Croydon Council

REPORT TO:	**PENSION COMMITTEE** **5 June 2018**
SUBJECT:	**Progress Report for Quarter Ended 31 March 2018**
LEAD OFFICER:	**Richard Simpson** **Executive Director of Resources**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Resources**
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 2018 was £1122.3m compared to £1150.4m at 31 December 2017, a decrease of £28.1m and a return of -2.44% 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.

2 EXECUTIVE SUMMARY

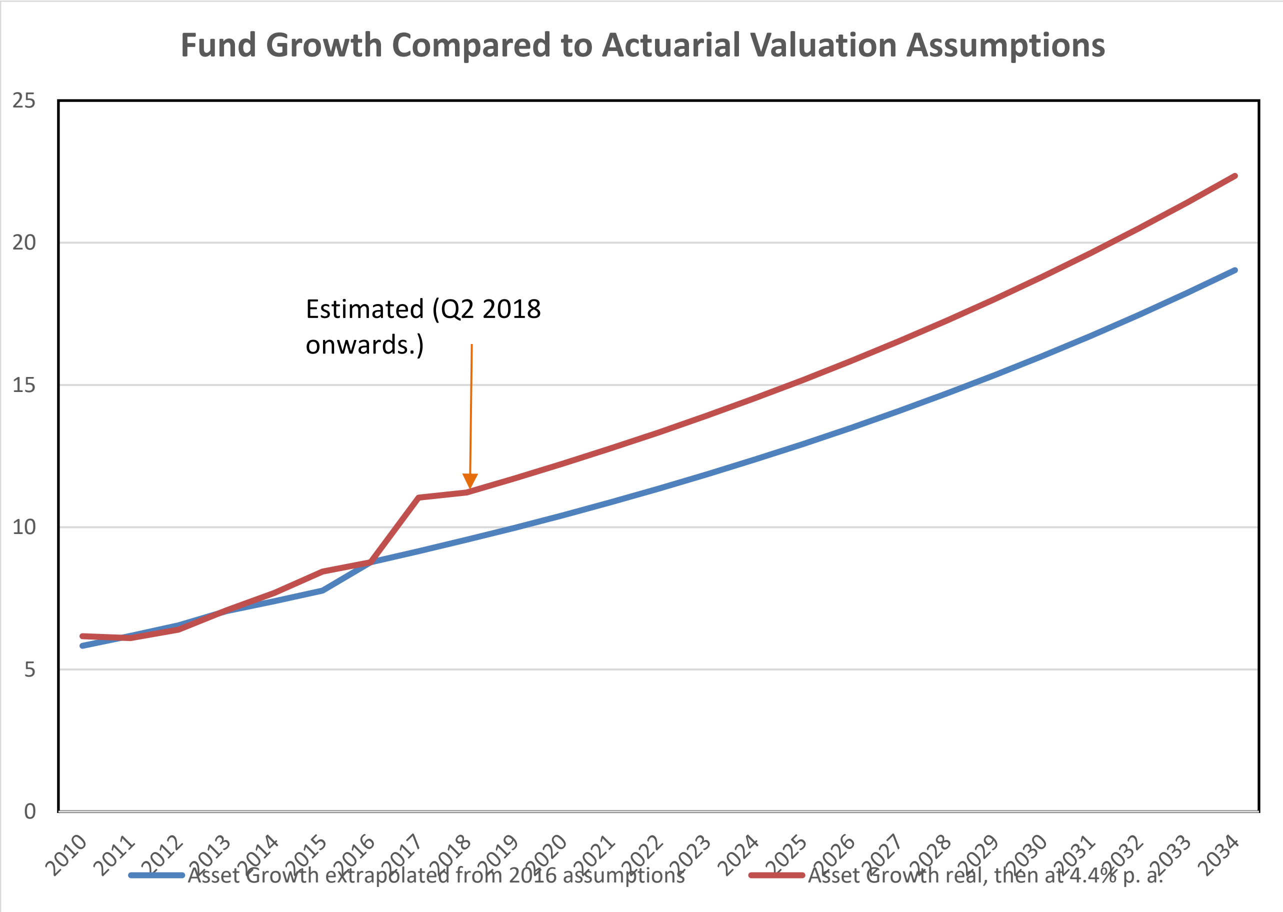
2.1 This report provides an update on the London Borough of Croydon Pension Fund's (the Fund's) performance for the quarter to 31 March 2018. The report falls into four parts. Section 1 addresses performance against strategic goals. The second section considers the asset allocation strategy and how that 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**

