Non-Executive Report of the: **Pensions Committee** 29 November 2017	
Report of: Zena Cooke, Corporate Director, Resources	**Classification:** Unrestricted
Update on Market Outlook and the Fund Investment Managers by the Independent Adviser for Quarter Ending 30th September 2017	

Originating Officer(s)	Raymond Haines, Independent Adviser Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report informs Members the views of the Independent Adviser on the performance of the markets and the Pension Fund investment managers for the second quarter of 2017/18.

Recommendations:

Members are recommended to note the contents of this report

1. REASONS FOR THE DECISIONS

1.1. The report informs the Pensions Committee of the views of the Fund Independent Adviser on markets and the performance of the Fund pension fund managers and the overall performance of the Tower Hamlets Pension Fund.

2. ALTERNATIVE OPTIONS

2.1. The Pension Fund Regulations require that the Council establishes arrangements for monitoring the investments of the Pension Fund and to engaged the use of an expert in gaining required knowledge and advice so there is no alternative but to note the views of the Independent Adviser of the Fund to the Pension Committee on a regular basis,

3. UPDATE FROM INDEPENDENT ADVISER – Raymond Haines

Markets and Economics

3.1 For the last twelve months I have been cautioning that markets were getting ahead of themselves and were losing touch with the fundamentals. The third quarter of 2017 continued the trend. Global equity markets moved ahead with the MSCI World Index (+2.0% in GBP)* reaching record highs despite ongoing geopolitical tensions and tighter US monetary policy and the US Federal Reserve, confirming plans to start reducing the size of its balance sheet. This is the start of the normalisation of monetary policy, of which more later. In the US, the S&P 500 index reached new highs.

3.2 The UK market underperformed global markets, but UK mid-cap stocks delivered better returns, benefitting from sterling strength. European markets (+3.6% in GBP)* gained as stronger business confidence. Emerging market equities continued to perform well (+4.6% in GBP)*. Rising commodity prices also supported emerging market equities.

3.3 In the face of rising inflation around the world, bond markets and Global government yields moved broadly sideways over the third quarter. The Federal Reserve maintained its benchmark interest rate over the quarter having raised it in June by 25bp (basis points; 25bp = 0.25%), but confirmed would begin to shrink its balance sheet from October.

3.4 In Europe, the European Central Bank (ECB) suggested it will remain very cautious in unwinding its highly accommodating monetary policy; Europe has negative interest rates. The headline inflation rate nevertheless remains below the ECB's 2% target. In the UK, inflation continued to overshoot its target. One of the largest factors increasing the inflation rate was the depreciation of sterling since last year's EU referendum. This ought to be transitory and as wage inflation remains at best muted the "excuse" for the recent hike is questionable.

3.5 In its commentary for the third quarter Ruffer highlights the issues about which I have talked. Jonathan Ruffer suggests "that this is the most difficult market that I can remember, excepting only the TMT boom in 1999, when 'new economy' stocks soared upwards." He highlights the reason is the cost of money, i.e.

interest rates, “it yields nothing, and this means that all assets are overpriced, since all assets are priced against the return on cash.” What he means is that investors start with the risk free rate (RFR) and require returns relative to the RFR.

3.6 The more volatile (riskier) the investment, the higher the required margin over the RFR. “We are therefore in the topsy-turvy world that the more inherently safe an investment is – a promise from HM government to pay interest and give your capital back in a year’s time, say – the more risky it is, because it is wrongly priced”.

3.7 Ruffer’s philosophy and what attracted us to them was its risk averse approach looking more a preservation of real capital than nominal growth. Inherent in this is the search for hedges, things that will offset the impact if the investment thesis is wrong. “Booms are much easier as opportunities to lose money than to make it” in that they tend to suck investors in on the belief that there will always be a ‘greater fool’ to whom to sell, or as Ruffer put it “....there’s no obvious thought process to leave the winning trade.” The problem is that the RFR is zero or in real terms, negative. It highlights areas which give it cause for concern as the funds flowing into Private Equity, infrastructure and property where there is little liquidity and prices are subjective.

3.8 Interestingly our property managers are saying “despite the current resilience of the UK real estate market we continue to adopt a defensive stance.” They are cautious about the Central London office market due to falling rents and are looking for “niche sectors and strategies (e.g. residential land, real estate debt) which should be less correlated with the main commercial markets.” Which perhaps suggest the best has been seen.

