Croydon Council

REPORT TO:	**PENSION COMMITTEE** **6 December 2016**
AGENDA ITEM:	**9**
SUBJECT:	**Progress Report for Quarter Ended 30 September 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 September 2016 was £981.5m compared to £915.2m at 30 June 2016, an increase of £66.3m and a return of 6.05% 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.

2 EXECUTIVE SUMMARY

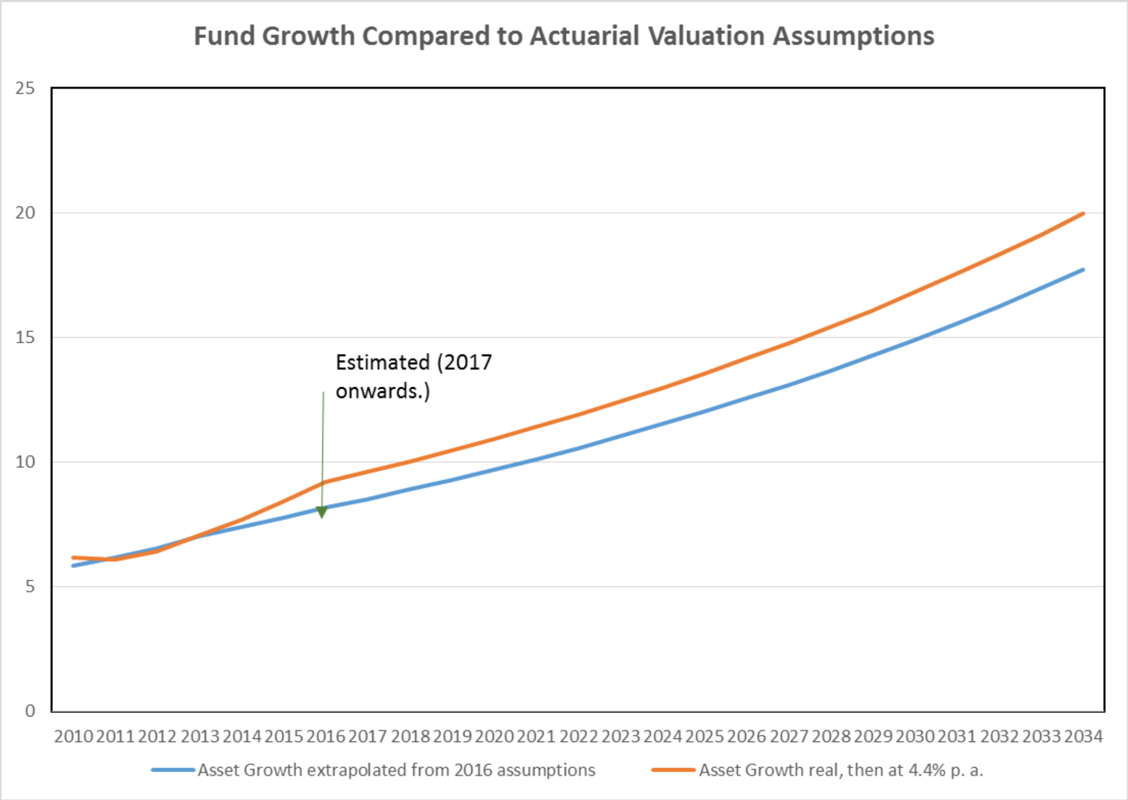
2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 30 September 2016. The report falls into three parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and 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 2.2%), currently equivalent to 4.4% in total. 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 –** A net investment of £3.5m has been made with our existing private equity managers; coupled with increases in their valuations, this has lead to our allocation increasing from 7.5% to 7.8%. The Fund is also undergoing Legal due diligence on another Private Equity fund, which is expected to be completed by the year end. This will bring the Fund up to the 8% target allocation. Going forward, further opportunities will be explored with existing managers and potentially new mangers in order to maintain the allocation in line with the target.

Allocation: on target.

3.6.2 **Infrastructure –** During the quarter a net investment of £0.2m was drawn by existing infrastructure managers and although valuations increased, they did not increase at the same rate as the rest of the portfolio, so the allocation percentage decreased from 5.0% to 4.7%. During the next quarter we are expecting over £25m to be drawn, the majority of this by The Green Investment Bank Offshore Wind Fund. 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). During the quarter £5.1m was drawn by M&G and a further £3.9m will be drawn in the next quarter. We are currently exploring options with the London CIV in order to fill the rest of the allocation.

Allocation: on target.

3.6.5 **Global Equities –** The Fund remained overweight at 56.9% when compared to the previous quarter, despite £7.5m being transferred to other assets. This is due to the strong performance of equities continuing over the quarter. A further £25m is planned to be transferred from global equities to infrastructure over the next quarter. Members will be aware that the asset allocation strategy recognized that moving from the previous asset allocation would be a gradual process, driven by the availability of opportunities. It is also recognized that the preservation of returns is important. Consequently the current over-weight position in equities represents a positive benefit to the Fund. This must intentionally be a short-term position and the transfer of funds to other alternate asset classes, as described above, is part of the process of locking in some of the recent returns. The Fund's view is that this beneficial environment will persist for a while yet. Officers will continue to identify opportunities within the asset allocation strategy which will be funded by taking some of the growth in value from the equity allocation.

3.6.6 **Fixed Interest –** The Fund is currently underweight in its fixed income allocation and this is largely due to outperformance of other assets. Officers are exploring alternate opportunities to our traditional bond portfolio including debt managers.

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 September 2016

	Valuation at 30/06/2016 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 30/09/2016 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**56.9%**	**42%**
Legal & General World DB	51,145	- 7,500	3,955	47,600		
Legal & General FTSE4Good	469,861	-	41,029	510,890		
Fixed Interest					**19.7%**	**23%**
Standard Life	124,167	-	4,623	128,789		
Wellington	62,648	-	1,782	64,430		
Infrastructure					**4.7%**	**10%**
Temporis	7,308	659	- 0	7,967		
Equitix	38,389	- 486	632	38,535		
Private Equity					**7.8%**	**8%**
Knightsbridge	15,792	- 235	942	16,499		
Pantheon	47,911	- 394	3,391	50,908		
Access	4,692	4,179	208	9,079		
Property					**9.5%**	**10%**
Schroders	93,409	-	- 257	93,152		
Property PRS					**0.5%**	**6%**
M&G		5,130	- 195	4,935		
Cash					**0.9%**	**1%**
Cash	- 109	8,786	7	8,684		
Fund Total	**915,212**	**10,139**	**56,116**	**981,467**	**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, although this has since recovered slightly. 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 30 September 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.

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 Council Solicitor comments that there are no additional legal implications arising by virtue of the recommendations in this report.

6.2 (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.

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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 30 September 2016

Appendix D: AON Hewitt Quarterly Investment Outlook