

# Bath & North East Somerset Council

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| MEETING:   | AVON PENSION FUND COMMITTEE                                     |                    |
| MEETING DATE:  | 22 JUNE 2012  | AGENDA ITEM NUMBER |
| TITLE:   | Review Of Investment Performance For Periods Ending 31 Mar 2012 |                    |
| WARD:  | ALL   |                    |
| <b>AN OPEN PUBLIC ITEM</b>   |   |                    |
| List of attachments to this report:<br>Appendix 1 – Fund Valuation<br>Appendix 2 – JLT performance monitoring report<br>Exempt Appendix 3 - Summaries of Investment Panel meetings with Investment Managers<br>Appendix 4 – Euro Exposure Analysis |   |                    |

## 1 THE ISSUE

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

1.2 This report contains performance statistics for periods ending 31 March 2012.

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. Corporate Governance and Responsible Investment (RI) Update

## 2 RECOMMENDATION

**That the Committee:**

**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 16), the investment managers (pages 17 to 36) and a commentary on investment markets (pages 5 to 7).

#### A – Fund Performance

4.2 The Fund's assets increased by £134m (+5.1%) in the quarter, giving a value for the investment Fund of £2,757m at 31 March 2012. 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 Mar 2012

|  | 3 months               | 12 months                     | 3 years (p.a.)          |
|--|------------------------|-------------------------------|-------------------------|
| <b>Avon Pension Fund (incl. currency hedging)</b>                          | 5.1%                   |                               |                         |
| <b>Avon Pension Fund (excl. currency hedging)</b>                          | 4.8%                   | 3.6%                          | 14.5%                   |
| <b>Strategic benchmark</b><br><i>(Fund relative to benchmark)</i>          | 5.0%<br><i>(-0.2%)</i> | 2.8%<br><b><i>(+0.8%)</i></b> | 14.2%<br><i>(+0.3%)</i> |
| <b>Customised benchmark</b><br><i>(Fund relative to benchmark)</i>         | 4.7%<br><i>(+0.1%)</i> | 4.2%<br><b><i>(-0.6%)</i></b> | 14.8%<br><i>(-0.3%)</i> |
| <b>Local Authority Average Fund</b><br><i>(Fund relative to benchmark)</i> | 5.6%<br><i>(-0.6%)</i> | 2.6%<br><b><i>(+1.0%)</i></b> | 14.5%<br><i>(=)</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, supported by smaller returns from hedge funds and property. Fixed income assets had negative returns in the quarter except for UK corporate bonds.

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 over the early period of the 12 months (versus the benchmark) which performed strongly over this period, and also as a result of the emerging markets and property managers

outperforming their benchmarks. In addition the hedge fund managers outperformed the hedge fund index used in the strategic benchmark. Over the quarter the Fund underperformed marginally due to being overweight index linked gilts which performed negatively, and because the Fund had a small cash holding. This is despite benefitting from being underweight gilts and from the outperformance by the UK equity managers.

**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 Schroder Equity, more than offsetting outperformance by Jupiter, Genesis and Invesco over the year. 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:** This quarter sterling strengthened against the euro, US dollar and yen, resulting in the returns from equity assets denominated in these currencies reducing in sterling terms. On the c£690m assets in the programme, underlying currency return had an impact of -3.17% over the quarter, with the hedging programme offsetting this by 0.83% by generating a value of c£5.5m (this is the realised value of matured contracts and the unrealised market value of outstanding contracts). Therefore the currency return on the £690m assets after hedging was -2.35%. In terms of the Fund's total return, the hedging programme contributed 0.3% to the Fund's total return in the quarter.

**4.9** Monthly movements in the value of the currency programme have been volatile in April and May. Sterling has stayed strong versus the euro; however, it has weakened against the dollar. As expected, the hedge ratio on dollar assets has fallen, but because of the sterling weakening versus the dollar, we expect negative returns from the hedging activity during this period (to date) which will be offset by the benefit from an increase in the sterling value of the underlying dollar equity assets. The full performance data at the Fund level is only calculated on a quarterly basis.

**4.10** Since the end of the quarter, global equity markets have been less positive with the FTSE All Share down 7.4% (to 28<sup>th</sup> May). In contrast, the total return for the Over 15-year Gilt index was c. +4.4% during the same period.

## **B – Investment Manager Performance**

**4.11** A detailed report on the performance of each investment manager has been produced by JLT – see pages 17 to 36 of Appendix 2. Their report does not identify any new performance issues with the managers.

**4.12** After reviewing the performance of TT, the Panel had been reassured to some degree and recommended Officers continue to closely monitor TT's performance and report back to the Panel any issues resulting in significant underperformance.

