# REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND

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| *Papers with this report* | Northern Trust Executive Report<br>WM Local Authority Quarter Reports<br>Private Equity Listing<br>Private Equity reports from Adams Street and LGT |
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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 2013. The total value of the fund's investments as at the 30 September was £698m. This represents an increase of £17m from the end of Q2, June 2013. However, in the months since September 2013, the Fund's value has increased again to around £713m at the end of November.

## 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 30 September 2013 showed an underperformance of 0.08%, with a return of 2.44% compared to the benchmark of -2.52%. However, the significant underperformance by Macquarie in Q3 slightly skews the whole fund position. One year figures show returns of 14.15%, 2.27% relatively better than the benchmark.

**Performance Attribution Relative to Benchmark**

| | Q3 2013 % | 1 Year % | 3 Years % | 5 Years % | Since Inception % |
|---|---|---|---|---|---|
| Barings | 0.27 | - | - | - | (1.71) |
| JP Morgan | 0.06 | (2.05) | - | - | 0.18 |
| Kempen | 0.54 | - | - | - | (4.91) |
| Macquarie | (8.17) | (2.40) | (11.82) | - | (11.82) |
| M&G Investments | 1.03 | 1.98 | 0.50 | - | 0.38 |
| Newton | (2.02) | - | - | - | (1.51) |
| Ruffer | 0.01 | 12.85 | 6.34 | - | 5.80 |
| SsgA | (0.02) | (0.11) | 0.00 | - | 0.02 |
| UBS TAA | (2.33) | - | - | - | (2.33) |
| UBS | 2.87 | 10.48 | 3.44 | 1.43 | 1.26 |
| UBS Property | (0.22) | (1.42) | (0.51) | (1.08) | (0.67) |
| **Total Fund** | **(0.08)** | **2.27** | **0.90** | **(0.05)** | **0.05** |

## 2. MANAGER PERFORMANCE

### 2.1 Manager: Barings Asset Management

**Performance Objective:** The fund aims to achieve an absolute return of 4% in excess of cash based on the 3 month Libor.
**Approach:** Focus on identifying and exploiting unrecognized growth opportunities.
**Performance:**
In the first full quarter for the new Barings mandate the fund produced a return of 1.38% which compares favourably against the target of the 3 Month LIBOR +4% per annum, which posted 1.12%. However in the short period since inception in April 2013 they returned 0.21% which is below the target of 1.95%.

### 2.2 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 relatively outperformed since inception (Nov 2011) by 0.18%. In the quarter under review, JP Morgan outperformed by 0.06 % with a return of 0.94 % against benchmark return of 0.87%.

### 2.3 Manager: Kempen International

**Performance Objective:** Seek to outperform their benchmark index by 2-4% per annum over rolling three year periods.
**Approach:** To earn a higher total return than its benchmark, MSCI World Total Return Index, including reinvestment of net dividends.
**Performance:**
In contrast to the previous quarter the Kempen mandate produced both positive absolute and relative returns with 2.48% versus 1.93% for the MSCI All World Index +2%, leading to an outperformance of 0.54%. However, since inception in January 2013, despite the absolute return improving to 5.70% the relative return falls to -4.91% when compared to the benchmark of 11.16%.

### 2.4 Manager: Macquarie

**Performance Objective:** Seek to outperform their benchmark index by 3% per annum over rolling three year periods.
**Performance:**
Macquarie wiped out most of the gains of 2013 by posting the second lowest absolute return at -7.37%, against the 3 Month LIBOR +3% p.a. is a relative return of -8.17%. Year to date they have delivered growth of 1.14% but this is below the benchmark of 2.63%. Over the last twelve months the underperformance is 1.04% against a benchmark of 3.53%. In the 3 years since inception they have delivered eight negative quarterly relative returns, leading to an annualised loss of -8.49% against a target of 3.78%.

**2.5 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 +4-6% (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.

**Relative Performance**

| | Q3 2013 % | 1 Year % | 3 Years % | 5 Years % | Since Inception % |
|---|---|---|---|---|---|
| Performance | 2.15 | 6.61 | 5.31 | - | 5.18 |
| Benchmark | 1.12 | 4.53 | 4.79 | - | 4.78 |
| Relative Return | 1.03 | 1.98 | 0.50 | - | 0.38 |

During the third quarter of 2013, M&G produced a 2.15% return, about 1.03% ahead of the 3 Month LIBOR of +4% p.a. Over the last year the account registers 6.61% against 4.53%; whilst since inception at the end of May 2010, the portfolio returned 5.18% pa against the benchmark of 4.78% pa.

