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 30 September 2012. The total value of the fund's investments as at the 30 September was £618.8m. This represents an increase of £16.8m over the value of fund's assets at the end June 2012.

RECOMMENDATION

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

1. INFORMATION

The performance of the Fund for the quarter to 30 September 2012 showed an outperformance of 0.03%, with a return of 2.64% compared to the benchmark of 2.61%. All Managers except SSgA (Drawdown portfolio) outperformed or matched their relative benchmark during the quarter. One year figures show returns of 9.80%, an underperformance of (0.93)%.

Performance Attribution Relative to Benchmark

	Q3 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
UBS	5.75	18.95	6.65	2.37	9.64
UBS Property	0.43	2.96	7.91	(4.01)	(0.90)
SSgA	3.77	14.53	7.44	-	12.62
SSgA Drawdown	1.73	4.45	4.03	-	5.21
Ruffer	1.06	3.68	-	-	3.83
M&G	4.19	5.21	-	-	4.58
Marathon	4.34	20.02	-	-	9.31
JP Morgan	2.41	-	-	-	6.08
Total Fund	**2.64**	**9.80**	**6.55**	**0.91**	**6.32**

Market Commentary

Equity markets performed fairly well over the third quarter of 2012 with most major markets showing gains on the back of losses for the second quarter of 2012.

Reports show the US market slowing to a growth rate of just over 1% for the year compared with an annualised rate of 3.0% for Q4 2011. Despite this and other weak economic data, the markets continued to advance to reach multi-year highs with low levels of volatility. The market advances are largely a result of additional stimulus in the form of QE3 from the Fed. Unlike QE1 and QE2, QE3 does not have a fixed term or a targeted total dollar amount and the open-ended nature has provided the flexibility and commitment markets had hoped for.

The European sovereign debt crisis continued to bounce from one country to the next with economic growth in the region being at record lows. In spite of the continuing weakness of peripheral European Union countries, the Eurozone markets performed well compared with the prior quarter albeit with a higher level of volatility. The strong performance of the European markets comes on the back of ECB's announcement to support bond prices through an unlimited buying program in an attempt to ease the ongoing challenges in the region.

Emerging markets performed relatively well, with the strongest gains coming from emerging European countries. In addition to the monetary easing measures announced in developed markets, several economic stimulus packages were unveiled in emerging markets including:

- China's $157 billion infrastructure commitment
- Brazil's $66 billion infrastructure program
- South Korea's $5.2 billion stimulus package

In addition to the stimulus measures, the major emerging economies including China, Brazil, Taiwan and South Korea all cut interest rates to spur economic growth.

2. MANAGER PERFORMANCE

2.1 Manager: JP Morgan

Performance Objective: The investment objective of the company is to achieve a return of +3% over Libor 3 Month rate.
Approach: The aim of the portfolio is to be diversified across various corporate bonds with an average quality of BBB+ and derivatives may be used to achieve fund objectives.
Performance: To incorporate an element of risk adjusted return, the benchmark has been set to include outperformance of an absolute benchmark, in this case 3 Month Libor, by a further 3%. In relation to this benchmark JP Morgan have outperformed since inception (Nov 2011) by 2.53% and in the quarter under review, outperformed by 1.48 % with a return of 2.41 % against benchmark return of 0.93%.

2.2 Manager: M&G

Performance Objective: The investment objective of the Prudential/M&G UK Companies Financing Fund LP is to seek to maximise returns consistent with prudent investment management. The Fund aims to provide an absolute return of Libor +4% (net of fees). Additional returns may be achieved through equity participation or success fees.

Approach: The objective of the Fund is to create attractive levels of current income for investors, while maintaining relatively low volatility of Net Asset Value. The fund was set up to provide medium to long term debt financing to mid-cap UK companies with strong business fundamentals that are facing difficulties refinancing existing loans in the bank market.

