PENSIONS COMMITTEE

Thursday, 28 November 2019 at 6.30 p.m.

Committee Room One - Town Hall Mulberry Place

SUPPLEMENTAL AGENDA

This meeting is open to the public to attend.

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Non-Executive Report of the: **Pensions Committee** 28 November 2019	TOWER HAMLETS
Report of: Neville Murton, Corporate Director, Resources	**Classification:** Part Exempt – Appendix C
Investment and Fund Managers Performance Review for Quarter End September 2019	

Originating Officer(s)	Miriam Adams, Pensions & Investments Manager
Wards affected	All wards

Summary

This report informs members of the performance of the Pension Fund investments and its investment managers for the quarter ending September 2019. Details of manager and whole Fund performance is included in the performance report from Mercer attached (Appendix C). This appendix is not for publication as it contains exempt information relating to the financial or business affairs of a particular person as defined in and paragraph 3 of schedule 12A of the Local Government Act 1972.

Recommendations

The Pensions Committee is recommended to:

- Note the content of this report;
- Note the Independent Adviser quarterly commentary (Appendix A);
- Note the PIRC reports (Appendix B); and
- Note the detailed fund performance by Mercer (Appendix C) (restricted)

1. REASONS FOR THE DECISION

1.1 The report informs the Pensions Committee of the performance of Pension Fund managers and overall performance of the Tower Hamlets Pension Fund.

2. ALTERNATIVE OPTION

2.1 The Pension Fund Regulations require that the Council establishes arrangements for monitoring the investments of the pension Fund so there is no alternative but to report the performance to those charged with governance of the Fund on a regular basis.

3. DETAILS OF REPORT

3.1 The Pension Fund Regulations require that the Council as administering authority establishes arrangements for monitoring the investments of the Fund.

3.2 It considers the activities of the investment managers including the CIV and ensures that proper advice is obtained on investment issues.

The Fund's investment adviser prepares quarterly detailed investment performance reports on the Fund's investment and manager performance. This report attached as Appendix informs the Committee of the performance of the Fund and its investment managers for the quarter end 30 September 2019.

3.3 SUMMARY OF THE PENSIONS FUND INVESTMENTS

3.3.1 Over the quarter to 30 September 2019, the Fund generated a return of 1.5% and underperformed its benchmark by 0.9%. On a year to date, the Fund's return of 6.1% underperformed benchmark by 1.3%.

3.3.2 The Fund's LGIM global passive equities hedged portfolio outperformed benchmark by 0.2%. On a year to date perspective the portfolio outperformed benchmark by 0.8%.
LGIM global passive equities unhedged and LGIM global passive Low Carbon equities both performed at par with benchmark.

3.3.3 The Baillie Gifford Global Alpha fund underperformed its benchmark by 2.6% over the quarter. The fund also underperformed on a year to date basis.

3.3.4 The Baillie Gifford Diversified Growth Fund outperformed benchmark by 1.2% in the quarter and on a year to date outperformed benchmark by 0.6% and 0.4% outperformance on a three year to date.

3.3.5 Appendix C to this report is the detailed report prepared by Mercer.

3.3.6 The returns from the PIRC Local Authority universe which comprises of 64 funds with a value of over £193bn showed a strong equity market performance during the quarter driving the positive result of 7.5% on a year to date for the average Local Authority fund. Three year result fell to just under 9.0%.

3.3.7 Across the Local Authority PIRC universe, equities have been the strongest performing asset over the medium and longer term. Local authority funds that held a relatively high level of equities will have delivered returns towards the top of the range whilst those with a more defensive asset allocation have performed less well.

3.3.8 Members are asked to note PIRC paper (Appendix B3) on why recent complexity which has developed in LGPS strategic asset allocation over the years and the resulting impact on Fund performance.

4. INTERNAL CASH MANAGEMENT

4.1 Cash is held by the managers at their discretion in accordance with limits set in their investment guidelines. Cash is also held internally by LBTH to meet the

Fund's working cashflow requirements, although transfers can be made to Fund managers to top up or rebalance the Fund.

4.2 The Pension Fund cash balance is invested in accordance with the Council's Treasury Management strategy agreed by Full Council in February 2019, which is delegated to the Corporate Director, Resources to manage on a day to day basis within the agreed parameters.

4.3 The cash balance as at 30 September 2019, constituted £8.98m working capital cash of the Fund.

5. COMMENTS OF THE CHIEF FINANCE OFFICER

5.1 The Council as Administering Authority has the responsibility of ensuring that the Pension Fund is administered effectively and efficiently and that arrangements for financial management are properly scrutinised.

5.2 This is a noting report which fulfils the requirement to report quarterly performance of the Pension Fund investments portfolio to those charged with governance. There are no direct financial implications arising from this report, however the long term performance of the Pension Fund will impact employer pension contribution rates set by the Committee.

6. LEGAL COMMENTS

6.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 govern the way in which administering authorities should manage and make investments for the fund. There are no longer explicit limits on specified types of investment and instead administering authorities should determine the appropriate mix of investments for their funds. However, administering authorities must now adhere to official guidance; broad powers allow the Government to intervene if they do not. Under regulation 8, the Secretary of State can direct the administering authority to make changes to its investment strategy; invest its assets in a particular way; that the investment functions of the authority are exercised by the Secretary of State and that the authority complies with any instructions issued by the Secretary of State or their nominee.

6.2 The Council must take proper advice at reasonable intervals about its investments and must consider such advice when taking any steps in relation to its investments.

6.3 The Council does not have to invest the fund money itself and may appoint one or more investment managers. Where the Council appoints an investment manager, it must keep the manager's performance under review. At least once every three months the Council must review the investments that the manager has made and, periodically, the Council must consider whether or not to retain that manager.

6.4 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate, having regard to these

matters, for the Committee to receive information about asset allocation and the performance of appointed investment managers. The Committee's consideration of the information in the report contributes towards the achievement of the Council's statutory duties.

6.5 When reviewing the Pension Fund Investment Performance, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty). The Committee may take the view that good, sound investment of the Pension Fund monies will support compliance with the Council's statutory duties in respect of proper management of the Pension Fund.

7. ONE TOWER HAMLETS CONSIDERATIONS

7.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

8. BEST VALUE (BV) IMPLICATIONS

8.1 This report helps in addressing value for money through benchmarking the Council's performance PIRC Universe of Funds.

9. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

9.1 There is no Sustainable Action for a Greener Environment implication arising from this report.

10. RISK MANAGEMENT IMPLICATIONS

10.1 Any form of investment inevitably involves a degree of risk.

10.2 To minimise risk, the Pensions Committee attempts to achieve a diversified portfolio. Diversification relates to asset classes and management styles.

11. CRIME AND DISORDER REDUCTION IMPLICATIONS

11.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- None

Appendices

- Appendix A – Independent Adviser's Quarterly Report
- Appendix B – PIRC Q2 2019 Reports

- Appendix C – LBTH Investment Performance Quarterly Report (**not for publication**)

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report

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UPDATE FROM INDEPENDENT ADVISER – Colin Robertson
Quarter to 30 September 2019

Market performance
The 3 month period to 30 September 2019 was made up of two distinct halves. In the first, equity markets fell as investors worried about the US / China trade war and global economic growth. In the second half, equity markets recovered their falls and have continued to rise since the end of the quarter as central banks cut interest rates and otherwise eased monetary policy, reassuring investors once more.

A feature of the second half of the period was the outperformance of "growth" stocks by "value" stocks after many years of "growth" stocks outperforming "value" stocks. While the relative valuations of the two groupings had become very stretched, it is not clear what triggered the reversal in performance. Possibly, the poor performance of recent tech IPOs (Initial Public Offerings) and the withdrawal of others before they took place led to investors reassessing their attitude to the likes of Amazon and Facebook. In any event, there are considerable implications for fund manager performance if this trend continues.

Bond market performance was also made up of two halves. In the first, bond yields fell sharply reflecting the same factors which were driving equities and also pre-empting central bank action. However, bond yields stabilised over the second half and, at the time of writing, yields are back up close to their level on 30 June as investors have taken on board that central bankers have become more circumspect about further monetary stimulus and that interest rate cuts are close to an end.

Economics and markets
The US economy continues to grow at a moderate rate while growth elsewhere in developed countries is generally lower but still positive. Periodically, there has been fear of impending recession, notably in Germany, but more stimulative monetary policy and talk of looser fiscal policy appear to have turned the situation around. While this economic cycle is very long in the tooth, as the saying goes "economic cycles don't die of old age".

