Non-Executive Report of the: **Pensions Committee** 25th November 2015	TOWER HAMLETS
Report of: Zena Cooke, Corporate Director of Resources	**Classification:** Unrestricted
Pension Fund Investment Performance Review for Quarter End 30 September 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 September 2015.

For the quarter, the Fund underperformed the benchmark by -1.1%, delivering a negative absolute return of -4.0% against benchmark return of -2.9%.

The Fund is slightly behind its benchmark for the last twelve months to end of September 2015, the Fund returned 1.6%, and it's behind the benchmark by 0.7%.

For longer term performance the Fund outperformed the benchmark by posting three year returns of 8.3% ahead benchmark return of 7.9% and posted five year returns of 6.7% marginally behind benchmark return of 6.8%.

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

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 September 2015.

3.4 Baillie Gifford & Co

3.4.1 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 September 2015 was £189.3m. 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.

3.4.2 The diversified growth fund mandate was opened in February 2011 with contract value of £40m. £6.409m was added to this portfolio during the month of June 2015. The market value of assets as at 30 September 2015 was £55.5m. 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%.

3.5 GMO

3.5.1 GMO manages a Global Equity Mandate which at 30 September 2015 had a market value of £226.6m. 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 assets taken on at the commencement (29 April 2005) of the contract was £201.8m.

3.5.2 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.

3.6 Investec Asset Management

3.6.1 Investec manages a Global Bond Mandate which at 30 September 2015 had a market value of £98.7m. The initial value of the assets taken on at the commencement (26 April 2010) of the contract was £97m.

3.6.2 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.

3.7 Legal & General Investment Management

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

3.7.2 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.

3.8 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 added to this portfolio on 02 June 2015. The value of assets under management as of 30 September 2015 was £53.6m.

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 September 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.

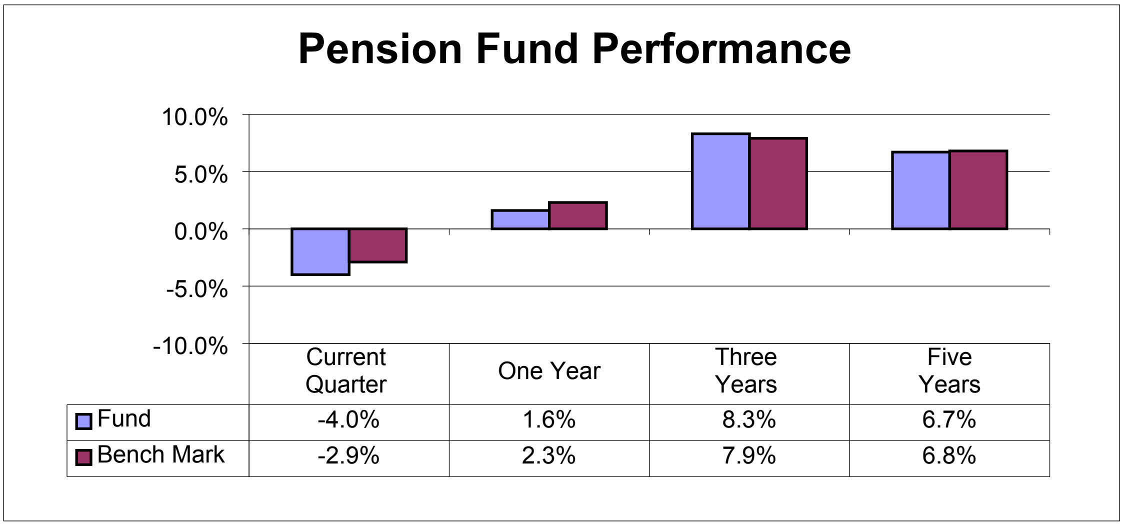
3.10. INVESTMENT PERFORMANCE

3.10.1 The Fund's overall value has reduced by £44m from £1,115.6m as of 30 September 2015 to £1,071.6m as of 30 September 2015.

