



Agenda Item 8

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: 13 January 2020

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 2 December 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 September 2019 and;
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel (JISP).

3. Market Review and Outlook

- 3.1 The third quarter of 2019 saw financial markets maintain positive momentum from the first half of the year. Global equities rose by +3.3% in sterling terms. Sterling bond markets also delivered very strong returns. Fixed and index-linked gilts returned +6.2% and +8.7%, respectively, as UK bond yields fell to historic lows while investment grade bonds returned +3.7%.
- 3.2 Economic indicators showed ongoing weakness in the global economy, with the US and German manufacturing sectors showing signs of contraction. This was in addition to falls seen in other indicators and consumer/business confidence.
- 3.3 Recognising potential weakness in the growth outlook, the US Federal Reserve cut interest rates twice - in July and September – taking the US reserve rate down from 2.5% to 2.0%. This was followed by a further 0.25% rate cut at the end of October, leaving the reserve rate at 1.75%. Despite these cuts, US interest rates remain the highest among all major economies.
- 3.4 Global 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. US / China trade negotiations continue to drive market sentiment, with the on-again / off-again rhetoric continuing from both sides towards year end.

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

8 November 2019		Permitted	Strategy	Actual	
£2,601m	Manager	Range (%)	Allocation	Allocation	Deviation
EQUITIES (Gilts +3.5%pa)					
Passive Equity (UK 36%/O'seas 64%)	L&G			16.9%	
Fundamental Weighting Global Equity	L&G			4.8%	
Active UK Equity	Schroder			11.2%	
Active Global Equity	Newton			17.1%	
Global Low Volatility (GLOVE mirror)	L&G			10.2%	
<i>Listed Equity Subtotal</i>				60.3%	
Private Equity LPs	Wilshire/SL Capital			2.0%	
<i>Private Equity Subtotal</i>				2.0%	
Total Equities		45 - 65	60%	62.3%	2.3%
REAL ASSETS (Gilts +2.5%pa)					
Property	Various			5.6%	
Property (Affordable Housing)	Hearthstone			0.8%	
Infrastructure FoF	Grosvenor Capital			2.7%	
Infrastructure	Various			5.9%	
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			3.4%	
Illiquid Credit (Private Debt/Loans)	Various			1.4%	
Total Non-Gilt Debt		0 - 25	15%	4.8%	-10.2%
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			4.4%	
Total Cash		0 - 10	0%	4.4%	4.4%
OTHER					
Diversified Growth	Baillie Gifford			9.7%	
Total Other			0%	9.7%	9.7%
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 a recently appointed independent provider of performance measurement services, Portfolio Evaluation. Work is ongoing to finalise data migration and reporting processes with the Fund's managers and this work is expected to be finalised soon. The interim figures provided for Q3 2019 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 2.7% over the quarter, behind the benchmark return, which rose by 5.3%. Over the 5-year period, the Fund rose 9.4% per annum compared with the benchmark return of 9.1% per annum.
- 5.4 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 (other than cash) over 5 years, returning 4.8% per annum.
- 5.5 Long term return data shows Fund appreciation of 7.9% per annum since September 2001, which is above the benchmark return.
- 5.6 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 October 2019 indicated a funding level of 93%, broadly similar to the position at the valuation of 31 March 2017. This is in the face of sharply increasing liabilities attributable to a recent decline in bond yields.

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 is holding a significant cash reserve 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 +2.7% for the Fund during Q3 2019 was behind benchmark, but follows on from positive returns of +6.5% in Q1 2019 and +3.3% for Q2 2019. This has resulted in a total Fund return of +13.0% year to date. Over 5- and 10-year timeframes, the Fund has achieved returns above benchmark and, in absolute terms, +9.4% and +9.7% 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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Appendices

Appendix 1 – Performance Measurement (Rates of Return)

