Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**23 JUNE 2017**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 March 2017)**
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 Investment Managers Appendix 4 – LAPFF Quarterly Engagement Monitoring Report	

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 2017.

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. Portfolio Rebalancing and Cash Management
Section 8. 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 4**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund from 1 April 2016 will affect the next triennial valuation in 2019. 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 risen c.10% over the year from 86% to 96%.

(2) The improvement over the year was driven by a positive return on assets (particularly strong absolute returns from equities) outweighing an increase in the present value of the liabilities.

5 ANNUAL INVESTMENT REVIEW

5.1 This quarter Mercer has provided an annual investment review of the year to 31 March 2017 (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 The 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. These factors will be considered in greater detail as part of the 2017 strategic investment review.

6 INVESTMENT PERFORMANCE

A – Fund Performance

6.1 The Fund's assets increased by £618m (16.5%) over the year ending 31 March 2017 giving a value for the investment Fund of £4,356m. 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 Investment Panel. The Fund's investment return and performance relative to benchmark is summarised below.

Table 1: Fund Investment Returns

Periods to 31 March 2017

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	4.0%	17.2%	9.1%
Avon Pension Fund (excl. currency hedging)	3.8%	20.2%	10.8%
Strategic benchmark (no currency hedging) *(Fund incl. hedging, relative to benchmark)*	3.7% *(+0.3%)*	20.1% ***(-2.9%)***	11.3% *(-2.2%)*

6.2 **Fund Investment Return:** Over the year both developed market and emerging market equities delivered strong absolute returns. Upward momentum in developed market equities initially continued into Q1 2017 but started to correct as the market questioned President Trump's ability to implement healthcare, taxation and regulatory reforms. Equity market valuations appear to remain stretched and the prospect of unified interest rate increases from developed economies could lead to a more material downward move in the medium-term. Despite waning risk appetite among investors the FTSE 100 posted all-time highs in March and UK business activity growth hit a three-month high in the same month. The US Federal Reserve sought to head off rising inflation with the second interest rate rise in three months, taking the base rate from 0.75% to 1%. A tightening in US monetary policy tends to increase the cost of borrowing for many emerging market economies but this did not seem to impair returns this quarter as emerging markets performed well on a perceived mellowing of Trump's protectionist rhetoric and a number of upside surprises in China's economic data. There is increasing speculation that the ECB may follow the Fed by reducing their quantitative easing program and tightening monetary policy by implementing rate hikes in 2017. Benchmark 10-year bond yields rose marginally in most European countries in the quarter as a result of increasing inflation. Conversely, UK 10-year yields fell by c0.20%, consistent with the scaling-back in equity market performance toward the end of the quarter. In the currency markets, the USD broadly weakened. While sterling posted gains against the US dollar, it depreciated against the Yen and Euro.

6.3 **Fund Performance versus Benchmark: -2.9% over the year, attributed to**

(1) **Asset Allocation:** The contribution to outperformance from asset allocation was **-0.2%** over the year. The currency hedging programme detracted **-3.0%** over the year. The Fund marginally outperformed the unhedged strategic benchmark return (which excludes currency hedging) over the year. Passive equities and infrastructure were the main contributors to this performance whilst DGFs and the UK SRI mandate were the main detractors.

(2) **Manager Performance:** In aggregate, the contribution of manager performance was **+0.3%** over the year, relative to the strategic benchmark. The fact active managers were not able to capture the market preference for 'value' stocks – where many hold portfolios tilted toward 'quality' stocks – led to minimal contribution to returns.

6.4 **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 contributed +0.2% to the total Fund return over the quarter and detracted -3.0% over the year.

B – Investment Manager Performance

6.5 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 one manager has been downgraded from Green to Amber** (explained in Exempt Appendix 3). Therefore, currently 6 managers are Amber rated, Schroder (global equity), Jupiter, TT, Pyrford, Unigestion and Genesis.

