

The background of the slide features a large, light blue outline of the Coat of Arms of the Government of Nunavut. The crest is a shield divided into four quadrants. The top-left quadrant shows a stylized building, the top-right shows a caribou head with antlers, the bottom-left shows a sailing ship on wavy lines representing water, and the bottom-right shows a bird with spread wings. Above the shield is a crown with four maple leaves. A banner at the bottom contains the motto 'ANE FOR A'.

Agenda Item 10

Market Review and Fund Manager Performance

Falkirk Council

Subject: Market Review and Fund Manager Performance

Meeting: Joint Meeting of Pensions Committee and Pension Board

Date: 24 August 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.
- 1.2 The Fund's new governance structure delegates the implementation of investment strategy to the Chief Finance Officer, who takes advice from the Joint Investment Strategy Panel of the Falkirk and Lothian Pension Funds. An update on the Panel meeting of 24 July 2017 will be given later in this meeting.
- 1.3 This paper updates the Committee and Board on recent investment market developments; the Fund's strategic allocation and performance; and on the monitoring activity of the Fund's investment mandates during the most recently completed quarter.

2. Recommendations

2.1 The Committee and Board are asked to note:-

- (i) recent investment market developments;**
- (ii) the Fund's strategic allocation;**
- (iii) the Fund's performance for the period ending 30 June 2017; and**
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.**

3. Market Review and Outlook

- 3.1 During the second quarter of 2017, investor sentiment was boosted by the improving outlook for Europe as the moderate, pro-European Union candidate Emmanuel Macron won the French Presidential Election. This meant that even as the US continued to move towards more normalisation of interest rates, the European currency performed well against the dollar and this helped European equities to outperform - with a return to UK investors of 4.4%, against -1.0% for North America and 0.4% for global equities overall.
- 3.2 Bonds generally weakened as the unwinding of Quantitative Easing appeared to be in prospect (in the US). Ahead of Quantitative Easing, bond yields had declined, anticipating the Federal Reserve's bond purchases. By analogy, bond yields seemed to be rising in anticipation of this reversing. Conventional gilts returned minus -1.3% and index-linked gilts returned minus -2.3%. Generally positive sentiment on growth led to a further tightening of credit spreads to 6 year lows – of 3% versus over 10% in 2011 for High Yield, and just over 1% versus 3% for the overall market.
- 3.3 The US Federal Reserve further increased its target benchmark bank rate to 1.25%, signalling their confidence in the state of the US economy. Their stated expectation is for interest rates to be 1.4% at end-2017, 2.1% at end-2018 and 2.9% at end-2019. There is still some market scepticism that rates will rise this quickly.
- 3.4 The outlook for the global economy and markets remains broadly unchanged. US policy seems to be supportive for equities but negative for bonds. Low bond yields and low credit spreads seem to discount a "Goldilocks" economy that is both weak and strong at the same time. Low bond yields may instead have been driven by Quantitative Easing. In this context, it may be worth noting the recent comments from former Federal Reserve Chairman, Alan Greenspan: "By any measure, real long-term interest rates are much too low and therefore unsustainable. When they move higher they are likely to move reasonably fast. We are experiencing a bubble in bond prices. This is not discounted in the marketplace." Greenspan is of course widely known for the "irrational exuberance" speech he gave in 1996 when he (correctly) warned about the bubble in equity prices.

4. Fund Strategy

- 4.1 The Fund's strategic asset allocation, being the broad balance between growth and defensive assets, is the most significant driver of Fund returns and risk. Accordingly, the key focus of the Pensions Committee is on investment strategy and oversight, in line with its responsibility for the overall funding and investment arrangements and the level of investment risk within the Fund. The table below shows the Fund's most recent change to strategic allocation along with the current actual allocation.

