Leicestershire County Council

Meeting: **Local Pension Committee**

Date/Time: **Friday, 17 March 2017 at 9.30 am**

Location: **Guthlaxton Committee Room, County Hall, Glenfield.**

Contact: **Mr. M. Hand (Tel. 0116 305 6038)**

Email: **matthew.hand@leics.gov.uk**

AGENDA

	Item	Report By	Marked
1.	Minutes of the meeting held on 17 January 2017.		(Pages 5 - 8)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Summary Valuation of Pension Fund Investments and Performance of Individual Managers.	Director of Corporate Resources	(Pages 9 - 12)
7.	Closure of Tactical Underweight Position In Index - Linked Bonds.	Director of Corporate Resources	(Pages 13 - 16)
8.	Risk Management and Internal Controls.	Director of Corporate Resources	(Pages 17 - 18)

9.	Funding Update as at 31 December 2016.	Hymans Robertson	(Pages 19 - 28)
10.	Market Updates - Reports of the Independent Advisor and Kames Capital.	Independent Investment Advisor and Kames Capital	(Pages 29 - 48)
11.	Any other items which the Chairman has decided to take as urgent.		
12.	Exclusion of the Press and Public.		

The public are likely to be excluded during consideration of the following items in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information).

13.	Kempen Capital Management Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
14.	Aspect Capital Quarterly report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
15.	Kleinwort Benson Investors Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
16.	Ruffer Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
17.	Pictet Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
18.	Millennium Global Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
19.	IFM Investors Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
20.	Delaware Investments Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
21.	JP Morgan Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
22.	Aviva Investors Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager

23.	Legal and General Investment Manager Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
24.	Ashmore Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
25.	Kames Capital Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
26.	Stafford Timberland Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
27.	KKR Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	

TO:

Leicestershire County Council

Mr. G. A. Hart CC
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC

Mr. P. C. Osborne CC (Chairman)

Leicester City Council

Cllr D. Bajaj and Cllr L. Moore

District Council Representatives

Cllr. M. Graham MBE
Cllr. N. Frost

University Representative

Mr. J. Shuter

Staff Representatives

Mr. R. Bone
Mr. N. Booth

Ms. J. Dean

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Agenda Item 1

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Tuesday, 17 January 2017.

PRESENT:

Leicestershire County Council

Mr. G. A. Hart CC
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. P. C. Osborne CC

District Council Representative
Cllr. M Graham MBE
Cllr. N. Frost

Staff Representatives

Mr. R. Bone
Mr. N. Booth

Independent Advisers and Managers

Mr. A. Green	Hymans Robertson
Mr. S. Jamieson	Independent Investment Advisor

513. Appointment of Chairman

The Committee noted that work to establish Local Government Pension Scheme pooling arrangements was ongoing and there was an expectation that the Chairman of the Local Pension Committee would attend meetings concerning the new arrangements. Mr G. A. Hart CC had indicated that he would not be standing for re-election as a County Councillor in May 2017 and therefore considered it to be in the best interest of the Committee if he stood down as Chairman in order for another member to take on the role and represent the Committee at pooling meetings going forward.

RESOLVED:

That Mr. P. C. Osborne CC be appointed Chairman of the Local Pension Committee for the period ending with the date of the Annual Council meeting in May 2017.

Mr. P. C. Osborne in the Chair

514. Election of Vice Chairman

The Committee noted that due to the former Vice Chairman of the Committee Mr. P. C. Osborne CC being appointed Chairman, a new Vice Chairman was being sought.

RESOLVED:

That Mr. G. A Hart CC be elected Vice Chairman of the Local Pension Committee for the period ending with the date of the Annual Council meeting in May 2017.

515. Minutes of the previous meeting.

The minutes of the meeting held on 15 November 2016 were taken as read, confirmed and signed.

516. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

517. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

518. Urgent items.

There were no urgent items for consideration.

519. Declarations of interest.

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting. No declarations were made.

520. Market Outlook.

The Committee received a report concerning global market conditions which was presented by the Fund's Independent Investment Advisor. A copy of the report, marked '8' is filed with these minutes.

RESOLVED:

That the update be noted.

521. Strategic Investment Benchmark and Portfolio Structure of the Fund.

The Committee considered a report of the Director of Corporate Resources which was accompanied by appendices produced by the Fund's Independent Investment Advisor, Scott Jamieson, and Investment Consultants Hymans Robertson. The report recommended a small number of changes to the Leicestershire Fund's strategic investment benchmark and portfolio structure. A copy of the report and appendices marked '9'are filed with these minutes.

The Director reported that the proposed changes to the Fund's strategic benchmark, whilst modest, would improve the overall structure of the portfolio. He explained that the recommended additional investment in private lending through the sale of a small amount of the Fund's equities investments would enable additional exposure to a safer asset class with similar medium-term return expectations.

The Board acknowledge that whilst the proposed additional investment would need to be made in stages as opportunities arose, the selling of the required equity assets straight away and holding them as cash, would mean that the Fund would be insulated from any fall in equity markets over the intervening period and would also avoid the risk of being a

forced seller of equities (to pay drawdowns on private debt investments) at what might not be deemed an appropriate point.

It was moved by Mr. P. C. Osborne CC and seconded by Mr. G. A. Hart CC:

a) That a revised strategic benchmark for the Fund as detailed on page 15 of Appendix A to the report be approved;

b) That the selling of equity assets to raise the required capital to bring the Fund's credit weighting up to 7.5% as soon as is practical be approved;

c) That a revised portfolio split within the Fund's targeted return portfolios as below be approved:

Ruffer	6.5% of total Fund assets
Aspect Capital	3.5% of total Fund assets
Pictet	1.5% of total fund assets

d) That a change in the benchmark, against which the Fund's index-linked gilt exposure will be managed, to the All Stocks Index-Linked Gilt Index, be approved;

e) That a change in the neutral hedging position in respect of the Fund's currency exposure created by its overseas equity benchmark position to 2/3rd be approved.

The motion was passed and carried unanimously.

522. Draft Investment Strategy Statement.

The Committee considered a report of the Director of Corporate Resources which recommended the approval of an Investment Strategy Statement (ISS) for the Leicestershire County Council Pension Fund. A copy of the report marked '10' is filed with these minutes.

The Director reported that one of the requirements identified within the ISS was the stipulation that pension funds should consider social, environmental and corporate governance factors when appointing and retaining its investment managers. He was confident that the necessary processes were in place to ensure that the Leicestershire Fund adhered to these requirements.

RESOLVED:

That the Investment Strategy Statement be approved.

523. Draft Funding Strategy Statement.

The Committee considered a report of the Director of Corporate Resources which sought approval for a revised Funding Strategy Statement. A copy of the report marked '11' is filed with these minutes.

The Director reported that the revised document was an updated version of the Fund's existing statement approved by the Committee in February 2014. The main changes

related to the inclusion of details to reflect the 2016 actuarial valuation and the expanding of explanations regarding the Fund’s policies in certain areas.

RESOLVED:

That the Funding Strategy Statement be approved.

524. Exclusion of the Press and Public.

RESOLVED:

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the remaining item of business on the grounds that it involves the likely disclosure of exempt information as defined in paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Act.

525. Potential Investment with Partners Group - Private Debt Investments.

The Committee considered an exempt report of the Director of Corporate Resources which provided information in respect of a potential investment in Private Debt with the Partners Group. A copy of the report marked 13 is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That an Investment in the Partners Group 2016 and 2017 Multi Asset Credit Fund be approved in order for the Leicestershire Pension Fund to reach its target benchmark weighting in credit investment of 7.5%.

09.30 – 11.10 CHAIRMAN
17 January 2017

Agenda Item 6

Leicestershire County Council

LOCAL PENSION COMMITTEE – 17TH MARCH 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS AND INVESTMENT PERFORMANCE OF INDIVIDUAL MANAGERS

Purpose of the Report

1. The purpose of the report is to present a summary valuation of the Fund's investments at 31st December 2016 (attached as an appendix to this report), together with figures showing the performance of individual managers.

Summary Valuation

2. The total market value of investments at 31st December 2016 was £3,744.6m compared to £3,581.7m at 30th September 2016, an increase of £162.9m. In the three month period non-investment related net cash inflows amounting to £2.9m were received. After adjusting for non-investment related cash flows the Fund value increased by £160.0m, or 4.5%, due to changes in the value of investments.

3. The total returns of various indices since 30th September 2016 were as follows:-

	Local Currency %	**Converted to Sterling %**	**Return with 50% hedge %**
UK Gilts	-3.4	-3.4	-3.4
UK Index-Linked	-2.7	-2.7	-2.7
UK Equities	+3.9	+3.9	+3.9
North American Equities	+3.8	+9.0	+6.4
European Equities	+6.0	+4.8	+5.4
Japanese Equities	+15.2	+5.1	+10.1
Pacific (Ex Japan) Equities	+1.9	+1.6	+1.7

4. The current split of investments over sectors is as follows:-

	31st December 2016		**30th September 2016**
	£m	**%**	**%**
UK Equities	312.7	8.4	8.2
Overseas Equities	1,586.5	42.4	41.5
Targeted Return/Credit/Opportunity Pool	800.9	21.4	22.9
Private Equity	142.0	3.8	3.7
Property	316.3	8.4	8.6
Cash	172.1	4.6	3.9
Inflation-Linked Assets	427.5	11.4	11.5
Active and Passive Currency	(13.4)	(0.4)	(0.3)
	3,744.6	**100.0**	**100.0**

5. The investment performance of the individual managers is laid out in the tables below, over various periods. For most managers the benchmark performance quoted is based on indices, for targeted return managers the benchmark is cash + 4% p.a. and for Millennium the benchmark is 1.5% p.a.

