Croydon Council

REPORT TO:	**PENSION COMMITTEE** **20 June 2017**
AGENDA ITEM:	**8**
SUBJECT:	**Progress Report for Quarter Ended 31 March 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 March 2017 was £1,091.5m compared to £1,021.4m at 31 December 2016, an increase of £70.1m and a return of 3.45% 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

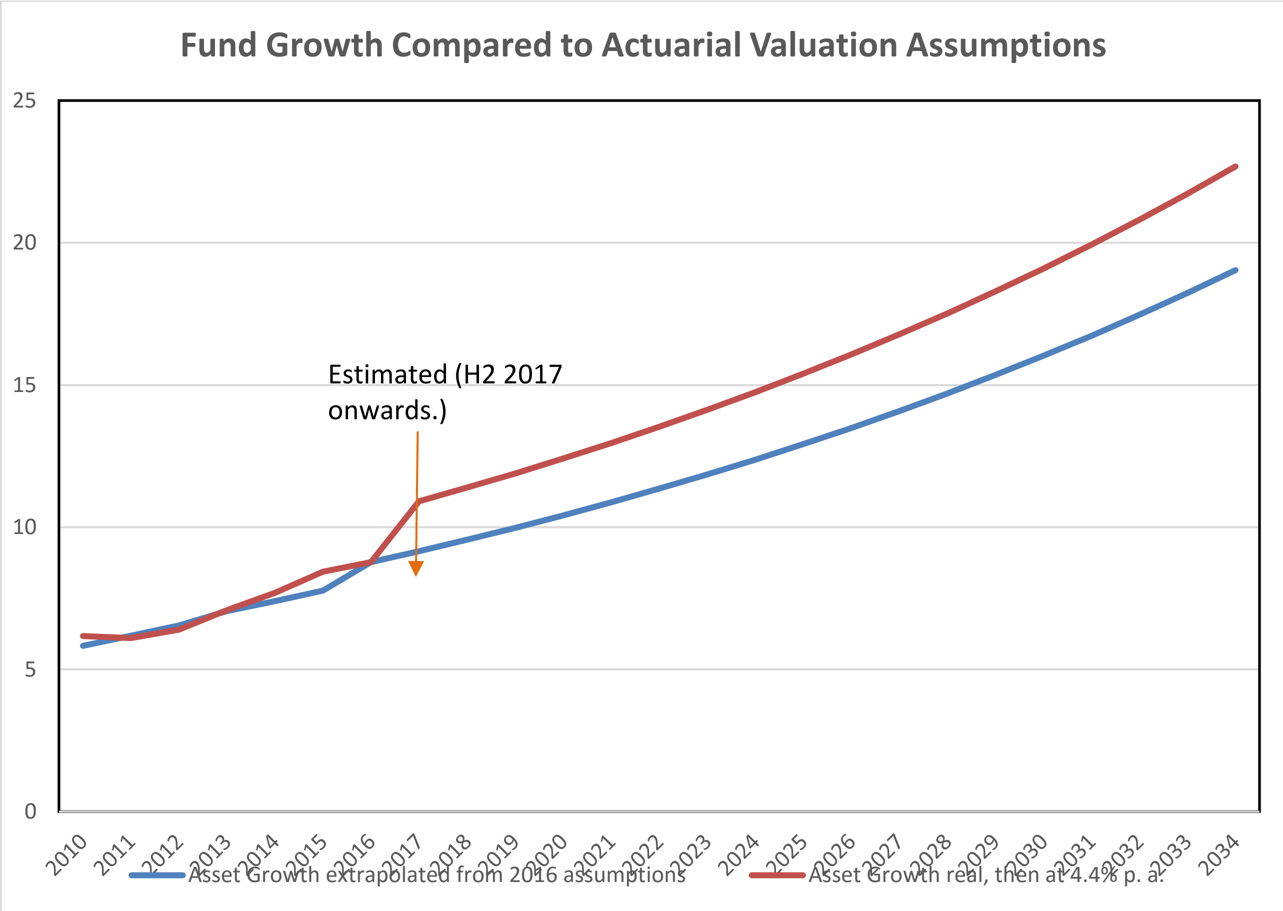
2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 31 March 2017. The report falls into three parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and how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

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**

3.6.1 **Private Equity –** A net investment of £4.2m has been made with our existing private equity managers; although returns over the quarter were negative due to immature funds and negative currency effects and this has lead to our allocation decreasing from 8.1% to 7.8%. The allocation is considered on target.

Allocation: achieved target allocation early.

