Schroders

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 April 2022

Over the year to date (to 31 March 2022), the Fund's investment in the Schroder Sterling Broad Market Fund produced a return of -7.22%. In comparison, the benchmark, 50% iBoxx GBP Gilts + 50% iBoxx GBP Non-Gilts, generated a total return of -6.82%.

The main detractor from relative performance came from our rates strategy. Major government bond yields have risen almost uniformly over the quarter as markets discounted a higher inflation regime and tighter monetary policy. Some of our outright duration overweights, particularly in the UK, detracted as 2- and 10-year yields rose in response to the Bank of England (BOE) raising rates for a second time in February. Nevertheless, the rate of change differed across markets and we benefited from cross-market positioning, most notably an overweight to the UK 5-year against the US. With the more interest rate-sensitive shorter maturities bearing the brunt of the sell-off, yield curves have flattened. We were positioned to benefit from this flattening across the US Treasury curve.

In Europe, an overweight to the periphery, through Italy versus Germany, detracted from relative performance as persistent inflation led to a more hawkish stance by the European Central Bank (ECB), raising the prospect of reduced monetary policy support. Our underweight inflation stance in Europe generated losses, and we closed the position.

It was a volatile quarter for credit, with spreads widening sharply. The fund's overweight to European credit (particularly high yield) suffered from a combination of a withdrawal of liquidity (as central banks tightened monetary policy conditions) and a souring of risk sentiment relating to the war in Ukraine. Spreads did retrace some of their previous widening, but remained elevated at the end of the quarter. Our underweight to US investment grade credit through derivatives, however, mitigated some of the losses over the quarter.

Isle of Wight Council Pension Fund Fixed Income performance to 31 March 2022 (% pa)

	YTD	12 months	3 years	5 years	Inception*
Fixed Income Portfolio	**-7.22**	**-5.98**	**1.69**	**1.91**	**5.30**
Benchmark	**-6.82**	**-5.29**	**0.28**	**1.08**	**4.40**

Schroder Sterling Broad Market Gross Attribution: YTD 31 March 2022

	Alpha	FX	Rates	Credit	Residual
Total	**-40**	**-3**	**-64**	**30**	**-2**

*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

Understandably, headlines continue to be dominated by the terrible humanitarian crisis unfolding in Ukraine. This brings not only an awful social cost but also an economic one, which may catalyse structural changes around the globe.

The narrative on inflation has certainly changed, with the sharp rise in commodity prices creating both winners and losers in terms of trade. The UK, as a relatively open economy and a commodity importer, is vulnerable to imported supply side inflation. To avoid higher inflation expectations becoming entrenched, the Bank of England (BoE) has been keen to hike rates and has also raised the prospect of quantitative tightening. However, we are already seeing a note of caution on growth in its more recent communications. At some point we think elevated prices, falling real wages and a fiscal drag will begin to weigh on the UK economy and the market will begin to scale back its rate expectations.

So far, major central banks have looked through global uncertainties, pressing ahead with normalising monetary policy as supply disruption pushes inflation even higher beyond targets. However, we believe there comes a point when these elevated cost-push pressures lead to demand destruction.

In the near term we have the greatest concern over the growth outlook in Europe, given its reliance on Russian energy supplies and other commodities. The wildcard here could be a more activist European fiscal policy, either at a regional or national level. That said, we think efforts on the fiscal front will only mitigate, not prevent, a slowdown. In comparison, the US should fare relatively better despite a tightening of financial conditions. While we don't expect the US to be immune from a global growth slowdown, it will be more resilient to external shocks.

Heading into the second quarter of the year, the cheapening of many fixed income asset classes has provided positive investment opportunities. We continue to look for areas of market dislocation, where prices are not accurately reflecting underlying fundamentals.