Agenda Item

9

Market Review and Fund Manager Performance

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FALKIRK COUNCIL

Subject: **Market Review and Fund Manager Performance**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **8 December 2016**

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. This paper reports on Manager activities for the most recently completed quarter.

2. Recommendations

2.1 The Committee and Board are asked to note:-

(i) the Managers' performance for the period ending 30 September 2016, and

(ii) the actions taken by Managers during the quarter to 30 September 2016 in accordance with their investment policies.

3. Background

3.1 The rates of return achieved by the Fund's managers are measured against pre-determined benchmarks, as calculated by the Fund Custodian, Northern Trust.

3.2 The following benchmarks are in place to measure performance:

- Aberdeen Asset Management (AAM) – MSCI All Countries World Index
- Baillie Gifford Bonds (BGB) – a customised benchmark comprising UK Fixed Interest and UK Index Linked Bonds
- Baillie Gifford Diversified Growth (BGDG) – UK base rate
- Legal & General (L&G) – a customised benchmark comprising UK and Overseas Equities
- Newton Investment Management (NIM) – the MSCI AC World (NDR) Index
- Schroder Investment Management (SIM)
  (i) UK Equities – the FTSE All Share Index
  (ii) Property – HSBC/APUT Pooled Property Fund Indices

3.3 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.

4. Market Review and Outlook

4.1 The third quarter of 2016 was affected by the aftermath of the surprise UK Brexit vote and the build up to the November US Presidential Election. Equity markets performed well in Sterling terms as Sterling's trade weighted index fell a further 4% during the quarter. Bond markets, especially the UK, began the quarter strongly as the MPC reduced the bank rate and restarted QE in August. In Sterling terms, most developed stock markets returned around 8-10% during the quarter.

4.2 The bond market rally during the quarter resulted in conventional gilts returning 2.3% while index-linked gilts returned 11.0%. In the credit markets, investment grade bonds returned 6.0% and high yield bonds returned 4.1%.

4.3 During Q3 2016, the US Federal Reserve left monetary policy unchanged despite growing tightness in the labour market. The fall-out from the Brexit vote and the upcoming US Presidential Election militated against a tightening. In the UK, the MPC cut the bank rate to a record low of 0.25% in August and restarted QE. The European Central Bank (ECB) and the Bank of Japan maintained negative repo rates and continued their QE programmes.

4.4 The fundamental outlook for the global economy is for steady developed market growth while emerging market growth remains weak. The outlook for global equity and bond markets depended on the outcome of the US Election. The Trump Presidency will cause an increase in asset price volatility. US reflation should support equities, be negative for US bonds and support the USD. However, increased protectionism would be negative for global growth, global equities and raise the risk of a global recession.

5. Analysis of Performance Results

5.1 The total fund and individual external manager returns are shown in the table in Appendix 1. The returns for the quarter ending 30 September 2016 are shown, but this is a very short period to measure performance. It simply reflects the regular reporting cycle. Each manager has been set its own individual investment objective, which depends on the type of mandate awarded. Each active manager is tasked with outperforming its benchmark over either three or five year periods. The table in Appendix 1 incorporates the relevant return and benchmark data and the excess return relative to the manager's benchmark and outperformance objective. More detail on individual manager mandates and objectives can be found in Appendix 2.

5.2 The overall Fund's return of +6.1% over the quarter was ahead of the benchmark return by +0.6%. Over the 3 year period, the Fund rose +10.5% per annum compared with the benchmark return of +9.1% per annum, an excess return of +1.4% per annum. Over the 3 year period, the Fund benefited from double digit returns from global equities, bonds and the commercial property market in the UK. Notable positive contributions from managers were NIM's outperformance in global equities and BGDF, whose relative performance was very strong, but whose absolute returns lagged those of the major asset classes. Long term return data shows Fund appreciation of +12.3% per annum over 5 years and +7.8% per annum since September 2001. These long term returns are above the benchmark returns.

5.3 Over the third quarter of 2016, the returns of the Fund's three active equity managers ranged from +6.0% to +8.5%. SIM outperformed while AAM and NIM underperformed their respective benchmarks. The Fund's passive equity manager, L&G, produced a return of +8.4%, in line with its benchmark return, and so consistent with its mandate.

The return from BG's bond mandate was +6.8%, ahead of its benchmark return. BG's other mandate, the Diversified Growth portfolio, rose +4.8%, which was ahead of its cash benchmark.

The property portfolio managed by SIM rose +0.1%, ahead of its benchmark by +0.8%.

5.4 Longer term return data shows that SIM's UK equity portfolio is below its objective of +1.25% per annum above the benchmark over the 3 year period, but it remains comfortably ahead over 5 years and since inception.

NIM's global equity mandate stipulates an objective of +3% per annum above the benchmark over 5 year rolling periods. Returns over the past 5 years and since inception have beaten the benchmark comfortably, but they have not achieved the objective.

The AAM mandate's objective is +3% per annum outperformance over 3 year rolling periods. Performance is lagging the benchmark and the objective by a wide margin over 3 years and since inception.

