INVESTMENT STRATEGY AND FUND MANAGER PERFORMANCE (Part I)

Contact Officers	Sian Kunert, 01895 556578 Scott Jamieson David O'Hara, KPMG

Papers with this report	Northern Trust Performance Report Draft Investment Strategy Statement

SUMMARY

This is the main report which focuses on the investment of the Fund's assets. The report includes an overview of fund performance as at 30 December 2016, an update on recent investment decisions, and progress of the London CIV. It is timely following each valuation of the Fund that a review of the Fund's Investment Strategy is undertaken and this will form the main part of the discussions at the meeting. Following those discussions, the draft Investment Strategy Statement will be considered and, subject to any drafting amendments, members asked to approve.

The total size of the fund was £931m at 31 December 2016 an increase from £890m at the end of last quarter, with an overall investment return over the quarter was 3.85%, giving rise to relative out-performance of the benchmark by 1.03%.

Included with this report is the Northern Trust performance report and in Part II there is an update on each Fund Manager and detailed current market backdrop. These papers all form background reading to inform Committee and to aid discussion.

RECOMMENDATIONS

It is recommended that Pensions Committee:

1. **Discuss and agree the revised investment strategy for the Fund and the target Strategic Asset Allocation;**
2. **Approve, subject to any agreed amendment, an initial version of the Investment Strategy Statement, which will then be published and circulated to Pensions Board for comment;**
3. **Discuss the Fund performance update and agree any required decisions in respect of mandates or Fund Managers;**
4. **Delegate the implementation of any decisions to the Officer and Advisor - Investment Strategy Group;**
5. **Note the follow up activity to previous investment decisions and progress in the development of the London CIV.**

INFORMATION

1. Fund Performance

Over the last quarter to 31 December 2016, the Fund returned 3.85% (5.96% to September 2016) against the fund benchmark of 2.78% (5.16% September 2016) resulting in an outperformance for the quarter. The value of the Fund increased over the quarter by £34.1m, to bring the fund balance to £930.7m as at 31 December 2016.

Period of measurement	Fund Return %	Benchmark %	Arithmetic Excess
Quarter	3.85	2.78	+1.07
1 Year	17.81	14.83	+2.98
3 Year	9.29	8.46	+0.83
5 Year	10.19	9.14	+1.05
Since Inception (09/1995)	7.17	7.00	+0.17

In continuation of Q3 returns the most notable outperformance on investments in the quarter were produced by the LCIV Ruffer DGF fund and UK Value Equities held by UBS, with the biggest underperformance by Newton Global Income Equities.

Outperformance over a one year rolling period was 17.81% compared to the benchmark of 14.83%, also in part from the over performance of UBS UK Equity and Ruffer Funds.

During the quarter the SSGA mandate was terminated and transferred to LGIM and the fund received £14.3m in cash distributions from the M&G Private Credit Fund.

2. Market and Financial climate overview

The global economy has performed well over the last quarter despite the uncertainty of Brexit, instability in Europe and the election of President Trump. This positive trend looks to remain over the short-term with financial markets continuing to price in growth following fiscal and monetary stimulus. The FTSE All share was up in the quarter and has risen 16.8% over the year, whilst UK economic data is still positive with the latest quarter's estimate for UK GDP coming in ahead of market expectations at 0.7%.

The fall in sterling is expected to have a paradoxical impact going forward by boosting exports but weakening consumer spending through imported inflation. The devaluation in currency should assist the economy rebalance away from the usual negative contribution from net trade to GDP growth, through this weaker domestic demand and improvement in exports.

Over the medium-term the potential for protectionism in the US and the rise of populist sentiment within Europe could dampen global growth and investment activity levels through continued uncertainty, but in the meantime, investment returns and economic growth remain positive.

3. Investment Strategy and the Investment Strategy Statement

Following each valuation it is timely to undertake a review of the investment strategy of the Fund. The Fund's advisors, David O'Hara (KPMG) and Scott Jamieson (Independent) will be making a presentation to Committee on the current investment strategy and strategic asset allocation and leading Committee through a discussion on potential changes to the strategy and asset allocation Committee may wish to consider, in light of the valuation results and the suggestion that it may be worth considering reducing the risk exposure of the Fund. A few slides to set out the background to introduce the discussion will be forwarded by email to Committee members in advance of the meeting.

Following agreeing any revisions to the investment strategy, Committee will then be asked to review the draft Investment Strategy Statement. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, effective from 1 November 2016, require an Investment Strategy Statement (ISS) to be in place by 1 April 2017 and replaces the Statement of Investment Principles. The fund is required to invest all money in accordance with this Investment Strategy Statement that is not immediately required to make payments.

