QUARTERLY REVIEW PREPARED FOR

Oxfordshire Council Pension Fund

Q4 2013

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Peter Davies
AllenbridgeEpic Investment Advisers Limited (AllenbridgeEpic)

peter.davies@allenbridgeepic.com www.allenbridgeepic.com

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PENSION FUND COMMITTEE - 14 MARCH 2014

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. The UK economy grew by a provisional 0.7% in the fourth quarter, with all areas of the economy contributing. This was ahead of expectations, and forecasts for growth in 2014 have also been revised upwards. After the upturn in the second-quarter, the Eurozone was flat in the third quarter; the ECB has kept interest rates unchanged in February. The Japanese and Chinese economies have maintained their growth levels, and there has been an upward revision in the outlook for the United States.

(In the table below, bracketed figures show the forecasts at the time of the report to the December Committee)

Consensus real growth (%)	2011	2012	2013E	2014E	Consumer prices latest (%)
UK	+0.9	-0.1	(+1.4) 1.8	+2.7	+2.0 CPI)
USA	+1.7	+2.2	(+1.6) 1.9	+2.9	+1.5
Eurozone	+1.5	-0.5	(-0.4) -0.4	+1.0	+0.7
Japan	-0.7	+1.9	(+1.9) 1.7	+1.6	+1.6
China	+9.2	+7.8	(+7.7) 7.7	+7.2	+2.5

[Source: The Economist 8th February 2014]

2. In his Autumn Statement on December 5th, George Osborne was able to forecast a budget deficit of £111bn this fiscal year (from £120bn previously expected) as a result of the improvement in economic growth. The deficit is forecast to reduce to £96bn in 2014/15 and to £79bn in 2015/16, and even to turn into a small surplus in 2018/19. Other measures included an earlier raising of the state pension age to 68 (in the mid-2030's), the freezing of fuel duty for the remainder of this Parliament, and increasing the personal allowance to £10,000 from April 2014.

3. At the end of November the UK government announced that under the 'Funding for Lending' programme banks must only lend to companies, and no longer lend on property. UK unemployment data for December showed a fall of 167,000 to 2.23m, and a reduction of the unemployment rate to 7.1%. Since the Governor of the Bank of England has mentioned a rate of 7% as a possible trigger for interest rate rises – but that this level was not expected to

be attained until 2016 - it now appears that his ‘forward guidance’ may be due for a reassessment. The UK inflation rate, as measured by the CPI, fell to 2% in December, hitting its target rate after four years of above-target rises. This suggests that there is no imminent danger of ‘over-heating’ in the present economic recovery.

4. In December, strong US industrial production data, and a reduction in the rate of unemployment to 7.0%, prompted the Federal Reserve to announce that it would be ‘tapering’ its $85bn per month bond-buying programme by $10bn in January. Despite sluggish growth in US jobs in January, the unemployment rate has now fallen to 6.7% and a further $10bn reduction in QE in February has been announced.

Markets

5. **Equity** markets in the US and Europe ended the year strongly, while Pacific Basin and Emerging Markets were flat or slightly down. For the full year there has been a wide divergence between the performance of Emerging Markets and Asia Pacific ex-Japan (affected by relatively weak currencies as well as slowing economies) when compared with the gains of 20% and more in Japan, Europe and North America. In the UK, mid-and small-cap shares rose slightly more during the 4th quarter than the large-cap FTSE 100 stocks, and by considerably more for the year as a whole.

