



Agenda Item 12

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 August 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 11 June 2020 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 March 2020 and;
- (iv) the investment monitoring activity of the Joint Investment Strategy Panel (JISP).

3. Market Review and Outlook

- 3.1 The first quarter of 2020 will be remembered for the unprecedented lockdown of various world economies by fearful politicians faced with a global pandemic. Economists and financial market observers witnessed extreme volatility in equities, bonds and currencies, including the swiftest 30% decline in equity prices in history. Extraordinary events were in the making in commodity markets too – shortly after the quarter end, the April future price for oil recorded a negative price for the first time ever as negotiations between Russia and Saudi Arabia to cut production broke down at precisely the same time as world demand plummeted.
- 3.2 The economic statistics were truly “off the charts” as many businesses ceased trading. Economic activity and world trade nosedived. This was no ordinary recession as the opportunity for many businesses to generate cash flow was forbidden by government diktat. Unemployment and government-supported employment soared globally as governments stepped in to support individuals at this time of crisis. Government debt also soared as a result.
- 3.3 The outlook for markets is as uncertain as ever, but some trends have become much clearer and have accelerated as a result of the disruption to everyday lives. Technological advances enabled remote working when needed and many businesses continued without missing a beat. Online retailing boomed as non-essential shops were forced to close. Central banks and governments around the world have responded extremely quickly to fend off the economic depression that many feared as a result of the lockdown. They have expanded the supply of money and put it in the pockets of their citizens. Their actions have resulted in a strong rebound in financial markets.
- 3.4 Bond yields, however, remain very low and are expected to remain very low. Central banks have been quite clear that they will intervene to allow their economies to recover and businesses to survive. The impact on equities as a whole and other risk markets has been positive, and these seem likely to provide superior returns to bonds over the long term, but the lesson of the first quarter is that it is folly to try to predict short term market returns. There are simply too many scenarios for which the outcomes and timing cannot be known; these might include escalating trade wars between the US and China, the discovery of a vaccine for COVID-19 or the emergence of another pandemic. The pursuit of an investment strategy that can cater for any environment appears to be the best course of action.

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. A summary of the Fund's commitments to infrastructure and other private market investments is shown in Appendix 2.
- 4.3 Table 2 on the following page 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**24 July 2020**

£2,538m	Manager	Permitted Range (%)	Strategy Allocation	Actual Allocation	Deviation
EQUITIES (Gilts +3.5%pa)					
Passive Equity (UK 36%/O'seas 64%)	L&G			17.5%	
Fundamental Weighting Global Equity	L&G			4.6%	
Active UK Equity	Schroder			8.7%	
Active Global Equity	Newton			18.3%	
Global Low Volatility (GLOVE mirror)	L&G			9.8%	
<i>Listed Equity Subtotal</i>				58.9%	
Private Equity LPs	Wilshire/SL Capital			1.8%	
<i>Private Equity Subtotal</i>				1.8%	
Total Equities		45 - 65	60%	60.7%	0.7%
REAL ASSETS (Gilts +2.5%pa)					
Property	Various			5.4%	
Property (Affordable Housing)	Hearthstone			0.9%	
Infrastructure FoF	Grosvenor Capital			2.4%	
Infrastructure	Various			6.6%	
Total Real Assets		10 - 25	20%	15.3%	-4.7%
NON-GILT DEBT (Gilts +1%pa)					
Liquid Credit (Corporate Bonds/Loans)	Baillie Gifford/M&G			2.4%	
Illiquid Credit (Private Debt/Loans)	Various			2.0%	
Total Non-Gilt Debt		0 - 25	15%	4.4%	-10.6%
GILTS					
Gilts (60% nominal/40% index-linked)	Baillie Gifford			2.7%	
Gilts	In-house			1.6%	
Total Gilts		0 - 20	5%	4.3%	-0.7%
CASH (7-day LIBID)					
Cash	Various			5.7%	
Total Cash		0 - 10	0%	5.7%	5.7%
OTHER					
Diversified Growth	Baillie Gifford			9.6%	
Total Other			0%	9.6%	9.6%
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 up to end March 2020 at the Panel's latest meeting in June 2020. These returns are measured against pre-determined benchmarks, as calculated by a recently appointed independent provider of performance measurement services, Portfolio Evaluation. The latest figures provided for Q1 2020 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 decreased by 12.7% over Q1 2020, behind the benchmark return, which declined by 8.1%. It is important to note that the Fund benchmark represents long term, not quarterly objectives and a range of benchmarks that do not decline when equities decline. In addition, the Fund's private market assets are not valued as frequently as listed assets and benchmarks. Consequently, it is more appropriate to consider long term data for assessment purposes.
- 5.4 Long term return data shows Fund appreciation of 6.9% per annum since September 2001, which is above the benchmark return of 6.7% per annum. Over the 5-year period the Fund rose 5.0% per annum compared with the benchmark of 5.4% 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), while UK bonds have also generated respectable 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 latest estimate from the Fund's actuary at 31 March 2019 indicated a funding level of 93.4%, an improvement from the 31 March 2017 valuation position of 92%. However, given the decline in bond yields since then we estimate that the current funding level will have fallen. The Fund's actuary is currently working on the actuarial valuation at end March 2020 and this will be reported to Committee over the next few months.

