

| Bath & North East Somerset Council | |
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| MEETING: | AVON PENSION FUND COMMITTEE |
| MEETING DATE: | 26 SEPTEMBER 2014 |
| TITLE: | REVIEW OF INVESTMENT PERFORMANCE (for periods ending 30 June 2014) |
| WARD: | ALL |
| AN OPEN PUBLIC ITEM | |
| <p>List of attachments to this report:</p> <p>Appendix 1 – Fund Valuation</p> <p>Appendix 2 – JLT Performance Monitoring Report</p> <p>Exempt Appendix 3 – Changes in RAG status of Managers</p> <p>Appendix 4 – LAPFF Quarterly Engagement Monitoring Report</p> | |

1 THE ISSUE

- 1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic aspects of the Fund's investments and funding level. This report contains performance statistics for periods ending 30 June 2014.
- 1.2 The main body of the report comprises the following sections:
 - Section 4. Funding Level Update
 - Section 5. Investment Performance: A - Fund, B - Investment Managers
 - Section 6. Investment Strategy
 - Section 7. Portfolio Rebalancing and Cash Management
 - Section 8. Annual Assurance on Control Environment of 3rd Party Suppliers
 - Section 9. Corporate Governance and Responsible Investment (RI) Update

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

- 2.1 **Note the information set out in the report**
- 2.2 **Note LAPFF Quarterly Engagement Report at Appendix 4**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund from 1 April 2013 will affect the next triennial valuation in 2016. Section 4 of this report discusses the trends in the Fund's liabilities and the funding level.

4 FUNDING LEVEL

4.1 Using information provided by the Actuary, JLT has analysed the funding position as part of the quarterly report at Appendix 2 (section 3). This analysis shows the impact of both the assets and liabilities on the (estimated) funding level. ***It should be noted that this is just a snapshot of the funding level at a particular point in time.***

4.2 Key points from the analysis are:

- (1) In the quarter the funding level increased by 3% to c. 87% due mainly to the advance lump sum deficit payments (c. +2% on the funding level) and investment returns. The impact of bond yields and inflation was slightly negative.
- (2) Since the March 2013 valuation, the funding level has increased 9% from 78% to c. 87% and the deficit has contracted to c. £532m from £876m. Real yields have improved slightly and investment returns are ahead of expectations. The advanced deficit payments will unwind over time.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £156m (c.2.4%) in the quarter, giving a value for the investment Fund of £3,486m at 30 June 2014. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers. Manager performance is monitored in detail by the Panel. The Fund's investment return and performance relative to benchmarks is summarised in Table 1.

Table 1: Fund Investment Returns
Periods to 30 June 2014

| | 3 months | 12 months | 3 years (p.a.) |
|---|----------------|-----------------------|-------------------|
| Avon Pension Fund (incl. currency hedging) | 2.4% | 10.3% | 8.3% |
| Avon Pension Fund (excl. currency hedging) | 2.2% | 9.2% | 8.0% |
| Strategic benchmark (no currency hedging) | 2.2% | 8.2% | 6.8% |
| <i>(Fund incl hedging, relative to benchmark)</i> | <i>(+0.2%)</i> | <i>(+1.9%)</i> | <i>(+1.4%)</i> |
| Local Authority Average Fund | 1.9% | 9.2% | 8.0% |
| <i>(Fund incl hedging, relative to benchmark)</i> | <i>(+0.5%)</i> | <i>(+1.1%)</i> | <i>(+0.3%)</i> |

5.2 **Fund Investment Return:** All Equity markets achieved positive if only modest returns over the quarter with emerging markets (+5%) outperforming developed markets, of which Europe was the weakest performing region at +0.3% for the quarter. Bond yields fell over the quarter leading to positive returns from Gilts (+2.3%) and corporate bonds (+2.8%) over the quarter.

5.3 Over the one year period UK, European and US equities outperformed their strategic return assumptions as did property, hedge funds and UK bonds (gilts corporates and index linked). Over 3 years developed market equities, UK bonds (gilts, corporates and index-linked) and property all outperformed their strategic return assumption, whilst emerging market equities and hedge funds underperformed their strategic return assumption.

5.4 Fund Performance versus Benchmark: +1.9% over 12 months, attributed to

(1) **Asset Allocation:** The contribution to outperformance from asset allocation was **1.1%** over the 12 months. This was due to the underweight to fixed income gilts within the bond portfolio; underweight to hedge funds; overweight in developed equities and underweight to emerging markets in final quarter. The currency hedging programme contributed **1.1%** over 1 year.

(2) **Manager Performance:** In aggregate, manager performance detracted **-0.3%** over the 12 month period, relative to the strategic benchmark.

5.5 **Versus Local Authority Average Fund:** Over one year, the Fund significantly outperformed the average fund.

5.6 **Currency Hedging:** The hedging programme is in place to manage the volatility arising from overseas currency exposure, in particular to protect the Fund as sterling strengthens and returns from foreign denominated assets reduce in sterling terms. The hedging programme has contributed 0.2% to the total Fund return over the quarter and added 1.1% over the year.

B – Investment Manager Performance

5.7 In aggregate over the three year period the managers' performance is marginally ahead of the benchmark. Twelve mandates met or exceeded their three year performance benchmark, which offset underperformance by Schroder Equity, Gottex and Signet. Genesis, RLAM, and Jupiter all continue to perform particularly well against their three year performance targets.

5.8 As part of the 'Meet the Managers' programme, the Panel met with Schroder (global equity mandate) and Record (currency hedging mandate) on 3 September 2014. The summary of the Panel's conclusions can be found in Exempt Appendix 3 to the Investment Panel Activity Report.

