| COMMITTEE: | DATE: | CLASSIFICATION: | REPORT NO. | AGENDA NO. |
|---|---|---|---|---|
| **Pensions Committee** | **24 February 2015** | **Unrestricted** | | |
| REPORT OF: Acting Corporate Director of Resources<br>ORIGINATING OFFICER(S): Bola Tobun– Investment and Treasury Manager | | TITLE: **Investment Performance Review for Quarter End 31 December 2014**<br>Ward(s) affected: N/A | | |

## 1. SUMMARY

1.1 This report informs Members of the performance of the Fund and its investment managers for the quarter ending 31st December 2014.

1.2 For the quarter, the Fund outperformed the benchmark by 0.3%, delivering a positive absolute return of 2.8% against benchmark return of 2.5%.

1.3 The Fund is ahead its benchmark for the last twelve months to end of December 2014, the Fund returned 7.3%, and this exceeds the benchmark by 0.2%.

1.4 For longer term performance the Fund posted three year returns of 10.4% ahead the benchmark return of 10% and posted five year returns of 8.1% against benchmark return of 8.2%.

1.5 For this quarter end, five out of the eight mandates matched or achieved returns above the benchmark. The Fund performance was above the benchmark over the quarter, this was mainly due to relatively good returns from Ruffer, Baillie Gifford Global Equities, Investec and Legal & General portfolio.

1.6 The Fund is still in line with its long term strategic equity asset allocation and the distribution of the Fund’s assets amongst the different asset classes is broadly in line with the strategic benchmark weight.

## 2. DECISIONS REQUIRED

2.1 Members are recommended to note the contents of this report.

## 3. REASONS FOR DECISIONS

3.1 There are no decisions to be made as a result of this report. The report is written to inform committee members of the performance of pension fund managers and the overall performance of the Tower Hamlets Pension Fund.

## 4. ALTERNATIVE OPTIONS

4.1 The Pension Fund Regulations require that the Council establishes arrangements for monitoring the investments of the Pension Fund.

## 5. BACKGROUND

5.1 The Pension Fund Regulations require that the Council establish arrangements for monitoring the investments of the Fund. It considers the activities of the investment managers and ensures that proper advice is obtained on investment issues.

5.2 Officers and fund advisers meet regularly with investment managers to discuss their strategy and performance and may recommend that investment managers are invited to explain further to the Pensions Committee.

5.3 This report informs Members of the performance of the Fund and its investment managers for the quarter 31 December 2014.

**Legal & General Investment Management**

5.4 Legal & General was appointed (2 August 2010) to manage passively UK Equity and UK Index-Linked Mandates, which at 31 December 2014had a market value of £216.1m. The value of the assets taken on at the commencement of the contract was £204.7m.

5.5 The performance target is to track the FTSE All Share index for the UK Equity mandate and FTSE A Gov Index-Linked > 5 years benchmark for the UK Index-Linked Mandates.

**Baillie Gifford & Co**

5.6 Baillie Gifford manages two distinct mandates; global equity mandate and diversified growth fund mandate. The global equity fund had a value of £118.9m at the start of the mandate in July 2007. The market value of the assets as of 31 December 2014 was £199.4m. The performance target for this mandate is +2% to 3% above the benchmark MSCI AC World Index gross of fees over a rolling 3-5 year periods.

5.7 The diversified growth fund mandate was opened in February 2011 with contract value of £40m. The market value of assets as at 31 December 2014 was £49.1m. The performance target for this mandate is to outperform the benchmark (UK base rate) net of fees over rolling 5 years with annual volatility of less than 10%.

**GMO**

5.8 GMO manages a Global Equity Mandate which at 31 December 2014 had a market value of £250.7m. £20.8m was redeemed from the portfolio in order to keep it in line with the strategic asset allocation weight for this manager. The initial value of the assets taken on at the commencement (29 April 2005) of the contract was £201.8m.

5.9 The performance target is to outperform a balanced global equity benchmark by 1.5% per annum net of fees over a rolling three year period.

**Investec Asset Management**

5.10 Investec manages a Global Bond Mandate which at 31 December 2014had a market value of £99.5m. The initial value of the assets taken on at the commencement (26 April 2010) of the contract was £97m.

5.11 The performance target is to outperform the benchmark (3 Month LIBOR) by 2.0% per annum net of fees over a rolling three year period.

