Non-Executive Report of the: **Pensions Committee** 29 November 2018	
Report of: Neville Murton, Acting Corporate Director, Resources	**Classification:** Unrestricted
Independent Advisor Report on Market Outlook and Fund Assets Performance for Quarter Ending 30 September 2018	

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

REASONS FOR URGENCY

The report was not published five clear days in advance of the meeting. Therefore, before this report can be considered at this meeting, the Chair would need to be satisfied that it is necessary to consider the views of the Independent Adviser without that consideration being delayed to a later meeting. The Committee may also take the view that it is important that there is no delay in member oversight of the views of the Independent Adviser.

Summary

This report presents the views of the Independent Adviser (Colin Robertson) in respect of the performance of the markets and the Fund Assets for the second quarter of 2018/19.

The Independent Adviser will also be present at the meeting to take questions from Members.

Recommendations:

Members are recommended to note the contents of this report

1. REASONS FOR THE DECISIONS

1.1. The report presents the Pensions Committee with the views of the Fund's Independent Adviser on markets and the performance of the Fund pension fund managers and the overall performance of the Tower Hamlets Pension Fund. This is intended to assist Members with their considerations on relevant issues.

1.2. 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.

1.3. Understanding and being aware of the financial markets and its economics dynamics will assist the Committee in considering the longer term financial impact of its strategy for the Pension Fund and the investment decisions it makes as a consequence.

1.4.

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 engage the use of an expert in gaining required knowledge and advice. .

2.2. The Fund employs professional investment advisors to undertake that role (Mercers) but also uses an independent advisor to provide challenge and support on the advice and direction of the fund on investment and other relevant matters. It could adopt alternative arrangements provided that it satisfies itself that this was reasonable in the circumstances.

3. MARKETS AND ECONOMICS UPDATE (Quarter to 30 September 2018) FROM THE INDEPENDENT ADVISER TO THE FUND – Colin Robertson

Market performance

3.1 Equity markets performed strongly over the 3 months to 30 September 2018, following good performance in the previous quarter. Improved investor confidence in economic growth and strong reported corporate earnings pushed equities up despite the US / China trade dispute and discouraging news from some emerging markets and Italy. The variation in performance across markets was significant with UK and Emerging Market equities broadly flat while US, especially large technology / social media, and Japanese stocks rose sharply.

3.2 However, equity markets across the board have fallen sharply since the end of the quarter. As is usually the case in these situations, there is no one cause of the fall but a sharp increase in bond yields, the imposition of tariffs, concerns that economic growth has peaked, together with the European issues of Brexit and the Italian budget deficit, doubtless all played their part.

3.3 Bond yields rose pretty much everywhere during the third quarter. In the UK, this could be partly attributed to raised expectations for future inflation but generally the driver of the upward move was a rise in 'real" (after inflation has been deducted) yields. Reduced economic concern and the ongoing withdrawal

of central bank support for bond markets are likely causes. Since the end of the quarter, US yields have continued to rise whereas European / UK yields have fallen somewhat.

Economics and markets

3.4 Economic growth in the US has now continued for close to 10 years without a recession and there has been growing concern that this cycle is very long in the tooth. Nevertheless, US growth has remained robust with stimulus provided by the Trump administration's tax cuts. Elsewhere there have been distinct slowdowns in growth but these have been considered temporary, caused in Japan by the extreme summer weather, in the Eurozone by a change in car regulations and in the UK by uncertainty over Brexit. The problem is that interest rates remain at extremely low levels outside of the US so cannot be cut meaningfully when recession inevitably looms, while budget deficits limit the scope to increase public spending or cut taxes.

3.5 The slowdown in Chinese growth has been a worry for some but it appears that actions taken by the authorities in a centrally managed economy will at least stabilise the situation. In other emerging economies, new Presidents in Mexico and Brazil have led to some apprehension. However, the relative underperformance of Emerging Markets equities and bonds would seem to indicate that investors have already priced in this uncertainty.

3.6 Against this backdrop, quoted company earnings growth in 2018 remains robust in the US and, although expectation have been lowered, decent growth is still expected in Europe and Japan this year. The high single figure growth in earnings anticipated in 2019 is likely to prove rather a stretch but positive growth should still be achievable in the absence of a recession. This has left equity market valuations at similar or more attractive levels than 3 months ago. Equity valuations are rather high from an historical perspective, making equities vulnerable, but almost all asset classes are expensive so that equity valuations are not unduly demanding relative to the valuations of other asset classes.

3.7 Unemployment has fallen to very low levels in the US and UK but wages have not risen as one might have expected. This has been a source of consternation for central bankers who have struggled to bring inflation up to the widely adopted 2% target. However the latest quarter has seen some increase in wage growth, leading to interest rate increases in the US and UK with a further US increase expected in December. Combined with the end of 'quantitative easing' in these countries and reduced purchases of Eurozone bonds by the European Central Bank, this should mean that the upward trend in bond yields (and downward trend in bond prices) is unlikely to be reversed.