Under the new LGPS Investment Regulations the strategic asset allocation remains the responsibility of the Pension Committee and will continue to be the key strategic tool for the Committee to manage the fund to obtain the return targets as required in the Funding Strategy Statement.

The investment strategy statement required under the regulations must include -

a) A requirement to invest money in a wide variety of investments;
b) The authority's assessment of the suitability of particular investments and types of investments;
c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The ISS must also set out the maximum percentage of the fund held in any asset class or investment.

Consultation is required over the content of the fund's investment strategy with those the fund considers appropriate. The fund has consulted and taken proper advice from the investment advisors and independent advisor and the ISS will be taken to the next Local Pensions Board in April as a representative group for fund members. The ISS will be updated regularly along with each strategy review. The draft ISS is attached to this item as an appendix for discussion and approval.

4. Investment decision updates

This section of the report provides an update to Members on activity by officers to implement previous decisions taken by Pensions Committee. At the meeting in September 2016, Pensions Committee agreed to liquidate the GMO mandate and the funds reinvest in a mix of passive funds through LGIM. The Investment strategy group agreed a balance of passive funds in which to move the GMO funds to invest at a lower

cost than the premium of investing in the current DGF in the current economic market. This was completed on 22 February 2017 with all funds transferred totalling £62.25m.
The mix of passive funds has been allocated as follows:

Fund	% weight
Global equities (£ hedged)	25
Long dated UK corporate bonds	25
Emerging market equity	25
Over 15y UK Index-linked	25

This mix of passive funds is expected to return Gilts plus 2.6% which is slightly lower than the expected return from DGFs, however this will help trim the Funds risk relative to liabilities and will be managed at a significantly lower cost.

In addition, in relation to the cashflow of the Fund, having received distributions of £14.3m from M&G the fund was holding excess cash of £15m above that required to meet the immediate payments of the fund. Under delegated authority and in line with the LGPS Investment regulations to ensure all cash is invested, £15m was invested into the JPMorgan Bond fund during the week commending 27 February. This investment reduces the funds counterparty and bail in risk from holding large cash balances. The JP Morgan Bond fund is a mix of credit instruments including EM debt and High Yield bonds. Allocation to this fund is in line with the strategic asset allocation and the fund is liquid, making transition of the cash into this fund cost effective. JP Morgan's mandate as a result of this addition is now valued at £54m. The fund manager charges 30bps for assets under management (AUM) and the fund is performing as expected with returns of 8.9% (+3.4% above the market) in the past year. There is currently no equivalent passive option for this type of investment.

5. LCIV update

In the past quarter the London CIV (LCIV) has opened an additional sub fund - LCIV NW Real Return Fund managed by Newton which launched 16 December 2016, bringing the total to 6 active sub funds.

Sub funds available on the platform currently are:
- Global equity funds (Allianz and Baillie Gifford)
- Diversified growth Funds (DGF)/Absolute Return funds (Ruffer, Pyrford, Baillie Gifford and Newton)

Currently, the CIV are working on launching 2 further funds in May 2017 which will be global equity quality managed by Newton and UK equity managed by Majedie. Discussions are ongoing in relation to Global equities managed by Longview.

Once these mandates are in place, this will end the creation of sub funds as a result of consolidation of current mandates across boroughs. Future sub funds will be brought on line from direct procurement exercises by the London CIV, established as best in class for their asset type

The first such exercise is a Global Equity manager procurement process and the first three Global Equity sub funds have been agreed to go ahead. These are for an Income manager, an Emerging Markets manager and a Sustainable manager. The CIV will begin procedures to bring these funds onto the platform and produce information to boroughs to consider investing within these funds once they have been launched.

The next steps for the CIV are income generation products including traditional Fixed Income to support the many funds which are faced with negative cashflows. The CIV are working with the Investment Advisory Committee to consider a range of fixed income and cashflow generating products Funds may wish to access later next year.

Hillingdon Fund Investment with the London CIV

The Hillingdon Pension Fund currently invests in Ruffer with CIV holdings totalling £104m at 31 December 2016.

The London CIV carried out extensive work over the past year in relation to passive funds and negotiated fees with LGIM and Blackrock on behalf of the funds. As London Boroughs benefited from lower management fees from the negotiations and the increased buying power of the CIV, it was agreed by the London CIV joint committee that Funds will pay 0.5bp of AUM from April 2017 to recover the costs associated with the passive funds negotiations and to support he continued working relationship and build up the reporting requirements as laid out by government of these passive funds via the pools.