

The background of the slide features a large, light blue watermark of the City of Vancouver's coat of arms. The crest includes a crown with four maple leaves, a shield divided into four quadrants (top-left: a ship, top-right: a stag, bottom-left: a ship, bottom-right: an eagle), and a banner at the bottom with the motto 'A NE FOR A'.

## **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: 20 September 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 11 September 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 30 June 2018 and;
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.

### **3. Market Review and Outlook**

- 3.1 Perhaps counterintuitively, the headlines about trade wars have coincided with strong economic data from the US – GDP growth of 4.1% with low unemployment is the envy of many developed market nations. Trump's fiscal policies and trade rhetoric have benefitted US stock markets, encouraging repatriation of US dollars from abroad. Fears that Italy would leave the Euro in May and growing concerns of emerging market contagion from brewing debt and exchange rate crises in Argentina, Turkey and Venezuela failed to derail world financial markets.
- 3.2 Certainly emerging markets posted a second consecutive decline in sterling terms, but the (developed market only) FT World Index rebounded strongly after a weak first quarter. It rose over 7% in sterling terms with the (UK's) FTSE All Share Index rising over 9%.
- 3.3 With the US central bank raising interest rates again in June, bond market investors were less exuberant, expecting further rate rises to come. In the UK, index-linked gilts fell 1% while there was little change to conventional either gilt or investment grade bond prices.
- 3.4 The OECD's May 2018 economic outlook was entitled "Stronger growth, but risks loom large" and it maintained the overall increase in global growth from the interim outlook in March at around 3.9% for 2018 and 2019, helped by fiscal easing in many economies. The outlook has improved slightly for the UK. Strong employment and little slack in the UK economy helped increase the outlook for 2018 and 2019 by 0.1% to 1.4% and 0.2% to 1.3% respectively.
- 3.5 The current economic environment appears more positive for equities than for bonds, although the latter are gradually becoming more competitive investments. This is particularly the case in the US, the largest financial market, where short-term interest rates are now 2%, not very different from the equity dividend yield. Still, with inflation rising, real interest rates remain low. The trajectory of interest rates from here will impact both the strength of the US dollar, which affects emerging markets with dollar borrowings, and the strength of the domestic US economy, which will affect perceptions about future corporate profits growth. Meantime, back home in the UK, EU exit negotiations are a constant source of uncertainty and anxiety.

### **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 August 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>81.4%</b>
Listed equities	55%	55%	62.8%
Private Equity	5%	0%	2.6%
Multi Asset	10%	10%	9.7%
Property	10%	10%	6.3%
<b>Defensive Assets</b>	<b>20%</b>	<b>25%</b>	<b>18.7%</b>
Bonds	10%	10%	7.3%
Private Debt	0%	5%	0.3%
Infrastructure	9%	9%	6.6%
Social/Affordable Housing	1%	1%	1.0%
Other Real Income Assets	0%	0%	0.0%
Cash	0%	0%	3.5%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

*Sources: SIP & NT*

\* at 17 August 2018

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel reviewed strategy implementation and performance on 11 September 2018 with a particular focus on global equity managers. In conjunction with the internal teams at Falkirk, Fife and Lothian an investment strategy review has been initiated. Hymans Robertson are also advising 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, potential investments continue to be assessed in areas previously identified by Committee, including infrastructure, private debt and low volatility equities. As indicated last quarter, the Fund made further commitments to infrastructure and private debt. A summary of the Fund's commitments to infrastructure and other private market investments are presented in appendix 2.
- 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, subject to any revisions to strategy agreed by Committee.

## **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 rose 5.3% over the quarter, ahead of the benchmark return of 4.8%. Over the 5-year period, the Fund rose 9.9% per annum compared with the benchmark return of 8.8% 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, returns.
- 5.4 Long term return data shows Fund appreciation of 7.9% 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 rose 5.3% over the quarter to end June 2018, which was better than the benchmark return (4.8%). Over 3- and 5-year timeframes, the Fund has achieved returns above benchmark and, in absolute terms, +10.7% and +9.9% per annum respectively.
- 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, 30 June 2018

