INVESTMENT STRATEGY and FUND MANAGER PERFORMANCE (Part I)	

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Papers with this report	Northern Trust Performance Report

SUMMARY

This item will be preceded with a training item from KPMG on investing in Infrastructure.

This report asks Members to discuss and agree a new investment into long dated inflation linked property. The report includes an overview of fund performance as at 30 June 2018, sub funds available within the London CIV and recent voting and engagement.

The total size of the fund was £1,054m at 30 June 2018 an increase £40m from £1,014m at the end of previous quarter. There was an overall investment return over the quarter of 4.08%. The estimated funding position at 30 June 2018 is 78.9%.

Part II includes an update on each Fund Manager and the detailed current market backdrop. The papers all form background reading to inform Committee and to aid discussion.

RECOMMENDATIONS

It is recommended that Pensions Committee, following consideration of the Part II papers:

1. **Consider and discuss any issues raised in the training item**
2. **Discuss the Fund performance update and agree any required decisions in respect of mandates or Fund Managers;**
3. **Agree 5% investment of Long- Dated inflation linked property**
4. **Delegate the implementation of any decisions to the Officer and Advisor - Investment Strategy Group.**

INFORMATION

1. Fund Performance

Over the last quarter to 30 June 2018, the Fund returned 4.08%, an under-performance of 8 basis points relative to the fund benchmark of 4.16%. The Fund value increased over the quarter by £40m, to £1,054m as at 30 June 2018.

Period of measurement	Fund Return %	Benchmark %	Arithmetic Excess
Quarter	4.08	4.16	(0.08)
1 Year	6.16	7.01	(0.85)
3 Year	9.37	9.09	+0.28
5 Year	8.74	8.49	+0.25
Since Inception (09/1995)	7.14	7.03	+0.11

During the quarter, distributions received from Alternative investments were $3.4m, €1.5m & £1.1m. The cash was utilised to fund drawdowns of outstanding commitments in both Permira and Macquarie. The largest detractor from performance during the quarter was JP Morgan, with a relative return of -2.69 behind the benchmark. Whilst Macquarie outperformed the benchmark by 5.75% as the biggest contributor.

Relative performance over a one-year rolling period was 0.79% behind the benchmark with the largest detractor being JP Morgan; with a return of 4.61% in excess of benchmark from AEW as the best performing fund manager at the end of quarter under review.

2. Asset Allocation

The current asset allocation, the key strategic tool for the Committee, is in the table below. The assets of the Fund is invested across 11 different Fund Managers in a range of passive and active mandates, including a mix of liquid and illiquid allocations to reflect the Fund's long-term horizon.

Current Asset Allocation by Asset Class

ASSET CLASS	Market Value As at 30 June 2018 £'000	Actual Asset Allocation %	Benchmark Allocation %
UK Equities	233,447	22.2	44.0
Global Equities	253,216	24.1	
UK Index Linked Gilts	86,106	8.1	14.0
Multi Asset Credit	80,051	7.6	
Corporate Bonds (Global)	31,322	3.0	
Property	132,613	12.6	12.0
DGF/Absolute Returns	105,647	10.0	10.0
Private Equity	20,101	1.9	2.0
Infrastructure	26,770	2.5	3.0
Private Credit	71,579	6.8	10.0
Long Lease Property	0	0	5.0
Cash & Cash Equivalents	13,072	1.2	0.0
Totals	**1,053,934**	**100.0**	**100.0**

The overweight positions in both Equities and Bonds will adjust itself once the cash allocated to Long lease property is drawn-down. Total of 5% fund assets has been earmarked for investments in this asset class and a manager search is currently under way.