Performance

Over the third quarter of 2012, M&G investments more than made up for the previous period's results with figures of 4.19% versus 1.17% for the 3 Month LIBOR +4% p.a. target. For one year the returns now stand at 5.21% against 4.99%, whilst since inception at the end of May 2010, the portfolio registers a 4.58% pa return against the benchmark of 4.89% pa, underperforming by (0.31)%. The since inception Internal Rate of Return for this portfolio is now ahead of the target with a figure of 5.27% opposed to the comparator of 5.12%.

2.3 Manager: MARATHON (Assets transitioned during October)

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

Performance: In the 3rd quarter Marathon investments grew 4.34%, which was 0.57% above the MSCI World index return of 3.77%. This continues the run of all three quarters of 2012 beating the index, meaning for the year to date and 1 year outperformance of 5.75% and 3.22% respectively is the highest seen from all mandates. This coupled with the results in Q3 2010 means since inception (June 2010) they beat the index by 1.90%, returning 9.31% pa against 7.27% pa benchmark.

2.4 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 believe are central to absolute return investing which are to be agnostic about market direction and also to remove market timing from the portfolio.

Performance: The Ruffer portfolio returned 1.06% during the quarter and against the return of 0.26% for LIBOR 3 Month GBP delivers an outperformance of 0.80%. This partly offsets the previous quarter and means that the year to date and 1 year numbers are now ahead of target. This culminates in a since inception return from May 2010 of 3.83% pa, which translates as an excess return of 2.96% against the benchmark of 0.87% pa.

2.5 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.
Performance:
The SSGA passively managed portfolio produced a return of 3.77% in the quarter to match the benchmark; further analysis confirms the passive nature with both allocation and performance aligned with the neutral position. This improves the year to date to 7.32%, which is still just behind target of 7.40%, while over one year the return increases further to 14.53%, also just below the benchmark of 14.63%. Positive absolute performance in line with the benchmark is seen in longer periods; with the since inception return of 12.62% pa only 0.06% above the benchmark.

2.6 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.
Performance:

	Q3 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	5.75	18.95	6.65	2.37	9.64
Benchmark	4.70	17.25	8.05	3.52	8.68
Excess Return	1.05	1.70	(1.40)	(1.15)	0.97

The UK market bounced back over the latest quarter and the FTSE All Share returned 4.70%, in this environment UBS UK Equity posted the highest absolute return of all mandates with 5.75%, leading to outperformance of 1.05% against the benchmark. Looking into the attribution analysis, stock selection was the main driver and in contrast to last quarter investments in Financials (1.58%) were by far the biggest contributor, this was partly offset by Basic Materials which detracted -0.78%. UBS exhibits relative underperformance across longer periods, with -1.29%, -1.11% and -0.97% for three, five and ten years respectively; however they still demonstrate outperformance since inception with figures of 9.64% versus 8.68% on an annualised basis.

2.7 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.
Performance:

	Q3 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	0.43	2.96	7.91	(4.01)	(0.90)
Benchmark	0.40	2.83	9.51	(3.57)	(0.34)
Excess Return	0.03	0.13	(1.60)	(0.44)	(0.55)

The UBS Property portfolio posted a return of 0.43% during the period, to continue the run of consecutive positive returns; this was slightly above the IPD UK PPFI All Balanced Funds index, return of 0.40%. Over one year the portfolio achieved a growth of 2.96%, now 0.13% above the benchmark. However, driven by the underperformance of Q4 2009 the three year period still falls below target with figures of 7.91% versus 9.51%, an underperformance of (1.60) %. Since inception, in March 2006, there are losses of (0.90) % and while the benchmark also falls, at (0.34) % this translates to a (0.55) % underperformance on an annualized basis.