**2.6 Manager: Newton**

**Performance Objective:** To outperform the FTSE World Index by over 2% p.a. over rolling five year periods.

**Approach:** Increasing income and capital growth over the long term by investing in shares (i.e. equities) and similar investments of companies listed or located throughout the world.

**Performance:**

During the third quarter of 2013 Newton posted a -0.38% return compared to 1.68% for the FTSE World Index +2%, leading to an underperformance of -2.02%. Since inception (January 2013) they have delivered a return of 7.39% against the benchmark of 9.03%, producing a relative return of -1.51%.

**2.7 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 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 produced 0.14% over the last three months, which is almost exactly the same as the 0.13% for LIBOR 3 Month GBP. Driven by Q1's return all longer periods show high absolute and relative returns. As a result, over the last twelve months they have posted a return of 13.46% against 0.54% for the target, resulting in the highest outperformance of all mandates at 12.85%. While since the inception in May 2010, 10 out of 13 quarters show positive returns and lead to figures of 6.62% versus 0.77% per annum, which translates as a relative return of 5.80%.

**2.8 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.

**Relative Performance:**

| Account | | **Q3 2013 %** | **1 Year %** | **Since Inception %** |
|---|---|---|---|---|
| SSgA Main Account | Performance | 3.57 | 16.43 | 13.40 |
| | Benchmark | 3.59 | 16.56 | 13.37 |
| | Relative Return | (0.02) | (0.11) | 0.02 |

The SSGA passively managed portfolio produced a return of 3.57% in the quarter which was a mere 2 basis points below the benchmark; further analysis confirms the passive nature with all categories aligned with their respective indices. So over the year they produce a 16.43% return, which is 11 basis points behind target, while over 3 years the per annum return falls to 9.17% which exactly matches the benchmark. Since inception (November 2008) a return of 13.40% pa is just 2 basis points above the benchmark.

**2.9 Manager: UBS Tactical Asset Allocation**
**Performance Objective:** Outperform the Barclays Capital US Inflation Linked Index.

**Performance:** The UBS Tactical mandate was funded during this quarter and over that period produces a return of -7.94% against the Barclays US Inflation Linked Index of -5.74%.

**2.10 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.

**Relative Performance:**

| | Q3 2013 % | 1 Year % | 3 Years % | 5 Years % | Since Inception % |
|---|---|---|---|---|---|
| Performance | 8.61 | 31.40 | 13.86 | 12.74 | 10.44 |
| Benchmark | 5.58 | 18.93 | 10.07 | 11.16 | 9.07 |
| Relative Return | 2.87 | 10.48 | 3.44 | 1.59 | 1.26 |

Performance for the quarter was positive and ahead of the benchmark with the largest contributions to out-performance coming from overweight positions in Lloyds Banking Group, IAG and BAE Systems. In fact, UBS outperformed the benchmark all through one, three and five year periods. This resulted in the since inception performance relative return increasing to 1.26% from 1.15% in the previous quarter.

**2.11 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.

**Relative Performance:**

| | Q3 2013 % | 1 Year % | 3 Years % | 5 Years % | Since Inception % |
|---|---|---|---|---|---|
| Performance | 2.18 | 3.05 | 4.40 | 0.50 | (0.38) |
| Benchmark | 2.40 | 4.53 | 4.93 | 1.59 | 0.29 |
| Excess Return | (0.22) | (1.48) | (0.51) | (1.08) | (0.67) |

The UBS Property portfolio produced a return of 2.18%, in contrast to last quarter this was 22 basis points below the IPD UK PPFI All Balanced Funds index figure of 2.40% by. Underperformance continues to be seen in all long periods, with 1 and 3 year showing positive absolute returns of 3.05% and 4.40 % respectively by these were -1.42% and -0.51% below the benchmark. Since inception, in March 2006, the funds loses value with a figure of -0.38% while the benchmark shows a positive 0.29% return, meaning the underperformance is now -67 basis points.

