

Democratic Services

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Date: 10 November 2015

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To: All Members of the Avon Pension Fund Committee - Investment Panel

Councillor Christopher Pearce (Chair), Councillor David Veale, Councillor Cherry Beath,
Ann Berresford, Councillor Mary Blatchford and Shirley Marsh

Chief Executive and other appropriate officers
Press and Public

Dear Member

Avon Pension Fund Committee - Investment Panel: Wednesday, 18th November, 2015

You are invited to attend a meeting of the **Avon Pension Fund Committee - Investment Panel**, to be held on **Wednesday, 18th November, 2015 at 9.30 am** in the **Council Chamber - Guildhall, Bath**.

The agenda is set out overleaf.

Yours sincerely

Sean O'Neill
for Chief Executive

If you need to access this agenda or any of the supporting reports in an alternative accessible format please contact Democratic Services or the relevant report author whose details are listed at the end of each report.

This Agenda and all accompanying reports are printed on recycled paper

NOTES:

1. **Inspection of Papers:** Any person wishing to inspect minutes, reports, or a list of the background papers relating to any item on this Agenda should contact Sean O'Neill who is available by telephoning Bath 01225 395090 or by calling at the Guildhall Bath (during normal office hours).
2. **Public Speaking at Meetings:** The Council has a scheme to encourage the public to make their views known at meetings. They may make a statement relevant to what the meeting has power to do. They may also present a petition or a deputation on behalf of a group. Advance notice is required not less than two full working days before the meeting (this means that for meetings held on Wednesdays notice must be received in Democratic Services by 4.30pm the previous Friday)

The public may also ask a question to which a written answer will be given. Questions must be submitted in writing to Democratic Services at least two full working days in advance of the meeting (this means that for meetings held on Wednesdays, notice must be received in Democratic Services by 4.30pm the previous Friday). If an answer cannot be prepared in time for the meeting it will be sent out within five days afterwards. Further details of the scheme can be obtained by contacting Sean O'Neill as above.

3. **Recording at Meetings:-**

The Openness of Local Government Bodies Regulations 2014 now allows filming and recording by anyone attending a meeting. This is not within the Council's control.

Some of our meetings are webcast. At the start of the meeting, the Chair will confirm if all or part of the meeting is to be filmed. If you would prefer not to be filmed for the webcast, please make yourself known to the camera operators.

To comply with the Data Protection Act 1998, we require the consent of parents or guardians before filming children or young people. For more information, please speak to the camera operator

The Council will broadcast the images and sound live via the internet www.bathnes.gov.uk/webcast An archived recording of the proceedings will also be available for viewing after the meeting. The Council may also use the images/sound recordings on its social media site or share with other organisations, such as broadcasters.

4. **Details of Decisions taken at this meeting** can be found in the minutes which will be published as soon as possible after the meeting, and also circulated with the agenda for the next meeting. In the meantime details can be obtained by contacting Sean O'Neill as above.

Appendices to reports are available for inspection as follows:-

Public Access points - Reception: Civic Centre - Keynsham, Guildhall - Bath, Hollies - Midsomer Norton, and Bath Central, Keynsham and Midsomer Norton public libraries.

For Councillors and Officers papers may be inspected via Political Group Research Assistants and Group Rooms/Members' Rooms.

5. **Attendance Register:** Members should sign the Register which will be circulated at the meeting.

6. THE APPENDED SUPPORTING DOCUMENTS ARE IDENTIFIED BY AGENDA ITEM NUMBER.

7. Emergency Evacuation Procedure

When the continuous alarm sounds, you must evacuate the building by one of the designated exits and proceed to the named assembly point. The designated exits are sign-posted.

Arrangements are in place for the safe evacuation of disabled people.

Avon Pension Fund Committee - Investment Panel - Wednesday, 18th November, 2015

at 9.30 am in the Council Chamber - Guildhall, Bath

A G E N D A

1. EMERGENCY EVACUATION PROCEDURE

The Chair will draw attention to the emergency evacuation procedure as set out under Note 9.

2. DECLARATIONS OF INTEREST

At this point in the meeting declarations of interest are received from Members in any of the agenda items under consideration at the meeting. Members are asked to complete the green interest forms circulated to groups in their pre-meetings (which will be announced at the Council Meeting) to indicate:

(a) The agenda item number in which they have an interest to declare.

(b) The nature of their interest.

(c) Whether their interest is a **disclosable pecuniary interest** or an **other interest**, (as defined in Part 2, A and B of the Code of Conduct and Rules for Registration of Interests)

Any Member who needs to clarify any matters relating to the declaration of interests is recommended to seek advice from the Council's Monitoring Officer or a member of his staff before the meeting to expedite dealing with the item during the meeting.

3. APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

To receive any declarations from Members of the Committee and Officers of personal/prejudicial interests in respect of matters for consideration at this meeting, together with their statements on the nature of any such interest declared.

4. TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

5. ITEMS FROM THE PUBLIC - TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

6. ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

To deal with any petitions or questions from Councillors and, where appropriate, co-opted and added members.

7. MINUTES: 11 SEPTEMBER 2015 (Pages 7 - 12)

Before discussing the exempt minutes of 11 September 2015, Members are invited to

consider the arguments set out in the Public Interest document and to pass the following resolution:

*“The Committee having been satisfied that the public interest would be better served by not disclosing relevant information, **RESOLVES** that the public shall be excluded from the meeting during the discussion of the exempt minutes of the meeting of 11 September 2015, in accordance with the provisions of section 100(A)(4) of the Local Government Act 1972, because of the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A of the Act as amended.”*

8. MANAGING LIABILITIES - ADDITIONAL ANALYSIS (Pages 13 - 96)
9. REBALANCING POLICY (Pages 97 - 164)
10. REVIEW OF INVESTMENT PERFORMANCE (Pages 165 - 236)

Before discussing exempt appendix 3, Members are invited to consider the arguments set out in the Public Interest document and to pass the following resolution:

*“The Committee having been satisfied that the public interest would be better served by not disclosing relevant information, **RESOLVES** that the public shall be excluded from the meeting during the discussion of exempt appendix 3, in accordance with the provisions of section 100(A)(4) of the Local Government Act 1972, because of the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A of the Act as amended.”*

The Committee Administrator for this meeting is Sean O'Neill who can be contacted on 01225 395090.

Protocol for Decision-making

Guidance for Members when making decisions

When making decisions, the Cabinet/Committee must ensure it has regard only to relevant considerations and disregards those that are not material.

The Cabinet/Committee must ensure that it bears in mind the following legal duties when making its decisions:

- Equalities considerations
- Risk Management considerations

- Crime and Disorder considerations
- Sustainability considerations
- Natural Environment considerations
- Planning Act 2008 considerations
- Human Rights Act 1998 considerations
- Children Act 2004 considerations
- Public Health & Inequalities considerations

Whilst it is the responsibility of the report author and the Council's Monitoring Officer and Chief Financial Officer to assess the applicability of the legal requirements, decision makers should ensure they are satisfied that the information presented to them is consistent with and takes due regard of them.

AVON PENSION FUND COMMITTEE - INVESTMENT PANEL

Minutes of the Meeting held

Friday, 11th September, 2015, 2.00 pm

Members: Councillor Christopher Pearce (Chair), Councillor David Veale, Councillor Cherry Beath, Ann Berresford and Councillor Mary Blatchford

Advisors: Tony Earnshaw (Independent Advisor), Steve Turner (Mercer) and James Giles (Mercer)

Also in attendance: Tony Bartlett (Head of Business, Finance and Pensions), Liz Woodyard (Investments Manager) and Matthew Clapton (Investments Officer)

1 EMERGENCY EVACUATION PROCEDURE

The Democratic Services Officer read out the procedure.

2 DECLARATIONS OF INTEREST

There were none.

3 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

Apologies were received from Shirley Marsh.

4 TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

There was none.

5 ITEMS FROM THE PUBLIC - TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

Two questions had been submitted by Virginia Williamson of Transition Bath. These and the answer provided by officers were:

- 1. What is the size of the Avon Pension Fund's investment in fossil fuels, including exploration?*

The Fund has approximately 1.2% of its assets invested in fossil fuel companies or c. £44m.

- 2. How much does the APF invest in renewable energies, including their research?*

The Fund does not allocate directly to renewables. The investment managers can invest in both renewable energy and research into renewables through the stocks that they hold in their portfolios.

At the invitation of the Chair, Ms Williamson made a statement about her background and how she had come to raise these questions. The Head of Business, Finance

and Pensions informed Ms Williamson that the Committee would be conducting a review of its responsible investment policy over the next twelve months, commencing with a paper that would be on the agenda of the next meeting on 25 September. Issues like the ones that Ms Williamson had raised would be considered as part of the review.

6 ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

There were none.

7 MINUTES: 4 MARCH 2015

These were approved as a correct record and signed by the Chair.

8 MANAGING LIABILITIES

The Investment Manager presented the report. She said that the two main means of managing a gap between the Fund's liabilities and its investment assets to meet those liabilities were generating more income / capital through the Investment Strategy or by raising the level of employer contributions. Mercer had produced a presentation on investment options and possible ways of managing this investment risk. The Panel was being invited to explore these issues before decisions were taken by the Committee.

Mr Turner gave a presentation based on the Mercer document that had been circulated with the agenda. He explained the possible options as to how the Fund could more effectively manage the risk that the mismatch between liabilities and assets posed to the Fund. The concept of leverage was explained in detail.

The Chair asked for clarification of the discount rate. He wondered whether it meant that future liabilities were calculated at present cash value and, secondly, whether the amount of bonds held would need to vary inversely to the level of interest rates. Mr Turner confirmed both of these suggestions.

There was discussion about the future trend of interest rates. The Head of Business, Finance and Pensions pointed out that political, rather than purely market factors, would have a major impact on the trend. Mr Turner said that markets had already priced in an expected rise in interest rates.

After discussion, the Panel felt that it was not able to make firm recommendations to the Committee at this time, and that they should consider Mercer's proposals again at a future meeting. Members agreed with the suggestion of the Investments Manager that a presentation by an investment manager on how such strategies including leverage worked would be useful.

RESOLVED

1. To request that further work be done on Mercer's proposals on an investment risk management framework and that they should appear on the agenda of a future meeting of the Panel.

2. To increase the allocation to Index Linked Gilts to the maximum permitted, funding the switch from fixed interest gilts.
3. To invite one of the Fund's investments manager to present to the Panel on how leverage works.

9 REVIEW OF STRATEGIC HEDGING OF CURRENCY EXPOSURE

RESOLVED that the Committee having been satisfied that the public interest would be better served by not disclosing relevant information, the public shall be excluded from the meeting during the discussion of this item, in accordance with the provisions of section 100(A)(4) of the Local Government Act 1972, because of the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A of the Act as amended.

The Investment Manager presented the report.

After discussion, Members **RESOLVED** to made recommendations to the Committee.

The meeting returned to open session.

10 INVESTMENT REPORT

The Investments Manager presented the report. She said that there no major issues to report to the Panel at the moment. The headline figures were given in paragraph 3 of the covering report. The latest funding position was not available at present, but would be given in the report to the next Committee meeting. She drew attention to Appendix 4 dealing with performance reporting of Partners Overseas Property Mandate; it was proposed to make changes to Partners' benchmarks as explained on agenda page 227 in order that the benchmark and performance target more accurately reflected the assets held within the portfolio.

Mr Turner commented on the Mercer investment report.

No issues arising from the investment report were identified for reporting to the Committee.

RESOLVED to note the information set out in the reports.

11 WORKPLAN

The Investments Manager presented the report.

It was noted that the next meeting of the panel was scheduled for 18 November 2015.

The Investments Manager suggested that the Meet the Managers Workshop should take place in November, and said that proposed dates would be circulated to Members.

RESOLVED

- 1. To note the workplan to be included in the Committee papers.
- 2. To note the proposed manager meeting schedule for the Panel.

The meeting ended at 4.42 pm

Chair(person)

Date Confirmed and Signed

Prepared by Democratic Services

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

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Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND INVESTMENT PANEL	
MEETING DATE:	18 November 2015	AGENDA ITEM NUMBER
TITLE:	MANAGING LIABILITIES – ADDITIONAL ANALYSIS	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report:		
Appendix 1 – Mercer Report: Risk Management Framework – Further training and scenario analysis		
Appendix 2 – <u>Copy of Mercer report to September Panel Meeting</u> - Risk Management Framework		

1 THE ISSUE

- 1.1 At the September meeting, the Panel considered recommendations from Mercer on how the liability risks could be managed more effectively. At the meeting the Panel requested further analysis before making full recommendations to Committee.
- 1.2 The report from Mercer providing the additional analysis is at Appendix 1.
- 1.3 Insight Investment (an investment manager with experience of managing liability matching mandates) will give a presentation to the Panel on how an investment mandate of this nature can be implemented.

2 RECOMMENDATION

- 2.1 **The Panel having considered the additional information provided by Mercer and agrees:**
 - (1) That, in principle, the Fund should put a framework in place to more effectively use the investment assets to match the liabilities.
 - (2) To prepare the proposed framework to be considered by the Panel for recommendation to the Committee. The proposal will bring together the work done to date and the proposed framework including a 3 year plan to increase the level of matching and a longer term plan to reach a target level of matching when affordable.

3 FINANCIAL IMPLICATIONS

- 3.1 There is provision in the 2015/16 budget for investment advice relating to the review of the Fund's management of liability risks. Any future implementation of a liability risk management framework may incur additional costs for future budgets.

4 BACKGROUND

- 4.1 Pension liabilities are the accrued benefits that will be paid out in the future. The monetary values of these cashflows are known. However, the "net present value" of these liabilities changes over time and the investment strategy only partially matches these cashflows, i.e. there is a "mismatch". The funding strategy calculates the contributions required to be paid into the Fund to fully fund pension cashflows as they fall due.
- 4.2 **Why manage these risks?** By managing the mismatch between the change in value of assets and liabilities over time, the Fund can minimise funding level volatility and stabilise employer contribution rates more effectively.
- 4.3 **What are the causes of such risks?** The 2 largest factors affecting changes in the value of liabilities are as follows:
- Changes in interest rate – higher interest rates increase the discount rate used to value liabilities, thereby reducing the current value put on future liabilities (and vice versa)
 - Changes in inflation rate – higher rates of inflation lead to larger benefits payments to members
- 4.4 **How can we manage these risks?** The impact of these risks on the funding level and contributions can be reduced by investing in assets whose value responds to changes in interest rates, inflation rates or longevity, in a similar way as the value of liabilities responds to such changes (i.e. by improving the 'matching characteristics' of the stabilising portfolio to the liabilities).
- 4.5 The stabilising portfolio seeks to reduce volatility in the valuation outcome; the majority of the investment portfolio remains invested in growth assets that generate higher returns. These "excess" returns help reduce the deficit contributions and employer contribution rates within the funding strategy.
- 4.6 **Progress to date:** In September, the Panel considered recommendations from Mercer and requested additional information before making full recommendations to Committee. Mercer's original recommendations to the September Panel are outlined in Appendix 2 which is a copy of the September paper in which they explain the rationale, the impacts and the risks of the proposed framework. Specifically the report included:
- (1) How interest rates and inflation rates impact the liabilities and investments portfolio and how the 'mismatch' in changes to liabilities and assets arises.
 - (2) How by using current bond assets more efficiently the Fund can significantly improve the matching characteristics of the investments portfolio.

- (3) How by setting a target level of matching and putting an appropriate framework in place to reach that target the Fund can ensure the programme is implemented in an efficient manner.
- (4) How by managing this mismatch, the increased certainty of outcome allows the actuary to reassess the level of prudence assumed when valuing the liabilities and thereby manage consistent contribution levels.
- (5) An explanation of the nature of the investments to be made to achieve the desired outcome.

5 MERCER REPORT WITH ADDITIONAL ANALYSIS

5.1 Having considered Mercer's report at the September meeting, the Panel requested further work covering the following:

- (1) How interest rates and inflation rates impact the liabilities and investments
- (2) Explanation of leverage, how it is used and the risks
- (3) Scenario analysis outlining the impact of moves in yields
- (4) Explanation of gilt repo's as a hedging instrument and the inherent risks

5.2 The new report produced by Mercer with the additional information requested is included at Appendix 1.

6 RECOMMENDATIONS

6.1 Mercer's original recommendations to the September Panel are outlined in Appendix 2. The recommendations were:

- (1) An immediate change to the UK government bond portfolio to improve matching.
- (2) Developing a three year plan to increase the level of matching.
- (3) Establish a longer term plan to reach a target level of matching when affordable.

6.2 At the September meeting the Panel agreed recommendation 1, to change the government bond portfolio to improve the matching of liabilities.

6.3 Having considered the information on liability driven investing provided to date, the Panel is asked to agree the following:

- (1) Whether in principle they believe the Fund should put a framework in place to more effectively use the investment assets to match the liabilities.
- (2) To prepare the proposed framework to be considered by the Panel for recommendation to the Committee. The proposal will bring together the work done to date and the proposed framework including a 3 year plan to increase the level of matching and a longer term plan to reach a target level of matching when affordable.

6.4 The final proposal to be put forward to the Committee will be considered at the next Panel meeting in February.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in

place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary as the report contains only recommendations to note.

9 CONSULTATION

9.1 N/a

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 Are set out in the report.

11 ADVICE SOUGHT

11.1 The Council's Section 151 Officer (Divisional Director – Business Support) has had the opportunity to input to this report and has cleared it for publication.

Contact person	Liz Woodyard, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	

RISK MANAGEMENT FRAMEWORK – FURTHER TRAINING AND SCENARIO ANALYSIS

AVON PENSION FUND

18 NOVEMBER 2015

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Steve Turner
Partner

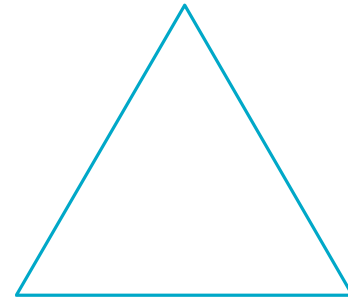
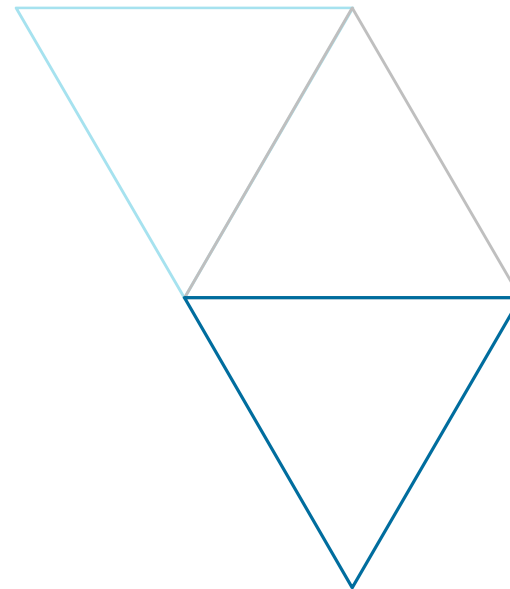
AGENDA

• Recap – September Panel Meeting	2
• Why do yields matter?	5
• What is leverage?	7
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RECAP – SEPTEMBER PANEL MEETING

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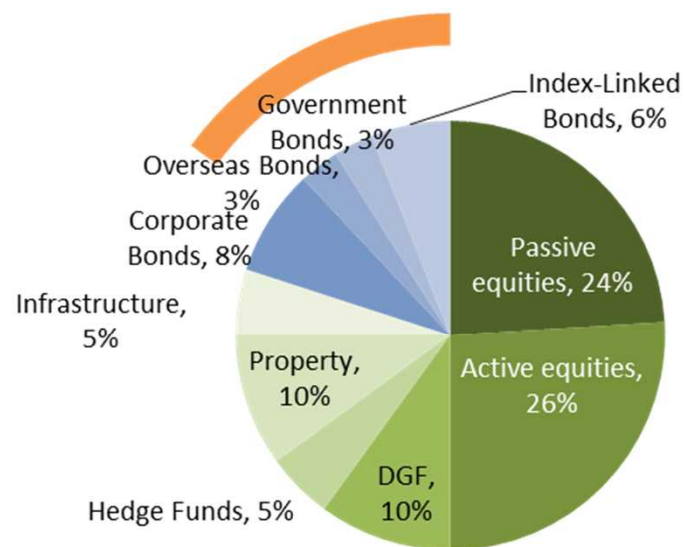


RECAP – SEPTEMBER PANEL MEETING

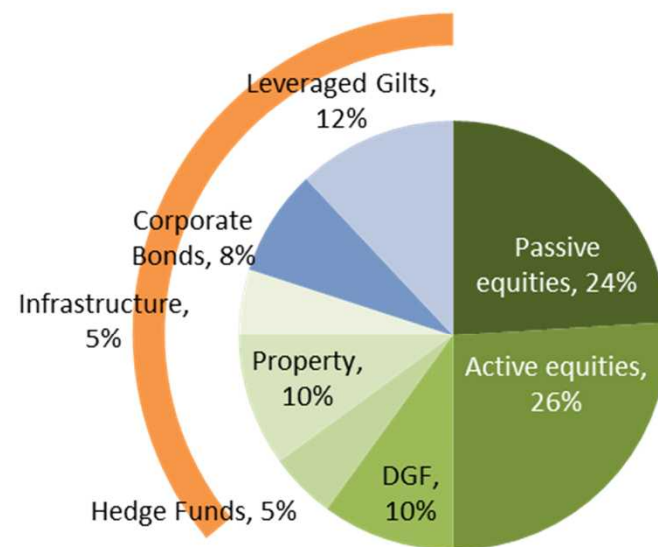
- At the September meeting, the Investment Panel agreed to switch the Fund's current holdings in fixed interest and overseas government bonds into Index Linked Gilts in order to better match the Fund's liabilities (with 12% in Index-Linked Gilts).
- This move makes “better use” of the Fund's existing “bond” assets to help (modestly, but in the right direction) to reduce funding level volatility.
- As a further step, it was noted that using 3x leveraged funds would allow the Fund to match 36% of funded liabilities. The attraction of this is that funding level volatility could be reduced, whilst maintaining the current allocation to growth assets.
- This report provides more training on the use of leverage, and the impact on the Fund and on leveraged assets should yields rise or fall.

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IMPROVING MATCHING INITIAL TARGET (NEXT THREE YEARS)



■ Liability protection (% of assets)



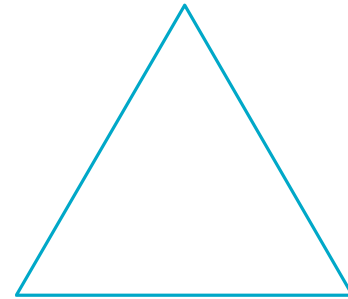
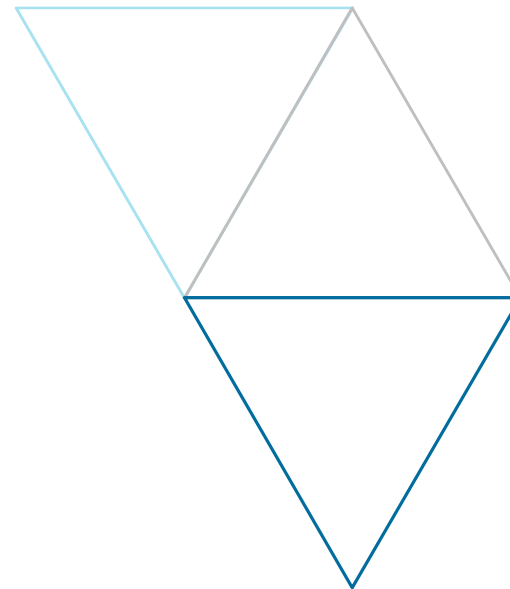
■ Liability protection (% of assets)

Strategy	Current – switch fixed interest gilts to index-linked gilts to match duration	Initial target
Liability protection from government bonds (% of assets)	12% of assets	36%
Best estimate return (% p.a.)	6.0%	6.0%
Illustrative discount rate (% p.a.)	4.3%	4.5% 
One year deficit risk	£1.0bn	£0.9bn 

**INCREASE IN DISCOUNT RATE POSSIBLE BECAUSE
GREATER CERTAINTY ALLOWS PRUDENCE TO BE
RELEASED**

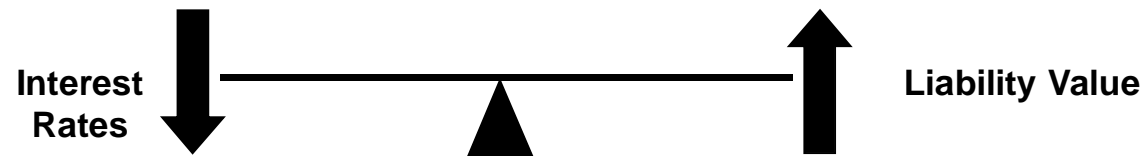
WHY DO YIELDS MATTER?

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HOW DO INTEREST RATES AND INFLATION AFFECT LIABILITIES ON THE CURRENT FUNDING BASIS?

- There is an **inverse** relationship between interest rates (aka long-term gilt yields) and liability values



If long-term interest rates fall, the Fund's discount rate falls

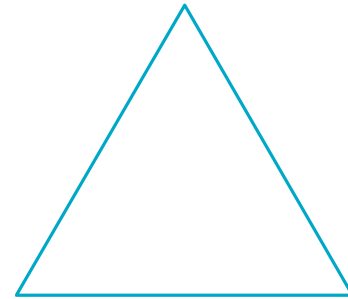
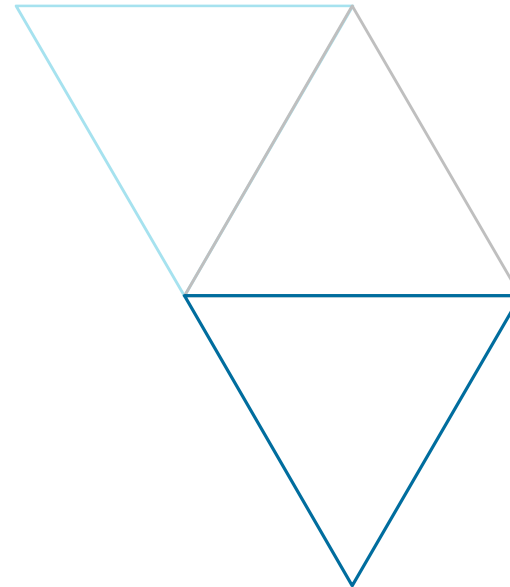
Hence the Fund's liabilities rise

So, all else being equal, the funding level deteriorates

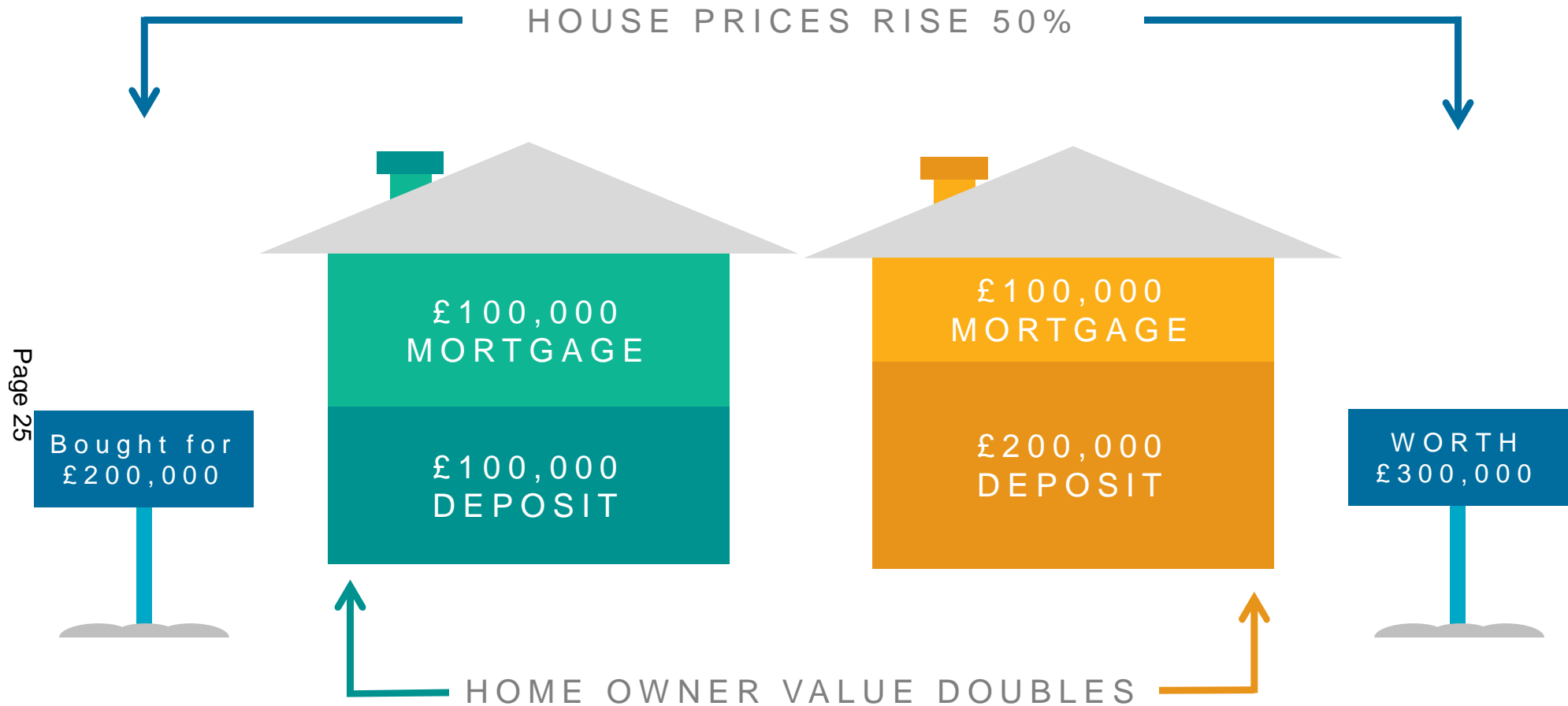
- Index-Linked Gilt yields are currently used to value the liabilities and therefore the type of gilt yield that matters most to the Fund. Index-Linked Gilts provide exposure to real yield (a combination of nominal interest rates and inflation)
- Getting more exposure to real yields should help reduce funding level volatility

WHAT IS LEVERAGE?

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EVERY DAY EXAMPLE OF LEVERAGE



Exposed to £200,000 of movements in house prices, but only requires £100,000 of investment –
“two times leveraged”

HEDGING INSTRUMENTS

Physical Instruments (1:1 exposure)

- Physical instruments require a capital investment at outset (i.e. funded)
- Liquidity varies by instrument
- Pricing is typically transparent and standard instruments are traded
- Commonly held by pension schemes and generally well understood

Fixed-Interest Gilts

Corporate Bonds

Index-Linked Gilts

Synthetic / Derivative Instruments (allows leveraged exposure)

- Can be funded (i.e. capital commitment is made) or unfunded (i.e. geared or leveraged)
- Typically these are Over the Counter (“OTC”, i.e. bespoke) although some exchange traded versions also exist
- Liquidity varies by instrument and within each type, some are highly illiquid and could be more illiquid than physicals
- Less transparency on pricing for OTC contracts, although some standard contracts address this
- Can offer more efficient hedging – i.e. more liability hedging per pound invested

Interest Rate Swaps

Inflation Swaps

Gilt repos

LEVERAGE EXPLAINED

Funded vs Unfunded exposure

Funded exposure

- It is said that the position is funded (or unleveraged) if the amount of assets (i.e. collateral*) invested in the hedging portfolio is backing the same amount of risk exposure
- e.g. £100 of collateral is backing £100 of risk

£100
bond
exposure

£100
collateral

Unfunded exposure

- If amount of collateral invested is less than the amount of liabilities being hedged then the hedging portfolio is said to be levered
- e.g. £100 of assets hedging £300 of risk

£300
bond
exposure

£100
collateral

Unfunded

Why use leverage? To “free up” assets to use elsewhere in the portfolio, i.e. for return seeking purposes

*Collateral: a term used to describe the underlying assets invested in the LDI funds. The assets are typically high quality and liquid assets such as cash instruments and government bonds, and are “on deposit” as security. These assets would be used to offset the potential loss should either counterparty default on its obligation under a swap or gilt repo.

LEVERAGE EXPLAINED

What if?

- Starting position: £300 of interest rate exposure
- Obtained using £100 of collateral (e.g. cash)
- i.e. **3** times levered (i.e. 3 times more sensitive to movements in rates)

If yields rise by 1%, it increases leverage

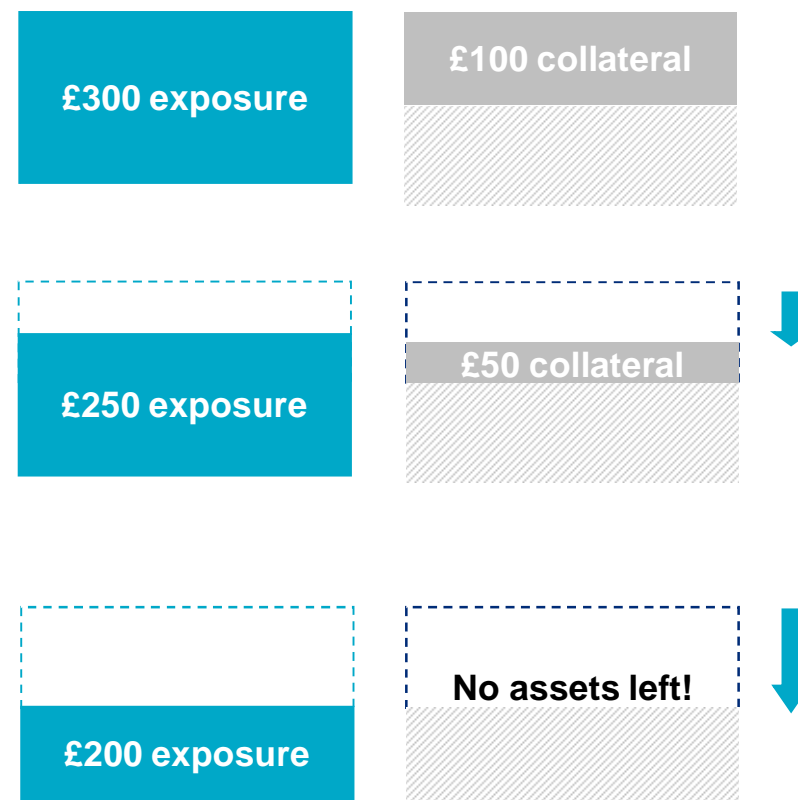
Loss on interest rate exposure of £50

So value of collateral drops from £100 to £50

- Leverage is $\text{£}250 / \text{£}50 = \mathbf{5}$ times (up from 3)

If yields rise by 2%, collateral extinguished(!)

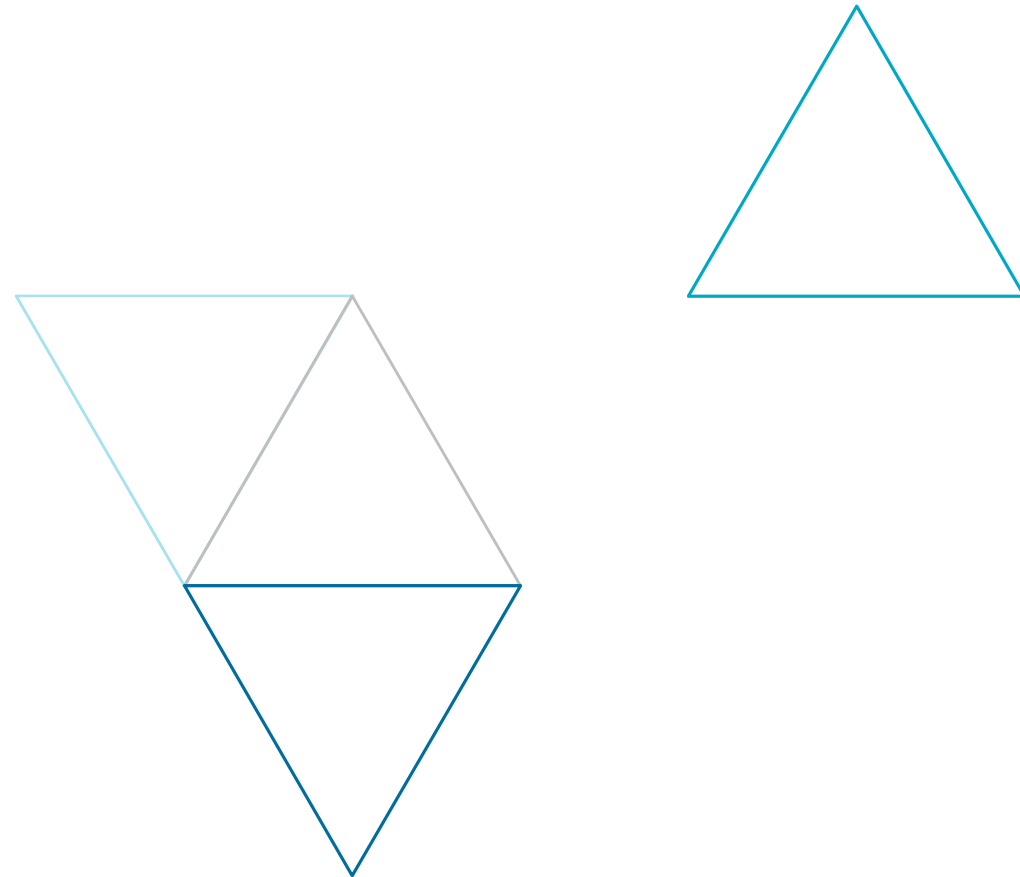
- Loss on interest rate exposure of £100
- Value of collateral drops from £100 to zero
- More collateral required or close position
- In practice, collateral should be replenished long before this point is reached.



Leverage will rise / fall as net interest rates rise / fall

SENSITIVITIES

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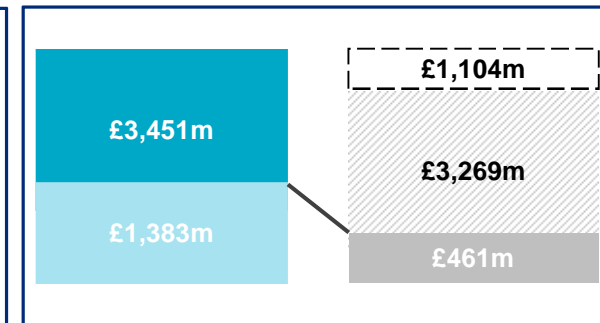
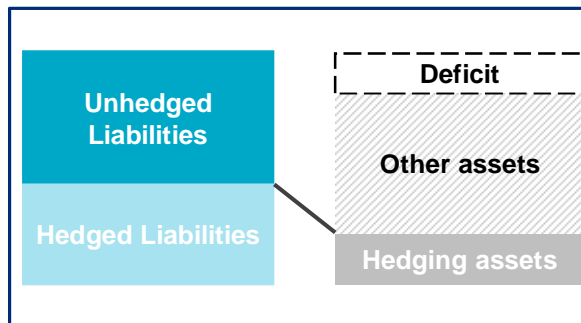


SENSITIVITIES – WORKED EXAMPLE

RATES FALL

Starting position

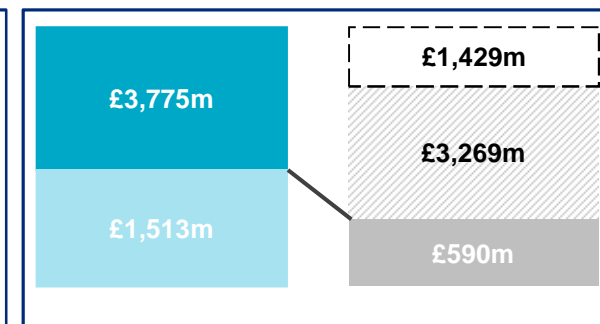
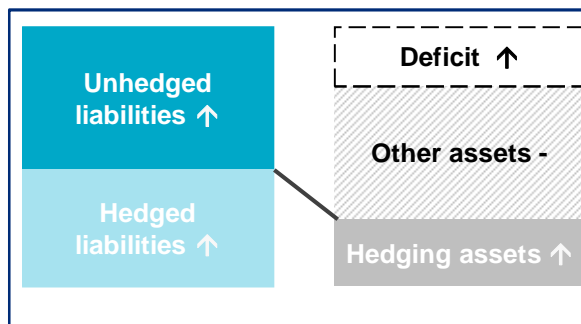
- At 30 June 2015 the Fund had an estimated deficit of c.£1.1bn with a funding level of 77%.
- LDI assets amount to c.12% of asset portfolio. Based on leverage of around 3x around 36% of funded liabilities could be hedged (c. 29% of total liabilities because of the deficit)



RATES FALL BY 0.5% p.a.

Liabilities increase, assets also increase

- The value of the liabilities increases by around £455m, with hedging assets increasing by £130m (asset increase would be c. £43m without leverage)
- The deficit increases by around £325m and **funding level falls to 73%**. (would be c. 71% without leverage)
- Leverage in the LDI portfolio falls to c.2.6x.



Liabilities increase, funding level falls (but matching assets provide some protection).

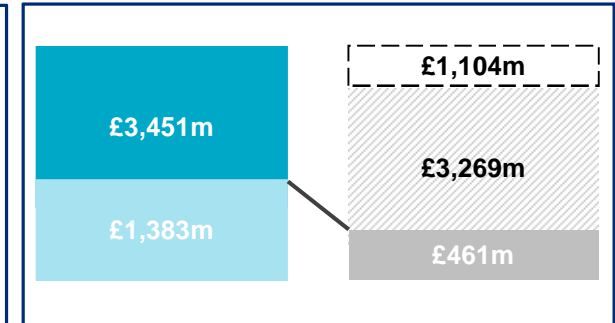
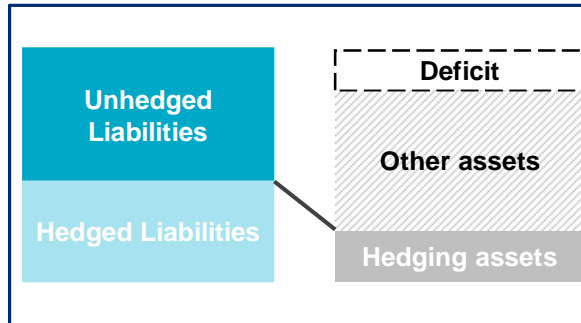
Numbers assume liabilities are 100% real in nature; ignores impact of changes in interest rates on corporate bond portfolio.

SENSITIVITIES – WORKED EXAMPLE

RATES RISE

Starting position

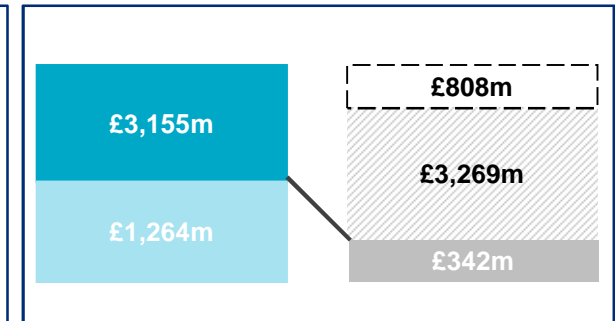
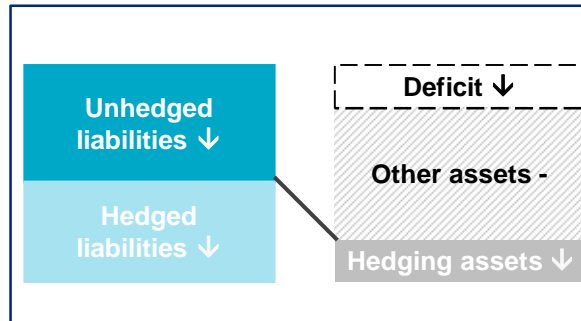
- At 30 June 2015 the Fund had an estimated deficit of c.£1.1bn with a funding level of 77%.
- LDI assets amount to c.12% of asset portfolio. Based on leverage of around 3x around 36% of funded liabilities could be hedged (c. 29% of total liabilities because of the deficit)



RATES RISE BY 0.5% p.a.

Liabilities decrease, assets also decrease

- The value of the liabilities reduces by around £415m, with hedging assets falling by £120m (asset increase would be c. £40m without leverage)
- The deficit reduces to around £810m and **funding level increases to 82%**. (would be c. 84% without leverage)
- Leverage in the LDI portfolio increases to c.3.7x.

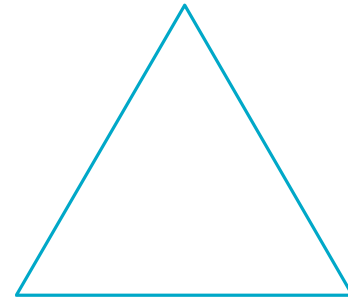
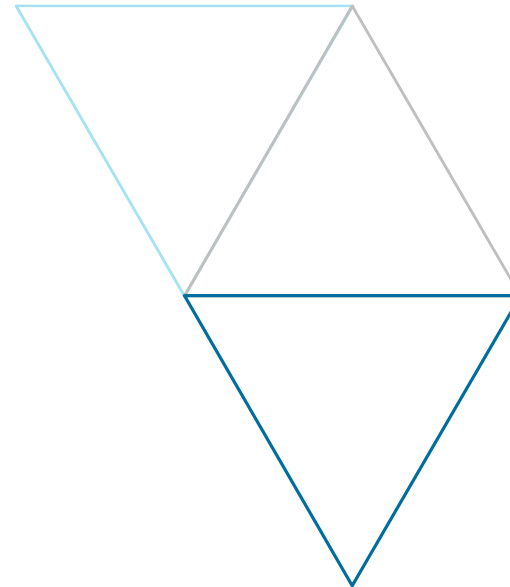


Positive outcome for the Fund – liabilities fall and funding level increases.

Numbers assume liabilities are 100% real in nature; ignores impact of changes in interest rates on corporate bond portfolio.

RECAPITALISATION / RE-LEVERAGING EVENTS

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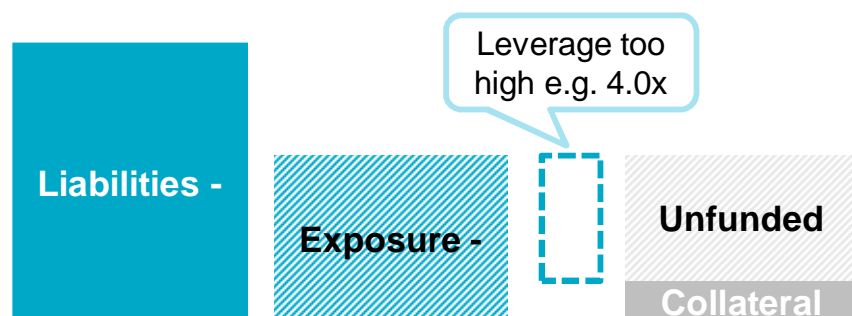
RECAPITALISATION / RE-LEVERAGING EVENTS

If yields rise or fall beyond certain points the leverage may be too high or low to be managed efficiently. Once certain levels are breached a **recapitalisation** or **re-leveraging** event may be triggered.

Recapitalisation

An increase in yields means that leverage levels increase.

If this level becomes too high, the value of the fund may be too volatile as increasingly small changes in yields can decrease the level of collateral materially.



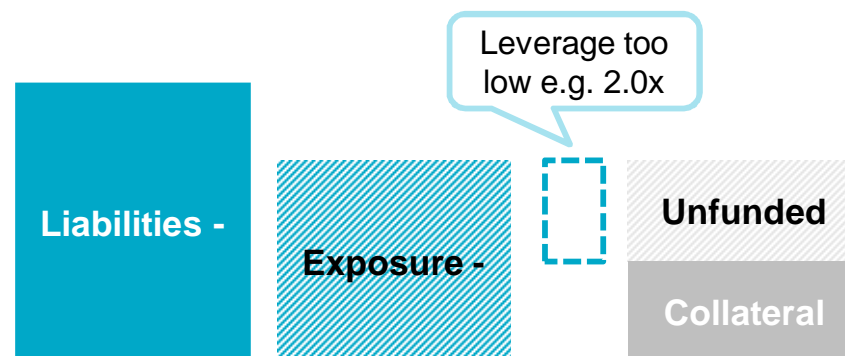
A manager may require that collateral be “topped up” within a particular timeframe. This additional money decreases the unfunded exposure.

This additional capital would have to be funded from the Fund’s holdings in growth assets or corporate bonds, which would reduce the expected return on assets. However, in this scenario yields have risen and so the funding level of the Fund has improved. All else being equal, less risk needs to be taken to achieve the existing funding objective

Re-leveraging

A reduction in yields means that leverage levels fall.

If this level becomes too low, the LDI portfolio may be seen as inefficient as additional liabilities could be hedged with the same level of collateral.



A manager may “return” to the Fund cash to invest, whilst maintaining the level of liability matching.

VOLATILITY OF BOND YIELDS

Pooled liability driven investment funds “typically” constructed to be able to withstand a 1% - 1.5% p.a. shift in yields without requiring adjustment (i.e. recapitalisation or re-leveraging)

Bespoke segregated mandates can be designed to withstand more significant shifts in yields

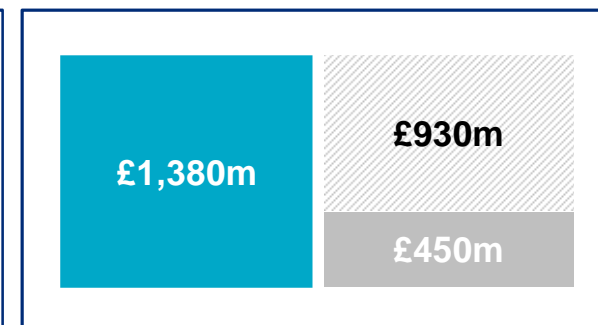
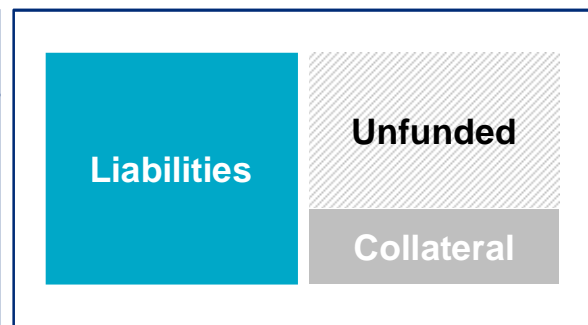


Source: Thomson Reuters Datastream

RECAPITALISATION EVENT – WORKED EXAMPLE

STARTING POSITION

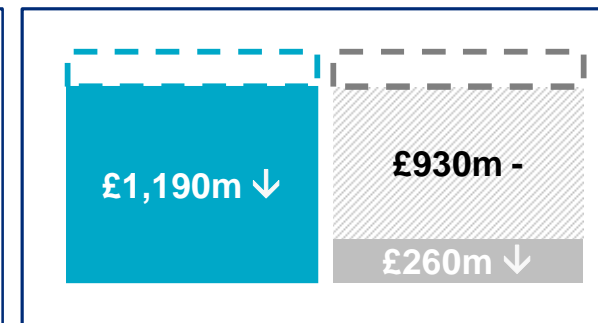
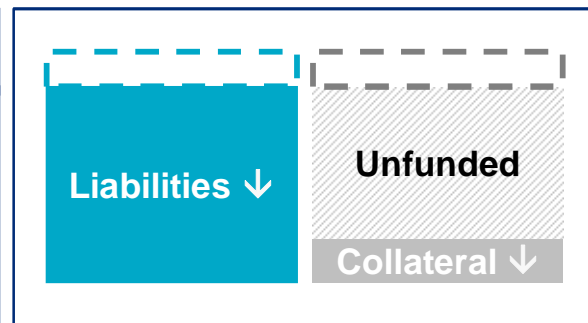
- Assume that the Fund invests £450m in the BlackRock 2032 Leveraged Index Linked Gilt fund (currently **3.07x** leveraged, i.e. effectively hedging approximately £1,380m of liabilities).
- In practice, the Fund would invest in a number of LDI funds rather than just one.



RATES RISE

INITIAL IMPACT – LEVERAGE INCREASES

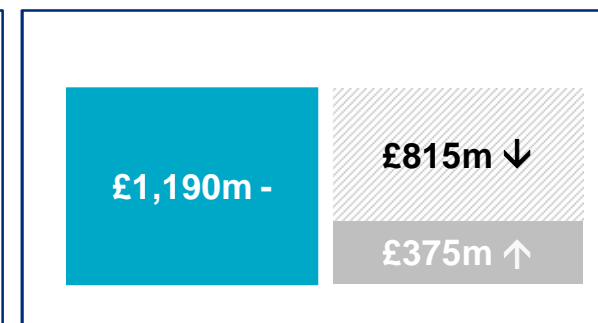
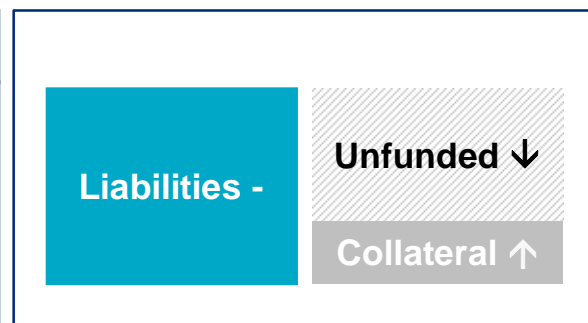
- Gilt yields rise (by 0.94%*), and the value of the leveraged fund falls by £190m to £260m
- The value of the liabilities hedged also falls to £1,190m
- Net result, the leverage increases from 3.07x to **4.6x** (at BlackRock's limit for the fund).



MANAGER REQUIRES £115m

“RECAPITALISATION” EVENT OCCURS

- Manager requires £115m within an agreed timeframe (to be taken from pre-agreed source).
- The level of hedging provided by the fund remains unchanged, while the collateral in the fund is increased.
- Leverage moves from 4.6x to **3.2x**

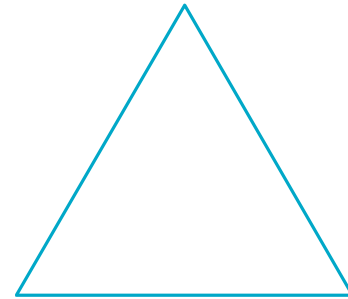
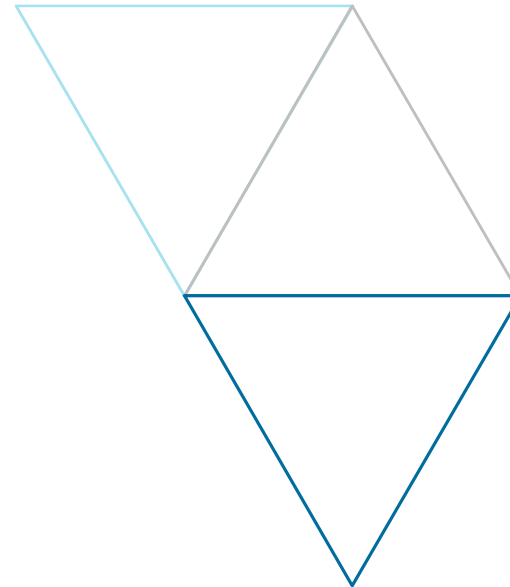


Summary: liabilities have fallen, and so have matching assets; collateral is reduced and so additional assets required to replenish capital.

*Based on recent market conditions – the actual rise in yields to trigger a recapitalisation event will depend on the specific funds invested in, and market conditions at the time of investment.

WHAT IS A GILT REPO?

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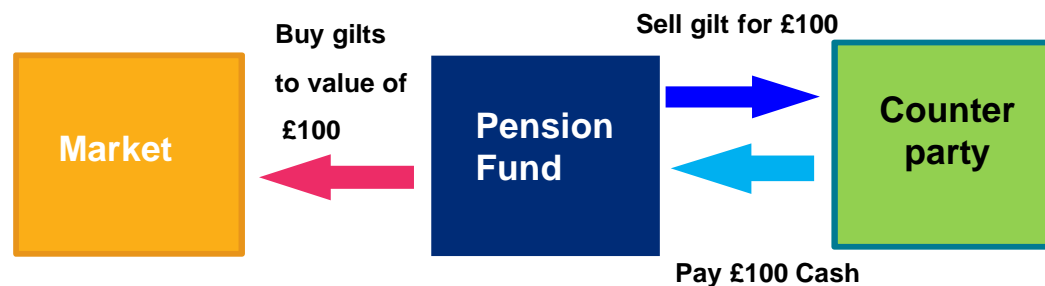
WHAT IS A GILT REPO? (1)

A gilt repurchase agreement is a liability hedging instrument which allows investors to employ leverage, that is to hedge a higher level of liabilities than the value of the underlying assets.

Gilt repo contracts work as follows

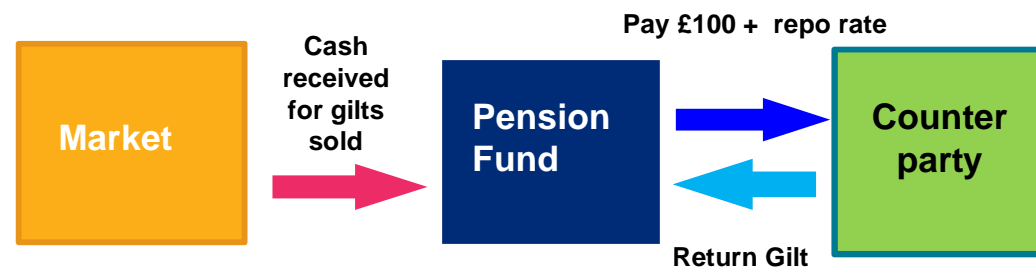
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Day of the trade



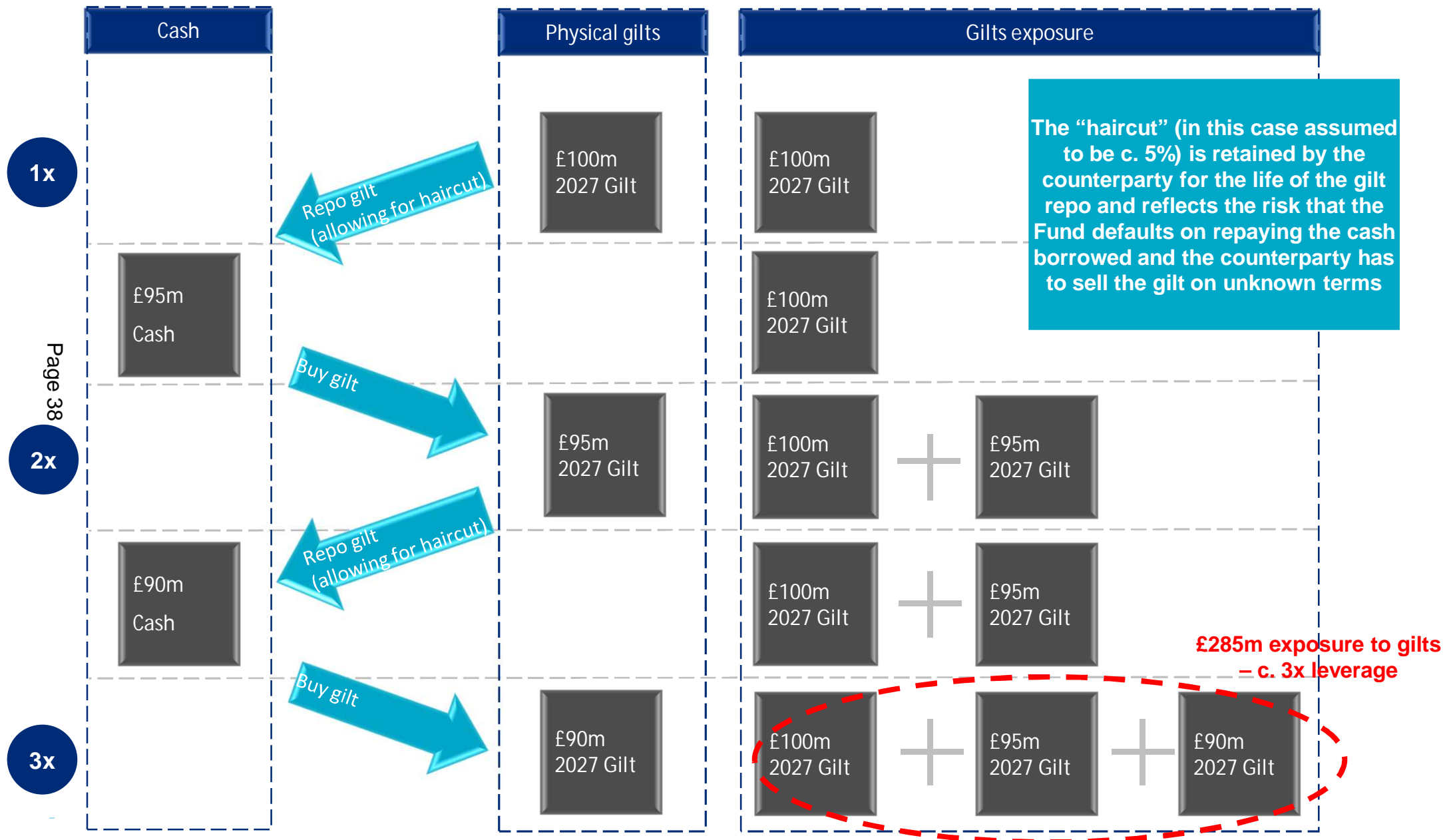
- A pension scheme buys a gilt and subsequently “sells” it to a counterparty.
- The pension scheme agrees to repurchase it (“repo”) at a pre-fixed price in the future. The cash received may be subject to a “haircut” retained by counterparty.
- The pension scheme can use the cash to purchase another gilt (and use repo again if desired).
- Exposure to the changing value of the gilt is retained.

End of contract



- The pension scheme re-purchases the gilt at the pre-determined price.
- Gilt coupons received during the term of the contract are passed to the pension scheme.
- The pension scheme benefits/loses from increases/falls in the market value of the gilts.
- At the end of the contract a repo arrangement can occur again.

WHAT IS A GILT REPO? (2)



KEY RISKS ASSOCIATED WITH REPO

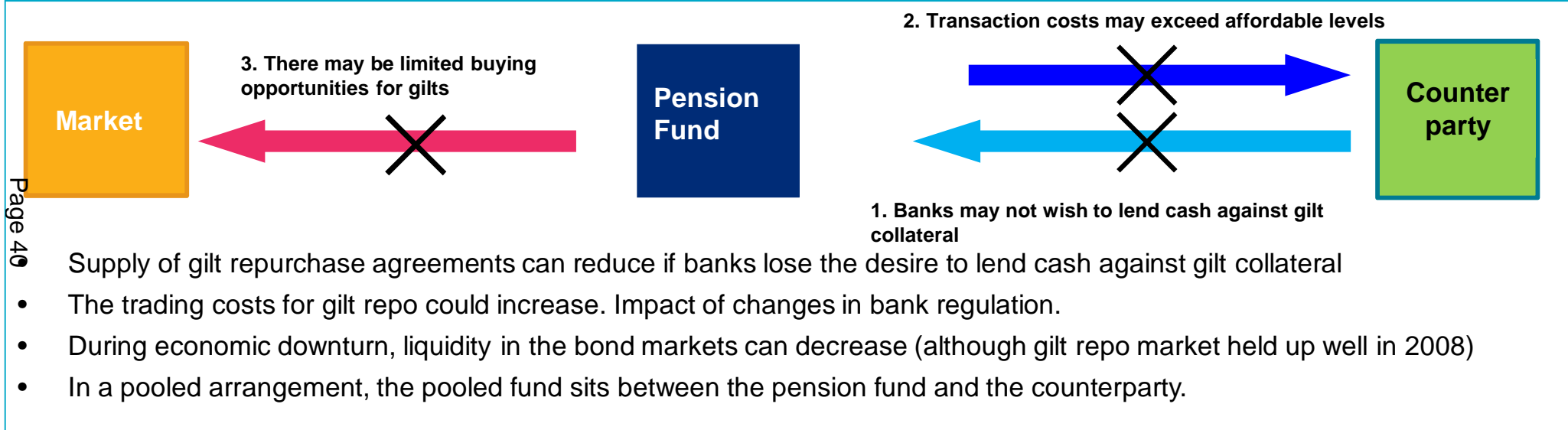
	Challenges	Mitigants
Roll/liquidity risk	<p>Roll risk is the risk that it becomes either:</p> <ul style="list-style-type: none"> • very/too expensive to re-transact the position (i.e. repo rates rise); or • it becomes impossible to roll the position (i.e. counterparties refuse to transact); <p>and there is insufficient liquidity available to purchase the gilt securities outright to preserve the hedge – see overleaf for more detail</p>	<p>This risk can be partially mitigated through laddering the repo maturity dates, reducing gilt repo exposure in favour of using other (potentially less efficient) instruments and/or ensuring that there is sufficient access to liquidity to purchase the gilts outright.</p>
Counterparty risk	<p>The risk that the investment bank on the other side of the repo transaction defaults on its obligation.</p>	<p>This risk can be mitigated (but not removed) by regular collateralisation of the repo position.</p> <p>We note that since repo contracts can be short term in nature, exposure could be moved away from counterparties with deteriorating credit quality (but this clearly would not work in a jump-to-default situation).</p>
Collateral adequacy risk	<p>Most market participants trade gilt repo under documentation that specifies that collateral be posted in the form of either cash or gilts. Collateral needs to be posted to cover any mark-to-market losses on the gilt repo positions and collateral adequacy risk is the risk that sufficient eligible collateral is not available (forcing sales of other assets).</p>	<p>The more cash/gilts retained as collateral, the lower collateral adequacy risk will be.</p>

WHAT IS ROLL RISK?