Current Asset Allocation by Manager

		Market Value As at 30 June 2018	**Actual Asset Allocation**
FUND MANAGER	**ASSET CLASS**	**£'000**	**%**
ADAMS STREET	Private Equity	13,595	1.3
LGT	Private Equity	6,465	0.6
AEW	Property	56,464	5.4
JP MORGAN	Corporate Bonds (Global)	80,051	7.6
LCIV - EPOCH	Global Equities	137,983	13.1
LCIV - RUFFER	DGF/Absolute Returns	105,647	10.1
M&G	Private Credit	11,228	1.1
MACQUARIE	Infrastructure	26,770	2.6
PERMIRA	Private Credit	60,351	5.8
LGIM	UK Equities	94,364	8.6
	Global Equities	115,233	10.9
	UK Index Linked Gilts	86,106	8.2
	Corporate Bonds (Global)	31,332	3.0
UBS EQUITIES	UK Equities	139,083	13.2
	Property	22	0
	Private Equity	41	0
	Cash & Cash Equivalents	5,120	0.5
UBS PROPERTY	Property	76,127	7.3
	Cash & Cash Equivalents	152	0
Non Custody	Cash & Cash Equivalents	47,461	0.7
		1,053,934	**100**

Note: Asset Market Valuation is at BID price, as per accounting requirements, which differs from the attached Northern Trust Performance report, which is measured at MID price.

3. Market and Financial climate overview

The FTSE All-Share index rose 9.2% over the period, enjoying strong relative performance versus global equities. UK equities bounced back as international investors reduced their underweight in the country, albeit sentiment towards the UK remains extremely negative. Prior to the period under review, the UK's unpopularity with international investors had hit levels not seen since the global financial crisis. This situation had weighed heavily on UK returns at a time when investor sentiment in general was fragile, amid fears that resurgent inflationary pressures in the US could derail the “Goldilocks scenario” of low inflation and stable growth. The absence of a rate hike was a further positive for UK equities, as it contributed to a renewed decline in the value of sterling against a strong US dollar. As a result, the more internationally exposed large caps outperformed mid caps. Ongoing merger and acquisition activity also supported returns over the period.

US equities advanced in Q2, with positive earnings momentum and supportive economic data ultimately outshining escalating US-China trade posturing. Consumer confidence remained strong and retail sales data suggested a rebound in consumption from a softer Q1. The unemployment rate also reached an 18-year low of 3.8%, accompanied by robust wage growth. Average earnings in May were 2.7% higher than a year earlier. As expected, the Federal Reserve (Fed) raised the target rate for Fed Funds by 0.25% and marginally increased its 2018 forecasts for growth and inflation. It now anticipates two further rate increases for this year and three for next. The positive economic data was, however, balanced by moves from the Trump administration to impose tariffs on Chinese imports, and withdraw from the Iran nuclear accord. In combination, the steps amounted to a more combative trade posture from the US, driving oil prices higher, and weighing on longer-term growth expectations.

Eurozone equities posted positive returns in the second quarter. Top performing sectors included energy, information technology and healthcare. Financials were among the main laggards, posting a negative return; Italian banks in particular struggled amid political uncertainty in May. Elsewhere, auto stocks fell against a backdrop of intensifying trade concerns as US President Trump threatened tariffs on imported vehicles. Economic data from the eurozone pointed to steady growth but at a slower pace than last year. GDP growth for the first quarter was 0.4%, down from 0.7% in Q4 2017. However, the flash eurozone composite purchasing managers’ index for June came in at 54.8, an improvement on the 18-month low of 54.1 seen in May. The European Central Bank (ECB) announced that it expects to end its quantitative easing programme in December 2018. The ECB added that interest rates would remain at current levels through the summer of 2019.

Emerging markets (EM) equities recorded a sharp fall in Q2 with US dollar strength a significant headwind. Escalation in global trade tensions also contributed to risk aversion as US-China trade talks failed to deliver a sustainable agreement. Meanwhile the US moved to extend steel and aluminium tariffs to the EU, Canada and Mexico, resulting in the announcement of retaliatory measures. The MSCI Emerging Markets Index recorded a negative return and underperformed the MSCI World.

