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

SUMMARY

This report reviews the fund manager performance for the London Borough of Hillingdon Pension Fund for the period ending 31 March 2011. The value of the fund investments as at the 31 March was £594.1m.

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 Fund for the quarter to 31 March 2011 showed an underperformance of 0.54%, with a positive return of 0.81% compared to the benchmark of 1.35%. One year figures show returns of 5.04% but behind the benchmark by 3.21%.

Performance Attribution Relative to Benchmark

	Q1 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Goldman Sachs	(0.15)	(0.19)	(0.67)	(0.48)	(0.58)
UBS	(1.08)	(2.75)	(1.38)	(2.13)	0.98
Alliance Bernstein	(1.18)	(4.68)	(5.71)	(3.93)	(3.93)
UBS Property	0.23	(1.11)	(1.32)	(0.74)	(0.74)
SSgA	(0.01)	0.05	-	-	0.06
SSgA Drawdown	(0.02)	0.29	-	-	0.33
Ruffer	(0.82)	-	-	-	5.21
Marathon	(0.26)	-	-	-	3.01
Fauchier	0.60	-	-	-	(1.41)
Total Fund	**(0.54)**	**(3.21)**	**(2.88)**	**(2.53)**	**(0.54)**

Market Commentary

2. Equity markets began the first quarter of 2011 in a volatile fashion. Worries over European debt were put to one side and US equities continued in a positive trend leading to overall rises until mid February. Then concerns over US job losses,

European credit and global trade started to reinforced a sense of caution. This was then followed by the tragic events in Japan all of which culminated in falling equity indices. Investors then started to look at valuations and when the Bank of Japan added trillions of Yen of fresh liquidity, equity prices began to recover. This was carried forward to the end of the quarter. The quarter overall was positive with developed markets outperforming emerging markets.

3. Bond yields tended to rise over the quarter against a backdrop of upward inflationary pressures. This was particularly evident in Europe with concerns over Greece, Portugal and Ireland and with the expectation of an ECB rate rise in April. Investment grade and high yield credit spreads continued to narrow in line with generally improving equity markets.

4. The UK commercial property market managed a positive return over the quarter, but forward looking indicators have now moderated their previous positive view.

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

	Q1 2011 %	1 Year %	3 Years %	Since Inception %
Performance	0.77	1.37	0.46	0.42
Benchmark	1.95	6.05	6.17	4.35
Excess Return	(1.18)	(4.68)	(5.71)	(3.93)

Alliance Bernstein was unable to add value in the first quarter of 2011 with both security and sector selection detracting from returns. In aggregate emerging markets detracted the most and included technology firms such as Samsung and AU Optronics as well as financials such as HFDC and Halkbank. In line with previous underperformance, Alliance Bernstein claim there is potential in their holdings to add value which is yet to be rewarded. However the latest quarter's underperformance only adds to accumulating long term negative figures.

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 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) by 1.41% albeit with outperformance in the last quarter of 0.60%. However since their appointment Fauchier have delivered a positive return of 2.90%, and as such have met their investment objective by delivering an overall absolute return. Further analysis shows that there was broadly positive performance in the underlying funds with Equity Hedged Managers benefiting from the general increase in risk appetite and with the Fixed Income manager generating positive returns from tactical trading around short term rates. Specialist Credit Managers, Event Driven Managers and Multiple Strategy Funds were also positive with there respective approaches showing gains. The laggards within the fund were the Short Bias managers who struggled in the face of generally increasing equity markets.

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

	Q1 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	0.42	5.49	6.17	5.07	5.76
Benchmark	0.57	5.68	6.84	5.55	6.34
Excess Return	(0.15)	(0.19)	(0.67)	(0.48)	(0.58)

The top down analysis for Q1 failed to deliver results with negative performance in the country strategy and cross sector positioning. Within these areas the portfolio was not set up to deal with the softer than expected US data and hawkish ECB comments. The bottom up approach was more successful with corporate selection adding value with good positioning in utility issuers and being underweight in high quality UK names. The first quarter's results impacted the one year figure, turning positive results into underperformance. The first quarter of 2011 along with poor 2008 results are still more than offsetting the gains made during 2009 and 2010.

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 the current quarter, one year and three years results are slightly below the average, however the spread is not wide.

7. **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:
In the first quarter of 2011 the portfolio marginally underperformed the benchmark by returning 2.10% against a benchmark of 2.36%, with geographical allocation having the largest negative effect on performance. In contrast Marathon's stock selection remains successful adding the most value. Since inception in June 2010, the portfolio has outperformed delivering returns of 20.34% against the benchmark of 17.33%. Again stock selection was by far the strongest contributor to relative returns over the period.

Whilst the mandate benchmark is based on developed markets, Marathon has the ability to 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 nine month period this index has returned 21.16%, which is more comparable, if albeit slightly better than Marathon's returns.

8. **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 nine months ago Ruffer has returned 5.82% 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 by an overall appreciation within this asset class. However the latest quarter's fall in Japanese equities detracted from cumulative figures, as did gold which sold off in Q1.

