Avon Pension Fund

Review for period to 30 September 2014

Contents

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1 Executive Summary

This report is produced by JLT Employee Benefits ("JLT") to assess the performance and risks of the investment managers of the Avon Pension Fund (the "Fund"), and of the Fund as a whole.

Funding level

- There is expected to have been a decrease in the funding level by around 4% over the third quarter of 2014.
- The drivers of this were:
  - A negative effect from the liabilities, as the valuation interest rate has decreased, increasing the value placed on liabilities. This was partially offset by a fall in inflation expectations.
  - A modest positive asset return, which did not offset the estimated rise in liabilities.

Fund Performance

- The value of the Fund's assets increased by £53m over the third quarter of 2014 to £3,539m. The total Fund returned 1.9% (2.0% excluding Record), which was a result of modest positive returns from most funds. This was behind the benchmark return of 2.4%.

Strategy

- Global equities generally rose over the quarter. The best regions were the US (+6.4%) and Frontier Markets (+7.1%), partly driven by a strengthening of the US Dollar relative to Sterling, but also due to positive economic figures from the US.
- UK and European equities fell over the quarter (by 1% and 2.6% respectively) as there were some indicators of a slower growing economy, particularly in Europe, at the start of the quarter.
- Over the last twelve months, equity returns in each of the major regions were positive, with returns ranging from 1.2% in Japan to 30.4% in Frontier Markets.
- Three year equity returns have been boosted by a very poor Q3 2011 falling out of the figures. The three year developed market equity returns remained ahead of the assumed strategic return. The three-year emerging market equity return was 6.1% p.a., which has improved on the negative return seen in the last report, but is still below the assumed strategic return.
- Gilts produced a positive return, as yields fell. Corporate bonds were also positive, but with a lower return than gilts as the yield gap widened. Three-year gilt and corporate bond returns remained ahead of the assumed strategic return despite a very strong Q3 2011 falling out of the analysis.
- The Overseas Fixed Interest return has fallen further back to -1.8% p.a. over three years, as US yields rose.
- Hedge funds remain below the assumed strategic returns although the three year return showed further improvement this quarter. The Property return has moved further ahead of the assumed strategic return to stand at 9.6% p.a., driven by the economic recovery in the US and the UK.
- The strengthening of the US dollar against Sterling meant that the overall impact of currency hedging has had a detrimental impact, as the majority of the hedging was in US Dollars, offsetting some of the positive impact of the Dollar movement. Currency hedging was beneficial in Euros and Yen, which both weakened against Sterling.

Managers

- Over the quarter, absolute returns from the managers were mixed. As last quarter, the highest returns came from emerging market equities and property, with Unigestion returning 5.9% and Schroder Property 4.5%. As a result of market movements, SSgA Europe produced the lowest quarterly return (-2.3%) but the fund was ahead of its benchmark.
- Over one-year, the highest return came from Schroder Property (19.1%). In line with markets, all funds (except Partners) produced a positive return over one year, and only Schroder Equity, Signet and Partners underperformed their one-year benchmarks.
- Over three years, similarly all funds produced a positive return and only Schroder Equity, Signet and Partners underperformed their respective benchmarks. Each of the outperforming managers also met their outperformance target, apart from SSgA Europe which was 0.1% below.
- The three year performance of the three hedge funds and Genesis emerging markets were below their strategic assumed returns – again this was mainly market-related as Stenham, Gottex and Genesis all outperformed their targets.

Key points for consideration

- The absolute and relative performance of Partners Property could be misleading and lead to an unfair negative assessment. The net internal rate of return, which has been 9.3% p.a. since inception, is a more meaningful measure as it properly accounts for the timing of cashflows.
  - Near term performance can be distorted as the nature of the portfolio generally results in greater costs up front for each individual investment and performance being realised once the investment is sold.
- The Fund has fully disinvested from the Barings Dynamic Asset Allocation Fund following the departure of the lead fund managers.
  - Since the Fund's disinvestment, the Barings fund has experienced significant cash outflows such that its size has fallen from c. £7bn to £3bn, and the cost of exiting the fund has increased from c. 0.6% to c 0.8%.
  - The proceeds were invested in the BlackRock Multi Asset portfolio in such a way as to broadly replicate the underlying asset allocation of the Barings Fund. However, from the Total Fund asset allocation point of view, these changes mean that there is a significant underweight position to Diversified Growth and overweight positions to equities and bonds.
  - The search for a replacement diversified growth fund manager is currently underway and, once appointed and funded, these over- and underweight positions relative to benchmark will reduce.
- The Fund has confirmed the appointment of IFM as infrastructure manager.
  - This is expected to be funded from the Fund's developed market equity allocation, further reducing the current overweight position to that asset class.
- Unigestion has enjoyed very strong relative performance since inception
  - This is expected given the market environment, where there is a large divergence between the outlook for, and therefore return from, different emerging markets. Unigestion's approach of taking into account macro factors whilst focussing on quality, less risky stocks has benefited relative performance.
  - Relative performance could suffer over periods where riskier stocks rally but, over the medium and long term, this is expected to be offset from Unigestion's focus on fundamental quality.

- The Schroder Global Equity portfolio continues to underperform its benchmark.
  - Performance should be monitored closely to assess the impact of the changes made by lead portfolio manager Simon Webber.
  - The impact of the appointment of Alex Tedder as Head of Global Equity will also be assessed over the coming months.

2 Market Background

The figures below cover the three months, 1 year and 3 years to the end of September 2014.

Market Statistics

Yields as at 30 September 2014	% p.a.
UK Equities	3.34
UK Gilts (>15 yrs)	2.98
Real Yield (>5 yrs ILG)	-0.37
Corporate Bonds (>15 yrs AA)	3.83
Non-Gilts (>15 yrs)	4.15

Absolute Change in Yields	3 Mths %	1 Year %	3 Years %
UK Equities	0.07	-0.07	-0.32
UK Gilts (>15 yrs)	-0.36	-0.43	-0.47
Index-Linked Gilts (>5 yrs)	-0.25	-0.33	-0.53
Corporate Bonds (>15 yrs AA)	-0.33	-0.48	-1.29
Non-Gilts (>15 yrs)	-0.28	-0.36	-0.88

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	7.2	11.4	6.4
Index-Linked Gilts (>5 yrs)	5.9	9.9	7.2
Corporate Bonds (>15 yrs AA)	5.5	11.1	9.2
Non-Gilts (>15 yrs)	5.1	11.3	9.2

* Subject to 1 month lag

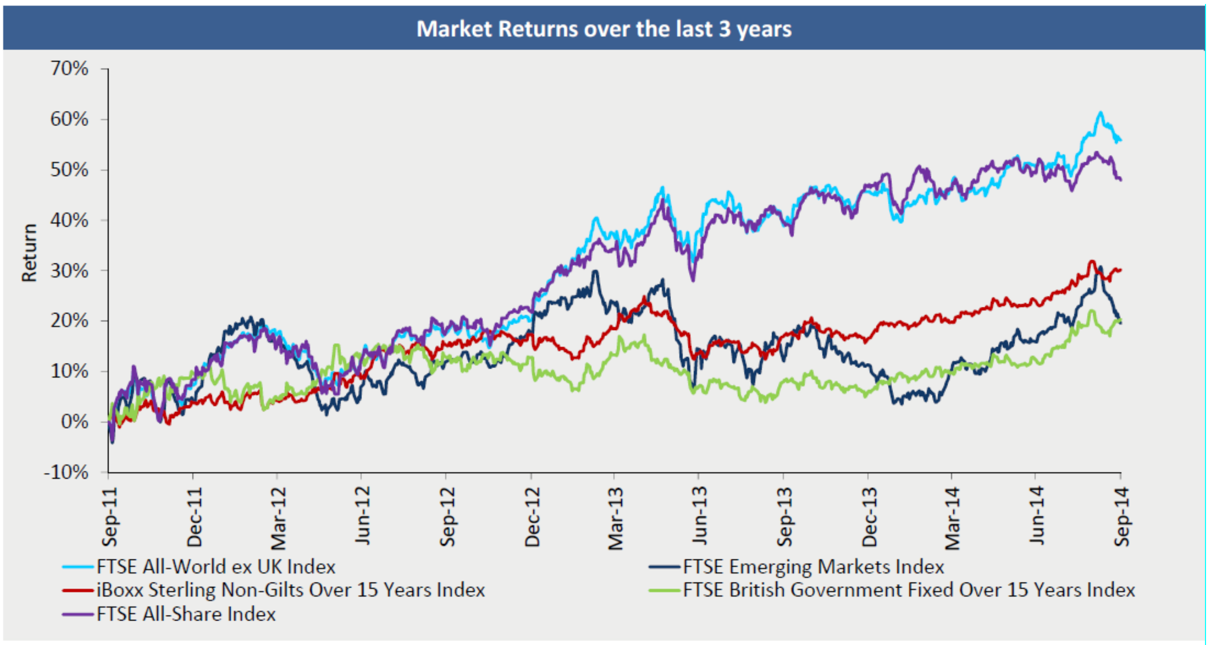
Source: Thomson Reuters and Bloomberg

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-1.0	6.1	13.9
Overseas Equities	3.5	12.3	16.0
USA	6.4	19.3	21.5
Europe	-2.6	5.3	14.6
Japan	3.1	1.2	8.0
Asia Pacific (ex Japan)	2.4	6.6	9.8
Emerging Markets	3.2	6.7	6.1
Frontier Markets	7.1	30.4	16.8
Property	4.7	19.7	9.6
Hedge Funds	0.6	8.0	7.5
Commodities	-7.7	-7.9	-1.4
High Yield	2.0	6.1	10.1
Emerging Market Debt	-0.6	9.7	7.9
Senior Secured Loans	0.4	4.6	7.9
Cash	0.1	0.5	0.5

Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-5.2	0.1	1.3
Against Euro	2.8	7.3	3.4
Against Yen	2.7	11.9	14.0

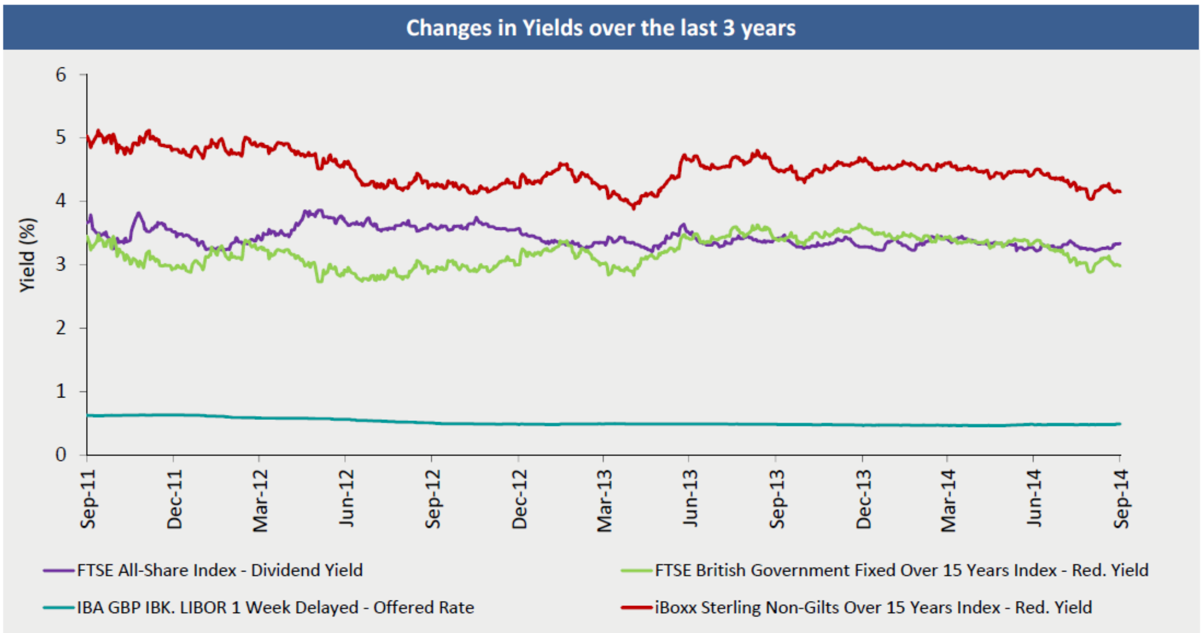
Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.5	2.3	2.7
Price Inflation – CPI	0.1	1.2	1.3
Earnings Inflation *	0.3	1.2	1.3

Market Summary charts



Source: Thomson Reuters.

The graph above shows market returns for the last three years; demonstrating both the medium-term trend and short-term volatility.



Source: Thomson Reuters.

The trend between September 2011 and April 2013 shows falling UK gilt yields, corporate bond yields and the dividend yield on the FTSE All-Share Index. Bond yields rose in the second half of 2013 but declined over the first three quarters of 2014, whilst the dividend yield has remained relatively flat since April 2013.

The table below compares general market returns (i.e. not achieved Fund returns) to 30 September 2014, with assumptions about returns made in the Investment Strategy agreed in 2013.

Asset Class	Strategy Assumed Return % p.a.	3 year Index Return % p.a.	Comment
Developed Equities	8.25	16.9	Significantly ahead of the assumed strategic return. This has increased from 9.8% p.a. reported last quarter as the large equity falls of Q3 2011 are no longer part of the 3 year return. Equity markets rebounded in the final quarter of 2011 as concerns reduced over a possible EuroZone breakup and US GDP slowed less than expected. Over the last 12 months, the developed equity return was 12.3%.
Emerging Market Equities	8.75	6.1	The 3-year return from emerging market equities has improved and moved into positive territory. Like developed markets, market prices corrected after the panic drops of Q3 2011. The 3 year return remains below the assumed strategic return as 2013 returns were affected by negative sentiment from slowing growth and the tapering of the US asset purchase programme.
Diversified Growth	Libor + 4% / RPI + 5%	4.7 / 7.7	DGFs are expected to produce an equity like return over the long term – 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 very strong equity returns, such as the recent three year period, we would expect DGF to underperform equities but deliver a return close to the long term equity assumed strategic return.
UK Gilts	4.5	6.3	Bond returns, despite slight reductions, remain above the long term strategic assumed return as the fragile nature of the global markets has encouraged investors to overweight fixed income.
Index Linked Gilts	4.25	7.2	
UK Corporate Bonds	5.5	7.8	
Overseas Fixed Interest	5.5	-1.8	Well behind the assumed strategic return and has fallen further into negative territory as strong growth and potential inflation acceleration in the US increased yields.
Fund of Hedge Funds	6.0	4.9	Hedge fund returns remain below long term averages and the strategic return, as they are affected by low cash rates. Volatility remains low but returns have improved slightly as hedge funds increase equity exposure..
Property	7.0	9.6	Property returns continue to increase above the expected returns, driven by the economic recovery in the US and the UK.

Source: Statement of Investment Principles, Thomson Reuters.

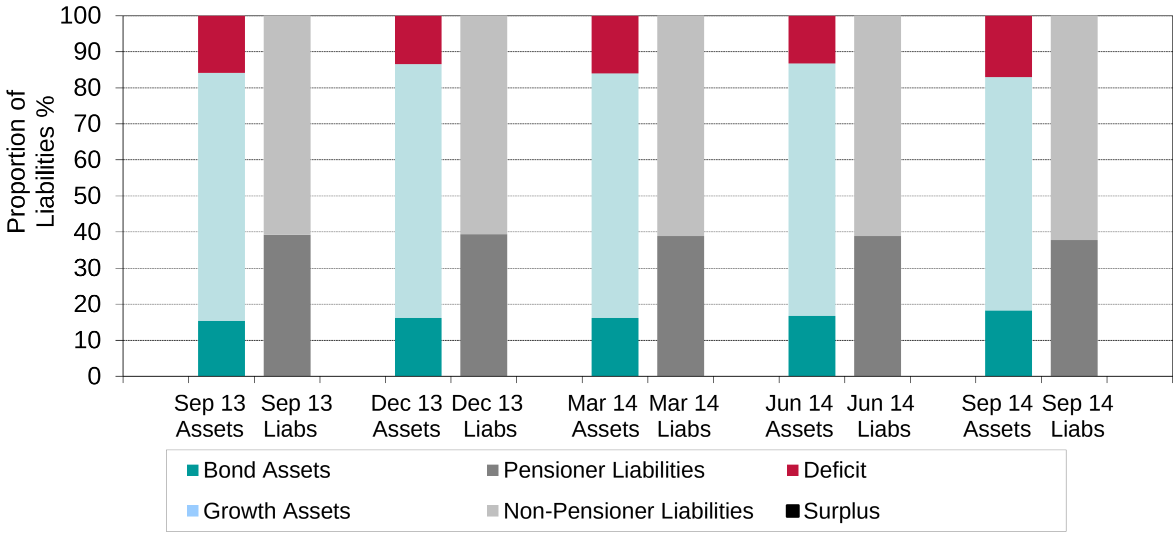
See appendix 1 for economic data and commentary.

