

The background of the slide features a large, light blue watermark of the Coat of Arms of the Government of Yukon. The crest includes a crown with four maple leaves, a shield divided into four quadrants (top-left: a diagonal cross, top-right: a stag's head, bottom-left: a sailing ship, bottom-right: an eagle), and a ribbon at the bottom with the motto "A NE FOR A".

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: 7 December 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. An update on the Panel meeting of 1 December 2017 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 September 2017; and**
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.**

3. Market Review and Outlook

- 3.1 The third quarter of 2017 was generally a positive quarter for higher risk assets, with commodities and emerging market equities being two of the strongest performers. Most equity markets delivered solid returns. Emerging market equities returned +8% and US equities returned +4.3% (both in USD), while UK equities returned +2.3%. Overseas equity returns to UK investors were moderated by currency, as sterling strengthened against the dollar during September by +3%.
- 3.2 Bond yields in most major markets traded in the same narrow range as they have for most of 2017. 10-year bond yields ended the quarter marginally higher in the US and UK. A rise in yields in September was most notable in the UK (alongside a strengthening pound), following comments from Bank of England Governor Mark Carney indicating that the UK base rate would be increased at the November MPC meeting. Against this backdrop, conventional gilt returns were modestly negative at -0.5% and index-linked gilts returned -0.8%. Continued positive sentiment on growth led to high yield bonds returning +1.9%, while investment grade credit returned +0.1%. Credit spreads remain at or close to their lowest levels since the financial crisis of 2008/2009.
- 3.3 In its latest September 2017 projection, the Organisation for Economic Co-operation and Development (OECD) raised its forecast for 2017 global GDP growth to 3.7% (from 3.6% in its June 2017 outlook), with its 2018 forecast unchanged at 3.6%. The main changes were upgrades in Europe, Japan and Canada, partially offset by a sharp downgrade for India, while annual forecasts for UK GDP growth were unchanged. Positive sentiment and economic data from the Euro area alongside an improving picture in the US, contrasted with the UK outlook.
- 3.4 In the UK, the November increase in the base rate reverses the rate cut from August 2016, which many saw as an emergency measure (and possibly unnecessary). The minutes from the November MPC meeting maintain the largely cautious tone that has been in place for much of the year. Ongoing uncertainty around the Brexit process - highlighted by the £3bn Brexit fund allocation in the November budget - remains the major risk for the UK economy.
- 3.5 US policy is important for world asset prices and it seems to be supportive for equities but negative for bonds at this point. This is because better-than-expected economic data in the US has already prompted the central bank to increase interest rates and more recently has supported an increase in the market implied probability of a further rate rise in December. Although there is considerable uncertainty around the ability of the Trump administration to enact policy, with tax reform being the current focus, the economy continues on a moderate growth path, which should be good for equities unless monetary policy becomes too tight. European developments will also be important, and for now continued positive economic momentum is supportive of equity asset prices, but is likely to support further tapering of the ECB quantitative easing programme.

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 3 November 2017.

Table 1

Asset Class	Previous Strategic Allocation	Current* Strategic Allocation	Current* Actual Allocation
Growth Assets	80%	75%	81.4%
Listed equities	55%	55%	61.8%
Private Equity	5%	0%	2.9%
Multi Asset	10%	10%	10.3%
Property	10%	10%	6.3%
Defensive Assets	20%	25%	18.6%
Bonds	10%	10%	7.7%
Private Debt	0%	5%	0.1%
Infrastructure	9%	9%	5.9%
Social/Affordable Housing	1%	1%	1.1%
Other Real Income Assets	0%	0%	0.0%
Cash	0%	0%	3.8%
Total	100%	100%	100%

* at 3 November 2017

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel reviewed strategy implementation and performance on 1 December 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 +1.7% over the quarter was ahead of the benchmark return by 0.2%. Over the 3-year period, the Fund rose 10.6% per annum compared with the benchmark return of 9.3% per annum. Over the 3-year period, the Fund benefited from double digit returns from global equities, which were higher than single digit UK equity returns, partly due to sterling weakness against overseas currencies. Fixed income returns were respectable, particularly for long-dated index-linked and conventional gilts, which achieved high single digit annualised gains. Likewise, the UK commercial property market returned approximately 9% per annum over the past 3 years.
- 5.4 Long term return data shows Fund appreciation of 11.3% 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. One of the key drivers of change in liabilities is the index-linked gilt yield, a proxy used to discount the future value of the liabilities to the present day. It has been the case for many years that falling gilt yields have put pressure on the funding level. An actuarial valuation is currently underway and an update is being provided to the Pensions Committee at this meeting. The valuation will entail reassessing financial and demographic assumptions in light of the inter-valuation experience between 2014 and 2017.

