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 December 2012. The total value of the fund's investments as at the 31 December was £631.7m. This represents an increase of £12.9m over the value of fund's assets at the end September 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 31 December 2012 showed an outperformance of 0.84%, with a return of 3.12% compared to the benchmark of 2.28%. All Managers except UBS Property outperformed their relative benchmark during the quarter. One year figures show returns of 9.07%, an outperformance of 0.96%.

Performance Attribution Relative to Benchmark

	Q4 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
UBS	6.73	17.76	7.78	3.84	9.83
UBS Property	(1.36)	(0.09)	6.07	(2.76)	(1.06)
SSgA	3.80	11.40	7.59	-	12.83
SSgA Drawdown	0.97	4.11	4.28	-	5.12
Ruffer	2.49	3.36	-	-	4.43
M&G	1.05	5.00	-	-	4.55
JP Morgan	1.69	7.23	-	-	6.83
Total Fund	**3.12**	**9.07**	**6.62**	**1.74**	**6.41**

Market Commentary

'Cautiously optimistic' perhaps best captures the market's sentiment over Q4 2012. Issues within the Eurozone took a back seat, while events in the US moved to the fore. Investors increasingly focused their attention on the US presidential election and, more importantly, the fiscal cliff. Markets moved both in anticipation of, and reaction to the political deadlock.

While a convincing November election victory for President Obama reduced immediate political uncertainty, the US ultimately returned the governing landscape to its status quo leaving markets vulnerable to after-shocks of brinkmanship. Unease was compounded by a weak US earnings season. Market nerves calmed in December, with the Federal Reserve cementing its commitment to accommodative monetary policy provided inflation expectations remain moderate.

In Europe, an overhaul of Greece's floundering bailout plan in November, and agreement on ECB banking supervisory powers suppressed the sovereign debt concerns of Q3 2012, however prevailing economic conditions have been weak. That said, aversion of further sovereign debt headwinds, and, attractiveness on a valuation basis keeping Europe on a solid footing.

Equities

Markets in aggregate were higher over the period but with some sizeable differences in returns between countries and regions. There was also a reversal between the laggards and leaders, e.g. the US equity market, having led gains through Q1 - Q3 2012, underperformed the market over the quarter, suffering a slight negative return. The hype surrounding Japan's Liberal Democratic Party turned into market euphoria following a landslide election victory. Japan, the perennial underperformer, with a Q4 return of around 17% (in local terms), finished the year as one of the best performing markets. Emerging markets, which outperformed their developed market counterparts, and many European markets (aggregate return 7% in Q4) were no different.

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 2.96% and in the quarter under review, outperformed by 0.82 % with a return of 1.69% against benchmark return of 0.88%.

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
During fourth quarter of 2012, M&G investments underperformed its' benchmark of 3 Month LIBOR +4% p.a. target by (0.07)% with a portfolio return of 1.05% against benchmark figure of 1.12%. For one year the returns regressed to 5.00% compared to 5.21% in Q3 2012, but still outperforming the benchmark return of 4.86% by 0.14%. Since inception at the end of May 2010, the portfolio registers a 4.55% pa return against the benchmark of 4.86% pa, underperforming by (0.31)%. The since inception Internal Rate of Return for this portfolio is now 5.10%.

2.3 Manager: MARATHON (Assets transitioned during October, but manager retained for future investments)

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 2.49% during the quarter and against the return of 0.15% for LIBOR 3 Month GBP delivers an outperformance of 2.33%. This further consolidates outperformance of the previous quarter and means that the year to date and 1 year numbers are now ahead of target by 2.39%. This culminates in a since inception return from May 2010 of 4.43% pa, which translates as an excess return of 3.59% against the benchmark of 0.84% 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 3.80% in the quarter, just 0.01% ahead of the benchmark. However, the year to date return of 11.40% is just behind target of 11.48%, same as the one year figure. Positive absolute performance in line with the benchmark is seen in longer periods; with the since inception return of 12.83% 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:

