REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND

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SUMMARY

This report reviews the fund manager performance for the London Borough of Hillingdon Pension Fund for the period ending 30 September 2011. The total value of the fund's investments as at the 30 September was £564.3m.

RECOMMENDATION

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

INFORMATION

1. The annual performance of the Fund as at 30 September 2011 showed an outperformance of 1.99%, with a positive return of 1.34% against the negative benchmark of 0.65%. The three year return figure of 7.33% is also ahead of the plan benchmark which showed 5.78%.

Performance Attribution Relative to Benchmark

	Q3 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Goldman Sachs	(0.48)	(0.39)	(0.02)	(0.60)	(0.60)
UBS	(0.75)	(1.19)	(1.52)	(2.12)	0.94
UBS Property	(0.23)	(0.24)	(1.52)	(0.55)	(0.67)
SSgA	0.23	0.19	-	-	0.13
SSgA Drawdown	(0.04)	(0.04)	-	-	0.32
Ruffer	(2.01)	3.86	-	-	3.21
M&G	0.60	(0.72)	-	-	(0.71)
Marathon	(2.37)	(2.72)	-	-	0.91
Fauchier	(5.06)	(5.52)	-	-	(6.53)
Total Fund	**1.27**	**1.99**	**1.55**	**(0.30)**	**0.16**

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

Market Commentary

2. Equity markets suffered significant falls during the quarter with concerns over the Eurozone still unsettling sentiment. The rating agencies added to anxiety by downgrading Portuguese debt to below investment grade and by raising alarm over a proposal to roll over Greek Debt. The largest impact though was that contagion could spread to Italy, the worlds third largest and Europe's largest issuer of debt. Another European emergency bail out initially resulted in a modest rally, however sentiment turned quickly as a new area of focus emerged regarding the US debt ceiling. Approval to increase the limit was finally agreed at the last hour however this news was overshadowed by the downgrading of the US credit rating. The continued flow of poor economic data, leading to worries of another recession, along with continued European fiscal apprehension pushed markets lower. As the quarter continued concerns that Greece would not receive their next tranche of aid, along with further weak economic data and the US warning that there were significant downside risks to the economic outlook added to the negative sentiment.

3. Gilts benefited from the negative sentiment which plagued the equity markets as they were seen as a safe refuge away from the perceived high risk asset classes. The 10 year UK gilt and US Treasury bond fell to their lowest levels since 1899 and 1950 respectively, demonstrating the levels investors are willing to accept for perceived safety. Corporate bonds also managed a positive return mainly due to the attractive yields they offer.

4. The UK commercial property market continued to deliver positive results during the third quarter. Returns comprised of capital growth, rental income and to a small degree rental growth. One year results also remain positive with the office sector being the best performer in this area.

MANAGER PERFORMANCE

5. **Manager: FAUCHIER**

Performance Objective: The investment objective of the company is to achieve an absolute return over a market cycle.

Approach: The aim of the portfolio is to be diversified across 10-12 strategies and allocate to those strategies according to perception of the potential which exists to generate returns over a period of time.

Performance:

	Q3 2011 %	1 Year %	Since Inception %
Performance	(3.61)	0.33	(0.70)
Benchmark	1.45	5.85	5.83
Excess Return	(5.06)	(5.52)	(6.53)

To incorporate an element of risk adjusted return, the benchmark has been set to include outperformance of an absolute benchmark, in this case cash, by a further 5%. In relation to this benchmark Fauchier have underperformed since inception

(June 2010) by 6.53%. Although not a full market cycle, returns since inception are currently negative at 0.70% and as such an absolute return has not been achieved.

During the quarter there was mixed performance in the underlying strategies. Positive impacts came from the Short Bias managers which profited not only in the general market sell off but also from their selection in names and themes. Fixed Income was slightly up with volatility benefiting the manager. The Macro strategy was flat with gains by one manager being offset by losses from another. Equity Hedged managers, both high and low volatility were also flat, again with compensating performance. Losses were experienced by Equity Long Bias as markets retreated and Specialist Credit where the bulk of the losses were down to one manager.

Conditions for fund of hedge fund managers have not been conducive over the last twelve months and Fauchier's performance, although behind their benchmark is not dissimilar to other managers in the sector. This indicates it is the market environment rather than the manager's skill which is hindering performance.

Manager: GSAM

Performance Objective: To outperform their benchmark indices by 0.75% per annum.

Approach: The corporate credit research process is grounded upon an analysis of the macro environment, commonly referred to as top-down analysis, along with a detailed understanding of the characteristics pertaining to each corporate entity, commonly referred to as bottom-up analysis. Multiple ideas resulting from this analysis are brought together and a balanced portfolio is constructed.