The performance of BG's bond mandate is slightly below its benchmark since inception in 2007. Over the 3 year period, the mandate is above benchmark but below the objective of +0.9% per annum.

SIM's property performance has been disappointing in recent years, and this reversed positive results in the early years of the mandate. The last 3 year period has been more positive in absolute terms (+11.1% per annum), validating the allocation to property, but the portfolio has performed less well than the benchmark and objective of +0.75% per annum.

6. Conclusion

6.1 The anxiety about the potential impact of Brexit largely dissolved over the quarter and most assets staged a strong recovery. This was supported by central bank action where the Bank of England cut interest rates in the aftermath of the referendum. Sterling bond markets also had a quarter of strong performance as investors anticipated rates staying low in response to the prospect of lower economic growth from Brexit. Corporate Bonds performed even better as the Bank renewed its quantitative easing programme and widened its remit to include investment grade corporate bonds.

6.2 The quarter saw a total Fund return of 6.1% ahead of the Fund's benchmark of 5.5%. The 3 and 5 year positions were also ahead of benchmark. There was outperformance during the quarter from the two Baillie Gifford mandates and from the Schroder UK Equities and Property mandates. Aberdeen, whose performance remains under scrutiny had a poor quarter and remain substantially behind benchmark over all time periods. Aberdeen are scheduled to report to the March 2017 Committee at which time further consideration will be given as to their retention or otherwise.

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pp Director of Corporate & Housing Services

Authors:

Alastair McGirr, Pensions Manager
01324 506333 alastair.mcgirr@falkirk.gov.uk

Bruce Miller, Chief Investment Officer
0131 469 3866 bruce.miller@edinburgh,.gov.uk

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Appendices

Appendix 1 – Performance Measurement (Rates of Return)

List of Background Papers:

1. Northern Trust – Investment Risk & Analytical Services, 30 Sept. 2016

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 September 2016							
			Returns				
Manager	**Market Value £**	**Weight**	**3 months**	**3 year**	**5 year**	**Since inception**	**Inception Date**
Aberdeen Portfolio	262,494,000	12.9%	6.0%	8.7%	11.5%	9.1%	May-10
Benchmark			8.5%	13.8%	15.4%	10.8%	
Excess Versus Benchmark			**-2.4%**	**-4.5%**	**-3.4%**	**-1.5%**	
Excess Versus Objective			-	**-7.5%**	**-6.4%**	**-4.5%**	
Baillie Gifford Bond Portfolio*	177,176,870	8.7%	6.8%	10.5%	9.4%	7.5%	Mar-07
Benchmark			5.9%	10.2%	8.5%	7.7%	
Excess Versus Benchmark			**0.9%**	**0.2%**	**0.8%**	**-0.2%**	
Excess Versus Objective			**-**	**-0.7%**	**-0.1%**	**-1.1%**	
Baillie Gifford Diversified Growth**	215,389,346	10.5%	4.8%	5.5%	**-**	6.0%	Feb-12
Benchmark			0.1%	0.5%	**-**	0.5%	
Excess Versus Benchmark			**4.8%**	**5.0%**	**-**	**5.5%**	
Excess Versus Objective			**-**	**-**	**-**	**2.0%**	
Legal & General	432,114,632	21.2%	8.4%	11.6%	14.2%	13.7%	Jan-09
Benchmark			8.4%	11.4%	14.1%	13.6%	
Excess Versus Benchmark			**0.0%**	**0.1%**	**0.1%**	**0.1%**	
Excess Versus Objective			**0.0%**	**0.1%**	**0.1%**	**0.1%**	
Newton	343,536,062	16.8%	7.2%	16.9%	17.3%	10.7%	Jun-06
Benchmark			8.4%	13.7%	15.3%	9.0%	
Excess Versus Benchmark			**-1.1%**	**2.8%**	**1.7%**	**1.5%**	
Excess Versus Objective			-	-	**-1.3%**	**-1.5%**	
Schroders UK Equity	256,604,184	12.6%	8.5%	6.6%	14.7%	9.0%	Sep-01
Benchmark			7.8%	6.6%	11.1%	6.9%	
Excess Versus Benchmark			**0.7%**	**0.0%**	**3.3%**	**1.9%**	
Excess Versus Objective			-	**-1.2%**	**2.0%**	**0.7%**	
Schroders Property	143,602,366	7.0%	0.1%	11.1%	7.7%	3.7%	Nov-05
Benchmark			-0.7%	11.4%	8.0%	3.6%	
Excess Versus Benchmark			**0.8%**	**-0.3%**	**-0.3%**	**0.0%**	
Excess Versus Objective			-	**-1.0%**	**-1.1%**	**-0.7%**	
Total Fund	2,042,375,650	100.0%	6.1%	10.5%	12.3%	7.8%	Sep-01
Benchmark			5.5%	9.1%	10.6%	7.3%	
Excess Return			**0.6%**	**1.2%**	**1.5%**	**0.5%**	

* Baillie Gifford Bond Portfolio Q3 Manager return 5.99%
** Baillie Gifford Diversified Growth Portfolio Q3 Manager return 4.6%

*** Note that 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.