Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**6 DECEMBER 2019**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 September 2019)**
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 2019.

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 was unchanged over the quarter at c.98%

(2) The increase in the value of the assets, largely driven by developed market equities, was broadly matched by an increase in the present value of the liabilities.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £46m (c.1.2%) over the quarter ending 30 September 2019 giving a value for the Fund of £4,992m. 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 -0.5% over the quarter.

Table 1: Fund Investment Returns (Periods to 30 September 2019)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	1.2%	5.0%	6.6%
Avon Pension Fund (excl. currency hedging)	1.7%	6.3%	7.1%
Strategic benchmark (no currency hedging) *(Currency hedge impact)*	2.2% (-0.5%)	6.5% *(-1.3%)*	7.6% *(-0.5%)*

5.2 **Fund Investment Return:** Global equity markets ended the quarter in positive territory. Developed markets increased c.1.7% over the quarter while emerging markets declined. US and UK equities were up by 1.6% and 0.7% respectively. UK 10-year gilt yields fell 0.35% over the quarter and ended the quarter at 0.49%. The Fund's strongest performance came from the corporate bond and global equity managers. The Fund's infrastructure and multi-asset credit mandates posted positive returns as did the DGF's and property funds. Sterling weakened against the US Dollar and the Yen by 3.2% and 2.9% respectively and strengthened against the Euro by 1.1%. The net effect meant the currency hedge detracted c.0.5% from total Fund returns.

5.3 **Fund Performance, exclusive of currency hedging and LDI, was 2.2% over the quarter versus a Benchmark return of 2.0% The relative 0.2% over the quarter is attributed to;**

(1) **Asset Allocation:** Asset allocation contributed **0.1%** over the quarter, driven by an overweight in developed overseas equities versus the strategic benchmark. There was a negative swing in the value of the equity protection strategy (c. £12.6m) which detracted value.

(2) **Manager Performance:** Active manager impact over the quarter was **0.1%,** driven primarily by the Fund's core infrastructure manager.

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 -0.5% over the quarter and detracted -1.3% 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 Qualifying Investor Fund (QIF). Over the quarter, the liability hedging component posted a positive return as a result of changes in market conditions over the period. Interest rate expectations fell across the curve and inflation expectations rose at the shorter but fell materially at the medium and longer durations. The LDI trigger framework was reviewed in October 2019 in light of the RPI reform consultation announcement due to start in January 2020. Longer dated triggers were adjusted to reflect any likely change in inflation reform.

5.6 **Equity Protection Strategy (EPS) 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. 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'. Over the third quarter the underlying equity markets returned 3.1% in GBP terms as equity markets rose across all four hedged regions, particularly in the US. As a result, the corresponding market value of the equity options fell by 0.7% due to the market levels being further from the protection in place and consequently decreasing the value of the insurance contracts. Panel are currently reviewing options to renew the EPS once the existing protection expires.

5.7 **Corporate Bond Buy and Maintain Portfolio:** The buy-and-maintain corporate bond portfolio cash flow matches the 'low-risk' bucket of liabilities that are valued on a corporate bond basis, in order to reduce funding risk in respect of these liabilities and is inflation hedged. The yield on the portfolio is 2.3%, the duration is 12 years and has an average credit rating of A- with a subordinated debt allocation of 6.3%.

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 Absolute returns over the quarter were largely positive, with global equities, corporate bonds, real assets, credit and DGFs posting positive absolute returns. On a relative basis, active manager returns were mixed. One emerging market mandate significantly outperformed its benchmark while the Fund's global active equity mandate lagged. Over the 12 months to 30 September the majority of managers posted positive absolute returns but struggled to outperform on a relative basis. This was also true of 3 year returns, where the majority of managers posted positive absolute returns but failed to keep pace with their respective benchmark with the exception of infrastructure which exceeded its cash benchmark by c.9%. Detailed analysis of investment manager performance can be found at Appendix 2.

6 INVESTMENT STRATEGY

6.1 **Asset Class Returns:** Developed market equity returns over the last 3 years were 12.6% p.a., ahead of the assumed strategic return of 8.1% p.a. on the same basis. The 3 year return from emerging market equities was 8.4%; below the assumed 3 year return of 8.7%. Over the three-year period index-linked gilts returned 5.3% 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 remain below long-term averages and the strategic return of 5.1% p.a.

6.2 **Private Markets Commitments to Brunel Portfolios:** The Fund has an allocation of 7.5% to Secured Income which is managed by Brunel. The drawdown of the committed capital started in Jan 2019. During 3Q19 a further commitment was made to a UK operating infrastructure equity fund which focuses on renewable energy assets. Investment into UK operating infrastructure is considered complimentary to traditional long-lease assets and serves to reduce the time taken to deploy capital (long investor queues remain in traditional long-lease funds) and also dampens sensitivity to the UK property market while not fundamentally altering the return profile of these predominantly inflationary-linked, income based investments. Separately, capital calls totalling £8.6m were issued by Brunel's underlying renewable infrastructure managers over the quarter. The Fund has now invested c.17% (£19.5m) of its total 2.5% (£115m) commitment to renewable infrastructure.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

7.1 As at 30 September 2019 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark. The Multi-Asset Credit (MAC) mandate remains overweight with redemptions matching the pace of Private Markets capital calls. MAC currently represents c. 8% against a strategic allocation of 6%.

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 STEWARDSHIP UPDATE

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

Companies Meetings Voted:	3641
Resolutions voted:	39483
Votes For:	36545
Votes Against:	2586
Abstained:	219
Withheld* vote:	133

** 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.

8.3 **Responsible Investment (RI) Activity:** The Fund signed the Global Investor Statement to Governments on Climate Change. The statement is a call from investors to policy makers for the urgent implementation of the Paris Agreement, a quicker transition to a low carbon economy and greater climate-related financial reporting. It has been signed by 515 investors managing over $35 trillion in assets, including Brunel. Over the quarter, Brunel signed the investor statement on deforestation and forest fires in the Amazon, which has to date been endorsed by 244 investors representing approximately $17.2 trillion in assets. The statement urgently requests companies to redouble their efforts and demonstrate clear commitment to eliminating deforestation within their operations and supply chains. Hermes - Brunel's appointed voting and engagement provider – also supported the investor statement. Appendix 5 includes details of the work being undertaken by Brunel as an active member of the PRI Plastic Working Group and presents the key findings of the most recent Transition Pathway Initiative Report on the Energy sector.

8.4 **Voting and Engagement Activity:** Hermes engaged with 25 companies held by Avon in the Brunel segregated portfolios on a range of 68 ESG issues. Environmental topics featured in 36.8% of engagements, 40% of which related directly to climate change. Social topics featured in 14.7% of engagements, where human capital management and corporate conduct and culture featured prominently. Of the 33.8% of Governance related engagements the majority of discussions revolved around executive remuneration. Aggregate voting data across all of the Fund's investment managers will be reported to Committee at their next meeting. Post quarter end, Brunel supported a shareholder resolution calling on BHP Group to withdraw from industry groups with positions contrary to the Paris Agreement. Avon holds BHP Group in the Brunel UK active equity portfolio. The resolution won 27.1% support and despite not being carried has led to further engagement between company management and shareholders, which will inform BHP's 2019 Industry Association Review.

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. 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 CLIMATE CHANGE

10.1 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 is in the process of addressing this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee

11 OTHER OPTIONS CONSIDERED

11.1 None.

12 CONSULTATION

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

Contact person	Nathan Rollinson, Assistant Investments Manager (Tel: 01225 395357)
Background papers	Data supplied by Mercer & SSBT Performance Services
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