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 Advisor Investment Reports

SUMMARY

This report reviews the fund management performance for the London Borough of Hillingdon Pension Fund for the period ending 31 December 2010. The value of the fund as at the 31 December was £588.7m.

RECOMMENDATION

1. **That the content of this report be noted and the performance of the Fund Managers be discussed.**

INFORMATION

1. The performance of the whole Fund for the quarter to 31 December 2010 showed an underperformance of 0.95% with a positive return of 5.13%, compared to the benchmark 6.08%. The Fund's underweight position in equities compared to its benchmark was the main reason for the deficit. One year figures show returns of 10.82% but behind the benchmark by 3.43%.

Performance Attribution Relative to Benchmark

	Q4 2010 %	1 Year %	3 Years %	5 Years %	Since Inception %
Goldman Sachs	0.14	0.47	(1.03)	(0.74)	(0.59)
UBS	0.17	(2.22)	(1.42)	(2.08)	1.05
Alliance Bernstein	(0.13)	(5.00)	(5.69)	-	(3.88)
UBS Property	(0.54)	(1.14)	(1.11)	-	(0.83)
SSgA	0.00	0.02	-	-	0.06
SSgA Drawdown	(0.17)	0.41	-	-	0.40
Ruffer	5.59	-	-	-	6.07
Marathon	(1.38)	-	-	-	3.23
Fauchier	0.66	-	-	-	(1.99)
Total Fund	**(0.95)**	**(3.43)**	**(3.08)**	**(2.46)**	**(0.51)**

Market Commentary

2. Equity markets continued to gain through the quarter with good returns from most regions. Overall developed markets outperformed emerging markets. The momentum was fuelled by the expectation that the US Federal Reserve would resume its quantitative easing programme and this drove prices through October. Confirmation of this was received in November and was in line with market expectations. November also saw prices ease as anxiety over weaker European nations emerged. Concerns over Ireland finally lead to the Irish government accepting support from the European Union. In December equities rallied following the decision by the US policy makers to continue with existing tax incentives, providing a boost to the economy and leading to improved expectations for US growth.

3. Bond yields rose during the quarter over expectations of rising inflation and the resumption of US quantitative easing. Yields also rose in the Eurozone periphery with concerns over Ireland, Portugal and Spain. Conversely inflation fears helped index linked bonds provide positive returns. Improving risk appetite led to a contracting of spreads within corporate bonds.

4. The UK commercial property had a strong finish to the year. This trend looks to continue, albeit at lower levels, with the forward looking real estate derivative market indicating gains for 2011.

MANAGER PERFORMANCE

5. **Manager: ALLIANCE BERNSTEIN**
Performance Objective: To achieve 2% above index returns over a full market cycle.
Approach: Alliance Bernstein is a bottom up stock picker relying on research based company fundamentals. They aim to perform well when the market discriminates between stocks and company fundamentals matter to investors.

Performance

	Q4 2010 %	1 Year %	3 Years %	Since Inception %
Performance	9.06	7.41	(3.58)	0.28
Benchmark	9.19	12.41	2.11	4.16
Excess Return	(0.12)	(4.45)	(5.57)	(3.73)

Alliance Bernstein claim that in general over the last three years there has been a flight to safety and that many equity movements have been driven by index trades rather than specific stock selection. As such the markets have not distinguished between stocks and Alliance Bernstein has been unable to add value. During 2009 fundamentals returned to an extent and the overseas element of the portfolio did contribute, however Alliance Bernstein was unable to capture gains in the UK and their underperformance in this region more than offset any overseas gains. Throughout 2010 global markets had rises and falls which were mainly driven by short term macroeconomic factors. Differences between companies were generally ignored with stock prices tending to move together. Again because of this lack of stock discrimination, and despite the change in mandate which removed the UK aspect of the portfolio, performance remained behind the benchmark in 2010. Alliance Bernstein have consistently maintained their philosophy as they hold a firm conviction that ultimately company fundamentals are the only thing that should count and as macroeconomic conditions improve investors should start to differentiate between stocks.