(Capital return in % to 31.12.13)	3 months	12 months
FTSE 100	+ 4.4	+14.4
FTSE 250	+ 6.9	+28.8
FTSE Small Cap	+ 5.4	+29.6
FTSE All-Share	+ 4.8	+16.7

	Capital return (in £, %) to 31.12.13		
Weight %	**Region**	**3 months**	**12 months**
100.0	**FTSE All-World Index**	**+ 4.5**	**+ 17.9**
51.4	FTSE All-World North America	+ 6.9	+25.6
8.4	FTSE All-World Japan	- 0.1	+22.6
11.5	FTSE All-World Asia Pacific ex Japan	-0.4	- 1.7
17.5	FTSE All-World Europe (ex-UK)	+ 4.9	+19.8
8.1	FTSE All-World UK	+ 4.4	+14.6
8.9	FTSE All-World Emerging Markets	-1.0	- 8.1

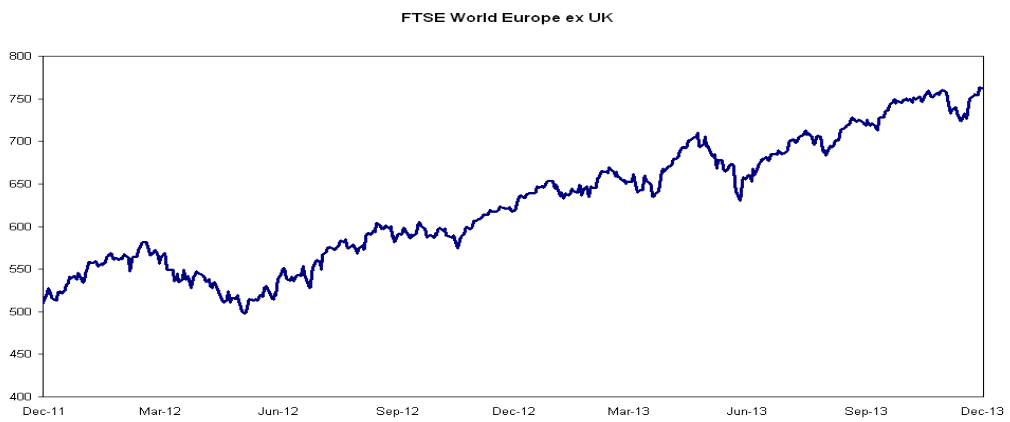
[Source: FTSE All-World Review, December 2013]

6. All industry groups except Utilities registered gains in the quarter, but for the full year it was noticeable that Oil & Gas, Utilities and Basic Materials performed considerably worse than the other sectors.

Capital return (in £, %) to 31.12.13		
Industry Group	**3 months**	**12 months**
Health Care	+5.6	+29.9
Consumer Services	+5.9	+28.8
Industrials	+6.2	+24.5
Technology	+9.0	+23.0
FTSE All-World	**+4.5**	**+17.9**
Financials	+4.2	+17.8
Telecommunications	+4.4	+17.1
Consumer Goods	+2.2	+16.3
Oil & Gas	+2.7	+8.7
Utilities	-0.9	+4.7
Basic Materials	+2.0	- 4.9

[Source: FTSE All-World Review, December 2013]

7. Despite the uncertainties surrounding the euro, shares in Continental Europe have risen strongly over the past two years (see graph below).

