REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND

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Papers with this report	Northern Trust Executive Report WM Local Authority Quarter Reports Private Equity Listing Private Equity reports from Adams Street and LGT

SUMMARY

This report reviews the fund manager performance for the London Borough of Hillingdon Pension Fund for the period ending 31 March 2012. The total value of the fund's investments as at this date was £611.8m.

Following the end of the financial year, as part of the annual process to prepare the Pension Fund Accounts, a review was undertaken of all fund manager and custodian internal control reviews. A summary of the key issues identified in each of the reports is attached, but there are no significant issues to report to committee.

RECOMMENDATION

1. **That the content of this report be noted and the performance of the Fund Managers be discussed.**

INFORMATION

The annual performance of the Fund as at 31 March 2012 showed an outperformance of 0.49%, with a positive return of 3.64%. The three year return figure of 13.93% was however behind the plan benchmark of 14.46%.

Performance Attribution Relative to Benchmark

	Q1 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
UBS	1.73	0.76	(0.31)	(1.65)	0.97
UBS Property	(0.19)	0.25	(1.68)	(0.28)	(0.59)
SSgA	0.01	0.21	0.17	-	0.14
SSgA Drawdown	(0.67)	(0.48)	-	-	0.03
Ruffer	2.43	4.21	-	-	5.12
M&G	0.08	0.78	-	-	(0.46)
Marathon	3.50	(0.57)	-	-	1.19
JP Morgan	2.36	-	-	-	2.39
Total Fund	**0.51**	**0.49**	**(0.53)**	**(1.25)**	**(0.07)**

Private equity and infrastructure returns are included in the relative total fund results, but due to their long term nature and irregular investment profile they do not have individual benchmarks assigned.

Market Commentary

The first quarter of 2012 represented the second consecutive quarter of above normal stock market returns. This favorable performance reflected the modest improvement in economic conditions in the US, and increasing evidence the financial markets in Europe were stabilizing.

The rally in equities that began in tentative fashion during December gathered momentum over the New Year and extended well into the first quarter, propelling market indices back up to levels seen prior to the steep falls in late July and early August of 2011. Emerging markets outpaced their developed counterparts by a meaningful margin, while cyclical stocks held sway over defensives and growth outperformed value.

The modest but steady economic growth of the past few quarters has been accompanied by a reduction in unemployment and a gradual improvement in job creation. At the same time, inflation and interest rates have remained low and relatively stable, and corporate profits have been in an upward trend.

As economic conditions in the US were improving, the ECB took steps to stabilize financial markets in the EU. The ECB has not brought forward a set of circumstances consistent with long term financial stability, but there has been a demonstrated willingness on the part of the more financially sound members of the EU to provide the resources to overcome the current bout of instability. The boost in sentiment resulting from this relatively rosy picture was bolstered further by a growing realisation that, after innumerable false starts, the European Central Bank's longer term re-financing operation (LTRO) initiated during the latter stages of the previous quarter (and repeated in February) signified a shift towards a more decisive, proactive and arguably innovative direction on the part of policy makers, led by the ECB.

Returns in the UK commercial property market were made up entirely of income and at a sector level industrial was the strongest performer. There was no capital growth over the quarter.

MANAGER PERFORMANCE
Manager: J P MORGAN

Performance Objective: To outperform their benchmark index by 3.00% per annum.

Approach: The JPM Strategic Bond Fund is a dynamic global bond fund, providing access to their most compelling fixed income ideas, wherever in the world they are to be found. With the ability to invest across the fixed income spectrum, from government bonds to corporate credit to high yield and emerging market debt, the fund offers a diversified fixed income solution. Unlike many traditional fixed income funds, the fund does not have a yield target and does not aim to produce a consistent income. Instead, its goal is to focus on the most attractive return opportunities from across the fixed income spectrum.

	Q1 2012 %	1 Year %	Since Inception %
Performance	3.37	-	3.99
Benchmark	1.01	-	1.59
Excess Return	2.36	-	2.40

The portfolio was funded at the start of November 2011 and performance for the Q1 2012 month showed a return of 3.37%, outperforming their target by 2.36%.

Manager: MARATHON
Performance Objective: To achieve a return in excess of their benchmark index over a rolling five year period.