Why do gilt repos need to roll?

Although the maturity of gilts are many years in to the future, gilt repurchase agreements often have terms of up to 12 months. If a pension scheme uses gilt repo as a liability hedging instrument the gilt exposure may have to be rolled many times during the life of the hedge. This introduces roll risk.

Examples of roll risk

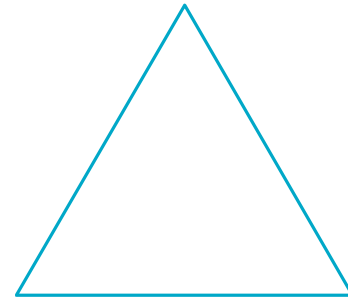
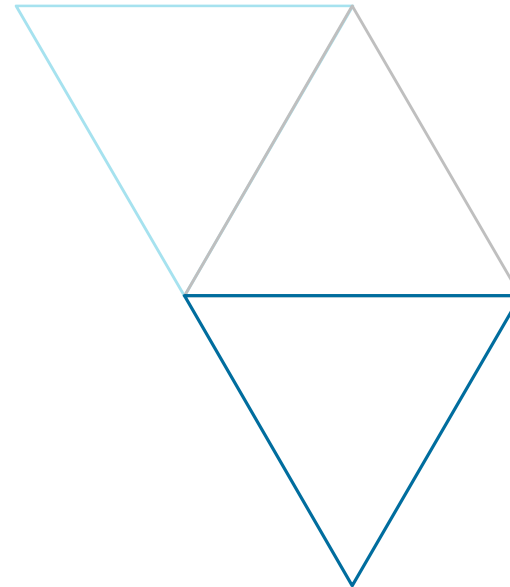


What happens if repo cannot be rolled?

- Reduce level of liability hedging until market more attractive
- Replace gilt exposures with swaps when required
- Diversify initial hedge with gilts and swaps
- Reduce leverage by investing in physical gilts if funding position improves
- Reduce leverage by synthesising growth assets (e.g. equity total return swaps) and investing in gilts

SUMMARY AND NEXT STEPS

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SUMMARY: RECAP OF SENSITIVITIES WITH AND WITHOUT LEVERAGE

	0.5% fall in rates		0.5% rise in rates	
	Current	Using leverage	Current	Using leverage
Change in liabilities (c. £4.8bn)	+£455m	+£455m (=)	-£415m	-£415m (=)
Change in hedging assets (c. £460m)	+£43m	+£130m (↑)	-£40m	-£120m (↓)
Change in funding level (starting position 77%)	-6%	-4% (Fund better off than without leverage due to improved matching)	+7%	+5% (Fund worse off than without leverage due to improved matching, but funding level still improves)
Change in leverage	N/A	3x → 2.6x	N/A	3x → 3.7x
Impact on other assets		Potential for re-leveraging – assets returned and invested elsewhere		Potential for re-capitalisation – assets required from elsewhere (growth portfolio or corporate bonds)

Illustrative figures as at 30 June 2015 based on current funding basis and change in real rates – see pages 13 and 14 for details. Numbers assume liabilities are 100% real in nature; ignores impact of changes in interest rates on corporate bond portfolio.

SUMMARY AND NEXT STEPS

- Agreement in principle from September Panel meeting to switch current fixed-interest UK and overseas government bonds to index-linked gilts to improve inflation protection
 - Better matches the Fund's liabilities which are predominantly linked to inflation
 - Discussing appropriate allocation with BlackRock to best match liabilities of the Fund
- Significant benefit from “putting a plan in place” to be able to increase the level of liability protection when acceptable to the Fund.
 - Initial suggestion would be using a combination of time and yield based triggers to switch this combined 12% of assets to provide greater liability protection over the next three years using leverage
 - with a longer-term plan to increase this to 50%
- Next steps
 - Agree proposal to take to Committee (formal written advice)..
 - Use Fund specific liability cash-flows to identify broad characteristics of hedging portfolio (already undertaking this analysis for index-linked gilt portfolio)
 - Agree implementation route (e.g. pooled funds or other approach)
 - LDI manager selection decision – combine with passive equities / other form of growth assets in order to facility future de-risking opportunities in a timely fashion
 - Identify specific hedging solution with the appointed manager
 - Legal and investment review of relevant documentation.
 - Ongoing training throughout the process

QUESTIONS?

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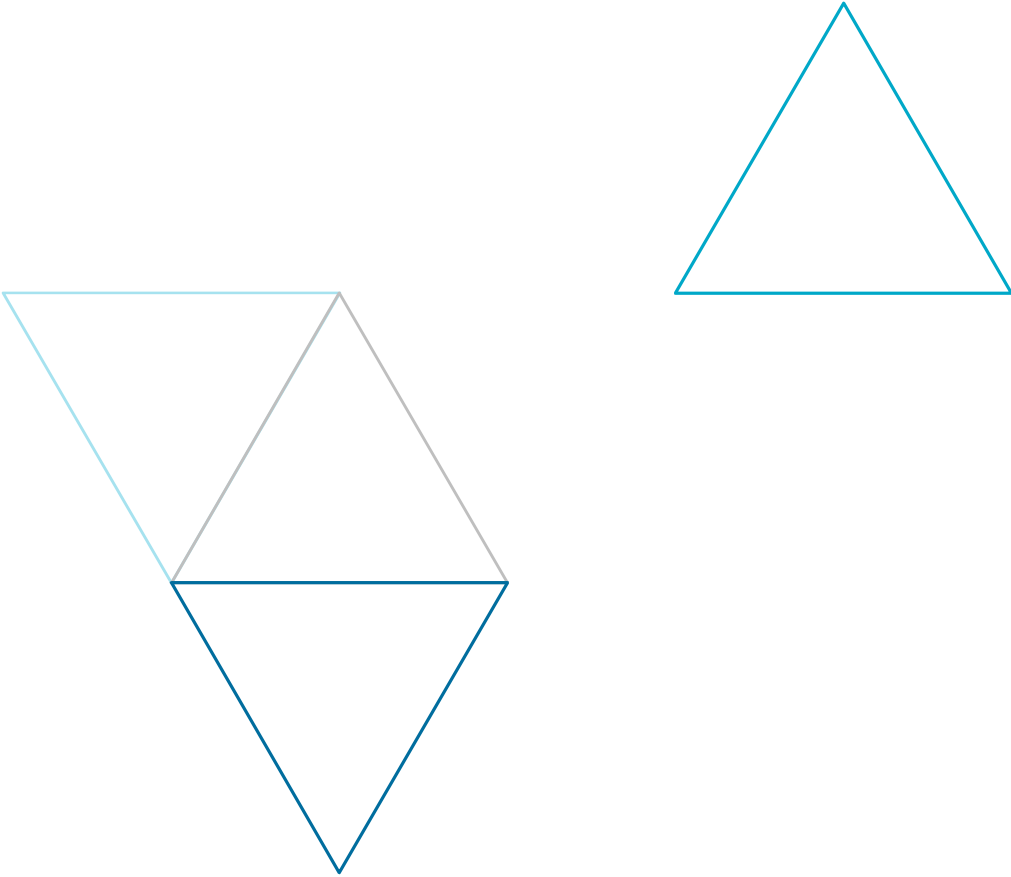
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APPENDIX

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IMPORTANT TERMS

- **Interest Rate Swap** – Two parties exchanging two sets of cashflows, usually based on one party paying a “fixed” rate (e.g. 3% p.a.) and the other paying a “floating” rate (e.g. Bank of England Base Rate + 2%)
- **Repurchase Agreement (Repo)** – An agreement to sell a security (usually a bond) to another party with the promise to buy it back at a specified date and price
- **Repo Rate** – The interest rate charged to the seller of the security in a repo
- **Basis Risk** – Risk that arises when an investor aims to hedge a position using an instrument that has an underlying security whose risk is being hedged. For example, a pension fund using bonds to hedge liabilities they do not perfectly match

WHAT IS A “SWAP” ?

An Over-The-Counter (“OTC”) transaction between a pension fund and counterparty bank.

Using an inflation swap as an example:

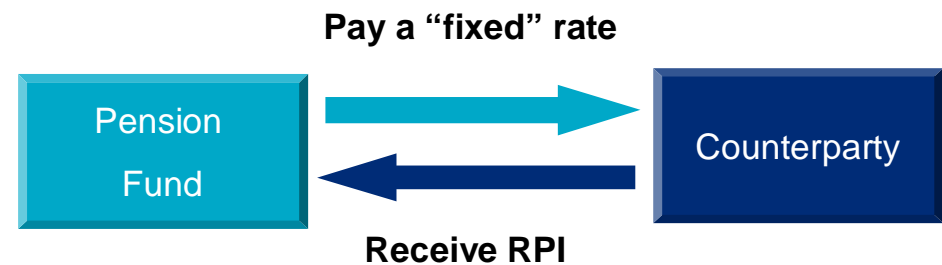
One party (usually the pension fund, but not always):
pays a fixed “swap” rate
receives a floating Retail Price Index (RPI) rate.

The other party (usually the bank) pays the floating RPI and receives the fixed rate.

The fixed rate varies by maturity and rates are quoted by many banks.

Creates *inflation rate exposure* similar to that of a bond

Fixed and floating cash flows have equal value (apart from transaction costs) at outset – no initial payment required.



For LGPS funds, swaps typically not held directly but through pooled funds.

MAKE
TOMORROW,
TODAY



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HEALTH WEALTH CAREER

RISK MANAGEMENT FRAMEWORK

AVON PENSION FUND

11 SEPTEMBER 2015

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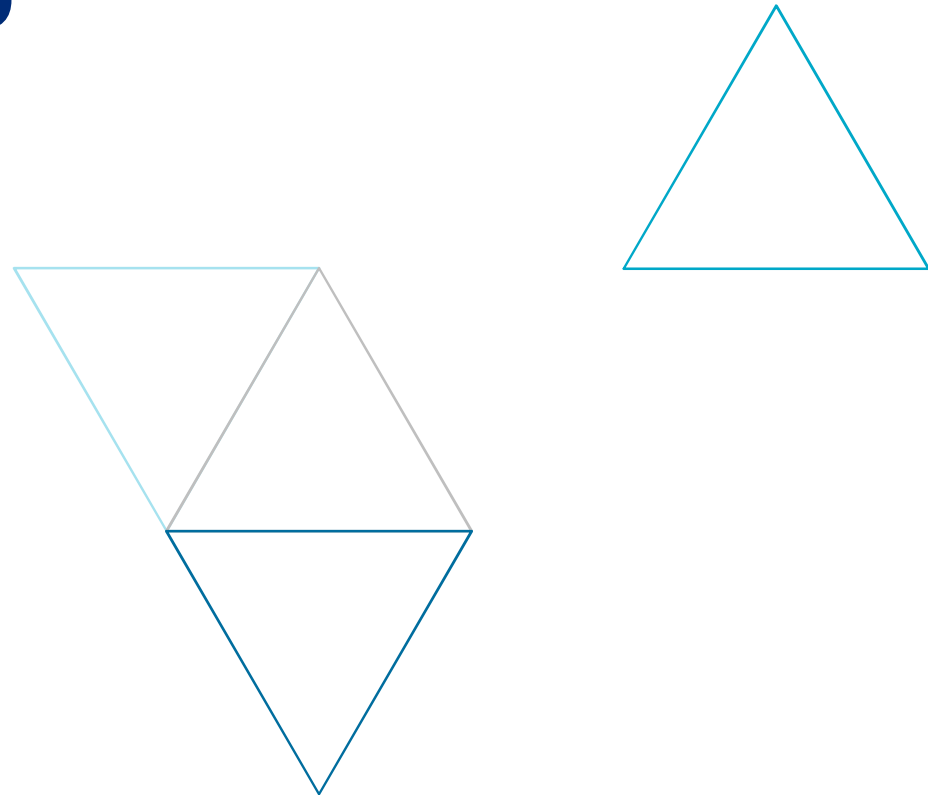
Steve Turner
Partner

AGENDA

• Introduction and objectives	2
• Risk management options	13
• Proposed risk management framework	21
• Next steps	32
• Appendices	36

INTRODUCTION AND OBJECTIVES

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RISK CONSIDERATIONS

Risk	Manage, reduce or monitor?	How?
Equity and growth asset risk	Monitor (and potentially reduce) We expect to be rewarded for this risk but could reduce if we get ahead of plan	Performance monitoring + de-risking if affordable
Credit risk	Monitor (and potentially reduce) We expect to be rewarded for this risk but could reduce if we get ahead of plan	Performance monitoring
Active manager risk	Monitor We expect to be rewarded for this risk	Performance monitoring
Interest rate risk	Reduce – two of the larger risks facing the Fund, and arguably unrewarded	Use physical index-linked gilts and in time leveraged index-linked gilts
Inflation		
Longevity risk	Monitor	As part of the actuarial valuation
Covenant risk	Manage and monitor	Develop employer specific investment strategies

PRINCIPLES OF RISK MANAGEMENT

Stable and affordable
contribution rate

versus

Achieve investment returns
required under current
funding arrangements



Objectives are two-fold but conflicting

- Risk needs to be taken in order to achieve returns but risk does not guarantee returns

Need to ensure a reasonable balance between the two objectives

- No need to take the same level of risk when 70% funded (say) than when 100% funded

RISK MANAGEMENT FRAMEWORK



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Strategic Rationale

- Will help reduce deficit volatility which is high, through better protection against adverse changes in long-term interest rates and inflation expectations
- Expected return on the investment policy is expected to remain broadly the same given proposed initial structure (i.e. no reduction, which is clearly expected to help reduce the deficit over the long-term)

Forward Looking

- Initial emphasis on putting in place “the plumbing” to facilitate future de-risking in a timely fashion, following improvements in the funding level and / or increases in market yields

HOW DO INTEREST RATES AND INFLATION AFFECT LIABILITIES?

- There is an **inverse** relationship between interest rates and liability values



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If long-term interest rates fall, the Fund's discount rate falls

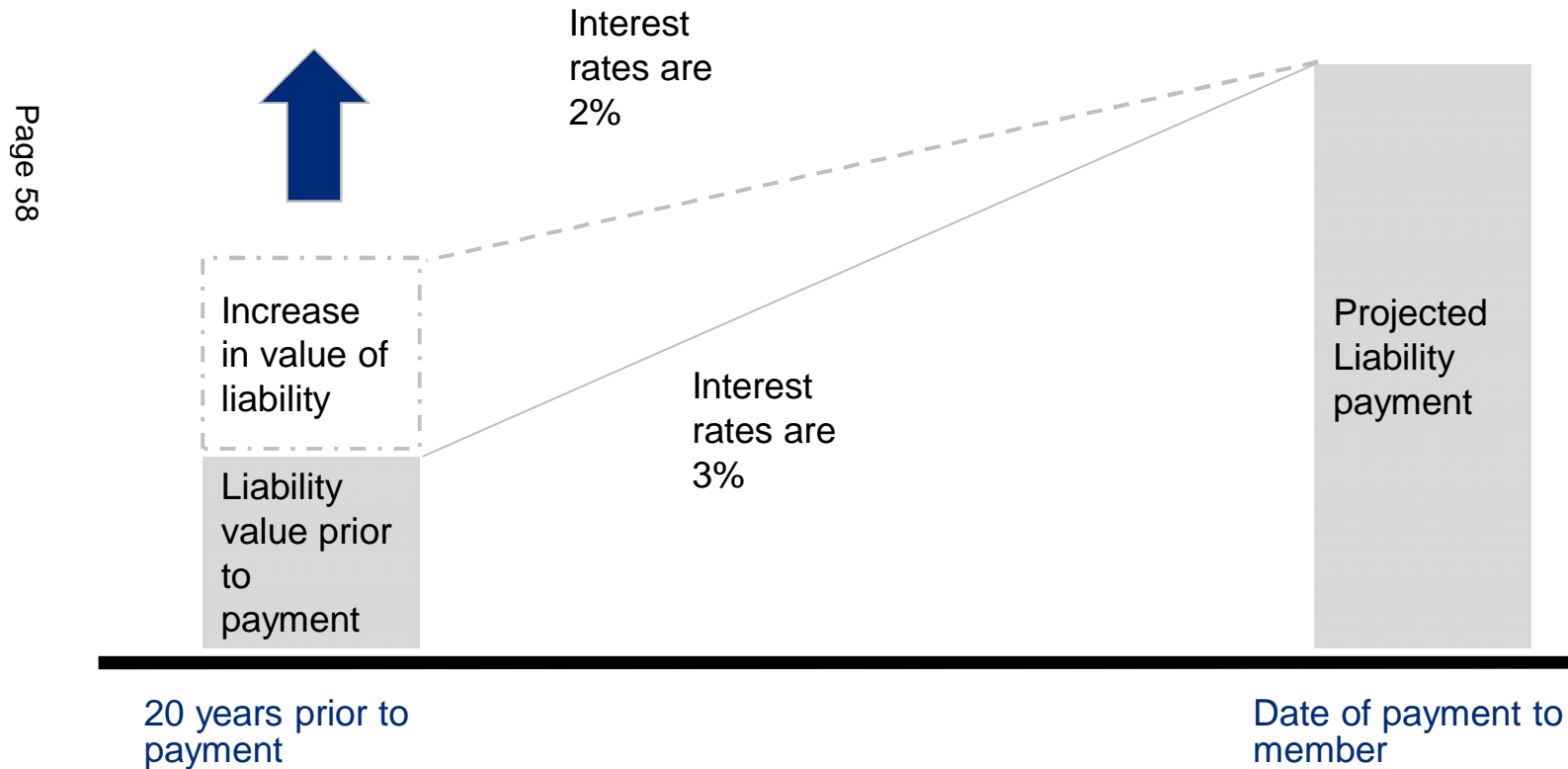
Hence the Fund's liabilities rise

So, all else being equal, the funding level deteriorates

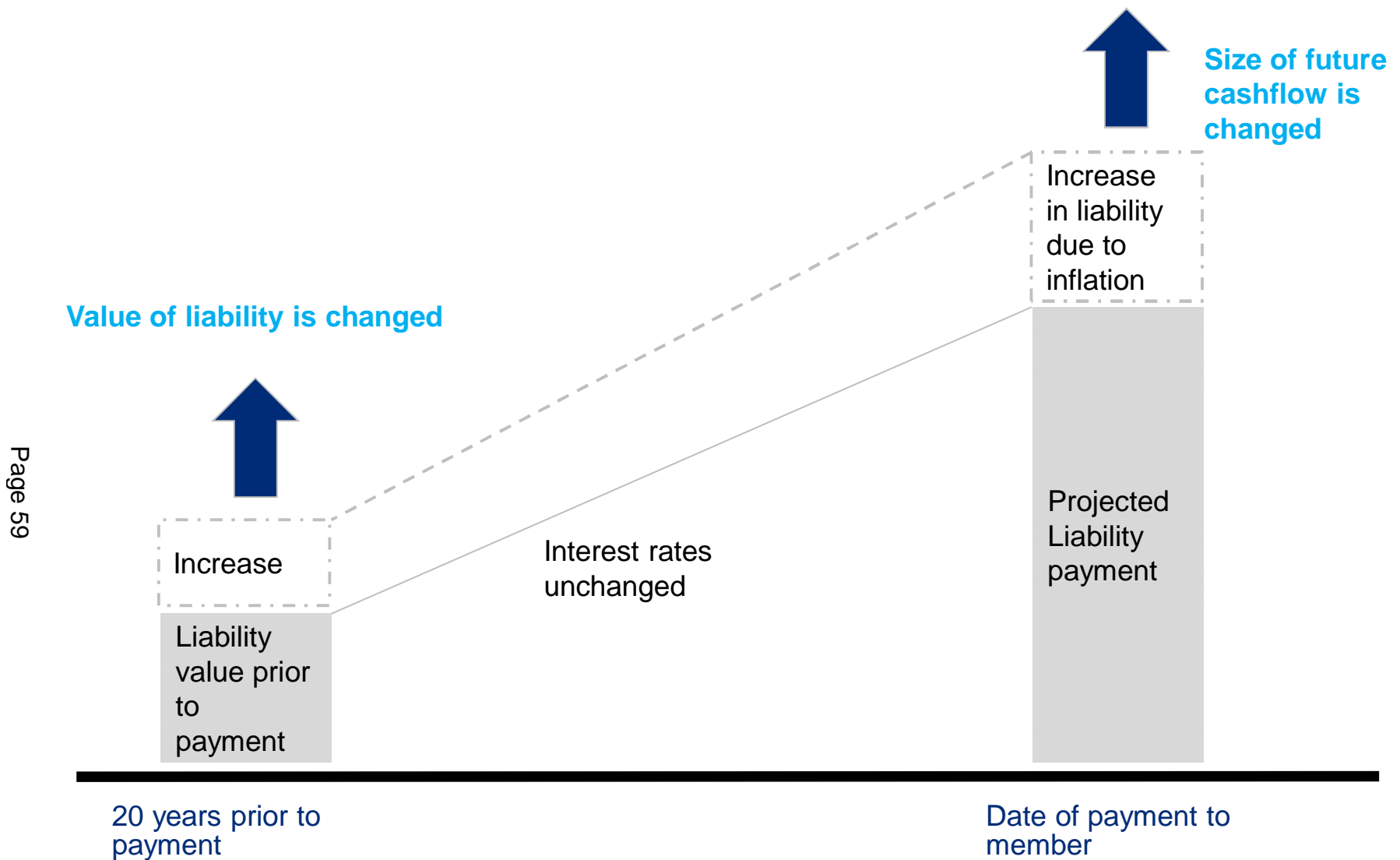
- There is a **direct** relationship between changes in inflation expectations and liability values

HOW DO INTEREST RATES AFFECT LIABILITIES?

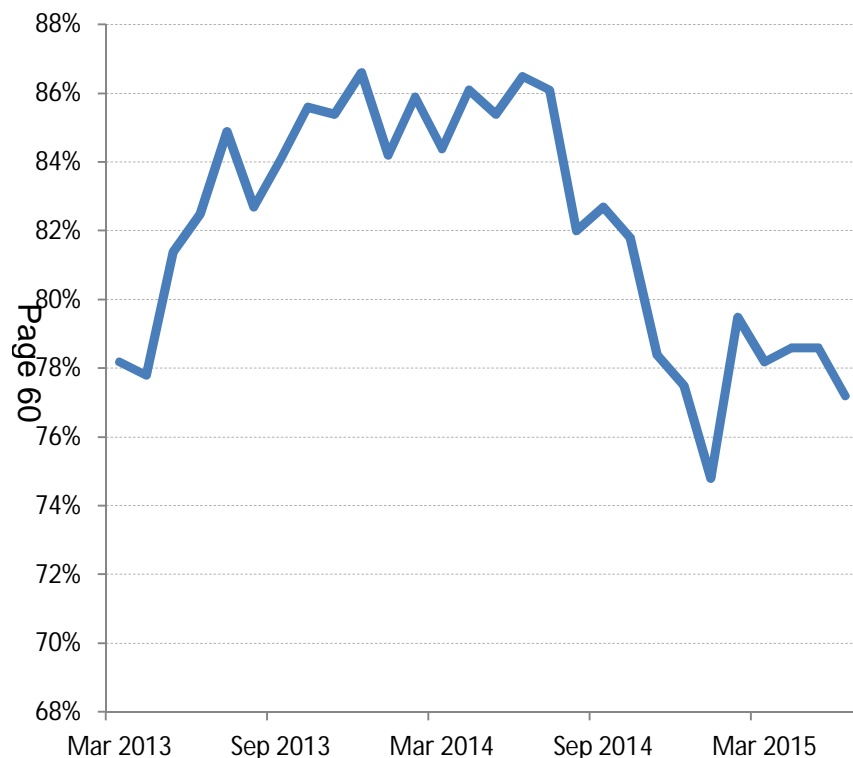
Value of liability is changed
(but projected cashflow is not)



HOW DOES INFLATION AFFECT LIABILITIES?



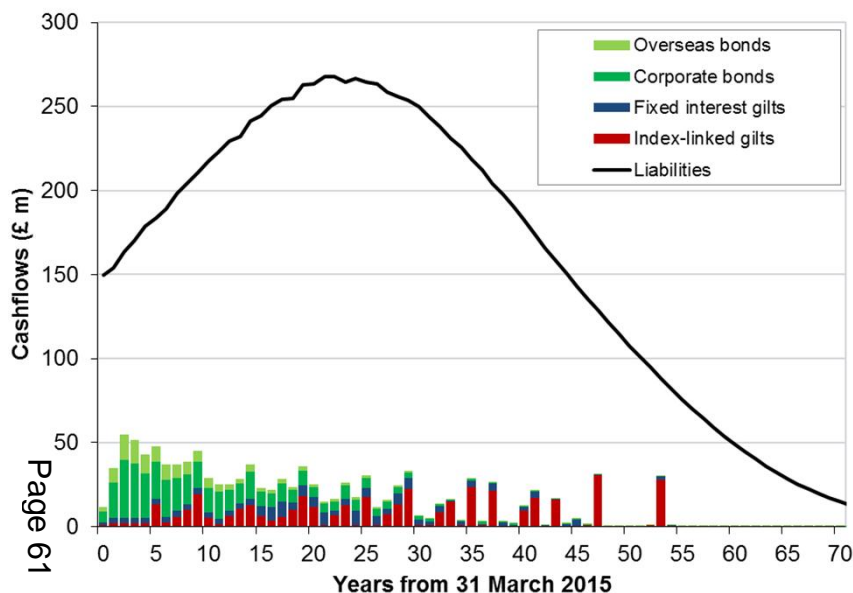
SINCE THE LAST VALUATION AVON FUNDING LEVEL VOLATILITY



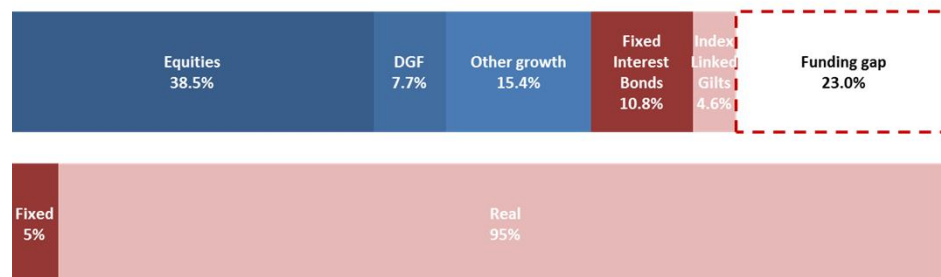
Source: FSM

- Funding level at 30 June 2015 marginally lower than from March 2013 actuarial valuation
- **BUT:** deficit has increased from **£877m** to c. **£1,100m** at 30 June 2015
- Strong returns from Fund's assets and deficit contributions more than offset by impact of falling discount rates.
- Avon's funding level experience in line with the rest of the LGPS
- **Key learning points:**
 - "Investment returns" (i.e. being below expectations) have not been the issue
 - Increase in deficit due a significant asset and liability mis-match
 - Stronger focus needed on liability risk management, combined with achieving strong investment returns

WHY IS THE MISMATCH SO GREAT?



ASSETS: DURATION C. 2 YEARS



LIABILITIES: DURATION C. 18 YEARS

- Value of liabilities linked to changes in expected asset returns / interest rates and inflation.
- Fund does not hold enough index-linked bonds to match the change in value of the liabilities (the “best” matching asset given nature of liabilities).
- Duration is a measure of sensitivity to changes in the value of bonds. The Fund’s liabilities are approximately 8 - 9x more sensitive to changes in interest rates than the Fund’s assets
- This means that on the current funding basis, changes in interest rates and inflation have a significant impact on the funding position and could lead to increased contribution requirements to meet a deficit

INTERACTION WITH 2016 VALUATION



**Covenant
(Affordability)**

	£m	
	31 March 2013	31 March 2010
Total assets	3,146	2,459
Liabilities:		
Active members	1,528	1,300
Deferred pensioners	749	451
Pensioners	1,745	1,260
Total liabilities	4,023	3,011
Past service surplus / (shortfall)	(876)	(552)
Funding level	78%	82%

**Funding
Strategy**



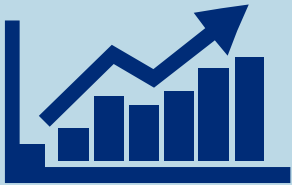
**Investment
Policy**

All three aspects are interlinked

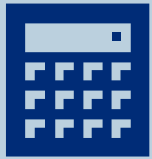
More certainty of outcomes (e.g. around deficit volatility and contributions)
can be achieved by investing in a more liability aware manner

DISCOUNT RATES

DECIDE ON LEVEL OF PRUDENCE



Liabilities are calculated using a “prudent” expected return on assets.



Increasing the certainty over returns means a smaller prudent margin is required

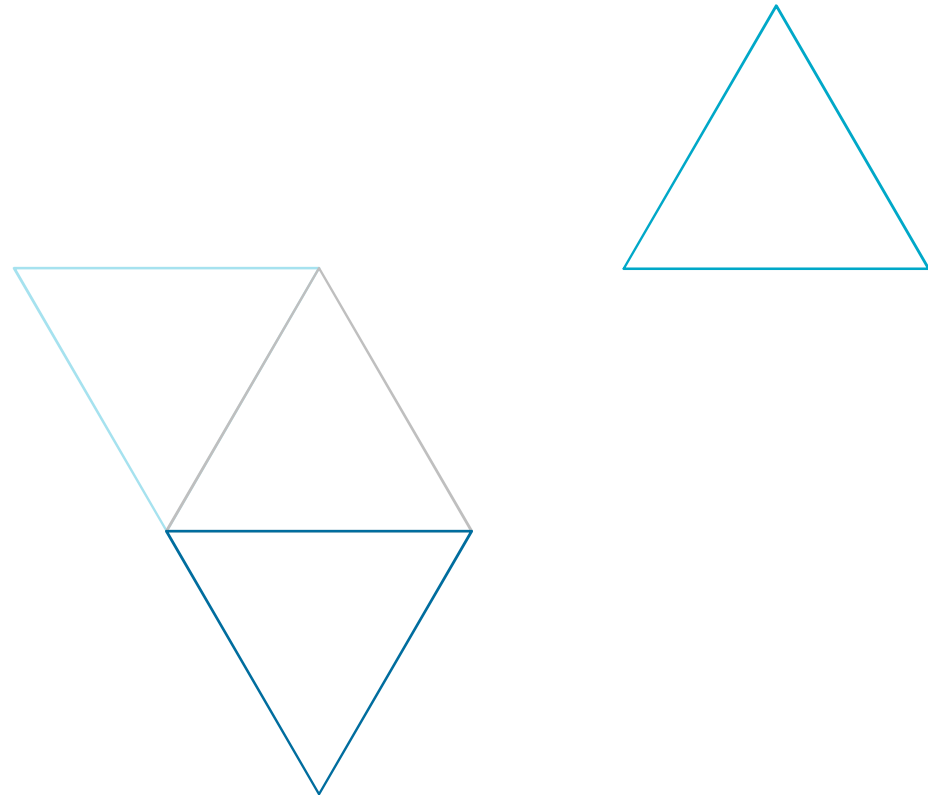


In combination this means:

- Lower value placed on liabilities
- Lower deficit
- More certain outcome

RISK MANAGEMENT OPTIONS

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THE KEY RISK MANAGEMENT OPTIONS

Make the physical bond holdings more efficient

- Better match assets and liabilities to reduce volatility of the funding position
- Use current government bond allocation to do this and retain growth assets (needed to provide returns to meet cost of benefits and remove deficit).

Use of leverage

- Put pragmatic plan in place to move from current level of liability protection to improved position by using leverage (building up over three years, but accelerating if market conditions are attractive)
- And then on to longer-term target (suggested at 50%).

Employer specific strategies

- Potentially a longer term development – will be considered at a future meeting
- Introduce flexibility for employers to align strategy with covenant and tolerance for volatility
- Specific cashflow driven strategy for “orphan” / corporate-bond basis liabilities to minimise volatility

PLAN TO IMPROVE MATCHING ASSETS

Make the bond
portfolio more
efficient

STABILISING ASSET	BENCHMARK ALLOCATION	ROLE
Index-Linked Gilts	6%	Match for inflation characteristics
Fixed Interest Gilts	3%	Small allocation and limited link to majority of liabilities. No contribution to excess return. Propose moving to index-linked gilts
Overseas Government Bonds	3%	Small allocation and very limited link to majority of liabilities. No contribution to excess return. Propose moving to index-linked gilts
Corporate Bonds	8%	Contributes to asset returns - retain

Proposal:

1. Move Fixed-Interest Gilts and Overseas Government Bonds to Index-Linked gilts to provide more liability protection (exact transfer process to be agreed). No reduction in expected return.
2. Put plan in place to improve protection from these gilts by moving to leveraged version over next three years (with a trigger in place to complete switch if real yield above CPI is at least 1%).

WHAT IS LEVERAGE?

Make the bond
portfolio more
efficient

Funded Exposure

- It is said that the position is funded (or unleveraged) if the amount of assets invested in the hedging portfolio is backing an equivalent amount of risk exposure.
- e.g. £100 of collateral is hedging £100 of risk.

£100 Collateral

£100 Liabilities

Unfunded Exposure

- If the amount of collateral invested in the hedging portfolio is less than the equivalent amount of risk being hedged then the hedging portfolio is said to be geared.
- e.g. £100 of collateral hedging £300 of risk.

Unfunded

£300 Liabilities

£100 Collateral

Leverage can be used to “free up” assets to use elsewhere in the portfolio while still hedging a greater proportion of the liabilities; it is implemented using derivatives.

NEW RISKS INTRODUCED AS A RESULT OF USING LEVERAGE

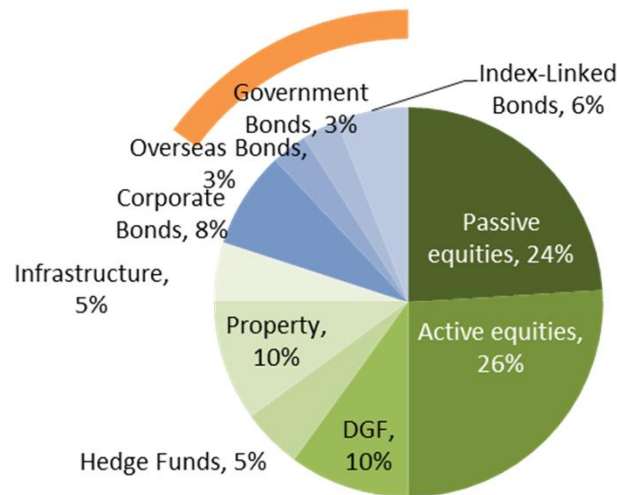
Make the bond portfolio more efficient

Counterparty and manager risk	<ul style="list-style-type: none"> • Default of counterparty bank may lead to losses • Significantly mitigated through collateralisation, but not eliminated • Process managed by the fund manager
Funding	<ul style="list-style-type: none"> • Pension schemes obligation to pay a cash (LIBOR) rate with interest rate swaps and repo rate with repurchase agreement • LIBOR cannot be generated without taking risk
Valuation	<ul style="list-style-type: none"> • Potential for basis risk between assets held by pension scheme (e.g. swaps) and yields used to value the liabilities (i.e. gilts or corporate bonds) • Some level of mismatch vs. the liabilities is inevitable as it may not be possible to find assets that are a perfect match for the liabilities
Liquidity	<ul style="list-style-type: none"> • Liquidity can be low at times (particularly for inflation swaps) and transaction costs have increased in both physical and synthetic markets
Regret	<ul style="list-style-type: none"> • Unrealistic to expect sustained and significant increases in long-term gilt yields • Consider trigger mechanisms to hedge at acceptable levels
Leverage	<ul style="list-style-type: none"> • Profits or losses will vary with changes in interest rates and inflation • May require the transferring of assets from another portfolio to the hedging mandate so that collateral can be posted by the pension scheme to the counterparty banks

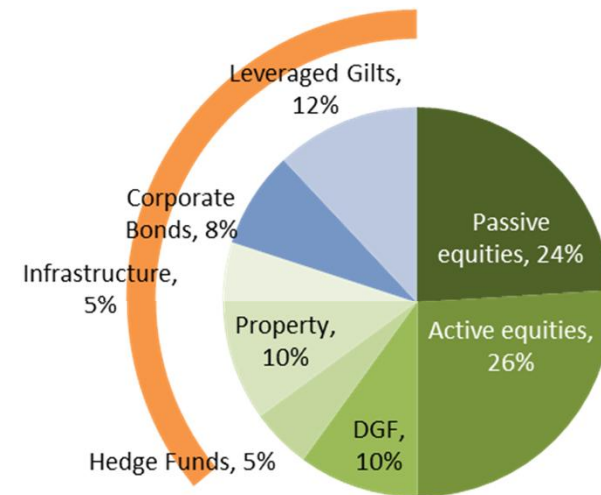
Majority of risks can be mitigated through a combination of holding collateral, diversification of counterparty exposure and providing limits on leverage allowed

IMPROVING MATCHING INITIAL TARGET (NEXT THREE YEARS)



Make the bond
portfolio more
efficient



■ Liability protection (% of assets)



■ Liability protection (% of assets)

Category	Current	Initial target
Liability protection (% of assets)	15% of assets* (18.5% when switched to ILG)	36%
Best estimate return (% p.a.)	6.0%	6.0%
Illustrative discount rate (% p.a.)	4.3%	4.5% 
One year deficit risk	£1.0bn	£0.9bn 

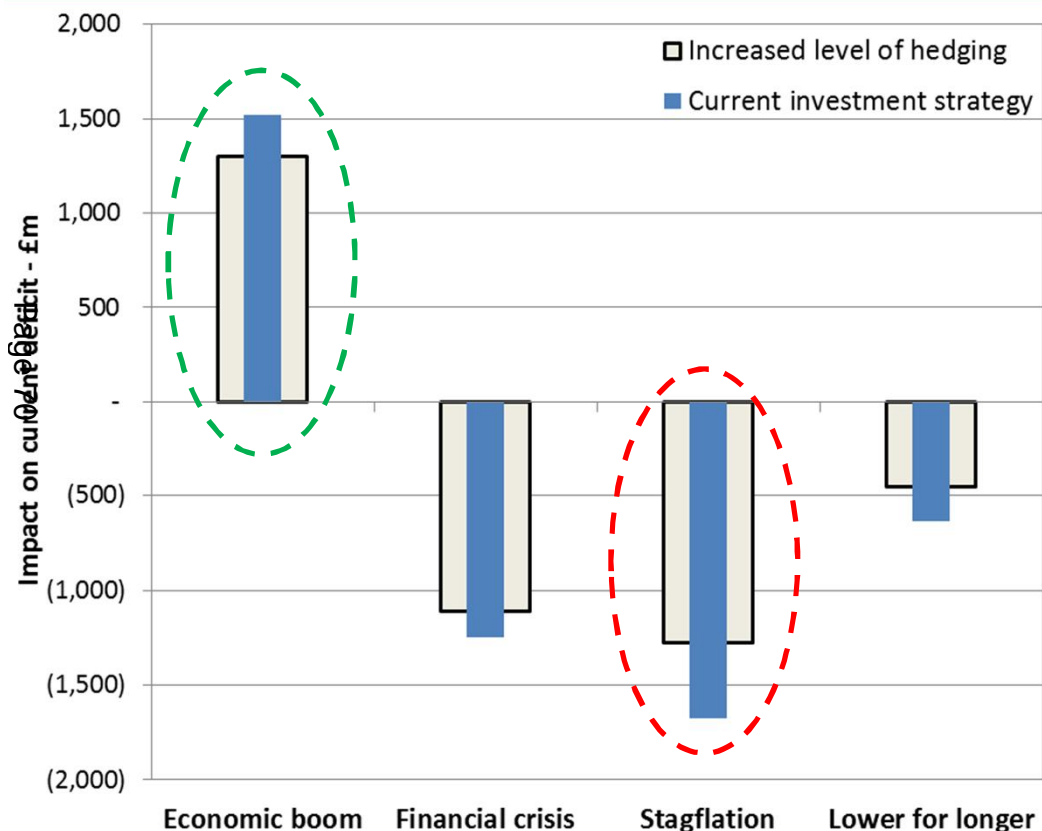
*Higher level of liability protection than bond holding, as bonds held are of slightly longer duration than liabilities

**INCREASE IN DISCOUNT RATE POSSIBLE BECAUSE
GREATER CERTAINTY ALLOWS PRUDENCE TO BE
RELEASED**

IMPACT OF IMPROVED PROTECTION

Make the bond portfolio more efficient

Impact on deficit of increase in hedging



Protection in downside scenarios

Some upside given up in “boom” times

More stable position

More certainty of outcomes

In an **economic boom**, the liabilities and (bond) assets are both expected to fall; as the liability protection is not 100%, liabilities fall by more than the assets do and the deficit falls. Improving liability protection limits this upside to c. £1.3bn (the white bar), whilst under the current allocation the upside is c. £1.5bn (the blue bar)

However, in a **stagflation scenario**, liabilities rise more than assets and the deficit rises; this increase in deficit is smaller when better liability protection is in place (and so the impact on contribution requirements is limited).

IMPLEMENT A FLIGHTPATH

Implement a
flightpath

1.

- Propose moving Fixed Interest and Overseas Government bonds to Index-Linked gilt holdings (increasing protection from current 15% of assets to c. 18.5%, as index-linked gilts are a better match for liabilities).

2.

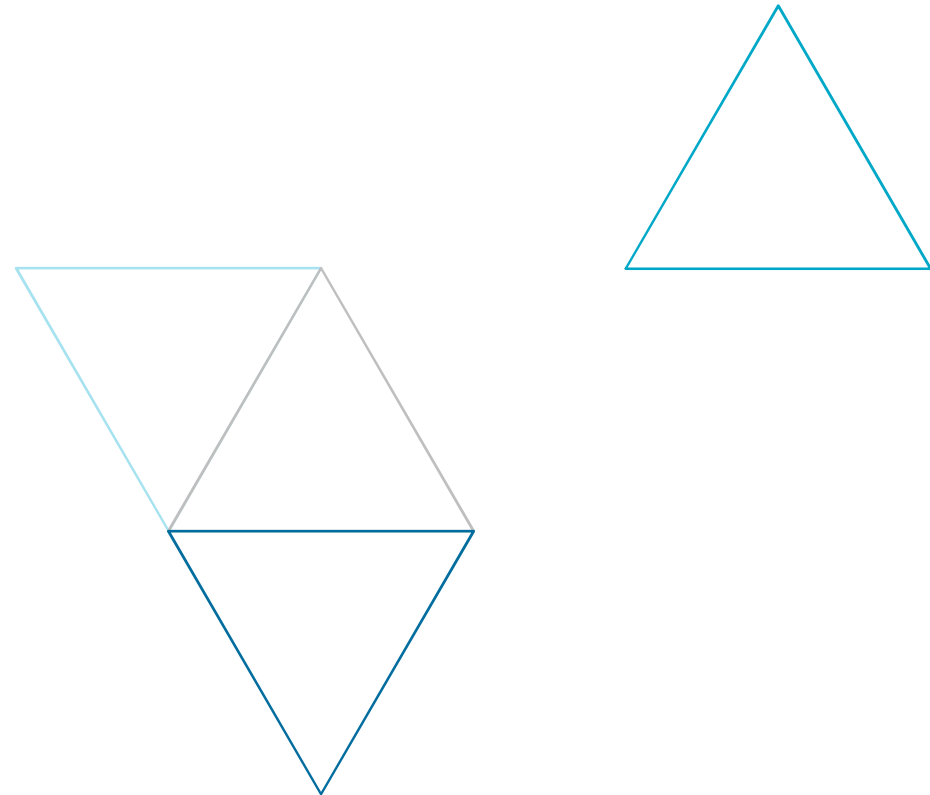
- And over a three-year period increase the level of liability protection from 18.5% to 36% by quarterly switches of 1% of total Fund assets from index-linked gilts to leveraged index-linked gilts
- **Phased approach helps diversify timing risk of the move and provides certainty that risk reduction will be achieved**

3.

- With a trigger that if the Fund can buy liability protection with an expected return of at least 1% p.a. above CPI then implement the switch to 36% liability protection immediately.
- **Use of trigger helps takes advantage of potential market opportunity**

PROPOSED RISK MANAGEMENT FRAMEWORK

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SUMMARY

OBJECTIVE

- Achieve a fully funded position by 2033 (in line with the current deficit recovery plan) or earlier
- Increase certainty of outcomes and contributions but maintain sufficient real returns to achieve the objective

HOW TO ACHIEVE THIS

- Make the bond portfolio more efficient
- Have a plan to remove risk over time when affordable
- Develop alternative strategies for different employers

IMMEDIATE CHANGE

- Use existing government bonds to avoid reducing expected returns
- Switch fixed interest and overseas government bonds to index-linked gilts for better liability protection

NEXT THREE YEARS

- Increase liability protection by switching 1% of Fund assets from index-linked gilts into leveraged gilts each quarter (to spread timing)
- Accelerate switch if a real yield of CPI + 1% is available.

LONG TERM PLAN

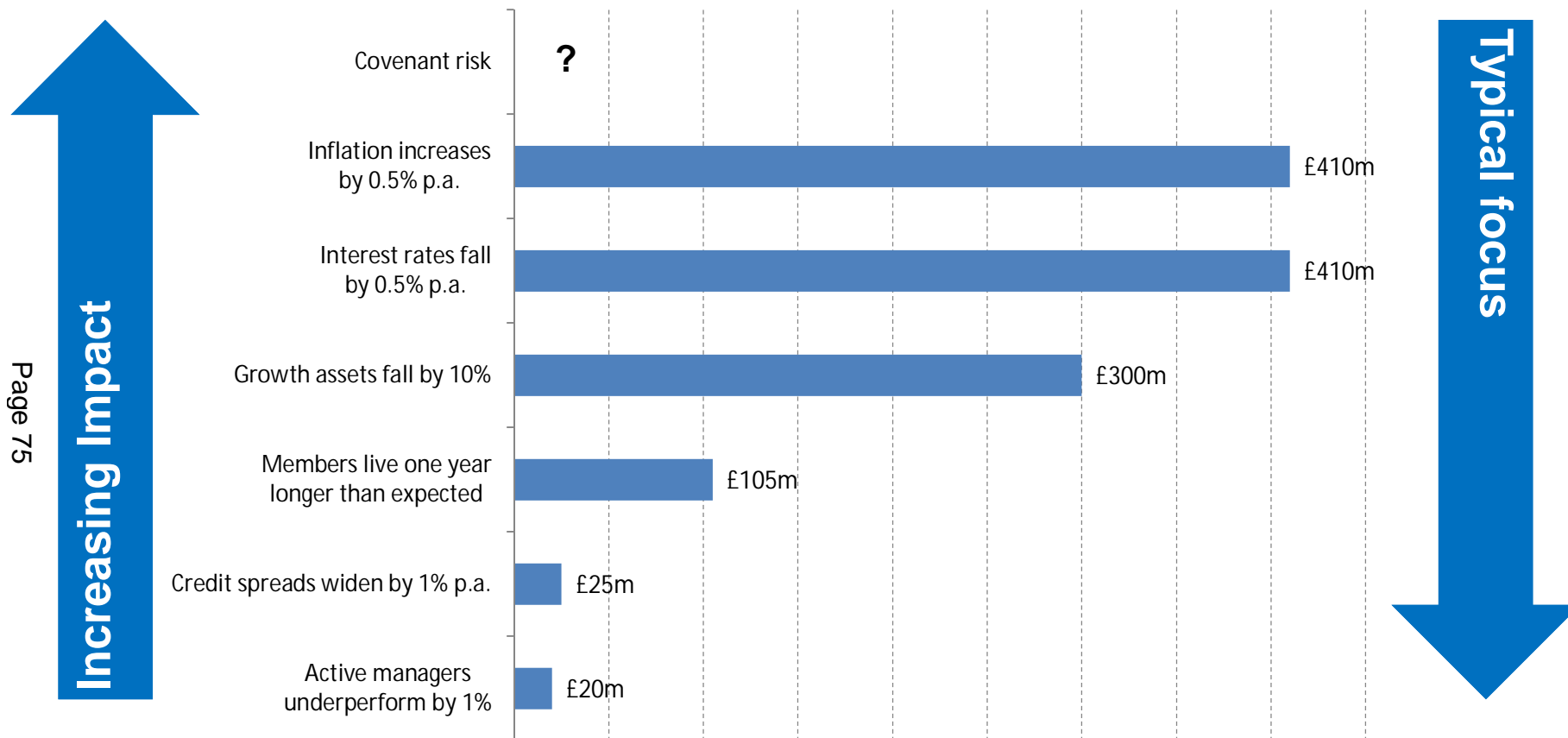
- Funding level based triggers to increase liability protection to 50% when affordable
- Cashflow driven strategy for selective employers / liabilities

RISK CONSIDERATIONS

Risk	Manage, reduce or monitor?	How?
Equity and growth asset risk	Monitor (and potentially reduce) We expect to be rewarded for this risk but could reduce if we get ahead of plan	Performance monitoring + de-risking if affordable
Credit risk	Monitor (and potentially reduce) We expect to be rewarded for this risk but could reduce if we get ahead of plan	Performance monitoring
Active manager risk	Monitor We expect to be rewarded for this risk	Performance monitoring
Interest rate risk	Reduce – two of the larger risks facing the Fund, and arguably unrewarded	Use physical index-linked gilts and in time leveraged index-linked gilts
Inflation		
Longevity risk	Monitor	As part of the actuarial valuation
Covenant risk	Manage and monitor	Develop employer specific investment strategies

WHAT REALLY MATTERS?

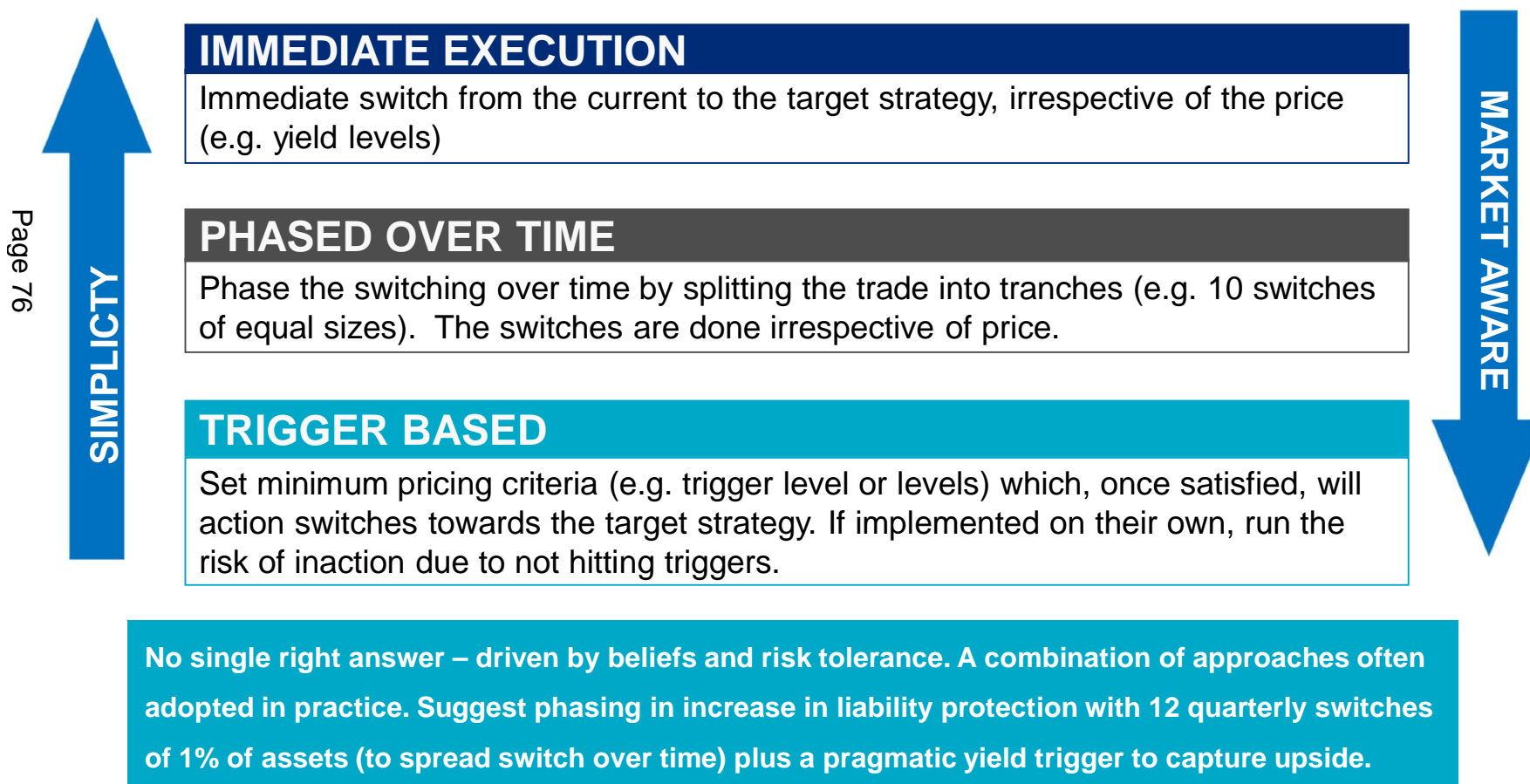
IMPACT ON DEFICIT – CURRENT BASIS



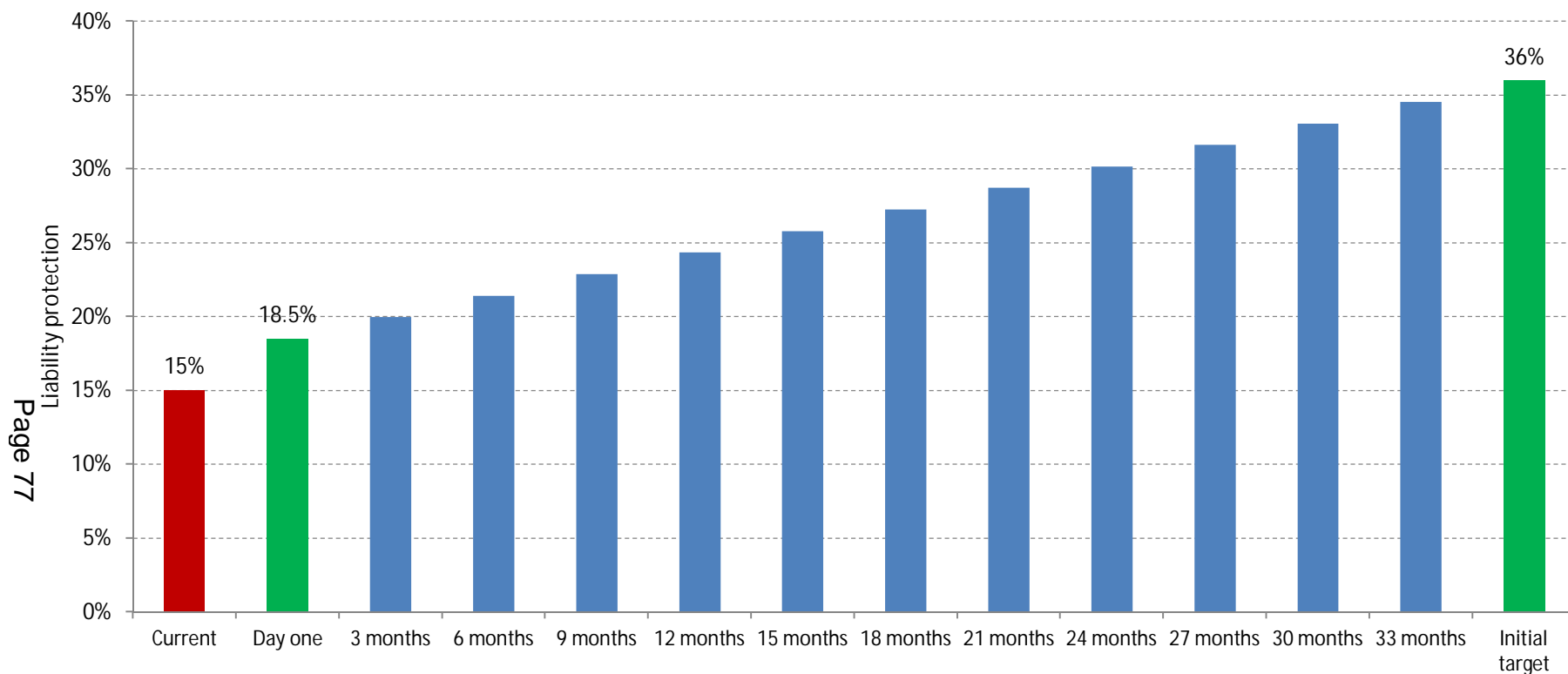
Approximate figures based on 2013 valuation sensitivities and 30 June 2015 estimated funding position.

WHEN TO HEDGE

- Options for implementing increase in hedging from 12% in conventional index-linked gilts to use leveraged gilts



WHEN TO HEDGE

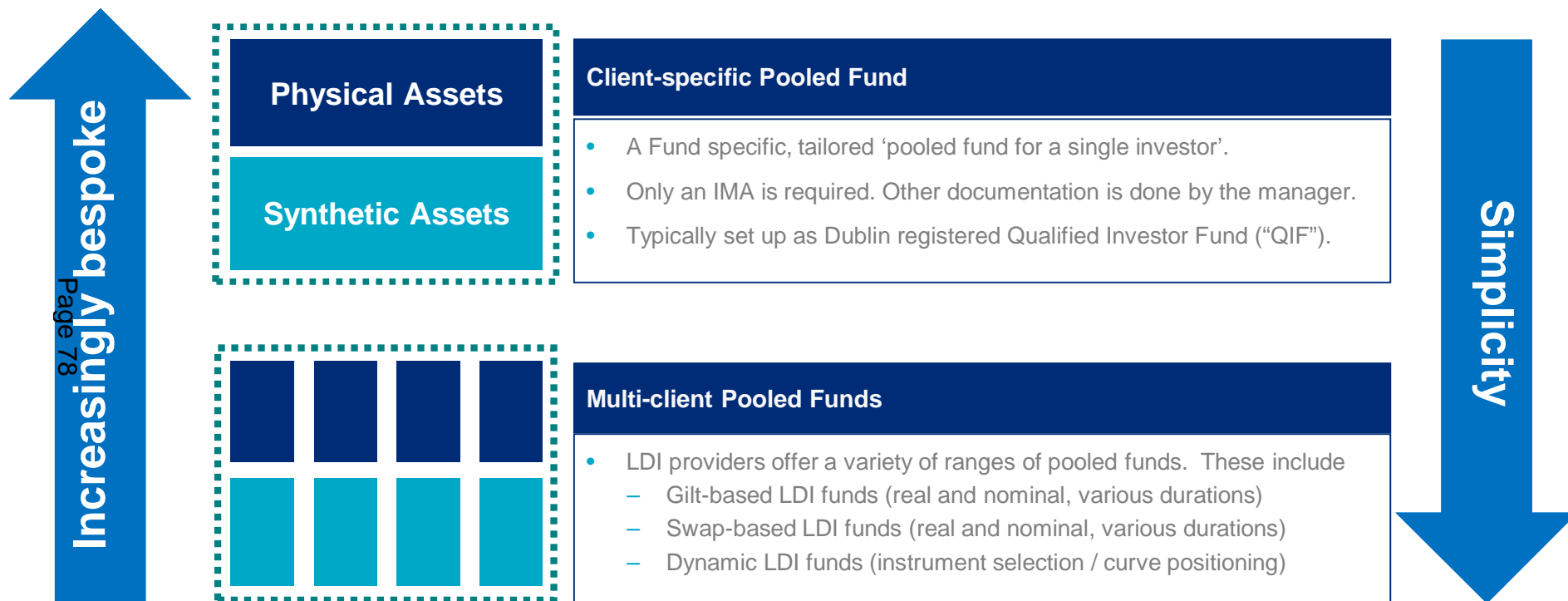


**SWITCH FIXED INTEREST
GOVERNMENT BONDS TO
INDEX-LINKED GILTS**



**INCREASE LIABILITY PROTECTION
THROUGH LEVERAGE (QUARTERLY
SWITCHES) – ACCELERATE IF REAL
YIELD TRIGGER MET**

HOW IMPLEMENT?



Can be comfortably implemented using pooled funds. While liability protection remains at 50% or lower; most straightforward approach.

Not concerned over manager concentration risk at these levels and initially using 12% of assets (currently all held with one manager anyway); re-evaluate this if and when increasing further (and consider if a bespoke pooled fund is more efficient).

Currently use income on segregated bond holdings to pay benefits; this will not be available from pooled leveraged funds, and so disinvestments from elsewhere will be needed.

GOVERNANCE STRUCTURE

Decision making

- Strategic decisions to be confirmed / made by Committee, e.g. level of liability protection to target
- Implementation detail to be agreed by Panel, e.g. broad vehicles to use, use of pooled funds
- Detail on triggers, execution and choice of manager to be delegated to Officers

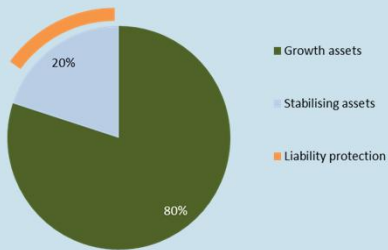

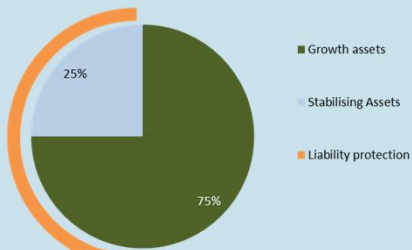
Delegation

- Delegate implementation of agreed triggers and liability protection increases to LDI manager (ensures opportunities captured, and time based triggers implemented to plan)

Monitoring

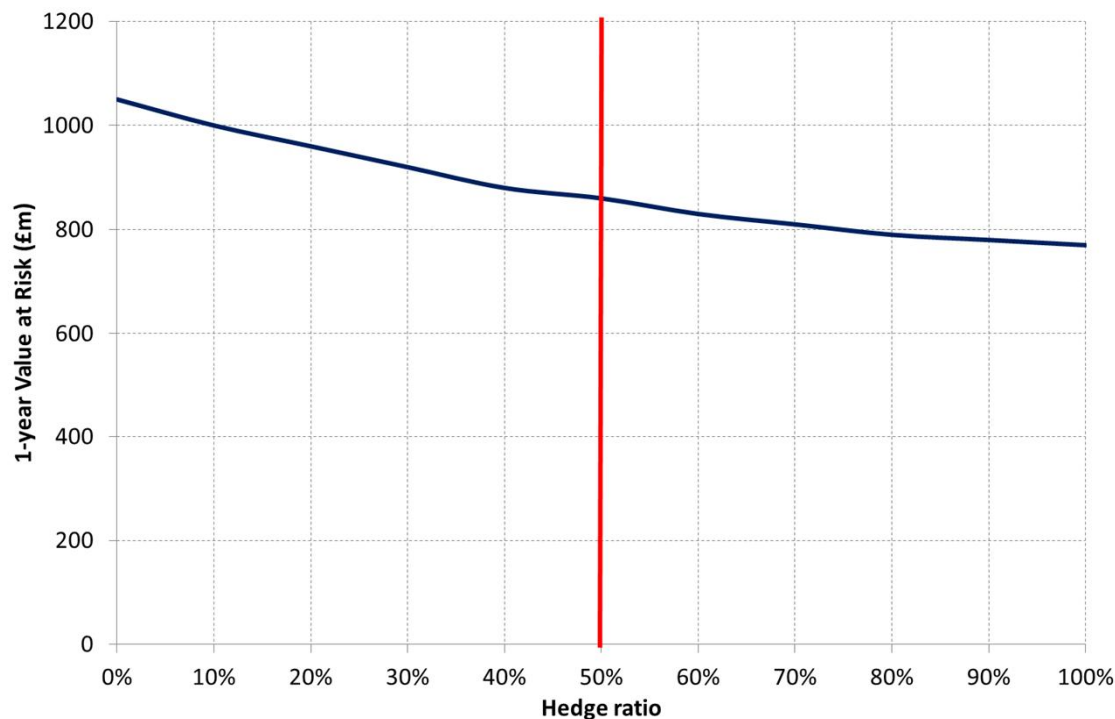
- Limited additional governance requirements once implemented, although reporting likely to be required on the level of hedging in place, and market levels relative to any triggers.