3 months

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+6.8	+6.8	-
Aviva Investors (property)	+1.8	+2.3	-0.5
Aspect Capital (managed futures)	-5.9	+1.1	-7.0
Delaware (emerging market equities)	-0.8	+0.7	-1.5
Kleinwort Benson (equity dividend)	+7.3	+6.4	+0.9
Kempen (equity dividend)	+9.3	+6.4	+2.9
Ruffer (targeted return)	+3.0	+1.1	+1.9
Pictet (targeted return)	+1.6	+1.2	+0.4
Ashmore (emerging market debt)	+2.8	+0.5	+2.3
Millennium (currency)	+1.6	+0.4	+1.2

Financial year-to-date (9 months)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+25.0	+25.0	-
Aviva Investors (property)	+3.0	+2.8	+0.2
Aspect Capital (managed futures)	-9.4	+3.3	-12.7
Delaware (emerging market equities)	+25.7	+22.3	+3.4
Kleinwort Benson (equity dividend)	+25.8	+25.2	+0.6
Kempen (equity dividend)	+26.2	+25.2	+1.0
Ruffer (targeted return)	+13.1	+4.4	+8.7
Pictet (targeted return)	+12.9	+4.4	+8.5
Ashmore (emerging market debt)	+28.2	+18.7	+9.5
Millennium (currency)	+0.2	+1.1	-0.9

One year

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+27.8	+27.8	-
Aviva Investors (property)	+3.1	+2.8	+0.3
Aspect Capital (managed futures)	-9.0	+4.4	-13.4
Delaware (Emerging market equities)	+36.9	+32.6	+4.3
Kleinwort Benson (equity dividend)	+31.7	+28.7	+3.0
Kempen (equity dividend)	+34.8	+28.7	+6.1
Ruffer (targeted return)	+13.1	+4.4	+8.7
Pictet (targeted return)	+11.5	+4.4	+7.1
Ashmore (emerging market debt)	+41.8	+29.4	+12.4
Millennium (currency)	-0.7	+1.5	-2.2

Three years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+12.1	+12.1	-
Aviva Investors (property)	+11.9	+10.7	+1.2
Aspect Capital (managed futures)	+9.5	+4.4	+5.5
Delaware (Emerging market equities)	+7.0	+7.4	-0.4
Ruffer (targeted return)	+7.2	+4.4	+2.8
Kleinwort Benson (equity dividend)	+13.7	+13.7	-
Kempen (equity dividend)	+13.4	+13.7	-0.3
Millennium (currency)	+1.6	+1.5	+0.1

Five years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+14.3	+14.3	-
Aviva Investors (property)	+9.1	+8.2	+0.9
Delaware (Emerging market equities)	+8.1	+6.0	+2.1
Ruffer (targeted return)	+7.7	+4.4	+3.3
Millennium (currency)	+1.4	+1.5	-0.1

Equality and Human Rights implications

6. The matters referred to in this report have no identifiable equal opportunities implications.

Recommendation

7. That the report be noted.

Officer to Contact

Colin Pratt, Investments Manager
Tel: (0116) 305 7656
Email: Colin.Pratt@leics.gov.uk

APPENDIX

PENSION FUND INVESTMENTS AS AT 31ST DECEMBER 2016

	Market Value £	Value %	Benchmark %	Variance %
Equities				
United Kingdom	312,737,370	8.35	8.10	0.25
Overseas:				
Global dividend-focused	312,003,253	8.33	8.00	0.33
North America	574,541,822	15.34	14.20	1.14
Europe (Ex UK)	239,053,691	6.38	6.10	0.28
Japan	121,320,725	3.24	3.00	0.24
Pacific (Ex Japan)	115,731,665	3.09	3.00	0.09
Emerging Markets	223,876,298	5.98	6.10	-0.12
Total	1,586,527,454	42.37	40.40	1.97
Private Equity	141,997,897	3.79	4.00	-0.21
Property				
Direct Holdings*	96,490,000	2.58	3.30	-0.72
Indirect Holdings	219,791,785	5.87	6.70	-0.83
Total	316,281,785	8.45	10.00	-1.55
Alternative Investments				
Fauchier	755,147	0.02	0.00	0.02
Pictet	94,845,033	2.53	2.00	0.53
Ruffer	243,406,077	6.50	7.00	-0.50
Credit Opportunities	147,326,238	3.93	5.00	-1.07
Aspect	125,892,902	3.36	4.00	-0.64
Emerging Market Debt	102,827,113	2.75	2.50	0.25
Opportunity pool	85,865,139	2.29	2.50	-0.21
	800,917,649	21.39	23.00	-1.61
Commodities	0	0.00	0.00	0.00
Inflation-Linked Assets				
Global Government Index-Linked Bonds	182,749,280	4.88	5.00	-0.12
Infrastructure	164,218,584	4.39	5.00	-0.61
Timberland	80,520,604	2.15	2.00	0.15
	427,488,468	11.42	12.00	-0.58
Cash on Deposit	172,090,861	4.60	2.50	2.10
Unrealised Profit On Currency				
Active	2,626,072	0.07	0.00	0.07
Passive	-16,116,028	-0.43	0.00	-0.43
Total	-13,489,956	-0.36	0.00	-0.36
TOTAL	**3,744,551,528**	**100.00**	**100.00**	**0.00**

Direct Property Holdings*		
Retail	13,590,000	14.08
Retail Warehouses	19,695,000	20.41
Offices	24,590,000	25.48
Industrials	17,395,000	18.03
Leisure (Hotels/Health Club)	18,445,000	19.12
Farms	2,775,000	2.88
	96,490,000	100.00

Agenda Item 7

LOCAL PENSION COMMITTEE – 17TH MARCH 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CLOSURE OF TACTICAL UNDERWEIGHT POSITION IN INDEX-LINKED BONDS

Purpose of the Report

1. The purpose of this report is to inform the Committee of the action taken in February 2017, which brought the Fund's exposure to global index-linked bonds back up to its 7.5% strategic asset allocation weighting.

Background

2. The Fund's strategic benchmark weight in index-linked bonds has been 7.5% of total fund assets since early in 2013. These holdings have performed well and the asset class performed particularly strongly in the aftermath of the Brexit vote. Whilst there were a number of reasons as to why the asset class might continue to produce good returns, there was also a strong case for suggesting that prices had risen "too far, too fast" and that the balance of probability was that prices might fall or simply stagnate.

3. Given how far prices had risen in such a short period of time, it was considered sensible to consider reducing the index-linked weighting on a tactical basis. At the end of August 2016, and following consolation with the Chairman of the Committee, delegated powers were used to instruct the sale of sufficient quantity of index-linked bonds as to bring the actual weighting down to 5%. The Committee were informed of this action in an urgent report presented to the meeting held on 2nd September 2016.

4. As there were a number of potential scenarios in which the price of index-linked gilts might continue to rise in the short term, it was not considered appropriate to reduce the weighting of index-linked bonds below 5%. The strategic benchmark remained at 7.5% and the underweight was purely tactical, with the intention to bring the actual weighting back up to the strategic benchmark level when market conditions suggested that this was sensible.

5. As part of the January 2017 Annual Strategy Meeting the continuation of the strategic benchmark weighting of 7.5% to index-linked gilts was reaffirmed, although the benchmark against which the portfolio (managed by Kames Capital) would be measured was changed to one that reflected all UK Government Index-Linked Bonds in issue – the previous benchmark encouraged a higher level of investment in long-dated bonds where market prices are more volatile. The Committee also approved that Officers and Investment Consultants effect the return to the strategic benchmark investment level, as-and-when the time was deemed appropriate.

Closure of tactical underweight

6. In late February 2017 conditions within index-linked markets were such that it was considered advisable to bring the weighting back up to its target. Attached to this report as appendix an appendix is a note produced by Scott Jamieson, the Fund's independent investment advisor that summarises why this action was proposed. Once agreed, the action was implemented quickly.

7. If the same holdings had been repurchased in late February 2017 as those that had been sold in August 2016, then the cost of the repurchase would have been £4.2m less than the proceeds of the sales. This £4.2m should be considered the 'profit' from the action taken – in effect the sales that occurred meant that the Fund avoided a fall in the value of its assets of this amount.

8. Whilst the 'profit' from the action is actually quite modest relative to the size of the Fund's assets, the nature of the LGPS means that this is £4.2m (plus future investment growth on this sum) that the employing bodies will not have to pay into the Fund. As such, the action should be considered a success.

Recommendation

9. The Committee is asked to note the report.

Equality and Human Rights Implications

None specific

Appendix

Note on restoring target exposure to UK Index-linked bonds

Officers to Contact

Colin Pratt – telephone (0116) 305 7656
Chris Tambini – telephone (0116) 305 6199

APPENDIX

Note: On restoring target exposure to UK Index-linked bonds

Summary

In August 2016 the weighting to index-linked bonds was tactically reduced in an attempt to monetise some of the spectacular gains seen in UK government bonds that followed the UK vote to leave the European Union. Subsequently Officers, supported by the Independent Advisor, together with Kames Capital were granted discretion to reinstate the strategic weighting at a time and level of their choosing – mindful of the desire to maximise the profit generated and the need to maintain the desired weighting in a defensive asset. The position was restored at the end of February; the move resulted in a profit of just over £4m.

Detail

Members will be well aware of the sustained climb in UK Government bond prices in recent years (it is this that has driven the relentless ascent in the Scheme's liability values). This move acquired feverish proportions following the *Brexit* vote as investors feared that the UK economy (and that of the EU) would enter a sharp recession. The clamour for defensive exposure resulted in the real yield on 50-year UK Government bonds falling below minus 1.8% - at this level, investors would be guaranteed to lose more than half their capital in real terms. Recognising the extreme conditions, the Director of Corporate Resources' Delegated Powers were utilised (following due consultation with the Chair) to allow the liquidation of one third of the index-linked bonds held in an attempt to avoid the value erosion that would result from the move higher in real yields that might follow a sober market re-assessment of the long term outlook. The move was implemented in the last week of August 2016.

At the 2017 Strategy Review Members further resolved to alter the benchmark for the index-linked portfolio from a long duration index to one that captured the movements in the broader market[1]. This change is a structural move intended to 'lock in' the exceptional rise in long-dated IL bond prices. The interaction between the tactical move last summer and the change in strategic benchmark meant that the bonds sold would not necessarily be those repurchased. [In practice, the IL bond manager (Kames Capital) has discretion over which particular bonds they wish to own at any particular point in time.] This strategic change means then that an exact measurement of the profit from the tactical sale would not be available.

In February 2017 it was the view of those delegated to manage the weighting restoration, that the gilt market had entered a period of consolidation where the tactical merit of being underweight in a strategic asset (UK IL) was much less clear cut than was the case last summer. The Government had auctioned material quantities of fresh stock and met solid demand (the auctions were twice covered). The US bond market (this market sets the tone for world bond markets) had itself also stabilised after a period of an unprecedented selling generating the potential of a material recovery if a supportive catalyst emerged. In this context, the upcoming elections in Holland and France are judged have the potential to initiate such a move. As a result, the strategic weighting (against the new benchmark) was restored ahead of month end. Allowing for the absence of like-for-like purchases, the profit gained (or capital preserved) from the tactical reduction was just over £4m.

Members are asked to note that the target weighting in index-linked bonds has been restored for a profit of over £4m.

[1] In practice the UK Index-linked All Stocks index as compiled by FTSE has been adopted.

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Leicestershire County Council

LOCAL PENSION COMMITTEE

17 MARCH 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RISK MANAGEMENT AND INTERNAL CONTROLS

Purpose of the Report

The purpose of this report is to inform the Committee of a requirement for a report concerning risk management and internal controls to be a standing item on every Local Pension Committee agenda as stipulated in the Pension Regulator's Code of Practice.

Background

In April 2015 The Pension Regulator (TPR) published its code of practise on governance and administration of public service pension schemes. This introduced a number of areas pension administrators need to record and members be kept aware of.

One area within the code is risk, more specifically 'risk management and internal controls', which the code states should be a standing item on each Pension Board and Pension Committee agenda.

The Leicestershire Fund already manages risk and has a risk register in place that is regularly reviewed by officers and presented to the Local Pension Board annually. Internal and external audit also consider risks within Pensions and highlight any risk concerns. However, in order to comply with the code the Director of Finance has agreed to have this as a standard item on both agendas.

Identified Risks

There are currently no identified risks

Recommendation

The Committee is asked to note the report.

