REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND

Contact Officers	Nancy Leroux Tel: 01895 2503530

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 provides a summary of fund manager performance for the quarter ending 30 September 2014. The total value of the fund's investments as at 30 September 2014 was £748m.

RECOMMENDATION

That the content of this report be noted.

1. GENERAL BACKDROP

Recent years have seen all financial markets respond positively to the cheap liquidity that has flooded the globe. Consequently any reversal is most likely to be negatively for capital values. The Hillingdon Pension Fund (and all other investors) would be adversely impacted by such a decline unless it was accompanied by a rising yield structure (which would reduce the current value of the projected liabilities).

Conversely the current economic expansion, which began in 2009, is very mature by historical standards and yet many regions, e.g. Europe, continue to face fundamental challenges. Central bankers and policymakers would have investors believe that the recovery is still in its infancy; the reality threatens to be quite different.

Principal among the trends exposed to change has been the policy response to the Great Financial Crisis (GFC) of ultra-low interest rates. The money markets already discount higher policy rates. By the end of 2016 the US Federal Reserve and UK's Monetary Policy Committee are each expected to raise rates by around 1.5% respectively. However this has been the case for much of the period since the GFC; markets failed to anticipate this unprecedented period of low rates. Nonetheless there is clear appetite among central bankers to generate a higher rate structure. The rationale is not to dampen excess demand. Rather the current near-zero rate structure would be a wholly inappropriate starting point for monetary policy when the next recession hits.

The exception to this is Europe where the deterioration in economic activity and the associated slide towards deflation (EU CPI remains at a perilously low 0.4% p.a.) now sees markets discounting effectively a decade of near zero interest rates. It is hard to believe that market expectations are wrong in this instance.

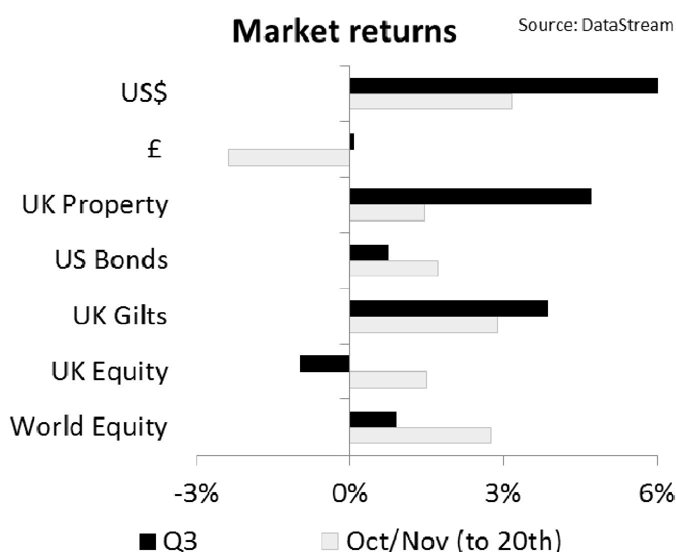
This contrast emerging between the US and elsewhere is likely to prove one of the most significant developments in the months ahead. It is likely to lead to a stronger US$; something that US Federal Reserve will probably not resist. This will help transfer US final demand into other areas of the world that are struggling to show any progress whatsoever.

Further comments on the market backdrop are contained in the detailed report prepared by Northern Trust and in the Investment Advisor's report.

2. MAJOR MARKET RETURNS

As doubts about the resilience of the global recovery and the effectiveness of central bank policies began to creep in, Q3 saw defensive assets outperform. Despite very low starting yields bond markets posted solid returns. The US$ dollar was buoyed by myriad factors – the imminent end of unconventional monetary policy, favourable demographic trends, energy neutrality and a financial system reborn to name but four.

UK property prices continued to rise as the buoyancy of the London market spills out to the regions and as some evidence of rental growth comes through. The better opportunities remain in non-London secondary properties.



Equity markets experienced more erratic trading conditions than the simple quarter on quarter look conveys. With multiples elevated by low bond yields evidence of better earnings performance needs to come through. The improvement in equity markets in Q4 is earnings driven and so should endure.

3. FUND PERFORMANCE

The performance of the Fund for the quarter to 30 September 2014 showed a relative underperformance of 0.3%, with a return of 1.2% compared to the benchmark of 1.5%. One year figures show returns of 7.4%, 0.4% relatively behind the benchmark.

