

LOCAL PENSION COMMITTEE – 28th FEBRUARY 2020

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

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

Purpose of Report

- The purpose of this report is to present to the Committee, an update on the investment markets and how individual asset classes are performing, a summary valuation of the Fund's investments at 31st December 2019 (Appendix A), together with figures showing the performance of individual managers.

Market Outlook and Performance

- An update on asset classes and market performance is provided by LGPS Central's (Centrals) Tactical Asset Allocation report (Appendix B) whose 6 -18 month view is summarised below, arrows indicate movement in weighting since the last quarter.

	Significant Underweight	Underweight	Neutral	Overweight	Significant Overweight
Estimated Probability	80-70%	70-65%	55-45%	70-65%	70-80%
BROAD ASSET CLASS		Stabilising	Growth ▼	Income	
GROWTH ASSET CLASS	US Equities, Private Equity	GEM Equities		UK Equities, EU Equities Commodities, Asia Pac Equities	Japan Equities
INCOME ASSETS		Credit	Property, EM Debt ▲▼	Infrastructure	
STABILISING ASSETS	JP Bonds	Index-Linked, EU Bonds, IG Bonds ▼	UK Bonds ▲	Gold ▼	US Bonds ▲
INVESTMENT STYLES	Low Volatility ▼	Size ▲	Growth	Momentum, Value, Quality/ESG ▲	
CURRENCIES		US Dollar	Euro, Yen	GBP	

- In summary Central's view remains underweight in stabilising assets and overweight in income assets and has downgraded Growth assets from overweight to neutral. While Growth assets retain a positive sentiment, recent valuations look more expensive, hence the move to a neutral position. Stabilising assets have done well but Central's outlook remains cautious, noting that they can provide downside protection in times of recession. Central prefers exposure to income assets as an alternative as stabilising assets where yields and expected returns will combine with a low correlation to those riskier growth assets.
- An extract of Portfolio Evaluation's view on the market outlook is stated below. The full report is included within Appendix A

"Looking forward market commentators continue to expect lower global economic growth and corporate earnings growth with the Eurozone looking particularly vulnerable. Many investors seem to expect growth to continue into 2020 and potentially to 2021 as the outlook for a recession gets moved back due partly positive central bank actions

and benign inflation. However, many market commentators are discussing more defensive strategies going forwards (this would not have been not a successful relative strategy in 2019) although many are also viewing emerging markets positively and corporate bonds over government bonds. There are some risks in the returns that can be achieved, these include Trade Wars remain on going between the US, China and to some degree Europe, we are also in the position where central banks may not be able to continue lowering interest rates much more. We are also seeing increased political risk and it must be remembered that 2020 is an election year in the United States. In the UK despite Brexit going ahead there are significant risks as the UK seeks a trade deal with both Europe and the United States.”

Overall Investment Performance

5. A comprehensive performance analysis over the quarter, year and three-year period to 31st December 2019 is provided in Appendix A. Portfolio Evaluation collate information directly from managers and calculate performance, which will provide an independent check of valuations and allow greater reporting flexibility. Introduction of this reporting enhances the control and assurance for the Fund. Current performance reporting is limited to three years, however work is ongoing to provide longer history.
6. It is important to note that the valuations produced can be different to those provided by managers or included in the Statement of Accounts. For example, timing differences of use of different accounting methodologies. The differences are not expected to be material in the context of the messages being conveyed by the report.
7. For the period ending 31st December 2019 the Fund delivered an investment return of 1.5% for the quarter, 7.8% over the last 12 months and 7.0% annualised over the three year period.
8. The Fund’s total value as at 31 December 2019 is £4.6 billion.
9. The Fund’s asset allocation compared to the investment strategy at 31st December is shown in the table below:

	Weighting	Benchmark	Difference
Equities	51.5%	48.0%	3.5%
Real Income Fund	24.9%	26.5%	-1.6%
Alternatives	22.6%	25.5%	-2.9%
Cash	1.0%	0.0%	1.0%
	100.0%	100.0%	0.0%

10. The Fund’s actual allocation varies over time due to different market movements across the various asset types. However, the allocation remains broadly in-line with the strategy. At the end of the quarter, overweight positions in equities (+3.5%) are offset by underweight positions in real Income fund assets (-1.6%) and Alternatives (-2.9%). The largest underweight allocation within Alternatives started to be addressed with a £100 million commitment to private debt which was agreed at the October 2019 Investment Subcommittee. The Fund’s Equity allocations can be adjusted quickly via liquid passive holdings, but the underweight positions in property and infrastructure can take longer.

