Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**22 MARCH 2019**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 December 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 31 December 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 decreased by c. 3% over the quarter to c.94% (based on 2016 valuation assumptions).

(2) The decrease in the funding level was driven by negative returns on assets (particularly from developed market equities) combined with an increase in the present value of the liabilities.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets decreased by £134m (c.2.8%) over the quarter ending 31 December 2018 giving a value for the investment Fund of £4,648m. 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. The Fund's currency hedge detracted -0.6%, while the LDI mandate contributed +0.4% to returns over the quarter.

Table 1: Fund Investment Returns (Periods to 31 December 2018)

	3 Months	12 Months	3 Years (p.a.)*
❶ Total Fund (inc. FX/LDI)	-2.7%	0.4%	7.8%
❷ Total Fund (ex. FX/LDI)	-2.5%	0.9%	9.2%
❸ Strategic Benchmark (ex. FX/LDI)	-3.7%	0.5%	9.0%
Relative Return (❶ vs.❸)	1.0%	-0.1%	-1.2%
Relative Return (❷ vs.❸)	1.2%	0.4%	0.2%
Combined FX/LDI Impact	-0.2%	-0.5%	-1.4%

* 3 year returns do not include LDI attribution analysis as mandate went live in July 2017

5.2 **Fund Investment Return:** Global equity markets declined over the quarter by 12.4%. Developed markets fell by 13.0% while emerging markets were down over 7%. US equities were heavily impacted on continued political uncertainty and trade tensions. The yield on the US 10-year government bond ended December at 2.69%, 0.37% lower than the previous quarter. In the UK, 10-year gilt yields fell 0.31% over the quarter and ended December at 1.27%. The Fed's fourth rate hike in the year came in December against the unusual backdrop of the S&P500 having dropped nearly 10.0% since the previous meeting in

November. In the UK, despite a strong labour market the Bank of England left policy unchanged as it pointed to a softening outlook for global growth and intensified Brexit uncertainties. The Fund's currency hedge detracted from Fund performance as sterling depreciated against the US Dollar, Euro and the Yen.

5.3 **Fund Performance, exclusive of LDI and currency hedging, was -2.5% over the quarter versus a Benchmark return of -3.7% The relative +1.2% over the quarter is attributed to;**

(1) **Asset Allocation:** Asset allocation detracted **-0.3%** over the quarter, driven by an overweight in developed overseas equities versus the strategic benchmark.

(2) **Manager Performance:** In relative terms, the aggregate contribution of manager performance was **+1.5%** over the quarter. Stock selection in developed overseas equities was the biggest contributor (+2.6%) due to the large positive swing in the value of the equity protection strategy. Excluding the impact of equity protection, the stock selection attribution was -0.4% reflective of active developed overseas equity managers underperforming their respective benchmarks.

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 0.6% from the total Fund return over the quarter and 1.4% 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 inflation expectations 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 c.-11.5% in GBP terms as equity markets declined across the four hedged regions. As a result the corresponding market value of the EPS rose 7.5% relative to the hedged exposure at the start of the quarter. The market value of the EPS was £67.4m at the end of the quarter, which equates to a £127m positive swing versus 3Q18. 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 away from the 'cap' and toward the protection levels the strategy increased in 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. 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 largely negative, particularly the overseas developed market equity mandates. The Fund's Diversified Growth Fund strategies, although posting negative absolute returns, did provide significant downside protection and were able to offset the sharp falls from equity markets. The Fund's Property and Infrastructure mandates generated positive absolute returns, the latter benefitting from the depreciation of GBP against the US Dollar over the quarter. Over the year returns were mixed with underperformance noted in the UK SRI mandate, significant outperformance posted by one of the Fund's defensive Emerging Market managers and demonstrable diversification benefits from the Fund's DGF and Multi-Asset Credit mandates. On a rolling 3 year basis, 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 12.3% 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 14.8% in 4Q18; 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 9.2% p.a. versus an assumed return of 2.2%. Similarly, property and infrastructure are 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 31 December 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.

Private market commitments to Brunel portfolios

7.2 In 2017, the Fund allocated 2.5% to Renewable Energy and 7.5% to Secured Income assets, with both allocations to be managed within Brunel's private market portfolios. In 4Q18, the first drawdowns of the Fund's committed capital occurred. Of the capital committed to Renewables, EUR13m was drawn down in December and deployed across two pan-European funds. One fund invests solely in renewable energy; the other includes sustainable and social infrastructure such as mass transport (metros) which are typically electric, and social infrastructure such as hospitals and government accommodation as well as renewable energy projects such as renewable energy powered district network heating assets. Shortly after the quarter closed, £16.5m was drawn down in the Secured Income portfolio by one of the selected funds.

Cash Management

7.3 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.

7.4 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 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:	208
Resolutions voted:	1859
Votes For:	1580
Votes Against:	237
Abstained:	8
Withheld* vote:	34

** 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
Please contact the report author if you need to access this report in an alternative format	