Croydon Council

REPORT TO:	**PENSION COMMITTEE** **13 March 2018**
SUBJECT:	**Progress Report for Quarter Ended 31 December 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 31 December 2017 was £1150.4m compared to £1113.9m at 30 September 2017, an increase of £36.5m and a return of 3.42% 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 is asked to note the performance of the fund for the quarter.

1.2 The Committee is asked to note the decision to invest 5% of the value of the Fund in an actively managed Emerging Market equity fund (paragraph 3.6.7. refers) by transitioning 5% of the value of the portfolio into the London CIV emerging markets sub-fund.

2 EXECUTIVE SUMMARY

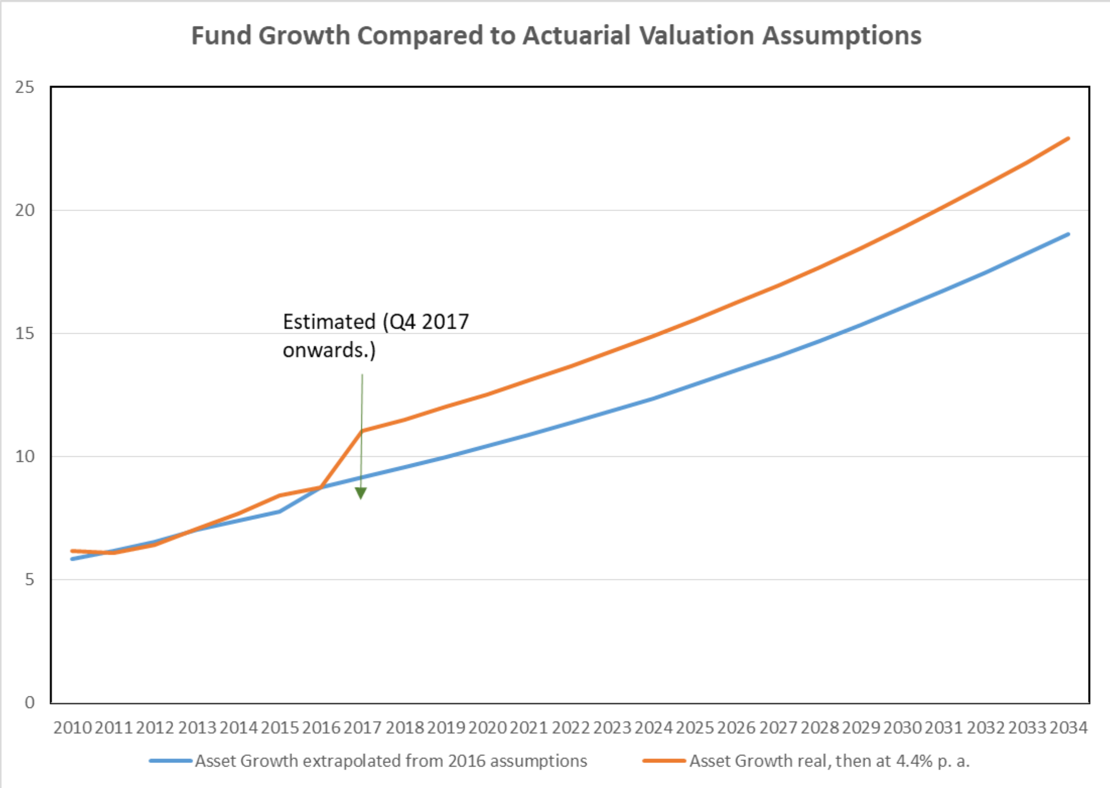
2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 31 December 2017. The report falls into four parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and how that is being applied, specifically current and planned investments. 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.

3 DETAIL

Section 1: Performance

3.1 The 2016 Triennial Actuarial Valuation used 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 measure 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. 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 the other managers 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, less emphasis should be put on the performance for immature investments; Temporis, GIB, Access, Markham Rae, North Sea Capital 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 £69.2m 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, £71m in infrastructure, £25m in Private Rental Sector property and £16.4m in traditional property.

3.6.1 **Private Equity –** During the quarter net distributions of £2.1m were paid from our existing private equity managers and positive returns were generated over the quarter meaning the allocation was 7.9% of the Fund. The allocation is considered on target.