3.10.2 The fund underperformed the benchmark this quarter with a return of -4.0% compared to the benchmark return of -2.9%. The twelve month period sees the fund underperforming the benchmark by 0.7%.

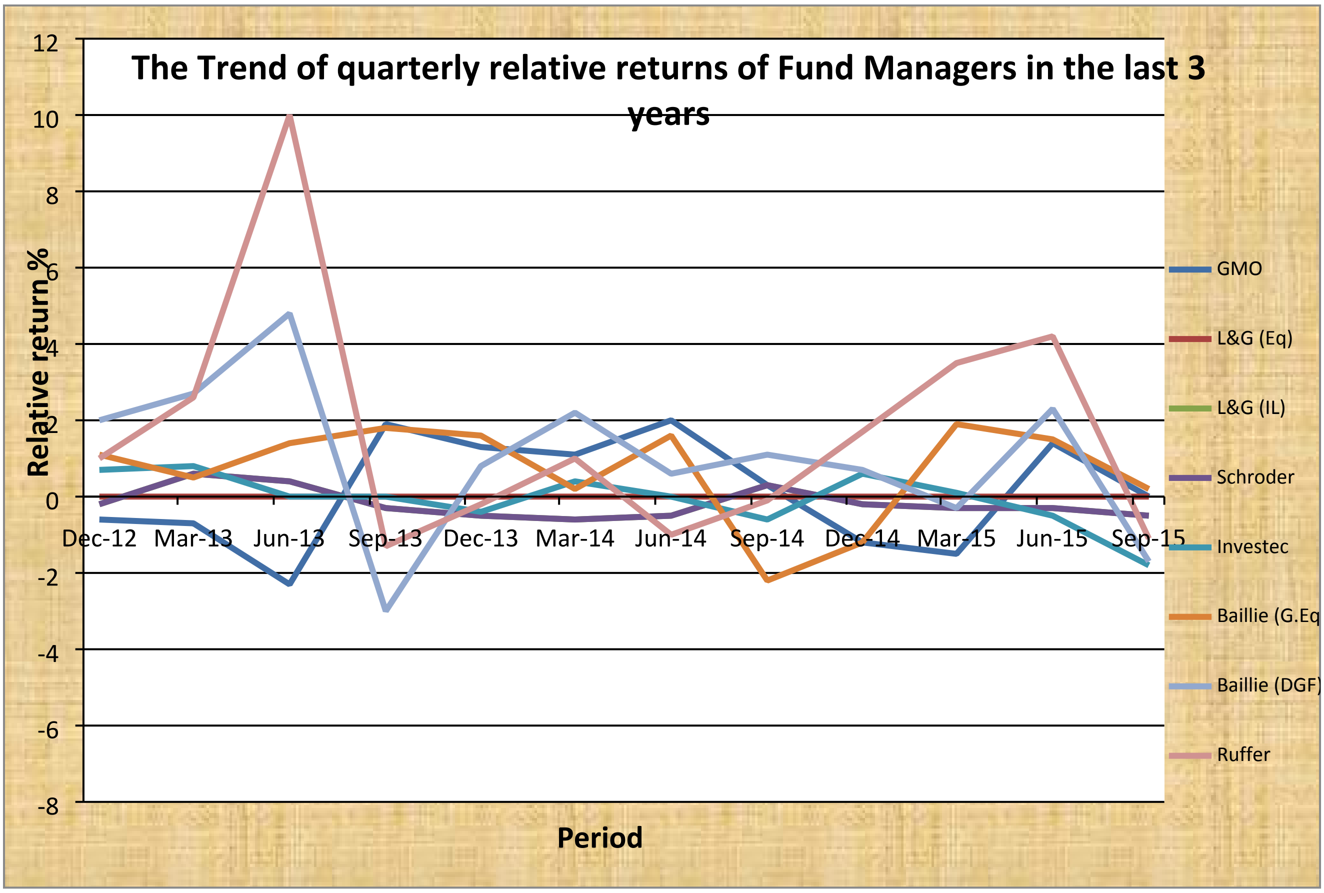
3.10.3 The performance of the fund over the longer term is as set out in the chart below.

