Croydon Council

REPORT TO:	**PENSION COMMITTEE** **19 September 2017**
AGENDA ITEM:	**6**
SUBJECT:	**Progress Report for Quarter Ended 30 June 2017**
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 2017 was £1,102.1m compared to £1,091.5m at 31 March 2017, an increase of £10.6m and a return of 1.22% 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

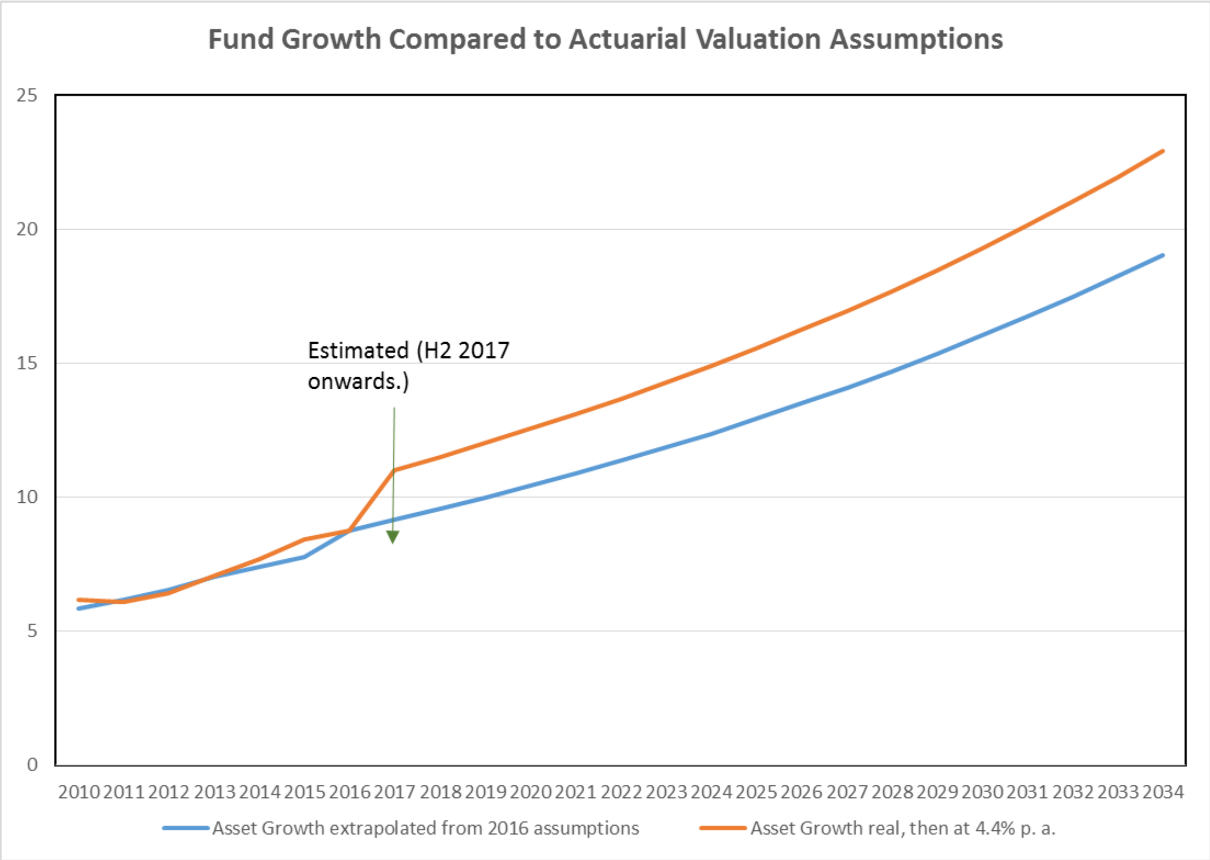
2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 30 June 2017. The report falls into three parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and how that is being applied. The third section deals with risk management and the fourth and final section summarises the recent investment manager site visit. 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 2016 Triennial Actuarial Valuation has recommended an asset outperformance assumption of 2.2% over gilt yields, meaning an asset return assumption, otherwise described as the discount rate, of 4.4%. The valuation also assumes that the funding gap will be closed over a 22 year period. However, as a risk based model has been adopted, the recovery period is less critical. In setting the Pension Fund's investment strategy, performance is measured against a benchmark return of CPI + 4% for the whole fund. Achieving this benchmark return will ensure the investments achieve a higher return than as calculated in the valuation and assuming other assumptions remain constant, the funding gap will reduce.