Allocation: On target.

3.6.2 **Infrastructure –** During the quarter a net investment of £7.9m was drawn from existing managers. Positive returns of £2.9m were also generated in the quarter meaning the allocation percentage increased to 9.6%. This target allocation for this asset class can now be achieved from the current mandates.

Allocation: On target which is ahead of the original planned date of 31 December 2019.

3.6.3 **Traditional Property –** During the quarter positive returns of £3.4m meant the allocation remained on target.

Allocation: On 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 fund is generating positive returns. The allocation remained at 2.2% over the quarter. Officers anticipate the second tranche to be 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 52.7% when compared to the previous quarter of 53.4%, a movement of -0.7 %. £15m was divested from equities over the quarter. Equities provided the most 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 recognised that moving from the previous asset allocation would be a gradual process, driven by the availability of opportunities. It is also recognised 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 During the quarter the Equity holdings were transferred from the L&G FTSE4Good tracker fund to the L&G World Developed (Ex Tobacco) Index Fund. The equity holdings are now considered part of the London CIV for pooling purposes.

3.6.7 Following extensive discussions and thorough due diligence officers are able to provide a high degree of comfort that investing in the London CIV's emerging market sub fund would meet the investment strategy goal of accessing this asset class. Consequently 5% of the value of the portfolio will be transitioned into this sub-fund, subject to a timetable to be agreed with the CIV. The intention is that this sub-fund will be managed by Janus Henderson for the CIV. Appendix E provides more detail. This is the information sheet published through the CIV portal and is thus included in the Part B report as it should be considered commercially sensitive.

3.6.8 **Fixed Interest –** The Fund has moved below the lower end of the target range in its fixed income allocation and this is largely due to outperformance of other assets. As outlined in the previous quarter's progress report officers have explored the use of private debt as an option to close this gap. Reduced lending by banks due to tightened regulation and legacy issues has led to retreat by banks from the credit markets post the 2008 crisis. The structural shift towards non-bank lenders in Europe has created an opportunity for alternative lenders. Private debt lenders are becoming key capital providers while banks continue their deleveraging process. Officers are seeing more and more that corporations are diversifying their financing sources and private debt and direct lending funds are capitalising on the opportunity. This asset class is at an early but fast-growing stage of development. For example private debt funds secured a combined $107bn among 136 funds that reached a final close in 2017. Investor demand continues to be strong for alternative credit strategies and new funds are launching at the moment. The key advantages of private debt compared with the current allocation to corporate bonds and gilts and so forth are that officers can see an illiquidity premium in private debt due to proprietary deal flow; an attractive overall yield and steady cash yield; a hedge against inflation and rising interest rates given floating rate debt instruments; and a significant diversifier to equity market exposures. Officers will explore options on private debt subject to the committee's views focusing first on any offering from the London CIV.

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 31 December 2017

	Valuation at 30/09/2017 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 31/12/2017 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**52.7%**	**42%**
Legal & General FTSE4Good	594,670	-609,974	16,866	1,562		
Lega & General FTSE World (Ex Tobacco)	-	594,974	9,930	604,904		
Fixed Interest					**16.8%**	**23%**
Standard Life	128,477	-	890	129,367		
Wellington	62,328	-	1,488	63,816		
Infrastructure					**9.6%**	**10%**
Access	11,049	1,279	581	12,910		
Temporis	12,041	5,155	53	17,248		
Equitix	51,741	2,218	1,156	55,115		
Green Investment bank	25,242	-744	1,120	25,618		
Private Equity					**7.9%**	**8%**
Knightsbridge	19,215	446	-27	19,633		
Pantheon	60,632	-2,929	1,926	59,629		
Access	10,430	404	308	11,141		
North Sea	881	-	-86	796		
Markham Rae	-1	-53	53	-1		
Property					**10.0%**	**10%**
Schroders	111,401	-	3,442	114,842		
Property PRS					**2.2%**	**6%**
M&G	24,499	-	398	24,896		
Cash					**0.8%**	**1%**
Cash	1,341	7,573	5	8,919		
Fund Total	**1,113,945**	**-1,651**	**38,103**	**1,150,397**	**100%**	**100%**

