Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**23 MARCH 2018**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 December 2017)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	

List of attachments to this report:

Appendix 1 – Fund Valuation

Appendix 2 – Mercer Performance Monitoring Report

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 strategic aspects of the Fund's investments and funding level; and policy and operational aspects of the Fund.

1.2 This report contains performance statistics for periods ending 31 December 2017.

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 increased by c.1% over the quarter to 98.5%.

(2) The increase in the funding level over the quarter was driven by the positive return on assets outweighing the change in the present value of the liabilities.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £86m (2%) over the quarter ending 31 December 2017 giving a value for the investment Fund of £4,660m. 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 December 2017

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	2.4%	9.7%	8.5%
Avon Pension Fund (excl. currency hedging)	2.0%	8.1%	9.6%
Strategic benchmark (no currency hedging) *(Fund incl. hedging, relative to benchmark)*	2.7% *(-0.3%)*	8.7% ***(+1.0%)***	10.1% *(-1.6%)*

5.2 During the quarter bond markets rallied, equity indexes continued to beat records and a weak US Dollar in combination with a strong global economic outlook benefitted commodity prices. Developed and emerging market equities both posted gains in excess of 5%. US and UK equities posted returns of 6.5% and 4.9%, respectively. Japanese equities also continued the momentum from last quarter gaining 8.6%, helped by the landslide victory of Japanese Prime Minister Shinzo Abe in a snap general election held in October. Eurozone equities ended the three months to December 2017 down by 0.5% due to in part to The European Central Bank halving its asset purchases under its quantitative easing program. UK 10-year bond yields fell 0.18% and 30-year yields fell 0.16%. Over the quarter, sterling appreciated against the Dollar and marginally more so against the Yen (by

0.8% and 0.9% respectively). Sterling depreciated against the Euro over the quarter by 0.7%.

5.3 **Fund Performance versus Benchmark: -0.3% over the quarter, attributed to**

(1) **Asset Allocation:** Asset allocation, adjusted for the impact of the equity protection strategy, detracted -0.3% over the quarter. The currency hedging programme contributed +0.4**%** over the quarter.

(2) **Manager Performance:** In aggregate, the contribution of manager performance was -0.4% over the quarter, 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 a drag on relative returns this quarter.

5.4 **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 the returns from foreign denominated assets reduce in sterling terms. The hedging programme contributed +0.4% to the total Fund return over the quarter and contributed +1.6% over the year.

B – Investment Manager Performance

5.5 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 and 1 manager is Red rated.

5.6 Manager absolute returns over the quarter were all positive. Emerging Market mandates delivered the highest absolute returns, with both managers posting in excess of 6%.

6 INVESTMENT STRATEGY

6.1 **Asset Class Returns:** Developed equity returns over the last three years were 15.5% p.a., materially ahead of the assumed strategic return of 8.05% p.a. from the review undertaken in April 2017. The three year return from emerging market equities increased to 13.7% p.a. from 11.6% p.a. last quarter and remains well ahead of the assumed strategic return of 8.7%. Index-linked gilts returned 8.9% p.a. versus an assumed return of 2.15% p.a. as yields remain low against historical averages. Corporate bonds, property and infrastructure are also ahead of their respective assumed returns. Hedge Funds lag their assumed return due to exceptionally low cash rates.

6.2 **Currency Hedging Policy:** The Fund's currency hedging policy was positive for overall Fund performance since the Pound Sterling appreciated against the US Dollar and Japanese Yen over the quarter but fell against the Euro.

6.3 **Equity Protection Strategy:** The equity protection strategy, designed to guard against a large draw-down in equity markets, was fully implemented in December. As at 31 December the strategy detracted c. £12.9m from fund returns as equity markets continued to move higher. The performance of the strategy was in line with expectation and at time of publishing held a positive market value due to a correction in wider equity market prices. For reference, gains in equity markets are capped at c.8% from the respective index level at inception of the strategy and the extent to which the strategy adds/detracts value is driven by the likelihood of equity markets being above 8% at maturity of the strategy.

6.4 **Liability Driven Investment (LDI) Strategy:** No further hedging took place under the Funds LDI strategy. The Fund remains c. 29% hedged against inflation and c. 13% hedged against nominal interest rates.