**Ruffer Investment Management**

5.12 Ruffer manages an Absolute Return Fund; the value of this contract on the 28 February 2011 was £40m. The value of assets under management as of 31 December 2014 was £48.3m.

5.13 Their overall objective is firstly to preserve the capital over rolling 12 month periods and secondly to grow portfolio at a higher rate after fees than could reasonably be expected from the alternative of depositing the cash value of the portfolio in a reputable UK bank.

**Schroder Investment Management**

5.14 Schroder manages a property mandate. The value of this mandate on 20 September 2004 was £90m. The market value of assets at 31 December 2014 was £119.2m.

5.15 The performance target for this mandate is to outperform the IPD UK Pooled Property Fund Indices All Balanced Funds Median by 0.75% net of fees over a rolling three year period.

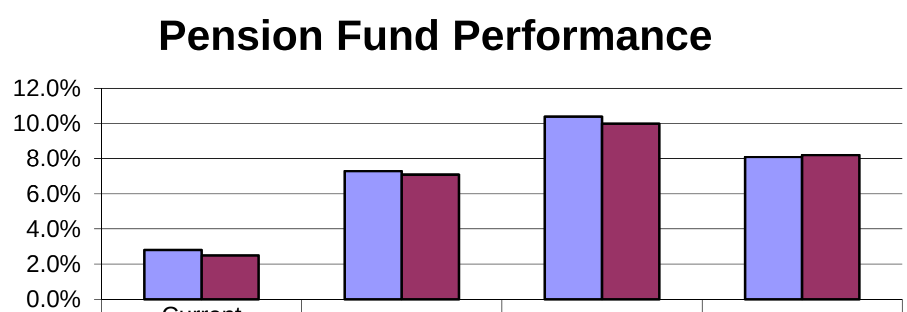
# 6. INVESTMENT PERFORMANCE

6.1 The Fund's overall value has increased by £31.77m from £1,049.7m as of 30 September 2014 to £1,081.5m as of 31 December 2014.

6.2 The fund outperformed the benchmark this quarter with a return of 2.8% compared to the benchmark return of 2.5%. The twelve month period sees the fund outperforming the benchmark by 0.2%.

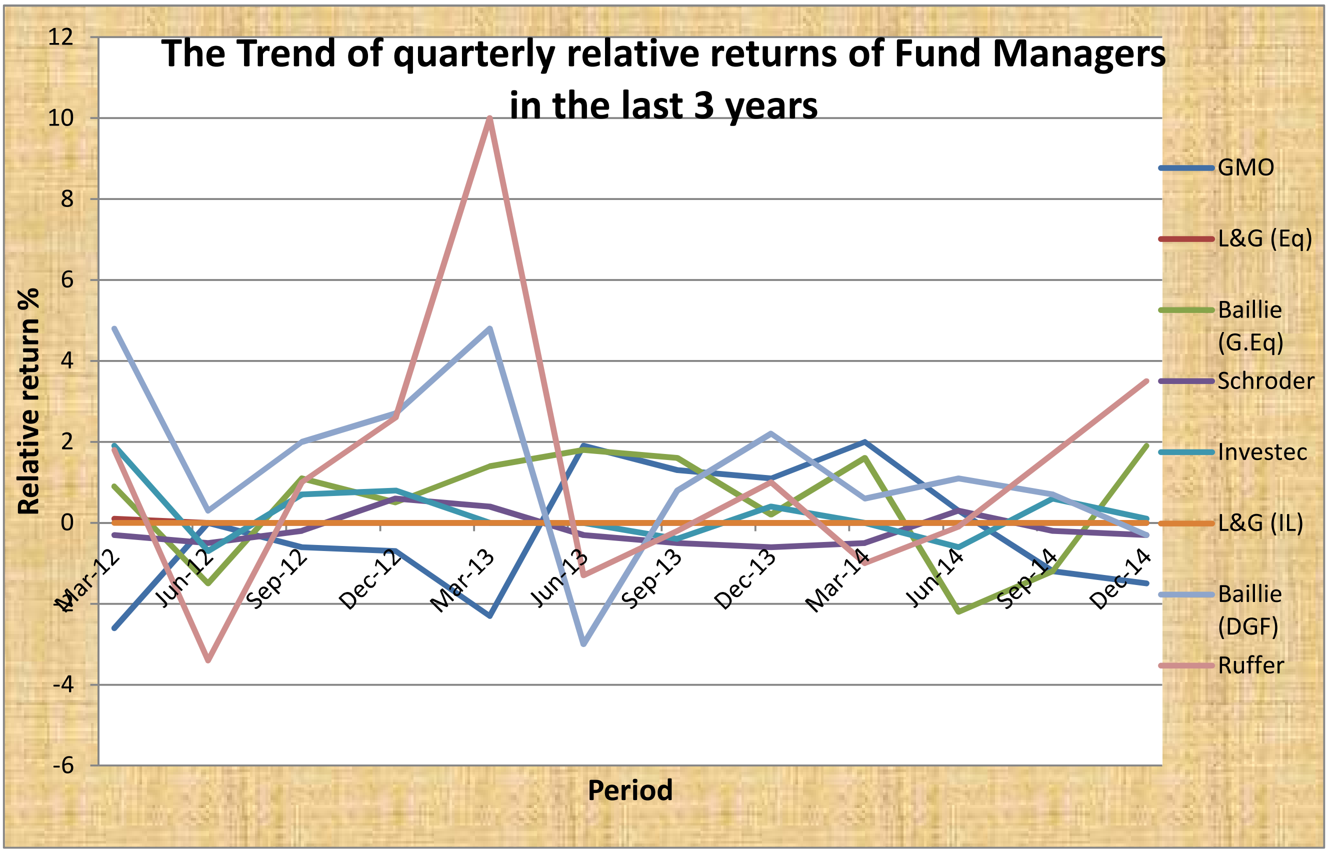
6.3 The performance of the fund over the longer term is as set out in the chart below.

