



Agenda Item 9

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: 26 September 2019

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 (JISP) of the Falkirk, Fife and Lothian Pension Funds. An update on the Panel meeting on 10 September 2019 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 2019 and;
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel (JISP).

3. Market Review and Outlook

- 3.1 The second quarter of 2019 saw financial markets maintain positive momentum from the first quarter. Global equities rose by +6.1% in sterling terms. Sterling bond markets delivered positive returns with fixed and index-linked gilts returning +1.3% and +2.0% respectively, while investment grade bonds returned +2.0%.

- 3.2 In the US, GDP growth was higher than expected at +2.1% for the quarter (year on year), but slower than +3.1% in Q1. Manufacturing indicators have weakened as uncertainty around US/China trade persists, but employment and wage indicators remained relatively strong.
- 3.3 In the UK, GDP unexpectedly fell by 0.2% quarter on quarter. Manufacturing and construction indicators were particularly weak, with industrial output experiencing the largest decline in manufacturing since 2009 amid high inventory levels and ongoing Brexit uncertainty. The fall in manufacturing output was also driven by the partial closures of several car plants. Despite this backdrop, UK employment, earnings and inflation indicators remained robust, with CPI steady at 2.1% year on year.
- 3.4 European GDP grew by +0.2% quarter on quarter in Q2, following growth of +0.5% in Q1. Italian growth was flat: over 6 quarters Italy has grown by just +0.1%. Germany's economy contracted by 0.1% in Q2, having narrowly avoided recession in 2018.
- 3.5 Markets continue to expect looser monetary policy as global manufacturing activity has contracted, although inflation trends are firmer than the "Japanification" theme suggests, particularly in the US and UK. Following the end of the quarter, bond yields fell sharply as recession fears came to the fore and, in September, the ECB announced a renewal of quantitative easing and a further reduction to already negative bank deposit rates. The global economic outlook remains uncertain.

4. Fund Strategy

- 4.1 The Fund's strategic asset allocation was approved by the Pensions Committee in December 2018. It is presented in table 1 with the target weighting for each of the 5 policy groups and ranges around the target strategy within which the Chief Finance Officer is permitted to operate. The policy groups are presented in the order of most to least volatile and highest to lowest expected real return over the long term. 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.

Table 1

Policy Group	Minimum	Strategy	Maximum
Equities	45%	60%	65%
Real Assets	10%	20%	25%
Non-Gilt Debt	0%	15%	25%
Gilts	0%	5%	20%
Cash	0%	0%	10%
Total		100%	

- 4.2 The Fund has continued to make investments in areas previously identified by Committee to move towards its strategic allocation. Additional work is also underway to create a framework that should reduce funding level volatility by making asset allocation level changes. A summary of the Fund's commitments to infrastructure and other private market investments is shown in Appendix 2.

- 4.3 Table 2 below presents the current policy group allocations along with the investment mandates that populate those groups. The current allocations will evolve gradually to the target allocations as appropriate investments become available.

Table 2

16 August 2019		Permitted	Strategy	Actual	
£2,569m	Manager	Range (%)	Allocation	Allocation	Deviation
EQUITIES (Gilts +3.5%pa)					
Passive Equity (UK 36%/O'seas 64%)	L&G			17.6%	
Fundamental Weighting Global Equity	L&G			5.0%	
Active UK Equity	Schroder			10.6%	
Active Global Equity	Newton			17.0%	
Active Global Equity	L&G			10.1%	
<i>Listed Equity Subtotal</i>				60.2%	
Private Equity LPs	Wilshire/SL Capital			2.1%	
<i>Private Equity Subtotal</i>				2.1%	
Total Equities		45 - 65	60%	62.4%	2.4%
REAL ASSETS (Gilts +2.5%pa)					
Property Multi-Manager	Schroder			5.7%	
Property (Affordable Housing)	Hearthstone			0.9%	
Infrastructure FoF	Grosvenor Capital			2.8%	
Infrastructure LPs	Various			5.8%	
Total Real Assets		10 - 25	20%	15.1%	-4.9%
NON-GILT DEBT (Gilts +1%pa)					
Liquid Credit (Corporate Bonds/Loans)	Baillie Gifford/M&G			3.9%	
Illiquid Credit (Private Debt/Loans)	Various			0.9%	
Total Non-Gilt Debt		0 - 25	15%	4.7%	-10.3%
GILTS					
Gilts (60% nominal/40% index-linked)	Baillie Gifford			3.7%	
Total Gilts		0 - 20	5%	3.7%	-1.3%
CASH (7-day LIBID)					
Cash	Various			4.5%	
Total Cash		0 - 10	0%	4.5%	4.5%
DIVERSIFIED GROWTH					
Diversified Growth	Baillie Gifford			9.5%	
Total Diversified Growth				9.5%	9.5%
TOTAL				100%	