6. Investment Manager Monitoring

- 6.1 The Fund's allocation to Managers within asset classes is typically 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 has increased the cash level as an interim step and further changes will be implemented over the coming quarters based on the latest investment strategy.

- 7.2 Over the short term, financial markets were badly affected by the COVID-19 lockdown resulting in a negative return of 12.7% for the Fund during Q1 2020 and a negative return over the financial year to end March 2020 of 6.6%. Over 5 years, the Fund has achieved an absolute return of 5.0% per annum slightly below its benchmark return of 5.4% per annum.
- 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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Date: 01 August 2020

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, 31 March 2020

APPENDIX 1 – PERFORMANCE MEASUREMENT (RATES OF RETURN)

Rates of Return by Manager with Excess Returns - 31 March 2020							
Fund/Portfolio	Market Value £	Weight	Annualised Returns				Inception Date
			3 months	3 year	5 year	Since inception	
Falkirk Council Pension Fund	2,319,592,175	100.0%	-12.7%	1.5%	5.0%	6.9%	Sep-01
Benchmark			-8.1%	3.1%	5.4%	6.7%	
Excess Return			-4.6%	-1.6%	-0.5%	0.2%	
Schroders UK Equity	222,079,112	9.6%	-30.1%	-7.8%	-1.5%	5.0%	Sep-01
Benchmark			-25.1%	-4.2%	0.6%	3.7%	
Excess Versus Benchmark			-5.0%	-3.5%	-2.0%	1.3%	
Excess Versus Objective			-	-4.8%	-	-	
Global Low Volatility Equity	230,311,664	9.9%	-13.9%	-	-	-12.1%	Jun-19
Benchmark			-16.0%	-	-	-12.1%	
Excess Versus Benchmark			2.1%	-	-	-0.1%	
Excess Versus Objective			-	-	-	-	
Newton	408,069,190	17.6%	-15.5%	3.5%	8.1%	9.2%	Jun-06
Benchmark			-16.0%	1.8%	6.7%	8.0%	
Excess Versus Benchmark			0.5%	1.7%	1.4%	1.2%	
Excess Versus Objective			-	-	-1.6%	-1.8%	
Legal & General Passive	372,553,511	16.1%	-18.5%	0.2%	5.1%	10.3%	Jan-09
Benchmark			-19.2%	-0.2%	4.8%	10.1%	
Excess Versus Benchmark			0.6%	0.4%	0.3%	0.2%	
Excess Versus Objective			0.6%	0.4%	0.3%	0.2%	
Legal & General Fundamental Weighting	99,605,108	4.3%	-22.8%	-3.0%	-	-0.2%	Nov-16
Benchmark			-23.0%	-3.0%	-	-0.3%	
Excess Versus Benchmark			0.2%	0.0%	-	0.0%	
Excess Versus Objective			-	-	-	-	
Private Equity	51,901,719	2.2%	4.3%	-	-	8.3%	Sep-01
Benchmark			-15.9%	-	-	-2.2%	
Excess Versus Benchmark			20.2%	-	-	10.5%	
Excess Versus Objective			-	-	-	-	
Infrastructure	244,482,675	10.5%	8.8%	-	-	14.2%	Sep-01
Benchmark			11.7%	-	-	9.1%	
Excess Versus Benchmark			-3.0%	-	-	5.1%	
Excess Versus Objective			-	-	-	-	
Internal Property	140,829,086	6.1%	-0.5%	-	-	-0.7%	Sep-19
Benchmark			-1.3%	-	-	-1.0%	
Excess Versus Benchmark			0.8%	-	-	0.2%	