11. The only significant changes in the quarter were as follows:

- i. £100million commitment to private debt of which £55million was drawn down.
- ii. Divestment of £32million and £23million from the Ruffer and Pictet portfolio to provide liquidity for the private debt call and move closer to the targeted return strategic asset allocation target.

12. The following table provides the performance of the Fund and the asset classes over short and longer-term periods, compared to their respective benchmarks.

	3 Months %		1 Year %		3 Years %	
	Fund	Benchmark	Fund	Benchmark	Fund	Benchmark
Equities	4.8	3.5	22.3	21.3	10.2	10.0
Private Equity	2.2	1.5	12.7	22.3	11.5	10.4
Income	-2.2	-1.6	4.3	4.6	5.8	5.1
Alternative	-0.5	0.6	9.0	5.0	3.6	4.5
TOTAL FUND	1.5	1.3	13.2	12.8	7.0	6.8

13. The investment performance of the individual managers for the year to 31st December 2019 is set out in appendix A.

14. The remainder of this report covers certain asset classes in more detail. Equities, property and targeted return and inflation linked bonds are covered. The remaining asset classes will be covered in more detail at future committee meetings.

Equities

15. The Fund maintained a 46.6% allocation at the end of the quarter. This includes the allocation to LGPS Central sub funds which total 12.2% of the total fund value (£564 million). The bulk of the Fund's equity holdings is with Legal and General (LGIM) totalling £1.52 billion.

LGIM

16. The LGIM portfolio contains a number of passive funds covering the UK, all world and geographic specific funds. The total value of these funds is £1.52billion with a growth of 1.9% over the quarter. The LGIM portfolio performed in line with the index.

17. Some minor re balancing occurred in the period across the various funds with the most notable being a movement out of the North America Equity Index fund and into the UK Equity Index Fund. Over the year this portfolio of passive investments returned 20.4%, with a high of 26.5% return from North America and a low of 12.7% from Asia Pacific (excluding Japan). The 26.5% return from North America was driven by the returns from the technology sector which represents 22.7% of the North America Equity Fund and has Apple, Microsoft and Amazon as its top three holdings.

LGPS Central Active Global Equity

18. This fund had a valuation of £379million at quarter end having initially invested in March 2019. The performance since inception has lagged the target by 1.45% having returned 13.66%. The performance in the quarter was more favourable with a 2.3% return which was +0.8% vs benchmark and +0.4% vs target.
19. Central had appointed three managers for the mandate, Harris, Schrodgers and Union. Harris, predominantly a value biased manager gained 4.0% and outperformed its benchmark by 2.5%. This outperformance was derived from a number of sources with banks being a major positive. BNP Paribas (a French international banking group) was the leading contributor (+53bp) as it produced revenue and earnings that exceeded market forecasts resulting in a 13% share price increase over the quarter. On the downside the biggest impact was from Apple, which Harris do not hold.
20. Schrodgers also outperformed the benchmark in the December quarter (2.27% vs. 1.53%), with the outperformance coming from a large number of relatively small positives. Schrodgers are currently wary of market levels, and particularly what they see as 2020 profits growth expectations in the US that seem to be contrary to expectations of economic growth. While their style is to run quite a diversified portfolio, they currently hold more stocks and have lower active positions than they would consider to be normal.
21. The third manager Union, produced another poor quarter of performance with their return of 0.49%, net of costs, being 1.04% below the benchmark. Union's investment process is based on identifying stocks that are valued at below their view of fair value, waiting for 'data points' to validate their investment thesis and then buying the stock. In recent months there have been a number of stocks held by Union that have disappointed – often the original positive signs have proven something of a “false dawn” – and this has been negative to performance.
22. Their investment process leads to current meaningful overweight positions in technology, basic materials and healthcare. The most material underweights, at around 3% relative to the benchmark, are in financials and telecoms. Geographically the portfolio is 10% under-weight in Asia-Pacific (including Japan), with overweight positions in North America and Europe.
23. Union's level of Active Share (how different their portfolio is to the benchmark) remains high at about 86%, and the tracking error of around 3% is appropriate for the performance objective for the portfolio. Union do not target specific levels of risk within their investment process but are aware of the risks that they have within the portfolio and will take mitigating action if they move too far away from what they consider to be necessary to achieve the performance objective.