Equality and Human Rights Implications

None specific

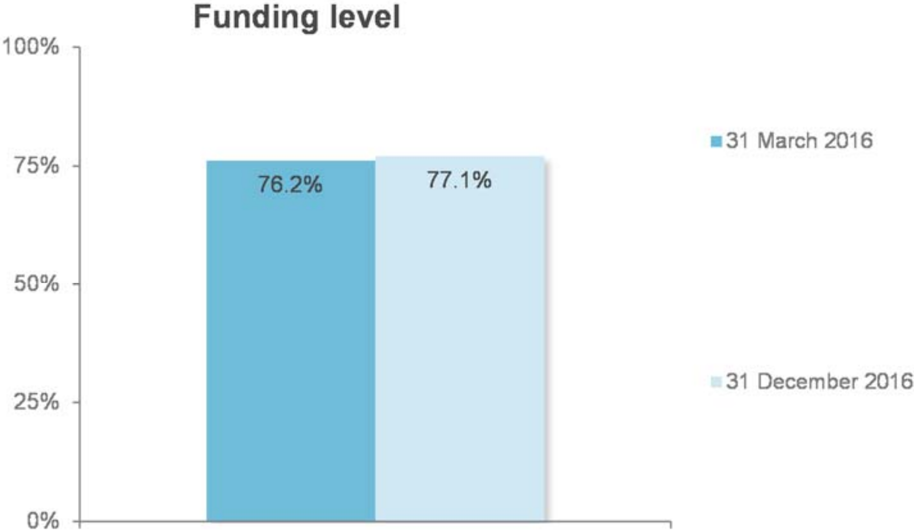
Officers to Contact

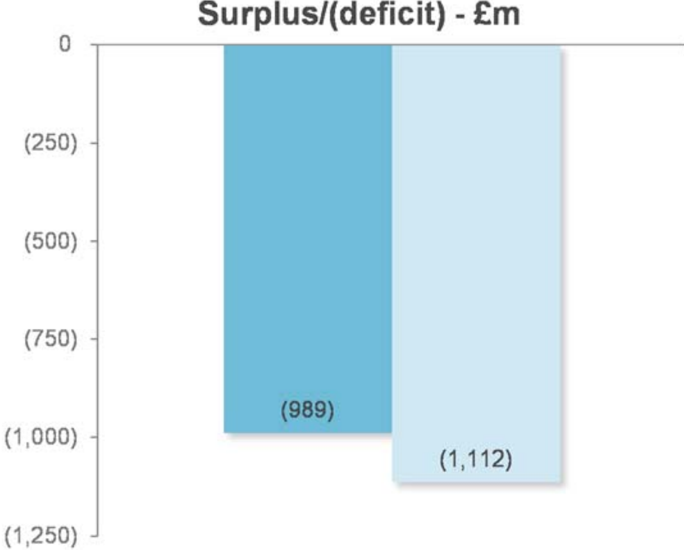
Colin Pratt – Investments Manager - telephone (0116) 305 7656

Chris Tambini - Director of Finance - telephone (0116) 305 6199

Leicestershire County Council Pension Fund

Funding update as at 31 December 2016





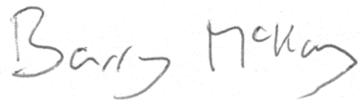
Summary

This funding update is provided to illustrate the estimated development of the funding position from 31 March 2016 to 31 December 2016, for the Leicestershire County Council Pension Fund ("the Fund"). It is addressed to Leicestershire County Council in its capacity as the Administering Authority of the Fund and has been prepared in my capacity as your actuarial adviser.

The funding level at the latest formal valuation was 76.2%. As at 31 December 2016 the funding level has increased to 77.1%. This represents a deficit of £989m at 31 March 2016 increasing to a deficit of £1,112m at 31 December 2016. A breakdown of this can be found in the graph on page 5 of this report.

This report has been produced exclusively for the Administering Authority. This report must not be copied to any third party without our prior written consent.

Should you have any queries please contact me.



Barry McKay FFA
Fund Actuary

Differences between this funding update and a full actuarial valuation

The accuracy of this type of funding update calculation is expected to decline over time as the period since the last valuation increases. This is because this funding update does not allow for changes in individual members' data since the last valuation.

Details of the approach used in this funding update are given in the appendix.

The figures in tables throughout this document may not add up due to rounding.

Estimated financial position at 31 December 2016

Ongoing funding basis

£m	31 Mar 2016	31 Dec 2016
Assets	3,164	3,745
Liabilities	4,153	4,857
Surplus/(deficit)	**(989)**	**(1,112)**
Funding level	76.2%	77.1%

Investment return

Quarter Ending	%
30/06/2016	6.5%
30/09/2016	6.2%
31/12/2016	4.5%

Market indicators

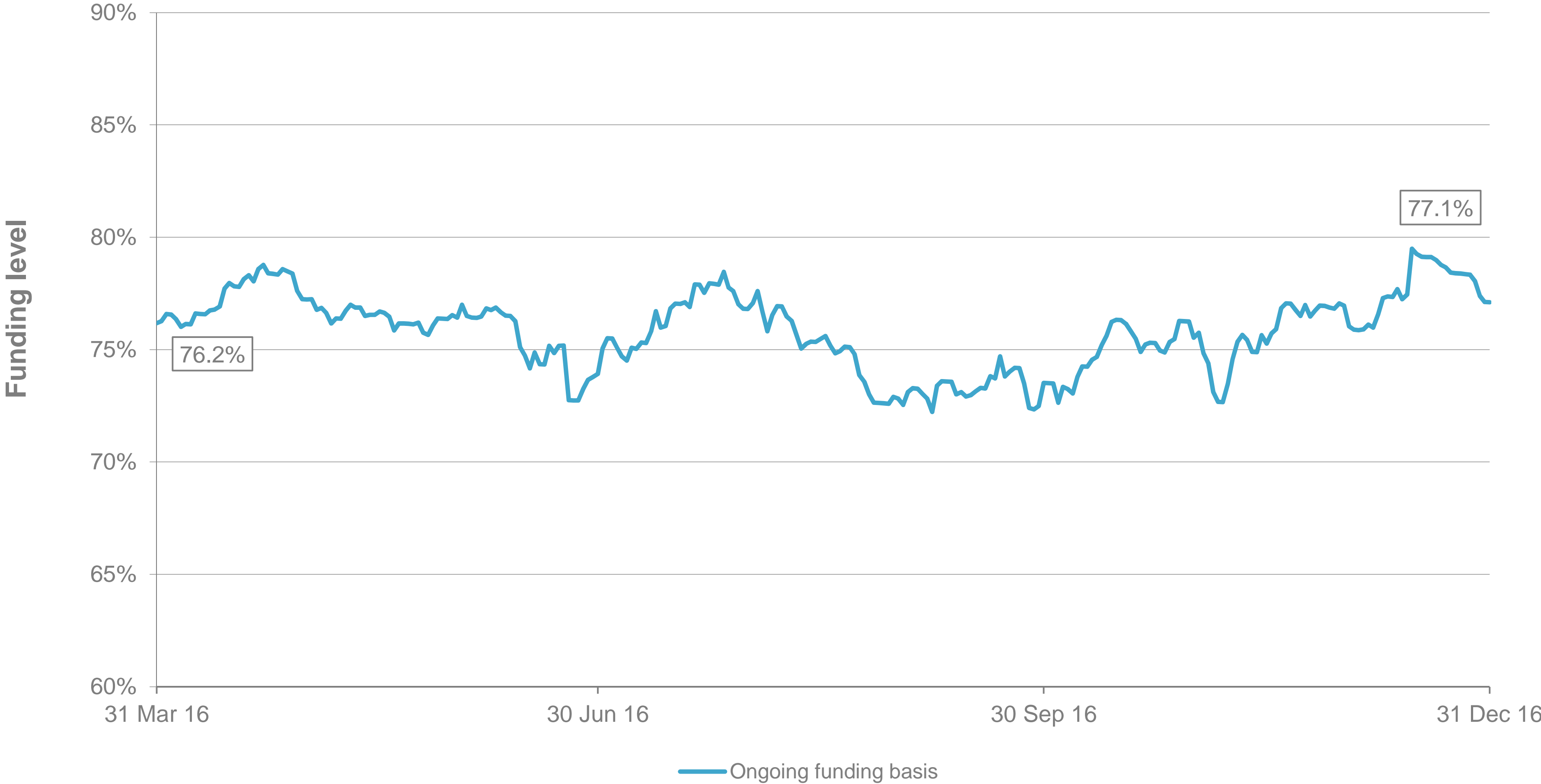
	31 Mar 2016	31 Dec 2016
Market yields (p.a.)		
Fixed interest gilts	2.18%	1.77%
Index linked gilts	-0.96%	-1.61%
Implied inflation (RPI)	3.20%	3.40%
Implied inflation (CPI)	2.10%	2.40%
AA corporate bonds	3.36%	2.62%
AOA	1.80%	1.80%
Price indices		
FTSE All Share	3,395	3,873
FTSE 100	6,175	7,143

Basis summary

	31 Mar 2016	31 Dec 2016
Pre retirement discount rate		
Nominal	4.0%	3.6%
Real	0.8%	0.2%
Post retirement discount rate		
Nominal	4.0%	3.6%
Real	0.8%	0.2%
Salary increase rate	3.2%	3.4%

The assumptions underlying the funding bases are set out in the Funding Strategy Statement. They are those set for the 2016 valuation of the Fund updated for market conditions as at the calculation date.

Change in funding level since last valuation

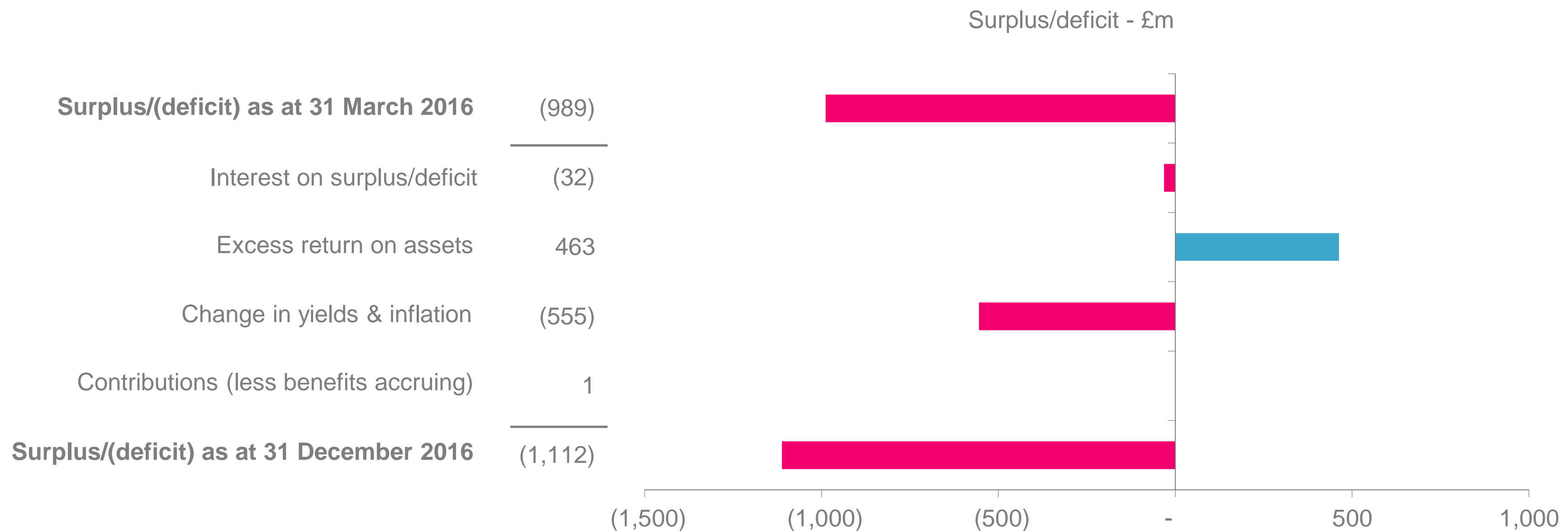


What's happened since last valuation? – Ongoing funding basis

Assets		£m
Asset value as at 31 March 2016	**3,164**	
Contributions paid in:		**125**
Benefit payments:		**(103)**
Expected return on assets:		**96**
Excess return on assets:		**463**
Asset value as at 31 December 2016	**3,745**	

