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LGPS Investment Current Topics

July 2025

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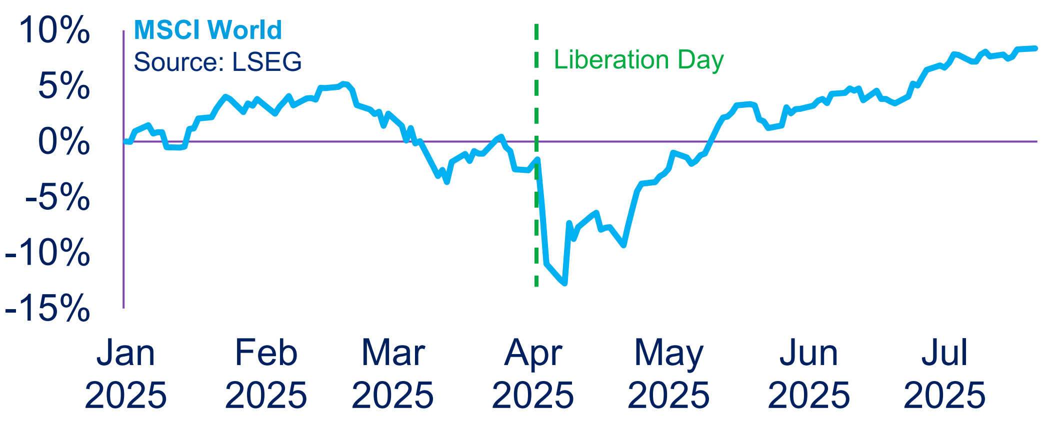
Agenda

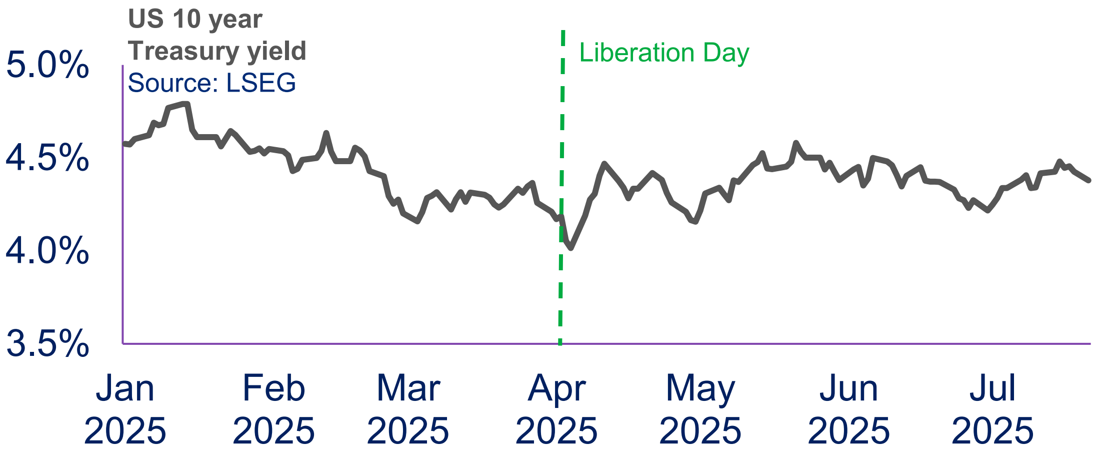
1. Market Update - 2025 Year to Date
2. Diversification – why is it important now and where to find it
3. Net Zero Initiatives Update 2025

