

The background of the slide features a large, light blue watermark of the University of Toronto crest. The crest is a shield divided into four quadrants. The top-left quadrant shows a building, the top-right shows a stag's head with antlers, the bottom-left shows a three-masted sailing ship, and the bottom-right shows an eagle with wings spread. Above the shield is a crown with four floral motifs. 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: 15 March 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 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 12 March 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 December 2017; and**
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.**

**3. Market Review and Outlook**

- 3.1 The fourth quarter of 2017 was a positive quarter for most growth assets. Global equities delivered strong returns (+5% overall) with emerging market equities and US equities the strongest regional performers, returning +6.6% and +5.6%, respectively. Commodities also delivered strong returns of +4.7%, underpinned by a rising oil price which ended

the quarter at just under \$60 a barrel. UK equities performed broadly in line with global equities, returning +4.9% for the quarter.

- 3.2 10-year bond yields in most major markets continued to trade in the same narrow range as they had for most of 2017. In November, the Bank of England increased the base rate as expected, though this was accompanied by commentary suggesting that further rate rises were less imminent given the Bank's cautious outlook for the UK economy. In December, the US Federal Reserve also raised rates, its third rise in 2017, though this again was also largely anticipated by markets. In the UK, index-linked gilts returned +3.9% for the quarter as real yields fell, outperforming conventional gilts which rose +2.0%. Investment grade bonds benefited from the fall in yields over the quarter, returning +1.8%, outperforming high yield bonds which rose +0.9%. While bond returns for Q4 2017 were positive, bond markets have weakened early in 2018, as stronger US inflation data has pushed up expectations that US rates (and global bond yields) may rise faster than previously anticipated.
- 3.3 In its latest November 2017 projection, the OECD marginally raised its forecasts for global GDP growth for 2017 and 2018 to 3.6% and 3.7%, respectively. 2017 has seen positive sentiment and economic data from the Euro area, but the OECD expects this to weaken in 2018. In contrast, the US is expected to see stronger growth in 2018 while the UK outlook has weakened further.
- 3.4 In the minutes of its November Monetary Policy Committee (MPC) meeting, the Committee members "agreed that any future increases... would be expected to be at a gradual pace and to a limited extent". However, the tone of commentary changed in the MPC's February 2018 Inflation Report, where Mark Carney stated that "monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than it anticipated at the time of the November Report". This is subject to the Bank's central projections eventuating, including continued strength in UK exports and investment, in addition to ongoing labour market tightening and UK wage growth.
- 3.5 US policy remains important for world asset prices. In 2017 it was seen as being supportive for equities and negative for bonds. But recent US policy announcements of tariffs on steel and aluminium imports have confirmed Mr Trump's protectionist credentials and unnerved investors with the prospect of a developing trade war. Alongside heightened expectations for an increased pace in monetary policy tightening by the central banks, including the US Fed and the Bank of Japan, the current outlook is as uncertain as it has been for some time. Whether the global economy can maintain a reasonable growth rate against the various headwinds that appear to be developing remains to be seen.

#### **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 16 February 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>81.6%</b>
Listed equities	55%	55%	62.0%
Private Equity	5%	0%	2.8%
Multi Asset	10%	10%	10.4%
Property	10%	10%	6.5%
<b>Defensive Assets</b>	<b>20%</b>	<b>25%</b>	<b>18.4%</b>
Bonds	10%	10%	7.5%
Private Debt	0%	5%	0.1%
Infrastructure	9%	9%	6.3%
Social/Affordable Housin	1%	1%	1.1%
Other Real Income Asset:	0%	0%	0.0%
Cash	0%	0%	3.5%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

\* at 16 February 2018

- 4.2 The Chief Finance Officer and the Joint Investment Strategy Panel will review strategy implementation and performance on 12 March 2018 and, in conjunction with the internal teams at Falkirk and Lothian, will be working to implement the strategy. With the valuation exercise close to completion, a more fundamental review of investment strategy will be undertaken in the coming months and proposals brought to Committee for approval.
- 4.3 Notwithstanding the imminent strategic review, potential investments continue to be investigated 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 3, which is an excerpt from the Statement of Investment Principles.
- 5.3 The overall Fund's return of +3.2% over the quarter was below the benchmark return by 0.3%. Over the 3-year period, the Fund rose 10.6% per annum compared with the benchmark return of 9.5% per

annum. Over the 3-year period, the Fund benefited from double digit returns from global equities, which were higher than 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 8% per annum over the past 3 years.