Approach: Marathon's investment philosophy is based on the capital cycle and the idea that high returns will attract excessive capital and hence competition, and vice versa. Given the contrarian and long-term nature of the capital cycle, Marathon’s approach results in strong views against the market and long holding periods by industry standards (5 years plus). Marathon believes “out of favour” industries and companies, highlighted by the capital cycle, are characterised by lack of interest and research coverage. Moreover, long-term price anomalies arise because business valuations and investment returns are not normally distributed due to the short-term focus of the investment industry. With a long-term view and fundamental valuation work, Marathon believes it can identify the intrinsic worth of a business. The process is by its very nature bottom-up with individual stock selection expected to drive investment performance.

	Q1 2012 %	1 Year %	Since Inception %
Performance	11.50	(0.16)	10.66
Benchmark	8.00	0.41	9.48
Excess Return	3.50	(0.57)	1.18

Returns since inception are positive at 10.66% and these have been boosted by 11.50% returns in quarter. This has consequently improved the one year excess returns to negative 0.57%, compared to negative 3.74% in Q4 2011. The outperformance in the first quarter was largely attributable to stock selection. Asset allocation was a small negative contributor to return, where the residual cash holding dampened performance in a rising market, with currency allocation was a small positive contributor to return. Geographical allocation was the main cause of the underperformance over the last twelve-month period. The underweight to the US and the overweight to Asia ex Japan had the largest negative impact on performance. Stock selection, however, made a large positive contribution

Whilst the mandate benchmark is based on developed markets, Marathon has the ability to invest in emerging markets. As such any positive or negative returns from emerging market investments can unduly influence relative performance. A proxy to the mandate benchmark is the MSCI All Countries index which includes both developed and emerging markets. For the twelve month period this index has returned a negative 6.66%, which is closer, albeit still better, than Marathon's returns.

Manager: RUFFER
Performance Objective: The overall objective is firstly to preserve the Client's capital over rolling twelve month periods, and secondly to grow the Portfolio at a higher rate (after fees) than could reasonably be expected from the alternative of depositing the cash value of the Portfolio in a reputable United Kingdom bank.

Approach: Ruffer applies active asset allocation that is unconstrained, enabling them to manage market risk and volatility. The asset allocation balances "investments in fear", which should appreciate in the event of a market correction and protect the portfolio value, with "investments in greed", assets that capture growth when conditions are favourable. There are two tenets that Ruffer believes are central to absolute return investing which are to be agnostic about market direction and also to remove market timing from the portfolio.

	Q1 2012 %	1 Year %	Since Inception %
Performance	2.70	5.11	5.94
Benchmark	0.28	0.90	0.82
Excess Return	2.42	4.21	5.12

Over the last year and since inception Ruffer has returned 5.11% and 5.94% respectively and met their brief by preserving capital and growing the portfolio. For the quarter, performance was also positive at 2.70% outperforming their benchmark by 2.42%.

The continued strong performance of equities in Q1 was the biggest contributor (3.17%) to Ruffer's returns during the quarter, with Japanese equities rising by about 17% and JP Morgan Chase added to the portfolio and going up by 20% due to the ECB actions and announcement of increased dividend and share buyback by the bank. Factors which detracted from performance included the "Long-dated index-linked bonds" which dropped by 6% due to recovery of risk assets such as equities, thus giving back gains of the past year by these 'safe haven' assets.

Manager: SSgA
Performance Objective: To replicate their benchmark indices

Approach: The calculation of the index for passive funds assumes no cost of trading. In order to simply match the index, it is necessary to trade intelligently in order to minimise costs, and where possible, make small contributions to return in order to mitigate the natural costs associated with holding the securities in the index. Activities which SSgA employ to enhance income include; tactical trading around index changing events and stock lending. They also aim to alleviate costs by efficient trading through internal and external crossing networks.

	Q1 2012 %	1 Year %	Since Inception %
SSgA Main Account			
Performance	6.11	2.66	14.26
Benchmark	6.09	2.45	14.11
Excess Return	0.02	0.21	0.15
SSgA Draw Down Account			
Performance a/c 2	0.72	4.13	5.28
Benchmark a/c 2	1.39	4.61	5.25
Excess Return	(0.67)	(0.48)	0.03

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.15%. The Draw Down fund which commenced June 2009 has also outperformed its benchmark and has delivered an excess return of 0.03%. In both cases SSgA has delivered against its objective. Underperformance in Q1 2012 in drawdown account is mainly because of the shift in portfolio weighting to 75/25 in favour of cash holding, against the benchmark split of 50/50 between cash and corporate bonds.