Meanwhile inflation remains not far below the 2% target in the US and UK. Although inflation of 0.5% - 1.0% in the Eurozone and Japan is more worrisome, nevertheless it remains positive and the dangers of deflation have so far been avoided. Indeed there is now some concern that central bankers are creating too much inflation in *asset prices* (soaring equity markets and negative bond yields) as they try to boost growth and *consumer price* inflation.

The problem is instability caused by issues that refuse to go away and which could tip markets and economies over. Progress in resolving the US / China trade war has been modest while the impact is increasing. President Trump continues to attack the Federal Reserve Board in the US and its chairman Jerome Powell, undermining policymaking. In Europe, minority governments struggle to take decisions and Brexit, whether deal or no deal, will cause short term disruption. With so much stimulus being already applied, it will not be easy to stabilise the situation and instigate a recovery should one of the many dangers become a reality

Equity valuations have become quite stretched by historical yardsticks as company earnings forecasts have been cut back, be it only modestly, and equity markets continue their relentless if somewhat erratic rise. However with bond yields at such extraordinary low levels and other competing asset classes bid up to such an extent, equities are not unappealingly valued on a *relative* basis. Nevertheless, as equities are a particularly volatile asset class, they can be expected to initially fall just as much or more than other classes when markets fall.

There is very little new to say about bonds. Cuts in short term interest rates have acted to push yields down while central bank purchases of bonds by way of "quantitative easing", whether actual or expected, have suppressed yields. However sharp increases in bond yields from time to time have made it clear that short term interest rates need to keep falling and central banks need to keep buying bonds to avoid bond yields riseing

Rising equity and bond markets have dragged "alternative" asset classes up with them so that it is now difficult to find any attractively priced asset classes. The so called illiquidity premium which rewards investors for purchasing illiquid assets now appears to have been eliminated in some cases by investors desperate for any investment with a relatively high yield.

Asset allocation

At the time of writing, the US equity market as measured by both the S&P 500 and Nasdaq indices has reached a new all-time high, up 23% and 27% respectively on these measures in 2019. With plenty of scope for bad news as highlighted above, equity markets are clearly vulnerable. The problem is that it can be argued that other asset classes, most notably bond markets, are even less attractive.

This points to making sure that the fund's equity weighting is no greater than the strategic equity benchmark. As suggested in my previous reports, funds with a "cash plus" return target such as Diversified Growth Funds can provide a suitable home until other asset classes become more attractive.

Infrastructure is one asset class where it appears justified to make a commitment to invest without delay. In any case, the drawdown of funds to invest in infrastructure will be spread over a number of years. Diversification within infrastructure investment is as important as for any other asset class and in my view a start should be made when a viable fund is on offer, rather than waiting until the "perfect" fund becomes available, especially if this would mean running an overweight equity position in the interim.

Investment Managers Performance Review

London CIV

As the London CIV (LCIV) has selected the investment managers for the majority of the funds held by the London Borough of Tower Hamlets pension fund, I have commented on the LCIV in this report.

At least from the perspective of the core activity of manager selection, resourcing at LCIV appears to be in crisis with the organisation unable to either retain or attract suitable staff. This is evidenced by:

- the new Chief Investment Officer resigning within a matter of weeks of joining LCIV
- one of the two senior manager researchers leaving at the end of 2019 for an unknown period
- no new experienced manager research people being appointed when I believe LCIV was already short staffed in this area prior to the departures referred to above.

In my view, the LCIV's manager monitoring reports are unsatisfactory, showing limited ability to look beyond what the LCIV are told by the managers. Given the LCIV's resourcing issues, I find it remarkable that the LCIV are opposed to letting the underlying managers send reports directly to their London Borough clients.

At this stage it is difficult to assess the performance of the LCIV in selecting managers. This is because most of the managers were chosen on the basis that their funds were already held by quite a number of London Boroughs and also because insufficient time has passed since appointment to make a fair assessment. However, a few of the managers selected have already been placed on the 'Watchlist" which, while not wrong, is surprising,

Active Equity Fund

After many years of strong outperformance, the Baillie Gifford fund's performance has become more mixed and the fund performed particularly poorly this quarter. This left it underperforming its benchmark by 1.5% over the last year and it has continued to underperform since quarter end.

To a large extent this performance can be attributed to Baillie Gifford's philosophy for managing the fund which is to focus on longer term themes, in particular on those related to disruptive technology. This leads to holdings of so called "growth" stocks whose performance tends to be an exaggerated version of overall market performance and also to exposure to the performance of "growth" versus "value" stocks. Recently, investors have been moving towards investing in "value" stocks, following a very long period of outperformance of "growth" stocks. This has doubtless hit the fund's performance.

Baillie Gifford cannot be expected to suddenly change their investment style so it is a case of potentially waiting out a period of underperformance in the belief that longer term returns will be good (as indeed they have been in the past). It should be noted that the London CIV do not offer a "value" fund and that the LCIV Sustainable Equity Fund has some similarities with the Baillie Gifford equity fund.

Diversified Growth Funds

Both of the Diversified Growth Funds performed strongly over the quarter and Baillie Gifford's return of 4.5% over the last year is good. Ruffer have done less well over the last year with a return of 2.0%. Both managers have retained relatively high exposures to equities and to economically cyclical investments although these exposures have been edged down over the quarter. Nevertheless, a recession induced fall in equity markets would be likely to be quite painful for both managers.

A major contributor to Baillie Gifford's performance was a holding in nickel which is rather unusual and illustrates the benefits of holding a diverse range of asset classes. Ruffer benefitted from their unusually large (relative to their peers) holdings in index-linked gilts and gold which were in fact held for defensive purposes.

Absolute Return Bond Funds

I have not commented on the GSAM fund which is in the process of being sold.

Insight had yet another poor quarter with the fund underperforming the return on cash by 0.2% over the quarter and by more than 1.4% over the last year. As their stated target is to outperform cash by 3% p.a. they are actually behind target by 4.4% over the last year. Over 3 years they are behind target by 4.2% p.a.

For the second consecutive quarter, Insight's long US Treasuries / short German bunds position came right. However the benefit was more than wiped out by taking two separate mistaken views on Italian bonds. Argentina was the disaster area for bond managers in the quarter to 30 September and Insight had some exposure to that market.

Multi Asset Credit Fund

The returns over the quarter and the year were both positive but below the target return, as the LCIV point out in their quarterly commentary. The LCIV is also concerned that the manager, CQS, do not hold any investment grade bonds and that the manager is taking on unnecessary risk. However, CQS must invest in credit markets and if both credit spreads (excess yield of corporate bonds and loans over government bond yields) and the underlying government bond yields are very low then the target return may not be achievable without taking very high risks. In short, the target return may be too high for current market conditions. Reassuringly, CQS produced positive returns from all 5 sub asset classes.

Property Fund

There is little new to report with regard to the Schroder Real Estate Capital Partners fund except that Schroders' head of real estate has resigned and will be leaving early next year. Schroders appear to have the situation under control. Performance continues to be broadly in line with the benchmark over all time periods up to 5 years. The successful strategy of overweighting the industrial sector, regional offices and niche areas such as retirement villages and student accommodation while underweighting retail and London offices is unchanged.

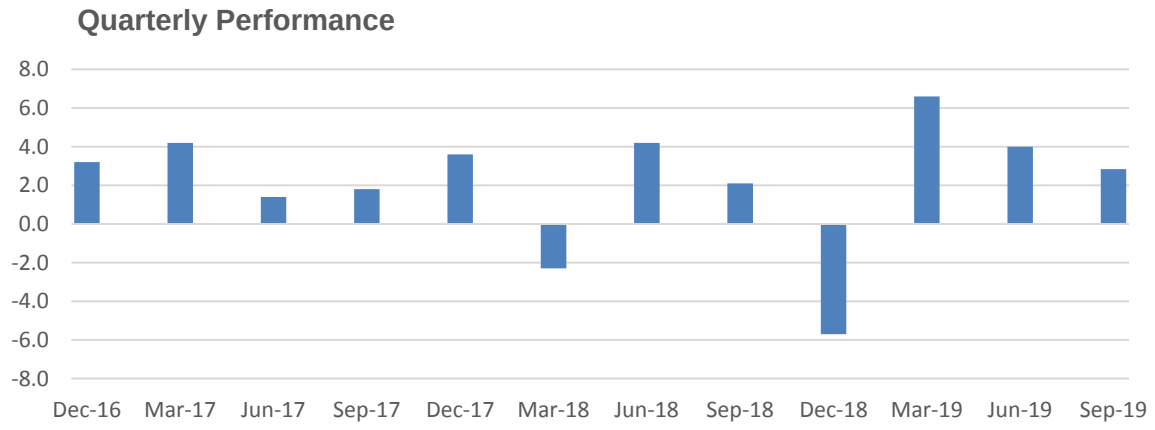
Passive Funds

The LGIM passive funds performed in line with their benchmarks as one would expect except for the Low Carbon fund which outperformed its benchmark by 0.5% over one year.