	Q4 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	6.73	17.76	7.78	3.84	9.83
Benchmark	3.82	12.30	7.48	4.12	8.75
Excess Return	2.91	5.46	0.30	(0.28)	1.08

The UK equity market continued its' recent resurgence from previous quarter and the FTSE All Share returned 3.82%, in this environment UBS UK Equity posted the highest absolute return of all mandates with 6.73%, leading to outperformance of 2.91% against the benchmark. Looking into the attribution the largest positive contributors amongst overweight positions were Lloyds Banking Group, Dixons and Barclays over both the quarter and 2012 as a whole. Lloyds Banking Group and Barclays shares continued to recover as investors became more willing to look through regulatory and Euro problems and look instead at the large discounts to asset value at which banks trade. Dixons successfully refinanced their borrowings and generated positive like-for-like sales performance despite difficult economies.

The largest negative contributors were overweight positions in the more defensive holdings, notably Vodafone and GlaxoSmithKline, and also the impact of being underweight in HSBC, as it rose through the quarter along with other financial stocks.

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:

	Q4 2012 %	1 Year %	3 Years %	5 Years %	Since Inception %

Performance	(1.36)	(0.09)	6.07	(2.76)	(1.06)
Benchmark	(0.40)	1.10	6.62	(1.97)	(0.39)
Excess Return	(0.96)	(1.19)	(0.55)	(0.80)	(0.67)

The UBS Property portfolio broke the run of positive returns with a figure of -1.36%, the lowest of all mandates, and although the IPD UK PPFI All Balanced Funds index also was in the red, at (0.40) % this translates as an underperformance of (0.96) % (also the lowest of all mandates). This also feeds into the one year as the portfolio now shows a loss of-0.09%, which is (1.19) % behind the IPD. All long periods also demonstrate underperformance and with the exception of the 6.07% pa return over three years, absolute returns are also negative. Since inception, in March 2006, these losses stand at -1.06% and while the benchmark also falls with (0.39) %, the underperformance is now 67 basis points.

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	115,726	6,754	1,032	0	123,512	3,387
UBS Property	49,629	(1,189)	512	(1)	48,951	(481)
SSgA	118,833	4,515	0	0	123,348	8
SSgA Drawdown	10,621	82	0	(4,600)	6,103	(11)
Ruffer	116,286	2,490	401	0	119,177	2,713
M&G	12,782	156	0	1,991	14,929	0
Marathon	59,991	593	0	(60,584)	0	0
SSgA Temporary	0	1,778	0	60,346	62,124	(181)
JP Morgan	73,462	1,243	0	0	74,705	599
Adams Street	20,882	309	6	(114)	21,083	314
LGT	16,580	697	0	(200)	17,077	693
Macquarie	5,840	(6)	0	470	6,304	(7)
Cash	17,027	0	10	(3,418)	13,619	0
Nomura	16	(173)	18	186	47	(36

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 five I fund managers had a positive impact on the appreciation of holdings contributing £7,714k in total. Whilst underperformance by the rest, reduced overall appreciation by £716k.

4. M&G Update

M& G UK Companies Fund

The NAV was valued at £939 million on December 31, 2012 compared with £847 million at the end of the previous quarter. The increase resulted from the earned income, fees, and a new loan for £100m to Drax Finance Ltd, which was offset by the change in market value of the interest rate swap. The fund's return since inception was 5.10%, compared to 5.07% the previous period. The loans are performing in line with expectations and remain marked at par.

M&G Debt Opportunities Fund IV
During the quarter under review, two draw-downs totalling £531k for the M&G Debt opportunities fund was made in October 2012, representing 3.54% of our commitments (£15m) to the fund and total drawdown to date of £1.8m. The fund's NAV as at 31 December 2012 was £37.7m with a total return since inception of 11.87%. The Fund is currently trying to increase its stake in one of the leverage loan names in which it is already invested. They are actively involved in sourcing the relevant loan and are hopeful that further purchases will be made in the next two quarters. In addition, they are conducting final due diligence on more than five other leveraged loans.

