

Bath & North East Somerset Council

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| MEETING: | AVON PENSION FUND COMMITTEE |
| MEETING DATE: | 11 DECEMBER 2015 |
| TITLE: | REVIEW OF INVESTMENT PERFORMANCE (for periods ending 30 September 2015) |
| WARD: | ALL |
| AN OPEN PUBLIC ITEM | |
| List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Performance Monitoring Report Appendix 3 – LAPFF Quarterly Engagement Monitoring Report Appendix 4 – Revised Statement of Investment Principles | |

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 30 September 2015.
- 1.2 The main body of the report comprises the following sections:
 - Section 4. Funding Level Update
 - Section 5. Investment Performance: A - Fund, B - Investment Managers
 - Section 6. Investment Strategy
 - Section 7. Changes to Statement of Investment Principles
 - Section 8. Portfolio Rebalancing and Cash Management
 - Section 9. Annual Assurance on Control Environment of 3rd Party Suppliers
 - Section 10. Corporate Governance and Responsible Investment (RI) Update

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 3**
- 2.3 **Agree minor updates to the Statement of Investment Principles (SIP) as explained in Section 7, and approve the revised SIP in Appendix 4.**

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 c.4% over the quarter from 77% to c. 73% and the deficit has risen from c. £1.1bn to c. £1.35bn.
- (2) The deterioration over the quarter was largely due to negative returns from major asset classes over the quarter and a fall in the discount rate from 4.3% to 4.0% increasing the value of liabilities. There was a slight fall in long term inflation but not enough to offset the fall in the discount rate.

Note: this funding level is based on the 2013 valuation assumptions including the discount rate. In the earlier agenda paper "Interim Valuation 2015", the actuary modified the discount rate which resulted in a higher funding position than the one reported here.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets decreased by £129m (a return of -3.6%) in the quarter, giving a value for the investment Fund of £3,601m at 30 September 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 30 September 2015

| | 3 months | 12 months | 3 years (p.a.) |
|---|----------------|----------------|----------------|
| Avon Pension Fund (incl. currency hedging) | -3.6% | 2.2% | 8.3% |
| Avon Pension Fund (excl. currency hedging) | -2.8% | 2.5% | 8.3% |
| Strategic benchmark (no currency hedging) | -2.5% | 2.8% | 7.7% |
| <i>(Fund incl hedging, relative to benchmark)</i> | <i>(-1.1%)</i> | <i>(-0.6%)</i> | <i>(+0.6%)</i> |
| Local Authority Average Fund | -3.5% | 2.5% | 8.3% |
| <i>(Fund incl hedging, relative to benchmark)</i> | <i>(-0.1%)</i> | <i>(-0.3)</i> | <i>(0.0%)</i> |

5.2 **Fund Investment Return:** All Equity markets produced negative returns over the quarter in Sterling terms. Emerging Markets was the worst performing region (-

15.6%) whilst the UK All Share Index fell by -5.7%. Bond yields fell across all maturities leading to positive returns from Gilts 5.1% and Corporate Bonds 1%.

5.3 Over 3 years asset class performance was mixed compared to their strategic return assumption. Developed Market Equities, UK Gilts, Index Linked Gilts and Property were all ahead of the assumed return whilst Corporate Bonds were marginally behind. Overseas Fixed Interest and Hedge Funds were behind whilst Emerging Market Equities were significantly behind the assumption.

5.4 Fund Performance versus Benchmark: -0.3% over 12 months, attributed to

(1) **Asset Allocation:** The contribution to outperformance from asset allocation was **0.3%** over the 12 months. This was due to the underweights to hedge funds and emerging market equities, and an overweight to overseas equities. The currency hedging programme detracted **-0.3%** over 1 year.

(2) **Manager Performance:** In aggregate, manager performance detracted **-0.3%** of the outperformance over the 12 month period, relative to the strategic benchmark, driven by under performance in diversified growth, hedge funds and property versus their individual benchmarks.

5.5 Versus Local Authority Average Fund: Over one year, the Fund underperformed the average fund and was in line over 3 years.

5.6 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 detracted -0.8% to the total Fund return over the quarter and -0.3% over the year.

B – Investment Manager Performance

5.7 Nine mandates met or exceeded their three year performance benchmark, which offset underperformance by Partners, Signet, Gottex and Schroder Global Equity. SSgA, RLAM, and Jupiter all continue to perform particularly well against their three year performance targets.

5.8 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 no changes have been made to any managers rating.** Currently 1 manager is amber rated, Schroder (global equity) and Panel are monitoring performance which has shown signs of improvement over recent quarters.

6 INVESTMENT STRATEGY

6.1 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.

6.2 The Investment Panel is undertaking a review of the Fund's management of liability risk which will form a significant part of the workplan over the coming months.

7 CHANGES TO STATEMENT OF INVESTMENT PRINCIPLES

7.1 The Fund's Statement of Investment Principles (SIP) 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

SIP 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”.

7.2 The SIP has been updated to reflect the changes to the currency hedging mandate from an active dynamic approach to a passive approach as agreed by the Investment Panel and notified to Committee in September. The list of Investment Manager mandates has also been updated to reflect the fund of hedge fund mandates that have been (or are in the process of being) redeemed and the new fund of hedge funds mandate managed by JP Morgan has now been seeded.

7.3 The Committee is asked to approve the revised SIP in Appendix 4.

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 (inc. DGFs):Bond allocation is estimated to be 76.5:23.5 at 11 November 2015 which is within the acceptable range, requiring no action.

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.

8.5 The Fund continues to deposit internally managed cash on call with NatWest, Bank of Scotland and Svenska Handelsbanken. The Fund also deposits cash with the Goldman Sachs Asset Management Global Treasury Fund (AAA rated). In addition The Fund 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 During the period there were no breaches of the Fund's Treasury Management Policy (approved June 2015).

9 ANNUAL ASSURANCE ON CONTROL ENVIRONMENT OF 3RD PARTY SUPPLIERS

9.1 As part of the risk management process the Fund annually reviews the internal control reports (ICR) of the custodian and investment managers (and their administrators where relevant), and reports the findings to Committee. These reports are often designated SSAE16 or ISAE3402 reports (previously AAF 01/06 and SAS70 reports), that states which set of standards are being reported against.

9.2 ICR reports describe the internal control environment of an organisation. The management of the organisation are responsible for identifying the control procedures which they consider appropriate to enable certain control objectives to

be met. External auditors verify that the controls identified are in place and comment on whether the controls will achieve the stated objectives or not.

9.3 For the reports reviewed in 2014/15, in each case the external auditor's report stated that the controls were in place and achieved the control objective and there are no issues to bring to the attention of the Committee. As part of the process, officers discuss the significance of the internal control reports with investment managers and custodian on an on-going basis and follow-up any issues flagged in the reports.

9.4 The ICRs of the pooled funds (and their administrators/custodian) and the Fund's custodian are also audited by the Fund's external auditor as part of the annual audit.

10 CORPORATE GOVERNANCE UPDATE

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

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|---------------------------|-------|
| Companies Meetings Voted: | 153 |
| Resolutions voted: | 2,205 |
| Votes For: | 2,148 |
| Votes Against: | 20 |
| Abstained: | 9 |
| 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 3.

11 RISK MANAGEMENT

11.1 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.

12 EQUALITIES

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

13 CONSULTATION

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

14 ISSUES TO CONSIDER IN REACHING THE DECISION

14.1 The issues to consider are contained in the report.

15 ADVICE SOUGHT

15.1 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.

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