Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**26 JUNE 2015**
TITLE:	**REVIEW OF INVESTMENT PERFORMANCE (for periods ending 31 March 2015)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Annual Investment Review Exempt Appendix 3 – Changes in RAG status of Managers Appendix 4 – LAPFF Quarterly Engagement Monitoring Report Appendix 5 – Revised Statement of Investment Principles Appendix 6 – Potential impact of 2014 Budget flexibilities	

1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic aspects of the Fund's investments and funding level. This report contains performance statistics for periods ending 31 March 2015.

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

Section 4. Funding Level Update
Section 5. Annual Investment Review
Section 6. Investment Performance: A - Fund, B - Investment Managers
Section 7. Investment Strategy
Section 8. Portfolio Rebalancing and Cash Management
Section 9. Potential impact of 2014 Budget flexibilities
Section 10. Corporate Governance and Responsible Investment (RI) Update
Section 11. Update to Statement of Investment Principles

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

2.1 **Note the information set out in the report**

2.2 **Note LAPFF Quarterly Engagement Report at Appendix 4**

2.3 **Agree minor updates to the Statement of Investment Principles (SIP) as explained in Section 11, and approve the revised SIP in Appendix 5.**

2.4 **Note the assessment on the potential impact of the 2014 budget flexibilities on the Fund's cash flow and liabilities in Appendix 6.**

3 FINANCIAL IMPLICATIONS

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

4 FUNDING LEVEL

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

4.2 Key points from the analysis are:

(1) The funding level has fallen 7% over the year from 85% to c. 78% and the deficit has grown to c. £1.1bn from £876m.

(2) The deterioration over the year was largely due to a fall in real bond yields used to value the liabilities (from 5.1% to 3.9%), offset only partially by lower inflation expectations and better than expected investment returns.

5 ANNUAL INVESTMENT REVIEW

5.1 This quarter Mercer has provided an annual investment review of the year to 31 March 2015 (see Appendix 2) rather than the normal quarterly performance report. It was agreed as part of the strategic investment review in 2013 to provide an annual report to the Committee following the delegation of some investment decisions to the Investment Panel.

5.2 This purpose of this report is to inform the Committee as to how the strategy has performed over the last year, whether the underlying assumptions of the investment strategy remain valid, and whether the investment manager structure is delivering against expectations.

6 INVESTMENT PERFORMANCE

A – Fund Performance

6.1 The Fund's assets increased by £187m (a return of 5.5%) in the quarter, giving a value for the investment Fund of £3,829m at 31 March 2015. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers. Manager performance is monitored in detail by the Panel. The Fund's investment return and performance relative to benchmark is summarised below.

Table 1: Fund Investment Returns
Periods to 31 March 2015

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	5.5%	13.5%	11.2%
Avon Pension Fund (excl. currency hedging)	5.4%	13.3%	11.0%
Strategic benchmark (no currency hedging) *(Fund incl hedging, relative to benchmark)*	4.6% *(+0.9%)*	13.2% ***(+0.3%)***	9.9% *(+1.3%)*
Local Authority Average Fund *(Fund incl hedging, relative to benchmark)*	5.6% *(-0.1%)*	13.2% ***(+0.3)***	11.1% *(+0.1%)*

6.2 **Fund Investment Return:** Returns from Equity markets were positive over the quarter with Japan (16.4%) and Europe (10.6%) outperforming the US (5.9%) and the UK (4.7%). Emerging Markets also experienced strong returns (7.4%). Gilts and corporate bonds produced more moderate positive returns over the quarter following last quarters significantly strong returns.

6.3 Over the one year period all asset classes except UK Equities and hedge funds met or outperformed their strategic return assumption. Over 3 years all asset classes outperformed their strategic return assumption, with the exception of Emerging Market equities, hedge funds and overseas fixed interest.

