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 report from Adams Street Private Equity report from LGT

SUMMARY

This report reviews the fund manager performance for the London Borough of Hillingdon Pension Fund for the period ending 30 June 2012. The total value of the fund's investments as at the 30 June was £602m. (Whilst this represents a drop of around £10m from the end of financial year in March 2012, in the months since June the Fund's value has rebounded back to around £612m at the end of August.)

RECOMMENDATION

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 June 2012 showed an underperformance of -0.45%, with a negative return of -1.59% compared to the benchmark of -1.14%. All Managers except Marathon underperformed their relative benchmark during the quarter. One year figures show returns of 0.35%, an underperformance of (0.31)%.

Performance Attribution Relative to Benchmark

	Q2 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
UBS	(0.62)	(0.42)	(1.27)	(1.72)	0.93
UBS Property	(0.05)	(0.13)	(1.73)	(0.55)	(0.58)
SSgA	(0.09)	0.16	0.13	-	0.10
SSgA Drawdown	(0.55)	(1.23)	(0.16)	-	(0.16)
Ruffer	(3.11)	(0.24)	-	-	2.93
M&G	(2.82)	(2.23)	-	-	(1.82)
Marathon	1.80	(0.16)	-	-	1.98
JP Morgan	(1.37)	-	-	-	0.99
Total Fund	**(0.45)**	**(0.31)**	**(0.24)**	**(1.40)**	**(0.09)**

Market Commentary

Equity markets had a volatile quarter. After four consecutive months of positive returns for equity markets, investor sentiment deteriorated in April leading to falls across the board. Markets began the month on a relatively sour note with the much-watched US payrolls data release disappointing. Economic data out of China indicated that the economy was in the process of slowing down. Contrasting this to some extent was the broadly positive earnings data from the first quarter reporting season. Once again, the Eurozone that attracted the most attention with Spain being placed firmly under the spotlight. Over the month Spain suffered a weak bond auction, announced more austerity measures, was downgraded by a credit rating agency, re-entered recession and announced that non-performing loans had reached an 18 year high.

Equity markets staged something of a rally in June. Markets waited until the final few days of the month to really make their mark with European markets leading the way higher in the aftermath of the latest in a series of European summits. In particular, markets were buoyed by the fact that it seemed to pave the way for the European Stability Mechanism, Europe's rescue funding programme, to directly recapitalise struggling banks within the region.

Investors seeking a safe haven from the volatility of equity markets poured money into treasury securities. Demand for treasury bonds pushed the yield on the 10-year treasury bond down to 1.66% at the end of June from 2.22% at the end of March and down from 3.16% one year ago.

According to the IPD Monthly Index, UK commercial property recorded a total return of +0.3% for the three months ending 30 June 2012. This comprised an income return of +1.6% and capital growth of -1.3%. At a sector level, Industrial was the strongest performer over the quarter, delivering a total return of +1.0. By comparison, the Retail and Office sectors recorded -0.3% and 0.8% respectively.

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 0.99%. However, in the quarter under review, JP Morgan underperformed by (1.37) % with a return of (0.38) % against benchmark return of 0.99%

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

	Q2 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	(1.59)	2.80	-	-	3.09
Benchmark	1.23	5.03	-	-	4.91
Excess Return	(2.82)	(2.23)	-	-	(1.82)

Over the second quarter of 2012, M&G investments posted their first negative return with -1.59% being relatively -2.79% behind 3 Month LIBOR +4% p.a. target of 1.23%. For one year the account now stands ay 2.80% versus 5.03% whilst since inception at the end of May 2010, the portfolio registers a 3.09% pa return against the benchmark of 4.91% pa. While the since inception Internal Rate of Return for this portfolio is also short of the target with a figure of 2.69%.

2.3 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

Performance: In the 2nd quarter Marathon portfolio fell exactly 2%, however this was 1.80% above the MSCI World index return of 8.00%. This leads to a great start to 2012, with a return of 9.27% being 5.37% ahead, but unfortunately this is still not enough to reverse the underperformance over the one year with returns of -3.86% versus -3.71%. Although since inception the good results seen last quarter and Q3 2011 means they are now beating the benchmark by 1.98%, returning 8.25% pa against 6.27% pa

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 -2.83% during the quarter and against the return of 0.28% for LIBOR 3 Month GBP delivered the worst return of the period with -3.11%. This feeds into the year to date and 1 year numbers, with returns of -0.76% and -0.24 respectively. However, since inception from May 2010, a higher absolute return is seen as the portfolio registers a 3.78% pa return, the upshot of which is a much improved relative return of 2.93% against the benchmark of 0.85% pa. Ruffer's Q2 performance was undermined by economically sensitive equities, such as Cisco, Texas Instruments and Ericcson which all declined in value on fears of lower capital expenditure. The largest single hit taken by the portfolio was however JP Morgan, with total value loss of 20% and just finished slightly above it's' purchase price. (Due to a variation in the performance model and how accrued income is treated there is a difference in the Northern Trust reporting and Ruffer presentation)

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:

Account		**Q2 2012 %**	**1 Year %**	**Since Inception %**
SSgA Main Account	Performance	(2.53)	(1.60)	12.39
	Benchmark	(2.44)	(1.76)	12.29
	Excess Return	(0.09)	0.16	0.10
SSgA Drawdown Account	Performance a/c 2	0.64	3.55	5.05
	Benchmark a/c 2	1.19	4.78	5.21
	Excess Return	(0.55)	(1.23)	(0.16)

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.10%. The Draw-Down fund which commenced June 2009 has underperformed its benchmark with a since inception return of (0.16) %. 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.

