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 provides a summary of fund manager performance for the quarter ending 31 December 2014. The total value of the fund's investments as at 31 December 2014 was £764.8m.

RECOMMENDATION

That the contents 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). The market movements into the end of 2014 and beyond were led by plunging bond yields and were therefore extremely challenging for Schemes.

The world economy continues to be characterised as the US vs. the Rest and nowhere is this reflected more than in the strength of the US$. The US Federal Reserve (Fed) stopped adding to its quantitative easing programme late in 2014 and is now musing over when to lift its policy interest rate. By contrast the European Central Bank has joined the Bank of Japan in rapidly expanding its monetary base as both pursue the economic gains evident in America.

Whether quantitative easing (QE) was primarily responsible for boosting jobs growth and growth in the US is a moot point however the Europeans and Japanese have few alternatives. With bond yields already low, the main channel by which QE may boost performance is via the currency and the € and the ¥ have both fallen sharply (their trade weighted currency levels have fallen respectively by 13% and 7% over the past year).

January saw the dramatic consequences of a currency policy that became unstuck. Having invested heavily to prevent currency from strengthening against the €, the Swiss

National Bank eventually had to capitulate against market demand and let the currency rise sharply (by more than 20% at one stage). Hitherto QE could have been described as a cost-free policy; apart from seeing central bank balance balloon to huge proportions of domestic GDP there has arguably, yet, been no negative consequence. That is no longer the view of the Swiss; something not be lost on central bankers in other nations.

The other major theme in recent months has involved the Chinese economy and credit system. Anecdotes abound surrounding the immense scale of property related debt invite memory of the experience of Japan three decades ago. China's inflation rate is now just 0.8% and it cannot afford a significant slowdown. As a result the Chinese authorities have started to ease interest rates and they are allowing some gentle weakness against the (strong) US$. Nonetheless demand for commodities from China remains weak and this is ripping through many emerging market nations and the likes of Australia and Canada. The Reserve Bank of Australia cut its policy rate in December.

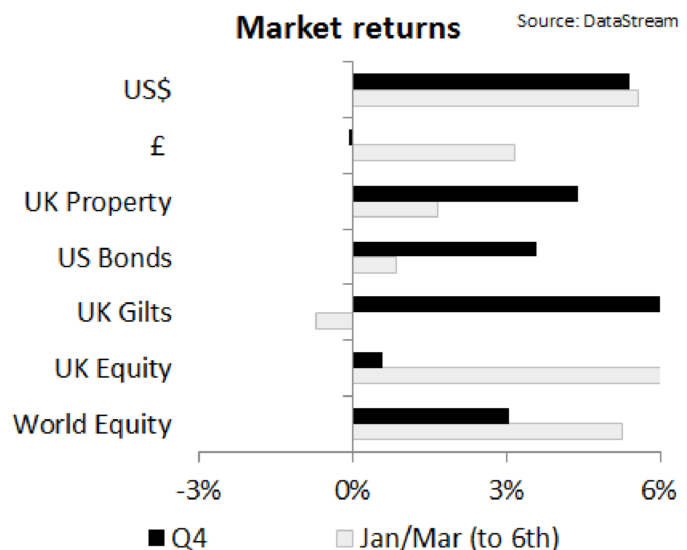
Further comments on the market backdrop are contained in the detailed report prepared by Northern Trust and in the Investment Advisor's report.

2. MAJOR MARKET RETURNS

The sense of improvement in the US economy, the fillip coming from sharply lower energy costs and the prospect of fresh policy stimulus coming from the ECB, saw financial assets perform strongly in Q4. A strong US$ transfers competitiveness from the relatively vibrant US economy to the more anaemic parts of the world economy; that the US$ rallied strongly in Q4 aided to the rise in all markets.

The buoyancy has continued into Q1, 2015 albeit bond markets have sold off after reaching lofty heights in January. The US$ has remain very strong supported by building expectations that the Fed will lift interest rates and after the ECB announced its QE programme.

