

Bath & North East Somerset Council

MEETING:	Avon Pension Fund Investment Panel	
MEETING DATE:	16 MARCH 2012	AGENDA ITEM NUMBER
TITLE:	Review Of Investment Performance For Periods Ending 31 Dec 2011	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – JLT performance monitoring report Exempt Appendix 3 - Summaries of Investment Panel meetings with Investment Managers		

1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Investment Panel on routine strategic areas concerning the Fund's investments.

1.2 This report contains performance statistics for periods ending 31 Dec 2011.

1.3 The main body of the report comprises the following sections:

Section 4. Investment Performance: A - Fund, B - Investment Managers.

Section 5. Investment Strategy

Section 6. Funding Level Update

Section 7. Portfolio Rebalancing and Cash Management

Section 8. Custody Contract

Section 9 Corporate Governance and Responsible Investment (RI) Update

2 RECOMMENDATION

That the Investment Panel:

2.1 Notes the information as set out in the report.

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund for the three years commencing 1 April 2010 will impact the next triennial valuation which will be calculated as at 31 March 2013. Section 6 of this report discusses the trends in the Fund's liabilities and the funding level.

4 INVESTMENT PERFORMANCE

4.1 JLT's report in Appendix 2 provides a full commentary on the performance of the fund (pages 10 to 15), the investment managers (pages 16 to 36) and a commentary on investment markets (pages 5 to 7). In the section on the Fund (page 10), three year rolling returns are included to provide a longer term perspective.

A – Fund Performance

4.2 The Fund's assets increased by £135m (+5.6%) in the quarter, giving a value for the investment Fund of £2,623m at 31 December 2011, which was marginally less in value (by £3m) than December 2010. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers.

4.3 The Fund's investment return and performance relative to benchmarks is summarised in Table 1.

Table 1: **Fund Investment Performance**

Periods to 31 Dec 2011

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	5.6%		
Avon Pension Fund (excl. currency hedging)	5.7%	-0.2%	10.0%
Strategic benchmark <i>(Fund relative to benchmark)</i>	5.4% <i>(+0.3%)</i>	-0.7% <i>(+0.5%)</i>	9.6% <i>(+0.4%)</i>
Customised benchmark <i>(Fund relative to benchmark)</i>	6.1% <i>(-0.4%)</i>	0.7% <i>(-0.9%)</i>	10.3% <i>(-0.3%)</i>
Local Authority Average Fund <i>(Fund relative to benchmark)</i>	5.2% <i>(+0.5%)</i>	-1.5% <i>(+1.3%)</i>	9.6% <i>(+0.4%)</i>

Note that because currency hedging has been in place for less than 12 months, for consistency all "*Fund relative to benchmark*" data in the above table excludes currency hedging. The impact of currency hedging is addressed at paragraph 4.8.

4.4 **Avon Pension Fund:** Quarterly return driven by positive returns from all equity markets with the exception of Japan, supported by strong returns from UK bonds and smaller returns from property and hedge funds. The marginally negative annual return was a result of negative returns across all equity markets over the

year (with the exception of North America) negating strong returns from the bond portfolio.

- 4.5 Versus Strategic Benchmark (which reflects an allocation of 60% equities, 20% bonds, 10% property, 10% hedge funds):** Annual relative outperformance driven by the Fund being overweight UK government bonds (versus the benchmark) which performed strongly over the period and as a result of the emerging markets, hedge fund and property managers outperforming their benchmarks. Over the quarter the Fund benefitted from being underweight Japanese equities and hedge funds and from the outperformance by the property managers. This is despite a small cash holding.
- 4.6 Versus Customised Benchmark (which reflects the individual benchmarks of each manager and as such, measures the relative performance of the managers as a whole):** Underperformed the benchmark over the year, with relative underperformance of the Hedge Funds and TT, more than offsetting outperformance by Jupiter, Genesis and the property managers. The other managers performed broadly in line with their benchmarks.
- 4.7 Versus Local Authority Average Fund:** Annual relative outperformance driven by Fund's lower than average allocation to equities which performed negatively over the year, and higher than average allocation to bonds which performed well and provided protection from equity losses.
- 4.8 Currency Hedging:** The implementation of the active currency hedging programme commenced in July and will be implemented fully within a twelve month timeframe. This quarter movements in currency markets were mixed with sterling strengthening against the Euro but weakening against the US dollar and Yen. Overall the hedging programme detracted 0.1% from the Fund's return in the quarter. The programme provided some protection from currency loss on Euro denominated assets (especially in December) and passed through some of the currency gains from the US dollar and Yen assets.
- 4.9** Since the beginning of 2012 global equity markets have been more positive with the FTSE All Share index rising by over 5% (to 8 February). In contrast, the total return for the Over 15-year Gilt index was c. -3% during the same period.