Table 1

30 June, 2017	Previous Strategic	Current Strategic	Current Actual
Asset Class	Allocation	Allocation	Allocation
Growth Assets	80%	75%	81.9%
Listed equities	55%	55%	61.7%
Private Equity	5%	0%	3.1%
Multi Asset	10%	10%	10.4%
Property	10%	10%	6.8%
Defensive Assets	20%	25%	14.2%
Bonds	10%	10%	7.8%
Private Debt	0%	5%	0.0%
Infrastructure	9%	9%	5.2%
Social/Affordable Housing	1%	1%	1.1%
Cash	0%	0%	3.9%
Total	100%	100%	100%

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel reviewed strategy implementation and performance on 24 July 2017, and in conjunction with the internal teams at Falkirk and Lothian are working to implement the strategy.
- 4.3 The Fund raised cash levels from its equity allocation during the quarter to end June 2017 as an initial step to reduce the weighting in growth assets. Potential investments are being reviewed in areas previously identified by Committee, including infrastructure, private debt and low volatility equities. The current allocation will evolve gradually as appropriate investments become available, and the Fund will reduce its exposure to growth assets in favour of more defensive assets.

5. Fund Returns

- 5.1 The Chief Finance Officer and Joint Investment Strategy Panel also noted the rates of return achieved by the Fund and its managers. These returns are measured against pre-determined benchmarks, as calculated by an independent provider of performance measurement services, currently the Fund's Custodian, Northern Trust. They are shown in Appendix 1. In relation to the Fund's investments in alternative assets (e.g. Private Equity, Infrastructure), a schedule showing the market value and total value including distributions is attached at Appendix 2.
- 5.2 The Chief Finance Officer and Joint Investment Strategy Panel review and assess returns and manager implementation in the context of risk taken, mandate constraints and objectives, which depend on the type of mandate awarded. These objectives are shown in Appendix 3, which is an excerpt from the Statement of Investment Principles.

- 5.3 The overall Fund's return of +0.8% over the quarter was ahead of the benchmark return by 0.2%. Over the 3-year period, the Fund rose 10.8% per annum compared with the benchmark return of 9.5% per annum. Over the 3-year period, the Fund benefited from double digit returns from global equities, approximately half of which was due to sterling weakness against overseas currencies. Despite only achieving a mid-single digit return over the past year due to Brexit-related concerns, the commercial property market in the UK produced a high single digit return over 3 years, which was higher than the return from UK equities and UK bonds.
- 5.4 Long term return data shows Fund appreciation of 11.7% per annum over 5 years and 7.9% per annum since September 2001. These long-term returns are above the benchmark returns.
- 5.5 While the above data shows strong growth in assets over mid and long-term time periods, the funding level is determined by a combination of the growth in assets and changes in liabilities. The index-linked gilt yield is used as a proxy to discount the future value of the liabilities to the present day. It has been the case for some time now that falling gilt yields continue to put pressure on the funding level. The actuarial valuation is currently in process and will be reported to Pensions Committee by March 2018 at the latest.

6. Investment Manager Monitoring

- 6.1 The Fund's allocation to managers within asset classes is a less significant driver of returns and risk than the strategic allocation. The Chief Finance Officer now monitors managers quarterly as per the regulations supported by the Joint Investment Strategy Panel and the internal teams at Falkirk and Lothian, who review managers and portfolios quarterly and hold meetings with managers (in person or by telephone) at least 3 out of 4 quarters in the year. Reporting is conducted using a traffic light system, which highlights issues and concerns across a range of areas, including portfolio activity, portfolio construction, portfolio risk and return and business operations.
- 6.2 Over the 3-year period to end June 2017, positive contributions from managers were Newton Investment Management's outperformance in global equities and Schroder Investment Management's outperformance in UK equities.
- 6.3 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.
- 6.4 A separate report provides further details on investment monitoring, including information on the nature of the mandates and the investment approach of the managers as well as current developments and issues identified through the monitoring process.