Table 1 – Pension Fund Performance



	Current Quarter	One Year	Three Years	Five Years
Fund	-4.0%	1.6%	8.3%	6.7%
Bench Mark	-2.9%	2.3%	7.9%	6.8%

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.



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:

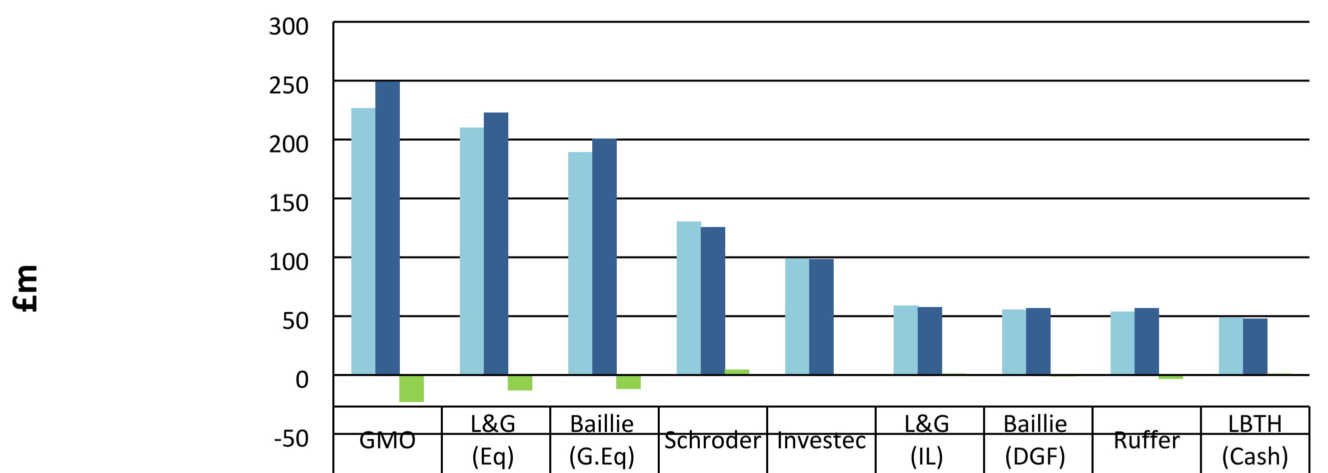
Table 2: Management Structure

Manager	Mandate	Value £M	Target % of Fund	Actual % of Fund	Difference %	Date Appointed
GMO	Global Equity	226.6	23.0%	21.1%	-1.9%	29 Apr 2005
Baillie Gifford	Global Equity	189.3	18.0%	17.7%	-0.3%	5 Jul 2007
L & G UK Equity	UK Equity	210.0	20.0%	19.6%	-0.4%	2 Aug 2010
Baillie Gifford Diversified Growth	Absolute Return	55.5	5.0%	5.2%	0.2%	22 Feb 2011
Ruffer Total Return Fund	Absolute Return	53.7	5.0%	5.0%	0.0%	8 Mar 2011
L & G Index Linked-Gilts	UK Index Linked	58.9	3.0%	5.5%	2.5%	2 Aug 2010
Investec Bonds	Bonds	98.7	14.0%	9.2%	-4.8%	26 Apr 2010
Schroder	Property	130.1	12.0%	12.1%	0.1%	30 Sep 2004
Cash	Internal cash management	48.8	0.0%	4.6%	4.6%	
Total		**1,071.6**	**100.0%**	**100.0%**	**0.0%**	

3.11.2 The Fund was valued at £1,071.6million as at 30 September 2015. This includes cash held and being managed internally (LBTH Treasury Management), this stands at 4.6% 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.

