Croydon Council

REPORT TO:	**PENSION COMMITTEE** **18 October 2016**
AGENDA ITEM:	**10**
SUBJECT:	**Progress Report for Quarter Ended 30 June 2016**
LEAD OFFICER:	**Richard Simpson** **Executive Director of Resources**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**

CORPORATE PRIORITY/POLICY CONTEXT:

Sound Financial Management: Reviewing and ensuring that the performance of the Council's Pension Fund investments are in line with their benchmark and in line with the assumptions made by the Actuary.

FINANCIAL SUMMARY:

This report shows that the market value of the Pension Fund (the Fund) investments as at 30 June 2016 was £915m compared to £863.2m at 31 March 2016, an increase of £51.8m, equivalent to 5.9% over the quarter. The performance figures in this report have been compiled from data provided by each fund manager and are quoted net of fees. Independent information and analysis on the fund managers and markets have been provided by the Fund's independent investment advisor AON Hewitt.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

1 RECOMMENDATIONS

1.1 The Committee are asked to consider and note the contents of this report.

1.2 The Committee is asked to agree that the delegation to select fund managers granted to the Assistant Chief Executive (Corporate Resources & s151 Officer) in consultation with the Chair of the Pension Committee on 8 September 2015 (Minute A29/15 refers), should henceforth refer to the Executive Director of Resources following a change in title of the Assistant Chief Executive

2 EXECUTIVE SUMMARY

2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 30 June 2016. This report represents a break from the earlier established format; with the introduction of regional pools focus will, in the longer run, shift away from individual fund manager's performance. At the same time the previous arrangements for generating independent performance monitoring metrics have ended. These twin developments offer an opportunity that allows the Committee to scrutinise more efficiently the effectiveness of strategic policy decisions in ensuring that the Croydon Fund generates sufficient returns so that, when contributions are taken into account, it is sufficient to pay out pension scheme entitlements. With less focus required on individual fund's performance, the Committee can invest more attention towards how to address risks jeopardising this outcome.

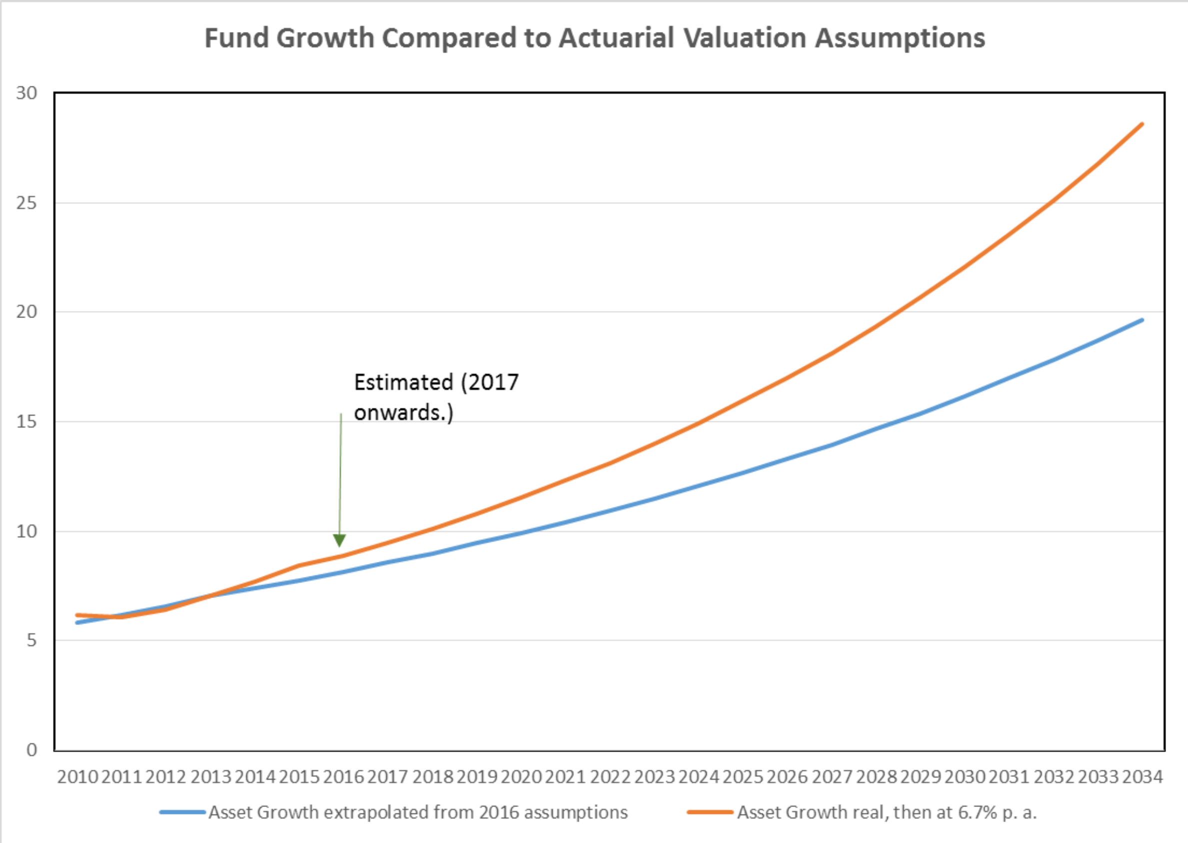
2.2 The report thus falls into three parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and how that is being applied. The third and final section deals with risk management. Detailed numeric data and commentary from the Fund's advisors is included as appendices to this report for readers who are interested in that deeper analysis.