6. **Manager: FAUCHIER**
Performance Objective: The investment objective of the company is to achieve an absolute return.
Approach: The aim of the portfolio is to be diversified across 10-12 strategies and allocate to those strategies according to perception of the potential which exists to generate returns in any given strategy over a period of time.

Performance: To incorporate an element of risk adjusted return the benchmark has been set to include outperformance of an absolute benchmark, in this case cash, by a further 5%. In relation to this benchmark Fauchier have underperformed since inception (June 2010) albeit with outperformance in the last quarter. However since their appointment Fauchier have delivered a positive return of 0.86%, and as such have met in part their investment objective by delivering an overall absolute return. Further analysis shows there was a mix of performance in the underlying funds with Short Bias and Fixed Income struggling against the headwind of the equity rally. Conversely the rally benefited Equity Hedged Managers and concerns over inflation helped the Multiple Strategy funds make gains. Whilst the diversification of strategies helped provide an absolute return, market conditions meant those strategies also gave contrasting performance against the benchmark.

7. **Manager: GSAM**
Performance Objective: To outperform their benchmark indices by 0.75% per annum.
Approach: The corporate credit research process is grounded upon an analysis of the macro environment, commonly referred to as top-down analysis, along with a detailed understanding of the characteristics pertaining to each corporate entity, commonly referred to as bottom-up analysis. Multiple ideas resulting from this analysis are brought together and a balanced portfolio is constructed.

Performance:

	Q4 2010 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	(1.18)	9.08	5.78	5.81	5.87
Benchmark	(1.32)	8.61	6.81	6.55	6.46
Excess Return	0.14	0.47	(1.03)	(0.74)	(0.59)

In 2008, the portfolio returned (3.46%), while the benchmark returned 4.14%. This underperformance can be attributed to the top-down cross sector strategy, the bottom-up security selection of mortgage backed securities (MBS) and corporate securities. The year saw turmoil in the US housing markets and the financial crisis, spreads widened and the overweight position in corporates, was a strong detractor from relative performance.

During 2009, however, the portfolio returned 12.74% relative to benchmark performance of 7.73%, for an outperformance of 5.01%. Bouncing back from 2008, in 2009, the portfolio’s overweight to corporates and non-agency MBS within the cross-sector strategy, were strong contributors to performance. Corporate, government agency and collateralised security selection also contributed to the outperformance.

In 2010, the prospect of further accommodative monetary policy supported demand for riskier asset classes and growth trends started to look more positive around the world. The cross-sector and corporate selection strategies contributed positively to the portfolio’s outperformance versus the benchmark.

In general there is a tendency for bond managers to perform in harmony and to either outperform or underperform their benchmarks at the same time. If GSAM’s broad performance is compared with a selection of its peers, it shows three year returns behind the average. However the trend changes over the one year and in the current quarter with GSAM results ahead of the average.

8. **Manager: MARATHON**

Performance Objective: To achieve a return in excess of their benchmark index over a rolling five year period.

Approach: Marathon's investment philosophy is based on the capital cycle and the idea that high returns will attract excessive capital and hence competition, and vice versa. Given the contrarian and long-term nature of the capital cycle, Marathon’s approach results in strong views against the market and long holding periods by industry standards (5 years plus). Marathon believe “out of favour” industries and companies, highlighted by the capital cycle, are characterised by lack of interest and research coverage. Moreover, long-term price anomalies arise because business valuations and investment returns are not normally distributed due to the short-term focus of the investment industry. With a long-term view and fundamental valuation work, Marathon believes it can identify the intrinsic worth of a business. The process is by its very nature bottom-up with individual stock selection expected to drive investment performance

Performance: Since inception in June 2010 Marathon has outperformed against their benchmark of 14.63% by returning 17.86%. Given Marathon’s philosophy, research and focus on stock picking, it is perhaps not surprising that stock selection added most value over the six month period and two examples of this include Cablevision and Liberty Media. Both companies participated in the consolidation of the cable industry following the bursting of the TMT (Technology Media and Telecommunications) bubble and are now benefiting from their dominant positions in regional cable assets.