Fund Value by Manager as at 30 September 2015 compared to 30 June 2015



	GMO	L&G (Eq)	Baillie (G.Eq)	Schroder	Investec	L&G (IL)	Baillie (DGF)	Ruffer	LBTH (Cash)
Value at 30/09/2015	226.6	210.0	189.3	130.1	98.7	58.9	55.5	53.7	48.8
Value at 30/06/2015	249.2	222.8	200.8	125.6	98.4	57.6	56.7	56.8	47.7
Gain/(Loss) in Value	(22.6)	(12.8)	(11.5)	4.50	0.30	1.30	(1.2)	(3.1)	1.10

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	-3.10%	-3.70%	-0.60%	-0.60%
Baillie Gifford Global Equities	0.10%	3.70%	2.6%	1.70%
L & G UK Equity	0.00%	0.00%	0.10%	0.10%
Baillie Gifford Diversified Growth	-3.00%	-2.80%	0.70%	N/A
Ruffer Total Return Fund	-6.10%	0.20%	3.10%	N/A
L & G Index Linked-Gilts	0.00%	0.00%	0.00%	0.00%
Investec Bonds	-0.50%	-2.80%	-1.70%	-2.10%
Schroder	0.60%	-0.50%	-0.50%	-0.60%
Total Variance (Relative)	**-0.50%**	**0.20%**	**0.70%**	**0.20%**

3.12 **GMO** - The portfolio performed discouragingly by posting a massive negative return of 9.0% against a target return of -5.9% over the quarter

3.12.1 The Emerging Markets overweight accounts for the majority of the underperformance in this reporting quarter. The underweight position of the portfolio to the US also hurt relative performance, although this was counterbalanced by strong stock selection in the US.

3.12.2 Stock selection in the rest of the portfolio was detrimental, driven by the holdings in Canada, France and Germany. From a sector perspective, the overweight to Energy was a drag on performance as was stock selection in IT, Utilities and Healthcare.

3.12.3 Global equities generally posted strong negative returns in U.S. dollar terms during the reporting quarter. Few markets were safe from the escalating concerns about a global growth slowdown.

3.12.4 Unexpected currency devaluation and weak economic signs from China, weakening commodity prices, and guessing how and when the Fed would actually take action all helped to pull the bottom out from under the equity markets. MSCI ACWI fell by 9.4%.

3.12.5 Regional performance was negative with the S&P 500 down 6.4%, MSCI Europe down 8.7% and MSCI Japan down 11.8%. Emerging equities bore the brunt of the impact from heightened concerns about China and the extent of any contagion. MSCI Emerging Markets fell by 17.9%.

3.13 **Baillie Gifford** – the portfolio slightly outperformed the benchmark of -5.9% over the quarter, delivering a return of -5.8% resulting in relative outperformance of 0.1%. 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, Ryanair, Amazon and Naspers. 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 consumer discretionary and technology/internet retailing stocks which have benefitted returns greatly in the past.

3.13.3 At stock level, contributors included Royal Caribbean Cruises, Ryanair and Amazon, whilst Baidu, Alibaba, Inpex and Ultra Petroleum detracted.

3.14 **Legal & General - L & G (UK Equity)** – The portfolio returned -5.7% matching the index return over the quarter.

3.14.1 At the quarterly review Sophos Group, PureTech Health and Kainos Group were added to the index. No deletions were made. Acquisitions for cash by non-index constituents were: TSB Banking Group by Banco de Sabadell (Spain), CSR by Qualcomm (USA), Anite by Keysight Technologies (USA) and Colt Group by Lightening Investors (USA).

3.14.2 HMRC sold down stakes in Royal Bank of Scotland and Lloyds Banking Group, resulting in holdings of 73% and 13% respectively. Capital raisings for acquisitions and growth were made by Renewables Infrastructure Group, P2P Global Investments, Britvic, GKN, Ladbrokes, Woodford Patient Capital and VPC Specialty Lending Investments. Raisings for debt repayments included Glencore, Empiric Student Property and NextEnergy Solar Fund.

