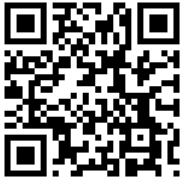

Leicestershire County Council

Meeting: **Local Pension Committee**

Date/Time: **Friday, 1 September 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 2 June 2017.		(Pages 5 - 12)
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 13 - 16)
7.	Funding Update as at 30 June 2017.	Hymans Robertson	(Pages 17 - 26)
8.	Responsible Investment.	Director of Corporate Resources	(Pages 27 - 38)
9.	Action Agreed by the Investment Subcommittee.	Director of Corporate Resources	(Pages 39 - 44)

10.	LGPS Central - Update Presentation.	Director of Corporate Resources	(Pages 45 - 50)
11.	Risk Management and Internal Controls.	Director of Corporate Resources	(Pages 51 - 52)
12.	Market Update	Independent Investment Advisor and Kames Capital	(Pages 53 - 76)

13. Dates of Future Meetings.

Future meetings of Local Pension Committee will be held at 9.30am on the following dates:-

10 November 2017
19 January 2018
23 February 2018
25 May 2018
7 September 2018
9 November 2018

The next Annual General Meeting of the Leicestershire Pension Fund will be held on Thursday 11 January 2018 at 6.00pm.

14. Any other items which the Chairman has decided to take as urgent.

15. 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).

16. Kames Capital Quarterly Report — Fund Manager

(Exempt under paragraphs 3 and 10 of Schedule 12A)

17. Aspect Capital Quarterly report. — Fund Manager

(Exempt under paragraphs 3 and 10 of Schedule 12A)

18. Kleinwort Benson Investors Quarterly Report. — Fund Manager

(Exempt under paragraphs 3 and 10 of Schedule 12A)

19. Ruffer Quarterly Report. — Fund Manager

(Exempt under paragraphs 3 and 10 of Schedule 12A)

20. Pictet Quarterly Report. — Fund Manager

(Exempt under paragraphs 3 and 10 of Schedule 12A)

21.	Millennium Global Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
22.	IFM Investors Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
23.	Delaware Investments Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
24.	JP Morgan Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
25.	Legal and General Investment Manager Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
26.	Ashmore Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
27.	Kempen Capital Management Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager
28.	Stafford Timberland Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager

TO:

<u>Leicestershire County Council</u>

Mr. P. C. Osborne CC (Chairman)
Mr. L. Breckon JP CC
Dr. S. Hill CC
Mr. Max Hunt CC
Mrs. R. Page CC

<u>Leicester City Council</u>

Cllr Deepak Bajaj and Cllr Dr Lynn Moore

<u>District Council Representatives</u>

Cllr Chris Frost and Cllr. Malise Graham MBE

University Representative

Ms. M. Holden

Staff Representatives

Mr. R. Bone
Mr. N. Booth
Ms. J. Dean

Agenda Item 1

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Friday, 2 June 2017.

PRESENT:

Leicestershire County Council

Mr. L. Breckon JP CC
Dr. S. Hill CC
Mr. Max Hunt CC
Mr. P. C. Osborne CC
Mrs. R. Page CC

Leicester City Council

Cllr Dr Lynn Moore

District Council Representative

Cllr Chris Frost

University Representative

Ms. M. Holden CC

Staff Representatives

Mr. N. Booth
Ms. J. Dean

1. Election of Chairman.

RESOLVED:

That Mr. P. C. Osborne CC be elected Chairman of the Local Pension Committee for the period ending with the date of the Annual Council meeting in May 2018.

Mr. P. C. Osborne in the Chair

2. Election of Deputy Chairman.

RESOLVED:

That Mr. L. Breckon JP CC be elected Deputy Chairman of the Local Pension Committee for the period ending with the date of the Annual Council meeting in May 2018.

3. Minutes of the previous meeting.

The minutes of the meeting held on 17 March were taken as read, confirmed and signed.

4. Question Time.

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

5. Questions asked by members.

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

6. Urgent items.

There were no urgent items for consideration.

7. 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.

Mr. L. Breckon JP CC declared a personal interest in all substantive items on the agenda as a member of the Leicestershire Local Government Pension Scheme as a result of his current employment.

8. Summary Valuation of Pension Fund Investments and Performance of Individual Managers.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present a summary valuation of the Fund's investments at 31 March 2017. A copy of the report is filed with these minutes, marked '8'

The Committee recognised the strong performance of many of the Fund's assets which had resulted in its value increasing by over £128m in the three month period up to 31st March 2017. In response to questions from members, the Director explained that whilst the Fund's investment in Aspect Capital had underperformed in recent times, the portfolios return over a three year period was significantly above its benchmark and the drop in recent performance was due to specific market conditions that were unhelpful to their investment style. The extent of the underperformance was consistent with what would have been expected and officers were comfortable that they would continue to manage the portfolio in the expected manner.

RESOLVED:

That the report be noted.

9. Update on Local Government Pension Scheme Investment Pooling.

The Committee considered a report of the Director of Corporate Resources which provided an update to members concerning the progress made towards the formation of the Local Government Pension Scheme (LGPS) Central Investment Pool. A copy of the report marked '9' is filed with these minutes. The Committee also considered a presentation as part of this item, a copy of which is filed with these minutes.

The Director reported that the LGPS Central Pool, of which the Leicestershire Fund would be one of 9 member schemes, was on schedule to meet the requirement to be operational by April 2018.

Arising from discussion the following was noted;

- Subsequent to the establishment of LGPS Central, the Local Pension Committee would continue to set the Leicestershire Fund's strategic asset allocation thereby deciding which types of investments the Fund would invest in;

- In order to establish the LGPS Central pool, the participating Funds had agreed to share the necessary set up costs with each fund required to contribute in the region of £500,000;

- In addition to the initial contribution, each Fund was required to invest a further £2m by way of Regulatory Capital. The Leicestershire Fund's significant cash flow meant that the contribution would have no impact on the investment activities of the Fund and the dividend/interest received from LGPS Central on the capital was likely to be higher than would be earned if the amount continued to be held as cash within the Fund;

- The Regulatory Business Plan, which would support the LGPS Central's Financial Conduct Authority application, was expected to be approved by the LGPS Central Shadow Shareholders' Forum on 19th June. Both the Director of Finance and Investments Manager had reviewed the document at length and were comfortable with its contents;

- A common investment policy in certain areas would need to be established between the 9 Funds and the Committee would consider a report on the matter at a future meeting.

RESOLVED:

That the report be noted.

10. Funding Update as at 31 March 2017.

The Committee considered a report by Hymans Robertson which presented the funding projection at 31 March 2017. A copy of the report, marked '10', is filed with these minutes.

In response to questions from members the Director explained that various factors had contributed to the Fund's deficit continuing to grow despite its assets significantly increasing over the past 12 months. Such factors included the continued low level of government bond yields on which the Fund's actuary based the Fund's expected future investment returns.

RESOLVED:

That the funding position of the Leicestershire Pension Fund as at 31 March 2017 be noted.

11. Market Update.

The Committee considered a report concerning global market conditions which was presented by the Fund's Independent Investment Advisor. A copy of the report, marked '11' is filed with these minutes.

RESOLVED:

That the update be noted.

12. Investment Subcommittee Membership.

The Committee considered a report from the Director of Corporate Resources concerning the membership of the Investment Subcommittee for the period ending with the date of the annual Council meeting in May 2018. A copy of the report marked 12 is filled with these minutes.

RESOLVED:

That the report be noted.

13. Risk Management and Internal Controls.

The Director of Corporate Resources presented a report, the purpose of which was to detail any concerns relating to the risk management and internal controls of the Fund. A copy of the report is filed with these minutes, marked '13'.

The Director reported that the Fund's risk management was managed as part of the authority's corporate risk register and since the Committee's last meeting no additional risks had been identified.

RESOLVED:

That the report be noted.

14. 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 items of business on the grounds that they involved the likely disclosure of exempt information as defined in paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Act.

15. Colliers Capital - Property Performance and Investment Strategy Report

The Committee considered an exempt report by Colliers Capital, a copy of which marked '16' 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 the report be noted.

16. Aspect Capital Quarterly report.

The Committee considered an exempt report by Aspect Capital, a copy of which marked '17' 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 the report be noted.

17. Kleinwort Benson Investors Quarterly Report.

The Committee considered an exempt report by Kleinwort Benson Investors, a copy of which marked '18' 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 the report be noted.

18. Ruffer Quarterly Report.

The Committee considered an exempt report by Ruffer, a copy of which marked '19' 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 the report be noted.

19. Pictet Quarterly Report.

The Committee considered an exempt report by Pictet, a copy of which marked '20' 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 the report be noted.

20. Millennium Global Quarterly Report.

The Committee considered an exempt report by Millennium Global, a copy of which marked '21' 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 the report be noted.

21. IFM Investors Quarterly Report.

The Committee considered an exempt report by IFM Investors, a copy of which marked '22' 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 the report be noted.

22. Delaware Investments Quarterly Report.

The Committee considered an exempt report by Delaware Investments, a copy of which marked '23' 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 the report be noted.

23. JP Morgan Quarterly Report.

The Committee considered an exempt report by JP Morgan, a copy of which marked '24' 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 the report be noted.

24. Legal and General Investment Manager Quarterly Report.

The Committee considered an exempt report by Legal and General, a copy of which marked '25' 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 the report be noted.

25. Ashmore Quarterly Report.

The Committee considered an exempt report by Ashmore, a copy of which marked '26' 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 the report be noted.

26. Stafford Timberland Quarterly Report.

The Committee considered an exempt report by Stafford Timberland, a copy of which marked '27' 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 the report be noted.

27. Kempen Capital Management Quarterly Report.

The Committee considered an exempt report by Kempen Capital Management, a copy of which marked '28' 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 the report be noted.

28. Aviva Investors Quarterly Report.

The Committee considered an exempt report by Aviva Investors, a copy of which marked '29' 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 the report be noted.

09.30- 10.55am CHAIRMAN
02 June 2017

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Agenda Item 6

Leicestershire County Council

LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

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

Purpose of Report

1. The purpose of this report is to present to the Committee a summary valuation of the Fund's investments at 30th June 2017 (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 30th June 2017 was £3,907.4m compared to £3,872.9m at 31st March 2017, an increase of £34.5m. In the three month period non-investment related net cash inflows amounting to £3.1m were received. After adjusting for non-investment related cash flows the Fund value increased by £31.4m, or 0.8%, due to changes in the value of investments.

3. The total returns of various indices since 31st March 2017 were as follows:-

	Local Currency %	Converted to Sterling %	Return with 70% hedge %
UK Gilts	-1.3	-1.3	-1.3
UK Index-Linked	-2.3	-2.3	-2.3
UK Equities	+1.4	+1.4	+1.4
North American Equities	+2.8	-0.9	+1.7
European Equities	+2.9	+5.2	+3.6
Japanese Equities	+1.7	+6.4	+3.1
Pacific (Ex Japan) Equities	+0.3	+4.6	+1.6

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

	30th June 2017		31st March 2017
	£m	%	%
UK Equities	312.3	8.0	8.0
Overseas Equities	1,556.6	39.8	40.0
Targeted Return/Credit/Opportunity Pool	853.0	21.8	20.4
Private Equity	143.4	3.7	3.7
Property	321.7	8.2	8.3
Cash	181.5	4.7	5.4
Inflation-Linked Assets	535.2	13.7	13.9
Active and Passive Currency	3.7	0.1	0.3
	3,907.4	**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)	+0.5	+0.5	-
Aviva Investors (property)	+2.3	+2.3	-
Aspect Capital (managed futures)	-3.1	+1.1	-4.2
Delaware (emerging market equities)	+2.9	+2.3	+0.6
Kleinwort Benson (equity dividend)	-1.0	+0.4	-1.4
Kempen (equity dividend)	+0.3	+0.4	-0.1
Ruffer (targeted return)	-0.8	+1.1	-1.9
Pictet (targeted return)	-0.4	+1.1	-1.5
Ashmore (emerging market debt)	+2.5	+2.5	-
Millennium (currency)	+0.3	+0.4	-0.1

One year

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+22.8	+22.8	-
Aviva Investors (property)	+5.5	+6.0	-0.5
Aspect Capital (managed futures)	-11.3	+4.4	-15.7
Delaware (Emerging market equities)	+17.2	+12.7	+4.5
Kleinwort Benson (equity dividend)	+20.7	+22.2	-1.5
Kempen (equity dividend)	+24.8	+22.2	+2.6
Ruffer (targeted return)	+7.3	+4.4	+2.9
Pictet (targeted return)	+8.1	+4.4	+3.7
Ashmore (emerging market debt)	+12.4	+5.9	+6.5
Millennium (currency)	-0.1	+1.5	-1.6

Three years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+13.1	+13.1	-
Aviva Investors (property)	+10.4	+9.5	+0.9
Aspect Capital (managed futures)	+7.9	+4.4	+3.5
Delaware (Emerging market equities)	+12.7	+10.8	+1.9
Ruffer (targeted return)	+7.1	+4.4	+2.7
Kleinwort Benson (equity dividend)	+13.4	+14.9	-1.5
Kempen (equity dividend)	+13.6	+14.9	-1.3
Millennium (currency)	+1.6	+1.5	+0.1

Five years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+14.8	+14.8	-
Aviva Investors (property)	+9.9	+9.0	+0.9
Delaware (Emerging market equities)	+12.6	+8.0	+4.6
Ruffer (targeted return)	+7.5	+4.4	+3.1
Millennium (currency)	+1.1	+1.5	-0.4

Equality and Human Rights Implications

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

Recommendation

7. It is recommended that the Committee notes the report.

Officer to Contact

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

APPENDIX

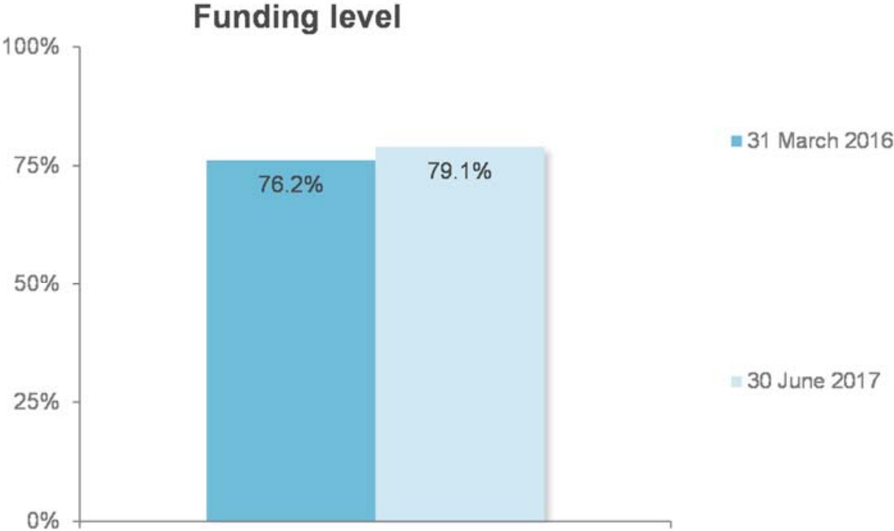
PENSION FUND INVESTMENTS AS AT 30TH JUNE 2017

