

The background of the slide features a large, light blue crest of the University of Alberta. The crest is a shield divided into four quadrants. The top-left quadrant shows a cross with a vertical bar. The top-right quadrant shows a stag's head facing left. The bottom-left quadrant shows a sailing ship on wavy lines. The bottom-right quadrant shows an eagle with spread wings. Above the shield is a crown with four maple leaves. Below the shield is a banner with the motto 'ANNE 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: 21 June 2018**

**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 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 on 12 June 2018 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 31 March 2018; and
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.

**3. Market Review and Outlook**

- 3.1 *Equities began 2018 with a roar, with the strongest January returns since 1987. However, this was followed by a resurgence in volatility in February, accompanied by a sharp sell-off in equities. Global equities returned -4.4% for the quarter, while UK equities were weaker, returning -6.9%.*

- 3.2 Decent US corporate earnings, fiscal easing, firmer inflation expectations, withdrawal of central bank stimulus and the prospect of large deficits weighed particularly heavily on US government bonds, and the US Federal Reserve raised rates in March. At the end of the quarter, the market was anticipating between two and three further hikes in US rates by the end of the year.
- 3.3 In the UK, both index-linked gilts and conventional gilts held their value, returning +0.1% and +0.3% respectively. Investment grade bonds returned -1.2%, while high yield bonds returned -0.2%. In its February 2018 inflation report, the Bank of England signalled that interest rates could rise faster and to a greater extent than previously expected. Subsequently, however, data towards the end of the quarter and a lack of progress on EU exit negotiations, dented near term expectations of interest rate rises.
- 3.4 In its March 2018 interim economic outlook, the OECD raised its forecasts for global GDP growth for 2018 and 2019 to 3.9% apiece. Projections for 2018 for France and the US were raised by 0.4%, and projections for 2019 for the US, Germany and Australia were increased by 0.7%, 0.3% and 0.3% respectively. The OECD expects the UK to have the weakest outlook amongst developed economies.
- 3.5 The relative performance of asset classes in the coming quarters will be determined by the ebb and flow of economic momentum. Should the US economy sustain its strength even if European activity slows, then the Federal Reserve will likely feel justified in raising rates several more times this year and US government bonds could continue to struggle. That environment is positive for equities until the interest rate increases start to impinge on growth by affecting debt servicing. With considerable growth in debt post-2008, relatively small increases in debt servicing costs are likely to expose borrowers that have overextended themselves. Predicting near term market movements is difficult, but tighter monetary policy, which is underway in the US, is a more challenging backdrop for financial markets than the easy monetary policy environment of the past few years.

#### **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 11 May 2018.

**Table 1**

<b>Asset Class</b>	<b>Previous Strategic Allocation</b>	<b>Current* Strategic Allocation</b>	<b>Current* Actual Allocation</b>
<b>Growth Assets</b>	<b>80%</b>	<b>75%</b>	<b>81.3%</b>
Listed equities	55%	55%	62.3%
Private Equity	5%	0%	2.5%
Multi Asset	10%	10%	10.1%
Property	10%	10%	6.4%
<b>Defensive Assets</b>	<b>20%</b>	<b>25%</b>	<b>18.6%</b>
Bonds	10%	10%	7.4%
Private Debt	0%	5%	0.1%
Infrastructure	9%	9%	6.4%
Social/Affordable Housing	1%	1%	1.0%
Other Real Income Assets	0%	0%	0.0%
Cash	0%	0%	3.8%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Sources: SIP & NT

\* at 11 May 2018

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel reviewed strategy implementation and performance on 12 June 2018 and, in conjunction with the internal teams at Falkirk and Lothian, have initiated an investment strategy review. Hymans Robertson will also advise on the strategy review, which will take into account the results of the 31 March 2017 actuarial valuation.
- 4.3 While work on the review proceeds over the summer months, potential investments will continue to be assessed in areas previously identified by Committee, including infrastructure, private debt and low volatility equities. During the quarter, the Fund made its first commitment to a private debt fund of £20m (c.1% of Fund assets). Further commitments to private debt are expected, with a separate £20m commitment to a second private debt fund agreed following quarter end.
- 4.4 The current allocation will continue to 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 3, which is an excerpt from the Statement of Investment Principles.

- 5.3 The overall Fund value fell 2.6% over the quarter, but that was better than the benchmark return of -3.1%. Over the 5-year period, the Fund rose 8.8% per annum compared with the benchmark return of 7.7% per annum. Over the 5-year period, the Fund benefited from its exposure to overseas equities (which performed much better than UK equities partly due to sterling weakness against overseas currencies) and UK property. Both overseas equity and UK property assets generated double-digit returns while bond and UK equity assets provided more modest, but still respectable, mid-single digit returns.
- 5.4 Long term return data shows Fund appreciation of 7.7% per annum since September 2001, which is above the benchmark return.
- 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 latest actuarial valuation at end March 2017, which reassessed a range of financial and demographic assumptions in light of inter-valuation experience, showed that the funding level had improved to 92% (from 85% at end March 2014).