**3. ABSOLUTE RETURNS FOR THE QUARTER**

| | Opening Balance £000's | Net Investment | Appreciation £000's | Income Received £000's | Closing Balance £000's | Active Management Contribution £000's |
|---|---|---|---|---|---|---|
| Barings | 61,256 | 8 | 848 | - | 62,112 | 159 |
| JP Morgan | 73,807 | - | 690 | - | 74,497 | 44 |
| Kempen | 45,649 | 0 | 1,084 | 49 | 46,782 | 226 |
| Macquarie | 8,645 | (1,488) | (544) | - | 6,613 | (595) |
| M&G | 19,704 | 2,078 | 471 | - | 22,253 | 233 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Newton | 22,722 | - | (85) | - | 22,637 | (495) |
| Ruffer | 84,124 | - | (187) | 305 | 84,242 | 8 |
| SSgA | 133,588 | - | 4,767 | - | 138,355 | (29) |
| SSgA Drawdown | 6,039 | (6,038) | - | - | 1 | - |
| UBS | 125,616 | - | 9,879 | 941 | 136,436 | 3,849 |
| UBS Property | 50,051 | - | 560 | 530 | 51,141 | (112) |
| UBS TAA | 84 | 14,002 | (1,148) | 27 | 12,965 | (324) |

The above table provides details on the impact of manager performance on absolute asset values over the quarter based on their mandate benchmarks.

**4. M&G Update**

**M&G Companies Fund -** The NAV of the fund was £846 million on 30 September 2013 compared with £836 million at the end of the previous quarter. The increase resulted from the accumulation of income in the fund as well as a very modest reduction in the interest rate swap mark to market position. Since inception, the fund has returned 5.01%, compared with 5.05% at the end of the last period. For the third quarter 2013 the fund returned 1.13% compared with 1.34% in the same period last year. The performance was driven by the income in the fund, rather than the upfront fees earned on new loans coming into the fund in the earlier periods. The loan remains marked at par, with a weighted average credit rating of BB+.

**M&G Debt Opportunities Fund IV -** During the quarter under review, 3 draw-downs totalling £4.03m for the M&G Debt opportunities fund was made, representing 26.85% of our commitments (£15m) to the fund and total drawdown to date of £10.53m. The fund's NAV as at 30 Sep 2013 was £131.9m with a total return since inception of 19.91%.

**Investments made by the Fund this quarter -** During the 3rd quarter of 2013 the fund continued to add to three existing positions. The fund was able to continue to build a position in a mining company which issues into the high yield bond market. The company's bonds are relatively liquid and the mark-to-market price moves with market sentiment towards both the issuer and wider macroeconomic drivers. DOF's longer-term investment horizon and limited need of liquidity allows the fund to withstand this volatility and the team continues to be comfortable with the issuers' financial position.

The fund also increased its position in an international gaming company, which is a co-investment alongside other M&G funds. While the company's immediate liquidity needs appear to have been met through the arrangement of a senior facility, the company still faces challenges with its capital structure. M&G continues to work towards a longer term solution that will be commercially acceptable for all stakeholders.

Finally, the fund continued to build on its position in a logistics business, purchasing both term-loan debt and super senior. The term debt benefits from participation in any equity up-side, while the Super Senior sits at the top of the capital structure and pays a high cash coupon.

**5. Macquarie Update**

Overall cost of investment in Infrastructure by the fund was £7.2m as at 30 September 2013. This is spread across three Macquarie funds. This is up by £2.03m from last quarter.

**MSIF – Macquarie SBI Infrastructure Fund -** The Manager continues to review investment opportunities that complement the current portfolio of MSIF. The Manager is currently focussed on identifying investment opportunities in sectors such as ports, fuel storage facilities and waste management facilities that MSIF currently has no exposure to. Given the sizes of some of these investment opportunities, the Manager may approach investors for co-investments.

The Manager had been actively working with TTPL and the banks on a debt refinancing initiative that will reduce the interest cost by ~110 bps as well as extend the loan to a longer tenure. A credit approved term sheet has been received from a bank and the Manager is currently discussing this proposal with the minority shareholders of TTPL. The refinancing, which is expected to be completed prior to end December 2013, is likely to improve the cash flow profile from the asset.