3 DETAIL

Section 1: Performance

3.1 The investments comprising the Croydon Fund are expected to outperform gilt yields by 2%. This target, established by the 2013 Actuarial Valuation, is set out in the Funding Strategy Statement (FSS) adopted by this Committee 8 July 2014 (Minute A18/14). This will be revised by the 2016 Triennial Actuarial Valuation which is currently being undertaken and which has agreed upon an asset outperformance assumption of 2.2% over gilts (gilt yield being assessed by the market as being 4.5%), currently equivalent to 6.7% in total. At the time of the 2013 valuation the asset outperformance assumption had increased from the figure set in 2010 because of two factors: the Fund's high allocation to return seeking assets and the Fund's view that gilt markets at the valuation date were temporarily depressed by the Government's quantitative easing programme. Both of these factors are still applicable. The assumption at the time of the 2013 valuation was that gilt yields would be 3% so the real expected return, otherwise described as the discount rate, was 5%. That valuation also assumed that the funding gap would be closed over a 22 year period. However, as a risk based model has been adopted, the recovery period is less critical.

3.2 The following graph has been compiled from this information. The blue line shows the expected track of the value of assets growing in line with the FSS assumptions. This will be adjusted in the light of the 2016 and subsequent valuations. The orange line shows the actual value of the Fund to date and plots the course of growth over subsequent years using the same assumptions. This is a simplistic measure of the success of the strategy which does not take account of other variables, such as changes in demographic factors, wage inflation forecasts and other assumptions and that does not reflect changes in cash contributions nor movements in the gilt yield curve. However it is valuable as a tool to help track whether the direction of travel is in the right direction.



3.3 Details of the performance of individual components of the portfolio are summarised in Appendix A. As the portfolio has been built on the premise that diversification mitigates the impact of return volatility, the performance of individual investments is less important than the return of the Fund in aggregate and certainly cannot be assessed over less than a full cycle, and the duration of the cycle will vary from asset to asset.

Section 2: Asset Allocation Strategy

3.4 A new asset allocation strategy was approved at the Committee meeting held on 8 September 2015 (Minute .A29/15 refers). Recognising that there are a number of factors dictating the delivery timeframe for the asset allocation, namely: the selection process and time taken to undertake due diligence; the revision of the LGPS investment regulations; and the role of the London CIV; delivering the revised asset allocation remains a work in progress.