5. Macquarie Update

Overall cost of investment in Infrastructure by the fund was £6.7m as at 31 December 2012. This is spread across three Macquarie funds.

MSIF – Macquarie SBI Infrastructure Fund
The Net Asset Value ("NAV") of the Fund was USD 471.4 million as at 31 December 2012, an increase of USD 3.7 million from USD 467.7 million as at 30 September 2012. MSIF issued capital call notices totalling USD 40 million in October and November 2012 to fund MSIF's commitments to Ashoka Concessions Limited, Adhunik Power and Natural Resources and for payment of management fees. The total capital drawn from MSIF investors as at 31 December 2012 increased to USD 584.8 million from USD 544.8 million as at the previous quarter-end.

MEGCIF
Macquarie Everbright Greater China Infrastructure Fund (MEGCIF) issued two capital call notices to investors during the quarter ended 31 December 2012 totalling US$106.44 million. The first capital call during the quarter was made in October 2012 to fund the acquisition of Project Spinnaker (US$26.00 million) and to cover the base management fee for the quarter ended 31 December 2012 (US$2.10 million). The second capital call during the quarter ended 31 December 2012 was made during December. The call comprised US$77.06 million to fund purchase consideration for Zhejiang Wanna and US$0.56 million for budgeted due diligence costs. The Net Asset Value (‚NAV') of the Fund was US$182.94 million as at 31 December 2012, an increase of US$102.91 million from US$80.03 million as at 30 September 2012.

MEIF4 - Macquarie European Infrastructure Fund 4
The Manager's valuation of the Fund's net assets at 31 December 2012 was €270.1 million, a 4.5 per cent increase from €258.4 million at 30 September 2012. The major valuation movement was the roll forward of OGE from the previous quarter. There were no investments or disposals during the quarter. The investment in Czech Gas Holdings, described in the Fund Overview, was completed post quarter-end and a call notice was sent to investors on 22 January 2013.

OGE
The transition of Open Grid Europe (OGE) to the Fund's ownership continued during the quarter, with many key integration objectives now complete. Major milestones included the signing of a major contract with Hewlett Packard to manage IT infrastructure which is being transferred from the internal system of the previous owner, E.On, agreement with the Works Council and union for an efficiency programme and initiation of the rating process.

Czech Gas Holdings
In December 2012, MEIF4 announced its second acquisition, a Czech gas distribution network. A MEIF4-led consortium acquired a 35 per cent interest (through Czech Gas Holdings1) in RGH, a gas distribution business owning a network covering 80 per cent of the Czech Republic's gas distribution system. The Network consists of 63,700km of pipeline and 2.3 million connection points and has a regulated asset base in excess of €1.5 billion. Czech gas distribution was privatised in 2002 and is supported by an incentive-based regulatory system similar to that found in the UK and Germany.

6. Other Items

At the end of December 2012, £28.8m (book cost) had been invested in private equity, which equates to 4.56% of the fund against the target investment of 5.00%. In terms of cash movements over the quarter, Adams Street called £1.3m and distributed £1.5m, whilst LGT called £756k and distributed £1.1m. 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 £16.2k. Offset against this was £5.7k of expenses leaving a net figure earned of £10.5k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 December 2012 the average value of assets on loan during the quarter totalled £31.8m representing approximately 15.3% of this total.

The passive currency overlay agreed by Committee was put in place at in May 2010 with 100% Euro and 50% Australian dollars (June 2012) hedges. The latest quarterly roll occurred on the 6 February 2013 and resulted in a realised loss of £1.8m, with hedged Euro position accounting for £1.757m of the overall loss. Since inception, the programme has made a net loss of £110k.

For the quarter ending 31 December 2012, Hillingdon returned 3.12%, underperforming against the WM average of 3.60% by (0.48) %. The one year figure shows an underperformance of 4.2%, returning 9.07% against the WM average return of 13.3%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

NIL