

REPORT PREPARED FOR
Oxfordshire Pension Fund Committee

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Summary

The value of the Fund in the quarter rose slightly to £3.05bn, an increase of £40m compared to the end September value of £3.01bn. The Fund produced a return of 1.3% over the quarter, which was -0.6% behind the benchmark. While disappointing, it would be fair to say that the Fund has not suffered unduly in absolute value terms from the challenges that we have seen in markets over 2022, which has certainly been helped by the diversified spread of assets. Put simply in the first three quarters the alternatives portfolio has provided support while public markets had suffered a fair amount of stress, including volatility. Over this final quarter of the calendar year the situation reversed somewhat, with public markets recovering while private markets started to show some element of catch up in valuations, falling to reflect a more cautious outlook. This was exacerbated by some significant falls in the valuation of the property assets, sparked in large part by the turmoil in markets during the Liability Driven Investments (LDI) crisis in September/October. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -4.7% (-9.8% v. -5.1%). The scale of the recent underperformance has also had an impact on the longer term performance periods, now behind the benchmark over the three and five year periods and in line over the ten year period, details of which can be found in Brunel's report.

The highlights

1. As referred to above, it is encouraging to see a small lift in value for the Fund over the final quarter of 2022, a year that brought many challenges, not just for the Fund. The relative performance is disappointing, but in a sense this shows that challenges still remain, economically and politically.
2. All the equity funds enjoyed both an increase in value and positive relative performance against benchmarks over the quarter. That's the good news, but over the year there remains a significant fall in value with poor performance to recover from.
3. With the exception of Index Linked Gilts, the Fixed Income portfolio also showed some decent recovery in Q4. Index Linked Gilts have been an accident waiting to happen for some time, but with a fall of 38% over 12 months possibly some value has returned.
4. Infrastructure has proved to be a good diversifying sub asset class over the last 12 months with rising valuations, this continued to be the case in Q4. Although investor demand remains good for infrastructure assets, some valuations are starting to be of concern.
5. The Listed Private Equity portfolio had a much better quarter in comparison to the first 3 quarters of 2022, with performance of 8.2% v. the All Share Index at 8.3%. Longer-term performance remains well in excess of the wider public market. The discounts to NAV continue to be much wider than we have seen in recent times, but

the underlying health of the portfolios is substantially better than the discounts imply. As confidence returns, I would expect to see those discounts start to narrow again.

The lower points

1. There is one legacy of Trussonomics that lives on. The rush by corporate pension funds to provide additional collateral for their LDI positions included the need to sell some illiquid assets, including property. In a sense the sector had enjoyed a rather disjointed recovery from the Covid period, which started to unravel. The UK property market fell 22% in value terms last year, Europe by 5%, with most of that occurring in Q4. The demand for redemptions from property funds will take some time to work through the system, but will offer some good buying opportunities for long term investors. The same comments apply to Secured Income, being property based.
2. Our Unlisted Private Equity valuations had in general terms held up well during 2022, but during Q4 valuations started to trend downwards, reflecting growing economic concerns and comparisons to public markets.

Points for consideration (in conjunction with the Strategic Asset Allocation review)

1. The issue of the slow rate of drawdowns in some of the Private Market commitments continues to be of concern. I am beginning to wonder if Brunel needs to bring in additional external support to accelerate the process.
2. The revised format of the Brunel report is to be welcomed, particularly the section dealing with Private Markets. It would be good to see the Fund value included over the short, medium and long term periods. The emphasis on assets transitioned to Brunel is not particularly useful, in my opinion.
3. In due course would Brunel consider taking on the elements of Diversified Growth Funds and Multi Asset Credit as stand alone sub funds, such as to give member Funds better flexibility in selecting assets to meet their requirements. It is acknowledged that their current resource constraints are an issue.

Overview and Outlook thoughts

Global overview

Q4 was a very positive quarter for risk assets generally, with equities and credit rebounding from losses in Q3 as investors have grown more optimistic that inflation may have peaked and Central Banks will soon have reason to end their rate hikes. Inflation still remains uncomfortably high however, and Central Bank rhetoric has so far remained hawkish generally. Long-term bond yields showed little overall movement (with the exception of UK gilts returning to normality), while short-term yields generally rose as monetary policy was tightened further. Additional positive impetus was provided by China's relaxing of its zero-COVID policy, improving the outlook for growth in its economy, and by the surprising resilience of European gas supplies, reducing oil/gas prices and easing fears of recession: oil and gas finished the year only 10% and 20% above their end-2021 levels. Equity markets rallied this quarter, especially beleaguered European and Emerging Markets, although global equities are overall unchanged from June 2022 levels, despite volatile price moves in this period. The UK was one of the best-performing equity markets, and sterling recovered some of its earlier losses vs the dollar. Value stocks (+14.2%) outperformed growth (+4.6%) by a wide margin this quarter.