6.4 **Fund Performance versus Benchmark: +0.3% over 12 months, attributed to**

(1) **Asset Allocation:** The contribution to outperformance from asset allocation was **0.7%** over the 12 months. This was due to the underweights to Hedge Funds and Diversified Growth, and an overweight in developed overseas equities. The currency hedging programme contributed **0.2%** over 1 year.

(2) **Manager Performance:** In aggregate, manager performance detracted -**0.6%** of the outperformance over the 12 month period, relative to the strategic benchmark, driven by under performance in overseas equities, hedge funds and property versus their individual benchmarks.

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

6.6 **Currency Hedging:** The hedging programme is in place to manage the volatility arising from overseas currency exposure, in particular to protect the Fund as sterling strengthens and returns from foreign denominated assets reduce in sterling terms. The hedging programme has contributed +0.1% from the total Fund return over the quarter and added 0.2% over the year.

B – Investment Manager Performance

6.7 Fifteen mandates met or exceeded their three year performance benchmark, which offset underperformance by Partners and Signet. SSgA, RLAM, and Jupiter all continue to perform particularly well against their three year performance targets.

6.8 Under the Red Amber Green (RAG) framework for monitoring manager performance, the Panel consider updates on all managers not currently achieving Green status including progress on action points. Any change in the RAG status of any manager is reported to Committee with an explanation of the change. **This quarter TT has been downgraded from a Green to an Amber rating (explained in Exempt Appendix 3).** Currently 3 managers are amber rated, Schroder (global equity), TT (UK equity) and Signet (fund of hedge funds).

7 INVESTMENT STRATEGY

7.1 Fund of Hedge Funds: Following a review of the Fund of Hedge Funds portfolio, and an open OJEU tender process, the Fund has appointed JP Morgan Asset Management to manage a bespoke portfolio of hedge fund investments.

7.2 Infrastructure: The Fund's investments in infrastructure are awaiting drawdown by the selected manager IFM who anticipate the funds being drawn down over the next 12 to 18 months.

7.3 A review of the Fund's management of liability risk is another item on the meeting agenda and will form a significant part of the workplan over the coming months.

8 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

8.1 The rebalancing policy requires automatic rebalancing between the allocations to Liquid Growth (equities and diversified growth funds) and Stabilising (Bonds) assets when the liquid growth portion deviates from 75% by +/- 5%. Tactical rebalancing is allowed between deviations of +/- 2 to +/- 5%, on advice from the Investment Consultant. The implementation of this policy is delegated to Officers.

8.2 The Equity:Bond allocation is estimated to be 77.3: 22.7 at 20 May 2015 which is within the range to review rebalancing. The upcoming investments in infrastructure will be funded from the equity portfolio which will bring the overweight to equites back into target range. Given this, it was decided not to rebalance ahead of this time to avoid overtrading.

Cash Management

8.3 Cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.

8.4 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies and during the quarter were invested in line with the Fund's Treasury Management Policy (latest approved on 28 March 2014).

8.5 The Fund continues to deposit internally managed cash on call with NatWest and Bank of Scotland. Following the withdrawal of Barclays Platinum Account and the March Committee's concern regarding the Eurozone the Fund is also depositing cash on call with Svenska Handelsbanken. This is following the approval by the Vice Chair to use counterparties meeting the required credit ratings that are outside the Eurozone. The Fund also deposits cash with the Goldman Sachs Asset Management Global Treasury Fund (AAA rated) and another AAA rated fund with Deutsche Bank is available for deposits if required. The Fund also has access to the Government's Debt Management Office, however the interest paid currently may not cover the transfer and administration costs incurred.

8.6 Following the lump sum deficit recovery payments in April 2014 it was forecast that there would be an average cash outflow of c. £3m each month during the year to 31 March 2015. In the quarter ending 31st March the outflow of cash averaged just over £2.2m. To fund the cash flow shortfall £5m of investment income was transferred back from the custodian during the quarter.