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 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 quarter to end September 2017 saw a total Fund return of 1.7% against the Fund benchmark of 1.5%. The 3 and 5 year positions also remain 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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Director of Corporate & Housing Services

Authors:

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)

Appendix 2 – Alternatives Portfolio Update

Appendix 3 - Benchmarks and Objectives

List of Background Papers

Northern Trust – Investment Risk & Analytical Services, 30 September 2017

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 September 2017							
Fund/Portfolio	Market Value £	Weight	Returns				Inception Date
			3 months	3 year	5 year	Since inception	
Falkirk Council Pension Fund	2,254,140,906	100.0%	1.7%	10.6%	11.3%	7.9%	Sep-01
Benchmark			1.5%	9.3%	9.7%	7.4%	
Excess Return			0.2%	1.1%	1.5%	0.5%	
Aberdeen Portfolio	234,969,786	10.4%	0.8%	10.0%	10.5%	9.6%	May-10
Benchmark			2.0%	15.1%	15.0%	11.4%	
Excess Versus Benchmark			-1.1%	-4.4%	-3.9%	-1.6%	
Excess Versus Objective			-	-7.4%	-6.9%	-4.6%	
Baillie Gifford Bond Portfolio*	173,525,908	7.7%	-0.2%	6.5%	6.4%	6.6%	Mar-07
Benchmark			-0.2%	6.9%	6.0%	6.7%	
Excess Versus Benchmark			0.1%	-0.4%	0.4%	-0.2%	
Excess Versus Objective			-	-1.3%	-0.5%	-1.1%	
Baillie Gifford Diversified Growth**	232,471,618	10.3%	0.8%	5.6%	6.2%	6.3%	Feb-12
Benchmark			0.1%	0.4%	0.4%	0.5%	
Excess Versus Benchmark			0.7%	5.1%	5.7%	5.9%	
Excess Versus Objective			-	-	2.2%	2.4%	
Hearthstone Social	25,449,227	1.1%	2.3%	-	-	-0.9%	Nov-14
Benchmark			1.5%	-	-	4.3%	
Excess Versus Benchmark			0.7%	-	-	-5.0%	
Excess Versus Objective			-	-	-	-	
In-House	273,604,198	12.1%	1.6%	12.1%	10.7%	10.9%	Sep-01
Benchmark			0.0%	0.3%	0.3%	2.2%	
Excess Versus Benchmark			1.6%	11.8%	10.4%	8.5%	
Excess Versus Objective			-	-	-	-	
Legal & General Fundamental Weighting	111,128,836	4.9%	2.8%	-	-	11.1%	Nov-16
Benchmark			2.8%	-	-	11.1%	
Excess Versus Benchmark			0.1%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
Legal & General Passive	382,901,427	17.0%	2.2%	13.2%	13.8%	13.8%	Jan-09
Benchmark			2.1%	13.1%	13.6%	13.7%	
Excess Versus Benchmark			0.0%	0.1%	0.1%	0.1%	
Excess Versus Objective			0.0%	0.1%	0.1%	0.1%	
Newton	369,942,824	16.4%	0.6%	15.6%	15.0%	10.4%	Jun-06
Benchmark			1.8%	14.7%	14.8%	9.5%	
Excess Versus Benchmark			-1.2%	0.8%	0.2%	0.8%	
Excess Versus Objective			-	-	-2.8%	-2.2%	
Schroders UK Equity	294,430,011	13.1%	3.9%	9.5%	13.2%	9.3%	Sep-01
Benchmark			2.1%	8.5%	10.0%	7.2%	
Excess Versus Benchmark			1.7%	1.0%	2.9%	2.0%	
Excess Versus Objective			-	-0.2%	1.6%	0.7%	
Schroders Property	155,717,072	6.9%	3.3%	8.8%	9.2%	4.1%	Nov-05
Benchmark			2.4%	8.9%	9.5%	4.1%	
Excess Versus Benchmark			0.9%	-0.1%	-0.2%	0.0%	
Excess Versus Objective			-	-0.9%	-1.0%	-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 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 - 30/09/17

Exchange Rates	
\$	1.3417
€	1.1349

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.
Private Equity	153,144	21,276	131,868	120,772	66,459	187,232	1.42
Infrastructure	219,252	71,131	148,121	38,031	127,942	165,974	1.12
Debt/Loans	15,801	0	15,801	16,199	2,610	18,809	1.19
Social/Affordable Housing	30,000	3,850	26,150	893	24,504	25,397	0.97
	£418,197	£96,257	£321,940	£175,895	£221,515	£397,412	

Allocation to Private Equity
(based on unfunded commitment plus market value) 3.9%

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

Allocation to Infrastructure
(based on unfunded commitment plus market value) 8.8%

Allocation to Infrastructure
(based on market value only) 5.6%

Appendix 3

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