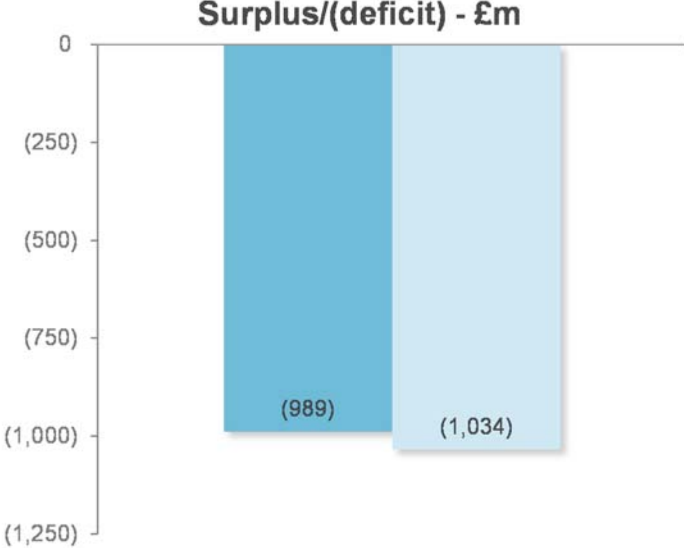
	Market Value £	Value %	Benchmark %	Variance %
Equities				
United Kingdom	312,318,207	7.99	7.50	0.49
Overseas:				
Global dividend-focused	320,134,292	8.19	8.00	0.19
North America	521,652,720	13.35	13.20	0.15
Europe (Ex UK)	245,218,128	6.28	5.70	0.58
Japan	112,936,916	2.89	2.80	0.09
Pacific (Ex Japan)	113,974,533	2.92	2.80	0.12
Emerging Markets	242,664,340	6.21	6.00	0.21
Total	1,556,580,929	39.84	38.50	1.34
Private Equity	143,435,226	3.67	4.00	-0.33
Property				
Direct Holdings*	96,224,000	2.46	3.30	-0.84
Indirect Holdings	225,460,467	5.77	6.70	-0.93
Total	321,684,467	8.23	10.00	-1.77
Alternative Investments				
Fauchier	533,158	0.01	0.00	0.01
Pictet	95,871,907	2.45	3.00	-0.55
Ruffer	241,689,539	6.19	6.50	-0.31
Credit Opportunities	209,011,088	5.35	7.50	-2.15
Aspect	121,280,577	3.10	3.50	-0.40
Emerging Market Debt	105,620,208	2.70	2.50	0.20
Opportunity pool	79,048,902	2.02	2.50	-0.48
	853,055,379	21.83	25.50	-3.67
Commodities	0	0.00	0.00	0.00
Inflation-Linked Assets				
Global Government Index-Linked Bonds	273,411,689	7.00	7.50	-0.50
Infrastructure	179,324,241	4.59	5.00	-0.41
Timberland	82,424,614	2.11	2.00	0.11
	535,160,544	13.70	14.50	-0.80
Cash on Deposit	181,511,245	4.65	0.00	4.65
Unrealised Profit On Currency				
Active	2,225,242	0.06	0.00	0.06
Passive	1,461,176	0.04	0.00	0.04
Total	3,686,418	0.09	0.00	0.09
TOTAL	**3,907,432,415**	**100.00**	**100.00**	**0.00**

Direct Property Holdings*		
Retail	13,495,000	14.02
Retail Warehouses	19,310,000	20.07
Offices	24,615,000	25.58
Industrials	17,585,000	18.28
Leisure (Hotels/Health Club)	18,425,000	19.15
Farms	2,794,000	2.90
	96,224,000	100.00

Leicestershire County Council Pension Fund

Funding update as at 30 June 2017





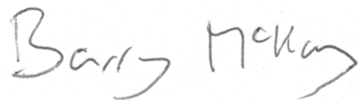
Summary

This funding update is provided to illustrate the estimated development of the funding position from 31 March 2016 to 30 June 2017, 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 30 June 2017 the funding level has increased to 79.1%. This represents a deficit of £989m at 31 March 2016 increasing to a deficit of £1,034m at 30 June 2017. A breakdown of this can be found in the graph on page 5 of this report.

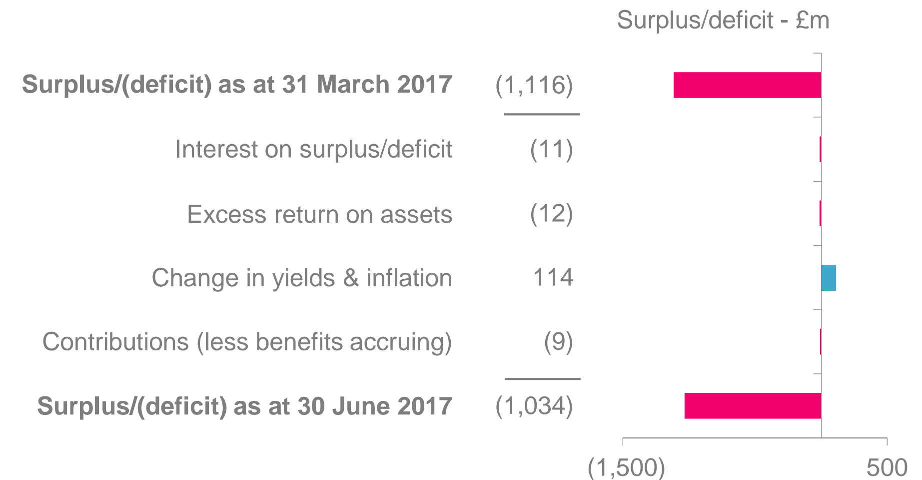
This report has been produced exclusively for the Administering Authority. This report must not be copied to any third party without our prior written consent.

Should you have any queries please contact me.



Barry McKay FFA
Fund Actuary

What's happened since the last update – Ongoing funding basis



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 30 June 2017

Ongoing funding basis

£m	31 Mar 2016	31 Mar 2017	30 Jun 2017
Assets	3,164	3,873	3,905
Liabilities	4,153	4,989	4,939
Surplus/(deficit)	**(989)**	**(1,116)**	**(1,034)**
Funding level	76.2%	77.6%	79.1%

Investment return

Quarter Ending	%
30/06/2016	6.5%
30/09/2016	6.2%
31/12/2016	4.5%
31/03/2017	3.3%
30/06/2017	0.7%

Market indicators

	31 Mar 2016	31 Mar 2017	30 Jun 2017
Market yields (p.a.)			
Fixed interest gilts	2.18%	1.66%	1.81%
Index linked gilts	-0.96%	-1.67%	-1.54%
Implied inflation (RPI)	3.20%	3.40%	3.40%
Implied inflation (CPI)	2.10%	2.40%	2.40%
AA corporate bonds	3.36%	2.51%	2.57%
AOA	1.80%	1.80%	1.80%
Price indices			
FTSE All Share	3,395	3,990	4,002
FTSE 100	6,175	7,323	7,313

Basis summary

	31 Mar 2016	31 Mar 2017	30 Jun 2017
Pre retirement discount rate			
Nominal	4.0%	3.5%	3.6%
Real	0.8%	0.1%	0.2%
Post retirement discount rate			
Nominal	4.0%	3.5%	3.6%
Real	0.8%	0.1%	0.2%
Salary increase rate	3.2%	3.4%	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.

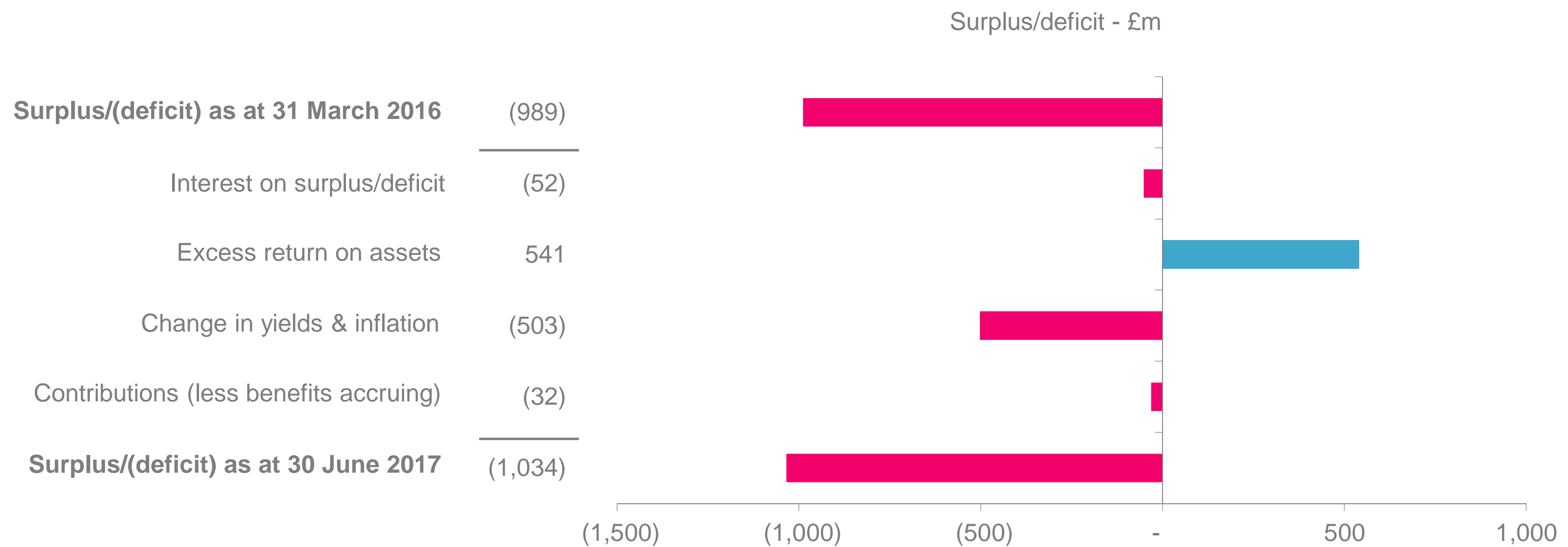
Change in funding level since last valuation

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

Assets		£m
Asset value as at 31 March 2016	**3,164**	
Contributions paid in:		**211**
Benefit payments:		**(170)**
Expected return on assets:		**160**
Excess return on assets:		**541**
Asset value as at 30 June 2017	**3,905**	

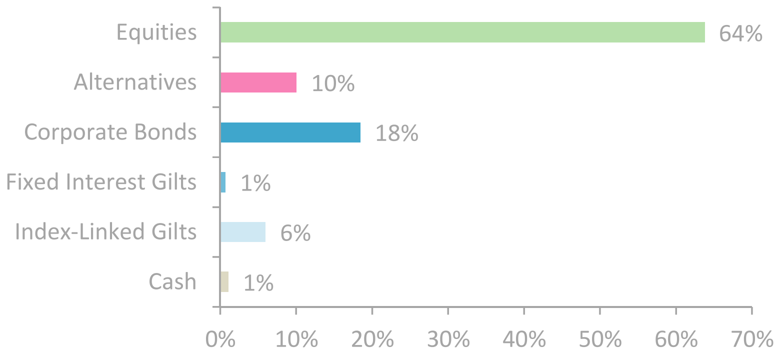
Liabilities		£m
Liability value as at 31 March 2016	**4,153**	
Cost of benefits accruing:		**242**
Interest on liabilities:		**212**
Change in yields & inflation:		**503**
Benefit payments:		**(170)**
Liability value as at 30 June 2017	**4,939**	

Overall effect

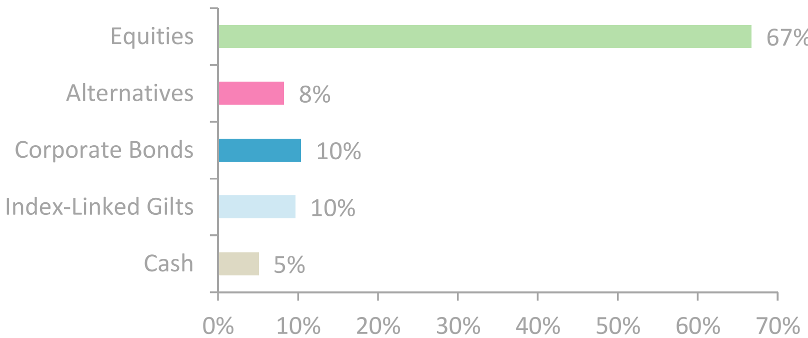


What caused your assets to change?