GDP growth and labour markets: Despite the ongoing recovery from the pandemic, the impact of tight monetary policy and the war in Ukraine are expected to slow growth, particularly in the UK and Europe. Labour markets have to date remained strong with unemployment at very low levels historically for the US, UK and Europe (3.5%, 3.7%, and 6.0% respectively from the most recent data).

The 'new' UK Government under Rishi Sunak has restored order to gilt markets and sterling by promising fiscally conservative plans. Markets have so far looked favourably on this and returned bond yields to their former positions relative to peer yields.

Quarterly GDP Growth Rate and Monthly CPI

%	GDP		CPI		
	Q3 2022	Q4 2022	Oct	Nov	Dec
UK	-0.3	0.0	11.1	10.7	10.1
US	0.7	0.5**	7.7	7.1	N/a*
Eurozone	0.3	-0.4**	10.6	10.1	9.2**
Japan	-0.2	0.1**	3.7	3.8	N/a*

Source: Bloomberg; Trading Economics.

Notes: * Not available at time of publication; ** Forecasts based on leading indicators

UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index)

Outlook thoughts

It is worth highlighting the following themes, impacting investment markets:

Inflation – the story after the peak. While YoY CPI inflation appears to have now peaked for the US, UK and Europe, concern remains over how rapidly and to what level inflation will fall. There are indications of inflation becoming more entrenched, but investors appear to be pricing in a more rapid cut in rates than that which Central banks are currently forecasting. Perhaps the misstep by the Fed in 2021 of calling inflation ‘transitory’ has reduced markets’ trust. Euro inflation reached 10.6% in October, a fresh high, however this fell in November to 10.1%. Similarly for the UK, a high of 11.1% was reached in October before falling in November. For the US, the high in CPI appears to have been reached in June at 9.1% and has since declined to 7.1%.

Inflation vs Recession – the next stage for monetary policy. Monetary policy continued to tighten in most major developed countries, with the Fed, the BoE and the ECB all raising rates several times in Q4. Markets now expect rates to peak at ~4.5% for the UK, ~5% for the US, and a little over 3% for the ECB which indicates hiking cycles are coming towards their end. In addition, the Bank of Japan (BoJ) surprised markets by lifting the yield ceiling for their 10-year bond to 0.5% from 0.25%. The BoJ noted this was to restore proper market function, but as the BoJ owns over half of the bonds on issue investors have questioned if there is another rationale for the change. Prime Minister Kishida has also announced they will discuss the BoJ’s inflation target approach when a new BoJ Governor starts his term in April.

A return to fixed income? The repricing of debt of all forms, following the rapid rises in interest rates last year, has increased yields on many debt asset classes, potentially increasing long-term returns. Interest rates are now in a more volatile phase, in marked contrast to the repressed volatility of the past decade of QE, so this potential for improved returns is likely to come with increased volatility.

Equity valuations reflect “mild” recession – earnings on watch in 2023. Following the 18% decline in US equities this year they are now trading at 16.5x forward earnings, below the 10-year average of 17.2x, but up from 15x in Q3. Over the course of Q4, expectations for 2023 earnings fell by -4.4% with much of the negative impact expected in the first half of 2023, and some of the leading economic indicators (e.g. ISM survey data) are starting to signal a decline. Investors appear willing to look through any potential decline in earnings but clearly there remains a risk to earnings, as corporate profit margins remain elevated by historical standards, and inflating costs may yet impact these.

Energy crisis: off the boil, but not gone. While the immediate threat of blackouts in Europe this winter has probably been avoided, and gas storage levels are high, the problem is not over. Furthermore. China’s reopening is likely to increase demand pressure on global supplies.

Equities

Global equities rose sharply in Q4, as inflation appears to have now peaked and investors expect that Central Banks will not need to maintain restrictive monetary policies for as long as they have been guiding. Given the rise in equity markets, the VIX decreased by -31.5%, from 32 to 22, although this level is above the pre-COVID-19 average.

In the US, the S&P 500 rose by 7.5% and the NASDAQ fell by -1.0% as markets rallied due to falling inflation data, but investors remain wary of growth and tech stocks. A number of tech companies have announced staff layoffs and cost cutting measures in a response to investor concerns.