3.6.2 **Infrastructure –** During the quarter a net investment of £10.4m was drawn: being the remaining commitment to the Green Investment Bank Offshore Wind Fund and Equitix. The allocation percentage increased from 6.8% to 7.5%. Officers are looking at committing a further £50m to £70m to another three infrastructure funds. This will enable the Fund to meet the target asset allocation as set out in the original timetable.

Allocation: on target to meet allocation by 31 December 2019 as planned.

3.6.3 **Traditional Property –** The target allocation has slipped 1% below the target allocation and Officer are actively engaging with our property fund manager in order to fill this gap.

Allocation: Now below target due to weak performance when compared to other assets.

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. We are expecting the first tranche of £25m to be fully drawn by 30 September 2017 and the second tranche to be drawn throughout 2018. During the quarter £10.5m was drawn by M&G. We had an opportunity to buy more units within the fund valued at about £4m. Unfortunately our bid was unsuccessful, although the successful bid was well above the bid valuation which is the price we use for the valuation of the asset in our accounts.

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 53.2% when compared to the previous quarter of 56.4%, a movement of 3.2 % points. Equities again outperformed the rest of the portfolio over the quarter and the 1 year return has been 32.4% and this has contributed significantly to the overall 1 year performance of the Fund which was 21.56%. During the quarter a further £26.7m was divested from equities and is currently being held in cash. 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. Paragraph 3.10~~9~~ below provides more detail on the progress towards achieving this goal.

3.6.6 **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.

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 March 2017

	Valuation at 31/12/2016 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 31/03/2017 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**53.2%**	**42%**
Legal & General World DB	25,359	- 26,692	1,333	-		
Legal & General FTSE4Good	550,778	-	30,015	580,793		
Fixed Interest					**17.5%**	**23%**
Standard Life	126,902	-	1,175	128,077		
Wellington	62,109	-	970	63,079		
Infrastructure					**7.5%**	**10%**
Temporis	9,848	-	-	9,848		
Equitix	40,022	5,153	1,584	46,758		
Green Investment bank	19,282	5,272	168	24,722		
Private Equity					**7.8%**	**8%**
Knightsbridge	17,997	507	- 738	17,766		
Pantheon	56,845	990	- 519	57,316		
Access	7,846	1,621	- 57	9,410		
North Sea	-	965	- 110	855		
Markham Rae		127	- 129	- 2		
Property					**8.9%**	**10%**
Schroders	94,697	-	2,075	96,772		
Property PRS					**1.8%**	**6%**
M&G	9,462	10,488	31	19,981		
Cash					**3.3%**	**1%**
Cash	237	35,851	76	36,164		
Fund Total	**1,021,385**	**34,282**	**35,874**	**1,091,541**	**100%**	**100%**

3.8 Members should note that at present, none of the investments comprising the asset allocation strategy 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.

3.10 At the time of drafting this report the Fund remains over-weight to equities to the extent that the proportion in this asset class is outside the allowable variance. This is set out in paragraph 3.6.5 above. Whilst officers believe that this over-weight position benefits the Fund in the short- to medium-term, this position is not consistent with the Fund investment strategy. The opportunities outlined above will result in around £81m being invested in alternate asset classes, although £31m of that will be funded from employer contributions. A further £45m could be transitioned from equities into fixed interest and this option is being actively pursued. Most of the recent growth experienced in equity markets can be attributed to currency: sterling has weakened over a prolonged period of time against the dollar and the Euro. This issue is addressed in a report elsewhere on this agenda.

Section 3: Risk Management

3.11 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.

3.12 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.

3.13 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.
- There remain concerns about the European economy, especially around German and Italian banks and the unresolved Euro question.
- While the Brexit negotiations are ongoing sterling will remain at depressed levels.

3.14 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.

3.15 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.

3.16 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.

3.17 The portfolio term Brexit encompasses a number of risks. Immediate concerns that the UK economy would register a shock have not materialised. However, risks remain and 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.

3.18 AON Hewitt, the Fund's investment advisor, have drafted a Manager Monitoring Report, a Market Review for the 3 months to 31 March 2017 and a Quarterly Investment Outlook which provides context for this risk analysis. These reports are included in Part B papers.

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 considerations arising other than 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.

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BACKGROUND DOCUMENTS:

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

Appendices

Appendix A: Fund Returns

Please note there are no Appendix B and C

The following appendices are considered commercially sensitive:

Appendix D: AON Hewitt Manager Monitoring Report

Appendix E: AON Hewitt Market Review: 3 months to 31 December 2016

Appendix F: AON Hewitt Quarterly Investment Outlook