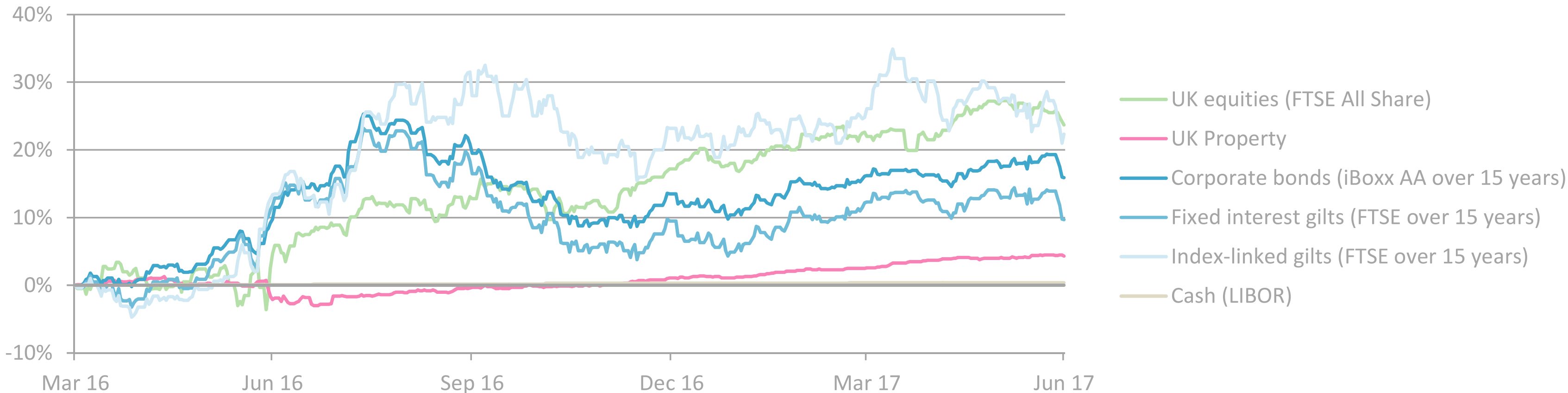
Allocation at valuation date



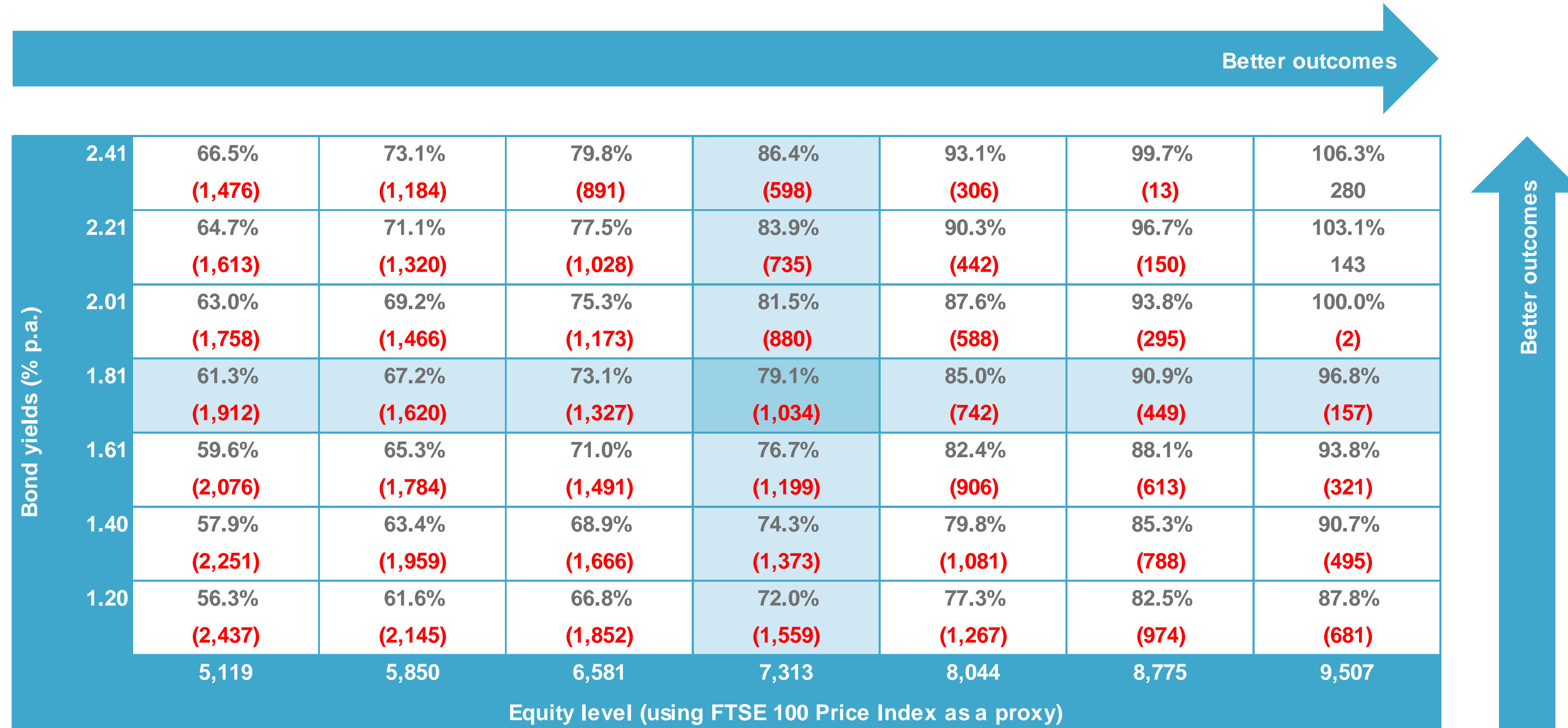
Allocation at 30 June 2017



Sterling total returns of major asset classes



Sensitivity matrix – Ongoing funding basis



Bond yields (% p.a.)	5,119	5,850	6,581	7,313	8,044	8,775	9,507
2.41	66.5% (1,476)	73.1% (1,184)	79.8% (891)	86.4% (598)	93.1% (306)	99.7% (13)	106.3% 280
2.21	64.7% (1,613)	71.1% (1,320)	77.5% (1,028)	83.9% (735)	90.3% (442)	96.7% (150)	103.1% 143
2.01	63.0% (1,758)	69.2% (1,466)	75.3% (1,173)	81.5% (880)	87.6% (588)	93.8% (295)	100.0% (2)
1.81	61.3% (1,912)	67.2% (1,620)	73.1% (1,327)	79.1% (1,034)	85.0% (742)	90.9% (449)	96.8% (157)
1.61	59.6% (2,076)	65.3% (1,784)	71.0% (1,491)	76.7% (1,199)	82.4% (906)	88.1% (613)	93.8% (321)
1.40	57.9% (2,251)	63.4% (1,959)	68.9% (1,666)	74.3% (1,373)	79.8% (1,081)	85.3% (788)	90.7% (495)
1.20	56.3% (2,437)	61.6% (2,145)	66.8% (1,852)	72.0% (1,559)	77.3% (1,267)	82.5% (974)	87.8% (681)

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

Key	
79.1%	Funding level
(1,034)	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 30 June 2017. 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:

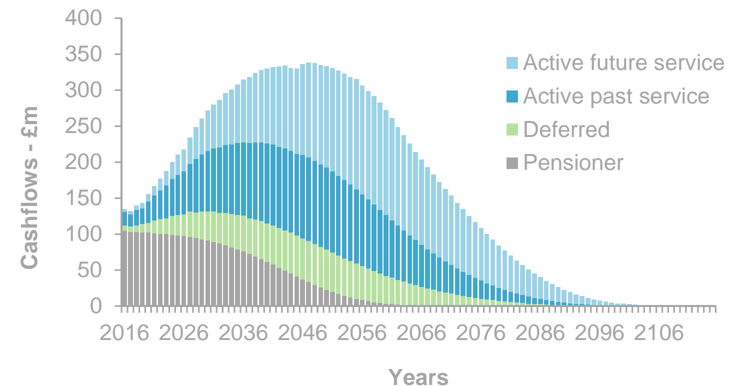
- Valuation Assumptions Briefing Note
- Funding Strategy Statement
- Valuation Report
- Rates and Adjustments Certificate

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

TAS 100: Principles for technical actuarial work

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.

LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RESPONSIBLE INVESTMENT

Purpose of the Report

1. The purpose of this report is to provide the Committee with information in respect of the wide-ranging issue of Responsible Investment, to recommend approval of the LGPS Central's Responsible Investment Policy and that the Leicestershire Pension Fund become a member of the Local Authority Pension Fund Forum. Approval is also sought to enable the Director of Finance to determine whether or not the Leicestershire Pension Fund should become a signatory to Responsible Investment principles and initiatives.

2. The report also provides information to members concerning the referral of several LGPS Funds (including Leicestershire) to the Pensions Regulator regarding their investments and the potential risks they face as a result of climate change.

Background

3. The LGPS is a statutory pension scheme and, as such, does not have trustees. Leicestershire County Council is the Administering Authority for the Leicestershire Fund, and its responsibilities are discharged via the Local Pension Committee, the Investment Subcommittee and the Local Pension Board. These bodies, and the individuals that sit on them, are often referred to as quasi-trustees because they fulfil much the same role as that of a trustee; members of these bodies, however, do not have the personal liability for decisions taken in the same way that a trustee would normally have.

4. It is universally accepted that the Administering Authority has a responsibility to act as a trustee and a legal requirement to seek to obtain the highest possible investment return within acceptable levels of risk. The LGPS is a defined benefit pension scheme where the benefits are guaranteed (and based on a mixture of pensionable pay and service accrued), and investment returns have no impact on benefit levels of individual members. Employing bodies effectively bear the investment risks within the LGPS, and the level of investment returns will have a direct impact on their contribution rates.

5. The Local Pension Committee is able to exclude investment in certain types of assets if it wishes, as long as it is satisfied that this does not compromise the potential investment return or produce unduly high levels of risk. Exclusion

of investments must be based solely on a financial judgement, rather than being based on a moral perspective.

What is Responsible Investment

6. There are many definitions of Responsible Investment (RI), but the most commonly used one is that produced by the United Nations Principles for Responsible Investment (UNPRI):

"Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns."

7. Some of the factors included in ESG, are as follows:

Environmental	Social	Governance
Climate change	Working conditions, including slavery and child labour	Executive pay
Greenhouse gas emissions	Local communities, including indigenous communities	Bribery and corruption
Resource depletion, including water	Conflict	Political lobbying and donations
Waste and pollution	Health and safety	Board diversity and structure
Deforestation	Employee relations and diversity	Tax strategy

8. The UNPRI is very clear that RI is not the same as Socially Responsible Investment. The major difference is that RI is not overlaid with any moral or ethical aspect, and is pursued simply because to ignore ESG factors is to ignore risks and opportunities that have a material effect on investment returns. RI is a holistic approach that aims to include any information that could be material to investment performance.

Current Fund Approach to Responsible Investment

9. The Fund has, for many years, satisfied itself that potential investment managers take account of RI as part of their decision-making processes before they are considered for appointment. The majority of investment managers have, in recent years, invested heavily in enhancing the resources available in the area of RI and have formally integrated RI issues into their investment decisions. Whilst the Fund has not become directly involved in RI issues, the investment managers have been active on its behalf.

LGPS Central Responsible Investment Policy

10. LGPS Central, the investment management company that has been set up to manage the assets of nine LGPS Funds (including the Leicestershire Fund) from 1st April 2018, must have a Responsible Investment Policy that is common to all nine Funds if it is going to deal with the issue of RI in an efficient and consistent manner. There are no meaningful differences between the Funds in terms of how they currently deal with RI so a Policy has been easy to develop, and the draft version is attached as an appendix to this report.

11. The RI Policy will ultimately be agreed by all the LGPS Central Shareholders and it is possible that there will be small changes to the draft Policy attached. However, in the event that there are any meaningful changes to the Policy a further report will be brought back to this Committee as appropriate.

12. The Responsible Investment Policy is not overly detailed and includes sufficient flexibility to deal with issues on a case-by-case basis. The major points of it are:

    - RI is considered to be relevant to all asset classes;
    - Whether the assets are managed internally or externally, there is a requirement that RI will be integrated in to the investment decision-making process. External investment managers that cannot fulfil this will not be utilised;
    - Engagement rather than exclusion is preferred. Retaining a position of influence as a shareholder is a better option than simply selling if there are issues at a company;
    - The policy will evolve in line with latest market developments in the area of RI;
    - Harnessing the influence of multiple investors is likely to bring better results and more speedy changes.

13. LGPS Central will employ its own RI resources and this will assist in ensuring that RI is fully integrated into the investment process, whether the assets are managed by LGPS Central itself or by investment managers that it has appointed.

14. In future it is expected that the reports produced for this Committee by LGPS Central will have a strong emphasis on RI issues and what actions are being taken to preserve and enhance shareholder value, or to mitigate some of the risks involved.

Membership of relevant trade bodies

15. Unlike the Leicestershire fund, the other eight Funds within LGPS Central are members of the Local Authority Pension Fund Forum (LAPFF). This is a collaborative shareholder engagement group with over 70 LGPS Fund members and over £200bn in combined assets. The LAPFF is likely to be heavily utilised in any shareholder engagement conducted by LGPS Central,

and it is not reasonable for the Leicestershire Fund to receive the benefit of any such work unless it becomes a member. Whilst there are currently discussions about the future membership fee policy of the LAPFF, the expected cost if the Leicestershire Fund was to join the Forum would be around £9,000 p.a.

16. There are some concerns about the way in which the LAPFF is currently structured and constituted, and in particular the potential for the organisation and its future direction to be overly influenced by certain individuals or Funds. It is expected that these concerns will ultimately be dealt with and, whilst it is recommended that the Leicestershire Fund join the Forum, it is considered sensible to defer such membership until the Director of Finance is satisfied that these concerns have been addressed.

Becoming a signatory to key initiatives and principles

17. The Leicestershire Fund has not historically become a direct signatory to certain key initiatives relating to RI, and has been comfortable that, as its investment managers have always been signatories, the Fund was adhering to the broad principles by default. However, under the new pooling arrangements that will come into place in 2018, it is now considered appropriate for the Leicestershire Fund to become a direct signatory similar to the other Funds within LGPS Central, particularly given the focus and resources within RI that LGPS Central will have. The most obvious example is the United Nations Principles for Responsible Investment (UNPRI), but there may be others where a direct signature is relevant.

18. There is no immediate requirement to become signatories, given that the Fund has operated effectively for many years without having done so. However, it is considered expedient for the Director of Finance to be authorised to sign up to those initiatives in the future that LGPS Central believe are appropriate and where the agreed RI Policy is clearly supportive of the initiative. Where there is any doubt about the compatibility of the RI Policy and a particular initiative, the Fund will not become a signatory without the prior approval of this Committee. This Committee will be notified of any relevant initiatives that the Fund signs up to.

Pressure from Pension Fund Members

19. Members of this Committee may be contacted on occasions by individual LGPS members with questions about the Fund’s exposure to certain companies or industries, and these will often be accompanied with a suggestion that the Fund should divest from certain areas as the risks have not been appropriately assessed. In February 2017 a referral was made by ClientEarth and ShareAction to the Pensions Regulator entitled “The Local Government Pension Scheme and Climate Risk”.

20. The basis of the referral was that the LGPS (or, more specifically, certain LGPS Funds) were operating under some misconceptions, were failing to comply with their legal duties and/or putting scheme members' savings at risk.

The Leicestershire Fund was quite heavily quoted in the report that accompanied the referral. A copy of the report can be found at: https://shareaction.org/wp-content/uploads/2017/04/TPRReferral.pdf

21. One reason that the Leicestershire Fund was quoted throughout the report is because it provided a number of detailed responses to the questions asked, unlike many Funds that either did not reply or provided minimal levels of detail. Whilst all of the quotes are accurate, they are often a small part of a much longer response that loses its true meaning when taken out of context. Officers are comfortable that the fuller responses are a fair reflection of the Fund’s activities and that there are no misconceptions, failures to comply with legal duties or any risk to members’ savings at the Leicestershire Fund.

22. The issue that was included in the referral to the Pensions Regulator was climate change, and in particular a supposition that the LGPS is failing to take into account the risks that exist by holding shares in oil companies. More specifically, the argument is that in order to comply with agreed temperature increases it will be impossible for the reserves of oil companies to be used and they have balance sheets with billions of pounds attributed to assets that will ultimately prove worthless (or worse). These assets are generally referred to as ‘stranded’.

23. It is, of course, entirely possible that the stranded assets issue may ultimately prove to be correct. But the issue is one that is fully in the minds of investors, and one that individual investment managers are capable of forming a judgement on. Market prices are the level at which buyers and sellers come together; if an investment manager does not believe the risks are fully factored into prices (and, hence, prices are too high) they are free to avoid the investment.