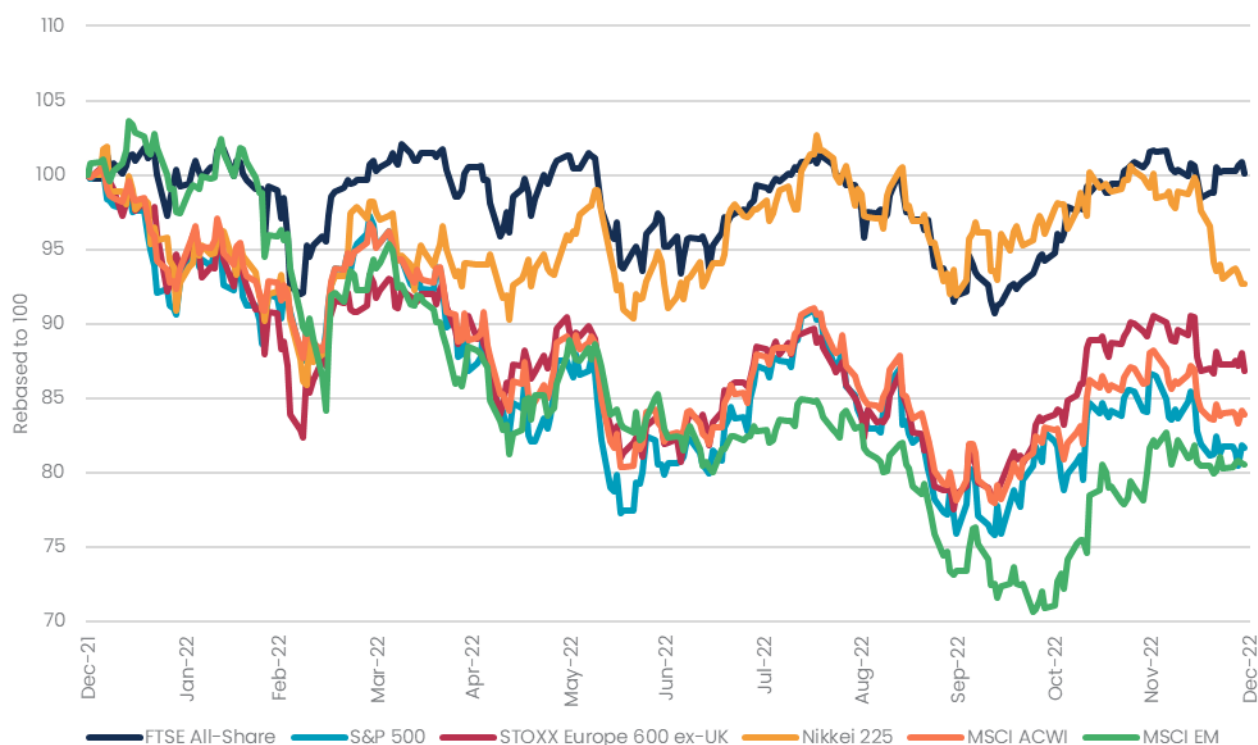
UK equities rallied in Q4, rising 8.7% as investors welcomed the government leadership change and return to normal market functioning of gilts following the BoE's intervention. Energy price declines amid warmer temperature and rising inventories of natural gas also helped temper inflation expectations. The BoE raised the base rate to 3.5% in December, however two committee members voted to keep rates unchanged which could signal the start of a shift toward more dovish policy. The BoE also expects Q4 GDP at -0.1%, a 0.2% improvement from its November report.

The Euro Stoxx 50 rose by 14.9% in Q4 as investors were cheered by inflation data declining in the quarter, albeit it is still at high levels. Inflation in Europe has been particularly high due to the impact of energy prices following Russia's invasion of Ukraine and consequent impact to European energy supply.

Japanese equities underperformed other equity markets, rising by only 0.7% in Q4. Japanese equities performed well in the quarter until core CPI in December was announced at a 40-year high and the BoJ increased the ceiling of the trading range for the 10-year bond to 0.5% (from 0.25%) which proved a headwind for equities. While inflation remains well below other major economies, investors are wary of a hawkish pivot at upcoming BoJ meetings due to the upcoming retirement of Governor Kuroda. The yen reached a high (i.e. a weak yen) of 150 vs the US dollar during Q4 but ended the year at 131 following the inflation peak and yield curve adjustment.

