REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND

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Papers with this report	Northern Trust Executive Report WM Local Authority Annual and Quarter Reports Private Equity Listing Private Equity reports from Adams Street and LGT

SUMMARY

This report reviews the fund management performance for the London Borough of Hillingdon Pension Fund for the quarter to 30 June 2009. The value of the fund as at 30 June 2009 was £447m.

RECOMMENDATIONS

1. **That the content of this report be noted and the performance of the Fund Managers be discussed.**
2. **That committee note the inclusion of information on the Fund Managers absolute returns.**

INFORMATION

1. The performance of the whole fund for the quarter to 30 June 2009 showed an outperformance of 0.19% with a positive return of 7.21%, compared to the benchmark 7.02%. The long term performance figures have improved slightly on the previous quarter with one, three and five year figures now underperforming by 1.59%, 2.23% and 1.92% compared to Q1's figures of 3.10%, 2.46% and 1.96%. The since inception figure also shows an improvement but still remains just below the benchmark by 0.27% compared to 0.29% for Q1.

Performance Attribution

	Q2 2009 %	1 Year %	3 Years %	5 Years %	Since Inception %
Capital International	(1.07)	0.35	(1.86)	(1.80)	(1.11)
Goldman Sachs	3.12	(3.35)	(1.44)	(1.02)	(0.97)
UBS	2.16	2.21	(1.96)	(1.84)	1.23
Alliance Bernstein	(1.72)	(7.68)	(3.83)	-	(3.62)
UBS Property	0.02	0.80	0.69	-	0.31
SSgA	0.00	-	-	-	(0.01)
Total Fund	**0.19**	**(1.59)**	**(2.23)**	**(1.92)**	**(0.27)**

(The performance of Capital International is included in the above table as it impacted on the total fund performance, however, as their agreement has now been terminated we have made no specific comments about their performance in this report.)

2. The positive performance this quarter was primarily derived from stock selection with UK and overseas equities contributing 0.50% and 2.74% respectively. However much of the overseas gains were lost as a result of the negative currency effect. Fixed income also provided a positive contribution as did holding cash within the property portfolio.

3. Alliance Bernstein underperformed over the quarter returning 7.69% compared to a 9.41% benchmark. Stock selection in both the UK and North America detracted from performance with overall negative relative returns in these areas of 1.99% and 2.90%. Underperformance was also seen in Emerging Markets and Asia but to a lesser extent. Two regions had a positive impact, namely Japan and Europe. Amongst holdings the largest detractors included Vodafone and Apollo. Additionally not holding HSBC also hurt performance. Positive influences were obtained with Barclays, Credit Suisse and Nissan.

4. GSAM returned 5.46% against their benchmark of 2.34%, outperforming by 3.12%. The cross-sector allocation strategy added to excess returns with mortgage credit and corporate credit performing well. Over the quarter, investor risk appetite returned to the market causing credit spreads to tighten and the demand for riskier assets to increase. The corporate security selection had a positive influence led by the choice of financial names. The finance sector benefited from a variety of government support measures which reduced the perceived risk in that sector increasing asset values.

5. UBS performance over the quarter showed a return of 13.04% compared to the benchmark of 10.88%, outperforming by 2.16%. The largest positive influences on performance resulted form overweight positions in Aviva, and Prudential. Positive performance was also enhanced by not holding the poor performing BG Group and BHP Billiton. In terms of negative influences, holdings which performed poorly included BP, HMV, Vodafone and GSK. An additional detractor from performance included HSBC which was not held in the fund but performed well.

6. UBS Property slightly outperformed their benchmark by 0.02% delivering negative returns of 3.28% against a negative benchmark of 3.30%. The high cash holding currently within the fund had a positive influence on performance adding 1.20% to returns. Within the property sub funds, the Lothbury fund outperformed against the benchmark by 0.30% albeit with negative returns.

7. The requirement for SSgA as a passive manager is to replicate their performance benchmark. This was achieved for Q2 with positive returns of 8.68%.

Absolute Returns

	Alliance Bernstein £k	GSAM £k	SSgA £k	UBS £k	UBS Property £k
Opening Balance	79,839	52,789	73,732	70,618	40,513
Appreciation	5,001	2,842	6,397	7,986	-1,683
Income Received	1,118	40	-	1,239	356
Investment Movement	-765	22	1,435	-1,435	-
Closing Balance	85,193	55,693	81,564	78,408	39,186
Active Management Contribution	(1,394)	1,647	-	1,542	10

8. The above table provides details on the impact of manager performance on absolute asset values. The outperformance of GSAM and UBS had a positive impact on the appreciation of holdings contributing £1,647k and £1,542k respectively. In contrast the underperformance of Alliance Bernstein reduced asset appreciation by £1,394k. The flat returns against benchmark by SSgA and UBS Property show little active contribution to absolute values.

