing €20bn of bonds a month until such time as it raises interest rates. Trade tensions between the US and China escalated in August following the surprise imposition by President Donald Trump of an additional 10% tariff on $300bn of Chinese imports, prompting retaliatory measures.

PORTFOLIO REVIEW

Investment outlook

- Global growth is likely to slow further before bottoming out next year. In our base case we think that a global recession will be avoided, although we acknowledge that the recessionary risks are significant. Business sentiment and global growth are likely to be weighed down by higher tariffs and uncertainties surrounding global trade policies and Brexit. That should encourage further monetary and fiscal easing from central banks and policymakers, supporting economic growth. We think that inflationary pressures will build in some countries, despite weak growth, but modestly.
- We have further reduced our growth forecasts. We expect 2019 global GDP growth to be 3.1%, compared to 3.2% previously, and 2020 growth to be 3.0%, down from 3.3%, with some growth momentum from mid-2020.
- We expect the Fed to cut rates at least another 25bps later this year. We think that the ECB to continue its asset purchase programme through to the end of 2020. We anticipate that the People's Bank of China (PBOC) will ease monetary policy further in the coming months. We expect further monetary policy easing from the Bank of Japan (BoJ). We anticipate a modest rate cut from the Bank of England (BoE) in the next few months.

FUND PERFORMANCE

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2019	**4.58**	**4.97**	**-0.39**
Year-to-date	13.20	13.40	-0.20
Rolling 12 months	13.38	13.58	-0.20
3 years p.a.	5.32	4.05	1.27
5 years p.a.	7.59	6.97	0.62
Since inception p.a. 02.07.2007[2]	8.80	8.75	0.05

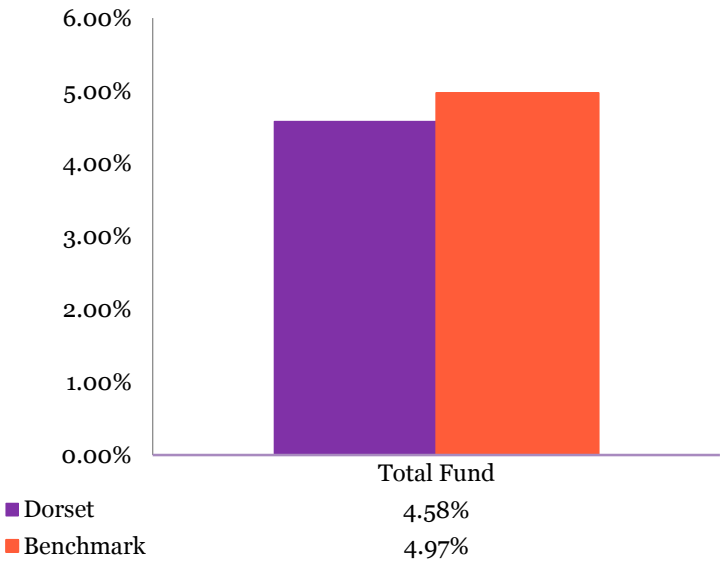
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, [1]Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

[2] The fund launched 02.07.2007 but its benchmark and objective changed on 30.06.2012.Performance prior to 30.06.2012 has therefore been omitted. If you require performance prior to this change, please contact your client account manager.

The fund objective is to outperform the benchmark by 0.80% per annum gross of the standard management fees.



Source: RLAM, gross of standard management fees.

**Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.*

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.7	99.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.3	1.0
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	10.3 years	10.6 years
Gross redemption yield[4]	2.73%	1.96%
No. of stocks	438	728
Fund size	£231.7m	-

Source: RLAM, Launch date: 20.07.2007.

[1]Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[3]Excluding cash

[4]The gross redemption yield is calculated on a weighted average basis

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2019	**4.58**	**4.97**	**-0.39**
Year-to-date	13.14	13.40	-0.26
Rolling 12 months	13.45	13.58	-0.12
3 years p.a.	5.30	4.05	1.25
5 years p.a.	7.61	6.97	0.63
Since inception p.a. 02.07.2007[2]	8.59	7.41	1.17