3.9 There is a general consensus across the managers that the economic outlook is positive and stable. However even Baillie Gifford has been taking some risk off the table. In the Diversified Growth Fund it is cautioning that there is a clear risk that the path of monetary policy in the developed world, particularly in the US, becomes less supportive for investment markets.

3.10 The announcement by the US Federal Reserve that its intention was to reduce the vast book of bonds accumulated during its quantitative easing programme is but a beginning. Alongside an increase in interest rates, this could result in US government bond yields rising markedly. “Given the broad range of financial instruments influenced by the US Fed’s decisions – both domestically and internationally – this is an important consideration for investment markets and future return expectations.”

3.11 It also cautions on current valuations. “Specifically, what to make of the rising valuations we are seeing across the broad range of asset classes we look at.” The nine year long period of extraordinarily loose monetary policy since the Great Financial Crisis has driven asset prices higher rather than, as had been hoped, a boom in capital investment. This has “helped to push an increasing number of markets to a point where they are at least fully valued if not expensive.” An unexpected or sudden removal of stimulus would likely have a detrimental impact on sentiment and market levels. That central banks are aware of this is highlighted by the way they are providing “forward guidance”; it is clear they are acutely aware of the impact they can have.

3.12 Growth is currently running at around or slightly above-trend rate. Unemployment levels have fallen and in the UK and US at levels which have historically seen wage growth; capacity utilisation is rising. The market is not anticipating significant increases in interest rates. Sooner or later, it will become appropriate for central banks to tighten monetary policy. This is likely to come through a both interest rate rises and withdrawal of the stimulus provided by quantitative easing. This has already begun in the United States, and other developed economies may follow over the next year. There is already some momentum towards a gradual tightening of policy in the UK and Europe.

3.13 **How far will interest rates rise?** Low inflation and the high debt levels found in many countries suggest rate rises will be limited as a small increase in the cost of debt could, given high debt levels, bring on a meaningful slowdown in growth. On the other hand, economic activity can exhibit strong momentum. So far, falling unemployment levels have not translated into strong wage growth, limiting spending power and keeping inflation low. In turn, this has given central banks greater leeway in judging where to set policy. However, this state of affairs may not persist and any indication that central banks have misjudged the situation would be damaging.

3.14 Regardless of whether interest rate rises are small and limited, or large and significant, we are moving into a period of tighter credit conditions. This will have a dampening effect on returns and will call into question valuations across asset markets. Most obviously, bond yields are set to rise. Government bond yields continue to trade at historically low levels and it is difficult to see government bonds delivering positive returns. Credit spreads, the additional return on offer from credit markets are very low and looking increasingly unattractive.

Conclusion

3.15 We have as they say been living in 'interesting times', we have had a series of economic, political and weather 'crises' and markets have sailed serenely along. It has long been my contention that this liquidity and momentum driven bull market will end in tears. Jonathan Ruffer likens this to the 1999 tech boom, it reminds me of 2006/7 when the mispricing was of risk and especially credit risk. We are still living with the consequences. The problem Ruffer highlights is the absence of alternative homes for fund assets that are not already overpriced which probably means emerging economies and markets. However, the focus should be on protection and diversification.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1. There are no direct immediate financial implications arising as a consequence of this report. The governance role of the Pensions Committee requires that they ensure that they take proper advice at reasonable intervals about its investments and must consider such advice when taking any steps in relation to its investments.

4.2. Understanding and being aware of the financial markets and its economics dynamics will compel the Committee to be able to consider the longer term financial impact of this parameters and make reasonable financial decisions when setting investment and contribution strategies.

4.3. The costs of obtaining the advice are estimated to be in the region of £20k - £35k per annum and will be met from the pension fund.

5. LEGAL COMMENTS

5.1. In accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, the Council must take proper advice about its investments and must consider such advice when taking any steps in relation to its investments. 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. 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 the performance of the markets 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.

5.2 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.

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1. 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.

6.2. A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1. This report helps in addressing value for money through benchmarking the Council's performance against the WM Local Authority Universe of Funds.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1. There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

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

9.2. To minimise risk the Investment Panel attempts to achieve a diversification portfolio. Diversification relates to asset classes and management styles.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

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

Linked Reports, Appendices and Background Documents

Linked Report

- [None]

Appendices

- [None]

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

- [None]

Officer contact details for documents:

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