3.15 **L & G Index Linked Gilts** – The portfolio returned 2.3% matching the index return over the quarter.

3.15.1 The UK economy continues to rove along nicely, with RPI inflation only edging up slightly in August to 1.1% year-on-year and preliminary estimates of Q3 GDP falling only modestly to 2.6%. The UK base rate remains at 0.5%, but the time is fast approaching for lift off, particularly if the US Federal Reserve decides to raise US rates this year

3.15.2 During the quarter there were two auctions and a single syndication. The auctions were used to tap the existing 2058 maturity bond as the DMO looks to build this to benchmark weight. A second auction was held to launch a brand new 10-year 2026 maturity bond. The syndication was held to tap the ultra-long 2068 maturity bond; these operations collectively raised approximately £7bn for government funding.

3.15.3 The Fund held all 22 stocks contained within the benchmark index. The Fund and index had a modified duration of 23.93 years at the end of the quarter and the real yield was -0.83% (yield curve basis).

3.15.4 **Investec (Bonds)** – The portfolio delivered a return of 0.10% against a performance comparison index return of 0.6%. The currency management added strongly to relative returns, this was more than offset by the combined effect of the other risk exposures detracting. However, the underperformance was marginal, reflective of the fairly limited drawdown from each of the other detractors individually.

3.15.5 A key component of the contribution from the currency management was the long-held, strategic position in the US dollar which once again rallied after a weaker second quarter. The dollar benefited from the wave of risk aversion from investors, and the decision by the US Federal Reserve (Fed) to keep rates on hold did not lead to any material depreciation.

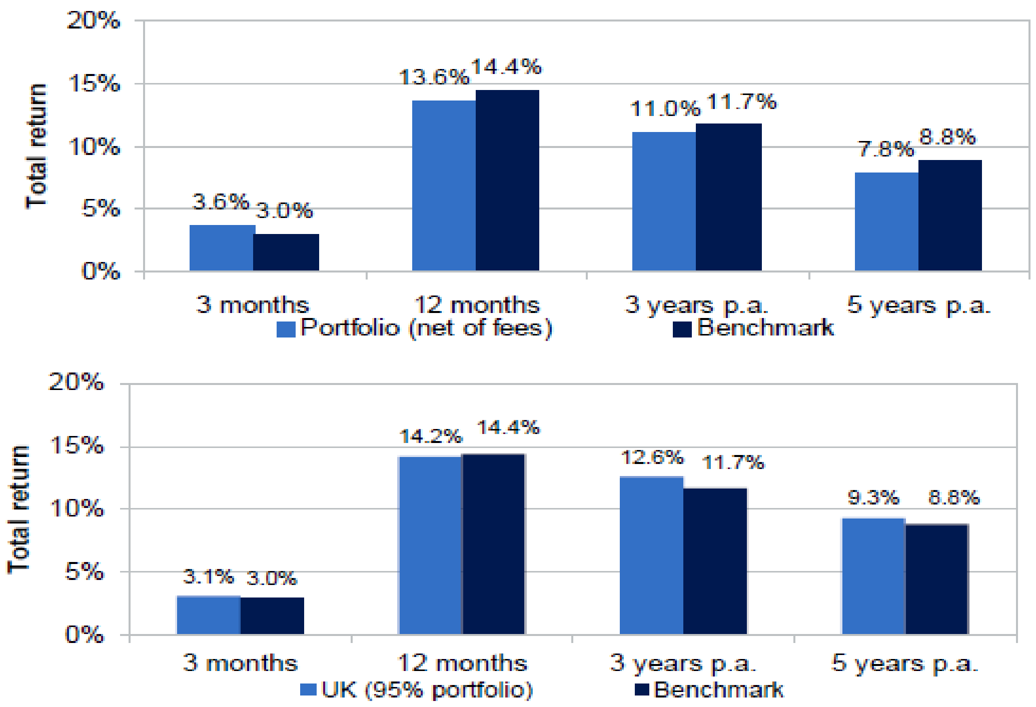
3.16 **Schroder (Property) –** The portfolio outperformed the benchmark over the quarter by +0.6%, although the longer term performance continues to lag the benchmark; with an underperformance 0.6% p.a. over the 5 years to 30 September 2015.