Market Update - 2025 Year to Date

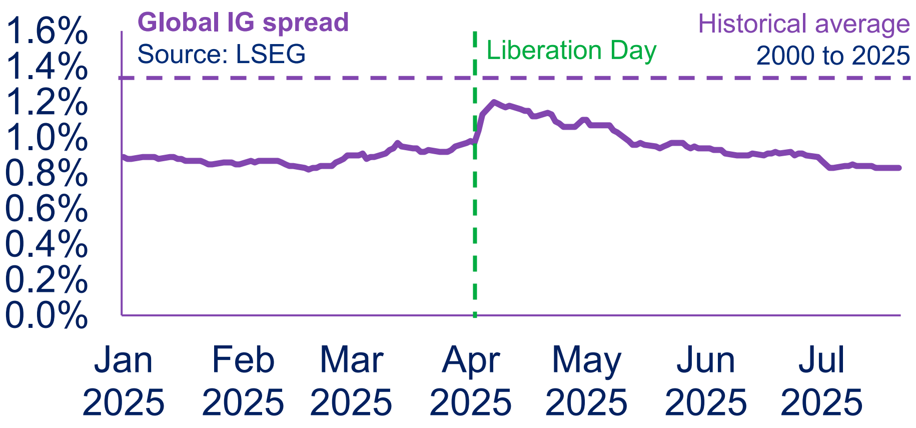
Equity markets
2025 Year to Date



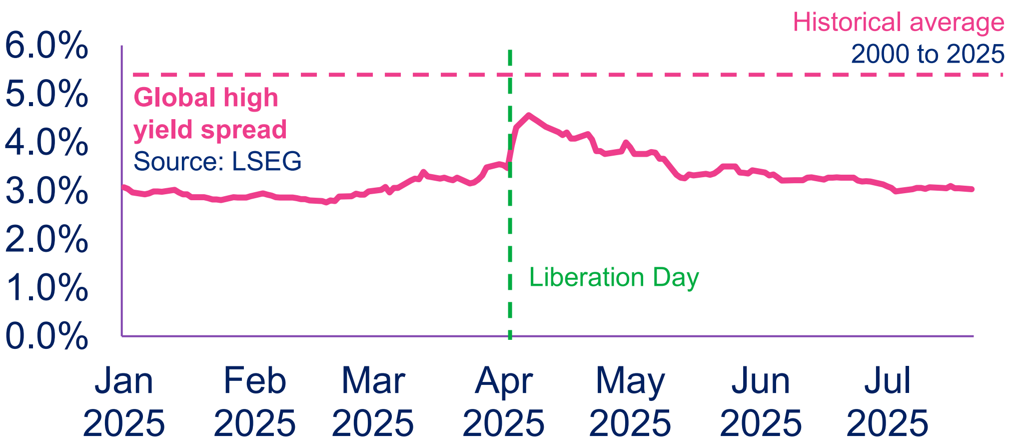
US treasury yields
2025 Year to Date



Global IG spreads
2025 Year to Date



Global high yield spreads
2025 Year to Date



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2025 Global Outlook

Worst-case scenarios have eased but material uncertainty remains

Growth

Global economy to slow following tariffs by the US on global trading partners

US likely fall into a mild recession as tariffs will lead to a large fiscal tightening while EU, China embarking on fiscal loosening

Inflation

US Inflation likely to move modestly higher in the near term as tariffs lead to a one-off spike in price levels.

Wage growth is slowing and labour markets broadly balanced which should underpin structural inflation

Central Banks

The Fed will want to assess the impact of tariffs and **proceed cautiously** in the near term.

The **ECB may continue to cut** but at a slower pace. The **BoE may want to see more progress on inflation**.

Risks

There is **heightened uncertainty** for markets due to tariffs and it is **unlikely this will fade** in the near term.

US announcement on 9 April and 12 May to pause reciprocal tariffs mean the **worst-case scenario for growth has eased**

2025 Market Outlook

Equities

The outlook for equities looks more bearish given market pricing of earnings remains above historical average levels. We expect earnings to be weaker and equities more sensitive due to high valuations

Growth Fixed Income

Corporate balance sheets in reasonable place coming into this period. However financial conditions are tightening, and should defaults start to rise it will likely lead to some **widening in spreads from historically tight levels**

Defensive Fixed Income

Long gilt yields attractive from a valuation perspective as offering yields not seen since the 1990s.

Investment grade spreads are relatively tight, given the uncertain outlook

Currencies

US dollar weakness likely continue given slowdown in US growth. USD came into this with high valuations

Japanese yen, euro are cheap and are expected to benefit from valuation rerating and narrowing of growth differential

Diversification – why is it important now and where to find it

Why is Diversification Valuable?

A range of benefits

Portfolio Efficiency

- By accessing a wider range of risk and return drivers, diversified portfolios are more efficient at converting risk into return
- In technical terms, this means a portfolio with a higher Sharpe ratio (return ÷ volatility)

Controlling Exposure Concentrations

- By diversifying across asset classes, investment styles and managers, investors are less exposed to any one element of the portfolio underperforming

Regime Resilience

- Given higher initial valuations, equity-heavy portfolios will be hard pressed to deliver risk-adjusted returns as high as seen in the last decade
- Diversified portfolios can be built to deliver more consistent returns across a range of economic environments

More Ways to Win

- By spreading risk and return across strategic allocations, dynamic positions and active management, diversified portfolios have more ways to win and are not reliant on the success of a single strategy or asset class