7. Conclusion

- 7.1 The quarter saw a total Fund return of 0.8% against the Fund benchmark of 0.6%. The 3 and 5 year positions also remain marginally ahead of the respective benchmarks. There was outperformance during the quarter from the Aberdeen Global Equities mandate, Baillie Gifford Diversified Growth and from the in house portfolio which includes Private Equity, Infrastructure and Cash.

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Date: 14 August 2017

Appendices

Appendix 1 – Performance Measurement (Rates of Return)
Appendix 2 – Alternatives Markets Update
Appendix 3 – Manager Benchmarks and Investment Objectives

List of Background Papers:

1. Northern Trust – Investment Risk & Analytical Services, 30 June, 2017

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 June 2017							
Fund/Portfolio	Market Value £	Weight	Returns				Inception Date
			3 months	3 year	5 year	Since inception	
Falkirk Council Pension Fund	2,216,039,079	100.0%	0.8%	10.8%	11.7%	7.9%	Sep-01
Benchmark			0.6%	9.5%	10.0%	7.4%	
Excess Return			0.2%	1.2%	1.6%	0.5%	
Aberdeen Portfolio	233,021,849	10.5%	1.9%	10.5%	11.0%	9.9%	May-10
Benchmark			0.6%	15.5%	15.4%	11.6%	
Excess Versus Benchmark			1.3%	-4.4%	-3.8%	-1.5%	
Excess Versus Objective			-	-7.4%	-6.8%	-4.5%	
Baillie Gifford Bond Portfolio*	173,789,139	7.8%	-0.5%	8.1%	7.1%	6.8%	Mar-07
Benchmark			-0.6%	8.3%	6.6%	6.9%	
Excess Versus Benchmark			0.2%	-0.2%	0.5%	-0.2%	
Excess Versus Objective			-	-1.1%	-0.4%	-1.1%	
Baillie Gifford Diversified Growth**	230,641,935	10.4%	1.9%	5.9%	6.6%	6.5%	Feb-12
Benchmark			0.1%	0.4%	0.5%	0.5%	
Excess Versus Benchmark			1.8%	5.5%	6.1%	6.0%	
Excess Versus Objective			-	-	2.6%	2.5%	
Hearthstone Social	24,888,976	1.1%	-1.6%	-	-	-1.9%	Nov-14
Benchmark			1.6%	-	-	4.1%	
Excess Versus Benchmark			-	-	-	-	
Excess Versus Objective			-3.2%	-	-	-5.7%	
In-House	269,271,457	12.2%	1.8%	13.4%	10.3%	11.0%	Sep-01
Benchmark			0.0%	0.3%	0.3%	2.3%	
Excess Versus Benchmark			1.8%	13.0%	10.0%	8.5%	
Excess Versus Objective			-	-	-	-	
Legal & General Fundamental Weighting	108,084,298	4.9%	-0.8%	-	-	8.1%	Nov-16
Benchmark			-0.8%	-	-	8.1%	
Excess Versus Benchmark			0.0%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
Legal & General Passive	374,840,807	16.9%	1.0%	13.1%	14.2%	14.0%	Jan-09
Benchmark			1.0%	12.9%	14.1%	13.8%	
Excess Versus Benchmark			0.0%	0.1%	0.1%	0.1%	
Excess Versus Objective			0.0%	0.1%	0.1%	0.1%	
Newton	367,306,360	16.6%	0.3%	16.6%	15.8%	10.6%	Jun-06
Benchmark			0.4%	15.2%	15.3%	9.6%	
Excess Versus Benchmark			-0.1%	1.2%	0.5%	0.9%	
Excess Versus Objective			-	-	-2.5%	-2.1%	
Schroders UK Equity	283,408,515	12.8%	-0.7%	8.0%	14.0%	9.2%	Sep-01
Benchmark			1.4%	7.4%	10.6%	7.2%	
Excess Versus Benchmark			-2.1%	0.5%	3.1%	1.9%	
Excess Versus Objective			-	-0.7%	1.8%	0.6%	
Schroders Property	150,785,743	6.8%	1.9%	9.0%	8.5%	3.9%	Nov-05
Benchmark			2.3%	9.5%	9.0%	4.0%	
Excess Versus Benchmark			-0.4%	-0.5%	-0.4%	-0.1%	
Excess Versus Objective			-	-1.3%	-1.2%	-0.9%	

Notes:

- 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.
- 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.