Local Authority Pension Performance Initial Indicators to September 2019

Latest Quarter

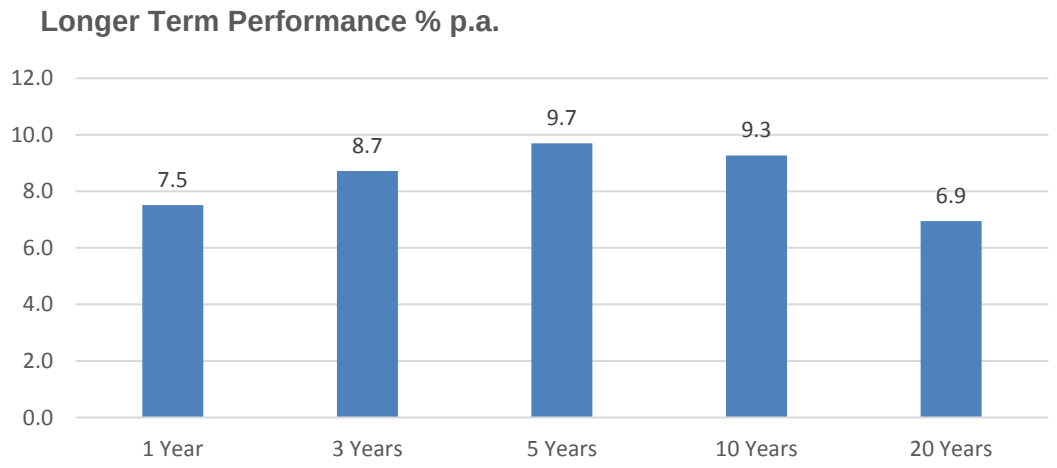
Equity market performance slowed in the latest quarter on the back of poorer economic data and the continuing global trade disputes, delivering returns around 3% for the Sterling investor. These returns were eclipsed by the stronger performance of bonds as government bond yields fell across the world.



Longer Term

The one year average is now 7.5% while the three year result has fallen to just under 9% p.a.

Equities have been the strongest performing asset over the medium and longer term. Funds that held a relatively high level of equities will have delivered returns towards the top of the range whilst those with a more defensive asset allocation will have performed less well.



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The returns for the latest period are based on the asset allocation of the PIRC Local Authority Universe with index returns applied. The previous periods are updated to include actual Universe returns.

The PIRC Local Authority Universe is currently comprised of 64 funds with a value of £193bn.

For further details or for information about subscribing to this service please contact:

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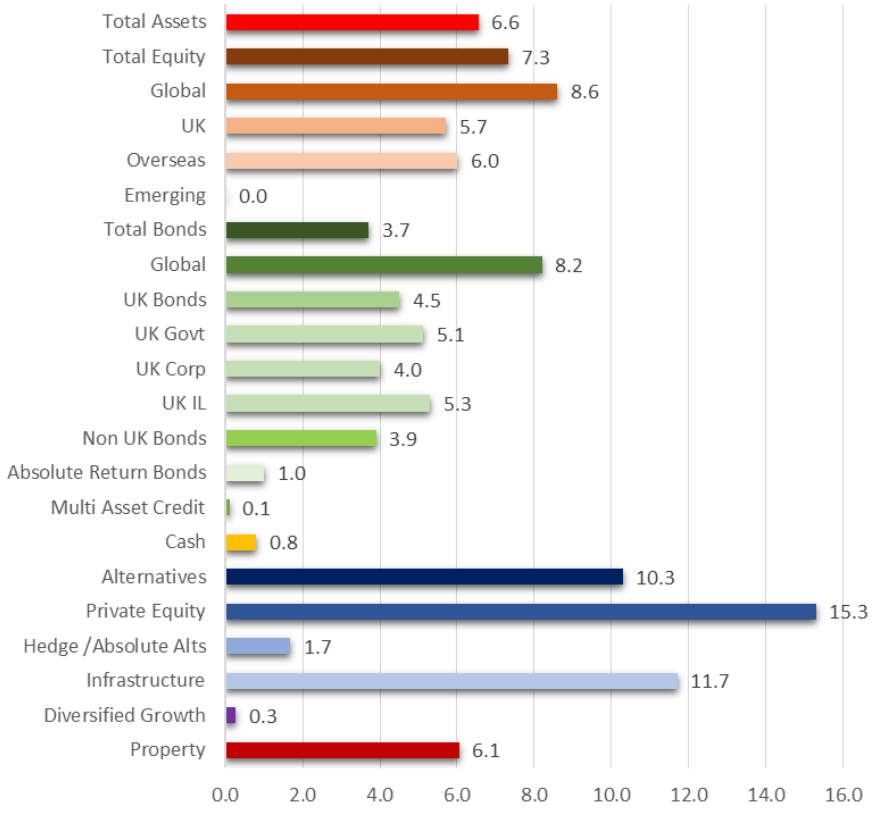
2018/19 Looking Back

Neil Sellstrom

2018/19 Results



- Despite a difficult economic and political environment the average Local Authority fund produced a return of 6.6%
- Asset class returns were tightly grouped with bonds, equities and alternatives returning 4%, 6%, and 7% respectively for the year.
- Alternatives returned 10.3% driven by excellent returns from private equity.
- Most funds failed to outperform their benchmark.

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What Did Well?

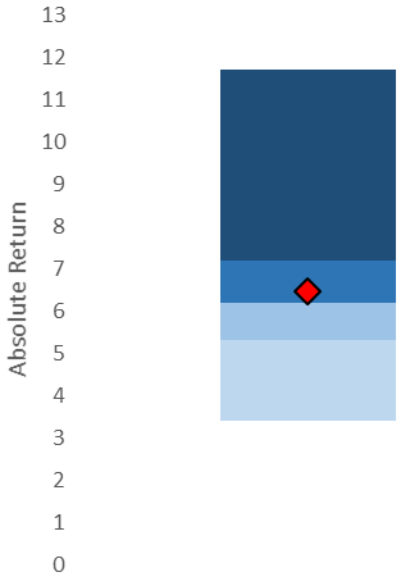
- Strong performance from **US equities** meant funds with high equity components tended to outperform last year.
- **Private equity** continued to perform strongly with a return of 15% for the year.
  It has outperformed quoted equity in the medium term but the outperformance is not yet visible over the longer term.
- **Infrastructure** too performed extremely well
- **US** equities (the key component of global equity funds) continued their extended run of excellent performance, assisted by the ongoing strengthening of the US Dollar.
- **Ethical / Green / Environmental investment did well in garnering funds.** These strategies saw a large influx of money across a range of funds. This was focussed principally in global equity portfolios where we saw a net inflow of £3 billion.

What Did Less Well?

- **Emerging market equities** after being the best performing equity area in the previous year, fared particularly badly this year, failing to deliver a positive return.
- With an average return of 1% **absolute return** funds performed relatively poorly across a variety of strategies and asset types.
- **Equity protection**, taken out by some funds as insurance against possible market falls was not required and the cost had a drag on performance for the year.
- Continued low interest rates meant holding any level of **cash** continued to have a negative impact on return.