Performance is not always flat and quarterly variances should be expected as a result of a number of factors including; cash drag, stock lending cycles and rights Issue opportunities, however over the longer period these are expected to smooth out.

Note: FTSE free float Changes

On 13 January 2012, FTSE announced that it will move to an actual free float methodology, from the current banding process, for the composition of the FTSE UK Index Series. Free float can be loosely defined as the percentage of a company's shares in issue which are considered to be available for trading on public exchanges. Government holdings, restricted employee share schemes and significant long-term holdings by founders, for example, are not considered to be freely tradable and such holdings would therefore be excluded from a constituent's free float.

As a result of this change slated for close of business on 15 June 2012, SSgA will have to rebalance about 9% of fund's assets under its management as the changes only affects the FTSE UK index series. In Cash terms, trading in these assets is envisaged to cost the fund roughly about £100k which is negligible in relation to assets under management of about £118 m.

Manager: UBS
Performance Objective: To seek to outperform their benchmark index by 2% per annum, over rolling three year periods.

Approach: UBS follow a value-based process to identify businesses with good prospects where, for a variety of reasons, the share price is under-estimating the company's true long term value. Ideas come from a number of sources, foremost of which is looking at the difference between current share prices and UBS's price target for individual stocks. The value-based process will work well in market environments where investors are focussing on long term fundamentals.

	Q1 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	7.84	2.14	18.54	2.21	9.75
Benchmark	6.10	1.39	18.85	3.87	8.78
Excess Return	1.74	0.75	(0.31)	(1.66)	0.97

UBS outperformed its benchmark by 0.75% over the last year, riding on the back of resurgent equity markets from Q4 2011. The biggest contributors to the portfolio's performance during quarter under review were, Dixons with a rise of 90% in share price on the back of a trading update suggesting the new strategy is starting to bear fruit in a very challenging retail environment. Barclays also produced solid results during the quarter allaying investor concerns over future returns and funding costs. Lastly, Logica recovered from the previous quarter's poor performance on the back of further restructuring announcement having short term impact on profits.

For the quarter, UBS's biggest detractors to performance were FirstGroup with the issuance of profits warning on the back of reduced UK Government subsidies and high fuel prices. Vodafone and GlaxoSmithkline were the other underperforming stocks with negative performance contributions to the portfolios Q1 2012 figures.

Notably during the quarter, UBS realised profits from best performing cyclical stocks and reinvested in stocks left behind in the recent equity rally. Within the banking sector, part of HSBC holdings were switched into Lloyds Banking Group as it traded at 40% discount to the tangible asset value and continues to make strong positive returns due to its perceived UK retail business attractive market positions. The portfolio also added to its position in Centrica whilst disinvesting from Scottish Southern Electric in the Utilities sector and consolidated existing position in technology sector by purchasing additional shares in Invensys, the technology supplier.

Manager: UBS Property
Performance Objective: To seek to outperform their benchmark index by 0.75% per annum over rolling three year periods.

Approach: UBS take a top down and bottom up approach to investing in property funds. Initially the top down approach allocates sector and fund type based on the benchmark. The bottom up approach then seeks to identify a range of funds which are expected to outperform the benchmark.

	Q1 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	0.61	5.96	7.11	(3.86)	(1.08)
Benchmark	0.80	5.72	8.79	(3.58)	(0.49)
Excess Return	(0.19)	0.24	(1.68)	(0.28)	(0.59)

As the fund is based on the benchmark, normally performance should also reflect the benchmark, albeit with a margin of outperformance. However the initial fund set up and the subsequent part dissolution and reinvestment have resulted in transaction costs, which detract from performance. Since inception, many of the underlying funds have outperformed, but not by a margin large enough to outweigh the funds set up costs. No further diversification will take place, however the fund will continue to actively trade and as such any transactions costs should be justified by long term gains.

Underperformance for quarter one was driven primarily by poor performance by Standard Life Pooled Pension Property Fund, Standard Life UK Shopping Centre Trust, Rockspring Hanover Property Unit Trust, Henderson UK Retail Warehouse Fund and Threadneedle Pensions Ltd.