The investment objective for the Hillingdon Pension Fund, agreed with the Actuary and sustained through Q3, is to generate, over the longer term, a real rate of return of 4% per annum; the current asset allocation is judged appropriate to that objective. Other LGPS will have set their objectives appropriate to their Scheme characteristics. Funds seeking greater returns will typically operate a higher allocation to riskier investments and vice versa. Against the average LGPS (as captured by WM data) for the quarter ending 30 September 2014, the Fund underperformed by 0.6%. The one year figure also shows underperformance, this time by 1.1%.

The Hillingdon Pension Fund's investment strategy comprises a deliberate defensive bias both through the strong allocation to multi-asset programmes – where the managers are tasked to deliver specific investment returns rather than track establish market benchmarks – and through the allocation to equity programmes that have a focus on sustainable dividend yields.

Recent quarters have seen many investors maintain a more optimistic view about the outlook for the world economy and financial markets. In the face of ongoing debt accumulation and the continued threat of outright deflation, such optimism is judged dangerous and a defensive stance remains the preferred asset allocation strategy. Further comments on the investment back are provided below in Section 5.

4. MANAGER / PROGRAMME SUMMARY

The table below provides an update on the range of programmes into which the assets of the Pension Fund are deployed. With the exception of the State Street allocation, all programmes are actively managed.

Performance Attribution Relative to Benchmark (rounded)

	Value £m	Q3 2014 %	1 Year %	3 Years (% p.a.)	5 Years (% p.a.)	Since Inception (% p.a.)	Target (% p.a.)	Fees (% p.a.)
Adams St*	22.4	10.3	24.9	11.1	13.9	3.7	4.0**	1.20
AEW	15.6	0.2	-	-	-	0.2		0.70
Barings	64.4	(0.7)	(0.9)	-	-	(1.8)	4.0	0.50
JP Morgan	61.0	(1.8)	(1.5)	-	-	0.2	3.0	0.30
Kempen	79.6	(4.6)	(9.6)	-	-	(8.7)	2.0	0.42
LGT*	14.3	2.4	7.4	5.8	9.0	8.2	4.0**	1.00
Macquarie	7.3	6.3	2.6	(10.2)	-	(8.4)	3.0	1.38
M&G	30.5	2.8	2.7	1.6	-	0.9	4.0	1.5
Newton	24.6	(1.8)	(4.5)	-	-	(3.6)	2.0	0.75
Ruffer	87.3	2.8	3.1	6.1	-	5.2	4.0**	0.80
SSgA	148.6	0.0	(0.1)	(0.1)	(0.0)	0.01	0.0	0.10
UBS TAA	14.0	(0.1)	6.3	-	-	3.0	0.0	n/a
UBS Eq	113.9	(0.9)	(1.0)	3.5	1.0	1.2	2.0	0.35
UBS Property	60.4	0.0	1.1	0.3	(0.6)	(0.2)	1.0	0.20
Total Fund	**748.4**	**(0.3)**	**(0.4)**	**0.4**	**0.4**	**0.0**	**2.2**	**0.45**

*Absolute performance
**Set against LIBOR

Highlights:

- MacQuarie has stepped up the pace of investment in their European and US programmes. The China and India Funds are now virtually fully invested and the previous situation involving an Indian telecoms company has been turned around. Macquarie advises that all programmes are on their original expected-return trajectory.

- Ruffer's programme had been treading water in recent quarters. Their strong exposure to Japan and index-linked bonds has seen performance start to improve in Q3. The outlook offered by the Manager remains subdued.

- Kempen and Newton operate equity programmes around the dividend yield theme; markets have been treating this style harshly until very recently. An improvement is expected in Q4. The yield generated by these funds (Kempen - 4.9%, Newton - 4.4%) remains considerable in the context of Hillingdon's funding requirements. To a lesser degree evidence of the market's distaste for yield in Q3 is evident in the UBS Equity performance data.