However whilst the mandate benchmark is based on developed markets, Marathon has the ability to also invest in emerging markets. As such any positive or negative returns from emerging market investments can unduly influence relative performance. A proxy to the mandate benchmark is the MSCI All Countries index which includes both developed and emerging markets. For the six month period this index has returned 18.80%, which is more comparable, if albeit slightly better, with Marathon's returns.

9. **Manager: RUFFER**

Performance Objective: The overall objective is firstly to preserve the Client's capital over rolling twelve month periods, and secondly to grow the Portfolio at a higher rate (after fees) than could reasonably be expected from the alternative of depositing the cash value of the Portfolio in a reputable United Kingdom bank.

Approach: Ruffer applies active asset allocation that is unconstrained, enabling them to manage market risk and volatility. The asset allocation balances investments in fear, which should appreciate in the event of a market correction and protect the portfolio value, with investments in greed, assets that capture growth when conditions are favourable. There are two tenets that Ruffer believe are central to absolute return investing which are to be agnostic about market direction and also to remove market timing from the portfolio.

Performance: Since their inception six months ago Ruffer has returned 6.50% and met their brief by preserving capital and growing the portfolio. Equities make up almost half of the portfolio and so outperformance and the increase in asset value was aided considerably by an overall appreciation within this asset class. Protective elements of the fund including gold and index linked bonds helped reduce volatility and the increase in gold prices also complemented performance.

An alternative approach to measuring against the absolute benchmark of cash is to construct a benchmark which better reflects the make up of the portfolio. In the case of Ruffer if the benchmark is split to show returns weighted at 45% equities, 40% index linked bonds and 15% cash, the performance for the six month period since inception is 10.43%. With equities being the largest contributor over the period, the mandate returns show that not all the gains were captured in this class. This was evident in the "put option" which was in place in order to add some protection against the market reversing recent gains.

10. **Manager: SSgA**

Performance Objective: To replicate their benchmark indices

Approach: The calculation of the index for passive funds assumes no cost of trading. In order to simply match the index, it is necessary to trade intelligently in order to minimise costs, and where possible, make small contributions to return in order to mitigate the natural costs associated with holding the securities in the index. Activities which SSgA employ to enhance income include; tactical trading around index changing events and stock lending. They also aim to alleviate costs by efficient trading through internal and external crossing networks.

Performance:

	Q4 2010 %	1 Year %	Since Inception %
SSgA Main Account			
Performance	6.36	14.18	21.52
Benchmark	6.36	14.16	21.46
Excess Return	0.00	0.02	0.06
SSgA Draw Down Account			
Performance a/c 2	(1.34)	4.79	6.59
Benchmark a/c 2	(1.17)	4.38	6.49
Excess Return	(0.17)	0.41	0.40

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.06%. The draw down fund which commenced June 2009 has also outperformed its benchmark and has delivered an excess return of 0.40%. In both cases SSgA has delivered against its objective.

Performance is not always flat and quarterly variances should be expected as a result of a number of factors including; cash drag, stock lending cycles and rights Issue opportunities, however over the longer period these are expected to smooth out.

11. **Manager: UBS**

Performance Objective: To seek to outperform their benchmark index by 2% per annum, over rolling three year periods.

Approach: UBS follow a value-based process to identify businesses with good prospects where, for a variety of reasons, the share price is under-estimating the company's true long term value. Ideas come from a number of sources, foremost of which is looking at the difference between current share prices and UBS's price target for individual stocks. The value-based process will work well in market environments where investors are focussing on long term fundamentals.

Performance:

	Q4 2010 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	7.55	12.29	2.70	3.92	10.23
Benchmark	7.38	14.51	4.12	6.00	9.18
Excess Return	0.17	(2.22)	(1.42)	(2.08)	1.05

Over the last three years performance is behind the benchmark by 1.42%. During 2008 much of the underperformance was attributable to the overweight position in UK banks which suffered considerably in the financial crisis. Following this, the mandate was taken over by Mark Powers and the weighting in financials was reduced. In 2009 market conditions changed and UBS's value approach and defensive position in mega caps paid off allowing the portfolio to outperform by 1.6%. In 2010 performance again fell behind the benchmark with the market environment favouring momentum and growth stocks over value.