Performance

	Q3 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	2.97	5.03	9.25	5.81	6.07
Benchmark	3.45	5.42	9.27	6.41	6.67
Excess Return	(0.48)	(0.39)	(0.02)	(0.60)	(0.60)

The top down analysis for Q3 failed to deliver results in terms of the cross sector and duration strategies, both of which detracted from performance. GSAM's overweight exposure to corporates experienced a heavy sell off in the risk adverse environment. The bottom up approach added a small outperformance in terms of corporate selection.

In general there is a tendency for bond managers to perform in harmony and to either outperform or underperform their benchmarks at the same time. In a peer group of thirty three bond managers the median return over Q3 was 1% behind the benchmark. During the quarter the GSAM aggregate portfolio sat sixth on the list and only four of the managers were able to outperform. Dispersion of returns was not particularly large with approximately three quarters of managers within plus or minus 1% of the median return. Managers were generally caught out by asset allocation, through being underweight both gilts and duration, which was also the case with GSAM.

6. **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 believe “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:

	Q3 2011 %	**1 Year %**	**Since Inception %**
Performance	(16.43)	(5.96)	1.79
Benchmark	(14.06)	(3.24)	0.88
Excess Return	(2.37)	(2.72)	0.91

Performance since inception remains positive at 1.79% with an outperformance against the benchmark of 0.91***%.*** However, following three quarters of positive returns, this quarter's decisive reversal in markets has resulted in one year returns being negative at 5.96***%*** against a negative benchmark of 3.24***%.*** Geographical allocation was the main detractor over the year; underweight US and overweight Hong Kong having the largest effect. Stock selection made a small positive impact and with the exception of North America all areas added value. Again stock selection was the main contributor for the since inception results.

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 4.98%, which is more comparable, if albeit marginally better than Marathon's returns.

7. **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.

Performance:

	Q3 2011 %	1 Year %	Since Inception %
Performance	(1.82)	4.61	3.95
Benchmark	0.19	0.75	0.74
Excess Return	(2.01)	3.86	3.21

Over the last year Ruffer has returned 4.61% and met their brief by preserving capital and growing the portfolio. For the quarter however performance was negative 1.82% with the strong gains made from bonds being more than offset by the large fall in equity prices. The flight to safety drove government bond yields lower resulting in strong gains in the portfolio's index linked gilts, especially the long dated US Treasury Inflation Protected Securities. Towards the end of the quarter commodity prices fell as the prospects for global growth came under pressure. Carry trades unwound leading to a rise in the US dollar against the Australian and Canadian currencies driving the price of Ruffer's "put warrant higher". Factors which detracted from performance were mainly attributable to the fall in equity prices and in Ruffer's case, especially their holdings in Ericsson, Deutsche Post, BP and Invensys.

An alternative approach to measuring against the absolute benchmark of cash is to construct a benchmark which better reflects the make up of the portfolio. In the case of Ruffer, if the benchmark is split to show returns weighted at 45% equities, 40% index linked bonds and 15% cash, the benchmark performance for one year returns 3.34% meaning Riffer's allocation has been able to capture a greater return over the last twelve months.

8. **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:

	Q3 2011 %	1 Year %	Since Inception %
SSgA Main Account			
Performance	(10.84)	(2.42)	11.96
Benchmark	(11.07)	(2.61)	11.83
Excess Return	0.23	0.19	0.13
SSgA Draw Down Account			
Performance a/c 2	0.85	1.24	5.55
Benchmark a/c 2	0.89	1.28	5.23
Excess Return	(0.04)	(0.04)	0.32

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.13%. The Draw Down fund which commenced June 2009 has also outperformed its benchmark and has delivered an excess return of 0.32%. In both cases SSgA has delivered against its objective.

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.

9. **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 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	(14.25)	(5.55)	5.24	0.29	9.25
Benchmark	(13.50)	(4.36)	6.76	2.41	8.31
Excess Return	(0.75)	(1.19)	(1.52)	(2.12)	0.94

Performance for the past year has been behind the benchmark primarily because of three reasons; an overweight to General Retailers, an underweighting of Tobacco and the performance of Value as a style. UBS believe there is tremendous latent value in retailers such as Dixons (which they expect to generate more bottom line performance for the fund than any other stock in the coming 3-5 years), they did underestimate the shorter term impact of the weak UK consumer backdrop when combined with rising costs and a VAT increase. Conversely, the Tobacco sector has enjoyed a re-rating because of its defensive qualities, despite falling volumes and regulatory pressure. As regards the value cycle, the last three years have not been conducive whilst 'growth, quality and momentum' have significantly outperformed stocks displaying good value characteristics. (Following the alteration of the portfolio three years ago, UBS now only quote their performance in terms of the revised UK equities only mandate. The above results show performance for all historic UBS attributions)

To better determine performance and manager skill based on their investment approach, it is possible to measure against an alternative index. The above performance is benchmarked against the FTSE All Share, which includes all UK stocks regardless of the style of investing. UBS are a value based manager and will only hold stocks which represent their value style. If performance is measured against the S&P Broad UK Value index, which only includes value stocks, UBS have outperformed over the one year time period by 0.9% and three years by 3.2%.