IMPACT ON THE VALUATION

Strategy	Current	Initial target	Long-term (see overleaf)
Asset allocation	 <p>■ Growth assets ■ Stabilising assets ■ Liability protection</p>	 <p>■ Growth assets ■ Stabilising Assets ■ Liability protection</p>	 <p>■ Growth assets ■ Stabilising Assets ■ Liability protection</p>
Hedging ratio (of assets)	15% (18.5% when switched to ILG)	36%	50%
Best-estimate return (p.a.)	6.0%	6.0%	5.8%
Illustrative discount rate (p.a.)	4.3%	4.5%	4.5%
One year deficit risk	£1.0bn	£0.9bn	£0.8bn

INCREASE IN HEDGING RATIO THROUGH USE OF LEVERAGE; DISCOUNT RATE INCREASED / RETAINED THROUGH RELEASE OF PRUDENCE

LONG-TERM LIABILITY PROTECTION TARGET



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Increasing the hedge ratio to 50% has the greatest impact on risk and hence certainty of outcomes. Increasing the hedge ratio above this level has marginal benefits due to the level of growth asset risk.

Further risk reductions may be achieved by selling growth assets and extending the hedge ratio further (but this would be a longer term consideration).

MOVING TO LONG-TERM TARGET

Increasing liability protection from 36% of assets to 50% would require an extra 4.7% of Fund assets to be held in leveraged index-linked gilts (c. £170m)

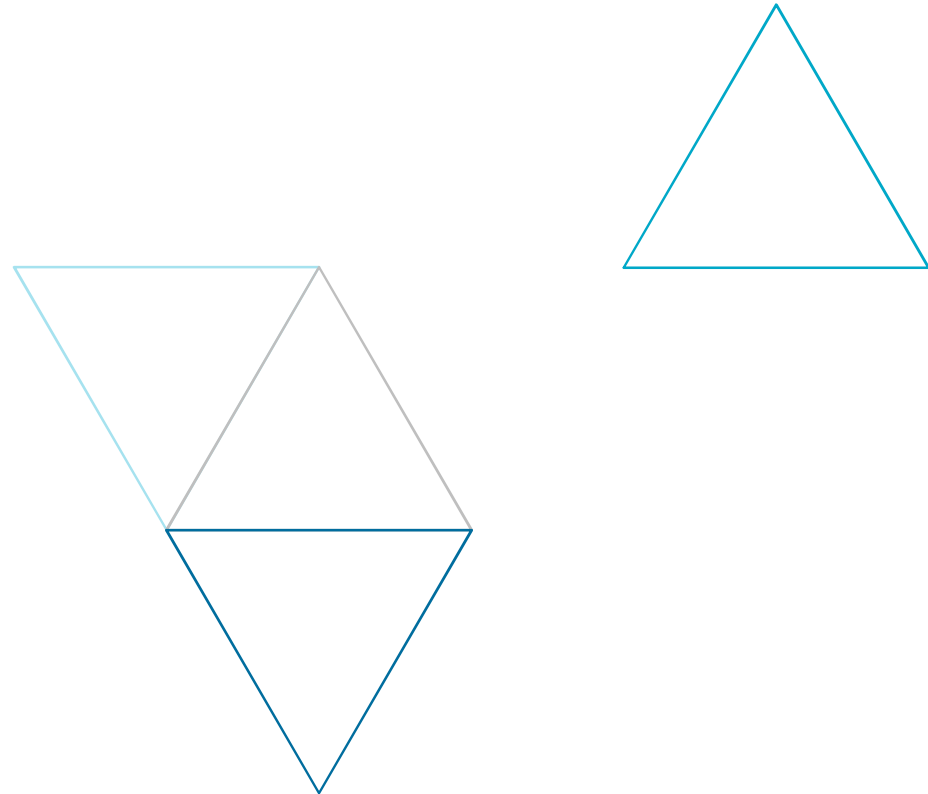
Page 82

We would propose assessing the funding position once the interim position has been achieved (i.e. after three years at the latest) and then agreeing a real yield trigger to implement this switch

This would require disinvestment from other assets – potentially those with lower expected returns, e.g. the RLAM corporate bond mandate, or the Fund's Diversified Growth Fund holdings

NEXT STEPS

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SUMMARY AND NEXT STEPS

- Significant benefit from “putting a plan in place” to be able to increase the level of liability protection when acceptable to the Fund.
 - Propose switching the current fixed-interest and overseas government bonds (totalling 6% of assets) to index-linked gilts which better match the Fund’s liabilities, and using a combination of time and yield based triggers to switch this combined 12% of assets to provide greater liability protection over the next three years...
 - ... with a longer-term plan to increase this to 50%
- Next steps
 - Agree proposal to take to Committee
 - Use Fund specific liability cash-flows to identify broad characteristics of hedging portfolio
 - Agree implementation route (pooled funds are most straight-forward)
 - LDI manager selection decision – combine with passive equities / other form of growth assets in order to facility future de-risking opportunities in a timely fashion
 - Identify specific hedging solution with the appointed manager
 - Ongoing training throughout the process

QUESTIONS?

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IMPORTANT NOTICES

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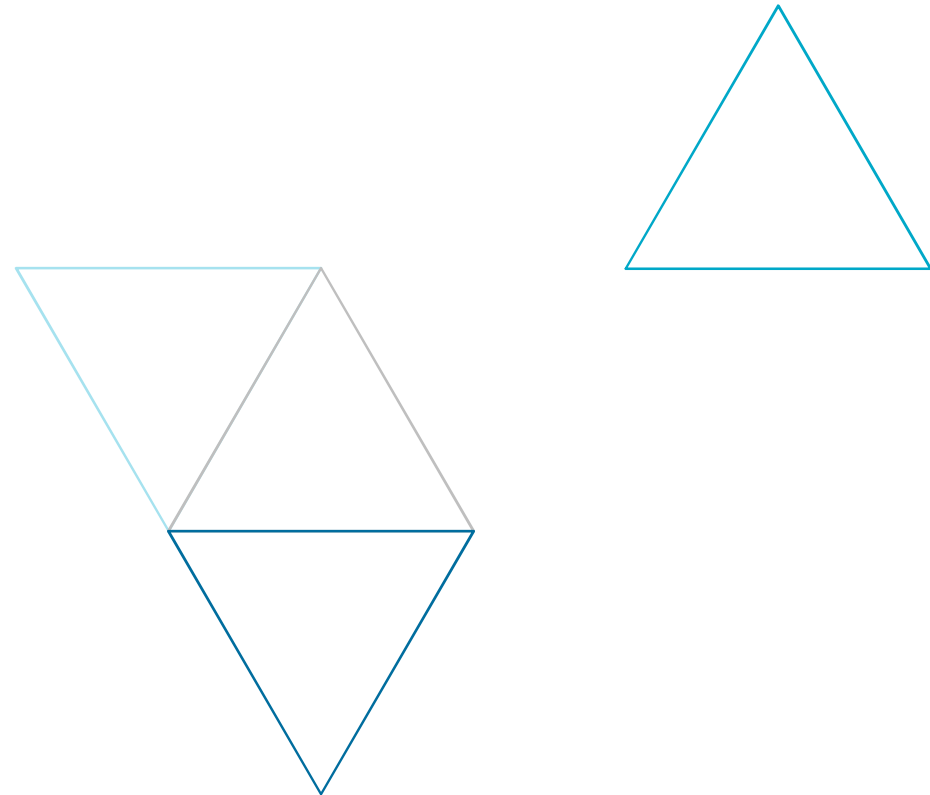
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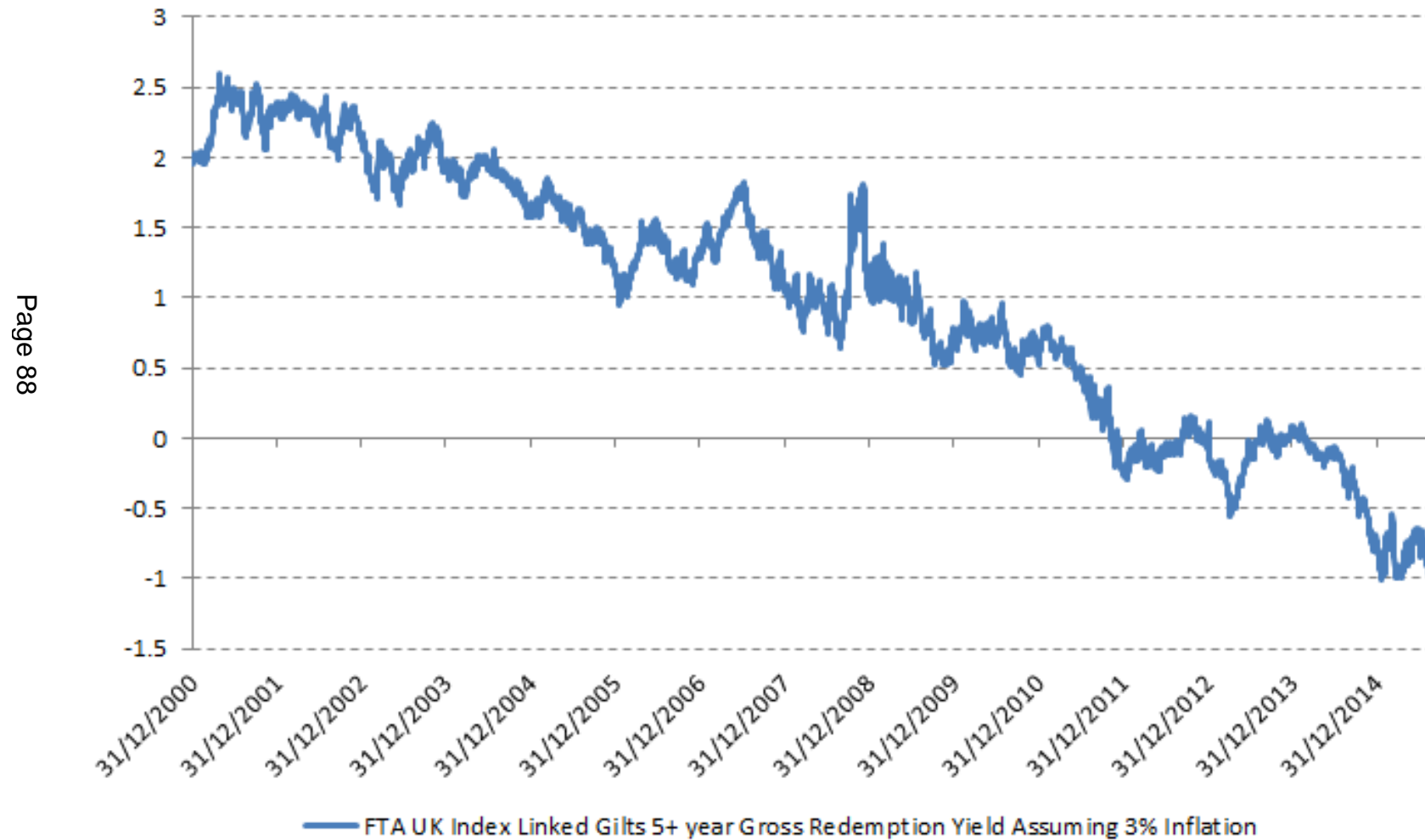
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APPENDICES

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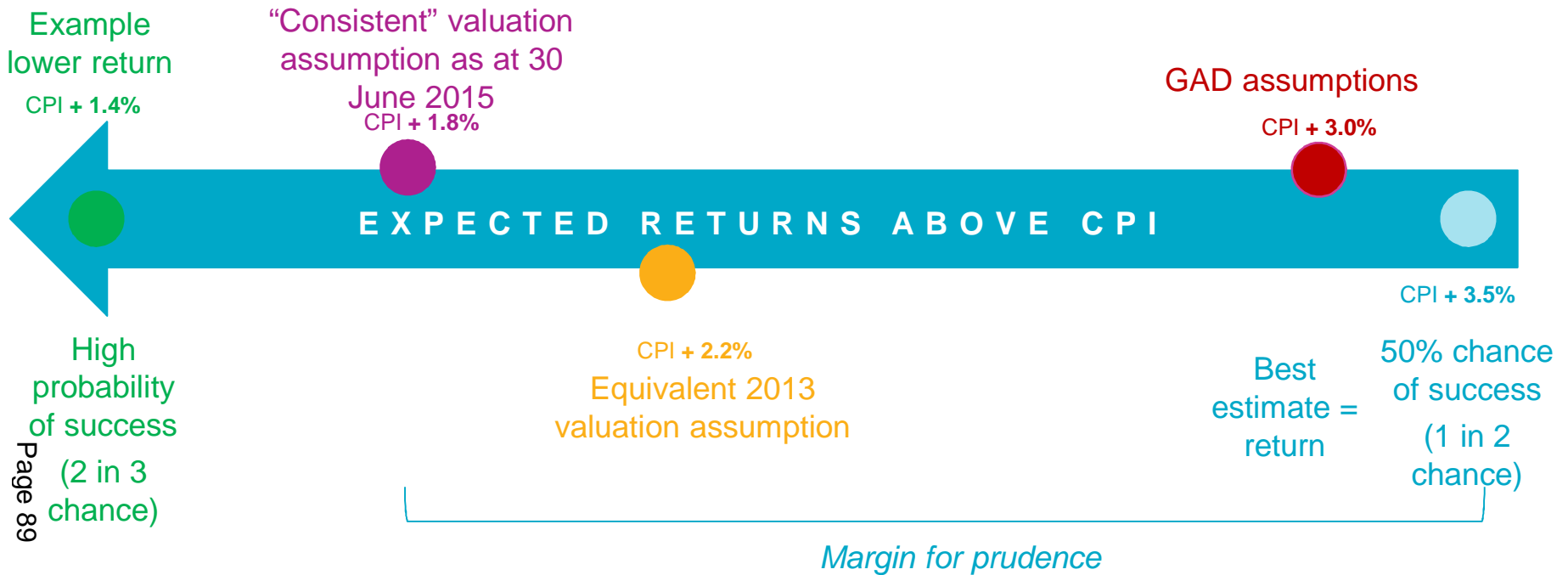
REAL YIELDS OVER THE LAST 15 YEARS



SOURCE: THOMSON REUTERS DATABANK

DISCOUNT RATES

DECIDE ON LEVEL OF PRUDENCE



- Liabilities are calculated using a “prudent” expected return on assets; given the fall in real yields since 2013, a “consistent” approach to defining the discount rate would give a lower expected return relative to CPI inflation.
- Increased certainty over returns means a smaller prudent margin is required
- In combination this means
 - Lower value placed on liabilities
 - Lower deficit
 - More certain outcome



KEY CONSIDERATIONS

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How “much” to hedge

What level of protection would be optimal?

“When” to hedge

Difficulty in timing decisions can be addressed through phasing and use of triggers

“What” to hedge with

There is always a decision about which assets to purchase to increase the hedge ratio – both now and in the future

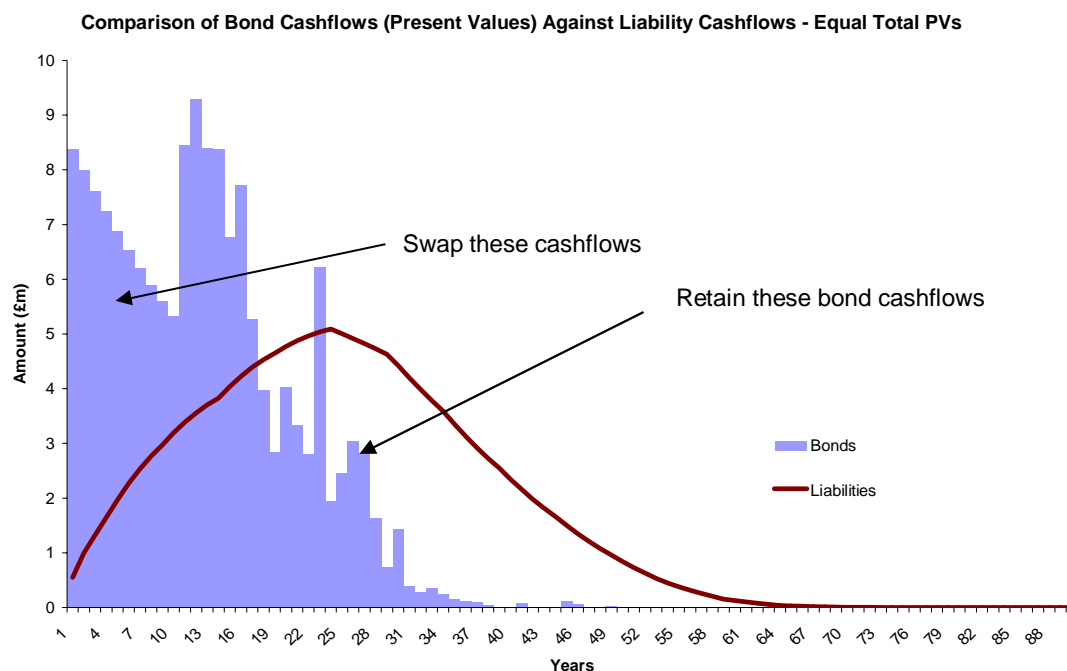
WHY NOT JUST USE BONDS?

- Using only physical bonds does not provide a close match to the Fund's liability cash flows:

- duration of broad market bonds are not as long as the liabilities, particularly where corporate bonds are used
- there are 'gaps' in the durations of available bonds
- the Fund also holds growth assets

- By using derivatives (e.g. swaps or gilt repos – see later) it is possible to efficiently overcome this problem

- for example, by swapping earlier cash flows for later cash flows

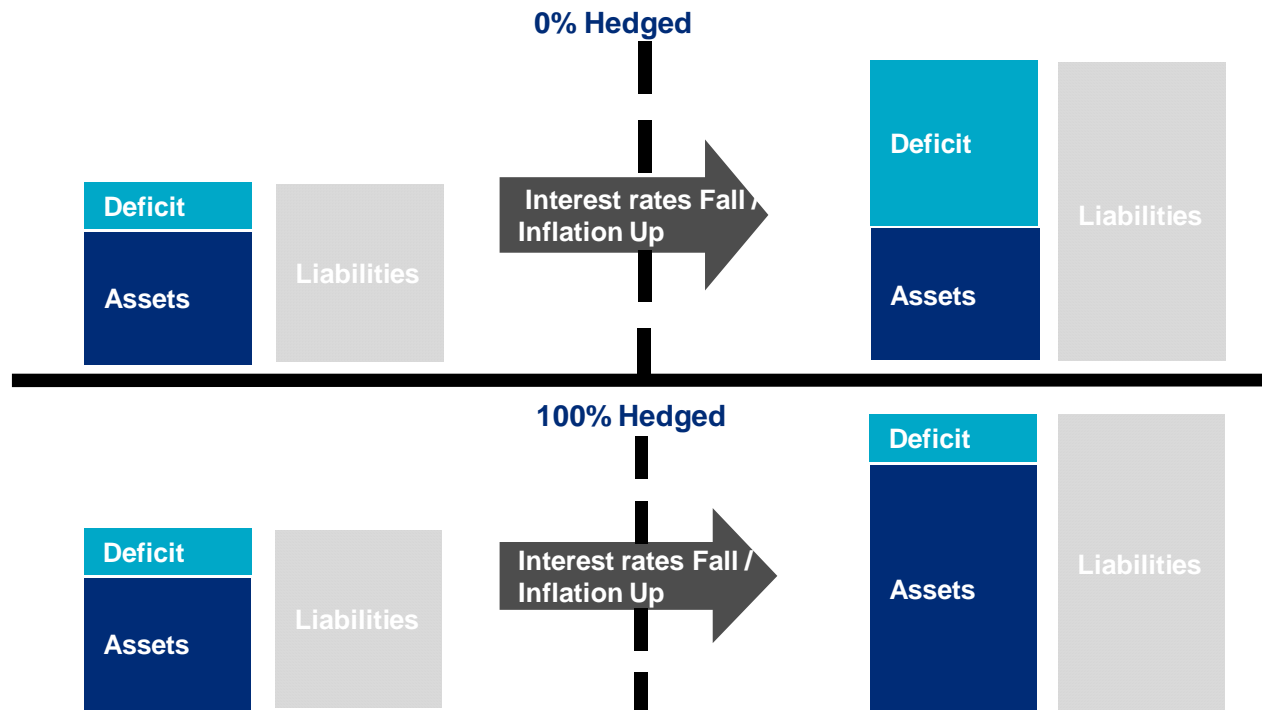


WHAT IS “LIABILITY DRIVEN INVESTMENT”?

ONE OPTION TO MANAGE RISKS

Offsetting the impact of movements in interest rates and inflation on the value of the liabilities by holding assets that respond in a similar way

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Assets mimic liability movements due to changes in inflation/interest rates by protecting against increases in inflation/falls in interest rates

In practice, the Fund will be limited to buying fixed or RPI-linked assets to hedge the liabilities; whilst it may be possible to buy CPI swaps, liquidity is very poor in these markets.

HOW TO HEDGE

Physical Instruments

- Physical instruments require a capital investment at outset (i.e. funded)
- Liquidity varies by instrument
- Pricing is typically transparent and standard instruments are traded
- Commonly held by pension schemes and generally well understood

Fixed-Interest Gilts

Corporate Bonds

Index-Linked Gilts

Synthetic / Derivative Instruments

- Can be funded (i.e. capital commitment is made) or unfunded (i.e. geared or leveraged)
- Typically these are Over the Counter ("OTC", i.e. bespoke) although some exchange traded versions also exist
- Liquidity varies by instrument and within each type, some are highly illiquid and could be more illiquid than physicals
- Less transparency on pricing for OTC contracts, although some standard contracts address this
- Can offer more efficient hedging – i.e. more liability hedging per pound invested

Interest Rate Swaps

Inflation Swaps

Gilt repos

WHAT IS “DURATION”?

“A measure of interest rate sensitivity, with the price of longer duration bonds or liabilities being more sensitive to changes in interest rates”

This therefore explains how a Fund’s liabilities will change in response to changes in interest rates

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Duration is calculated as:

“The average term (in years) of the payments from a bond/liability taking into account the present value of each payment”

For example, a **20 year duration** means:

The liabilities will *decrease* in value by 20% if interest rates rise 1%

The liabilities will *increase* in value by 20% if interest rates fall 1%.

IMPORTANT TERMS

- **Interest Rate Swap** – Two parties exchanging two sets of cashflows, usually based on one party paying a “fixed” rate (e.g. 3% p.a.) and the other paying a “floating” rate (e.g. Bank of England Base Rate + 2%)
 - **Repurchase Agreement (Repo)** – An agreement to sell a security (usually a bond) to another party with the promise to buy it back at a specified date and price
 - **Repo Rate** – The interest rate charged to the seller of the security in a repo
- Page 95 • **Basis Risk** – Risk that arises when an investor aims to hedge a position using an instrument that has an underlying security whose risk is being hedged. For example, a pension fund using bonds to hedge liabilities they do not perfectly match

MAKE  **MERCER**
TOMORROW,
TODAY

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Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND INVESTMENT PANEL	
MEETING DATE:	18 November 2015	AGENDA ITEM NUMBER
TITLE:	REBALANCING POLICY	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Current Rebalancing Policy Appendix 2 – Mercer Report: Rebalancing Framework Appendix 3 – Proposed Rebalancing Policy		

1 THE ISSUE

- 1.1 The current policy for rebalancing has been in place since 2012. Changes to the asset allocation and the structure of the portfolio make it necessary to periodically review the rebalancing policy to ensure it remains appropriate.
- 1.2 In particular, in 2013 the Fund introduced flexibility into the strategic asset allocation by allowing 'permitted ranges' for each asset class.
- 1.3 Mercer have evaluated the current rebalancing policy (see Appendix 1) and provided recommendations for changes to be made to accommodate the permitted ranges and make the policy more efficient. Appendix 2 provides the detailed analysis and recommendations from Mercer, with the proposed policy drafted at Appendix 3 for agreement.

2 RECOMMENDATION

2.1 The Panel recommends to Committee:

- (1) the revised rebalancing policy set out in Appendix 3 Section 1.
- (2) the implementation of the policy be delegated to Officers in consultation with the Investment Consultant where appropriate, as set out in Appendix 3 Section 2.

3 FINANCIAL IMPLICATIONS

- 3.1 There is provision in the 2015/16 budget for investment advice relating to the review of the Fund's rebalancing policy. Any change to the way rebalancing activity of the Fund is undertaken may incur additional costs for future budgets.

4 BACKGROUND

- 4.1 **What is Rebalancing?** Rebalancing actions make adjustments within a portfolio to counteract the effect of varying performance of different asset classes over a period of time that result in the percentage allocated to any asset category moving away from intended targets.
- 4.2 **Why Rebalance?** Rebalancing is important in order to ensure the Fund's assets remain invested in line with the target investment strategy or that any allowable deviation is an active choice rather than a result of 'drift'. This helps the Fund to avoid taking unintended risks that could result in returns outside of expected parameters. A secondary consideration is that efficient rebalancing activity can itself add value over time as it forces the selling of relatively expensive assets and the purchasing of relatively cheap assets. This is explained further in Appendix 2.
- 4.3 **Current Rebalancing Policy.** This is attached at Appendix 1 and consists of 2 main elements:
- (1) Liquid Assets: Maintain the balance between growth and stabilising assets but requiring a review of possible action when the balance deviates by +/- 2% and automatic action when the balance deviates by +/- 5%.
 - (2) Illiquid Assets: Review no less than 6 monthly with a further review by Panel when Property allocation deviates by +/- 5% and Hedge Funds by +5%.

5 MERCER REPORT

- 5.1 The report produced by Mercer (see Appendix 2) includes the following:
- (1) The theory behind why rebalancing is desirable
 - (2) The options for implementing a rebalancing policy
 - (3) How the policy can incorporate tactical asset allocation
 - (4) Proposed ranges and recommendations for how rebalancing should be implemented
- 5.2 When considering the report, Members should also have in mind the following:
- (1) How will the proposed changes impact upon the efficiency of maintaining target allocations and on the trading costs incurred?
 - (2) Does the proposed policy appropriately address the differing characteristics of the asset classes within the portfolio (characteristics such as liquidity, cost and practicality of trading), and allow the flexibility to make tactical allocations?
 - (3) How will the proposed changes impact upon the governance arrangements? Is there robust decision making and adequate monitoring? Will it enable timely decision-making and implementation?
 - (4) Are there circumstances in which the policy should be suspended?

6 MERCER RECOMMENDATIONS

6.1 Mercer summarise their recommendations in Appendix 2. They comprise:

- (1) Narrow $\pm 2\%$ rebalancing ranges for all liquid asset classes and $\pm 3\%$ rebalancing range at the growth:stabilising asset level.
- (2) Allowance for rebalancing ranges to vary (whilst remaining within the permitted ranges set out in the Fund's Statement of Investment Principles (SIP)) when relative attractiveness of the asset class is judged to be attractive or unattractive at any particular time.
- (3) Illiquid assets allowed to vary within the permitted range set out in the SIP. Review by Panel no more frequently than 6 months apart.
- (4) Rebalancing within the neutral rebalancing range to be implemented by Officers.
- (5) Where it is intended for allocations to remain outside the neutral rebalancing range the decision will be based on advice from the Investment Consultant. It is proposed that Officers will use Mercer evaluations of the outlook for asset classes and, where Officers decide that using the wider range allowed in either the attractive or unattractive ranges is beneficial, they will seek advice from Mercer.
- (6) Any positions outside of the neutral rebalancing range will be reviewed at Panel meetings.

7 PROPOSED POLICY

7.1 Having considered Mercer's report and recommendations, Officers have drafted an updated rebalancing policy for agreement by Panel that reflects the recommendations.

The proposed policy can be found at Appendix 3.

The Panel are asked to agree the proposed policy and the delegations for implementing the policy.

7.2 The policy and its implementation will be monitored over the first year by Officers to ensure it is practical to implement and does not lead to overtrading. The policy ranges will be updated for any future changes to the allocation ranges in the SIP.

7.3 As the Fund's cash flow matures and assets are required to be sold down to meet cash outgoings, the rebalancing policy provides a guide to where such divestments can be made within the portfolio.

7.4 **Note on Rebalancing Policy and tactical asset allocations.** In 2013 the Fund added asset allocation ranges to the strategic asset allocation to allow flexibility for tactical allocations to be made as opportunities arise. Under the Terms of Reference, the Panel are permitted to make tactical asset allocation decisions within the permitted ranges and the revised rebalancing policy does not alter this. The implementation of any tactical position is done on the advice of the Investment Consultant and will usually set triggers for the reversal of the position. This type of allocation i.e. an active switch between asset classes for a particular gain is different from the overweight or underweights caused by the drift in asset values over time and whether they are allowed to remain in place or not. It is important to note that the Rebalancing policy is key to the latter (allocations as a result of drift) but in the case of the former (an active tactical allocation switch on specific advice of the consultant) the rebalancing policy is overridden by any triggers decided when the tactical position is put in place.

8 RISK MANAGEMENT

8.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

9 EQUALITIES

9.1 An equalities impact assessment is not necessary as the report contains only recommendations to note.

10 CONSULTATION

10.1 N/a

11 ISSUES TO CONSIDER IN REACHING THE DECISION

11.1 Are set out in the report.

12 ADVICE SOUGHT

12.1 The Council's Section 151 Officer (Divisional Director – Business Support) has had the opportunity to input to this report and has cleared it for publication.

Contact person	Matt Betts, Assistant Investments Manager 01225 395420
Background papers	
Please contact the report author if you need to access this report in an alternative format	

Rebalancing Policy

- (1) For the ratio between and equities / bonds, there is a two-tiered set of boundaries;
 - i. A deviation of 2% to 5% is subject to tactical review by Officers, having consulted the Investment Consultant, and
 - ii. A deviation of 5% or more results in 'automatic' rebalancing back to at least the 2% threshold. An additional tactical decision is then taken by the Officers supported by the Fund's consultants on whether this is fully rebalanced back to the central benchmark allocation or otherwise.
- (2) For hedge funds and property allocations the following will trigger a review by the Investment Panel, no-less than 6 monthly:
 - i. Property +/- 5% (i.e. a range of 5% to 15% of Fund assets)
 - ii. Fund of Hedge Fund +5% (i.e. a max range of 15% of Fund assets)
- (3) Rebalancing within equities and bonds will be based on the strategic benchmark and performance (of active managers) and will take account of any tactical position
- (4) Net new money should be invested pro rata in line with the strategic policy, taking account of tactical positions, and net new money should be utilised first if a rebalancing is triggered.
- (5) The rebalancing policy will be implemented by Officers, having consulted the Investment Consultant. Any recommendations from the Panel regarding (2) would have to be agreed by the Committee.
- (6) Any rebalancing activity will be reported to Committee at the following quarterly meeting.

Approved by Avon Pension Fund 22 June 2012.

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REBALANCING FRAMEWORK

AVON PENSION FUND

NOVEMBER 2015

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1

Introduction

Like many pension schemes, the Avon Pension Fund (“the Fund”) currently has a target asset allocation to the various asset classes it invests in. These target allocations then have ranges set around them that set out the permitted deviations from the target allocation.

This paper has been prepared for the Investment Panel of the Fund and discusses preparing a framework for the rebalancing of total Fund assets, including the rebalancing ranges, and the use of the Fund’s dynamic ranges for making tactical asset allocations (and how such positions could be determined).

In summary, this paper proposes that the existing rebalancing policy is updated alongside a policy on tactical asset allocation, such that within the constraints of the strategic asset allocation (determined by Committee), Panel determines a shorter-term tactical asset allocation position. This would be reviewed regularly, and rebalancing ranges would exist around this tactical asset allocation position.

2

Current rebalancing policy and ranges

The table below sets out the current target asset allocation for the Fund, and the permitted ranges that the allocation is allowed to deviate away from each target. This target allocation is also used for performance monitoring purposes.

The Fund's Statement of Investment Principles ("SIP") states: *"The strategic framework includes a target allocation against which strategic performance will be monitored. In addition there are ranges for each asset category that allow limited deviation within the framework. The ranges enable the Fund to reflect changes in the market outlook and provide greater flexibility to implement cash management and rebalancing. Over the longer-term it provides a framework within which de-risking strategies could be implemented."*

Asset class	% of Fund	Permitted Range
Growth assets	80%	65-85%
Equities	50%	45-55%
Developed	40%	35-45%
Emerging	10%	5-15%
Diversified Growth Funds	10%	5-15%
Illiquid Growth	20%	15-25%
Hedge Funds	5%	0-7.5%
Property	10%	5-15%
Infrastructure	5%	0-7.5%
Other Growth	0%	0-5%
Stabilising Assets	20%	15-35%
Government Bonds	3%	0-10%
Index Linked Bonds	6%	3-10%
Corporate Bonds	8%	4-20%
Other Bonds	3%	0-5%
Cash	0%	0-5%

While the SIP sets out a reasonably wide range for potential asset allocations, this does not reflect the rebalancing processes that are used in practice (not least as the ranges permit a relatively large, but reasonable, degree of variation in the growth / stabilising asset split).

3

Current rebalancing practice

The current policy for rebalancing¹, which has been in place since 2012, consists of two parts. The first applies to the more liquid assets (i.e. the 80% of total assets excluding “illiquid growth”), where the benchmark allocation is 75% growth assets (equities or DGF) and 25% stabilising assets (bonds).

At this level, a “two-tiered” set of boundaries is applied:

- i) a deviation of between 2% and 5% is subject to a review by the Officers having consulted the Investment Advisers;
- ii) a deviation greater than 5% results in an automated rebalancing back to at least +/- 2% weighting as a default. An additional decision is then taken by the Officers supported by the Fund’s Advisers on whether this is fully rebalanced back to the central benchmark allocation or otherwise.

In practice the need to rebalance is checked on a weekly basis by Officers, based on asset data from the custodian.

Whilst this applies to a more focussed level of rebalancing, there is no formal process in place to allow the Fund to make tactical asset allocation decisions (and to utilise the framework in place in the SIP, as set out on page 2).

For the less liquid assets, there is a “soft” bandwidth at which the allocation should be reviewed and discussed by the Investment Panel no less than on a six-monthly basis:

- i) Property: +/- 5%;
- ii) Fund of Hedge Funds: + 5%.

Whilst we agree with treating less liquid assets separately (see later), the range for the Fund of Hedge Funds above will need updating to reflect the revised allocation as set out in the SIP (which sets out a benchmark allocation of 5% within a range of 0 – 7.5%, i.e. only up to 2.5% above benchmark).

¹ <http://democracy.bathnes.gov.uk/mgAi.aspx?ID=6996>

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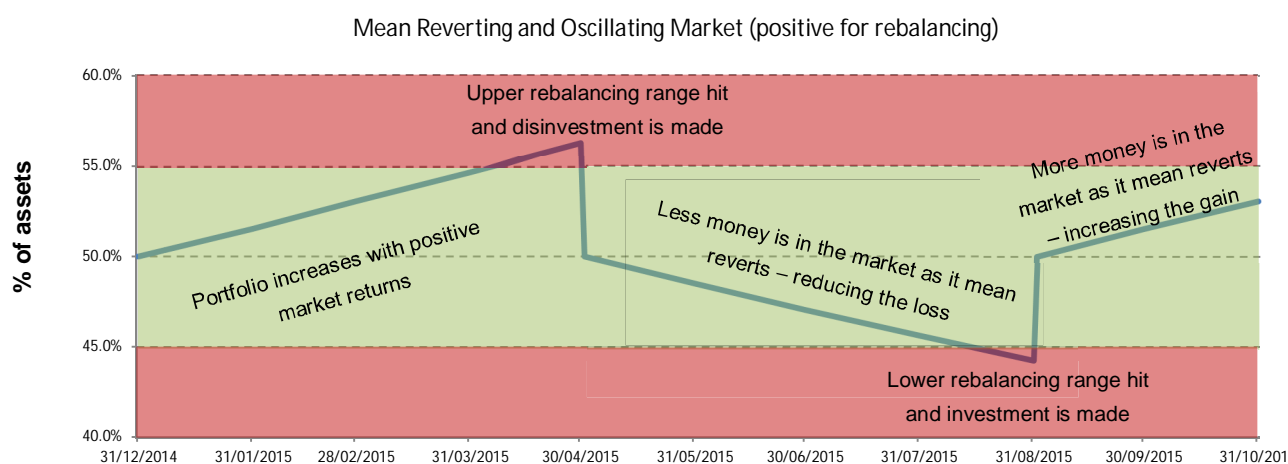
Theory – why have rebalancing?

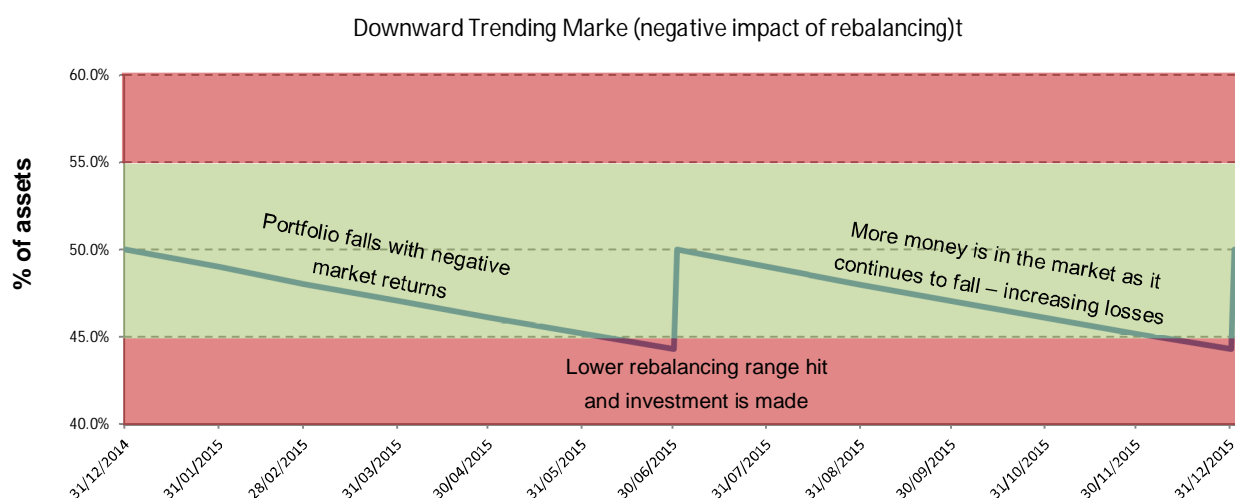
Pension funds generally set an investment strategy and benchmark allocation to reflect the portfolio they believe will generate a long term return sufficient to meet future obligations, for an expected level of risk that is deemed acceptable. The key reason for a pension fund to adopt rebalancing ranges is to ensure that the fund's assets remain invested in line with (or at least reasonably close to) the target investment strategy.

This is desirable because it ensures that the level of expected excess return on the pension fund's assets is consistent with the level that the fund has agreed to target, whilst also ensuring that the fund is not exposing itself to a higher (or lower) level of investment risk than intended.

In addition, rebalancing activity can be expected to add value over time if markets mean-revert. In other words, pension funds that adopt rebalancing ranges can add value by seeking to buy assets when they are relatively cheap and sell them when they are relatively expensive. However, rebalancing does not necessarily always add value if, for example, markets trend for a sustained period (e.g. rebalancing into an underperforming equity market).

This is illustrated by the charts below, which set out the potential rebalancing actions taken for an allocation of 50% to an asset class, with a rebalancing range of +/- 5%.





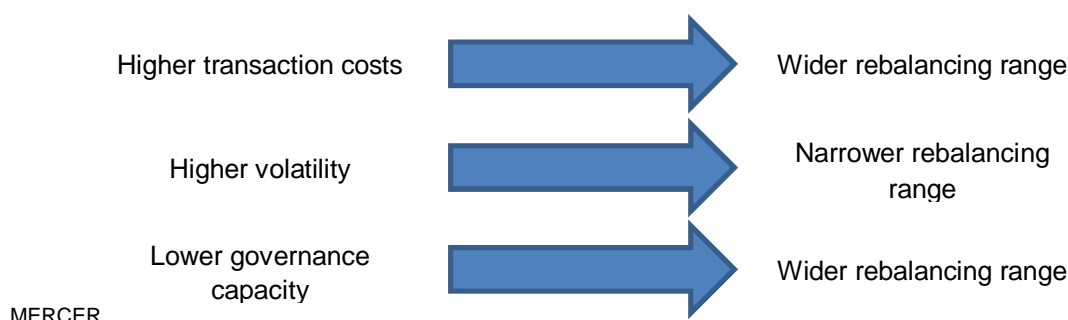
The main drawbacks to rebalancing are that, firstly, transaction costs will likely be incurred each time a rebalancing exercise is undertaken, which arise as a result of the need to sell one asset class and buy another. The costs involved will depend on a number of factors which cannot be known in advance, such as which asset classes and managers are involved in the switch, as well as market conditions at the time of the transfer. We believe that it is sensible to have wider rebalancing ranges for asset classes with higher transactions costs in order to reduce the amount of benefit offset by the costs. Asset classes that are more illiquid and hence less easily trade-able, also merit having wider ranges.

Note that derivatives can be used to rebalance “synthetically” and significantly reduce such costs – this is covered in section 5.

Secondly, the Panel should consider the additional governance burden associated with rebalancing. Given that rebalancing opportunities arise through market movements, it is important to be able to implement in a timely fashion when action is required. Furthermore, it is worth noting that the tighter the ranges are around the central benchmark, the more often rebalancing will be required, which can mean more involvement from Officers and potentially additional consulting and/or investment transaction costs.

Finally, more volatile assets are by definition higher risk, and the Panel may wish to put in place narrower rebalancing ranges for such assets to prevent an overweight position representing a significant build-up of risk.

In summary, key considerations for setting rebalancing ranges are:



Section 7 of this paper sets out a proposed set of rebalancing ranges for more liquid assets (reflecting the higher transaction costs and lower liquidity of property, infrastructure and hedge fund holdings).

5

Rebalancing options

This section outlines the various ways of managing a rebalancing process:

1. Fund-led

This approach consists of the Officers monitoring the split and agreeing actions to re-balance as required, using input from their advisers. This has the benefit of being consistent with the current governance approach.

However, this requires an increased governance oversight and Officer time relative to other options if it is to be monitored regularly. This is because regular and up-to-date asset values are needed for all of the liquid managers within the rebalancing framework. As such, the Officers would need to be able to act quickly on any breaches of the rebalancing ranges. In practice, this level of oversight may not be viewed as being particularly onerous by Officers.

2. Manager-led (physical assets)

Responsibility for rebalancing could be delegated to an investment manager. This would use data feeds from the custodian, and the manager would affect timely rebalancing if any asset classes move out of their ranges. In the case of the Fund, this could be done by BlackRock, who have assets in both the growth and bond portfolios which could be bought/sold as required. This would of course come with a cost, however, as the manager would likely charge a fee for their monitoring (although it would free up Officer time). In addition, the granularity of the rebalancing achievable would be limited by the assets the manager holds (unless they are given authority to move assets to or from other managers, which would mean a delegation of control to a degree).

3. Manager-led (synthetic approach)

As an alternative to (2) above, the manager can look to reduce transaction costs and act quicker by implementing changes using futures to achieve the rebalancing. Futures are less costly and easier to trade than the underlying assets due to the futures market being relatively liquid, although they could only be used to implement rebalancing for more liquid markets where futures are readily available (equities and bonds, but not DGF, hedge funds or property for example).

One potential issue with this, however, is that a significant proportion of the Fund's holdings are in active managers and, in particular, strategies whose holdings would be expected to

differ significantly from the respective benchmark index. For example, it is not possible to purchase or sell futures on the return of an investment fund such as the TT International UK Equity fund. This means that if the allocation to this fund needed to be altered, it would have to be done by either not using futures (i.e. investing/disinvesting directly) or by trading futures on a related index, such as the FTSE All-Share. This second option, however, would not replicate any alpha TT International may generate. In practice, we do not see this as a key concern given that any potential “alpha” will be expected to be less significant than the underlying market return. This would also be an issue for the multi-asset/diversified growth portfolios, as it is not possible to replicate exposure to these strategies synthetically.

Another issue is the availability of the correct futures. For example, the Fund may want to replicate an exposure to a certain index, such as the MSCI AC World, and find that the futures market in this index is not as liquid as the MSCI World. This would mean that Fund may have to purchase futures in an index different to its actual exposure, which may have different returns over the period.

Finally, legal advice would have to be sought before implementing such a policy to ensure that it was compliant with the restrictions in the LGPS Investment Regulations on investments in derivatives.

Comment

In practice, for an LGPS scheme then either option one or option two is likely to be the most straightforward to implement given the greater complexity of option three and potential complications with the LGPS investment regulations. In order to incorporate some element of subjectivity to make tactical decisions within the framework, we propose that option one is retained.

6

Tactical Asset Allocation

While the SIP sets out the benchmark allocation, aligned with the Fund's long-term objectives, it is arguable that a simple mechanistic rebalancing framework may miss the opportunity to factor in views on market valuations and the relative attractiveness of assets classes. Put simply, this could lead to selling out of assets deemed to be attractive, or buying assets deemed to be expensive.

The current arrangement incorporates broad ranges for asset allocation, in part to enable the Fund to reflect changes in the market outlook through **tactical asset allocation** (i.e. short to medium term deliberate over- or under-weight positions relative to the strategic benchmark to reflect market views), although no formal mechanism exists for doing so.

Proposed framework

The following pages set out a potential pragmatic framework for allowing tactical asset allocation decisions. We note that this is a separate decision from the use of "other" asset classes to make short to medium term specific opportunistic investments, which will be considered in the future.

In practice, we propose that this is implemented through a two-tier rebalancing framework (similar to the current structure). The benchmark allocation would be maintained within relatively narrow ranges by Officers, but they could be allowed to take moves outside these ranges (within reasonable limits) to reflect tactical over- or under-weight positions in either growth assets versus matching assets, or at the individual asset class level.

In order to make use of these wider ranges, Officers (referring to Investment Consultant's broad asset allocation views within the quarterly report) would decide on whether an opportunity exists for entering into a tactical asset allocation position. At this point advice would be sought from the Investment Consultant regarding the specific relative value and investment outlook for the various asset classes.

If the allocation to a wider range is the result of an active tactical allocation decision then advice from the Investment Consultant will have been taken on deciding to implement such an allocation. If it is the result of 'drift' then advice will be sought from the Investment Consultant as set out in the proposed rebalancing framework.

The Fund has a benchmark allocation of 20% to “less liquid” growth assets, which includes hedge funds, property and infrastructure (together with potential illiquid holdings of up to 10% as part of the “Other Growth” and “Other Bonds” allocations).

Given the practicalities of implementing changes to these allocations, with high transaction costs and long investment lead times / “lock-in” periods, we propose that these asset classes are excluded from the rebalancing framework as long as weightings are within the wider permitted ranges. Panel will review allocations to these illiquid holdings if the permitted ranges are breached and may do so more frequently, although no more frequently than every six months. The timeframe for any rebalancing of illiquid asset allocations will be made with due consideration for liquidity and transaction costs.

It should be noted that the greater liquidity within the remaining growth and matching assets will allow the overall “Growth” and “Stabilising Assets” allocation to be maintained within limits while the illiquid asset allocation varies.

There is a wealth of information and expert views available to assist the Panel or Officers in making these decisions. The challenge which the Fund faces is in filtering this information in a way that ensures the decisions taken are consistent over time.

Consequently, there is a need for the Fund to develop a governance framework to simplify the decision-making process. Such a framework should identify a small number of criteria for assessing the relative attractiveness of the respective asset classes, and create a relatively simple framework to determine whether a tactical position is warranted.

Mercer has a Dynamic Asset Allocation (DAA) framework that is assessed on a quarterly basis to provide clients with assessments of relative value across a broad range of asset classes over a 1-3 year horizon. Our DAA views assess three broad factors: **long-term valuations**, **cyclical influences** which could result in deviations from long-term value, and behavioural influences such as **investor sentiment and market positioning**.

The information considered under each of the three factors is as follows:

1. Long-term Valuation

There are a wide range of valuation indicators for the major asset classes. For equities, the most commonly used measures utilise **price-earnings (“PE”) ratios**, which express the market value of a company, or an equity market as a whole, as a multiple of its current or expected future profits, or some average of its past profits. PE ratios are usually monitored against their historic averages to determine whether they are cheap or expensive.

For bonds there are many approaches, including comparing current yields to historic averages, comparing yields to the rate of inflation (i.e. the “real” yield) or even the rate of GDP growth.

2. Cyclical Factors

Measures of value for the major asset classes often vary over the economic cycle. For bonds, yields usually fall below their historic averages during a recession and rise above their historic average during periods of economic expansion. The behaviour of PE ratios over an economic cycle varies according to the type of measure used. If the PE ratio is based on current earnings, they might rise during a recession as earnings temporarily fall, provided investors “look through” the economic cycle.

The importance of cyclical effects on valuation measures increases the shorter the investors’ time horizon is. For tactical asset allocation purposes (say a one-year horizon), taking account of cyclical influences on relative value is very important. For a pension fund with a 20-30 year investment horizon, cyclical factors are of limited importance. Many UK funds have a three-year investment horizon, due the triennial valuation requirements, putting them somewhere in the middle of this spectrum.

3. Sentiment and Positioning Factors

Financial markets are driven by expectations of the future and the prevailing consensus view of the future can have a powerful effect on market prices, even if it is wrong. Financial assets must be bought and sold in a market and if there more willing buyers than sellers the price of that asset will rise. Being human, investors are prone to herding behaviour and this herding behaviour often creates what have become known as “bubbles”. The “credit bubble” precipitated the financial crisis of 2008. In the late 1990s we experienced the “tech stock bubble”. In the 1920s there was the “radio bubble” and so on backwards through history.

“Bubbles”, however, provide opportunities for investors who buy the market when they burst, or at least recognise them early enough to exit their investments before the “bubble” meets its end.

Taking account of sentiment factors is critical for tactical asset allocation. Sentiment factors may explain why an asset class looks cheap or expensive and understanding market sentiment is the first step towards understanding what events might cause sentiment to change. Assessing market sentiment is an art rather than a science but there are a number of market indicators which can provide clues, including surveys of market positioning (e.g. are institutional investors over or under weight equities) and biases in the market pricing of options.

The high level output of these DAA discussions is included in the quarterly reports received by the Panel; the appendix to this paper includes the more detailed full report for Q2 2015. We recommend that as a pragmatic mechanism for making tactical asset allocation decisions, at each Panel meeting the current position relative to the benchmark allocation is considered and assessed by Panel **with the input of the investment consultant relative to the DAA framework.**

From this starting point, we propose that reasonably narrow rebalancing ranges are set but that Officers are permitted to allow holdings to move over/under these ranges (within the overall ranges set out in the SIP, as set out on page 2) if the DAA framework suggests that the asset classes are relatively attractive / unattractive. Any decision by Officers to remain outside of the narrow neutral rebalancing range (set out in section 7) will be made after seeking advice from the Investment Consultant.

At quarterly Panel meetings any positions outside the neutral rebalancing ranges will be reviewed in light of the individual views of Panel members and Officers, the views of Fund's asset managers and any other information available could be taken into account in deciding whether to rebalance. The existing permitted ranges in the SIP would be retained as "hard" rebalancing ranges. Rebalancing would be back to the benchmark allocation.

From a cost and flexibility perspective, it would be expected that such tactical asset allocation changes would typically be made through the Fund's passive multi-asset portfolio.

There may be exceptional circumstances where Officers and advisors agree that the rebalancing framework should be suspended (for example, if market liquidity greatly reduces and transaction costs increase). This would be communicated to Panel.

7

Proposed ranges

The table below sets out the current benchmark allocation together with permitted ranges from the SIP (labelled “Permitted Range”), and suggested narrower rebalancing ranges (“neutral rebalancing range”).

The intention is that the allocation is kept within the narrower neutral rebalancing ranges, but that Officers are given discretion to allow holdings to move outside this narrower range (but within the permitted range), based on the Investment Consultant’s views on relative attractiveness of respective asset classes. Any positions outside the neutral rebalancing range will be reviewed at Panel meetings.

Asset class	Benchmark	Neutral rebalancing range	Permitted Range
Growth assets	80%	+/- 3%	65-85%
Equities	50%	+/- 2%	45-55%
Developed	40%	+/- 2%	35-45%
Emerging	10%	+/- 1%	5-15%
Diversified Growth Funds	10%	+/- 2%	5-15%
Illiquid Growth	20%	-	15-25%
Hedge Funds	5%	-	0-7.5%
Property	10%	-	5-15%
Infrastructure	5%	-	0-7.5%
Other Growth	0%	Depends on investment	0-5%
Stabilising Assets	20%	+/- 3%	15-35%
Government Bonds	3%	+/- 1%	0-10%
Index Linked Bonds	6%	+/- 1%	3-10%
Corporate Bonds	8%	+/- 2%	4-20%
Other Bonds	3%	Depends on investment	0-5%
Cash	0%	-	0-5%

Neutral rebalancing ranges for the opportunistic “other” investments would be agreed on implementation (depending on the volatility, liquidity and trading costs of the specific assets).

As a starting point, we propose that Officers implement rebalancing within the neutral rebalancing range set out above, unless the DAA outlooks for particular asset classes are either “attractive” or “unattractive”, at which point Officers will rebalance within the “attractive” or “unattractive” rebalancing ranges as set out overleaf after confirming the view of the asset class outlook with the Investment Consultant.

Asset class	DAA asset class	Benchmark	Permitted Range SIP	Neutral rebalancing range	Unattractive Rebalancing Range	Attractive Rebalancing Range
Growth assets		80%	65-85%	+/- 3%	65%-83%	77%-85%
Equities		50%	45-55%	+/- 2%	45%-52%	48%-55%
<i>Developed</i>	<i>Developed Market Equities</i>	40%	35-45%	+/- 2%	35%-42%	38%-45%
<i>Emerging</i>	<i>Emerging Market Equities</i>	10%	5-15%	+/- 1%	5%-11%	9%-15%
Diversified Growth Funds	Growth	10%	5-15%	+/- 2%	5%-12%	8%-15%
Illiquid Growth, of which	-	20%	15-25%	-	N/A	N/A
<i>Hedge Funds</i>	-	5%	0-7.5%	-	N/A	N/A
<i>Property</i>	-	10%	5-15%	-	N/A	N/A
<i>Infrastructure</i>	-	5%	0-7.5%	-	N/A	N/A
Other Growth	-	0%	0-5%	Depends on investment	N/A	N/A
Stabilising Assets		20%	15-35%	+/- 3%	15%-23%	17%-35%
Government Bonds	Fixed Interest Gilts	3%	0-10%	+/- 1%	0%-4%	2%-10%
Index Linked Bonds	Index Linked Gilts	6%	3-10%	+/- 1%	3%-7%	5%-10%
Corporate Bonds	Sterling Non-Government Bonds	8%	4-20%	+/- 2%	4%-10%	6%-20%
Other Bonds	-	3%	0-5%	Depends on investment	N/A	N/A
Cash		0%	0-5%	-	N/A	N/A

Taking a working example, if the DAA view on developed market equities was “neutral” then they would be rebalanced within a range of 38% - 42%, to keep them aligned to the strategic asset allocation. Should the DAA view change to “attractive” or “very attractive” then Officers would be allowed to keep the allocation within a range of 38% - 45% (the higher top end reflecting the option to implement an overweight position relative to benchmark), after confirming with the Investment Consultant.

This range deliberately allows a holding up to 2% below benchmark to reflect that decisions on individual asset classes cannot be made in isolation; in the extreme example that developed market equities are “attractive” but other asset classes are all “extremely attractive” then the Fund may not want to hold an overweight position relative to benchmark. This also reduces the likelihood that a rebalancing event is “forced” by a change to the DAA view in isolation, although Panel should be aware that the potential for this remains.

The benchmark allocation and the neutral rebalancing ranges (together with the permitted ranges) should be regularly reviewed (in line with the annual investment review) and updated following any change to strategy.

Steve Turner

Mercer

November 2015

APPENDIX A

Important Notices

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APPENDIX B

Q2 2015 Dynamic Asset Allocation report

EUROPEAN DYNAMIC ASSET ALLOCATION 2015 Q2 ECONOMIC & MARKET OUTLOOK



This document summarises Mercer's views on the medium term outlook for returns from the key asset classes; by medium term we mean one to three years. Relevant market indicators are included to illustrate market levels at the time the views were constructed.

The views expressed in this report are relevant for reflecting medium term market views in determining appropriate asset allocation. We do not expect investors to make frequent tactical changes to their asset allocation based upon these views.

The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future market returns.

This document does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

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Executive Summary and DAA Views

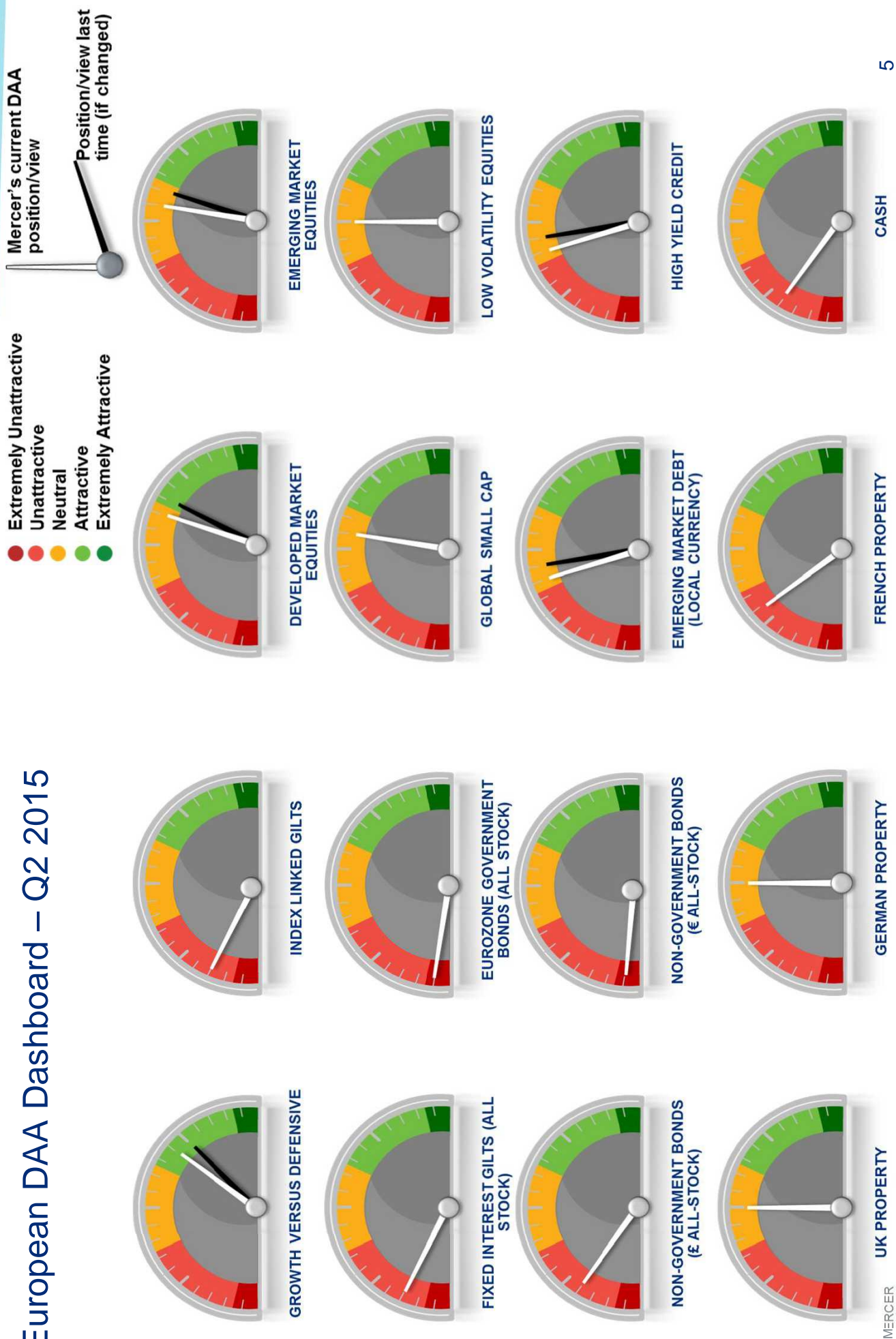
- We continue to expect growth assets to substantially outperform defensive assets such as government bonds. However, following the strength of global equities over the last few years we have downgraded developed global equities to neutral from attractive. We continue to expect equities to perform well (especially compared to other assets), but see prospective returns as more in-line with historical norms (around 7% p.a.).
- We retain our cautious views on UK and Eurozone bonds, with UK bonds at unattractive and Eurozone bonds at extremely unattractive. These views reflect the recent fall in yields which has seen German 10 year yields tumble to almost 0%.
- The US economy weakened in the first quarter, despite the positive backdrop of lower oil and stronger asset prices. We expect this weakness to prove temporary and the US economy to grow at a decent, above trend, pace for the rest of the year. In contrast to the weakness in the US, the Eurozone was stronger than expected with strength in most countries. The region was boosted by the weakness in the euro and oil prices as well as the substantial fall in bond yields. Importantly, credit growth has at last started to recover and this means the recovery could be sustained for some time.
- We continue to expect the US Federal Reserve to raise interest rates this year. However, the weakness in the US economy over the last few months may allow the Fed to wait until the autumn. When the Fed does raise rates, it is likely to signal that it will proceed cautiously. Nonetheless, the first rate hike in almost 10 years may unnerve markets and lead to bouts of volatility.
- The biggest risk to financial markets is whether the Fed is able to raise interest rates to more normal levels over the next few years without damaging the US and global economy or financial markets. In addition, it remains unclear whether Greece will be able to reach agreement with its creditors. While the Eurozone is much more stable than a few years ago, an exit from the euro could destabilise markets.

Asset Class	Jan 2015	April 2015
Fixed Interest Gilts	Unattractive	Unattractive
Index-Linked Gilts	Unattractive	Unattractive
Eurozone Government Bonds	Extremely Unattractive	Extremely Unattractive
Non-Government Bonds (£ All-Stocks)	Unattractive	Unattractive
Non-Government Bonds (€ All-Stocks)	Extremely Unattractive	Extremely Unattractive
Global Equities	Attractive	Neutral
Emerging Market Equities	Neutral	Neutral
Small Cap Equities	Neutral	Neutral
Low Volatility Equities	Neutral	Neutral
UK Property	Neutral	Neutral
High yield bonds	Neutral	Neutral
Local currency emerging market debt	Neutral	Neutral
UK Cash	Unattractive	Unattractive

Valuation Scale: Extremely Attractive → Attractive → Neutral → Unattractive → Extremely Unattractive.

Shaded Items represent views that have changed from the previous meeting.