Over the 12 months the Fund delivered a return of +6.0% which compares to the benchmark return of +5.7%. At the property level the portfolio generated a return of 6.2% which represents an outperformance of 50 basis points over the year. The five best performing funds during this 12 month period comprised.

Absolute Returns for the quarter

	Opening Balance £000's	Appreciation £000's	Income Received £000's	Net Investment £000's	Closing Balance £000's	Active Management Contribution £000's
Fauchier	24,286	-	-	(24,286)	-	-
JP Morgan	69,664	2.348	-	-	72,012	1,640
M&G	9,208	147	-	1,794	11,149	10
Marathon	52,619	6,051	-	-	58,670	1,832
Ruffer	115,307	2,402	715	-	118,424	2,795
SSgA	120,056	6,875	1	5,506	132,438	(85)
UBS	104,881	7,300	920	-	113,101	1,786
UBS Prop	48,998	(246)	545	-	49,297	(93)

The above table provides details on the impact of manager performance on absolute asset values over the quarter based on their mandate benchmarks. The outperformance of JP Morgan, Marathon, M&G, Ruffer and UBS had a positive impact on the appreciation of holdings contributing £8,063k in total. Underperformance from SSgA (overall) and UBS Property reduced appreciation by mere £178k.

M&G Update

An addition of two new holdings in January and February 2012, has increased holdings in the fund to ten from eight in the last quarter. Final documentation details are being negotiated on a new deal an M&G hope to close this in early 2012. M&G continue to evaluate new transactions and expect the pipeline to build as the year progresses. The fund has returned 4.43% since inception.

Macquarie Update

Macquarie Everbright Greater China Infrastructure Fund (MEGCIF) has raised total commitments of US$519m and a further US$250m of co-investment capital. MEGCIF is on track for US$1b in total commitments with a further close planned for March 2012 before a final close in May 2012 which will include a number of potential investors that have indicated a strong appetite for MEGCIF. As at 31 March 2012, $92k had been drawndown out of the commitment of £$4,750k. At the time of preparing this update, 13 transactions are being actively pursued with total investment value of about $1.7 billion and of these, due diligence is being conducted on seven transactions and financial close has been agreed on one.

Macquarie SBI Infrastructure Fund
The Macquarie State Bank of India Fund (MSIF) has developed a well diversified portfolio of assets across the sectors of thermal power, airports, telecom towers and renewables and is currently evaluating several opportunities, primarily in the roads and power transmission sectors. There were no new investments made in the last quarter.

On 2 February 2012, the Supreme Court of India ordered the cancellation of 122 licences allocated to telecom operators in 2008 due to irregularities in the process followed for the issuance of these licences. This order came in response to a "Public Interest Litigation" petition filed in the Supreme Court.
The cancellation is effective after a period of four months. During this four month period, the Telecom Regulatory Authority of India ("TRAI") has been directed to frame guidelines for the auction of the spectrum released due to this cancellation. We understand that companies whose licences have been cancelled will also be able to participate in the spectrum auction.

The Macquarie SBI Infrastructure Fund invested USD 202 million in Viom Networks Limited in August 2010. The events described above are likely to have an impact on Viom's business. The impact on Viom's largest customer, Tata Teleservices, is minimal as only 3 of its licenses have been cancelled. However, Uninor, Viom's second largest customer has been significantly impacted as all its licenses have been cancelled. In the event Uninor decides to materially exit the business, the business of Viom will be significantly impacted.

The Manager is in the process of evaluating the impact of the impending cancellations on the valuation of Viom Networks in MSIF's portfolio. Based on preliminary analysis, the Manager expects a reduction in the valuation of Viom as at 31 March 2012. Further updates on the issue will be communicated to Committee members as soon as it is available.

The European fund (MEIF4) is still in its infancy and no capital calls have yet been made.

Other Items

At the end of March 2012, £30m (book cost) was invested in private equity, equating to 4.91% of the fund against the target investment of 5.00%, well below the limit of the over-commitment strategy of 8.75%. In terms of cash movements over the quarter, Adams Street called £413k and distributed £671k, whilst LGT called £757k and distributed £619k. Returns for the last twelve month period show Adams Street delivering 9.28% and LGT 3.69%.

