

The background of the slide features a large, light blue outline of the Coat of Arms of the Government of Nunavut. The crest includes a crown at the top with four maple leaves, a shield with a cross and a caribou head, and a banner at the bottom with the motto 'ANE FOR A'.

## **Agenda Item 11**

# **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: 6 December 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 3 December 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 September 2018 and;
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel.

### 3. Market Review and Outlook

- 3.1 The third quarter of 2018 was a positive one for growth assets, with global equities rising by almost 6% in sterling terms. UK fixed and index-linked gilts declined modestly (-1.7% and -1.4% respectively), while investment grade bonds also delivered marginally negative returns, returning -0.3%. In contrast, high yield bonds reflected the positive sentiment towards risk assets, rising by +1.9%.
- 3.2 As widely expected, the US Federal Reserve raised rates in September, with markets discounting a further hike by the end of the year, and a slower annual pace of rate hikes in 2019. The Treasury yield curve flattened again to fresh cycle lows previously seen in 2007, whilst implied volatility remained close to all-time lows.
- 3.3 Despite the headwinds of slower growth and increasing uncertainty within domestic politics, both the European Central Bank (ECB) and Bank of England (BOE) have been consistent in their message about monetary stimulus withdrawal and, surprisingly, the tone remains relatively upbeat compared with the previous quarter. Nevertheless, even with this guidance, the US dollar strengthened and US bond yields continued to diverge from other developed markets.
- 3.4 In the UK, the BOE raised rates by 0.25% to 0.75% at its August meeting. GDP picked up in Q3, growing by 0.6% from 0.4% (quarter-on-quarter), although late Q3 data suggests momentum may have stalled heading into the late stages of Brexit negotiations. In contrast, European growth slowed to 0.2% from 0.4% (quarter-on-quarter). Within that, both Germany and Italy came to a standstill.
- 3.5 Political uncertainty came to a head in July following Prime Minister May's vaunted Chequers meeting. Brexit Secretary Davis and Foreign Secretary Johnson resigned. Much of parliament remains opposed to the Chequers Deal, with which May has pressed on ahead regardless.
- 3.6 The OECD's September 2018 interim economic outlook included small downward revisions to global growth: 2018 down by 0.1% to 3.7% and 2019 down by 0.2% to 3.7%. US growth was downgraded by 0.1% to 2.7%, while Europe, Germany, France, UK and Italy were also downgraded. Emerging market countries, including Turkey and Argentina, saw the largest downgrades, while Saudi Arabia and India are expected to buck the trend and see slightly better growth.
- 3.7 Since the end of the quarter, investor sentiment has turned decidedly bearish, with global equity markets falling by 7% in October alone (6% in sterling). Technology stocks, that have enjoyed an unprecedented run-up in valuations over the past three years, have been particularly hard-hit. In this recent environment, more defensively-oriented strategies have provided some element of capital preservation. With continued uncertainty on economic and political fronts, the outlook for risk assets appears as precarious as it has been for some time.

## 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 strategic allocation along with the current actual allocation at 9 November 2018.

**Table 1**

<b>Asset Class</b>	<b>Current* Strategic Allocation</b>	<b>Current* Actual Allocation</b>
<b>Growth Assets</b>	<b>75%</b>	<b>80.8%</b>
Listed equities	55%	62.0%
Private Equity	0%	2.4%
Multi Asset	10%	9.8%
Property	10%	6.6%
<b>Defensive Assets</b>	<b>25%</b>	<b>19.2%</b>
Bonds	10%	7.3%
Private Debt	5%	0.4%
Infrastructure	9%	7.1%
Social/Affordable Housing	1%	1.0%
Other Real Income Assets	0%	0.0%
Cash	0%	3.5%
<b>Total</b>	<b>100%</b>	<b>100%</b>

*Sources: SIP & NT*

*\* at 9 November 2018*

- 4.2 The Fund is in the process of finalising its review of investment strategy based on the results of the 31 March 2017 actuarial valuation. The Chief Finance Officer and Joint Investment Strategy Panel have analysed the asset liability modelling undertaken by Hymans Robertson and will present the recommendations to Committee elsewhere on the agenda.
- 4.3 The Fund has continued to gradually make investments in areas previously identified by Committee, including infrastructure and private debt, to achieve the current strategic allocation shown above. A summary of the Fund's commitments to infrastructure and other private market investments are presented in appendix 2.
- 4.4 Subject to the revisions to strategy agreed by Committee, the current allocation will continue to evolve gradually as appropriate investments become available.

## **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 2.6% over the quarter, ahead of the benchmark return of 2.3%. Over the 5-year period, the Fund rose 10.0% 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 equities 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 31 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). The latest funding update at 31 October (covered in a separate report at today's meeting) shows that there has been a further improvement to 94%.

## **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 based on the new investment strategy, which Committee is concluding elsewhere on the agenda.
- 7.2 The Fund value rose 2.6% over the quarter to end September 2018, which was better than the benchmark return of 2.3%. Over 3- and 5-year timeframes, the Fund has achieved returns above benchmark and, in absolute terms, +12.9% and +10.0% per annum respectively.
- 7.3 The Joint Investment Strategy Panel monitors the Fund's investment managers and portfolios and advises the Chief Finance Officer quarterly in line with the regulations.