European DAA Dashboard – Q2 2015



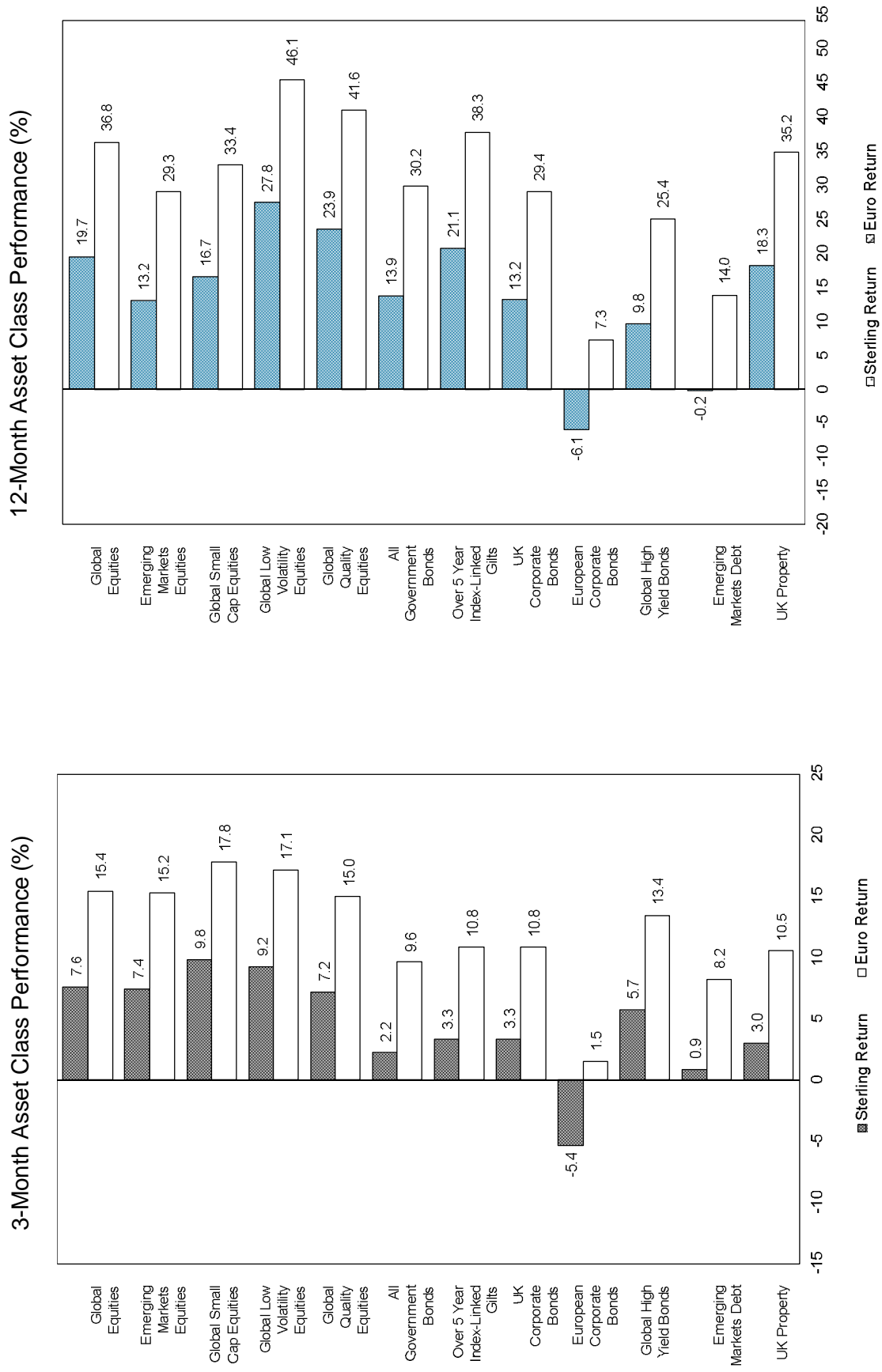
Quarterly Market Commentary – Surging central bank liquidity lifts all asset classes

- Defensive and growth assets both performed strongly across a wide range of global markets in the first quarter. Duration, yield and relative earnings momentum accounted for much of the relative performance across and within asset classes. While realised currency volatility continued to increase, equity and fixed interest volatility abated.
- Even as both the oil price and inflation expectations increased moderately over the course of the quarter, bond yields continued to decline in most major markets. The broad-based decline in real yields followed the earlier decision by the Bank of Japan (BoJ) to expand Quantitative Easing (QE), the commencement of QE in Europe (with the ECB expected to purchase twice the size of new sovereign bond issuance in 2015), and re-affirmation of the Fed's cautious approach towards policy normalisation.
- Reflecting the ECB's monetary bazooka, the deepest declines in yields were in the core European economies, with roughly 50% of EMU bonds now trading at a negative yield. Yields also fell in most of the EMU periphery, although spreads have started to widen in the face of renewed uncertainty over Greek debt negotiations. Long yields also fell in the US. UK government bond returns (2.2% in GBP terms) fell slightly short of global credit and UK inflation-linked bonds (both returned 3.3%), as well as global high yield (returned 5.7%). Conversely, the rising USD contributed to further poor performance in local currency EMD (0.9% over the quarter and -0.2% over the year).
- Nevertheless, amid the combination of falling real yields, broadening growth (at least in the developed economies), and abating deflation fears, equity markets performed strongly in the quarter. Across the major sectors, global small caps were the best performers (returning 9.8% in GBP terms), followed by Low Volatility (9.2%) and MSCI World (7.6%). Even Emerging Markets recovered (up 7.4% in the three months to March), with quality the weakest performing sector (7.2%).
- Across countries, local currency (total) returns were strongest in continental European markets, ranging from 31.1% in Denmark to 'just' 10.0% in Norway. MSCI EMU was up 18.7% in the quarter, while Japanese and Australian equities also delivered returns of over 10%. In contrast, the FTSE 100 posted a return of 4.2%, while the S&P 500 only managed to eke out a gain of 1.0% (all local currency returns).
- The strength of the dollar (as well as oversupply and slowing demand in China and other emerging economies) continued to counteract on the recovery in oil and other commodity prices. The S&P GSCI Total return Index fell a further 8.2% in the quarter, and has fallen by 40.3% over the past year.

Asset Class	Market Indicator	Market Indicator	Market Indicator
Equities			
Global	MSCI World	9822	10569
Emerging Markets	MSCI EM Emerging Markets	2305	2476
Small Cap Equities	MSCI World Small Cap	350	384
Low Volatility Equities	MSCI World Minimum Volatility	1781	1945
Government Bonds			
	MSCI World Quality	978	1048
Fixed Interest Gilts	FTA All Stocks Yield	2.1%	2.0%
German Government Bonds	REX General Bond Index Yield %	0.2	0.1
Index Linked Gilts	FTA Over 5 Year yield (5% inflation)	-0.8%	-0.93%
Corporate Bonds			
Corporate bonds £ All-ML	£ non-gilt credit spread	128bps	109bps
Stocks	ML £ non-gilt yield	3.0%	2.7%
Corporate bonds € All-ML	€ non-gilt credit spread	97bps	98bps
Stocks	ML € non-gilt yield	1.2%	1.0%
Other Bonds			
High Yield Bonds	Barclays Capital Global High Yield Credit Spreads	516bps	500bps
	Barclays Capital Global High Yield Redemption Yield	6.7%	6.3%
Local currency emerging market debt	JP Morgan GBI EM Global Diversified Composite Yield	6.5%	6.3%
Property			
UK	IPD Initial Yield	5.4%	5.3%

Source: Thomson Reuters Datastream.

Market Performance to 31 March 2015

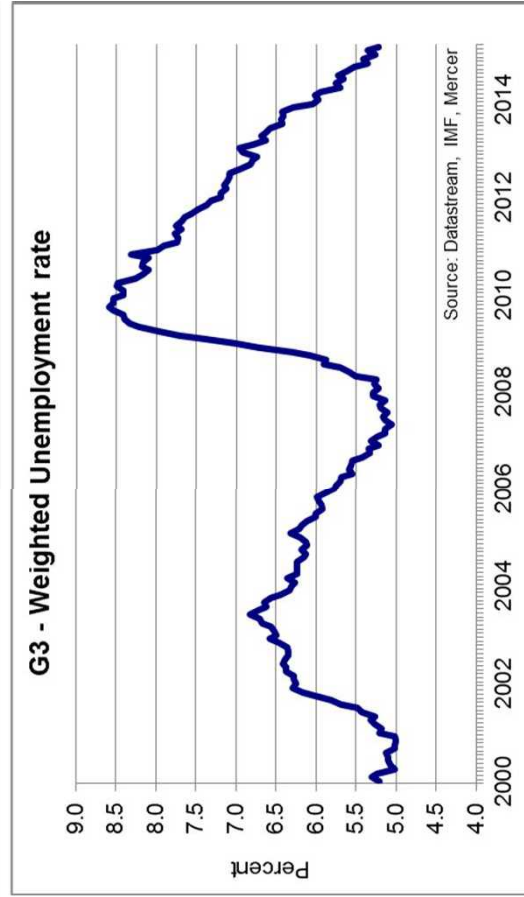
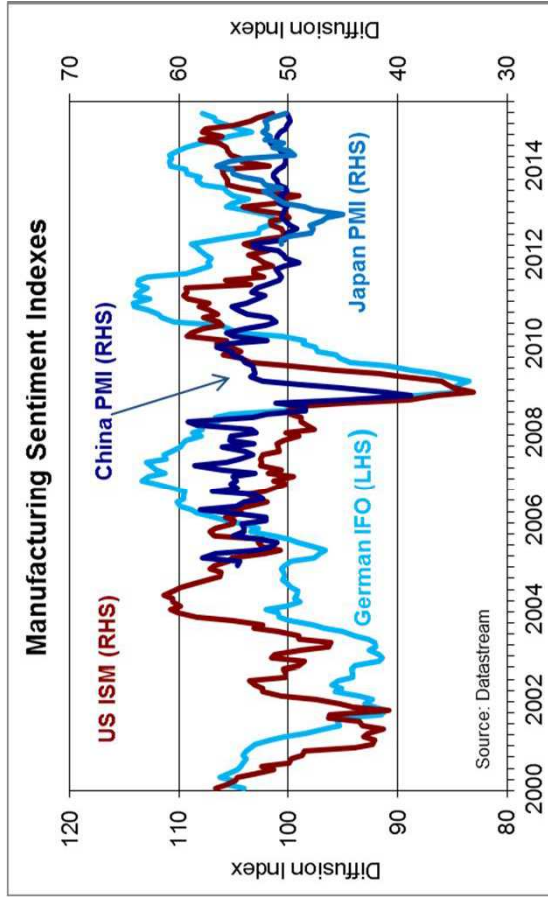


Source: Thomson Reuters Datastream

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Global growth in early 2015: not bad, not good, still uneven

- Uneven global growth continues in early 2015. After an average annualised rate of over 4% in the second and third quarters of 2014, US GDP growth has cooled in the past two quarters. More positively, growth appears to be strengthening in the euro area, and is becoming more broadly based across both the core and the periphery. Japan also appears to have entered a tentative recovery after the mild recession of mid-2014. Although partly due to cold weather as well as to the effects of the labour strikes, the moderation in US growth and the contemporaneous strengthening in Europe and Japan appear also to reflect the rotation of global QE policies and the accompanying large exchange rate adjustments.
- In contrast, growth continues to moderate in China, amid a rapidly weakening residential property sector and overcapacity in manufacturing. Many other parts of the emerging world also are continuing to struggle in the face of various headwinds, including the steady unwinding of credit cycles and low commodity prices. Some emerging economies, however, those like India that are commodity importers and embarking on significant structural reforms, are performing much better.
- Inflation has fallen almost everywhere in early 2015, with headline CPI numbers turning negative in the US, the UK and the euro area, although largely reflecting the earlier plunge in the oil price. Since the low of \$US46/bbl in mid-January, however, the price of Brent crude has since rebounded to close to \$US60/bbl. In the meantime, employment continues to expand moderately in the core developed economies, with the weighted G-3 unemployment rate now close to the previous two cyclical lows, and poised to fall further in 2015. Accelerating wage growth appears only a matter of time.
- Despite the soft start to the year, the IMF has left the 2015 global growth forecast unchanged at 3.5%, with manufacturing and other business surveys pointing to growth in the developed world bouncing back in Q2. This marked seasonal pattern of growth has been particularly evident in the US in the past five years (possibly reflecting distortions to seasonal adjustment processes following the 2008/09 recession), adding to the consensus view that the sharp slowdown in the US is largely temporary.
- With rising oil and labour costs, stronger efforts in Japan and Europe to combat deflation risks, and the US Federal Reserve continuing to emphasise the asymmetric risks of commencing tightening too early, inflation expectations in the major economies have rebounded since mid-January. In the emerging world, the Peoples' Bank of China (PBoC) has also started to ease monetary policy, and we anticipate further measures over the coming quarters. Nevertheless, with the Fed still poised to lift the funds rate by late 2015, an inflection point in the global monetary policy cycle is gradually approaching. In our view, this potential further divergence in global growth and monetary policies portends continuing volatility in currency and other markets.



Consumers poised to underpin stronger growth in both the US and euro area

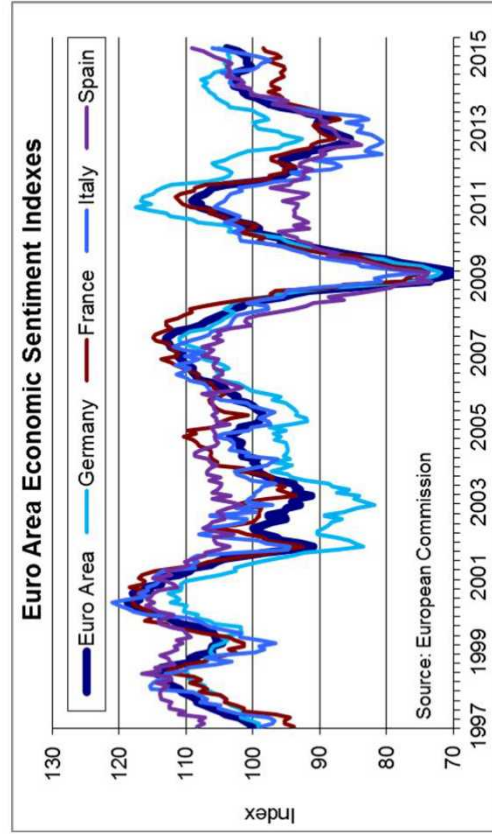
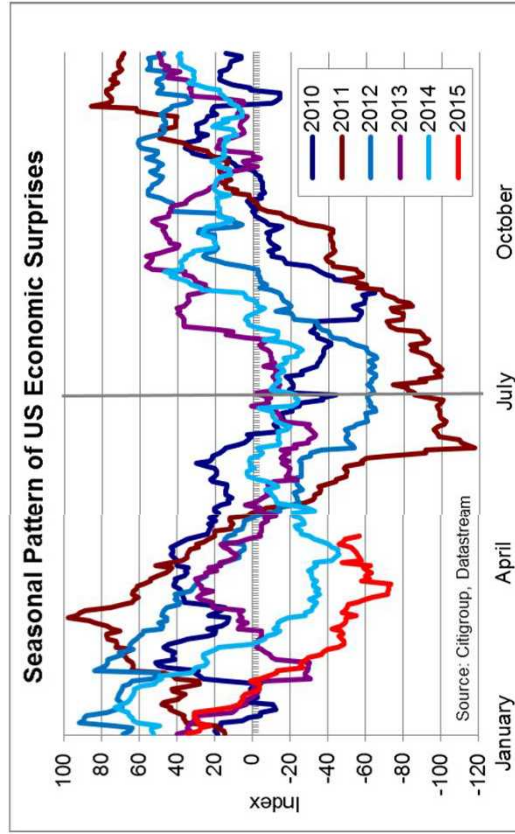
■ In the United States, GDP growth slowed markedly in late 2014 and early 2015. Some of the slowdown in late 2014 most likely reflects 'payback' for the strong increases in the second and the third quarter last year (average annualised increases of over 4%), while the expected weak outcome in the first quarter partly reflects the effects of cold weather and labour strikes. Indeed, in the past five years US GDP growth in first quarters has averaged just 1.7%, compared with average annualised growth of 2.9% in the remaining three quarters.

Correspondingly, more recent indicators suggest growth may have already started to strengthen towards the end of the quarter. Much of the recent softness has been concentrated in consumer spending, despite surging real disposable incomes (stronger employment and wages growth and falling energy and import prices), buoyant levels of consumer confidence and plentiful job openings.

■ In contrast to strong household fundamentals, US corporate income growth has lost some momentum, with the rising USD and unit labour costs starting to pressure profit margins. The ISM survey suggests manufactured export orders have now fallen for three months. The slowdown in profit growth appears also to be feeding through into weakening durable goods orders and non-residential fixed investment, and could be expected to contribute to a moderation in payroll growth (after a very strong 2014). In the public sector, in contrast, final demand is no longer contracting. Moreover, even with some moderation in GDP and payrolls growth, the unemployment rate is poised to fall towards 5.0% by late 2015, pointing to a further gradual strengthening in wages growth.

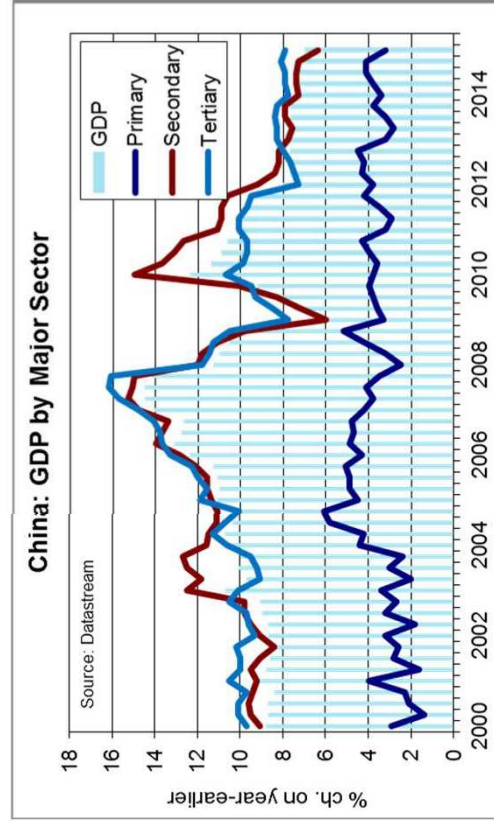
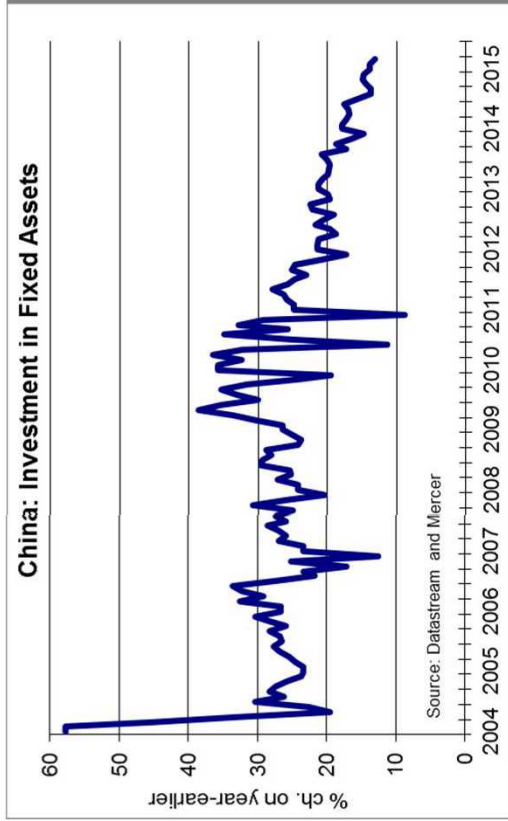
■ In the Eurozone, the recovery is gaining traction, as fiscal drag continues to abate, credit growth begins to recover, and as the weaker euro and structural reforms spur an upturn in export growth. More positively, the recovery has been concentrated in parts of the periphery (especially Spain, Italy and Ireland), and has been accompanied by further declines in unemployment rates in at least some countries (most notably in Spain). Within the core, Germany again leads the upturn, with the German unemployment rate continuing to fall to new lows (standing at just 4.8% in February). France remains a laggard, and the unemployment rate in France continues to drift steadily higher. The consensus forecast for 2015 Eurozone GDP growth subsequently has increased from 1.1% to 1.5% over the past quarter, with growth expected to strengthen further to 1.8% in 2016 (the strongest since 2010).

■ GDP has shown some sign of bottoming in Greece, although the outlook remains overshadowed by the fractious negotiations between the new government and the creditor institutions. To date, Greece has been able to meet official repayment obligations, but has signalled this is unlikely to remain the case without some re-negotiation of bail-out conditions. In the meantime, the EU has hinted that any fallout from a 'Grexit' would likely be quarantined by the various financial stability mechanisms put in place in the past few years. The EU's stance suggests the risk of a Greek exit have increased materially, but given the stakes involved for both sides we expect the standoff to persist for some time. Greece has a €763mn payment to IMF due on 12 May.



Growth prospects mixed elsewhere

- Elsewhere among developed economies, the UK continues to produce solid growth, with the consensus expecting the 2.8% increase in GDP in 2014 to be followed by 2.6% in 2016. Correspondingly, employment growth remains strong, while the unemployment rate has slipped to a new cyclical low of 5.6%. Less positively, nominal wage growth remains tepid, with household spending largely underpinned by falling goods and services inflation and buoyant house price gains. Moreover, at 5.5% of GDP in 2014, the UK's current account deficit was among the largest in the developed world.
- In Japan, a modest recovery appears to have continued into early 2015. Although GDP expanded by just 0.4% in the fourth quarter (after contractions in three of the previous four quarters), and the PMI has struggled to remain in expansionary territory, other indicators continue to paint a brighter outlook. Exports, which were initially slow to respond to the collapsing yen in 2013, have risen steadily from mid-2014, contributing to a re-tooling of the Japanese manufacturing sector. Indeed, machinery orders bounced in late 2014 and early 2015, and (in contrast to other developed economies), private business investment continues to rise steadily as a proportion of GDP. Most promisingly, the ratio of job offers to applicants is now at the highest level in over two decades, and employment and income growth are slowly strengthening. Furthermore, nominal GDP is now comfortably outpacing real output growth, as the long decline in the GDP deflator appears to have been arrested. After a 1.0% increase in 2015, the consensus expects a further 1.7% increase in Japanese GDP in 2016.
- At 7.0% in the first quarter, GDP growth in China has fallen to the weakest rate since early 2009, while the quarterly 1.3% (non-annualised) increase was the lowest since estimates were first released in 2010. Much of the weakness remains concentrated in secondary industry (growth in which has also fallen to the lowest level since 2009), reflecting a sharp moderation in both export and fixed asset growth. Substantial capacity overhangs remain in the industrial and residential property sectors, and along with accompanying non-performing loans will remain a drag on Chinese growth for several years. At this point, weakness has yet to spread to other major sectors or components of final demand, supported by market liberalisation measures and rising personal incomes. In our view, the risks to consensus growth forecasts (6.9% in 2015 and 6.8% in 2016) remain tilted to the downside.
- The outlook remains equally mixed in the other major emerging economies. India remains the standout performer, benefiting from lower energy prices and an ambitious structural reform program. Other emerging Asian economies confront cross-currents from lower exchange rates and commodity prices, but the prospect of a sustained moderation in China's long-term growth path. In contrast, Brazil and Russia appear to have slipped into recession, both the victims of plunging commodity prices. Poor economic management and sanctions, respectively, remain hurdles to quick turnarounds in both economies.



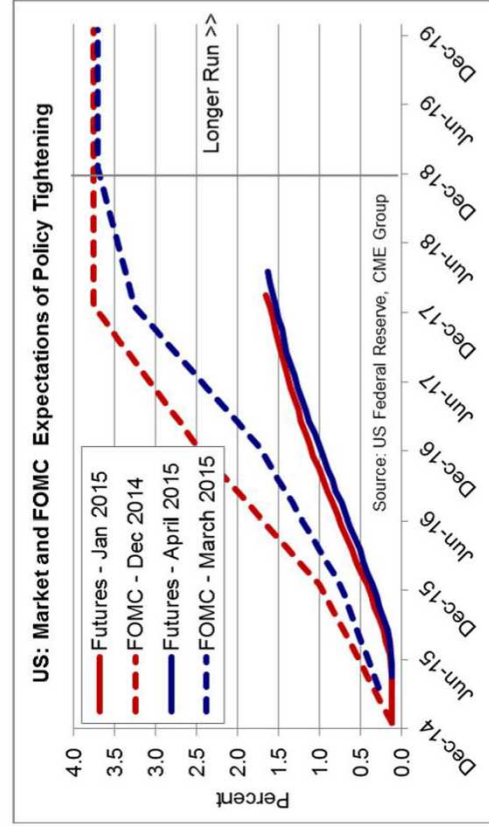
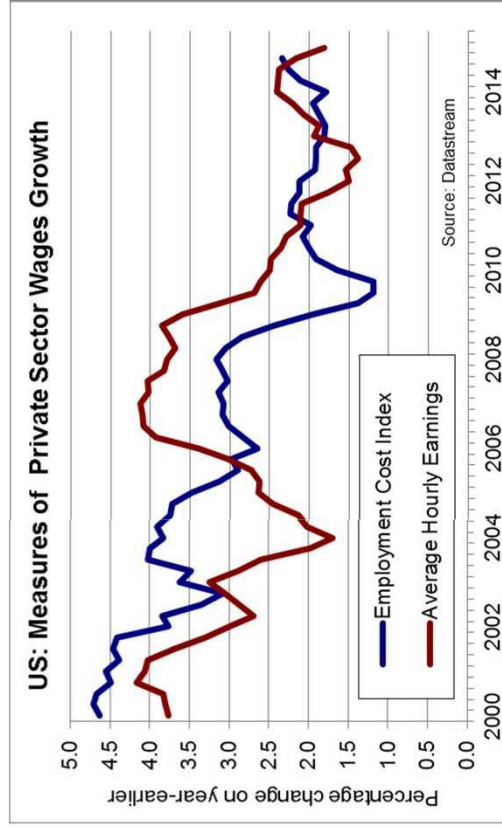
The global monetary policy cycle to hit an inflection point by late 2015?

■ The People's Bank of China is the latest central bank to adopt a more aggressive approach to monetary easing, cutting required reserve ratio by 100 basis points in mid-April. In the meantime, however, evidence is mounting US core inflation bottomed in the first quarter, giving the Fed reasonable confidence inflation will return towards the 2.0% target over in 2016. We continue to expect a first US rate increase by the end of 2015. Nevertheless, US bond markets continue to discount a more dovish process of policy normalisation than the median of FOMC member forecasts. While long-term inflation break-evens have jumped in the US (and other countries) in tandem with the rebound in oil prices, they remain below central bank inflation targets, and underscore the continuing low levels of US and global real interest rates.

■ We concur with both the Fed and market pricing that the terminal funds rate is likely to be lower this cycle compared with those prior to the 2008/09 recession. Potential GDP growth is now likely to be lower in the US and across much of the developed and emerging worlds, largely reflecting the impact of demographics. The global shortage of risk free assets is a further source of downward pressure on real interest rates in the short- to medium-term. In addition to the massive ECB and BoJ asset purchase programs, narrowing budget deficits in the US and the UK are also reducing new bond supply. In the meantime, both new issuance and falling bond yields leads to a strengthening in demand among passive fixed interest funds and liability-driven investors. In addition to the extent of negative yields in Europe, term premiums on longer dated US Treasuries are also beenestimated to have turned negative.

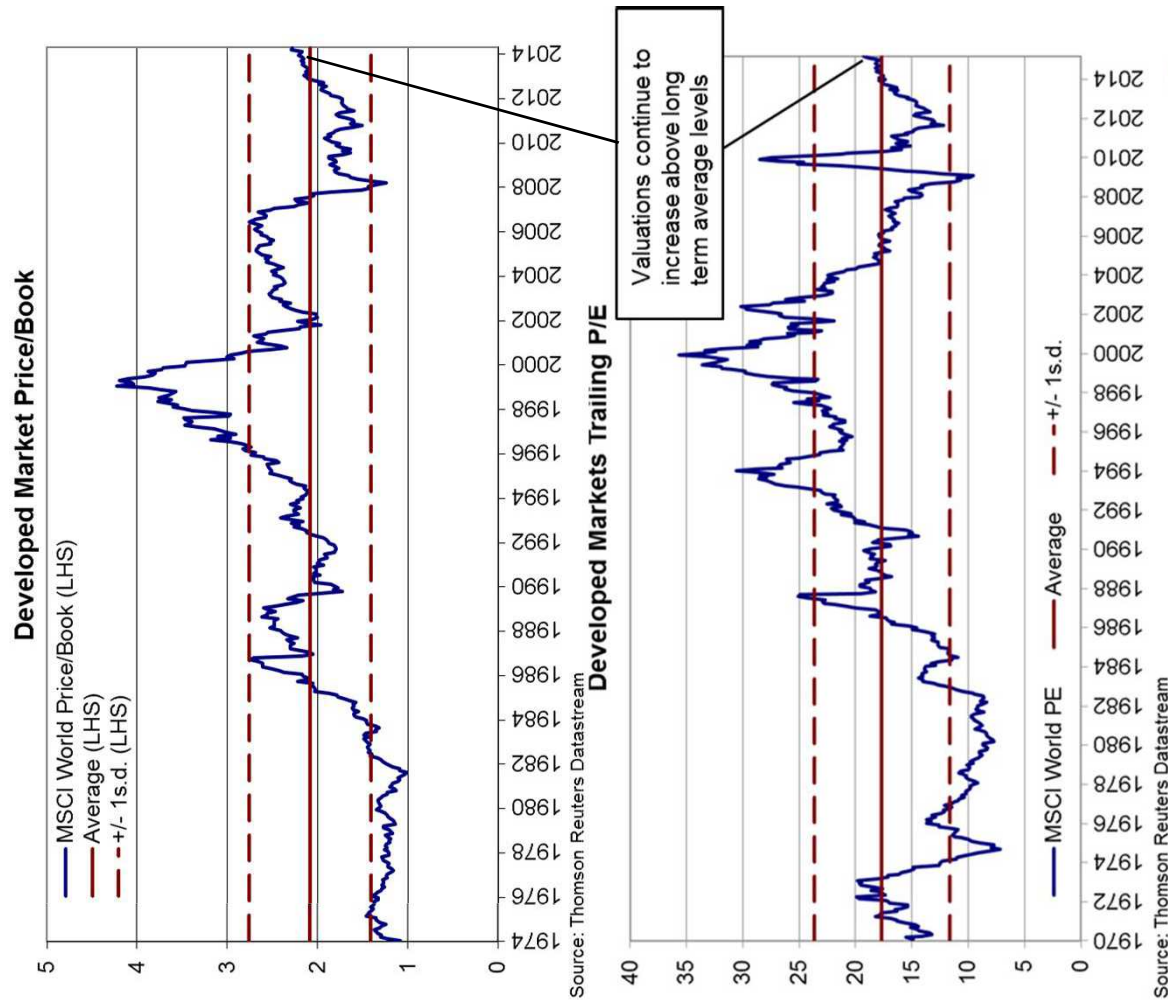
■ In our view, however, steadily tightening labour markets in the developed economies rest uncomfortably with the notion of 'secular stagnation' - structurally deficient aggregate demand, high unemployment and disinflation. Moreover, some studies suggest that developed economies may be approaching an inflection point at which rising global savings rates (another cornerstone of secular stagnation) give way to dis-saving, eventually placing upward pressure on global real interest rates. Rather, we believe there is also a strong cyclical dimension to the long period of trend/sub-trend global growth and disinflation, specifically the unusually asynchronous pattern of growth across the major regions.

■ With investors prepared to pay increasingly large premia for safety, we remain wary that the US bond market (and global bond markets more generally) are continuing to under-price cyclical risks over the next 1-3 years. Similarly, European bond yields imply the ECB is unlikely to commence tightening before 2019, again suggesting investors see risks to European growth and inflation skewed heavily to the downside. In other European countries experimenting with negative policy rates, the alternative of hoarding cash also potentially limits the downside to yields. At current levels, we believe the risks to long global bond yields are highly asymmetric.



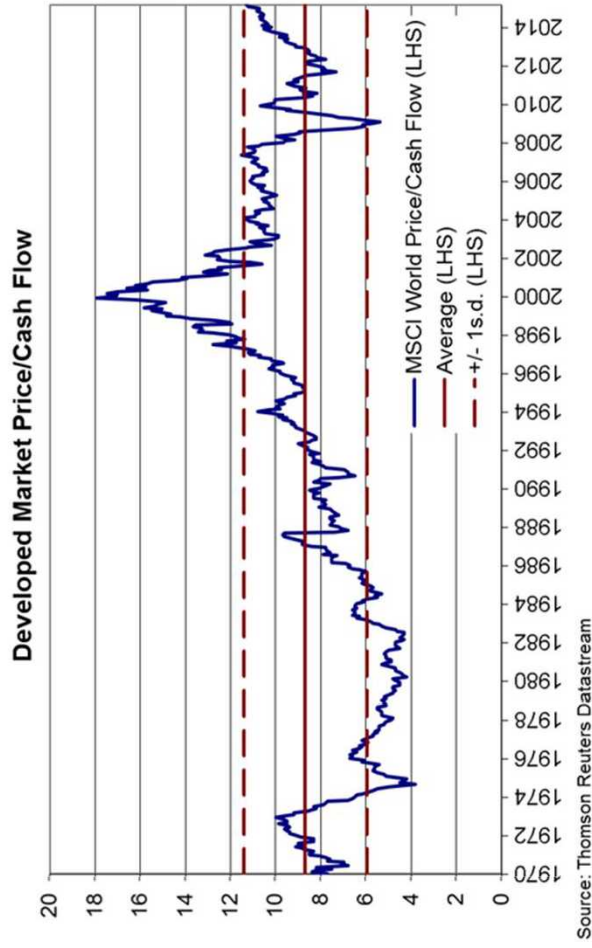
Developed equities viewed neutrally as valuations rise

- **Our rating for developed equities has moved to Neutral.** Equity markets experienced a turbulent start to the year, as markets fell during the first half of January before rebounding strongly in February. The MSCI World finished the quarter 7.6% in GBP terms. In contrast to the recent past, upward momentum generally came from outside the US, notably Japan (which was up 15.9% over the quarter in GBP terms) and many parts of Europe.
- In terms of **valuations**, these generally rose over the quarter with developed market equities, on the whole, looking more expensive than they did last year. Overall we are increasingly of the view that when looked at over the longer term, the asset class is generally fully valued. Price to Book ratio crept up marginally from 2.2x to 2.3x and Price to Cashflow also increased from 10.7x to 11.3x. These measures are towards the top end of their historical average. Price to Earnings increased materially from 18.0x to 19.3x, as did Cyclically Adjusted Price to Earnings (CAPE) which went from 19.2x to 19.5x over the quarter. Generally speaking, there appears to be more upside potential for Japan and the Eurozone compared to the US.
- As regards **market behaviour**, investor confidence appears to have been buoyed by the news of larger than expected quantitative easing measures in the Eurozone and in general market sentiment remains bullish on the expectation that the US will continue to support global economic growth.
- Investor positioning continues to illustrate a preference for equities over bonds, with the net percentage overweight up to a 7-month high in February. The current allocation is around 1.1 standard deviations above its long-term average (BofAML Global Fund Manager Survey, 17 February 2015). At regional level, the overweight allocation to US equities declined sharply over the quarter, with investors instead showing a preference for Japanese and Eurozone equities.
- Whilst the recent oil price collapse has led to a significant rotation out of energy and materials and into global technology and discretionary stocks, some commentators suggest that cuts to energy earnings projections, in particular, may have overshoot the fall in the oil price. JP Morgan, for example, find energy to be one of the few value sectors currently and have recently positioned themselves overweight (JPM Equity Strategy, 23 March 2015).
- Overall, market volatility still remains below the historic average, though has increased from the all-time-lows seen in 2014. In our view, volatility is likely to increase to more elevated levels, in light of the anticipated policy rate lift-off in the US.

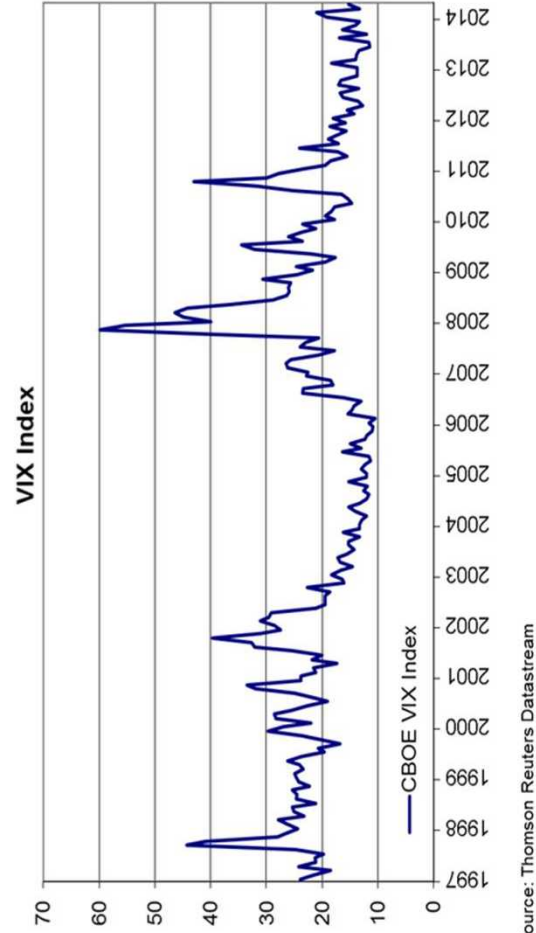
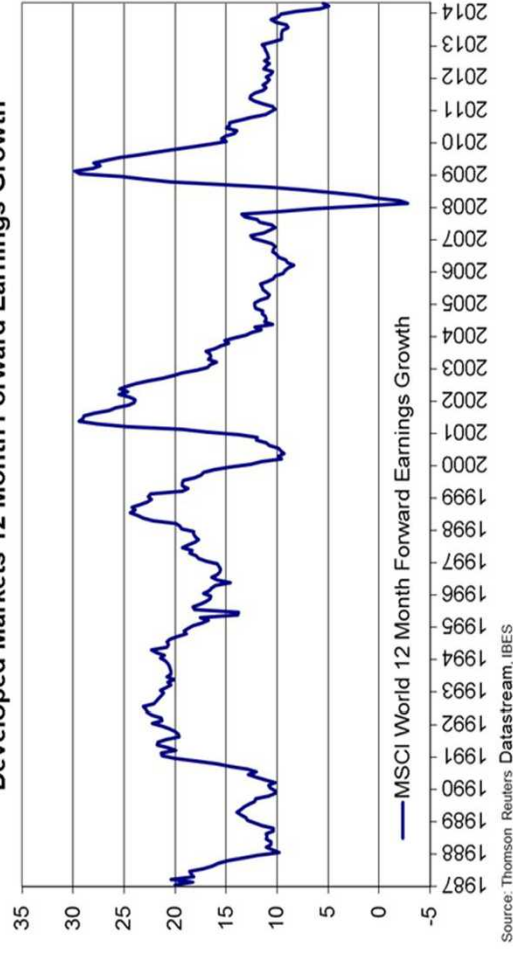


Developed equities viewed neutrally as valuations rise (cont'd)

- Investor sentiment, as gauged by Citi's News Implied Sentiment Indicator, improved marginally, but remains in bearish territory. On the other hand the Global Risk Aversion Macro Index (a global measure of risk aversion across asset classes) decreased, signalling a slight improvement in global risk appetite. This measure remains positive, after spending much of the second half of 2013 and first half of 2014 in negative territory (Citi Global Macro Strategy, 30 March 2015).
- With the Fed ending its forward guidance, equity markets are likely to remain sensitive to economic data releases in the US over the coming months, as they are expected to be a deciding factor for the initial interest rate lift-off date. Muted inflation prints and weaker than expected consumer spending data has led some market participants to push out their expectations on any Fed rate hikes, and this is now broadly anticipated for late 2015.



Developed Markets 12 Month Forward Earnings Growth



EM Equities face a number of headwinds

- **We maintain our Neutral rating for emerging market equities.** The MSCI Emerging Markets index returned 7.4% in GBP terms over the quarter (4.9% in local currency). Performance across major regions varied over the quarter, with Latin America returning -4.9% (1.3%), EM EMEA 7.2% (5.7%) and EM Asia performing strongly with a return of 10.6% (5.7%) (all in GBP terms, local currency returns in brackets). We expect US dollar strength to continue to provide a headwind to emerging market growth.

- Performance continues to vary considerably across countries and has tended to reflect instances of correction for initial market overreaction. Russia, for example, fell -30.1% in the fourth quarter of 2014, but rebounded in the first quarter of 2015 returning 24.6%. Meanwhile, Turkey, which returned 16.0% in Q4 2014, experienced a significant negative return of -11.5% over the first quarter of 2015 (all in GBP terms). The difference between the best and worst performing countries in the index remains substantial, at around 50% over the first quarter of 2015 in GBP terms. We continue to advocate the use of active management in this asset class and remain of the view that skilled managers should be able to add value and identify opportunities, as well as manage risk.

- **Valuations** generally increased over the quarter and, whilst still generally below their long-term averages, remain at around their highest level since early 2011. The MSCI EM Index currently trades at a price/earnings ratio of 13.7x, price/book ratio of 1.6x and a price/cash flow ratio of 8.2x. Valuations have also increased slightly on a cyclically-adjusted basis: emerging markets traded at a P/E ratio of 13.1x (versus 12.9x at the end of last quarter). Earnings have fallen considerably over the last 12 months, which can be attributed in large part to the energy sector. The long awaited improvement in EM earnings has not yet materialised.

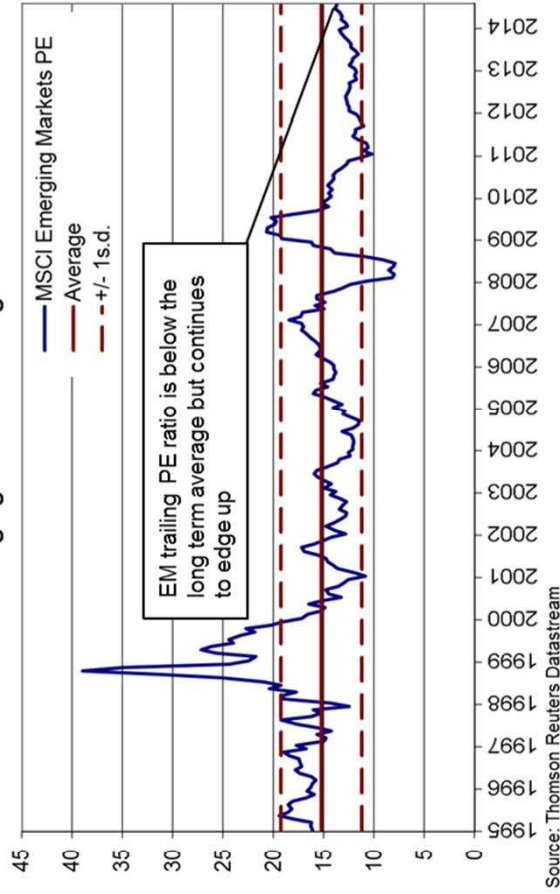
- Looking at **market behaviour**, participants continue to view emerging markets as a source of considerable tail risk within the global economy. According to BofAML, ongoing geopolitical crises, China debt defaults and an outright crisis within emerging markets are among the largest risks which concern investors (BofAML Global Fund Manager Survey, 17 February 2015).

- IMF head Christine Lagarde commented in March that emerging markets are set to face a renewed period of economic instability when the US interest rates rise, forecasting a repeat of the “taper tantrum” episode experienced in 2013. Other commentators have been equally tempered and overall, investor sentiment remains muted. Some market participants believe that more volatility is not unlikely, given the magnitude of the general rotation out of emerging markets.

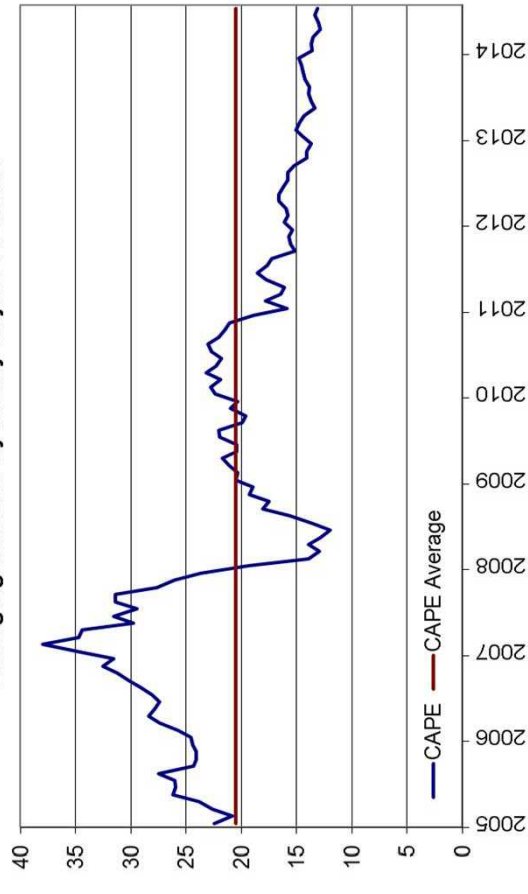
- Market overreactions to major events (both globally and within emerging markets) remain a challenge but also an opportunity for investors to add value, as idiosyncratic stock strengths are often overlooked in broad sell offs.

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Emerging Markets Trailing P/E



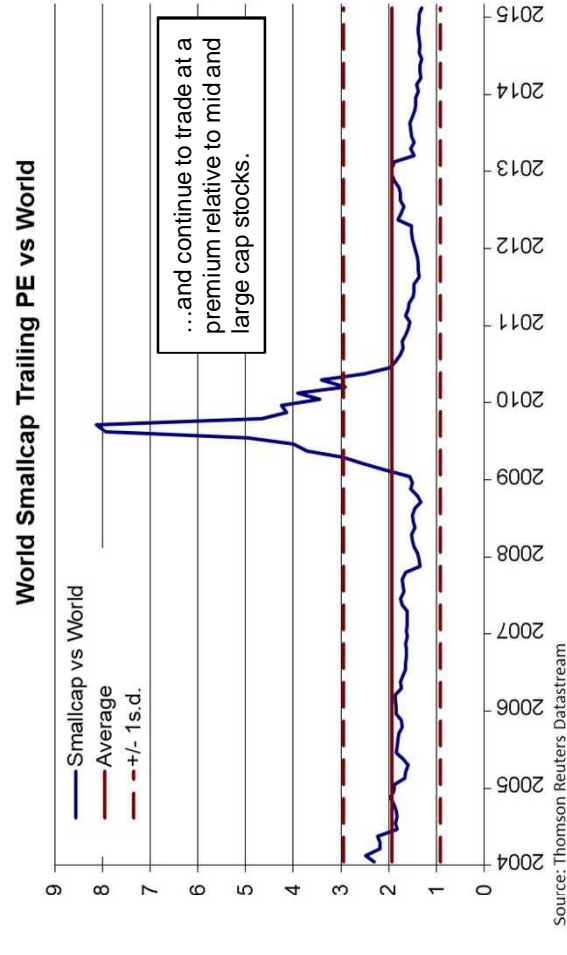
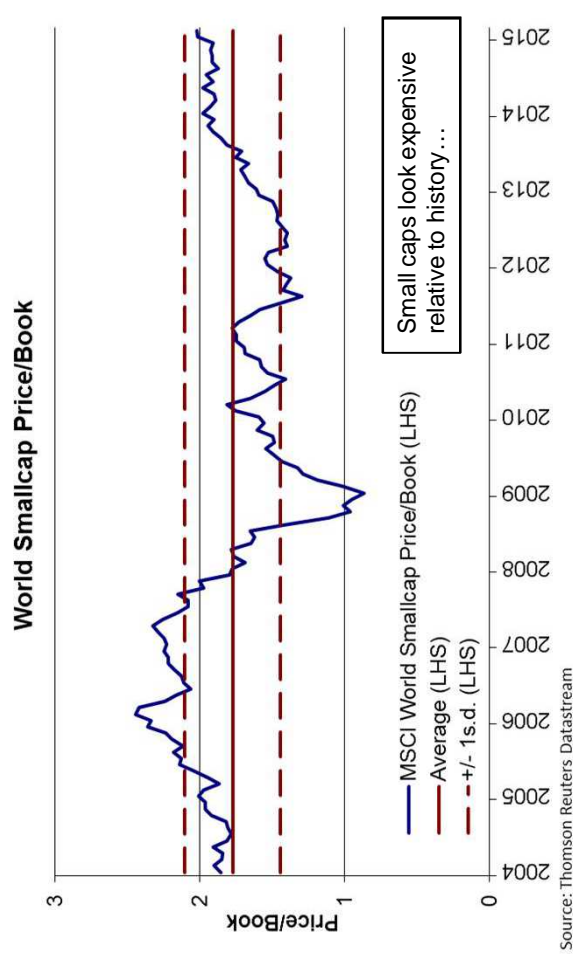
Emerging Markets Cyclically Adjust P/E Ratio



Source: Thomson Reuters Datastream, IBES

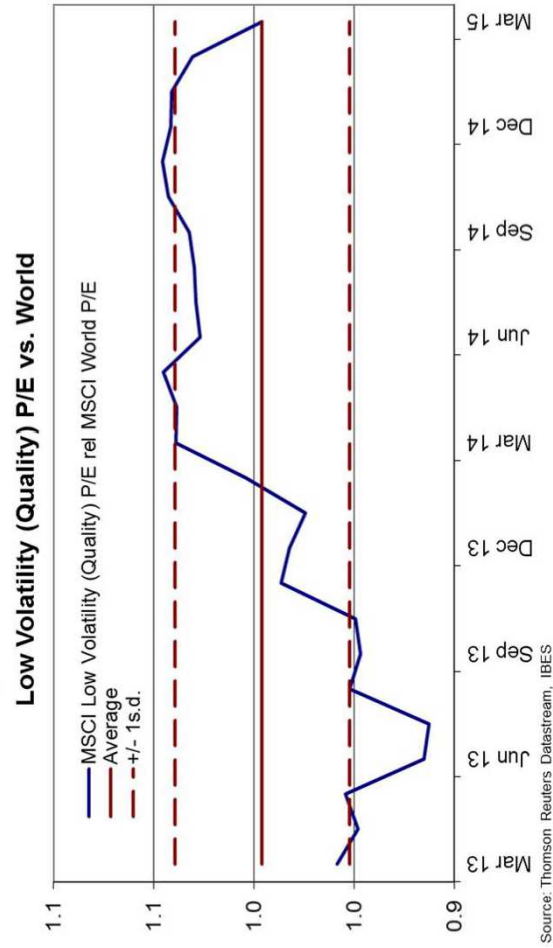
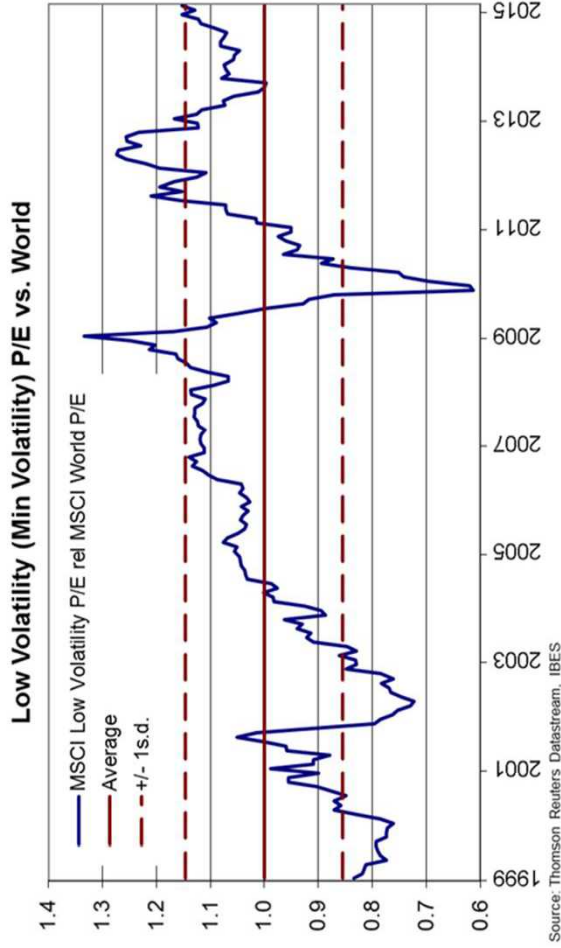
Small caps continue their revival, but look expensive

- **Our view on small caps remains Neutral**, Divergence across regions is intensifying and country level analysis is becoming increasingly critical, though the market is still dominated to a large extent by the US.
- The MSCI World Small Cap index returned 9.8% in GBP terms (6.9% in local currency terms) over the quarter, outperforming the MSCI World Index by 2.2%. US small cap performance was 10.1% over the first quarter of 2015, eclipsed by the strong performance of Japanese small caps which rose by 14.8% in GBP terms. Overall, European small caps performed broadly in line with the US and wider index, though with some considerable country dispersion which saw the periphery (including the likes of Spain and Portugal) generally outperforming core countries such as the UK and Germany.
- In terms of **valuations**, as at the end of the quarter, the MSCI Small Cap index still trades at a premium to the MSCI World based on forward price/earnings (19.9x vs. 16.6x). This premium has increased over the quarter as small caps have outperformed, but still lies somewhat below the level seen a year ago.
- Trailing price/earnings ratios remain increasingly diverse across regions. As at the end of the first quarter of 2015, the trailing PE ratio in the US, which accounts for c.60% of the index, decreased marginally to 29.2x as performance in the US lagged a number of the other major country constituents over the quarter. Meanwhile, the trailing PE in Japan (10% of the market cap) increased from 17.5x to 18.4x after a strong quarter. Looking at European small caps which account for c.20% of the index in total, PE ratios generally rose over the quarter - particularly across peripheral Europe, whilst increases were less pronounced in the core.
- Looking at **market behaviour**, 2014 saw small caps generally underperform their large cap counterparts. Some commentators have suggested that 2015 will bring better relative performance for small and mid-caps, particularly in the US, as the US dollar strength disproportionately hinders large multinational company earnings due to their overseas revenue streams. Indeed this has been the case year to date. Increased M&A activity may also benefit the valuation of mid-cap companies in particular.
- In the US, small caps face considerable cyclical headwinds. Tighter financial conditions, which had previously been supportive for small cap performance, are likely to weigh on investor sentiment. On the other hand, lower oil prices should be beneficial and as the US equity bull market matures, high-quality smaller companies should provide exposure to accelerating domestic economic growth.



Maintaining our neutral rating on global low volatility equities

- There are a number of approaches to managing low volatility portfolios. We assign two sub-categories to this segment: minimum variance and quality. Returns between these different approaches will vary significantly at times. The key idea behind these types of mandates is that they should have some counter-cyclical tendencies and will often be lower beta than the general equity market. In periods of strong equity market performance we would expect low volatility strategies to lag the wider market cap approaches but would expect these strategies to outperform the wider market during falling markets. **We continue to rate low volatility equities as neutral.**
- The Minimum Volatility and Quality indices returned 9.2% and 7.2% in total return GBP terms over the quarter (5.3% and 3.4% in local currency terms), outperforming the MSCI World by 1.6% and underperforming the MSCI World by 0.4% both in GBP terms.
- Looking at **valuations**, low volatility stocks remain relatively expensive, but we think that higher price multiples are justified by their defensive nature. On a valuation basis, we believe that stocks with a higher exposure to economic growth still have more upside potential than defensive stocks at this stage.
- The Minimum Volatility index continues to look expensive relative to the MSCI World index, with price/book of 2.8x vs. 2.3x, price/cash-flow of 13.8x vs. 11.3x and trailing price/earnings of 22.2x vs. 19.3x relative to the market cap index. These measures generally increased marginally in relative terms over the first quarter.
- Valuations for the Quality index also remained on their upward trend. Over the quarter, trailing price/earnings increased to 19.2x, though now trades at a marginal discount to the MSCI World P/E of 19.3x. Price/cash-flow increased marginally from 14.3x to 14.5x, and remains significantly above the MSCI World at 11.3x. Price/book increased over the quarter from 5.0x to 5.2x.
- We expect to see low volatility equities starting to look more attractive on a relative basis as we enter the later stages of the equity market cycle and it becomes more difficult to find pockets of value. Indeed we saw low volatility equities fare well towards the end of 2014 as volatility spiked amidst the sharp decline in the oil price.
- We note also that there should be potential for active approaches to incorporate valuation into the stock selection process, which should help lessen the exposure to areas of the market that become expensive.



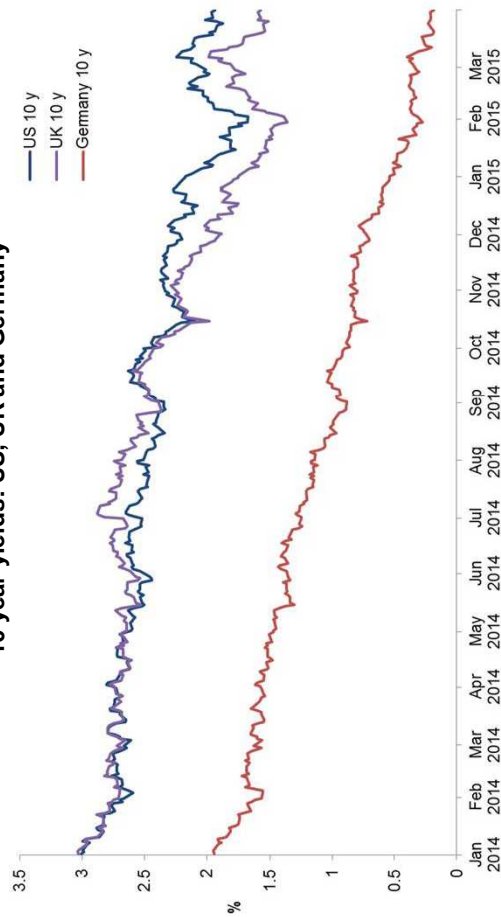
Government bonds - European QE brings yields lower

- Global Yields moved lower in the first quarter, especially in Europe, due to the commencement of QE by the ECB and due to softer economic data in the US. However, there was a degree of volatility during the quarter, with US and UK yields rising c. 50/60bps in February. **Negative yields now prevail** at the shorter-end of many core Government bond markets, with the German curve being negative out to 8 years. Interestingly, there has been an increased level of market commentary seeking to explain/justify/normalise' negative yields - might this mark some form of contrarian signal?
- Global sovereign bonds remain expensive, although a two-tone developed market fundamental outlook persists. US and UK growth and reduced monetary accommodation contrasts with the situation in the Eurozone and Japan. Investment managers continue to underweight global bonds on an aggregate basis, whilst nuanced demand from the LDI fraternity remains strong in the UK. We retain our Unattractive ratings for gilts and our Extremely Unattractive rating for core Eurozone bonds.
- In terms of **Valuation**, European sovereign bonds **continue to look expensive** on traditional valuation measures, but these have less relevance as long as markets are driven by unconventional monetary policy. We have previously referenced a rough fair value yield calculation for Government bonds of "long-term inflation plus 2%". For markets such as the US and the UK, this gives answers in the region of 4% plus. We had commented that sub 3% yields looked rich in comparison, and clearly sub-2% yields now look even richer. Using this measure 10-yr yields in Germany at c. 0.1% look even more expensive. However, as long as central banks continue to operate these unconventional methods we are unlikely to see a huge reversal in yield movements.

- In terms of **Macro/Cyclical** factors, the big picture view is that economic recovery and global healing remains in place. However, the first quarter has not been as strong as might have been expected, given the potential boost from the sharp decline in the oil price in late 2014. For example, the US economy was weaker than expected in the first quarter; some of this weakness is due to adverse weather, and to the west coast port strike. However, the US labour market has remained very strong. The \$ rise has also been a factor for the US, while boosting the Eurozone economy. In the Eurozone economy there has been a boost from the weak Euro, but also credit growth is turning up – this is critically important. On balance, the macro environment would point to rising bond yields over time.

- In terms of **Market Behaviour** factors, the main development in the first quarter of 2015 was that the ECB announced details of their QE programme in January, which involves buying €60 billion per month of Eurozone bonds (mostly government bonds) from March 2015 through to September 2016, or earlier if inflation can be brought back up to the 2% level. The primary aim of this initiative is to improve Eurozone inflation dynamics by supporting economic demand and credit lending.
- The **size of the QE programme was larger than had been anticipated by markets**. To place the QE programme in context, overall Euro Government bond market monthly issuance is c. €75bn. However, monthly issuance post redemptions and coupon payments is merely c. €5bn. Hence relatively speaking, the QE programme is enormous, and provides a substantial 'anchor' for European markets. 10-year bonds of peripheral countries such as Italy and Spain now trade c. 1.25%. Interestingly the ECB have also set a yield floor of negative 0.25% on their purchases.
- More generally, geopolitical turbulence appears to have eased and safe-haven demand seems to be less of a factor in markets at present. Investment managers continue to be underweight global bonds on average.

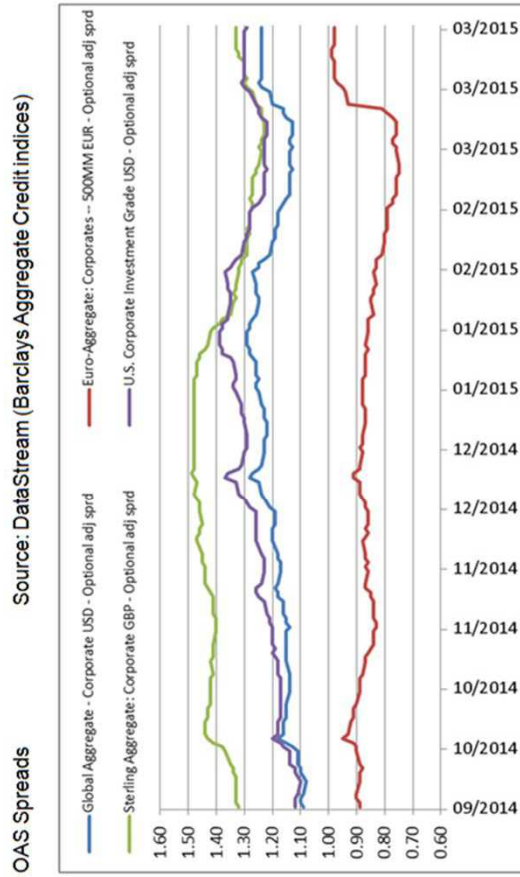
10 year yields: US, UK and Germany



Source: Thomson Reuters Datastream

Limited returns from Investment grade credit

- Credit yields continue to trade at **low levels and prospective returns are limited**. We retain our Unattractive view for Sterling investment grade credit and our Extremely Unattractive rating for Euro investment grade credit where spreads are trading at tighter levels due to the impact of the ECB's quantitative easing policy.
- In terms of **Valuation** factors, we note that OAS levels are not at extreme lows. There appears to be less divergence in regional spreads than previous quarters. It should be noted that European spreads widened sharply in mid-March. However, this was largely attributable to an adjustment in the index methodology, which came into effect from 13 March, which involved including negative rates to construct the European government curve.
- In terms of **Macro/cyclical** factors, the outlook for the global economy is broadly positive in part reflecting a boost from the substantial fall in oil prices towards the end of 2014. Investment grade corporates remain cash rich, and in the absence of economic growth there has been little incentive to increase spending. The disinflationary environment also will have contributed to high levels of cash hoarding. This is bondholder positive and defaults appear to remain low. Deleveraging, capital rebuilding and regulatory constraint in the financial sector provides a positive backdrop for investment grade bondholders.
- The credit cycle does not look as if it has peaked, however at a more mature stage we might expect smaller excess returns from credit. Companies may be increasingly dependent on financial engineering (stock buybacks/higher dividends) or M&A to grow earnings per share. As leverage increases, we might expect more volatility in equity and credit markets going forwards.
- In terms of **Market Behaviour** factors, investors are still wary of fighting central bank policies and the search for yield continues. However, the "herd" behaviour is increasingly a risk in itself. We are increasingly concerned about risk-off events given the potential for poor liquidity in a sell-off. We are still conscious that "non-credit" market moves are explaining much of the performance in credit markets – with much of the return being driven by the rate component.
- Central Bank buying in Europe should support credit markets. The purchases mainly target sovereign bonds, supranational bonds, ABS and covered bonds, however investors seeking investment grade assets are likely to be continually forced into investment grade credit. However, corporate bond issuance is strong, with record breaking issuance in the first quarter of 2015 in both Euro and USD non-financial market (excluding the first quarter of 2009), and also USD financials. A large proportion of Euro issuance came from non-euro area issuers.