- 5.4 Long term return data shows Fund appreciation of 11.5% per annum over 5 years and 8.0% 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. The recently completed actuarial valuation at end March 2017, which reassessed a range of financial and demographic assumptions in light of inter-valuation experience, shows that the funding level has 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 returned 3.2% over the quarter to end December 2017, slightly behind the benchmark return, but over 3- and 5-year

timeframes, the Fund has achieved returns above benchmark and, in absolute terms, greater than 10% 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 December 2017

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

Rates of Return by Manager with Excess Returns - 31 December 2017							
Fund/Portfolio	Market Value £	Weight	Returns				Inception Date
			3 months	3 year	5 year	Since inception	
<b>Falkirk Council Pension Fund</b>	2,328,987,849	100.0%	3.2%	10.6%	11.5%	8.0%	Sep-01
Benchmark			3.5%	9.5%	10.1%	7.5%	
Excess Return			-0.3%	1.0%	1.3%	0.5%	
<b>Aberdeen Portfolio</b>	245,267,778	10.5%	4.4%	11.6%	10.8%	9.9%	May-10
Benchmark			5.0%	15.2%	15.6%	11.8%	
Excess Versus Benchmark			-0.6%	-3.2%	-4.1%	-1.6%	
Excess Versus Objective			-	-6.2%	-7.1%	-4.6%	
<b>Baillie Gifford Bond Portfolio*</b>	177,894,711	7.6%	2.5%	5.6%	6.3%	6.7%	Mar-07
Benchmark			2.3%	5.6%	6.1%	6.8%	
Excess Versus Benchmark			0.2%	-0.1%	0.2%	-0.1%	
Excess Versus Objective			-	-1.0%	-0.7%	-1.0%	
<b>Baillie Gifford Diversified Growth**</b>	236,944,176	10.2%	1.9%	6.0%	6.1%	6.4%	Feb-12
Benchmark			0.1%	0.4%	0.4%	0.5%	
Excess Versus Benchmark			1.8%	5.6%	5.7%	5.9%	
Excess Versus Objective			-	-	2.2%	2.4%	
<b>Hearthstone Social</b>	24,940,857	1.1%	0.3%	-0.8%	-	-0.8%	Nov-14
Benchmark			1.6%	4.6%	-	4.5%	
Excess Versus Benchmark			-1.3%	-5.2%	-	-5.0%	
Excess Versus Objective			-	-	-	-	
<b>In-House</b>	292,522,929	12.6%	1.5%	11.1%	10.8%	10.9%	Sep-01
Benchmark			0.1%	0.3%	0.3%	2.2%	
Excess Versus Benchmark			1.5%	10.8%	10.5%	8.5%	
Excess Versus Objective			-	-	-	-	
<b>Legal &amp; General Fundamental Weighting</b>	116,414,505	5.0%	4.8%	-	-	14.5%	Nov-16
Benchmark			4.8%	-	-	14.5%	
Excess Versus Benchmark			0.0%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
<b>Legal &amp; General Passive</b>	401,499,285	17.2%	4.9%	13.8%	14.2%	14.0%	Jan-09
Benchmark			4.9%	13.7%	14.1%	13.9%	
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>	382,067,834	16.4%	3.3%	14.7%	15.7%	10.5%	Jun-06
Benchmark			4.9%	14.8%	15.3%	9.8%	
Excess Versus Benchmark			-1.5%	-0.1%	0.4%	0.7%	
Excess Versus Objective			-	-	-2.6%	-2.3%	
<b>Schroders UK Equity</b>	303,046,262	13.0%	2.9%	9.7%	12.3%	9.4%	Sep-01
Benchmark			5.0%	10.1%	10.3%	7.4%	
Excess Versus Benchmark			-1.9%	-0.4%	1.8%	1.8%	
Excess Versus Objective			-	-1.7%	0.6%	0.6%	
<b>Schroders Property</b>	148,389,513	6.4%	3.2%	8.4%	9.9%	4.3%	Nov-05
Benchmark			3.1%	8.4%	10.3%	4.3%	
Excess Versus Benchmark			0.1%	0.0%	-0.3%	0.0%	
Excess Versus Objective			-	-0.8%	-1.1%	-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.

## Appendix 2

### Falkirk Council Pension Fund Alternative Markets Update - 31/12/17

Exchange Rates	
\$	1.3528
€	1.1265

### 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	197,247	48,773	148,474	45,286	134,533	179,819	1.22
Private Equity	153,445	20,610	132,834	124,718	66,650	191,369	1.44
Affordable Housing	30,000	3,850	26,150	937	24,445	25,382	0.97
Debt/Loans	15,801	0	15,801	16,377	2,454	18,831	1.19
	<b>£396,493</b>	<b>£73,233</b>	<b>£323,259</b>	<b>£187,318</b>	<b>£228,082</b>	<b>£415,401</b>	

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Allocation to Private Equity  
(based on unfunded commitment plus market value) 3.7%

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

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Allocation to Infrastructure  
(based on unfunded commitment plus market value) 7.8%

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Allocation to Infrastructure  
(based on market value only) 5.7%

## 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