REVIEW ON PERFORMANCE MEASUREMENT OF THE PENSION FUND	

Contact Officers	Nancy Leroux Tel: 01895 2503530

Papers with this report	Northern Trust Executive Report

SUMMARY

This report provides a review of financial markets and fund performance for the quarter ending 31 March 2015. The total value of the fund's investments as at 31 March 2015 was £801.3m. The attached Northern Trust report has been reduced in size to make more meaningful and to enable closer scrutiny by Members. The full report is available and will be sent to any Member who wishes to continue to receive it.

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 LBH 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 in the early part of Q1, 2015 were led by surging bond prices – at one point German 10-year bond yields were almost zero - and this is therefore extremely challenging for Funds. The arrival of Spring has brought higher yields while equity markets have progressed towards or through all-time highs.

In 2014 world economic growth was driven by strength in the US economy and held back by weakness everywhere else; this was reflected in a strong US$. Currency movements of the magnitude seen tend to act to rebalance growth across nations and so it was in Q1, 2015; the US lagged while Europe in particular, found fresh strength. Beyond the currency impact, Europe benefitted from lower energy prices and the onset of quantitative easing (QE) out of the European Central Bank (ECB). Together with the Bank of Japan the ECB is injecting around £80bn per month into world money markets. The US Federal may have ended their QE programmes but official liquidity continues to flood into the world financial system. Whether QE will actually boost jobs growth and growth is a moot point however the Europeans and Japanese have few alternatives.

The next major development in unconventional monetary policy will probably involve China. Chinese economic growth continues to undershoot expectations and this is intensifying the challenge of managing the excesses within the Chinese credit system.

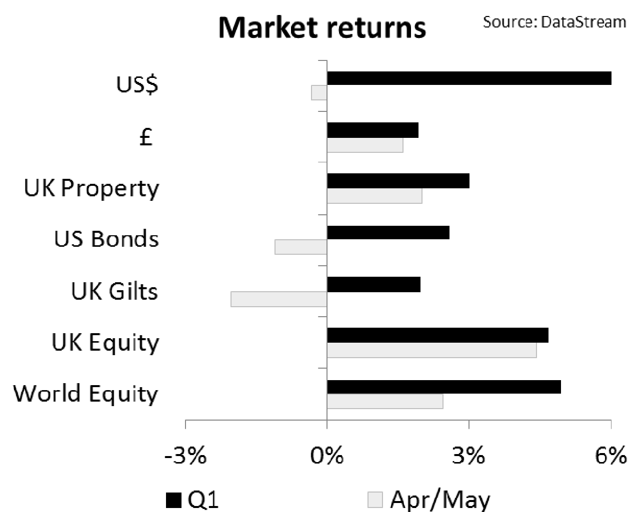
Anecdotes abound surrounding the immense scale of property related debt and unwanted buildings – last year saw the stock on unoccupied property rise by 130 million square metres. China today invites memory of the experience of Japan three decades ago.

Chinese consumer prices are now falling and China cannot easily absorb a significant economic slowdown; a Chinese 'Lehman' is a genuine and growing threat. As a result the Chinese authorities have started to ease interest rates but they are struggling to cope with the strength of the US$ to which their own currency is pegged; Yuan devaluation is a genuine prospect.

Across global markets, the UK election struggled to command much investor attention. The clear result was greeted favourably by markets but the benefit is beginning to look short-lived as investors begin to worry about tighter fiscal policy.

2. MAJOR MARKET RETURNS

The year began with the unexpected capitulation by the Swiss National Bank (SNB) in its efforts to prevent a rising Swiss franc. Through being prepared to absorb all market demand for francs the SNB accumulate vast amounts of foreign currency – predominately €s. With selling of €s threatening to become unbounded the SNB stepped aside; the resulting surge in the CHF led to losses on the SNB's balance sheet equivalent to 5% of Swiss GDP. The ensuing turbulence proved short lived once the ECB launched QE; financial markets ended the quarter well bid.



The buoyancy of risk assets continued into Q2 despite – or because of – the increasingly erratic behaviour of bond prices. The US$ has traded in a narrow range in April and May as investors wonder whether the slowdown in US economic activity in Q1 – GDP barely grew – will continue and whether, as a result, the US Federal Reserve will have to delay its plans to raise interest rates. £ has enjoyed the clarity of the recent election result

UK property prices rose on rental growth – especially in London - and strong foreign demand. The ripple effects from a firm London market continue to be seen in regional markets.

3. FUND PERFORMANCE

The investment objective for the LBH 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 Fund 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 March 2015 showed a relative

outperformance of 0.5%, with a return of 4.8% compared to the benchmark of 4.2%. (Excess return 0.6%) One year figures show returns of 10.4% (substantially ahead of the RPI+4% target return and in line with the benchmark). Over the three period, the Fund returned 0.8% pa over the benchmark; the absolute rate was 9.9% 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.

Recent quarters have seen many investors maintain a more optimistic 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. In illustration, over the long term the real returns from equity investments are driven by dividend distributions; the equity mandates of the Fund have a focus on sustainable dividend yields. A dividend focused equity programme will tend to lag broader market indices when prices are rising strongly on expectations of faster economic growth.

