Partners Overseas Property Mandate – Performance Reporting

1. Introduction

Panel members have previously expressed concern that the performance information they were receiving on the Partners overseas property portfolio did not clearly show whether the portfolio was performing in line with expectations. Officers have reconciled the various performance measures and reviewed the choice of benchmarks used to monitor the portfolio. They have also asked for more detailed data to provide greater assurance of the monetary value being created by Partners

2. Issue

The benchmark returns and returns calculated by WM (external performance measurement provider) are not reported in measures that are directly comparable with the performance data provided by Partners. This arises because the specific nature of the investments (i.e. they are closed-ended funds) means that returns are best measured by an Internal Rate of Return (IRR) measure, but the available benchmarks and WM's calculations are time weighted return measures. As a result there are significant differences between the two investment returns, with WM's time weighted return being below the returns reported by Partners in IRRs.

The benchmark used for global property in the strategic benchmark and the benchmark used for monitoring Partners performance also have other shortcomings explained below (see 4.).

3. Why are IRRs the best performance measure for Closed-ended funds?

The investments with Partners Group are held in closed-ended funds. In such vehicles the manager invests for a defined period; investors commit a level of money to be invested; it is drawndown over time and when assets are realised capital is returned to investors. The nature of the way such funds are invested results in significant cash flows to and from investors and the closed-end fund.

Ultimately the return of these funds will be known once all underlying assets have been sold and value is realised. To monitor performance in the meantime, it is necessary to evaluate the estimated value of the assets held and also the cashflows they have generated. The impact on performance of such cashflows is not captured efficiently by the traditional time weighted return calculation used for the majority of the Fund's assets which do not experience such significant cashflows. IRRs do calculate the impact of such cashflows and therefore provide a more accurate view of added value and performance for closed-end funds. IRRs are routinely used throughout the industry to measure the return of closed ended funds , whether they invest in property, private equity or private debt.

WM use time weighted return calculations because it is the industry norm for the majority of asset classes and it is not possible to combine different measurement approaches for individual mandates when calculating the aggregate fund return.

4. Benchmark Considerations

i) Current Benchmarks

Strategic Benchmark – The Fund uses the strategic benchmark to measure the Fund's return against the return generated by the asset allocation. Thus is uses the strategic asset allocation and applies a "benchmark" for each part. To generate the strategic benchmark, index returns for an asset class (as proxy for long term return expectations if invest passively) are preferred where available. **Therefore the best benchmark in this instance would be one that represents the generic market returns from investing in global property.**

Partners Mandate Benchmark – This benchmark aims to evaluate how Partners are performing compared to the expectations the Fund has of the particular mandate. **Therefore the best benchmark in this instance would be one that reflects the expected returns for a portfolio of closed-end global property funds.**

Both the strategic benchmark and the mandate benchmark currently use the IPD UK Property benchmark which reflects the performance of funds investing in core UK property.

ii) Shortcomings of current Benchmarks

At the time the Partners mandate was put in place the IPD UK Property index was the only established property benchmark available, but it was recognised at the time that it was not ideal for the following reasons:

Strategic benchmark (represents generic global property returns):

- Strategy allocates to global property, the benchmark reflects only UK property returns

Mandate benchmark (represents performance measure for Partners):

- Partners invest in a global opportunity set, the benchmark reflects only UK
- Partners invest in core, value-added and opportunistic investments, the benchmark reflects only core property investments

- Partners investments are via closed-end funds which inherently experience significant cash flows, the benchmark does not reflect closed-end type cashflows.

The difficulty in finding an appropriate benchmark for such mandates is one faced by many investors. Other LGPS funds adopt a range of approaches from using the IPD, to using cash plus benchmarks or absolute return benchmarks. No one approach has gained acceptance as a 'best practice' approach for benchmarking a closed end fund mandate.

iii) Proposed changes to benchmarks

After consultation with Mercer the following changes are proposed:

Strategic Benchmark – It is proposed that the IPD Global benchmark is used which better aligns the benchmark to the generic market returns from investing in global property rather than just UK property.

Partners Mandate Benchmark – It is proposed that a cash plus 4% benchmark is used which is a more appropriate proxy (and therefore performance measure) for the expected returns for a portfolio of closed-end global property funds similar to Partners portfolio. It should be noted that when using cash plus benchmarks performance should be considered over the long term and not over shorter time periods.

5. Partners Performance

At the 31 March 2015 the IRR of the portfolio was 10.1% per annum since inception. This is in line with their target of 10% IRR p.a..

WM calculate the time weighted return of the portfolio since inception at 6.3% p.a. (as explained, it is expected that difference between IRR measures and time weighted return measures will continue). Compared to the IPD UK benchmark return of 9.7% p.a. this is an underperformance of 3.3% p.a. (which has been reported to Panel and Committee). From 1st October the time weighted return from WM will be reported versus a cash plus 4% benchmark.

