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 30 June 2011. The total value of the fund's investments as at the 30 June was £601.4m. (The value of the fund has since dropped around £30m following the recent market turbulence.)

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 30 June 2011 showed an outperformance of 0.03%, with a positive return of 1.64% compared to the benchmark of 1.61%. One year figures show returns of 16.26%, an underperformance of 3.04%.

Performance Attribution Relative to Benchmark

	Q2 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Goldman Sachs	0.10	0.40	(0.48)	(0.48)	(0.56)
UBS	0.55	0.69	(0.12)	(1.92)	1.00
UBS Property	0.32	0.18	(1.14)	(0.50)	(0.66)
SSgA	(0.06)	(0.15)	-	-	0.03
SSgA Drawdown	0.17	0.33	-	-	0.37
Ruffer	1.19	9.50	-	-	5.92
Marathon	1.46	4.48	-	-	4.47
Fauchier	(1.49)	(2.97)	-	-	(2.97)
Total Fund	**0.03**	**(3.04)**	**(2.45)**	**(2.51)**	**(0.57)**

Market Commentary

2. Equity markets were unsettled over the quarter with the ongoing issues in the Middle East and concerns over inflation and Eurozone debt. The quarter began positively, supported by encouraging economic data including the second consecutive large gain in US non farm payrolls and a wave of merger and

acquisition activity. Sentiment then turned negative during May and the early part of June following renewed concerns over the periphery of Europe and the potential for contagion to Spain and Italy. Standard & Poors announcement that it had downgraded the long term outlook for the US to negative, added to the downward trend in sentiment. Concerns over German and French banks as a result of their exposure to Greece continued to drag on equity performance until the end of June. Then votes in the Greek Parliament helped restore confidence and helped equity markets surge at the end of the quarter. Overall developed markets outperformed emerging with the UK providing the strongest performance over the quarter and managing to post a positive return.

3. Gilts benefited from a flight to quality over fears in the European bond market and the political stalemate over the increase in the US debt ceiling. Index linked bonds provided positive returns with inflation remaining a concern and little chance of an increase in the Bank of England base rate. Corporate bond spreads widened reflecting a rise in risk aversion. Markets focused on disappointing UK economic data, indicating a weak outlook for the consumer and ongoing uncertainty in peripheral Europe.

4. The UK commercial property market posted a positive return for the quarter comprising of capital growth and rental income, however there was no rental growth during the three month period. The office sector continues to be the best performing area as it has done for the past twelve months.

MANAGER PERFORMANCE

5. **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 2.97%. However since their appointment Fauchier have delivered a positive return of 2.84%, and as such have met their investment objective. For the quarter, returns were negative at 0.06% against a benchmark of 1.43%. A number of the underlying strategies did not perform well; Macro managers struggled to generate gains in a market increasingly driven by politics rather than economics, Equity Hedged managers lost money in a sentiment driven environment, Specialist Credit managers were slightly down in a relatively subdued credit market and Multiple Strategy managers were down with losses stemming from commodity related exposures. Positive impacts came from Event Driven managers who generally profited from an increase in corporate activity and Fixed Income managers also generated gains from tactical trading. (Due to a one month lag in obtaining information, Northern Trust's performance figures will differ from the Fauchier presentation)

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

	Q2 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	2.78	6.98	7.80	5.88	5.91
Benchmark	2.68	6.58	8.28	6.36	6.47
Excess Return	0.10	0.40	(0.48)	(0.48)	(0.56)

The top down analysis for Q2 failed to deliver results with the duration strategy detracting from results, as worse than expected macro economic data implied a slower than expected pace of interest rate rises. The cross sector strategy also detracted with an overweight position in corporate credit underperforming in line with riskier assets. Corporate selection was more successful with an overweight position in the media and cable sector adding to returns. The bottom up approach was positive with the strongest performance coming from positions in Lloyds Banking, Barclays, Anadarko Petroleum and Northern Ireland Electricity. Government/Agency was also positive with index linked securities outpacing the market.

