



## **Agenda Item 7**

# **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: 21 September 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.
- 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 Over July and August, markets have had to contend with increasing tensions resulting from North Korea's demonstration of its military capabilities. Despite this geopolitical threat, the evidence of synchronised global economic growth and the absence of inflationary pressures has allowed equity markets to rise and bond yields to decline over the two months.
- 3.5 The longer term 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 latest change to the Fund's strategic allocation along with the current actual allocation at 31 August 2017.

**Table 1**

<b>31 August, 2017</b>	<b>Previous Strategic</b>	<b>Current Strategic</b>	<b>Current Actual</b>
<b>Asset Class</b>	<b>Allocation</b>	<b>Allocation</b>	<b>Allocation</b>
<b>Growth Assets</b>	<b>80%</b>	<b>75%</b>	<b>81.4%</b>
Listed equities	55%	55%	61.3%
Private Equity	5%	0%	3.1%
Multi Asset	10%	10%	10.2%
Property	10%	10%	6.8%
<b>Defensive Assets</b>	<b>20%</b>	<b>25%</b>	<b>14.7%</b>
Bonds	10%	10%	7.8%
Private Debt	0%	5%	0.1%
Infrastructure	9%	9%	5.7%
Social/Affordable Housing	1%	1%	1.1%
<b>Cash</b>	<b>0%</b>	<b>0%</b>	<b>3.9%</b>
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel reviewed strategy implementation and performance on 7 September 2017, and in conjunction with the internal teams at Falkirk and Lothian are working to implement the strategy.
- 4.3 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.
- 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 2, 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 most recent change to the Fund's strategic allocation requires a reduction in growth assets and an increase in defensive assets. The Fund has increased the cash level as an interim step and further changes will be implemented as investment opportunities are identified and become available.
- 7.2 The quarter to end June 2017 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.

7.3 The Investment Strategy Panel monitors the Fund's investment managers and portfolios and advises the Chief Finance Officer quarterly in line with the regulations.

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## **Appendices**

Appendix 1 – Performance Measurement (Rates of Return)

Appendix 2 – Alternatives Market Update

Appendix 3 – Benchmarks and Objectives

## **List of Background Papers**

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	
<b>Falkirk Council Pension Fund</b>	<b>2,216,039,079</b>	<b>100.0%</b>	<b>0.8%</b>	<b>10.8%</b>	<b>11.7%</b>	<b>7.9%</b>	<b>Sep-01</b>
Benchmark			0.6%	9.5%	10.0%	7.4%	
Excess Return			0.2%	1.2%	1.6%	0.5%	
<b>Aberdeen Portfolio</b>	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%	
<b>Baillie Gifford Bond Portfolio*</b>	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%	
<b>Baillie Gifford Diversified Growth**</b>	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%	
<b>Hearthstone Social</b>	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%	
<b>In-House</b>	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			-	-	-	-	
<b>Legal &amp; General Fundamental Weighting</b>	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%	
<b>Legal &amp; General Passive</b>	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%	
<b>Newton</b>	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%	
<b>Schroders UK Equity</b>	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%	
<b>Schroders Property</b>	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
		<b>£809,993</b>	<b>£233,007</b>	<b>£576,986</b>	<b>£325,355</b>	<b>£408,478</b>	<b>£733,833</b>
	Allocation to Private Equity		4.3%				
	(based on unfunded commitment plus market value)						
	Allocation to Private Equity		3.2%				
	(based on market value only)						
	Allocation to Infrastructure		9.4%				
	(based on unfunded commitment plus market value)						
	Allocation to Infrastructure		5.3%				
	(based on market value only)						



## Appendix 3

Fund Manager	Strategic Allocation	Benchmark	Performance Objective
<b>Listed Equities Active</b>	<b>33%</b>		
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
<b>Listed Equities Passive</b>	<b>22%</b>		
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
<b>Private Equity/Debt</b>	<b>5%</b>		
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
<b>Property</b>	<b>10%</b>		
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
<b>Multi Assets</b>	<b>10%</b>		
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%
<b>Bonds</b>	<b>10%</b>		
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
<b>Infrastructure</b>	<b>9%</b>		
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
<b>Social/Affordable Housing</b>	<b>1%</b>		
Hearthstone	1%	RPI	RPI Index +2% pa