


Non-Executive Report of the: Pensions Committee 17 th September 2015	 TOWER HAMLETS
Report of: Zena Cooke, Corporate Director of Resources	Classification: [Unrestricted or Exempt]
Pension Fund Investment Performance Review for Quarter End 30 June 2015	

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

Summary

This report informs Members of the performance of the Fund and its investment managers for the quarter ending 30 June 2015.

For the quarter, the Fund underperformed the benchmark by -0.5%, delivering a negative absolute return of -2.14% against benchmark return of -1.9%.

The Fund is slightly ahead its benchmark for the last twelve months to end of June 2015, the Fund returned 7.2%, and this exceeds the benchmark by 0.2%.

For longer term performance the Fund posted three year returns of 10.7% ahead the benchmark return of 10% and posted five year returns of 9.2% against benchmark return of 9.0%.

For this quarter end, four out of the eight mandates matched or achieved returns above the benchmark. The Fund performance was below the benchmark over the quarter, this was mainly due to poor returns from Ruffer, Baillie Gifford (DGF), Investec and Schroder Property Funds.

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.

Recommendations:

Members are recommended to note the contents of this report.

1. REASONS FOR THE DECISIONS

- 1.1 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.

2. ALTERNATIVE OPTIONS

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

3. DETAILS OF REPORT

- 3.1 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.

- 3.2 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.

- 3.3 This report informs Members of the performance of the Fund and its investment managers for the quarter 30 June 2015.

3.4 Legal & General Investment Management

- 3.4.1 Legal & General was appointed (2 August 2010) to manage passively UK Equity and UK Index-Linked Mandates, which at 30 June 2015 had a market value of £221.8m. The value of the assets taken on at the commencement of the contract was £204.7m.

- 3.4.2 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.

3.5 Baillie Gifford & Co

- 3.5.1 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 30 June 2015 was £2200.9m. 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.

- 3.5.2 The diversified growth fund mandate was opened in February 2011 with contract value of £40m. £6.409m was contributed or added to this portfolio during the month of June 2015. The market value of assets as at 30 June 2015 was £56.7m. 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%.

3.6 GMO

- 3.6.1 GMO manages a Global Equity Mandate which at 30 June 2015 had a market value of £273.4m. On 25 November 2014, £20.8m was redeemed from the portfolio; further £10.674 was redeemed from the portfolio on 29 May 2015 in order to keep the strategic asset allocation weight in line with the investment policy. The initial value of the assets taken on at the commencement (29 April 2005) of the contract was £201.8m.
- 3.6.2 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.

3.7 Investec Asset Management

- 3.7.1 Investec manages a Global Bond Mandate which at 30 June 2015 had a market value of £98.5m. The initial value of the assets taken on at the commencement (26 April 2010) of the contract was £97m.
- 3.7.2 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.

3.8 Ruffer Investment Management

- 3.8.1 Ruffer manages an Absolute Return Fund; the value of this contract on the 28 February 2011 was £40m. £6.474m was contributed or added to this portfolio on 02 June 2015. The value of assets under management as of 30 June 2015 was £56.8m.
- 3.8.2 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.

3.9 Schroder Investment Management

- 3.9.1 Schroder manages a property mandate. The value of this mandate on 20 September 2004 was £90m. The market value of assets at 30 June 2015 was £125.6m.
- 3.9.2 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.