LGPS Central Emerging Markets Active Equity

24. This fund had a valuation of £186million at quarter end having initially invested in July 2019. The performance since inception has lagged the target by 1.3% having returned +0.25%. The performance in the quarter was with a +3.6% return which was -0.4% vs benchmark and -0.9% vs target.
25. Central employ three managers, BMO, UBS and Vontobel. BMO significantly underperformed the benchmark return of +4.01%, with a return of +1.54%. They

underperformed in all three months, but the majority of the underperformance came in December, when the market produced a strong rebound from a lacklustre period and returned 4.47% over the month. During December alone BMO's underperformance was 1.85%.

26. The portfolio is concentrated with about 40 companies so at times performance will be divergent to the index. The portfolio is built from a company-specific (bottom-up), benchmark agnostic perspective in line with the investment manager's investment philosophy and process of investing in cash generative, high quality companies with strong and sustainable franchises that produce an in-built advantage to growth. On a country basis, the largest exposures are to China and India where combined they account for approximately 40% of the portfolio. Relative to the index, the portfolio is underweight China and overweight India.
27. UBS outperformed the benchmark by 1.58% (net of costs), with a performance of 5.59% against the benchmark of 4.01% during the quarter. The portfolio held a number of companies whose share price rose by over 25% including Chinese educational services provider TAL Education (positive impact of 50bp on performance), property company China Jinmao (+27bp) and Brazilian post-secondary education provider Yduqs (+13bp). An overweight position in index heavyweight Taiwan Semiconductor was the highest positive contributor to performance.
28. The portfolio is heavily overweight in Technology, primarily because the manager can find many companies with competitive advantage, inexpensive valuations and high potential levels of growth. They continue to find very few opportunities within industrials and basic materials and are consequently underweight by a meaningful amount in these two sectors.
29. Vontobel is the funds third manager, who produced a performance of +3.81% over the quarter, net of costs, which was 20bp behind the index.
30. There was a major positive impact of 54bp from the overweight position in Brazilian education provider Yduqs, who announced higher-than-expected medium term growth targets that were received favourably by the market. At the end of the quarter the Vontobel portfolio consisted of 42 companies. The largest sector over weights versus benchmark are financials, consumer goods and technology, although at around 3 – 3 ½% these positions are not substantial.
31. Overall this funds quarterly underperformance came primarily as a result of the fact that the significant outperformance of UBS (+158bp) was more-than-offset by the poor performance of BMO (-247bp).
32. Underperformance since inception in the middle of July 2019 to the end of December is 43bp (+0.25% vs. +0.68%), and again meaningful out-performance by UBS has been overshadowed by significant BMO underperformance and relatively minor underperformance by Vontobel. The focused nature of all three portfolios means that there are likely to be periods of meaningful divergence from the benchmark for all of them, both from a negative and positive perspective. The relatively low level of stock overlap continues, which shows that the managers have different methods of assessing the attractiveness of stocks and structuring their portfolios accordingly.

