AGENDA ITEM
11

Market Review and Fund Manager Performance

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FALKIRK COUNCIL

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

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

Date: **16 March 2017**

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 31 December 2016, and

(ii) the actions taken by Managers during the quarter to 31 December 2016 in accordance with their investment policies.

3. Background

3.1 The undernoted benchmarks are in place to measure the performance of each Manager.

- 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

3.2 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 During the fourth quarter of 2016, investor attention was largely focused on the November US Presidential election. Having sold off over the quarter to early November, equity markets then recovered strongly following the unexpected result and ended the quarter in positive territory, confounding those that had predicted market turmoil accompanying a Trump victory, at least in the short term. Equity market returns for sterling-based investors were boosted by further Sterling weakness over the quarter. In contrast, bond markets delivered negative returns as yields rose against a backdrop of rising inflation expectations.

4.2 Rising bond yields contributed to conventional gilts falling -3.4% and index-linked gilts returning -3.0%. In credit markets, investment grade bonds also delivered negative returns of -2.8%. However, high yield bonds returned +2.1%, as spreads narrowed.

4.3 During Q4 2016, the US Federal Reserve increased its target benchmark bank rate by 25bps to 0.75%, signalling the Fed's confidence in the state of the US economy. While signalling further rate increases would be likely in 2017, Fed Chair Yellen noted that the outlook remained uncertain. In the UK and Japan, both the MPC and BOJ left their respective bank rates unchanged and maintained their QE programmes. However, the European Central Bank (ECB) voted to extend its programme by a further nine months to the end of 2017, as its latest estimates suggested inflation would remain below its 2% target in 2019.

4.4 The outlook for the global economy – steady developed market growth with weaker growth in emerging markets - remains broadly unchanged. Recent divergence in central bank monetary policy, suggests the US is ahead of the rest of the world in its economic cycle, and Trump's promises of higher infrastructure spending and tax cuts have supported the "reflation trade", positive for equities but negative for US bonds. However, the prospect of US protectionism looms large, which would be negative for global growth and raise the risk of a global recession. The year ahead also sees opportunities for further surprises on the political front, most notably in Europe, where elections in the Netherlands, France and Germany fall due.

5. ANALYSIS OF PERFORMANCE RESULTS

5.1 The total fund and individual external manager returns are shown in the table in Appendix 1. The returns for the quarter ending 31 December 2016 are shown, but this is a very short period over which 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 can be found in Appendix 2.

5.2 The overall Fund's return of +3.9% over the quarter was ahead of the benchmark return by +0.5%. Over the 3 year period, the Fund rose +10.5% per annum compared with the benchmark return of +9.1% per annum, an excess return of +1.3% per annum. Over the 3 year period, the Fund has benefited from strong returns across equities (both global and UK), bonds and the UK commercial property market. Notable contributions from managers came from NIM, who outperformed in global equities, SIM, who outperformed in UK equities, and BGDF, whose relative performance was very strong, but whose absolute returns lagged those of the major asset classes. Long term return data shows Fund appreciation of +11.9% per annum over 5 years and +7.9% per annum since September 2001. These long term returns are above the benchmark returns.

5.3 Over the fourth quarter of 2016, the returns of the Fund's three active equity managers ranged from +3.1% to +10.3%. SIM outperformed while AAM and NIM underperformed their respective benchmarks. The Fund's passive equity manager, L&G, produced a return of +5.7%, in line with its benchmark return, and so consistent with its mandate. L&G's new fundamentally weighted portfolio, funded during the quarter, performed in line with its benchmark, again consistent with its mandate.

The return from BG's bond mandate was -3.3%, behind its benchmark return. BG's other mandate, the Diversified Growth portfolio, rose +2.1%, which was ahead of its cash benchmark.

The property portfolio managed by SIM rose +1.1%, behind its benchmark by -1.2%.

5.4 Longer term return data shows that SIM's UK equity portfolio is performing in line with its objective of +1.25% per annum above the benchmark over the 3-year period, and 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, 5 years and since inception.

The performance of BG's bond mandate is slightly below its benchmark since inception in 2007, and over the 3 year period. Over the 5 year period, the mandate is above benchmark but below 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 (+10.2% 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 During the quarter, whilst most developed markets across the globe delivered gains, the return to UK investors from overseas equities was again enhanced by sterling weakness. US equities stood out as generating the greatest gains, with markets expressing a broadly positive reaction to President Trump's initial policy comments. Expectations of a fiscal stimulus in the US pushed up bond yields but had a corresponding negative effect on prices. The strong valuations seen in markets at the year-end seem to run contrary to the geopolitical and economic uncertainties that lie ahead.