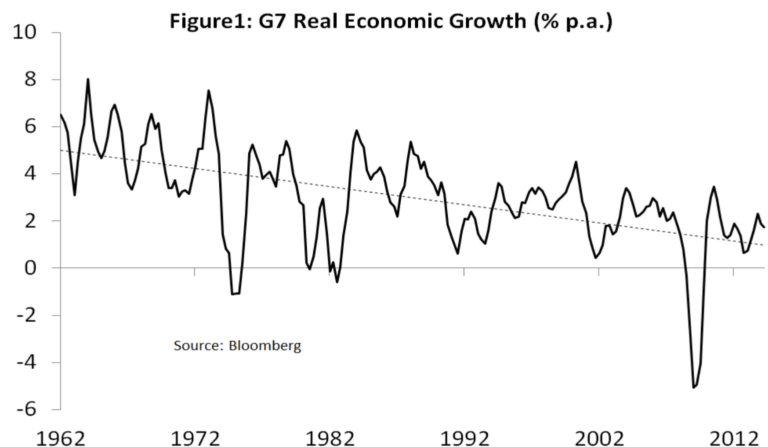
- JP Morgan's programme is being run down due to its now low expected return and the lack of defensive contribution to the overall strategy. Performance in Q3 supports the removal of this programme.

Also shown in the table are the individual programme costs. Across the Scheme, the aggregate annual excess return pursued in the spread of mandates is 2.2% against which the Scheme incurs approximate investment management costs of 0.45% p.a. This is a ratio of 5:1, ahead of an approximate norm of 4:1.

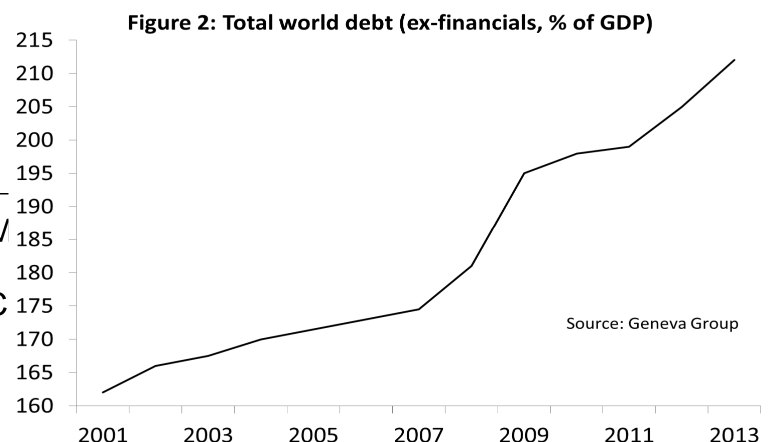
Further details on manager performance are contained in the Northern Trust report.

5. STRATEGY OVERVIEW

Driven by adverse demographic and productivity trends, economic growth in the world's major economies has been decelerating steadily for forty years (Figure 1). Indeed hard to believe as it may be, aggregate demand has recovered from the Great Financial Crisis to be currently running above trend.



Meanwhile the world's debt burden continues to grow as Governments, in particular, borrow to support spending (Figure 2). The debts were hard to finance before the GFC struck, affordability has since deteriorated.



Slowing growth and the need to keep the cost of funds low has

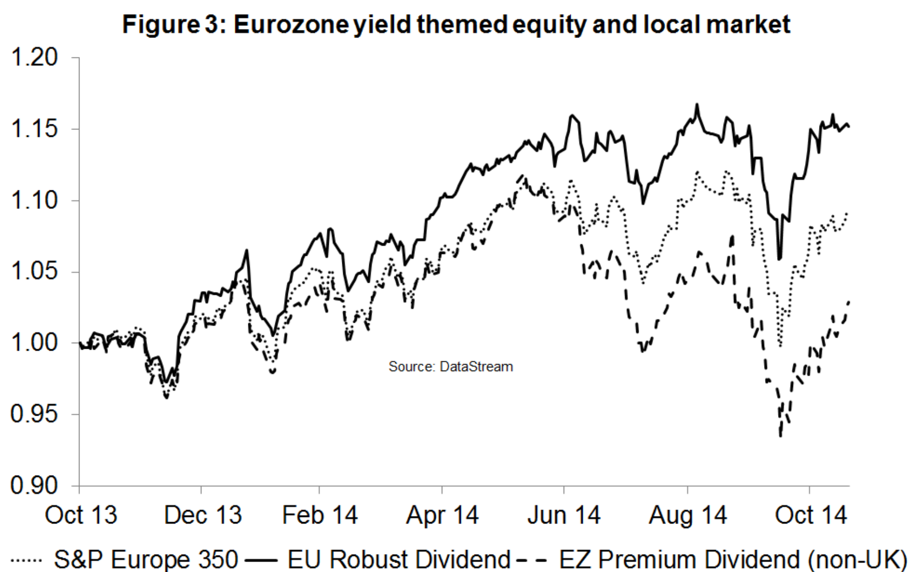
seen central bankers sustain an unprecedented era of near-zero short-term interest rates. This has ricocheted into bond markets to such a degree that the average 'hard currency' bond yield is a mere 1%. The ballooning debts of today are set against consumption or economic returns from tomorrow. These ultra-low risk-free bond yields are reflecting the limited amount of tomorrow's profits not already 'mortgaged'; they are also likely to continue for the foreseeable future.