Asset allocation

3.8 The risks to equity markets abound. Many of these are political, for example US isolationism, the regulation of social media, Brexit and the strange alliance in Italy of populist left and right fighting together against the European authorities. As such it may require an economic agent to trigger material damage to markets but with the economic cycle being already so extended and money much less plentiful now that the central banks have started tightening policy, the situation is fragile. Therefore the equity protection strategy which has been

put in place to partly hedge the fund's very sizeable underlying equity exposure continues to look justified.

3.9 For many years equities and bonds have tended to be negatively correlated, meaning that if the price of one went up, then the price of the other would go down. This is now being questioned as the withdrawal of central bank liquidity is liable to cause all asset classes to move in the same direction simultaneously, leaving nowhere to hide. This has encouraged investment in fund manager products focussed on manager skill, as distinct from investments which are susceptible to changes in market levels. Unfortunately, manager skill has often not been evident in these products (see below) and a reappraisal of the fund's specific investments of this nature may be in order.

Investment Managers Performance Review

3.10 I have not commented on the passive funds for which I do not as yet have performance statistics but which should in any case not be contentious given the nature of the funds involved.

Active Equity Fund

3.11 The remarkable outperformance of its benchmark by the LCIV Baillie Gifford Global Equity fund was interrupted in the latest quarter when it underperformed its benchmark by 2.6% over the quarter. The fund has held an above average exposure to Emerging Markets (EM) equities for some time but had still managed to match its benchmark in the previous quarter despite the poor performance of EM equities. However on this occasion the continuing poor EM equity relative performance, combined with an underweight to the US market which performed particularly well, was more problematic. Individual stock selection within markets was also unhelpful.

3.12 Baillie Gifford have been quite aware of the fund's sensitivity to the economic cycle and to a reversal in performance of their highly valued top performing stocks. Accordingly, they have continued to reduce the size of their holdings in top performing stocks and the exposure to cyclical stocks was also reduced over the quarter.

Diversified Growth Funds

3.13 The LCIV Baillie Gifford fund rose by a very meagre 0.1% over the quarter, leaving it up by 1.25% over the last year. Funds which aim to outperform cash by set amounts, typically 3%-5%, have found market conditions very difficult in recent years. Consequently, while Baillie Gifford's Diversified Growth Fund performance is disappointing, it is better than that of many similarly targeted funds. Factors restraining the fund's performance were varied and included exposure to nickel and Argentine bonds.

3.14 The LCIV Ruffer fund performed poorly, falling by 0.4% over the quarter. This was surprising given that the fund's performance is sensitive to equity market movements and equities performed strongly over the quarter. This can be partly attributed to the significant exposure to the UK equity market which did not perform well but the fund also has a significant exposure to Japanese equities which did perform well. Negative factors are reported to have been the large holding of index-linked gilts and the investment in gold. I understand that Ruffer

have now hedged the interest rate component of the index-linked gilts holding, but not the inflation component.

Absolute Return Bond Funds

3.15 The Insight and GSAM Absolute Return Bond funds had yet another poor quarter with both funds falling by 0.2% over the 3 month period. Over the last year, the Insight and GSAM funds have fallen short of their targets by 5.0% and 6.4% respectively. GSAM has a 1% tougher target so actual performance has been similar.

3.16 In both cases, positions which had already cost them dearly again contributed to underperformance. For GSAM, this was a positive view on Argentine and Venezuelan bonds and also on the Argentine peso, which more than offset all the positive contributors to performance. For Insight, this was a negative stance on German bonds, partly offset by a positive stance on US bonds, both legs of which have done badly. Worryingly, there were significant negative contributions from 5 of the 9 sources of potential outperformance. Interestingly, GSAM do not use 'stop losses' at all for their product while Insight do not use 'stop losses' when the view is 'strategic'. 'Stop losses' are a commonly used technique to prevent investment views which have gone wrong becoming an ongoing burden for the fund. In short, risk management is an issue at both companies.

Multi Asset Credit Fund

3.17 The LCIV CQS Multi Asset Credit Fund was launched only in May 2018 so it is too soon to make a meaningful comment on performance. However, the fund has got off to an encouraging start, rising 1.3% from launch and 1.5% over the quarter with each sub asset class within the fund making a positive contribution to performance.

Property Fund

3.18 The Schroder Real Estate Capital Partners fund continued its solid performance, outperforming its benchmark by 0.3% over the quarter, by 0.5% over the year and by 0.3% over 3 years. There was nothing new here: an overweighting of the strongly performing industrial sector and an underweighting of the poorly performing Central London offices sector again drove performance and no change in strategy is envisaged. Not for the first time, the small Continental European exposure made a minor negative contribution to performance). The more sustained trends have been for US Treasury yields to rise (prices fall), German yields to fall and UK gilt yields to be fairly stable.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1. This report has been produced independently by Colin Robertson to inform the Committee's knowledge and understanding of a wide range of issues relating to the Pension Funds investment activiity. There are no other direct financial implications arising from this report.

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 Council 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]

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