3 Consideration of Funding Level

This section of the report considers the estimated funding level of the Fund. Firstly, it looks at the Fund asset allocation relative to its liabilities. Then it looks at market movements, as they have an impact on both the assets and the estimated value placed on the liabilities.

Asset allocation and liability split

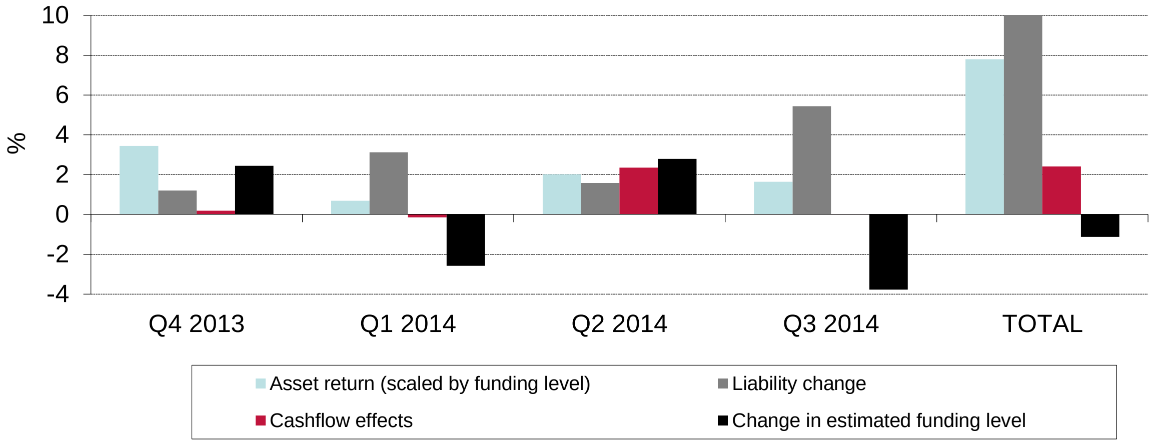
- The chart below shows the allocation of the Fund to Bond and Growth assets against the estimated liability split, which is based on changes in gilt yields underlying the Scheme Actuary's calculation of liabilities. The reference yield used for the liabilities is the Mercer Gilt yield (see appendix for definition). The liability benchmark is based on the valuation results from 31 March 2013.
- These calculations do not take account of any unexpected changes to the Fund membership or changes to the demographic assumptions and should not be construed as an actuarial valuation.



- Based on financial market values, investment returns and cashflows into the Fund, the estimated funding level decreased by circa 4% over the third quarter of 2014, all else being equal. This was driven by:
  - » A negative effect from the liabilities, as the valuation interest rate has decreased, increasing the value placed on liabilities. This was partially offset by a fall in inflation-linked liabilities.
  - » A modest positive asset return, which did not offset the estimated rise in liabilities.
- At the valuation date, 31 March 2013, the Scheme was 78% funded. Since then financial market movements, actual cashflows, and investment returns are expected to have increased the overall funding level to 83%. This improvement has come mainly from positive asset returns over the period.

Scheme performance relative to estimated liabilities

- The chart below shows, quarter by quarter, the return on the assets and the impact on the liabilities due to changes in financial market values and expected member movements.
- As detailed above, such movements in liabilities are based upon the bond yield underlying the Scheme Actuary's calculation of liabilities.

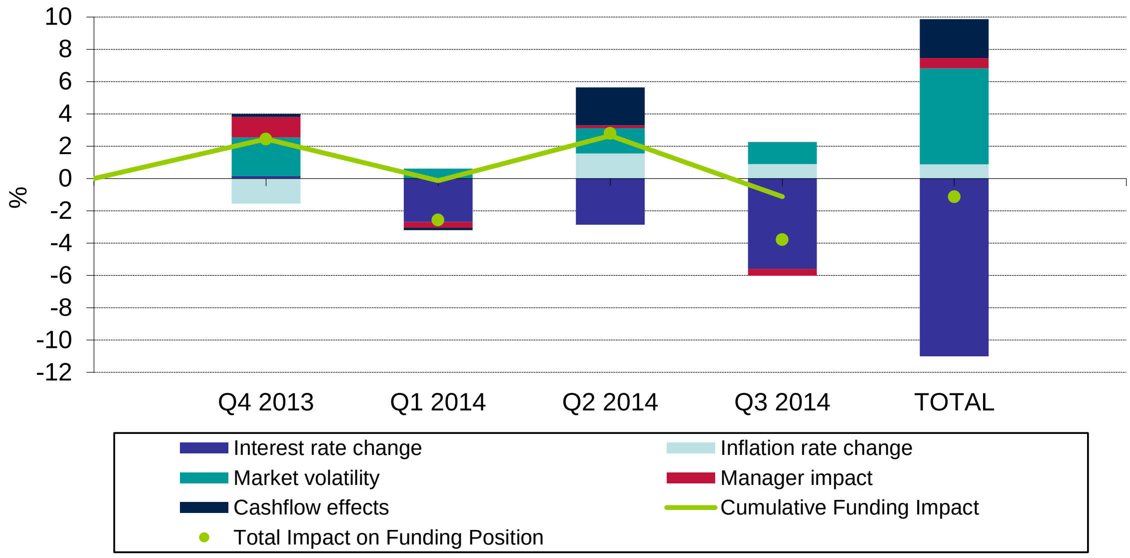


Note : A decrease in liabilities and an increase in assets improves the funding level and vice-versa.

- The graph above shows that the Fund's assets, scaled to take into account the estimated funding level, have produced an absolute return of 1.6%, over the last quarter.
- The value placed on the liabilities increased by 5.4% due to a fall in the discount rate, offset to some extent by a smaller decrease in the inflation assumption used to value inflation-linked liabilities.
- The 'cashflow effect' was negligible this quarter – the 2.3% in Q2 2014 represents several employing bodies paying their deficit payments in advance.
- Overall, the combined effect has led to a decrease in the estimated funding level to 83% (from 87% at 30 June 2014).

Key drivers of performance against the estimated liabilities

- The chart below shows the main contributors to the change in the estimated funding level. For reference, please note that the underlying calculations are based on the Mercer gilt yield.



- ‘Interest rate change’ reflects the impact caused by the difference in the duration of the liabilities compared to the assets. When yields fall, as in the last three quarters, this has a negative impact, as the liabilities have a longer duration than the assets.
- The Market Implied (RPI) inflation assumption fell by 0.1% p.a. over the quarter. This gives a positive contribution as future inflation-linked payments are projected lower.
- For Growth assets, ‘Market volatility’ is simply the (benchmark) return on the assets; for Bond assets it is the return less the return that would be expected given the changes in bond yields. This has had a positive impact over the quarter as Growth assets posted positive returns.
- 'Manager impact’ is the investment performance compared to the strategic benchmark. This was negative over the last quarter as the total fund returned 0.5% below the benchmark.
- The ‘cashflow effects’ reflect factors such as pension payments, contributions and disinvestments.
- Overall the investment factors have had a negative impact on the estimated funding level of the Fund over the last quarter.
- Over the last year, investment factors have had a small negative effect due to a fall in the discount rate assumption, which increases the value placed on the liabilities (‘interest rate change’). This was offset by the positive asset returns (‘market volatility’) and manager outperformance (‘manager impact’), all else being equal.

4 Fund Valuations

The table below shows the asset allocation of the Fund as at 30 September 2014, with the BlackRock Multi-Asset portfolio and the BlackRock property portfolio (assets “ring fenced” for investment in property) split between the relevant asset classes.

Asset Class	30 June 2014 Value £'000	30 June 2014 Proportion of Total %	30 September 2014 Value £'000	30 September 2014 Proportion of Total %	Strategic Benchmark Weight %
Developed Market Equities	1,592,727	45.7	1,740,605	49.2	40.0
Emerging Market Equities	327,819	9.4	339,745	9.6	10.0
Diversified Growth Funds	346,321	9.9	118,799	3.4	10.0
Bonds	673,456	19.3	778,076	22.0	20.0
Fund of Hedge Funds	164,589	4.7	163,610	4.6	5.0
Infrastructure	-	-	-	-	5.0
Cash (including currency instruments)	116,595	3.4	103,242	2.9	-
Property	264,693	7.6	295,202	8.3	10.0
TOTAL FUND VALUE	**3,486,200**	**100.0**	**3,539,279**	**100.0**	**100.0**

Source: Data provided by WM Performance Services

- The value of the Fund's assets increased by £53m over the third quarter of 2014 to £3,539m.
- The amount invested in Diversified Growth (DGF) has decreased significantly. This is due to the decision to fully disinvest from the Barings Dynamic Asset Allocation Fund following the departure of the lead fund managers. Almost all proceeds from this sale were invested in the BlackRock Multi Asset portfolio, and the remainder in Cash.
- As a result of this change, the allocation to DGF reduced from 9.9% to 3.4%, with the allocations to Developed Market Equities and Bonds increasing. This takes the exposure further away from the strategic benchmark weight.
- However, when considering the asset allocation within the previously held Barings fund, the allocation to equities and bonds has not changed significantly.
- The search for a replacement DGF manager has commenced.
- Over the quarter the appointment of IFM as infrastructure manager for the Avon Pension Fund was confirmed. IFM’s allocation is expected to be met from equities over time, thus reducing the current overweight position.