6.2 The quarter saw a total Fund return of 3.9% against the Fund benchmark of 3.3%. The 3 and 5 year positions also remain ahead of the respective benchmarks. There was strong outperformance during the quarter from the Schroder UK Equities portfolio reflecting resurgence in value stocks. The Aberdeen portfolio continues to struggle and performance remains under scrutiny with the Investment Adviser further reducing its rating. The fee waiver offered by Aberdeen one year ago following their below benchmark returns expires at the end of March 2017. Aberdeen are presenting to the March Committee.

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Appendices

Appendix 1 – Performance Measurement (Rates of Return)

List of Background Papers:

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

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 31 December 2016							
			Returns				
Manager	**Market Value £**	**Weight**	**3 months**	**3 year**	**5 year**	**Since inception**	**Inception Date**
Aberdeen Portfolio	270,498,349	12.7%	3.1%	9.3%	10.2%	9.3%	May-10
Benchmark			6.5%	14.3%	15.1%	11.4%	
Excess Versus Benchmark			**-3.2%**	**-4.4%**	**-4.3%**	**-1.9%**	
Excess Versus Objective			-	**-7.4%**	**-7.3%**	**-4.9%**	
Baillie Gifford Bond Portfolio*	171,352,278	8.1%	-3.3%	9.3%	7.6%	7.0%	Mar-07
Benchmark			-3.0%	9.4%	6.9%	7.2%	
Excess Versus Benchmark			**-0.3%**	**-0.1%**	**0.7%**	**-0.2%**	
Excess Versus Objective			**-**	**-1.0%**	**-0.2%**	**-1.1%**	
Baillie Gifford Diversified Growth**	219,867,135	10.4%	2.1%	5.3%	-	6.1%	Feb-12
Benchmark			0.1%	0.5%	-	0.5%	
Excess Versus Benchmark			**2.0%**	**4.9%**	-	**5.6%**	
Excess Versus Objective			-	-	-	**2.1%**	
Legal & General Fundamental Weighting	104,554,425	4.9%	-	-	-	**4.6%**	Nov-16
Benchmark			-	-	-	**4.6%**	
Excess Versus Benchmark			-	-	-	**0.0%**	
Excess Versus Objective			-	-	-	**0.0%**	
Legal & General Passive	352,181,464	16.6%	5.7%	11.7%	13.8%	14.0%	Jan-09
Benchmark			5.7%	11.6%	13.7%	13.9%	
Excess Versus Benchmark			**0.0%**	**0.1%**	**0.1%**	**0.1%**	
Excess Versus Objective			**0.0%**	**0.1%**	**0.1%**	**0.1%**	
Newton	354,445,755	16.7%	3.2%	16.4%	16.8%	10.8%	Jun-06
Benchmark			6.4%	14.2%	15.1%	9.4%	
Excess Versus Benchmark			**-3.0%**	**2.0%**	**1.5%**	**1.2%**	
Excess Versus Objective			-	-	**-1.5%**	**-1.8%**	
Schroders UK Equity	283,017,105	13.3%	10.3%	7.3%	15.7%	9.5%	Sep-01
Benchmark			3.9%	6.1%	10.1%	7.1%	
Excess Versus Benchmark			**6.2%**	**1.2%**	**5.1%**	**2.3%**	
Excess Versus Objective			-	**-0.1%**	**3.9%**	**1.1%**	
Schroders Property	145,129,026	6.8%	1.1%	10.2%	7.7%	3.7%	Nov-05
Benchmark			2.3%	10.6%	8.2%	3.8%	
Excess Versus Benchmark			**-1.2%**	**-0.4%**	**-0.4%**	**-0.1%**	
Excess Versus Objective			-	**-1.2%**	**-1.2%**	**-0.8%**	
Total Fund	2,123,722,883	100.0%	3.9%	10.5%	11.9%	7.9%	Sep-01
Benchmark			3.3%	9.1%	10.0%	7.4%	
Excess Return			**0.5%**	**1.3%**	**1.8%**	**0.5%**	

Notes:

1. Objectives vary and are set over 3 or 5 year periods highlighted by the boxes for each manager.
2. There are small rounding effects in the table above. This is the result of excess returns being calculated on a geometric basis rather than an arithmetic basis.
3. The independent performance measurement provider shows a different performance for Baillie Gifford than the manager itself. This is due to an intra-day valuation timing difference.