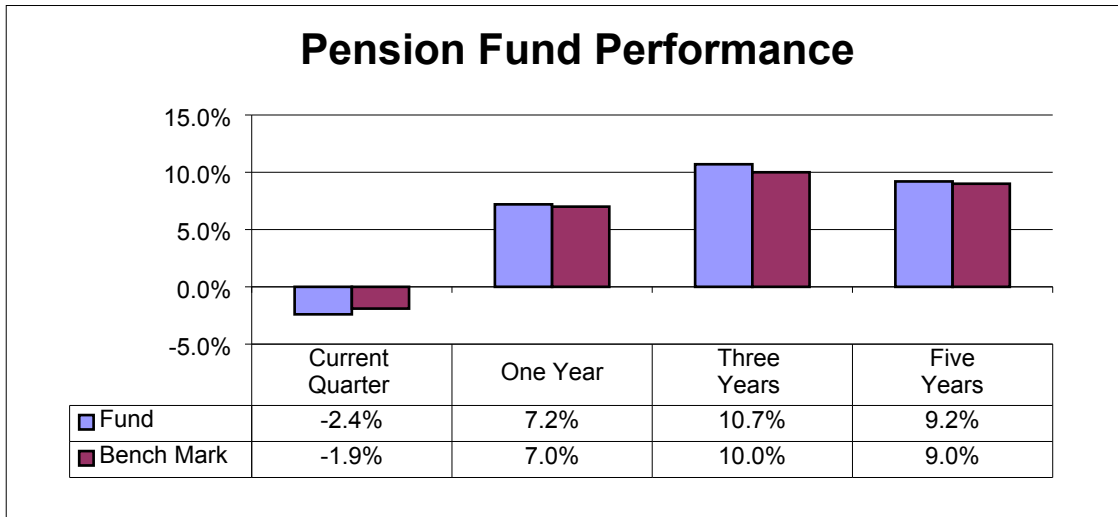
3.10. INVESTMENT PERFORMANCE

- 3.10.1 The Fund's overall value has reduced by £31.04m from £1,141.9m as of 31 March 2015 to £1,115.6m as of 30 June 2015.

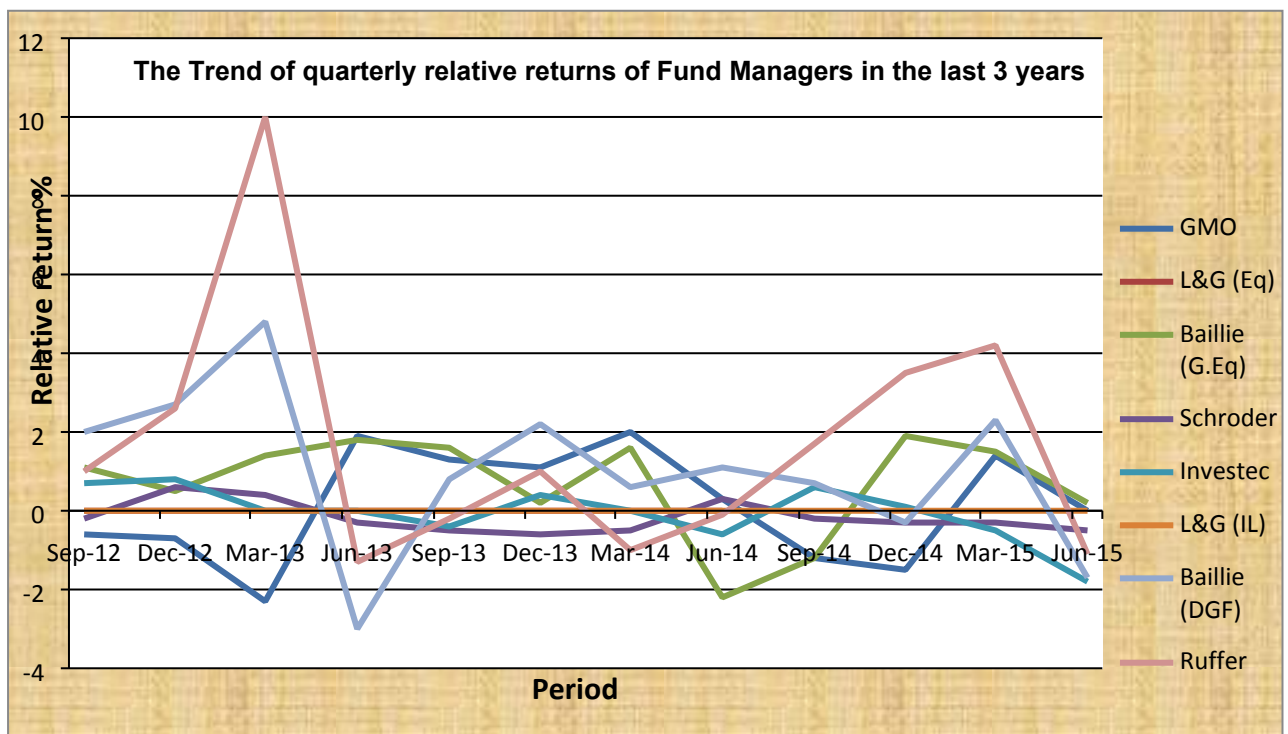
3.10.2 The fund underperformed the benchmark this quarter with a return of -2.4% compared to the benchmark return of -1.9%. The twelve month period sees the fund outperforming the benchmark by 0.2%.

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

Table 1 – Pension Fund Performance



3.10.4 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 can effectively ride out short term volatility in markets.