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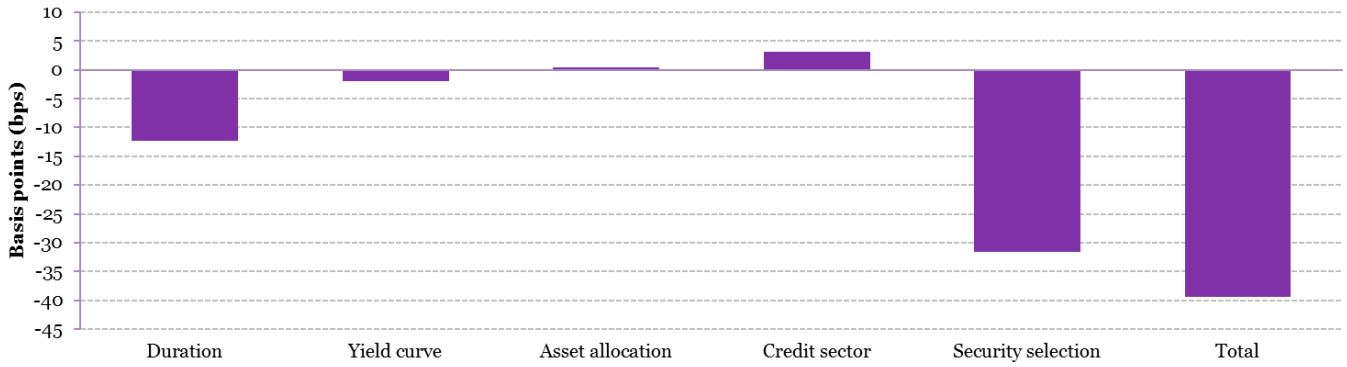
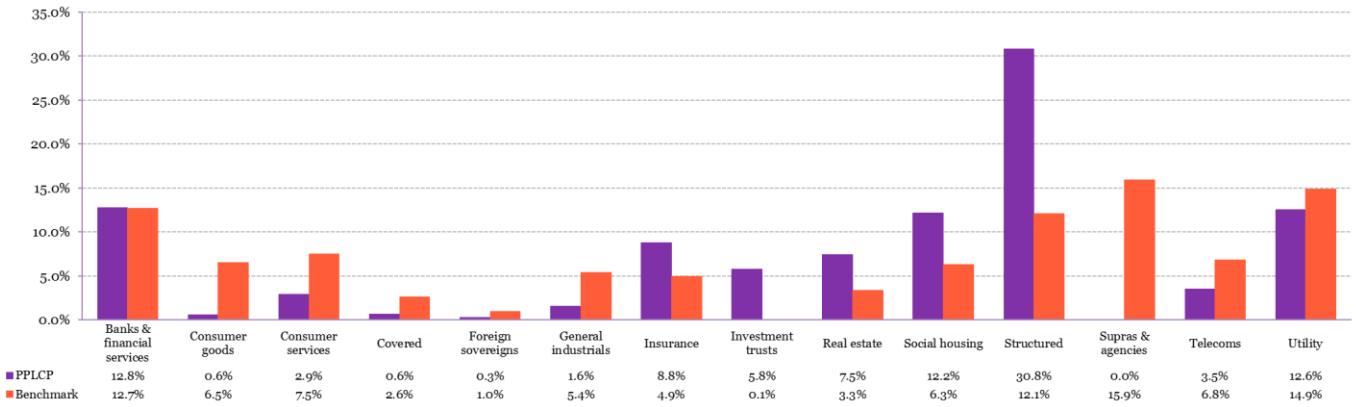
Performance attribution for quarter 3 2019



Source: RLAM and UBS Delta. The above performance attribution is an estimate. Please note that the attribution chart does not include residual effect returns.