24. There is little doubt that climate change is one of the issues that investors face, but there are also many others. The Fund is entirely comfortable that its active investment managers have investment processes that include integrated assessment of the RI issues including climate change; furthermore it would be very surprising if they all came to the same conclusion about how much of a risk climate change is to the future prospects of oil companies.

Recommendations

25. It is recommended that the Local Pension Committee:

a) Approves the Responsible Investment Policy of the LGPS Central, attached as an appendix to this report;

b) Agrees that the Leicestershire Pension Fund becomes a member of the Local Authority Pension Fund Forum (LAPFF), subject to the Director of Finance being comfortable with its organisational structure and constitution;

c) That the Director of Finance be authorised to agree for the Leicestershire Pension Fund to become a direct signatory of those Responsible Investment

principles or initiatives aligned to the Responsible Investment Policy of the LGPS Central, including the United Nations Principles for Responsible Investment, noting that where there is any doubt about compatibility the Fund will not become a signatory without the approval of the Local Pension Committee.

Appendix

LGPS Central Responsible Investment

Equal Opportunities Implications

None specific

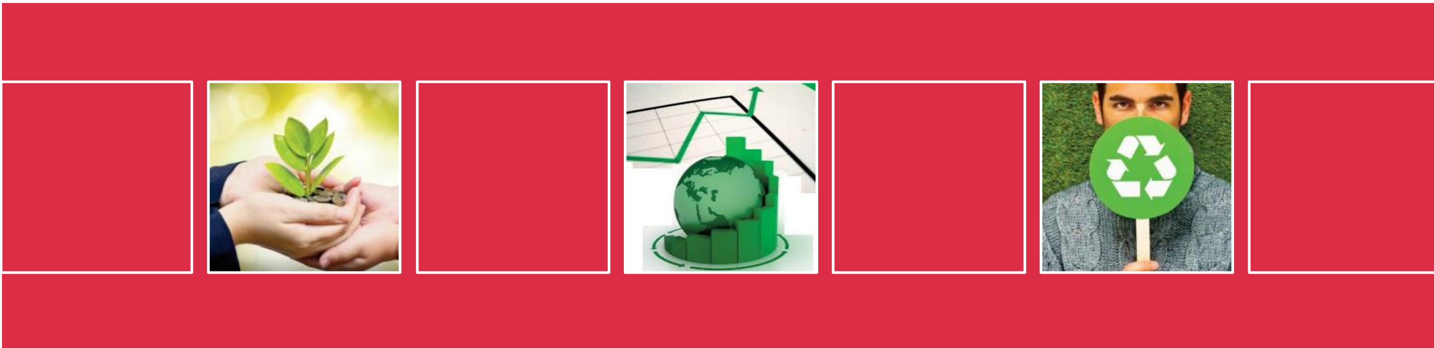
Background Papers

None

Officers to Contact

Colin Pratt, Investments Manager, Corporate Resources
– telephone (0116) 305 7656
Chris Tambini – Director of Finance, Corporate Resources,
telephone (0116) 305 6199

APPENDIX



RESPONSIBLE INVESTMENT FRAMEWORK

RESPONSIBLE INVESTMENT FRAMEWORK 2016

1) INTRODUCTION

This framework defines the commitment of LGPS Central Investment Pool ('the Pool') to responsible investment (RI). Its purpose is to detail the approach that the Pool aims to follow in integrating environmental, social and governance (ESG) issues in its investments. This framework has been adopted by the Section 101 Committees of the Pool's participating funds.

1.1 Beliefs and Guiding Principles

The Pool's RI beliefs and guiding principles underpin its RI approach and are described below.

ESG Integration
The Pool believes that effective management of financially material ESG risks should support the Pool's requirement to protect returns over the long term. With regard to climate change risks, the Pool recognises that the scale of the potential impacts is such that a proactive and precautionary approach is needed in order to address them.

The Pool considers RI to be relevant to investment performance across asset classes.

The Pool recognises the need to operate at a market-wide level to promote improvements that will help it to deliver sustainable long-term growth.
It is supportive of the UK Stewardship Code and will, on commencing operation, be a Tier 1 signatory to the Code.

Engagement Versus Exclusion
Investee companies with robust governance structures should be better positioned to handle the effects of shocks and stresses of future events. There is risk but also opportunity in holding companies that have weak governance of financially material ESG issues. Thus, the Pool has a policy of risk monitoring and engagement in order to positively influence company behaviour and enhance shareholder value, influence that would be lost through a divestment approach. The Pool extends this principle of 'engagement for positive change' to the due diligence, appointment and monitoring of external fund managers who are at an early stage of developing its RI approach.

The Pool believes that it will improve its effectiveness by acting collectively with other like-minded investors because it increases the likelihood that it will be heard by the company, fund manager or other relevant stakeholder compared with acting alone.

Fees and Incentives
Managing fees and costs matter in low-return environments. Fee arrangements with external fund managers – as well as the remuneration policies of investee companies – should be aligned with the participating funds' long-term interests. The Pool recognises that it is part of its fiduciary duty to ensure that there is appropriate alignment.

An Evolving and Flexible Approach
The Pool recognises that it, along with the entire investment chain, is on a journey with respect to RI. This framework will remain flexible and will evolve over time to reflect evolving market developments.

1.2 Oversight and Application

Section 101 Committees of participating funds will review this policy at a minimum annually, or whenever they or the Pool proposes revised RI policies and procedure. The Head of RI is responsible for policy implementation.

1.3 Content

The RI framework is divided into two distinct sections:

- What the Pool expects of itself, companies and fund managers with respect to RI (Section 2).
- How the RI beliefs and guiding principles are implemented in practice (Section 3).

Definitions are also provided in Section 4.

2) RI EXPECTATIONS

2.1 Pool

2.1.1 General
The Pool aims to:

1) Be aware of and monitor financially material ESG issues in the context of investment and manager selection. Depending on the asset class and nature of the proposed mandate or vehicle, the Pool will monitor:
   - ESG issues in relation to internally managed investments;
   - the extent to which the external managers incorporate ESG issues into their investment processes; and
   - hold external managers to account for improvement in their ESG performance over a reasonable timeframe.

2) Make full use of its ownership rights, including voting and engagement activities. Either directly, collaboratively or through specialist service providers:

- hold constructive dialogue with listed companies;
- encourage the disclosure by companies of ESG issues; and
- participate in the development of public policy on ESG issues.

3) Disclose and maintain a policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of participating funds' beneficiaries first.

4) Keep our stakeholders aware of our RI activities through:

- making its RI policy documents public, eg, voting policies, RI policy;
- providing a summary of the Pool's RI activities for publication in participating funds' annual reports;
- publishing aggregate voting and company engagement statistics on a quarterly basis

2.1.2 *Climate Change*

The Pool aims to:

- encourage improvement in the level of disclosure by companies of material climate change impacts through collaborative initiatives;
- support – and where applicable co-file – reasonable shareholder proposals to disclose/ justify a company's approach to climate change risk;
- review its fund managers to understand their approach to incorporating climate change considerations and encourage improvements in identifying and assessing the potential impact of climate change;
- contribute to public policy with regard to climate change as it relates to investment considerations;
- increase awareness of climate change as it applies to investment decision making through participation in relevant industry forums and collaborative initiatives; and
- keep up to date on the latest research and thinking on the financial materiality and interconnectedness of climate change within and across asset classes.

2.2 Companies

The Pool expects UK companies to adhere to the UK Corporate Governance Code[1] on a comply or explain basis. Further, the Pool has bespoke UK corporate governance guidelines which aim to deal with issues that are either not covered by the Code, require greater emphasis or are specifically left open for shareholders to resolve with company boards.

The Pool expects companies outside the UK to adhere to international voting principles, recognising local application and development.

Environmental and Social Risks

The Pool expects companies to manage and disclose its environmental and social risks to the extent required for an understanding of the development, position and performance of the company.
In alignment with the Association of British Insurers' position, there are aspects of environmental and social reporting on which the Pool places particular value given their relevance across all sectors, its holistic approach to risk management, and the view that owners should not micro-manage companies. This is narrative reporting which:

- sets ESG risks in the context of the whole range of risks and opportunities facing the company;
- contains a forward looking perspective; and
- describes the actions of the board in mitigating these risks.

In terms of the specific environmental and social issues to focus upon, the Pool takes a case-by-case sector-based approach.

2.3 Fund Managers

2.3.1 *Due Diligence*

The Pool collects the following information from each manager before they are appointed where applicable to the asset class:

- Copy of their ESG, active ownership policies or equivalent which articulates how ESG factors (stemming from research, active ownership activities or other sources) are integrated into their investment process
- Case studies or examples of where ESG issues have influenced an investment decision
- Information on the process for integrating any third party ESG data (for example, MSCI) into their company financial models, investment strategies and portfolio construction
- RI reporting format

[1] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

- Whether they are a signatory of the UN-backed Principles for Responsible Investment (PRI) and Stewardship Code, copy of their PRI public report and annual assessment scores if applicable.

2.3.2 *Appointment*
The Pool assesses the ESG capability of a fund manager as a factor within each of the people, process and performance categories. In its decision to appoint a fund manager, the Pool takes a balanced consideration of all relevant factors including ESG. However, the Pool will pay particular attention to adherence to relevant soft regulatory codes[2], notably the UK Stewardship Code, depending on the market in which it invests.

In practice, this means the Pool is willing to hire a fund manager at an early stage of developing its RI approach so long as there is a demonstrable RI commitment and a willingness to improve in their approach over time. In alignment with our guiding principles on 'engagement versus exclusion', the Pool believes that there is added value in working with them to improve their approach.

2.3.3 *Monitoring and Reporting*
Each external fund manager is expected to report[3] at agreed intervals to the Pool on how their RI activities are contributing to improved long-term risk-adjusted returns. Examples of information that can be provided in aid of this objective include but are not limited to the following:

- The evolution of how the manager integrates the consideration of ESG issues into its investment and active ownership activities.
- How investment and active ownership functions are combined to protect and/or enhance shareholder value
- How the manager exercised the Pool's voting rights.
- Any outcomes arising from the manager's engagement with companies and their effectiveness.

3) RI IMPLEMENTATION

The Pool's active ownership approach can be divided into three distinct areas: **voting globally, engagement through partnerships** and **shareholder litigation**. This section briefly outlines the Pool's processes for each.

3.1 Voting Globally
Where practical[4], the Pool aims to vote in every single market in which it invests. In the interests of sending a consistent signal to investee companies, the Pool has decided to use a third party provider for analysis of governance issues and executing its proxy voting rights across all markets in which it invests. At the present time, the Pool believes that the advantage of a consistent signal outweighs the inherent disadvantages to disconnecting the voting function from the investment and engagement decisions of external fund managers. However, given market developments in this area, the Pool will re-evaluate this position on a yearly basis.

Reference to the Pool's voting policies is provided in Section 2.2 under 'Company Expectations'.

Securities Lending Programme
The Pool has an active securities lending programme. To ensure that the Pool is able to vote all its shares at important meetings, the Pool has worked with service providers to establish procedures to restrict lending for certain stocks and recall shares in advance of shareholder votes. The Pool monitors the meetings and proportion of the securities on loan, and will restrict and/or recall lent stock in select circumstances.

3.2 Engagement Through Partnerships
The Pool uses various engagement platforms to maximise its influence as an active owner in collaboration with other like-minded investors. The Pool's primary engagement partnerships are highlighted below.

Local Authority Pension Fund Forum
The Pool is a member of the Local Authority Pension Fund Forum (LAPFF). LAPFF is the UK's leading collaborative shareholder engagement group encompassing local authority pension funds from across the country with combined assets of over £160 billion. The Pool is an active participant in LAPFF's engagement programs. Membership of LAPFF provides the Pool with:

- independent research and advice on the ESG risks of companies to inform further stakeholder engagement;
- advice on the governance practices of companies;

[2] For example, UK and Japanese Stewardship Codes
[3] Refers to either formal written reporting and to informal verbal communications, which can be regular and/or ad-hoc in frequency.
[4] Issues such as power of attorney or share blocking in certain markets may prevent the Pool's ability to do so

- a forum to engage with companies to improve governance practices; and
- proxy voting advice on proxy voting for annual general meetings.

Industry Engagement
In collaboration with other like-minded investors, notably other LGPS investment pools, the Pool may engage with public policy makers, regulators, trade bodies, indexes and other players in the financial markets to achieve the aim of promoting sustainable growth. The Pool considers these initiatives on a case-by-case basis.

3.3 **Shareholder Litigation**
The Pool frequently hold securities that are the subject of individual and class action securities litigation. There are a number of litigation options available when a company has violated securities laws that result in losses to participating funds.

For US-based claims, the options would be to:

- remain in the class action and file proof of claim;
- participate as a lead plaintiff in a class action; or
- opt out and file a private action.

For non-US based claims, the options would be to join an existing group action or file a group action as a lead plaintiff.

The Pool takes a case-by-case approach in determining whether or not to join a class action but considers factors such as:

- advantages and disadvantages of the Pool becoming actively involved;
- relative size of the Pool's potential losses compared to other organisations;
- likelihood of success; and
- whether the Pool is fully indemnified against costs, expenses, counterclaims and any other losses.

3.4 Where external service providers are used for voting, engagement and shareholder litigation, the Head of RI will be responsible for ensuring that the quality of service provision is kept under regular review, reporting concerns internally and following up with the supplier. This includes verifying that engagement and voting are undertaken in line with LGPS Central's agreed RI Framework.