Manager	Asset Class	30 June 2014 Value £'000	30 June 2014 Proportion of Total %	Net new money £'000	30 September 2014 Value £'000	30 September 2014 Proportion of Total %
Jupiter	UK Equities	163,584	4.7	-	163,669	4.6
TT International	UK Equities	183,391	5.3	-	183,858	5.2
Schroder	Global Equities	219,456	6.3	-	222,855	6.3
Genesis	Emerging Market Equities	152,851	4.4	-	154,408	4.4
Unigestion	Emerging Market Equities	174,969	5.0	-	185,337	5.2
Invesco	Global ex-UK Equities	244,970	7.0	-	254,766	7.2
SSgA	Europe ex-UK Equities and Pacific incl. Japan Equities	109,464	3.2	-	110,065	3.1
Pyrford	DGF	117,921	3.4	-	118,799	3.4
Barings	DGF	228,400	6.6	-232,730	0	0.0
MAN	Fund of Hedge Funds	890	0.0	-	706	0.0
Signet	Fund of Hedge Funds	67,005	1.9	-206	65,940	1.9
Stenham	Fund of Hedge Funds	38,056	1.1	-	38,038	1.1
Gottex	Fund of Hedge Funds	58,639	1.7	-	58,926	1.7
BlackRock	Passive Multi-asset	1,038,803	29.8	225,106	1,288,341	36.4
BlackRock (property fund)	Equities, Futures, Bonds, Cash (held for property inv)	44,470	1.3	-30,500	14,913	0.4
RLAM	Bonds	279,336	8.0	-	287,071	8.1
Schroder	UK Property	159,480	4.6	-	166,655	4.7
Partners	Property	108,905	3.1	30,500	139,147	3.9
Record Currency Mgmt	Dynamic Currency Hedging	14,069	0.4	-	1,130	0.0
Record Currency Mgmt 2	Overseas Equities (to fund currency hedge)	22,858	0.7	-	30,851	0.9
Internal Cash	Cash	58,685	1.7	7,831	53,805	1.5
Rounding		-2	-0.2	-	0	0.0
TOTAL		**3,486,200**	**100.0**	**0**	**3,539,279**	**100.0**

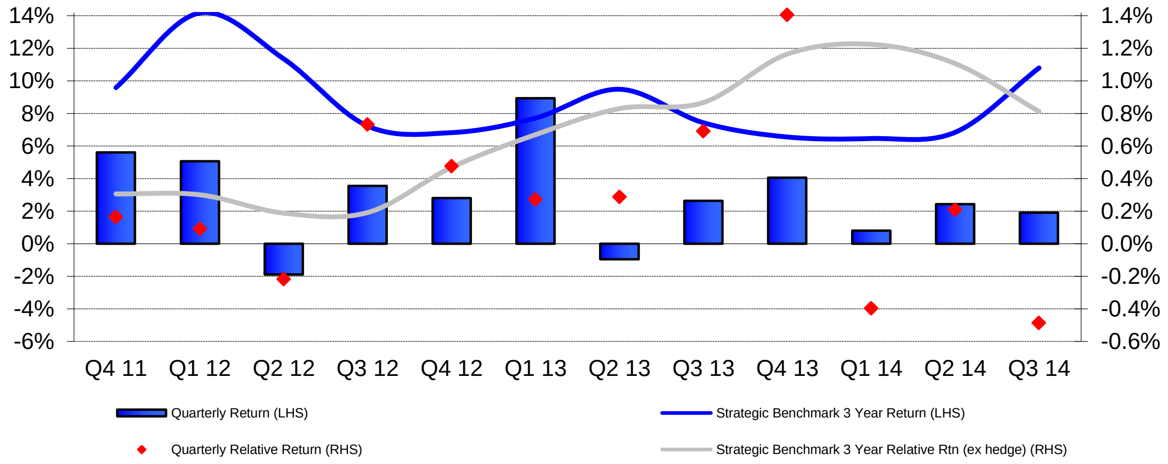
Source: Avon Pension Fund Data provided by WM Performance Services

5 Performance Summary

Total Fund performance

The chart below shows the absolute performance of the total Fund's assets over the last 3 years.

Total Fund absolute and relative performance



fund	3 months (%)	1 year (%)	3 years (% p.a.)
Total Fund (inc currency hedge)	1.9	9.4	12.0
Total Fund (ex currency hedge)	2.0	8.9	11.7
Strategic Benchmark (no currency hedge)	2.4	8.7	10.8
Relative (inc currency hedge)	-0.5	+0.6	+1.1

Source: Data provided by WM Performance Services

- The largest component of the quarter's underperformance was stock selection in overseas developed equities.

Benchmark allocation

The table below shows the strategic allocation to each of the major asset classes and the benchmark returns over the quarter and 1 year to 30 September 2014, and thereby analyses what we would expect the strategy to return if all assets had been invested passively and met their benchmark returns.

Asset Class	Weight in Strategic Benchmark		Index returns	Contribution to total benchmark	Index returns	Contribution to total benchmark
	Sep 13	Sep 14	Q3 2014	(quarter)	1 year	(1 year)
UK Equities	18%	15%	-1.0%	-0.1%	6.1%	0.9%
Overseas Equities	42%	25%	3.6%	0.9%	12.7%	3.2%
Emerging Market Equities	-	10%	1.8%	0.2%	4.2%	0.4%
Diversified Growth Funds	-	10%	1.1%	0.1%	4.5%	0.5%
UK Government Bonds	6%	3%	7.2%	0.2%	11.4%	0.3%
UK Corporate Bonds	5%	8%	2.9%	0.2%	7.5%	0.6%
Index Linked Gilts	6%	6%	5.9%	0.3%	9.9%	0.6%
Overseas Fixed Interest	3%	3%	1.9%	0.1%	-0.2%	-0.0%
Fund of Hedge Funds	10%	10%	1.1%	0.1%	4.5%	0.5%
Property	10%	10%	4.0%	0.4%	16.8%	1.7%
Total Fund	**100%**	**100%**		**2.4%**		**8.7%**

Source: Returns data provided by WM Performance Services

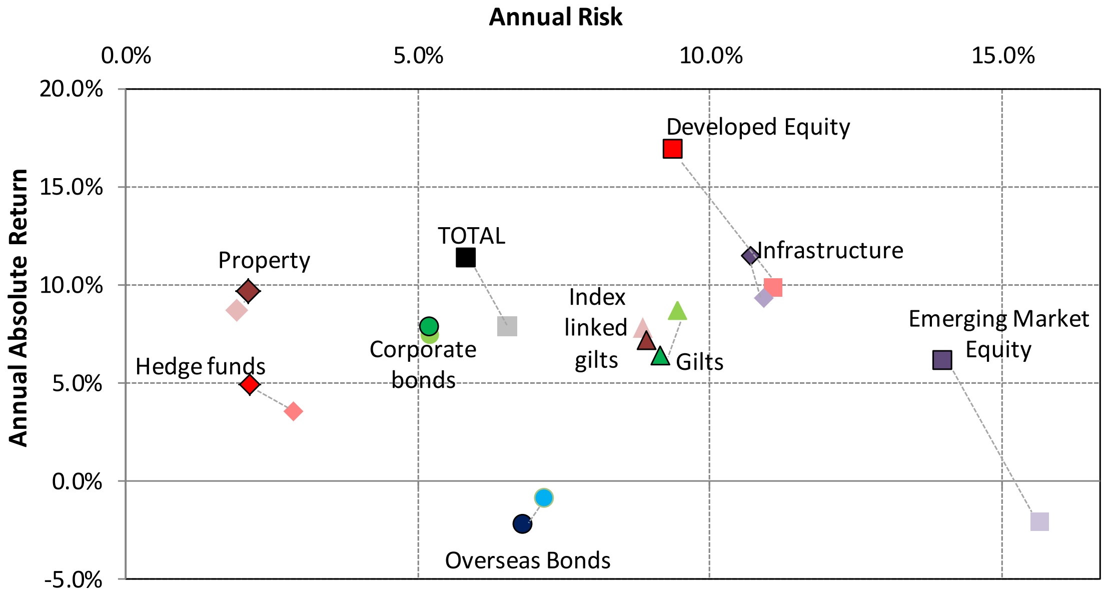
- The benchmark weights above are those held by WM to partly reflect the changes to the investment strategy, agreed in 2013, whilst they are implemented.
- Over the quarter, the benchmark was 2.4%. This was driven by contributions from most asset classes, in particular overseas equities and property.
- Over the last twelve months, the benchmark was 8.7% p.a. All asset classes except Overseas Fixed Interest gave a positive contribution, with equities the main contributor.
- The assumed strategic return for the Fund as a whole, weighted by the strategic benchmark allocation over the last year, is 7.3% p.a. Hence the actual one-year benchmark return was 1.4% p.a. ahead of this.
  - The 1 year benchmark for overseas equities (12.7%) was ahead of its assumed strategic return of 8.25%. The property benchmark of 16.8% was well ahead of its assumed strategic return of 7%, and UK government, corporate and index-linked bonds were also well ahead.
  - UK equities, Emerging market equities, Overseas Fixed Interest and Fund of Hedge Funds were below their assumed strategic returns over the year.

