Non-Executive Report of the: **Pensions Committee** 20 June 2019	TOWER HAMLETS
Report of: Neville Murton, Corporate Director, Resources	**Classification:** Unrestricted
Independent Advisor Report on Market Performance and Fund Performance for Quarter Ending 31 March 2019	

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

Summary

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

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

REASONS FOR URGENCY

The report was not published five clear days in advance of the meeting. Therefore, before this item can be considered at this meeting, the Chair of the Committee would need to be satisfied that it is necessary to consider Independent Advisors Report at this meeting, the Committee may also take the view that it is important that there should not be an extended period without member oversight.

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.

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 31 December 2018) FROM THE INDEPENDENT ADVISER TO THE FUND – Colin Robertson

Market performance

3.1 Equity markets fell very sharply over the 3 months to 31 December 2018. In Equity markets rose very strongly over the 3 months to 31 March 2019, recouping a lot of the ground lost in the previous quarter when equity markets fell sharply. The flow of news continued to be poor but this led to the Federal Reserve Board in the US and central banks elsewhere loosening monetary policy. In turn, this resulted in relieved investors and rising stock markets. Stimulus provided by the Chinese authorities was important as investors had become particularly concerned over the slowdown in the Chinese economy.

3.2 Having fallen significantly in Q4 2018 on the back of slowing economic growth and falling stock markets, government bond yields continued to fall in Q1 2019 as economic growth remained subdued and interest rates started to seem likely to be cut later in the year. Credit spreads (excess yields of corporate bonds over government bonds) fell for the same reasons as equity markets rose, leading to sizeable rises in corporate bond prices.

3.3 It is notable that equity and government bond investors reacted quite differently to economic developments than in Q4 2018 when equity and bond markets moved in opposite directions. Either bond investors were only interested in the outlook for short term interest rates or they did not share equity investors' improved sentiment towards the economy.

Economics and markets

3.4 Few of the problems which investors faced at the turn of the year have gone away. In particular, the political situation globally has worsened. Tariffs affect global assembly chains which in recent years have boosted global growth, while using trade sanctions to win trade deals is highly disruptive. Investors are generally assuming that trade wars will be managed and short lived but there is a risk of the situation getting out of hand. In the UK, Brexit is affecting both domestic capital investment and overseas investment in the UK.

3.5 More positively, unemployment is low and wages appear to be starting to pick up. Inflation is not about to force policymakers to tighten policy, indeed too low inflation in their eyes is as likely to lead to policy being loosened. Although it is difficult to envisage economic growth strengthening markedly, continuing moderate growth appears perfectly plausible. The issue is that with policy already so simulative, policymakers have few tools at their disposal when something goes awry.

3.6 Equity market valuations have risen as a result of the strong rise in markets during the first quarter of this year but, especially outside of the US, valuations are still not unduly demanding. Compared to the valuations of most other asset classes, equity valuations are clearly attractive. For example, gilt yields are not far from the all-time low level recorded and UK equities yield some 3% more than the yield on 10 year gilts.

3.7 However, there is a significant proviso which is that company earnings do not fall substantially on a sustained basis. In very broad terms, the corporate profits of quoted companies in developed markets are expected to grow at a mid-single digit rate in 2019 and by close to 10% in 2020. With corporate profit margins at historically very high levels, this seems rather optimistic. The various threats to profits include rising wages, economic slowdown and regulatory restraints on companies such as Facebook and Google. Nevertheless, so long as profits can be expected to recover after a fall to a level not too far from current levels, then the impact on equity markets of disappointing profits should be relatively short term.

3.8 Bonds offer ever worse value. German 10 year bonds now yield negative 0.2% so investors are guaranteed to lose money, even before allowing for inflation. In the UK, index-linked gilts yield less than negative 2% at a time when one might have anticipated that the Brexit shambles would lead to a downgrading of the UK's credibility and consequently higher yields. Explanations for this state of affairs include the need to buy protection against a fall in equity markets and the need to buy gilts to match liabilities, not least pension fund liabilities. An obvious question is what price should pension funds be prepared to pay for this protection?

Asset allocation

3.9 While the fund's allocation to liability matching bonds is not that different from that of many other LGPS funds, it is very low both from an historical perspective for a pension fund and relative to the typical private sector pension fund at this time. Given my comments above, this would not appear to be the ideal time to increase exposure to liability matching bonds but this should be considered on a significant rise in gilt yields.

