Bath & North East Somerset Council

MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**23 SEPTEMBER 2011**	**AGENDA ITEM NUMBER**
TITLE:	**Review Of Investment Performance For Periods Ending 30 June 2011**	
WARD:	**ALL**	

AN OPEN PUBLIC ITEM

List of attachments to this report:

Appendix 1 – Fund Valuation

Appendix 2 – JLT performance monitoring report

Appendix 3 - Euro and European Financials exposure

Exempt Appendix 4 – Summaries of Investment Panel meetings with Investment Managers

1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic areas concerning the Fund's investments.

1.2 This report contains performance statistics for periods ending 30 June 2011.

1.3 The main body of the report comprises the following sections:

Section 4. Investment Performance: A - Fund, B - Investment Managers.

Section 5. Investment Strategy

Section 6. Funding Level Update

Section 7. Portfolio Rebalancing and Cash Management

Section 8. Corporate Governance and Socially Responsible Investment (SRI) Update

2 RECOMMENDATION

That the Avon Pension Fund Committee:

2.1 Notes the information as set out in the report.

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund for the three years commencing 1 April 2010 will impact the next triennial valuation which will be calculated as at 31 March 2013. Section 6 of this report discusses the trends in the Fund's liabilities and the funding level.

4 INVESTMENT PERFORMANCE

4.1 JLT's report in Appendix 2 provides a full commentary on the performance of the fund (pages 15 to 21), the investment managers (pages 22 to 42) and a commentary on investment markets (pages 5 to 11). In the section on the Fund (page 15), three year rolling returns are included to provide a longer term perspective.

A – Fund Performance

4.2 The Fund's assets rose in value by £396m (+16.5%) over the previous 12 months and £42m (+1.5%) in the quarter, giving a value for the investment Fund of £2,701m at 30 June 2011. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and managers.

4.3 The Fund's investment return and performance relative to benchmarks is summarised in Table 1.

Table 1: **Fund Investment Performance, periods to 30 June 2011**

	3 months	12 months	3 years (p.a.)
Avon Pension Fund	1.5%	16.5%	7.2%
Strategic benchmark *(Fund relative to benchmark)*	1.1% *(+0.4%)*	16.3% ***(+0.2%)***	6.1% *(+1.1%)*
Customised benchmark *(Fund relative to benchmark)*	1.5% *(=)*	16.7% ***(-0.2%)***	7.9% *(-0.7%)*
Local Authority Average Fund *(Fund relative to benchmark)*	1.6% *(-0.1%)*	17.8% ***(-1.3%)***	6.5% *(+0.7%)*

4.4 **Avon Pension Fund**: Quarterly return driven by good returns from bonds, with positive contributions coming from most equity regions and property. These offset small negative overall returns from the hedge funds this quarter. Annual return driven by positive absolute returns across all asset classes especially equities.

4.5 **Versus Strategic Benchmark (which reflects an allocation of 60% equities, 20% bonds, 10% property, 10% hedge funds):** Quarterly relative outperformance driven by Fund being overweight both UK and overseas equities (versus the benchmark) and the equity and bond managers outperforming their benchmarks. Annual outperformance resulted from being underallocated to hedge funds which have underperformed other asset classes and from the Fund's property and bond managers outperforming benchmark returns from their asset classes over the year. This is despite a small cash holding.

4.6 **Versus Customised Benchmark (which reflects the individual benchmarks of each manager and as such, measures the relative performance of the managers as a whole):** Underperformed the benchmark over the year, with underperformance of Jupiter, TT, Stenham and Lyster Watson more than offsetting outperformance by State Street, RLAM and Gottex. The other managers performed broadly in line with their benchmarks.

4.7 **Versus Local Authority Average Fund**: Annual relative underperformance driven by Fund's lower than average allocation to equities which performed positively over the year, and higher than average allocation to hedge funds which did not match the returns made by equities.