Risk Return Analysis

The chart below shows the 3 year absolute return ("Annual Absolute Return") against the 3 year volatility of absolute returns ("Annual Risk"), based on monthly/quarterly (as available) data points in sterling terms, to the end of September 2014 of each of the underlying asset benchmarks, along with the total Fund strategic benchmark. We also show the position as at last quarter, as shadow points.

This chart can be compared to the 3 year risk vs return managers' chart on page 17.

3 Year Risk v 3 Year Return to 30 September 2014

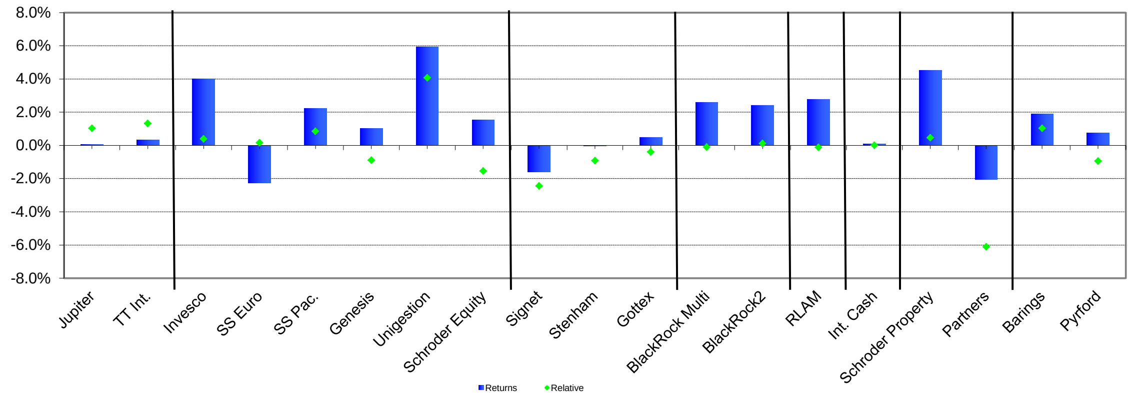


- There has been a large change in the 3 year risk/return characteristics of equities over the quarter, as the equity market slump of Q3 2011 has fallen out of the analysis, which has significantly improved the three year returns of the both developed and emerging market equities.
- Conversely, the 3 year risk/return profile of bonds remained reasonably stable as Q3 2014 returns were positive, akin to Q3 2011.
- Developed equity produced the best 3-year return, of 16.9% p.a. The next highest were Infrastructure (11.5% p.a.) and Property (9.6% p.a.)
- The emerging market equity return improved significantly and is no longer negative, currently standing at 6.1% p.a. The hedge fund index continues to produce steadily improving returns, increasing the three-year return to 4.9% p.a.
- Overseas bonds remains in negative territory and currently is the only negative returning asset class charted.
- In terms of risk, the three-year volatility has fallen for most asset classes in the above chart following the removal of the volatile Q3 2011 period.
- The three-year return on developed equities is significantly above its assumed return; property, gilts, index-linked gilts and corporate bonds remain above their assumed strategic return. Hedge funds and emerging market equities remain below their assumed strategic return, with overseas bonds well below.

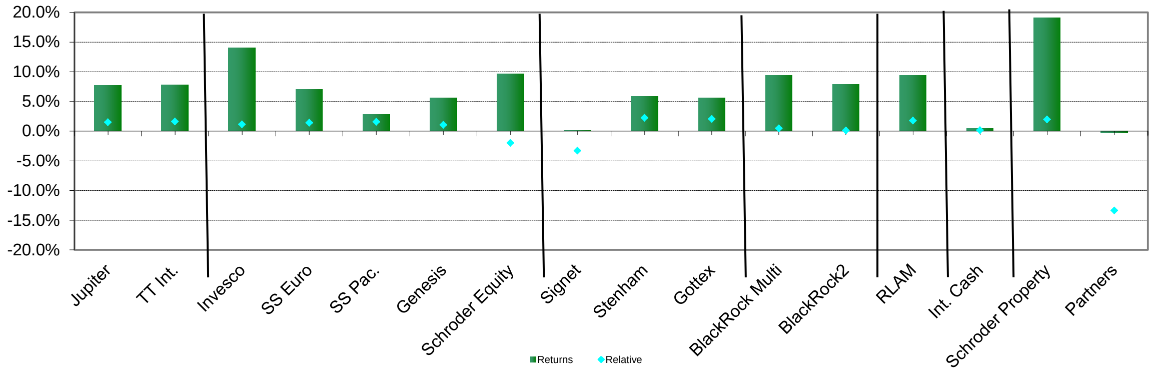
Aggregate manager performance

The charts below show the absolute return for each manager over the quarter, one year and three years to the end of September 2014. The relative quarter, one year and three year returns are marked with green and blue dots respectively.

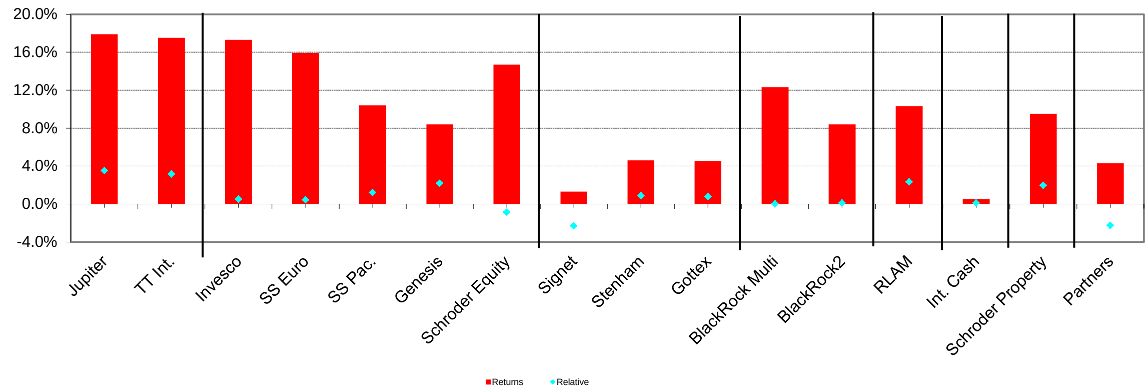
Absolute and relative performance - **Quarter to 30 September 2014**



Absolute and relative performance - **Year to 30 September 2014**



Absolute and relative performance - **3 years to 30 September 2014**



Source: Data provided by WM Performance Services

The table below shows the relative returns of each of the funds over the quarter, one year and three years to the end of September 2014. Returns in blue text are returns which outperformed the respective benchmarks, red text shows an underperformance, and black text represents performance in line with the benchmark.