5.9 Under the Red Amber Green (RAG) framework for monitoring manager performance, the Panel consider updates on all managers not currently achieving Green status including progress on action points. Any change in the RAG status of any manager is reported to Committee with an explanation of the change. **This quarter 2 green rated managers (TT and Barings) have been downgraded to an Amber rating (explained in Exempt Appendix 3).** Currently 5 managers are amber rated.

6 INVESTMENT STRATEGY

6.1 Changes to the Investment Strategy agreed in March 2013 that are still in the process of being implemented are as follows:

| Project | Progress |
|----------------|---|
| Infrastructure | On Track: Manager selected, implementation underway with a view to completing subscription process during the next quarter. Note that funds will be drawn down over a period of up to 2 years. |

- 6.2 The Investment Panel is reviewing how best to structure the Fund's exposure to hedge funds. This issue is addressed in another item on the meeting agenda.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

- 7.1 The rebalancing policy requires automatic rebalancing between the allocations to Liquid Growth (equities and diversified growth funds) and Stabilising (Bonds) assets when the liquid growth portion deviates from 75% by +/- 5%. Tactical rebalancing is allowed between deviations of +/- 2 to +/- 5%, on advice from the Investment Consultant. The implementation of this policy is delegated to Officers.
- 7.2 At 13 August 2014 the Equity:Bond allocation was 77.8:22.2. In April/May the Fund received lump sum deficit contribution payments from some employers which was invested to maintain allocation targets, resulting in a small reduction in the Equity:Bond ratio. Monies were invested in the following portfolios: Royal London, Pyrford and Barings. The remainder is held as cash as monthly contributions will be lower as a result of the lump sum payments. Officers will continue to incorporate any rebalancing considerations as the new strategy is implemented.

Cash Management

- 7.3 Cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.
- 7.4 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies and during the quarter were invested in line with the Fund's Treasury Management Policy (latest approved on 28 March 2014).
- 7.5 The Fund continues to deposit internally managed cash on call with NatWest, Barclays and Bank of Scotland. The Fund deposits cash with the Goldman Sachs Asset Management Global Treasury Fund (AAA rated) and another AAA rated fund with Deutsche Bank is available for deposits if required. The Fund also has access to the Government's Debt Management Office; however the interest paid currently may not cover the transfer and administration costs incurred.
- 7.6 During the quarter the net cash flow was boosted by lump sum advance deficit recovery payments of £80m and the bulk transfer in of £10m relating to South Gloucestershire and Stroud College. Excluding these abnormal factors the Fund's cash flow in the quarter was close to neutral with benefits paid and costs incurred approximately equalling contributions and cash income received (including Investment Income). The cash flow model now forecasts an average monthly outflow of c. £3m for the last three quarters of the year to 31 March 2015. This is an increase on the previous level as a result of the reduction in monthly deficit recovery payments that followed the lump sum payments in advance.

8 ANNUAL ASSURANCE ON CONTROL ENVIRONMENT OF 3RD PARTY SUPPLIERS

- 8.1 As part of the risk management process the Fund annually reviews the internal control reports (ICR) of the custodian and investment managers (and their administrators where relevant), and reports the findings to Committee. These

reports are often designated SSAE16 or ISAE3402 reports (previously AAF 01/06 and SAS70 reports), that states which set of standards are being reported against.

- 8.2 ICR reports describe the internal control environment of an organisation. The management of the organisation are responsible for identifying the control procedures which they consider appropriate to enable certain control objectives to be met. External auditors verify that the controls identified are in place and comment on whether the controls will achieve the stated objectives or not.
- 8.3 For the reports reviewed in 2013/14, in each case the external auditor's report stated that the controls were in place and achieved the control objective and there are no issues to bring to the attention of the Committee. As part of the process, officers discuss the significance of the internal control reports with investment managers and custodian on an on-going basis and follow-up any issues flagged in the reports.
- 8.4 The ICRs of the pooled funds (and their administrators/custodian) and the Fund's custodian are also audited by the Fund's external auditor as part of the annual audit.

9 CORPORATE GOVERNANCE UPDATE

- 9.1 During the quarter, the Fund's external managers undertook the following voting activity on behalf of the Fund:

| | |
|---------------------------|--------|
| Companies Meetings Voted: | 705 |
| Resolutions voted: | 10,523 |
| Votes For: | 10,137 |
| Votes Against: | 397 |
| Abstained: | 16 |
| Withheld* vote: | 43 |

** A withheld vote is essentially the same as a vote to abstain, it reflects a view to vote neither for or against a resolution. Although the use of 'abstain' or 'withheld' reflects the different terms used in different jurisdictions, a 'withheld' vote can often be interpreted as a more explicit vote against management. Both votes may be counted as votes against management, where a minimum threshold of support is required.*

- 9.2 The Fund is a member of LAPFF, a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds. LAPFF's activity in the quarter is summarised in their quarterly engagement report at Appendix 4.

10 RISK MANAGEMENT

- 10.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. This report monitors (i) the strategic policy and funding level in terms of whether the strategy is on course to fund the pension liabilities as required by the funding plan and (ii) the performance of the investment managers. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

11 EQUALITIES

11.1 An Equality Impact Assessment has not been completed as this report is for information only.

12 CONSULTATION

12.1 This report is for information and therefore consultation is not necessary.

13 ISSUES TO CONSIDER IN REACHING THE DECISION

13.1 The issues to consider are contained in the report.

14 ADVICE SOUGHT

14.1 The Council's Monitoring Officer (Divisional Director – Legal and Democratic Services) and Section 151 Officer (Divisional Director – Business Support) have had the opportunity to input to this report and have cleared it for publication.

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| Background papers | LAPPF Member Bulletins, Data supplied by The WM Company |
| Please contact the report author if you need to access this report in an alternative format | |