4.8 Since the end of June global equity markets retreated with the FTSE All Share index falling c. 13% (to 9 September). In contrast, the total return for the Over 15-year Gilt index was c. 12% during the same period. The Fund value is estimated to be c. £2.55bn, down c. 6%. These market moves impact the funding position and this is discussed in Section 6 below.

4.9 At the time of writing this report, the markets remain extremely volatile but with negative sentiment overall. Given that the sovereign debt and fiscal crisis in the Eurozone has not been resolved and official statistics for consumer confidence and global economic growth show a deteriorating economic environment. As a result the risk of many western countries going into recession has increased. In such an environment bond yields are expected to stay at low levels and the outlook for corporate earnings could deteriorate.

B – Investment Manager Performance

4.10 A detailed report on the performance of each investment manager has been produced by JLT – see pages 21 to 41 of Appendix 2. Their report does not identify any performance issues with the managers.

4.11 The decisions taken following the review of the Fund's investments in hedge funds were fully implemented in August.

4.12 The Committee agreed in December 2010 to appoint Schroder to manage the Fund's active global equity mandate. Following a managed transition process, the assets were transferred to Schroder on 20 April 2011.

4.13 At its meeting on 7 September, the Investment Panel discussed the decrease in the overall size of the State Street pooled funds in which the Fund is invested. The Panel have requested that State Street attend the next Investment Panel meeting to allow the Panel to fully assess the current situation.

4.14 The Investment Panel requested that following the decision to lag the reporting of Partners performance data by a quarter (due to the difficulty in collecting the data within the necessary timeframe for inclusion in the quarterly report), that Officers verbally update the Panel and Committee on the latest performance of Partners where necessary.

4.15 As part of the ongoing "Meet the Managers" programme, the Investment Panel received presentations from 3 managers in a workshop on September 7: BlackRock, TT and Schroder Property. The summaries of these meetings are in Exempt Appendix 4.

5 INVESTMENT STRATEGY

5.1 JLT's report notes the changes to the strategic allocation that were implemented this quarter following the decision by the Committee to increase the allocation to overseas equities and reduce the allocation to UK equities within the equity portfolio. This implementation was completed with the transition of assets to Schroder described above.

5.2 Following the appointment of Record as the Fund's active currency hedging manager, the implementation of the currency hedging programme commenced in July and will be implemented fully within a 12 month timeframe. The decision to employ an active currency hedge was an action that came out of the conclusions following the strategic investment review in 2009.

5.3 Appendix 3 provides an analysis of the Fund's current exposure to Euro denominated assets and European financial institutions in light of the current concerns regarding European sovereign debt and the potential impact upon financial institutions. The Fund's exposure to Spanish and Italian government bonds is very small (there is no exposure to Greece, Ireland and Portugal). Approximately 7% of the Fund's equity holdings are exposed to UK and European financial institutions. The active currency hedging programme currently covers approximately 25% of the Fund's Euro denominated equity exposure of approximately £185m in total. Implementation of the programme is continuing.

6 FUNDING LEVEL UPDATE

6.1 As at 30 June 2011 the Actuary has estimated that the funding level is 82%, the same as at 31 March 2010 triennial valuation.

6.2 Since the 2010 valuation, the value of the assets have increased by £255m (10.4%) to £2.7bn, and liabilities increased by £296m (9.8%) to £3.3bn. As a result the deficit has increased from £552m to £593m. Note that the revised funding level takes into account benefit payments and contributions received during the period.

6.3 Table 2 shows the change in financial assumptions:

Table 2: **Change in Financial Assumptions**

	31 March 2010	30 June 2011
UK Gilt yield	4.50%	4.30%
Real yield	0.70%	0.60%
Implied RPI inflation p.a.	3.80%	3.70%
Inflation adjustment p.a.	0.80%	0.80%
CPI Inflation p.a.	3.00%	2.90%