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*	22.5	9.4	29.3	-	-	4.8	4.0**	1.20
AEW	32.1	0.1	-	-	-	-0.1	8.0*	0.70
GMO	65.7	1.0		-	-	1.8	4.0	0.50
JP Morgan	38.4	0.4	-1.5	-0.5		0.3	3.0	0.30
Kempen	87.3	-0.5	-7.6	-	-	-8.5	2.0	0.42
LGT*	12.7	1.4	6.8	7.7		8.2	4.0**	1.00
Macquarie	13.2		7.0	-0.4	-	-6.7	3.0	1.38
M&G	35.2	2.6	3.8	-	-	2.0	4.0	1.5
Newton	27.2	-1.5	-5.3	-	-	-4.1	2.0	0.75
Permira	5.4	0.3	-	-	-	0.1	4.0	0.85
Ruffer	94.9	5.1	11.6	7.2		6.4	4.0**	0.80
SSgA	161.8	-0.1	-	-0.1	-	0.0	0.0	0.10

UBS TAA	32.0	-0.1	1.4	-	-	0.8	0.0	n/a
UBS Eq	104.9	-0.9	-3.2	3.1	1.5	1.1	2.0	0.35
UBS Property	65.3	0.8	1.7	0.4	0.2	-0.2	1.0	0.20
Total Fund	**801.3**	**0.5**	**0.0**	**0.8**	**0.8**	**0.1**	**2.2**	**0.45**

*Absolute performance **Set against LIBOR

Highlights:

- The private equity programmes of Adams St and LGT continue to exploit the favourable credit market conditions of recent years to off-load companies and crystallise returns. The Hillingdon Fund is experiencing strong cash returns. The private debt programme, managed by Permira, targets a yield around 8%. Recently funded, it is still in its investment phase; six investments have been made

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

- 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; a style generally not favoured by investors when markets are rising strongly. The defensive nature of these programmes will come to the fore when financial conditions turn less favourable. The yield generated by these funds (Kempen - 4.9%, Newton - 4.0%) remains considerable in the context of the market and Hillingdon's funding requirements.

- UBS 'value' equity mandate is outperforming comparable market yardsticks but, due to the defensive style, is lagging the broader market.

- JP Morgan's programme is being run down due to its low expected return and the lack of defensive contribution to the overall strategy.

- The AEW programme was procured because of its high target yield of 8+%. Although a UK secondary property investment, the programme will meet the Fund's objectives if it delivers this annual return. A nominal return target has therefore been set for the programme. UBS's property programme is ahead of target.

- Ruffer enjoyed a favourable Q1 supported in particular by the strength of equity markets (Japan in particular). Ruffer retains a deep concern about the future outlook for financial markets and the broader economies and continues to look at inventive ways of delivering the capital preservation they prize above all else.

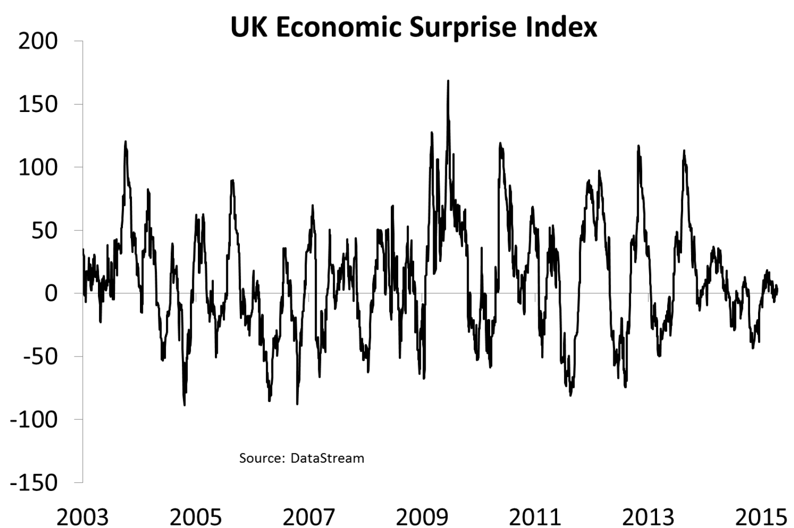
- The GMO programme was funded during Q4, 2015. After a slow start in Q1 performance has lifted in April/May. The Manager retains a very cautious outlook and maintains a very narrow spread of investments as a result. GMO (as Ruffer) are expected to manage their asset allocation across a market cycle, flexing risk according to their assessment of opportunity. There will times, as now, when risk-taking will be modest.

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.