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. This is shown in Q2 2011 where the median return for a group of bond managers was broadly in line with the benchmark and with around two thirds of funds performing within 1/4% of this. If GSAM's broad performance is compared with a selection of its peers, it shows the one year results are slightly behind the average, however the spread is not wide.

6. **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 second quarter of 2011 the portfolio outperformed the benchmark by returning 1.77% against a benchmark of 0.31%. As in the previous quarter, the geographical allocation had the largest negative effect on performance but in contrast Marathon's stock selection continues to be successful adding the most value. Since inception in June 2010, the portfolio has outperformed delivering returns of 21.13% against the benchmark of 16.66%. 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 twelve month period this index has returned 21.28%, which is more comparable, if albeit marginally better than Marathon's returns.

7. **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: Over the last year Ruffer has returned 10.25% and met their brief by preserving capital and growing the portfolio. For the quarter performance was also positive at 1.39% and with inflation generally on a rising trend across both developed and emerging markets, Index Linked Bonds performed well during this period. Ruffer's equity themes also contributed in a generally subdued quarter; with defensive stocks and beneficiaries of rising capital expenditure adding value. Factors which detracted included the funds holding in Sony, which suffered due to hacking attacks on customers accounts and also the failure of the Japanese authorities to weaken the Yen as Ruffer expected. Despite further rises in the underlying gold price, gold mining stocks continued to perform poorly, hindered by rising input costs and general equity risk aversion. The Put Option held to protect against a sharp sell off in equities also detracted from performance as markets ended up broadly flat over the quarter. (Due to a variation in the performance model and how accrued income is treated there is a difference in the Northern Trust reporting and Ruffer presentation)

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 benchmark performance since inception is 13.84%. As in previous quarters equities have been the largest contributor but the mandate returns indicate that not all the gains were captured in this class.

8. **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:

	Q2 2011 %	**1 Year %**	**Since Inception %**
SSgA Main Account			
Performance	1.69	20.46	18.33
Benchmark	1.75	20.61	18.30
Excess Return	(0.06)	(0.15)	0.03
SSgA Draw Down Account			
Performance a/c 2	1.20	3.20	5.81
Benchmark a/c 2	1.03	2.87	5.44
Excess Return	0.17	0.33	0.37

Since its inception in November 2008 the SSgA main portfolio has delivered a return in excess of its benchmark index of 0.03%. The Draw Down fund which commenced June 2009 has also outperformed its benchmark and has delivered an excess return of 0.37%. 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.

9. **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:

	Q2 2011 %	**1 Year %**	**3 Years %**	**5 Years %**	**Since Inception %**
Performance	2.46	26.32	8.42	4.25	10.11
Benchmark	1.91	25.63	8.54	6.17	9.11

Excess Return	0.55	0.69	(0.12)	(1.92)	1.00

Performance for the quarter was positive and ahead of the benchmark with the largest contributions coming from GlaxoSmithKline, William Hill and a reversal in performance of Dixons, which was a major detractor in the last quarter. The positive quarter and the fall out of Q2 2010's negative returns have improved the rolling one year figure which now stands ahead of the benchmark.

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 MSCI UK Value index, which only includes value stocks, UBS have outperformed over the one year time period by 18.0%, three years by 3.4% and five years 0.3%.