Global bond markets suffered from bouts of volatility in Q2 due to a confluence of factors. These included a greater dispersion between accelerating US growth and a softening of economic activity elsewhere, escalating trade tensions between the US and China and the formation of a populist coalition government in Italy.
US 10-year Treasury yields rose from 2.74% to 2.86%. They rose significantly in April, touching a seven-year high in mid-May, as growth and inflation expectations continued to build, before risk aversion and “safe haven” buying led to a significant retracement. Bund 10-year yields fell from 0.50% to 0.30% on safe haven demand and as European data saw further softening.

4. Implementation of Long Dated Inflation Linked Property

Pensions Committee in March 2018 agreed to invest 5% of the portfolio in Long Lease Property: Long dated, inflation linked, contractual income. The committee discussed the direction to invest in this asset class at its meeting in July in light of access to this asset class not being available via the London CIV pool. Committee agreed to carry out its fiduciary duty and implement its strategy by undertaking due diligence of shortlisted managers with the view to invest outside the pool, until an offering is established when options would be reassessed. KMPG advised that the return on investment over the period in which it will take the London CIV to establish this asset class based on meetings with the CIV and the risk and return in going forward, coupled with the risk of unwinding in the future better meet the investment need of the beneficiaries of the fund than waiting.

KPMG carried out analysis into the best managers to meet the needs of the fund, that supply this product, and short listed 3 managers for selection to meet with and assess the best match for the Hillingdon Pension fund to match its investment strategy. Attached is a KPMG paper “Long Lease Property – Manager Selection Paper” which explains the process KPMG took to select and then shortlist opportunities for consideration, the report was written in advance of officers meeting the managers. On 21 September. Officers and Advisors met with the three shortlisted managers – Blackrock, LGIM and AEW - who each delivered a short presentation on their Funds.

All Funds would be capable of delivering value to the Hillingdon Fund and were relatively similar in costs. AEW and LGIM have pre-existing relationships with the Hillingdon Pension Fund. AEW were the most expensive provider but also offered a higher return. Blackrock and LGIM were similar in cost and return and both have an existing relationship with the London CIV; however, it is not clear that this investment would be taken on or possible to transfer to the CIV.

As each Fund had its own merits, the choice is largely subjective. Following a lengthy discussion, it was agreed that the LGIM offering would be recommended to Committee on the basis that we have existing investments with them, their inflation linkage was the strongest, there is significant government sector backing of leases and costs were lowest for this fund.

Recently, officers have been advised that the London CIV offering is expected to be rolled out sooner than expected, however there are currently no details of this offering. The LCIV expect this fund to launch in Q1 2019 and will be an inflation protection fund, which is likely to be wider than purely long dated inflation linked property and is expected to consist of two managers. The fund would also have a queue to deploy funds, although this may be quicker than the pooled funds in consideration. There are a lot of unknowns in relation to this offering at this time. A verbal update will provided if more details are available by the meeting date to take into consideration.

5. LCIV update

Sub funds available on the platform currently

Fund Name	Manager	Launch Date
UK Equities		
LCIV MJ UK Equity Fund	Majedie Asset Management	18-May-17
Global Equities		
LCIV EP Income Equity Fund	Epoch Investment Partners	08-Nov-17
LCIV Global Alpha Growth Fund	Baillie Gifford & Co	11-Apr-16
LCIV Global Equity Alpha Fund	Allianz Global Investors GMBH	02-Dec-15
LCIV LV Global Equity Fund	Longview Partners	17-Jul-17
LCIV NW Global Equity Fund	Newton Investment Management	22-May-17
LCIV RBC Sustainable Equity Fund	RBC Global Asset Management (UK) Limited	18-Apr-18
Emerging Market Equities		
LCIV HN Emerging Market Equity Fund	Henderson Global Investors Limited	11-Jan-18
Multi-Asset		
LCIV Diversified Growth Fund	Baillie Gifford & Co	15-Feb-16
LCIV NW Real Return Fund	Newton Investment Management	16-Dec-16
LCIV PY Global Total Return Fund	Pyrford International Limited	17-Jun-16
LCIV RF Absolute Return Fund	Ruffer LLP	21-Jun-16
Fixed Income		
LCIV Global Bonds Fund	Pyrford International Limited	Available pending capital
LCIV MAC Fund	CQS	31-May-18

The London CIV have been working on an infrastructure offering for London Boroughs and the full information pack should be available shortly, it is expected the product will be launched in Q4 2018.