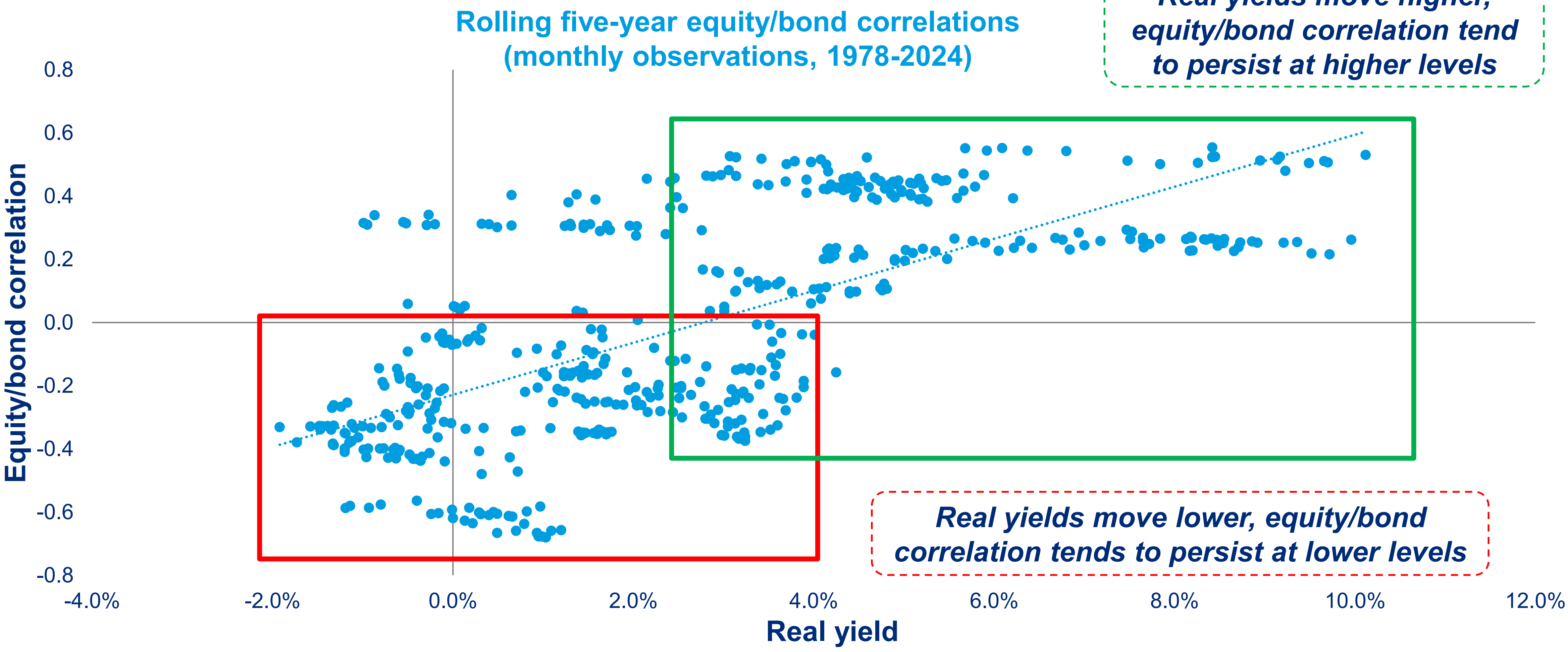
Scenario Protection

- Portfolios that incorporate exposure to a wide range of risk factors and growth drivers can hold up better in stress scenarios