High levels of issuance

Source: Deutsche Bank

Figure 12: EUR (€bn, left), GBP (£bn, middle) and USD (\$bn, right) Non-Financial IG (Fixed Rate) Issuance YTD

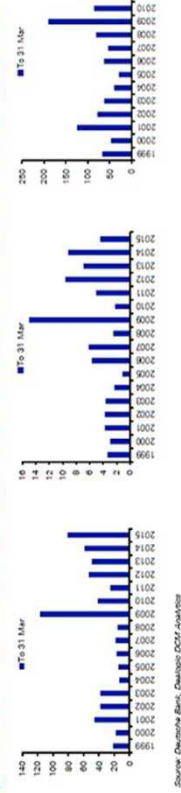
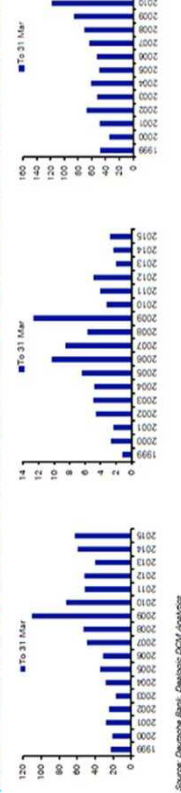
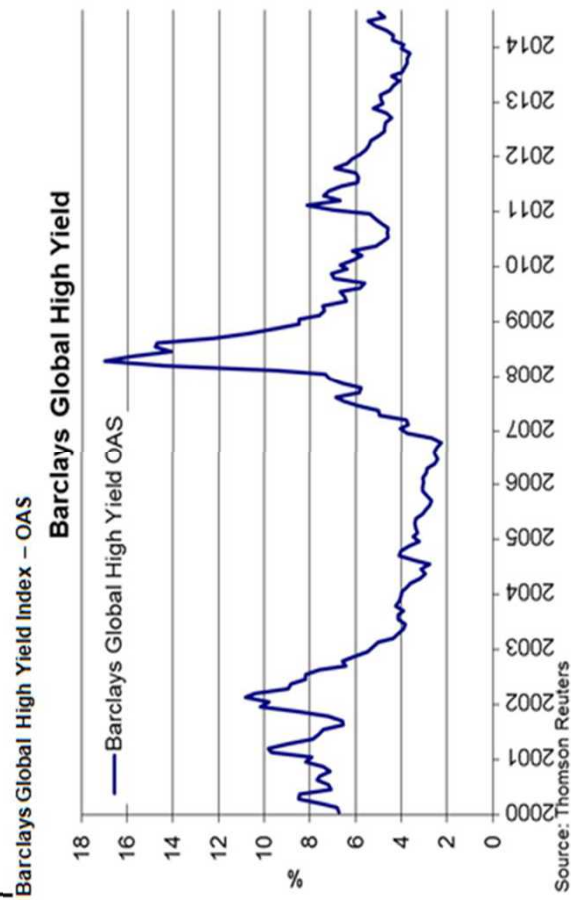
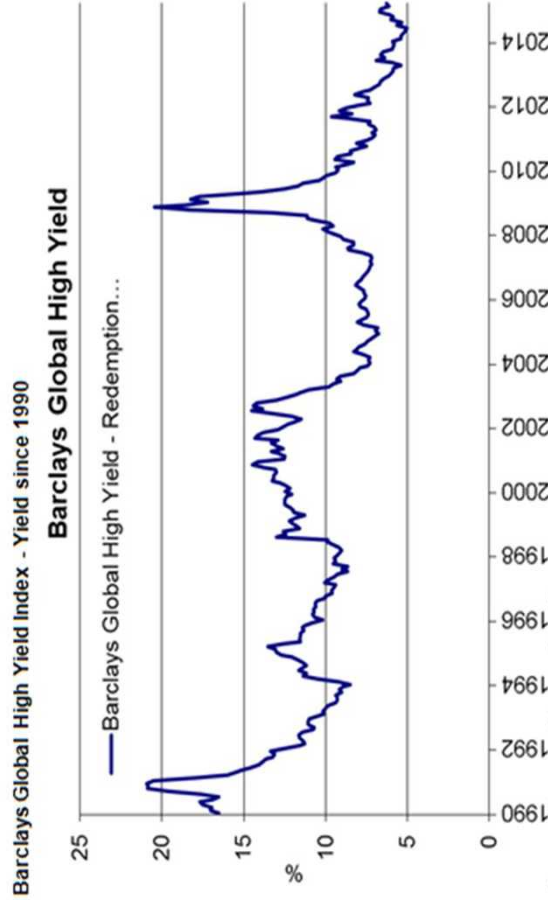


Figure 13: EUR (€bn, left), GBP (£bn, middle) and USD (\$bn, right) Unsecured Financial All (Fixed Rate) Issuance YTD



Outlook for High Yield bonds remains neutral with stable default outlook

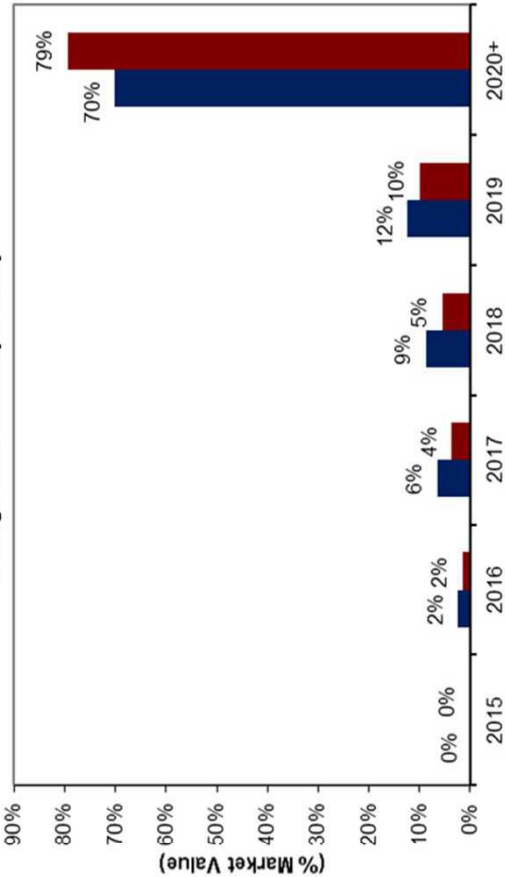
- On balance, we believe that current yields are beginning to look relatively cheap to government counterparts as can be seen in the second chart. With relatively muted refinancing risk and a low default rate, conditions are supportive for institutional investors to take advantage of the supply/demand imbalance, particularly in US high yield markets. The wild card, however, is the energy sector. While a decline in oil prices should be positive for consumers, it is negative for many energy companies, which may need to consider asset sales or other forms of balance sheet restructuring to address declining cash flow.
- There was some solid performance in high yield markets in the first quarter. Absent a significant exposure to energy, European high yield continues to benefit from a strong technical bid. On the grounds of a declining Euro relative to the US dollar and some other currencies, the recent performance looks best in local currency terms. In Valuation terms, the European high yield markets yield 6.2% compared to US high yield markets which yield 3.9% (with spreads around 400bps in both markets). As has been true for some time, spreads offer meaningful coverage against long-term average high yield default rates.
- Profit margins continue to be strong for the vast majority of issuers (ex-energy sector), and the "wall of maturities" is no longer the threat that it was over the last several years as many CFOs took advantage of frothy credit markets to refinance and extend (or term-out) looming maturities. The high yield market has exhibited some deterioration in fundamentals over the last year, with leverage ratios generally increasing. This has led to higher volatility in some names, so naturally, issue selection is paramount. The deterioration is – again – most pronounced in the US energy sector. Regardless, US default rates do not appear to be accelerating.
- In relation to **macro/cyclical** factors, any macro issue that affects investor appetite toward risk will have some impact on the demand for high yield credit, regardless of region. Recently, instability in Europe as well as the ongoing conflict between Russia and the Ukraine has negatively affected spread sectors such as high yield. Geopolitical concerns can lead to 'safe haven' demand for fixed income but also can adversely impact higher yielding sectors.



Outlook for High Yield bonds remains neutral with stable default outlook (cont'd)

- In terms of Market Behaviour, investors in the US withdrew approximately \$23.8bn from leveraged credit mutual funds in 2014. However in the first quarter of 2015, there have been approximately \$10 billion of net inflows to US high yield mutual funds. Technical support for the asset class has been strong in Europe as well, with nearly the same level of net inflows year to date.

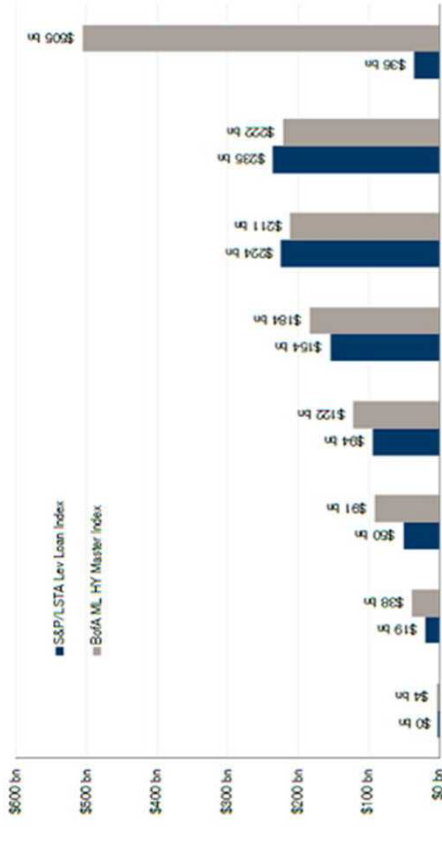
US High Yield Bonds by Maturity



Source: Thomson Reuters Datastream

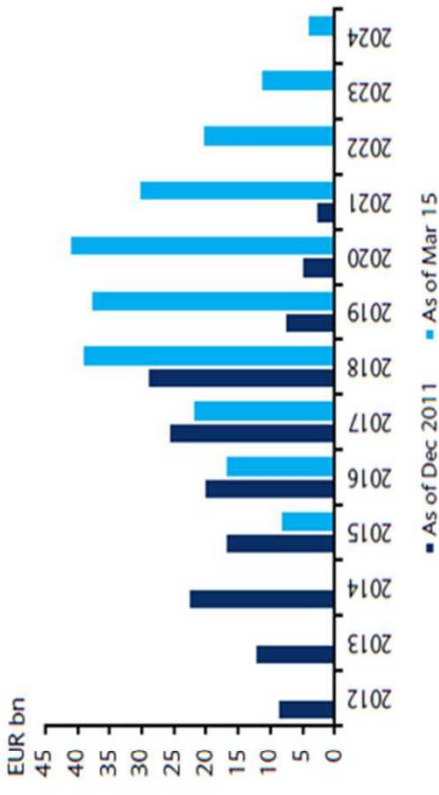
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US Maturity Calendar



Source: S&P LCD, BofA Merrill Lynch, data as of March 27, 2015

European Maturity Calendar



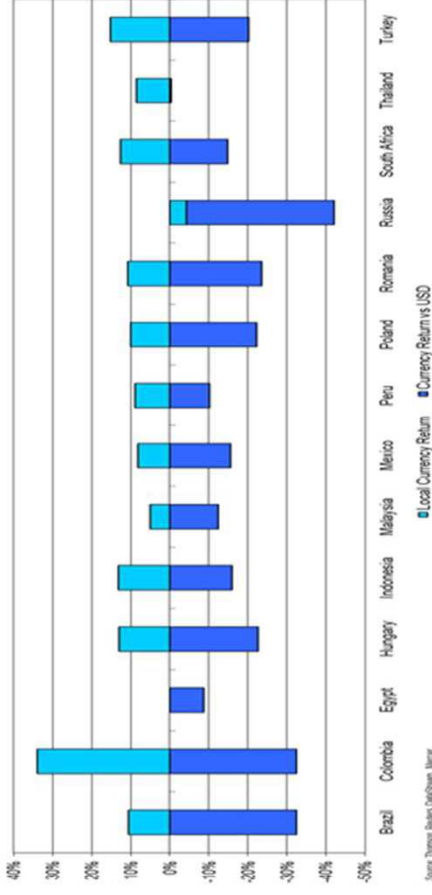
Source: Barclays Index Products

FX weakness continues to drive EMD markets

- Conditions continue to be difficult for Emerging Market local currency bonds. As was the case in 2014, the muted level of returns was predominantly due to weakness in Emerging Market currencies in dollar terms, which in turn is partly due to Dollar strength. Most EMD issuer currencies were down 3% to 10% versus USD over the first quarter, with the Brazilian Real falling 17% against the Dollar.
- There was some improvement in **market sentiment** during the quarter given supportive global developments including the interim agreement between Greece and her bailout creditors, as well as the dovish tone in Federal Reserve Chair Janet Yellen's semi-annual testimony to Congress.
- For the first time in over half a year, oil prices rebounded significantly, up 18% in February (Brent Oil). This contributed to the strong performance of oil exporting countries, most significantly Venezuela and Russia (note these are more hard currency issuers than local currency).
- In terms of **valuation factors**, in our view valuation levels are attractive. Current yields offer investors 'growth portfolio' returns. We have a neutral house view on the long-term attractiveness of EMD FX, but EMD FX obviously has been a significant contributor to volatility and returns. Economic performance has been mixed in EM countries. Whilst this is not surprising, given different economic exposures (e.g. importer or exporter) to oil prices, the mix of weaker fundamentals in some countries, the ongoing economic rebalancing in China, and the prospect of monetary policy normalization in the US, paints a complicated picture for EM assets.
- As stated in previous reports, we can expect big dispersion between individual EMD countries. This will be due to the different exposures to oil amongst different countries, but also due to factors such as a country's currency regime (given the market's propensity to focus on FX) as well as market liquidity and a country's general economic fundamentals.

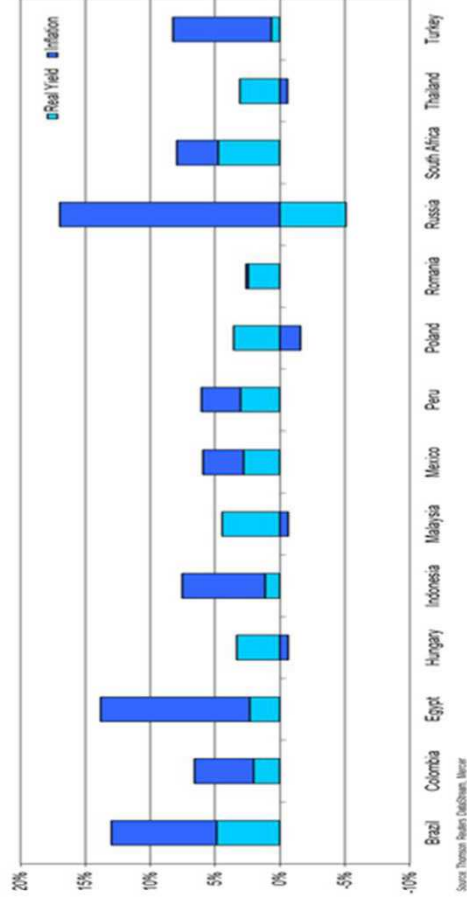
One-year Bond market returns and FX moves versus USD

1 Year JP Morgan GBI-EM Global Diversified Local Currency and USD Returns



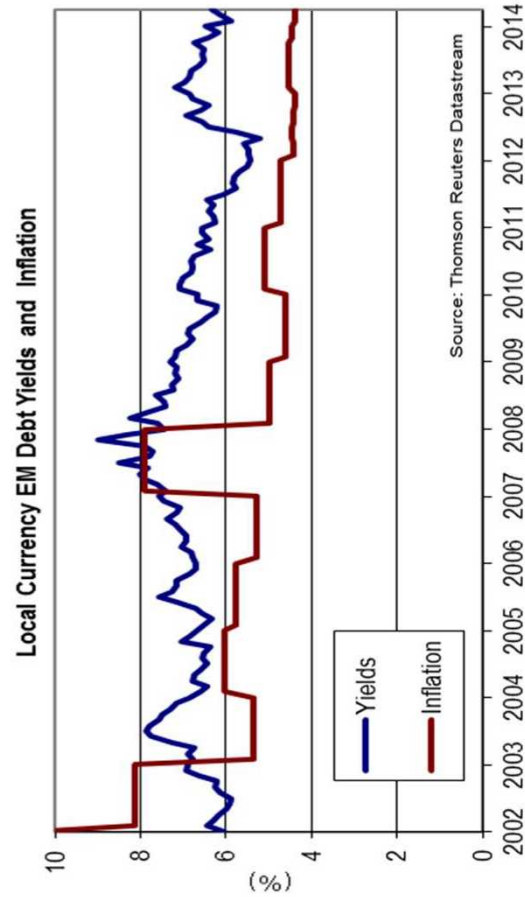
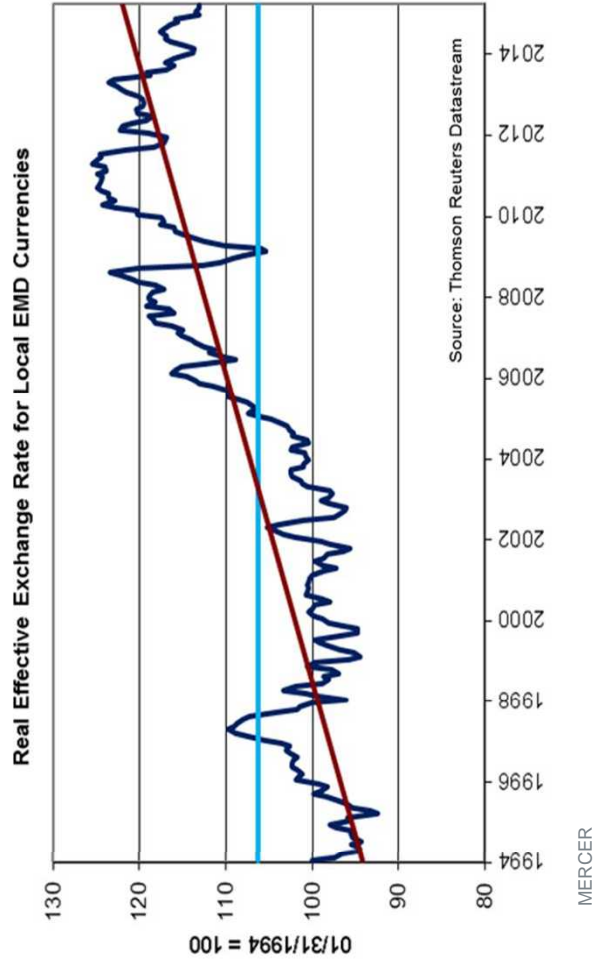
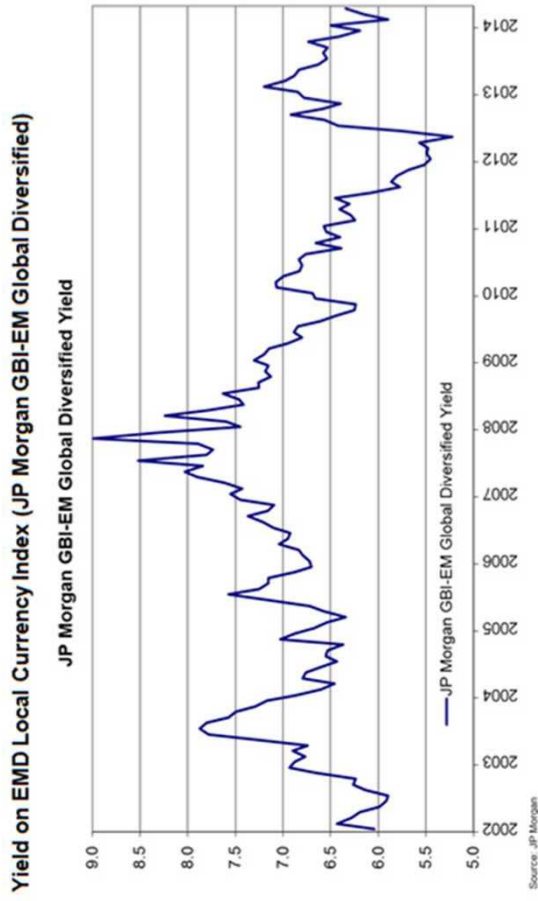
Inflation Rates in EMD countries

JP Morgan GBI-EM Global Diversified Real Yields and Inflation



FX weakness continues to drive EMD markets (cont'd)

- The US Fed may start to raise rates in June or later this year, although expectations are becoming more muted in this regard. Weak economic data has clouded the picture on this and increase the chances of the Fed holding fire on a rate move if growth continues to be slower. A key risk is whether markets will be able to withstand the possibility of interest rate increases from 2015 onwards, as (US fixed income) markets have not priced in much by way of interest rate hikes. Higher US yields could divert capital away from EMD. In EM countries, we can expect big dispersion between winners and losers; for example between oil exporters and importers, and between those countries who can cut rates because of lower oil and those that cannot.

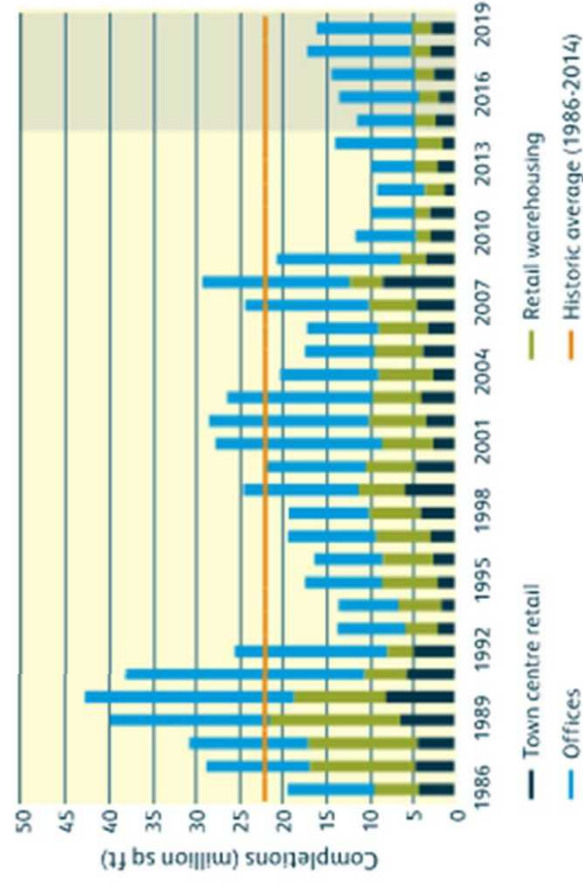


UK Property - Neutral, with pockets of opportunity

- Yields have continued to fall over the quarter, albeit at a slower rate than has been the case for some quarters. There has **continued to be a strong level of institutional interest in UK real estate** and overseas buyers have remained active. Yields are now below long-term averages and this has been driven by the continued low level of bond yields.
- In absolute terms, yields look expensive, but we note that in a low interest rate environment the gap remains attractive and capital values are therefore somewhat protected against interest rate rises.
- Vacancy has levelled out following a period of decline, but we suspect that this is more of a pause than indicative of a turning point. There continue to be improvements in occupier interest and rental values continue to grow at a healthy but sustainable rate.
- Supply of new, good quality space continues to be below trend and this should underpin returns while the economy remains strong. Although yields are on the low side, capital values are defensive and the market does not face oversupply.
- **Rental growth should remain** while the UK economy is buoyant but we note that tail risk remains. This, coupled with the fall in yields leads us to believe that UK real estate, taken as a whole, is fair value. However, there continues to be a big discrepancy between prime real estate (driven by safe haven investors and those looking for alternative income to bonds) and secondary real estate (driven by those looking for growth).
- Whilst we don't believe that there is good value to be had, we do think that there continue to be interesting opportunities selectively available. That said, from now on returns will be driven by income growth, not yield shift.
- The yield gap relative to government bonds continues to suggest that **HLV property remains attractively priced**. The amount of capital being committed to these types of funds has fallen of late and yields have largely stabilised at low-4%'s.
- Debt margins have shown further signs of falling. Margins on low risk senior debt are now well below 200bps and even debt on regional assets is approaching these levels of margin.

- **We like value-add strategies** in general as they aim to take advantage of structural and demographic change. Creating stock which is considered core is a sensible strategy as there is a lack of high quality space. Secondary real estate is attractive when combined with value-add potential. We believe that the low-hanging fruit has largely been picked.
- **We are cautious of opportunistic strategies**. Although they could perform well, we prefer to see some downside protection by way of assets which are income-producing or where investment is done through defensive capital structures, such as investing through debt or acquiring assets with fundamentally sound business plans which have simply been constrained by a lack of finance.

Construction is subdued



Source: PMA, September 2014.

German Property – core remains neutral

- Strong domestic and international demand for low risk assets with secure income, as well as good availability of low-cost debt, is keeping yield levels well below long term averages. Investment volumes were high in the first quarter of 2015. At €40bn, this is the highest level since the start of the Global Financial Crisis in 2007. Large transactions (single assets and portfolios) increased as did the share of foreign investors.
- Yields remained at historically low levels over the first quarter. For core property we still think there is little room for further inward yield shift, although we think that significant demand pressure will persist in the short to mid-term due to low financing costs and low bond yields. An outward yield shift is not likely yet but the risk of this is increasing.
- Leasing was solid in 2014 but in some areas there are signs of disconnections between market fundamentals and investment markets.
- Risk-averse investors are still dominating the investment market but value-add to opportunistic activity is increasing and we expect the yield divergence between prime and secondary markets to decline further across key sectors due to increased investor interest. This is driven partly by the shortage and high pricing of core and prime investments, partly by an increased risk tolerance in the market.
- **The overall positive economic outlook supports the German property sector.** Core property assets in the main investment centres and strong retail properties are looking reasonably well supported. Demand for such assets considerably outstrips supply.
- However, we think there are early signs of market over-heating. The investment pressure on core properties, the increased risk tolerance of investors, the increasing number of portfolio deals and the potentially weakening economy could be warning signs.
- We think German **core property should be viewed as Neutral** whilst we believe **good secondary investments, retail and logistics hubs are attractive.**

French Property – remains unattractive

- **The overall French economic outlook does not support strong property market performance.** The slow pace of structural changes adds some uncertainty and in combination with unemployment at 10%, constrains household spending. Because of the lack of structural reforms, the economy shows only subdued growth.
- Core property pricing is high with **low yield levels** and persisting demand from investors. Again, cheap financing is an important driver but the sheer size and liquidity of the French and especially Parisian markets attract robust investment volumes. Paris prime office yields at the end of 2014 stood at around 3.9%. In contrast, other locations like La Défense stand at 5.5% providing a significant yield gap. Yields on prime retail properties in Paris stood at 3.5% at the end of the third quarter.
- Against the backdrop of high pricing, the weak economic environment and softening property markets, **we think French property should be viewed as Unattractive.**
- In 2014, investment volumes increased by about 30% compared with the corresponding period in 2013 and stood at €24bn.
- Investors have become more flexible in their selection criteria and are increasingly targeting secondary assets in peripheral locations or with short lease terms.

Hedge funds post good results for the quarter

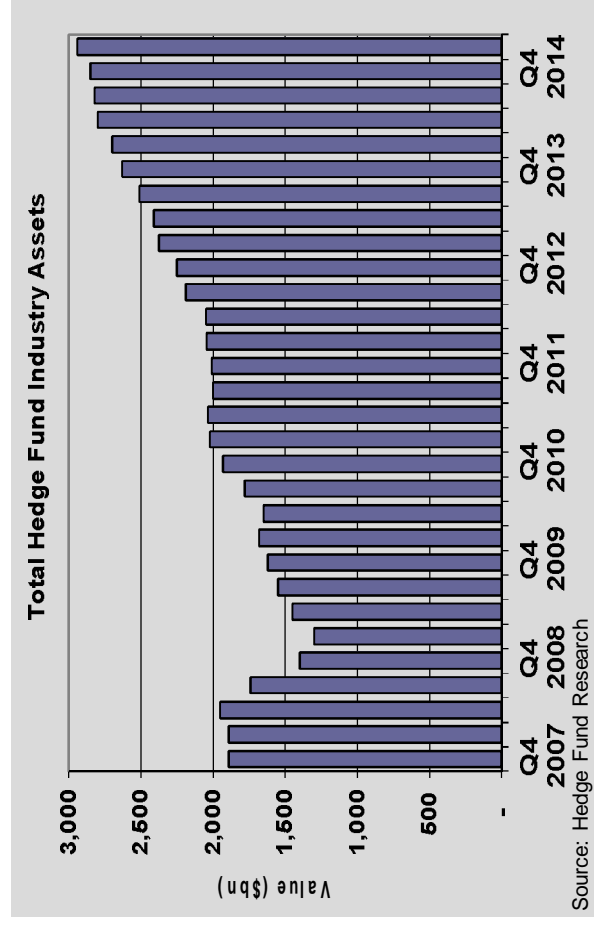
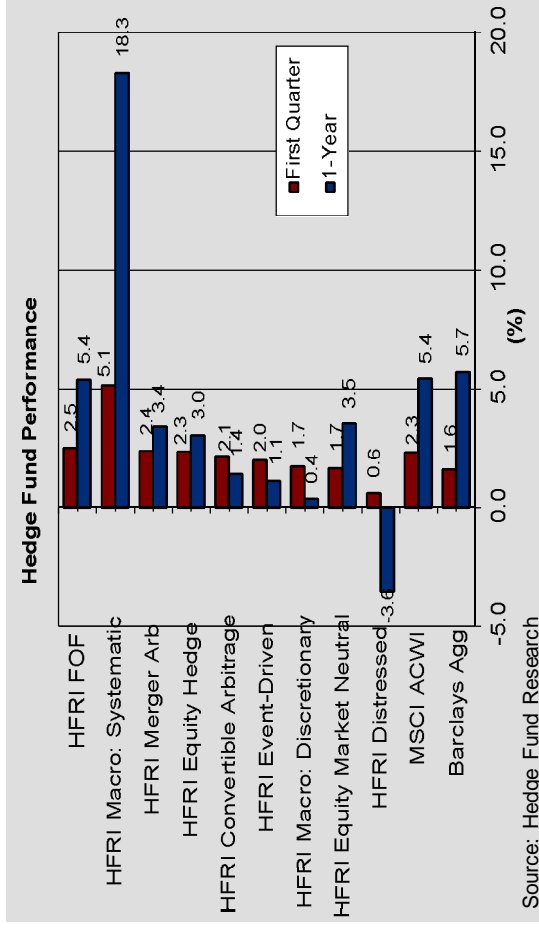
Due to the idiosyncratic nature of hedge fund investing, we do not place formal ratings on these strategies. Instead, we comment on performance, trends and opportunities.

View

- For the first quarter, hedge funds were able to add value over both global equities and bonds, earning consistently positive returns in an otherwise volatile quarter.
- We continue to believe that the outlook for skilled hedge fund managers is favorable, particularly in light of the current micro and macro environment. Continuing macro and policy divergences globally, along with higher security and asset class dispersion, should support the opportunity set for alpha generation. Furthermore, with traditional assets priced to provide relatively weak returns, the potential opportunity cost of hedge fund investing is arguably low.

Performance and industry commentary

- Macro events drove markets in the first quarter, leading to rather wild swings as investors tried to digest the effects of European QE, the Greek election, the abandonment of the Swiss Franc peg, energy price volatility and weak US economic data.
- The average fund of hedge fund was able to post a good results, earning a positive return in each of the three months to post a 2.5% return for the quarter.
- Asset growth in the hedge fund industry continued to set new highs in the first quarter. Total hedge fund assets broke \$2.9 trillion for the first time, marking the fourteenth consecutive quarter of record asset levels and appearing relatively un-phased by the recent high profile defections from the space.
- Investors allocated over \$18 billion to hedge funds during the quarter, with hedged equity strategies receiving the largest share, followed by event-driven, macro and relative value.



Hedge funds: Alpha opportunities remain plentiful

Multi-strategy / Event

- The multi-strategy / event space experienced a relatively positive quarter, aided by a robust deal pipeline.
- Completion of a number of large deals (Allergan, in particular) and few notable breaks drove merger performance for the quarter, leading the event-driven strategy as a whole. Activity in the space remained elevated in the first quarter, accompanied by healthy spread levels. As a result, multi-strategy managers have continued to allocate capital to the M&A space.
- Outside of mergers, special situation and post-reorganization equity exposure was generally additive, despite relatively modest progress in major restructurings.
- The outlook for the strategy remains attractive. Multi-strategy managers can allocate across strategies over market cycles, toggling between strategies to capture new opportunities. They also have more "levers" available to them to better balance their portfolios through rough waters.
- Established managers with roots in the event-driven space should be well-placed to capture the opportunities arising from increased corporate activity, reduced dealer activity and continued bank deleveraging. Manager selection remains paramount and we remain wary of asset/liability mismatches and excessive leverage in this part of the hedge fund space.

Long/short equity

- Long/short equity posted solid results for the quarter, as dispersion, particularly in US equities, provided opportunity.
- Popular long positions generally added value over US stocks, yet overall performance was hurt by commonly-held short positions, which also outpaced domestic equities. However, manager dispersion was wide and many managers were able to generate short alpha, producing more favorable results. Overall, inter-sector, style, market cap, and regional disparities were plentiful, creating plenty of opportunities
- In the current environment of disparate security performance, security selection specialists (hedged managers, in particular) should be able to continue to produce added value.

Long/short credit

- The quarter provided a reasonable environment for credit managers broadly. Performing credit benefitted from relatively favorable spread movement and idiosyncratic issuer performance, though energy-related names continued to lag. Stressed and distressed credit had a relatively quiet quarter, with few developments in commonly held situations.
- Structured credit produced mixed results in the quarter. RMBS allocations have continued to shift towards more complex and activist-driven opportunities, such as mortgage settlement-related claims. These positions have continued to produce attractive results.
- Primary dealer inventory continues to decline, representing a fraction of 2007 levels, while the amount of corporate bonds outstanding in the US has doubled. This liquidity gap is increasingly becoming a topic of conversation. With the Volker Rule putting limitations on the dealers' ability to provide liquidity, we've seen massive moves occur in a variety of markets, punctuated by the Swiss Franc's unprecedented move following the Swiss National Bank's decision to abandon the currency peg. While this obviously introduces risk, the opportunities to be a liquidity provider may ultimately compensate for these risks.

Global macro

- Systematic macro strategies continued 2014's stellar performance. Trends were plentiful in the first quarter, with interest rates, particularly German Bunds, representing a primary driver to returns for many managers.
- Discretionary macro strategies also posted a positive return during the quarter, benefitting from currency and select equity positions, but were hurt by commodity-related exposure, particularly energy and agriculture.
- Overall, dispersion was elevated, with a number of portfolios hurt by the Swiss National Bank's decision to abandon its peg to the Euro.
- Divergent global monetary policy expectations should continue to drive meaningful dispersion across asset classes, creating opportunities for macro-focused managers to exploit.

Private Equity – a slowing market but prices remain high

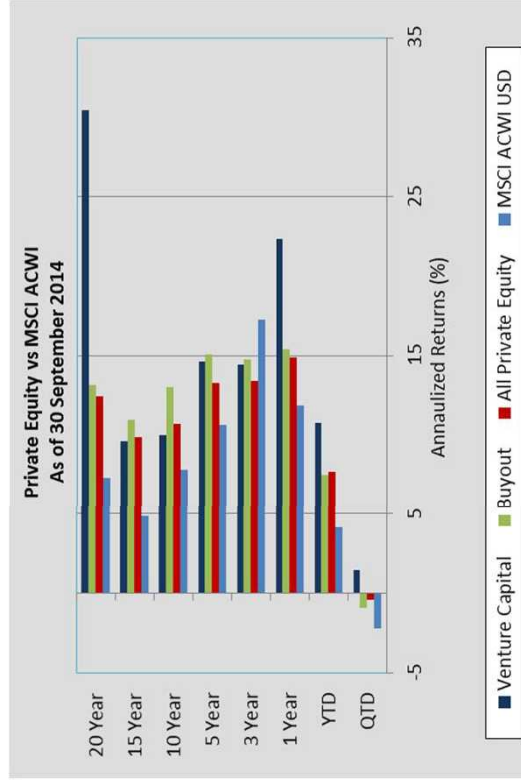
Due to the long-term nature of private equity investing and the lack of reliable valuation data, **we do not place a formal rating on the asset class**. Instead, we comment on performance and trends, and we identify areas of focus for the next 6 to 18 months.

- We remain cautiously positive on the global private equity market against a backdrop of full valuations for buyouts being fueled by plentiful amounts of debt. Capital markets have been very supportive for exits and the amount of liquidity being generated for private equity investors has been robust. Our overall view is a shift from being underweight special situations to a neutral posture across buyouts, special situations and venture capital/growth equity.
 - The buyout market is fully priced, but there are some pockets of value, and we are focused on funds with strategies predicated on fundamentally improving companies.
 - We remain positive on US venture capital, but the level of activity on both the investment and realization fronts is unusually robust.
 - The distressed energy debt play may be the most over-hyped, over-invested opportunity in recent memory.
 - Private debt yields have come down significantly for the highest quality credits, but are still quite strong at the sub-investment grade level.

- Benchmark returns for Q4 2014 are not yet available. Global pooled private equity performance flattened in the third quarter of 2014 (see Chart 1) with returns coming in at -0.4% versus a global public equity index return of -2.2%. The 1-year return was 14.9%, versus the 11.9% return of the MSCI ACWI. The three year pooled return lags public markets by 3.8% with a return of 13.4% versus 17.2%, but 5-year to 20-year comparisons show outperformance of roughly 3%-5% per annum.
- The fundraising environment has been very active, but still remains below the peak years of 2006-2008 as shown in Chart 2. Strong demand for firms with good near-term track records, realizations, and distributions continues. The significant demand for high performing fund managers requires a particularly pro-active approach to portfolio management in order to gain access.
- **Venture Capital** – 2014 was a particularly buoyant investment environment for venture-backed companies. A total of \$48.3 billion was invested in 2014, a 60% increase over 2013, with expansion stage financings doubling to \$19 billion of the total. Such financings are having positive impacts on our unrealized VC fund investments. However, we have reduced our view on the attractiveness of adding new exposure to late stage IT. Growth equity may offer a better value proposition and can serve as an attractive substitute.
- Both M&A and IPO markets have been very good for private equity investors, but the first quarter of 2015 saw a slowdown in activity. The 17 IPOs represented a 54% decline in the number of issuers and about the same decline in capital raised. However, life science companies have enjoyed a particularly welcoming IPO environment and 13 of the 17 IPOs in the first quarter were life science companies.

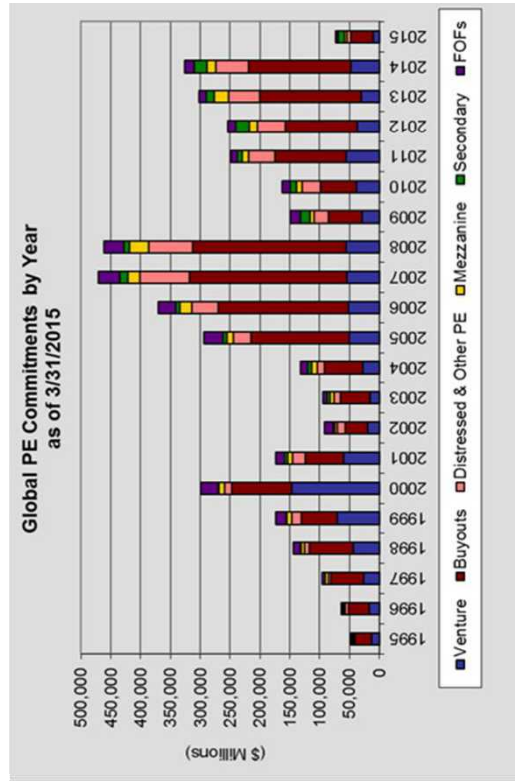
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Chart 1



Source: Thomson One

Chart 2



Source: Thomson One

Private Equity – a slowing market but prices remain high (cont'd)

- **Buyout** – Loose credit tends to be the enabling force in rising valuations for buyout deals. One result of the financial crisis is stricter scrutiny that is holding back lenders from getting too carried away. While leverage is high and terms are certainly accommodating, we are not seeing the extreme excesses of the last cycle. As a result, prices are high, but have flattened. Transaction volumes have declined and it is a seller's market if one has quality assets to sell. We are watching for signs that the market has become untenable, but rational heads are prevailing.

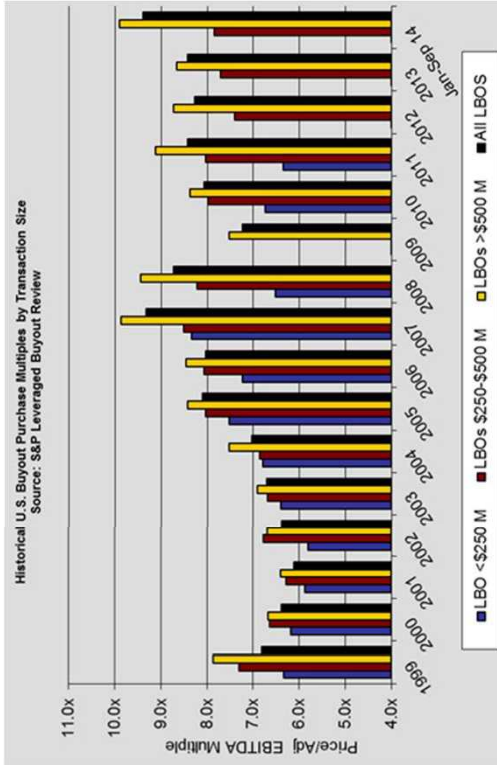
- When market conditions get precarious we emphasize the importance of manager quality, revenue growth, valuation sensitivity, and leverage management as well as the importance of operational improvement in buyouts. A review of value drivers should show EBITDA growth as a key determinant of success. The ability to improve businesses can serve as a buffer against higher interest rates and is a more durable source of value added than clever financial management. This talent can be found across the size spectrum, from small and mid market buyouts through larger fund managers. The key is being able to separate out good management from good fund marketing.

- **Distressed** – Last quarter we highlighted the opportunities emerging in the energy sector as a result of the steep fall in energy prices. However, we were obviously not alone in recognizing this market dynamic. In the interim we have seen a significant amount of capital being raised to target the sector. While it seems certain that some funds will succeed in this space, it feels like the capital wave will dilute whatever opportunities exist. If the banks are expected to play a role as catalyst to force debt restructurings, we learned in the last cycle that they might just sit this one out. Lenders may allow the energy borrowers enough flexibility to get themselves out of the financial hole in which they find themselves.

- **Secondaries** - Secondary private equity remains an area that can benefit investors building new portfolios, but the current market environment favors sellers over buyers. There are still transactions to be done, but we find that post-acquisition performance of the secondary interests is now the driver of returns rather than discount to NAV at which they are acquired. More deeply discounted assets tend to have more uncertainty over performance potential and the quality of the fund manager.

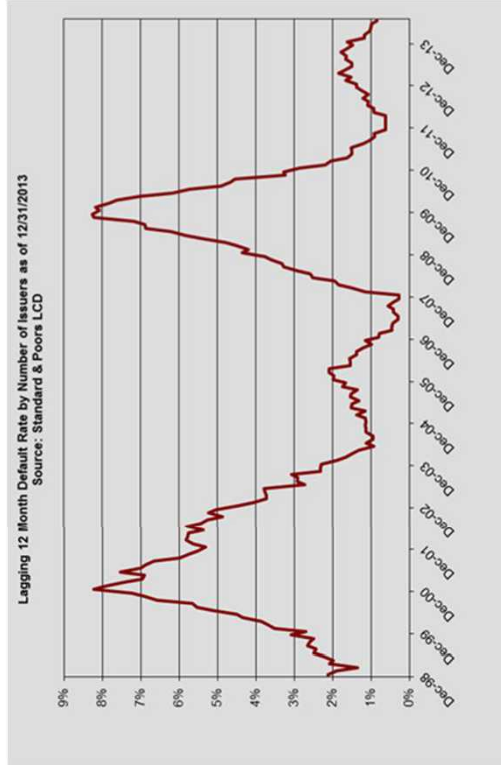
- **Private Debt** – The market dynamics of the last year remain unchanged, but credit spreads have narrowed for larger transactions of good quality. Smaller and less standard transactions offer higher returns, but may also have a commensurate higher level of event risk. Overall we believe the corporate debt sector still offers an attractive incremental return versus publicly traded debt. High demand for senior debt from investment grade issuers, and senior debt backed by real estate and infrastructure in particular, have driven those yields down to levels that might not justify the illiquidity for some investors.

Chart 3



Source: Standard & Poor's Leveraged Buyout Review

Chart 4



Source: Venture Economics

Commodity supply/demand dynamics continue to evolve

- We continue to believe that the influence of the **broad macro-economic environment will remain a significant driver of commodity prices** for the foreseeable future - even if more commodity-specific stories will differentiate the underlying returns. Over the first quarter of 2015, the focus had been on the political instability in the Middle East, economic developments in China and the continued fall in the price of oil following increased supply from the US and stagnant demand.

- The long-term underlying demand growth for many commodities is driven by global population growth, urbanisation in the developing markets and the emerging middle class there. The demand growth from Asia, and in particular China continues to be positive for commodity prices.

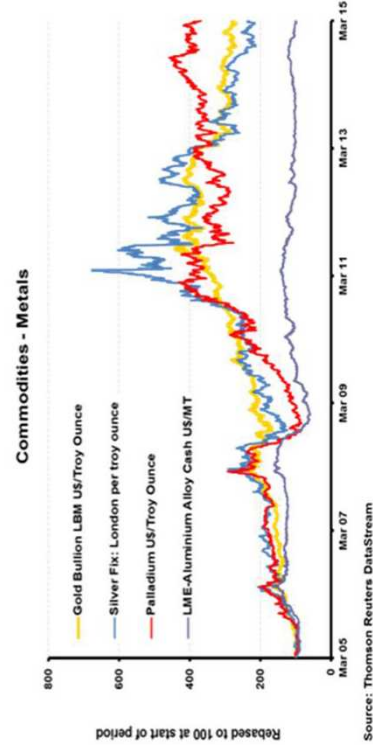
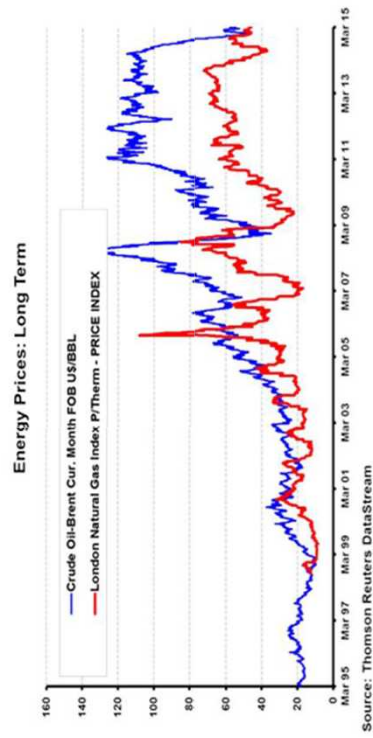
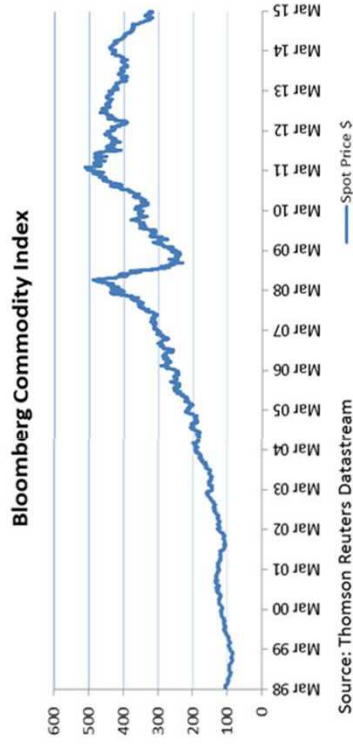
- Indeed, over the longer-term, if we expect that commodity demand will continue to increase steadily, the market will need to focus on accessing new sources of supply or alternatives. Without this, if this is too slow, or if alternatives do not exist, there will likely be more persistent upward pressure on commodity prices, as inventory levels diminish. This will make commodities potentially more sensitive to short-term supply shocks (such as flooding or droughts). The uncertainty in the Middle East, for example, also raises the potential for sharp supply shocks for commodities such as Gasoline and Petroleum.

- The Bloomberg Commodity Index (BCOM) (previously the Dow-Jones-UBS Commodity Index) posted losses for the first quarter of 2015, returning -6.0%. The majority of the Index's sub-sectors posted negative returns with the exception of the Precious Metals sub-sector, which returned 1.3%. The worst performing sub sectors over the quarter were the Softs and Livestock sectors, which returned -13.7% and -9.8% respectively. (All returns quoted in USD).

- Looking at specific commodities, among the Softs sub-sector both coffee and sugar experienced significant declines, attributed to increased supply from Brazil. The Livestock sub sector also experienced large losses over the quarter, with the Lean Hogs sub sector the worst performing component of the BCOM index in the first quarter. The positive performance in the Precious Metals sub-sector was driven by the strong performance of Silver, which outperformed Gold due to dwindling supply and continued robust demand.

- **A key dynamic for the future of the commodity markets will be the impact of new energy supplies.** The ability to access new sources of reserves through fracking has markedly changed the energy outlook for the United States and has the potential to do so globally. China reportedly has the largest untapped reserves of shale gas globally. How far this goes, and the potential impact on other commodities (positively if it triggers new manufacturing / infrastructure; negatively to the extent that it reduces transport costs) will be a key issue over the next few years. In the shorter term, ample supplies have contributed to the recent weakness in energy prices - exasperated by weaker demand due to reduced global growth.

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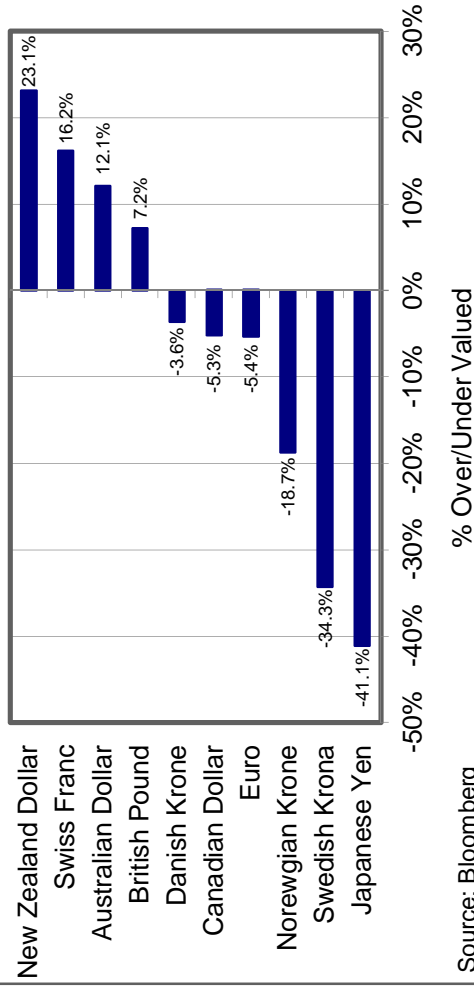
Cyclical divergence has more to give to the US dollar

- USD continued to strengthen against a broad range of currencies in 2015 Q1, the broad currency index rising a further 4.5%, and the major currency index 8.1%. Much of the gains in both indexes followed a 13% jump against EUR, while the rises against JPY and GBP were much more modest.
- Long dollar remains the consensus global trade, although increasingly crowded positioning suggests a period of consolidation ahead. In a quarter in which US data disappointed, the Fed turned even more dovish, and growth increasingly strengthened outside the US, sustained gains have hinged largely on escalating asset purchase by the ECB and BoJ.
- Nevertheless, we believe this widening divergence in monetary policy cycles can give more to USD in the current cycle. Under current proposals, both the ECB and BoJ will more than double balance sheets from current levels in the next 18 months. In that time, we anticipate the Fed will be well advanced in normalising US interest rates. We expect the strong dollar will remain more of a problem for US earnings growth than US GDP.

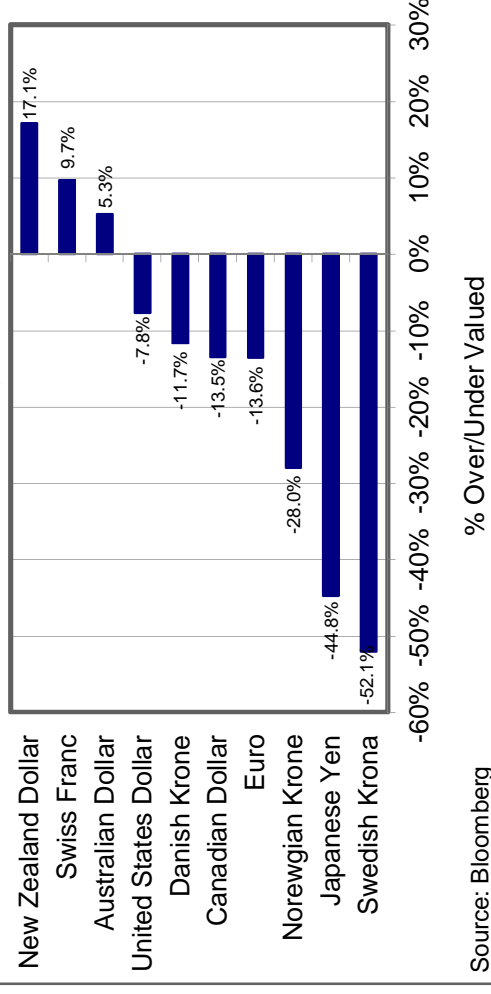
■ We note the past two USD upcycles have lasted around five years. The current cycle commenced in mid-2011.

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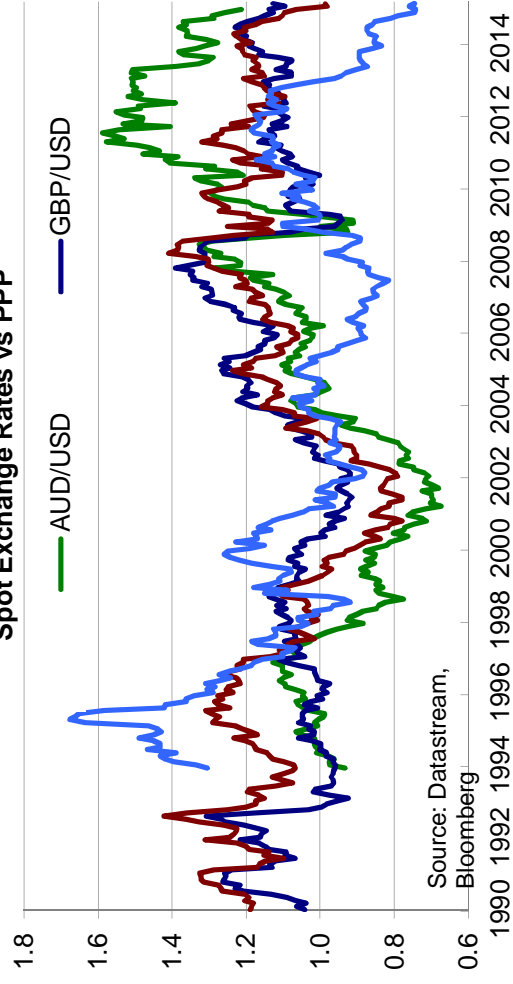
Relative PPP - Majors vs USD



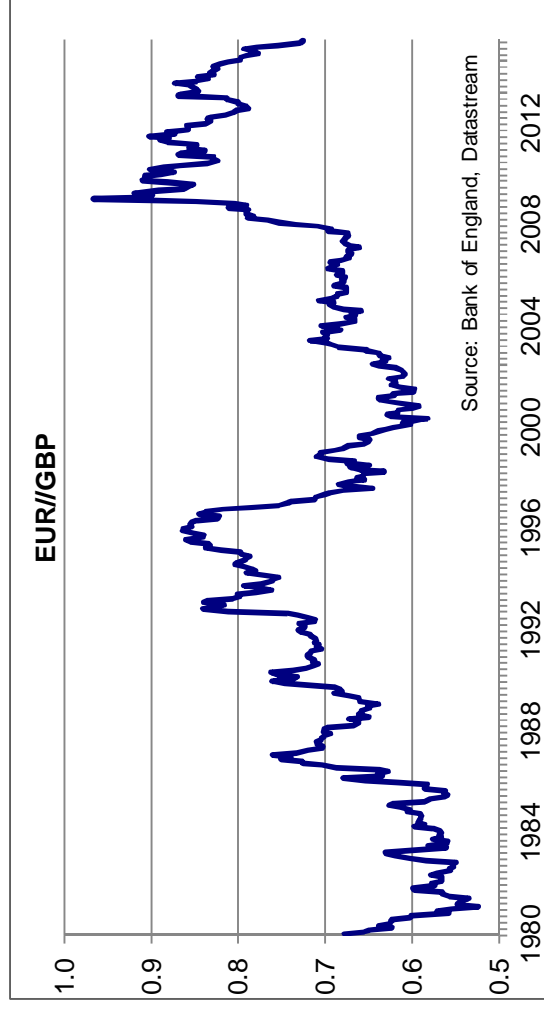
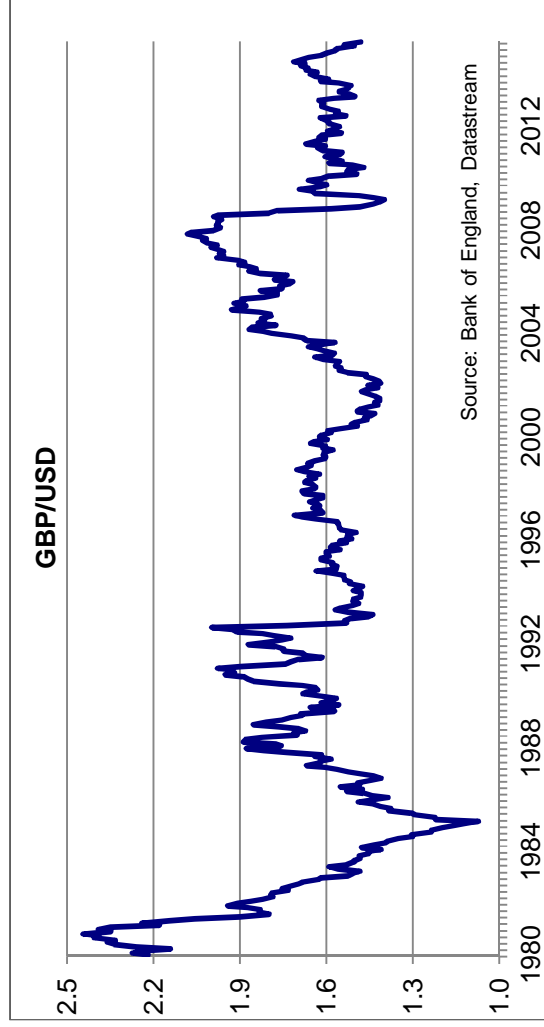
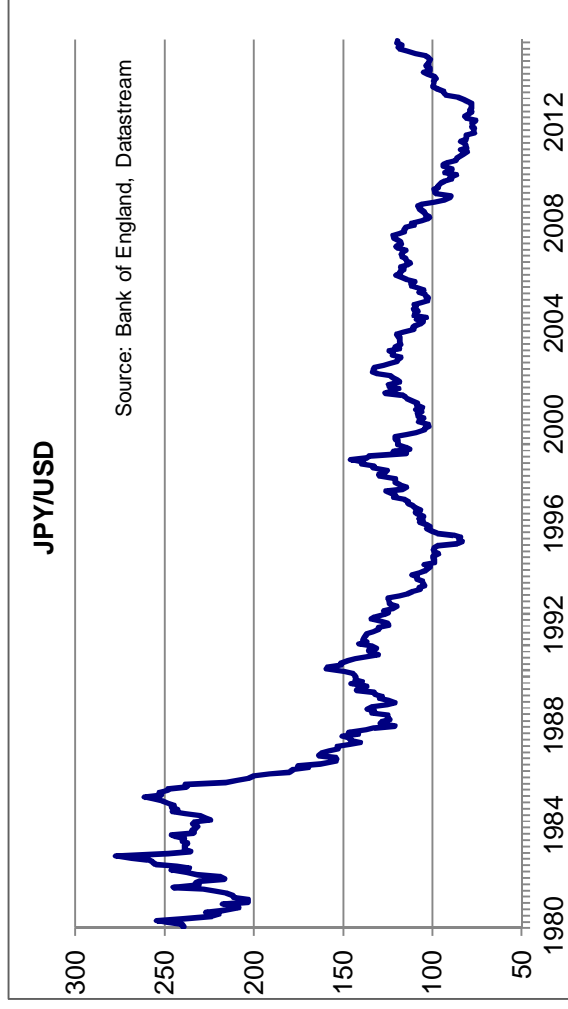
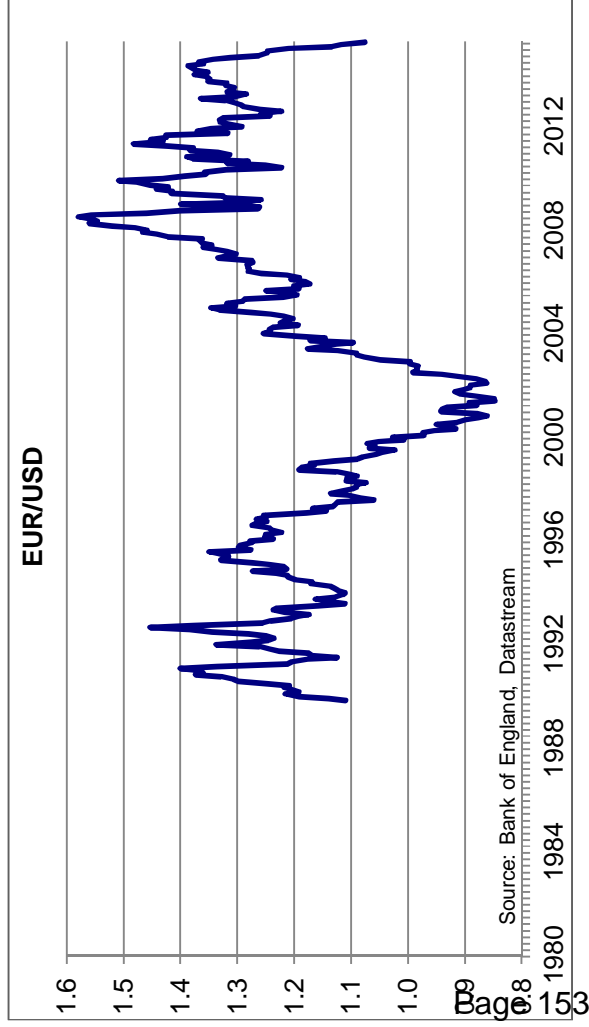
Relative PPP - Majors vs GBP



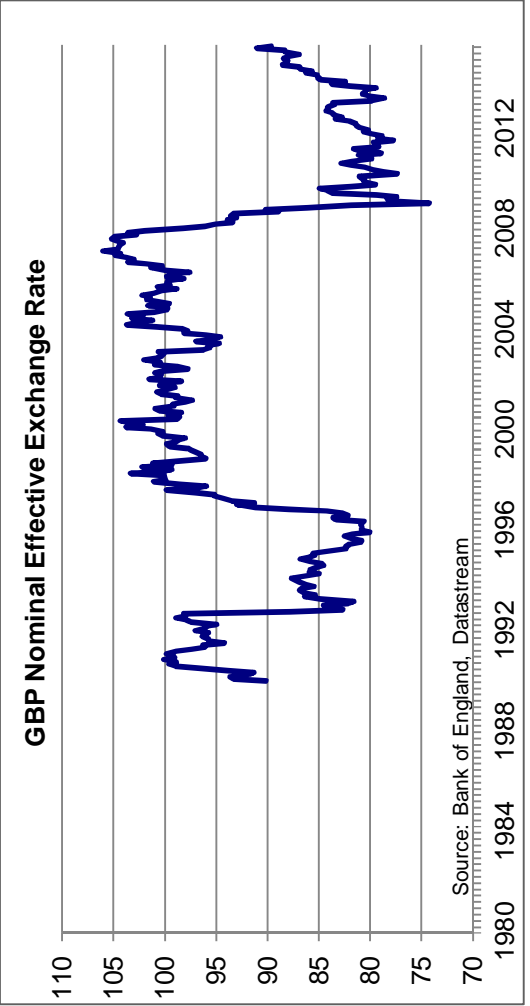
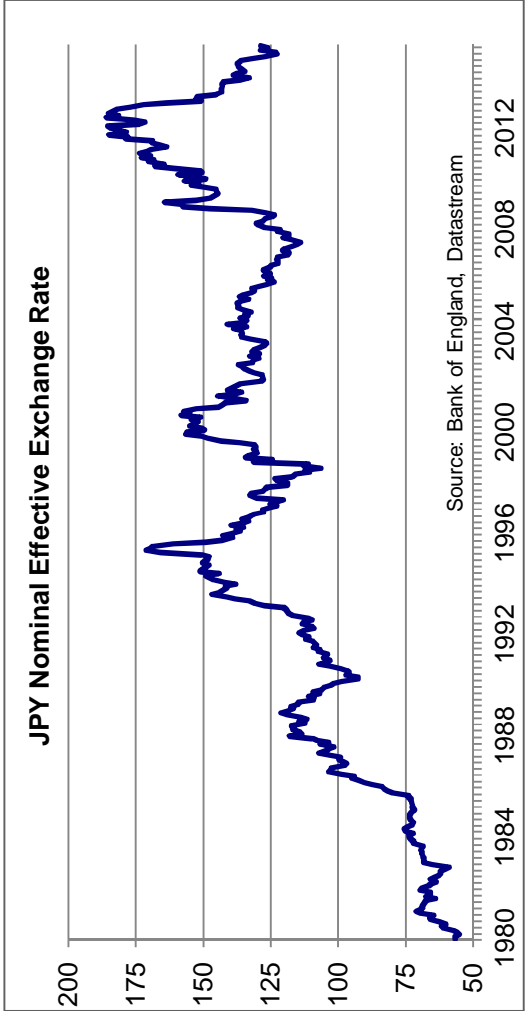
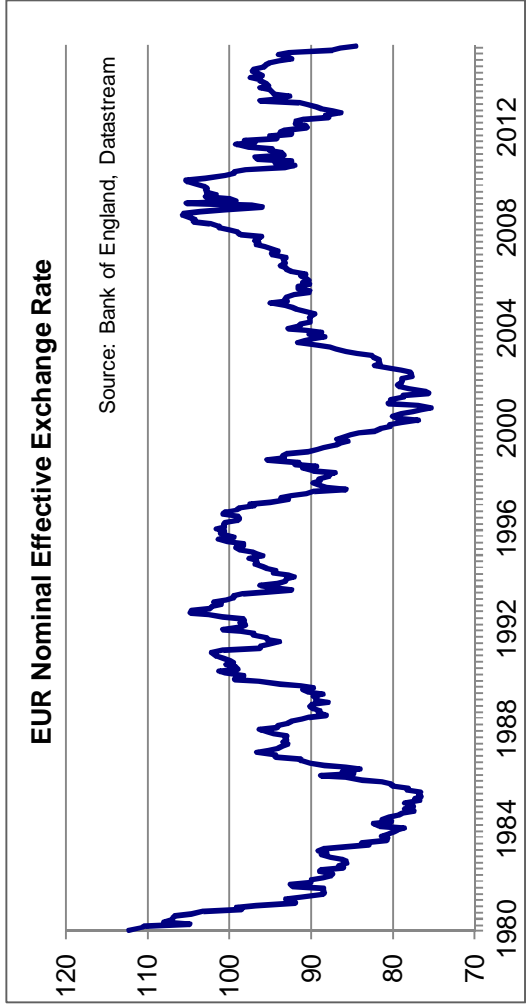
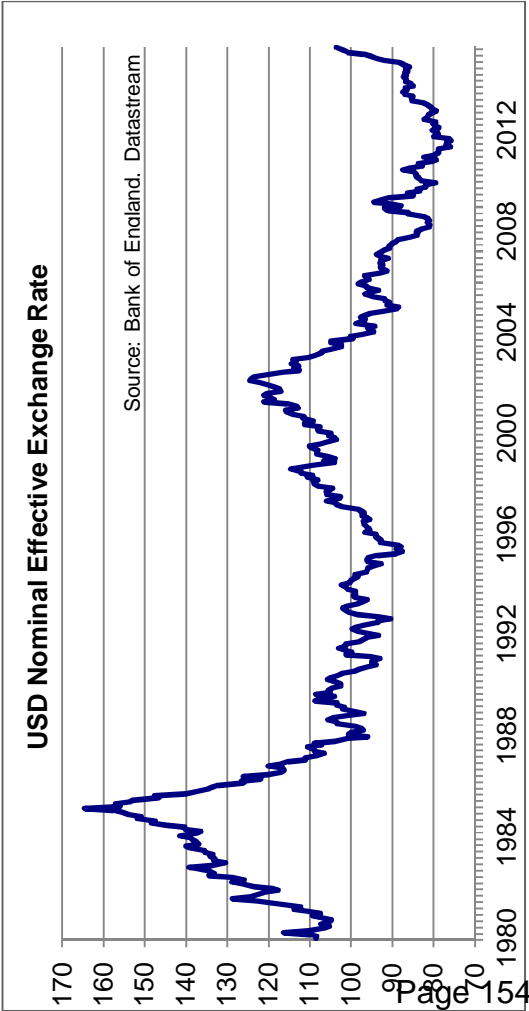
Spot Exchange Rates vs PPP



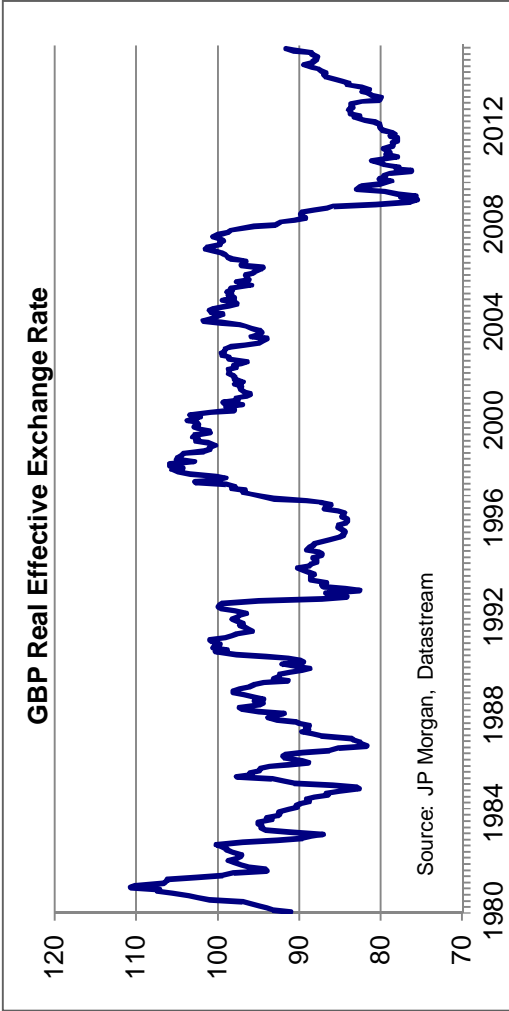
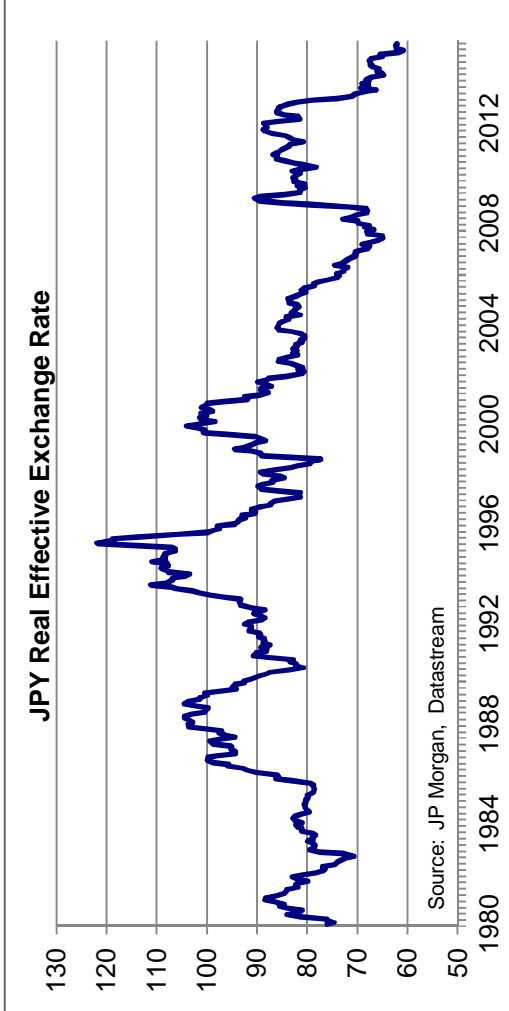
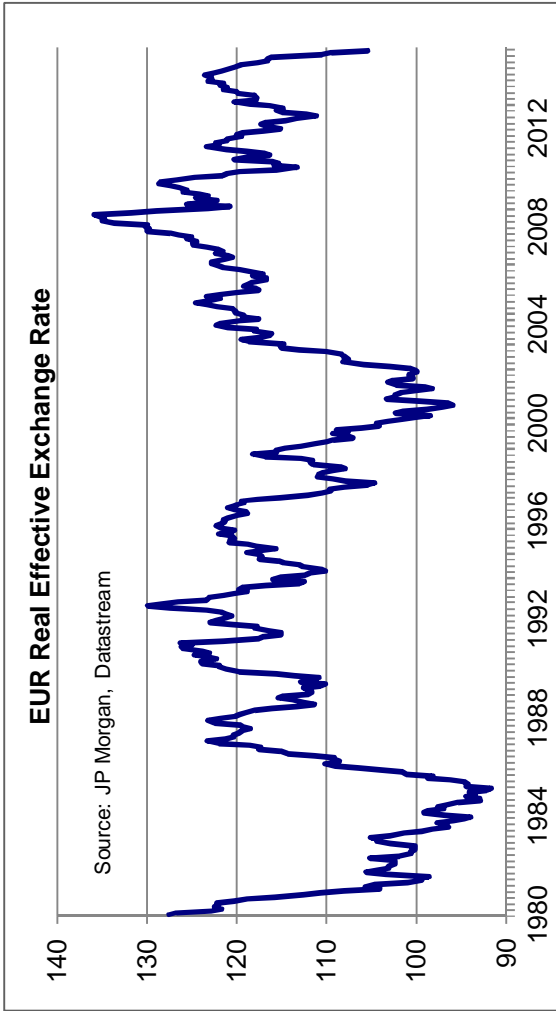
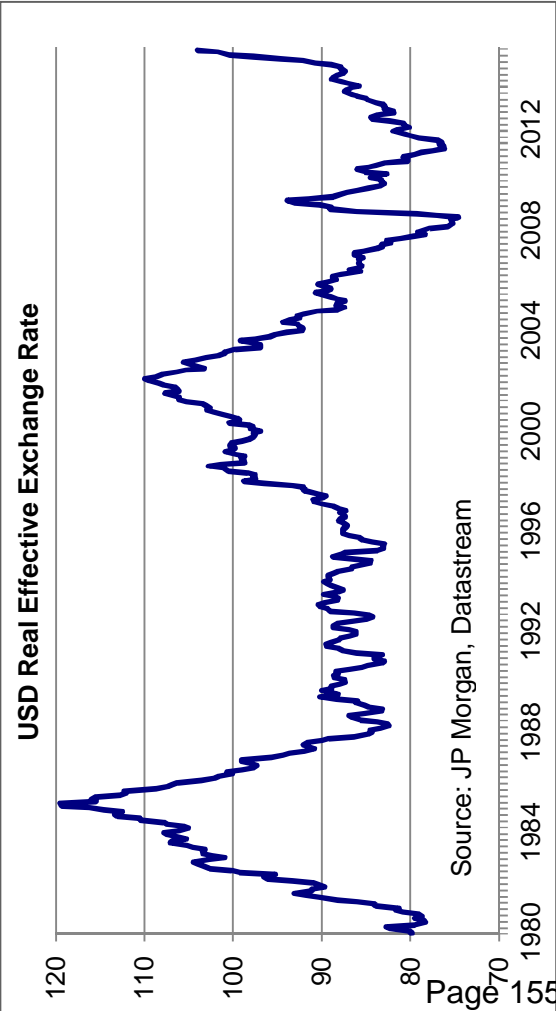
Major Foreign Exchange Cross Rates



Major Nominal Effective Exchange Rates



Major Real Effective Exchange Rates



Mercer DAA Signals

Following a meeting of the Global DAA team in April 2012, it has been decided to change the nomenclature of the DAA recommendations from a valuation-based to a performance-based signal. The former signals of "Fair Value", "Overvalued", and "Undervalued" (and their "Extreme" equivalents) will be replaced by "Neutral", "Unattractive" and "Attractive" respectively (with, once again, "Extreme" variants when appropriate).