Hillingdon Fund Investment with the London CIV

The Hillingdon Pension Fund currently invests in Ruffer and Epoch on the LCIV platform and LGIM, which sits alongside the LCIV Platform accessing the economies of scale created via the LCIV. The Fund has total LCIV holdings of £571m at 30 June 2018 accounting for 54% of total assets of the Pension Fund. Data from the London CIV shows the Hillingdon fund to be 6th out of the 32 boroughs in relation to the percentage of assets under management through the pool.

6. ESG, Voting and Engagement

As part of the Pension Committees role in making investment decisions it is required to take into account factors that are financially material to the performance of an investment and balancing returns against risks. This includes risks to the long-term sustainability of a company's performance, due to a number of factors including poor governance, environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees.

During the quarter ended 30 June 2018 the Hillingdon, investment managers made the following votes:

Fund Manager	Meetings Voted	Resolutions	Votes With Management	Votes Against Management	Abstentions
UBS	6,217	68,12	59,052	9,069	0
JP Morgan	929	13,923	12,496	1,406	21
LGIM	2,235	32,063	26,519	5,269	275

Voting reports obtained from managers reflected the period of the year when most companies in Europe and America hold their AGMs. Hence, increased voting activities across the three fund managers reported. UBS were the most active fund manager by attending and voting at more meetings. On average, the reported managers opposed about 14% of proposals at meetings attended.

ESG and climate change within the pension investments has been prominent, as it has been in other sectors of the media and within parliament in the last quarter. The Department of Work and Pensions, laid revised regulations before parliament in September 2018, requiring pension funds to include a policy on how they take account of financially material ESG considerations, including specifically climate change, "over the appropriate time horizon of the investments" in their statement of investment principles (SIP) by October 2019. Although these regulations apply to occupational pension schemes and not the LGPS, it is expected MHCLG will amend the LGPS regulations to match these changes in the near future.

The Environmental Audit committee called for a requirement for schemes to actively seek the views of their members when producing the SIP. This can have implications for defined benefit schemes as funds need to be able to pay beneficiaries the amount laid out in statute rather than an amount dependant on investment returns, and as a result repercussions to funding levels.

In addition the top 14 largest pension funds in the UK were approached by lawyers in July 18 suggesting they could face legal action if they ignore the consequence of climate change for their investment portfolios.

The law relating to fiduciary duty is complex and is defined by the Law Commission as ‘ensuring that pensions can be paid, ensuring that this is undertaken at the best possible value’. The Law commission clarified that pension funds could take into account environmental and social factors in their investment decisions, and should take them into account if they are financially material. As part of the Paris 2015 Agreement the government has committed to keep the global temperature increase to under 2 degrees and aim for 1.5 degrees; reports from Intergovernmental Panel on Climate Change, United Nations suggest that to meet this target 60-80% of fossil fuels would need to stay in the ground and not be used for energy production. Pension funds as part of their legal duty are required to consider longer term impacts of the investment portfolios and interest of the younger members of the scheme who could be more effected as a result of environmental issues.

The London CIV has recently drafted a Responsible Investment Policy for ratification at the next Shareholder meeting which aligns with the Hillingdon Pension Fund Investment Strategy Statement policy on ESG and responsible investment. In the last quarter the LCIV have also become a UNPRI signatory and both the Hilligndon pension fund and the LCIV are signatories to the UK Stewardship code.

FINANCIAL IMPLICATIONS

The financial implications are contained within the body of the report

LEGAL IMPLICATIONS

There are no legal implications in the report.