3.11 MANAGERS

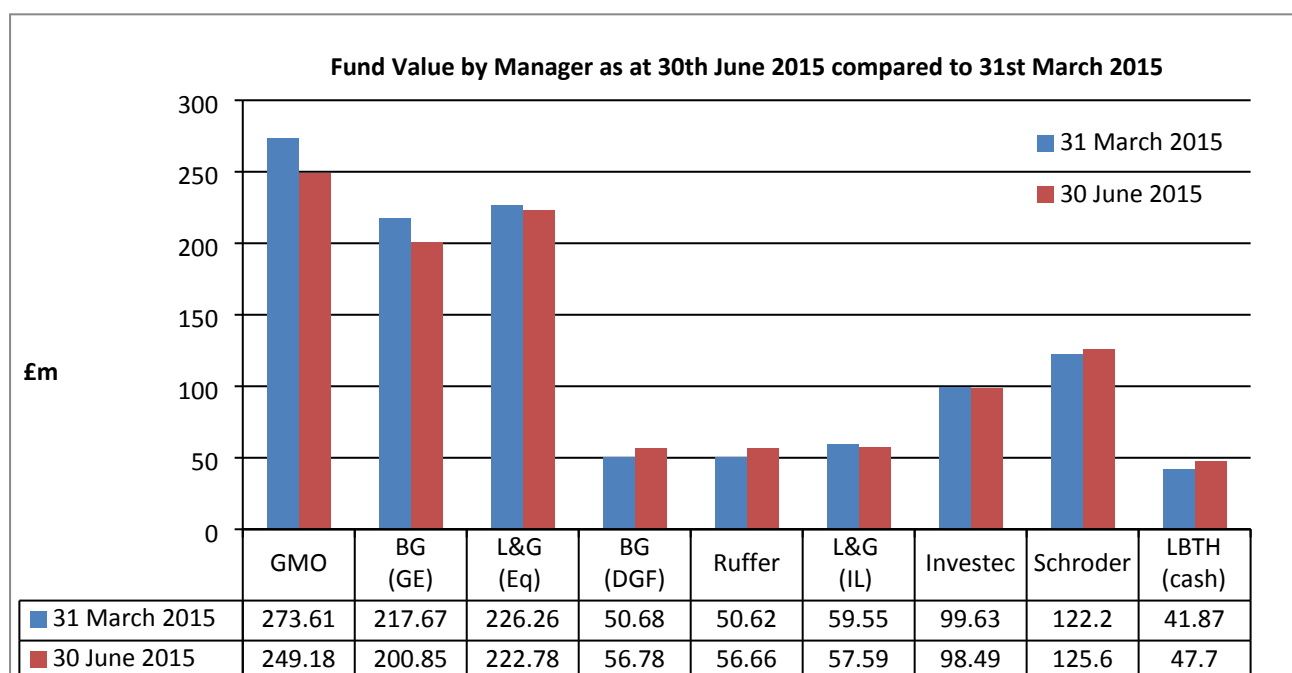
3.11.1 The Fund employs six specialist managers with eight mandates. The managers, mandate and funds held under management are set out below:

Table 2: Management Structure

Manager	Mandate	Value £M	Target % of Fund	Actual % of Fund	Difference %	Date Appointed
GMO	Global Equity	249.2	23.0%	22.3%	-0.7%	29 Apr 2005
Baillie Gifford	Global Equity	200.9	18.0%	18.0%	0.0%	5 Jul 2007
L & G UK Equity	UK Equity	222.8	20.0%	20.0%	0.0%	2 Aug 2010
Baillie Gifford Diversified Growth	Absolute Return	56.7	5.0%	5.1%	0.1%	22 Feb 2011
Ruffer Total Return Fund	Absolute Return	56.8	5.0%	5.1%	0.1%	8 Mar 2011
L & G Index Linked-Gilts	UK Index Linked	57.6	3.0%	5.2%	2.2%	2 Aug 2010
Investec Bonds	Bonds	98.5	14.0%	8.8%	-5.2%	26 Apr 2010
Schroder	Property	125.6	12.0%	11.3%	-0.7%	30 Sep 2004
Cash	Internal cash management	47.7	0.0%	4.3%	4.3%	
Total		1,115.6	100.0%	100.0%	0.0%	

3.11.2 The Fund was valued at £1,115.6million as at 30 June 2015. This includes cash held and being managed internally (LBTH Treasury Management), this stands at 4.3% of the total assets value.

3.11.3 Market performance for the quarter is illustrated below by depicting the fund value by manager for this reporting quarter compared to the last quarter.