10. **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 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	1.47	7.26	(1.14)	(3.32)	(1.58)
Benchmark	1.70	7.50	0.22	(2.77)	(0.91)
Excess Return	(0.23)	(0.24)	(1.36)	(0.55)	(0.67)

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 ongoing set up costs. As the portfolio diversifies further out of Triton, transaction costs will continue to challenge the outperformance of the underlying funds.

In Q3, there were transactions on four property funds. In July 2011, sale proceeds of £3.5m were received from the redemption in UBS Triton. This sale has reduced the weighting in the fund to 28.6%. In August 2011, UBS purchased £2.4m in Standard Life Shopping Centre Trust at a 0.5% discount to the prevailing Net Asset Value (NAV), which now has a weighting in the portfolio of 5.1%. In the same month an opportunity was taken to acquire an additional £0.8m of units in Lothbury Property Trust at the prevailing NAV price, which increased its weighting in the portfolio to 6.8%. The fourth transaction took place in September, when £2.1m was deployed into Hermes Property Unit Trust, a balanced fund that now represents 4.3% of the portfolio.

There was a mix of performance in the underlying funds with many adding value, however the main source of underperformance for Q3 were the transaction costs.

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
Fauchier	25,503	(919)	-	-	24,584	(1,291)
GSAM	67,811	1,948	67	-	69,826	(315)
M&G	7,983	142	-	(166)	7,959	47
Marathon	59,809	(9,824)	-	-	49,985	(1,358)
Ruffer	114,235	(2,667)	586	-	112,154	(2,294)
SSgA	126,635	(12,532)	-	-	114,103	251
UBS	113,453	(17,100)	937	-	97,290	(937)
UBS Prop	47,524	79	618	(10)	48,211	(112)

11. 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 M&G and SSgA had a positive impact on the appreciation of holdings contributing £298K in total. Underperformance from Fauchier GSAM, Marathon, Ruffer, UBS and UBS Property reduced appreciation by £6,307k.

M&G Update

12. There were no additions during Q3 to the six holdings already in the fund. M&G have ended discussions with one of the companies in the pipeline but are continuing with the remaining three deals, one of which has entered the documentation stage. Since inception the fund has delivered returns of 4.11***%.***

Macquarie Update

13. Macquarie Everbright Greater China Infrastructure Fund (MEGCIF) has raised total commitments of US$519 million and a further US$250 million of co-investment capital. In September, management conducted an investor roadshow in the United States and will commence a European roadshow in October/November. MEGCIF is on track for US$1 billion in total commitments with a further close planned for early 2012 which will include a number of potential investors that have indicated a strong appetite for MEGCIF. No capital calls have been made at 30 September 2011 but the first capital call for MEGCIF to cover establishment costs will be called before the year end. At the time of preparing this update, six transactions are being actively pursued with an approximate total investment value of up to US$830 million.

    In July 2011 the Macquarie State bank of India Fund (MSIF) completed its newest investment in a company that develops small hydropower plants. With this, MSIF is now close to 60% invested. The assets owned by the fund continue to perform in line with forecasts, with current investments in telecom towers, airports and power generation companies (thermal and renewables), as well as a strong pipeline with investment opportunities in the roads, power transmission, renewables and ports. MSIF is on track to build a well diversified portfolio.

This quarter also saw the first closing of the European fund (MEIF4). All the necessary documentation was approved and executed to enable Hillingdon to participate in the first closing. As this fund is still in its infancy no capital calls have currently been made.

Other Items

14. At the end of March 2011, £31.1m (book cost) had been invested in private equity, which equates to 5.52% of the fund against the target investment of 5.00%. This level still remains within the limits of the over-commitment strategy of 8.75%. In terms of cash movements over the quarter, Adams Street called £327k and distributed £242k, whilst LGT called £725k and distributed £634k.

15. The securities lending programme for the quarter resulted in income of £12.8k. Offset against this was £4.5k of expenses leaving a net figure earned of £8.3k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 September 2011 the average value of assets on loan during the quarter totalled £21.9m representing approximately 10.5% of this total.

16. The passive currency overlay agreed by Committee was put in place at the end of January 2011 with 100% Euro and 50% Japanese Yen hedges. On the 5th August 2011 the Japanese Yen was removed from the programme and a 100% Swiss Franc (CHF) hedge was put in place. During the quarter the second roll took place which resulted in income of £708k. As at the 30 September the hedge continued to appreciate and was showing a positive figure of £632k. In Q3 performance was ahead of the assumed half hedge benchmark by 1.4%. Since inception results also show an outperformance with a return of 0.8% against a negative benchmark of 0.2%.

17. For the quarter ending 30 September 2011, Hillingdon returned a negative 6.20%, outperforming against the WM average by 3.10%. The one year figure shows an outperformance of 2.54%, with positive returns of 1.34% against the average negative return of 1.20%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None