Agenda Item 11

Falkirk Council

Subject: **Market Review and Fund Manager Performance**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **22 September 2016**

Submitted by: **Director of Corporate and Housing Services**

1. Purpose of Report

1.1 The Local Government Pension Scheme Regulations require that administering authorities review the investments and performance of their managers at least once every three months. This paper reports on Manager activities for the most recently completed quarter.

2. Recommendations

2.1 The Committee and Board are asked to note:-

(i) the Managers' performance for the period ending 30 June, 2016, and

(ii) the actions taken by Managers during the quarter to 30 June, 2016 in accordance with their investment policies.

3. Background

3.1 The rates of return achieved by the Fund's managers are measured against pre-determined benchmarks, as calculated by the Fund Custodian, Northern Trust.

3.2 The following benchmarks are in place to measure performance:

- Aberdeen Asset Management (AAM) – MSCI All Countries World Index
- Baillie Gifford Bonds (BGB) – a customised benchmark comprising UK Fixed Interest and UK Index Linked Bonds
- Baillie Gifford Diversified Growth (BGDG) – UK base rate
- Legal & General (L&G) – a customised benchmark comprising UK and Overseas Equities
- Newton Investment Management (NIM) – the MSCI AC World (NDR) Index
- Schroder Investment Management (SIM)
  (i) UK Equities – the FTSE All Share Index
  (ii) Property – HSBC/APUT Pooled Property Fund Indices

3.3 Full details of each Manager’s portfolio activity and any engagement with companies on corporate governance issues are recorded in their individual quarterly investment reports, which have been uploaded to the Objective Connect portal.

4. Market Review and Outlook

4.1 The second quarter of 2016 was dominated by the surprise UK Brexit vote. Equity markets performed well as Sterling depreciated during the quarter. Bond markets continued rallying as the ECB and Bank of Japan pursued quantitative easing (QE) and the Bank of England signalled it would be easing policy in Q3. In Sterling terms, the UK and European stock markets returned around 5%. The US and Japanese stock markets returned around 10% in Sterling terms.

4.2 The bond market rally during the quarter resulted in conventional gilts returning 6.2% while index-linked gilts returned 11.1%. In the credit markets, investment grade bonds returned 4.2% and high yield bonds returned 1.8%.

4.3 During Q2, the US Federal Reserve indicated that it was in no hurry to raise interest rates further. Moderate developed market growth and weakness in emerging markets militated against any further increase. Meanwhile, the European Central Bank (ECB) and the Bank of Japan maintained negative repo rates and continued their QE programmes. The biggest change in the thrust of monetary policy was in the UK, where the Brexit vote put monetary easing firmly on the agenda.

4.4 The outlook for global equity and bond markets remains dependent on global growth, particularly in the emerging markets. Developed market growth is slow but steady while emerging market growth remains weak. Any further increase in the Fed’s fund rate is expected to be very limited. Further monetary easing is expected by the ECB and the Bank of Japan. The UK will move to further monetary easing after 7 years of unchanged rates. The size of further monetary easing depends on how deep and long any UK recession is expected to be.

5. Fund and Manager Performance

5.1 The total fund and individual external manager returns are shown in the table in Appendix 1. The returns for the quarter ending 30 June 2016 are shown, but this is a very short period to measure performance. It simply reflects the regular reporting cycle. Each manager has been set its own individual investment objective, which depends on the type of mandate awarded. Each active manager is tasked with outperforming its benchmark over either three or five year periods. The table in Appendix 1 incorporates the relevant return and benchmark data and the excess return relative to the manager’s benchmark and outperformance objective. More detail on individual manager mandates and objectives is provided in a separate report on the meeting agenda.

5.2 The overall Fund’s return of +5.4% over the quarter was ahead of the benchmark return by +0.3%. Over the 3 year period, the Fund rose

+9.1% per annum compared with the benchmark return of +8.0% per annum, an excess return of +1.1% per annum. Over the 3 year period, the Fund benefited from double digit returns from global equities and commercial property market in the UK. Notable positive contributions from managers were NIM's outperformance in global equities and SIM's outperformance in UK equities. Long term return data shows Fund appreciation of +8.9% per annum over 5 years and +7.5% per annum since September 2001. These long term returns are above the benchmark returns.

5.3 Over the second quarter of 2016, the returns of the Fund's three active equity managers ranged from +3.1% to +11.1%. AAM outperformed while NIM and SIM underperformed their respective benchmarks. The Fund's passive equity manager, L&G, produced a return of +7.3%, broadly in line with its benchmark return, and so consistent with its mandate.

The return from BG's bond mandate was +6.2%, in line with its benchmark return. BG's other mandate, the Diversified Growth portfolio, rose only +0.6%, which was ahead of its cash benchmark by +0.5%.

The property portfolio managed by SIM fell -0.2%, behind its benchmark by -0.3%.