UK property prices rose on evidence of rental growth. Foreign demand remains firm and, increasingly, finds its way into areas beyond the London and the South East.



3. FUND PERFORMANCE

The investment objective for the Hillingdon Pension Fund, agreed with the Actuary, is to generate a trend 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.

The performance of the Fund for the quarter to 31 December 2014 showed a relative underperformance of 0.1%, with a return of 2.2% compared to the benchmark of 2.3%. One year figures show returns of 6.5% (0.4% ahead of the RPI+4% target return but 0.3% behind the benchmark). Over the three period the Fund returned 0.7% pa over the benchmark; the absolute rate was 9.8% p.a., well ahead of the required investment return.

The average LGPS (as captured by WM data) maintains a higher proportion in equity markets and overseas markets in particular. Further while the Hillingdon Pension Fund holds a comparable exposure to bond investments, the actual investments are of a shorter duration than the typical bond fund; on any measure, long duration bonds are expensive. As a result, while the trend rates of return from the Fund's bond investments are expected to meaningfully contribute to the overall investment earnings, there will be periods of underperformance relative to long duration bonds. 2014 was characterised by strong bond markets. For the quarter ending 31 December 2014, the Fund underperformed the WM average by 0.9%. The one year figure also shows underperformance, this time by 1.6%.

The Hillingdon Pension Fund's investment strategy sustains 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 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.

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	Q4 2014 %	1 Year %	3 Years (% p.a.)	5 Years (% p.a.)	Since Inception (% p.a.)	Target (% p.a.)	Fees (% p.a.)
Adams St*	21.7	4.28	26.30	14.3	14.41	4.02	4.0**	1.20
AEW	16.5	2.13	-	-	-	2.13	8.0*	0.70
GMO	64.9	-	-	-	-	0.88	4.0	0.50
JP Morgan	37.9	(0.19)	(1.67)	0.14	-	0.14	3.0	0.30
Kempen	81.1	(3.47)	(7.43)	-	-	(9.29)	2.0	0.42
LGT*	13.7	2.29	7.53	7.75	9.48	8.23	4.0**	1.00
Macquarie	7.7	3.32	3.20	(5.22)	-	(7.23)	3.0	1.38
M&G	32.4	(1.81)	1.41	1.02	-	0.47	4.0	1.5
Newton	25.5	(1.39)	(3.87)	-	-	(3.83)	2.0	0.75
Permira	5.3	-	-	-	-	-	4.0	0.85

Ruffer	90.2	3.13	5.79	6.27	-	5.59	4.0**	0.80
SSgA	152.5	0.10	0.06	(0.06)	0.01	0.02	0.0	0.10
UBS TAA	33.0	(2.15)	8.07	-	-	1.06	0.0	n/a
UBS Eq	115.2	0.60	(1.40)	3.92	1.54	1.18	2.0	0.35
UBS Property	63.0	(0.20)	0.73	0.12	0.11	(0.26)	1.0	0.20
Total Fund	**764.8**	**(0.16)**	**(0.32)**	**0.67**	**0.60**	**0.04**	**2.2**	**0.45**

*Absolute performance **Set against LIBOR

Highlights:

- The private equity programmes are enjoying the favourable credit market conditions of recent years to off-load companies and crystallise returns. On balance the programmes are returning cash to investors.

- M&G Debt Opportunities Funds (DOF) remain on target to deliver their target 15% net annual performance. The first programme is now starting to return cash to the Fund (15% of NAV) and one of its assets is being pursued aggressively by private equity funds (having secured a major contract in its market); this asset alone has the potential to deliver the Fund's full target return.

- In recent years the Hillingdon Fund has directed its private or illiquid investments away from equity to debt. The experience of the first DOF supports this move. As a matter of course, Officers and Advisors are reviewing this focus in full.

