

Bath & North East Somerset Council

MEETING:	AVON PENSION FUND COMMITTEE
MEETING DATE:	7 DECEMBER 2018
TITLE:	INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 September 2018)
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Quarterly Investment Review Appendix 3 – 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 September 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 3**

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 remained steady over the quarter at c.97% (based on 2016 valuation assumptions).
- (2) Positive returns on assets (particularly from developed market overseas equities and infrastructure) offset an increase in the present value of the liabilities.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £72m (c.1.7%) over the quarter ending 30 September 2018 giving a value for the investment Fund of £4,782m. 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 September 2018

	3 months	12 months	3 years (p.a.)
Avon Pension Fund (incl. currency hedging)	1.7%	5.6%	10.0%
Avon Pension Fund (excl. currency hedging)	1.9%	6.3%	11.4%
Strategic benchmark (no currency hedging) <i>(Fund incl. hedging, relative to benchmark)</i>	2.5% <i>(-0.8%)</i>	7.6% <i>(-2.0%)</i>	11.5% <i>(-1.5%)</i>

5.2 **Fund Investment Return:** During the quarter global equities were largely flat and moved lower late into the quarter, with the exception of US equities which benefited from strong economic growth. The combination of rising US interest rates and a strong US Dollar presented a challenge for many regions, particularly for Emerging Markets where borrowing is often US Dollar denominated. The oil price rose by 6% and notably US bond yields moved higher, with the yield on the 10-year bond breaching 3% for the first time since 2013. This, along with mounting trade tensions between China and the US, provided the impetus late into the quarter to push equity prices down; a trend that continued into 4Q18. For the calendar year to October the MSCI World and Emerging Markets Indices posted losses of 11% and 20% respectively. At time

of writing, the US technology sector had been leading declines. The NASDAQ, the index that comprises many US technology companies, posted losses of 11% in October, which made it the worst performing month since 2008. Over the quarter, sterling depreciated against the US Dollar by 1.2% and against the Euro by 0.7% and appreciated against the Japanese Yen by 1.3%.

5.3 Fund Performance, exclusive of LDI and currency hedging, was 1.8% over the quarter versus a Benchmark return of 2.5% The relative -0.7% over the quarter is attributed to;

(1) **Asset Allocation:** The contribution to relative performance from asset allocation was **+0.2%** over the quarter. An overweight versus the strategic benchmark in developed overseas equities was the lead contributor.

(2) **Manager Performance:** In relative terms, the aggregate contribution of manager performance was **-0.9%** over the quarter. Stock selection in developed overseas equities was the biggest detractor (-1.0%) from relative performance due to the fall in value of the equity protection strategy. On a like-for-like basis - with the equity protection strategy neutralised - the stock selection effect of overseas equities would have been close to zero; reflective of active managers broadly performing in line with their respective benchmarks.

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 0.2% from the total Fund return over the quarter and 0.7% 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 long-term interest rate and inflation expectations both increased. Given the liability hedging portfolio currently has more exposure to inflation than interest rates; the net result was a positive return for the hedging assets. No triggers were breached over the quarter.

5.6 Equity Protection Strategy Performance (EPS): 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 underlying markets returned 4.7% in GBP terms as equity markets rose across the four hedged regions. As a result the corresponding market value of the EPS fell 2.7%. 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. As market levels moved closer to the 'cap' and further from the protection levels the strategy detracted value, as expected.

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. Part way through the quarter the 'early warning test' was triggered which is designed to alert Officers to a potential collateral call. Market prices then retraced and no action was required. To allow additional collateral to be raised when required and in order to keep leverage within the QIF guidelines, the investment manager has discretion to sell down a passive equity fund and replace any lost equity exposure synthetically.

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. **There were no changes to manager ratings this quarter.**
- 5.9 Manager absolute returns over the quarter were mixed, with the strongest returns coming from overseas developed market equity mandates. Over the year most mandates delivered positive absolute returns, with the exception of the Fund's Multi-Asset Credit mandate and one DGF manager. 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 a number of active funds underperformed their benchmarks over the period.

6 INVESTMENT STRATEGY

- 6.1 **Asset Class Returns:** Developed market equity returns over the last 3 years were 20.1% 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 17.5% in 3Q18; 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 7.2% 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 the strategic return of 5.1% due in part to exceptionally low cash rates.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

- 7.1 As at 30 September 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:	246
Resolutions voted:	3155
Votes For:	2926
Votes Against:	213
Abstained:	4
Withheld* vote:	12

** 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 3.

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

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