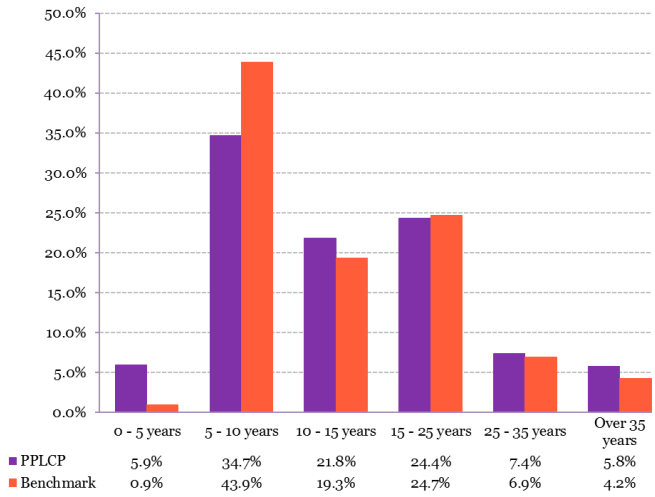
RLPPC OVER 5 YEAR CORPORATE BOND FUND

Sector breakdown

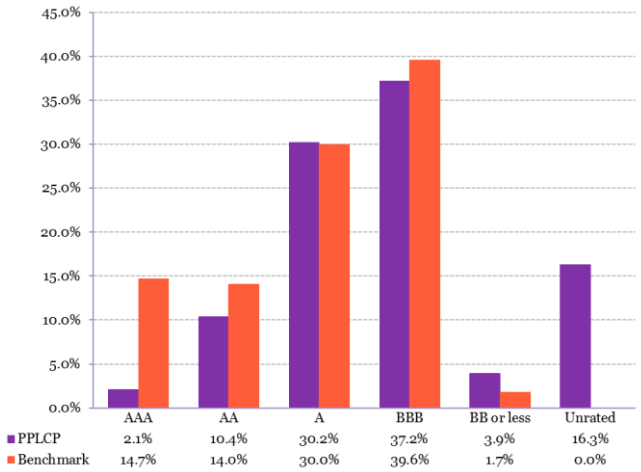


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
HSBC Bank 5.375% 2033	2.0
Finance for Residential Social Housing 8.368% 2058	1.4
Électricité De France 6% 2114	1.3
Prudential Plc 5.7% VRN 2063	1.3
Innogy Finance 6.125% 2039	1.3
Exchequer Partnership 5.396% 2036	1.2
Thames Water Utilities 2 7.738% 2058	1.2
Annes Gate Property 5.661% 2031	1.2
Equity Release 5.7% 2031	1.1
Barclays Plc 3.25% 2033	1.1
Total	**13.0**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Portfolio review

	What we thought	What we did	What happened	Effect on portfolio
Sector	We expected corporate bonds to outperform supranational debt.	We kept the significant underweight position in supranationals versus corporate issues.	Supranational debt held up well as credit spreads widened, but its low duration constrained absolute returns.	The fund's substantial underweight position in supranationals had a positive impact on performance this quarter.
Sector	We continued to see value in financials (banks and insurers), and to favour subordinated debt over senior bonds.	The overweight exposure to subordinated financial debt and the below benchmark holding of senior issues were broadly maintained.	Banks and insurers both marginally outperformed the broader market. Senior insurance bonds underperformed subordinated issues, whereas senior bank issues outperformed their junior peers.	The above benchmark position in financials was positive. However, the impact on performance over the quarter was only modest because of the mixed performance of the sub-sectors.
Sector	We continued to believe that secured bonds were undervalued relative to unsecured debt.	We kept the significant overweight positions in sectors that benefit from enhanced security, e.g. asset-backed securities (ABS), social housing and investment trusts.	Within secured and structured sectors, which typically comprise longer-dated bonds and span a wide range of industries, ABS underperformed: however, social housing strongly outperformed.	Above benchmark exposure to secured debt was broadly positive for performance.
Ratings	We believed lower-rated credit bonds offered better value than AAA and AA rated securities.	The bias towards lower-rated debt was maintained over the quarter.	Despite the overall widening of credit spreads in corporate bonds, the different rating bands delivered mixed performance.	The preference for lower - rated debt had a limited impact on performance this quarter.
Ratings	Credit ratings, while useful, are not a complete assessment of value and creditworthiness.	We maintained exposure to bonds rated below investment grade where we believed they were consistent with the overall objective of the fund. Exposure to unrated issues, which predominantly have investment grade risk characteristics and are in many instances secured, was broadly unchanged.	High yield debt outperformed investment grade credit over the quarter. Unrated bonds in the fund, which consist mainly of secured and structured issues, were relatively slow to respond to the improving sentiment in markets.	The allocation to sub-investment grade debt was positive for returns. Exposure to unrated bonds had a mixed impact on performance.
Duration	We think the level of gilt yields is challenging over the longer term. However, our level of conviction is low regarding their short-term direction.	The fund maintained its slight short duration stance versus the benchmark over the quarter.	The yield on the 10-year gilt fell by 35 basis points to 0.49%, extending this year's decrease.	The duration position had a negative impact on performance.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Fund activity