- The TAA programme comprises shorter dated US index-linked bonds, currency unhedged as a preferred alternative to the near zero or negative yields available on cash. Absent other uses, not currently foreseen, these balances will be used to de-risk the Scheme through the purchase of longer dated index-linked bonds – arguably the Fund's natural asset – when entry levels are appropriate.

- Kempen and Newton operate equity programmes around the dividend yield theme; markets treated this style harshly in 2014. Premium dividend yield is generally in poor supply in the US equity market and virtually all yield themed equity managers favour other locations. The US equity market (currency unhedged) was the equity market of choice last year. The yield generated by these funds (Kempen - 4.9%, Newton - 4.4%) remains considerable in the context of Hillingdon's funding requirements and is being delivered. Q1, 2015 has seen European equity markets return to the fore as they respond to the ECB's move to launch QE. These conditions should see the managers recoup prior underperformance.

- 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 Q4 supports the removal of this programme.

- The AEW programme was procured because of its high target yield of 8+%. Although it invests in UK secondary properties the programme will meet the Fund's objectives if it delivers this annual return. The target rate of return has been set accordingly.

- Ruffer enjoyed a favour Q4 supported by the strength of index-linked and Japanese equity markets. Ruffer retains a deep concern about the future outlook for financial markets and the broader economies. In the past Ruffer would have used bond market exposures to help nurse their growth assets through any market turbulence. Now, however, their sense is that the bond markets themselves face considerable challenges and the Manager is pursuing alternative means of defending their mandates via a range of complicated derivative strategies.

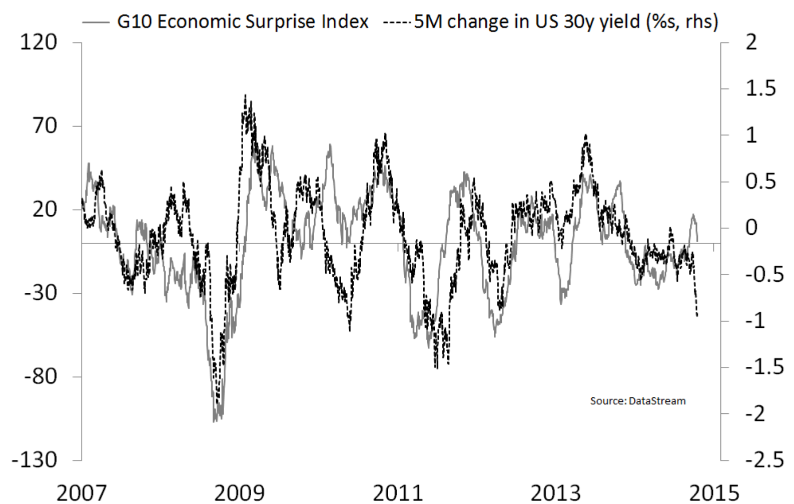
- The GMO and Permira programmes were funded during Q4.

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. OUTLOOK

The decline in long term interest rates seen in December/ January not only challenged the sense that economies are 'out of the woods' but actually suggested that a fresh, sharp recession was at hand. This was at odds with the general the economic backdrop, which although subdued, was performing broadly on line with expectations (Figure opposite).



One area of particular concern was the Eurozone which had re-entered deflation and recession. In January the European Central Bank (ECB) responded aggressively and announced a QE programme of €60bn of government bond purchases per month. As the ECB and Bank of Japan are showing, policy formulation is becoming more desperate and selfish; both are 'exporting' deflation on the rest of the world economy through currency debasement. For the moment it suits the US to 'receive' that deflation. The Fed is most likely receptive to anything that enables it to refrain from raising its policy interest rate. A higher $ lower import prices and the fall in import costs has probably taken about 0.75% off core US inflation.