**Table 1 – Pension Fund Performance**




| | Current Quarter | One Year | Three Years | Five Years |
|---|---|---|---|---|
| Fund | 2.8% | 7.3% | 10.4% | 8.1% |
| Bench Mark | 2.5% | 7.1% | 10.0% | 8.2% |

6.4 The graph below demonstrates the volatility and cyclical nature of financial markets, but the outcomes are within the range of expectations used by the Fund actuary in assessing the funding position. The Fund can take a long term perspective on investment issues principally because a high proportion of its pension liabilities are up to sixty years in the future. Consequently it an effectively ride out short term volatility in markets.




## 7. MANAGERS

7.1 A decision was made at the last quarterly meeting of rebalancing the Fund, in order to reduce the Fund's overweight to equities given the strength of equity markets. And also to provide a better balance between the two global equity mandates. Taking into account the current overweight position of Baillie Gifford global equity portfolio, it was agreed that:

- the target allocation to Baillie Gifford GE should be increased from 16% to 18%;
- the target allocation to GMO should be reduced from 25% to 23%; and
- 2.0% would be subsequently disinvested from GMO portfolio to bring this mandate broadly in line with the new target allocation, to be held as cash for later investment opportunity.

7.2 The Fund employs six specialist managers with eight mandates. The managers, mandate and funds held under management are set out below:

## Table 2: Management Structure

| Manager | Mandate | Value December 2014 £m | Benchmark Weight % of Fund Managers | Actual Weight % of Fund Managers | Difference % | Value September 2014 £m | Revised B/Mark Weight Dec 2014 | Date Appointed |
|---|---|---|---|---|---|---|---|---|
| GMO | Global Equity | **250.74** | 25.0% | 23.3% | -1.7% | **267.83** | 23.0% | 29 Apr 2005 |
| Baillie Gifford | Global Equity | **199.44** | 16.0% | 18.4% | 2.4% | **187.28** | 18.0% | 5 Jul 2007 |
| L & G UK Equity | UK Equity | **216.08** | 20.0% | 20.0% | 0.0% | **214.80** | 20.0% | 2 Aug 2010 |
| Baillie Gifford Diversified Growth | Absolute Return | **49.08** | 5.0% | 4.5% | -0.5% | **48.77** | 5.0% | 22 Feb 2011 |
| Ruffer Total Return Fund | Absolute Return | **48.29** | 5.0% | 4.5% | -0.5% | **46.34** | 5.0% | 8 Mar 2011 |
| L & G Index Linked-Gilts | UK Index Linked | **57.65** | 3.0% | 5.3% | 2.3% | **52.68** | 3.0% | 2 Aug 2010 |
| Investec Bonds | Bonds | **99.49** | 14.0% | 9.2% | -4.8% | **98.69** | 14.0% | 26 Apr 2010 |
| Schroder | Property | **119.21** | 12.0% | 11.0% | -1.0% | **114.27** | 12.0% | 30 Sep 2004 |
| Cash | Currency | **41.47** | 0.0% | 3.8% | 3.8% | **19.03** | | |
| **Total** | | **1,081.46** | **100.0%** | **100.0%** | **0.0%** | **1,049.69** | **100.0%** | |

