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 31 December 2011. The total value of the fund's investments as at this date was £583.7m.

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 December 2011 showed an underperformance of 0.14, but with a positive return of 0.12%. The three year return figure of 8.79% is also behind the plan benchmark which showed 9.63%.

Performance Attribution Relative to Benchmark

	Q4 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
UBS	(0.59)	(1.87)	(1.64)	(2.18)	0.90
UBS Property	0.04	0.37	(1.59)	(0.34)	(0.63)
SSgA	(0.05)	0.15	0.11	-	0.14
SSgA Drawdown	0.07	0.20	-	-	0.31
Ruffer	2.59	0.89	-	-	4.35
M&G	0.01	(0.54)	-	-	(0.60)
Marathon	(2.58)	(3.74)	-	-	(0.83)
Fauchier	(2.69)	(8.83)	-	-	(7.26)
Total Fund	**(0.98)**	**(0.14)**	**(0.84)**	**(1.16)**	**(0.10)**

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

Following a poor quarter three, equities bounced back in quarter four delivering healthy returns overall. Most of the gains were achieved during October with November and December only delivering a modest contribution masked by considerable volatility. In aggregate developed markets continued to outperform emerging markets. US equities performed the best and managed to achieve a positive return for the whole year.

Equity markets in October, initially started slowly but then gathered pace on speculation the EU was examining measures to support the banks and help them with the problems associated with peripheral Europe. Risk appetite was further improved following the Bank of England's announcement they would increase their asset purchase program by a further £75b. The first EU summit was a non event but the second was met with a positive reaction by the market and sentiment was bolstered with encouraging US economic data.

The ongoing issues in Europe dominated events during November and December with France's credit rating being called into question, the European Central Bank announcing measures to support bank lending and EU leaders agreeing a fiscal compact aiming to limit government deficits. A further announcement by the EU sounded less decisive, with little talk of fiscal union and no Eurobond. Markets however tended to focus on the strength of the US economy rather than the issues in Europe.

The recovery in equities did not prevent further gains by UK government bonds with conventional and index linked both increasing in value following the announcement of further quantitative easing by the Bank of England. Corporate bonds also performed positively in conjunction with the general improvement in risk appetite.

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

MANAGER PERFORMANCE

Manager: FAUCHIER

Performance Objective: The investment objective of the company was to achieve an absolute return over a market cycle. All monies have now been removed from Fauchier following the decision by Committee to withdraw funding for the time being.

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.

	Q4 2011 %	1 Year %	Since Inception %
Performance	(1.21)	(2.91)	(1.39)
Benchmark	1.48	5.92	5.87
Excess Return	(2.69)	(8.83)	(7.26)

To incorporate an element of risk adjusted return, the benchmark was 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 7.26%. Although not a full market cycle, returns since inception are currently negative at 1.39% and as such their objective of delivering an absolute return has not been achieved.

The challenging environment for hedge funds continued during the fourth quarter. Markets were dominated by a series of high level events with sentiment overwhelming fundamentals and as such the security selection skills of many of Fauchier's managers were unrewarded. Many market moves were driven by political factors rather than macro economic events and therefore outcomes which should have been lucrative for strategies suited to a top down environment were more difficult to predict. Although there was some success for managers of this type, losses outweighed any gains.

Several managers fared well with six of the ten largest allocations delivering an average positive return. However all but three of the next twenty allocations lost money. These results are indicative of the hedge fund industry as a whole which lost 5% according to hedge fund research.

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.

The portfolio was funded at the start of November 2011 and performance for the two month period showed a return of 0.60%, ahead of their performance objective by 0.02%.

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.

	Q4 2011 %	**1 Year %**	**Since Inception %**
Performance	5.27	(8.58)	4.90
Benchmark	7.85	(4.84)	5.73
Excess Return	(2.58)	(3.74)	(0.83)

Returns since inception are positive at 4.90%, however results over the last two quarters have had a negative impact on relative returns which now show an underperformance of 0.83%. The main impact in the fourth quarter was regional allocation and stock selection. Being underweight in the US and overweight Asia (ex Japan) was the main negative contributor to regional attribution. Stock selection in the US though was the largest overall contribution to underperformance. The regional allocations mentioned above were also a drag on the one year figures whilst being overweight the South African Rand contributed to a negative currency effect. Again as with the quarters results stock selection in the US was the biggest detractor.

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

	Q4 2011 %	1 Year %	Since Inception %
Performance	2.81	1.69	5.12
Benchmark	0.22	0.80	0.77
Excess Return	2.59	0.89	4.35

Over the last year and since inception Ruffer has returned 1.69% and 5.12% respectively and met their brief by preserving capital and growing the portfolio. For the quarter, performance was also positive at 2.81% outperforming their benchmark by 2.59%. Although equities rallied, returns from UK and US government bonds as well as UK index linked gilts all had a major impact on performance. In particular the equity holding in BP added, following strengthening oil prices and with the settlement with Transocean over the Gulf of Mexico oil spill being seen as positive. Cisco share prices responded positively following the company's improved operating performance. At a currency level better US economic data along with European interest rate cuts aided US dollar performance. Factors which detracted from performance included the "Put Warrants" which gave up some of their gains from the third quarter and gold mining related equities which suffered following a fall in gold bullion prices.