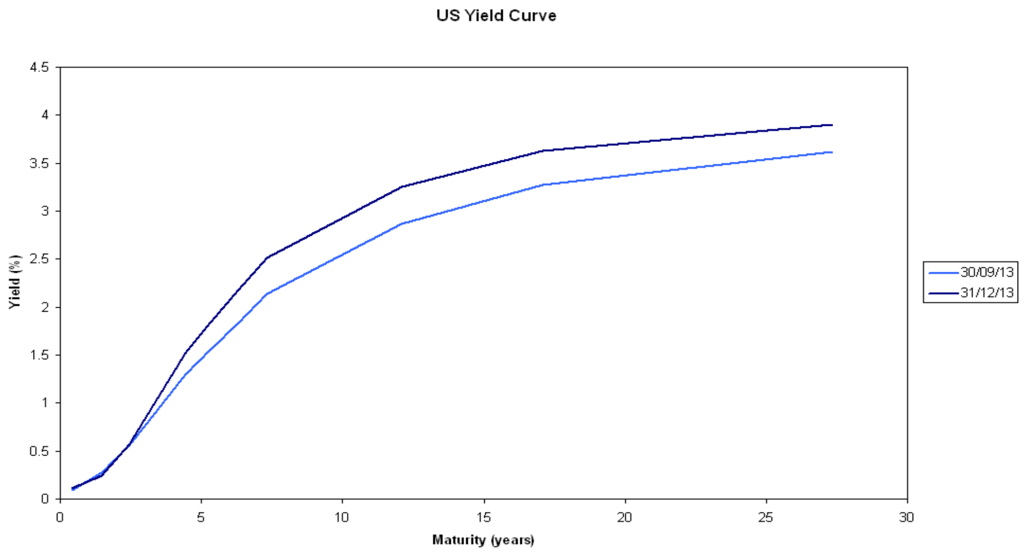


8. **Government Bond** yields rose again in the 4th quarter, as economic recovery became more established in the US and UK, while the confirmation that tapering would begin in January 2014 gave a further upward push to yields in December.

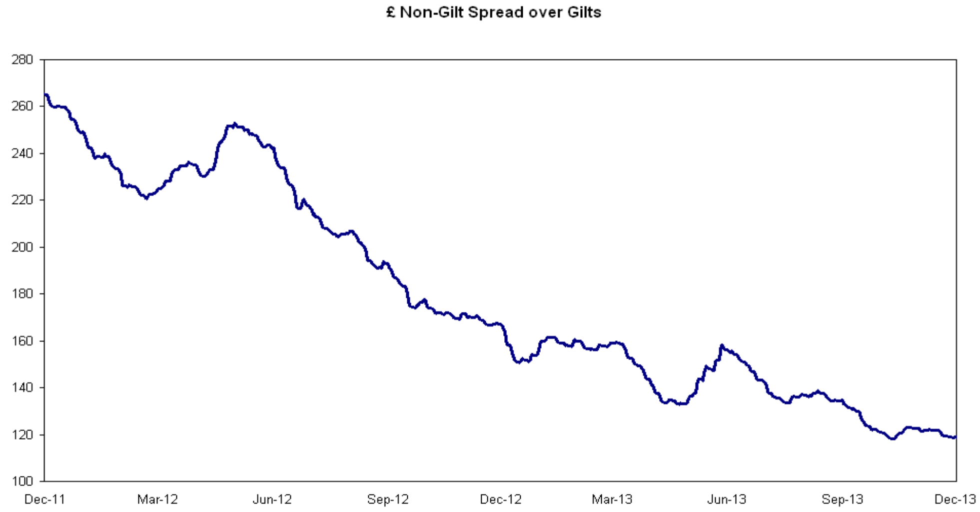
10-year government bond yields (%)					
	Dec 11	**Dec 12**	**June 2013**	**Sept 2013**	**Dec 2013**
US	1.88	1.76	2.49	2.62	3.03
UK	1.98	1.85	2.45	2.73	3.04
Germany	1.83	1.32	1.73	1.78	1.94
Japan	0.98	0.79	0.86	0.69	0.74

[Source: Financial Times]

Yields on US government bonds of all durations have risen during the past quarter.



9. Meanwhile, the UK corporate bond market has been rising strongly relative to gilts during the past two years. The graph below shows how the non-gilt spread has narrowed during the past two years – so that the average corporate bond yield has hardly changed during this period.