---

## **Director of Corporate & Housing Services**

Author:

Bruce Miller, Chief Investment Officer  
0131 469 3866 [bruce.miller@edinburgh.gov.uk](mailto:bruce.miller@edinburgh.gov.uk)

Date: 28 November 2018

## **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 2018

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

Rates of Return by Manager with Excess Returns - 30 September 2018							
Fund/Portfolio	Market Value £	Weight	Annualized Returns				Inception Date
			3 months	3 year	5 year	Since inception	
<b>Falkirk Council Pension Fund</b>	2,456,552,591	100.0%	2.6%	12.9%	10.0%	7.9%	Sep-01
Benchmark			2.3%	11.3%	8.8%	7.4%	
Excess Return			0.3%	1.5%	1.1%	0.5%	
<b>Aberdeen Portfolio</b>	252,405,042	10.3%	3.2%	16.8%	9.3%	9.4%	May-10
Benchmark			5.7%	19.9%	14.1%	11.7%	
Excess Versus Benchmark			-2.3%	-2.5%	-4.2%	-2.1%	
Excess Versus Objective			-	-5.5%	-7.2%	-5.1%	
<b>Baillie Gifford Bond Portfolio*</b>	174,620,153	7.1%	-1.1%	4.5%	5.8%	6.0%	Mar-07
Benchmark			-1.0%	4.7%	5.7%	6.2%	
Excess Versus Benchmark			-0.1%	-0.1%	0.1%	-0.1%	
Excess Versus Objective			-	-1.0%	-0.8%	-1.1%	
<b>Baillie Gifford Diversified Growth**</b>	236,639,229	9.6%	0.2%	5.9%	5.2%	5.7%	Feb-12
Benchmark			0.2%	0.4%	0.5%	0.5%	
Excess Versus Benchmark			0.0%	5.5%	4.8%	5.2%	
Excess Versus Objective			-	-	1.3%	1.7%	
<b>Hearthstone Social</b>	23,619,680	1.0%	0.6%	-2.0%	-	-1.5%	Nov-14
Benchmark			1.4%	5.1%	-	4.5%	
Excess Versus Benchmark			-0.8%	-6.7%	-	-5.8%	
Excess Versus Objective			-	-	-	-	
<b>In-House</b>	312,170,476	12.7%	1.5%	11.5%	11.1%	10.8%	Sep-01
Benchmark			1.4%	0.9%	0.7%	2.3%	
Excess Versus Benchmark			0.2%	10.5%	10.4%	8.4%	
Excess Versus Objective			-	-	-	-	
<b>Legal &amp; General Fundamental Weighting</b>	122,178,196	5.0%	4.9%	-	-	11.3%	Nov-16
Benchmark			4.9%	-	-	11.3%	
Excess Versus Benchmark			0.0%	-	-	0.0%	
Excess Versus Objective			-	-	-	0.0%	
<b>Legal &amp; General Passive</b>	422,741,333	17.2%	3.4%	17.0%	12.0%	13.5%	Jan-09
Benchmark			3.4%	17.0%	11.9%	13.4%	
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>	427,446,228	17.4%	7.7%	18.0%	14.7%	10.8%	Jun-06
Benchmark			5.6%	19.2%	13.8%	9.8%	
Excess Versus Benchmark			2.1%	-1.0%	0.8%	0.9%	
Excess Versus Objective			-	-	-2.2%	-2.1%	
<b>Schroders UK Equity</b>	321,575,653	13.1%	-0.4%	13.7%	8.7%	9.3%	Sep-01
Benchmark			-0.8%	11.5%	7.5%	7.1%	
Excess Versus Benchmark			0.4%	2.0%	1.1%	2.0%	
Excess Versus Objective			-	0.7%	-0.1%	0.8%	
<b>Schroders Property</b>	156,389,770	6.4%	1.6%	7.3%	10.1%	4.4%	Nov-05
Benchmark			1.6%	7.1%	10.4%	4.5%	
Excess Versus Benchmark			0.0%	0.2%	-0.3%	0.0%	
Excess Versus Objective			-	-0.5%	-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.
- 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*	122,690	32,303	99,861	56,808	69,747	126,555	1.27
In House Infrastructure*	106,770	18,210	92,001	18,741	92,051	110,792	1.20
<b>Infrastructure</b>	<b>229,460</b>	<b>50,513</b>	<b>191,862</b>	<b>75,549</b>	<b>161,798</b>	<b>237,347</b>	<b>1.24</b>
SL Capital Partners	90,852	9,941	80,911	81,603	31,799	113,402	1.40
Wilshire Associates	64,919	7,862	57,058	60,244	28,856	89,100	1.56
<b>Private Equity</b>	<b>155,771</b>	<b>17,803</b>	<b>137,969</b>	<b>141,847</b>	<b>60,655</b>	<b>202,502</b>	<b>1.47</b>
<b>Affordable Housing</b>	<b>30,000</b>	<b>3,850</b>	<b>26,150</b>	<b>1,393</b>	<b>23,577</b>	<b>24,970</b>	<b>0.95</b>
<b>Debt/Loans*</b>	<b>56,198</b>	<b>33,575</b>	<b>22,774</b>	<b>16,919</b>	<b>8,752</b>	<b>25,671</b>	<b>1.13</b>
<b>Total</b>	<b>471,429</b>	<b>105,741</b>	<b>378,755</b>	<b>235,708</b>	<b>254,782</b>	<b>490,490</b>	
Allocation to Private Equity (based on unfunded commitment plus market value)		3.2%					
Allocation to Private Equity (based on market value only)		2.5%					
Allocation to Infrastructure (based on unfunded commitment plus market value)		8.6%					
Allocation to Infrastructure (based on market value only)		6.5%					
Allocation to Private Debt/Loans (based on unfunded commitment plus market value)		1.7%					
Allocation to Private Debt/Loans (based on market value only)		0.4%					

\* Cost may include charges that don't affect unfunded balances or charges outwith commitment



## 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