3.8 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 has had advantages in the short-term. However this position is not consistent with the Fund investment strategy. Officers estimate that the commitments made in Infrastructure and PRS outlined above will result in an extra £35-50m being transitioned from equities to alternatives over the next 12 months and the pension fund will have a net cash outflow of approximately £18m as a result of the advance payment of .deficit contributions. Efforts are being made to rebalance further the portfolio and, in particular as referenced earlier, the London CIV is being considered in order to correct the under-weight position in fixed interest products, based on it meeting the funds objectives.

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 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.

3.13 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.

3.16 AON Hewitt, the Fund's investment advisor, have drafted a Manager Monitoring Report, a Market Review for the 3 months to 31 December 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 Members of the Pensions Committee visited Pantheon at their Finsbury Square offices. The meeting covered the evolution of the investment, prospects for the market and performance.

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 additional legal considerations arising from the recommendations within this report.

Approved by: Sandra Herbert, Head of Litigation and Corporate Law, for and on behalf of Jacqueline Harris-Baker, Director of Law 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:

Part A appendices:

Appendix A: Fund Returns

Part B appendices:

Pursuant to Schedule 12A paragraph 3: Information relating to the financial or business affairs of any particular person (including the authority holding that information), the following appendices are considered to be precluded from publication:

Appendix B: AON Hewitt Manager Monitoring Report

Appendix C: AON Hewitt Market Review: 3 months to 31 December 2017

Appendix D: AON Hewitt Quarterly Investment Outlook

Appendix E: London CIV Emerging Markets Sub Fund Information Sheet

Appendix A

London Borough of Croydon fund returns for the period ending 31 December 2017

EQUITIES					
L&G Ex tobacco	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	1.7%				1.7%
Benchmark	1.8%				1.8%
L&G Ex FTSE4Good	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	2.8%	11.1%			10.4%
Benchmark	2.8%	11.2%			10.5%
FIXED INTEREST					
Standard Life	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.7%	1.9%	3.1%	3.6%	4.7%
Benchmark	0.6%	2.2%	3.3%	3.8%	4.8%
Wellington	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	2.4%	2.7%	4.2%	4.4%	6.6%
Benchmark	2.0%	2.6%	4.5%	4.8%	6.3%
INFRASTRUCTURE					
Equitix	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	1.9%	10.0%	12.6%	21.8%	14.6%
Benchmark	1.4%	7.9%	6.6%	6.5%	7.4%
Temporis	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.4%	-1.10%			-0.2%
Benchmark	1.4%	7.94%			7.5%
GIB	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	4.7%	8.9%			8.9%
Benchmark	1.4%	7.9%			7.9%
PRIVATE EQUTIY					
Knightsbridge	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	-0.1%	-4.1%	14.5%	16.4%	12.6%
Benchmark	1.4%	7.9%	6.6%	6.5%	7.1%
Pantheon	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	3.3%	13.1%	15.4%	15.3%	13.1%
Benchmark	1.4%	7.9%	6.6%	6.5%	7.2%
Access	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	3.3%	9.4%			9.8%
Benchmark	1.4%	7.9%			7.5%
Markham Rae	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.0%	0.0%	0.0%	0.0%	0.0%
Benchmark	1.4%				
North Sea Capital	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	0.0%	0.0%	0.0%	0.0%	0.0%
Benchmark	1.4%				
PROPERTY					
Schroders	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	3.1%	10.3%	7.8%	10.7%	10.2%
Benchmark	3.1%	10.2%	8.4%	10.3%	9.5%
PROPERTY PRS					
M&G	**Quarter**	**1 year**	**3 year**	**5 year**	**inception**
Fund	1.62%	0.67%	0.00%	0.00%	-0.46%
Benchmark	3.09%	10.09%	0.00%	0.00%	7.74%
Total Fund					
	Quarter	**1 year**	**3 year**	**5yr**	**inception**
Fund	3.42%	9.67%	11.22%	11.23%	8.23%
CPI + 4%	1.18%	6.94%	5.56%	5.45%	6.26%

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 calculate