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

Rates of Return by Manager with Excess Returns - 30 June 2018							
Fund/Portfolio	Market Value £	Weight	Annualized Returns				Inception Date
			3 months	3 year	5 year	Since inception	
<b>Falkirk Council Pension Fund</b>	<b>2,391,777,487</b>	<b>100.0%</b>	<b>5.3%</b>	<b>10.7%</b>	<b>9.9%</b>	<b>7.9%</b>	<b>Sep-01</b>
Benchmark			4.8%	9.3%	8.8%	7.3%	
Excess Return			0.6%	1.3%	1.0%	0.5%	
<b>Aberdeen Portfolio</b>	<b>244,502,202</b>	<b>10.2%</b>	4.4%	12.1%	8.6%	9.3%	May-10
Benchmark			7.0%	15.3%	13.1%	11.3%	
Excess Versus Benchmark			-2.8%	-2.8%	-4.0%	-1.9%	
Excess Versus Objective			-	-5.8%	-7.0%	-4.9%	
<b>Baillie Gifford Bond Portfolio*</b>	<b>176,530,783</b>	<b>7.4%</b>	-0.4%	5.7%	6.3%	6.3%	Mar-07
Benchmark			-0.2%	5.7%	6.2%	6.4%	
Excess Versus Benchmark			-0.2%	0.1%	0.1%	-0.1%	
Excess Versus Objective			-	-0.8%	-0.8%	-1.0%	
<b>Baillie Gifford Diversified Growth**</b>	<b>236,232,633</b>	<b>9.9%</b>	-0.9%	4.9%	5.4%	5.9%	Feb-12
Benchmark			0.1%	0.4%	0.4%	0.5%	
Excess Versus Benchmark			-1.1%	4.5%	5.0%	5.4%	
Excess Versus Objective			-	-	1.5%	1.9%	
<b>Hearthstone Social</b>	<b>23,482,607</b>	<b>1.0%</b>	-2.3%	-2.2%	-	-1.8%	Nov-14
Benchmark			1.6%	4.8%	-	4.5%	
Excess Versus Benchmark			-3.8%	-6.7%	-	-6.0%	
Excess Versus Objective			-	-	-	-	
<b>In-House</b>	<b>312,289,188</b>	<b>13.1%</b>	6.0%	12.5%	10.1%	10.9%	Sep-01
Benchmark			2.0%	0.5%	0.4%	2.2%	
Excess Versus Benchmark			4.0%	11.9%	9.7%	8.5%	
Excess Versus Objective			-	-	-	-	
<b>Legal &amp; General Fundamental Weighting</b>	<b>116,451,979</b>	<b>4.9%</b>	5.5%	-	-	9.9%	Nov-16
Benchmark			5.6%	-	-	9.9%	
Excess Versus Benchmark			-0.1%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
<b>Legal &amp; General Passive</b>	<b>408,756,094</b>	<b>17.1%</b>	7.3%	13.5%	11.8%	13.4%	Jan-09
Benchmark			7.4%	13.4%	11.8%	13.3%	
Excess Versus Benchmark			-0.1%	0.1%	0.1%	0.1%	
Excess Versus Objective			-0.1%	0.1%	0.1%	0.1%	
<b>Newton</b>	<b>396,777,927</b>	<b>16.6%</b>	8.3%	14.3%	13.0%	10.4%	Jun-06
Benchmark			6.8%	14.7%	12.8%	9.5%	
Excess Versus Benchmark			1.3%	-0.4%	0.2%	0.8%	
Excess Versus Objective			-	-	-2.8%	-2.2%	
<b>Schroders UK Equity</b>	<b>322,811,437</b>	<b>13.5%</b>	10.1%	10.9%	10.5%	9.5%	Sep-01
Benchmark			9.2%	9.6%	8.8%	7.3%	
Excess Versus Benchmark			0.8%	1.2%	1.5%	2.0%	
Excess Versus Objective			-	-0.1%	0.3%	0.8%	
<b>Schroders Property</b>	<b>153,942,639</b>	<b>6.4%</b>	2.0%	7.9%	10.2%	4.4%	Nov-05
Benchmark			2.0%	7.6%	10.6%	4.4%	
Excess Versus Benchmark			0.0%	0.3%	-0.4%	0.0%	
Excess Versus Objective			-	-0.5%	-1.2%	-0.8%	

### 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 slightly different performance for Baillie Gifford than the manager itself. This is due to an intra-day valuation timing difference.
- 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 – PRIVATE MARKET COMMITMENTS

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.
Grosvenor Capital	121,185	31,927	98,615	49,784	75,626	125,410	1.27
In House Infrastructure	96,755	19,533	77,222	17,921	80,826	98,747	1.28
<b>Infrastructure</b>	<b>217,940</b>	<b>51,460</b>	<b>175,837</b>	<b>67,705</b>	<b>156,452</b>	<b>224,157</b>	<b>1.27</b>
SL Capital Partners	90,202	10,201	80,001	77,687	32,375	110,062	1.38
Wilshire Associates	73,311	9,521	63,790	66,181	34,192	100,373	1.57
<b>Private Equity</b>	<b>163,513</b>	<b>19,722</b>	<b>143,791</b>	<b>143,868</b>	<b>66,567</b>	<b>210,435</b>	<b>1.46</b>
<b>Affordable Housing</b>	<b>30,000</b>	<b>3,850</b>	<b>26,150</b>	<b>1,351</b>	<b>23,482</b>	<b>24,833</b>	<b>0.95</b>
<b>Debt/Loans</b>	<b>56,052</b>	<b>40,251</b>	<b>15,801</b>	<b>16,681</b>	<b>2,127</b>	<b>18,808</b>	<b>1.19</b>
<b>Total</b>	<b>467,505</b>	<b>115,283</b>	<b>361,579</b>	<b>229,605</b>	<b>248,628</b>	<b>478,233</b>	

Allocation to Private Equity  
(based on unfunded commitment plus market value) 3.6%

Allocation to Private Equity  
(based on market value only) 2.8%

Allocation to Infrastructure  
(based on unfunded commitment plus market value) 8.6%

Allocation to Infrastructure  
(based on market value only) 6.5%



## APPENDIX 3 – INVESTMENT MANAGER ALLOCATIONS AND OBJECTIVES

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