B – Investment Manager Performance

- 4.10A** A detailed report on the performance of each investment manager has been produced by JLT – see pages 16 to 36 of Appendix 2. Their report does not identify any new performance issues with the managers.
- 4.11** On the 22nd February, the Investment Panel will receive a presentation from TT as part of the ongoing review of TT's performance. They also received presentations from Schroder Global Equity and Partners as part of the 'meet the managers' programme. A summary of these sessions is included in Exempt Appendix 3.
- 4.12** Performance reporting for Partners is lagged by a quarter. However, the latest estimate for the quarter ending 31 December 2011 is -1.1%.

5 INVESTMENT STRATEGY

- 5.1** JLT's report did not highlight any strategy issues for consideration.

5.2 During the quarter the decision to make a tactical allocation within the bond portfolio was implemented. On 12 December the Fund switched £80m (c.3% of the total Fund assets) from UK Gilts into UK corporate bonds to provide some protection from future rises in gilt yields (which are at or near historic lows) and in so doing achieve a higher yield from corporate bonds and an opportunity for capital returns should the spread between gilts and corporate bonds narrow. Officers will monitor changes in the relative yields to identify when the spread between gilts and corporate bonds reaches the pre-determined trigger at which point the allocation will be reversed. The spread on long dated corporate bond yields over gilt yields was 1.73% when the tactical switch was implemented, and as at 29 February it is 1.46%. This narrowing of the spread was a result of a 20 basis point reduction in corporate bond yields, and an increase in gilt yields of 7 basis points over this period. The trigger point for reversal is a spread of 1.2%.

6 FUNDING LEVEL UPDATE

6.1 As at 31 Dec 2011 the Actuary has estimated that the funding level has deteriorated to 68%, at 31 March 2010 triennial valuation it was 82%. (Note: The revised funding level takes into account benefit payments and contributions received during the period. However, the actuary uses estimates for asset returns and cashflows so the update is only an indication of the trend in the funding level.)

6.2 Since the 2010 valuation, the value of the assets has increased by £257m (10%) to £2.7bn, and liabilities increased by £985m (32%) to £3.99bn. As a result the deficit has increased from £552m to £1,280m, with much of the deterioration happening in the last six months.

6.3 The driver of the significant increase in the liabilities and the deficit since June (when liabilities were estimated to be £3.3bn) is the reduction in gilt yields from 4.3% at 30 June to 3.0% at end of December. More positively, implied inflation has continued to decline which has helped offset some of the impact from the reduction in gilt yields. The announcement of further “quantitative easing” by the MPC in early February should keep nominal gilts yields at depressed levels for the immediate future. It should however be noted that this is just a snapshot of the funding level at a particular point in time.

6.4 Table 2 shows the change in financial assumptions:

Table 2: Change in Financial Assumptions

	31 March 2010	30 Sept 2011	31 Dec 2011
UK Gilt yield	4.50%	3.60%	3.00%
Real yield	0.70%	0.20%	-0.20%
Implied RPI inflation p.a.	3.80%	3.40%	3.20%
Inflation adjustment p.a.	0.80%	0.80%	0.80%
CPI Inflation p.a.	3.00%	2.60%	2.40%

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

- 7.1 The rebalancing policy requires rebalancing of the Equity/Bond allocation to occur when the equity portion deviates from 75% by +/- 2%, and the valuation metric, in this case the equity gilt yield ratio, confirms that the relative valuation between equities and bonds is favourable. The implementation of this policy is delegated to officers.
- 7.2 There was no rebalancing undertaken this quarter. As at 29 February 2012 the Equity:Bond allocation was estimated at 73:27. Given the current market volatility and uncertainty over developments in the Eurozone, officers have temporarily suspended the rebalancing policy.