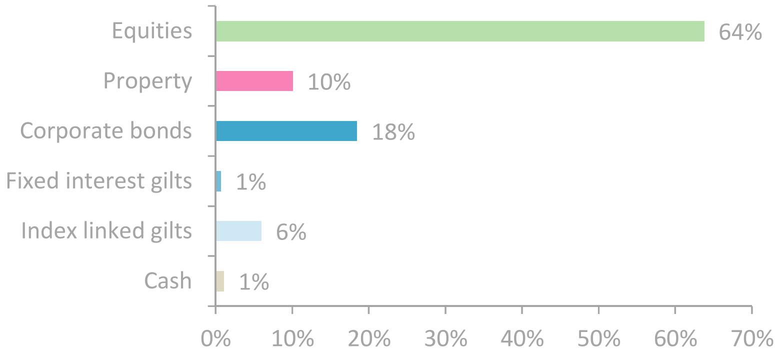
Liabilities		£m
Liability value as at 31 March 2016	**4,153**	
Cost of benefits accruing:		**124**
Interest on liabilities:		**128**
Change in yields & inflation:		**555**
Benefit payments:		**(103)**
Liability value as at 31 December 2016	**4,857**	

Overall effect

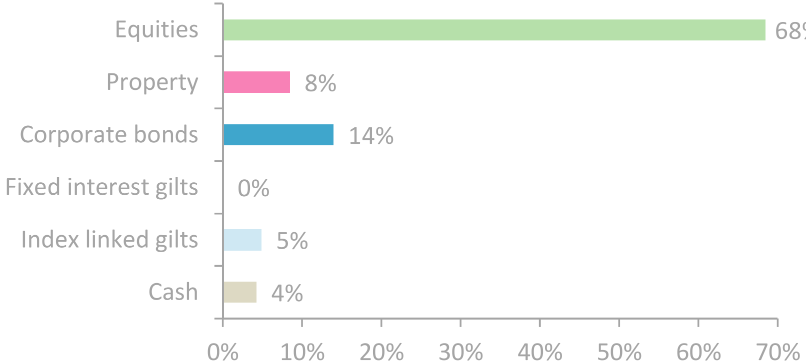


What caused your assets to change?

Allocation at valuation date

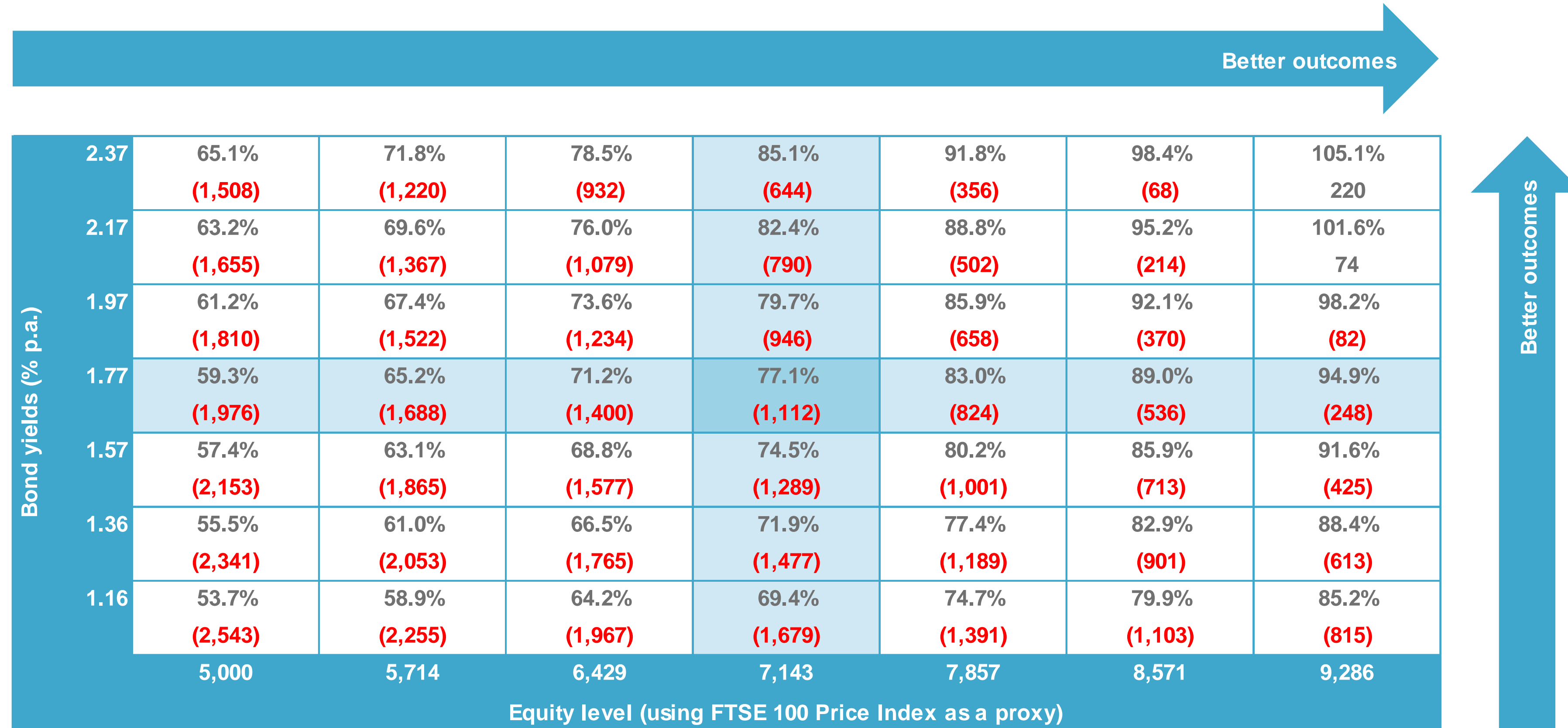


Allocation at 31 December 2016



Sterling total returns of major asset classes

Sensitivity matrix – Ongoing funding basis



Bond yields (% p.a.)	5,000	5,714	6,429	7,143	7,857	8,571	9,286
2.37	65.1% (1,508)	71.8% (1,220)	78.5% (932)	85.1% (644)	91.8% (356)	98.4% (68)	105.1% 220
2.17	63.2% (1,655)	69.6% (1,367)	76.0% (1,079)	82.4% (790)	88.8% (502)	95.2% (214)	101.6% 74
1.97	61.2% (1,810)	67.4% (1,522)	73.6% (1,234)	79.7% (946)	85.9% (658)	92.1% (370)	98.2% (82)
1.77	59.3% (1,976)	65.2% (1,688)	71.2% (1,400)	77.1% (1,112)	83.0% (824)	89.0% (536)	94.9% (248)
1.57	57.4% (2,153)	63.1% (1,865)	68.8% (1,577)	74.5% (1,289)	80.2% (1,001)	85.9% (713)	91.6% (425)
1.36	55.5% (2,341)	61.0% (2,053)	66.5% (1,765)	71.9% (1,477)	77.4% (1,189)	82.9% (901)	88.4% (613)
1.16	53.7% (2,543)	58.9% (2,255)	64.2% (1,967)	69.4% (1,679)	74.7% (1,391)	79.9% (1,103)	85.2% (815)

Equity level (using FTSE 100 Price Index as a proxy)

77.1%	Funding level
(1,112)	Surplus/(deficit) – £m

Appendix: Scope, methodology, reliances, limitations and market data

Scope

This funding update is provided to Leicestershire County Council as the Administering Authority of the Leicestershire County Council Pension Fund to illustrate the funding position as at 31 December 2016. It should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except with Hymans Robertson LLP's prior written consent, in which case it is to be released in its entirety. Hymans Robertson LLP accepts no liability to any third party unless we have expressly accepted such liability in writing.

Compliance with professional standards

The method and assumptions used to calculate the updated funding position are consistent with those used in the latest formal actuarial valuation, although the financial assumptions have been updated to reflect known changes in market conditions. As such, the advice in this report is consistent with that provided for the last valuation, as set out in the:

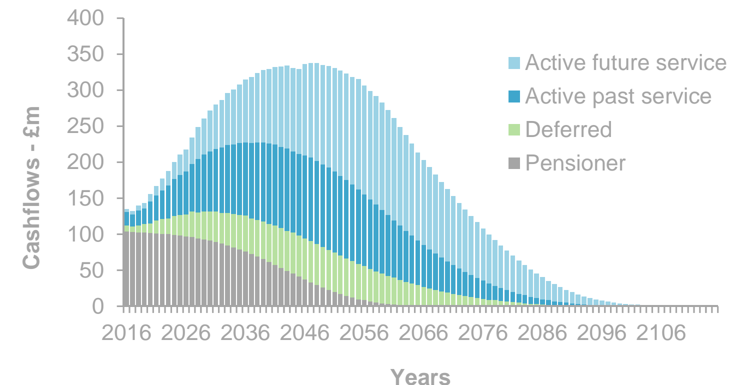
- Valuation Assumptions Briefing Note
- Funding Strategy Statement
- Valuation Report (to be issued by 31 March 2017)
- Rates and Adjustments Certificate (to be issued by 31 March 2017)

This update therefore complies with the following Technical Actuarial Standards (TASs):

- Reporting ("TAS R")
- Modelling ("TAS M")
- Data ("TAS D")
- Pensions TAS

How liabilities are calculated

- The future benefits that are payable from the Fund ("cash-flows") were calculated on a specific set of assumptions at the last valuation date.
- These cash-flows (on the Ongoing funding basis) are shown below.
- These cash-flows were adjusted using available financial and Fund information to produce estimated cash-flows at post valuation dates.
- The specific information used for this update is set out on the next page.
- Market information is used to produce discount rates at these dates.
- The estimated cash-flows are discounted to produce the estimated liability value at a specific date.



How assets are calculated

Assets are projected from the valuation date allowing for actual or estimated Fund cash-flows, actual quarterly returns (where available) and daily benchmark indices

The update allows for:

1. Movements in the value of the assets as measured by index returns and data from the administering authority where available.
2. Movements in liabilities as a result of changes in yields and hence inflation and discount rate assumptions.
3. Estimated cash-flows (contributions and benefit payments).
4. Expected accrual of benefits for employee members accrued since the last valuation (based on projected salary roll).
5. Demographic experience in line with assumptions.
6. Variations in liabilities arising from the changes in RPI since the valuation date differing relative to assumptions.
7. Benefit accrual in line with the 2014 scheme.

The update does not allow for:

1. Asset allocations differing from those assumed (other than when asset data is recalibrated based on available information).
2. The asset values as at the date of this report have not been based on audited Fund accounts.
3. Variations in liabilities arising from salary rises differing relative to assumptions.
4. Differences between estimated and actual salary roll of employees.
5. Variation between actual and expected demographic experience (e.g. early retirement or mortality).