Manager / fund	3 months (%)	1 year (%)	3 years (% p.a.)	3 year performance versus target
Jupiter	+1.0	+1.5	+3.5	Target met
TT International	+1.3	+1.6	+3.2	Target met
Invesco	+0.4	+1.2	+0.5	Target met
SSgA Europe	+0.2	+1.4	+0.4	Target not met
SsgA Pacific	+0.8	+1.6	+1.2	Target met
Genesis	-0.9	+1.1	+2.2	Target met
Unigestion	+4.0	N/A	N/A	N/A
Schroder Equity	-1.6	-2.0	-0.9	Target not met
Signet	-2.4	-3.3	-2.3	Target not met
Stenham	-0.9	+2.2	+0.9	Target met
Gottex	-0.4	+2.0	+0.8	Target met
BlackRock Multi - Asset	-0.1	+0.5	+0.1	Target met
BlackRock 2	+0.1	+0.1	+0.1	Target met
RLAM	-0.1	+1.8	+2.3	Target met
Internal Cash	0.0	+0.1	+0.1	N/A
Schroder Property	+0.5	+2.0	+2.0	Target met
Partners Property	-6.1	-13.4	-2.2	Target not met
Barings	+1.0	NA	NA	N/A
Pyrford	-1.0	NA	NA	N/A

Source: Data provided by WM Performance Services

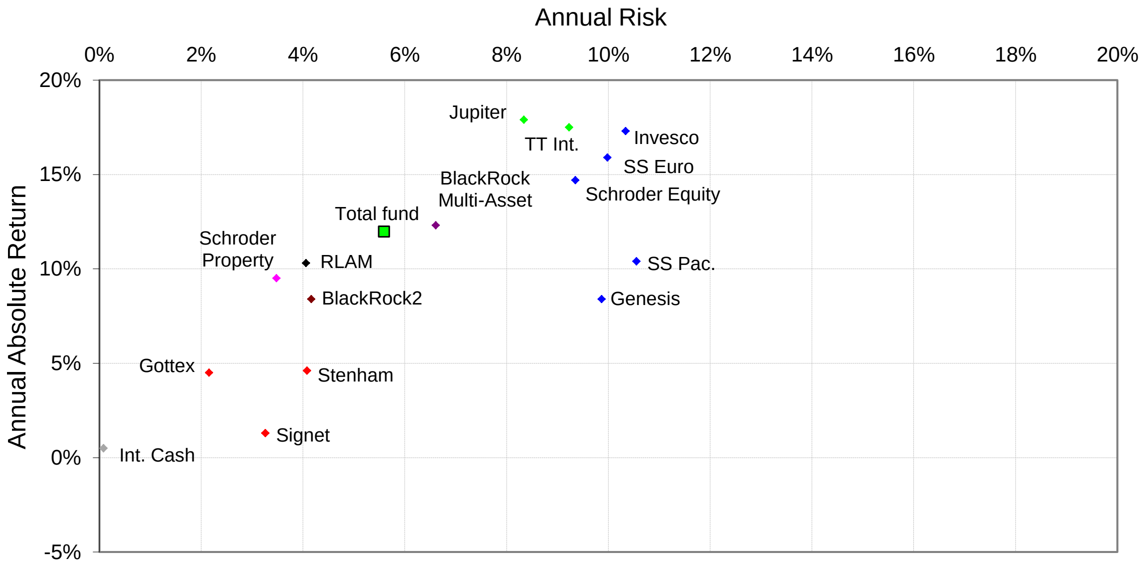
- The absolute and relative performance of Partners Property could be misleading and lead to an unfair negative assessment. The net internal rate of return, which has been 9.3% p.a. since inception, is a more meaningful measure as it properly accounts for the timing of cashflows.

» Near term performance for Partners can be distorted as the nature of the portfolio generally results in greater costs up front for each individual investment and performance being realised once the investment is sold.

Manager and Total Fund risk v return

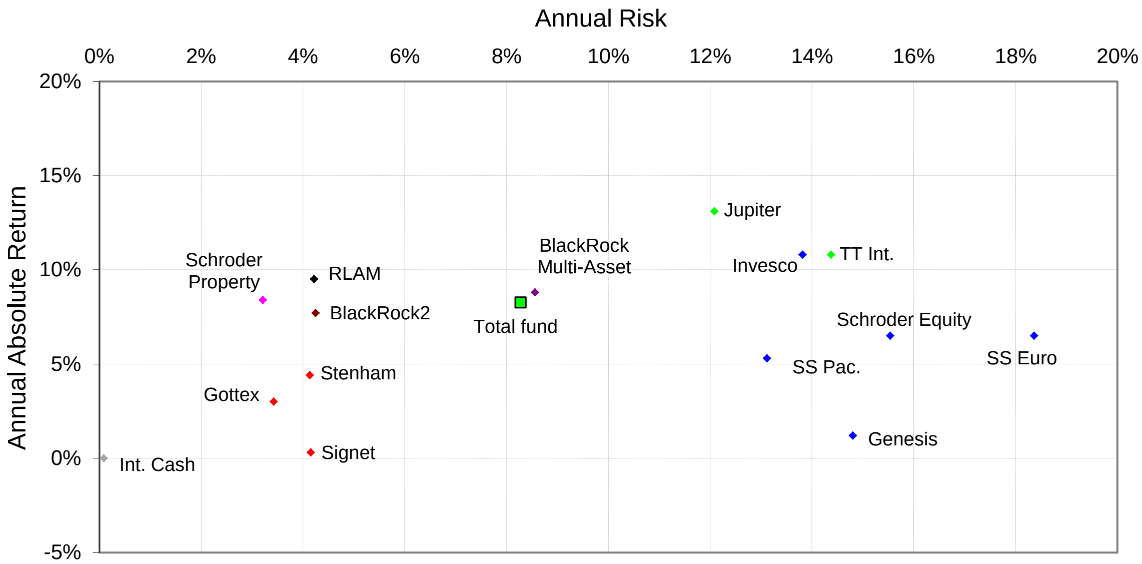
The chart below shows the 3 year absolute return ("Annual Absolute Return") against the 3 year volatility of absolute returns ("Annual Risk"), based on monthly/quarterly (as available) data points in sterling terms, to the end of September 2014 of each of the funds. We also show the same chart, but with data to 30 June 2014 for comparison.

3 Year Risk v 3 Year Return to 30 September 2014



Source: Data provided by WM Performance Services

3 Year Risk v 3 Year Return to 30 June 2014



Source: Data provided by WM Performance Services

The managers are colour coded by asset class, as follows:

- Green: UK equities — Blue: overseas equities
- Red: fund of hedge funds — Black: bonds
- Maroon: multi-asset — Brown: BlackRock No. 2 portfolio
- Grey: internally managed cash — Pink: Property
- Green Square: total Fund

- The three-year returns have increases markedly for equities, following the removal of the weak Q3 2011 market returns, and remained reasonably stable for all other funds..
- The UK equity managers' returns increased (Jupiter from 13.1% p.a. to 17.9% p.a. and TT from 10.8% p.a. to 17.5% p.a.) and they remain the best performing funds in absolute terms over three years.
- The other main shifts in the equity funds' three year returns were SSgA Europe (up from 6.5% p.a. to 15.9% p.a.) and Schroder Equity (up from 6.5% p.a. to 14.7% p.a.).
- The hedge fund managers' thee-year returns all improved over the quarter, in particular Gottex (up from 3.0% p.a. to 4.5% p.a.) and Signet (up from 0.3% p.a. to 1.3% p.a.).
- The three-year risk figures have fallen significantly over the third quarter for all equity funds, with the largest change being an 8.4% p.a. fall from SSgA Europe. For the non-equity funds, the risk figures have changed by 1.9% p.a. or less since last quarter. As would be expected, the equity-based funds have the highest volatility and hedge funds, property and fixed interest the lowest, in line with the market returns chart on page 8.
- Over the longer three year period, the three fund of hedge fund managers have underperformed the asset class assumed strategic return, although returns have been improving.
- Jupiter, TT, Invesco, the two SSgA funds, RLAM bonds and Schroder Property have all outperformed the assumed strategic return and also outperformed their benchmarks (SSgA Europe slightly behind target).
- Schroder Equity has outperformed the assumed strategic return, but is below its individual benchmark and target.

Appendix 1: Market Events

Asset Class	What happened? Positive Factors	What happened? Negative Factors
UK Equities	■ Towards the end of the quarter, Scotland voted to stay as part of the UK's political union. This cleared months of uncertainty over potential negotiations of sharing the nation's debts and assets that had weighed on investors' confidence. ■ The Office for National Statistics (ONS) revised the UK's economic growth up to 0.9% for Q2 2014 compared with the previous estimate of 0.8%. As per the ONS' revised estimates, GDP was 2.7% higher than its pre-crisis peak by the end of Q2 2014.	■ Consumer confidence in the UK edged down as reflected by the GfK Consumer Confidence Index which declined in September to −1 from 1 in August. The gauge, which had recovered sharply early in the year, slipped on concerns that economic growth would not benefit the personal finances of people in Britain. ■ Despite steady economic growth, the ONS figures indicate that the country's current account deficit widened from 4.7% of GDP in Q1 2014 to 5.2% in Q2 2014.
Overseas Equities:		
North America	■ Aided by a surge in exports and a rise in business spending, US GDP grew at an annualised rate of 4.6% in Q2 2014, marking the fastest pace of growth in two years. The growth rate has now exceeded 3.5% in three of the past four quarters. ■ The unemployment rate fell to 5.9% in September, marking the first time that unemployment has been below 6% since July 2008. The US Labour department said that the economy added 248,000 jobs in September while job growth numbers for July and August were also revised upwards.	■ As the Federal Reserve's quantitative easing program is due to end in Q4 2014, the timing of the first interest rate hike remains a headwind for the equity markets in the near term. While the market expects interest rates to start inching upward towards mid 2015, Janet Yellen has often emphasised that any such move will depend on the strength of economic data. ■ Labour force participation rate fell to 62.7% in September—the lowest reading since February 1978. A lower participation rate implies that fewer people are looking for work, limiting an economy's ability to grow.