To recap, 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 £0.7m were paid from our existing private equity managers. The current allocation to this asset class is 7.9% of the Fund. Markham Rae have reassessed the opportunity set for their offering and have agreed with officers that they will not be taking this forwards. The allocation is considered on target.

Allocation: On target.

3.6.2 **Infrastructure –** During the quarter a net distribution of £2.3m was paid out by existing managers. Positive returns of £3.9m were generated in the quarter meaning the allocation percentage increased to 10%, which is the target allocation for this asset class. It should be noted though that this class generates cash yield so it is necessary to periodically top up commitments to maintain this level of investments.

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 £2.5m meant the allocation remained on target; the ½ % over-weight is within acceptable tolerances.

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 51.6% which is fractionally lower than reported for the previous quarter but still outside of the agreed tolerances. Despite falling in value by £27.6m this part of the portfolio is still significantly overweight representing a risk. Markets on both side of the Atlantic fell in February ending a pro-longed period of steady growth but not the end of the current bull market. Because the portfolio's equity exposure is passively managed the Fund will see more volatility and this will be inevitably amplified by this overweight position.

3.6.6 As noted by the Committee in the last quarter's Progress Report, £50m is to be transitioned from the LGIM fund into a Janus Henderson Emerging Markets fund managed by the London CIV.

3.6.7 **Fixed Interest –** The Fund remains 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. Officers will continue to 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 March 2018

	Valuation at 31/12/2017 £'000	Net Cashflow £'000	Gain/loss £'000	Valuation at 31/03/2018 £'000	Asset Allocation Fund Percentage	Asset Allocation Target Percentage
Equities					**51.6%**	**42%**
Legal & General FTSE4Good	1,562	- 1,377	- 94	92		
Lega & General FTSE World (Ex Tobacco)	604,904	1,377	- 27,470	578,812		
Fixed Interest					**17.1%**	**23%**
Standard Life	129,367	-	- 651	128,716		
Wellington	63,816	-	- 125	63,692		
Infrastructure					**10.0%**	**10%**
Access	12,910	- 2,352	- 156	10,403		
Temporis	17,248	1,886	1,452	20,586		
Equitix	55,115	- 890	2,617	56,842		
Green Investment bank	25,618	- 1,019	-	24,599		
Private Equity					**7.9%**	**8%**
Knightsbridge	19,633	418	- 160	19,892		
Pantheon	59,629	- 1,210	- 1,856	56,563		
Access	11,141	62	344	11,547		
North Sea	796	-	- 10	786		
Markham Rae	- 1	- 6	7	-		
Property					**10.5%**	**10%**
Schroders	114,842	-	2,492	117,334		
Property PRS					**2.2%**	**6%**
M&G	24,896	-	333	25,229		
Cash					**0.6%**	**1%**
Cash	8,919	- 1,577	- 129	7,213		
Fund Total	**1,150,397**	**- 4,688**	**- 23,404**	**1,122,304**	**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 are 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. 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. Of greater concern is the fact that little progress has been made by either party towards a negotiated position.

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.

3.14 AON Hewitt, the Fund’s investment advisor, have drafted a Manager Monitoring Report, a Market Review for the 3 months to 31 March 2018 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

3.15 Members of the Pensions Committee visited Pantheon in January and Janus Henderson, to discuss their Emerging Markets offering, in February. Knightsbridge met with members in March; the meeting covered the evolution of different vintage funds, 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 Council Solicitor comments that there are no additional legal implications arising from the recommendations in this report, which is for information purposes only.

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 March 2018
Appendix D: AON Hewitt Quarterly Investment Outlook