Membership data

My calculations are based on the membership data provided for the most recent actuarial valuation. Details on the quality of this data and a data summary can be found in the last formal actuarial valuation report.

Limitations of this model

In the short term, the typical main contributors to funding position volatility are movements in the value of assets held, liability changes due to yield movements, benefit changes and deficit contributions to the Fund.

The accuracy of this type of funding update calculation is expected to decline over time. Differences between the position shown in this report and the position which a valuation would show can be significant; particularly if there have been volatile financial markets or material membership changes (these are more likely to occur in smaller schemes). It is not possible to fully assess the accuracy of this update without carrying out a full actuarial valuation.

Liability calculations are performed on the valuation date, the funding update date, anniversaries of the valuation date and each month-end in between. Interpolation is used for other dates shown in graphs. Some asset classes are not easily tracked by the benchmark indices used in this model which can lead to significant differences between actual and projected asset values.

Indices used to update projected asset values

Some of the following indices have been used to update projected asset values in this funding update.

- FTSE 100
- FTSE 250
- FTSE Small Cap
- FTSE All Share
- FTSE All World Series North America (£)
- FTSE All World Series Japan (£)
- FTSE All World Series Developed Europe (£)
- FTSE All World Series Developed Asia Pacific (£)
- FTSE All World Series All World Developed Ex UK (£)
- FTSE All World Series All World Ex UK (£)
- FTSE All World Series All Emerging (£)
- UK Government Fixed Interest Gilts (Over 15 Years)
- UK Government Index-Linked Gilts (Over 5 Years)
- UK Government Index-Linked Gilts (Over 15 Years)
- iBoxx A rated UK Corporate Bonds (Over 15 Years)
- iBoxx AA rated UK Corporate Bonds (Over 15 Years)
- iBoxx AAA rated UK Corporate Bonds (Over 15 Years)
- iBoxx All Investment Grades rated UK Corporate Bonds (Over 15 Years)
- IPC Property
- Cash Indices LIBOR 1 Month

The indices are a standard list and are not necessarily the same indices that managers have been asked to track or beat. All indices used to estimate projected asset values are total return indices. However, the market indicators quoted in this report are price indices, as these are more widely recognised.

Market information used to update liability values

Some of the following market information has been used to update liabilities values in this funding update.

- Nominal gilt yield curves derived from Bank of England data
- RPI gilt inflation curve derived from Bank of England data
- Nominal swap curves derived from Bloomberg data
- Real swap curves derived from Bloomberg data
- Inflation volatilities derived from the swap market
- FTSE Actuaries UK Fixed Interest Gilts Yields (Over 15 Years)
- FTSE Actuaries Index-Linked Gilts (3% Inflation) Yields (Over 15 Years)
- iBoxx AA rated UK Corporate Bond Yields (Over 15 Years)

Note: Market yields displayed in the market indicators table are on an annual basis.

Market Report

This note is intended to support the discussion at the upcoming Local Pension Committee meeting of the Leicestershire County Council Pension Fund.

Overview

The first table below updates on consensus real economic growth estimates as compiled by Bloomberg; expectations on the pace of growth in 2017 across the world have been revised upward in recent months. By the standards of recent decades these forecasts aren't that impressive. Viewed against the experience of recent years they have been enough to strength 'animal spirits' across asset markets and, importantly, in companies (many business sentiment surveys have reached multi-year highs).

	2016	2017		2018	
GDP growth (% p.a.)	Actual	Consensus	Change past Q	Consensus	Change past Q
US	**1.6**	**2.3**	**0.2**	**2.3**	**0.2**
Eurozone	**1.7**	**1.5**	**0.2**	**1.5**	**0.0**
UK	**2.0**	**1.4**	**0.5**	**1.3**	**-0.2**
Japan	**1.0**	**1.0**	**0.2**	**0.9**	**0.2**
China	**6.7**	**6.5**	**0.1**	**6.2**	**0.2**

The UK was arguably the first economy to challenge both the malaise of H1, 2016 and the Brexit spasm; the US economy also performed well in Q3 (+3.5% annualised pace). Driving the latest upgrades has been an almost unending succession of economic data prints in excess of forecasts all across the globe; surprises have become the norm. Notably this has included Europe where activity levels are as high as they have been for several years and in China (and thus allowing those most worried about China's credit excesses to postpone the perceived day of reckoning). Together these developments has reflected an impressive synchronised upswing. Real time, various '*nowcast*' measures suggest that the current pace of growth in the US lies between 2.2% (Atlanta Fed) and 3.1% (NY Fed); suffice to say that the US economy is running on or above the full year projection. In Europe growth is judged to be running at a 3% annualised pace.

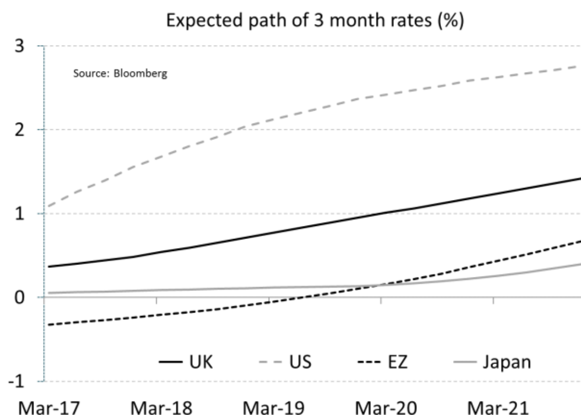
This has been reflected in upward revisions to inflation forecasts (table below) although the base effect from the recovery in oil prices that occurred from the Spring of 2016 is also a strong factor. The impact of the slump in £ is reflected by the change to the 2018 estimate of UK inflation although +2.6% fully a year after a major currency slump suggests inflationary pressures remain relatively modest.

	2016	2017		2018	
Inflation (% p.a.)	Actual	Consensus	Change past Q	Consensus	Change past Q
US (Core PCE)	**1.7**	**1.8**	**0.0**	**2.0**	**0.0**
Eurozone	**1.1**	**1.5**	**0.2**	**1.5**	**0.0**
UK	**1.6**	**2.5**	**0.2**	**2.6**	**0.4**
Japan	**0.0**	**0.6**	**0.1**	**0.9**	**-0.1**
China	**2.1**	**2.2**	**0.2**	**2.3**	**0.1**

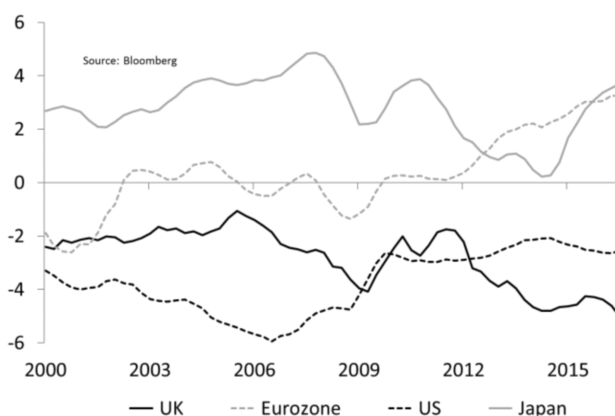
Overall, the growth and inflation outlook has encouraged the belief that the era of deflation has ended and that we have entered a period of reflation; having waited a long time for this, investors have embraced the change. The turnaround in sentiment has proved astonishingly rapid and is vulnerable to delivery risks. A factor

behind the malaise of recent years has been the unwillingness of companies to invest. It remains to be seen if managements are prepared to act upon their newfound confidence. Possible changes to US public spending and corporate taxes will be key. Trump has a lot to live up to!

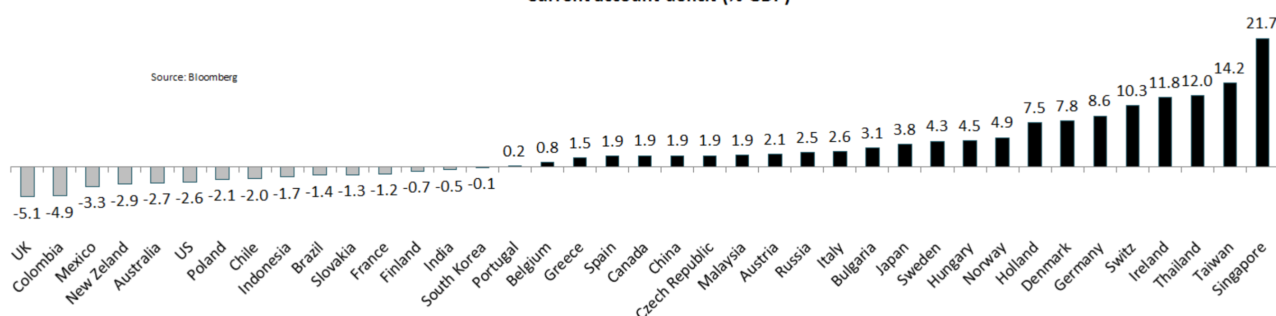
This changed perspective is reflected in the outlook for short-term interest rates. All major economies are now judged to have a rising rate profile albeit that the absolute level of rates is still expected to remain very low by historic standards. The Federal Reserve's latest estimate of the terminal policy rate in the US is 3%. Three US rate increases are expected in 2017. Given the current mood across markets, these increases will be seen as validating the jump in sentiment rather than as an attempt to cap the recovery. Failure to raise rates will therefore induce doubt in the minds of investors. Elsewhere the risk is that changes in the US force other central banks to tighten policy when they shouldn't.



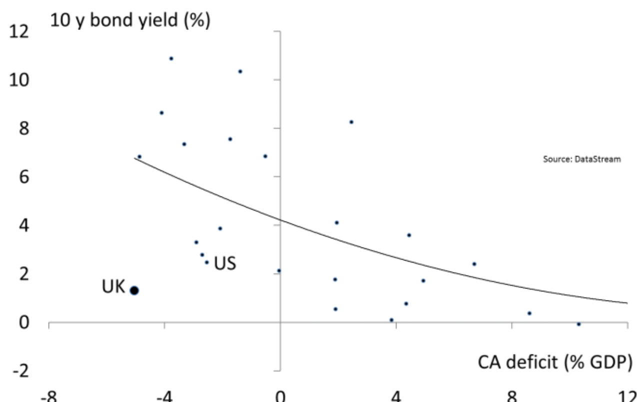
Challenges for non-US policymakers vary. In Europe, the ECB could soon run out of bonds to buy in their QE programme; with growth strong, the Bundesbank may anyway be keen to end such policies. If so, then the scale of the Eurozone current account surplus (chart opposite) could put unwelcome pressure on the €.



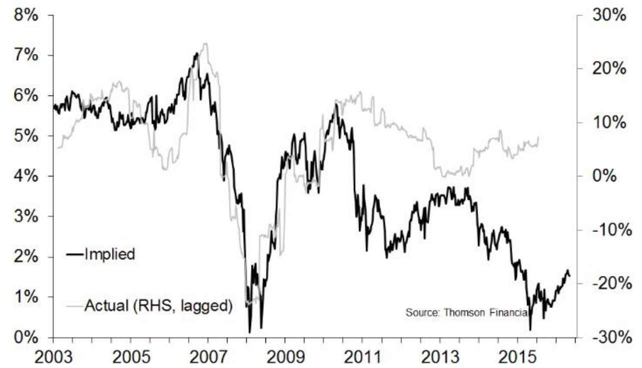
In the UK the opposite concern applies; the UK is in the ignominious position of having the largest current account deficit of any established economy. A healthy global economy (exhibiting a strong appetite for UK goods and services) would be a godsend for this country. Thankfully, £, on any econometric basis, looks cheap.