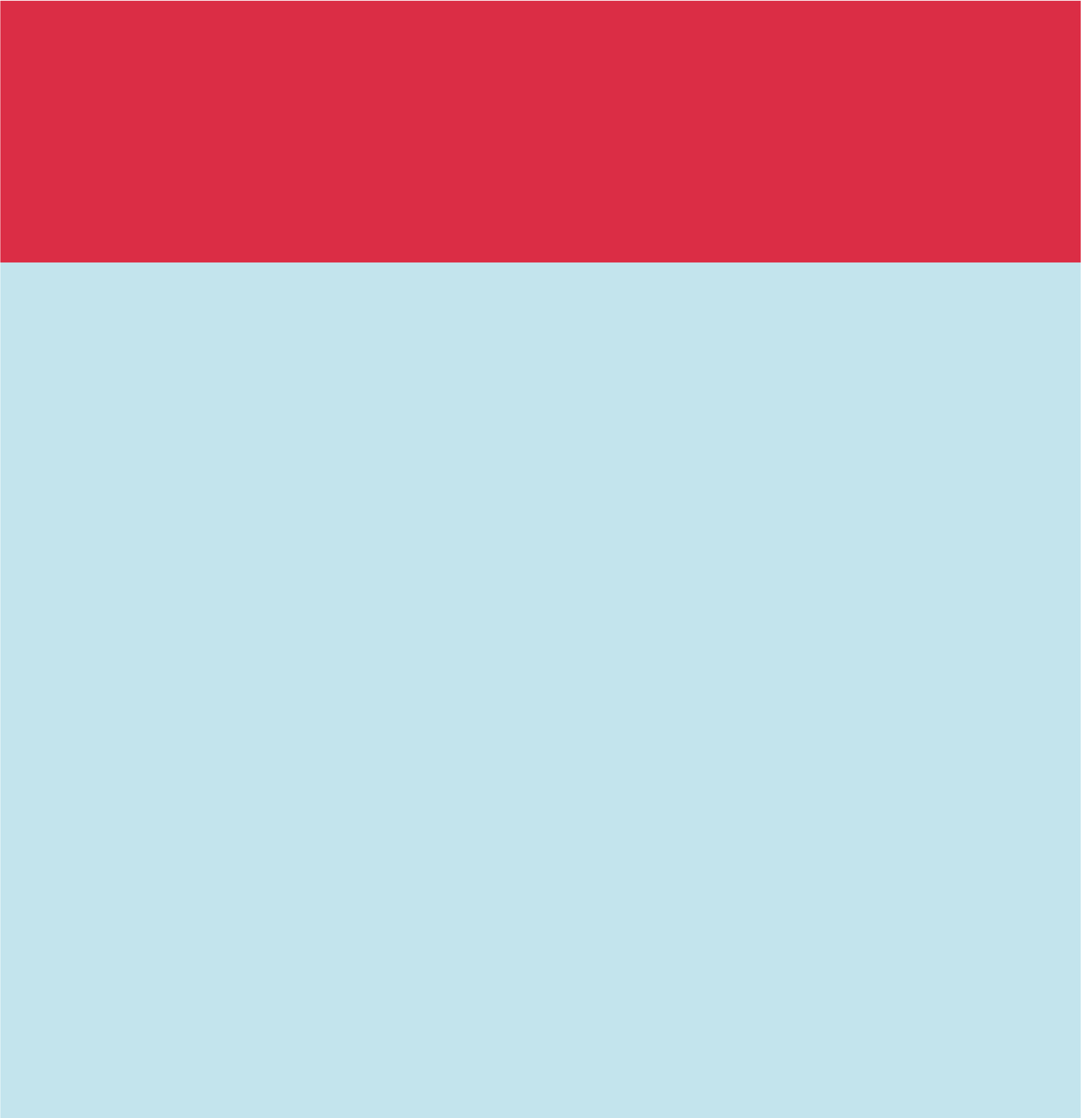
4) DEFINITIONS

Responsible Investment
The integration of environmental, social and corporate governance (ESG) considerations into investment management processes and active ownership practices in the belief that these factors can have an impact on financial performance. The Pool also supports the PRI's definition of responsible investment which can be found here:
http://www.unpri.org/introducing-responsible-investment

ESG
Environmental, social and governance factors which may impact on company performance and therefore investment returns. Examples include resource management and pollution prevention, climate change impacts, labour management, product integrity, executive compensation, board independence and audit function.

Governance
The process and principles by which a company or organisation undertakes its business. For the Pool, governance includes how it undertakes both its operational and investment responsibilities on behalf of its members.

Active Ownership
Refers to the responsibility of the Pool to participate, where appropriate, in the governance decision-making of companies in which it invests by way of voting and by engagement with company management, either directly or via its fund managers. It also recognizes the relevance of engaging with regulatory bodies and other market players to support policies that promote long-term sustainable growth.



Agenda Item 9

LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ACTION AGREED BY INVESTMENT SUBCOMMITTEE (ISC)

Purpose of the Report

1. The purpose of this report is to provide the Committee with details of an investment agreed by the Investment Subcommittee (ISC) at its meeting held on 14th June 2017.

Background

2. The Fund's investment consultant, Hymans Robertson, identified an investment opportunity that was felt to be appropriate for inclusion within the 'Opportunity Pool' portfolio, and the investment manager(Christofferson Robb & Company) were invited to present the opportunity to the ISC.

3. The 'Opportunity Pool' is a concept whereby the Fund has a certain amount of capital that can be deployed into investment opportunities that do not fit neatly into the remaining asset allocation split, but where the potential returns are thought to be sufficiently high to justify an investment. The Fund's target asset allocation weighting for the opportunity pool is between 4% - 6% and there is an expectation that the net investment return will be 10% p.a. or more.

4. As a general rule opportunity pool investments will tend to be highly specialist in their nature, and they will often be investments that arise as a result of a market dislocation or a general misunderstanding about the risk and return profile of the asset type. The manager will often operate in a highly niche market and be one of a handful of investors with the skills to access the opportunities.

CRC Capital Relief Fund III

5. Following a presentation by the manager, an investment of £40m was agreed by the ISC with an expectation that the investment would be funded in September 2017. Attached as an appendix is a report that was produced for the ISC which provides details of the investment opportunity.

Recommendation

6. The Committee is asked to note the report.

Equality and Human Rights Implications

None specific

Background Papers

None

Officers to Contact

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Chris Tambini – telephone (0116) 305 6199

APPENDIX

Leicestershire County Council

INVESTMENT SUBCOMMITTEE – 14TH JUNE 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT IN CRC CAPITAL RELEASE FUND III

Purpose of the Report

1. To provide information in respect of a recommended investment in the CRC Capital Release Fund III (CRC III).

Background

2. The Fund has a target allocation of 4 – 6% of total Fund assets to the 'Opportunity Pool' concept. In broad terms these should be considered as investments that are expected to produce returns that are at least as high as those expected from equities markets, but which will provide an element of diversification from broad-based equity markets. They will generally not fit comfortably elsewhere within the Fund's overall asset allocation strategy, and will almost always be investments that take advantage of market opportunities that exist at a point-in-time but that appear unlikely to persist indefinitely.

3. At present only 1.9% of the available Opportunities Pool funding is invested, and this is all within the specific opportunities within debt markets (via three M & G Debt Opportunities Funds). A further c.£40m has been committed to Opportunity Pool investments but is currently 'undrawn' (M & G Debt Opportunities Fund III and Markham Rae Trade Capital Partners), and it is anticipated that most of this will be invested within the next 12 -18 months. This will take the Opportunity Pool up to about 3% of total assets of the Fund.

4. The first two M & G Debt Opportunities Funds are, however, fully invested and are in their distribution stage. Over the last 12 months £41m of capital has been returned from these two funds and it is probable that further significant capital sums will be returned over the coming 12 months. The Opportunity Pool may, therefore, not increase significantly in size as the drawdowns are likely to be offset to a meaningful degree by distributions.

5. There is no reason to make Opportunity Pool investments unless they are considered likely to be better (on a risk-adjusted basis) than where the money would otherwise be invested. Once the Opportunity Pool is fully utilised there will be no room to fit in other opportunities that may come along, unless there is a strategic change to the benchmark agreed by this committee, and it has always been the case that waiting for the right opportunity is a better option than simply deploying capital into the best options available at any point in time. The ultimate

aim is for the Opportunity Pool to consist of about 6 -8 investments, and for all of these to be capable of adding meaningful value at a total Fund level. The expectation is that these individual opportunities will be for between ½% and 1½% of total assets each, with the size varying depending on the risk and potential return that is expected from each one.

6. CRC III is a fund that will effectively buy portfolios of loans from banks and be paid an insurance premium from the bank to do this. The investment manager (Christofferson, Robb and Company) is highly specialised in this area and has been carrying out these transactions since 2002, and has been able to produce very good returns for investors. Although the premium paid to the manager by the banks is significant given the overall risks associated with the portfolios, it is still financially advantageous for them to do this because it frees up capital for them to use elsewhere within their business.

7. This report is not intended to be an exhaustive analysis of the investment opportunity, and the Hymans Robertson note that is attached as an appendix provides further details. Christofferson, Robb and Company has also produced a presentation and will be in attendance at today's meeting to explain the investment more fully.

What is Bank Capital Release?

8. Within the banking regulatory environment, capital has to be held as backing for loans that have been made. If a bank wishes to increase its lending activity it has to hold more regulatory capital and this capital can be expensive (having averaged a cost of c.15% over recent years).

9. By arranging a mechanism for transferring the risk of loans made, banks can receive approval from the regulators to hold less regulatory capital against existing loans and this frees up capital to support further lending activities. Because capital is expensive for banks they can afford to pay a healthy premium to the counterparty that the risk is being transferred to. The risk transfer and the approval by regulators makes bank capital release attractive to both the bank and the investor.

10. In very simplistic terms, CRC III will assume part (and occasionally all) of the risk of default on the loan portfolios that it invests in. These portfolios have to pass certain 'quality' assessments before they are considered and the default risk can be estimated with reasonable accurately in advance. It is only in the event that the default rate is much higher than anticipated, and much higher than has ever occurred historically, that returns to investors start to be eroded to a meaningful extent. The target investment return for the fund is around 10% p.a. (net of all costs) and this is a highly attractive return to investors, and a return that fits in well with the expectations for the Opportunity Pool.

11. CRC III is clearly not risk-free but the manager has a long track record of avoiding meaningful defaults, and has produced highly credible returns to investors. Whilst the assets managed by them have increased in size, this has been matched with

increasing investment opportunities and there is a high probability that any commitment can be deployed in a speedy manner.

Recommendation

12. The Investment Subcommittee is recommended to approve a £40m commitment to invest in the CRC Capital Release Fund III.

Equal Opportunities Implications

None specific

Background Papers

Attached as appendix

Officers to Contact

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Chris Tambini, Director of Finance
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LGPS Central - Update

Asset pooling within the LGPS

Background

- Investment pooling is a government initiative, with an expectation of significant cost savings
- The savings will mainly arise from Funds combining their assets into larger portfolios, thereby harnessing economies of scale
- Likely to be eight pools in England and Wales
- Leicestershire belongs to LGPS Central, along with eight other Funds

Background

- LGPS Central has £40bn of assets
- The nine Funds have been working on the project since late in 2015
- The project is complicated but excellent progress has been made
- Willingness of Funds to compromise where there is a clear common good
- ‘Go Live’ date of 1st April 2018

Update of recent activity

- Board of LGPS Central is now complete:
  - Chief Executive Officer
  - Non-Executive Chair
  - Chief Operating Officer/Chief Financial Officer
  - 2 x Non-Executive Directors (one with expertise in investment management, one with expertise in operations and governance)

Update of recent activity

- Chief Investment Officer also appointed
- Adverts for next tier of management (Chief Risk Officer, Head of IT, Legal Counsel etc.) are all currently 'live'
- Appointment process expected to be completed within next two months
- Timing of appointments is going according to plan

Update of recent activity

- Application to Financial Conduct Authority (FCA) was completed in July
- First meeting with FCA has taken place. They do not see any ‘show-stoppers’
- All other key dates continue to be met
- Everything is going remarkably well
- But still time for unexpected events to cause problems!

Leicestershire County Council

LOCAL PENSION COMMITTEE

1 SEPTEMBER 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 any concerns relating to the risk management and internal controls of the Pension Fund, 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

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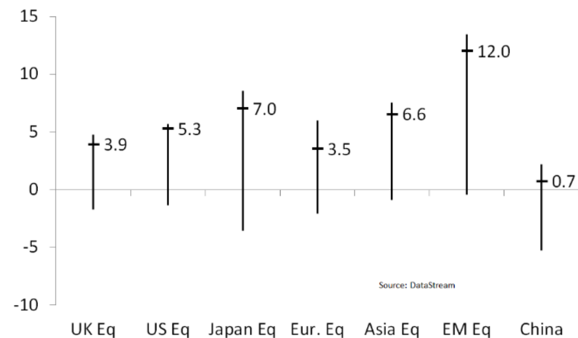
Market Backdrop

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

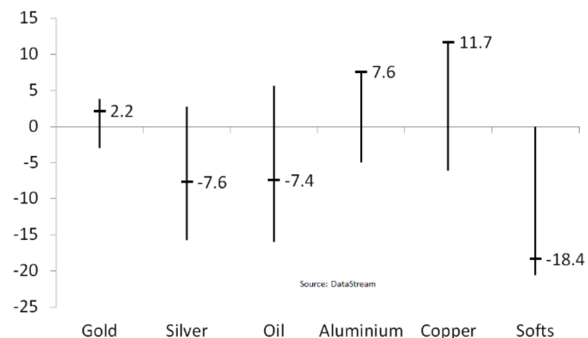
Market Movements

The figures below describe the % performance of various markets from the end of March 2017 to the close on 16th August 2017. Most equity markets have continued to deliver solid returns in 2017 consistent with a cautious optimism across investors. Market participants generally judge that stock markets are supported by an improving world economy and still benign monetary conditions despite apparently elevated valuations. The greatest challenge was judged to come from adverse political developments in Europe and the US; those threats have, thus far, failed to materialise. Across all markets, volatility remains low by historical standards.

Equity: % change in prices (high, low, last)



Commodity:

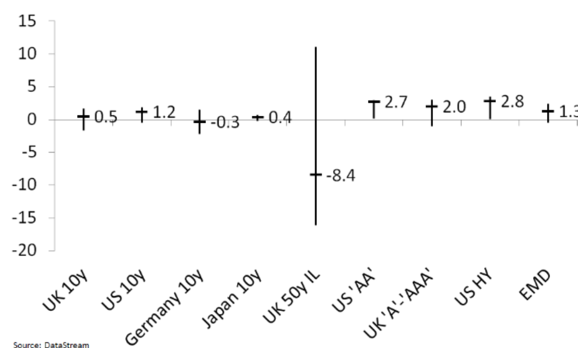


Regional performance was generally strong; China was the notable exception having been held back by tighter financial conditions imposed to subdue financial markets. Asia and Japan have both performed strongly supported respectively by the lower US$ and improving levels of domestic demand. Post Macron's victory in France, European equities have failed to keep pace with other markets. Underpinned by a more stable bond market than many had expected, a feature of the period has been that most regions never closed below their year-end level.

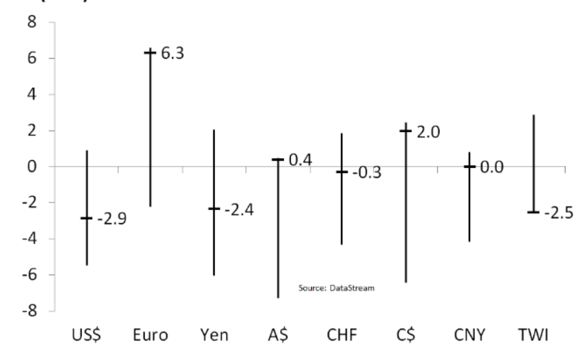
In commodity markets, industrial metals were initially underpinned by a healthy Chinese economy and the still-hoped-for Trump-inspired surge in US infrastructure spending. Oil prices are currently lower than at the start of the year on strong inventory and production levels; the OPEC production accord also looks increasingly likely to break. Gold lifted on a softer US$. 'Softs' have traded sharply lower on strong production.

