Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**21 JUNE 2019**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 March 2019)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Annual 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 March 2019.

1.3 **Please note:** A training session on investments has been arranged for 2 September at 2pm in the Guildhall, Bath. This will be for all Investment Panel members and all new Committee members.

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 2019 triennial valuation. 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 estimated funding level has remained stable over the year at 96%.

(2) There has been no material shift in the funding level due to the positive return on the Fund's assets (along with positive contributions into the Fund) being broadly matched by 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 2019 (see Appendix 2) rather than the normal quarterly performance report.

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.

6 INVESTMENT PERFORMANCE

A – Fund Performance

6.1 The Fund's assets increased by £211m (c.5%) over the year ending 31 March 2019 giving a value for the Fund of £4,819m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and manager. Manager performance is monitored in detail by the Investment Panel. The Fund's investment return and performance relative to the benchmark is summarised below. The Fund's currency hedge detracted -1.3% over the year.

Table 1: Fund Investment Returns (Periods to 31 March 2019)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	3.9%	5.2%	8.9%
Avon Pension Fund (excl. currency hedging)	3.3%	6.5%	9.7%
Strategic benchmark (no currency hedging)	4.9%	7.7%	10.0%
Fund incl. hedging, relative to benchmark	-1.0%	-2.5%	-1.1%
Currency hedge impact	0.6%	-1.3%	-0.8%

6.2 **Fund Investment Return:** Equity market returns were mixed over the year. 2Q18 and 3Q18 saw strong global equity market performance driven by broad economic expansion. Later in the year global trade tensions coupled with

expectations of increased US interest rates led to a sharp sell-off in equity markets. These two factors provided the impetus for a marked recovery in equity prices during 1Q19 as trade tensions subsided and a 'softening' in the Federal Reserve's position on future US interest rate increases bolstered investor confidence. The developed markets index (FTSE World) returned 11.1% over the year, while the emerging market index (FTSE All World EM) returned 1.9% over the same period. Equivalent MSCI emerging market indices were broadly flat over the year. At a regional level US stocks outperformed all other developed countries significantly, posting 17.7% as measured by the FTSE USA index. UK and European stocks returned 6.4% and 2.6%, respectively. Significant volatility was also felt in bond markets over the year. UK Government Bonds as measured by the FTSE Gilts All Stocks Index, returned 3.7%, while longer dated issues posted a return of 4.7%. Volatility in US Treasuries was exacerbated by multiple Fed rate increases followed by a softening of central bank rhetoric in 1Q19 which promptly led short term interest rates to increase over and above long term interest rates for the first time since 2007. This so-called 'yield curve' inversion failed to dampen investor risk appetite and credit spreads narrowed moving into the final quarter of the year ending March 2019. Over the same period Sterling depreciated by 7.1% against the US Dollar, 3.3% against the Yen and appreciated against the Euro by 1.7%.

6.3 **Fund Performance, exclusive of currency hedging, was 6.5% over the year versus a Benchmark return of 7.7% The relative -1.2% over the year is attributed to;**

(1) **Asset Allocation:** Asset allocation contributed **0.2%** over the year, driven by an overweight in developed overseas equities versus the strategic benchmark.

In addition there was a large negative swing in the value of the equity protection strategy (c. £29m) which detracted **-0.6%.**

(2) **Manager Performance:** Active manager impact over the year was **-0.8%,** driven primarily by underperformance of the Fund's diversified growth and credit managers.

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 added 0.6% to the total Fund return over the quarter and detracted -1.3% over the year.

6.5 **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 Qualifying Investor Fund (QIF). Over the year the shifting dynamic in short- and long-term inflation expectations and high investor demand for index-linked gilts drove positive absolute returns from the LDI mandate; 11.6% over the year.

6.6 **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. 70% 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'. Since inception of the strategy all markets have fallen aside from the US. Over the year the strategy performed broadly in line with expectation; adding value when underlying equity markets declined and detracting value as underlying equity markets increased toward the upside 'cap'. Notably, the strategy insulated the Fund from the sharp equity market sell off during December, by delivering a return of 7.5% against an underlying equity market return of -11.5%. Over the first quarter of 2019, the underlying markets returned 8.7% in GBP terms as equity markets rose significantly across the four hedged regions (UK, US, Japan and Eurozone), particularly in the US. As a result the corresponding market value of the equity protection strategy fell by 5.4% due to the market levels being further from the protection zone and a subsequent reduction in the likelihood the options would be exercised at expiry. Assuming market levels do not move from March 2019 levels the option strategy would be allowed to expire unused (as neither the upside 'cap', nor downside protection zone would have been breached) and the Fund would simply earn the return of the underlying equities that it holds.