Currencies

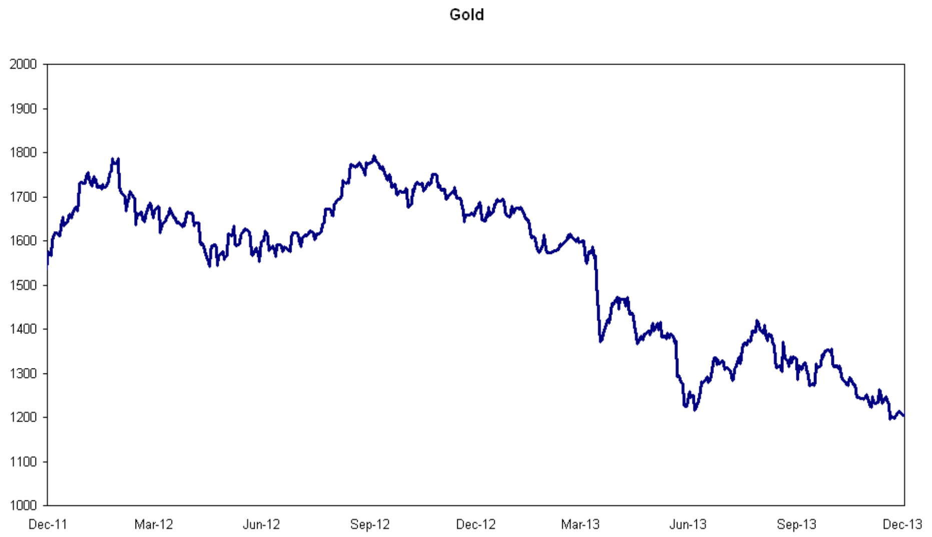
10. The pound rose to its highest level for the year against the dollar, although there was little change in the parity compared with its end-2012 level. The yen continued to weaken against all the other major currencies.

	31.12.12	**30.09.13**	**31.12.13**	**£ move** **3-month**	**12-month**
$ per £	1.625	1.619	1.656	+ 2.3%	+ 1.9%
€ per £	1.233	1.196	1.202	+ 0.5%	- 2.5%
Y per £	140.5	158.9	174.1	+ 9.6%	+23.9%

The pound has gained 45% against the yen in the past two years, as shown in the graph below.

Commodities

11. Gold lost a further 10% during the quarter, to complete a year when it fell by almost 30% in dollar terms. The prices of copper and oil were little changed in the quarter.



Property

12. The UK market has continued to strengthen, with an overall total return of 4.7% for the 3 months to end-December, according to the IPD UK Monthly Property Index. This means that the total return for the full year was +10.9% - the best figure for several years. The bulk of this gain was achieved in the second half of the year, pointing to an accelerating market. By sector the annual returns were:

Retail	**+ 7.6%**
Office	**+14.4%**
Industrial	**+14.2%**

Outlook

13. The air of optimism pervading markets at the end of 2013 has been rudely shattered by several developments in January. On the 23rd, the Argentinian peso fell by 10% after the Central Bank scaled back its support for the currency in an attempt to preserve its dwindling foreign exchange reserves. This triggered weakness in several other currencies – in Turkey, South Africa, Brazil and Chile – as part of a general withdrawal of capital from Emerging Markets. Turkey increased its interest rates by no less than 5%, while South Africa and India announced slight increases. These measures failed to placate investors, and pictures of violent demonstrations in Turkey, Brazil and Ukraine did little to burnish perceptions of Emerging Markets.

14. A further cause of nervousness has been the release of disappointing data on US manufacturing activity and Chinese Purchasing Managers Indices. While equity markets initially fell by 5 – 15%, they have recovered some of the lost ground, and on February 11th, the year-to-date declines in equity markets (in £) were approximately 1% in UK, Europe and North America, and 3-5% in Pacific Basin, Japan and Emerging Markets. In the government bond markets there has been a 'flight to quality' with 10-year yields on US, UK and German sovereigns *falling* by 25-30 bps.

15. The recent setbacks do not, in my opinion, herald the start of a major equity market fall. Instead they act as a reminder that there can always be unexpected events which change the mood of equity investors – especially after the exceptionally strong run in developed market equities during the past year. Looking ahead, I feel that the progress of China's economy and its financial system will be the main catalyst for sentiment towards equities, while the pronouncements of the Federal Reserve and the Bank of England will be closely scrutinised for any hints of impending rises in interest rates.

Peter Davies

Senior Adviser – AllenbridgeEpic Investment Advisers
February 12th 2014
[All graphs supplied by Legal & General Investment Management]