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 gilts and 15% cash, the benchmark performance for one year returns shows 6.46%, meaning Ruffer's defensive allocation has not been able to capture all of the available return potential.

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.

	Q4 2011 %	1 Year %	Since Inception %
SSgA Main Account			
Performance	6.71	(2.10)	13.30
Benchmark	6.76	(2.25)	13.16
Excess Return	(0.05)	0.15	0.14
SSgA Draw Down Account			
Performance a/c 2	1.30	3.94	5.52
Benchmark a/c 2	1.23	3.74	5.21
Excess Return	0.07	0.20	0.31

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.14%. The Draw Down fund which commenced June 2009 has also outperformed its benchmark and has delivered an excess return of 0.31%. 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.

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.

	Q4 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	7.80	(5.33)	11.24	0.93	9.50
Benchmark	8.39	(3.46)	12.88	3.11	8.60
Excess Return	(0.59)	(1.87)	(1.64)	(2.18)	0.90

Performance for the past year remains behind the benchmark with the same detracting factors as in quarter three; an overweight to General Retailers, an underweighting of Tobacco and the performance of Value as a style.

For the quarter UBS's biggest sector underweight positions were in the Tobacco and Beverage sectors. These sectors had performed well in the recent financial turmoil as investors sought companies with defensive earnings characteristics. In UBS's view however, the 'safety premium' in these sectors was too high. At a stock level Lloyds shares fell due to a number of factors including the requirement for a new CEO and general fears in the Eurozone. Shares in Logica fell after the company brought forward restructuring to counter weakness in Europe and made previsions for several loss making contracts. Kesa also performed poorly despite selling its loss making business Comet, as investors focused on its exposure to the Eurozone. Positive influences on performance came from the portfolios overweight holding in BP which appreciated following the settlement announcement and also because investors began to focus on BP's low valuation rather than their litigation proceedings. Wolseley, a leading supplier of building materials also performed well following excellent annual results proving the recovery programme introduced by new management was working well and was on target. Vodafone shares performed well supporting their high and growing dividend yield and defensive qualities. .

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 is 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 underperformed over the one year time period by 2.2% but have outperformed over three years by 2.5%.

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.

	Q4 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	1.64	7.56	4.12	(3.54)	(1.23)
Benchmark	1.60	7.19	5.71	(3.20)	(0.60)
Excess Return	0.04	0.37	(1.59)	(0.34)	(0.63)

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.

The quarter four total return was driven primarily by the outperformance of UBS Triton Property Fund, which at quarter-end accounted for 28% of the portfolio size. Other funds contributing to the quarter's outperformance included Unite Student Accommodation Fund and UBS Central London Office Value Added Fund. Over the 12 month period the portfolio outperformed the benchmark and whilst several funds contributed, the performance was driven by the same funds that outperformed in the fourth quarter.

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	24,584	(298)	-	-	24,286	(661)
JP Morgan	-	414	-	69250	69,664	17
M&G	7,959	115	(1)	1,135	9,208	6
Marathon	49,985	2,634	-	-	52,619	(1,215)
Ruffer	112,154	2,721	432	-	115,307	2,901
SSgA	114,103	7,088	-	(1,135)	120,056	(48)
UBS	97,290	6,462	1,129	-	104,881	(498)
UBS Prop	48,211	319	473	(5)	48,998	19

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, M&G, Ruffer and UBS Property had a positive impact on the appreciation of holdings contributing £2,943k in total. Underperformance from Fauchier, SSgA (overall), Marathon and UBS reduced appreciation by £2,422k.

M&G Update

With the addition of a new holding in November, here are now eight holdings in the fund. 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 4.26% 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. No capital calls have been made as of 31st December 2011. At the time of preparing this update, five transactions are being actively pursued and of these, due diligence is being conducted on three transactions.

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

Other Items

At the end of December 2011, £31.0m (book cost) was invested in private equity, equating to 5.32% 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 £1,072k and distributed £886k, whilst LGT called £690k and distributed £996k. Returns for the last twelve month period show Adams Street delivering 14.73% and LGT 10.25%.

The securities lending programme for the quarter resulted in income of £13.2k. Offset against this was £4.6k of expenses leaving a net figure earned of £8.6k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 December 2011 the average value of assets on loan during the quarter totalled £14.4m representing approximately 7.7% 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% 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. The CHF hedge was removed on the 25th November leaving only the Euro hedge running. During the quarter the third roll took place which resulted in income of £816k. The early redemption of the CHF resulted in a final payment of £44k but overall the net cash settlements over the life of the CHF hedge generated cash income of £410k. Since the third roll the Euro hedge has continued to increase in value and at the end of the quarter it showed a positive cash figure of £694k. In terms of performance against the assumed half hedge benchmark results for the quarter were positive with returns of 0.92% against the benchmark of 0.46%. Since inception results also show an outperformance with a return of 1.70% against 0.29%.

For the quarter ending 31 December 2011, Hillingdon returned 3.82%, underperforming against the WM average by 1.38%. However the longer term one year figure shows an outperformance of 1.62%, with positive returns of 0.12% against the average negative return of 1.50%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None