Asset Class	What happened? Positive Factors	Negative Factors
Europe	■ In response to a continued decline in inflation, employment and production readings, the European Central Bank (ECB) cut its benchmark interest rate to 0.05%, and reduced the deposit rate to -0.2% in September 2014. Moreover, they announced a programme to buy asset-backed securities later this year. ■ Equities were buoyed in the latter half of Q3 2014 as expectations rose that the ECB will announce a full-fledged quantitative easing program in the near term. Policymakers have hinted that the bank stands ready to try any unconventional measures to avert the threat of deflation in the Euro area.	■ Eurozone equities posted negative returns over Q3 2014 as macro-economic data released during the period further substantiated that the region's fragile economic recovery was slowing. In addition, worries over the volatile situation in Ukraine and the potential impact of sanctions on Russia weighed on the region's equities. ■ Eurozone GDP recorded zero growth in Q2 2014. Weakness in France and Germany, which together contribute approximately two-thirds of the output in the region, offset gains in some of the other countries such as Portugal and Spain. Moreover, inflation fell to 0.3% in September from 0.4% in August, fuelling fears that deflationary pressures may dampen the region's economic recovery.
Japan	■ Corporate earnings for Q2 2014 beat analysts' estimates—a trend held for seven consecutive quarters. The Yen, meanwhile, hit a multi-year low of JPY 108 versus the US dollar during the quarter. This weakness in the Yen is expected to further boost the profitability of export-oriented companies. ■ Japan's public pension funds, including the USD 1.2 trillion Government Pension Investment Fund, sold Japanese government bonds worth USD 10.1 billion during the April to June quarter. This was in line with the recently announced portfolio reallocation to move its assets away from low-yielding bonds into equities.	■ The sales tax hike in April continued to adversely impact economic data released during the Q3 2014. Q2 2014 GDP contracted sharply by 7.1% on an annualised basis—the largest since 2009. The effect of the hike in levy was widespread with consumption and capital spending falling by 5.1% each during the quarter. ■ The Bank of Japan (BoJ) kept monetary policy unchanged, maintaining its current annual expansion rate of JPY 60-70 trillion. However, analysts expect that the BoJ would have to undertake further easing to reach its inflation target of 2%.

Asset Class	What happened? Positive Factors	Negative Factors
Asia Pacific	■ A rally in Indian stocks continued following the election of a new government and the indices gained another 4.8% over Q3 2014. A better-than-expected GDP growth rate of 5.7% for Q2 2014 compared with 4.6% growth witnessed in Q1 2014 indicates that growth may be picking up pace. Also, Standard and Poor's raised the outlook for India's "BBB-minus" rating to "stable" from "negative" towards the end of September 2014. ■ South Korea recorded its 32nd consecutive month of trade surplus owing to strong exports, which grew by 6.8% year-on-year in September. The Korean government announced a stimulus package of USD 40 billion in July to stimulate the economy and unveiled a new tax plan prodding cash-hoarding companies to spend more in wages and dividends or face extra taxes.	■ Asia Pacific (excluding Japan) equities ended the quarter marginally lower as strong economic data coming out of the US and resulting expectations of an interest rate hike by the Federal Reserve concerned the markets. ■ Stocks fell marginally in Hong Kong over the quarter, with most losses arising in September, as the pro-democracy movement in the city gathered momentum and culminated into street protests towards the end of the quarter.
Emerging Markets	■ Chinese equities performed positively during the quarter amidst mixed economic data. Exports grew by 9.4% in August, while imports fell by 2.4%, further inflating the country's trade surplus. Although the HSBC Purchasing Managers Index (PMI) fell to a three-month low, it managed to remain in the expansionary territory, recording 50.2 in August. ■ Standard & Poor’s upgraded its debt rating for Greece from 'B-minus' to 'B' in September citing that the fiscal reform efforts are yielding results and the economy remains on track to emerge from a six-year recession next year.	■ For the first time in history, the Russian Rouble fell below the psychological 40-level mark versus the US dollar under the weight of Western sanctions. Russian firms shut out of capital markets due to these sanctions have been purchasing dollars, pushing the Rouble down by approximately 18% since the start of the year.

Asset Class	What happened? Positive Factors	Negative Factors
Gilts	■ Growth expectations in the UK remain strong. However, of the three major sectors (services, construction and manufacturing), services and manufacturing industries have been a drag over the quarter. The monthly Markit/CIPS PMI for the services sector dropped to 58.7 in September from 60.5 in August. Manufacturing output rose by 0.1% in August, down from growth of 0.3% in July. ■ Modest Inflation and more-than-estimated spare capacity in the labour market have been restricting the Bank of England (BoE) to undertake interest rate hikes.	■ Gilt prices slipped beginning September 2014 on account of the Scottish Independence referendum. It was speculated that a vote in favour of Scottish independence could result in economic uncertainty in the UK.
Index Linked Gilts	■ With limited issuance of new index-linked gilts and investors continuing to seek inflation protection, demand for index-linked gilts remains high, thus supporting prices.	■ The UK consumer price index grew by a modest 1.6% and 1.5% in July and August 2014 respectively, down from 2.0% in December 2013. ■ In an environment where central banks are able to control inflation within a target range, there is limited upside to the return expectations on these instruments.
Corporate Bonds	■ Investment grade credit continues to be an attractive asset class. Central bank policies remain supportive, while regulatory action is forcing banks to improve their creditworthiness. Also, bond defaults remain low as corporates are increasingly reporting improved operational performance.	■ The reduction in credit spreads over the past few months leaves little room for any further contraction.
Property	■ UK commercial property values rose by 0.9% in August 2014, albeit at a moderated pace as compared with the previous two months. The values have now risen by 12.8% over 16 months of consecutive growth. ■ Construction PMI rose to 64.2 in September 2014 from 64.0 in August 2014, the highest reading since January 2014.	■ Residential real estate in the UK declined by 0.2% in September 2014, following 16 consecutive months characterised by price increases. The new affordability tests (MMR) introduced in April for house buyers are influencing this, leading to a drop in the number of mortgage approvals to 64,212 in August 2014—the weakest reading since May 2014.

Economic statistics

	Quarter to 30 September 2014			Year to 30 September 2014		
	UK	Europe[1]	US	UK	Europe[1]	US
Real GDP growth	0.7%	n/a	0.9%	3.0%	n/a	2.3%
Unemployment rate	6.3%	11.5%	5.9%	6.3%	11.5%	5.9%
Previous	*6.5%*	*11.6%*	*6.1%*	*7.7%*	*11.1%*	*7.3%*
Inflation change[2]	0.1%	-0.1%	-0.1%	1.2%	0.3%	1.7%
Manufacturing Purchasing Managers' Index	51.6	50.3	56.6	51.6	50.3	56.6
Previous	*57.5*	*51.8*	*55.3*	*56.7*	*51.1*	*56.2*

Source: Thomson Reuters, market, Institute for Supply Management, Eurostat, United States Department of Labor, US Bureau of Economic Analysis. "Previous" relates to data as at the previous quarter or year end.