9. At the end of June 2009, £24.83m has been invested in private equity, which equates to 5.56% of the fund against the target investment of 5%. However this level still remains within the limits of the over-commitment strategy. The strengthening of Sterling against Euro and US Dollar denominated funds contributed to a reduction in the value of the holding compared to the previous quarter. In terms of cash movements, over the quarter £478k was called by Adams Street and £491k by LGT. There were no distributions received during the quarter.

10. Private Equity, like many other asset classes has suffered from the global recessionary environment. Problems within the financial system have slowed deal flows and exit opportunities. In addition the performance figures being reported by partners show a decline, basing valuations on public market comparables. However as public market prices improve the figures being reported should improve going forward.

11. The latest information available from Adams Street shows negative returns throughout the funds in which we are invested. In addition to the economic environment a major contributing factor is the age of the fund, which is relatively early in its development, being only 54% drawn. However despite the difficulty in recent conditions Adams Street remain confident about the future. The diversified portfolio should help mitigate future losses and current conditions provide opportunities to buy good companies at lower prices. In addition the secondary market is robust, with liquidity forcing managers to sell high quality funds at distressed prices.

12. LGT have advised the fund has withstood the downturn well with the overall value of the fund being at cost and with 30% of invested capital returned. Small and medium size buyouts have been affected by economic conditions but LGT feel reduced valuations have reached a low point. The fund shows positive internal rates of return in some of the older funds, with CEB 1 and CGS currently returning 7%

and 1% respectively. LGT feel investments should pick up before distributions as they take advantage of attractive buying opportunities.

13. The securities lending activity for the quarter resulted in income of £99k. Offset against this was £35k of expenses leaving a net figure earned of £64k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 June 2009 the assets on loan totalled £49m representing approximately 12% of this total.

14. Following the positive results for Q2 there was an improvement in the Hillingdon returns compared to the WM Local Authority summary figures. For the second quarter to 30 June 2009 Hillingdon outperformed the average by 0.81% compared to underperformance of 1.15% Q1 2009. The one year performance figure has also improved and the deficit has reduced from 4.40% Q1 2009 to 2.28% for Q2.

15. The WM Local Authority League Table figures for 2008/2009 show the Hillingdon Pension Fund at position 86 out of the 100 participating funds. This is an improvement on 2007/2008 when Hillingdon were ranked at position 93. The current revision to the investment strategy is aimed to deliver stronger returns going forward.

M&G UK Companies Financing Fund - update

16. M&G are in conversation with around ten companies with the possibility of two or three of these leading to investments over the next few weeks. However, some of the target companies are now less concerned about funding and are becoming more aggressive on the pricing they will accept. This is driven by a number of factors including Quantitative Easing, which has driven in spreads of public corporate bonds and the continued inflows into retail and institutional bond funds.

17. M&G have stated they will not chase the market and fully expect bank lending to remain weak with many foreign banks pulling away from lending in the UK. M&G feel the non-bank lending sector will need to take up the slack but also that the non-bank lending sector in general remains unprepared to invest in the quantities required. Given this analysis, they believe that there will be many opportunities for the Fund over the rest of the year and in 2010.

18. M&G are continually meeting with investors and the fund remains on track to reach the £2bn funding target by the end of the year. Volatility in the equity and debt markets is masking the true underlying picture of lending. While this may delay some investments in the next few months, it is likely to lengthen the duration of the investment opportunity for the fund.

Market Commentary

19. Equity markets showed strong performance in April and May but fell back in part during June. The improvement for the quarter reflected the growing confidence in global economic conditions, attractive pricing and a higher risk appetite. Small cap stocks helped drive the UK market, however emerging markets and Asia (ex Japan) showed the best performance despite sterling strength reducing gains.

20. An improvement in liquidity helped corporate bonds increase in value and push yields down as money flowed into the asset class. The impact of quantitative easing depressed gilt yields which remained low. The overall effect was corporate bonds outperformed gilts by over 10%.

21. UK commercial property values continued to fall but the pace of the decline appeared to be slowing. Rising unemployment has meant there is weak demand for commercial property and rental levels have fallen as a result of this.

Risk Management

22. The loss of pension fund value due to the credit crisis and market conditions, causing a need for increased employer contributions has been included as a risk within the Council's Corporate Risk Management Report over the last year. The likelihood of this risk has been noted as significant whilst its impact is shown as medium.

23. Within the actions to address this risk it is noted that whilst the drop in the equity market is significant, the pension fund is a long term investment and so the ongoing effect should be containable. A review of the investment strategy is underway to address the overall risk profile of the fund's investments along with measures to increase returns.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None