- Sterling investment grade credit issuance for the third quarter of 2019 was very similar to the second quarter. The fund participated in various new issues this quarter, including in AAA rated bonds of **Westfield Stratford**, a structured deal secured against retail property, and a longer-dated social housing ABS issue by **Accent Housing**. We also purchased financials debt of **Prudential** and **Reassure Group** (both Tier 2), and **Barclays** and **Nationwide** (both AT1). Otherwise, we bought new utilities issues from SSE subsidiary **Scottish Hydro**, **Western Power Distribution** and **Wessex Water Services**; and a sterling-denominated 12-year bond from French oil major **Total**.
- **Intu Properties**, the UK's largest shopping centre landlord, continues to be negatively impacted by well-publicised challenges in the UK retail sector. The company's half-year results, which were released during the quarter, pointed to further downward pressure on rental income and property values, reflecting the struggles of some of their underlying retail tenants. Although the secured and covenanted nature of Intu's bonds will help to dampen their fundamental exposure, the market move in the price of these bonds was significant, with spreads widening by around 300 basis points (bps) over the period. We will continue to invest on a very selective basis in the UK retail sector with a particular emphasis on secured and credit-enhanced opportunities.
- Financials remained an important component of sterling credit portfolios. Subordinated bank and insurance bonds were volatile over the quarter, reflecting changes in risk appetite and new issuance activity. However, our sterling credit portfolios have benefitted from exposure to these areas over the year, with good relative contributions being made from exposure to both **Prudential** and **Barclays Bank**.
- One of the most noticeable changes in sterling credit indices in recent years has been the increased weighting of the **social housing** sector. Having previously been a small part of the market, with typically unrated issues, the sector has become far more significant. Issues are now usually rated and are benchmark constituents. This reflects both the appetite by investors for longer-dated, highly-rated bonds, but also the greater reluctance of banks to offer long-term finance following the global financial crisis. During the quarter, we maintained our overweight position – which was beneficial as the sector outperformed – and participated in a new issue (see above). We believe that regulatory oversight, high asset backing and the sector's vital role in the provision of housing are all supportive factors.

Investment outlook

- Corporate bonds are largely being driven by macroeconomic factors at present, taking their cue from government bond markets. The yield on 10-year gilts fell by another 35bps to 0.49%, compared to its year high of 1.35% in mid-January. While Brexit-related concerns have had an impact, this shift has mainly been driven by lower expectations of global economic growth. US treasury yields have also fallen sharply, while German bund yields have extended their push into negative territory (-0.70%). While we feel these levels are challenging, with central banks pursuing ultra-loose interest rate policies and/or quantitative easing, our level of conviction is low regarding their short-term direction. For this reason, we have positioned duration moderately shorter than the benchmark.
- Over the quarter, the inversion of the yield curve attracted a great deal of comment as this has traditionally been seen as an augury of recession. However, we think there is a danger of over-interpreting these financial market dynamics and under-appreciating real-world economic developments. We believe curves are inverted because investors believe that central banks will do whatever it takes to avoid recession and think this won't ignite inflation. It is difficult to position against this – "Don't fight the Fed!" – so yields may stay lower for longer. The key is not to allow these conditions to undermine our investment philosophy chasing higher yields to deliver returns, thereby losing focus on quality.
- Brexit continues to dominate UK politics and is increasingly dampening economic activity. Our sterling credit portfolios have a low relative exposure to those sectors most exposed to trading interaction between the UK and the EU (e.g. general industrials and consumer goods). However, disruption arising from an adoption of World Trading Organisation (WTO) rules would have economic consequences that would impact a broad range of UK companies. Such uncertainty reinforces our favoured approach of ensuring significant diversification of issuers and biasing our portfolio towards bonds with strong asset backing and/or covenant protections to mitigate such risks.

Key views within the portfolio

- A significant underweight in supranational bonds, as we expect corporate debt to outperform over the medium term.
- Duration moderately below that of the benchmark, as we expect underlying gilt yields to gradually trend higher.
- A bias towards asset-backed securities, an area that we believe still offers very strong risk/return characteristics.
- An overweight position in subordinated financial debt, where we believe yields are attractive.

FURTHER INFORMATION

Market commentaries & investment outlook

Please click on link for further information.

Stewardship and Responsible Investment at RLAM

Please click on link for further information.

Royal London Fixed Income ESG Analysis

Please click on link for further information.

Royal London Equities Voting and Engagement

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Glossary

Please click on link for a glossary on terms.

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Portfolio Valuation

As at 30 September 2019

Dorset County Pension Fund

	Holding	Identifier	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held										
	85,353,190	GB00B1ZB3X88	RLPPC Over 5 Year Corp Bond Pen Fd	2.69907	108,221,886.76	230,374,235.68	0.00	230,374,235.68	0	100.0
				Funds Held total	**108,221,886.76**	**230,374,235.68**	**0.00**	**230,374,235.68**		**100.0**
				Grand total	**108,221,886.76**	**230,374,235.68**	**0.00**	**230,374,235.68**		**100.0**

Trading Statement

For period 01 July 2019 to 30 September 2019

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	04 Jul 2019	Acquisition Rebate	61,397.12	RLPPC Over 5 Year Corp Bond Pen Fd	2.65	162,617.64
					Funds Held total	**162,617.64**
					Acquisitions total	**162,617.64**