6.7 **Collateral Management:** Collateral held in the QIF that is used to capitalise the risk management strategies remained within its prescribed parameters throughout the year to March 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

6.8 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.**

6.9 Absolute returns over the year to March were broadly positive across the Fund's investment managers with all of the managers (aside from one Diversified Growth Manager) delivering positive returns over the period. On a relative basis and with the exception of the Fund's emerging market and infrastructure mandates, active managers have underperformed their respective benchmarks. In some cases this can be explained by the managers' style biases underperforming the wider market, for example the Fund's defensive, low-beta managers are expected to underperform in a rising market. Underperformance by diversified growth strategies is often symptomatic of high absolute return targets. Although the Fund's DGF managers did underperform across the year it should be noted that they fulfilled their objective of shielding the fund from equity market volatility by generating significantly higher returns during the market correction experienced in December. Elsewhere in the portfolio the UK SRI mandate underperformed its benchmark primarily due to its zero weighting in the oil & gas sector; by not owning stocks in this sector, the manager failed to capture c.2% of the c.6% index return (FTSE All Share) to March 19. The Fund's multi-asset credit mandate failed to outperform due in part to its emerging market debt exposure. On a longer-term basis, all investment mandates with a three-year track record delivered positive absolute returns. On a relative basis a number of active funds underperformed their benchmarks over the same period. Detailed analysis of investment manager performance can be found at Appendix 2.

7 INVESTMENT STRATEGY

7.1 **Asset Class Returns:** Developed market equity returns over the last 3 years were 15.0% p.a., materially ahead of the assumed strategic return of 8.1% p.a. on the same basis. At the end of March the 3 year return from emerging market equities was 14.5%; again well ahead of the assumed 3 year return of 8.7%. Index-Linked Gilts remain considerably above the assumed strategic return. Over the three-year period index-linked gilts returned 9.1% 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 fund returns moved higher toward the end of the year but remain below the strategic return of 5.1% due in part to low cash rates.

7.2 **Transition of Assets to Brunel Portfolios:** During the year the Funds passive low carbon equity and active UK equity mandates were transitioned to Brunel portfolios.

7.3 **Private Markets Commitments to Brunel Portfolios:** 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. During January 19, £16.5m was drawn down in the Secured Income portfolio by one of the selected funds.

7.4 **Liquidity Management:** During the last quarter of the year the Fund implemented a liquidity management solution that involved investing cash in a basket of Exchange-Traded Funds (ETFs) designed to replicate the return profile of the Fund's strategic benchmark, but offering a similar liquidity profile to cash. The strategy is designed to better manage the cash drawdowns for the private market commitments without having to give up yield.

8 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

8.1 As at 31 March 2019 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark.

Cash Management

8.2 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.

8.3 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.

9 STEWARDSHIP UPDATE

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

Companies Meetings Voted:	381
Resolutions voted:	5072
Votes For:	4559
Votes Against:	441
Abstained:	56
Withheld* vote:	16

** 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 3.

9.3 **Brunel Responsible Investment & Stewardship Activity:** Since the transition of Avon assets to Brunel, Hermes (Brunel's appointed voting and engagement provider) have engaged with 21 companies held by Avon in the Brunel portfolios on a range of 50 ESG issues. Environmental topics have featured in 32% of engagements, 63% of which relate directly to climate change. Social topics featured in 18% of engagements, where diversity and human rights featured prominently. Of the 40% of Governance related engagements the majority of discussions revolved around executive remuneration. Additionally, engagement activity undertaken by Climate Action 100+, of which Brunel is a signatory, published a report on the management quality and carbon performance of airlines during 1Q19, which led to follow-up engagement with companies on the setting of emissions reduction targets.

10 ANNUAL ASSURANCE ON CONTROL ENVIRONMENT OF 3RD PARTY SUPPLIERS

10.1 As part of the risk management process the Fund annually reviews the internal control reports (ICR) of the custodian and investment managers (and their administrators where relevant), and reports the findings to Committee. These reports are often designated SSAE16 or ISAE3402 reports, which states which set of standards are being reported against.

10.2 ICR reports describe the internal control environment of an organisation. The management of the organisation are responsible for identifying the control procedures which they consider appropriate to enable certain control objectives to be met. External auditors verify that the controls identified are in place and comment on whether the controls will achieve the stated objectives or not.

10.3 For the reports reviewed in 2018/19, in each case the external auditor's report stated that the controls were in place and achieved the control objective and there are no issues to bring to the attention of the Committee. As part of the process, officers discuss the significance of the internal control reports with investment managers and custodian on an on-going basis and follow-up any issues flagged in the reports.

10.4 The ICRs of the pooled funds (and their administrators/custodian) and the Fund's custodian are also audited by the Fund's external auditor as part of the annual audit.

11 RISK MANAGEMENT

11.1 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.

12 CLIMATE CHANGE

12.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and addresses this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

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 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	