7.2 The Fund was valued at £1,081.5million as at 31 December 2014. This includes cash held and being managed internally (LBTH Treasury Management), this has increased to 3.8% of the total assets value.

7.3 The performance, gross of fees of the individual managers relative to the appropriate benchmarks over the past five years is as set out in table 3.

## Table 3: Manager Investment Performance relative to benchmark

| Manager | Current Quarter | One Year | Three Years | Five Years |
|---|---|---|---|---|
| GMO Global Equities | -1.50% | -0.50% | -0.80% | 0.00% |
| Baillie Gifford Global Equities | 1.90% | -0.10% | 1.90% | 2.00% |
| L & G UK Equity | 0.00% | 0.10% | 0.10% | N/A |
| Baillie Gifford Diversified Growth | -0.03% | 1.40% | 3.00% | N/A |
| Ruffer Total Return Fund | 3.50% | 3.70% | 3.60% | N/A |
| L & G Index Linked-Gilts | 0.00% | 0.00% | 0.10% | N/A |
| Investec Bonds | 0.10% | -0.60% | -0.60% | N/A |
| Schroder | -0.30% | -0.80% | -0.70% | -1.30% |
| **Total Variance (Relative)** | **0.30%** | **0.20%** | **0.30%** | **-0.10%** |

7.4 **GMO** - A rebalancing decision was made at the last meeting, to reduce the portfolio from 25% strategic allocation weight to 23%. As a result £20.8m was redeemed from the portfolio, which was equivalent of 2% of the total fund. GMO made absolute return of 1.3% in the quarter, underperforming the benchmark of 2.8% by 1.5%.

7.5 With exception of the U.S market, global equities posted weak results for this quarter amidst heightened volatility and increased dispersion across regional markets around the world. GMO, U.S high quality position carries less cyclical economic exposure compared to the U.S market and this produced a positive selection impact during the quarter. High quality stock outperformed the U.S market during the period as U.S. investors generally favoured a mix of less cyclical sectors including Health Care and Consumer Staples. The light concentration in energy stocks also contributed to relative returns for the quarter.

7.6 The emerging markets position produced negative allocation and selection impacts during the quarter. The largest detractor was Russia Energy as investors reacted to the oil price drop and continued concern around Russia/Ukraine. The portfolio position in China Financials was the biggest contributor for the quarter and it offset some of the shortfall.

7.7 The Japan position produced a negative allocation and selection impact during the quarter. The largest detractor was the overweight position in Japan Autos, specifically Nissan and Honda, which underperformed during the quarter.

7.8 The European value position produced a negative allocation impact during the quarter, as European value stocks trailed the broader market. Allocation within France and Italy was the leading detractor from returns.

7.9 Strong performance over the past 12 months means that the portfolio's performance since inception is now marginally above the benchmark, despite the poor relative performance exhibited during 2012 and Q1 2013.

7.10 **Baillie Gifford** – the portfolio outperformed the benchmark of 4.5% over the quarter, delivering a return of 6.4% resulting in relative outperformance of 1.9%. The portfolio is relatively concentrated and seeks to generate strong absolute returns over the long-term through the use of an unconstrained bottom-up approach. The portfolio also delivered on this over the longer term, as performance remains ahead of the benchmark over 3 years and 5 years.

7.11 The fund one year performance was under the benchmark return. Although the fund has delivered on its objective over the longer term, as performance remains ahead of the benchmark over 3 years, 5 years and since inception.

7.12 The main contributors to performance were Naspers and Royal Caribbean Cruises, the Fund's largest holding. Royal Caribbean Cruises saw strong yield growth driven by an improving economic outlook and positive pricing trends. Naspers has a significant stake in the Chinese gaming and ecommerce site, Tencent, to which its share price is highly correlated. Tencent released positive third quarter results which showed an increase in revenues and operating profits.