**4.13** As part of the 'Meet the Managers' programme, the Panel met with 2 of the Fund's Fund of Hedge Fund managers on 19 April 2012 and with Jupiter on 17

May 2012. The summary of the Panel's conclusions can be found in exempt appendix 3 of this report. The Panel noted their continuing concerns about the performance of Man.

## 5 INVESTMENT STRATEGY

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

5.2 During the quarter the tactical allocation within the bond portfolio has remained in place. Officers continue to 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.

5.3 The analysis of the Fund's exposure to the Euro and to European financial institutions presented at the December 2011 Committee meeting has been updated and can be found at Appendix 4. This summarises the direct exposure the Fund has to the Euro currency and European banks and insurance companies (including those not in the Euro). However, this does not include the indirect exposure of the Fund to other companies and financial institutions that have exposure to the Euro currency or European financial institutions.

## 6 FUNDING LEVEL UPDATE

6.1 As at 31 March 2012 the Actuary has estimated that the funding level has improved over the quarter from 66% to 70%; 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 £290m (11%) to £2.75bn, and liabilities increased by £937m (31%) to £3.95bn. As a result the deficit has increased from £552m to £1,190m. Over the last quarter the deficit has narrowed very slightly as gilt yields have risen slightly more than implied inflation, hence the real interest rate is less negative than it was at 31 December 2011.

6.3 The reduction in the gilt yield from 4.5% at the 2010 valuation to 3.4% at end of March 2012 is the reason why liabilities and the deficit have increased so significantly. Furthermore, implied inflation has remained high given the current low gilt yields. The threat of more "quantitative easing", given the weak economic recovery, should keep nominal gilts yields at depressed levels for the immediate future, although inflation is expected to fall from current levels which should improve the funding position. ***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 | 31 Dec 2011 | 31 March 2012 |
|---------------------------|---------------|-------------|---------------|
| UK Gilt yield (nominal)   | 4.50%         | 3.00%       | 3.40%         |
| Real yield                | 0.70%         | -0.20%      | -0.10%        |
| Market Implied RPI p.a.   | 3.80%         | 3.20%       | 3.50%         |
| Inflation adjustment p.a. | 0.80%         | 0.80%       | 0.80%         |
| CPI Inflation p.a.        | 3.00%         | 2.40%       | 2.70%         |

## **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 23 May 2012 the Equity:Bond allocation was estimated at 71.6:28.4. Given the current market volatility and uncertainty over developments in the Eurozone, officers have temporarily suspended the rebalancing policy. A review of the current rebalancing policy is the subject of another agenda item.

### **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 revised Treasury Management Policy which was approved on 16 March 2012.

7.5 The Fund continues to deposit cash on call with Barclays, NatWest and Bank of Scotland. In line with the Treasury Management Policy NatWest and Bank of Scotland continue to be used although they are currently on a negative rating watch that could result in them falling below the required counterparty credit rating. Two triple A rated money market funds are now available to the Fund and will be used to deposit cash on call should these downgrades occur. The Fund also has access to the Government's DMO (Debt Management Office) if required, however the interest paid may not cover the transfer and administration costs incurred.

## 8 CORPORATE GOVERNANCE UPDATE

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

Companies Meetings Voted: 238  
Resolutions voted: 2746  
Votes For: 2678  
Votes Against: 66  
Abstained: 33  
Withheld vote: 5

- 8.2 In 2011 the Fund appointed Manifest to monitor its voting activity. Manifest's annual report on voting activity for 2011 is the subject of another agenda item.

- 8.3 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:

**8.3.1 LAPFF Voting Alerts:** LAPFF has issued 9 voting alerts this quarter, the most high profile being the recommendation to vote against the Barclays remuneration report. All 3 of the Fund's managers who held Barclays stock were part of the 31% of shareholders who voted against or withheld their vote on the remuneration report.

**8.3.2 LAPFF Engagement activity:** LAPFF reported on engagement meetings with National Express (labour issues), Meggitt (board succession), Heineken (remuneration and reporting) and Gazprom (reporting) among others. LAPFF's quarterly summary of their engagement activity can be found at <http://www.lapfforum.org/engagement-reports>

**8.3.3 LAPFF Consultation Response:** LAPFF has submitted a consultation response to the EU regarding gender diversity on corporate boards, advocating a 'comply or explain' approach to increasing the number of women on corporate boards.

## 9 RISK MANAGEMENT

- 9.1 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.

## 10 EQUALITIES

10.1 This report is primarily for information only.

## 11 CONSULTATION

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

## 12 ISSUES TO CONSIDER IN REACHING THE DECISION

12.1 The issues to consider are contained in the report.

## 13 ADVICE SOUGHT

13.1 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.

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