Compounding Returns

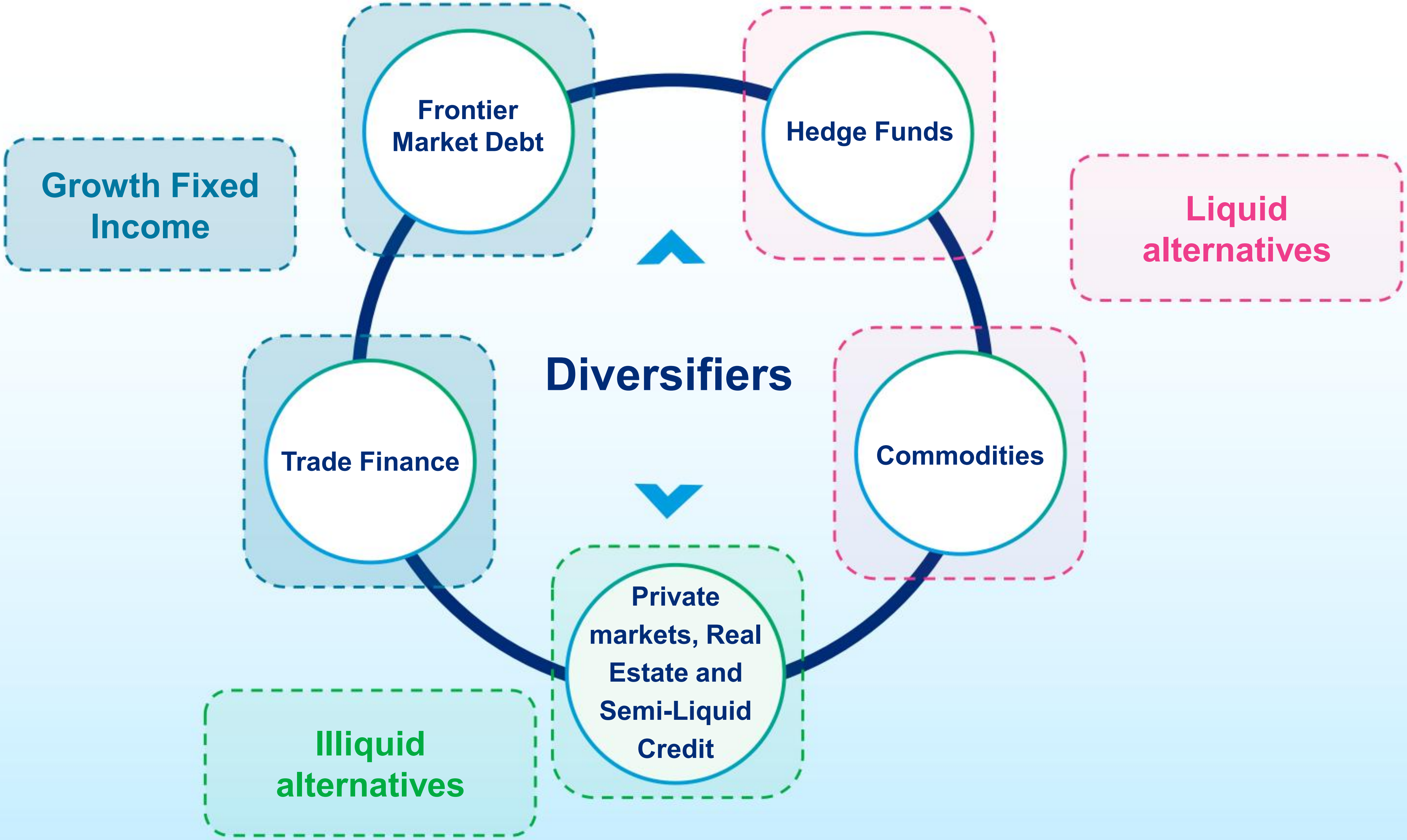
- Diversified portfolios typically have lower volatility and can therefore compound returns more efficiently than concentrated, higher risk portfolios

Equity / bond correlations

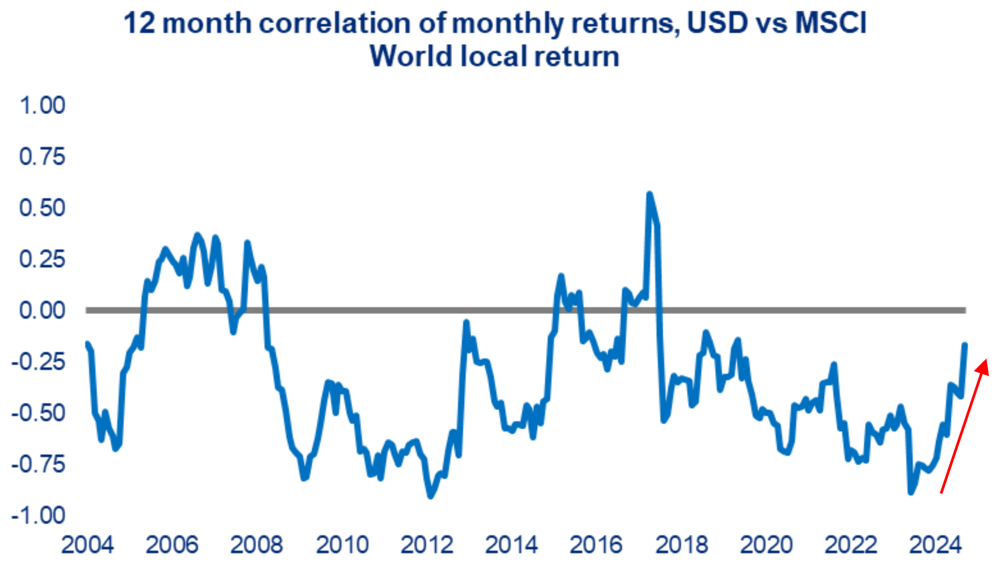


Over the long term, equities and bonds have been positively correlated more often than not. Particularly when inflation is higher. This means portfolios need to include strategies other than equities and bonds to gain diversification.