7.13 The stocks that detracted from performance were Rolls-Royce, which has seen an extended period of share price weakness throughout 2014 and Ultra Petroleum, whose share price fell following the drop in oil and gas prices.

7.14 **Legal & General - L & G (UK Equity)** – The portfolio returned 0.6% matching the index return over the quarter. At the quarterly index review there were two additions and four deletions.

7.15 **L & G Index Linked Gilts** – The portfolio returned 9.4% matching the index return over the quarter.

7.16 During the quarter there were four bond auctions, with maturities of 2024, 2034, 2042 and 2050. These raised approximately £5.7bn. The 2019 maturity fell out of the index as its remaining maturity fell below five years.

7.17 The portfolio held all 21 stocks contained within the benchmark index. The portfolio and index both had a modified duration of 22.51 years at the end of the quarter and the real yield was -0.74% (yield curve basis)

7.18 **Investec (Bonds)** – The portfolio delivered a return 0.7% against a target of 0.6% over the quarter. The marginal outperformance here was driven once again by the currency exposure.

7.19 The strategic long in the US dollar was a notable contributor after a buoyant US economy, and the subsequently more hawkish tones from the US Federal Reserve, helped the dollar rally.

7.20 Interest rate positioning and emerging market debt exposure both made broadly flat contributions. For the former, the contribution from the portfolio positioning in Australia was offset by the portfolio exposure to Japan. Meanwhile, emerging market debt came under significant pressure over the quarter and the fund manager selectivity served to help mitigate this drawdown and result in flat performance from their holdings here.

7.21 Corporate credit once again came over the pressure for the quarter and detracted modestly from returns for the portfolio. The unexpected volatility and subsequent 'risk-off' environment that ensued resulted in credit spreads widening. Nonetheless, the portfolio's defensive positioning helped limit the drawdown.

7.22 Longer term performance remains below the benchmark for 12 months, 3 years and since inception. 12 months to reporting period the benchmark returned 2.5% and the portfolio delivered 1.9%.

7.23 **Schroder (Property) –** The portfolio returned 4.3% over the quarter; this is below the benchmark of 4.6% resulting in underperformance of the benchmark by 0.3%.

7.24 There were a number of transactions in this quarter, with £3.2m of property purchases and £2.7m returns of capital. There were two returns of capital over the quarter: Columbus UK Real Estate Fund (£2.5m) and Schroder Continental European Fund I (£0.2m).

7.25 Longer term performance continues to lag the benchmark; with an underperformance 1.3% p.a. over the 5 years to 31 December 2014.

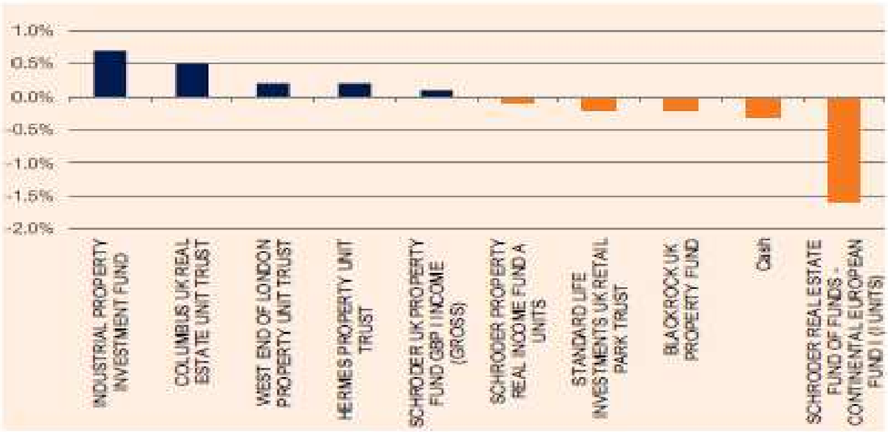
7.26 The UK investments assets (96% of the portfolio's value) outperformed by +1.4% over the past twelve months and 0.9% over the three years. The UK assets marginally underperformed the benchmark over the quarter due in part to cash held on account pending investment.

