Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**6 MARCH 2020**	**AGENDA ITEM NUMBER**
TITLE:	**Review of Investment Performance for Periods Ending 31 December 2019**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Performance Monitoring Report **Exempt Appendix 3 – RAG Monitoring Summary Report** **Exempt Appendix 4 - Risk Management Framework Quarterly Monitoring Report** Appendix 5 – Brunel Quarterly Performance Report Appendix 6 – Audit Log of Strategic Investment Decisions		

1 THE ISSUE

1.1 This paper reports on the performance of the Fund's investment managers and seeks to update the Panel on routine aspects of the Fund's investments. The report contains performance statistics for period ending 31 December 2019.

1.2 The report focuses on the performance of the individual investment managers and the implementation of the investment strategy. The full performance report with aggregate investment and funding analysis will be reported to the Committee meeting on 27 March 2020.

1.3 The report also includes the Risk Monitoring report (exempt Appendix 4) produced by Mercer which includes details of the Fund's liability driven investment strategy and equity protection strategy.

1.4 Appendix 5 is the quarterly performance report published by Brunel which focuses on the performance of the Brunel portfolios and responsible investment activity undertaken on the Fund's behalf over the quarter. Brunel will present the report at the meeting.

1.5 Appendix 6 is for reference only; it shows the implementation of strategic decisions following the 2017 Strategic Review and will be updated to reflect any strategic changes following the conclusion of the current review.

2 RECOMMENDATION

That the Panel:

2.1 **Notes information as set out in the reports.**

2.2 **Identifies any issues to be notified to the Committee.**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund for the three years commencing 1 April 2019 will impact the next triennial valuation which will be calculated as at 31 March 2022. The returns quoted are net of investment management fees.

4 INVESTMENTS UPDATE

A – Fund Performance

4.1 The Fund's assets decreased by c.£7m in the quarter ending 31 December 2019 giving a value for the investment Fund of £4,985m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers.

4.2 Global equity markets ended the quarter in positive territory. Developed markets increased 7.6% while emerging markets appreciated by 9.6% over the quarter. US and UK equities were up by 9.1% and 2.3% respectively. UK 10-year gilt yields rose 0.34% over the quarter and ended the quarter at 0.83%. Positive performance across most growth assets was countered by a decrease in the value of the LDI portfolio. Sterling appreciated against the US Dollar, Yen and Euro by 7.5%, 4.4% and 8.1%, respectively.

4.3 The Fund's overall performance relative to benchmarks is unavailable at the time of publishing. Full performance data will be reported to the Pensions Committee on 27 March 2020.

B – Investment Manager Performance

4.4 A detailed report on the performance of each investment manager has been produced by Mercer – see pages 22 to 41 of Appendix 2.

4.5 Brunel now reports on the performance of the assets they manage on behalf of the Fund. The report for each Brunel portfolio can be found in Appendix 5. However, Mercer will continue to provide quarterly commentary and analysis of all the Fund's mandates and at the strategic total fund level.

4.6 Manager absolute returns over the quarter were largely positive. The Fund's strongest performance came from the UK and EM equity mandates. In local currency terms the Fund's infrastructure and multi-asset credit mandates posted positive returns as did the DGF's, property funds and hedge funds. The recovery in UK yields coupled with falls in implied inflation meant the Funds LDI assets detracted value over the quarter. Sterling strength acted as a drag on the US denominated hedge fund and infrastructure mandates. The currency hedge partially offset this, contributing c.1.5% to total Fund returns. On a relative basis, active manager returns were largely positive, with UK active equity mandates delivering strong outperformance. Over the 12 months to 31 December most managers posted positive absolute returns. On a relative basis multi-asset credit, global sustainable equities and infrastructure significantly outperformed their respective benchmarks. Over the three-year period, all mandates with a three-year track record produced positive absolute returns. The majority of active funds underperformed their benchmarks over the period, with only IFM and Schroders Property generating positive relative returns.

4.7 Exempt Appendix 3 summarises the latest internal report used by officers to monitor manager performance. The summary report highlights the managers that are rated amber or red, detailing the performance and/or organisational issue(s), how they are being monitored and any actions taken by Officers and/or the Panel.

C – Risk Management Framework Quarterly Monitoring Report

4.8 A detailed report of the performance of the Fund's risk management strategies including details of how the Fund's collateral position has changed over the quarter is presented in Exempt Appendix 4.