Appendix 2							
Falkirk Council Pension Fund Alternative Markets Update - 31/03/17						Exchange Rates	
						\$	1.2505
						€	1.1691
Alternative Assets Summary - Sterling							
				(a)	(b)	(c)	(b + c)
						Market	Total
	Asset	Commitment	Unfunded	Cost	Distributions	Value	Value
		£ 000's	£ 000's	£ 000's	£ 000's	£ 000's	£ 000's
	Private Equity	154,147	23,509	130,638	112,489	70,820	183,309
	Infrastructure	227,949	91,069	136,879	43,208	118,377	161,585
	Debt/Loans	15,801	0	15,801	13,962	4,782	18,744
	Affordable Housing	30,000	3,850	26,150	0	25,301	25,301
		£809,993	£233,007	£576,986	£325,355	£408,478	£733,833
	Allocation to Private Equity (based on unfunded commitment plus market value)		4.3%				
	Allocation to Private Equity (based on market value only)		3.2%				
	Allocation to Infrastructure (based on unfunded commitment plus market value)		9.4%				
	Allocation to Infrastructure (based on market value only)		5.3%				

Appendix 3

Fund Manager	Strategic Allocation	Benchmark	Performance Objective
Listed Equities Active	33%		
Aberdeen Asset Management	11%	MCSI All Countries World Index	To outperform the benchmark by 3% pa gross of fees over rolling 3 year period
Newton Inv Management	11%	MCSI All Countries World Index	To outperform the benchmark by 3% pa net of fees over rolling 5 year period
Schroders UK Equity	11%	FTSE All Share Index	To outperform the benchmark by 1.25% pa net of fees over rolling 3 year period
Listed Equities Passive	22%		
Legal and General (Market Capitalisation Weighting)	11%	Composite of Regional Indices	To perform in line with the benchmark over all periods
Legal and General Fundamental Weighting	5.5%	FTSE RAFI All World 3000	To perform in line with the benchmark over all periods
Low Volatility	5.5%	To be appointed	To be appointed
Private Equity/Debt	5%		
Wilshire Capital	-	MSCI World Index	To outperform the benchmark by 5% pa net over the life cycle of the funds
Standard Life Capital	-	MSCI Europe Index	To outperform the benchmark by 5% pa net over the life cycle of the funds
M&G Investments	-	FT 7 day Sterling LIBID Index	To outperform the benchmark by 5% pa net over the life cycle of the fund
Property	10%		
Schroders	10%	IPD UK Pooled Property Fund Indices All Balanced Funds Weighted Average	To outperform the benchmark by 0.75% pa net of fees over rolling 3 year period
Multi Assets	10%		
Baillie Gifford Diversified Growth	10%	UK Base Rate	To outperform the benchmark by 3.5% pa net of fees over rolling 5 year period with annual volatility less than 10%
Bonds	10%		
Baillie Gifford	10%	50% Merrill Lynch Sterling Non Gilt 30% FTSE All Stocks Gilts 20% FTSE-A-Index Linked Over 5yr Index	To outperform the benchmark by 0.9% pa net of fees over rolling 3 year period
Infrastructure	9%		
Grosvenor	4.5%	RPI	To achieve a net return of 10% over the life cycle of the funds
Internal	4.5%	RPI	RPI Index +3.5% pa
Social/Affordable Housing	1%		
Hearthstone	1%	RPI	RPI Index +2% pa