7.27 The Continental European Fund (4% of portfolio) produced a positive return this quarter, reducing the negative impact on overall portfolio performance.

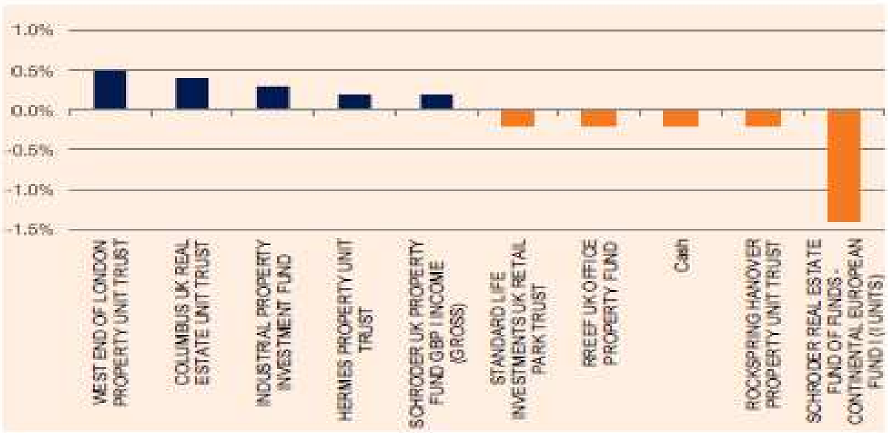
7.28 Please see below charts which illustrate the key drivers of performance in detail.

**Total return by region**
Periods to end 31 Dec 2014


**Total return attribution relative to benchmark top & bottom five contributors**
12 months to 31 Dec 2014




**Total return attribution relative to benchmark top & bottom five contributors**
3 years to 31 Dec 2014




7.29 **Baillie Gifford Diversified Growth Fund** generated a return of 0.6% for the quarter, underperformed the benchmark of 1.0% by 0.4%.

7.30 For the reporting quarter, the largest contributors to performance were absolute return, listed equities and property. The other asset classes were broadly flat over the quarter, with the exception of a negative contribution from active currency.

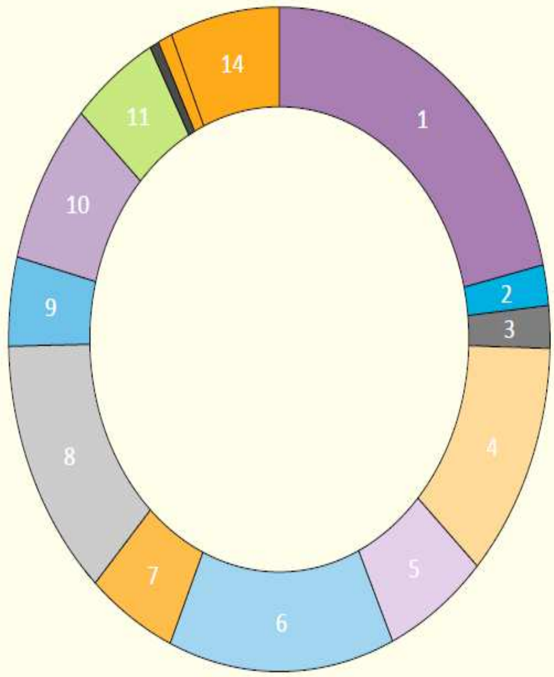
7.31 The long term performances are ahead of the benchmark. The last 12 months are ahead by 1.4% and the last 3 years by 3.0% above benchmark returns.

7.32 The greatest positive contributors over the past 12 months were listed equities, emerging market bonds and absolute return.

7.33 Please see below charts which illustrate the strategic asset allocation of the portfolio at the quarter end.

Asset Allocation at Quarter End

| | | (%) |
|---|---|---|
| 1 | Listed Equities** | 21.8 |
| 2 | Private Equity | 2.0 |
| 3 | Property | 2.1 |
| 4 | High Yield Credit | 11.7 |
| 5 | Investment Grade Bonds | 6.3 |
| 6 | Structured Finance | 13.7 |
| 7 | Commodities | 5.4 |
| 8 | Emerging Market Bonds | 13.0 |
| 9 | Infrastructure | 4.4 |
| 10 | Absolute Return | 8.1 |
| 11 | Insurance Linked | 5.3 |
| 12 | Special Opportunities | 0.6 |
| 13 | Active Currency | -0.9[T] |
| 14 | Cash and Equivalents | 6.6 |
| | Total | 100.0 |