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:

	Q2 2012 %	**1 Year %**	**3 Years %**	**5 Years %**	**Since Inception %**
Performance	(3.25)	(3.55)	12.55	0.90	9.49
Benchmark	(2.63)	(3.13)	13.81	2.62	8.56
Excess Return	(0.62)	(0.42)	(1.27)	(1.72)	0.93

Performance for the quarter was negative and behind the benchmark with the largest contributions to underperformance coming from Yule Catto, BP and Barclays Bank. However, UBS reiterated their belief in the inherent value in these stocks. In fact, UBS underperformed the benchmark all through one, three and five year periods but managed to outperform since inception by 0.93%.

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:

	Q2 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	0.25	4.03	8.39	(4.45)	(1.00)
Benchmark	0.30	4.16	10.12	(3.90)	(0.42)
Excess Return	(0.05)	(0.13)	(1.73)	(0.55)	(0.58)

The UBS Property portfolio posted a return of 0.25% during the period, now the twelfth consecutive positive return; however, this was slightly below the IPD UK PPFI All Balanced Funds index, which returned 0.30%. Over one year the portfolio achieved a respectable 4.03%, but this is 13 basis points behind the benchmark. Driven by the underperformance of Q4 2009 the three year period still falls below target with figures of 8.39% versus 10.12%, an underperformance of -1.73% is observed. Since inception, in March 2006, there are losses of exactly -1% and while the benchmark also falls, at -0.42% this still translates as a 58 basis points underperformance on an annualised basis. Since the increased allocation to the Unite Student Accommodation Fund (USAF) in March 2012 there have not been any property fund purchases or sales.

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	113,101	(5,234)	1,562	-	109,429	(643)
UBS Property	49,297	(421)	546	(1)	49,421	(23)
SSgA	117,490	(2,972)	-	-	114,518	(112)
SSgA Drawdown	14,948	95	-	(380)	14,663	(83)
Ruffer	118,424	(4,015)	661	-	115,070	(3,682)
M&G	11,149	(179)	-	380	11,350	(323)
Marathon	58,670	(1,172)	-	-	57,498	1,034
JP Morgan	72,012	(276)	-	-	71,736	(986)

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 Marathon had a positive impact on the appreciation of holdings contributing £1,034K in total.

Underperformance from UBS, UBS Property, SSgA, Ruffer, Marathon and JP Morgan reduced appreciation by £5,852k.

4. M&G Update

There are now eleven holdings within the fund at the official close in July 2012, with the last investment of £100m as loan to an unnamed UK power company. The average credit rating of all companies in the loan portfolio is BBB, with average loan period of 6.6 years. In total at the close of the fund, £930 million had been invested. The first draw-down of £883k for the M&G Debt opportunities fund was made on 14 September 2012, representing 5.88% of our commitments to the fund.

5. Macquarie Update

Macquarie European Infrastructure Fund 4 (MEIF4) reached agreement on its first acquisition during the quarter. A MEIF4 led consortium had an offer for Open Grid Europe (OGE) accepted by previous owner E.On, in May. The transaction has since been approved by the relevant authorities and closed on 23 July 2012, following the quarter end. 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 ultimate 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 will be €260.0 million, representing a 23.6 per cent interest.

During the quarter, Macquarie State bank of India Fund (MSIF) completed an investment of USD 108.0 million (including transaction costs) into Ashoka Concessions Limited (“ACL” or “Ashoka”), a holding company of seven toll roads in India. The total transaction size was USD 150.0 million including co-investment by SBI Macquarie Infrastructure Trust (“SMIT”) and transaction costs. Binding transaction documents in relation to the acquisition were entered into on 12 August 2012.Financial closure is expected to occur by the end of September 2012.

6. Other Items

At the end of June 2012, £30.4m (book cost) had been invested in private equity, which equates to 5.05% 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 £925k and distributed £1,076k, whilst LGT called £161k and distributed £555k. 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 £19.4k. Offset against this was £6.7k of expenses leaving a net figure earned of £12.7k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 June 2012 the average value of assets on loan during the quarter totalled £28.5m representing approximately 14.8% 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 August 2012 and resulted in a realised gain of £429k.

For the quarter ending 30 June 2012, Hillingdon returned (1.59) %, outperforming against the WM average of (1.90) by 0.31%. The one year figure shows an outperformance of 1.25%, returning 0.35% against the average return of (0.90)%.

FINANCIAL IMPLICATIONS

These are set out in the report.

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report.

BACKGROUND DOCUMENTS

None.