3.11.4 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	0.00%	-1.70%	0.50%	0.40%
Baillie Gifford Global Equities	0.20%	2.60%	3.10%	2.20%
L & G UK Equity	0.00%	0.10%	0.10%	N/A
Baillie Gifford Diversified Growth	-1.70%	1.00%	2.10%	N/A
Ruffer Total Return Fund	-1.10%	8.70%	5.70%	N/A
L & G Index Linked-Gilts	0.00%	0.00%	0.00%	N/A
Investec Bonds	-1.80%	-1.90%	-1.40%	-1.90%
Schroder	-0.50%	-1.60%	-0.90%	-0.90%
Total Variance (Relative)	-0.50%	0.20%	0.70%	0.20%

3.12 GMO - From July 2014, the new strategic allocation weight has been reduced from 25% to 23%.

3.12.1 GMO made absolute return of -5.1% in the quarter, achieving the same return as the benchmark (-5.1%).

3.12.2 Global equities were up slightly over the quarter in dollar terms, however they fell in sterling terms, largely due to the appreciation of the pound, and this was the largest detractor from the portfolio's absolute return.

3.12.3 In relative terms, GMO's regional and sector allocation generated a modest outperformance. The underweight to North America, combined with good stock selection in that region, was the key driver of outperformance. The portfolio holds a significant overweight emerging market position, which contributed to relative returns, as did a slight overweight to Japan.

3.12.4 At the sector level, an overweight to Russian and Chinese financials added to returns, although this outperformance was held back by stock selection in Healthcare and Information Technology.

3.13 Baillie Gifford – the portfolio outperformed the benchmark of -5.1% over the quarter, delivering a return of -4.9% resulting in relative outperformance of 0.2%. 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.

3.13.1 One of the largest contributors to performance was Royal Caribbean Cruises, Naspers, the South African pay TV and social media company. These companies have seen significant price appreciation over the past year.

3.13.2 Within all of its portfolios, Baillie Gifford has had a notable overweight to technology/internet retailing stocks which have benefitted returns greatly.

3.13.3 At stock level, contributors included China Resources Enterprise and Amazon, whilst Royal Caribbean Cruises and Ultra Petroleum detracted.