7.34 The fund returns exceeded the performance target for 12 months and 3 years as shown on table 3, page 5.

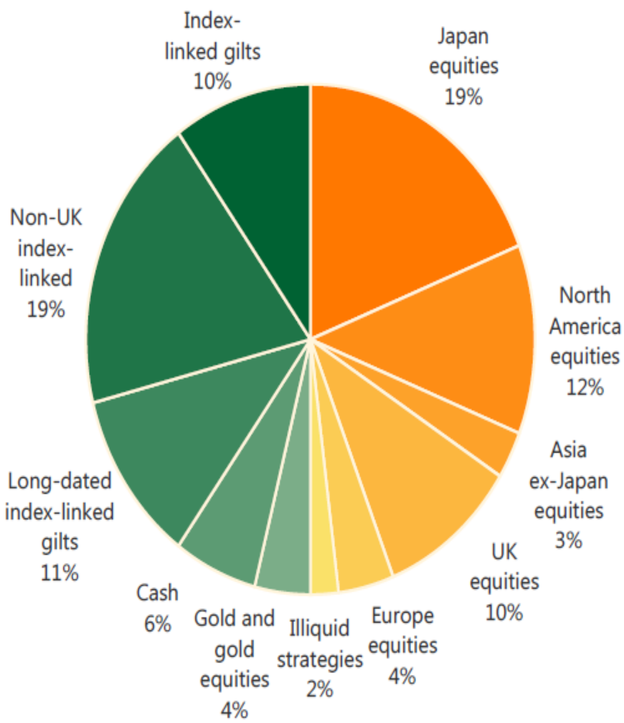
7.35 **Ruffer Total Return Fund (Absolute Return)** – The portfolio performed very encouragingly by posting a positive return of 4.2% against a target return of 0.6% over the quarter.

7.36 The portfolio had a good quarter. The portfolio option positions helped weather October's storm, while the promise of further low inflation readings, via weak commodity prices, caused government nominal and real bond yields to fall. Perhaps slightly unexpectedly this produced strong gains in the portfolio's UK index-linked stocks, especially the longer-dated issues. Other helpful developments were further strength in the US dollar and the continued restoration of Japanese equities, which rose by 6% in yen.

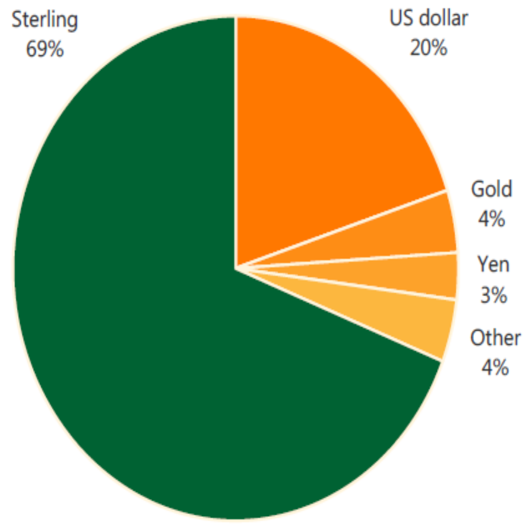
7.37 Other major contributors to positive returns were Chinese equities and key individual stock selections such as Oracle and Texas Instruments.

7.38 Please see below charts which illustrate the strategic asset and currency allocations of the portfolio.

*Asset allocation*




*Currency allocation*




**Internal Cash Management**

7.39 Cash is held by the managers at their discretion in accordance with limits set in their investment guidelines, and internally by LBTH to meet working requirements, although transfers can be made to Fund managers to top up or rebalance the Fund.

7.40 The Pension Fund invests in accordance with the Council's Treasury Management strategy agreed by Full Council in February 2014, which is delegated to the Acting Corporate Director of Resources to manage on a day to day basis within set parameters.

7.41 As at 31 December 2014 the Pension Fund internal cash balance was £41.5m. There was a rebalancing of managers' asset allocation weights whereby it was proposed to reduce GMO asset allocation weight from 25% to 23%. This occurred during the quarter whereby 2% of the total fund was redeemed from GMO portfolio, £20.8m realised from this transaction is added to internal cash management pending best investment opportunity.