Rationale

Mercer's DAA service began as a valuation based service, to warn clients when asset classes were perceived to be moving away from long term equilibrium values. However, clients are increasingly looking to utilise DAA signals to adjust their strategic asset allocation in order to enhance returns or reduce perceived risks.

Clearly, the most important parameter when considering tilting a portfolio is the expected return of the asset over the time horizon of the analysis (although the probability distribution of such expected returns, and particularly downside risks, are also relevant). As DAA is aimed at medium term timeframes (1 to 3 years), valuation is the most important consideration in determining such returns, but it is not the only factor that should be considered. Although well-chosen valuation variables are generally mean reverting over the long term, it can take a very long time (10 to 20 years) for a process based on valuation alone to add value.

In order to develop signals that will add value over timeframes more suitable for clients, Mercer supplements its valuation analysis with other factors which we believe influence asset returns in the short to medium term. The influence of the business cycle on asset valuations is widely recognised (partly due to the influence of the cycle on the inputs to valuation ratios) and we analyse the economic outlook to assess how these factors might influence market performance.

We describe these as Cyclical Factors.

We also recognise behavioural influences on financial markets, and consider both sentiment and investor positioning (Sentiment Factors) before we reach a final decision on our DAA signal. Thus we describe our overall DAA views as "valuation influenced", but not "valuation driven".

In order to reflect these other factors that are taken into consideration when forming our DAA views, we believe it is appropriate to change the names of the signals in order to avoid ambiguity.

Definitions

Our DAA signals are intended to provide information that will assist our clients to adjust the Strategic Asset Allocation of their portfolios to add value in the medium term. Since our long term assumptions are embedded in clients' strategic allocations, it is deviations from these assumptions that would cause us to recommend changes to the portfolio. Thus, our return based signals are based on the expected asset class returns **relative to our long term assumptions**. For example, an "Attractive" asset is one where we expect the return on the asset to exceed its long term equilibrium return over the next one to three years.

We will continue to develop our DAA analysis to refine and develop our recommendations in order to provide the best advice to our clients.

Mercer's long term asset class assumptions – as at 31 December 2014

The table shows our central capital market assumptions for a 10 year period beginning 31 December 2014. Asset class returns in the model are not normally distributed and thus the 'mean-variance' statistics do not fully define their distribution.

Asset Class	Equilibrium Return ¹ (% p.a.)	Standard Deviation (% p.a.)
Developed Global Equity	5.8	17.4
Emerging Market Equity	7.5	29.5
Low Volatility Equity	5.3	14.0
Global Small Cap Equity	7.1	22.9
UK Cash	2.0	4.6
Fixed interest gilts (all stocks)	1.8	3.7
Core Eurozone Government Bonds (>5 years)	1.9	6.8
Index-linked gilts (> 5 years)	1.5	8.3
Non-Government Bonds (£ All-Stocks)	2.7	3.6
Non-Government Bonds (€ All-Stocks)	2.9	3.6
High Yield Debt	4.5	9.2
Emerging Market Debt	5.1	13.3
Hedge Funds	4.0	8.2
Private Equity	8.2	24.2
UK Property	4.9	15.1

¹ Arithmetic mean return - the annualised return which gives the average expected £ asset value.

Ratings changes over the last two years

Asset Class	Jul 2013	Oct 2013	Jan 2014	April 2014	July 2014	Oct 2014	Jan 2015	April 2015
Fixed Interest Gilts	Extremely Unattractive	Extremely Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive
Index-Linked Gilts	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive
Eurozone Government Bonds	Extremely Unattractive	Extremely Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Extremely Unattractive	Extremely Unattractive
Non-Government Bonds (£ All-Stocks)	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive
Non-Government Bonds (€ All-Stocks)	Extremely Unattractive	Extremely Unattractive	Unattractive	Unattractive	Unattractive	Unattractive	Extremely Unattractive	Extremely Unattractive
Global Equities	Attractive	Attractive	Attractive	Attractive	Attractive	Attractive	Attractive	Neutral
Emerging Market Equities	Attractive	Attractive	Attractive	Attractive	Attractive	Attractive	Neutral	Neutral
Small Cap Equities	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral
Low Volatility Equities	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral
UK Property	Neutral	Attractive	Attractive	Attractive	Attractive	Neutral	Neutral	Neutral
High yield bonds	Neutral	Neutral	Neutral	Unattractive	Unattractive	Unattractive	Neutral	Neutral
Local currency emerging market debt	Neutral	Attractive	Attractive	Neutral	Neutral	Neutral	Neutral	Neutral
UK Cash	n/a	n/a	n/a	Unattractive	Unattractive	Unattractive	Unattractive	Unattractive

Valuation Scale: Extremely Attractive → Attractive → Neutral → Unattractive → Extremely Unattractive, **Shaded Items** represent views that have changed from the previous meeting

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Section 1 - Proposed Rebalancing Policy

Rebalancing Ranges

1. Allocations to be kept within the appropriate rebalancing ranges set out in Table 1. The neutral range is the range within which the allocation can move before any rebalancing is required, regardless of whether the asset class is deemed attractive or unattractive.
2. If the asset outlook is deemed attractive, then the allocation can be higher than the higher band of the neutral range but it cannot be below the lower band of the neutral range (as per the "Attractive" column in Table 1).
If the asset outlook is deemed unattractive, then the allocation can be lower than the lower band of the neutral range but it cannot be higher than the higher band of the neutral range (as per the "Unattractive" column in Table 1).
3. Where allocations breach the neutral rebalancing range boundary, action will be taken to rebalance to the benchmark allocation, unless it is decided that the outlook for an asset class is judged to be materially attractive or unattractive to warrant the use of a wider rebalancing range as set out in Table 1.

Table 1: Rebalancing Ranges

Asset class	Benchmark	Permitted Range SIP	Neutral rebalancing range	"Unattractive" rebalancing range	"Attractive" rebalancing range
Growth assets	80%	65-85%	+/- 3%	65%-83%	77%-85%
<i>Equities</i>	50%	45-55%	+/- 2%	45%-52%	48%-55%
<i>Developed</i>	40%	35-45%	+/- 2%	35%-42%	38%-45%
<i>Emerging</i>	10%	5-15%	+/- 1%	5%-11%	9%-15%
<i>Diversified Growth Funds</i>	10%	5-15%	+/- 2%	5%-12%	8%-15%
<i>Illiquid Growth, of which:</i>	20%	15-25%	-	N/A	N/A
<i>Hedge Funds</i>	5%	0-7.5%	-	N/A	N/A
<i>Property</i>	10%	5-15%	-	N/A	N/A
<i>Infrastructure</i>	5%	0-7.5%	-	N/A	N/A
<i>Other Growth</i>	0%	0-5%	<i>Depends on investment</i>	N/A	N/A
Stabilising Assets	20%	15-35%	+/- 3%	15%-23%	17%-35%
<i>Government Bonds</i>	3%	0-10%	+/- 1%	0%-4%	2%-10%
<i>Index Linked Bonds</i>	6%	3-10%	+/- 1%	3%-7%	5%-10%
<i>Corporate Bonds</i>	8%	4-20%	+/- 2%	4%-10%	6%-20%
<i>Other Bonds</i>	3%	0-5%	<i>Depends on investment</i>	N/A	N/A
Cash	0%	0-5%	-	N/A	N/A

Illiquid and Other Allocations

4. Illiquid asset classes will be allowed to vary within the permitted range (as per Table 1).
5. The Panel will review illiquid allocations when they breach the permitted range boundary and may do so as they approach the top or bottom of the permitted range but no more frequently than 6 monthly. The timeframe for any rebalancing of illiquid asset allocations will be made with due consideration for liquidity and transaction costs.
6. Neutral rebalancing ranges for the opportunistic 'other' investments categories to be agreed on implementation of such investments.

Section 2 – Policy Implementation

Decision Making Process

1. Rebalancing within the neutral rebalancing range will be implemented by Officers.
2. To allow an allocation to remain outside of the neutral rebalancing range but within the relevant (attractive or unattractive) rebalancing range, the process is as follows:
 - a. Investment Consultant view of outlook for the asset class must be either attractive or unattractive.
 - b. Officers decide it may be beneficial to make use of the wider ranges as set out in Table 1.
 - c. Confirmation advice is sought from Investment Consultant before allowing an allocation to remain outside of the neutral rebalancing range (but within the relevant attractive/unattractive rebalancing range).
3. Any positions outside the neutral rebalancing range will be reviewed at Panel meetings.

Implementation Considerations

4. Rebalancing within equities and bonds will take account of performance (of active managers), cost and efficiency considerations.
5. Net new money should be invested pro rata in line with the strategic policy, taking account of tactical positions, and net new money should be utilised first if a rebalancing is triggered.
6. Any positions outside of the neutral rebalancing range will be reviewed at Panel meetings, and all rebalancing activity will be reported to Committee at the following quarterly meeting.
7. This rebalancing policy is overridden by any triggers decided upon when an active tactical asset allocation is put in place on advice from the Investment Consultant.
8. There may be exceptional circumstances where Officers and Advisors agree that the rebalancing framework should be suspended. Committee will be notified of such circumstances.

For approval by Investment Panel, 18 November 2015

Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND INVESTMENT PANEL	
MEETING DATE:	18 NOVEMBER 2015	AGENDA ITEM NUMBER
TITLE:	Review Of Investment Performance For Periods Ending 30 September 2015	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer performance monitoring report (shortened version) Exempt Appendix 3 – RAG Monitoring Summary Report		

1 THE ISSUE

- 1.1 This paper reports on the performance of the Fund's investment managers and seeks to update the Panel on routine aspects of the Fund's investments. The report contains performance statistics for period ending 30 September 2015.
- 1.2 The report focuses on the performance of the individual investment managers. The full performance report with aggregate investment and funding analysis will be reported to the Committee meeting on 11 December 2015.

2 RECOMMENDATION

That the Investment Panel:

- 2.1 **Notes the information as set out in the reports.**
- 2.2 **Identifies any issues to be notified to the Committee.**

FINANCIAL IMPLICATIONS

- 2.3 The returns achieved by the Fund for the three years commencing 1 April 2013 will impact the next triennial valuation which will be calculated as at 31 March 2016. The returns quoted are net of investment management fees.

3 INVESTMENT PERFORMANCE

A – Fund Performance

- 3.1 The Fund's assets decreased by £129m (return of c. -3.4%) in the quarter ending 30 September 2015 giving a value for the investment Fund of £3,601m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers.
- 3.2 All Equity markets produced negative returns over the quarter in Sterling terms. Emerging Markets was the worst performing region (-15.6%) whilst the UK All Share Index fell by -5.7%. Bond yields fell across all maturities leading to positive returns from Gilts 5.1% and Corporate Bonds 1%.
- 3.3 The Fund's overall performance relative to benchmarks is unavailable at the time of publishing. Full performance data will be reported to the Pensions Committee on 11 December 2015.

B – Investment Manager Performance

- 3.4 A detailed report on the performance of each investment manager has been produced by Mercer – see pages 26 to 46 of Appendix 2.
- 3.5 Jupiter, TT, Invesco, SSgA (Europe and Pacific), Genesis, BlackRock, RLAM and Schroders Property are all outperforming their three year performance targets. Signet, Gottex and Schroder global equity are underperforming their respective 3 year targets.
- 3.6 Exempt Appendix 3 summarises the latest Performance Monitoring Report used internally to monitor manager performance. The summary report highlights the managers that are rated Amber or Red, detailing the performance and/or organisational issue(s), how they are being monitored and any actions taken by officers and/or the Panel. This quarter 1 manager remains on an amber rating, Schroder global equity. There is an update on this in Exempt Appendix 3. It should be noted that the Fund has terminated its mandate with Signet and Gottex.
- 3.7 The Panel met with BlackRock, Royal London, Unigestion and Pyrford at a workshop on 9 November.
- 3.8 The Panel previously agreed that the Strategic Benchmark for Partners is to remain the IPD Global Benchmark whilst the mandate specific benchmark to be used is cash plus 4% from 1st October. This change will be implemented within the RAG reporting from Q4 onwards where Internal Rates of Return (IRR) will also be used to assess Partners performance as agreed. Mercer and Officers are satisfied that performance is in line with long term expectations based on current IRR's.

4 INVESTMENT STRATEGY AND PORTFOLIO REBALANCING

- 4.1 Fund of Hedge Funds: JPMorgan has recently been appointed to manage the Fund's allocation to Hedge Funds via a bespoke arrangement. Two tranche payments have been invested with JPMorgan on 1 August and 1 October 2015.

Further investments will be made as the proceeds from the terminating mandates are realised.

4.2 Infrastructure: The Fund's investments in infrastructure are awaiting drawdown by the manager IFM who anticipate the first tranche of funds being drawn down early 2016.

4.3 Rebalancing: Following the second tranche payment to JPMorgan, the Equity (inc DGFs):Bond allocation is estimated to be 76.75: 23.25. This remains within the acceptable range requiring no action. A separate agenda item reviews the current rebalancing policy.

5 RISK MANAGEMENT

5.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. 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 the performance of the investment managers. The 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.

6 EQUALITIES

6.1 An equalities impact assessment is not necessary as the report is primarily for information only.

7 CONSULTATION

7.1 This report is primarily for information and therefore consultation is not necessary.

8 ISSUES TO CONSIDER IN REACHING THE DECISION

8.1 The issues to consider are contained in the report.

9 ADVICE SOUGHT

9.1 The Council's Section 151 Officer (Divisional Director – Business Support) has had the opportunity to input to this report and has cleared it for publication.

Contact person	Matt Betts, Assistant Investments Manager (Tel: 01225 395420)
Background papers	Data supplied by The WM Company
Please contact the report author if you need to access this report in an alternative format	

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AVON PENSION FUND VALUATION - 30 SEPTEMBER 2015

	Passive Multi-Asset	Active Equities					Enhanced Indexation		Active Bonds	Funds of Hedge Funds	DGFs		Property		In House Cash	TOTAL	Avon Asset Mix %
All figures in £m	BlackRock	TT Int'l	Jupiter (SRI)	Genesis	Unigestion	Schroder Global	Invesco	SSgA	Royal London		Pyrford	Standard Life	Schroder UK	Partners - Overseas	Currency Hedging		
EQUITIES																	
UK	198.1	186.1	158.2			36.3										578.7	16.07%
North America	201.3					110.9										312.1	8.7%
Europe	144.1					40.9		40.1								225.0	6.2%
Japan	35.1					18.3		39.5								92.9	2.6%
Pacific Rim	35.7					6.9		30.2								72.9	2.0%
Emerging Markets				132.4	161.6	16.8									0.0	310.8	8.6%
Global ex-UK							260.0									260.0	7.2%
Global inc-UK															17.9	17.9	0.5%
Total Overseas	416.2	0.0	0.0	132.4	161.6	193.8	260.0	109.8	0.0	0.0	0.0	0.0	0.0	0.0	17.9	1291.6	35.9%
Total Equities	614.3	186.1	158.2	132.4	161.6	230.1	260.0	109.8	0.0	0.0	0.0	0.0	0.0	0.0	17.9	1870.3	51.9%
DGFs											120.9	237.0				357.9	9.9%
BONDS																	
Index Linked Gilts	236.2															236.2	6.6%
Conventional Gilts	109.1															109.1	3.0%
Corporate Bonds	23.7								281.0							304.8	8.5%
Overseas Bonds	111.3															111.3	3.1%
Total Bonds	480.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	281.0	0.0	0.0	0.0	0.0	0.0	0.0	761.3	21.1%
Hedge Funds										157.3						157.3	4.4%
Property													177.4	150.5		327.8	9.1%
Cash	5.2	7.7	10.6			2.3							12.1		88.2	126.1	3.5%
TOTAL	1099.8	193.7	168.8	132.4	161.6	232.4	260.0	109.8	281.0	157.3	120.9	237.0	189.4	150.5	106.1	3600.7	100.0%

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AVON PENSION FUND

PANEL INVESTMENT PERFORMANCE REPORT QUARTER TO 30 SEPTEMBER 2015

NOVEMBER 2015

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IMPORTANT NOTICES

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Please also note:

- The value of investments can go down as well as up and you may not get back the amount you have invested. In addition investments denominated in a foreign currency will fluctuate with the value of the currency.
- The valuation of investments in property based portfolios, including forestry, is generally a matter of a valuer's opinion, rather than fact.
- When there is no (or limited) recognised or secondary market, for example, but not limited to property, hedge funds, private equity, infrastructure, forestry, swap and other derivative based funds or portfolios it may be difficult for you to obtain reliable information about the value of the investments or deal in the investments.
- Where the investment is via a fund of funds the investment manager typically has to rely on the underlying managers for valuations of the interests in their funds.
- Care should be taken when comparing private equity / infrastructure performance (which is generally a money-weighted performance) with quoted investment performance (which is generally a time-weighted performance). Direct comparisons are not always possible.

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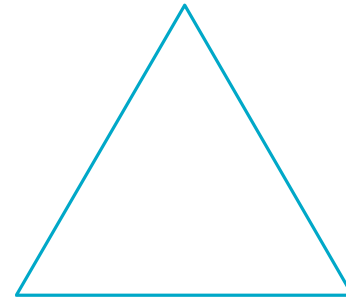
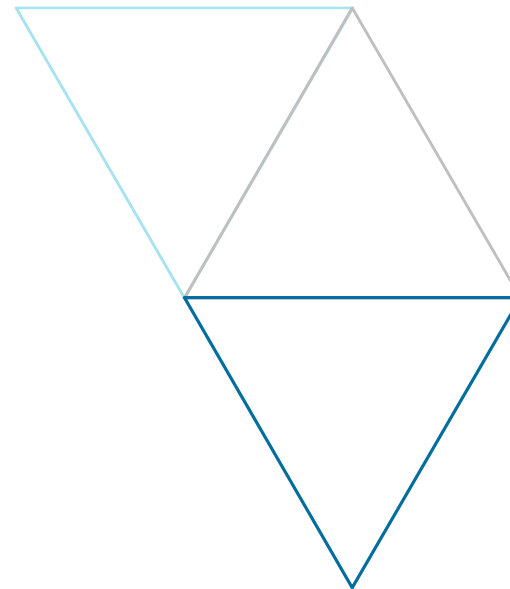
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SECTION 1

EXECUTIVE SUMMARY

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EXECUTIVE SUMMARY

This report has been prepared for the Investment Panel of the Avon Pension Fund (“the Fund”), to assess the performance and risks of the investment managers of the Fund.

Fund performance

- The value of the Fund’s assets decreased by £129m over the quarter, to £3,601m at 30 September 2015.

Strategy

- Global (developed) equity returns over the last three years at 11.3% p.a. have been significantly ahead of the assumed strategic return of 8.25% p.a. from the strategic review in March 2013. We remain neutral in our medium term outlook for developed market equities (over the next one to three years), and expect returns to be more modest over the next three years.
- The three year return from emerging market equities has fallen back into negative territory at -2.2% p.a. from 5.0% p.a. last quarter. The three year return remains well below the assumed strategic return (of 8.75% p.a.) as returns were affected by negative sentiment from fears of slowing growth in China and uncertainty created by the threat of US interest rates being hiked. As for developed markets, we are neutral in our medium term outlook for emerging market equities over the next one to three years.
- UK government bond returns over the three years to 30 September 2015 remain above the long term strategic assumed returns (with fixed interest gilts returning 6.7% p.a. against an assumed return of 4.5% p.a., and index-linked gilts returning 9.4% p.a. versus an assumed return of 4.25% p.a.) as investor demand for gilts remains high. Whilst from an absolute return perspective government bonds remain unattractive due to the low yields available, we continue to believe that their value in the context of the overall portfolio is important from a liability risk management perspective.

EXECUTIVE SUMMARY

Strategy (continued)

- UK corporate bonds returned 5.1% p.a. over the three year period, falling behind their assumed return of 5.5% p.a., while property returns of 13.7% continue to be above the assumed strategic return of 7% p.a., driven by the economic recovery in the US and the UK.
- Hedge fund returns remain below long term averages and the strategic return of 6% p.a., as they are affected by low cash rates.
- With most listed assets looking close to fully valued if not fully valued, we would expect 'alpha' driven investments such as hedge funds and dynamic multi-asset strategies to play an increasingly important role in return generation over the coming three years, particularly if 'beta' (i.e. market-driven) returns are lower looking forward. The same also applies to assets that are able to provide a relatively secure source of income (e.g. Infrastructure, Property and Credit), as the overall return is less dependent on capital appreciation.

EXECUTIVE SUMMARY

Managers

- Absolute returns over the quarter were mixed but generally negative as equities produced negative returns over the quarter. Bond markets remained resilient over the quarter, with RLAM returning 0.8%. The lowest absolute return was from Genesis, at -13.1%, however this was a positive relative return of 1.7% as emerging markets fell significantly over the quarter on the back of Chinese concerns and the strong US dollar.
- Returns over the year were more positive. The Fund's global equity mandates in particular fared well, however emerging market returns were still very negative, with Genesis and Unigestion returning -14.1% and -12.9% respectively against a benchmark of -13.4%.
- Over three years, all funds we have performance data for produced positive absolute returns (with the exception of Genesis), with Partners and Gottex failing to beat their benchmarks (although see comments on the measurement of Partners Group's performance later). In addition, Schroder failed to achieve its three-year performance objectives despite beating their benchmark. The remainder of the active managers achieved their objectives.

EXECUTIVE SUMMARY

Key points for consideration

- The hedge fund of funds transition into JP Morgan is ongoing, with £60m invested by 30 September 2015 (with a further £60m invested on 1 October 2015). Stenham has been completely sold down, with £58.4m remaining in Gottex and £38.9m remaining in Signet.
- Global and most regional equity markets produced negative performance over the quarter, hitting the Fund's asset level. This negative experience was compounded by positive performance from bond markets, meaning the present value of the liabilities is expected to have increased.
- After the end of the third quarter, global equity markets rebounded significantly. The FTSE All World fell 5.8% in Q3, but over Q4 to date at the time of writing (29 October) has returned +6.8% in sterling terms.
- Emerging Markets saw significantly negative performance over the quarter, as fears over China's growth slowing (and whether it had ever been as high as has been stated in the past) took their toll. This, combined with uncertainty created by the US Federal Reserve's potential interest rate hike, caused a significant sell off.
- Property continues its strong performance, despite other growth assets falling over the quarter.
- The Fund is in the process reviewing the Stabilising Asset portfolio.

EXECUTIVE SUMMARY

MANAGER INFORMATION

Manager	Mandate	Research Rating	Short Term Performance (1 year)	Long Term Performance (3 year)	Page
BlackRock	Passive Multi-Asset	✓	✓	✓	27
Jupiter	UK Equities	-	✓	✓	28
TT International	UK Equities	-	✓	✓	29
Schroder	Global Equities	✓	-	-	30
Genesis	Emerging Market Equities	✓	✗	✓	31
Unigestion	Emerging Market Equities	-	-	N/A	32
Invesco	Global ex-UK Equities	✓	✗	✓	33
SSgA	Europe ex-UK	-	✓	✓	34
SSgA	Pacific inc. Japan Equities	-	✓	✓	35
Record Currency Management	Dynamic Currency Hedging	-	N/A	N/A	36
Pyrford	DGF	-	✗	N/A	37
Standard Life	DGF	✓	N/A	N/A	38
Meets criteria	✓	A or B+ rating; achieved performance target			
Partially meets criteria	-	B, N or R rating; achieved benchmark return but not performance target			
Does not meet criteria	✗	C rating; did not achieve benchmark			

Focus Points

- Apart from the passive funds recategorisation explained in detail on page 27, there were no changes to any ratings over the quarter.

EXECUTIVE SUMMARY

MANAGER INFORMATION CONTINUED

Manager	Mandate	Research Rating	Short Term Performance (1 year)	Long Term Performance (3 year)	Page
Signet*	Fund of Hedge Funds	-	×	×	40
Gottex	Fund of Hedge Funds	-	×	×	41
JP Morgan	Fund of Hedge Funds	✓	N/A	N/A	42
Schroder	UK Property	-	×	✓	43
Partners*	Global Property	✓	×	×	45
RLAM	Bonds	✓	-	✓	46
Meets criteria	✓	A or B+ rating; achieved performance target			
Partially meets criteria	-	B, N or R rating; achieved benchmark return but not performance target			
Does not meet criteria	×	C rating; did not achieve benchmark			

Focus Points

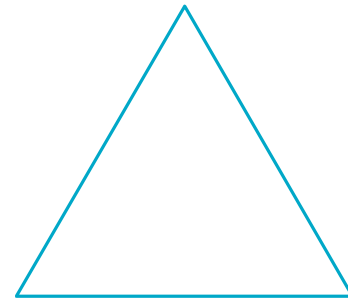
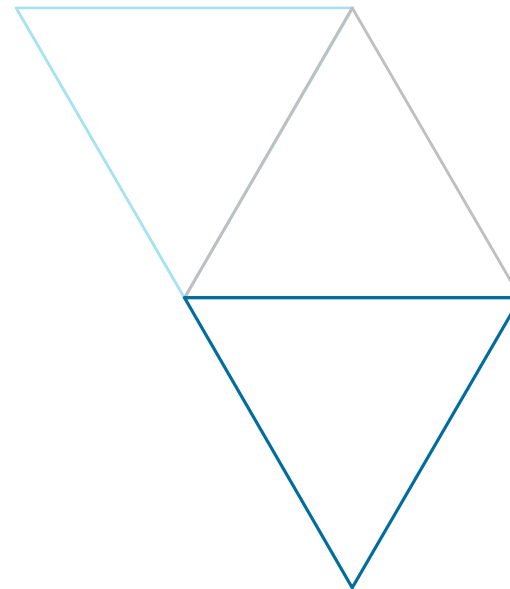
- Schroders announced the departure of three Real Estate Portfolio Managers: Jennifer Murray, Tony Doherty and Keeran Kang. See page 43 for detail.
- Partners' performance relative to benchmark is explained in more detail on page 45.
- Apart from the passive funds recategorisation explained in detail on page 27, there were no changes to any ratings over the quarter.

* Performance shown to 30 June 2015 as data to 30 September 2015 was unavailable at the time of writing.

SECTION 2

MARKET BACKGROUND

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MARKET BACKGROUND

INDEX PERFORMANCE

Equity Market Review

Growth assets continued their downward trend in Q3 as market volatility spiked. In August 2015, intraday equity market volatility rose to levels not seen since the global financial crisis. The sharp sell-off in risk assets was largely attributed to a surprise devaluation of the Chinese Yuan in August 2015. Global equities posted negative returns of 8.1% and 5.8% respectively in local currency and sterling terms over the quarter, with the relative depreciation of sterling partially offsetting the losses of un-hedged investors. Small capitalisation stocks, as measured by the FTSE World Small Cap Index, underperformed the broader market over the quarter, returning -10.8% and -7.4% in local currency and sterling terms, respectively.

Emerging Markets were the worst performing sector, returning -13.2% and -15.6% in local currency and sterling terms, with Latin American and Asian economies leading much of this negative performance. Brazil, in particular, looks set for a deep recession following deteriorating macroeconomic conditions and a downgrade in its credit rating status to junk over the quarter. Within developed market equities, Japanese equities underperformed the broader market following aggressive net selling by foreign investors, returning -13.3% in local currency terms (-8.0% in sterling terms). This underperformance followed the release of mixed economic data which showed Japan falling into deflation in August 2015 (for the first time since April 2013) in spite of improving consumer spending and corporate earnings.

In the United Kingdom, the FTSE All-Share Index fell by 5.7% over the quarter. The FTSE 100 returned -6.1% and continued to underperform the smaller segments of the market represented by the FTSE 250 and FTSE Small Cap indices, largely due to the ongoing weakness of resource-led stocks which constitute a significantly larger proportion of the FTSE 100.

Bond Market Review

Bond yields fell across all maturities over the quarter, resulting in positive returns for investors.

Nominal gilt yields decreased across all maturities during the third quarter, resulting in a return of 5.1% for Over 15 Year Gilts Index.

The real yield curve also moved down, although by less than nominal yields, resulting in a degree of normalization of previously depressed breakeven inflation rates. Index-linked gilts posted a quarterly gain of 2.3%, as measured by the Over 5 Year Index-Linked Gilts index.

Total returns from global credit were +3.0% in the third quarter in sterling terms, with a moderate loss of 0.8% in local currency terms. Credit spreads widened slightly in the UK, but yields still fell overall, resulting in a 1.0% total return on All Stocks UK corporate bonds.

Currency Market Review

Sterling depreciated by 3.7%, 3.9% and 5.7% respectively against the US dollar, euro and yen. The depreciation of sterling against its major counterparts was driven by safe haven demand which lifted the dollar and the unwinding of leveraged currency positions which bolstered the euro and the yen. The rise in the yen over the quarter erased most of its depreciation over the last 12 months.

Commodity Market Review

Energy prices led commodity prices lower, returning -24.4% over the quarter, as oil prices reached a six year low in August 2015 on the back of increased stockpiles in the United States and concerns that a slowing Chinese economy would adversely impact global demand.

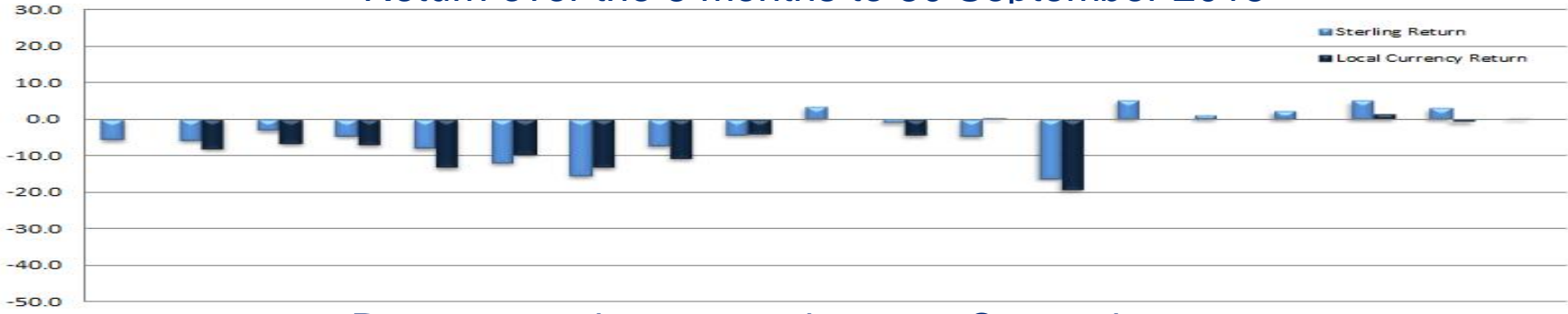
Gold prices fell over the period by 4.7%. The negative price impact from the stronger Dollar was partially offset by safe haven demand on the back of increased global market volatility.

Source: Thomson Reuters Datastream.

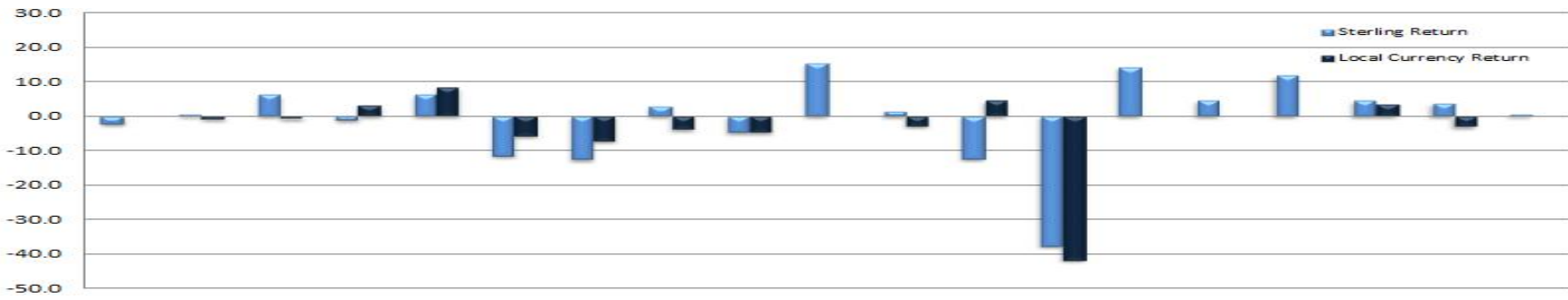
MARKET BACKGROUND

INDEX PERFORMANCE

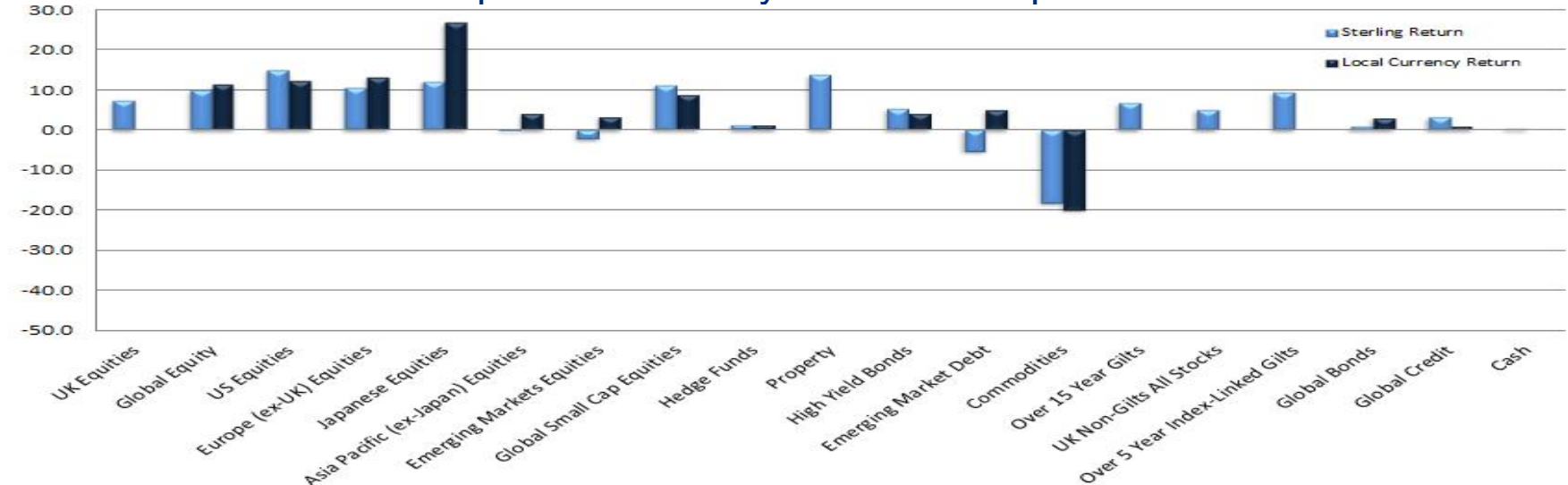
Return over the 3 months to 30 September 2015



Return over the 12 months to 30 September 2015



Return p.a. over the 3 years to 30 September 2015

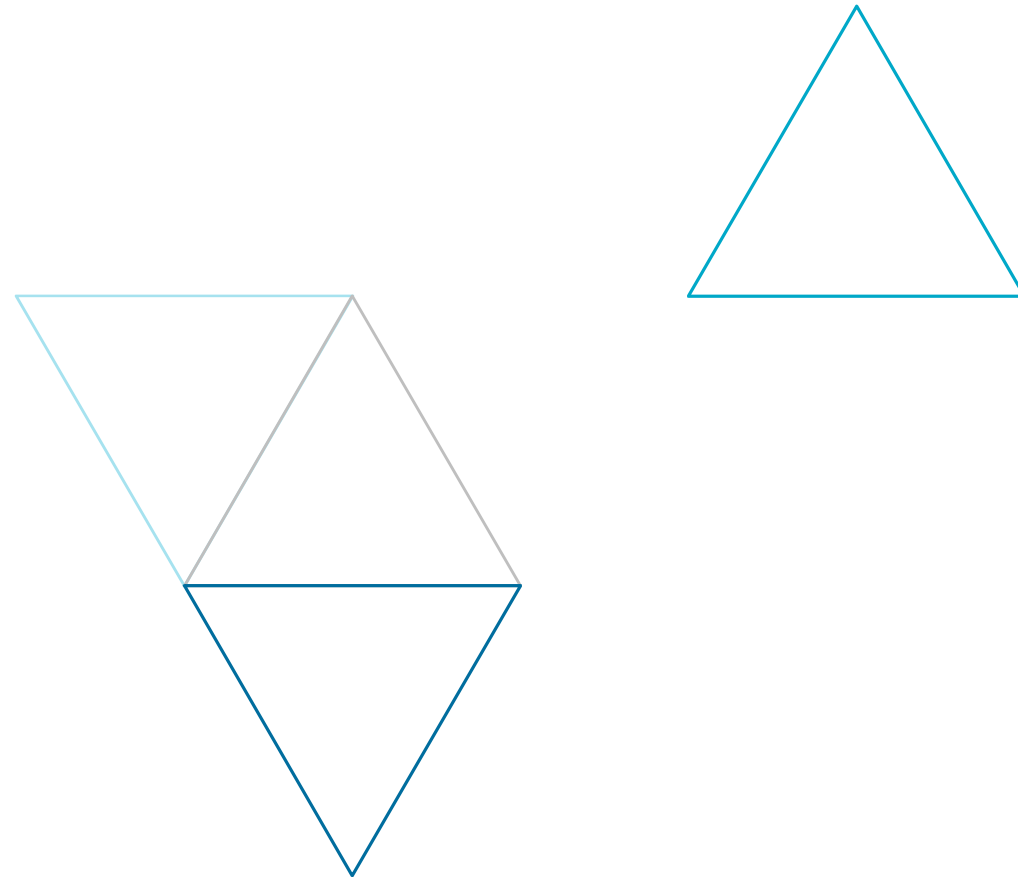


Source: Thomson Reuters Datastream.

SECTION 3

STRATEGIC ASSUMPTIONS

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MARKET BACKGROUND

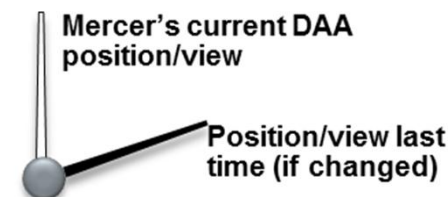
INDEX PERFORMANCE VERSUS STRATEGY

Asset Class	Strategy Assumed Return % p.a.	3 year Index Return % p.a.	Comment
Developed Equities (Global) (FTSE All-World Developed)	8.25	11.3	<i>Remains significantly ahead of the assumed strategic return. This has decreased from 14.6% p.a. last quarter as the latest quarter's return of -4.8% was lower than the 3.9% return of Q3 2012, which fell out of the 3 year return.</i>
Emerging Market Equities (FTSE AW Emerging)	8.75	-2.2	<i>The 3 year return from emerging market equities has fallen from 5.0% p.a. last quarter, driven by a negative return of -15.6% experienced last quarter, which was considerably lower than the quarter that fell out (+4.6%). The 3 year return remains below the assumed strategic return.</i>
Diversified Growth	Libor + 4% / RPI + 5%	4.5 / 7.1	<i>DGFs are expected to produce an equity like return over the long term but with lower volatility – this is the basis for the Libor and RPI based benchmarks. Low cash rates means that the Libor based benchmark has significantly underperformed the inflation (RPI) based benchmark and the long term expected return from equity. During periods of strong equity returns, such as the recent three year period, we would expect DGF to underperform equities.</i>
UK Gilts (FTSE Actuaries Over 15 Year Gilts)	4.5	6.7	<i>UK gilt returns remain above the long term strategic assumed return as yields remain depressed relative to historic averages. Returns have increased compared to the previous quarter as a result of the fall in yields (and hence negative total returns) experienced in the last quarter. On the other hand, corporate bond returns have reduced this quarter, and looking back over three years are now below the strategic assumed return.</i>
Index Linked Gilts (FTSE Actuaries Over 5 Year Index-Linked Gilts)	4.25	9.4	
UK Corporate Bonds (BofAML Sterling Non Gilts)	5.5	5.1	
Overseas Fixed Interest (JP Morgan Global Government Bonds ex UK)	5.5	-0.6	<i>The 3 year performance remains in negative territory despite positive returns this quarter as a result of the fall in global bond yields.</i>
Fund of Hedge Funds (HFRX Global Hedge Fund Index)	6.0	1.3	<i>Hedge fund returns remain below long term averages and the strategic return, as they are affected by low cash rates. Volatility remains low but recent returns have improved slightly given signs of volatility emerging.</i>
Property (IPD UK Monthly)	7.0	13.7	<i>Property returns continue to be above the expected returns, driven by the economic recovery in the US and the UK.</i>

Source: Thomson Reuters Datastream.

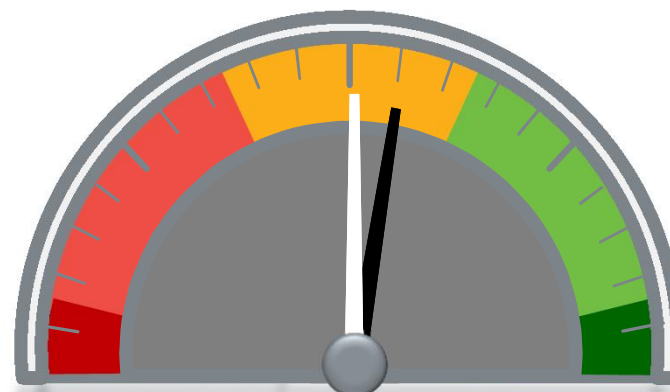
DYNAMIC ASSET ALLOCATION (DAA) DASHBOARD – Q4 2015

- Extremely Unattractive
- Unattractive
- Neutral
- Attractive
- Extremely Attractive



DEVELOPED MARKET EQUITIES

- ✓ Monetary policies remain generally supportive of equity markets
- ✓ Valuations have fallen closer to historical averages following price deterioration
- ! Slowdown in global growth has led to a deterioration in market sentiment and increased volatility



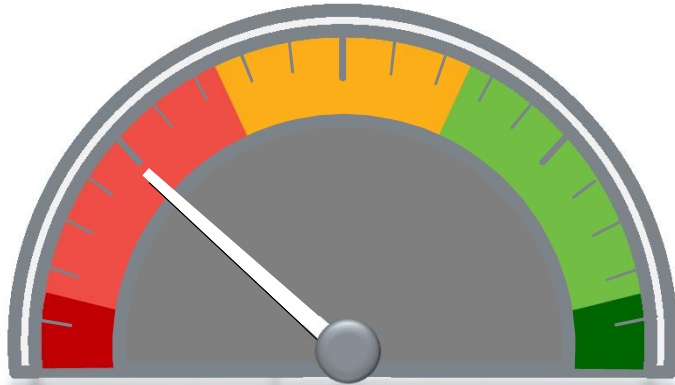
EMERGING MARKET EQUITIES

- ✓ Valuations significantly below long-term averages, though vary by region and country
- ! Decline in investor sentiment with added uncertainty over prospect of a Fed rate rise
- ! Interrelated headwinds include slowing Chinese growth, weak commodity prices and risk of further currency depreciation

These charts summarise Mercer's views on the medium term outlook for returns from the key asset classes; by medium term we mean one to three years. These views are relevant for reflecting medium term market views in determining appropriate asset allocation. We do not expect investors to make frequent tactical changes to their asset allocation based upon these views. These are also based from the view of an absolute return investor, and so do not take into account pension scheme liabilities.

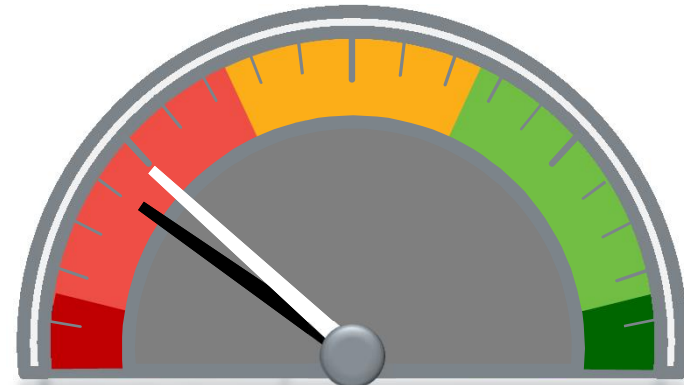
DYNAMIC ASSET ALLOCATION (DAA) DASHBOARD – Q4 2015

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FIXED INTEREST GILTS (ALL STOCK)

- ✓ Ongoing extraordinary monetary policy continues to restrain yield moves
- ! Disappointing growth and inflation data reports led to long dated yields drifting lower over the quarter
- ! Eventual policy rate hikes in the US could hurt performance of fixed income assets



INDEX-LINKED GILTS

- ✓ Real yields have remained broadly stable over the quarter despite a decline in nominal yields
- ✓ Breakeven inflation has fallen to cyclical lows
- ! Real yields remain historically low

DYNAMIC ASSET ALLOCATION (DAA) DASHBOARD – Q4 2015

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NON-GOVERNMENT BONDS (£ ALL-STOCK)



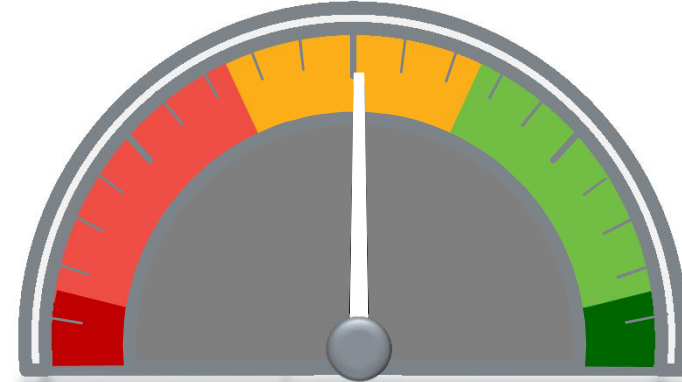
Credit spreads have increased over the quarter and provide reasonable compensation against current default rates



Credit yields remain historically low and prospective returns are limited



Lack of trading liquidity has led to risk of increased volatility in credit markets



UK PROPERTY



Yields look reasonable relative to other assets, despite a small decrease in Q3



Supply side imbalances remain with regions outside London starting to see a pickup in rental growth

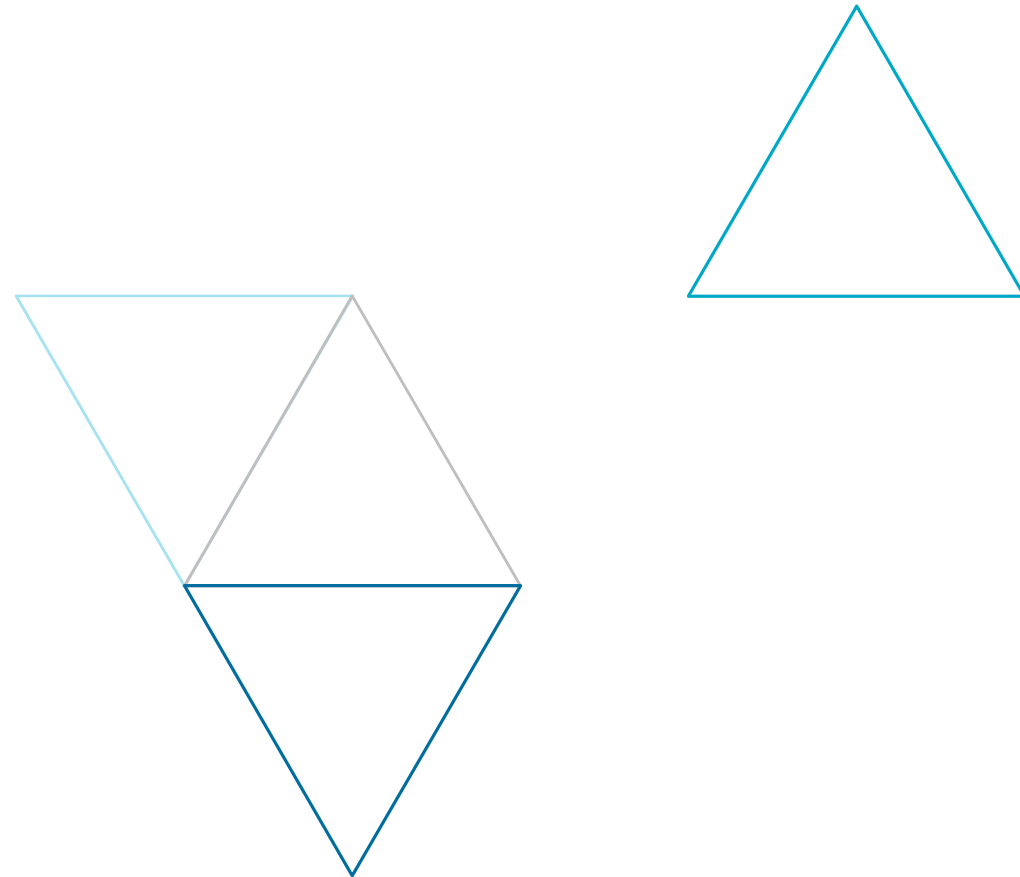


Cautious of opportunistic strategies, and of London market over-heating

SECTION 4

FUND VALUATIONS

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FUND VALUATIONS

VALUATION BY ASSET CLASS

Asset Allocation										
Asset Class	Start of Quarter (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)	Target Strategic Benchmark (%)	Ranges (%)			Difference (%)	
Developed Market Equities	1,700,572	1,568,521	45.6	43.6	40.0	35	-	45	+3.6	
Emerging Market Equities	333,534	293,957	8.9	8.2	10.0	5	-	15	-1.8	
Diversified Growth Funds	362,564	357,914	9.7	9.9	10.0	5	-	15	-0.1	
Fund of Hedge Funds	162,952	157,291	4.4	4.4	5.0	0	-	7.5	-0.6	
Property	314,626	327,832	8.4	9.1	10.0	5	-	15	-0.9	
Infrastructure	-	-	-	-	5.0	0	-	7.5	-5.0	
Bonds	759,781	761,311	20.4	21.1	20.0	15	-	35	+1.1	
Cash (including currency instruments)	96,070	133,923	2.6	3.7	-	0	-	5	+3.7	
Total	3,730,099	3,600,749	100.0	100.0	100.0				0.0	

Source: WM Performance Services, Mercer. Green numbers indicate the allocation is within tolerance ranges, whilst red numbers indicate the allocation is outside of tolerance ranges.

Invested assets decreased over the quarter by £129m due to negative returns across major asset classes. At the start of the quarter, developed equities were overweight relative to benchmark (and outside the range in the SIP); at 30 September 2015 they remained overweight but within the agreed tolerance ranges.

FUND VALUATIONS

VALUATION BY MANAGER

Manager Allocation						
Manager	Asset Class	Start of Quarter (£'000)	Cashflows (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)
BlackRock	Passive Multi-Asset	1,155,704	-40,000	1,099,762	31.0	30.5
Jupiter	UK Equities	178,108	-	168,771	4.8	4.7
TT International	UK Equities	198,482	-	193,736	5.3	5.4
Schroder	Global Equities	242,720	-	232,442	6.5	6.5
Genesis	Emerging Market Equities	152,092	-	132,393	4.1	3.7
Unigestion	Emerging Market Equities	181,442	-	161,564	4.9	4.5
Invesco	Global ex-UK Equities	273,939	-	260,036	7.3	7.2
SSgA	Europe ex UK & Pacific inc. Japan Equities	118,061	-	109,756	3.2	3.0
Record Currency Management	Overseas Equities (to fund currency hedge)	34,093	-	3,430	0.9	0.1
Pyrford	DGF	121,530	-	120,916	3.3	3.4
Standard Life	DGF	241,035	-	236,999	6.5	6.6

Source: WM Services, Avon. Totals may not sum due to rounding.

FUND VALUATIONS

VALUATION BY MANAGER

Manager Allocation						
Manager	Asset Class	Start of Quarter (£'000)	Cashflows (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)
MAN	Fund of Hedge Funds	549	-	593	0.0	0.0
Signet	Fund of Hedge Funds	63,153	-22,611	38,877	1.7	1.1
Stenham	Fund of Hedge Funds	39,745	-39,927	-	1.1	-
Gotham	Fund of Hedge Funds	59,505	-	58,405	1.6	1.6
JPMorgan*	Fund of Hedge Funds	-	59,879	59,416	-	1.7
Schroder	UK Property	183,792	-	189,410	4.9	5.3
Partners	Property	140,391	-	150,487	3.8	4.2
RLAM	Bonds	298,655	-20,000	281,004	8.0	7.8
Internal Cash	Cash	47,103	62,659	102,710	1.3	2.9
Total		3,730,099	-	3,600,749	100.0	100.0

Source: WM Services, Avon. Totals may not sum due to rounding.

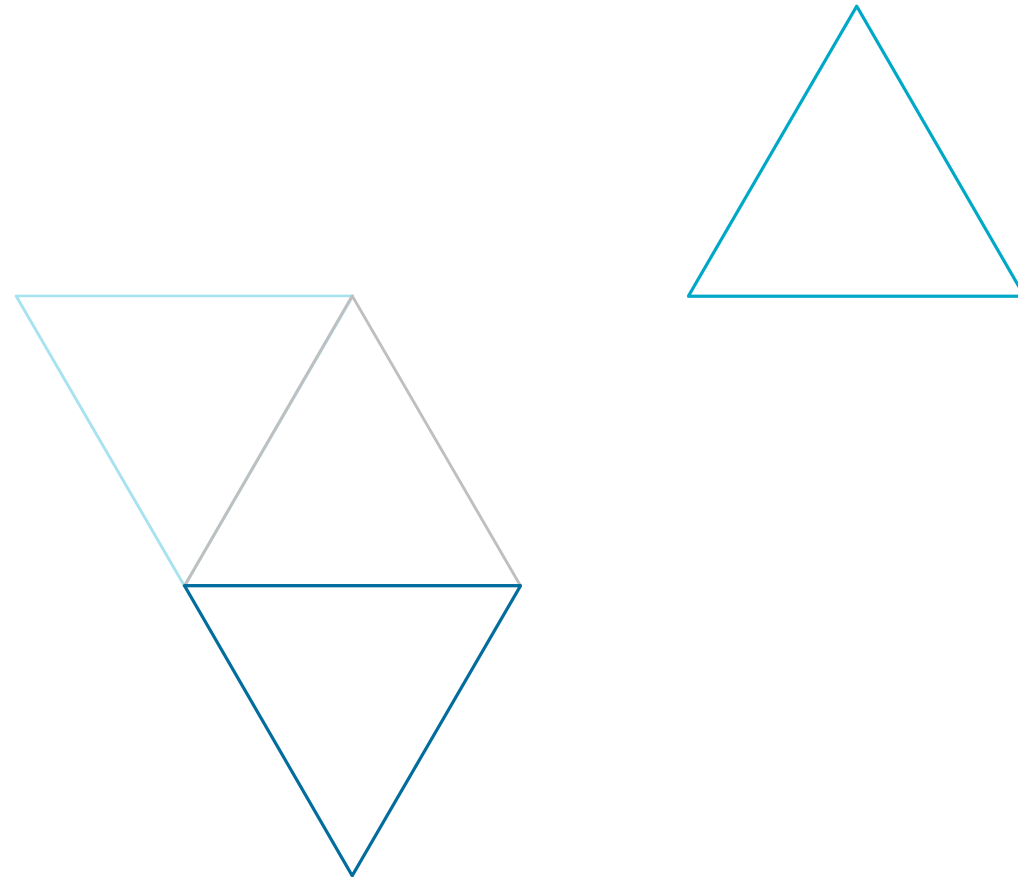
* £59,611k tranche to be invested on 1 October included in cash.