To better determine performance and manager skill based on their investment approach, it is possible to measure against an alternative index. The above performance is benchmarked against the FTSE All Share, which includes all UK stocks regardless of the style of investing. UBS are a value based manager and will only hold stocks which represent their value style. If performance is measured against the FTSE UK Value index, which only includes value stocks, UBS have outperformed by 6.0% for one year and 2.1% for three years. These figures show that although over three years the manager is behind the mandate benchmark, they have added value and outperformed against their style. In addition comparisons between the two indices show that the value style has been out of favour when compared to growth and momentum styles.

12. **Manager: UBS Property**
Performance Objective: To seek to outperform their benchmark index by 0.75% per annum over rolling three year periods.
Approach: UBS take a top down and bottom up approach to investing in property funds. Initially the top down approach allocates sector and fund type based on the benchmark. The bottom up approach then seeks to identify a range funds which are expected to outperform the benchmark.

Performance:

	Q4 2010 %	1 Year %	3 Years %	Since Inception %
Performance	1.36	11.05	(6.83)	(2.99)
Benchmark	1.90	12.19	(5.72)	(2.16)
Excess Return	(0.54)	(1.14)	(1.11)	(0.83)

As the fund is based on the benchmark, normally performance should also reflect the benchmark, albeit with a margin of outperformance. However the initial fund set up and the subsequent part dissolution and reinvestment have resulted in transaction costs, which detract from performance. The timing of the part redemption was positive however, as the cash balance helped protect some absolute value when property prices fell in 2008/09. Since inception many of the underlying funds have outperformed, but not by a margin large enough to outweigh the fund set up costs. As the portfolio diversifies further out of Triton, transaction costs will continue to challenge the outperformance of the underlying funds.

Absolute Returns for the quarter

	Opening Balance £000's	Appreciation £000's	Income Received £000's	Net Investment	Closing Balance £000's	Active Management Contribution £000's
Alliance Bernstein	56,621	4,928	201	(6)	61,744	(85)
Fauchier	24,504	509	-	-	25,013	161
GSAM	66,483	(863)	75	-	65,695	84

Marathon	53,155	4,401	-	-	57,556	(765)
Ruffer	50,653	2,762	159	-	53,574	2,831
SSgA	127,519	6,479	-	(2,143)	131,855	(37)
UBS	103,659	7,067	717	(658)	110,785	232
UBS Property	44,963	180	430	-	45,573	(245)

13. The above table provides details on the impact of manager performance on absolute asset values over the quarter based on their mandate benchmarks. The outperformance of Fauchier, GSAM, Ruffer, and UBS had a positive impact on the appreciation of holdings contributing £3,308k in total. Underperformance from Alliance Bernstein, Marathon, SSgA and UBS Property reduced appreciation by £1,132k.

M&G Update

14. M&G have made two further investments during December and issued their first distribution.

Macquarie Update

15. Since the last quarter two new transactions have been completed increasing the total number of assets in the fund. Macquarie is currently pursuing several other opportunities in sectors such as power, roads, ports and logistics. It is expected that one or more of these transactions will be closed in the next three to six months.

Other Items

16. At the end of December 2010, £31.5m (book cost) had been invested in private equity, which equates to 5.34% of the fund against the target investment of 5.00%. However this level still remains within the limits of the over-commitment strategy of 8.75%. In terms of cash movements over the quarter, Adams Street called £1.314k and distributed £513k whilst LGT called £857k and distributed £270k.

17. The securities lending programme for the quarter resulted in income of £19.2k. Offset against this was £6.7k of expenses leaving a net figure earned of £12.5k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 December 2010 the assets on loan totalled £26.8m representing approximately 12.1% of this total.

18. For the quarter ending 31 December 2010, Hillingdon returned 5.13%, underperforming against the WM average by 0.57%. The one year figure shows an underperformance of 2.58% against and average return of 13.40%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None