Emerging market equities performed strongly (+9.6%) with sentiment improving in China following the announcement of COVID-19 restrictions easing, and US dollar weakness provided a boost.

Global Equity Markets Performance



Source: Bloomberg. All in local currency.
FTSE All-Share Index (Ticker: ASX Index) S&P 500 Index (Ticker: SPX Index) STOXX Europe 600 (Ticker: SXXP Index)
Nikkei 225 Index (Ticker: NKY Index) MSCI World Index (Ticker: MXWO Index) MSCI Emerging Markets (Ticker: MXEF Index)

Fixed Income

Medium- and longer-term bond yields were largely rangebound in Q4 as investors weighed expected declines in inflation against Central Banks desires to ensure inflation is stamped out. Additionally, employment data generally has remained strong which provides the impetus for Central Banks to hike rates now while labour markets are viewed as strong enough to withstand it. In corporate bonds, high-yield credit outperformed as spreads tightened over the quarter but remain around their long-term average level. Emerging market bonds rose 7.8% in local currency, and 8.1% in hard currency.

The US 10-year Treasury yield rose marginally in Q4, ending at 3.88% from 3.83%. The 2-year yield rose in Q4, from 4.22% to 4.41%, as the yield curve inverted further. US rates rose initially in the quarter as core inflation data continued to be strong and Fed speakers maintained the narrative that hawkish policy needed to be maintained. Later in the quarter rates fell though, as markets maintained the view that the Fed will pivot and cut rates in 2023 as inflation falls, spurred by recent falls in monthly CPI data. The Fed raised short term rates to 4.25-4.5% as at end of Q4.

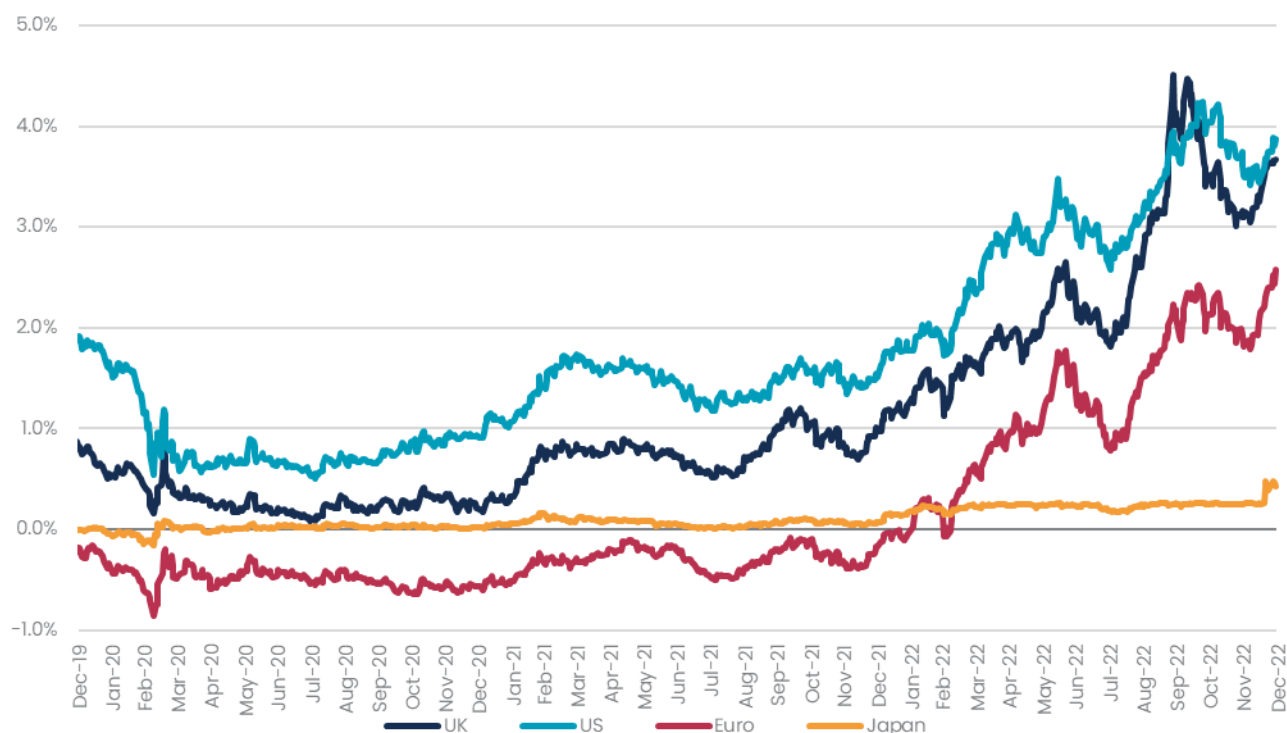
The UK 10-year Gilt yield fell from 4.09% to 3.67% and 2-year from 4.30% to 3.56%. The declines largely reflected markets returning to normal following the spike in yields in Q3 following the Truss government 'mini budget' and occurred despite the BoE hiking rates by 125bps. While Gilt rates fell sharply over the quarter, UK Gilts now trade in a similar relative position to peer government bonds as they did before Q3.