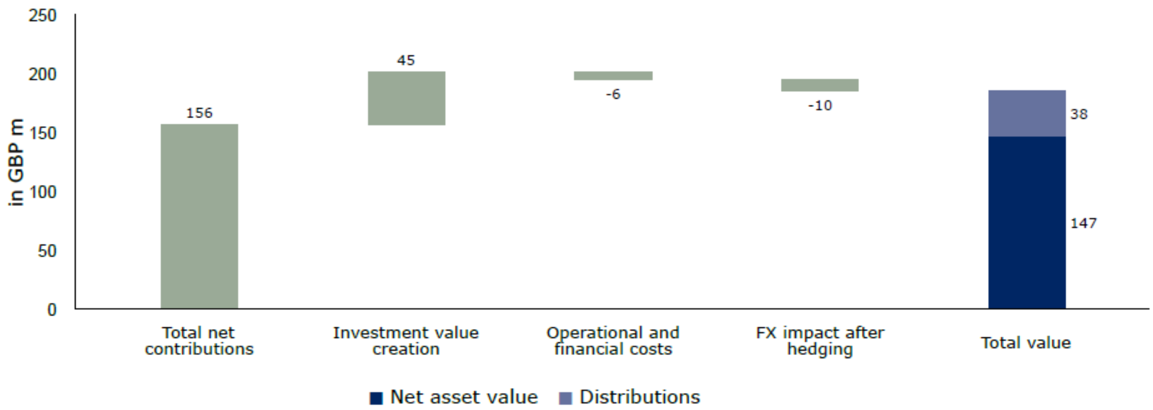
Partners are now providing quarterly IRRs and officers have reconciled these quarterly IRRs with the time weighted returns calculated by WM, providing confidence in the IRR measures provided by Partners and WM. Analysis in Table 1 shows the comparison between the 2 measures over the last 3 quarters. It shows a level of difference between the 2 calculation results that could be reasonably expected given the different methods of calculation. Because cash flows occur on a regular basis the 2 measures will always differ.

Table 1: Comparison of Partners quarterly returns calculated as IRRs and Time Weighted Returns

	Partners Quarterly IRR in GBP	WM Partners Return in GBP
Q2 2015	0.48%	1.00%
Q1 2015	4.85%	4.30%
Q4 2014	0.15%	0.10%

In addition, officers are receiving reporting from Partners which allows for analysis of value generated, an example of which is shown in Chart 1 below. This shows the total value of the portfolio (comprising current net asset value and distributions made to APF to date) and the corresponding contributions and value generated to attain the current value. The data in Chart 1 is as at 31 March 2015 and reflects an IRR of 10.1% since inception as reported above.

Chart 1: Partners Portfolio Summary of Value Added as at 31 March 2015



6. Future Reporting of Performance

i) Partners Mandate

Future reporting to Panel will show:

- the IRR of the portfolio (as the more preferred measure) compared to the target IRR return.
- WM's measure of Partners time weighted return versus the cash plus 4% benchmark.

Both measures will be used to evaluate how Partners are performing against expectations, with the focus on longer term measures of 3 years and beyond. The RAG reporting and Mercer performance reporting will be amended to reflect these changes.

Partners will also be providing the value generated (as per Chart 1) for each fund over the coming quarters and it will be monitored by Officers who will report any significant departure from long term expectations to the Panel as part of the routine performance reporting.

ii) Strategic level

WM will continue to calculate the time weighted return of the Partners portfolio in order to calculate the overall APF return versus the strategic benchmark. Overseas property will be represented in the strategic benchmark by the IPD Global Index which recognises the strategic decision to allocate to global property but not the investment approach taken. This means differences will continue to appear especially where significant cashflows occur within the Partners portfolio during the quarter. Such differences will be explained in the attribution analysis of the strategic benchmark provided in the Committee performance report.

7. SUMMARY

- Partners performance

Mercer and Officers are satisfied that the performance of the Partners portfolio is in line with long term expectations.

- Changes to Performance Reporting

The following changes to performance reporting should allow for a more meaningful measure of performance:

1. Partners performance (measured by WM as time weighted returns) to be evaluated against a cash plus 4% benchmark (currently use IPD UK property benchmark as the benchmark). In addition, IRRs generated by the portfolio (as calculated by Partners) will be compared to the target IRR return of 10%.

2. Overseas property allocation is to be represented in the strategic benchmark by the IPD global property benchmark (currently IPD UK property benchmark), and continues to be measured as time weighted return to fit in with the aggregate fund return analysis.

3. These changes will be reflected in performance reporting from next quarter.