If £ is cheap, the same cannot be said for UK gilts; relative to the scale of external finance that the UK needs to attract to 'balance the books', international comparison suggests that gilt yields remain far too low. Concerns around the manner of the UK's exit from the EU may see gilts retain a defensive premium but this isn't a cheap market. Those looking for value in stabilising assets should focus on US bonds.



On equities, it is worth noting that currently a discounted future dividend assessment suggests that, for the UK (shown opposite) and other markets, the level of future dividend growth required to breakeven with the alternative of investing in bonds, remains very low by historic standards. This should, if the global economy is indeed improving, offer strong support to equity investment.

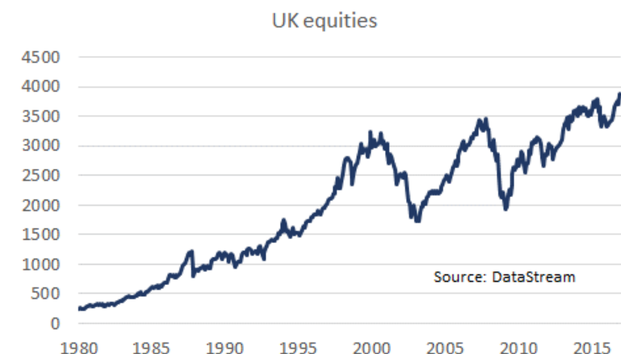


The remainder of this note attempts a longer term assessment of the prospects for equity markets. The positive outlook offered may be difficult for the Pension Fund to embrace fully – given the challenge that the inevitable equity market corrections could place upon, already strained, sponsor contribution rates. It does nonetheless suggest that the bar, against which alternatives (to investing in equities) are pursued should be assessed, is quite high.

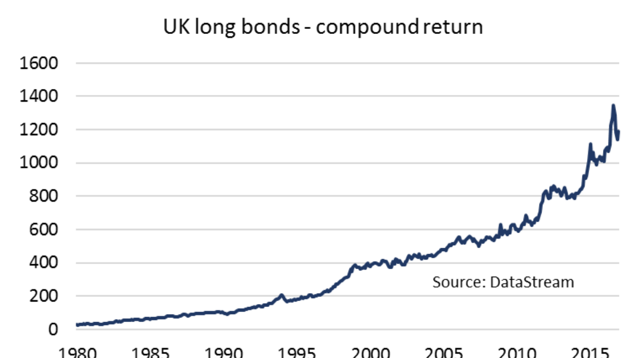
This argues against investing unduly in stabilising assets at this time; (much) better opportunities for doing so should present themselves. It doesn't suggest that simply investing in broad market aggregates will prove optimal. There are many misalignments that should correct in value portfolios and in EM. The still-subdued rate outlook should also prove highly supportive of resilient yield themed equity programmes.

Discussion: 'Stocks for the long run'

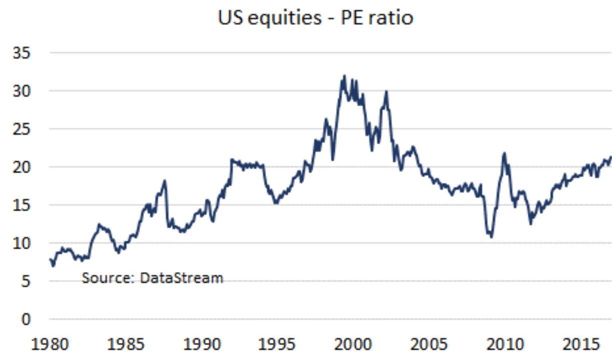
Last August I mused over when the equity bull market might start. The suggestion that equity markets were on their knees and about to turn was, of course, there to be challenged by the facts: indices had already seen very strong gains from the depths plumbed in the immediate aftermath of the Global Financial Crisis and were arguably back 'on track' (chart opposite). This was not denied. The proposition however was that, relative to bond markets and given the level of shorter term interest rates, equities, as a long term investment medium offering solid protection against value erosion caused by inflation, had woefully underachieved. UK equities have returned 7% since that argument was made.



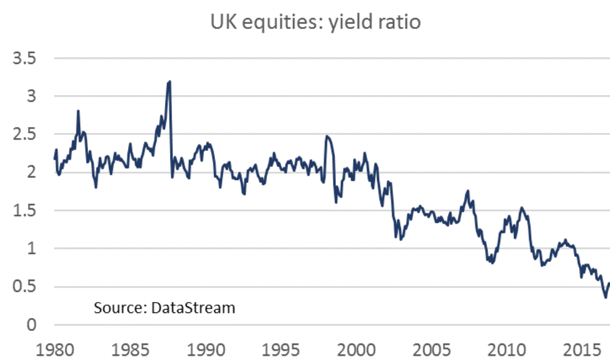
Developments since August have, arguably, made more important the question that we might still be at the foothills of a very strong multi-year equity bull market is considered. The contention is of course not that equities are risk free; there will always be testing periods of market angst. The outlook is, however, firmly for an era of equity market performance capable of emulating the returns seen from bond markets in recent decades. Equities have been good investments in recent years. Remembering the words of Randy Bachman – *you ain't seen nothing yet*.



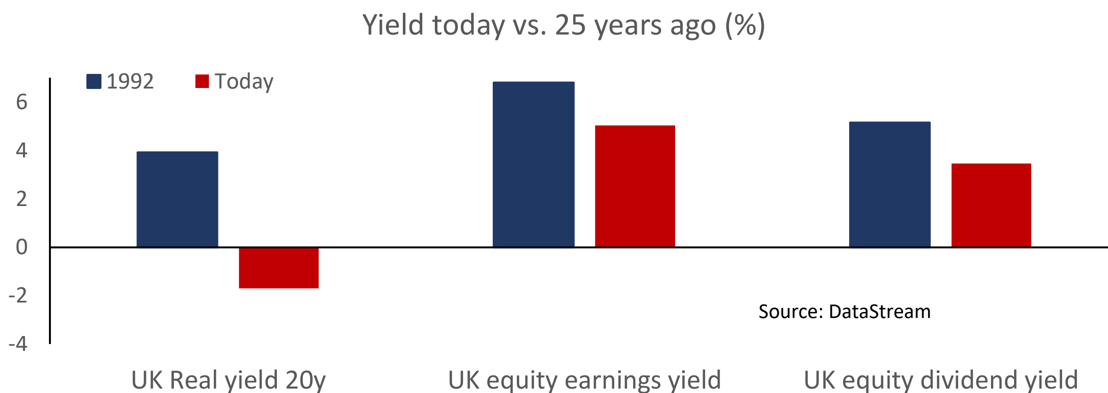
The strongest challenge offered against the suggestion that equity markets might currently be a compelling buy is generally based on valuation: price earnings ratios (PEs) are as high as they have been for a decade and higher than for all of the 20 years preceding the dotcom era. That is beyond challenge however dotcom itself showed that when conditions are favourable – as they now could be, equity ratings can rise significantly further. It should also be remembered that valuation constraints were often offered as an argument against continuing declines in bond yields. They were to prove to be no obstacle whatsoever against a move which would eventually see yields on the longest dated UK gilts almost touch 1%.



Thirty years ago a favoured valuation metric was the ratio between bond and equity yields. This comparison was favoured because it had shown stability – when gilt yields were around 2.5 times those on equities, you bought gilts, when the ratio was below 2, you bought equities. Valuation measures are invariably framed by mean reversion arguments around relationships that have previously shown some stability. The metric was ignored once it ceased to work. Other favoured 'rules' e.g. the Rule of 20 (PE ratio + yield = 20) were also to fall by the wayside.



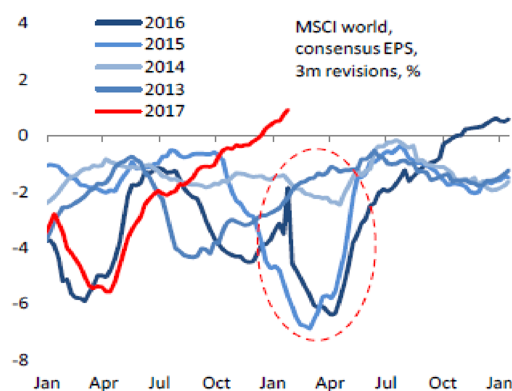
Actually inflation-linked bond yields, rather than nominal bond yields, are more relevant reference "risk-free rate" for valuing equities. Despite absolute equity valuations being above historic norms, the following chart suggests that shift over the last quarter of a decade has been extremely modest compared to bond markets.

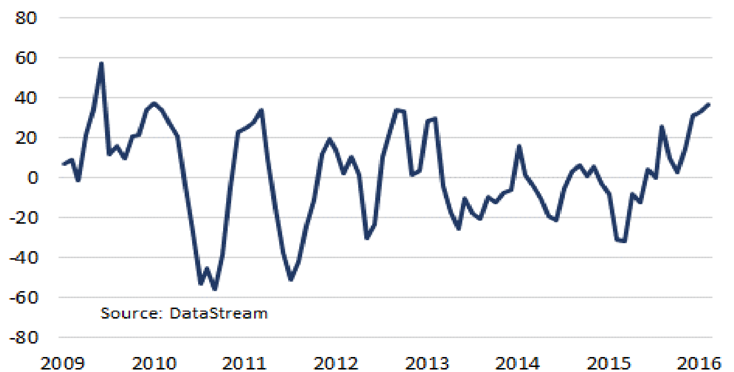


If beauty is in the eye of the beholder, then the assessment of *value* is no less subjective. The most relevant valuation metric is that which captures the behaviour of the category of investor dominating the market at that time. A generation ago long term institutional investors not yet impacted by balance sheet or solvency considerations freely selected between equities and bonds; small wonder that a comparison of equity yields with those available on long duration bonds makes sense. Pension funds etc. however have a frame of assessment that is different from corporates and also from retail investors. The dotcom burst began the decline in the dominance of equity market by institutional investors; institutional metrics began to lose their predictive power.

In recent years the strongest buyers of equities have been corporates themselves. For them 'value' is based on arguments associated with tax and short term debt yields. Looking forward it will be retail investors that are likely to emerge as the dominant category of investor. In that scenario comparison of dividend yields with cash yields may be most important. [I have always favoured a utilitarian approach – do the foreseeable returns/ income streams generated by an investment meet my needs after allowing for the likely risks involved?]

A more material problem for those trumpeting equities in recent years has been the difficulties that companies have faced in growing their earnings. Forecasts of future corporate profits having often started well only to be relentlessly pared back; not now. Currently and for the first time in many years, the profits outlook has improved, not diminished (chart overleaf).





An oft-mentioned concern involves the quality of earnings; particularly given the appetite of some companies to adopt sometimes-dubious accounting tricks. In a year of surprises, arguably the most significant development in 2016 was the synchronised global economic upswing which, as the year progressed, saw successive economic releases exceed expectations. The current solid progress on earnings is therefore underpinned by economic strength across the world (embracing even Europe where the real GDP growth rate for the first half of this year is remarkably expected to breach 3%). The shift away from monetary stimulation to fiscal support – strongly in the case of the US, is, ironically, coming at a time when uber-easy monetary policies looked to be gaining traction. For the first time in a decade, macro-economic policies look capable to delivering a period of above trend economic growth – a real world development that delivers the strongest challenge to those wary of investing in equities. Encouraged by these developments it is likely that corporate capital investment will increase and, in so doing, add resilience to the improvement in earnings; the outlook for corporate profits has improved. Trump's likely assault on US corporate tax rates offers yet another prop to future company earnings.