European government bonds had a total return of -2.1% in Q4. Yield curves flattened or inverted during the quarter, as short end rates rose in response to the ECB raising its policy

rate to 2.5% during the quarter and noted it expects to hike rates further based on its inflation outlook. Long-end rates rose less, as investors view inflation as likely to fall steadily. The German 10-year bund yield increased from 2.11% to 2.57%, and Italy's went up from 4.51% to 4.70%.

US high-yield bonds outperformed investment grade, returning 4.2%, and European high-yield bonds returned 4.7%. Investment-grade bonds returned 6.4% in the UK, 1.7% in Europe and 3.6% in the US.

Government Bond Yields



Source Bloomberg, US Generic Govt 10 Year Yield (Ticker: USGG10YR Index); UK Govt Bonds 10 Year Note Generic Bid Yield (Ticker: GLKG10 Index); Euro Generic Govt Bond 10 Year (Ticker: GECU10YR Index).

Currencies

In currencies, sterling strengthened sharply against the US dollar (+8.2%) but fell against the euro (-0.8%) over the fourth quarter. The principal driver was the appointment of Rishi Sunak as Prime Minister who is viewed as likely to pursue a more fiscally conservative agenda, and the BoE's intervention in gilt markets to stabilise yields. Overall, the US dollar fell in Q4 (Dollar index -7.7%), reversing much of the Q3 gains. Over the year 2022, the Dollar Index rose +8.2%. Notably, the US dollar also fell against the Japanese yen by -9.4% in Q4 as the BoJ shocked markets in December by increasing the top range at which the 10 year bond could yield.

[Commodities](#)

Energy prices fluctuated during Q4 as investors mulled over China re-opening, risk of looming recessions in Europe, UK, USA, and warmer weather than expected reducing near term demand for natural gas. Precious metals rose as the US dollar declined and also received a boost from falling interest rates.

US gas prices fell -33.9% over Q4, reversing some of the sharp gains earlier in 2022 as winter weather has been warmer than expected (reducing demand) and inventories have been higher than previously expected.

Brent crude oil fell -2.3% in Q4. Prices have been volatile as fears of a fall in demand from a global recession and structural trends toward renewable energy have clashed with supply side dynamics relating to Russia's invasion of Ukraine, OPEC production, and the US releasing oil from its Strategic Petroleum Reserve. Brent closed the quarter at \$86 per barrel.

Gold and Copper rose 9.9% and 11.7% respectively in Q4, with gold rising as interest rates and the US dollar declined, as well as reports of Central Banks including China and Turkey increasing their purchases. Copper rose as China, a significant copper importer, announced the start of COVID-19 re-opening. Gold and copper closed Q4 at 1,826 USD/toz and 381 USD/lb, respectively.

[Property](#)

Global listed property had another weak quarter, with the FTSE EPRA Nareit Global Index falling -0.3% in Q4.

The Nationwide House Price Index in the UK fell sharply over the quarter, with YoY growth at 2.8% for December. This is markedly down from 9.5% YoY growth in Q3, and 10.7% in Q2. The performance by region showed a smaller variance than prior years as the macro environment of high inflation and high mortgage rates are impacting affordability as real wages struggle to keep up.

European commercial property remained under pressure in Q4, with the Green Street Commercial Property Price Index down by -7% this quarter and -12% for the 2022 full year.