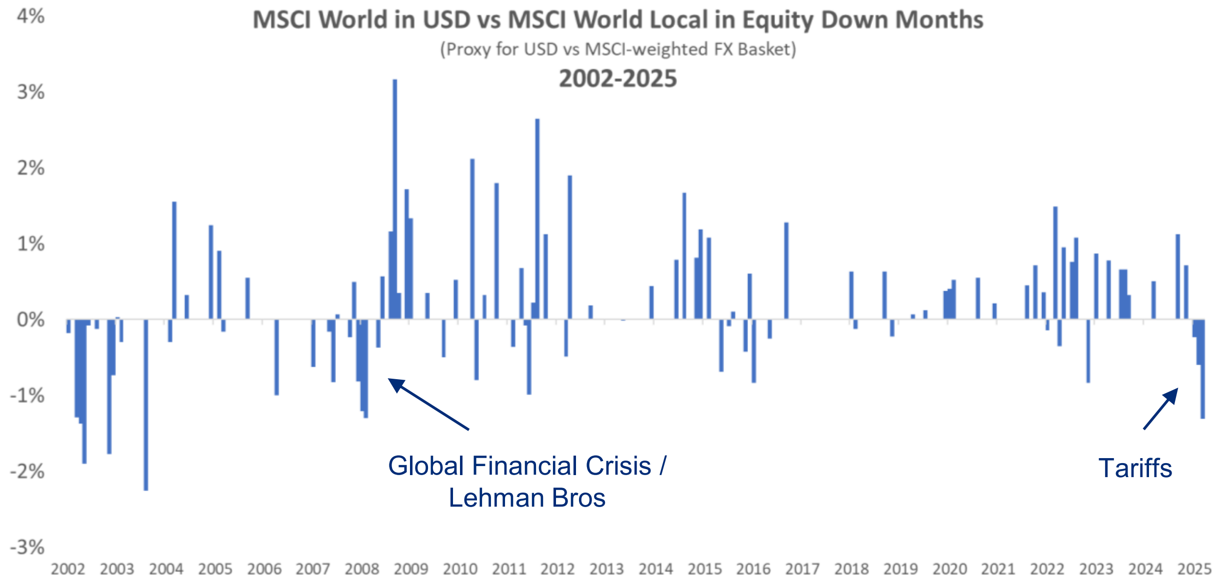
Where to find diversification?



Risk Diversification Benefits of USD are Falling



Source: Refinitiv, Mercer. Data as of March 31, 2025.



Source: Refinitiv, Mercer. Data as of March 31, 2025.

- For non-USD investors, the risk reduction and diversification from leaving FX exposure unhedged is largely a product of the negative (short-term) correlation between equity market and USD performance.
- For the last decade it has been characteristic that when equity markets sell off, USD rallies – this dampens portfolio drawdowns for non-US equity investors. Most non-USD investors have also benefited from USD appreciation, alongside strong returns for USD-denominated asset over this period.
- **Over the last year, the negative correlation has faded** and during 2025 YTD, the focus on US Tariff proposals has seen USD falling when equities sell off.
- Partly as a result, non-USD investors are paying more attention to the size of their structural USD exposure.

The volatility reducing benefits of FX exposure are falling as the USD's negative equity correlation weakens. We see this as a prime opportunity to revisit clients' currency hedging policy.

Conclusions for Risk-focused FX Exposure Management

- **In recent years, low hedge ratios have benefited investors.** USD has appreciated against most other DM currencies over the last 15 years, so for non-USD investors, unhedged portfolios have earned higher returns as well as experiencing lower volatility.