The world already had a deflationary bias (resulting from the debt overhang from the Great Financial Crisis) and this has been compounded by the oil shock (energy costs have halved). There are no redeeming features to deflation and economic leaders remain desperate to avoid discovering just how pervasive it could be. The onset of a currency war, started by the Japanese, now supported by the Europeans, threatens an extended period

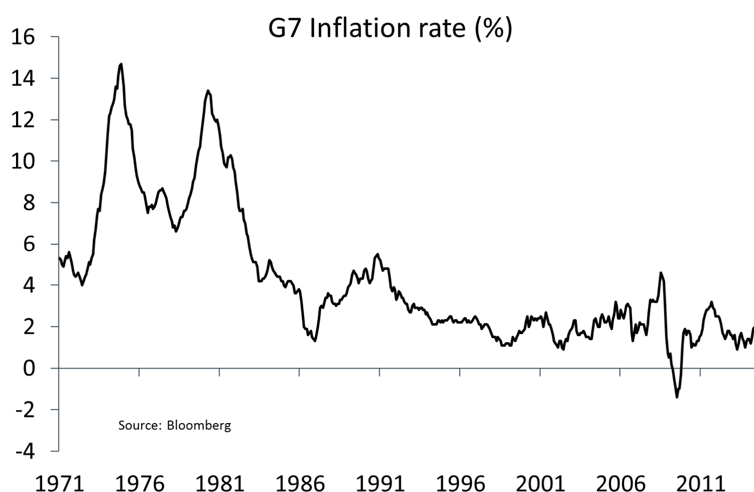
of instability. By and large the post GFC era has been characterised by policy unity; that cohesion is now under threat. It should be recalled that it was a dispute over currency levels (between the German Bundesbank and the US Federal Reserve) that spawned the equity market collapse of 1987.

Ultimately these currency adjustments could prove constructive if they succeed in re-balancing economic growth across the globe. The question throughout the post Credit Crunch era however has been less about the shape of final demand and more about its overall level. The pronounced weakness in energy prices (oil has fallen by 46% over the past six months) has the potential to bolster aggregate demand as it shifts purchasing power from oil exporting nations to energy imports, the latter having a much higher propensity to consume). However much of the drive beyond the US economy in recent years has come from the rapid development of the shale oil industry. It remains to be seen whether the retrenchment now underway in the energy sector is more powerful than the general boost to consumption from lower fuel prices; we hope not.

There is a fine line between a strong $ being a good or bad. With the RoW economy still languishing, there has to be a concern that investors will, in their clamour to own $ assets, create disruptive distortions in markets that deny the RoW access to capital needed to support economic growth. This could end badly especially if the US economy proves unable to resist the deflation pulse from a weak world economy, if so then the loss of confidence (and sense of hopelessness) would prove profound.

Further $ strength challenges currencies pegged to the US$. After the breaking of the peg against the €, the Swiss have shown that adjustments that can result from opposing strong market demand can be violent. Currencies pegged to the US$ risk the opposite if US$ strength enfeebles the associated domestic economy; the UK's ejection from the ERM in 1992 is a reminder of the potential consequences. The largest currency peg of them all involves China.

Away from the interplay between the world's major currencies, weak economic conditions have seen forty nations ease interest rates this year as they strove to avoid deflation. With inflation in the G7 now at its lowest level outside the Credit Crunch (0.8%), more will follow. Yield, the life-blood of most financial institutions remains in scarce supply. With the world's premier central bank apparently itching to raise rates this is a dangerous backdrop for investors.



Overall, of the economic and market features of recent years, the one most likely to change is subdued price behaviour. Notwithstanding the debate surrounding the next move is US monetary policy, 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 bankers 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; the Fund recently added to exposure at AEW, using monies raised out of the UK equity programme managed by UBS.

6. OTHER ITEMS

At the end of December 2014, £18.3m (book cost) had been invested in **Private Equity**, which equates to 2.40% of the fund against the target investment of 5%. In terms of cash movements over the quarter, Adams Street called £769k and distributed £2,424k whilst LGT called £202k and distributed £963k. 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 £11.2k. Offset against this was £3.9k of expenses leaving a net figure earned of £7.3k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 December 2014 the average value of assets on loan during the quarter totalled £16.9m representing approximately 8.5% 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