10. **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:

	Q2 2011 %	1 Year %	3 Years %	5 Years %	Since Inception %
Performance	2.12	7.89	(3.41)	(2.81)	(1.93)
Benchmark	1.80	7.71	(2.27)	(2.31)	(1.27)
Excess Return	0.32	0.18	(1.14)	(0.50)	(0.66)

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 Q2, there were no transactions within the fund and performance was positive against the benchmark with the best performance coming from the UBS Central London Office Value Added Fund (formally named the South East Recovery Fund). Despite a number of transactions taking place over the last twelve months performance against the benchmark for one year was also positive with strong performance from five 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
Fauchier	25,519	(16)	-	-	25,503	(383)
GSAM	65,974	1,759	78	-	67,811	73
Marathon	58,767	1,042	-	-	59,809	850
Ruffer	53,233	1,226	416	59,360	114,235	1,104
SSgA	131,081	2,151		(6,597)	126,635	(35)
UBS	110,729	1,375	1,349		113,453	609
UBS Property	46,541	551	435	(3)	47,524	149

11. 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 GSAM, Marathon, Ruffer, UBS and UBS Property had a positive impact on the appreciation of holdings contributing £2,785K in total. Underperformance from Fauchier and SSgA reduced appreciation by £418kk.

M&G Update

12. There are now six holdings within the fund and there is a further holding due to close in July. Discussions and due diligence continue with an additional four potential deals. Since inception the fund has delivered returns of 2.27%.

Macquarie Update

13. Macquarie Everbright Greater China Infrastructure Fund (MEGCIF) has completed its first close with commitments of US$488 million and a further US$250 million of co-investment capital. MEGCIF is on track for US$1 billion in total commitments with a second close in the third quarter of 2011 and third close planned for early 2012. These closes will include a number of potential investors that have indicated a strong appetite for MEGCIF. No capital calls have been made at 30 June 2011 as the first capital call for MEGCIF to cover establishment costs will be deferred over the near term. At the time of preparing this update, six transactions are being actively pursued with an approximate total investment value of up to US$850 million.

The Macquarie State bank of India Fund (MSIF) has completed its investment into Soham Renewable Energy for an amount of USD 28 million. Binding agreements related to this investment were executed in June 2011 and financial close will occur in July 2011. The current pipeline includes potential deals in the following sectors: Roads (US$ 200m), logistics (oil tanks – US$100m), port services ($US75 million), wind power (US$100 million).

Other Items

14. At the end of March 2011, £30.8m (book cost) had been invested in private equity, which equates to 5.12% 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 £394k and distributed £287k, whilst LGT called £1,067k and distributed £804k.

15. The securities lending programme for the quarter resulted in income of £25.8k. Offset against this was £9.0k of expenses leaving a net figure earned of £16.8k. The fund is permitted to lend up to 25% of the eligible assets total and as at 30 June 2011 the average value of assets on loan during the quarter totalled £22.3m representing approximately 10.6% of this total.

16. 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. The first quarterly roll occurred on the 3 May 2011 and resulted in a realised loss of £1.64m. Following the removal of Alliance Bernstein the hedges were revised and as at 30 June 2011 they were in a £259k negative position. In Q2 performance was ahead of the half hedge benchmark by 0.21%. Since inception results show an underperformance of 0.12%.

17. For the quarter ending 30 June 2011, Hillingdon returned 1.64%, outperforming against the WM average by 0.04%. The one year figure shows an underperformance of 1.54%, returning 16.26% against the average return of 17.80%.

18. Officers have also undertaken a longer term analysis of the movement in the total fund value against the MSCI world index over the last 10 years and the results are shown in the graph on the next page. It is worthy of note that the value of the fund has largely tracked the performance of the index and whilst the improvement in the last couple of years has been lower than the improvement in the index, the fall in 2009 was correspondingly less severe.