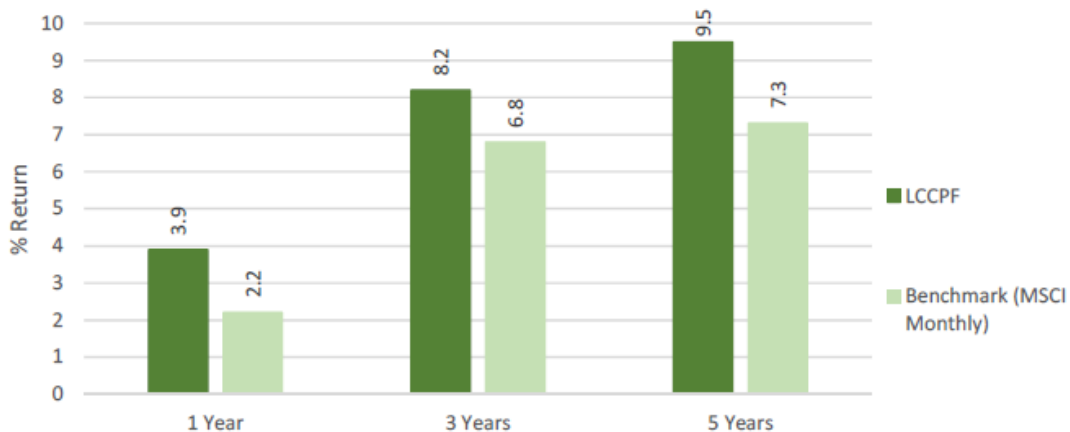
Property

33. The actual Property allocation is 8.9% and is -1.1% to target covering direct and indirect holdings. The target return of this portfolio is to achieve benchmark + 1% net fees.
34. In the commercial property investment market, the level of total returns has continued to reduce since the last quarter as the rate of capital value growth continues to slow in the industrial and office sectors, and capital values fall in the retail sector.
35. The industrial sector was the strongest performing market over the year, led by London and south-east industrials, followed by the provincial office market, the alternative sector, the other office markets, and then the retail sector. The strongest capital growth was again in the London and south-east industrial sector, followed by south-east and provincial offices. Capital value growth was negative in all the retail sectors.

Colliers direct and indirect portfolio

36. The Colliers portfolio has performed in line with its objective having beaten its benchmark by the required amount over all timeframes. At the quarter end it was valued at £130 million.
37. The Colliers portfolio has performed well with income making up about two thirds of the total return over all timeframes. The portfolio at the valuation date yields 5.6%. The Fund has benefited from having a low void rate which across the portfolio is 4.7% as a percentage of rental income. The largest unit will soon be let and the void rate will then fall to 1.7%.

Colliers Total Return as of 31st December 2019

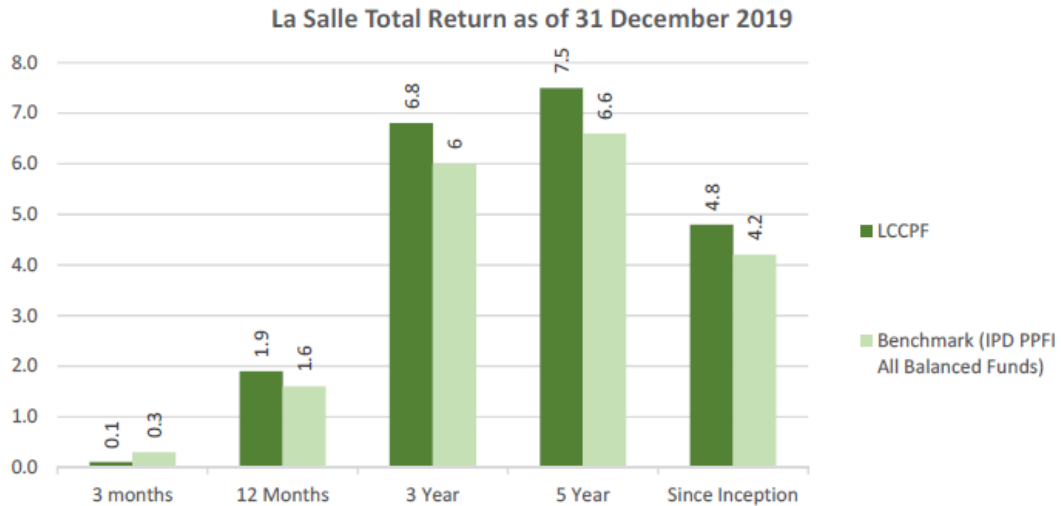


38. Over the quarter, the Fund, on advice from Colliers and Central served a redemption notice on the Greenoak WELPUT trust to redeem its holding in the Central London office fund. The redemption value at 31st December was £8million or 6% of our total holding with Colliers.