Fund Performance

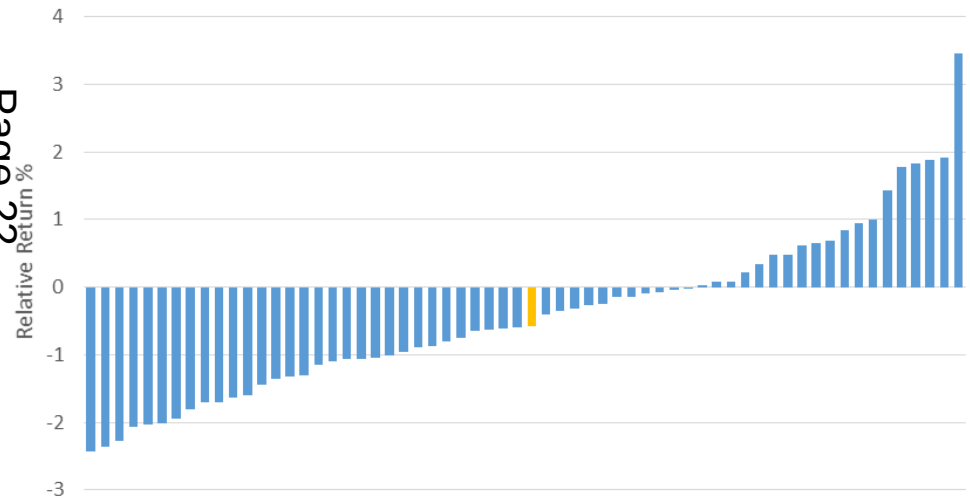
Range of Fund Returns – Year to End March 2019



- Larger funds performed relatively better than their smaller peers resulting in the average return of 6.6% being ahead of the median result of 6.2%.
- The range of results was relatively tight with most funds returning between 5% and 8% for the year.
- Lancashire was the best performing fund in the latest year with a return of 11.7% whilst Havering was the worst at 3.4%.

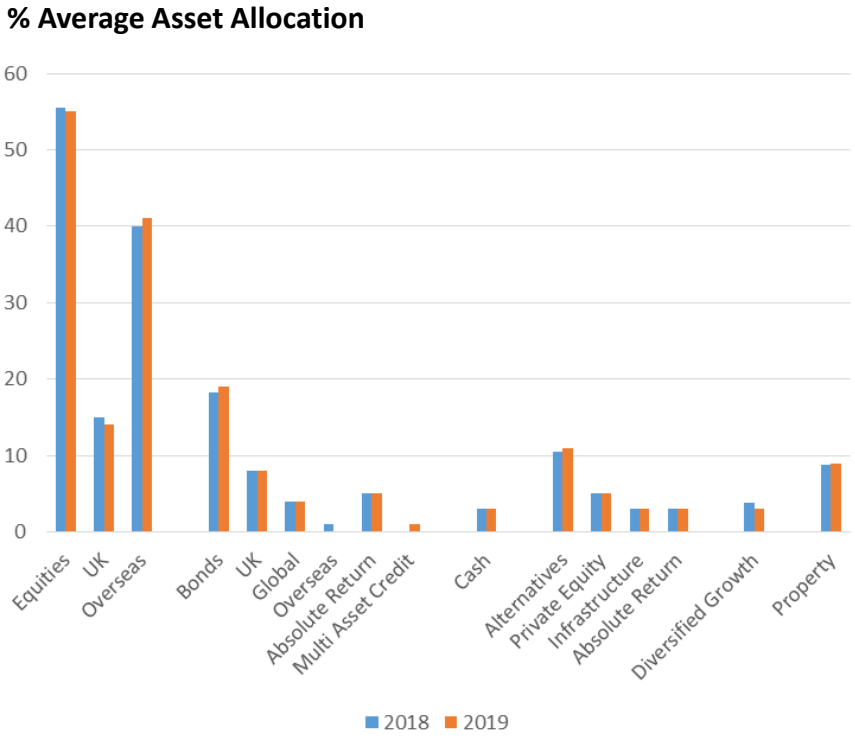
Performance Relative to Benchmark

Relative Performance– Year to End March 2019



- The median fund (in orange) underperfomed its benchmark by 0.5% last year.
- Less than a third of funds managed to achieve a better than benchmark return
- Only 6 funds outperformed by more than 1% while 22 underperformed by more than that margin

Asset Allocation



- High level asset allocation changes slowed down as funds were absorbed by pooling and waiting for the results of the upcoming actuarial revaluation.
- Move into **'green' investments** within Equity and infrastructure
- Within equities a continued move into **enhanced index / smart beta** investments including low volatility
- **Multi asset credit** gained ground.
- A continued move away from index based benchmarks towards **absolute return benchmarks** within alternative assets and within bond allocations.

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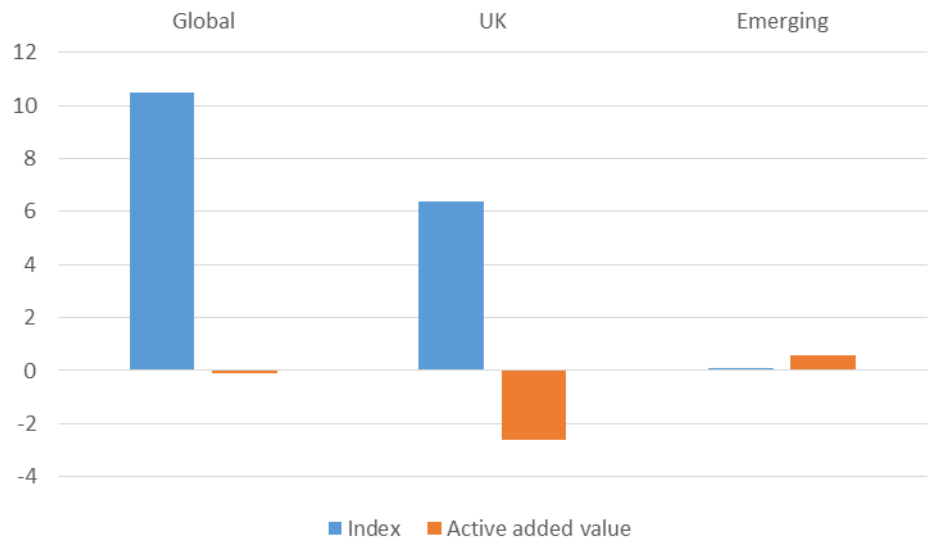
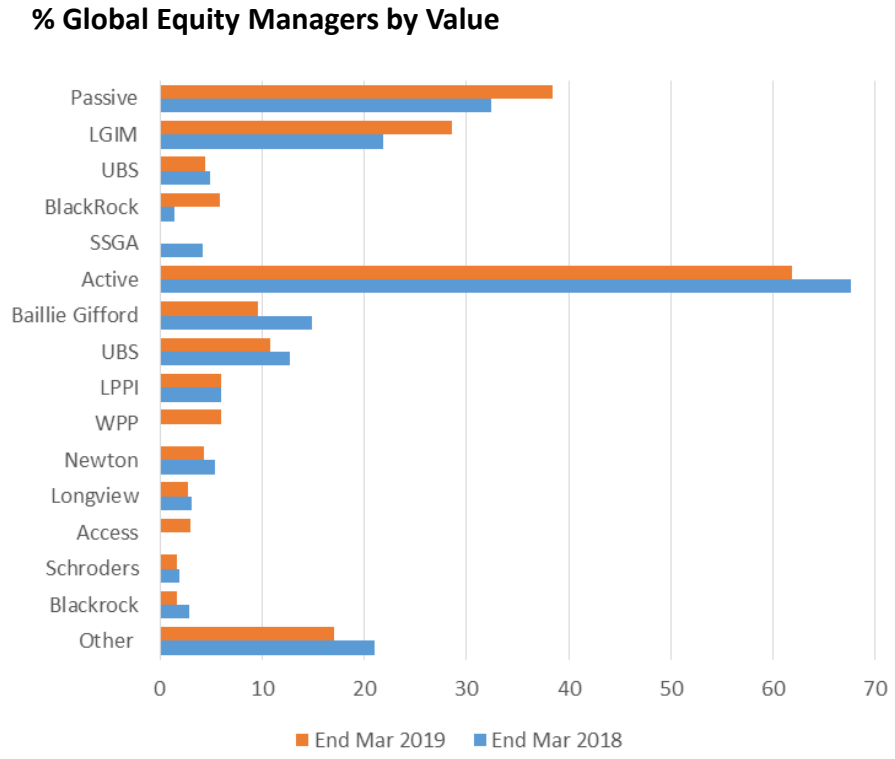
Equity – Regional Allocation Was Key

Performance of Regional Equities – Year to March 2019



- Funds holding a bespoke UK equity allocation would have delivered lower returns last year.
- Likewise funds with a higher weighting to emerging markets.
- The median actively managed global equity and UK equity portfolio underperformed its benchmark by 0.1% and 2.6% respectively over the year.
- Median EM market outperformed by 1.3%.