- **However, there are signs that this regime of USD supremacy may be coming to an end. Looking forward, we believe:**
  - *Investors should place less reliance on USD exposure for its risk reduction potential*. The risk dampening effect of unhedged USD exposure arises from its negative correlation with equity markets. While this has been the case for most of the post-GFC period, this relationship is not a permanent feature of market behaviour and has weakened over the last year.
  - *Investors should not assume USD will continue to strengthen*. From a position of relative cheapness 15 years ago, it is now expensive on a trade-weighted basis. It also faces a number **of structural threats and headwinds** including the impact of disruption to trading relationships from tariffs, and the ongoing need to fund growing US budget deficits.
  - While too early to call with certainty, it is possible we are entering an environment under which USD exposure **provides less risk reduction** and **has greater potential to depreciate.**

- We conclude that:
  - Non-USD investors who do not currently implement any currency hedging should **review their FX policy and its rationale.**
  - Non-USD investors with a currency hedging policy in place should **consider increasing hedge ratios** / reducing USD exposure.

Net Zero Initiatives Update 2025

What's the Issue?

Headlines on Asset Managers departing Collaborative Climate Initiatives

Departures from CA100+

Climate Action 100+

- Asset managers JPMorgan, State Street Global Advisors and PIMCO withdrew from the initiative in 2024 and BlackRock announcing its withdrawal from the NZAMI in January 2025. The asset manager stated that 'BlackRock's active portfolio managers continue to assess material climate-related risks, alongside other investment risks.[1]' The move comes as CA 100+ enters phase[2], which focuses on shifting from corporate climate-related disclosure to the implementation of climate transition plans.
- Positions taken by asset managers across the US reflect not only their fiduciary obligations to act in their clients' best interests, but also the challenges of navigating a federal system where individual states, in addition to the federal government, have the ability to regulate activities occurring in their state or with state assets.

1. Source: . https://www.ft.com/content/f0fb9841-db1d-442e-a757-1a1327497fb1
2. Source: https://www.climateaction100.org/news/climate-action-100-announces-its-second-phase/

Joiners and departures of NZAMI

Net Zero Asset Managers Initiative

- 'Recent developments in the U.S. and different regulatory and client expectations in investors' respective jurisdictions have led to NZAMI launching a review of the initiative to ensure NZAMI remains fit for purpose in the new global context. Signatories will be consulted throughout the review process and informed of any updates in a timely and transparent fashion.'
- UK asset manager, Baillie Gifford, departed from both CA100+ and NZAMI in November 2024, saying participating in collaborative climate initiatives risks "distracting from our core responsibilities"; this is along with BlackRock and Vanguard as two of the largest asset managers who have exited the initiative.
- NZAOA has seen no major exits by asset owners outside of the departure of 'Pensioenfonds Detailhandel' at the end of 2024 which attributed departure to lack of resourcing to support the needs of the coalition. It remains commitment to its Net Zero targets[3].

3. Source: https://www.responsible-investor.com/dutch-pension-fund-quits-net-zero-asset-owner-alliance/

Whilst these departures are grabbing headlines, investors should focus on their asset managers' stewardship priorities and broader engagement activities, rather than membership of specific groups (which may be driven by other motives)

CA100+ - Climate Action 100
NZAMI – Net Zero Asset Manager Initiative
NZAOA – Net Zero Asset Owner Alliance

What Actions can Funds take?

Review Fund Responsible Investment Beliefs

- In the lead up to Funds reviewing their investment strategy and ISS's, Funds should review their responsible investment beliefs (and investment beliefs) ahead of detailed strategy discussions to ensure policy documents reflect Committees views. This will allow Funds to clearly set objectives for their pools including their sustainability-related expectations of the underlying asset managers.

Review decarbonisation Targets

- Funds may wish to review short term / interim targets following analysis and discussions with asset managers.

Analytics for Climate Transition (ACT)

- Funds should conduct their own, independent analysis of investment portfolio climate metrics to effectively engage with asset managers and pools.

Climate Scenario Analysis

- Investors should look to quantify the long-term financial implications that Climate Change could have on the sustainability and affordability of the Fund.

Stewardship

- Investors should actively engage with their asset managers to gain a clear understanding of the stewardship and engagement activities they are undertaking on climate issues. Investors should also consider how the actions of their assets managers align with their own investment principles, policies and objectives.

Questions to ask your investment manager include:

- Are managers taking an active approach to engaging with companies on climate/other ESG matters, specifically regarding corporate disclosures, climate transition plans and metrics?
- What are managers' stewardship priorities? Do these align to asset owner priorities? How are managers evidencing their stewardship outcomes?
- Are they signatories or participants of collaborative industry initiatives (including but not limited to Climate Action 100+)?