6.5 **Collateral Management:** The Panel reviewed the collateral position at their meeting on 21 February. There was sufficient collateral in the QIF (Qualified Investment Fund managed by Blackrock) to support the LDI and the equity protection strategy. There were no counterparty breaches.

7 MIFID II OPT UP PROGRESS

7.1 In July the FCA released details of the revised criteria that LGPS schemes would have to fulfil in order to opt up to 'professional investor' status from the default position of 'retail investor'.

7.2 Following requests from the Fund to opt up in 4Q17, the process has been completed with all managers, advisors and custodians confirming that they will treat the Fund as an 'elective professional' client.

8 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

8.1 As at 31 December 2017 the Fund was within all strategic asset allocation ranges. Officers did not undertake any rebalancing activity during the quarter.

8.2 Further asset allocation changes agreed in the strategic review in July 2017 were implemented in the quarter, specifically to invest in Multi Asset Credit by trimming emerging market equities and corporate bond positions.

8.3 The switch to the Low Carbon Passive Fund was completed in two phases between December and February by Blackrock, the passive manager. The transition costs came in below the pre-transition estimate. The direct costs covering fees, charges, taxes and transaction costs were in line with the pre–trade estimate. The market impact costs (the extent to which trading activity moves prices adversely during the transition) were far lower than estimated and offset some of the direct costs.

Cash Management

8.4 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.

8.5 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.

8.6 The 2017/18 Service Plan forecast an average cash outflow of c. £1.3m each month during the year to 31 March 2018, making a total outflow of £16.4m for the year to 31st March 2018. The current forecast is for the cash in-flow for the year to be £12.6m, £4m less than forecast in the Service Plan. Further details are provided in the pension fund budget and cash flow monitoring report to this Committee.

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:	60
Resolutions voted:	670
Votes For:	595
Votes Against:	34
Abstained:	44
Withheld* vote:	17

** 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 TRANSFER TO NEW CUSTODIAN

10.1 The Fund instructed its legacy custodian to transfer assets to State Street on 13 December 2017. At time of publishing 91% of assets had successfully settled/re-registered or been redeemed and transferred as cash. The remaining 9% of assets are pooled funds that are out-to-registration with respective transfer agents and expected to be re-registered at the new custodian during 1Q18.

10.2 Due to the timing of the transition and time needed to close the accounting records for the month of December, performance measurement reports were not available at time of writing. This quarter investment manager data has been used to compile returns and Mercer has calculated the total Fund return. It is intended that performance reporting from the new custodian will be in place next quarter.

11 LGPS TRANSPARENCY CODE

11.1 The LGPS Transparency Code was launched in 2017 with the aim that all investment managers would provide their clients with consistent fees and cost data, so that accurate and consistent investment costs are reflected in financial accounts. The cost template for quoted assets was first launched in May 2017 with a view that CIPFA would look to embed the requirements into its guidance. Signing up to the Code is voluntary; however once signed up the manager has 12 months to provide the data to clients (the timeframe is required to ensure managers have systems in place to capture all costs details).

11.2 However, the LGPS the work on the LGPS Code of Transparency has now been folded into the FCA cost transparency initiative and the FCA Institutional Disclosure Working Group (IDWG) has been established which has LGPS representation on it. The IDWG, supported by the FCA, have been tasked with rolling out cost transparency across the UK institutional market. The LGA has confirmed that the templates produced by the IDWG will be adopted by the LGA for the LGPS Code of Transparency. The IDWG is developing a template covering all asset classes (including non-quoted and private assets and currency hedging), specifically designed for DB pension schemes such as the LGPS.

Managers have been asked to comment on this template with the intention of this template being produced in the summer of 2018.

11.3 All our managers of quoted equity and bond mandates have signed up to the code with the others intending to once the template is agreed and they will then have time to ensure systems are in place to capture and report the data.

11.4 As we will not have complete data for the financial year 2017/18 we will report the costs consistent with 2016/17 accounts. However in future years we intend to provide greater disclosure across all investments.

11.5 Brunel Pension Partnership has committed to report in line with the Transparency Code. They have set a target to have 100% of their appointed managers signed up to the code. As Brunel is currently designing their systems to capture the data needed, it makes sense to do this based on the final template produced by the FCA, as they believe this will build on the current LGPS requirements and will become an industry-wide standard. Therefore they should be in a position to provide this data from 2018/19 year end.

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 (Strategic Director of Resources) 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	