The securities lending programme for the quarter resulted in income of £12.9k. Offset against this was £4.5k of expenses leaving a net figure earned of £8.4k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 March 2012 the average value of assets on loan during the quarter totalled £19.6m representing approximately 7.9% of this total.

The passive currency overlay agreed by Committee was put in place at the end of January 2011 with 100% Euro. During the quarter the Fourth roll took place which resulted in income of £745k. Since the fourth roll the Euro hedge has continued to increase in value and at the end of the quarter it showed a positive cash figure of £1,439k.

For the quarter ending 31 March 2012, Hillingdon returned 4.71%, underperforming against the WM average by 0.89%. However the longer term, one year figure shows an outperformance of 1.08%, with positive returns of 3.64% against the average return of 2.60%.

FUND MANAGER & CUSTODIAN COMPLIANCE WITH STATEMENTS OF INTERNAL CONTROL

INFORMATION

Officers have undertaken a review of the latest versions of the custodian and fund manager statements of internal control. Reports were provided by Northern Trust, UBS, Marathon, Ruffer, State Street Global Advisors, JP Morgan and UBS. M&G outsource their back office services to a custodian (SSgA) who provided reports. Adams Street Partners, LGT Capital Partners and Macquarie have not implemented their own SSAE 16/ISAE 3042 review. The audit opinion for those managers who undertook and external review showed the described controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved. Testing highlighted a few exceptions where the control had not been applied successfully however these issues have now all been resolved by management. A brief description of the key issues with each manager if detailed below:

UBS: UBS test results detailed one IT exception, where there in house IT system was not fully identifying all users of the system, although they did have access. This has now been rectified.

Northern Trust: The fund's custodian Northern Trust had 15 exceptions in total, relating to areas of Account administration (2), Securities movement (1), Trade communication and settlement (1), Asset data maintenance (2), Asset pricing (1), Client accounting & reporting (2), Benefit payments (1), Fund accounting (1), Transfer agency (1), and Technology (3). None of the exceptions impacted significantly on the fund and management have taken measures to improve processes. Officers will follow these issues up further with Northern Trust.

Marathon: The only exception reported relates to log in access into their IT system, where users are supposed to be locked out of the system after three failed attempts. But tests showed it took seven failed attempts for the safety trigger to activate. There is no financial risk to the fund as a result of this exception and management have taken necessary steps to ensure accuracy of the trigger point.

M&G: M&G outsource their administration and custody services to State Street Corporation. The review of State Street (M&G) showed four exceptions in the area of IT access approval, backup and password deactivation based on specified time parameters. In a particular case, the individual for which access was been sought happen to be the approver as well. Management attributed these exceptions to limitations in the system being used and has proceeded to replace it with an updated version, thus eliminating the limitations. Regarding the back up failure, management agreed with the finding and narrowed it down to a configuration problem that has been corrected. It also pointed out that data integrity was not compromised due to the highlighted exceptions.

SSgA: SSgA had two areas where exceptions were noted. These included verification of letters of direction ("LODs"), where one instance of non-secondary verification was noted out of 25 selections from 160 samples and timely receipt of "LODs", with one sample noted to have been received outside of the trading cut-off time. In both cases, management acknowledge the exceptions and promised to revise the necessary procedures to ensure future occurrences are eliminated. The other area of concern was compliance review, where seven exceptions were discovered, in terms of lateness and non execution of necessary secondary review of processes to ensure completeness of procedures. Management noted the exceptions and has commenced a review of the procedures to ensure noted lapses are eliminated.

Ruffer: There were no exceptions raised in the internal control reports provided by Ruffer and so no further action is required regarding these managers.

J.P Morgan: An exception was noted by JP Morgan in the area of Access to systems. It was noted that transferred users access was not reviewed by management to determine if access remained commensurate with user's role and responsibility. Management responded to the exception by changing firm-wide transfer process and in future, lack of management responses to review of transferred user's access will result in termination of access.

Three managers did not undergo an external audit of their controls and these included Adams Street Partners, LGT Capital and Macquarie. Officers have reviewed their processes and sought assurance that their internal controls have been reviewed as part of the audit process.

FINANCIAL IMPLICATIONS

These are set out in the report.

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report.

BACKGROUND DOCUMENTS

None.