9 POTENTIAL IMPACT OF 2014 BUDGET FLEXIBILITIES

9.1 At the last meeting the committee requested an assessment of the potential impact on the fund of the pension flexibilities permitted from 1 April 2015 as set out in the 2014 budget. The 2014 Budget increased the flexibility available to members who hold Defined Contribution (DC) benefits, in particular allowing members the ability to take all DC benefits as a one off lump sum cash payment from April 2015 or drawdown on their pension pot as and when needed. The new flexibilities will potentially make transfers from DB schemes (including the LGPS) to DC arrangements more appealing for members than they have been in the past. Members have to get advice from an IFA before asking for a transfer and whilst it would be reasonable to expect that an IFA would not recommend a member to transfer their benefits away from an LGPS Fund (given the transfer terms), the option of taking all benefits as either a one off lump sum or as cash in different stages may be very appealing, depending on each individual's circumstances, such that the transfer may be taken anyway.

9.2 From the Fund's perspective, the changes coming into force in April 2015 could have a material negative impact on the liquidity of the Fund. The investment strategy takes the Fund's cash flow requirements in to account as the Fund is already experiencing negative cashflow if investment income is excluded. In recent years the investment strategy has focussed on income generating assets and the investment structure has been altered so that more income is distributed. The investment strategy and policies are monitored on an on-going basis and once there is more indication of the level of take up of these flexibilities, the investment strategy/structure may have to be reviewed in respect of investment income and treasury management (the level of cash reserves held).

9.3 Whilst one key impact is in relation to cash flows a further perhaps beneficial, albeit smaller at a total Fund level, impact is in relation to the reduction in liabilities and future risk e.g. in relation to longevity, given a member's benefit entitlements in the Fund would be extinguished if they take a transfer value. Equally there is a bigger proportionate impact for employers who have a small number of members.

9.4 Appendix 6 summarises the potential impact on the fund of these flexibilities in more detail.

9.5 The level of take up is as yet unknown but the actuary's view is that it is unlikely to be significant initially because of (i) the transfer terms currently offered given current market conditions; (ii) that the members will have to find a DC vehicle to transfer into and obtain independent financial advice if their pot is more than £30,000. A real "game-changer" in terms of take-up rates could be if defined benefit schemes (including the LGPS) were allowed to facilitate the flexibilities directly by for example, allowing members to "drawdown" on the value of their DB pension, as it removes at least one of the barriers. This is expected to be consulted on now that the General Election is over. However, based on anecdotal experience around the globe e.g. Australia where flexibilities have existed for many years now, it may not move the take-up to very high levels.

10 CORPORATE GOVERNANCE UPDATE

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

Companies Meetings Voted:	128
Resolutions voted:	1,631
Votes For:	1,574
Votes Against:	57
Abstained:	3
Withheld* vote:	0

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

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

11 STATEMENT OF INVESTMENT PRINCIPLES

11.1 The Fund's Statement of Investment Principles sets out the Fund's investment strategy and policies and states how the Fund complies with the Myners Principles for Effective Decision Making. The requirement to produce a Statement of Investment Principles is set out in the Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2009. These regulations provide that "the written statement must be revised by the administering authority in accordance with any material change in their policy … and published".

11.2 The SIP has been updated to include 3 new investment managers who have been added to the table of Investment Manager Mandates in page 5 of the SIP included in Appendix 5. Standard Life replace Barings DGF mandate, and IFM and JP Morgan Asset Management are new mandates.

11.3 The Committee is asked to approve the revised SIP in Appendix 5.

12 RISK MANAGEMENT

12.1 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.

13 EQUALITIES

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

14 CONSULTATION

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

15 ISSUES TO CONSIDER IN REACHING THE DECISION

15.1 The issues to consider are contained in the report.

16 ADVICE SOUGHT

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

Contact person	Matt Betts, Assistant Investments Manager (Tel: 01225 395420)
Background papers	LAPFF Member Bulletins, Data supplied by The WM Company Mercer report on 2014 Budget flexibilities
Please contact the report author if you need to access this report in an alternative format	