(1) EU changing composition area; (2) CPI inflation measure

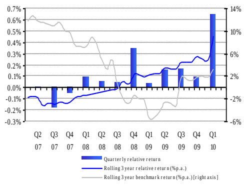
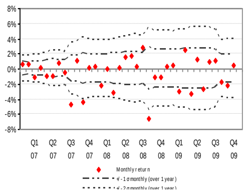
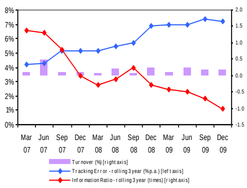
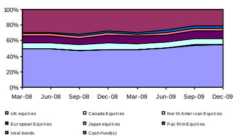
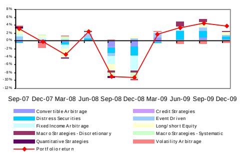
Appendix 2: Glossary of Terms

Term	Definition
Absolute Return	The actual return, as opposed to the return relative to a benchmark.
Annualised	Figures expressed as applying to 1 year.
Bond Assets	Assets held in the expectation that they will exhibit a degree of sensitivity to yield changes. The value of a benefit payable to a pensioner is often calculated assuming the invested assets in respect of those liabilities achieve a return based on UK bonds.
Growth Assets	Assets held in the expectation that they will achieve more than the return on UK bonds. The value of a benefit payable to a non-pensioner is often calculated assuming the invested assets in respect of those liabilities achieve a return based on UK bonds plus a premium (for example, if holding equities an equity risk premium may be applied). The liabilities will still remain sensitive to yields although the Growth assets may not.
Duration	The weighted average time to payment of cashflows (in years), calculated by reference to the time and amount of each payment. It is a measure of the sensitivity of price/value to movements in yields.
Funded Liabilities	The value of benefits payable to members that can be paid from the existing assets of the plan (i.e. those liabilities that have assets available to meet them).
High Yield	A type of bond which has a lower credit rating than traditional investment grade corporate bonds or government bonds. These bonds pay a higher yield than investment grade bonds.
Market Statistics Indices	The following indices are used for asset returns: UK Equities: FTSE All-Share Index Overseas Equities: FTSE AW All-World ex UK UK Gilts (>15 yrs or >20 yrs): FTSE Brit Govt Fixed Over 15 (or 20) Years Index Corporate Bonds(>15 yrs AA): iBoxx £ Corp 15+ Years AA Index Non-Gilts (>15 yrs): iBoxx £ Non-Gilts 15+ Years Index Index Linked Gilts (>5yrs): FTSE Brit Govt Index Link Over 5 Years Index Hedge Funds: CS/Tremont Hedge Fund Index Commodities: S&P GSCI Commodity GBP Total Return Index High Yield: Bank Of America Merrill Lynch Global High Yield Index Property: IPD Property Index (Monthly) Infrastructure: FTSE MACQ Global Infrastructure Index Cash: 7 day London Interbank Middle Rate Price Inflation: All Items Retail Price Index Earnings Inflation: UK Average Weekly Earnings Index - Whole Economy excluding Bonuses
Market Volatility	The impact of the assets producing returns different to those assumed within the actuarial valuation basis, excluding the yield change and inflation impact.

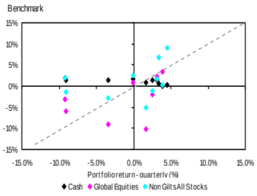
Term	Definition
Mercer Gilt Yield	An estimate of the yield available on a notional portfolio of UK Government conventional gilt stocks whose cashflows approximately match the Fund's estimated benefit cashflows
Money-Weighted Rate of Return	The rate of return on an investment including the amount and timing of cashflows.
Non-Pensioner Liability	The value of benefits payable to those who are yet to retire, including active and deferred members.
Pensioner Liability	The value of benefits payable to those who have already retired, irrespective of their age.
Relative Return	The return on a fund compared to the return on another fund, index or benchmark. For IMAGE purposes this is defined as: Return on Fund less Return on Index or Benchmark.
Scheme Investments	Refers only to the invested assets, including cash, held by your investment managers.
Surplus/Deficit	The estimated funding position of the Scheme. This is not an actuarial valuation and is based on estimated changes in liabilities as a result of bond yield changes, asset movements and, if carried out, output from an asset liability investigation (ALI). If no ALI has been undertaken the estimate is less robust.
Three-Year Return	The total return on the fund over a three year period expressed in percent per annum.
Time-Weighted Rate of Return	The rate of return on an investment removing the effect of the amount and timing of cashflows.
Unfunded Liabilities	The value of benefits payable to members that cannot be paid from the existing assets of the Scheme (i.e. those liabilities that have no physical assets available to meet them). These liabilities are effectively the deficit of the Scheme.
Yield (Gross Redemption Yield)	The return expected from a bond if held to maturity. It is calculated by finding the rate of return that equates the current market price to the value of future cashflows.

Appendix 3: Glossary of Charts

The following provides a description of the charts used in Section 6 and a brief description of their interpretation.

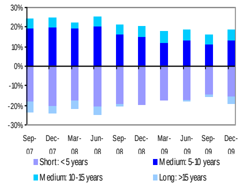
Reference	Description
#1 	This chart shows the quarterly relative return (blue bars) and rolling 3 year relative return (blue line) for the manager over 3 years/since inception. This shows the ability of the manager to achieve and outperform the benchmark over the medium term. The rolling 3 year benchmark absolute return (grey line) is overlaid to provide a context for relative performance, e.g. consistent underperformance in a falling market.
#2 	This chart shows the relative monthly returns for 3 years/since inception. It shows the level of fluctuation about the zero axis, i.e. the level of volatility of monthly returns and any tendency for positive or negative returns. The dotted lines show the standard deviation of returns over 1 year periods - this is a standard measure of risk which shows the magnitude of fluctuations of monthly returns. Under common **assumptions**, being within the inside dotted lines (i.e. 1 standard deviation) is roughly likely to occur 2/3rds of the time, while being within the outside lines is roughly likely to occur 1 in 20 times (i.e. 2 standard deviation - which is considered unlikely).
#4 	This chart shows the 3 year annualised tracking error (this is the standard deviation of returns which shows the magnitude of the fund returns compared to the benchmark) and the 3 year information ratio (this is the excess return divided by the tracking error). If tracking error increases, the risk taken away from the benchmark increases, and we would expect an increase in the excess return over time (albeit more variable). The turnover is provided to show if any increase in risk is reflected in an increase in the level of active management, i.e. purchases/sales in the portfolio.
#5 	This chart shows the absolute asset allocation or hedge fund strategy allocation over time. This helps to identify any significant change or trends over time in allocation to particular asset allocations/hedge fund strategies.
#6 	These charts show the breakdown of the return provided by each of the different hedge fund strategies or asset classes over time - this provides a profile of where the returns come from, and should be compared with the volatility chart above to see if risk taken is being rewarded accordingly. The total portfolio return is also shown.

#7



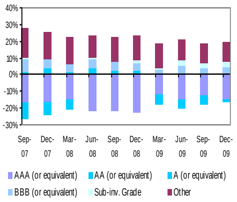
This chart plots the quarterly returns of the fund against quarterly returns of various indices. Any plots on the diagonal line represent the fund and the index achieving the same quarterly return - any below the line represents underperformance relative to the index, above the line represents outperformance. This is to highlight any apparent correlation between the fund returns and any particular index. If a fund is used as a diversifier from, say equities, we would expect to see a lack of returns plotted close to the diagonal line.

#8



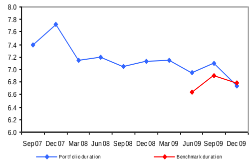
This chart shows the holding in short, medium and long maturity bonds relative to the benchmark. Over/underweight positions expose the fund to changes in the yield curve at different terms.

#9



This chart shows the holding in bonds with different credit ratings. AAA is the highest grading (usually for government or supranational organisation bonds) while below BBB is sub-investment grade and has a considerably higher risk of default. The lower the grade the higher the risk and therefore the higher the return expected on the bond.

#10



This chart shows the duration of the fund against the benchmark duration. It shows whether the fixed interest fund manager is taking duration bets against the benchmark.

Appendix 4: Summary of Mandates

Manager	Mandate	Benchmark	Outperformance target (p.a.)
Jupiter	UK Equities (Socially Responsible Investing)	FTSE All Share	+2%
TT International	UK Equities (Unconstrained)	FTSE All Share	+3-4%
Invesco	Global ex-UK Equities Enhanced (En. Indexation)	MSCI World ex UK NDR	+0.5%
Schroder	Global Equities (Unconstrained)	MSCI AC World Index Free	+4%
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%
Genesis	Emerging Market Equities	MSCI EM IMI TR	-
Unigestion	Emerging Market Equities	MSCI EM NET TR	+2-4%
Signet	Fund of Hedge Funds	3M LIBOR + 3%	-
Stenham	Fund of Hedge Funds	3M LIBOR + 3%	-
Gottex	Fund of Hedge Funds	3M LIBOR + 3%	-
BlackRock	Passive Multi-asset	In line with customised benchmarks using monthly mean fund weights	0%
BlackRock	Overseas Property	Customised benchmarks using monthly mean fund weights	0%
RLAM	UK Corporate Bond Fund	iBoxx £ non-Gilts all maturities	+0.8%
Schroder	UK Property	IPD UK pooled	+1.0%
Partners	Global Property	IPD Global pooled	+2.0%
Pyrford	DGF	RPI + 5%	-
Barings	DGF	3 Month Libor + 4%	-
Cash	Internally Managed	7 day LIBID	

JLT

JLT Employee Benefits

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