Appendix 2 – Private Markets Commitments

Appendix 3 – Mandate Benchmarks and Objectives

List of Background Papers

Portfolio Evaluation – Quarterly Risk and Return Analysis as at 30 Sept 2019

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 30 September 2019							
Fund/Portfolio	Market Value £	Weight	Annualised Returns				Inception Date
			3 months	3 year	5 year	Since inception	
Falkirk Council Pension Fund	2,636,654,359	100.0%	2.7%	8.4%	9.4%	7.9%	Sep-01
Benchmark			5.3%	8.8%	9.1%	7.5%	
Excess Return			-2.6%	-0.4%	0.3%	0.4%	
Schroders UK Equity	300,999,354	11.4%	-1.7%	5.5%	6.1%	7.5%	Sep-01
Benchmark			1.3%	6.8%	6.8%	5.8%	
Excess Versus Benchmark			-3.0%	-1.3%	-0.7%	1.7%	
Excess Versus Objective			-	-2.5%			
Global Low Volatility Equity	278,737,752	10.6%	6.3%	-	-	7.5%	Jun-19
Benchmark			3.3%	-	-	7.2%	
Excess Versus Benchmark			3.1%	-	-	0.3%	
Excess Versus Objective			-	-	-	-	
Newton	472,570,063	17.9%	3.4%	11.2%	14.6%	10.8%	Jun-06
Benchmark			3.3%	11.7%	12.8%	9.6%	
Excess Versus Benchmark			0.2%	-0.5%	1.8%	1.2%	
Excess Versus Objective			-	-	-1.2%	-1.8%	
Legal & General Passive	447,953,492	17.0%	2.7%	10.4%	11.1%	12.7%	Jan-09
Benchmark			2.6%	10.2%	11.0%	12.6%	
Excess Versus Benchmark			0.1%	0.2%	0.1%	0.1%	
Excess Versus Objective			0.1%	0.2%	0.1%	0.1%	
Legal & General Fundamental Wgt	127,553,437	4.8%	2.9%	-	-	8.8%	Nov-16
Benchmark			2.8%	-	-	8.9%	
Excess Versus Benchmark			0.0%	-	-	0.0%	
Excess Versus Objective			-	-	-	-	
Aberdeen Portfolio	792,676	0.0%	1.0%	8.2%	8.4%	9.4%	May-10
Benchmark			3.4%	12.3%	13.3%	11.8%	
Excess Versus Benchmark			-2.4%	-4.1%	-4.9%	-2.4%	
Excess Versus Objective			-	-7.1%	-7.9%	-5.4%	
Private Equity	54,898,844	2.1%	15.0%			20.6%	Sep-01
Benchmark			3.4%			10.0%	
Excess Versus Benchmark			11.6%	-	-	10.6%	
Excess Versus Objective			-	-	-	-	
Infrastructure	224,263,582	8.5%	1.5%			13.4%	Sep-01
Benchmark			11.3%			8.8%	
Excess Versus Benchmark			-9.8%	-	-	4.6%	
Excess Versus Objective			-	-	-	-	
Schroders Property	145,966,772	5.5%	0.2%	6.2%	7.3%	3.7%	Nov-05
Benchmark			0.4%	6.8%	7.6%	3.9%	
Excess Versus Benchmark			-0.2%	-0.6%	-0.3%	-0.2%	
Excess Versus Objective			-	-1.4%	-1.0%	-	
Hearthstone Social	21,858,606	0.8%	-0.2%	-0.4%	-	-0.3%	Nov-14
Benchmark			1.0%	5.2%	-	4.6%	
Excess Versus Benchmark			-1.2%	-5.6%	-	-4.9%	
Excess Versus Objective			-	-	-	-	
Baillie Gifford Bond Portfolio*	198,465,086	7.5%	5.3%	4.0%	6.7%	6.6%	Mar-07
Benchmark			5.5%	3.7%	6.8%	6.7%	
Excess Versus Benchmark			-0.2%	0.3%	-0.1%	-0.1%	
Excess Versus Objective			-	-0.6%	-1.0%	-1.0%	
Private Debt	31,275,768	1.2%	0.0%	-	-	3.5%	Jul-18
Benchmark			1.1%	-	-	4.8%	
Excess Versus Benchmark			-1.1%	-	-	-1.3%	
Excess Versus Objective			-	-	-	-5.3%	
Cash Fund	65,932,790	2.5%	0.2%	0.8%	2.0%	2.2%	Sep-01
Benchmark			0.1%	0.4%	0.4%	2.0%	
Excess Versus Benchmark			0.1%	0.4%	1.6%	0.2%	
Excess Versus Objective			-	-	-	-	
Baillie Gifford Diversified Growth*	248,633,587	9.4%	2.3%	5.0%	4.8%	5.4%	Feb-12
Benchmark			1.1%	1.1%	0.8%	0.7%	
Excess Versus Benchmark			1.2%	3.9%	3.9%	4.7%	
Excess Versus Objective			-	-	0.4%	1.2%	

* Manager returns

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.
- Manager return figures have been provided for Baillie Gifford mandates on an interim basis.
- Private Equity and Infrastructure performance figures are interim figures and being reviewed.
- 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 30/06/2019 (£m)	Market Value 30/09/2019 (£m)	% of Fund	Fundings Q3, 2019 (£m)	Distributions Q3, 2019 (£m)	Unfunded Commit (£m)	Unfunded Commit % of Fund	Comment - Q3, 2019
In House Infrastructure	139.1	153.2	5.8%	12.5	1.5	25.8	1.0%	Investment in 2 new funds
Global Infrastructure	68.9	71.0	2.7%	1.6	3.9	29.8	1.1%	
Private Equity	53.3	54.9	2.1%	0.3	2.0	16.2	0.6%	
Affordable Housing	24.1	21.9	0.8%	-	2.2	3.8	0.1%	
Private Debt	21.4	31.3	1.2%	10.0	0.2	51.2	1.9%	Investment in 1 new fund
Total Limited Partnerships	306.8	332.3	12.6%	24.4	9.8	126.8	4.8%	

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