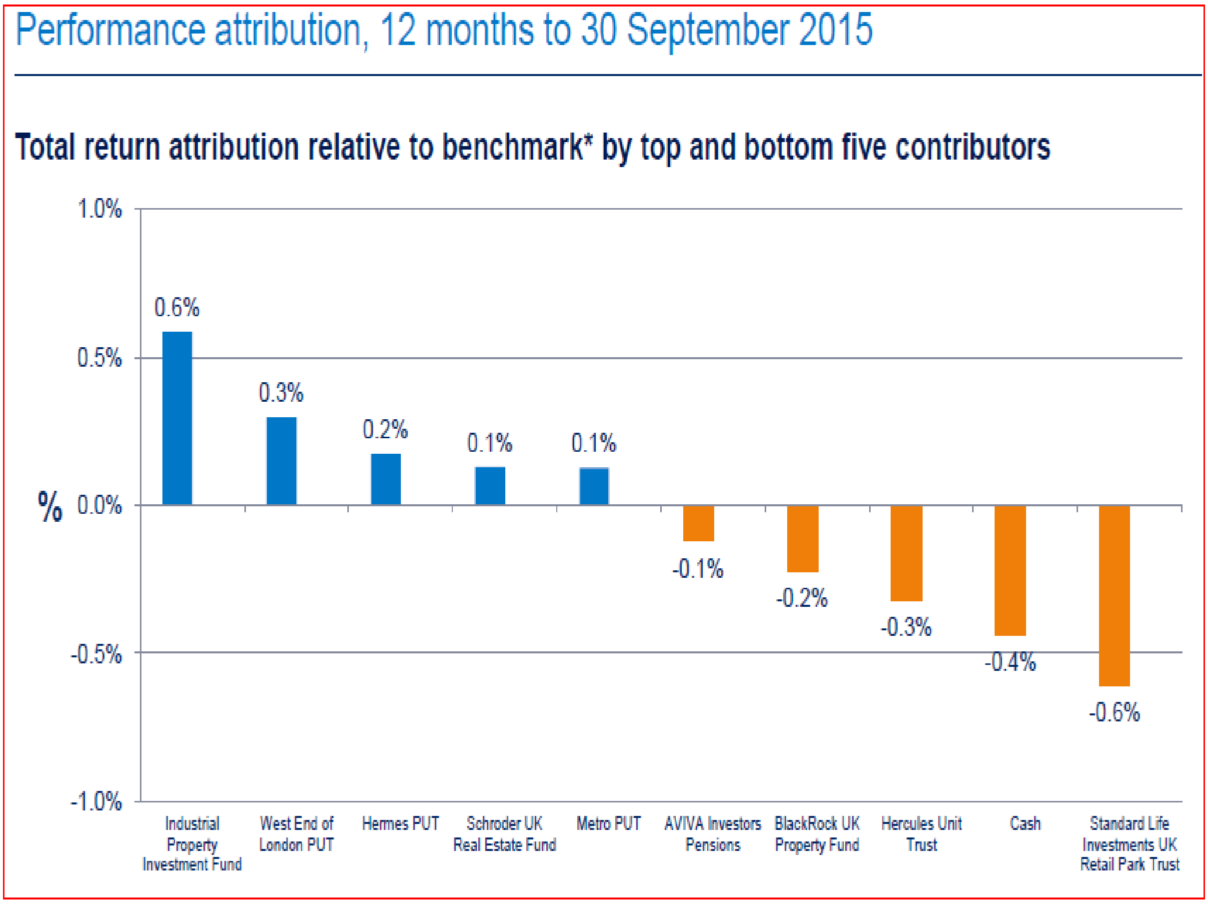
3.16.1 The Continental European Fund 1 (CEF 1) (5% of portfolio) made the strongest contribution to performance over the quarter delivering an absolute return of 31.1%. CEF 1's performance was boosted by the timing of a distribution that occurred in the last quarter but was not booked until this quarter.