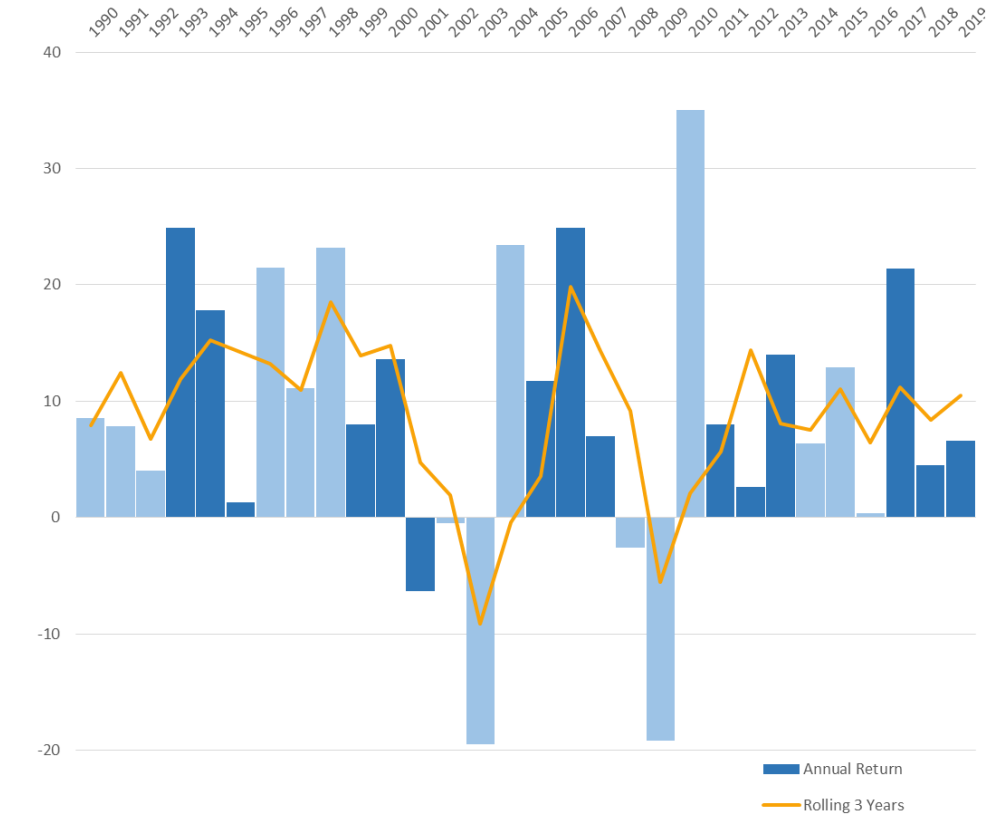
Global Equities



- Passive (index tracking) investment increased over the year
- There were substantial changes to passive managers as funds aligned with pools
- LGIM consolidated its position as the largest manager.
- Baillie Gifford saw direct assets fall but picked up indirect assets through Pooling.

Longer Term Performance

Performance Over One and Three Years to end March



- Thirty year return averages 8.4 %p.a.
- This is almost 6%p.a. above inflation.
- Only five out of the last thirty years have produced negative returns
- Rolling three year returns average around 8%p.a.

- Asset performance has been, and remains, extremely strong.

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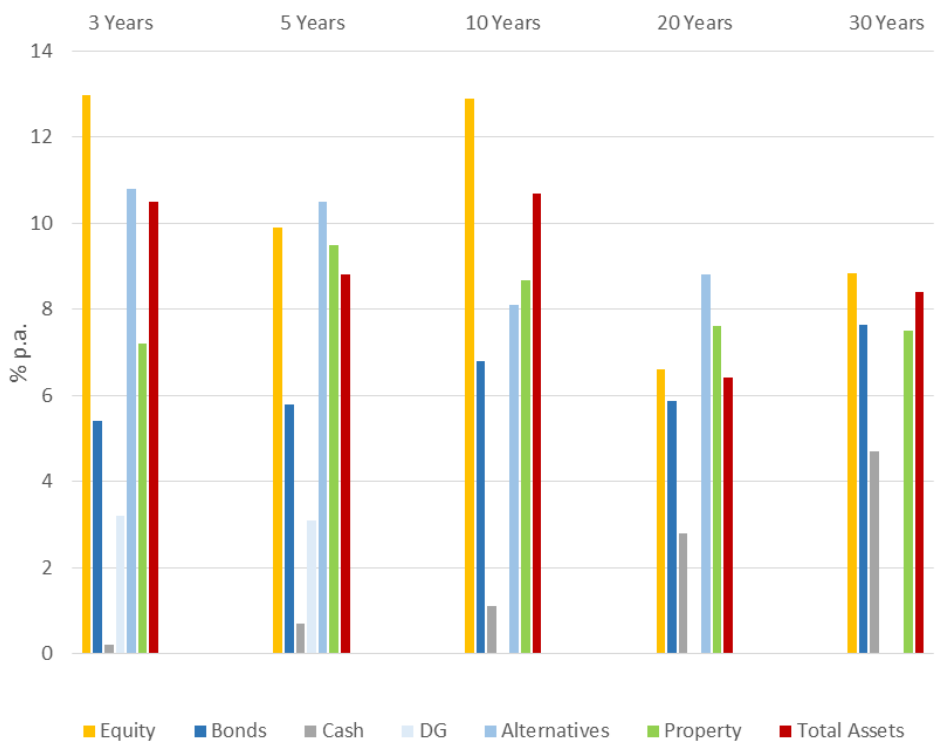
Longer Term Asset Performance

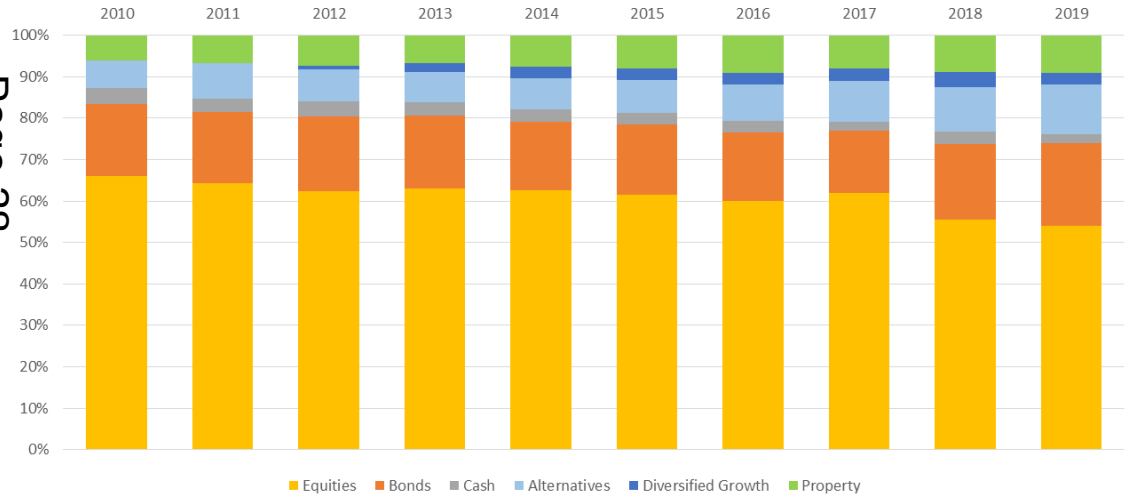
Performance by Asset Class to End March 2019



- Equities have driven the excellent long term performance of the LGPS
- Strong alternative results has been driven by private equity.
- Funds with diversified growth assets and absolute return investments have seen results well below other asset classes over the medium term.