Cash Management

- 7.3 Cash is not included in the strategic benchmark. However, cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The segregated portfolios, TT, Jupiter, Schroder Equity and BlackRock utilise money market funds offered by the custodian, BNY Mellon. The cash within the pooled funds is managed internally by the manager. The cash managed by BlackRock in the property portfolio is invested in the BlackRock Sterling Liquidity Fund. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.
- 7.4 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies and are invested in line with the Fund's Treasury Management Policy which was approved on 18 December 2009. The Fund adopts the Council's counterparty list and the latest list approved by the Council in February 2011.
- 7.5 Following the downgrades in the credit ratings of the UK banks in December, the Fund has invested money with the DMO (Debt Management Office) as required to prevent breaches of the current policy. Proposed changes to the Treasury Management Policy are discussed elsewhere on this agenda.

8 CUSTODY CONTRACT

- 8.1 The custody contract was re-tendered in 2011 in line with Council procurement policy. Due to the value of the contract it was tendered under EU competitive procurement rules. The custodian acts as "banker" for the Fund, settling all trades and collecting income. In addition, the custodian provides the Fund with investment accounting reports which are used in the preparation of the final accounts.
- 8.2 Mercers Sentinel, a specialist in custody advice, advised the Officers on the selection process.
- 8.3 The tender document set the evaluation criteria against which the bids were assessed and the appointment was made. The evaluation criteria took into account current best practice standards. The tender documentation also set out the Fund's legal requirements with regard to the Custody Agreement.

- 8.4 Five bids were received and due diligence meetings were held with the two custodians that scored highest under the tender's evaluation criteria. The due diligence meetings were held to clarify aspects of the custodians' responses.
- 8.5 The evaluation process took into account the criteria as set out in tender documentation. In accordance with the evaluation criteria, Officers concluded that the tender submitted by BNYM was the most economically advantageous. Following the completion of the tender process, BNY Mellon was appointed as custodian for a period of 5 years commencing 1 March 2012. The impact of the lower fee schedule that resulted from the tender process will be reflected in the 2012/13 budget.

9 CORPORATE GOVERNANCE UPDATE

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

Companies Meetings Voted: 163
Resolutions voted: 1657
Votes For: 1537 (92.7%)
Votes Against: 114 (6.8%)

- 9.2 In 2011 the Fund appointed Manifest to monitor its voting activity. Manifest will prepare an annual report for the June committee meeting which will provide more information of the Fund's voting activity as well as commentary about main themes during the year and issues arising from the Fund's own voting activity.
- 9.3 The Fund is a member of the Local Authority Pension Fund Forum (LAPFF), a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds. LAPFF's current activity includes:

9.3.1 LAPFF Study - Bank 'Post Mortem'

In December LAPFF published a report addressing the shortcomings of accounting standards that led to UK and Irish banks to overstate their solvency and directly contributed to banking losses. The Forum argues that the relatively simple misdiagnosis of the problem as one of liquidity rather than solvency resulted in the near collapse of the UK and Irish banking systems. For these reasons, LAPFF believes that the International Finance Reporting Standards (IFRS), in practice, has run contrary to the "true and fair" view in accounting, painting a false picture of the solvency of financial institutions, and that UK and Irish banks were hit the hardest because they adopted the IFRS more comprehensively than the rest of the EU.

9.3.2 Engagement activity:

- 9.3.2.1 Afren – Afren is a UK listed oil and gas development company active in Africa and the Middle East. The company is on the Forum's Global Focus List as it attempts to bring its governance practices in line with peers. The discussion with the company about remuneration, independence of non-executive directors and other governance challenges it faces, was productive and LAPFF expect a number of recommendations to be included in the company's governance reforms over the next year.

9.3.2.2 Easyjet – LAPFF met the Company to better understand how it incorporates climate change risk factors into its business model.

10 RISK MANAGEMENT

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

11 EQUALITIES

11.1 This report is primarily for information only.

12 CONSULTATION

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

13 ISSUES TO CONSIDER IN REACHING THE DECISION

13.1 The issues to consider are contained in the report.

14 ADVICE SOUGHT

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

Contact person	Liz Feinstein, Investments Manager (Tel: 01225 395306)
Background papers	LAPPF Member Bulletins, Data supplied by The WM Company
Please contact the report author if you need to access this report in an alternative format	