SECTION 5

PERFORMANCE

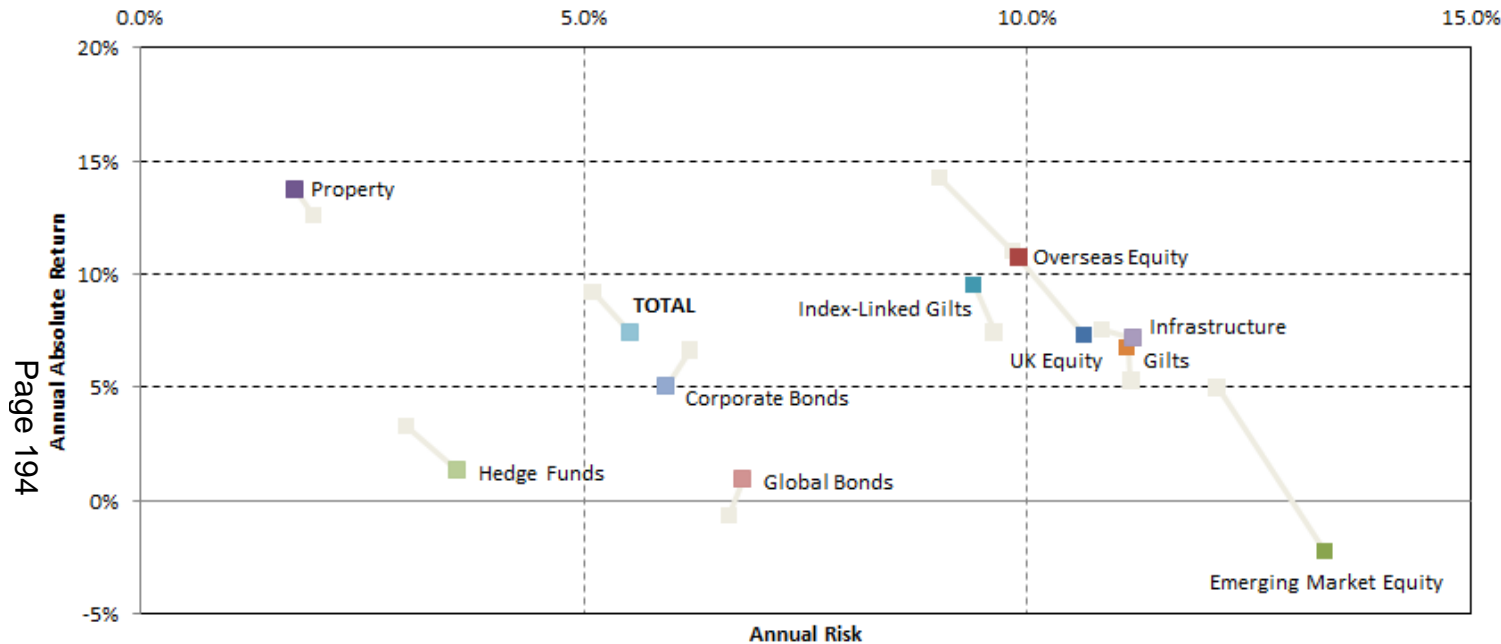
SUMMARY

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MANAGER MONITORING RISK RETURN ANALYSIS

3 Year Risk v 3 Year Return to 30 September 2015



This chart shows the 3 year absolute returns against three year volatility (based on monthly data in sterling terms), to the end of September 2015, for each of the broad underlying asset benchmarks (using the indices set out in the Appendix), along with the total Fund strategic benchmark (using the benchmark indices and allocations from WM Services). We also show the positions as at last quarter, in grey.

Comments

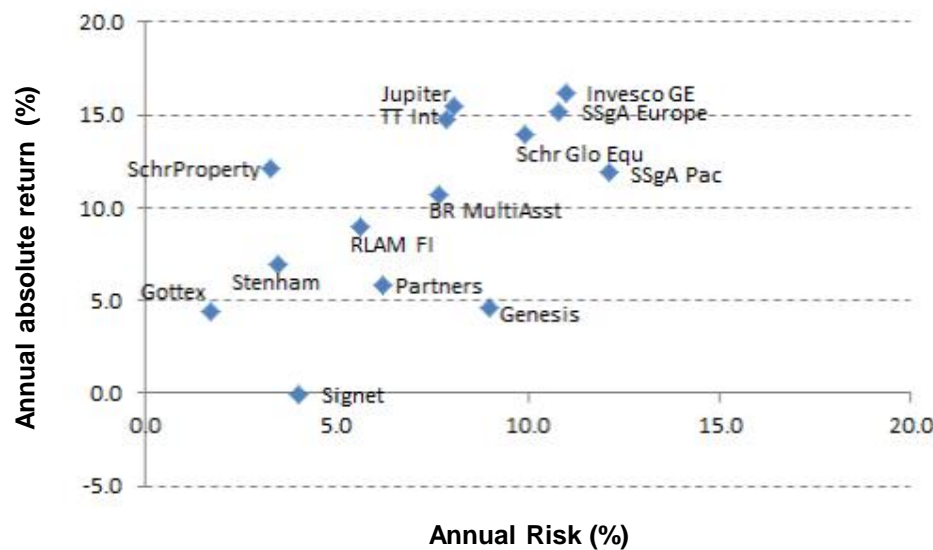
- *The most significant movement seen over the quarter was emerging market equity, which saw a significant decrease in three-year trailing return, driven by Latin American and Asian economies (with similar – albeit less pronounced – movements seen for UK and overseas equities).*
- *Index-linked gilts and property saw absolute returns rise and experienced volatility fall over the quarter.*

MANAGER MONITORING

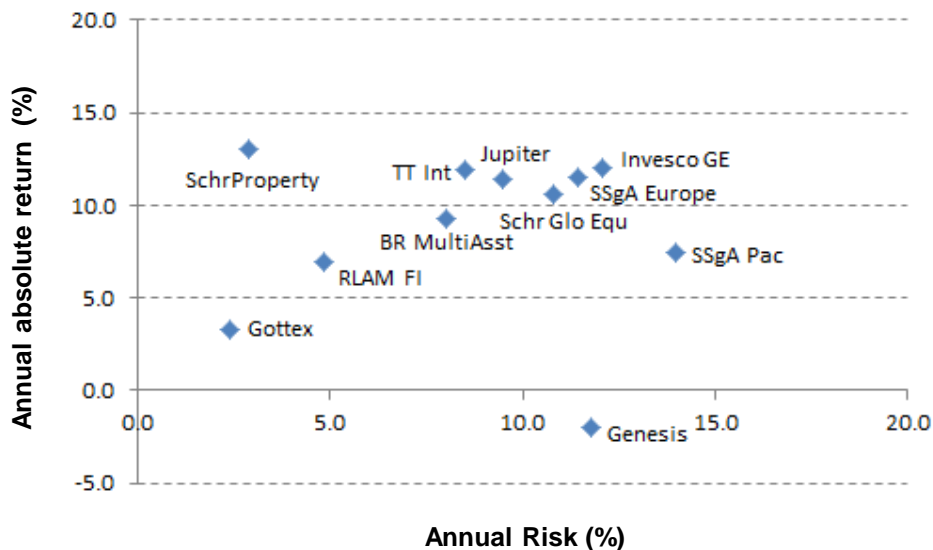
RISK RETURN ANALYSIS

Page 195

3 year Risk vs 3 year Return to 30 June 2015



3 year Risk vs 3 year Return to 30 September 2015



Comments

- In general absolute returns of the funds decreased over the quarter, whilst volatility increased. Genesis was the fund where this impact was most noticeable given the significantly negative returns delivered by emerging market equities.*

MANAGER MONITORING

MANAGER PERFORMANCE – RELATIVE RETURNS TO BENCHMARK (TO 30 SEPTEMBER 2015)

Manager / fund	3 months (%)	1 year (%)	3 years (% p.a.)	3 year versus performance target
BlackRock Multi-Asset	0.1	0.1	0.2	Target met
Jupiter	0.5	5.5	4.0	Target met
TT International	3.5	7.8	4.5	Target met
Schroder Equity	1.7	3.4	0.8	Target not met
Genesis	1.7	-0.9	0.9	Target met
Unigestion	4.3	0.7	NA	NA
Invesco	-0.3	-0.2	0.5	Target met
SSgA Europe	1.0	0.9	0.8	Target met
SSgA Pacific	0.5	1.1	1.3	Target met
Pyrford	-1.7	-3.3	NA	NA
Standard Life	-3.2	NA	NA	NA
Signet*	-2.0	-9.0	-3.6	Target not met
Gottex	-2.7	-4.3	-0.5	Target not met
JP Morgan	NA	NA	NA	NA
Schroder Property	0.1	-0.6	1.2	Target met
Partners Property*	-1.8	-11.5	-3.2	Target not met
RLAM	-0.1	0.4	1.9	Target met
Internal Cash	0.0	0.0	0.1	NA

Source: WM Services, Avon.

Returns in blue text exceeded their respective benchmarks, those in red underperformed, and black text shows performance in line with benchmark.

In the table above, and throughout this report, relative returns have been calculated geometrically (i.e. the portfolio return is divided by the benchmark return) rather than arithmetically (where the benchmark return is subtracted from the portfolio return).

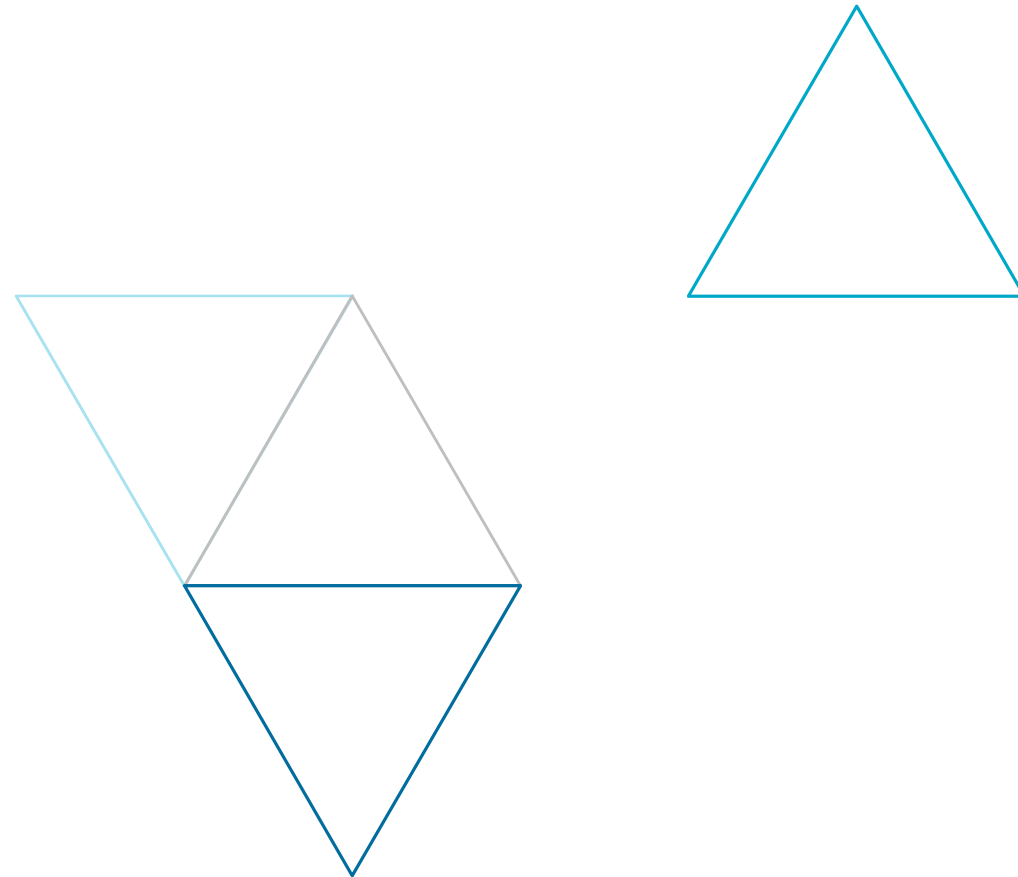
* Performance shown to 30 June 2015 as data to 30 September 2015 was unavailable at the time of writing.

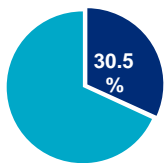
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SECTION 6

MANAGER PERFORMANCE

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BLACKROCK – PASSIVE MULTI-ASSET (POOLED EQUITIES, SEGREGATED BONDS)

£1,099.8M END VALUE (£1,155.7M START VALUE)

Item Monitored	Outcome
Mercer Rating	● A (recategorised from Preferred Provider)
Performance Objective <i>In line with the benchmark</i>	● Outperformed benchmark by 0.2% p.a. over three years

Manager Research and Developments

- Returns have been broadly in line with benchmark over the quarter, as expected for a passive mandate with a benchmark based on monthly mean fund weights.
- The exposure to the international equity fund was sold down by mid 2014 in order to fund the emerging market equity allocation managed by Unigestion (see page 32), but then subsequently increased with the proceeds of the disinvestment from Barings (and since sold down again to fund the investments in Standard Life GARS and JP Morgan – see pages 38 and 42 respectively).
- Current holdings in UK and overseas government bonds are approximately £457m, or 13% of the total Fund – these assets could be used as part of any liability risk management framework.
- We previously assigned “Preferred Provider” status to strategies we rated highly where the primary goal is not outperformance of a benchmark - for example, passively managed funds and cash funds. Going forwards, we will no longer be using the “Preferred Provider” rating, and will give these strategies ratings on our A-C scale reflecting our degree of confidence in a manager’s ability to achieve a strategy’s stated aims. These changes of rating do not represent an upgrade, rather the change of the rating scale applied to these strategies.

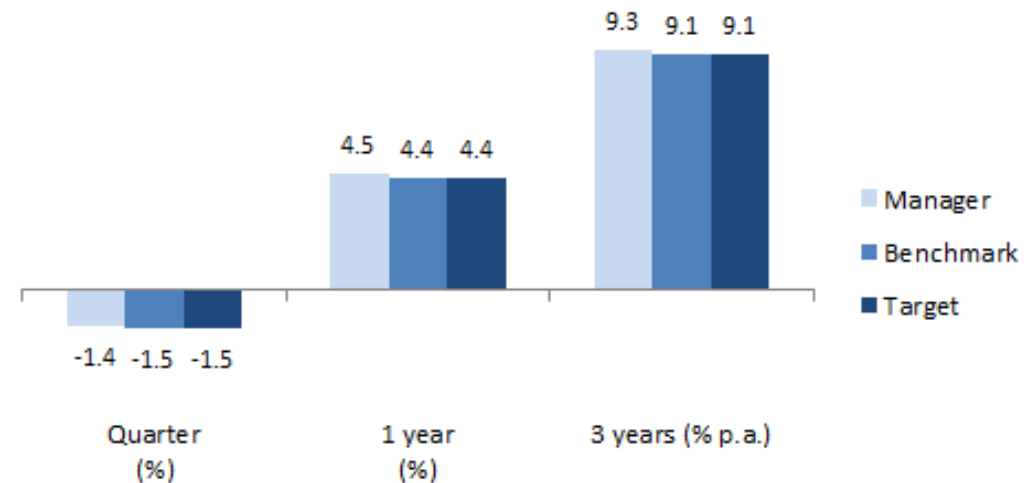
Reason for investment

To provide asset growth as part of diversified portfolio

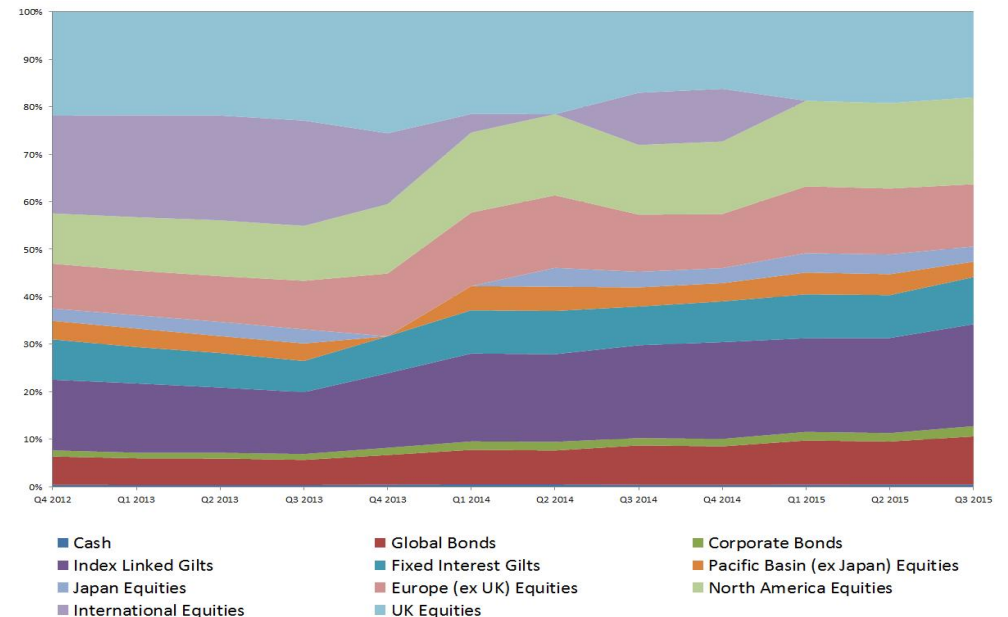
Reason for manager

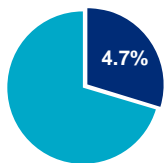
- To provide low cost market exposure across multi asset classes
- Provide efficient way for rebalancing between bonds and equities within a single portfolio

Performance



Asset Allocation





JUPITER ASSET MANAGEMENT – UK EQUITIES (SRI) (SEGREGATED)

£168.8M END VALUE (£178.1M START VALUE)

Item Monitored

Outcome

Mercer Rating



B (no change over period under review)

Performance Objective
Benchmark +2% p.a.



Outperformed benchmark by 4.0% p.a. over three years

Tracking error was 3.5% p.a.
(Q2: 3.5%) – source: Jupiter

Number of stocks: 58

Manager Research and Developments

- The fund achieved its target over the quarter, year and three year periods.
- The outperformance over the quarter was generated from the fund's underweight position in oil and gas and mining sector companies, which underperformed the wider market.
- However, the fund's natural underweight in tobacco detracted from relative performance, as defensive stocks outperformed the wider market over the quarter.
- The fund made two key stock purchases over the quarter. The first was a new holding in Thomas Cook (1% of the portfolio) due to Jupiter's view of long-term plans, which they expect to deliver debt reduction. The second was an addition to Centrica (2.2% of the portfolio) due to Jupiter's growing confidence around their operational performance. Jupiter sold all holdings in Rexam to realise recent profits.
- Tracking error remains reasonably high as a result of the fund's concentration and divergence from the index (in particular, its underweight to large cap stocks and overweight in mid cap).

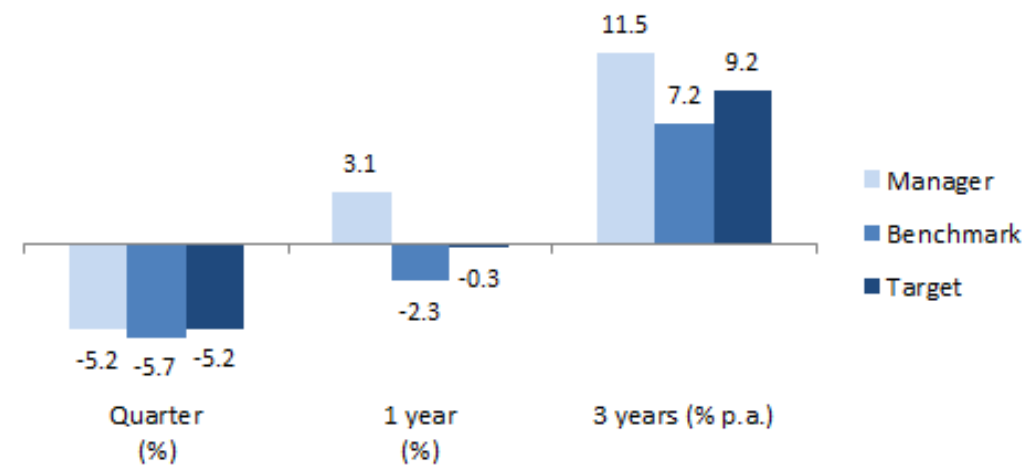
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

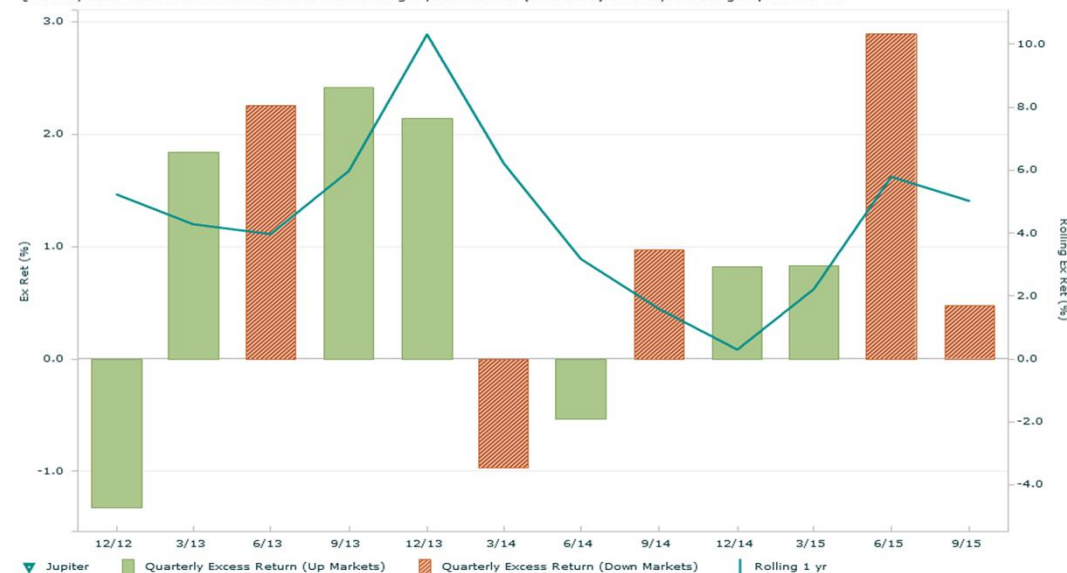
- Clear and robust approach to evaluating SRI factors within the investment process
- Dedicated team of SRI analysts to research SRI issues and lead engagement and voting activities
- Corporate commitment to SRI investment approach within a more mainstream investment team

Performance



Rolling relative returns

Quarterly Excess Return vs. FTSE All Share with rolling 1 yr line in GBP (after fees) over 3 yrs ending September-15



TT INTERNATIONAL – UK EQUITIES (UNCONSTRAINED) (SEGREGATED)

£193.7M END VALUE (£198.5M START VALUE)

Item Monitored	Outcome
Mercer Rating	● B (no change over period under review)
Performance Objective <i>Benchmark +3-4% p.a.</i>	● Outperformed benchmark by 4.5% p.a. over three years
Historic tracking error was 4.0% p.a. (Source: Mercer)	Number of stocks: 51

Manager Research and Developments

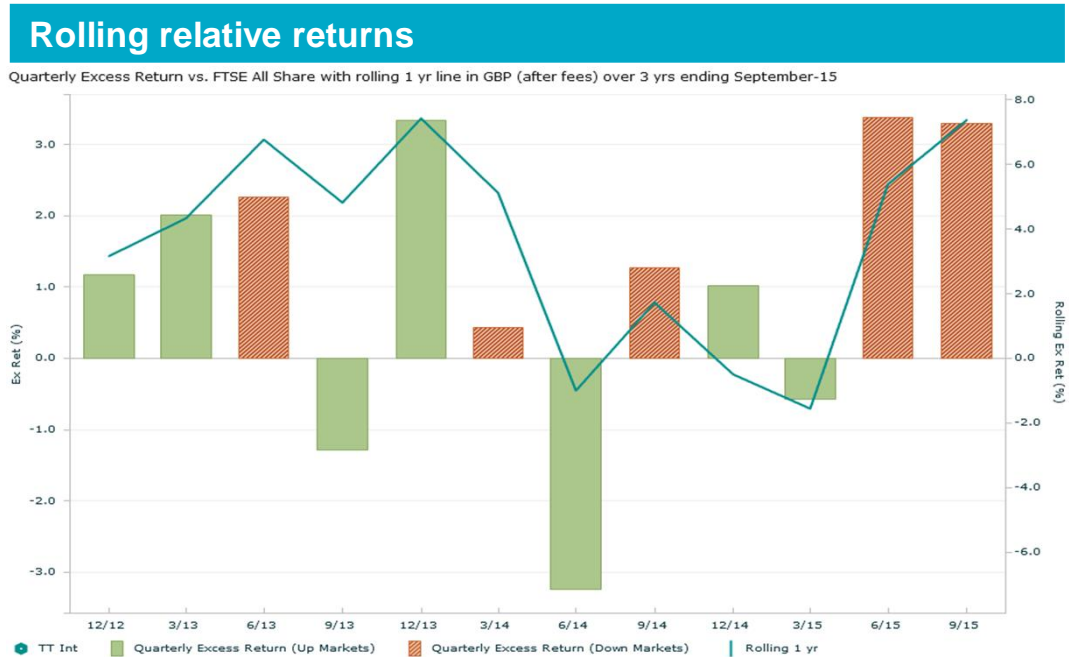
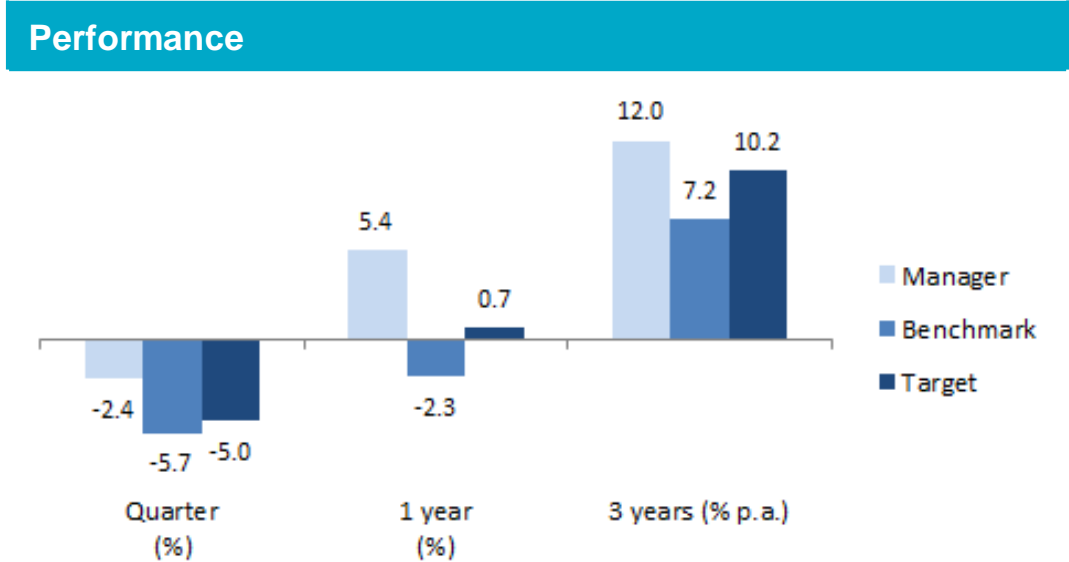
- TT significantly outperformed their benchmark by 3.5% over the quarter, and 7.8% over the year to 30 September 2015.
- This outperformance over the quarter was largely due to strong stock selection in the Consumer Services and Basic Materials sectors (adding 1.6% to returns in total).
- In terms of sector positioning, the fund gained from being underweight Basic Materials and overweight the Consumer sectors. It also benefited from a higher than normal cash holding (at 5.4% at the start of the quarter and 7.5% by the end) in a time of falling markets.
- Turnover decreased from 28.9% in Q2 to 25.2% in Q3 2015 while the three year tracking error (a proxy for risk relative to benchmark) rose from 3.8% to 4.0%.
- Three-year information ratios have increased over the quarter, as a result of the outperformance achieved.
- Assets under management in TT's UK equity strategies decreased slightly over the quarter given the negative performance to c. £495m (compared to £506m in June 2015, £474m in September 2014 and £576m in September 2012). This is a significant decrease over the three year period and should be kept under review.

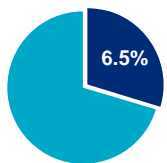
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

- Favoured the partnership structure that aligns manager's and Fund's interests
- Focussed investment activity and manages its capacity
- Clear, robust stock selection and portfolio construction





SCHRODER – GLOBAL EQUITY PORTFOLIO (SEGREGATED)

£232.4M END VALUE (£242.7M START VALUE)

Item Monitored	Outcome
Mercer Rating	● B+ (no change over period under review)
Performance Objective <i>Benchmark +4% p.a.</i>	● Outperformed benchmark by 0.8% p.a. over three years, but lagged target
Historic tracking error was 2.0% p.a. (Source: Mercer)	

Manager Research and Developments

- The fund outperformed the benchmark over the quarter, largely through stock selection in technology, healthcare and materials. Being underweight materials and energy also helped as both sectors underperformed the wider market.
- Looking on a region by region basis, the fund gained the most from UK holdings, with stock selection in North America and Europe positive. The underweight exposure to Asia Pacific (ex Japan) also had a positive impact on performance. The main detractor, from a regional perspective, was stock selection in Japan.
- The largest contributor over the quarter was Google where shares rose to an all-time high on the back of strong Q2 earnings results.

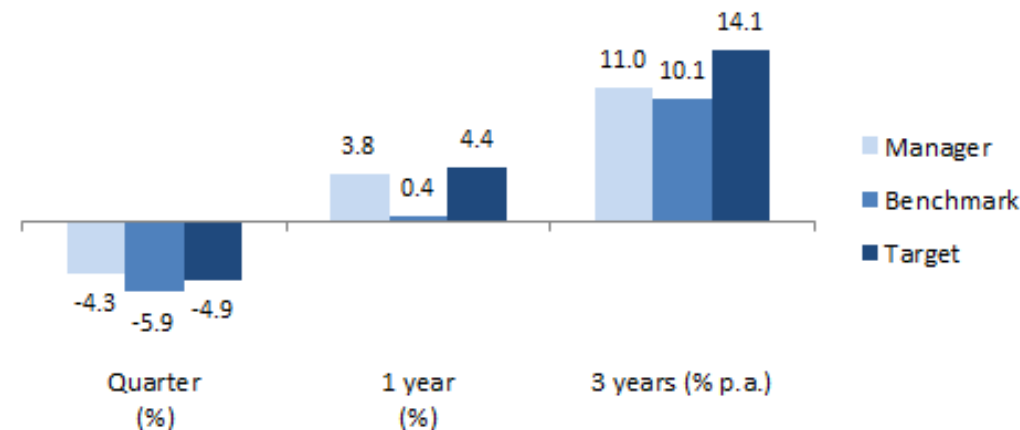
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

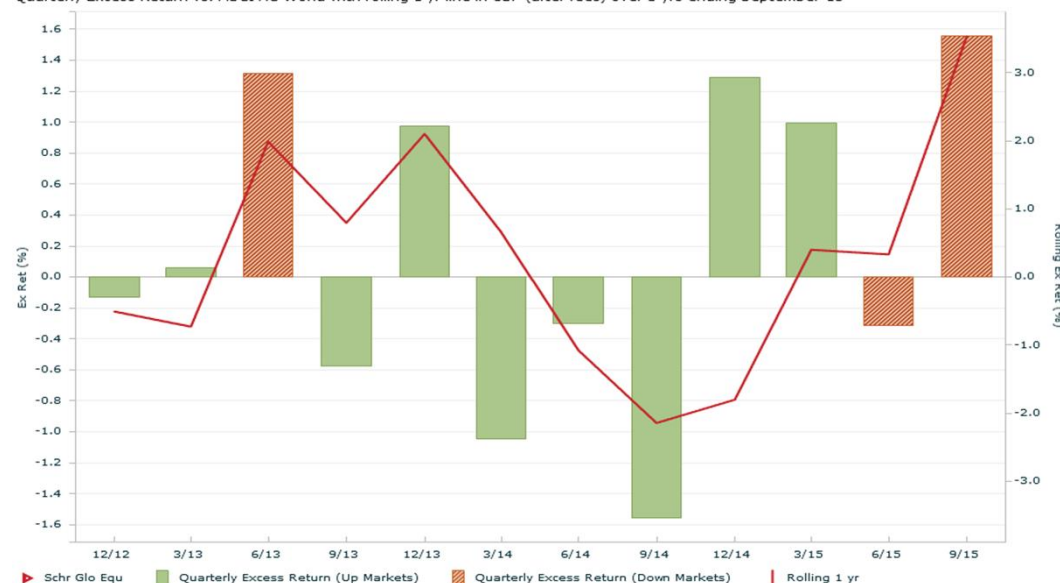
- Clear philosophy and approach
- Long term philosophy aligned with Fund's goals, commitment to incorporating ESG principles throughout the investment process
- Evidence of ability to achieve the Fund's performance target

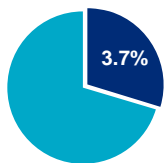
Performance



Rolling relative returns

Quarterly Excess Return vs. MSCI AC World with rolling 1 yr line in GBP (after fees) over 3 yrs ending September-15





GENESIS ASSET MANAGERS – EMERGING MARKET EQUITIES (POOLED)

£132.4M END VALUE (£152.1M START VALUE)

Item Monitored	Outcome
Mercer Rating	● A (no change over period under review)
Performance Objective <i>Benchmark</i>	● Outperformed benchmark by 0.9% p.a. over three years
Three year tracking error was 3.5% p.a. (Q2: 3.5%) – source: Genesis	Number of stocks: 159

Manager Research and Developments

- The fund outperformed its benchmark over the quarter. Relative to the index, the portfolio benefitted from stock selection in India and South Africa, and from being underweight the weak Chinese market. This was partly offset by being underweight in South Korea and Taiwan (comparatively strong markets).
- The biggest contributor was SABMiller (South Africa) whilst the biggest detractor was First Quantum Minerals (Zambia). Turnover over the quarter was 22%, approximately one third of which related to trading in Chinese equities given volatility in that market.
- The portfolio one-year returns are 0.8% below benchmark, while three year returns are 0.9% ahead. Some short-term volatility relative to benchmark is to be expected given their long-term approach of identifying under-priced companies and investing with a five year time horizon.
- Over the quarter our researchers met with Genesis as part of our regular research on the manager and from this have confirmed that the “A” rating should remain.

Reason for investment

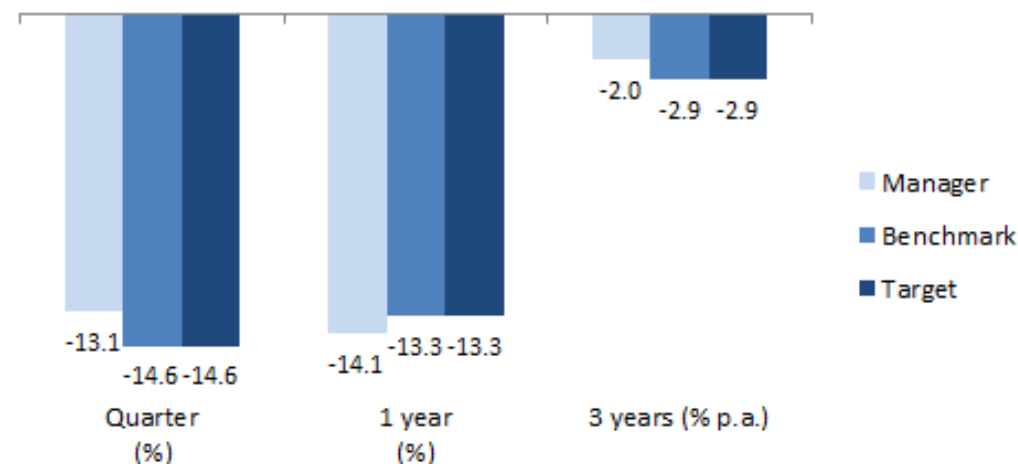
To provide asset growth as part of diversified equity portfolio

Reason for manager

- Long term investment approach which takes advantage of evolving growth opportunities
- Niche and focussed expertise in emerging markets
- Partnership structure aligned to delivering performance rather than growing assets under management

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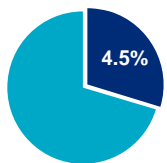
Performance



Rolling relative returns

Quarterly Excess Return vs. MSCI EM with rolling 1 yr line in GBP (after fees) over 3 yrs ending September-15





UNIGESTION – EMERGING MARKET EQUITIES (POOLED – SUB-FUND)

£161.6M END VALUE (£181.4M START VALUE)

Item Monitored	Outcome
Mercer Rating	● R (no change over period under review)
Performance Objective <i>Benchmark +2-4% p.a.</i>	● Outperformed benchmark by 0.7% over the year
Historic tracking error since inception was 7.3% p.a. (Source: Unigestion)	Number of stocks: 88

Manager Research and Developments

- The Fund outperformed by 4.3% over the quarter and by 0.7% over the year to 30 September 2015.
- This outperformance largely occurred in July, where the fund returned -3.1% against a benchmark return of -6.2%, benefiting from its defensive profile, with an overweight position in Food and Telecoms helping relative performance. From a geographical point of view, notable outperformance was generated by allocations to South Korea, China and South Africa. The fund also outperformed over the months of August and September.
- Volatility since inception is 15.0%, lower than the index (at 17.2%) and consistent with their objectives (and the strategy's bias towards quality and large- or mega-cap stocks).

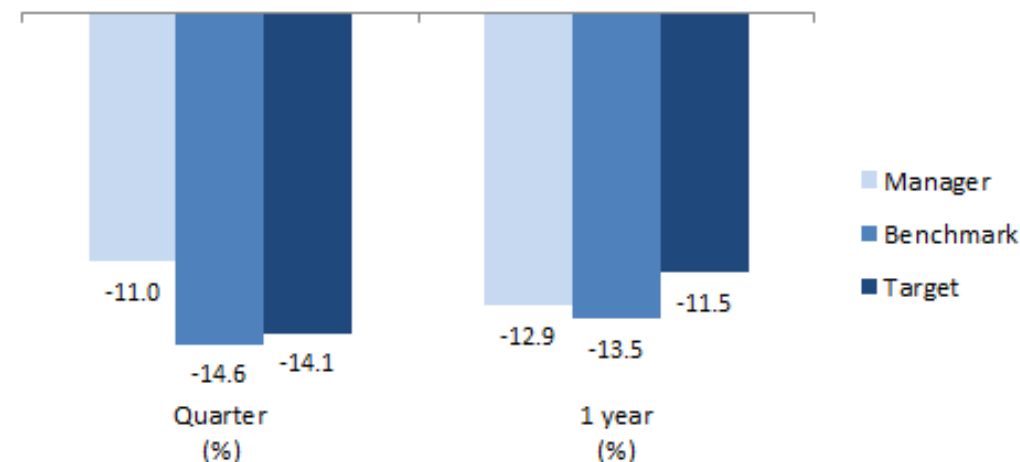
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

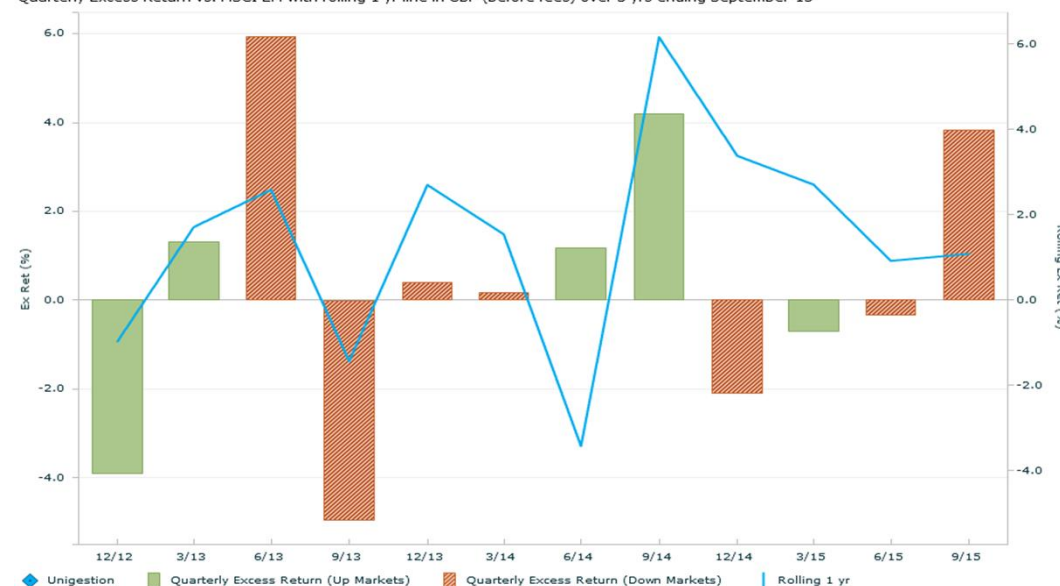
- Risk-based active management approach
- Aim for lower volatility than the MSCI Emerging Markets Index
- Combine fundamental and quantitative analysis

Performance



Rolling relative returns

Quarterly Excess Return vs. MSCI EM with rolling 1 yr line in GBP (before fees) over 3 yrs ending September-15



Note: Chart is pooled fund performance, gross of fees

INVESCO – GLOBAL EX-UK EQUITIES (ENHANCED INDEXATION) (POOLED)

£260.0M END VALUE (£273.9M START VALUE)

Item Monitored	Outcome
Mercer Rating	● B+ (no change over period under review)
Performance Objective <i>Benchmark +0.5% p.a.</i>	● Outperformed benchmark by 0.5% p.a. over three years
Tracking error since inception was 1.5% p.a. – <i>source: Invesco</i>	Number of stocks: 422 (up from 407)

Manager Research and Developments

- The fund underperformed its benchmark by 0.3% over the last quarter (source: WM), and is in line with its outperformance target over 3 years. Beta remains near to one, as expected.
- The sector and country allocations were broadly in line with the benchmark. All industry and country allocations were within +/- 1.2% of benchmark weightings, in line with general expectations for an enhanced indexation product.

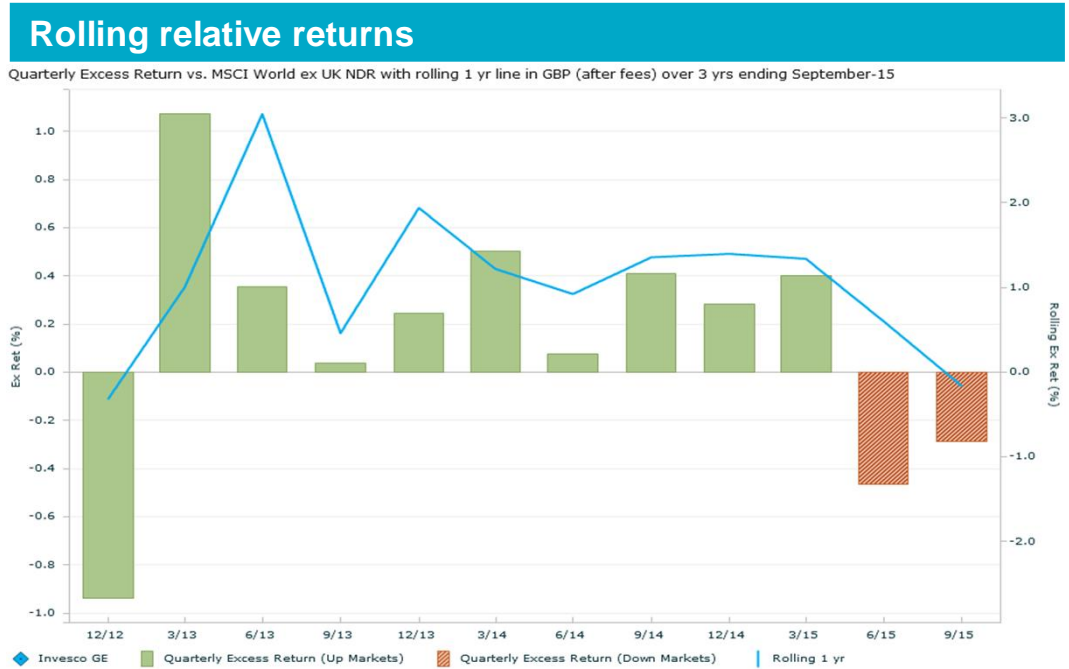
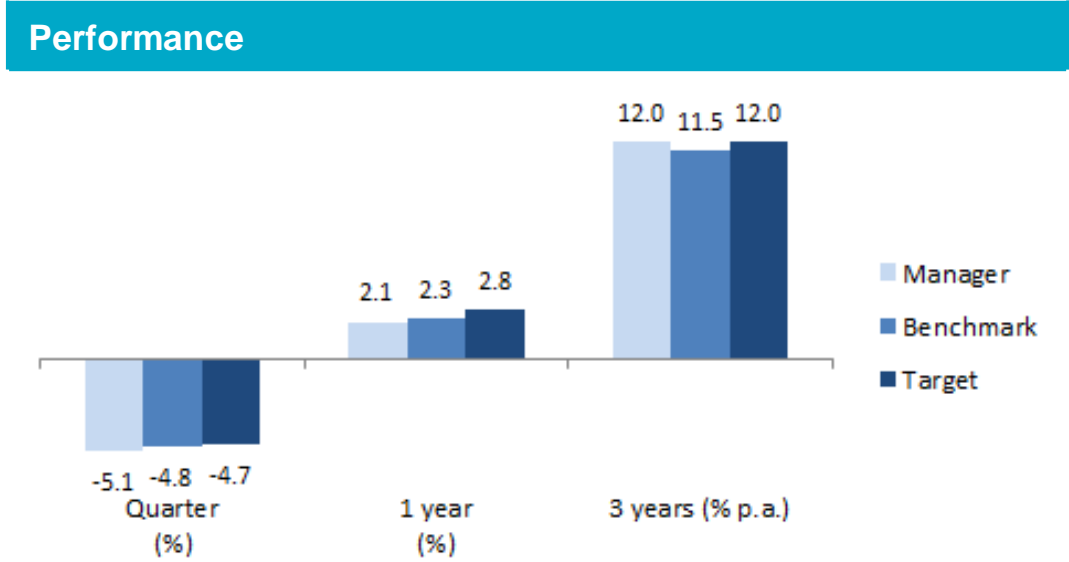
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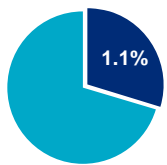
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

- Robust investment process supported by historical performance record, providing a high level of assurance that the process could generate the outperformance target on a consistent basis
- One of few to offer a Global ex UK pooled fund





SSGA – EUROPE EX-UK EQUITIES (ENHANCED INDEXATION) (POOLED)

£40.1M END VALUE (£41.5M START VALUE)

Item Monitored	Outcome
Mercer Rating	● R (no change over period under review)
Performance Objective <i>Benchmark +0.5% p.a.</i>	● Outperformed benchmark by 0.8% p.a. over three years
Historic tracking error was 0.8% p.a. (Source: Mercer)	Number of stocks: 203

Manager Research and Developments

- The Fund's return has outperformed its performance target over 3 years.
- The total pooled fund size on 30 September 2015 was £40.1m. This means that the Fund is practically the only investor, although the Panel has previously concluded that the Fund could be sustained even if the Avon Pension Fund was the only investor.
- The fund holds 203 out of 389 stocks in the index, around 52%, within the expected range of 35-65%. Beta over three years is as expected at around 1.

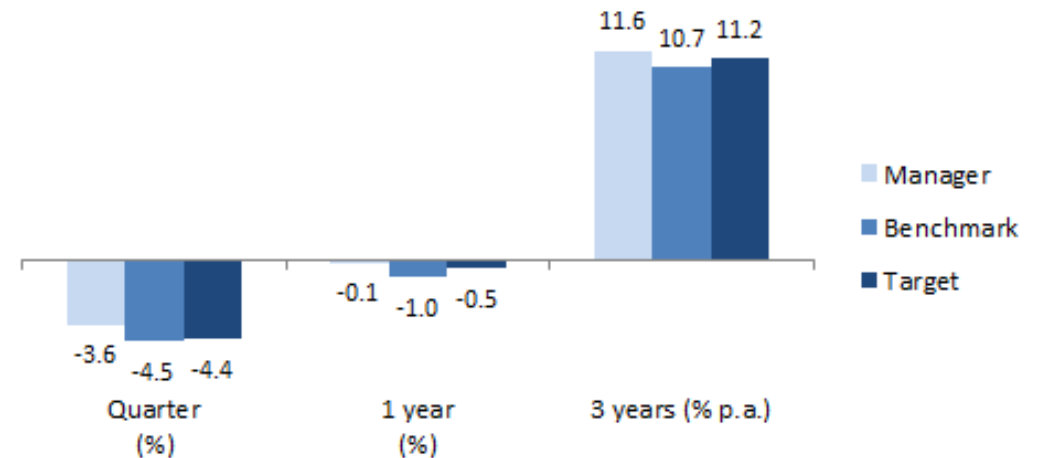
Reason for investment

To provide asset growth as part of diversified equity portfolio

Reason for manager

- Strength of their quantitative model and process, and ongoing research to develop the model
- Historic performance met the risk return parameters the Fund was seeking
- Two Funds (European and Pacific) to achieve the Fund's customised asset allocation within overseas equities

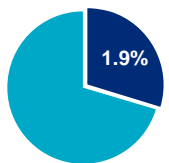
Performance



Rolling relative returns

Quarterly Excess Return vs. Europe ex UK (WM) with rolling 1 yr line in GBP (after fees) over 3 yrs ending September-15





SSGA – PACIFIC INCL. JAPAN EQUITIES (ENHANCED INDEXATION) (POOLED)

£69.8M END VALUE (£76.5M START VALUE)

Item Monitored	Outcome
Mercer Rating	● N (no change over period under review)
Performance Objective <i>Benchmark +0.5% p.a.</i>	● Outperformed benchmark by 1.3% p.a. over three years
Historic tracking error was 0.7% p.a. (Source: Mercer)	Number of stocks: 400

Manager Research and Developments

- The Fund's return has met its performance target over 3 years.
- The total pooled fund size on 30 September 2015 was £69.8m. As with the European fund, the conclusion has been that the Fund could be sustained even with the Avon Pension Fund as the only investor.
- As with the European fund, Beta is around 1 (i.e. broadly in line with a market cap approach).

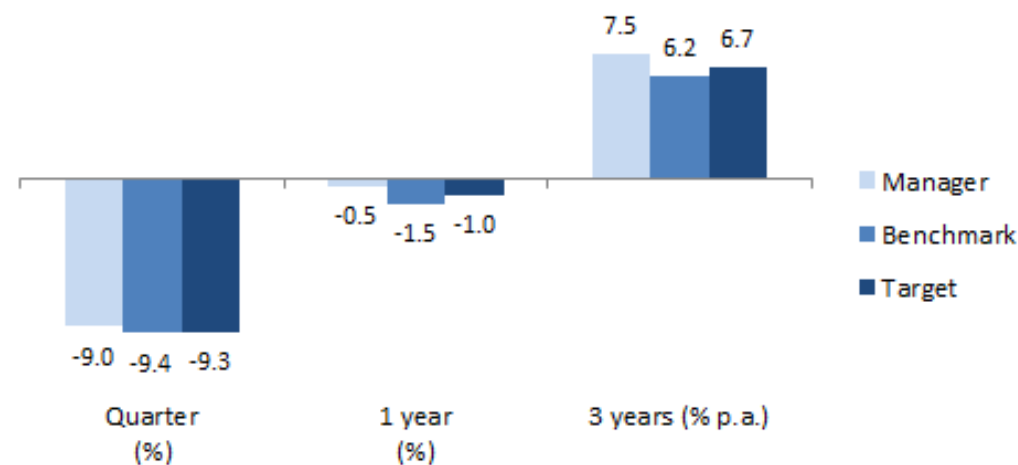
Reason for investment

To provide asset growth as part of diversified equity portfolio

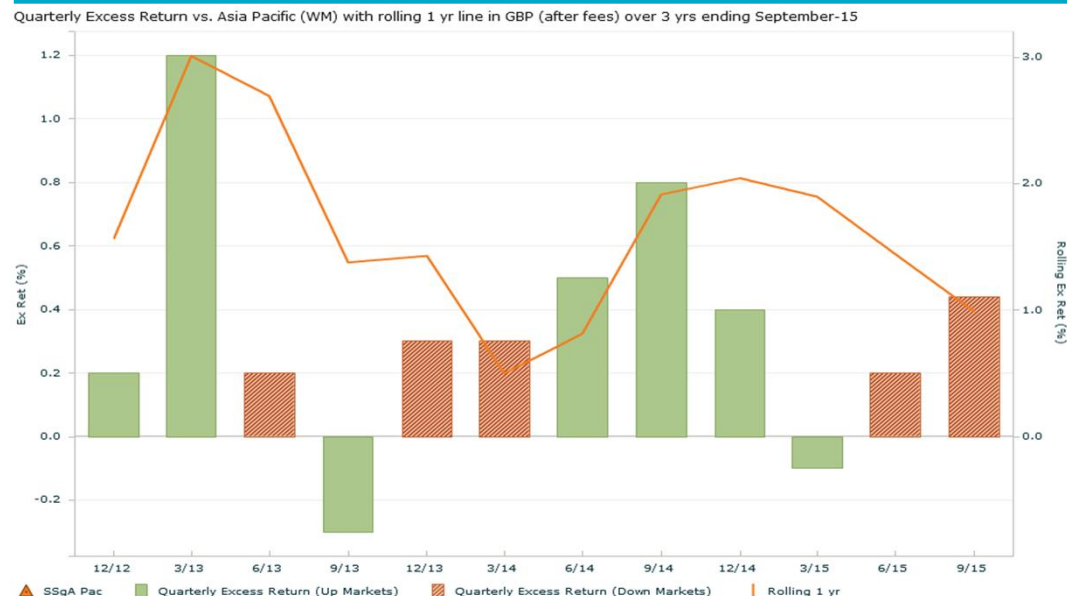
Reason for manager

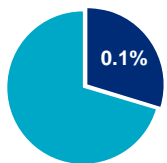
- Strength of their quantitative model and process, and ongoing research to develop the model
- Historic performance met the risk return parameters the Fund was seeking
- Two Funds (European and Pacific) to achieve the Fund's customised asset allocation within overseas equities

Performance



Rolling relative returns





RECORD – ACTIVE CURRENCY HEDGING (SEGREGATED) £3.4M END VALUE (£34.1M START VALUE)

Item Monitored	Outcome
Mercer Rating	● N (no change over period under review)
Performance Objective	● Underperformed a 50% passive hedge by 0.3% p.a. over three years
N/A	

Manager Research and Developments

Over the quarter, the US dollar, the euro and the yen all strengthened relative to sterling.

A 50% hedge on each currency would have had an overall negative return as some of the appreciation of the three currencies would have been protected against. Record had a higher hedge ratio against the US dollar, euro and yen, which resulted in a negative relative performance – see right.

Performance (Total Hedging Portfolio)

	3 months (%)	1 year (%)	3 years (% p.a.)
Record Hedge	-3.39	-1.50	0.28
50% Illustrative Hedge	-2.02	-1.42	0.53
Relative	-1.40	-0.08	-0.25

Currency Hedging 3 Month Performance (£ terms)

Currency	Start Exposure (£)	End Exposure (£)	Currency Return (%)	50% Hedge Return (%)	Record Hedge Return (%)	Net Return (%)
USD	512,547,836	491,943,312	3.83%	(1.85%)	(3.03%)	0.72%
EUR	200,472,608	188,257,965	4.02%	(1.90%)	(3.56%)	0.40%
JPY	144,091,744	120,361,671	6.08%	(2.90%)	(4.55%)	1.42%
Total	857,112,188	800,562,949	4.22%	(2.02%)	(3.39%)	0.75%

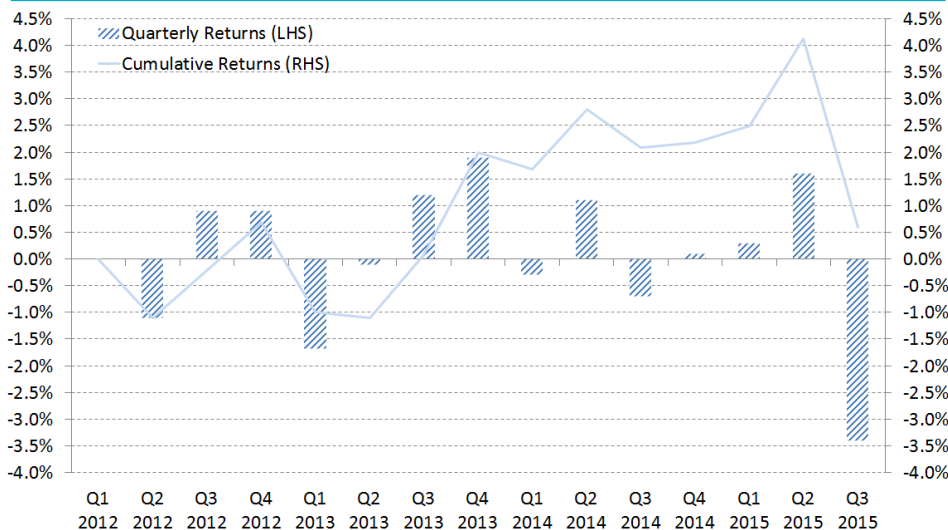
Reason for investment

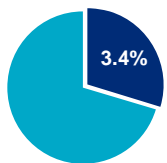
To manage the volatility arising from overseas currency exposure, whilst attempting to minimise negative cashflows that can arise from currency hedging

Reason for manager

- Straightforward technical (i.e. based on price information) process
- Does not rely on human intervention
- Strong IT infrastructure and currency specialists

Hedging Return





PYRFORD – DGF (POOLED) **£120.9M END VALUE (£121.5M START VALUE)**

Item Monitored	Outcome
Mercer Rating	● R (no change over period under review)
Performance Objective <i>RPI +5% p.a.</i>	● Underperformed benchmark by 3.3% p.a. over one year

Manager Research and Developments

- The fund has underperformed the benchmark over the quarter and year by 1.7% and 3.3% respectively.
- The asset allocation of the fund remained nearly unchanged over the quarter at 30% equities, 66% bonds and 5% cash.
- Performance in Q3 was disappointing, with a return of -0.2% although they did provide downside protection as equities fell.
- Pyrford continues to adopt a defensive stance by owning short duration securities in order to protect the capital value of the portfolio from expected rises in yields. At the end of the quarter the modified duration of the fixed income portfolio fell to 1.8 years.

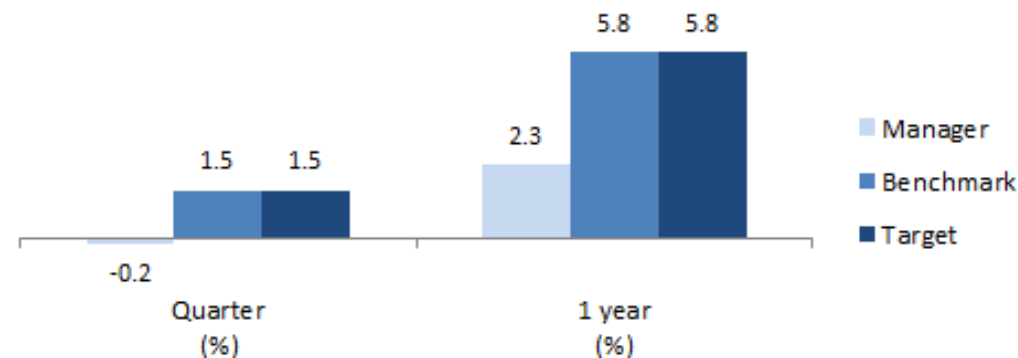
Reason for investment

To provide equity like return over the long term but with a lower level of volatility

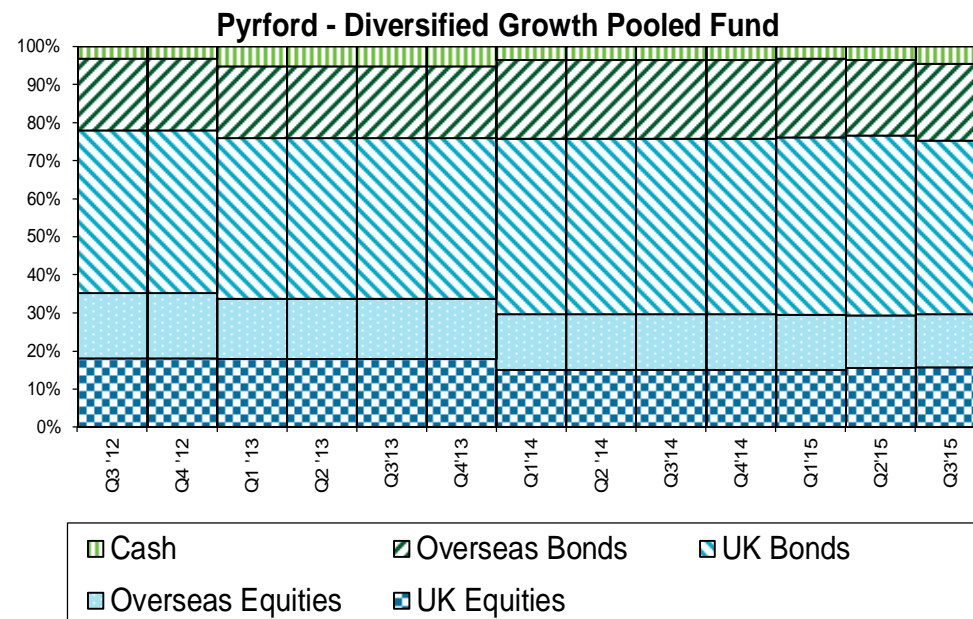
Reason for manager

- Asset allocation skill between equities, bonds and cash
- Fundamental approach to stock selection

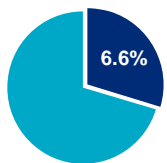
Performance



Asset Allocation



Annual data prior to Q1 2015.



STANDARD LIFE – DGF (POOLED) £237.0M END VALUE (£241.0M START VALUE)

Item Monitored

Outcome

Mercer Rating



B+ (no change over period under review)

Performance Objective
Cash +5% p.a.



Underperformed benchmark by 3.2% p.a. over the quarter



Underperformed benchmark since inception by 4.7% (-1.3% vs 3.6% gross of fees)

Manager Research and Developments

- Over the quarter the Fund returned -1.8% against a benchmark of 1.4%.
- The charts to the right (and overleaf) provide analysis of the performance of the pooled fund (net of fees) over the three years to 30 September 2015, illustrating that while returns have been broadly in line with the median DGF manager, the risk taken to produce these returns has been significantly lower and as a result risk adjusted returns are in the top quartile.
- The equity market falls hurt the fund's European and Japanese equity strategies, with global commodity price falls leading to negative returns from a global equity miners position. The market turmoil led to US Treasury bonds appreciating, which meant that the fund's strategy to benefit from rising treasury yields also produced negative returns.
- In July Gerry Fowler joined the Multi-Asset Investing Team as Investment Director, Idea Generation. He will be part of the 56 person team providing idea generation, investment recommendations and detailed implementation strategies for their range of multi-asset funds and will report directly to Guy Stern, Executive Director of Multi-Asset and Macro Investing. We are not proposing any changes to ratings.

Reason for investment

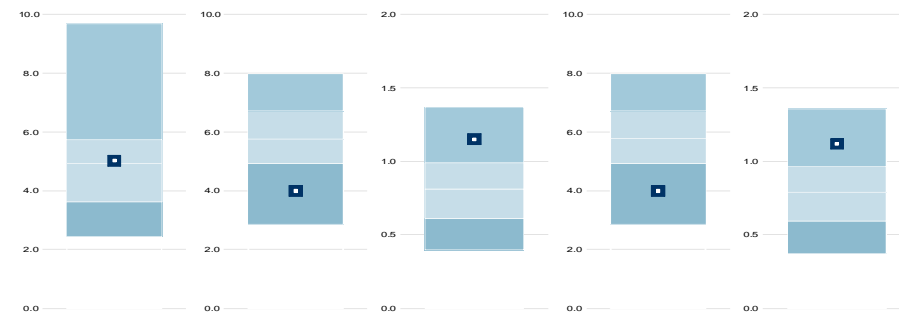
To provide equity like return over the long term but with a lower level of volatility

Reason for manager

- Diversification from equities
- Exposure to market-neutral trades, and different approach to Pyford's asset allocation approach.