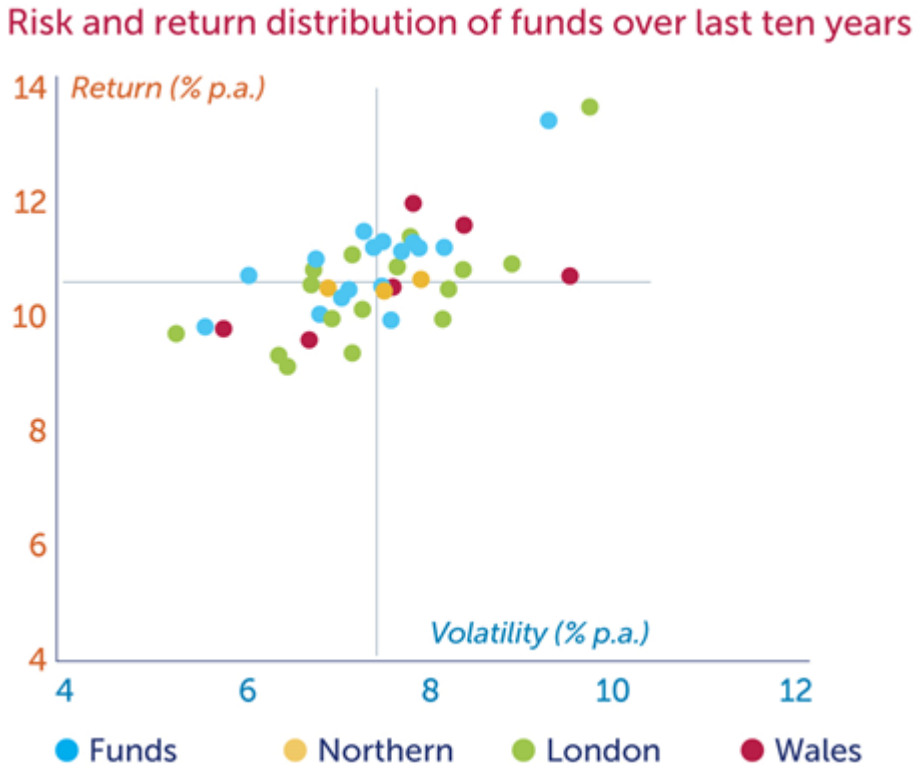
Asset Allocation Changes Over Time

Average Asset Allocation at End March



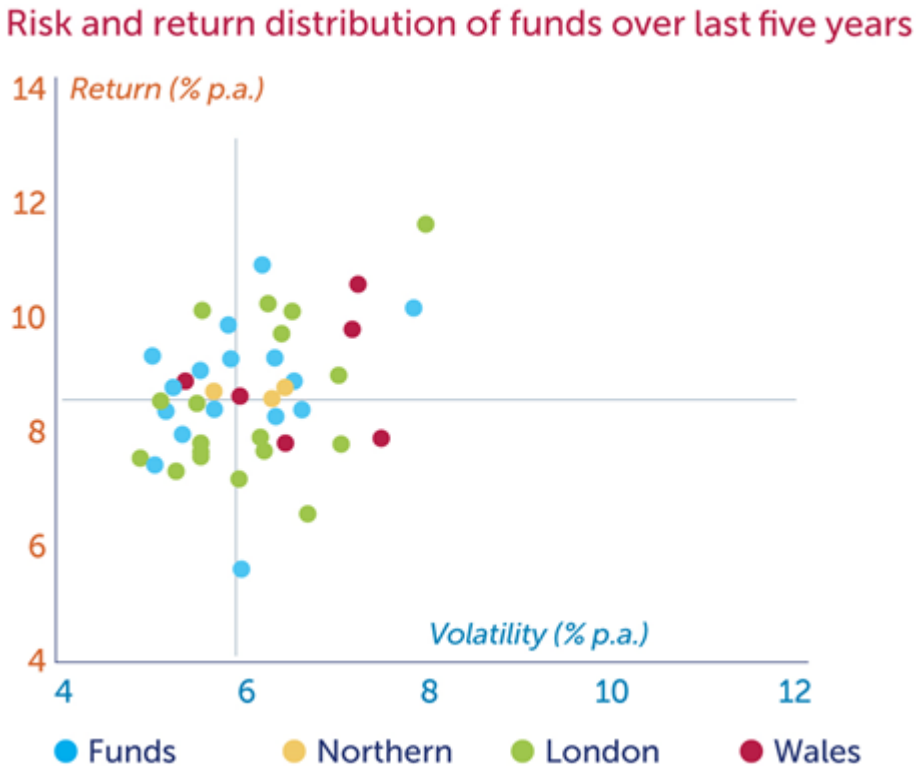
- High level asset allocation has remained little changed over the last decade.
- Equities remain the dominant asset class in most funds' allocations.
- Alternative asset exposure has increased and will likely increase
- There have been changes at asset class level however;
  - Domestic to global equity
  - Gilts to alternative credit sources
  - Hedge funds to more transparent alternative strategies

Risk and Return – Last Ten Years



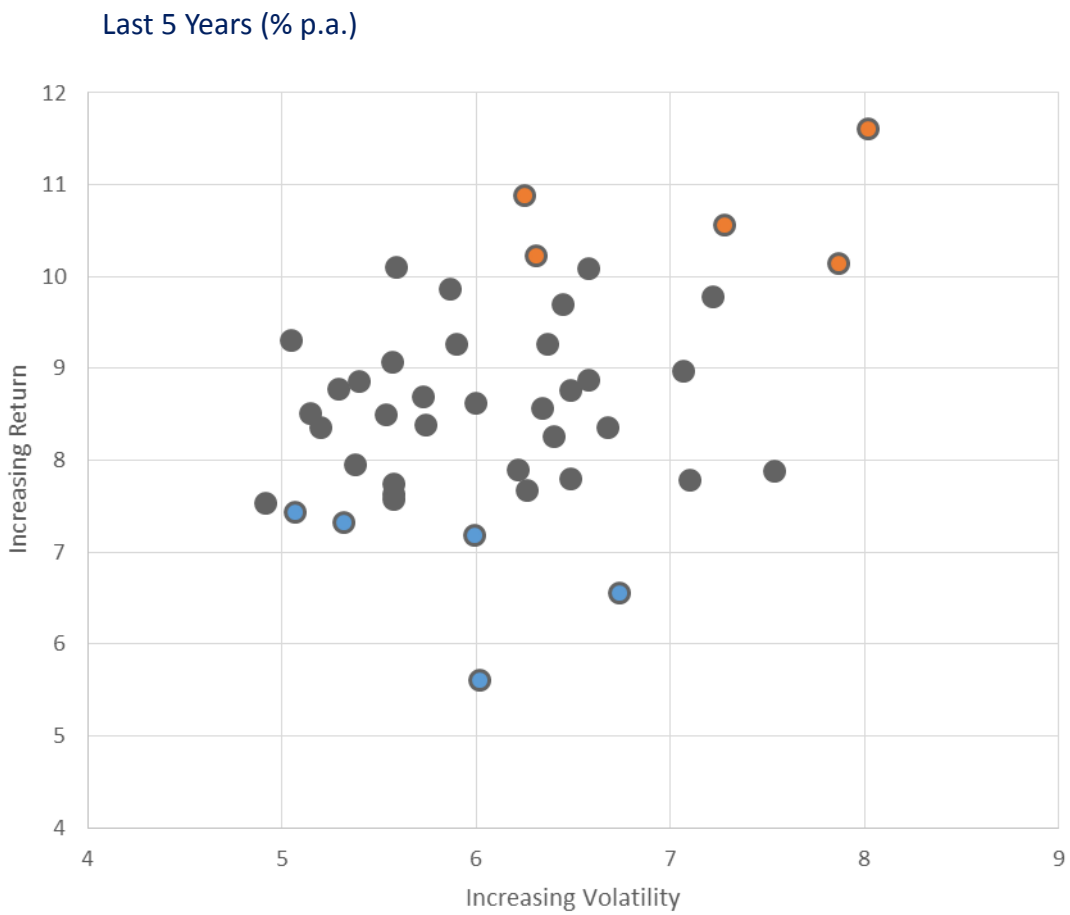
- We now look at individual funds' risk and return profiles
- Funds with 'riskier' asset profiles have tended to perform better
- This is an expected outcome in a 'normal' investment environment
- Asset class performance quite tightly bunched so strategy had less impact

Risk and Return – Last Five Years



- Volatility over this period has been lower while returns have remained well ahead of expectations.
- The positive correlation between risk and return is still evident but less pronounced
- The range of outcomes is wider, reflecting the large difference between the return from equities and that achieved from absolute return strategies.

Top & Bottom Performers



- The best performing funds have added significant value.
- This was in part structural - BM returns were around 1% higher - and part the result of strong active management.
- The poorest performing usually have a high exposure to diversified growth.

In Summary

- A volatile and uncertain year for investors but the final outcome was better than many had predicted at 6.6% for the year and 10.5% p.a. for the three years to end March.
- Little change at strategic level but significant transition of assets into Pools.
- Longer term results still extremely strong, dominated by excellent equity performance
- Absolute return investments have been disappointing over the recent past.
- Funds that have delivered the strongest returns have generally accepted higher levels of volatility.

Why Are Funds So Complicated?

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What Does A Fund Need To Do?