6.6 All mandates delivered positive absolute returns over the year to 31 March 2017. On a rolling 3 year basis SSgA (Europe and Pacific) was the only manager to outperform its target. Invesco, RLAM and Schroder Property were marginally below their performance targets but within the tolerance range for a Green RAG rating.

7 INVESTMENT STRATEGY

7.1 **Asset Class Returns:** Returns from developed equities, corporate bonds, index-linked gilts outperformed the strategic assumptions over three years; the latter two were significantly ahead of the assumed return. Emerging market equities benefitted from increased risk appetite from investors and improving fundamental economic data. Emerging market equities are ahead of their assumed return by c.4%. Infrastructure is well ahead of expected returns. Hedge Funds lag their assumed return due to exceptionally low cash rates.

7.2 **MIFID II**: The FCA will release details of the opt-up criteria LGPS will need to satisfy in order to be re-classified as a 'professional counterparty' from the default position of 'retail counterparty'. Once the FCA has made its position clear the Fund will work towards satisfying the revised tests to meet an 'elective professional status'. The deadline for implementation of MIFID II is 3 January 2018.

7.3 **Currency Hedging Policy:** Since the result of the EU referendum, Sterling has fallen significantly against other major currencies (increasing the local market value of non-sterling assets). This trend reversed slightly in Q1 versus the dollar with the pound appreciating against the dollar by c1.2% although sterling continued to weaken against the euro and yen over the quarter. Given the majority of hedging activity is versus the dollar, the currency hedge on the non-sterling assets has added value to local currency returns on infrastructure, hedge funds, and to a lesser extent, overseas equities and property. The Consultant and Officers reaffirmed their position on currency hedging at September 2016 Panel and will further review the hedging policy at the strategic review in July 2017.

8 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

8.1 As at 24 May 2017 the Fund was within all strategic asset allocation ranges. Officers, having taken advice from Mercer, sold $105m North American equities from the passive portfolio in January to fund the final commitment to the infrastructure mandate (IFM) in February.

8.2 After quarter end the Fund received c£84m in up front deficit payments from employers. On advice from Mercer this has been placed in cash liquidity funds in the short-term, pending the outcome of the ongoing investment strategy review. This relatively high cash balance will be reviewed on a monthly basis.

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 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. Deposits with NatWest (the Council / Fund's banker) are kept to the minimum necessary for day to day management.

8.6 During the year there were no breaches of the Fund's Treasury Management Policy for 2016-17(approved March 2016).

8.7 The 2016/17 Service Plan forecast an average cash outflow of c. £1.5m each month during the year to 31 March 2017, making a total outflow of £17.5m for the year to 31st March 2017. The actual cash out-flow for the year was £16.6m. Further details are provided in the pension fund budget and cash flow monitoring report to this Committee.

8.8 The 2017/18 Service Plan forecast an average cash outflow of c. £1.37m each month during the year to 31 March 2018. However this was based on the assumption that deficit contributions required by the 2016 Triennial Valuation would be spread over three years. In fact several major employers elected to pay their three year deficit contributions in April 2017 in order to achieve a discount. The consequent £86m cash in-flow was immediately passed on to the Fund's custodian to be available for investment.

8.9 As a consequence of the advance payments of deficit contributions the Fund will experience continued monthly net cash outflows. These will be managed by taking more income from the investment portfolio.

9 CORPORATE GOVERNANCE UPDATE

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

Companies Meetings Voted:	107
Resolutions voted:	1517
Votes For:	1372
Votes Against:	139
Abstained:	15
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.*

9.2 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.

10 RISK MANAGEMENT

10.1 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.

11 EQUALITIES

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

12 CONSULTATION

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

13 ISSUES TO CONSIDER IN REACHING THE DECISION

13.1 The issues to consider are contained in the report.

14 ADVICE SOUGHT

14.1 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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Background papers	Data supplied by BNY Performance Services
Please contact the report author if you need to access this report in an alternative format	