Central bank monetary policy is keeping short term interest rates negative. Unfortunately even a negative real rate of 2% hasn't dented the structural imbalances. The next step in simple – even deeper negative real rates; a view of minus 4% is forming within markets. If/when this happens the impact will be felt all along the yield curve. UK long duration rates recently hit minus 0.5%; this will just be the beginning if economies fail to acquire the self-sustaining growth momentum sufficient to rebalance the global economy.

High bond prices have seen investors intensify their hunt for yield elsewhere. With attractive yield sources scarce the pursuit of yield has developed into an attractive total return strategy; particularly within equity markets.

While non-zero rates and quantitative easing were in their infancy, any yield was attractive. However, recently investors have become more discriminating. Figure 3 demonstrates both the market beating ability of a basket of proven dividend distributing companies. It also illustrates the potential cost of simply focusing on the highest yields available.

Figure 3: Eurozone yield themed equity and local market



Japan continues to provide a 'road map' for unconventional policy measures (to arrest a deeply ingrained debt-deflation spiral). Their pursuit of reflationary policies has morphed into the explicit drive toward higher rates of inflation <u>and</u> higher asset prices (now through government sponsored buying). The recent decision to call a snap election may prove to acceleration in pro-growth policies.

Beyond directly economic matters two influences need to be highlighted: politics and regulation. If the future is indeed already mortgaged, then those that might have hoped to enjoy the fruit of their labours – the young – will express increasing dissent. Europe will likely be the epicentre of this political backlash.

Markets have, by the standard of previous years, been calm. In part this has been won by regulatory pressure on market traders – epitomised by the emasculation of investment bank proprietary desks. Perhaps a desirable feature, one unattractive consequence has been the sharp reduction in market liquidity when there is any hint of stress. Many investment programmes depend upon the ability to exploit volatility; already challenging, this will become increasingly difficult.

Overall, of the economic and market features of recent years, the one most likely to change is subdued price behaviour. Support for the view that the era of low growth and lower interest rates is nearing an end is hard to find. Japan has been dealing with these issues for more than 20 years and is no closer to a durable recovery than it was at the start. In aggregate central banks are still expanding the world's monetary base – hardly the beginning of the end. With the supply of positive real risk-free returns all but exhausted investors therefore need to speculate simply to preserve the value of their capital in real terms.

The indulgence of inflation and the ongoing regulatory crackdown should continue to direct investors to focus their 'speculation' on physical, yield bearing assets. It is consistent to favour simple, tangible programmes rather than those that rely on capturing trends consistent with past experience and volatility. This thinking underpins the investments in Kempen, Newton, UBS, Ruffer and GMO (added in October).

Opportunities remain in areas that once were the province of banks although investors do need to commit for the extended periods natural to pension funds. These will often be investments that generate a high level of income. The recent investments in the AEW, Permira and M&D Debt Opportunities Funds respond to this theme.

6. Other Items

At the end of September 2014, £18.5m (book cost) had been invested in **Private Equity**, which equates to 2.47% of the fund against the target investment of 5%. In terms of cash movements over the quarter, Adams Street called £420k and distributed £1,066k, whilst LGT called £199k and distributed £1,246k. 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 £8.7k. Offset against this was £3k of expenses leaving a net figure earned of £5.7k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 June 2014 the average value of assets on loan during the quarter totalled £15.9m representing approximately 8.2% of this total.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None