- Be able to pay pensions as they fall due
- Stay affordable

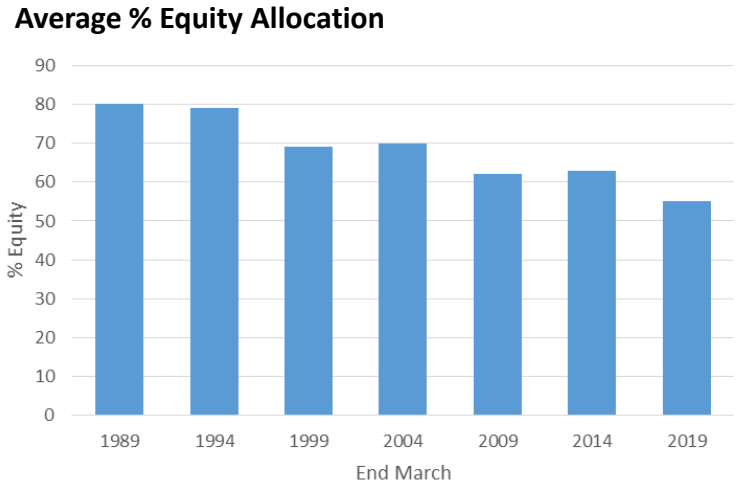
These factors need to be balanced:

- The fund needs to maximise the return earned but needs to ensure that the risk of asset values falling do not prevent pensions being paid or incur large employer contribution increases.

When funds had net positive cashflow the focus was on growing the assets – equities drive asset growth

As contributions fall below outflows income becomes more important.

Equity Allocation Has Reduced

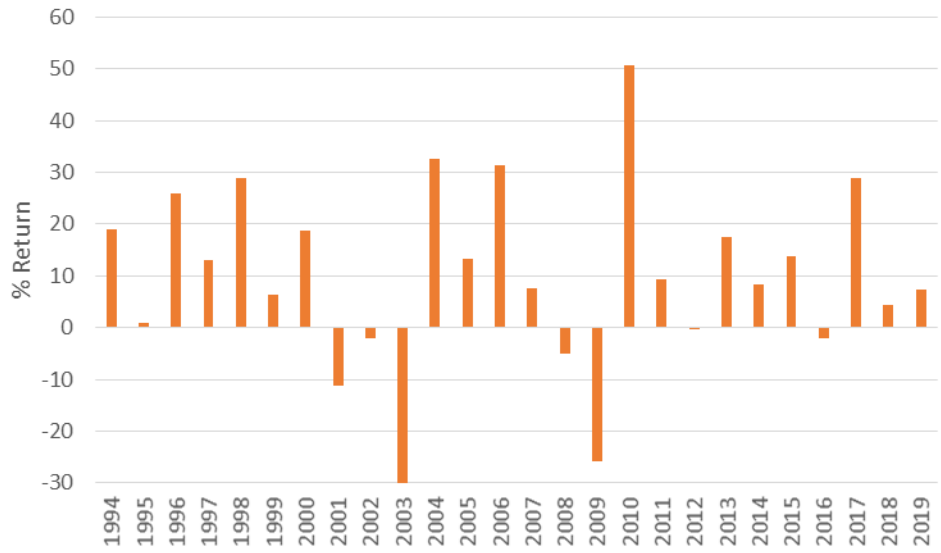


- Over the last thirty years the average equity allocation has fallen from 80% to 55% of assets.
- There has been a steady cashflow out of equities for most of this period but the sharpest decline in equity allocation has come about in the last two years.
- Will the trend continue?

Corporate schemes now hold only around 20% - but the cost has been huge.

Equity Volatility

Annual Equity Return to End March



- There have been periods of negative equity results.
- To date these have always been followed by a strong recovery.
- Some funds are prepared to live with equity volatility whilst others have:
  - chosen to hedge some of the currency risk
  - to invest in alternative equity strategies (low volatility indices / smart beta)
  - to put in places insurance against marked falls in equity markets

Asset Return Expectations

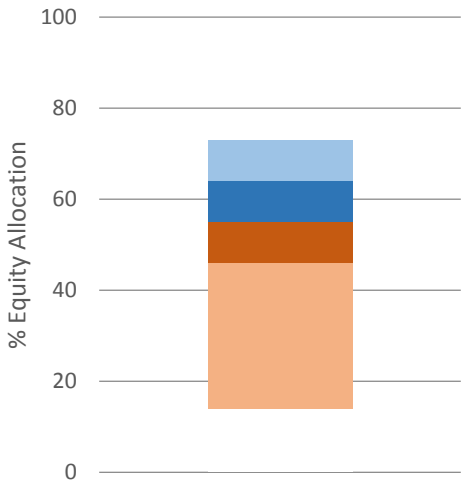
Long Term Asset Return Expectations

	% p.a. over cash
Equity	4.75
Property	4.5
Infrastructure	3.5
Credit	1.25
Govt Bonds	-0.75
Cash	2.0

- Even from current levels equities are expected to be the best performing asset over the next ten years.

Equity Reduction

Range of Fund Equity Allocation as at March 2019



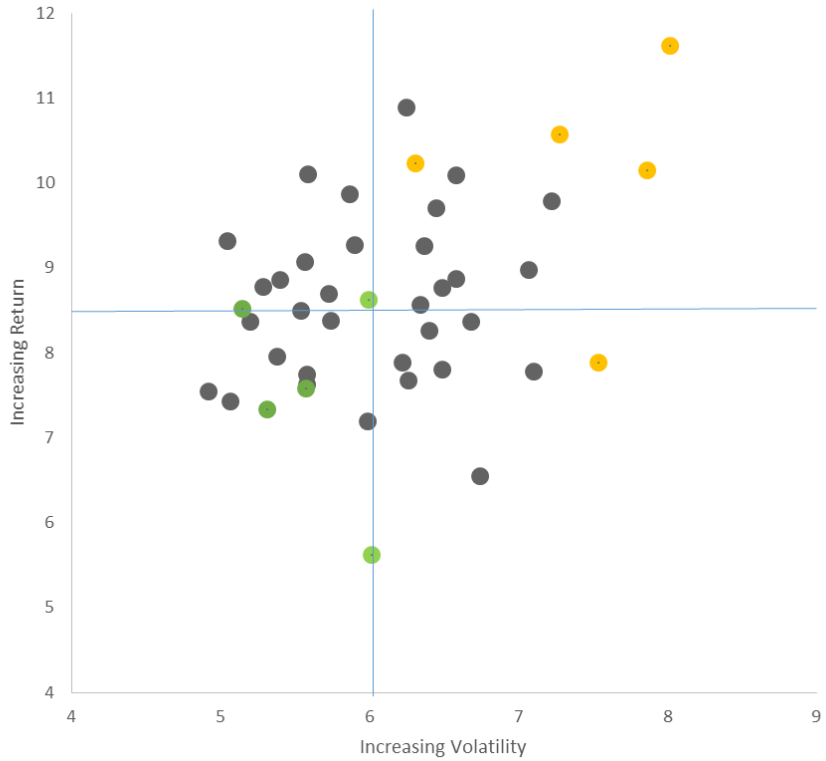
- While some funds have reduced their allocation markedly others have kept a much higher allocation.
- Currently no correlation between funding level and equity allocation.
- Intuitively surprising – a fully funded scheme should be able to reduce / remove risk?

  Not so.

  As the contribution rate is dependant on future cash expected returns, reducing the equity component will reduce the expected returns and thereby raise contribution levels.

Impact on Performance

Risk & Return by Equity Allocation – Five Years to March 2019



- The chart shows the funds with the highest equity allocation over the last five years in orange and the lowest allocation in green.
- The funds with the highest equity allocation also had the highest level of volatility.
- For some that volatility was rewarded, for others it was not.
- If funds pursue an active manager strategy then evidently the choice of manager remains key.
- Those with the lowest equity allocation tended to have much lower volatility but also lower return.

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Ever More Complex

	1999	2009	2019
Number of Managers	42	116	124
Average Number of Managers	5	9	12
% Passive	9	23	27
Asset Classes	UK Equity	UK Equity	UK Equity
	Overseas Equity	Overseas Equity	Overseas Equity
	Emerging Market Equity	Emerging Market Equity	Emerging Market Equity
	UK Gilts	UK Gilts	UK Gilts
	UK IL	UK IL	UK IL
	Cash	Cash	Cash
	Property	Property	Property
		Corporate Bonds	Corporate Bonds
		Private Equity	Private Equity
		Hedging	Hedging
		Absolute return	Absolute return
			Alternative Credit
			Hedge Funds
			Infrastructure
			Commodities
			Diversified Groeth
			Multi Asset Credit
			Liability Matching
			Smart Beta
			Climate Aware

- The range of investments available has increased markedly.
- This has led to greater reliance on consultants and arguably less in-depth understanding by those responsible for pension funds.