5. OUTLOOK

The issues confronting investors have changed little over recent quarters. Debt levels continue to build nearly a decade after debt burdens were first regarded as unbearable. Deflation continues to be the most significant monetary challenge and unemployment levels, while lower, remain high especially in Europe and the jobs that have been created are of low quality. The political backlash has however remained limited with the social unrest widely expected a few years ago absent even in the nations most impacted by austerity. Notwithstanding the cessation of QE in the UK and now the US, monetary policy remains highly accommodative with the Bank of Japan and the European Central Bank stimulating their economies – and the global monetary base – strongly. Geo-politics remain challenging, although it is probable that an accommodation with Greece will be found that will avoid having to deal with the adverse consequences that might follow should the country be cut loose from the Eurozone.

There have been many 'innovations' in market analysis of the post-crisis era. One of the most enduring has been economic 'surprise' indices. Accepting that the absolute level of economic activity is low, investors use these measures to determine whether the data is at least better than expected. The latest UK 'surprise' index suggests balance of UK data released in recent months has been in line with expectations.



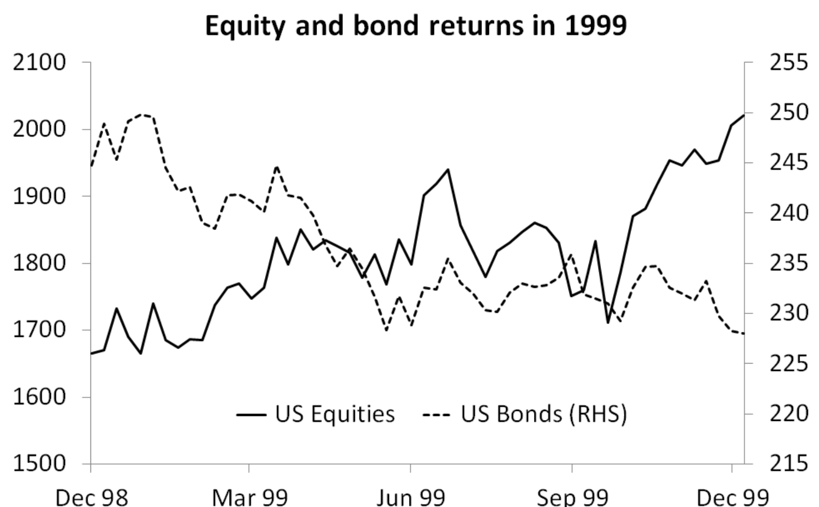
The focus on surprise indices can easily distract from the fact that the level of activity has undoubtedly improved. This can be seen – in Scotland as an example – in the substantial house construction underway, the increased activity in shopping centres and the traffic on

the major arterial routes. Across the UK, wages are rising, consumer confidence is up and car sales are booming – what was the chance of all this occurring in an election year?! Although it might be churlish to note that the bulk of half a million cars bought in March were purchased using ever more innovative finance terms; the credit conduit does look to be working better.

Economies always cycle and the UK is on an upswing consistent with the electoral cycle. Based on elections since 1970, consumer confidence in the UK has lifted strongly in the two years prior to an election. This year is no different and the improvement over the past two years has been sharper than average. This is in part has been fuelled by increased government spending; accordingly to the Bank of England, government spending swung from being a drag on activity in 2013 to a driver in 2014. The UK is starting to look a lot better.

Despite the improved tone the threat of deflation – inflation across the G7 is a mere 0.3% - is keeping bond yields low and unattractive to many investors. Negative interest rates and bond yields in Europe are fuelling a powerful surge in equity and property markets. Investors invariably push these trends too far but as yet there are few of classic signs of complacency.

This invites memory of 1999 when equity market sentiment was sufficiently strong to ignore rising bond yields; such a phase could happen again. In 1999 it was the hopes from new technologies that justified a new era for equity markets. Today, it is uber-easy monetary conditions that have been pursued – and continue to be delivered, by a raft of central banks together with the sense of better economic activity ahead. The recent volatility of bond prices has proved higher than that of normally riskier assets. This has encouraged a discernible switch in risk preference in favour of equities. If this trend continues then it is possible therefore that, in the period ahead, the Fund will enjoy a period of improving health – better real asset returns and falling liability values (following from higher bond yields).



Overall, 1999 marked the end of a golden period for equity markets, so too could 2015 should either market sentiment rise dangerously or the structural economic ‘headwinds’ return to the fore. It is important that those charged with the management of the Fund’s assets identify actions to be employed as and when the period of diverging market performance described above could be ending.

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 low interest rates are 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 and UBS.

The history of the past twenty years highlights the importance of making timely and meaningful asset allocation adjustments. In Ruffer and GMO the Fund has two managers acknowledged as successful asset allocators able both to adjust their own programmes and to support the management of all the Fund's assets..

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 investments in the AEW, Permira and M&G Debt Opportunities Funds respond to this theme.

6. OTHER ITEMS

At the end of March 2015, £13.8m (book cost) had been invested in **Private Equity**, which equates to 1.73% of the fund against the target investment of 5%. In terms of cash movements over the quarter, Adams Street called £453k and distributed £1,632k whilst LGT called £244k and distributed £1,163k. 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 £10.2k. Offset against this was £3.6k of expenses leaving a net figure earned of £6.6k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 March 2015 the average value of assets on loan during the quarter totalled £17.4m representing approximately 8.3% 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