Regulatory tightening has been a significant constraint on the financial sector and, by extension, the real economy – although admittedly demand for credit has hitherto been weak. The period of punitive taxation and enfeeblement in the US looks, led by Trump, to be easing. To ensure that their banks remain competitive policy makers across the world will have to echo these moves.

Funds flow for equities has been very poor for a long time. By compulsion (due to tighter capital requirements) and inspired by 'rear view' caution, most large investors are still looking to ways to secure equity-like returns from anywhere but the equity market. Many of these have merit and are generally characterised by a valuation vs. liquidity risk trade off. There will – soon perhaps - come a time for simplifying things and to buy equities.

Investors have already begun to question whether bond investments – in their myriad forms – should be the magnet for cash that they were. It will take time – and ironically higher index levels – to entice many institutional investors to re-engage with markets; individual investors are likely to move first. Longer term the unavoidable growth of DC pensions arrangements must see investors favouring sensible equity risk-taking. In

the short term the flood of monies being transferred out of DB pension schemes (£10bn in the UK at the last count) is not, other than at the margin, going into bond investments – this capital is headed to equity markets.

In recent years a favourable dis-inflationary backdrop, supported by an austerity drive, ensured that the multi-decade bond bull market defied prediction in its extent and duration. Austerity is out and central bank talk is now about allowing reflation (inflation) to take hold. Equities have become the ultimate unloved investment and yet, suitably selected, equities remain the most appropriate long-term investment and currently offer a premium real yield to boot.

Strong challenges to holders of equity risk are always going to emerge but, in the bigger picture, the tide (of austerity and disinflationary) has turned. Suffice to close by declaring that currently, as perhaps never before for a generation, the biggest risk associated with equity markets is not owning them.

Scott Jamieson, March 2017

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Leicestershire County Council Pension Fund Q4 2016 - Market Report

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Contents

Historic Returns for World Markets	**3**
Market Review	**5**
Key Market Movements	**10**
Quarterly Thought Piece	**12**

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Historic Returns for World Markets

Index	Q4 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	-3.84	21.89	9.37
FTSE 100 TR	4.32	19.07	5.78
FTSE 350 TR	3.88	16.85	5.98
FTSE A (Index Linked) British Govt All Stocks TR	-2.68	24.33	13.56
FTSE A British Govt All Stocks TR	-3.43	10.10	8.02
FTSE A British Govt Over 15 Years TR	-6.00	18.49	14.35
FTSE All-Share TR	3.89	16.75	6.05
FTSE Japan TR	5.11	22.68	13.99
FTSE Small Cap TR	4.04	14.29	7.96
FTSE World Europe ex UK TR GBP	4.81	19.69	8.08
FTSE World ex UK TR GBP	7.09	30.42	15.31
IPD UK All Property Monthly TR	1.34	1.41	11.31
LIBID GBP 7 Day	0.06	0.39	0.45
Markit iBoxx Sterling Non Gilts Overall TR	-2.58	10.65	7.64
MSCI EM (Emerging Markets) TR GBP	0.83	33.12	7.84
MSCI Pacific ex Japan TR GBP	2.31	28.82	9.75
S&P 500 TR	9.15	33.55	20.02
Commodities	2.55	11.40	-11.38
£ Trade Weighted Index	-0.53	-14.73	-3.24

Currency	Q4 (%)	1 Year (%)	3 Years (%)
Euro	-1.33	15.82	0.86
Japanese Yen	-8.73	23.02	6.49
US Dollar	5.13	19.28	10.25

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 31 December 2016. All returns over one year are annualised.

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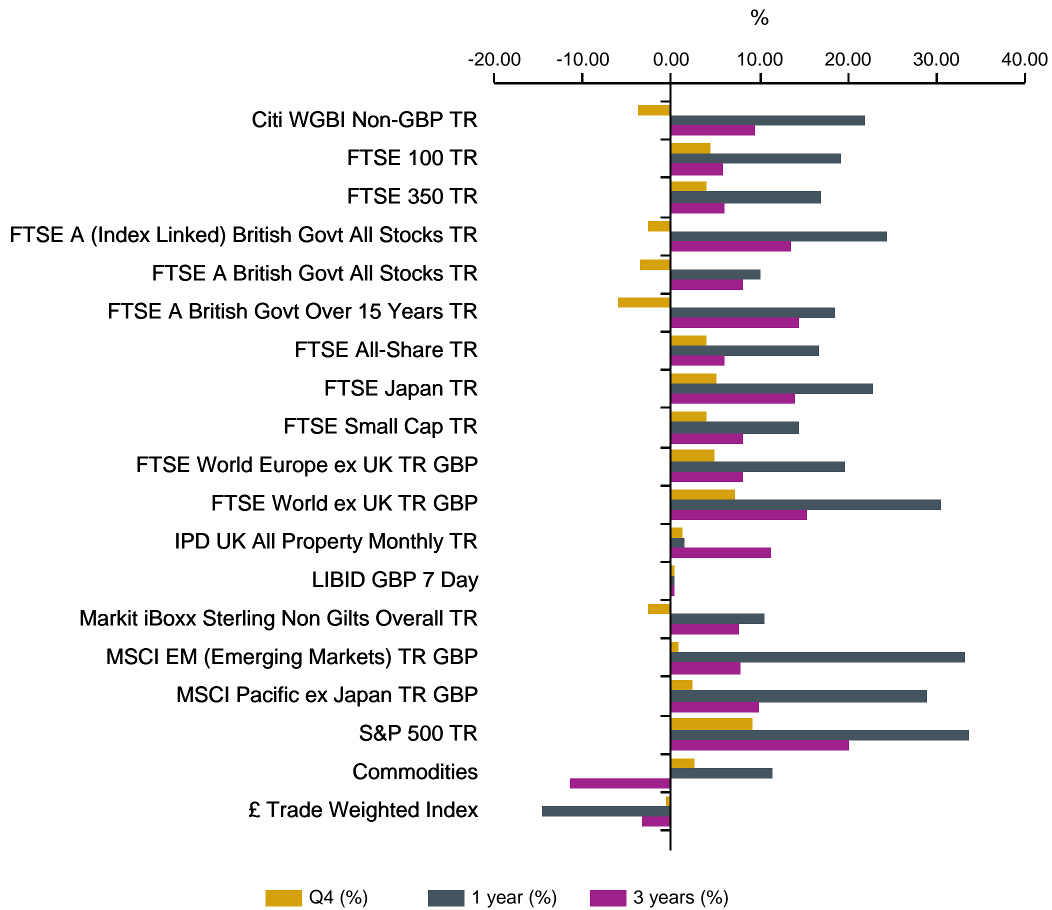
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 31 December 2016. All returns over one year are annualised.

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Market Review

UK Equities

UK equities advanced over the period, with the FTSE All-Share index returning 3.89%. The FTSE 100 rose 4.32%, outperforming both the FTSE 250 and the FTSE Small Cap indices. At the end of the quarter, the FTSE 100 made a series of new all-time highs, breaking through the 7000 level.

Economic data continued mainly to surprise on the upside, a trend in evidence since the vote to leave the EU back in June. Consumer spending was buoyant while exports benefited from the weakness in sterling against major currencies. Employment data continued to tighten.

Inflation rates began to climb as higher commodity prices started to feed through into the economy and as the weaker pound lifted the price of imported goods. UK consumer prices rose 1.2% year on year in November, the highest rate of growth for around two years.

Politics was dominated by the speculation and noise around whether the UK was heading for a hard or soft Brexit. Prime minister May insisted that Article 50, which formally triggers the start of negotiations to leave the EU, would be invoked in March.

Industrial metals was by far and away the strongest sector while banks, oil & gas producers and mining were also firm. More defensive sectors such as tobacco and pharmaceuticals & biotechnology, as well as technology hardware & equipment, were weaker.

US Equities

The S&P 500 rose 9.15% in sterling terms but only 3.82% in US dollar terms over the quarter, highlighting the material impact of sterling weakness against the US dollar on returns for the sterling investor.

The market prospered in spite of, or rather in hindsight, because of, Donald Trump's victory in the US Presidential election. The view in the run-up to the election was that a Trump victory could be negative for markets. The opposite proved to be the case and the equity market seemed to take comfort initially from Trump's conciliatory and inclusive acceptance speech and ultimately from the view that Trump's policies would be expansionary and good for domestic America, with high expectations of strong infrastructure spending and job growth.

Economic data largely surprised on the upside with robust employment and housing data in evidence. The October housing start figure showed growth of 25.5% year on year, to 1.32 million units, the highest level for nine years.

The Federal Reserve (Fed) raised rates by 0.25% to 0.5% in early December, a move that had been widely anticipated. The Fed increased guidance for 2017 to three rate hikes from two, given the increasing tightness in the labour market, rising commodity prices and the expectation of higher inflation from Trump's policies. Bond yields rose markedly as a result and the US dollar rallied, achieving a 14-year high against major currencies.

In terms of sector moves, financials, particularly banks, was by far the strongest performer. Consumer staples and health care were relatively weaker.

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European Equities

This was a good period for the European markets with the FTSE Europe ex-UK up by 4.81% in sterling terms.

Greece was the best performing country, up over 21%, followed by Italy, up over 15% in sterling terms.

European markets benefited from signs of a recovery in growth rates and improved confidence surveys. The eurozone economic sentiment index hit a 2016 high in October. The preliminary eurozone manufacturing purchasing managers index (PMI) came in at 54.9% for December, the highest level since April 2011. The European Central Bank announced that it would continue with its quantitative easing programme although at the same time it announced a tapering in the level of monthly bond purchases from €80bn to €60bn.

The political backdrop was dominated by the UK's impending split from the EU and what form that split might take, as well as elections and votes in countries such as Austria and Italy. Prime minister Renzi of Italy resigned following rejection by voters of his referendum on constitutional reform.

Italian banks were also in the spotlight. Banca Monte dei Paschi di Sienna (the country's third largest bank) failed to bridge its funding gap through private investment and began the process of government bailout. At the same time, Unicredit launched a €13bn rights issue, the largest in Italian history.

Oil & gas and financials were the strongest sectors while utilities, technology and health care were relatively weaker.

Japanese Equities

The FTSE Japan rose by 5.11% in sterling terms but by 15.16% in yen terms, underlining the marked weakness in the yen against sterling over the quarter.

The yen fell dramatically in November against the US dollar, from around the 105 level to 114, the largest drop in approximately 20 years. The Japanese market was buoyed by the weak currency which boosted the economy, specifically exporting companies.

The Bank of Japan continued with its unconventional efforts aimed at maintaining an upward-sloping yield curve and at targeting a zero percent yield on its 10-year government bond.

There was some comfort taken from inflation data and business survey data during the quarter.

Financials and oil & gas were the best performing sectors while health care and telecommunications both struggled.

Asia Pacific ex-Japan Equities

The MSCI Asia Pacific ex-Japan index posted a return of 2.31% in Sterling terms.