**MEGCIF -** The operations of our three completed investments performed broadly in line with our expectations during the second quarter:

- Shenyang Shengyuan Water continued its solid performance, although plant utilisation continued to be affected by delays to one key pipeline connecting to the East plant, now expected to complete by the end of December, and the management team is working with the Government to increase water treatment volumes across both plants. Operating cost management once again outperformed the budget, despite a temporary spike in chemical costs associated with higher water treatment requirements following unusually severe flooding at the end of August. The flooding did not directly impact the plant itself and effluent water continued to meet or exceed the required standards throughout the period.

- Longtan Tianyu Terminal's throughput volume for the third quarter exceeded the budget; however, revenue and EBITDA were impacted by a shift to lower value cargo mix as high value fertilizer exports were impacted by the depreciation of the Indian Rupee over the past six months (India is the primary export market for fertilizer products passing through the terminal). The management team is focused on attracting additional high value cargo and the business continues to display strong ramp-up growth.

- Zhejiang Wanna Environmental's operating plants continued to track broadly in-line with the budget. Utilisation and tipping fees met or exceeded expectations and a negative variance in power output was largely offset by continued outperformance of operating efficiency across the business. The Huzhou plant was the latest plant to successfully negotiate a tipping fee increase (+25%) with the local government.

The company reached financial close of its acquisition of the Huaibei plant and secured an 800 tonne/day BoT plant in Zhejiang.

**MEIF4 - Macquarie European Infrastructure Fund 4** The Manager has been focusing on a number of potential investment opportunities and progressing key asset management initiatives at Open Grid Europe (OGE) and Czech Gas Networks (CGN).

In July 2013, MEIF4 submitted a public tender offer to acquire up to 100.0 per cent of the share capital of Theolia, a Euronext Paris listed renewable energy company. The offer was open until 6 September 2013 and was subject to MEIF4 obtaining at least 66.7 per cent of the shareholding voting rights, which the Manager deemed necessary to achieve the Fund's corporate governance objectives. Unfortunately, despite gaining support of management, the board of Theolia and the majority of shareholders, the offer expired with MEIF4 achieving slightly below the required minimum level of acceptance. Whilst this is disappointing, the Manager remains actively engaged in a number of other acquisition processes.

The Manager initiated the refinancing process of OGE's ancillary facilities following the completion of its bond refinancing in July 2013. A positive outcome is expected regarding the company's application for the status of an "Independent Transport Operator" (ITO), with certification expected from the regulator by the end of November. In addition, the search for a COO is in its concluding stages with an announcement expected in due course.

CGN's overall performance continued to exceed expectations during the quarter and, following extensive work by the Manager and other stakeholders, the regulator has now engaged in a negotiated process in relation to the issue of changing the way in which distribution companies are remunerated. Furthermore, a merger of the four gas distribution networks into a single network with centralised resources took effect on 1 November 2013.

**6. Other Items**

At the end of September 2013, £26m (book cost) had been invested in **private equity**, which equates to 3.65% 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 £270k and distributed £944k, whilst LGT called £253k and distributed £754k. This trend is set to continue in the next few years as the fund's investments in private equity climbs up the "J-Curve" and more distributions will be received as the various funds mature.

The **securities lending** programme for the quarter resulted in income of £17.4k. Offset against this was £6.1k of expenses leaving a net figure earned of £11.3k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 September 2013 the average value of assets on loan during the quarter totalled £26.1m representing approximately 12.7% 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% Australian dollars (June 2012) hedges. The Investment

Sub-Committee decided, based on professional advice to abrogate all AU$ hedges with immediate effect and discontinue further AU$ hedging within all portfolios, resulting in a loss of £24k. The latest quarterly roll occurred on the 13 November 2013 and yielded a realised gain of £746k.

For the quarter ending 30 September 2013, Hillingdon returned 2.43%, underperforming against the WM average of 2.60% by 0.17%. The one year figure also, shows an under-performance of (0.15) %, returning 14.15% against the WM average return of 14.30%.

**FINANCIAL IMPLICATIONS**

These are set out in the report

**LEGAL IMPLICATIONS**

There are no legal implications arising directly from the report

**BACKGROUND DOCUMENTS**

None