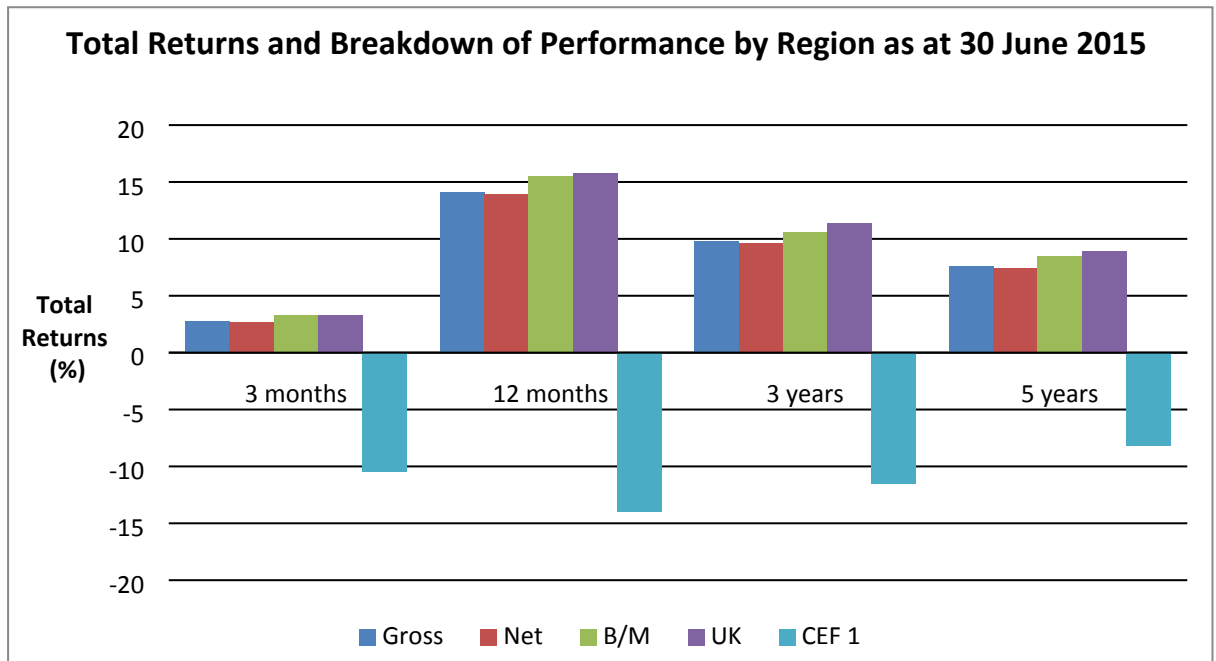
- 3.14 **Legal & General - L & G (UK Equity)** – The portfolio returned -1.5% matching the index returns over the quarter.
- 3.14.1 At the annual index review there were 21 additions, including Auto Trader Group, Woodford Patient Capital, Wizz Air, Aldermore Group and DFS Furniture. Tarsus, Shires Income and Afren were among the 11 deletions.
- 3.14.2 Friends Life merged with Aviva, whilst Spirit Pub Company was acquired by Greene King. Acquisitions by foreign companies included Catlin Group by XL Group (USA); BRIT by Fairfax Financial (Canada); and Domino Printing Sciences and Optos by Brother Industries and Nikon Corp respectively (both Japan). BHP Billiton spun off its non-core assets including bauxite, alumina and manganese to create South32 (Australia).
- 3.14.3 The UK government sold down holdings in Lloyds Banking Group and Royal Mail, whilst other increases to freely available shares were made in Saga, London Stock Exchange Group, Zoopla Property, Just Eat and Pets At Home.
- 3.15 **L & G Index Linked Gilts** – The portfolio returned -3.3% matching the index return over the quarter.
- 3.15.1 Contrary to the opinion polls, the Conservatives won an outright majority in the general election. RPI inflation ticked up to 1.0% year on year, primarily as wage inflationary pressures start to build. GDP came out at 2.9% year on year in June with upward revisions to the previous quarter's data mainly from construction, indicating a more robust level of recent growth
- 3.15.2 During the quarter there were auctions of 2024, 2040 and 2058 bonds and a syndication of a brand new 2046, 30-year benchmark bond. The 2020 bond fell out of the index by virtue of its remaining maturity falling below five years. These raised approximately £8.3bn for government funding
- 3.15.3 The Fund held all 21 stocks contained within the benchmark index. The Fund and index had a modified duration of 23.67 years at the end of the quarter and the real yield was -0.75% (yield curve basis).
- 3.16 **Investec (Bonds)** – The portfolio delivered a return of -1.2% against a performance benchmark return of 0.6%. The primary source of underperformance over the quarter was the currency exposure where returns were adversely realised by US dollar weakness and sterling strength.
- 3.16.1 Both the interest rate exposure and emerging market debt positions also detracted from relative returns after the broader bond market sold off over the course of the quarter.
- 3.16.2 More positively, in spite of a difficult time for corporate bond markets which were impacted by the sell-off in developed market bonds and the ongoing speculation around Greece's future, our corporate bond exposure made a neutral contribution to relative returns.
- 3.17 **Schroder (Property)** – The portfolio returned 2.8% over the quarter; this is 2.8% below the benchmark of 3.3% resulting in underperformance of the

portfolio. And also the longer term performance continues to lag the benchmark; with an underperformance 0.8% p.a. over the 5 years to 30 June 2015.

3.17.1 The UK assets, which represent the vast majority of portfolio value (97%), performed in-line with the benchmark but returns were offset by the performance of Continental European Fund 1 (CEF 1). The UK assets continue to outperform over the past one, three and five year periods.

3.17.2 The Continental European Fund (3% of portfolio) produced a negative return this quarter (-10.5%), still remains a drag to total returns in aggregate over all the periods.

3.17.3 Please see below graphs which show the performance in detail.



3.18 **Baillie Gifford Diversified Growth Fund** generated a return of -0.7% for the quarter, underperformed the benchmark of 1.0% by -1.7%.

3.18.1 The fall into negative territory came over the last week of June, largely as a result of the temporary noise created around Greece.

3.18.2 The return on the Fund, in the 12 months to 30 June 2015 was 5.0%.

3.18.3 The largest detractor in the three months was the Fund's exposure to commodities. Prices fell, as concerns over Greece took some of the momentum out of the European market, and slower Chinese growth has dented forecasts for sales in the world's fastest growing car market. This underperformance was mitigated to some extent by the performance of active currency and listed equities.

3.18.4 The long term performance, are ahead of the benchmark. The last 12 months are ahead by 1.0% and the last 3 years by 2.2% above benchmark returns.