Bond markets were generally calm except for ultra-long UK index-linked bonds where prices have again been very volatile. That most bond markets (government and corporate) should have seen prices hold steady (gain) on the period has confounded forecasters (many of whom had expected a Trump-induced rout especially against the backdrop of rising inflation). EMD markets have shed many of the Trump-related fears.

Bonds:



FX (vs £):



The Pound trade weighted index (TWI) ended the period lower burdened by a deteriorating political backdrop and the formal launch of *Brexit*. The € has been buoyed by Macron's victory and stronger economic performance.

Consensus expectations – economic growth and inflation

The consensus economic growth outlook for 2017 and 2018 has, out-with the US, firmed since the year end. The notable increases have occurred in Europe – where real time measures of economic performance have throughout Q2 and Q3 been strong, the UK which has improved on stronger consumer spending and from an admittedly low base, and, latterly, Japan where stronger domestic demand has driven growth. Although the US is expected to grow above trend (estimated by the FOMC to be 1.8% p.a.), the overall outlook for the rest of 2017 and into 2018 appears to suggest that global growth will remain moderate.

Table 1: Consensus forecasts – Real GDP growth (%)

	2016	2017	Change since end '16	2018	Change since end '16
US	1.6	2.1	-0.1	2.3	0
Eurozone	1.7	2.0	0.6	1.7	0.2
UK	2.0	1.5	0.3	1.3	0
Japan	1.0	1.4	0.4	1.0	0.2
China	6.7	6.7	0.2	6.3	0.2

The initial estimate of real US growth in the second quarter however is +2.6% which represents a reasonable rebound from the much slower performance of Q1; economists at the Atlanta Fed estimate that growth in the third quarter is running at a 3.9% annualised rate. Equivalent measures for the European economy show similar buoyancy (with +2.7% and +3.0% expected for Q2 and Q3 respectively). Given an improving outlook for Japan and resilience in the Chinese economy (despite clear credit tightening) there would be appear to be upside risks to the forecasts for most regions shown in the table above. Uncertainty surrounding the *Brexit* negotiations will likely ensure that the projections for the UK remain subdued, a viewpoint shared by the Bank of England which highlighted weak real disposable income growth as a particular concern.

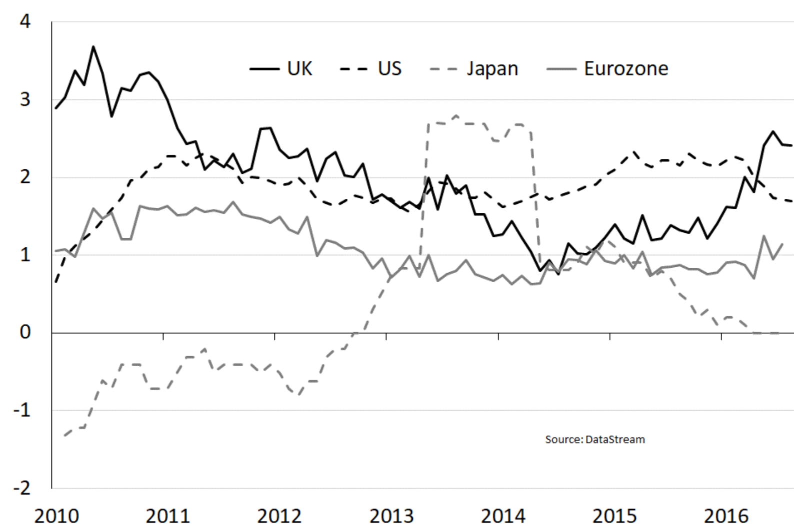
Despite this relatively rosy activity backdrop, the outlook for inflation in 2017 and 2018 is little changed (Table 2). The failure of inflation to prove stronger remains a conundrum defying policymakers and investors alike. Even in the US, where the Federal Reserve are hiking their policy rate, the guidance remains that increases will be gradual and that policy will remain accommodative for the foreseeable future – indeed given current inflation, the real policy rate is very low (see Page 4). That said, some central banks want to reverse their QE.

Table 2: Consensus forecasts – Inflation (CPI, %)

	2016	2017	Change since end '16	2018	Change since end '16
US	1.7	1.6	-0.3	1.8	-0.2
Eurozone	1.1	1.5	0.2	1.4	-0.1
UK	1.6	2.7	0.3	2.6	0.2
Japan	0.0	0.5	-0.1	0.8	-0.2
China	2.1	1.7	-0.5	2.2	0

On the ground, the benign level of core inflation rates in the major economies is shown in Chart 1. This can even be said to be true of the UK where the impact of the recovery in energy costs (feeding through indirectly into the core rate) and the sharp fall in £ seen in 2016, although evident, is starting to subside. Japan's inflation problem remains the lack of it – policymakers there have gone quiet on Abe's promise, made in 2012, of delivering a 2% inflation rate; a reminder, if it were needed, that high(er) inflation rates are not easily generated (beyond one-off jumps caused by base effects – most recently by oil). It is worth noting that Abe's popularity has fallen significantly this year (helped by being embroiled in a cronyism scandal) and it is generally thought that he will be re-elected. Among the possible explanations for still-low inflation are mis-measurement (an old favourite) and, more plausibly, the combined (and related) impact of online shopping and Amazon (the great price disrupter). With online US retail sales projected to surpass that through traditional outlets in the next two years and Amazon entering the food chain (through WholeFoods), these influences are unlikely to subside.

Chart 1: Core CPI rates (%, yoy)



UK headline retail and consumer price inflation rose strongly in Q2 but, as mentioned above, looks to be topping-out (Chart 2). Although £'s devaluation might see these rates rise further, input and output producer price rises look to be passing their peak (Chart 3). The rise in inflation has not been matched by higher wage, indeed there is no real wage growth.

Chart 2: UK inflation rates (%, yoy)

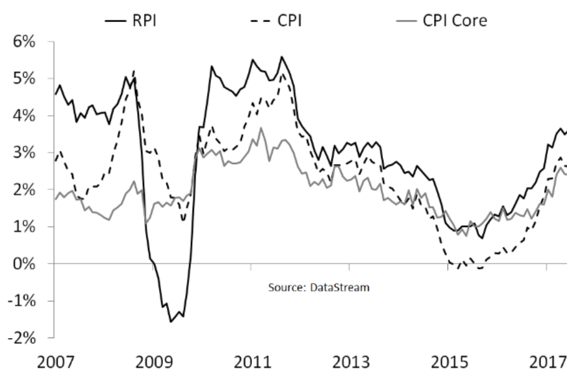
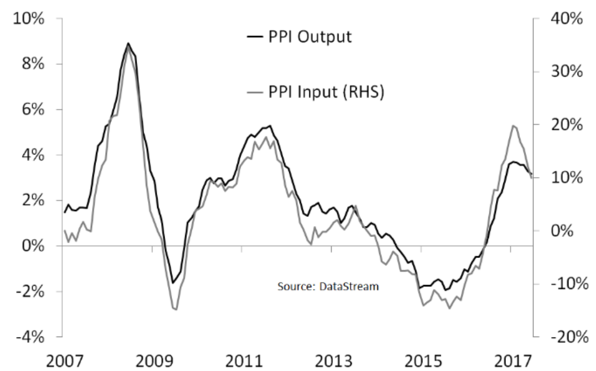


Chart 3: UK producer price growth (yoy)



Extending the point about Japan, experience of the post-GFC period suggests, and this is of interest for the UK, that currency-induced inflation doesn't lead to an enduring inflation problem.

Overall, while projected inflation rates (many years ahead) may cause central bankers some concern, it remains that actual inflation in the period ahead is unlikely to be a problem and should not influence the general asset strategy for the Fund. That said, some specific measures may be required if the fiscal taps are turned on. The UK has, thus far, failed to expand fiscal policy and Trump remains more hamstrung than expected. The recent UK election hasn't altered the outlook.

Short and long term interest rates

Having raised their policy rate in June to 1.25%, the Fed are arguably almost halfway to their predicted equilibrium policy rate (of 3%). After the latest announcement, Janet Yellen reiterated while other rate hikes will be delivered this year – they judge the recent moderate US inflation to be a 'soft patch' - the Fed intend to keep monetary policy accommodative. They are, however, moving forward with plans to shrink their balance (reduce the volume of bonds they bought through various QE exercises); this has not troubled bond markets.

The current consensus forecast for the main policy settings are shown in Table R1 and the market-implied path of interest rates over the next few years is shown in the accompanying chart. Despite the recent strength in the European economy, policy everywhere outside the US is expected to broadly remain on hold and ultra-low interest will be with us for many years yet.

Table R1: Consensus forecasts – main policy setting at year end (%) and market path

	2016	Latest	2017
US Fed	0.75	1.25	1.50
ECB	-0.40	-0.40	-0.40
BoE	0.25	0.25	0.25
BoJ	-0.10	-0.10	0.00

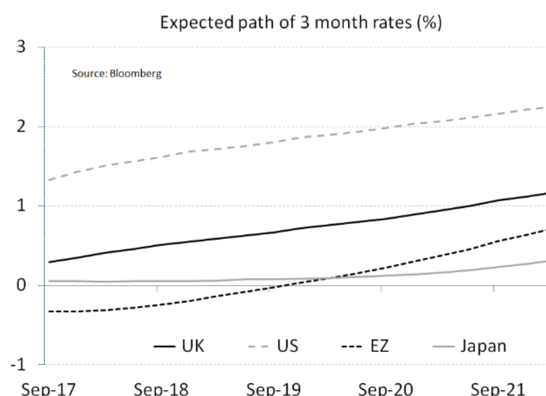


Table R2 provides a reminder of the current very low level of longer term government bond yields. Across all major markets, government bond yields remain below equity dividend yields.

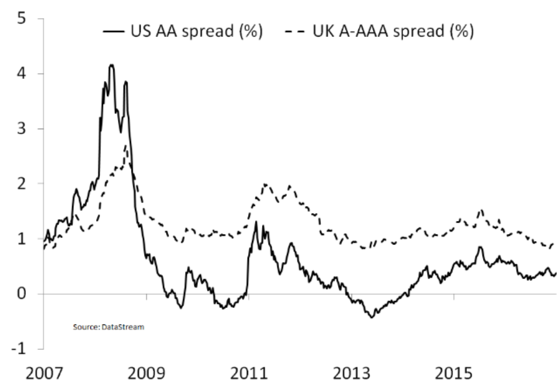
Table R2: 10-year bond yields and consensus forecasts at year end (%)

10 year	2016	Latest	2017
US	2.4	2.2	2.6
Germany	0.3	0.4	0.7
UK	1.4	1.1	1.3
Japan	0.0	0.0	0.1

Notwithstanding the changes seen in US policy interest rates, the outlook remains that bond markets will not see yields return to levels generally regarded as 'normal' (around 4-5%).

Non-Government Bonds

Investment grade bond spreads remain very tight as strong flows into (retail oriented) ETFs has kept demand for yield very strong; this has been particularly true in the UK. The same is true of high yield bonds where the spread is little off multi-year lows. Corporate bonds are enjoying the support that the government markets have delivered through 2017 thus far; neither market is concerned about the prospect of the US Federal ending their practice of reinvesting redeeming bonds held on their balance sheet (the result of past QE programmes).



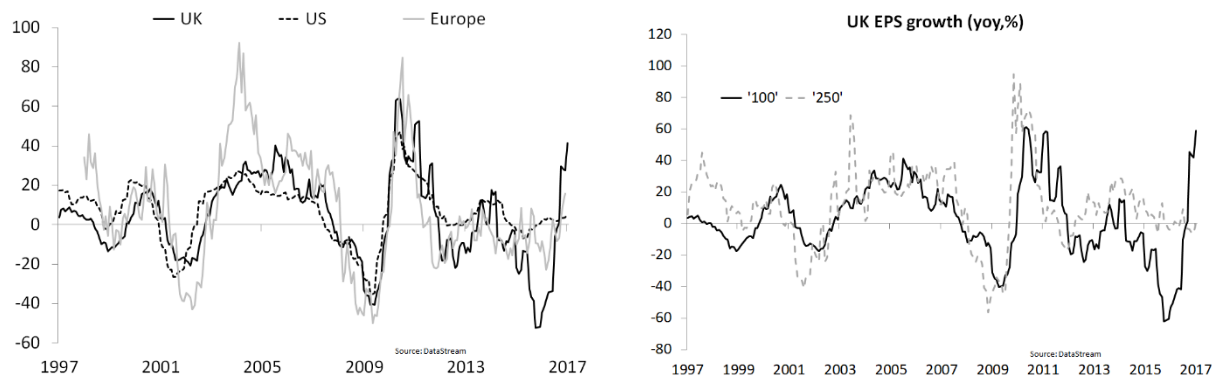
Regardless of which emerging market debt index is followed, all have recovered completely from the Trump-induced sell off last November. In a world of still wafer-thin, developed bond yields, investors continue to find EMD attractive – there is nowhere else to go for yield.

Within the array of available bonds out-with developed government bond markets, emerging market exposures remain the most attractive; active selection is to be preferred.

Equities

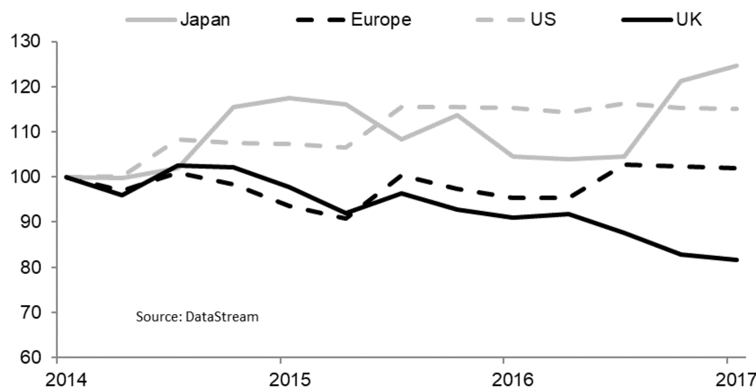
The chart below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; unsurprisingly they chime with the economic cycle. Since the previous report, earnings growth has improved, consistent with the better readings on general activity levels. Larger companies in the UK are seeing the foreign earnings currency boost generated by last year's £ slump come through strongly.

Chart E1: Experienced earnings per share growth



EPS forecasts for the next financial year continue to be most positive in Japan while weakness is expected in the UK as the currency impacts wash through. In broad terms the Eurozone and the US are expected to flat-line (Chart E2).

Chart E2: Forecast earnings per share (next financial year – FY1, rebased to 100 in 2014)



Looking beyond the next financial year, equity analysts generally remain optimistic (Table 5); although it should be remembered that analysts are rarely pessimistic. Japan's recent gains are not expected to be maintained in the medium term.