Sources: NT/Committee Papers

5. Fund Returns

- 5.1 The Chief Finance Officer and JISP noted the rates of return achieved by the Fund and its managers at the Panel's latest meeting. 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 JISP 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 increased by 3.3% over the quarter, just behind the benchmark return, which rose by 3.6%. Over the 5-year period, the Fund rose 9.3% per annum compared with the benchmark return of 8.1% 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). Overseas equity and UK property assets generated strong returns while bond and UK equity assets provided more modest, but still respectable, returns. The Baillie Gifford Diversified Growth Fund was the lowest returning allocation within the portfolio over 5 years, returning 4.6% per annum.
- 5.4 Long term return data shows Fund appreciation of 7.8% 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 estimate from the Fund's actuary at 31 March 2019 indicated a funding level of 93.4%, an improvement from the 31 March 2017 valuation position of 92%. However, given the decline in bond yields to September 2019, we estimate the current funding level is likely to have fallen again.

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 JISP 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 Sharefile 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 more defensive assets. The Fund has increased the cash level as an interim step and further changes will be implemented over the coming quarters based on the new investment strategy.
- 7.2 The positive return of +3.3% for the Fund during Q2 2019 (which was just behind benchmark) follows on from the strong return of +6.5% over the quarter to end March 2019. Over 3- and 5-year timeframes, the Fund has achieved

returns above benchmark and, in absolute terms, +9.6% and +9.3% per annum respectively.

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

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Date: 16 September 2019

Appendices

Appendix 1 – Performance Measurement (Rates of Return)

Appendix 2 – Private Markets Commitments

Appendix 3 – Mandate Benchmarks and Objectives

List of Background Papers

Northern Trust – Investment Risk & Analytical Services, 30 June 2019

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 June 2019							
Fund/Portfolio	Market Value £	Weight	Annualised Returns				Inception Date
			3 months	3 year	5 year	Since inception	
Falkirk Council Pension Fund	2,548,353,468	100.0%	3.3%	9.6%	9.3%	7.8%	Sep-01
Benchmark			3.6%	8.5%	8.1%	7.2%	
Excess Return			-0.3%	1.0%	1.1%	0.5%	
Aberdeen Portfolio	1,431,335	0.1%	3.8%	10.2%	8.8%	9.1%	May-10
Benchmark			4.2%	13.3%	12.8%	11.0%	
Excess Versus Benchmark			-0.3%	-2.7%	-3.6%	-1.7%	
Excess Versus Objective			-	-5.7%	-6.6%	-4.7%	
Baillie Gifford Bond Portfolio*	188,581,295	7.4%	2.4%	4.4%	6.5%	6.3%	Mar-07
Benchmark			1.8%	3.9%	6.5%	6.4%	
Excess Versus Benchmark			0.5%	0.5%	0.0%	-0.1%	
Excess Versus Objective			-	-0.4%	-0.9%	-1.0%	
Baillie Gifford Diversified Growth**	243,043,120	9.5%	1.1%	5.8%	4.6%	5.4%	Feb-12
Benchmark			0.2%	0.5%	0.5%	0.5%	
Excess Versus Benchmark			1.0%	5.3%	4.1%	4.9%	
Excess Versus Objective			-	-	0.6%	1.4%	
Hearthstone Social	24,120,998	0.9%	2.7%	-0.4%	-	-0.2%	Nov-14
Benchmark			2.1%	5.3%	-	4.6%	
Excess Versus Benchmark			0.6%	-5.3%	-	-4.6%	
Excess Versus Objective			-	-	-	-	
In-House	327,222,110	12.8%	1.8%	10.2%	12.0%	10.9%	Sep-01
Benchmark			2.2%	1.5%	1.0%	2.3%	
Excess Versus Benchmark			-0.3%	8.6%	10.8%	8.4%	
Excess Versus Objective			-	-	-	-	
Legal & General Fundamental Weighting	124,007,112	4.9%	5.4%	-	-	8.6%	Nov-16
Benchmark			5.4%	-	-	8.6%	
Excess Versus Benchmark			0.0%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
Legal & General Passive	436,339,995	17.1%	5.3%	12.4%	11.0%	12.8%	Jan-09
Benchmark			5.3%	12.3%	10.9%	12.7%	
Excess Versus Benchmark			0.0%	0.0%	0.1%	0.1%	
Excess Versus Objective			0.0%	0.0%	0.1%	0.1%	
Newton	456,306,659	17.9%	7.8%	12.5%	14.5%	10.7%	Jun-06
Benchmark			6.1%	13.5%	12.8%	9.5%	
Excess Versus Benchmark			1.6%	-0.9%	1.5%	1.1%	
Excess Versus Objective			-	-	-1.5%	-1.9%	
Private Debt	20,480,378	0.8%	4.7%	-	-	3.4%	Jul-18
Benchmark			1.2%	-	-	4.9%	
Excess Versus Benchmark			3.4%	-	-	-1.4%	
Excess Versus Objective			-	-	-	-5.4%	
Schroders UK Equity	306,288,887	12.0%	-1.3%	9.0%	6.3%	8.6%	Sep-01
Benchmark			3.3%	9.0%	6.3%	6.9%	
Excess Versus Benchmark			-4.4%	0.0%	0.0%	1.6%	
Excess Versus Objective			-	-1.3%	-1.2%	0.3%	
Schroders Property	158,380,358	6.2%	0.3%	6.2%	8.1%	4.3%	Nov-05
Benchmark			0.6%	6.4%	8.3%	4.4%	
Excess Versus Benchmark			-0.3%	-0.2%	-0.2%	-0.1%	
Excess Versus Objective			-	-0.9%	-1.0%	-0.8%	
Global Low Volatility Equity	262,151,220	10.3%	-	-	-	1.1%	Jun-19
Benchmark			-	-	-	2.0%	
Excess Versus Benchmark			-	-	-	-0.9%	
Excess Versus Objective			-	-	-	-	