3.5 This asset allocation will give rise to a portfolio which can be broken down as follows:

Equities including allocation to emerging markets.			42%	+/- 5%
Fixed interest			23%	+/- 5%
Alternates			34%	+/- 5%
Comprised of:				
	Private Equity	8%		
	Infrastructure	10%		
	Traditional Property	10%		
	PRS	6%		
Cash			1%	
			100%	

3.6 **Progress towards revised asset allocation**

3.6.1 **Private Equity -** During the quarter the Fund signed up to a $25m commitment with Markham Rae Trade Capital Partners and it is anticipated that a third of this will be drawn by the scheme year end. The Fund has also agreed a further commitment of €20m (subject to satisfactory Legal review of contract documentation and due diligence) to another Private Equity fund. £4.5m was drawn by our existing private equity managers meaning the allocation increased from 6.1% to 7.5% over the quarter and we are expecting the 8% allocation to be filled by the scheme year end.

Allocation: on target.

3.6.2 **Infrastructure –** During the quarter £2.3m was drawn by existing infrastructure managers increasing the allocation from 4.5% to 5%. At the time of writing this report the Fund had signed up to a commitment of £25m to The Green Investment Bank Offshore Wind Fund and officers are expecting the majority of our commitment to be drawn soon. Officers are also looking at two other opportunities which will enable the Fund to meet the target asset allocation.

Allocation: on target.

3.6.3 **Traditional Property –** The target allocation has been met and officers are expecting this level of investment to continue as Schroder, the Fund's property manager reinvests the income generated by the current portfolio of assets.

Allocation: achieved target level.

3.6.4 **Private Rental Sector -** The Fund signed a commitment of £25m to the M&G UK Residential Fund in January 2016 and the Fund has now reached the front of the queue for draw downs (this fund was heavily over-subscribed). At the time of writing this report £5.1m had been drawn and we are expecting our full commitment to this fund to be drawn by the end of the scheme year. We are currently exploring options with the London CIV in order to fill the rest of the allocation.

Allocation: on target.

The table below illustrates the movement in the Fund's valuation during the quarter and the current asset allocation against the target.

London Borough of Croydon Pension Fund
Fund valuation and asset allocation for the quarter ending 30 June 2016

	Valuation at 31/03/2016 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 30/06/2016 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**56.9%**	**42%**
Legal & General World DB	61,962	- 15,000	4,183	51,145		
Legal & General FTSE4Good	438,802	-	31,059	469,861		
Fixed Interest					**20.4%**	**23%**
Standard Life	121,355	-	2,812	124,167		
Wellington	59,124	-	3,524	62,648		
Infrastructure					**5.0%**	**10%**
Temporis	5,684	1,719	- 95	7,308		
Equitix	32,988	606	4,795	38,389		
Private Equity					**7.5%**	**8%**
Knightsbridge	14,337	654	801	15,792		
Pantheon	40,750	1,420	5,741	47,911		
Access	1,579	2,462	651	4,692		
Property					**10.2%**	**10%**
Schroders	95,732	-	- 2,323	93,409		
Property PRS					**0.0%**	**6%**
M&G						
Cash					**0.0%**	**1%**
Cash	- 3,212	3,103	-	- 109		
Fund Total	**869,101**	**- 5,036**	**51,147**	**915,212**	**100%**	**100%**

3.7 Including commitments made before the beginning of the year a further £164 million will be invested in private equity, infrastructure and property funds. This will be funded by cash from a combination of employer contributions, dividends paid in cash and cash disinvested from the equity portfolio. Depending on the opportunities identified by fund managers these sums may be drawn down over a period of several years. It should be noted that, even after the cash invested in equities but earmarked for other investments is invested, the portfolio will be over-weight in the equity asset class. This will be corrected over a period of time as investment opportunities in infrastructure and private rental sector funds are identified.

3.8 Members should note that at present, none of these investments feature on the London CIV's project plan to establish sub-funds and accommodate transferred investments. Nevertheless one of the core objectives for the pooling project has been achieved as the London CIV has negotiated a significant discount for equity fees.

3.9 Members' attention is drawn to the relative performance of equities compared with property. As the impact of Brexit worked its way through the markets, the fall in the value of Sterling gave a lift to equities whilst property was quite severely marked down. Thus the strategy of diversification across asset classes protected the portfolio from excess volatility and provided a degree of downside protection.