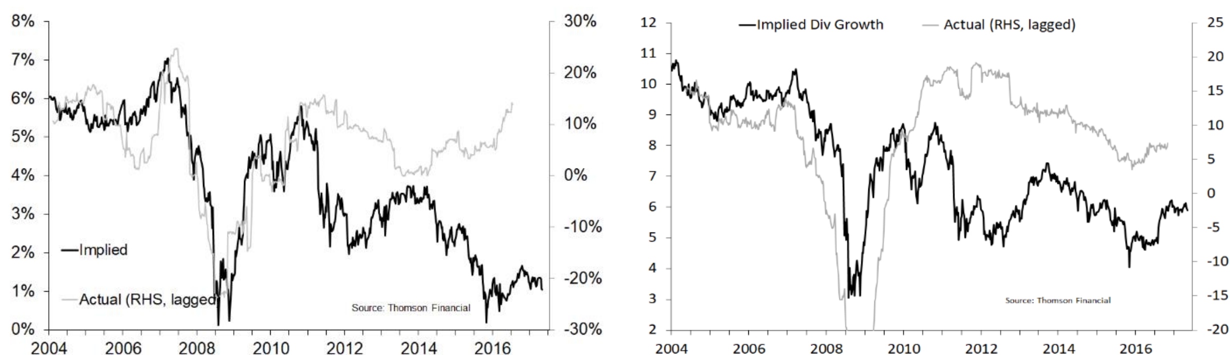
Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)

	UK	US	Japan	Europe
FY2	8% (0%)	11% (-1%)	5% (-3%)	9% (-1%)
FY3	9% (-1%)	10% (0%)	8% (-4%)	9% (0%)

Equity Valuation

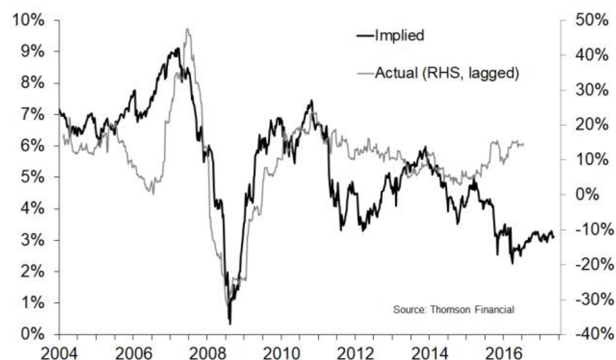
A preferred means of assessing how attractively priced equities are, is the implied level of dividend growth needed to break-even relative to the alternative of investing in bonds. In both the UK and US markets (Charts E3 and E4) the required level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered in recent years; the recent fall in bond yields has improved the comparison. If allowance is made for a risk premium then UK dividends may never grow but they would still offer better value than fixed income. The earnings outlook for companies may always be uncertain but equity markets still offer better value than bonds.

Charts E3 and E4: UK (FT All Share, left chart) and US (S&P Composite, right chart) implied dividend growth



The implied outlook for the more domestically focused FTSE 250 is as it is for the broader UK market. Here the path of actual dividend growth has been more consistent with the evolution of the breakeven rate (Chart E5). The chart also suggests that there may be some poor news on actual dividends to absorb in the near term. **Should the fiscal spigot ever open then there may be bargains to be had in UK domestic plays; sector baskets bought on 'bad days' may be the best way to exploit these.**

Chart E5: UK (FTSE 250 Index), implied div. growth



However delivered, if the recent broad economic upswing continues then, with central banks increasingly able to contain bond markets, equities could enjoy attractive relative returns – at least while investors expect there to be a strong correlation between growth and corporate profitability. Should the low level of inflation acquire a stronger market prominence then relative gains may be harder won.

Leicestershire County Council Pension Fund

Commentary

While falling short of declaring equity markets a ‘sell’, in a recent note to investors Howard Marks (of Oaktree) offered some observations and highlighted challenges facing investors today:

- we have some of the highest equity market valuations in history,
- the so-called complacency index is at an all-time high,
- a ‘can’t lose’ group of stocks [Facebook etc] has emerged,
- the movement of more than one trillion $s into value-agnostic investing [tracker funds],
- the lowest yields in history on low-rated bonds and loans,
- low yields on emerging market debt,
- the most fund raising in history for private equity,
- the biggest fund of all time raised for levered tech investing [Softbank] and
- billions in digital currencies whose value has multiplied dramatically.

He concluded that despite the above he was not currently inclined to liquidate his investments but knew that the time will come when he might need to act. Doubtless he would have found it a lot easier to move defensive if the cost of being defensive wasn’t so high: the returns from cash and bonds being so poor currently.

Meanwhile recent data highlights the growing importance of owning the correct (US) stocks. Over the past forty years the number of firms delivering half of the overall market earnings has shrunk by more than two-thirds while the actual dividend base has almost halved. Put differently, only 100 companies are responsible for delivering almost all market earnings and two-thirds of the dividends.

	# of firms accounting for 50% of:			Top 100 firms account for:		
	1975	1995	2015	1975	1995	2015
Earnings	109	89	30	48.5%	52.8%	84.2%
Assets	94	69	35	51.1%	56.5%	66.2%
Dividends	74	61	44	55.1%	60.6%	68.7%

When it comes to investment returns, slightly more than four out of every seven US stocks since 1926 have lifetime buy-and-hold returns, inclusive of reinvested dividends, less than those on one-month bonds. When stated in terms of lifetime ($) wealth creation, the entire gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed companies.

Marks’ comments highlight the importance (or opportunity) for a discerning investor to avoid expensive over-hyped companies and generate outperformance and yet the population of truly outperforming companies able to deliver rewards to investors is shrinking. Choosing the correct stocks may never been more important and it may never have been more difficult.

PENSION FUND

Summary

The most significant developments of the past quarter included

- the reduction in political risk (associated with a distracted/ embattled Trump and the start of the Macron Presidency),
- the slide in longer term inflation expectations combined with the fresh fall in energy prices,
- the broad-based weakening in the US$ despite widening interest rate support and
- the desire across many major central banks to emulate the US Fed and move policy rates above the zero bound and/or reverse their quantitative easing programmes.

Risk asset markets have taken these developments as confirmation of the better and more stable economic conditions needed to sustain current equity valuations. While the yield curve flattening that has taken place often heralds more austere trading conditions, equity investors have been prepared to believe that policy will remain 'behind the curve'. If headwinds emerge then confidence is high that interest rates can/will be eased.

Despite the strength of many equity indices, market leadership has generally come from defensive stocks especially those supported by strong balance sheets. This trend should continue while policymakers try to normalise monetary policy. Unless inflation expectations start to increase it is to be expected that the US$ may struggle to recover the ground recently lost; this should be to the benefit of emerging markets – local currency exposures could do well.

Overall and notwithstanding the challenges mentioned on the previous page, those cautioning against equity exposure need to provide investors with

an attractive alternative. Bond yields and short term interest rates remain far too low to be viable. Credit spreads remain tight by historical comparison and, for UK investors, property is best played perhaps on a specialist basis. Illiquid opportunities are continuing to emerge but, almost inevitably, these do not have capacity. Robust yield supported equity allocations should remain the kernel of the Fund's liquid risk allocations.

The Pound remains cheap against almost all alternatives but the recent election and subsequent developments suggest that this is for good reasons. It is hard to see why the mis-valuation will disappear unless other currencies are beset by difficult trading conditions. For the moment, the € remains well supported as investors return to the area; that said, a € long is a consensus trade.

There are of course myriad potential problems lying in wait for investors. The Macron 'bid' to the € and a raft of European sentiment indicators could evaporate if/when the new President meets opposition to his labour market reforms. Thus far, credit tightening in China has had limited impact on equity markets or economic activity. Although the Chinese interbank system appears sound, appearances can be deceptive – especially in China. Strains across to Middle East and the Korean peninsula retain the potential to become globally disruptive. Finally, market sentiment could easily shift to seeing falling inflation expectations as a portent of doom.

Scott M Jamieson, August 2017

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Leicestershire County Council Pension Fund Q2 2017 – Market Report

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Historic Returns for World Markets

Index	Q2 (%)	1 year (%)	3 years (%)
Citi WGBI Non-GBP TR	-0.92	-1.36	8.56
FTSE 100 TR	1.00	16.92	6.73
FTSE 350 TR	1.33	17.76	7.26
FTSE Actuaries UK Index-Linked Gilts All Stocks TR	-2.27	6.72	11.85
FTSE Actuaries UK Conventional Gilts All Stocks TR	-1.29	-0.86	6.99
FTSE Actuaries UK Conventional Gilts over 15 year TR	-2.32	-1.83	12.29
FTSE All-Share TR	1.42	18.12	7.39
FTSE Japan TR	1.53	23.97	16.70
FTSE Small Cap TR	3.81	28.50	10.96
FTSE World Europe ex UK TR GBP	5.16	29.05	11.42
FTSE World ex UK TR GBP	0.48	23.31	16.37
IPD UK All Property Monthly TR	1.47	4.02	9.88
LIBID GBP 7 Day	0.06	0.26	0.41
Markit iBoxx Sterling Non Gilts Overall TR	0.49	5.26	6.90
MSCI EM (Emerging Markets) TR GBP	2.41	27.79	11.17
MSCI Pacific ex Japan TR GBP	-2.21	23.07	11.10
S&P 500 TR	-0.76	21.33	20.11
Commodities	-3.22	-7.02	-15.03
£ Trade Weighted Index	-0.06	-3.91	-4.25

Currency	Q2 (%)	1 year (%)	3 years (%)
Euro	2.66	5.66	3.12
Japanese Yen	-4.53	-6.03	5.87
US Dollar	-3.73	2.91	9.59

All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 30 June 2017.

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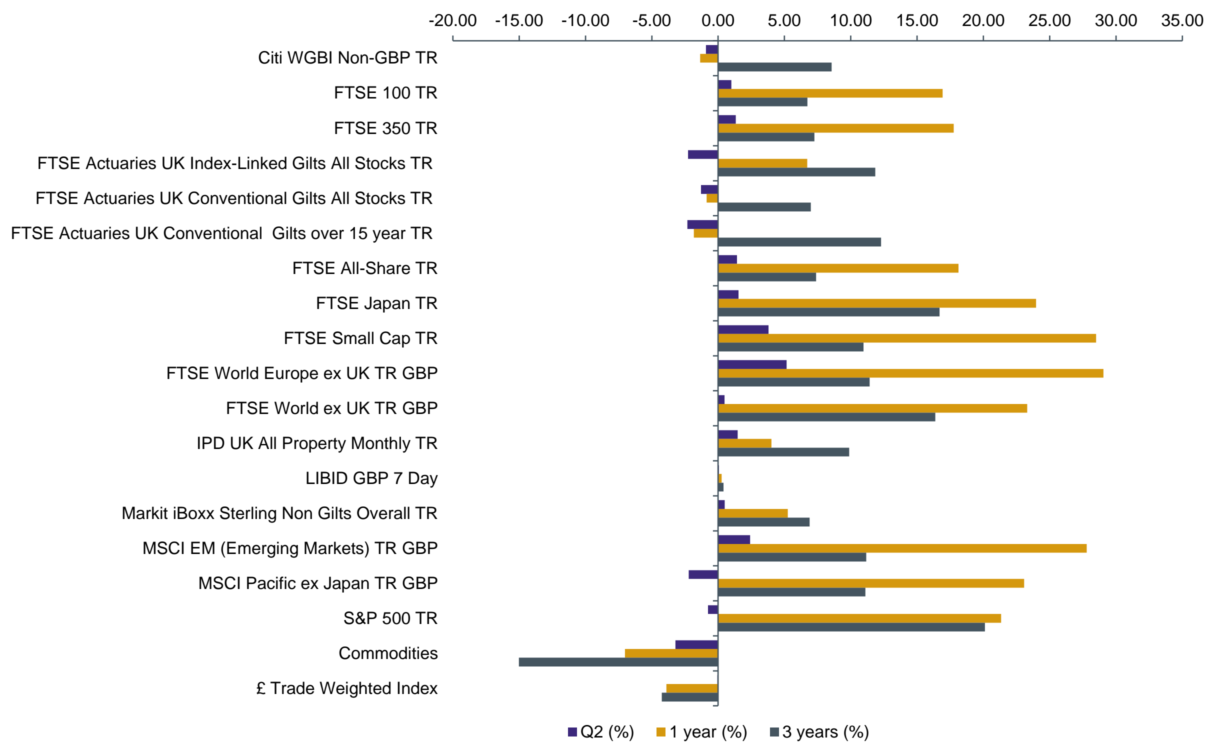
Historic Returns by Market Index



All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 30 June 2017.

Market Review

UK equities

UK equities rose over the second quarter, with the FTSE All Share index up 1.42%. The period saw the FTSE 100 breach the 7500 level, establishing new all-time highs, before falling back at the end of the quarter. Markets also sold off after the minutes of the Bank of England monetary policy committee meeting showed a rise in support amongst committee members for a rate hike.

The main focus continued to be on politics, as Theresa May's call for a general election backfired and, despite winning the election, she was forced to enter into a pact with the DUP (Democratic Unionist Party).

Inflation picked up with the consumer price index (CPI) rising 2.9% in May, from 2.7% in April, and growing at the fastest rate since June 2013. On the other hand, and a sign of potential stagflation in the UK economy, retail sales volumes (including fuel) were disappointing in May with a rise of 0.9% year on year and a fall of 1.2% over the month. Both figures were some way below expectations and the annual growth rate marked the weakest growth since April 2013. Also on the weaker side were GDP figures. UK GDP growth was revised down from 0.3% in the first quarter of the year to 0.2%; this compared to the 0.7% growth in the final quarter of 2016. UK employment data remained robust however with the unemployment rate in the three months to the end of February stable at 4.7% and the employment participation rate rising to 74.6%, the joint-highest level since 1971.

In terms of sectors, healthcare equipment, financials (notably financial services, insurance and banks), mobile telecommunications and software were among the best performers. Meanwhile, basic materials, utilities, resources, pharmaceuticals and tobacco were all weaker.

US equities

The S&P 500 fell by 0.76% in sterling terms, but rose 3.09% in US dollar terms. Both the S&P 500 and the Nasdaq touched new all-time highs during the second quarter.

On the political front, while Donald Trump scored a success in the repeal of Obama's Affordable Care Act, the administration remained deeply mired in allegations of clandestine links with Russia. The abrupt sacking of FBI director James Comey did little to boost confidence, while reports that Donald Trump had disclosed classified information to the Russian foreign minister continued to dog his presidency.

Data was mixed. Inflation came in below expectations at 1.9% in May, down from 2.2% in April, with falling energy prices a key influence on May's figure. Retail sales fell by 0.3% month on month in May, showing the largest decline since January 2016, and contrary to consensus estimates which had predicted a rise. Meanwhile, US unemployment dropped to a new recent low of 4.3% in May, from 4.4% in April, marking the lowest rate for 16 years. Citing delays to Trump's planned cuts and infrastructure spending, the OECD cut its forecasts for US GDP growth for 2017 and 2018 to 2.1% and 2.4% respectively (down from 2.4% and 2.8%).