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).
- Private debt total returns are not meaningful until underlying funds are fully invested.

APPENDIX 2 – PRIVATE MARKET COMMITMENTS

Falkirk Council Pension Fund Limited Partnerships	Market Value 31/03/2019 (£m)	Market Value 30/06/2019 (£m)	% of Fund	Fundings Q2, 2019 (£m)	Distributions Q2, 2019 (£m)	Unfunded Commit (£m)	Unfunded Commit % of Fund	Comment - Q2, 2019
In House Infrastructure	118.3	139.1	5.5%	32.6	14.4	23.6	0.9%	Investment in 5 new funds
Global Infrastructure	66.7	68.9	2.7%	-	-	31.2	1.2%	Adjusted commitment for CIS II
Private Equity	57.6	53.3	2.1%	0.4	7.1	16.4	0.6%	
Affordable Housing	24.1	24.1	0.9%	-	0.5	3.9	0.2%	
Private Debt	18.4	21.4	0.8%	2.3	0.1	41.1	1.6%	
Total Limited Partnerships	285.1	306.8	12.0%	35.3	22.1	116.2	4.6%	

APPENDIX 3 – MANDATE BENCHMARKS AND OBJECTIVES

Fund Manager	Benchmark	Objective
Listed Equities Active		
Newton Inv Management	MSCI All Countries World Index	To outperform the benchmark by 3% pa net of fees over rolling 5 year period
Schroders UK Equity	FTSE All Share Index	To outperform the benchmark by 1.25% pa net of fees over rolling 3 year period
Legal and General Low Volatility	MSCI All Countries World Index	To achieve a better risk-adjusted return than the benchmark over a full market cycle
Listed Equities Passive		
Legal and General	Composite of Regional Indices	To perform in line with the benchmark over all periods
Legal and General Fundamental Weighting	FTSE RAFI All World 3000	To perform in line with the benchmark over all periods
Private Equity/Debt		
Wilshire Capital	MSCI World Index	To outperform the benchmark by 5% pa net over the life cycle of the fund
Standard Life Capital	MSCI Europe Index	To outperform the benchmark by 5% pa net over the life cycle of the fund
M&G Investments	FT 7 day Sterling LIBID Index	To outperform the benchmark by 5% pa net over the life cycle of the fund
Internal	3 month LIBOR	To outperform the benchmark by 4% pa net over the life cycle of the funds
Property		
Schroders	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		
Baillie Gifford Diversified Growth	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		
Baillie Gifford	50% Merrill Lynch Stirling 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		
Grosvenor	RPI	To achieve a net return of 10% over the life cycle of the funds
Internal	RPI	RPI Index +3.5% pa
Social/Affordable Housing		
Hearthstone	RPI	RPI Index +2% pa