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 inflation and UK v. US Bonds.

The total size of the fund was £1,011m at 31 December 2018 a decrease £54m from £1,065m at the end of previous quarter. There was an overall investment return over the quarter of -5.02%, this was comparable to the benchmark. The estimated funding position at 31 December 2018 is 75.0% (78.9% as at 30 September 2018).

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 to invest 5% in the London CIV Infrastructure sub fund and invest 5% in UK IL Bonds through LGIM passive portfolio;**
4. **Delegate the implementation of any decisions to the Officer and Advisor - Investment Strategy Group.**

INFORMATION

1. Fund Performance

Over the last quarter to 31 December 2018, the Fund returned -5.02%, underperforming its benchmark return of -5.01% by 1 basis points. The Fund value decreased over the quarter by £54m, to £1,011m compared to the previous quarter.

Period of measurement	Fund Return %	Benchmark %	Arithmetic Excess
Quarter	(5.02)	(5.01)	(0.01)
1 Year	(2.67)	(1.97)	(0.70)
3 Year	7.63	7.24	+0.39
5 Year	6.68	6.51	+0.17
Since Inception (09/1995)	6.79	6.70	+0.09

During the quarter, distributions received from Alternative investments were $2.3m, €2.7m & £5.9m. The cash was utilised to fund drawdowns of outstanding commitments in Permira (£3.3m), Macquarie ($1.1m) and Adams Street ($45k). The biggest drag on performance in the quarter under review came mainly from the LCIV Ruffer Portfolio, -5.69 behind its benchmarks. Both Private Equity portfolios of LGT & Adams Street generated the best outperformance for the fund with 14.37% & 18.34% respectively above benchmark returns.

Relative performance over a one-year rolling period was 0.72% behind the benchmark with the largest detractors being JP Morgan and LCIV-Ruffer; with a return of -6.76% & -6.85% less than their respective benchmarks, whilst LGT & Adams Street with 19.85% & 22.87% relative excess performances the largest contributors.

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 31 December 2018 £'000	Actual Asset Allocation %	Benchmark Allocation %
UK Equities	118,262	11.70	44.0
Global Equities	330,092	32.64	
UK Index Linked Gilts	89,741	8.87	14.0
Multi Asset Credit	79,189	7.83	
Corporate Bonds (Global)	31,493	3.11	
Property	135,076	13.36	12.0
DGF/Absolute Returns	99,569	9.85	10.0
Private Equity	18,152	1.80	2.0
Infrastructure	27,262	2.70	3.0
Private Credit	70,388	6.96	10.0
Long Lease Property	0	0	5.0
Cash & Cash Equivalents	11,974	1.18	0.0
Totals	**1,011,198**	**100.0**	**100.0**

The overweight position Bonds will adjust itself once the cash allocated to Long lease property is drawn-down. A total of 5% fund assets has been allocated for investments in this asset class and in the queue awaiting drawdown.

Current Asset Allocation by Manager

		Market Value As at 31 December 2018	Actual Asset Allocation
FUND MANAGER	**ASSET CLASS**	**£'000**	**%**
ADAMS STREET	Private Equity	12,852	1.27
LGT	Private Equity	5,259	0.52
AEW	Property	58,432	5.78
JP MORGAN	Multi Asset Credit	79,189	7.83
LCIV - EPOCH	Global Equities	136,220	13.47
LCIV - RUFFER	DGF/Absolute Returns	99,569	9.85
M&G	Private Credit	9,449	0.93
MACQUARIE	Infrastructure	27,262	2.70
PERMIRA	Private Credit	60,939	6.03
LGIM			
	Global Equities	193,872	19.17
	UK Corporate Bonds	31,493	3.11
	UK Index Linked Gilts	89,741	8.87
UBS EQUITIES	UK Equities	118,262	11.70
	Property	22	0
	Private Equity	41	0
	Cash & Cash Equivalents	3,413	0.34
UBS PROPERTY	Property	76,622	7.58
	Cash & Cash Equivalents	381	0.04
Non Custody	Cash & Cash Equivalents	8,180	0.81
		1,011,198	**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 retreated 10.2% over the period, falling sharply, in line with global equities. It was one of the worst quarters for global equities in many years as fears over the outlook for the world economy came to a head against the backdrop of tightening global monetary conditions, US-China trade tensions and European political uncertainty. Many UK domestic-focused sectors also performed poorly as worries of a “no deal” exit from the EU intensified after the UK published its draft EU Withdrawal Agreement (endorsed by EU leaders) which triggered another period of intense political uncertainty. Despite the uncertainty, and the risk of a UK recession in the event of a “no deal”, the economy continued to recover from the very poor start to 2018. UK Q3 GDP growth came in at 0.6% quarter-on-quarter as expected, up from 0.4% in Q2 and the fastest pace since Q4 2016. More recent data, however, has been volatile: UK retail sales disappointed in October, falling -0.5% month-on-month, but bounced back very sharply in November, increasing by 1.4% month-on-month, which was significantly above consensus expectations. UK households enjoyed an acceleration in wage growth and lower inflation over the period.