Key Indicators at a Glance

Market Indicators

Index (Local Currency)		Q4 2022	Quarter-on-Quarter	YTD
Equities		Total Return		
UK Large-Cap Equities	FTSE 100	7,452	8.7%	4.6%
UK All-Cap Equities	FTSE All-Share	4,075	8.9%	0.2%
US Equities	S&P 500	3,840	7.5%	-18.1%
European Equities	EURO STOXX 50 Price EUR	3,794	14.9%	-8.5%
Japanese Equities	Nikkei 225	26,095	0.7%	-9.0%
EM Equities	MSCI Emerging Markets	956	9.6%	-19.9%
Global Equities	MSCI World	2,603	9.9%	-17.7%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Socks	3,018	1.7%	-23.8%
UK Gilts Over 15 Years	FTSE Actuaries UK Gilts Over 15 Yr	3,694	-1.8%	-40.1%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,000	-6.0%	-33.6%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,564	-12.8%	-46.9%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	208	-2.1%	-18.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,188	0.7%	-12.5%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	124	7.8%	-10.2%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	804	8.1%	-17.8%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	330	6.4%	-18.4%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	213	1.7%	-15.1%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	389	4.7%	-11.1%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	2,968	3.6%	-15.8%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,186	4.2%	-11.2%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	86	-2.3%	10.5%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	4.48	-33.9%	20.0%
Gold	Generic 1st Gold, USD/toz	1,826	9.9%	-0.1%
Copper	Generic 1st Copper, USD/lb	381	11.7%	-14.6%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.13	-0.8%	-5.0%
GBP/USD	GBPUSD Exchange Rate	1.21	8.2%	-10.7%
EUR/USD	EURUSD Exchange Rate	1.07	9.2%	-5.8%
USD/JPY	USDJPY Exchange Rate	131.12	-9.4%	13.9%
Dollar Index	Dollar Index Spot	103.52	-7.7%	8.2%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,658	11.0%	-0.2%
Private Equity	S&P Listed Private Equity Index	159	11.8%	-28.2%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,520	1.7%	-3.9%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,590	-0.3%	-14.0%
Volatility			Change in Volatility	
VIX	Chicago Board Options Exchange SPX Volatility Index	22	-31.5%	25.8%

* All return figures quoted are total return, calculated with gross dividends/income reinvested.

Source: Bloomberg

Market thoughts



I was going to spare you this section on this occasion, but then this appeared in my Inbox from Numis which I thought would be worth sharing. I will happily forward the full report to anyone (Nick?) who'd like to see it.

Listed Private Equity - Are public or private markets valuations right?

Most Listed Private Equity (LPE) funds are trading on wider than 30% discounts, indicating that investors have little faith in portfolio valuations and are expecting further falls given volatile equity markets. We believe the NAVs will be more resilient than most expect due to the focus on defensive, non-cyclical companies, and based on the strong exits that several funds have delivered. As a result, we believe that current discounts offer attractive value opportunities.

We seek to address various investor concerns about valuations and refresh our Recommended List:

- **What goes up, must come down:** Investors are wary that equity market falls have not been reflected in valuation multiples of private assets. We highlight that multiples in private equity deals did not rise as far as listed equity markets and therefore should not have as far to fall. In addition, multiples are a combination of listed and private transactions which has helped LPE NAVs to have a relatively low beta to equity markets.
- **Valuation lags are yet to work through:** Most LPE portfolios are based on underlying valuations at 30 September which covers the major period of equity market weakness. Markets are up since September, which should be a tailwind to comparable multiples, albeit Sterling strength may be a drag.
- **Have multiple declines been ignored?** NAV performance in H1 was surprisingly good for several funds, which may lead a cynic to conclude that valuers have their head in the sand. Typically, uplifts were supported by exit activity, whilst there have been write-downs across other holdings, driven by a significant impact from multiple declines, offset by continued double-digit earnings growth.

- **Higher finance costs mean PE deals do not stack up:** We acknowledge that higher debt costs will inevitably lead to prices adjusting for PE to maintain their return expectations. Some headroom will be provided by deals in recent years factoring in multiple contraction. In addition, operational performance has been the major driver of returns, rather than leverage. Deal volume in 2022 was down from the 2021 peak, but similar to levels seen in 2018-2020.
- **Is there too much leverage?** We are comfortable with balance sheets of LPE funds given leverage and commitments are at much lower levels than pre-GFC. In addition, most funds have some flexibility with debt facilities. Leverage on underlying portfolio companies has crept up in recent years, but we have not seen a repeat of the excessively leveraged mega-deals that occurred pre-GFC. In addition, leverage has typically been deployed against non-cyclical, cash generative companies.
- **Exits provide “proof” of valuations:** Ultimately, the only point when there is certainty about valuations of private assets is when they are sold. There have been numerous exits during 2022 that have continued to support valuations and led to significant uplifts to historic marks. In particular, we note that HgCapital has seen deals representing over 25% of the portfolio, at average uplifts of c.36% to the December 2021 valuations, whilst HarbourVest and ICG Enterprise have seen average uplifts on exits of 40% and 25%, respectively.