Excess Versus Objective			-	-	-	-	
Hearthstone Social	22,340,144	1.0%	1.5%	1.6%	0.7%	0.6%	Nov-14
Benchmark			0.7%	4.8%	4.6%	4.5%	
Excess Versus Benchmark			0.8%	-3.2%	-4.0%	-3.9%	
Excess Versus Objective			-	-	-	-	
Baillie Gifford Bond Portfolio*	151,260,208	6.5%	-0.9%	3.2%	3.9%	5.5%	Mar-07
Benchmark			1.5%	3.5%	4.0%	6.3%	
Excess Versus Benchmark			-2.4%	-0.3%	-0.1%	-0.7%	
Excess Versus Objective			-	-1.2%	-1.0%	-1.6%	
Internal Index Linked Fund	36,907,787	1.6%	-	-	-	2.3%	Mar-20
Benchmark			-	-	-	-4.6%	
Excess Versus Benchmark			-	-	-	6.9%	
Excess Versus Objective			-	-	-	-	
Private Debt	45,187,676	1.9%	5.5%	-	-	3.4%	Jul-18
Benchmark			1.2%	-	-	4.8%	
Excess Versus Benchmark			4.4%	-	-	-1.4%	
Excess Versus Objective			-	-	-	-5.4%	
Cash Fund	72,675,621	3.1%	0.4%	0.9%	1.6%	2.2%	Sep-01
Benchmark			0.1%	0.4%	0.4%	2.0%	
Excess Versus Benchmark			0.3%	0.5%	1.3%	0.2%	
Excess Versus Objective			-	-	-	-	
Baillie Gifford Diversified Growth*	220,578,678	9.5%	-13.5%	-0.9%	1.4%	3.5%	Feb-12
Benchmark			1.0%	1.7%	1.2%	0.9%	
Excess Versus Benchmark			-14.5%	-2.6%	0.2%	2.6%	
Excess Versus Objective			-	-	-3.3%	-0.9%	

* Manager returns

Notes:

1. Objectives vary and are set over 3- or 5-year periods highlighted by the boxes for each manager.
2. There are small rounding effects in the table above.
3. The independent performance measurement provider shows a slightly different performance for Baillie Gifford than the manager itself. This is due to intra-day valuation timing differences.
4. Manager return figures have been provided for Baillie Gifford mandates.
5. 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 31/12/2019 (£m)	Market Value 31/03/2020 (£m)	% of Fund	Fundings Q1, 2020 (£m)	Distributions Q1, 2020 (£m)	Unfunded Commit (£m)	Unfunded Commit % of Fund
In House Infrastructure	164.4	172.3	7.4%	6.8	2.8	28.1	1.2%
Global Infrastructure	65.8	69.6	3.0%	-	3.3	26.2	1.1%
Private Equity	50.3	51.9	2.2%	0.1	3.0	15.2	0.7%
Affordable Housing	22.3	23.5	1.0%	-	-	-	0.0%
Private Debt	39.5	45.2	1.9%	6.2	2.5	33.2	1.4%
Total Limited Partnerships	342.3	362.5	15.6%	13.1	11.6	102.7	4.4%

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		
BG 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		
BG Sterling Aggregate	50% FTSE-A UK Gilts All Stocks Index 50% ICE BofA Sterling Non-Gilt Index	To outperform the benchmark by 0.65% pa net of fees over rolling 3 year period
BG Investment Grade	ICE BofA Sterling Non-Gilt Index	To outperform the benchmark by 0.5% pa net of fees over rolling 3 year period
Internal Index-Linked Fund	FTSE-A Index Linked Over 5yr Index	To perform in line with the benchmark
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