Section 3: Risk Management

3.10 The principle risk addressed by the Funding Strategy is that returns on investment will fall below the target asset outperformance assumption to ensure that the Pension Fund matches the value of liabilities in the future. Dependent upon that are of course a number of issues.

3.11 The global economy will always represent a specific risk and opportunity for the Fund and will effectively be impossible to quantify or evaluate. As each asset class, investment strategy and characteristic will be impacted differently by any number of macroeconomic scenarios it is critical to ensure that the portfolio is sufficiently diversified. This will ensure that opportunities can be exploited and downside volatility reduced as far as possible.

3.12 In terms of the Pension Fund investment strategy in relation to the global picture, officers believe:

- The domestic US economy will continue to grow at a healthy rate and the outcome of the presidential election will not have a lasting impact on this outlook.

- China will also continue to demonstrate strong growth and this will be critical in stoking the continued expansion of emerging markets. By and large emerging market revenue account issues have been resolved.

- There remain concerns about the European economy, especially around German and Italian banks and the unresolved Euro question.

3.13 However there are equally many opportunities that can be exploited by very focused fund managers. The wave of elections culminating in the German Chancellor in October 2017 will create conditions of volatility that can be opportunities to capture returns.

3.14 The role of Central Banks in guiding local economies and that specific impact on the global economy remains an area for concern. Interest rates and inflation both represent significant headwinds impacting on the valuation of liabilities and the investments designed to match them.

3.15 Concentration risk is a particular concern, especially considering the extent to which the Fund is over-weight in equities. 9% of the value of the portfolio is invested in the top 10 stocks and arguably these are heavily correlated.

3.16 The portfolio term Brexit encompasses a number of risks. Immediate concerns that the UK economy would register a shock have not materialised. The fall in the relative value of sterling has masked a long term issue around productivity and actually benefitted the portfolio. Other concerns may manifest themselves in the future. One issue that seems certain to impact the fund is that of passporting and the cost of accessing investment opportunities. Although it is unlikely that performance will suffer there is a greater risk that costs, incurred by fund managers, as a function of being a custodian, and officer time, will increase. It is unlikely that these costs could be mitigated by negotiation or the use of pooling arrangements.

3.17 AON Hewitt, the Fund's investment advisor, have drafted a Manager Monitoring Report, a Market Review for the 3 months to 31 March 2016 and a Quarterly Investment Outlook which provides context for this risk analysis. These reports are included in the closed part of this Committee agenda.

Governance

3.18 Due to an internal restructure within the Council and an alteration in job title the Committee is asked to note and agree that the delegation to select fund managers granted to the Assistant Chief Executive (Corporate Resources & s151 Officer) in consultation with the Chair of the Pension Committee, should henceforth refer to the Executive Director of Resources.

4 CONSULTATION

4.1 Officers have fully consulted with the Pension Fund's advisers in preparing this report.

5 FINANCIAL CONSIDERATIONS

5.1 This report deals exclusively with the investment of the Council's Pension Fund and compares the return on investment of the Fund against the benchmark return.

6. COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

6.1 The Acting Solicitor to the Council comments that there are no direct legal implications arising from the recommendations within this report.

(Approved for and on behalf of Jacqueline Harris-Baker, Acting Council Solicitor and Acting Monitoring Officer)

7. FREEDOM OF INFORMATION/DATA PROTECTION CONSIDERATIONS

7.1 This report contains only information that can be publicly disclosed. The confidential information is reported in the closed part of the agenda.

CONTACT OFFICER:

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BACKGROUND DOCUMENTS:

Quarterly reports from each fund manager (circulated under separate cover)

APPENDICES:

Appendix A: Fund Returns

The following appendices are commercially sensitive:

Appendix B: AON Hewitt Manager Monitoring Report
Appendix C: AON Hewitt Market Review: 3 months to 31 March 2016
Appendix D: AON Hewitt Quarterly Investment Outlook