Australia was the best performer, up 5.92% and Thailand and Taiwan were both up around 3%, in sterling terms. On the downside were the Philippines, down 8.29% while China and Hong Kong were down 2.31% and 4.30% respectively.

Markets were unsettled by Donald Trump's sabre-rattling on trade issues and investors feared the potential escalation of a trade war with the US. Meanwhile, the US dollar rally caused concerns about the high level of US dollar-denominated debt in the region.

While perennial concerns around China's economic slowdown and the level of debt in its economy abounded, data releases from China abated some investor concerns as PMI and GDP data were largely within expectations.

In terms of sector moves, energy and materials were relatively strong while more defensive areas such as health care and telecoms were relatively weaker. Real estate also suffered.

Property

According to the IPD Monthly Index, the UK commercial property market completed a volatile year with a total return of 2.6% in 2016, comprising a 5.6% income return and a capital decline of 2.8% over the year. This fall in capital values was driven largely by an initial negative market response to the EU referendum result in the summer. However, investor confidence stabilised in Q4 and was reflected by a rise in All Property capital values of 1.1% in the final quarter. Encouragingly, whilst the pace of rental growth has slowed over the past 12 months, occupier markets appear to remain in reasonable shape with 2.0% rental growth recorded by IPD for the full year and representing the fourth consecutive year of rising market rents.

Industrials were the best performing sector in 2016 with a healthy total return of 7.0% over the year. Low vacancy rates and sustained occupier demand for both distribution sheds and multi-let industrial estates led to an acceleration of industrial rental growth towards the end of year and the sector appears well set to continue outperforming in 2017. In contrast, the office sector was the poorest performing sector with a total return of 1.0% in 2016. Investor confidence in Central London offices in particular was negatively affected by the referendum result with expectations of weakening occupier market demand given uncertainties for financial service firms over access to the EU single market. Retail sector returns continued to underperform in 2016 with IPD recording a total return of 1.1% and rental growth remaining weak due to the structural oversupply of retail space caused by the growth of internet shopping. Cost pressures on retailers as a result of higher input costs, business rates and labour costs are expected to squeeze retailer margins in 2017, which in turn is likely to limit rental growth potential in the sector.

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Fixed Income

Fixed income markets produced solid returns in 2016 as a whole although the fourth quarter brought a very turbulent end to the year with most bond markets selling-off significantly.

As we explain below, the fall-out from ‘Brexit’, the US presidential election result, the usual uncertainty over Central Bank intentions and (lest we forget) some much-needed attendance to bond market fundamentals all played a part in the sell-off.

The Trump victory in the US presidential race, which concluded in November, wrong-footed investors and subsequently led to a reappraisal of policy direction. In previous reports we have highlighted the debate within markets about whether monetary policies need to be implemented in conjunction with other measures such as fiscal policies. There is evidence of this happening in some countries, and with Trump’s victory these additional measures are a step closer to being implemented in the US although the extent to which he can implement the policies he alluded to on the campaign trail remains to be seen.

Government bonds under pressure

Government bond markets started the quarter on the back foot as investors began to reappraise the limits of monetary policy. With core markets already trading at extreme levels, and inflation expectations recovering from their commodity-induced lows, the scene was set for a re-pricing of core government bonds.

Concerns about a hard Brexit in the UK and uncertainty about where the European Central Bank was going with its QE programme also conspired to push yields higher. The US election in November brought further strain with US Treasuries selling-off sharply and bringing other bond sectors with it. The market was distinctly more subdued in December but the damage for the quarter was already done.

Given the volatile conditions, yields on 10-year government bonds in core markets increased as the table below highlights. UK government bonds, for example, returned -3.64% for the quarter although over 2016 as a whole the sector was up by 10.54%.

Index-linked bonds also came under pressure in the fourth quarter with the FTSE UK Index-Linked index returning -2.85%. Returns for the year however were very strong with the index up an impressive 23.39%.

Table 1: 10-year yield movements in core and European periphery benchmark bonds

	Core government bonds				Peripheral Europe				
Country	UK	US	Germany	Japan	Spain	Italy	Greece	Ireland	Portugal
Yield, end Sep 2016	0.75	1.60	-0.12	-0.09	0.88	1.19	8.19	0.33	3.31
Yield, end Dec 2016	1.24	2.44	0.21	0.05	1.38	1.81	7.02	0.75	3.75
Change in yield	0.49	0.85	0.33	0.14	0.50	0.63	-1.17	0.42	0.43

Source: Bloomberg.

Investment grade bonds outperform

Investment grade bonds outperformed their government counterparts in the fourth quarter; in total return terms the iBoxx £ Non-Gilts index returned -2.57%. Returns over 2016 as a whole were in line with the risk free asset class – the index returned a robust 10.66%.

The final quarter of 2016 saw the Bank of England commence its corporate bond buying programme in earnest. By year-end the Bank had completed close to £5 billion of purchases, around 50% of the £10 billion it had earmarked when it launched the programme. Were the Bank to continue the same pace in the New Year then it would complete its programme some 12 months ahead of schedule.

Investment grade bonds were given an additional boost after the election of Donald Trump as the next US president. Perceptions of Trump presiding over a pro-growth, anti-regulation administration have bolstered investor sentiment, and corporate bonds have been a clear beneficiary of this trend. The details around any future fiscal expansion may still be scant, but risk markets have largely been willing to assume the most positive of outcomes in terms of the ultimate prospects for improving corporate profitability.

High yield bonds

In sterling terms, the Barclays Global High Yield index returned 4.92% over the quarter, with little difference between the US and European high yield markets. Over 2016 as a whole however, US high yield was the clear winner; the Bank of America Merrill Lynch US High Yield index returned 17.49% compared to 9.07% for its European equivalent.

The recovery in commodity prices and the result of the US presidential election were the main drivers of the rally over the quarter. The energy sector continued to perform well and the Donald Trump's victory was seen as pro-growth with inflationary expectations subsequently increasing. In this environment, riskier assets rallied strongly.

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Key Market Movements

The following charts provide a pictorial summary of key market movements during the six-month period to end of December 2016.

Global Equities (FTSE World – Price Index)

Source: Datastream

Long Gilts (War Loans 3.5% Perpetual)

Source: Datastream

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Oil Price (Crude Oil Spot WTI Cushing ($per barrel))

Source: Datastream

UK Sterling (UK Sterling Trade Weighted Index)

Source: Datastream

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Quarterly Thought Piece

On the reflation trade: what is it and will it last?

Following the rate hikes by Fed Chair Paul Volcker in the late 1970's, the global economy and capital markets have enjoyed slowly decreasing inflation, accompanied by a secular decline in real natural rates.

The financial crisis in 2008 turned this into a deflationary dip, causing interest rates to fall even further, in some instances to below zero. However, Donald Trump winning the US presidential election has instigated the so-called 'reflation trade', potentially reversing these multi-year trends. This article takes a closer look at this phenomenon and considers whether it will last.

The term 'reflation trade' basically stands for any assets (or combination of assets) which will benefit from reflation. The latter means a recovery phase in the economy, often after a period of contraction, whereby demand is stimulated by monetary and/or fiscal policies. In some cases, these 'reflationary' policies are complemented by policies which address the supply-side of the equation.

In the current situation, expectations of reflation are associated with Trumponomics. Trumponomics is the term to describe the expected economic policies of Trump. To recap, they primarily consist of the following:

- Demand economics, like tax cuts, tax credits, and tax holidays, including corporate cash repatriation. This will increase both personal and corporate incomes.
- Supply economics, like infrastructure spending, deregulation, and energy independence. This will benefit related sectors, particularly domestic ones, in combination with the next point.
- Political economics, like renegotiating trade agreements (including tariffs), modernising the military and overhauling immigration.

Apart from the aforementioned sectors, other assets that benefit from reflation include commodities, banks and value stocks. One reason why investors have been front-running Trump's inauguration by buying these assets is that some, if not most, of his policies have a high likelihood of being implemented, if only because the Republican party has a majority in both the House and the Senate. On the other hand, the timing and extent of their impact remains unclear - it is likely the policies will have a more delayed impact that is respectively muted, than is currently priced-in. The IMF, for example, remains cautious regarding the impact of Trumponomics: this week it increased its forecast for US growth by 0.1% (and 0.4% for 2018).

What probably worries investors most in terms of the reflation trade is the risk that bonds enter a bear market. However, there are a number of factors which offer 'checks and balances', particularly regarding the extent of yield rises.

First, while the US now looks to be in the driving seat, until recently Japan was driving other bond markets. Unfortunately, the Bank of Japan's (BoJ) policy announcement in September contained an inconsistency, namely its wish to control (e.g. steepen) the curve while specifying how much it would buy via its QE program. Late last year we got clarification of the BoJ's real goal: it announced its first ever fixed-rate bond purchase operation through which it basically offers to buy unlimited amounts of bonds at the short end of the Japanese government bond curve at fixed rates. Not only does this mean that the BoJ is intent on preventing any tantrums at all cost (which, by the way, is getting easier as it becomes the only buyer in the market). It also means that US and other global rates will be anchored due to spill overs from the BoJ's QE program.

Second, and going forward, an interesting aspect of the reflation trade will be the role of the Fed. Although Trump had criticised Janet Yellen during his campaign for her loose monetary policy, he would not want the Fed to hike his (e.g. infrastructure) plans dead in the water, so to speak. A further strengthening in the US dollar, particularly if combined with increasing bond yields, will add to any tightening by the Fed in that regard. Due to its triple mandate, which now includes financial stability, the Fed is data *and* market dependent. On that note, the generally reflexive dynamics between economies and markets has meant, for example, that previous central bank actions themselves, i.e. lowering rates, have had a self-fulfilling effect. Back to the Fed, it means it will find itself between a rock and a hard place if market turbulence is caused by bonds collapsing while inflation exceeds its 2% target.

Last, but not least, based on extensive research, including by the Fed and the Bank of England, the deflationary forces which drive the aforementioned decline in rates include (in order of impact) demographics, declining productivity growth, price deflation in capital goods (i.e. excess capacity), reduced public (e.g. infrastructure) investment, inequality, and the ‘savings glut’. A more recent force is the relentless advance of technological disruption, including robotics and other forms of automation which is detrimental to wage inflation. Other forces, like demographics, add to this. For example, despite a tight labour market wages (and by extension inflation) in Japan are not responding as much as they might because women and older workers tend to have less bargaining power than prime-age males.

Personally, I do not expect trends in demographics, productivity and technology (nor the dogmatic beliefs of central bankers for that matter) to change much, even though the impact of the other forces may vary and even diminish over time. Consequently, rates are likely to remain range-bound, at least from an historic perspective. As far as the economic cycle is concerned, I continue to believe that stagflation is the most likely scenario going forward for Trump’s first term, because we cannot buy growth with yet more debt (certainly not without real rates going up). Growth will remain muted because it is related to global trade which is jeopardised by Trumponomics. On that note, the IMF dedicated its recent World Economic Outlook to global trade. Among other things, its findings suggest that given the subdued global growth outlook, further trade reforms that lower barriers, coupled with measures to mitigate the cost to those who shoulder the burden of adjustment, would boost the international exchange of goods and services and revive the virtuous cycle of trade and growth.

Overall, this means that the reflation trade is ‘capped’, whereby the further yields increase the more they reflect credit risks, rather than a benign endogenous growth outlook.

Patrick Schotanus
Investment Strategist
17 January 2017

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