3.10 Investment in infrastructure would provide some protection against movements in the value of the liabilities and should be achievable on reasonably attractive terms. It would also satisfy the Government's demands for LGPS funds to invest in infrastructure. Now that the London CIV has a plausible infrastructure fund, serious consideration should be given to investment in infrastructure.

3.11 Leaving aside the equity protection strategy, the fund's exposure to equities is some 4% above the strategic benchmark. Given the outlook for equities, it would be reasonable to rebalance the equity exposure back to benchmark, freeing up cash for investment elsewhere.

Investment Managers Performance Review

Active Equity Fund

3.12 Following two quarters of underperformance relative to its benchmark, the LCIV Baillie Gifford Global Equity fund outperformed its benchmark over the latest 3 month period by more than 2%. While the longer term performance is very good, the fund's performance relative to its benchmark during the last 12 months has proven sensitive to the direction of equity markets. Therefore relative outperformance in the latest quarter over which equities rose strongly was unsurprising.

3.13 The manager is conscious of this feature which is caused to a considerable extent by the fund's high exposure to so called 'growth' and emerging markets stocks which are both relatively volatile. Consequently, the manager took some profits during the quarter by selling part of the holdings in Amazon and Banco Bradesco which had both performed strongly. However, the purchase of a new holding of Reliance Industries in India and an increase in the holding in Alibaba, a Chinese growth stock, resulted in the emphasis on growth and emerging markets being maintained.

3.14 This should not be an undue source of concern so long as the appropriate controls are in place and the manager is willing to change the emphasis as investment conditions dictate. In this context, one trusts that the new Chinese office which the manager has opened can be justified by better stock selection and not by increasing the already large exposure to China.

Diversified Growth Funds

3.15 Diversified Growth Funds have target returns of 3%-4% above the return on cash and aim to provide diversification away from equities. However, in reality most have some degree of sensitivity to equity market movements. Therefore it could be expected that the LCIV Baillie Gifford and LCIV Ruffer funds would

perform strongly in Q1, after very poor performances in the previous quarter, as equity markets recovered from the falls in Q4.

3.16 Baillie Gifford increased risk during the quarter through buying UK property trusts, European High Yield bonds and Chinese stocks (see comments in the Active Equity section above). The fund price rose by over 6%, more than recovering the fall in the previous quarter but still broadly unchanged over the last 12 months.

3.17 Ruffer's 12 month performance was similar but more subdued over the quarter, restrained by sizeable exposure to inflation protected bonds.

Absolute Return Bond Funds

3.18 Bond fund managers had to contend with two opposing factors during the 3 The Absolute Return Bond fund managers have similar return targets to those of the Diversified Growth Fund managers but a smaller opportunity set from which to achieve these targeted returns. In particular, they are unable to invest in equities which performed so strongly in the first quarter.

3.19 The GSAM performance of +2.7% over the quarter was very good and attributable to a wide range of factors, most notably good country selection and choice of type of bond. However, as with the Diversified Growth Fund managers, the price was more or less flat over 12 months.

3.20 In contrast, Insight had yet another disappointing quarter with the fund price falling by 0.2% and by more than 4% over the last year. Of the 10 potential sources of outperformance, only the allocation to investment grade credit produced a significantly positive number while their doggedly negative stance on German bonds continued to be a major detriment to performance.

3.21 The longer term performance of both managers is unsatisfactory.

Multi Asset Credit Fund

3.22 Unlike the Absolute Return Bond fund managers, the LCIV CQS Multi Asset Credit Fund can only invest in credit markets and so has a more restricted universe from which to produce good investment returns. Nevertheless, the fund returned 2.6% over the quarter, the same as the GSAM fund discussed above. This return was derived from all 5 sub asset classes, as well as from their currency strategy.

3.23 To achieve this level of return, CQS use leverage and take strong views, currently being positive on US credit and on floating vs fixed rate instruments. They are also more at the mercy of the direction of market movements than the Absolute Return Bond fund managers. Regardless, they have managed to produce a good and fairly consistent longer term record to date.

Property Fund

3.24 Once again the Schroder Real Estate Capital Partners fund performed soundly and it is ahead of its benchmark over the quarter, one year and three years (although it has not achieved its rather demanding target of beating the benchmark by 0.75% p.a.). The exposure to European property which has been such a drag on performance over the years is now down to 0.5% of the fund's

value. The strategy of overweighting the industrial sector, regional offices and niche areas such as retirement villages and supported social housing is unchanged.

Passive Funds

3.25 The LGIM passive funds performed in line with their benchmarks as one would expect.

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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