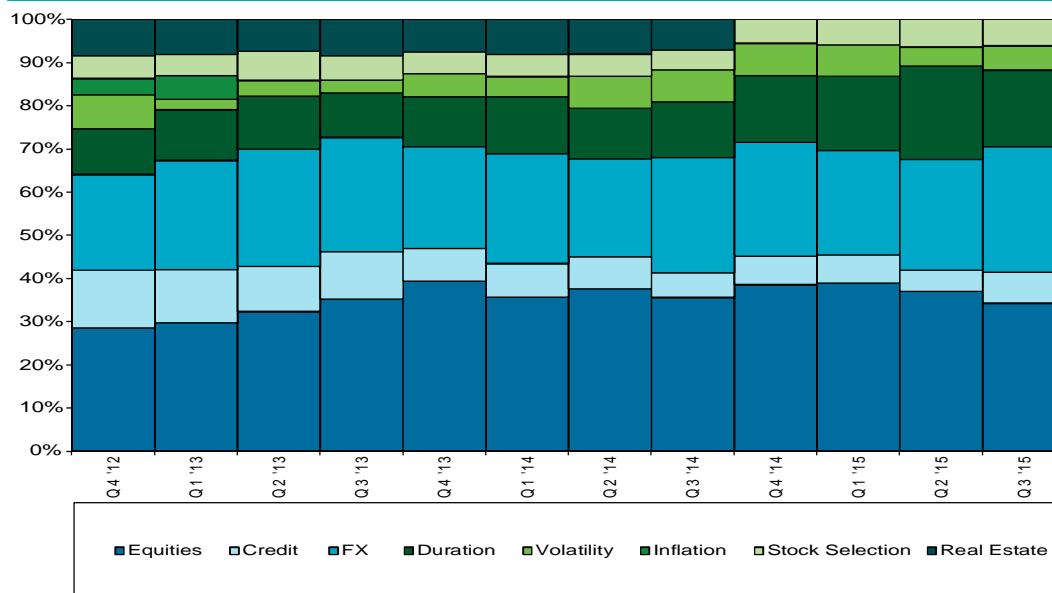
Performance

Performance characteristics vs. 3 Month Sterling LIBOR (after fees) over 3 years ending September-15 (quarterly calculation). Comparison with the International Multi-Asset GBP (Net) universe (Actual Ranking)



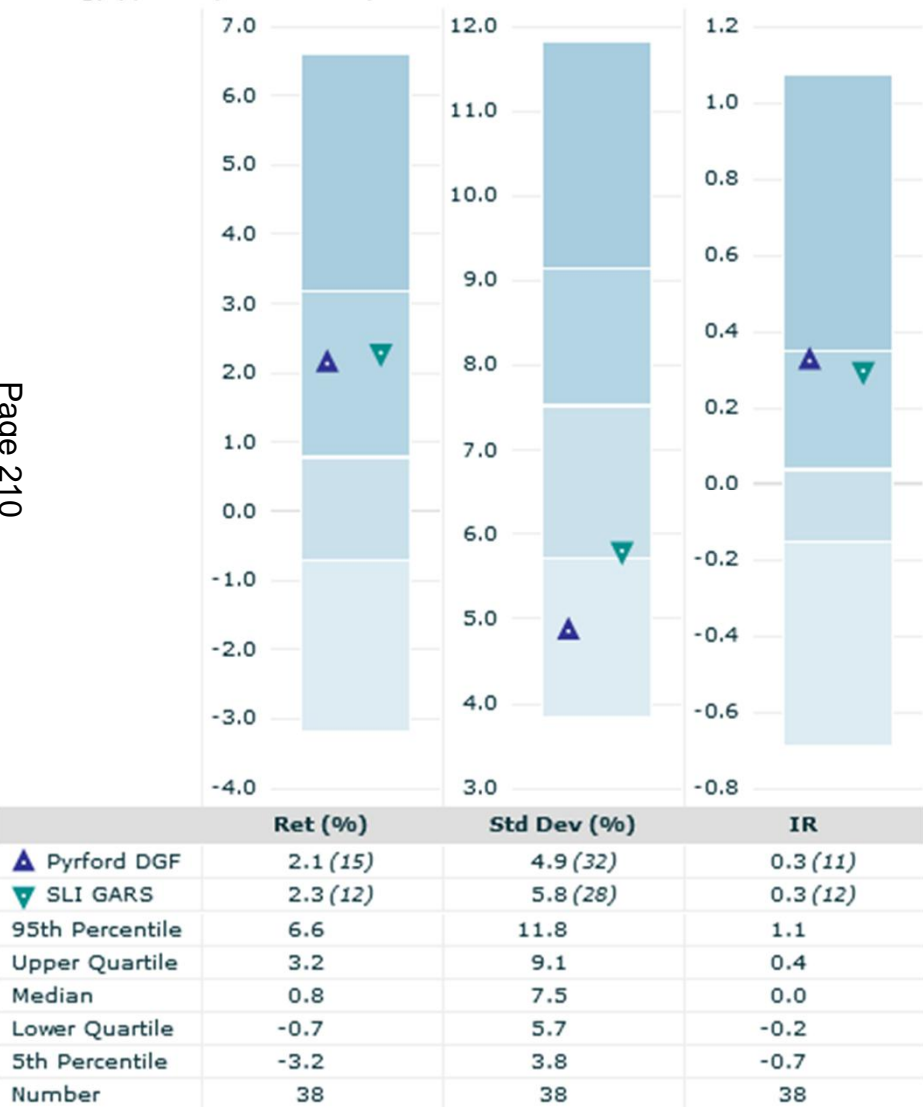
Name	Ret (% p.a.)	Std Dev (% p.)	Sharpe	TE (% p.a.)	IR
Standard Life	5.0 (15)	4.0 (26)	1.1 (3)	4.0 (26)	1.1 (3)
95th Percentile	9.7	8.0	1.4	8.0	1.4
Upper Quartile	5.7	6.7	1.0	6.7	1.0
Median	4.9	5.8	0.8	5.8	0.8
Lower Quartile	3.6	4.9	0.6	4.9	0.6
5th Percentile	2.4	2.8	0.4	2.8	0.4
Number of Funds	30	30	30	30	30

Asset Allocation/Risk Exposure



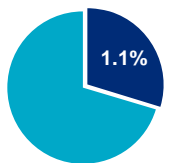
DGF MANDATES

Performance characteristics vs. BofAML LIBOR 3 month average UK in GBP (after fees) over 1 yr ending September-15
Comparison with the International Multi-Asset GBP (Net) universe (Actual Ranking) (quarterly calculations)



Commentary

- Over the year to 30 September 2015, the Standard Life GARS pooled fund outperformed Pyrford by 0.2% (however the Fund has only been invested since January 2015).
- This placed both Standard Life and Pyrford above the median manager of the DGF universe for performance. It should be noted that this universe is very diverse in styles.
- However this was achieved whilst taking different levels of risk, with Standard Life's volatility standing at 5.8% against Pyrford's 4.9%.
- Both managers were below the median manager for risk, meaning they took less risk than most managers in the universe.
- As a result, information ratios (a measure of risk adjusted returns) for both Pyrford and Standard Life were above the median of the universe.
- Note that this is a short time-frame over which to measure risk, and reflects the limited period the Fund has been invested for. More telling analysis will emerge as the track record grows.



SIGNET – FUND OF HEDGE FUNDS

£38.9M END VALUE (£63.2M START VALUE)

Item Monitored	Outcome
----------------	---------

Mercer Rating ● N (no change over period under review)

Performance Objective ● Underperformed benchmark by 3.6% p.a. over three years to 30 June 2015
Cash +3% p.a.

Item	
------	--

Number of funds 30

Strategy	Approximate Contribution to Performance over Q2 2015 (%)
----------	--

Long-Biased Credit +0.21

Long-Short Credit -0.13

Long Only Credit +0.03

Recovery Plays -0.23

Global Rates and FX +0.26

Mortgaged Backed Securities +0.06

Event Driven and Special Situations Fund +0.08

Source: Signet, Mercer. Approximate calculations based on largest holdings.

Reason for investment

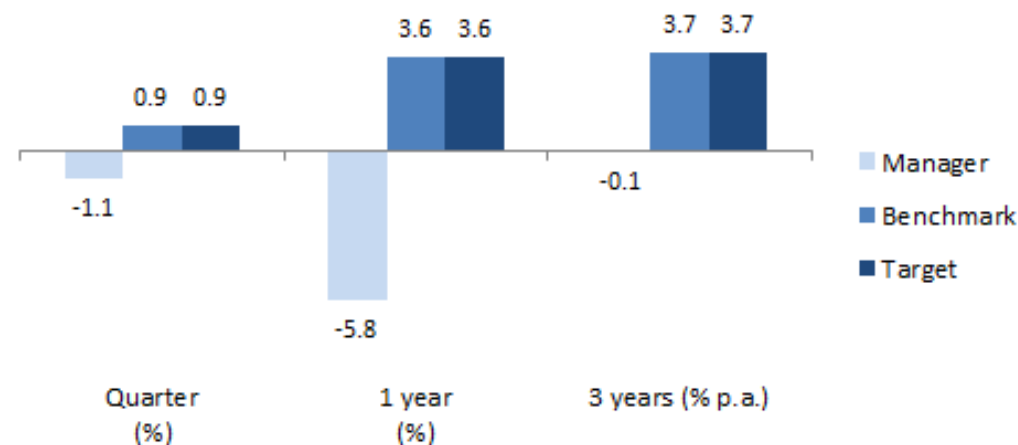
To reduce volatility of the Growth portfolio and increase diversification

Reason for manager

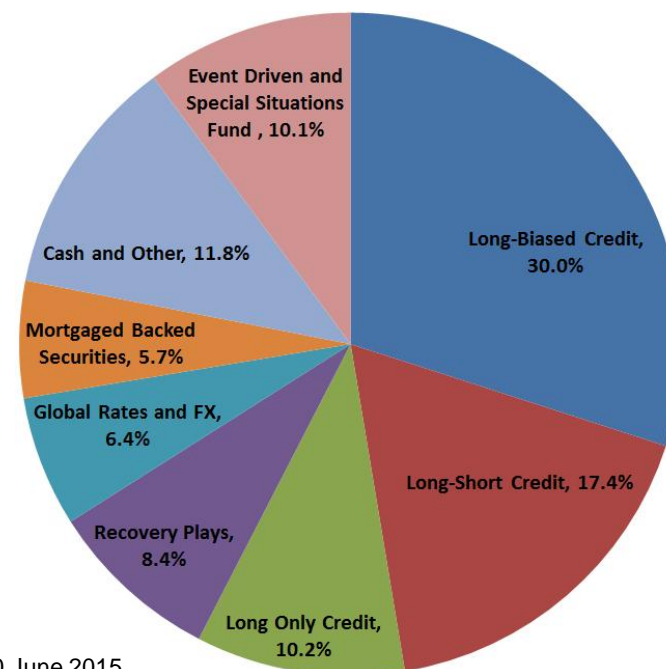
- Niche fixed income strategy focus
- Established team with strong track record
- Complemented other funds in the portfolio

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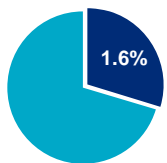
Performance to 30 June 2015



Allocation



As at 30 June 2015



GOTTEX – FUND OF HEDGE FUNDS

£58.4M END VALUE (£59.5M START VALUE)

Item Monitored Outcome

Mercer Rating	● R (no change over period under review)
Performance Objective Cash +3% p.a.	● Underperformed benchmark by 0.5% p.a. over three years

Item

Number of funds	Not Available
-----------------	---------------

Top 5 most significant contributing strategies

Gross Contribution to Performance over Q2 2015 (%)

Fundamental MN Equity	+0.43
Distressed Securities	+0.36
Asset-Backed Securities	+0.23
Long/Short Equity	+0.20
Long/Short Credit	+0.19

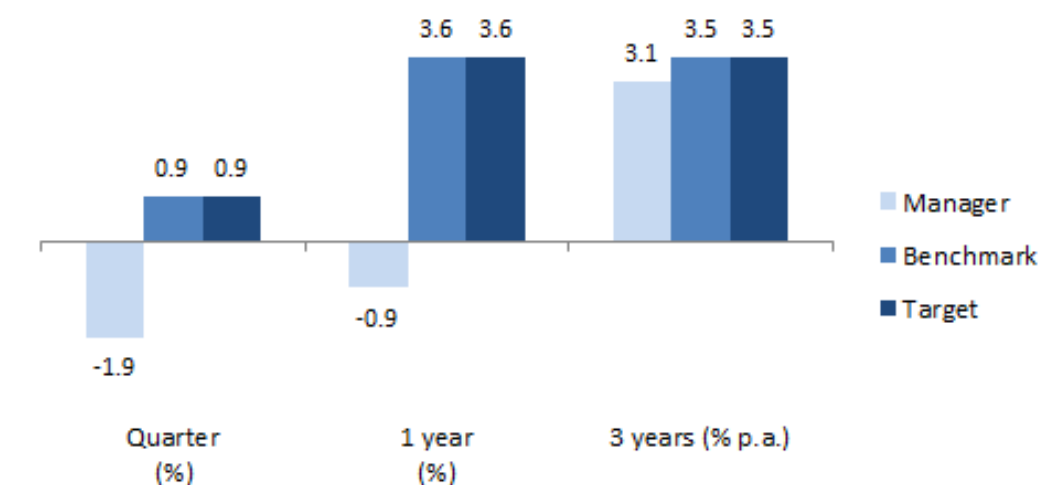
Reason for investment

To reduce volatility of the Growth portfolio and increase diversification

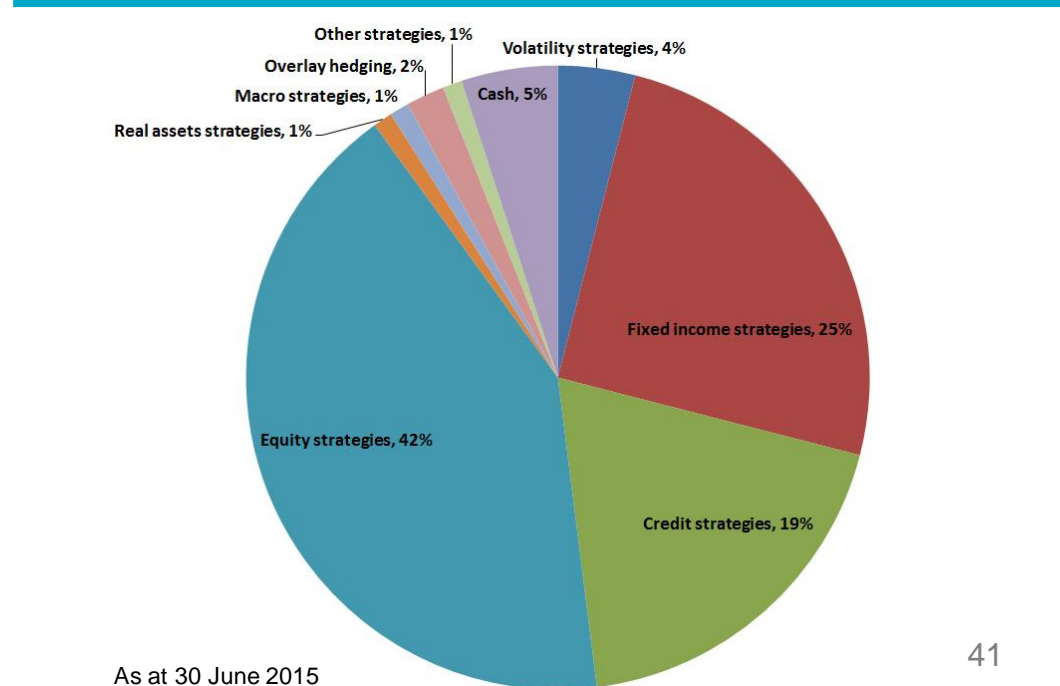
Reason for manager

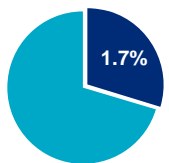
- Niche market neutral investment strategy
- Established team with strong track record
- Complemented other funds in the portfolio

Performance to 30 September 2015



Allocation





JP MORGAN – FUND OF HEDGE FUNDS

£59.4M END VALUE (£0.0M START VALUE)

Item Monitored Outcome

Mercer Rating	● B+ (no change over period under review)
Performance Objective Cash +3% p.a.	● Underperformed benchmark by 1.7% p.a. over August 2015

Item

Number of funds	23
-----------------	----

Strategy Contribution to Performance over August 2015 (%)

Relative Value	0.00
Opportunistic/Macro	-0.15
Long/Short Equities	-0.77
Merger Arbitrage/Event Driven	-0.46
Cash/Fees/Other	-0.07
Total	-1.45

Inception date: 1 August 2015.

Reason for investment

To reduce volatility of the Growth portfolio and increase diversification

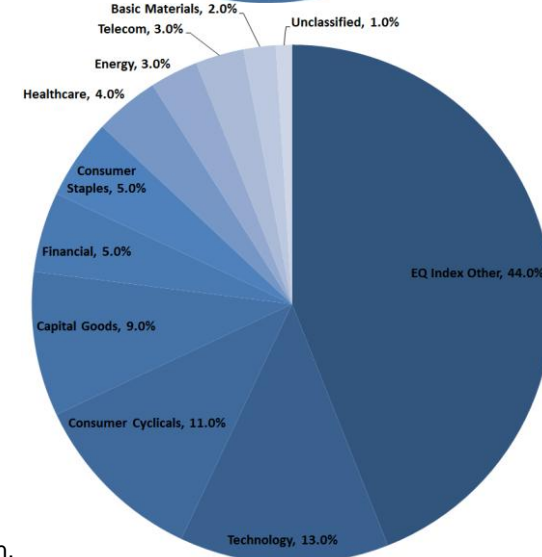
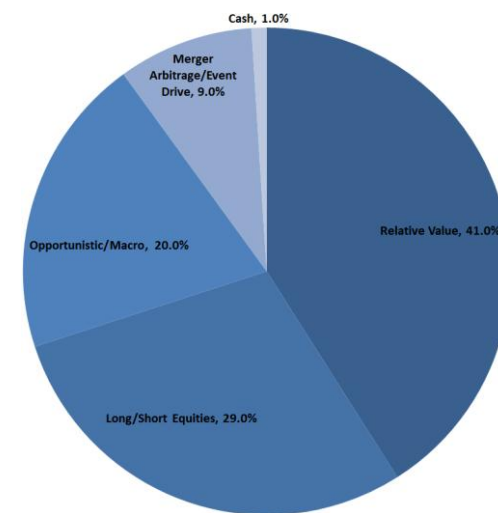
Reason for manager

- Niche market neutral investment strategy
- Established team with strong track record
- Complemented other funds in the portfolio

Performance to 31 August 2015 (in USD)

Since Inception (1 August 2015)	-1.45%
Benchmark	0.27%

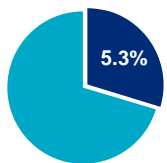
Allocation



FUND OF HEDGE FUND MANDATES

After the termination of the Stenham mandate, the Fund is in the process of divesting from Signet and Gottex, with the allocation to be managed by JP Morgan in a bespoke fund of funds vehicle.

Manager	30 September 2015 holding	Comments
Signet	£38.9m	Signet saw significant underperformance over the year to 30 June 2015, which led to a negative overall contribution to relative performance. This largely stemmed from the underperformance of their illiquid holdings in the Event Driven & Special Situations Fund (with the main holdings in the Global Fixed Income strategy returning -1.8% in US dollar terms over the twelve month period to 30 June 2015).
Gottex	£58.4m	Gottex's market neutral approach underperformed over the year (with poor returns in Q4 2014 and Q3 2015 in particular, and relatively weak returns in Q2 2015).
JP Morgan	£121.8m	<p>With the first investment being made at the beginning of August 2015, the JP Morgan fund underperformed its benchmark over that month (too short a time scale for reasonable analysis) . The long/short equities strategy that detracted the most from performance over the month.</p> <p>At the end of August the asset allocation was broadly in line with the target allocation of:</p> <ul style="list-style-type: none"> • 15-50% long/short equities • 15-50% relative value • 15-50% opportunistic/macro • 0-40% event driven



SCHRODER – UK PROPERTY FUND OF FUNDS

£189.4M END VALUE (£183.8M START VALUE)

Item Monitored

Outcome

Mercer Rating



B (no change over quarter)

Performance Objective
Benchmark +1% p.a.



Outperformed benchmark by 1.2% p.a. over three years

Manager Research and Developments

- The fund slightly outperformed the benchmark over the quarter by 0.1%.
- Over the three year period, the fund has outperformed its target by 0.3% p.a.
- Attribution analysis as of Q3 2015 is not available at the time of writing.
- Over the quarter, the fund purchased c. £0.4m of units in the Multi-Let Industrial Property Unit Trust.
- Over the last few months, Schroder announced the departure of three Real Estate Portfolio Managers: Jennifer Murray, Tony Doherty and Keeran Kang. Head of Real Estate, Graeme Rutter will inevitably take a more hands-on role on the majority of portfolios. Neil Turner will step back into the role of managing client portfolios and a new senior PM will be recruited. We continue to believe that Rutter is a suitable leader for the business but there will be short-term pressures on him. Our researchers have therefore recommended that this strategy is placed on Watch. This is to be confirmed by our UK Ratings Ratification Committee.

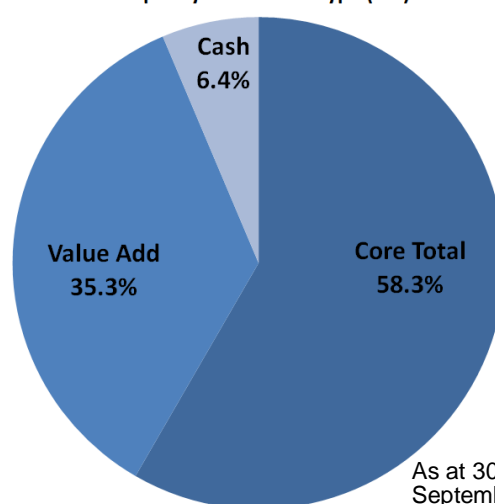
Manager and Investment type splits

Top 5 Holdings

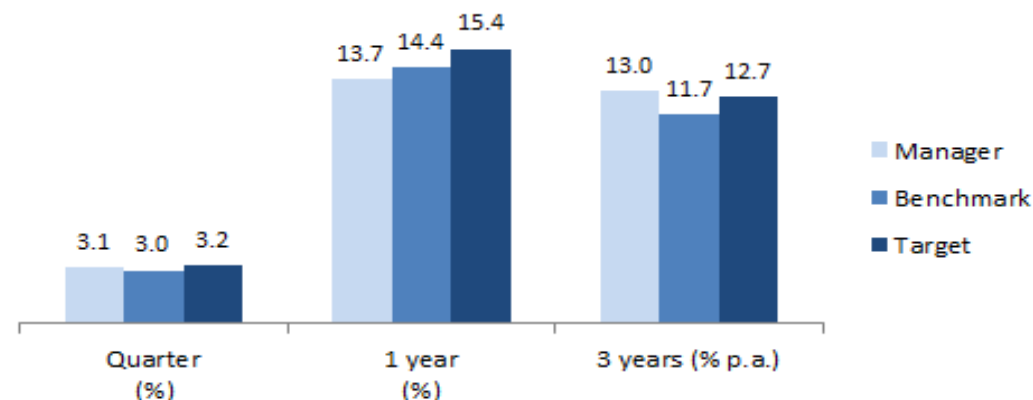
Proportion of Total Fund (%)

BlackRock UK Property Fund	12.9
L&G Managed Property Fund	12.9
Industrial Property Investment Fund	9.8
Standard Life Pooled Pension Property Fund	9.8
Schroder Real Estate Fund	8.6

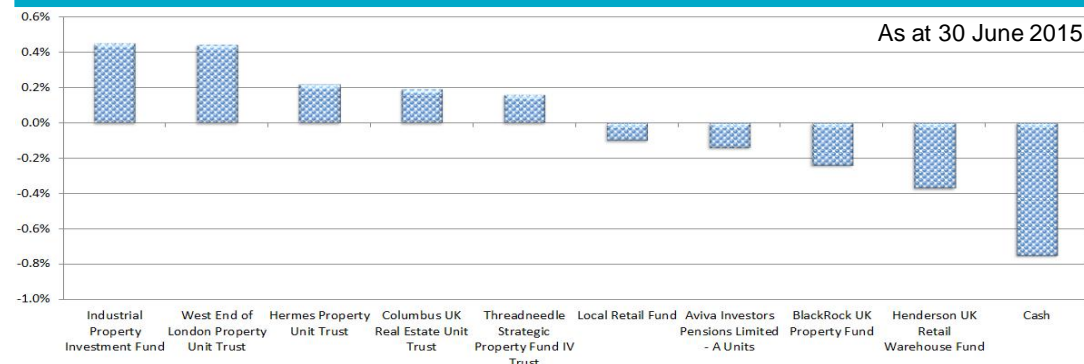
Split by Investment Type (£m)



Performance



Top 5 Contributing and Detracting Funds over 12 Months

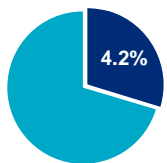


Reason for investment

To reduce volatility of the Growth portfolio and increase diversification

Reason for manager

- Demonstrable track record of delivering consistent above average performance
- Team though small is exclusively dedicated to UK multi-manager property management but can draw on extensive resources of Schroder's direct property team
- Well structured and research orientated investment process



PARTNERS – OVERSEAS PROPERTY

£150.5M END VALUE (£140.4M START VALUE)

30 September asset value estimated based on 30 June valuation and cash movements over the quarter.

Item Monitored Outcome

Mercer Rating ● B+ (no change over period under review)

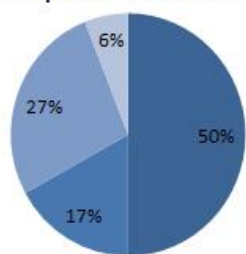
Performance Objective ● Underperformed benchmark by 3.2% p.a. over three years to 30 June 2015
Benchmark +2% p.a.

Manager Research and Developments

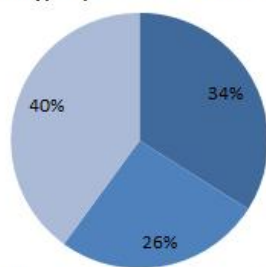
- Over Q2 2015, the fund underperformed the benchmark by 1.8%, and 3.2% p.a. over the three year period.
- Partners' drawdowns are made gradually over time, and the Fund is not yet fully invested. As a result of the volatile timing of cash flows for such investments, for example the initial costs of purchasing and developing properties, focus should be on longer term performance. Their IRR from inception to 30 June 2015 at 9.5% p.a. is slightly below their target of 10% p.a. but broadly consistent.**
- Over Q2, the allocation to Europe increased (from 45% to 50%) while Asia Pacific and North America both fell slightly (from 28% to 27%, and 20% to 17% respectively. These remain within the guidelines.
- Exposure to Secondary opportunities fell during the first quarter (from 42% to 40%), with Direct increasing by 3% and Primary by 1%. Primary exposure continues to be below the guidelines. Short-term deviation from the guidelines are expected whilst the amount drawn-down is below target.
- Note that Partners are rated B+ for global real estate, but A for secondary global real estate (as a result of their private equity skill set).

Geographical and Investment type splits as at 30 June 2015

Geographical Split Based on Net Asset Value



Investment Type Split Based on Net Asset Value



■ Europe (10% - 50%) ■ North America (10% - 50%) ■ Direct (0% - 30%) ■ Primary (40% - 100%)
■ Asia Pacific (10% - 50%) ■ Rest of World (0% - 20%) ■ Secondary (0% - 50%)

As at 30 June 2015

Portfolio update as at 30 June 2015

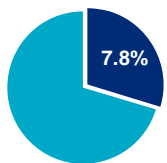
Partners Fund	Total Drawn Down (£m)	Total Distributions (£m)	Net Asset Value (30 June 2015) (£m)	Since Inception Net IRR
Global Real Estate 2008	31.66	15.29	22.62	8.5
Real Estate Secondary 2009	19.01	4.38	19.53	13.9
Asia Pacific and Emerging Market Real Estate 2009	15.76	5.39	13.99	6.5
Distressed US Real Estate 2009	14.75	12.35	8.57	9.9
Global Real Estate 2011	24.70	4.80	23.42	12.2
Direct Real Estate 2011	10.79	1.85	12.08	9.6
Real Estate Secondary 2013	3.90	0.00	4.56	21.9
Global Real Estate 2013	29.27	0.00	26.86	3.8
Real Estate Income 2014	7.85	0.00	7.09	1.7
Total	157.69	44.06	138.71	9.5

Reason for investment

To reduce volatility of the Growth portfolio and increase diversification

Reason for manager

- Depth of experience in global property investment and the resources they committed globally to the asset class
- The preferred structure for the portfolio was via a bespoke fund of funds (or private account) so the investment could be more tailored to the Fund's requirements



ROYAL LONDON ASSET MANAGEMENT – FIXED INTEREST (POOLED)

£281.0M END VALUE (£298.7M START VALUE)

Item Monitored Outcome

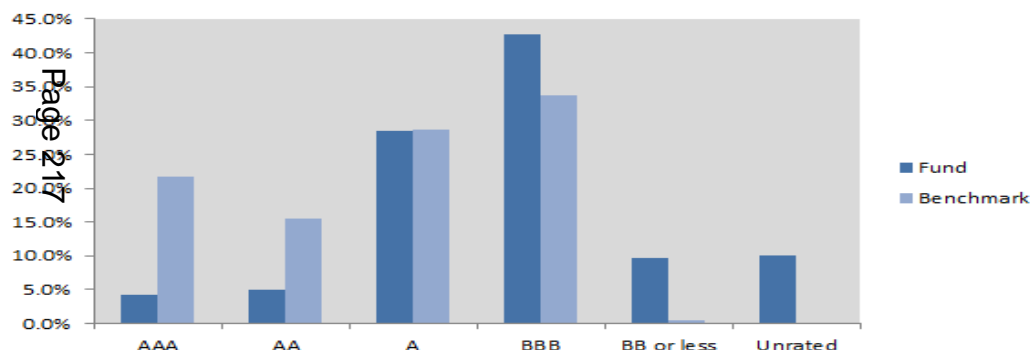
Mercer Rating ● A (no change over period under review)

Performance Objective ● Outperformed benchmark by 1.9% p.a. over three years
Benchmark +0.8% p.a.

Manager Research and Developments

- Royal London remain underweight AAA-A bonds, and overweight BBB-unrated, a strategy which has performed strongly over the three year period.

Credit Rating Allocation



Weighted Duration

	Start of Quarter	End of Quarter
Fund	7.5	7.5
Benchmark	7.8	7.7

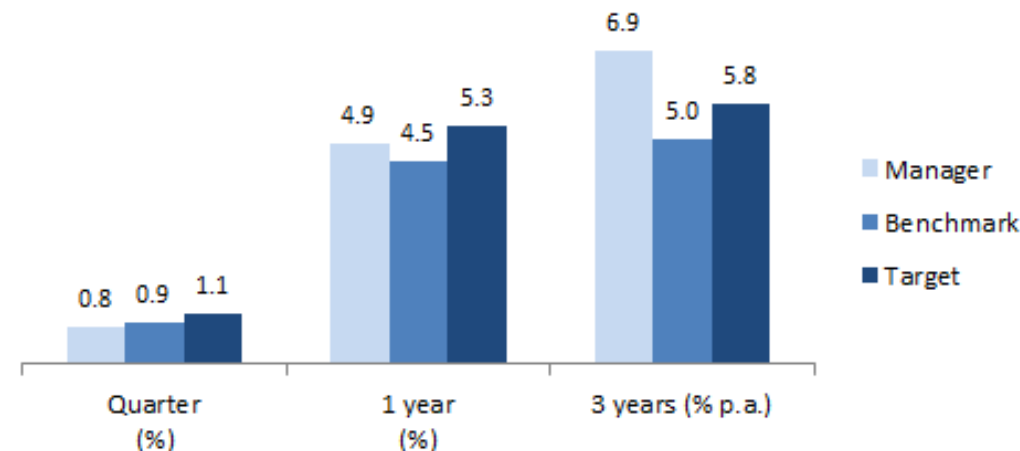
Reason for investment

To maintain stability in the Fund as part of a diversified fixed income portfolio

Reason for manager

- Focussed research strategy to generate added value
- Focus on unrated bonds provided a “niche” where price inefficiencies are more prevalent. Product size means can be flexible within market

Performance



Risk and Return relative to benchmark

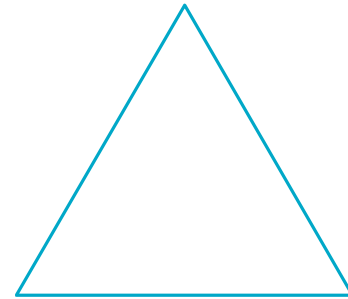
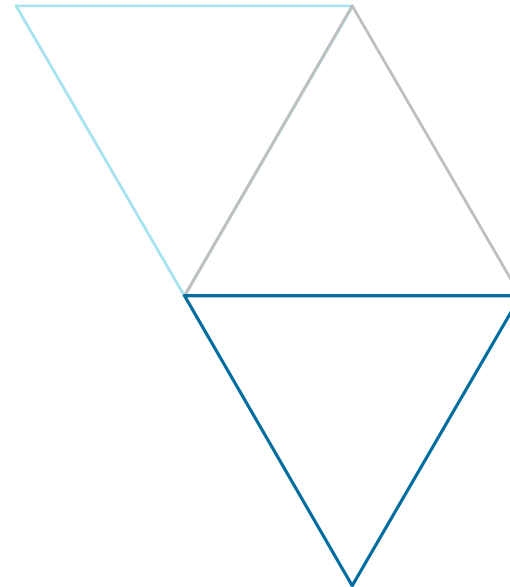
Performance characteristics vs. Markit iBoxx Non Gilts Overall in GBP over 3 yrs ending September-15
Comparison with the UK Fixed Income (Govt & Non-Govt) universe (Actual Ranking) (quarterly calculations)



APPENDIX 1

SUMMARY OF MANDATES

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SUMMARY OF MANDATES

Manager	Mandate	Benchmark	Outperformance target (p.a.)
Jupiter Asset Management	UK Equities (Socially Responsible Investing)	FTSE All Share	+2%
TT International	UK Equities (Unconstrained)	FTSE All Share	+3-4%
Schroder	Global Equities (Unconstrained)	MSCI AC World Index Free	+4%
Genesis	Emerging Market Equities	MSCI EM IMI TR	-
Unigestion	Emerging Market Equities	MSCI EM NET TR	+2-4%
Invesco	Global ex-UK Equities (Enhanced Indexation)	MSCI World ex UK NDR	+0.5%
SSgA	Europe ex-UK Equities (Enhanced Indexation)	FTSE AW Europe ex UK	+0.5%
SSgA	Pacific inc. Japan Equities (Enhanced Indexation)	FTSE AW Dev Asia Pacific	+0.5%
Record	Active Currency Hedging	N/A	-
Pyrford	Diversified Growth Fund	RPI +5% p.a.	-
Standard Life	Diversified Growth Fund	3 Month LIBOR +5% p.a.	-
Signet	Fund of Hedge Funds	3 Month LIBOR +3% p.a.	-
Gottex	Fund of Hedge Funds	3 Month LIBOR +3% p.a.	-
JP Morgan	Fund of Hedge Funds	3 Month LIBOR +3% p.a.	-
Schroder	UK Property	IPD UK Pooled	+1%
Partners	Overseas Property	IPD Global Pooled	+2%
Royal London Asset Management	UK Corporate Bonds	iBoxx £ Non-Gilts All Maturities	+0.8%
BlackRock	Passive Multi-Asset	In line with customised benchmarks using monthly mean fund weights	-
Cash	Internally Managed	7 Day LIBID	-

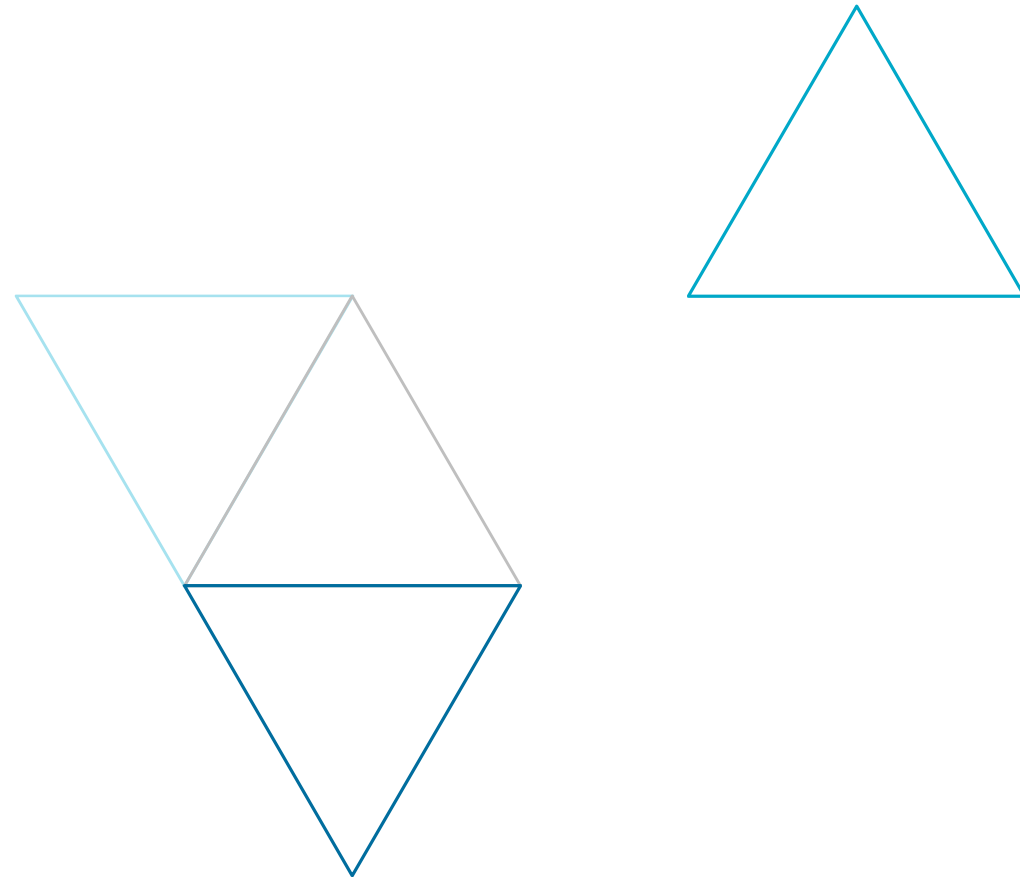
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APPENDIX 2

MARKET STATISTICS

INDICES

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MARKET STATISTICS INDICES

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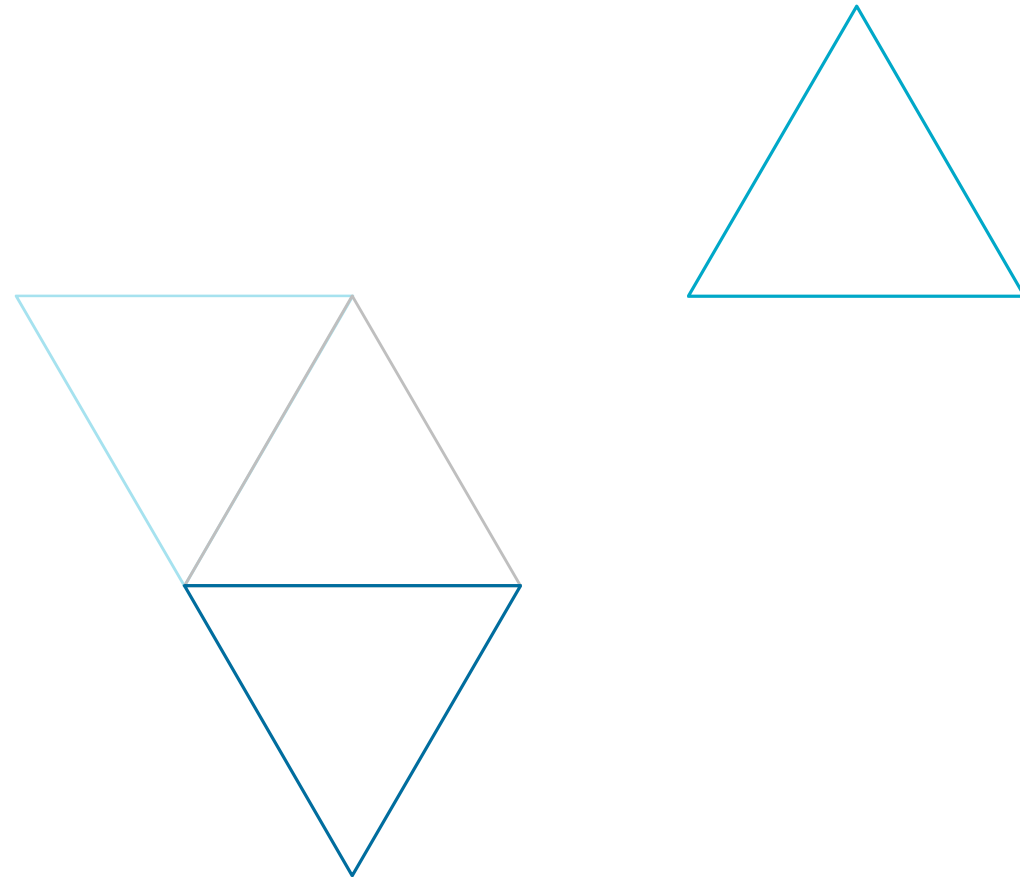
Asset Class	Index
UK Equities	FTSE All-Share
Global Equity	FTSE All-World
Overseas Equities	FTSE World ex UK
US Equities	FTSE USA
Europe (ex-UK) Equities	FTSE W Europe ex UK
Japanese Equities	FTSE Japan
Asia Pacific (ex-Japan) Equities	FTSE W Asia Pacific ex Japan
Emerging Markets Equities	FTSE AW Emerging
Global Small Cap Equities	FTSE World Small Cap
Hedge Funds	HFRX Global Hedge Fund
High Yield Bonds	BofA Merrill Lynch Global High Yield
Emerging Market Debt	JP Morgan GBI EM Diversified Composite
Property	IPD UK Monthly Total Return: All Property
Commodities	S&P GSCI
Over 15 Year Gilts	FTA UK Gilts 15+ year
Sterling Non Gilts	BofA Merrill Lynch Sterling Non Gilts All Stocks
Over 5 Year Index-Linked Gilts	FTA UK Index Linked Gilts 5+ year
Global Bonds	BofA Merrill Lynch Global Broad Market
Global Credit	Barclays Capital Global Credit
Eurozone Government Bonds	BofA Merrill Lynch EMU Direct Government
Cash	BofA Merrill Lynch United Kingdom Sterling LIBOR 3 month constant maturity

These are the indices used in this report for market commentary; individual strategy returns are shown against their specific benchmarks.

APPENDIX 3

CHANGES IN YIELDS

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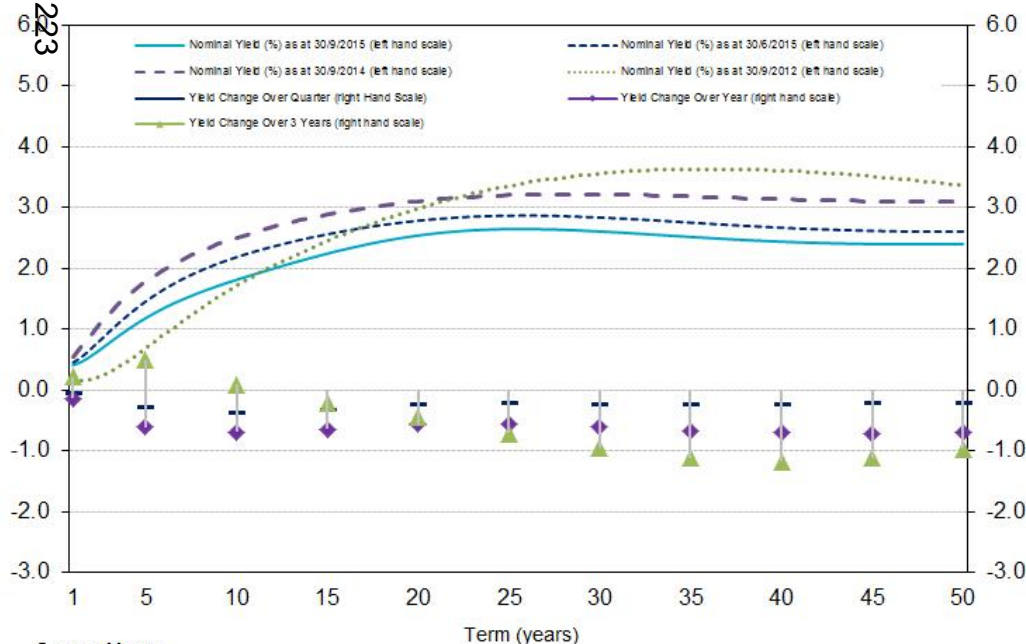


CHANGES IN YIELDS

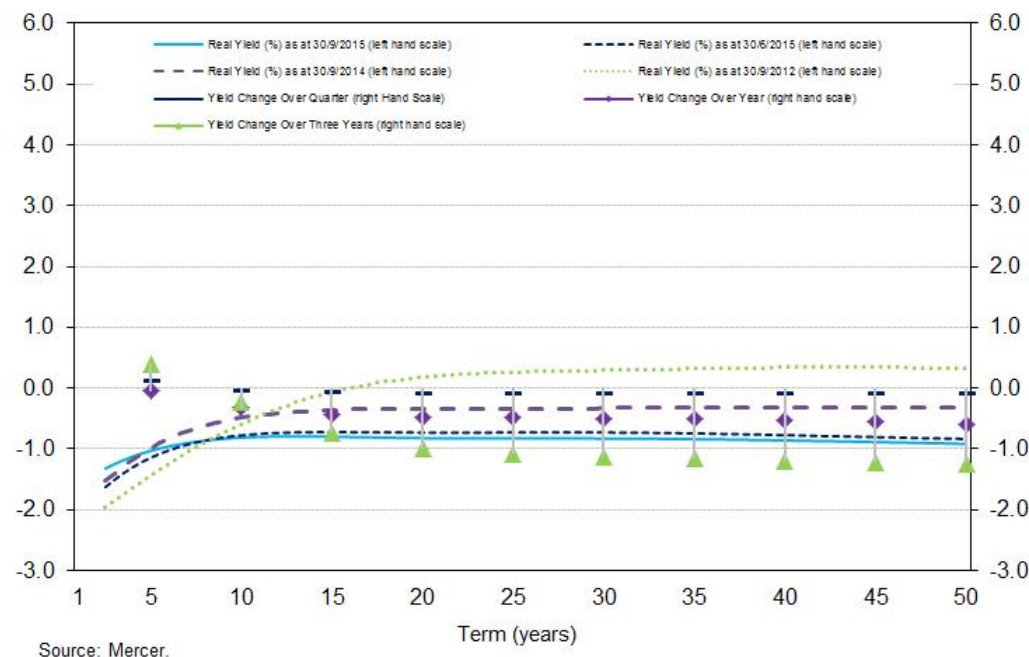
Asset Class Yields (% p.a.)	30 September 2015	30 June 2015	30 September 2014	30 September 2013
UK Equities	3.71	3.46	3.34	3.41
Over 15 Year Gilts	2.38	2.63	2.98	3.41
Over 5 Year Index-Linked Gilts	-0.83	-0.75	-0.35	-0.02
Sterling Non Gilts	3.16	3.15	3.39	3.64

- After a sharp rise during the second quarter of the year, bond yields fell across all maturities over the quarter, resulting in positive returns for investors.
- Nominal gilt yields decreased across all maturities during the third quarter, resulting in a return of 5.1% for Over 15 Year Gilts Index.
- The real yield curve also moved down, although by less than nominal yields, resulting in a degree of normalization of previously depressed breakeven inflation rates. Index-linked gilts posted a quarterly gain of 2.3%, as measured by the Over 5 year Index-Linked Gilts index.
- The total returns from global credit rose by 3.0% in the third quarter in Sterling terms, with a moderate loss of 0.8% in local currency terms, with a moderate loss of 0.8% in local currency terms. Credit spreads widened slightly in the UK, but yields still fell overall, resulting in a 1.0% total return on All Stocks UK corporate bonds.

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Nominal yield curves.



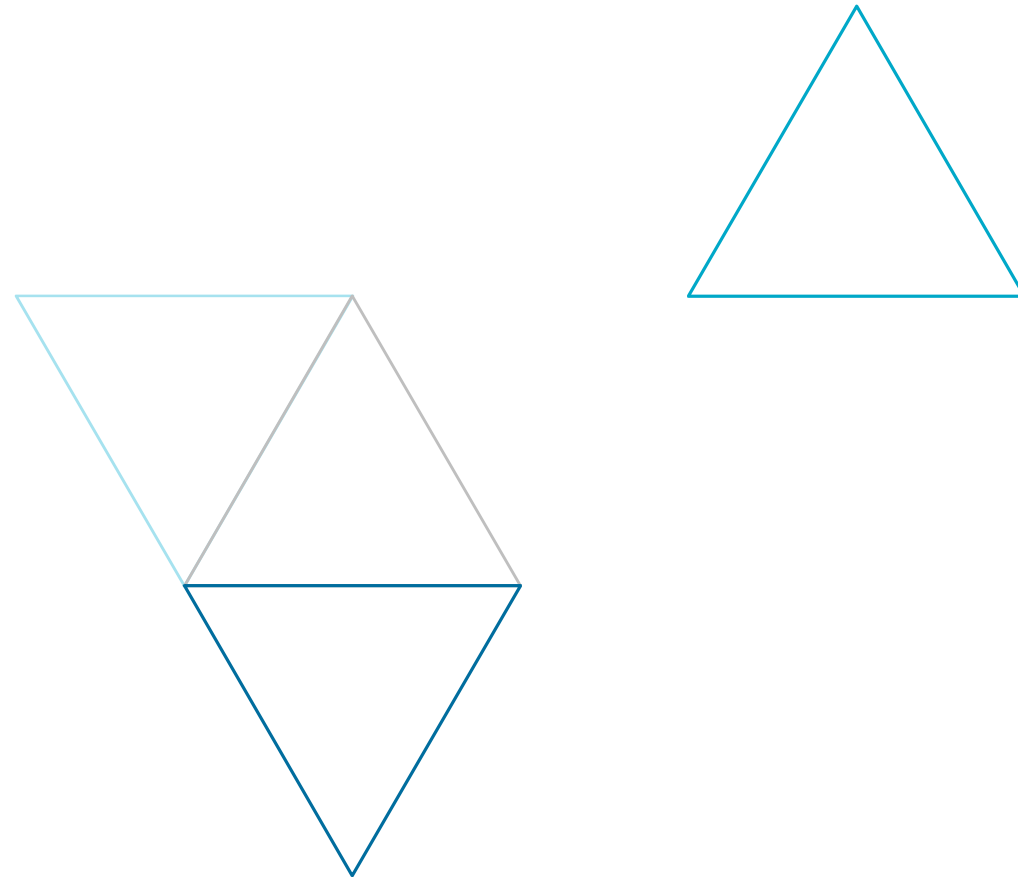
Real yield curves.



APPENDIX 4

GUIDE TO MERCER RATINGS

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GUIDE TO MERCER RATINGS

INTRODUCTION

This is a guide to the investment strategy research ratings (herein referred to as rating[s]) produced by Mercer's Investments business (herein referred to as Mercer). It describes what the ratings are intended to mean and how they should and should not be interpreted.

If you have any questions or would like more information about specific topics after reading this guide, please contact your Mercer consultant or click "Contact us" on our website www.mercer.com.

WHAT DO MERCER'S RATINGS SIGNIFY?

Mercer's ratings signify Mercer's opinion of an investment strategy's prospects for outperforming a suitable benchmark over a time frame appropriate for that particular strategy (herein referred to as outperformance). The rating is recorded in the strategy's entry on Mercer's Global Investment Manager Database (GIMD™) at www.mercergimd.com.

Mercer's ratings are normally assigned to investment strategies rather than to specific funds or vehicles. In this context, the term "strategy" refers to the process that leads to the construction of a portfolio of investments, regardless of whether the strategy is offered in separate account format or through one or more investment vehicles. There are exceptions to this practice. These are primarily in real estate and private markets where the rating is normally applied to specific funds.

WHAT DO MERCER'S RATINGS NOT SIGNIFY?

This section contains important exclusions and warnings; please read it carefully.

Past Performance

The rating assigned to a strategy may or may not be consistent with its past performance. While the rating reflects Mercer's expectations on future performance relative to a suitable benchmark over a time frame appropriate for the particular strategy, Mercer does not guarantee that these expectations will be fulfilled.

Creditworthiness

Unlike those of credit rating agencies, Mercer's ratings are not intended to imply any opinions about the creditworthiness of the manager providing the strategy.

Vehicle-Specific Considerations

As Mercer's ratings are normally assigned to strategies rather than to specific investment vehicles, potential investors in specific investment vehicles should consider not only the Mercer ratings for the strategies being offered through those investment vehicles but also any investment vehicle-specific considerations. These may include, for example, frequency of dealing dates and any legal, tax, or regulatory issues relating to the type of investment vehicle and where it is domiciled. Mercer's ratings do not constitute individualized investment advice.

Management Fees

To determine ratings, Mercer does not generally take investment management fees into account. The rationale for this is that, due to differing account sizes, differing inception dates, or other factors, the fees charged for a specific strategy will vary among clients. Potential investors in a specific strategy should therefore consider not only the Mercer rating for that strategy but also the competitiveness of the fee schedule that they have been quoted. The area of Alternative Investments is an exception — Mercer follows market practice for "Alternatives" and rates strategies on a net of fees basis.

GUIDE TO MERCER RATINGS

Operational Assessment

Mercer's research process and ratings do not include an evaluation of a manager's custodian, prime brokerage, or other vendor relationships, or an assessment of the manager's back office operations, including any compliance, legal, accounting, or tax analyses of the manager or the manager's investment vehicles. Research is generally limited to the overall investment decision-making process used by managers. In forming a rating, Mercer's investment researchers do not generally perform corporate-level operational infrastructure due diligence on a manager and do not perform financial or criminal background checks on investment management staff. Unless Mercer's investment researchers are aware of material information to the contrary (such as a view expressed by a manager's auditors or Mercer Sentinel®; see section 9), they assume that the manager's operational infrastructure is reasonable. Operational weaknesses that Mercer's investment researchers discover during their analysis of the four factors outlined in section 4 will be noted and, where appropriate, taken into account in determining ratings.

FACTORS CONSIDERED IN FORMING A RATING

In order to determine the rating for a particular strategy, Mercer's investment researchers review the strategy on the basis of four specific factors — idea generation, portfolio construction, implementation, and business management — each of which is assigned one of four scores: negative (-), neutral (=), positive (+), or very positive (++).

Mercer believes that idea generation, portfolio construction, and implementation are the main components of every investment process. These factors are defined as:

Idea generation encompasses everything that the investment manager (herein referred to as manager) does to determine the relative attractiveness of different investments.

Portfolio construction refers to the manner in which the manager translates investment ideas into decisions on which investments to include in a portfolio and what weightings to give to each of these investments.

Implementation refers to the capabilities surrounding activities that are required to achieve the desired portfolio structure.

Mercer believes that managers that do these activities well should have above-average prospects of outperformance. However, Mercer also believes that to remain competitive over longer periods, managers must be able to maintain and enhance their capabilities in these three areas. To do this, managers need to have significantly strong business management, which is the fourth factor Mercer assesses.

Business management refers to the overall stability of the firm, firm resources, and overall operations.

The four factors above apply to most product categories that Mercer researches. Variations on these factors are used in some product categories. Examples here include passive strategies, liability driven investment and private markets.

A strategy's overall rating is not determined as a weighted average of the four factor scores, and no prescribed calculations are made to arrive at the four-factor score or the overall rating. Instead, for each strategy, Mercer's investment researchers identify which factors Mercer believes are most relevant to a manager's investment process and place weight on the factors accordingly. Example considerations include:

- Mercer's confidence in the manager's ability to generate value-adding ideas.
- Mercer's view on any specified outperformance target.
- The opportunities available in the relevant market(s) to achieve outperformance.
- An assessment of the risks taken to try to achieve outperformance.
- An assessment of the strategy relative to peer strategies.
- An assessment of the manager's business management and its impact on particular strategies.

GUIDE TO MERCER RATINGS

MERCER RATING SCALE

Ratings	Rationale
A	Strategies assessed as having “above average” prospects of outperformance
B+	Strategies assessed as having “above average” prospects of outperformance, but which are qualified by at least one of the following: <ul style="list-style-type: none">There are other strategies that Mercer believes are more likely to achieve outperformanceMercer requires more evidence to support its assessment
B	Strategies assessed as having “average” prospects of outperformance
C	Strategies assessed as having “below average” prospects of outperformance
N/no rating	Strategies not currently rated by Mercer
R	The R rating is applied in three situations: <ul style="list-style-type: none">Where Mercer has carried out some research, but has not completed its full investment strategy research processIn product categories where Mercer does not maintain formal ratings but where there are other strategies in which we have a higher degree of confidenceMercer has in the past carried out its full investment-strategy research process on the strategy, but we are no longer maintaining full research coverage

The above definitions apply to the majority of product categories researched by Mercer. However for some product categories the rating scale reflects Mercer’s degree of confidence in a manager’s ability to achieve a strategy’s stated aims. Examples of where this applies include low volatility equities, cash, passive, liability driven strategies and DC specific solutions.

GUIDE TO MERCER RATINGS

SUPPLEMENTAL INDICATORS

Provisional (P)

If the Mercer strategy rating is followed by a (P) - for example, A (P) or B+ (P) - the rating is “provisional” - that is, there is temporary uncertainty about the rating, but it is expected that this will soon be resolved. For example, should two managers announce a merger, but without further details, this uncertainty may be highlighted by modifying the rating strategies for one or both of those firms - for instance, from A to A (P). (P) indicators are intended to be temporary and should normally last for no more than two weeks. As soon as the temporary uncertainty has been resolved, or if it becomes apparent that this uncertainty is unlikely to be resolved quickly, the (P) indicator will be removed and the rating confirmed or changed, or the strategy will be assigned the indicator “watch” (W).

Watch (W)

If the Mercer strategy rating is followed by a (W) – for example, A (W) or B+ (W) - the rating is “watch” - there is some uncertainty about the rating and resolution is not expected soon, but Mercer believes there is a low probability that the resolution of this uncertainty will lead to a change in the strategy's rating. (W) indicators are typically issued when there is an expectation of long-term uncertainty surrounding the rating - for example, a change, or potential change, in a manager's ownership.

Specifically Assigning (P) and (W) Supplemental Indicators

(P) and (W) indicators are assigned - and removed - by the regular ratings review process described earlier; however, there are circumstances where organizational or reputational issues that affect a manager warrant the specific assignment of a (P) or (W) indicator to an existing rating. In such circumstances, the decision to apply - or remove - a (P) or (W) indicator is taken by two senior members of the leadership group of the Manager Research team. These occasions are rare, and the relevant investment researchers will contribute to any discussions before a (P) or (W) indicator is assigned or removed.

High Tracking Error (T)

If the Mercer strategy rating is followed by a (T) — for example, A (T) or B+ (T) — the strategy is considered to have the potential to generate a tracking error substantially higher than the average for the relevant product category. In this context, “tracking error” refers to the variability of performance relative to the nominated benchmark for the strategy. A strategy may be assigned the (T) indicator because the potential for high tracking error has been demonstrated by the strategy's past performance and/or because the nature of the investment process is such that a significantly higher than average tracking error could be expected. The absence of a (T) following a rating does not guarantee that the strategy's tracking error will not be higher than the average for the relevant product category.

NICHE STRATEGIES

Mercer categorize a limited number of strategies as Niche. The Niche categorization is applied to strategies that are perceived as highly differentiated. Mercer does not have specific rules as to what characterizes a Niche strategy but examples might include strategies where a manager is seeking to exploit anomalies not generally recognized by other market participants. It might also be applied to strategies with a short track record and/or limited assets under management.

GUIDE TO MERCER RATINGS

RESEARCH INDICATIONS – INDICATIVE VIEW

For strategies where Mercer has conducted some initial research, we may apply Mercer Research Indications. Mercer's Research Indications are an indication of whether a strategy merits deeper / further due diligence. This indication is shown by an assigned indicative view, identified as a color. A Research Indication does not necessarily result in future research. All Research Indications are assigned as R rating.

- Red – further research has “below average” prospects of resulting in an investable rating.
- Amber – further research has “average” prospects of resulting in an investable rating.
- Green – further research has “above average” prospects of resulting in an investable rating.

An investable rating is defined as an A or B+.

OPERATIONAL RISK ASSESSMENTS

Mercer Sentinel, a division within Mercer, undertakes operational risk assessments (ORAs) on managers, most often on behalf of clients. These ORAs assess managers' operations and implementation risk profiles and cover some of the areas mentioned in section 3, as well as other areas related to operational risk. ORAs are undertaken separately from the Manager Research process; however, the results are shared with the Lead Researcher for the manager. A Mercer Sentinel ORA that concludes with an unsatisfactory rating (namely, a “Review” rating) for a manager will result in an immediate (P) rating for all that manager's relevant rated strategies. Discussions will follow and any subsequent change in investment rating will be ratified by the standard Manager Research process. Contact your Mercer consultant for more information.

ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE RATINGS

Mercer also assigns ratings to strategies that represent Mercer's view on the extent to which environmental, social and corporate governance (ESG) and active ownership practices (voting and engagement) are integrated into the manager's investment process and decision-making across asset classes. ESG factors are incorporated into the investment process on the basis that these issues can impact revenue, operating costs, competitive advantage, and the cost of capital. During discussions with managers about ESG integration, Mercer assesses the use of ESG information to generate outperformance.

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ESG Rating Scale	
ESG1	The highest ESG rating is assigned to strategies that Mercer believes to be leaders in integrating ESG and active ownership into their core processes, and that provide clear evidence that ESG overall, or a particular ESG theme, is core to idea generation and portfolio construction.
ESG2	The second highest rating is assigned to strategies that, in Mercer's view, include ESG factors as part of decision making, with a strong level of commitment made at a firmwide level and some indication that data and research are being taken into account by the managers in their valuations and investment process.
ESG3	The penultimate rating is assigned to strategies for which, in Mercer's view, the manager has made some progress with respect to ESG integration and/or active ownership, but for which there is little evidence that ESG factors are taken into consideration in valuations and investment process.
ESG4	The lowest ESG rating is assigned to strategies for which, in Mercer's view, little has been done to integrate ESG and active ownership into their core process.

For passive strategies, Mercer applies an ESGp1 through to ESGp4. There are two key distinctions between ESG ratings for passive and active strategies. First, for passive, the bulk of the focus is on voting and engagement practices. Second, most of Mercer's analysis focuses on firm-wide levels of commitment rather than at the individual strategy level.

RATINGS REVIEW COMMITTEES

Mercer has a process for reviewing and ratifying the ratings proposed by individual investment researchers. For most product categories, strategy ratings are reviewed regularly by one of several RRCs that operate within Mercer. These committees are composed of professionals from Mercer's investment research and consulting groups who draw on research carried out by Mercer investment researchers and consultants. The role of the RRCs is to review this research from a quality control perspective and ensure consistency of treatment across strategies within a product category.

For certain asset classes, ratings will not have been reviewed by an RRC; however, the rating will have been reviewed by at least two suitably qualified investment researchers or consultants other than the recommending researcher. An R rating will not necessarily have been reviewed by an RRC but will have been subject to Mercer's standard peer review process.

CONFIDENTIALITY OF MERCER'S RATINGS

Mercer's ratings, along with all other information relating to Mercer's opinions on managers and the investment strategies they offer, represent Mercer's confidential and proprietary intellectual property and are subject to change without notice. The information is intended for the exclusive use of the parties to whom it was provided by Mercer and may not be modified, sold, or otherwise provided, in whole or in part, to any other person or entity (including managers) without Mercer's prior written permission.

MAKE
TOMORROW,
TODAY



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Access to Information Arrangements

Exclusion of access by the public to Council meetings

Information Compliance Ref: LGA-1541/15

Meeting / Decision: AVON PENSION FUND INVESTMENT PANEL
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Date: 18 November 2015

Author: Matt Betts

Report Title: Review Of Investment Performance For Periods Ending 30 September 2015

Appendix 1 – Fund Valuation

Appendix 2 – Mercer performance monitoring report (shortened version)

Exempt Appendix 3 – RAG Monitoring Summary Report

The Report contains exempt information, according to the categories set out in the Local Government Act 1972 (amended Schedule 12A). The relevant exemption is set out below.

Stating the exemption:

<i>3. Information relating to the financial or business affairs of any particular person (including the authority holding that information).</i>
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The public interest test has been applied, and it is concluded that the public interest in maintaining the exemption outweighs the public interest in disclosure at this time. It is therefore recommended that the Report be withheld from publication on the Council website. The paragraphs below set out the relevant public interest issues in this case.

PUBLIC INTEREST TEST

If the Committee wishes to consider a matter with press and public excluded, it must be satisfied on two matters.

Firstly, it must be satisfied that the information likely to be disclosed falls within one of the accepted categories of exempt information under the Local

Government Act 1972. Paragraph 3 of the revised Schedule 12A of the 1972 Act exempts information which relates to the financial or business affairs of the organisations which is commercially sensitive to the organisations. The officer responsible for this item believes that this information falls within the exemption under paragraph 3 and this has been confirmed by the Council's Information Compliance Manager.

Secondly, it is necessary to weigh up the arguments for and against disclosure on public interest grounds. The main factor in favour of disclosure is that all possible Council information should be public and that increased openness about Council business allows the public and others affected by any decision the opportunity to participate in debates on important issues in their local area. Another factor in favour of disclosure is that the public and those affected by decisions should be entitled to see the basis on which decisions are reached.

Weighed against this is the fact that the exempt appendices contains the opinions of Council officers and Panel members. It would not be in the public interest if advisors and officers could not express in confidence opinions which are held in good faith and on the basis of the best information available.

The exempt appendices also contain details of the investment processes/strategies of the investment managers. The information to be discussed is commercially sensitive and if disclosed could prejudice the commercial interests of the investment managers.

It is also important that the Committee should be able to retain some degree of private thinking space while decisions are being made, in order to discuss openly and frankly the issues under discussion relating to the investment managers in order to make a decision which is in the best interests of the Fund's stakeholders.

The Council considers that the public interest has been served by the fact that a significant amount of information regarding the Investment Panel Activity has been made available – by way of the main report. Therefore it is recommended that exemption 3 of Schedule 12A stands, that the report be discussed in exempt session and that any reporting on the meeting is prevented in accordance with Section 100A(5A)

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

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