4.9 During December the collateral top-up test for the equity protection strategy was breached. This was due to US equities continuing to rise above the cap, resulting in an increased negative value on the equity protection mandate. On this occasion BlackRock did not use their discretion to sell passive equities to replenish the collateral buffer. Given the size of the move, selling a large portion of passive equities was deemed overly cautious and would likely have resulted in the QIF vehicle holding excess cash, creating a drag on returns. For this reason Officers, acting on Mercer advice, instructed BlackRock to reduce the collateral top-up test to a level that gave sufficient headroom to support the hedge and removed the need to synthesise equities.

4.10 Post quarter end, BlackRock commenced the rollover of the equity protection strategy that was delegated to Officers at the November 2019 Panel meeting. A full post-trade report with a breakdown of all transaction costs incurred will be provided at the next meeting.

4.11 At the meeting Mercer will discuss the implications of the potential reform to RPI on the inflation hedge within the LDI strategy. The government is set to start a consultation to implement the move from RPI to CPIH as the measure for inflation. There is potential for a re-pricing of inflation linked assets (in our case Index Linked Gilts and RPI swaps) during the consultation period which would lead to a structural fall in the value of RPI linked assets. Officers are still discussing this advice with Mercers but it will be issued ahead of the meeting.

5 INVESTMENT STRATEGY AND PORTFOLIO REBALANCING

5.1 **Asset Class Returns versus Strategic Assumptions**: Developed market equity returns over the last 3 years were 10.1% 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 9.0%; above 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 2.9%. 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.

5.2 **Rebalancing**: There was no rebalancing activity during the quarter.

5.3 **Private Markets Investments:**

Secure Income - The Fund has an allocation of 7.5% (£345m) to Secured Income which is managed by Brunel. The drawdown of the committed capital started in Jan 2019. The portfolio consists of two long lease managers and one operational infrastructure manager. Returns are generated primarily through income yield with inflation linkage and therefore meet the Secured Income criteria of CPI+2%. At the end of 4Q19 c.17% (£61m) of committed capital had been drawn down. Deployment of capital by the two underlying long-lease property managers was slow in the six months leading to up to December 2019. One manager is seeking to close a large deal that will result in a call of c. £40m for Avon. This transaction has been delayed since Summer 2019. The second long-lease manager has recently completed on a £240m transaction and has a strong pipeline of potential acquisitions that will bring Avon closer to the front of the investor queue. Avon made a commitment of £95m to the operational infrastructure fund in 3Q19, 50%

of which was drawn during 4Q19. The capital has mainly been invested in an operating biomass power plant as well as funding construction of agricultural greenhouse heat pump projects. Further diversification into solar power is in the pipeline for this manager for 2020.

Renewable Infrastructure – During 4Q19 capital calls totalling £3.4m were issued by Brunel's underlying renewable infrastructure managers. The Fund has now invested c.20% (£22m) of its total £115m commitment to renewable infrastructure. The underlying managers are on track with fund raising and deployment. One US fund acquired a new solar project and another manager has extended their fundraising period for a fund Brunel is already invested in due to investor demand.

5.4 **Responsible Investment (RI) Activity:** Over the quarter, Brunel continued to engage with BlackRock, who were appointed to deliver bespoke risk management services for Brunel clients. Joint engagement with other institutional investors led BlackRock to join ClimateAction 100+ and to publicly acknowledge the financial risks of climate change. The other highlight was the co-filing of a climate-related shareholder resolution that will go to a vote at Barclays' AGM in May 2020. The proposal requests that the bank publishes a plan to gradually phase out the provision of financial services to energy companies that are not aligned with the goals of the Paris climate agreement. Appendix 5 includes details of the work being undertaken by Brunel as an active member of the Transition Pathway Initiative and presents the key findings of their most recent report on the transportation sector. Brunel published their climate change policy in January.

5.5 **Voting and Engagement Activity:** Hermes engaged with 223 companies held by Avon in the Brunel segregated portfolios on a range of 617 ESG issues. Environmental topics featured in 25% of engagements, 74% of which related directly to climate change. Social topics featured in 20% of engagements, where human capital management and corporate conduct and culture featured prominently. Of the 35% of Governance related engagements the majority of discussions revolved around executive remuneration. Over the last quarter Hermes made voting recommendations at 60 meetings (545 resolutions). At 21 meetings they recommended opposing one or more resolutions and supported management on resolutions at the remaining 39 meetings. Over 60% of the issues Hermes voted against management on comprised board structure and remuneration. Aggregate voting data across all of the Fund's investment managers will be reported to Committee at their next meeting.

6 RISK MANAGEMENT

6.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

7 CLIMATE CHANGE

7.1 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.

8 OTHER OPTIONS CONSIDERED

8.1 None.

9 CONSULTATION

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

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Background papers	Data supplied by Mercer, Brunel & State Street Performance Measurement
Please contact the report author if you need to access this report in an alternative format	