FINANCIAL IMPLICATIONS

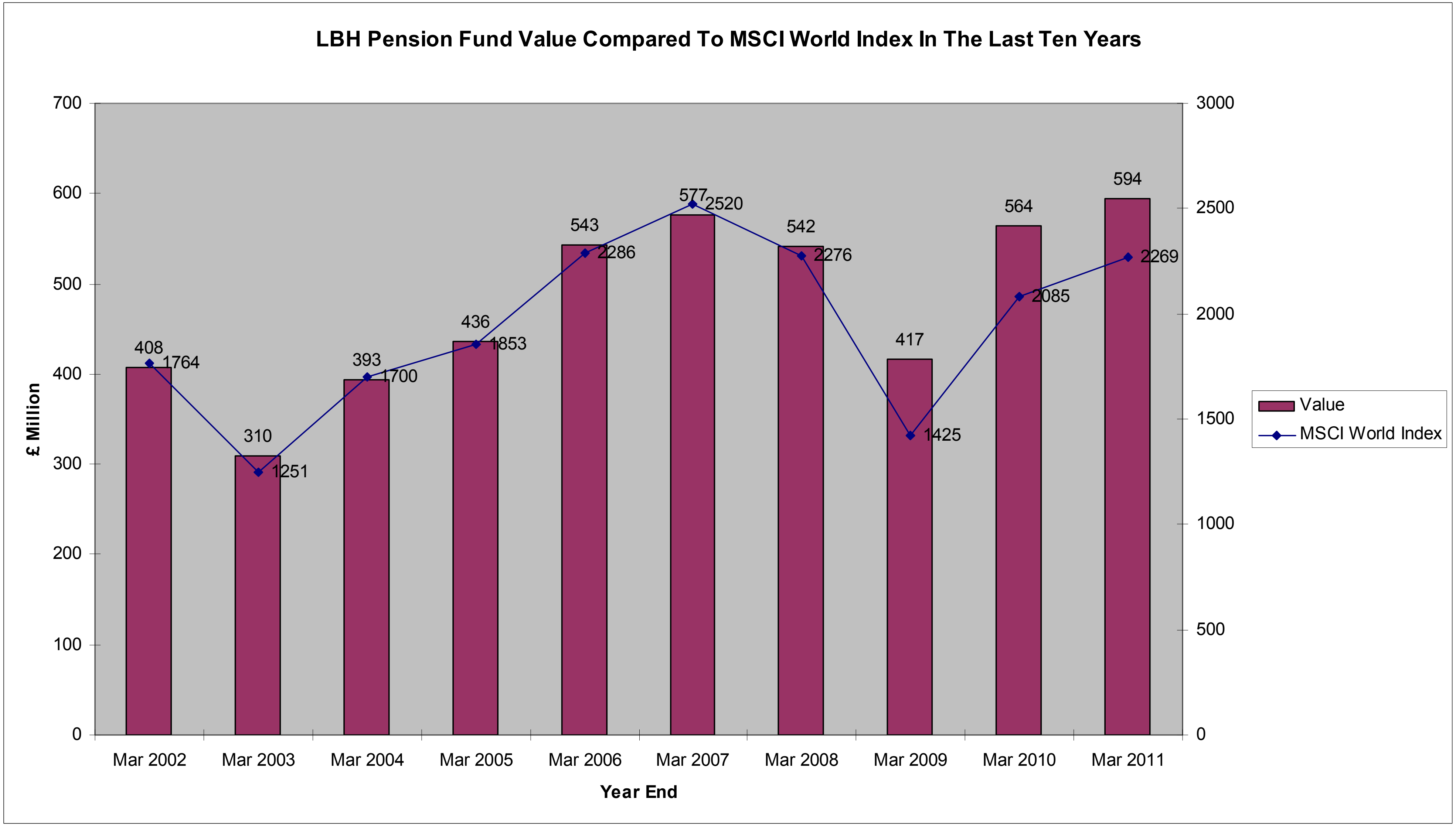
These are set out in the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

None



LBH Pension Fund Value Compared To MSCI World Index In The Last Ten Years
£ Million
700
600
500
400
300
200
100
0
3000
2500
2000
1500
1000
500
0
408
1764
310
1251
393
1700
436
1853
543
2286
577
2520
542
2276
417
1425
564
2085
594
2269
Mar 2002
Mar 2003
Mar 2004
Mar 2005
Mar 2006
Mar 2007
Mar 2008
Mar 2009
Mar 2010
Mar 2011
Year End
Value
MSCI World Index