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 nine month period since inception is 11.62%. With equities being the largest contributor over the period, the mandate returns show that not all the gains were captured in this class. This is still evident in the “put option” which is in place to protect against a downturn but continues to be a drag on performance, whilst in general equities keep rising.

9. **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:

	Q1 2011 %	1 Year %	Since Inception %
SSgA Main Account			
Performance	1.19	8.13	19.62
Benchmark	1.20	8.08	19.56
Excess Return	(0.01)	0.05	0.06
SSgA Draw Down Account			
Performance a/c 2	0.53	3.16	5.94
Benchmark a/c 2	0.55	2.87	5.61
Excess Return	(0.02)	0.29	0.33

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 0.33%. 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.

10. **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:

	Q1 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	(0.05)	5.97	5.99	2.98	10.10
Benchmark	1.03	8.72	7.37	5.11	9.12
Excess Return	(1.08)	(2.75)	(1.38)	(2.13)	0.98

Performance for the quarter was behind the benchmark and was primarily due to the sharp fall in the Dixons Retail Group share price in which the fund has a large holding. This along with the negative returns for 2008 and 2010, show one, three and five year figures still falling short of the benchmark. This indicates that cumulatively over these longer time frames the value style has been out of favour. However if the time horizon is extended further, the since inception performance is ahead of the benchmark by 0.98%.

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 a purely value index, which only includes value stocks, UBS have outperformed over the longer term by 3.5% for three years and 0.9% for five years. Performance over the last year alone shows a marginal underperformance of 0.1%. This can be attributed in a large part to the funds holding in BP, where UBS were overweight at the time of the Gulf of Mexico spill.

11. **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 of funds which are expected to outperform the benchmark.

Performance:

	Q1 2011 %	1 Year %	3 Years %	Since Inception %
Performance	2.13	7.98	(5.22)	(2.43)
Benchmark	1.90	9.09	(3.90)	(1.69)
Excess Return	0.23	(1.11)	(1.32)	(0.74)

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. Since inception many of the underlying funds have outperformed, but not by a margin large enough to outweigh the funds ongoing set up costs. As the portfolio diversifies further out of Triton, transaction costs will continue to challenge the outperformance of the underlying funds. In Q1, despite a further acquisition in the Unite Student Accommodation Fund, returns were ahead of the benchmark. This was mainly attributable to strong performance from the UBS South East Recovery Fund along with contributions from a number of other sub 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	61,744	234	242	-	62,220	(723)
Fauchier	25,013	506	-	-	25,519	149
GSAM	65,695	202	77	-	65,974	(99)
Marathon	57,556	1,211	-	-	58,767	(126)
Ruffer	53,574	(601)	260	-	53,233	(438)
SSgA	131,855	1,433	-	(2,207)	131,081	(6)
UBS	110,785	(827)	771	-	110,729	(1,198)
UBS Property	45,573	243	728	(3)	46,541	104

12. 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, and UBS Property had a positive impact on the appreciation of holdings contributing £253k in total. Underperformance from Alliance Bernstein, GSAM, Marathon, Ruffer, SSgA and UBS reduced appreciation by £2,590k.

M&G Update

13. There are now five holdings within the fund with a further two in the pipeline, which are expected to close in July 2011. The closing of the fund has been extended a further 12 months to July 2012, to allow for more time to increase and diversify the underlying holdings.

Macquarie Update

14. The fund is now over 50% invested with interests in telecom tower infrastructure, airports and power generation. The assets owned by the fund continue to perform in line with forecasts. Significant progress has been made on a new power generation plant investment, which has been pursued by the fund over the last six months. In addition to this, work continues on several other attractive investment opportunities across roads, power and logistics, of which several are expected to reach completion within the next 3 to 6 months. Macquarie and State Bank of India also completed the establishment of an Indian domestic fund that will co invest along side the fund, bringing together foreign and domestic capital in the same infrastructure projects

Other Items

15. At the end of March 2011, £30.2m (book cost) had been invested in private equity, which equates to 5.08% of the fund against the target investment of 5.00%. 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 £825k and distributed £74k, whilst LGT called £587k and distributed £879k.

16. The securities lending programme for the quarter resulted in income of £16.2k. Offset against this was £5.7k of expenses leaving a net figure earned of £10.5k. The fund is permitted to lend up to 25% of the eligible assets total and as at 31 March 2011 the average value of assets on loan during the quarter totalled £25.4m representing approximately 11.2% of this total. The annual gross income from the securities lending programme in 2010/11 totalled £115.7k with costs of £40.5k.

17. The passive currency overlay agreed by Committee was put in place at the end of January 2011 with 100% Euro and 50% Japanese Yen hedges. As at 31 March 2011 the hedges were in a £1.1m negative position and against a half hedge benchmark were down 0.75%. The interim figures were mainly attributable to expectations of a European Central Bank rate rise which strengthened the Euro, however fears over European Sovereign debt still loom and the Euro is still expected to weaken over the near term.

18. For the quarter ending 31 March 2011, Hillingdon returned 0.81%, underperforming against the WM average by 0.49%. The one year figure shows an underperformance of 3.16%, returning 5.04% against the average return of 8.20%.

FINANCIAL IMPLICATIONS

These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None