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Diversified Growth

Funds were shaken by the market fall in 2008.

Funds were strongly advised to 'derisk' – to reduce the equity component of their fund and therefore reduce volatility.

Some funds had already invested into hedge funds – some rebranded as TAA or SAA funds by the big balanced managers. Rather than be compared against market indices these were measured against an absolute target.

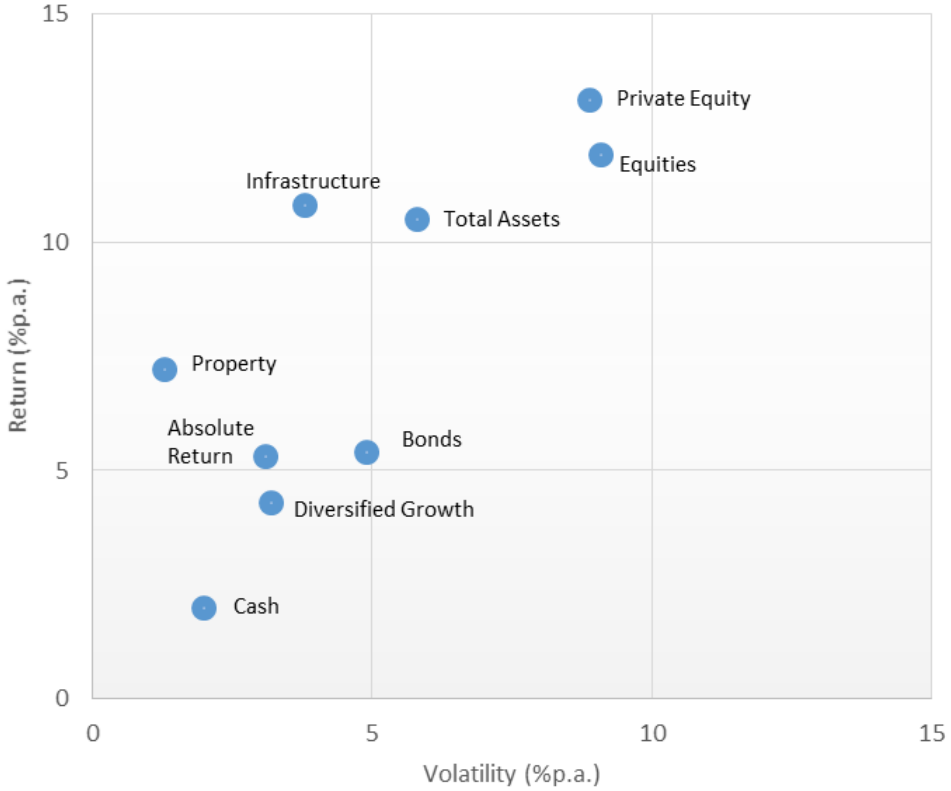
The launch of much lower fee diversified growth funds where the possibility of obtaining 'equity like returns at lower than equity risk' began to garner widespread consultant backing.

Over the last five years DG has produced an average return of 3% p.a. This was behind the benchmark aspirations of 4-8% p.a.

GARS failed to deliver a positive result over the five year period.

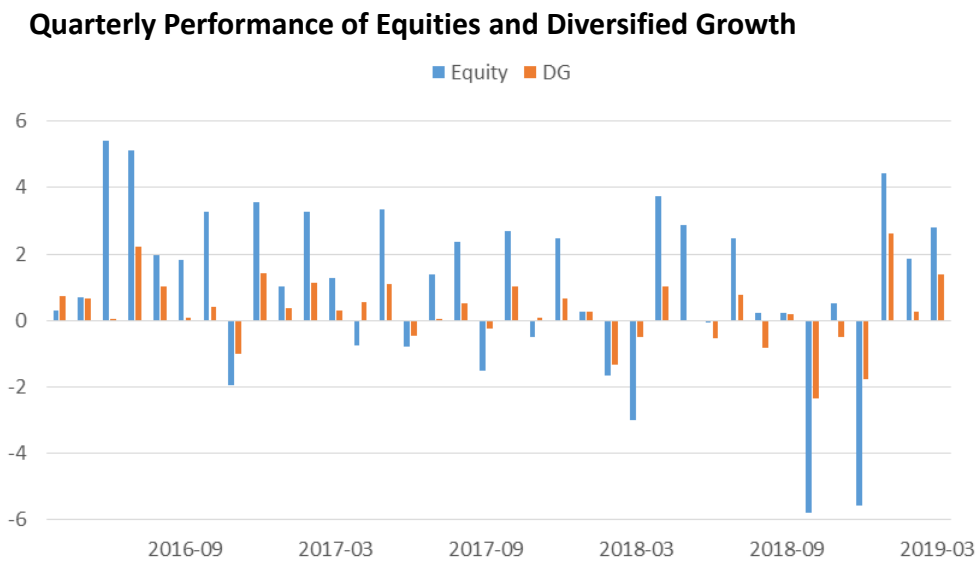
Low Risk Comes At a Cost

Risk & Return by Asset Class– Three Years to March 2019



- Most Diversified Growth funds target volatility of around 4%.
- They delivered volatility at this level – around half the 9% volatility of equities.
- However, the return is a third that achieved by equities over the period.

Impact on Fund Volatility



- At an overall fund level Diversified Growth does not reduce volatility as much as may have been expected.
- Returns are delivered in a very similar pattern.
- The returns are closely correlated.

% Correlations With Equities - Three Years to March 2019

	Equity
Bonds	0.44
Property	-0.15
DG	0.83
Absolute	0.86
Infrastructure	0.31
Absolute FI	0.55

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The Risk/Return Trade Off

Performance of Varying Allocations – three years to March 2019

% Allocation			% p.a.	
Equity	Bond	DG	Return	Volatility
80	20		11.5	7.6
70	20	10	10.5	7.0
60	20	20	9.5	6.4
50	20	30	8.5	5.9

- Over the last three years adding a 20% DG weighting would have reduced the overall fund volatility by 1.2% p.a.
- The cost in terms of performance would have been 2.0% p.a.
- On a fund of £2bn this represents in excess of £120m.

The cost needs to be clearly articulated, measured and understood. What benefit did the Fund gain from the reduced volatility? Was it worth the cost?

Too Much Diversification?

Impact of Strategic Allocations Five Years to March 2019

Fund Weightings							Performance Last 5 years	
Equity	Bond	Property	Alts	DG	AR Bond	Infra	Return	Volatility
100							9.9	9.1
80	20						9.1	7.7
70	20	10					9.1	6.7
60	20	10	10				9.2	6.0
50	20	10	10	10			8.5	5.4
50	15	10	10	10	5		8.4	5.4
50	15	10	5	10	5	5	8.5	5.4

- The scale of diversification has to be significant to make a tangible difference.
- At 5% they are making almost no difference to either the overall fund return or the overall fund risk.
- Challenge the value of incremental diversification – what will it achieve? Can a similar end be reached by reallocating existing assets?

Complexity Brings Challenges

- Range and complexity of asset types and products has led to a greater reliance on consultants.

It is your responsibility to understand what the Fund invested in – if you can't articulate it don't invest in it.

- Pressure continues to broaden investment.
- Increased administration and committee time burdens need added into any decisions.
- More choice makes manager selection more difficult
- Likelihood of increased manager / portfolio change
- Focus being moved from return to volatility without Funds fully understanding the cost impacts.
- Smaller portfolios likely to have limited impact and incur higher costs.

How Could Pooling Assist?

- By removing some manager selection Funds should be able to focus on understanding, defining and implementing strategy.

  May help reduce reliance on consultants.

  (But will this lead to more 'tinkering' with strategy?)
- More available resource and expertise to research and chose providers and create products that match the needs of the LGPS.
- Funds will have larger holdings from a smaller range of options.

  But

  Complexity potentially embedded into pool offerings

In Summary

- De-risking has got to be about more than just reducing volatility.
- Funds need to **understand** and define the key risks and ensure that they are invested accordingly.
- Be prepared to challenge advisors.
- Understand the risk / return trade off.
- There is such a thing as too much diversification.
- Pools may be able to assist in helping funds derisk but not there yet.

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

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