## **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 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 as well as business operations.
- 6.2 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.
- 6.3 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 Fund value fell 2.6% over the quarter to end March 2018, which was better than the benchmark return (-3.1%). Over 3- and 5-year timeframes, the Fund has achieved returns above benchmark and, in absolute terms, +8-9% per annum.
- 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 Portfolio Update

Appendix 3 – Benchmarks and Objectives

## **List of Background Papers**

Northern Trust – Investment Risk & Analytical Services, 31 March 2018

## APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 31 March 2018							
Fund/Portfolio	Market Value £	Weight	Returns				Inception Date
			3 months	3 year	5 year	Since inception	
<b>Falkirk Council Pension Fund</b>	2,270,468,351	100.0%	-2.6%	7.9%	8.8%	7.7%	Sep-01
Benchmark			-3.1%	6.8%	7.7%	7.2%	
Excess Return			0.5%	1.1%	1.1%	0.5%	
<b>Aberdeen Portfolio</b>	234,244,040	10.3%	-4.5%	8.0%	7.2%	9.0%	May-10
Benchmark			-4.4%	10.8%	11.5%	10.7%	
Excess Versus Benchmark			-0.1%	-2.8%	-4.4%	-1.8%	
Excess Versus Objective			-	-5.8%	-7.4%	-4.8%	
<b>Baillie Gifford Bond Portfolio*</b>	177,213,250	7.8%	-0.4%	4.5%	5.4%	6.5%	Mar-07
Benchmark			-0.5%	4.4%	5.4%	6.6%	
Excess Versus Benchmark			0.1%	0.0%	0.1%	-0.1%	
Excess Versus Objective			-	-0.9%	-0.9%	-1.0%	
<b>Baillie Gifford Diversified Growth**</b>	238,468,912	10.5%	0.6%	5.0%	5.0%	6.3%	Feb-12
Benchmark			0.1%	0.4%	0.4%	0.5%	
Excess Versus Benchmark			0.5%	4.6%	4.6%	5.8%	
Excess Versus Objective			-	-	1.1%	2.3%	
<b>Hearthstone Social</b>	24,491,549	1.1%	-1.8%	-1.4%	-	-1.2%	Nov-14
Benchmark			0.6%	4.7%	-	4.3%	
Excess Versus Benchmark			-2.4%	-6.1%	-	-5.5%	
Excess Versus Objective			-	-	-	-	
<b>In-House</b>	294,094,353	13.0%	-0.2%	10.6%	9.6%	10.7%	Sep-01
Benchmark			-1.1%	-0.1%	0.1%	2.1%	
Excess Versus Benchmark			0.9%	10.7%	9.6%	8.6%	
Excess Versus Objective			-	-	-	-	
<b>Legal &amp; General Fundamental Weighting</b>	110,393,979	4.9%	-5.2%	-	-	7.5%	Nov-16
Benchmark			-5.2%	-	-	7.4%	
Excess Versus Benchmark			0.1%	-	-	0.1%	
Excess Versus Objective			-	-	-	0.1%	
<b>Legal &amp; General Passive</b>	380,887,710	16.8%	-5.1%	9.4%	10.2%	13.0%	Jan-09
Benchmark			-5.2%	9.3%	10.1%	12.8%	
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>	366,483,579	16.1%	-4.1%	10.0%	11.4%	9.9%	Jun-06
Benchmark			-4.5%	10.3%	11.3%	9.1%	
Excess Versus Benchmark			0.4%	-0.4%	0.1%	0.7%	
Excess Versus Objective			-	-	-2.9%	-2.3%	
<b>Schroders UK Equity</b>	293,201,727	12.9%	-3.3%	6.7%	9.1%	9.0%	Sep-01
Benchmark			-6.9%	5.9%	6.6%	6.8%	
Excess Versus Benchmark			3.6%	0.9%	2.5%	2.2%	
Excess Versus Objective			-	-0.4%	1.2%	0.9%	
<b>Schroders Property</b>	150,989,251	6.7%	1.8%	8.2%	10.0%	4.3%	Nov-05
Benchmark			1.9%	8.1%	10.5%	4.3%	
Excess Versus Benchmark			-0.1%	0.1%	-0.5%	0.0%	
Excess Versus Objective			-	-0.7%	-1.2%	-0.8%	

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.
3. The independent performance measurement provider shows a slightly different performance for Baillie Gifford than the manager itself. This is due to an intra-day valuation timing difference.
4. Change in benchmark for In-House portfolio (1 January 2018) from cash to custom benchmark weighted by assets according to benchmarks in SIP (see Appendix 3).

## Appendix 2

### Falkirk Council Pension Fund Alternative Markets Update - 31/03/18

Exchange Rates	
\$	1.4028
€	1.1406

### Alternative Assets Summary - Sterling

Manager	Commitment £ 000's	Unfunded £ 000's	(a) Cost £ 000's	(b) Distributions £ 000's	(c) Market Value £ 000's	(b + c) Total Value £ 000's	Total Value to Paid in Cap.
Infrastructure	199,421	43,045	156,376	47,099	146,243	193,342	1.24
Private Equity	162,108	20,807	141,301	139,513	65,746	205,259	1.45
Affordable Housing	30,000	3,850	26,150	982	24,445	25,427	0.97
Debt/Loans	35,801	20,000	15,801	16,681	2,180	18,861	1.19
<b>Total</b>	<b>427,330</b>	<b>87,702</b>	<b>339,628</b>	<b>204,275</b>	<b>238,614</b>	<b>442,889</b>	

Allocation to Private Equity  
(based on unfunded commitment plus market value) 3.8%

Allocation to Private Equity  
(based on market value only) 2.9%

Allocation to Infrastructure  
(based on unfunded commitment plus market value) 8.3%

Allocation to Infrastructure  
(based on market value only) 6.4%



## 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 Investment Management	11%	MCSI All Countries World Index	To outperform the benchmark by 3% pa net of fees over rolling 5 year period
Schroder (UK)	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>		
Schroder	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 (GCM)	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