Remaining confident in the growing US economy and strengthening job market, the Federal Reserve raised rates in June for the third time in seven months and the second time this year with a further 0.25% increase and reiterated guidance for a further rate rise this year. They also signaled that they would begin to reduce the balance sheet, and thereby the level of liquidity in the system.

In terms of sectors, healthcare was the notable leader followed by industrials, financials and IT. All other major sectors declined in sterling terms, chief among them energy and telecommunications.

European equities

European equities were strong, with the FTSE Europe ex-UK index rising by 5.16% in sterling terms. Greece was the outstanding performer, up almost 30%. All countries rose in sterling terms.

Markets took comfort from political developments within Europe. After a tight first round in the French general election, Emmanuel Macron won convincingly in the second round, garnering approximately 65% of the popular vote. Markets were also relieved that euro-area finance ministers agreed to sign off on the next tranche of funds to Greece (approximately €8.5 billion) to help Greece meet bond redemptions due next month.

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Economic data was largely positive. Eurozone GDP for the first quarter was revised higher from 0.5% growth to 0.6%. Gross capital fixed formation and exports rose more strongly than previously estimated and growth for 2017 was revised higher from 1.7% to 1.9%. The average reading for the second-quarter eurozone composite PMI was 56.4, up from 55.6 in the first quarter, and the best since the first quarter of 2011. Job creation and demand remained very strong, and eurozone investor confidence as measured by the Sentix index rose to a near 10-year high in June.

The eurozone CPI for May came in below expectations at 1.4% year-on-year growth, below that of April which marked 1.9% growth. This was the lowest rate of growth this year and largely reflected falling energy prices as well as lower telecom costs.

All sectors were positive, led by utilities and financials, the only exception being oil & gas.

Japanese equities

The FTSE Japan index rose by 1.53% in sterling, or 6.35% in local currency, terms.

In April, the IMF revised Japan's forecast growth rate of 0.8% for 2017 to 1.2%. Along with the UK, this was one of the largest single economy revisions made by the IMF. However, Japan's first quarter GDP growth was revised downward from the initial figure of 0.5% growth to 0.3%. This equated to an annualized growth rate of just 1.0%, down from 2.2% previously. The lowered figure largely reflected lower oil inventories rather than a fall in demand. Other weak data was evident with the core machinery orders for April which fell more than expected, by 3.1% over the month. This was the first fall in three months in the series.

On the positive side was industrial output which rose at the fastest monthly pace since June 2011, growing by 4.0% in April from March. The year-on-year growth rate rose to 5.7% in April versus 3.5% in March, led by rising demand for steel and other raw materials.

Japanese retail sales picked up in April at department stores and supermarkets with an aggregate 1.1% rise following on from a fall in March. However, overall household spending fell 1.4% during the month.

The Bank of Japan kept its monetary stance unchanged in June and, in the wake of the Federal Reserve statement regarding the tapering of US quantitative easing, reiterated its firm stance, largely as domestic inflation is still shy of the 2.0% target.

Regarding sectors, technology was the best performing sector followed by telecoms and consumer services. Oil & gas was by far the weakest sector.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index rose by 2.32% in sterling terms. The best performing market was China, followed by Korea, Taiwan and Indonesia, while Pakistan, Australia, Thailand and India were negative.

After several previous failed attempts, China at last obtained admission of its A shares index to the MSCI global and emerging-market benchmarks. Chinese shares hit an 18-month high as investors bought stocks in the knowledge that inclusion in the MSCI should improve demand from international investors and liquidity.

However, the ratings agency Moody's cut the sovereign rating for China for the first time in 30 years in May due to worries about economic slowdown and rising debts. Hong Kong also had its rating downgraded by Moody's. Chinese 10-year bond yields soared to their highest level in two years as a result, rising above the 3.5% level. Additionally, the financial authorities tightened regulations, in an effort to prevent excessive borrowing and speculation in markets. The actions unnerved investors and caused a sell-off in government bonds.

The IMF revised its forecast for Chinese GDP growth from 6.6% to 6.7% for 2017. GDP growth attained a reading of 6.9% for the first quarter of the year.

India's CPI marked a new record low, growing by just 2.18% year on year in May compared to 2.99% growth in April and well below consensus estimates. The main factor behind the slump in CPI was weaker food prices.

In Australia, business confidence, as revealed by the NAB Business confidence index, fell in May to 7, down from April's figure of 13.

In Korea, liberal politician Moon Jae-in was elected as the new president following the impeachment and imprisonment of the former president.

Technology led the way in terms of sector moves followed closely by consumer services. Oil & gas, basic materials and telecommunications were the weakest sectors.

Property

Economic growth in the UK weakened at the beginning of 2017 with figures from the ONS showing GDP growth slowed to 0.2% during the first quarter. Consumer spending, which has been the main driver of growth over the past few years, has slowed in particular with limited wage growth and rising inflation, largely as a result of the depreciation of sterling following last year's EU referendum, squeezing household finances despite record levels of employment.

In contrast to the wider economy, the UK commercial property market continued to defy expectations from some commentators of a slowdown with the IPD Monthly Index recording a robust total return of 2.5% during the quarter. This represented the third consecutive quarter of solid positive returns following a modest correction in capital values in the immediate aftermath of the vote to leave the EU. Investment demand, especially from Far East Asian investors, has remained resilient and supported valuation yields. However, rental growth has slowed to 0.4% year on year, as occupiers become more cautious due to economic and political uncertainties associated with Brexit. In certain markets, such as central London offices, bargaining power has shifted from landlords to tenants with evidence of declining rents and greater tenant incentives.

Industrials continued to be the best performing sector of the market by some margin with an exceptional total return of 4.6% in Q2 2017. Diminishing supply of vacant space and healthy tenant demand for both multi-let estates and larger logistics warehouses continues to drive positive rental growth, whilst the weight of money seeking industrial exposure has driven industrial yields down to 10 year lows. In the office and retail sectors, returns were more restrained but remained positive. The office sector returned 1.9% with regional offices outperforming central London. The retail sector returned 1.8% in the quarter and continues its long term trend of underperformance. Rental growth remains weak due to a structural oversupply of retail space, especially in secondary and non-core locations.

Uncertainty over the Government's ability to agree a successful trade deal with the EU during Brexit negotiations is likely to remain over the medium term. However, our outlook for the UK commercial property market continues to be for steady, if unspectacular, returns over the next few years. On a relative value basis, commercial property remains attractive with All Property's net initial yield of 5.3% continuing to represent a healthy spread in excess of 400bps over 10-year gilts. In addition, when compared with commercial property markets overseas, the UK does not look expensive in capital value or yield terms, providing support for international capital that has also benefited from the weaker pound. With little evidence of any major development or credit bubble that has triggered previous commercial property corrections, the latest IPF Consensus Forecasts – an industry average of return forecasts by agents, fund managers and researchers – projects a respectable total return of 5.2% over five years to 2021.

Fixed Income

Government bond markets came under pressure over the quarter and posted a negative return overall. Much of the action was concentrated in June when markets demonstrated their ability to react dramatically in response to central bankers' comments. As they have done of late, credit markets continued to grind tighter.

The main dilemma facing authorities and markets was once again inflation and the extent to which (if at all) it will rise in the future. As we explain below, central bankers are displaying somewhat erratic behaviour in expressing a robust view; their change of thinking towards the end of the quarter was clearly viewed as a significant U-turn.

It is worth pointing out that we have adopted for some time now, a cautious approach within fixed income. We have avoided, where possible, the riskier assets within the corporate bond sector and we have, in particular, limited our exposure to government bond markets where valuations are challenging.

Government bonds sell off

Through April and May government bond markets were mainly focused on the political stories of the moment, namely the French presidential election in Europe and increased scepticism of Trump's ability to deliver any significant fiscal reform in the US. The fear of a continuation of 'populism' in Europe initially brought a tone of caution to core European markets, but as the likelihood of a Macron victory increased and eventually came to fruition, yields gently began to rise. As political concerns fell away, macroeconomic data returned to the fore and the market did not fail to notice the disappointing US retail sales, manufacturing data and inflation figures. In contrast European economic data was relatively stronger, including an upside surprise in Italian GDP, strong PMI figures and solid business confidence figures in Germany.

Central banks continued to be a key driver of market behaviour. Antipodean bond markets performed well in April on a combination of mixed data and dovish tones from the Reserve Bank of Australia. In May the market interpreted ECB comments as dovish, while in the US the Federal Reserve mulled over the dynamics of running down its balance sheet. As expected, the Fed raised rates in June but surprised markets with the extent of the hawkish note that FOMC Members' subsequent speeches struck. Weak inflation was deemed transitory, despite negative year-on-year readings in each of the three months of the period. In what looked like a conspicuously concerted effort, the ECB, Bank of Canada and the Bank of England also moved into hawkish territory. Andy Haldane, the Bank of England's chief economist (and a noted dove) spoke of the withdrawal of emergency monetary policy, albeit with conditions.

The cumulative effect sparked a general sell-off in government bond markets which was primarily concentrated in shorter-dated bonds. Through all of this, the Bank of Japan left monetary policy unchanged. Japanese government bond yields, nevertheless, rose in sympathy with other bond markets but to a much lesser extent.

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 Mar 2017	1.14	2.39	0.33	0.07	1.65	2.31	6.90	1.00	3.95
Yield, end Jun 2017	1.26	2.30	0.47	0.09	1.52	2.15	5.36	0.90	3.01
Change in yield	+0.12	-0.09	+0.14	+0.02	-0.13	-0.16	-1.54	-0.10	-0.94

Source: Bloomberg.

Index Linked

Inflation markets overall performed poorly due to softer CPI data and a fall in commodity prices. The notable exception was a rally in New Zealand index-linked bonds following an upside surprise in their inflation report. The UK index-linked market rallied at first but sold off towards the end of the quarter in sympathy with broader rates markets. On poor CPI readings in the US, the US 10-year breakeven inflation rate trended down over the period ending at 1.72%, below the Fed's 2% target where it began at the end of March.

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Investment grade

After displaying a measure of caution in April, due mainly to the French election and little attractive new issuance, investment grade markets continued to see their spreads grind tighter over the remainder of the quarter. Once the French elections were out of the way, credit spreads pushed aggressively tighter and financials outperformed non-financials as a pro-risk backdrop prevailed. May witnessed a heavy month of corporate new issuance, particularly in the US. Despite this significant supply pipeline, credit spreads continued to compress, driven by the same themes that dominated previous months. These themes included the ongoing appetite for yield against a backdrop of central banks squeezing prices higher. Overall, credit markets benefited from a stronger tone as the appetite for financial credit and particularly subordinated paper remained strong.

High yield

Global high yield markets performed well, with European high yield taking the lead. The Barclays Pan European High Yield index returned 2.33% in euro terms, and the Barclays US Corporate High Yield index returned 2.17% in US dollar terms. High yield credits largely ignored the political and central bank events that tested government bonds. Throughout April higher quality credits led outperformance, however in May in the US we returned to the recent trend of CCC and distressed credits outperforming. Conversely in Europe the higher quality single B names outperformed lower quality issues. High yield within emerging markets was a notable area of underperformance following corruption scandals in Brazil. Overall the market ground tighter, with some weakness in the energy sector influenced by the oil price. As central bank policy looks set to tighten, stock selection will increasingly take the lead on driving market returns.

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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 June 2017.

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

S&P 500 – don't judge an index by its acronyms

There has been talk in the market recently about the S&P 500 index reaching new highs but with an increasing dependence on a handful of stocks, which happen to sit in the technology sector. These are more commonly referred to as FAANNMGs. Bankers love a good acronym and the somewhat clumsy FAANNMGs has, over time, come to represent the top stocks that are contributing the most to the S&P 500's returns. The stocks are Facebook, Amazon, Apple, Netflix, Nvidia, Microsoft and Google. For aesthetic purposes I suggest referring to Google by its parent company (Alphabet) and rearranging the names to create the more palatable NAFMAAN.

However we term it, creating a basket of stocks in such a way, and then attaching such importance to them, has led to a narrative where these stocks are seen as the only names lifting the index. With the market discussing where the S&P 500 is heading after such a strong run, this basket approach to examining performance is problematic and potentially misleading.

Just because the biggest stocks (by virtue of their size) contribute the most to the index that does not mean they have to contribute the most to an investor's portfolio. A 40-stock global portfolio can include smaller stocks that attract less flow for the bankers but can provide more absolute performance for a portfolio than anything within NAFMAAN. In a global context, whilst the seven horseman of the NAFMAAN are contributing 'all the return' of the index, there are 3993 other stocks that trade more than US$10m per day that we can invest in. Many of these stock have performed very well and they are not always technology companies.

For the S&P 500, this is not a tech-driven 1999

Tech as a percentage of the S&P 500 has increased in recent years, but it is way below the peak of 1999 and this time valuations are in a normal range supported by real profits.

We shouldn't, therefore, discount NAFMAAN completely; they are not in an over-valued bubble. Software – and in particular internet-based software platforms – are the most mean repellent business models we have ever come across. Strength begets strength, scale begets scale, and cash flow begets cash flow. Absolute capital deployment by NAFMAAN has become vast (communications infrastructure, data centres and physical distribution infrastructure) yet these are still capital light, high-returning businesses in relative terms. On a free cash flow basis, technology yields over 4%, which is slightly more expensive than consumer staples but for more growth.

It is possible of course for software giants to be disrupted by new technology, but doing so is very difficult. Microsoft, for example, is so strong due to its scale and embedded products.

The fallacy of circular logic

There is another narrative fallacy here: that of circular logic. If a bank creates a basket of stocks and trades them as one homogenous 'thing' (an ETF for example), it is obviously going to distort short-term valuations and create inefficiencies. Indeed, the least liquid stock within the basket will be distorted the most.

Right now, we're told that NAFMAAN is a consensus 'long'. It's a crowded trade due for a rotation into cyclical or value or some other banker created basket. Maybe so, but when we dissect the stock specifics and valuations of the NAFMANN 'basket' we see two or three that we like a lot, three that we don't and one which we can take or leave.

As an active manager, I am part of a team that picks stocks. We pick stocks from a universe of around 4000 stocks that trade more than US$10m per day. Regardless of market conditions, from the height of the 1999 tech bubble to the depth of the 2008/9 financial crisis, there have always been some stock prices going up and there have always been stock prices going down. Just because a few large stocks are driving the majority of index returns at any point in time, does not mean that they are the only thing that matter.

In the end, we don't really care what basket a stock is part of, what sector the MSCI says it is in or how much it contributes to the return of an index. We only care about what it contributes to our portfolio.

P.S - Tesla has gone up a lot recently and it's a big company now. Perhaps we should add that to the basket!?

Craig Bonthron
Investment manager, global equities.

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