



**Isle of Wight Council Pension Fund
Schroder Sterling Broad Market
Fund**

Isle of Wight Council Pension Fund – Fixed Income Portfolio Review

Performance review & Portfolio Activity to December 2018

Over 2018, the Fund's investment in the Schroder Sterling Broad Market Fund produced a return of -1.73%. In comparison, the benchmark, 50% iBoxx GBP Gilts + 50% iBoxx GBP Non-Gilts, generated a total return of -0.51%.

The latter stages of 2018 brought with it greater volatility and a highly correlated sell-off across risk assets. As a result, fund performance was punished by holding an overweight allocation to credit. While credit hedges in the US and European high yield, (implemented through credit default swap indices) afforded some protection, they were insufficient to offset the losses from credit exposure held elsewhere. The sell-off was indiscriminate across ratings and sectors as weaker sentiment sparked safe-haven flows across financial markets. We viewed the market weakness as an opportunity in which to add exposure to investment grade credit.

More positively, the fund's duration (interest rate sensitivity) and yield curve strategy contributed positively overall, primarily due to our dominant underweight US duration stance. The position was predicated on our positive view on the economy given the additional fiscal stimulus and our expectation that the US Federal Reserve (Fed) would lead the way in tightening monetary policy conditions. We moderated the position going into the fourth quarter as Treasury yields reached multi-year highs and the Fed indicated that it was becoming increasingly data dependent in terms of forward guidance.

Elsewhere, tactical trading in Australia has elicited positive results, particularly from the fall in yields towards the end of the year. Australia's reliance on China has meant that this has been one of our favoured bond markets. China's economic outlook is looking increasingly vulnerable, with US trade tensions exacerbating the recent slowdown. Earlier in the year, our overweight UK duration stance (held on a directional basis and tactically versus the Eurozone) negatively impacted performance as the surprising resilience of the UK economy despite Brexit risks lead the Bank of England to raise interest rates (from 0.50% to 0.75%). We have become increasingly cautious on UK interest rate risk, given the binary risks relating to ongoing Brexit negotiations.

Political risk was also an important factor driving European bond markets. The fund was exposed to a sharp repricing of peripheral risk in May following the Italian elections (primarily through our overweight in Spain, having closed our position in Italy). However, by tactically trading both Spain and Italy over the longer term we were able to generate positive results overall, especially when accounting for the additional income earned from holding these markets over German Bunds.

Isle of Wight Council Pension Fund Fixed Income performance to 31 December 2018 (% pa)

	1 Year	3 Yrs (pa)	5 Yrs (pa)	Inception*
Fixed Income Portfolio	-1.73	+4.69	+5.75	+6.17
Benchmark	-0.51	+4.31	+5.28	+5.46

Schroder Sterling Broad Market Gross Attribution: Calendar year 2018

	Alpha	FX	Rates	Credit	Residual
Total	-112	-5	7	-121	7

*Isle of Wight inception date 31 August 2009. Rates (duration, yield curve, inflation, sovereign, carry and roll sovereign), Credit (Carry & Roll Credit, Credit Sector Allocation, Credit Selection, Credit ABS/MBS), Residual (Volatility, Valuation, Trading).

Outlook

A number of issues pertinent to the global outlook, such as China, global trade, Italy's fragility (despite the recent budget resolution) and the possibility of a disorderly Brexit, has seen uncertainty persist. Until we get clarity on these key issues, news-flow is likely to continue to drive sentiment, and by extension idiosyncratic volatility. More broadly, we expect the withdrawal of global liquidity, as central banks normalise monetary policy conditions, to contribute to a more volatile environment than that we have become accustomed. However, we envisage this will create opportunities for our active management strategy.

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Isle of Wight Council Pension Fund Schroder UK Real Estate Fund (SREF)

Isle of Wight Council Pension Fund - Real Estate Portfolio Review

Performance and market review to September 2018

SREF's performance in the year to September 2018 was above benchmark as shown below. SREF maintains a longstanding underweight to the retail sector and despite challenging market conditions, good progress was made on letting vacant space at the Fund's two main retail schemes in Bracknell and Hammersmith. The Fund's industrial portfolio contributed strongly to returns as high demand for space, coupled with supply constraints, have supported rental and value growth. Elsewhere, the One Lyric office building in Hammersmith, London W6 was let prior to the completion of refurbishment works in the third quarter of 2018. This added an additional £5.5 million to SREF's rent roll (or around 5% to the contracted income), de-risked the portfolio and generated capital appreciation.

Isle of Wight Council Pension Fund Real Estate performance to 30 September 2018 (% pa)

	YTD	12m	3 years	Inception*
Property Portfolio	6.9	10.5	8.9	10.9
Benchmark**	5.9	9.4	8.0	9.9

*Isle of Wight inception date 31 August 2009. **Client Benchmark: AREF/IPD UK Quarterly Property Fund Index All Balanced Fund Median.

Although average capital values rose during the past year, the pace of growth has slowed in recent quarters. Moreover, there is now a significant polarisation between the main sectors owing to both structural and cyclical factors; capital values are now moving in opposite directions for the first time in 15 years. City of London office and retail capital values are forecast to fall in value, while regional offices, industrials and certain alternative sectors are expected to be stable or increase. Political and economic uncertainties are affecting both corporate and consumer spending decisions, and these trends are expected to continue into 2019.

Portfolio activity

No acquisitions were made in the past 12 months, although we have continued to invest into the existing portfolio. This is cost effective and allows us to generate above market returns on a risk-mitigated basis.

Three properties were sold during the year to September 2018 with a total value of £18.5 million. Properties were sold in line with strategy to crystallise gains following the completion of their business plan and to dispose of smaller assets.

Outlook

Long run data from MSCI show that total returns from UK commercial real estate are driven primarily by income and income growth; this is at the core of SREF's investment strategy. The portfolio is comprised of high quality properties which are typically multi-let, to reduce risk and provide asset management opportunities. Properties are let at affordable rents to around 750 tenants and this underpins the rental income which drives long term returns. The portfolio has a long lease profile which provides good security of income. Our ability to capture income growth, and the associated valuation gains, is at the heart of our asset business planning process.

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