3. ABSOLUTE RETURNS FOR THE QUARTER

	Opening Balance £000's	Appreciation £000's	Income Received £000's	Net Investment	Closing Balance £000's	Active Management Contribution £000's
UBS	109,429	5,278	1,019	0	115,726	1,203
UBS Property	49,421	(479)	690	(3)	49,629	13
SSgA	114,518	4,316	0	0	118,833	4
SSgA Drawdown	14,663	198	0	(4,240)	10,621	(113)
Ruffer	115,070	569	646	0	116,286	922
M&G	11,350	482	0	950	12,782	353
Marathon	57,498	2,494	0	0	59,991	335
JP Morgan	71,736	1,726	0	0	73,462	1,061

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 all fund managers apart from SSgA Drawdown had a positive impact on the appreciation of holdings contributing £3,891k in total. Whilst underperformance by the latter reduced overall appreciation by £113k.

4. M&G Update

M& G UK Companies Fund

The NAV was valued at £847 million on September 30, 2012 compared with £837 million at the end of the previous quarter. The increase resulted from the earned income and fees, which was offset by the change in market value of the interest rate swap. The fund committed a new £100 million loan during the quarter. The fund's return since inception was 5.07%, same as the previous period. The loans are performing in line with expectations and remain marked at par.

M&G Debt Opportunities Fund IV
Two draw-downs totalling £1.2m for the M&G Debt opportunities fund was made in September 2012, representing 8.28% of our commitments (£15m) to the fund. The whole fund has a NAV of £15.8m and total return since inception of 4.01%. Though the debt opportunities fund started on 30 June 2012, various investment opportunities are being pursued by the managers and at the time of this report two further draw-downs totalling about £531k had been submitted for the month of October.

5. Macquarie Update

MEGCIF
Macquarie Everbright Greater China Infrastructure Fund (MEGCIF) issued one capital call notice to investors during the quarter ended 30 September 2012 totalling US$3.00 million. The capital call was made in relation to the US$1.96 million base management fee for the quarter ended 30 September 2012 and US$1.04 million fund operating expenses. MEGCIF has cumulatively drawn capital of US$95.81 million which represents 18.47% of its total capital commitment of US$518.75 million.

MEIF4
The Manager’s valuation of the Fund’s net assets at 30 September 2012 was €258.4 million. The valuation of the portfolio consisted of the OGE, which was held at acquisition cost, and the cash/other assets and liabilities in the portfolio.

OGE
A Macquarie European Infrastructure Fund 4 led consortium completed the acquisition of Open Grid Europe (OGE) on 23 July 2012. OGE is the owner and operator of the longest regulated supra-regional gas transmission network in Germany, with approximately 12,000km of gas pipeline and 27 compressor stations. Due to its position as the hub transmission network operator for pan-European gas flows, OGE represents the epitome of a core strategic infrastructure asset, not just in Germany but for the broader European economy. Germany is Europe’s largest and strongest economy with a well developed, reliable regulatory framework. MEIF4’s final commitment to OGE was €260.0 million, representing a 23.6 per cent interest.

6. Other Items

At the end of September 2012, £28.9m (book cost) had been invested in private equity, which equates to 4.68% of the fund against the target investment of 5.00%. In terms of cash movements over the quarter, Adams Street called £294k and distributed £432k, whilst LGT called £750k and distributed £226k. This trend is set to continue in the next few years as the fund's investments in private equity enters its' vintage years and more distributions will be received as the various funds mature.

The securities lending programme for the quarter resulted in income of £18.2k. Offset against this was £6.4k of expenses leaving a net figure earned of £11.8k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 September 2012 the average value of assets on loan during the quarter totalled £27.7m representing approximately 13.9% of this total.

The passive currency overlay agreed by Committee was put in place at the end of January 2011 with 100% Euro and 50% Australian dollars (June 2012) hedges. The latest quarterly roll occurred on the 7 November 2012 and resulted in a realised loss of £296k. Since inception, the programme has made a net profit of £1.9m.

For the quarter ending 30 September 2012, Hillingdon returned 2.64%, underperforming against the WM average of 3.30% by (0.66)%. The one year figure shows an underperformance of 2.80%, returning 9.80% against the WM average return of 12.6%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None