3.18.5 Please see below charts which illustrate contributions to performance per asset class for the quarter end and 12 months to 30 June 2015.

Contributions to Performance

Quarter to 30 June 2015



Ave. Weight %	0.1	18.2	1.5	4.7	13.0	0.0	9.3	0.6	4.3	6.2	10.0	3.0	16.4	8.2	4.6	100.0
Return %	0.2	0.6	4.2	1.1	0.3	-1.5	0.2	-0.9	-1.4	-1.0	-0.8	-2.5	-1.0	-3.6	-7.6	-0.6

One Year to 30 June 2015



Ave. Weight %	19.1	-0.1	8.0	2.5	13.2	4.9	4.5	6.9	1.4	1.9	7.1	0.6	12.7	12.0	5.2	100.0
Return %	8.9	1.4	8.3	28.4	2.2	6.5	4.5	2.1	6.2	7.0	0.2	1.4	-0.9	-4.2	-9.3	5.5

Source: Statpro/Baillie Gifford, gross of fees in sterling. Totals may not sum due to rounding

3.19 Ruffer Total Return Fund (Absolute Return) – The portfolio performed discouragingly by posting a negative return of 0.5% against a target return of 0.6% over the quarter.

3.19.1 The Japanese stock market built on its gains in the first quarter as financials, and banks in particular, delivered strong returns. Mizuho, MUFJ and SMFG all rose by over 18%, whilst life assurance stocks (Dai-ichi Life and T&D) also performed well. Yen weakness offset some of the positive impact, but the fund was largely hedged back to sterling for the quarter. Signs of an improvement in Japanese corporate governance also helped.

- 3.19.2 Option protection - long-dated index-linked bonds were considered to be a core protection. Therefore, in view of their strong recent performance and correspondingly low yields, the portfolio held appropriate interest rate protection to offset the risk of a back-up in bond yields.
- 3.19.3 Sterling strength - The unexpectedly clear cut outcome to the UK general election, and further progress in the domestic economy, saw the pound rise against most currencies. However, the currency headwind was much reduced due to earlier moves to cut portfolio exposure to the US dollar and the yen.
- 3.19.4 UK index-linked bonds - with bond yields globally rising off record lows, bond prices fell across the board. The long duration of the portfolio's index-linked bonds exaggerated the correction in prices, having previously been a benefit in the first quarter.
- 3.19.5 The long term performance, are ahead of the benchmark. The last 12 months are ahead by 8.5% and the last 3 years by 5.5% above benchmark returns.

3.20 Internal Cash Management

- 3.20.1 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 cash flows requirements, although transfers can be made to Fund managers to top up or rebalance the Fund.
- 3.20.2 The Pension Fund invests in accordance with the Council's Treasury Management strategy agreed by Full Council in February 2015, which is delegated to the Corporate Director of Resources to manage on a day to day basis within set parameters.
- 3.20.3 The cash balance as at 30 June 2015, was £47.7m. This constitutes £15m internal cash flow balance from 2013/14 and £7.7m internal cash balance as at 30 June 2015, plus £20.8m realised around November 2014 from rebalancing exercise and crystallising of equity gains by redeeming 2% of total fund position from GMO portfolio. A further 1% was redeemed from GMO portfolio in June 2015, and £4.2m from this proceed was added to the internal cash balance, that is cash awaiting investment into fixed income mandate.
- 3.20.4 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.

3.21 ASSET ALLOCATION

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

The benchmark asset distribution and the fund position at 30 June 2015 are as set out below:

Table 4: Asset Allocation

Asset Class	Benchmark	Fund Position as at 30 June 2015	Variance as at 31 June 2015
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%	

3.21.1 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:-

- 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.
- 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.
- 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.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The comments of the Corporate Director Resources are incorporated in the report

5. LEGAL COMMENTS

5.1 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.

- 5.2 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.
- 5.3 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.
- 5.4 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.
- 5.5 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.
- 5.6 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.

- 5.7 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.
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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

Investment Managers Quarterly reports for the managers; Investec, GMO, Schroder, Baillie Gifford, LGIM and Ruffer)
WM Quarterly Performance Review.

Local Government Act, 1972 Section 100D (As amended)

List of “Background Papers” used in the preparation of this report

Investment Managers Quarterly reports (Investec, GMO, Schroder, Baillie Gifford, LGIM and Ruffer)

WM Quarterly Performance Review.

Officer contact details for documents:

- Bola Tobun Investment & Treasury Manager x4733