3.16.2 Capital appreciation and a favourable currency movement also made a positive contribution to returns. Metro PUT and Mayfair Capital PUT were amongst the top performing strategies.

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

Portfolio total returns versus benchmark, September





3.17 **Baillie Gifford Diversified Growth Fund** generated a return of -2.1% for the quarter, underperformed the benchmark of 1.0% by -3.1%.

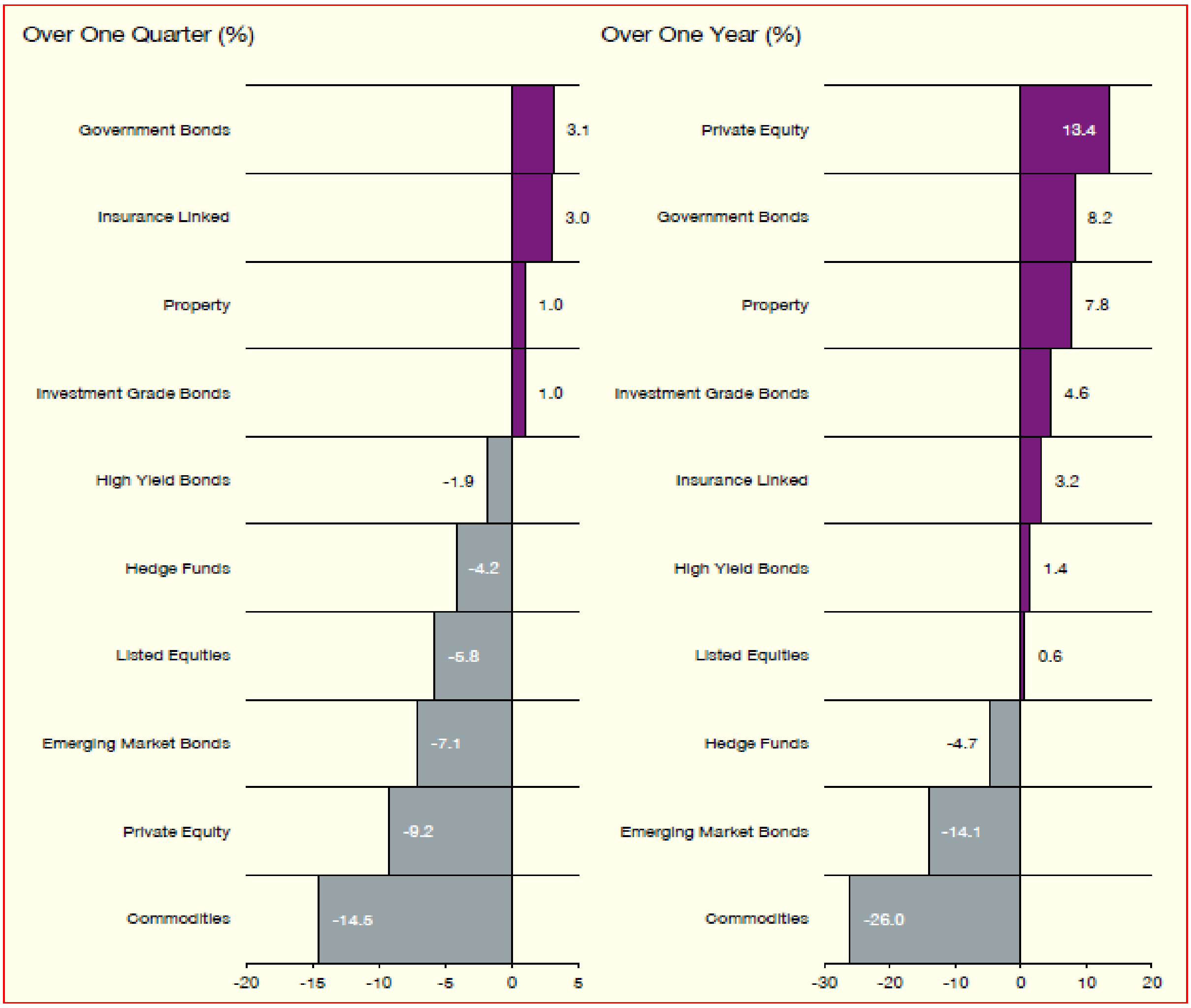
3.17.1 The large weightings in listed equities, emerging market bonds and high yield credit, all of which sold off during the period, were the largest negative contributors to performance. However, the diversified nature of the Fund meant that a number of asset classes with low correlation to equity markets provided some protection, among them active currency, absolute return and insurance linked securities.