US equities declined materially in Q4 - with especially steep falls in December - due to fears over economic momentum and slower earnings growth. The US-China trade dispute also continued to hamper investor optimism. The large cap S&P 500 index outperformed the small & mid cap Russell 2500 index (-16.7%), but still declined by -13.5%.The Federal Reserve (Fed) raised interest rates in December on continued stability in economic data. The labour market remained extremely strong. However, the central bank grew otherwise more dovish in tone, signalling a more cautious view for coming months. IT was amongst the quarter’s weaker sectors, while energy names struggled with expectations of softer China demand that weighed on oil prices. Less economically-sensitive sectors, such as utilities, generally performed better although most areas of the market lost ground.

It was a poor quarter for equities and Europe was no exception with the MSCI EMU index returning -12.7%. Worries over rising US interest rates, trade tariffs, slower Chinese growth and Brexit continue to combine to form a difficult environment for higher risk assets like shares. The defensive sectors of communication services and utilities – often perceived as safe havens due to their stable earnings throughout the cycle – were the only sectors to register a positive return. Materials and information technology were among the worst performing sectors.

The Japanese equity market reflected the deterioration in global sentiment, and ended the quarter down -17.6%. Emerging markets lost value in Q4 as the US-China trade dispute persisted and concerns over global growth increased. The MSCI Emerging markets index decreased in value but outperformed the MSCI World. Mexico was among the weakest index markets as rising concern over the incoming government’s policies, and the implications for investment, led to a sell-off in equities and the peso. The Asian EM of Taiwan, South Korea and China all underperformed with a combination of trade uncertainty, disappointing corporate earnings and technology cycle concerns a headwind.

Bond yields were lower over the quarter, broadly reflecting increased risk aversion and volatility amid continued macro uncertainty relating to trade tensions, Brexit and politics in Italy. US 10-year Treasury yields fell from 3.06% to 2.68%. In Europe, 10-year Bund yields declined from 0.47% to 0.24% as data remained lacklustre. At its final meeting of the year, the ECB confirmed it would end its bond purchase programme, but downgraded its growth and inflation forecasts for the year. Corporate bonds had a challenging quarter and underperformed government bonds. A deterioration of risk sentiment led to the broad-based underperformance across investment grade credit sectors relative to government bonds. High yield (HY) was weak, led down by the energy sector, particularly in the US.

4. Strategy Update

At the Pensions Committee in January 2019 it was agreed that the strategic asset allocation of 10% managed by Ruffer via the London CIV should be replaced with a 5% allocation to Infrastructure and 5% to bonds. Officers were asked to revert back with suitable replacement funds to implement this allocation. Included in the part II report is a paper by KMPG on what the allocation needs to achieve to meet the funding target objectives and a review of the most suitable offerings to implement this strategy through the London CIV.

Draft Statutory Guidance released by MHCLG in January for consultation reiterates that all investments should be transitioned and invested within the pool as quickly and cost effectively as possible. In the draft guidance it is stated that only in exceptional cases, can some existing assets be retained outside the pool on a temporary basis.

5. LCIV update

Currently open on the London CIV are
1 UK Equity sub fund
6 Global equity sub funds
1 Emerging Market Equity sub fund
4 Diversified Growth / Absolute Return funds
1 Multi Asset Credit fund
1 Global Bond Fund – opened November 18

The LCIV are currently finalising the set up of its infrastructure fund and Private Debt sub fund. Under consultation are inflation plus and property sub funds where an engagement pack has been issued to the funds on proposed offerings. An engagement pack will shortly be issued on a new Global Equity Core fund; within equities, the next step forward will be for Value and Sustainable exclusion sub funds.

The LCIV have recently appointed a permanent Chief Executive, Mike O'Donnell who will join to the team in March. The LCIV will now progress with its appointment of a Chief Investment Officer as this post have been temporarily covered jointly by the Head of Fixed Income and Head of Equities.

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 £551m at 31 December 2018 accounting for almost 55% of total assets of the Pension Fund.

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 31 December 2018 the Hillingdon investment managers made the following votes:

Fund Manager	Meetings Voted	Resolutions	Votes With Management	Votes Against Management	Abstentions
UBS	1,282	8,888	7,625	1,263	0
LGIM	480	4,140	3,499	637	4
JP Morgan	126	1,191	1,088	101	2

UBS were the most active fund manager by attending and voting at more meetings. On average, the reported managers opposed about 13% of proposals at meetings attended.

FINANCIAL IMPLICATIONS

The financial implications are contained within the body of the report

LEGAL IMPLICATIONS

There are no legal implications in the report.