5.4 Longer term return data shows that SIM's UK equity portfolio slipped below its objective of +1.25% per annum above the benchmark over the 3 year period, but it remains comfortably ahead over 5 years and since inception.

NIM's global equity mandate stipulates an objective of +3% per annum above the benchmark over 5 year rolling periods. Returns over the past 5 years and since inception have beaten the benchmark comfortably, but they have not achieved the objective.

The AAM mandate's objective is +3% per annum outperformance over 3 year rolling periods. Performance is lagging the benchmark and the objective by a wide margin over 3 years and since inception.

The performance of BG's bond mandate is slightly below its benchmark since inception in 2007. Over the 3 year period, the mandate is below benchmark and the objective of +0.9% per annum.

SIM's property performance has been disappointing in recent years, and this reversed positive results in the early years of the mandate. The last 3 year period has been more positive in absolute terms (+11.8% per annum), validating the allocation to property, but the portfolio has performed less well than the benchmark and objective of +0.75% per annum.

6. CONCLUSION

6.1 Towards the end of the quarter, the UK voted to leave the European Union, triggering political and market uncertainty which led to a pronounced weakening in Sterling. Prior to this event, sentiment during the quarter had generally been positive based on better than expected news from China and the likelihood of modest US interest rate hikes later in the year.

6.2 The quarter delivered a total return of 5.4% slightly ahead of the Fund's benchmark with strong absolute returns from the equity managers, albeit with only some of the Managers meeting their individual benchmarks. There was a welcome return to outperformance territory from Aberdeen, who in recognition of their sub-standard performance have given the Fund a one year fee waiver. They remain, nonetheless, under close scrutiny.

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Appendices

Appendix 1 – Performance Measurement (Rates of Return)

List of Background Papers:

1. Northern Trust – Investment Risk & Analytical Services, 30 June 2016

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 June 2016

Manager	Market Value £	Weight	Returns 3 months	3 year	5 year	Since inception	Inception Date
Aberdeen Portfolio	247,747,026	12.9%	11.1%	6.7%	7.6%	8.5%	May-10
Benchmark			8.8%	11.2%	9.9%	9.8%	
Excess Versus Benchmark			**2.3%**	**-4.5%**	**-2.4%**	**-1.3%**	
Excess Versus Objective			-	**-7.5%**	**-5.4%**	**-4.3%**	
Baillie Gifford Bond Portfolio	165,895,820	8.6%	6.2%	8.5%	8.9%	7.0%	Mar-07
Benchmark			6.2%	8.6%	8.3%	7.3%	
Excess Versus Benchmark			**0.0%**	**-0.1%**	**0.6%**	**-0.3%**	
Excess Versus Objective			**-**	**-1.0%**	**-0.3%**	**-1.2%**	
Baillie Gifford Diversified Growth	205,437,544	10.7%	0.6%	4.2%	-	5.2%	Feb-12
Benchmark			0.1%	0.5%	-	0.5%	
Excess Versus Benchmark			**0.5%**	**3.7%**	**-**	**4.7%**	
Excess Versus Objective			**-**	**-**	**-**	**1.2%**	
Legal & General	398,676,012	20.7%	7.3%	9.6%	9.0%	12.9%	Jan-09
Benchmark			7.3%	9.5%	8.9%	12.8%	
Excess Versus Benchmark			**0.1%**	**0.1%**	**0.1%**	**0.1%**	
Excess Versus Objective			**0.1%**	**0.1%**	**0.1%**	**0.1%**	
Newton	320,553,027	16.7%	6.9%	14.3%	12.4%	10.2%	Jun-06
Benchmark			8.6%	11.1%	9.8%	8.4%	
Excess Versus Benchmark			**-1.6%**	**3.2%**	**2.5%**	**1.8%**	
Excess Versus Objective			-	-	**-0.5%**	**-1.2%**	
Schroders UK Equity	236,492,322	12.3%	3.1%	6.5%	9.6%	8.5%	Sep-01
Benchmark			4.7%	5.9%	6.3%	6.5%	
Excess Versus Benchmark			**-1.6%**	**0.6%**	**3.3%**	**2.0%**	
Excess Versus Objective			-	**-0.6%**	**2.1%**	**0.8%**	
Schroders Property	143,509,216	7.5%	-0.2%	11.8%	7.8%	3.8%	Nov-05
Benchmark			0.1%	12.5%	8.5%	3.8%	
Excess Versus Benchmark			**-0.3%**	**-0.7%**	**-0.7%**	**0.0%**	
Excess Versus Objective			-	**-1.5%**	**-1.5%**	**-0.8%**	
Total Fund	1,922,463,654	100.0%	5.4%	9.1%	8.9%	7.5%	Sep-01
Benchmark			5.1%	8.0%	7.2%	7.0%	
Excess Return			**0.3%**	**1.1%**	**1.7%**	**0.5%**	

*** Note that objectives vary and are set over 3 or 5 year periods highlighted by the boxes for each manager.**

There are small rounding effects in the table above.