3.17.2 Within active currency, the short positions in a number of emerging market currencies, such as the Malaysian ringgit and South African rand were helpful. Within absolute return, the trend-following funds continued to benefit from a lower oil price and strong government bond performance.

3.17.3 This latest quarter has been a relatively challenging period, but the Fund's ability to invest in a broad range of assets means that overall performance held up better than investing solely in equities.

3.17.4 The long term performance - The last 12 months to 30 September 2015, the portfolio return was 1.1%, lagging the benchmark return of 4.0% by 2.9% and the last 3 years return was 0.7% above the benchmark return of 4.0%.

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



3.18 **Ruffer Total Return Fund (Absolute Return)** – The portfolio performed discouragingly by posting a massive negative return of 5.5% against a target return of 0.6% over the quarter.

3.18.1 **Index-linked gilts** - UK index-linked helped as yields fell on rising fear; however US inflation-linked treasuries did not. US real yields rose in the face of the potential September interest rate rise, which ultimately didn't materialise.

3.18.2 Ruffer Illiquid Multi Strategies Fund, this new vehicle performed as intended against the correlated fall in equity and bond markets. Its investments in credit default swaps benefited as spreads on corporate bonds rose to reflect risks in those markets.

3.18.3 **Japan equities** - with turmoil emanating from China, Japan was an easier, liquid proxy by which to sell Asian exposure. The portfolio's holdings in financial stocks were especially hard hit.

3.18.4 Options VIX call options provided strong protection in August; the manager took some profit, but the position held over into September in case of further stress was lost as market volatility subsided.

3.18.5 Volkswagen – the manager sold the portfolio's position as soon as the emissions scandal erupted. While this crystallised a loss, at the end of reporting quarter, the share price is now 25% lower.

3.18.6 The long term performance, are ahead of the benchmark. The last 12 months are ahead by 0.2% and the last 3 years by 3.1% above the benchmark returns.

3.19 Internal Cash Management

3.19.1 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.

3.19.2 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.

3.19.3 The cash balance as at 30 September 2015, was £48.8m. This constitutes £15m internal cash flow balance from 2013/14, £25m redeemed from GMO portfolio between November 2014. In addition to current internal cash balance of £8.8m as at 30 September 2015. £45m of this cash is cash awaiting investment into fixed income mandate.

3.19.4 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 <u>ASSET ALLOCATION</u>

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 September 2015 are as set out below:

<u>Table 4: Asset Allocation</u>

Asset Class	Benchmark	Fund Position as at 30 September 2015	Variance as at 30 September 2015
UK Equities	24.0%	19.6%	-4.4%
Global Equities	37.0%	38.8%	1.8%
Total Equities	**61.0%**	**58.4%**	**-2.6%**
Property	12.0%	12.1%	0.1%
Bonds	14.0%	9.2%	-4.8%
UK Index Linked	3.0%	5.5%	2.5%
Alternatives	10.0%	10.2%	0.2%
Cash	0.0%	4.6%	4.6%
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.

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

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) and WM Quarterly Performance Review. (To be email if required)

Officer contact details for documents:

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