Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**21 SEPTEMBER 2018**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 June 2018)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Quarterly 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; and policy and operational aspects of the Fund.

1.2 This report contains performance statistics for periods ending 30 June 2018.

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.1% over the quarter from 96% to 97%.

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

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £102m (c.2.3%) over the quarter ending 30 June 2018 giving a value for the investment Fund of £4,710m. 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 30 June 2018

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	2.3%	6.0%	8.1%
Avon Pension Fund (excl. currency hedging)	3.4%	5.9%	9.6%
Strategic benchmark (no currency hedging) *(Fund incl. hedging, relative to benchmark)*	3.4% *(-1.1%)*	6.5% ***(-0.5%)***	9.4% *(-1.3%)*

5.2 **Fund Investment Return:** Over the quarter European and Emerging Market stocks fell out of favour. European outflows were driven primarily by a quarter of political turbulence and tepid macroeconomic data. Declines in Emerging Markets intensified towards the end of the quarter with political posturing acting as the catalyst in an already challenging environment for Emerging Markets. With US interest rates on the rise and the US Dollar appreciating, a number of regions were faced with higher borrowing costs on already large levels of debt. US equities recovered outflows sustained in 1Q18 as prices were supported by sound fundamentals and positive investor sentiment. UK stocks followed suit, with large-cap stocks outperforming the broader market.

UK Gilt yields started the quarter on an upward trend consistent with an increase in risk appetite. The benchmark 10 year gilt yield rose from 1.35% at

the end of March to a high of 1.56% in mid-May. Later in the quarter the political uncertainty in Italy and heightened geopolitical risk in emerging markets drove a flight to quality assets. 10 year gilt yields in turn ended the quarter down 0.07%. Elsewhere, commodities performed well, led by a spike in the oil price from $70 to $80 a barrel – its highest level in over 4 years. Sterling depreciated against the US dollar by 5.9%, against the euro by 0.9% and against the Japanese Yen by 2.0%. The depreciation in sterling enhanced overseas returns.

The price the market assigns to equity option strategies indicated that investors were willing to pay more for downside protection than strategies that allowed participation in upside – a clear sign of caution about market moves. Finally, the spread between the yields on Government bonds and corporate bonds widened which is reflective of a risk-averse investor base. Consequently, credit as an asset class suffered.

5.3 **Fund Performance, exclusive of LDI and currency hedging, was 3.0% over the quarter versus a Benchmark return of 3.4% The relative -0.4% over the quarter is attributed to;**

(1) **Asset Allocation:** The contribution to relative performance from asset allocation was **-0.2%** over the quarter. Small underweight positions versus the strategic benchmark in UK and overseas equities detracted from performance.

(2) **Manager Performance:** In relative terms, the contribution of manager performance was **-0.2%** over the quarter. Positive manager impact was evident in the EM mandates as the Fund's defensive positioning in this asset class meant it was able to capture value as market prices declined. Manager performance in developed overseas equities and multi-asset credit detracted from relative performance.

Note: The Fund's LDI strategy and currency hedge are excluded from attribution analysis as they are not represented in the strategic benchmark.

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 returns from foreign denominated assets reduce in sterling terms. The hedging programme detracted 1.1% from the total Fund return over the quarter and +0.1% over the year.

5.5 **Liability Risk Management Strategy Performance:** The liability risk management strategy seeks to 'lock in' to attractive levels of real interest rates to achieve increased long-term certainty of real returns. Any increase in the present value of the Fund's liabilities should be met with a subsequent increase in the value of the liability hedging component of the BlackRock QIF. Over the quarter, the liability hedge posted a positive return as a result of changes in interest rates and long-term inflation expectations. One inflation trigger was breached over the quarter.

5.6 **Equity Protection Strategy Performance:** The EPS is structured to protect the Fund from a sharp draw down in equity valuations over the 2019 triennial valuation as equities, although c. 40% of assets contribute c. 75% of risk. The EPS will pay out a cash amount to compensate for any significant falls in the equity market and simultaneously allow the Fund to participate in upside gains to a predetermined level or 'cap'. Over the quarter the strategy performed in line with expectation, detracting value from gains made by the Fund's physical

equity portfolios. For reference, the extent to which the strategy adds or detracts value is driven by the likelihood of equity markets being above the upside 'cap' at maturity of the strategy.

5.7 **Collateral Management -** Collateral held in the Qualified Investor Fund (QIF) that is used to capitalise the risk management strategies remained within its prescribed parameters and was sufficient to absorb the stress tests that are routinely carried out to ensure operational efficiency. To allow additional collateral to be raised when required and in order to keep leverage within the QIF guidelines, equity assets formerly managed by Invesco, were transitioned in-specie to a global passive equity fund which the QIF subsequently purchased units in.

B – Investment Manager Performance

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 one manager was upgraded from Amber to Green status** (see Exempt Appendix 3).

5.9 Manager absolute returns over the quarter were broadly positive, particularly the developed market equity managers. Over the year most mandates delivered positive absolute returns, with the Fund's infrastructure mandate leading the way. On a rolling 3 year basis, and with the exception of one DGF manager, all investment mandates delivered positive absolute returns. On a relative basis active equity managers failed to meet their respective performance targets and only two were able to outperform their benchmarks.

6 INVESTMENT STRATEGY

6.1 **Asset Class Returns:** Developed market equity returns over the last 3 years were 15.8% p.a., materially ahead of the assumed strategic return of 8.1% p.a. on the same basis. The 3 year return from emerging market equities was 10.9% in 2Q18; again well ahead of the assumed 3 year return of 8.7%. Index-Linked Gilts remain considerably above the assumed strategic return as yields remain low relative to historic averages. Over the three-year period index-linked gilts returned 8.5% p.a. versus an assumed return of 2.2%. Similarly, property and infrastructure are significantly ahead of their assumed strategic returns on a 3 year basis. Hedge funds remain below long-term averages due in part to exceptionally low cash rates.

6.2 **Liability Risk Management Framework:** Recommendations made by the Panel to Committee pertaining to the liability risk management framework are included in the minutes of the Investment Panel Activity Paper and Item 11 – Annual Review of Risk Management Strategy.

6.3 **Responsible Investing:** Panel previously resolved to delegate authority to officers to invest £10m in the Jupiter Global Sustainable Equities Fund, subject to a satisfactory assurance statement being provided by Mercer. The investment into the Global Sustainable Equity pooled fund completed on 27 June 2018 and was funded from the Fund's existing mandate with Jupiter.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

7.1 As at 30 June 2018 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark. Officers did not undertake any rebalancing activity during the quarter.

Cash Management

7.2 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.

7.3 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 CORPORATE GOVERNANCE UPDATE

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

Companies Meetings Voted:	1000
Resolutions voted:	15421
Votes For:	14360
Votes Against:	1049
Abstained:	596
Withheld* vote:	53

** 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.*

8.2 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.

9 RISK MANAGEMENT

9.1 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.

10 EQUALITIES

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

11 CONSULTATION

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

12 ISSUES TO CONSIDER IN REACHING THE DECISION

12.1 The issues to consider are contained in the report.

13 ADVICE SOUGHT

13.1 The Council's Monitoring Officer and Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

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