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 2016 valuation assumptions. This will be adjusted after 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. The returns for L&G, Standard Life, Wellington and Schroders are calculated on a time series basis. This basis negates the effect of any cash flows made to and from a manager's portfolio (the reason being that the timing of investments and disinvestments is not the manager's decision) and so allows the performance of those managers to be compared fairly with their benchmarks and peers. The returns for Equitix, Temporis, GIB, Knightsbridge, Pantheon, Access and M&G are calculated using the Internal Rate of Return (IRR). Using the IRR considers the effect of cash flows and this is deemed appropriate for these managers as the timing of investments is determined by the manager. Due to the nature of these investments, little attention should be paid to the performance for immature investments; Temporis, GIB, Access and M&G, and more attention should be made to the performance since inception for the more mature investments; Equitix, Knightsbridge and Pantheon. The whole of fund return uses the IRR as this is in line with the Actuary when calculating the valuation. It should be noted that 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 (Commercial) Property	10%		
Private Rental Sector (Residential Property)	6%		
Cash		1%	
		100%	

3.6 **Progress towards revised asset allocation**

Since the revised asset allocation was agreed £54.2m has been disinvested from global equities and £32.2m from hedge funds. This along with new cash to the fund has been invested; £19.9m in private equity, £46m in infrastructure, £25m in PRS and £6.4m in property.

3.6.1 **Private Equity –** Net distributions of £1m were paid to the fund by our existing private equity managers. Strong positive returns over the quarter meant the allocation increased from 7.8% to 8.1%. No further new commitments are currently required in private equity portfolio. The allocation is considered on target.

Allocation: achieved target allocation early.

3.6.2 **Infrastructure –** During the quarter a net investment of £0.6m was drawn and positive contribution to returns meant the allocation percentage increased from 7.5% to 7.7%. Two new funds have been identified and legal due diligence is being carried out in order to commit a further £50m. This together with further drawdown from Equitix and Temporis will enable the Fund to meet the target asset allocation well ahead of the original timetable.

Allocation: on target to meet allocation before the original planned date of 31 December 2019.

3.6.3 **Traditional Property –** The target allocation has slipped 1% below the target allocation. During August £10m was transferred to Schroders, who have identified opportunities to deploy the capital. This should bring the allocation back towards the 10% target by the end of September 2017.

Allocation: Below target, but action taken to rebalance back towards target.

3.6.4 **Private Rental Sector -** The Fund signed a commitment of £25m to the M&G UK Residential Fund in January 2016 and during the quarter ending 31 December 2016 signed a commitment for a further £35m with M&G. The first tranche of £25m has now been fully drawn and the allocation increased from 1.8% to 2.2% over the quarter. We anticipate the second tranche drawn over the second half of 2018.

Allocation: on target to meet allocation by 31 December 2018 as planned.

3.6.5 **Global Equities –** The Fund's allocation to equities remained overweight at 53.0% when compared to the previous quarter of 53.2%, a movement of 0.2 %. Equities provided positive gains over the quarter, although these have been much lower than experienced over the previous year. 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.

3.6.6 **Allocation to emerging markets –** At the start of 2016 Officers ran a search process through bfinance in order to select an emerging markets fund to manage 5% of the Fund's allocation earmarked for emerging markets. The initial search process resulted in 77 offerings and officers spent considerable time in selecting Wells Fargo Asset Management. The strategy is based on investing in companies in Emerging Markets that have a sustainable dividend yield 100 basis points above the average yield of the MSCI Emerging Markets Index at the time of purchase. One of the main reasons for selecting the strategy was that it offers considerable protection compared to other strategies, when emerging markets are on a downward cycle. Since the selection Wells Asset Management have enhanced their ESG credentials to be in line with our views which is a great benefit to the Fund. Wells Fargo bank has received negative press over the course of the year, but Officers have been assured that action has been taken to address the issues. It must also be stressed that no issues have been raised in the asset management arm of their business. AON Hewitt currently rate this strategy "Qualified" following the quantitative screening their research team carry out on the peer group. While the screening has not identified any significant concerns or any material flags, their research team have not formally reviewed the strategy as it historically has not passed our screening tests due to its size.

3.6.7 **Fixed Interest –** The Fund has moved to below the lower end of the target range 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 London CIV is currently in the process of putting together a Fixed Interest offering which Officers are following closely.

3.7 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 2017

	Valuation at 31/03/2017 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 30/06/2017 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**53.0%**	**42%**
Legal & General FTSE4Good	580,793	-	3,727	584,521		
Fixed Interest					**17.3%**	**23%**
Standard Life	128,077	-	579	128,656		
Wellington	63,079	-	- 541	62,538		
Infrastructure					**7.7%**	**10%**
Temporis	9,848	-	- 144	9,705		
Equitix	46,758	1,151	959	48,869		
Green Investment bank	24,722	- 529	1,642	25,836		
Private Equity					**8.1%**	**8%**
Knightsbridge	17,766	734	402	18,903		
Pantheon	57,316	- 2,105	4,599	59,810		
Access	9,410	306	306	10,023		
North Sea	855		-	855		
Markham Rae	- 2	49	- 49	- 1		
Property					**9.0%**	**10%**
Schroders	96,772	-	2,172	98,944		
Property PRS					**2.2%**	**6%**
M&G	19,981	4,812	- 399	24,394		
Cash					**2.6%**	**1%**
Cash	36,164	- 7,179	23	29,008		
Fund Total	**1,091,541**	**- 2,759**	**13,278**	**1,102,060**	**100%**	**100%**

3.8 At the time of drafting this report the Fund remains over-weight to equities and under-weight to fixed interest to the extent that the proportion in these asset classes is outside the allowable variance. Officers believe that this over-weight position continues to benefit the Fund and this scenario will persist in the short- to medium-term. However this position is not consistent with the Fund investment strategy. Officers estimate that the opportunities in Infrastructure and PRS outlined above will result in an extra £60-70m being transitioned from equities to alternatives over the next 18 months and the pension fund will have a net cash outflow of approximately £18m as a result of the advance payment of .deficit contributions. The London CIV is being considered in order to correct the under-weight position in fixed interest.