6.4 Since the end of June, equity values have fallen and bond prices risen, neither of which are positive for the funding level. The fall in the value of the Fund since the end of June is estimated to be around 6%. Of more significance is the fall in long-dated gilt yields which have declined at least 0.5% (to c. 3.8%) since end June (real yields fallen to c. 0.45%). Such a significant fall in bond yields (which is the basis of the discount rate used to value liabilities) could increase the liabilities by an estimated 7-10%. As a result, the funding level is estimated to have fallen to 70-75% range. ***It should however be noted that this is just a snapshot of the funding level at a particular point in time.***

6.5 The Actuary is preparing an interim valuation at the Fund level as at 31 March 2011, rolled forward to 31 August. This will be discussed at the Committee workshop and meeting on 9 December 2011. The Actuary will also discuss the possible implications of the changes to the scheme as a result of the (expected) Hutton proposals and the changes put forward to achieve savings equivalent to 3.2% of contributions.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

7.1 The rebalancing policy requires rebalancing of the Equity/Bond allocation to occur when the equity portion deviates from 75% by +/- 2%, and the valuation metric, in this case the equity gilt yield ratio, confirms that the relative valuation between equities and bonds is favourable. The implementation of this policy is delegated to officers.

7.2 There was no rebalancing undertaken this quarter. As at 31 July 2011 the Equity:Bond allocation was estimated at 74.6:25.4. It is estimated that recent equity market falls will have reduced the equity weighting further.

Cash Management

7.3 Cash is not included in the strategic benchmark. However, cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The segregated portfolios, TT, Jupiter, Schroder Equity and BlackRock utilise money market funds offered by the custodian, BNY Mellon. The cash within the pooled funds is managed internally by the manager. The cash managed by BlackRock in the property portfolio is invested in the BlackRock Sterling Liquidity Fund. 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 and are invested in line with the Fund's Treasury Management Policy which was approved on 18 December 2009. The Fund adopts the Council’s counterparty list and the latest list approved by the Council in February 2011.

8 CORPORATE GOVERNANCE AND SRI UPDATE

8.1 The Fund is a member of the Local Authority Pension Fund Forum (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.

8.2 LAPFF's current activity includes:

(1) **Integrated Reporting Movement**
Current reporting standards such as International Financial Reporting Standards require organisations to produce a "fair and reasonable" account of their business in audited financial reports. However, these reports do not fully integrate the long-term social, environmental and economic contexts of their operating environments. While some companies produce stand-alone sustainability reports, they sometimes fail to make the link between their sustainability agenda and the company's overall strategy and business model. LAPFF has over a number of years been engaging with companies on increasing their Environmental Social Governance (ESG) disclosure within the Business Review of their annual reports. LAPFF believes "an integrated report is the most appropriate (possibly the only) place a company can hope to convey an understanding of how it combines physical and intangible resources into processes and practices that provide the organisational capital that sets one company apart from another."

(2) **Engagement activity:**

a) News Corp – LAPFF initiated a dialogue with News Corp in June 2010 to address the company's poor governance record. LAPFF will be meeting with News Corp directors in August 2011 to convey concerns about the situation and the concentration of power on the Board. The company's succession plans and the Board's oversight of internal investigations into the ethical conduct of company officers will also be discussed.

b) Palm Oil - LAPFF is currently engaging with companies in the food and beverage sector on the importance of seeking sustainable palm oil within their global supply chains.

c) Successful engagement outcome, FirstGroup - Unions first raised concerns over alleged anti-union activity in the Company's US operations in 2006. In response to the allegations, LAPFF engaged with both the Company and the unions through a series of investor meetings. LAPFF proposed the introduction of a "Compliance Monitoring Program" with an independent monitor. Several years later, the successful operation of the policy has much improved relations between the company and union members. It's an important example of shareholders playing a proactive role in ensuring that management and employees at an investee company work together more effectively for the benefit of all, and where LAPFF's intervention was a proactive factor.

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 the return of the strategic benchmark and 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 This report is primarily for information only.

11 CONSULTATION

11.1 This report is primarily 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 (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	LAPPF Member Bulletins, Data supplied by The WM Company
Please contact the report author if you need to access this report in an alternative format	