7.42 Members will continue to be updated quarterly of the Pension Fund in house cash investment strategy. Security of the Fund's cash remains the overriding priority, ahead of yield.

# 8 ASSET ALLOCATION

The benchmark asset distribution and the fund position at 31 December 2014 are as set out below:

**Table 4: Asset Allocation**

| **Asset Class** | **Benchmark** | **Fund Position as at 31 Dec 2014** | **Variance as at 31 Dec 2014** |
|---|---|---|---|
| UK Equities | 24.0% | 23% | -1.0% |
| Global Equities | 37.0% | 39% | 2.0% |
| **Total Equities** | **61.0%** | **62%** | **1.0%** |
| Property | 12.0% | 11.0% | -1.0% |
| Bonds | 14.0% | 9.0% | -5.0% |
| UK Index Linked | 3.0% | 5% | 2.0% |
| Alternatives | 10.0% | 9.5% | -0.5% |
| Cash | 0.0% | 4.5% | 4.5% |
| Currency | 0.0% | 0.0% | 0.0% |
| **Total Equities** | **100.0%** | **100.0%** | |

8.1 The original allocation of investments between the different asset classes was determined in conjunction with the Council's professional advisors in 2004 and is subject to periodic review by the Investment Panel – the latest review was carried out in January 2014.

Asset allocation is determined by a number of factors including:-

8.1.1 The risk profile. Generally there is a trade-off between the returns obtainable on investments and the level of risk. Equities have higher potential returns but this is achieved with higher volatility. However, as the Fund remains open to new members and able to tolerate this it can seek long term benefits of the increased returns.

8.1.2 The age profile of the Fund. The younger the members of the Fund, the longer the period before pensions become payable and investments have to be realised for this purpose. This enables the Fund to invest in more volatile asset classes because it has the capacity to ride out adverse movements in the investment cycle.

8.1.3 The deficit recovery term. All Council funds are in deficit because of falling investment returns and increasing life expectancy. The actuary determines the period over which the deficit is to be recovered and considers the need to stabilise the employer's contribution rate. The actuary has set a twenty year deficit recovery term for this Council which enables a longer term investment perspective to be taken.

8.2 Allocations are therefore considered to be broadly in line with the benchmark. Individual managers have discretion within defined limits to vary the asset distribution. The overweight position in equities has helped the fund's performance in recent months.

## 9. COMMENTS OF THE CHIEF FINANCIAL OFFICER

9.1. The comments of the Acting Corporate Director Resources are incorporated in the report.

## 10. LEGAL COMMENTS

10.1 Regulation 11(3) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 requires the Council, as an administering authority, to invest fund money that is not needed immediately to make payments from the Pensions Fund. Regulation 11(1) requires the Council to have a policy in relation to its investments. The investment policy should cover the following matters:

(a) the advisability of investing money in a wide variety of investments; and

(b) the suitability of particular investments and types of investments. The Council is also required to have a Statement of Investment Principles in accordance with regulation 12 (1) which cover the following matters:

(a) the types of investment to be held;

(b) the balance between different types of investments;

(c) risk, including the ways in which risks are to be measured and managed;

(d) the expected return on investments;

(e) the realisation of investments;

(f) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;

(g) the exercise of the rights (including voting rights) attaching to investments, if the authority has any such policy; and

(h) stock lending.

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.

10.2 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.

10.3 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.

## 11. ONE TOWER HAMLETS CONSIDERATIONS

11.1 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.

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

## 12. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

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

## 13. RISK MANAGEMENT IMPLICATIONS

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

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

## 14. CRIME AND DISORDER REDUCTION IMPLICATIONS

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

## 15. EFFICIENCY STATEMENT

15.1 The monitoring arrangement for the Pension Fund and the work of the Pension Fund Investment Panel should ensure that the Fund optimises the use of its resources in achieving the best returns for the Council and members of the Fund.

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**LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D**
**LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT**

| ***Brief description of "background papers"*** | ***Name and telephone number of holder And address where open to inspection*** |
| --- | --- |
| *Investment Managers Quarterly reports (Investec, GMO, Schroder, Baillie Gifford, LGIM and Ruffer)*<br>*WM Quarterly Performance Review* | *Bola Tobun Investment &Treasury Manager x4733* |