Section 3: Risk Management

3.9 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.

3.10 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.

3.11 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.

- 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.

- The European economy is showing positive signs of growth, especially when compared to the UK.

- While the Brexit negotiations are ongoing sterling will remain at depressed levels. Officers are continually considering the merits of currency hedging.

3.12 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.

3.13 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. Specifically Officers are concerned by the increasing threat of inflation and all infrastructure investments the Fund has committed to have an inflation linkage built into the return profile.

3.14 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.

3.15 The portfolio term Brexit encompasses a number of risks. Immediate concerns that the UK economy would register a shock have not materialised. However, the outcome of the snap election has done little to quieten concerns. 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.

3.16 AON Hewitt, the Fund's investment advisor, have drafted a Manager Monitoring Report, a Market Review for the 3 months to 30 June 2017 and a Quarterly Investment Outlook which provides context for this risk analysis. These reports are included in the closed part of this Committee agenda.

Section 4: Investment Manager Visit

3.17 On 26 July the Committee attended a site visit to Legal & General to gain more of an insight into how the Global Equity passive mandate delivers market returns and the inclusion criteria for the FTSE4Good mandate in which we are currently invested. Their currency manager provided training on the subject of currency hedging. Subsequent to the meeting Legal & General advised officers that in the Fund's current format, being a segregated mandate, Legal & General will not be able to offer a currency hedging service from January 2018 due to new requirements, to be brought in under legislation, involving the need to hold collateral for forward currency contracts. Officers are looking to change the fund structure to a pooled arrangement to enable Legal & General to carry out currency hedging.

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 solicitor to the Council comments that there are no legal considerations arising from the recommendations within this report beyond those already highlighted in relation to the previous report to members on 6 December 2016.

(Approved for and on behalf of Jacqueline Harris Baker, Director of Law, Council Solicitor and 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:

Nigel Cook – Head of Pensions and Treasury
Resources Department, ext. 62552.

BACKGROUND DOCUMENTS:

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

Appendices

Appendix A: Fund Returns

The following appendices are considered commercially sensitive:

Appendix B: AON Hewitt Manager Monitoring Report

Appendix C: AON Hewitt Market Review: 3 months to 30 June 2017

Appendix D: AON Hewitt Quarterly Investment Outlook

Appendix A

London Borough of Croydon fund returns for the period ending 30 June 2017

EQUITIES					
L&G FTSE 4GOOD	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.6%	24.4%			10.3%
Benchmark	0.7%	24.4%			10.3%
FIXED INTEREST					
Standard Life	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.5%	3.6%	3.9%	4.5%	4.9%
Benchmark	0.3%	2.7%	4.3%	4.5%	5.0%
Wellington	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	-0.9%	-0.2%	6.9%	4.7%	6.8%
Benchmark	-0.8%	0.9%	7.2%	5.1%	6.5%
INFRASTRUCTURE					
Equitix	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	2.1%	9.5%	14.6%	15.2%	15.3%
Benchmark	1.4%	7.7%	6.0%	6.6%	7.1%
Temporis	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.0%	0.00%			-0.4%
Benchmark	1.4%	7.66%			7.3%
GIB	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	7.4%				5.0%
Benchmark	1.4%				4.2%
PRIVATE EQUTIY					
Knightsbridge	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	2.3%	13.3%	23.8%	17.2%	14.5%
Benchmark	1.4%	7.7%	6.0%	6.6%	7.1%
Pantheon	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	9.3%	22.1%	18.6%	17.2%	13.2%
Benchmark	1.4%	7.7%	6.0%	6.6%	7.2%
Access	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	3.4%	0.5%			8.3%
Benchmark	1.4%	7.7%			7.3%
Markham Rae	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.0%				
Benchmark	1.4%				
North Sea Capital	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.0%				
Benchmark	1.4%				
PROPERTY					
Schroders	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	2.2%	5.9%	9.0%		10.1%
Benchmark	2.3%	6.0%	9.5%		9.4%
PROPERTY PRS					
M&G	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	-1.93%				-6.06%
Benchmark	2.25%				5.94%
Total Fund					
	Quarter	**1 year**	**3 year**	**5yr**	**inception**
Fund	1.22%	16.18%	11.97%	11.14%	8.13%
CPI + 4%	1.18%	6.66%	5.02%	5.57%	6.33%

Returns are net of fees and annualised apart from for the last quarter

Returns for Equity, Fixed Interest and Property Funds are calculated on a time weighted basis.

Returns for Infrastructure, Private Equity ,Property PRS funds and the Total return are calculated on an Internal rate of return basis.