LaSalle portfolio

39. This portfolio is valued at £206million at 31st December 2019. Although having beaten benchmark over one, three and five years the portfolio hasn't achieved the target return of +1% over benchmark. This holding combines 18 open and closed

ended funds and is invested primarily in Europe having exposure to many sectors. Given the European nature of this holding the managers employ currency hedging.



40. There was minor activity in the quarter with two distributions and one capital call in the period. The strongest performing funds over the quarter were the specialist funds investing in industrial markers and the two debt funds in the portfolio. As expected the weakest performers were the specialist retail which continue to see decline in value due to the overall weakness of the UK retail sector.

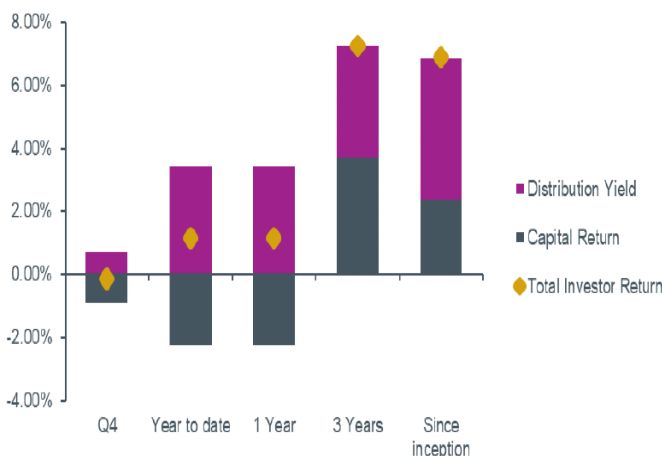
41. LaSalle’s stated future strategy is to up weight to the alternatives sector to position the portfolio more defensively and down weight the retail sector exposure which is currently under benchmark.

42. At the valuation date there was a 4.8% vacancy rate and a further 2.2% under development which is favourable versus benchmark.

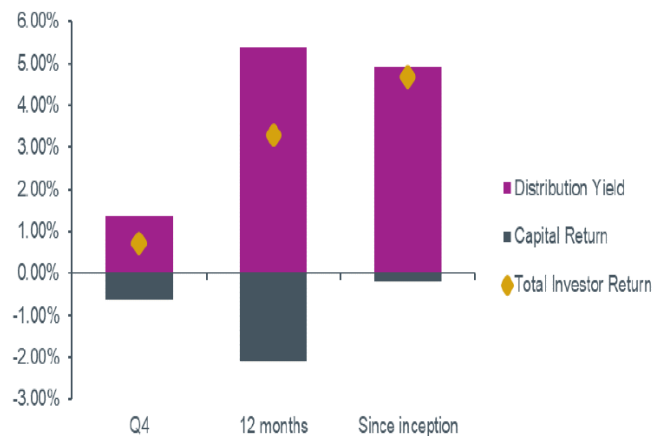
Kames portfolio

43. The fund has two holdings with Kames with a combined value of £72million. Kames I is valued at £25million and Kames II at £47million.

Kames UK active Value Trust I



Kames UK active value trust II



44. Kames I is now outside its investment period and as such is now actively managing the portfolio and selling properties.

45. Kames I saw a slightly negative return over the quarter at -0.15% vs a benchmark return of +0.3%. This is primarily due to the current high void percentage and capital value decline which was not offset by income. Over 12 months the fund produced a return of +1.2% vs benchmark of +1.6%. Kames I has identified the assets for sale which will allow them to maintain assets with the correct income profile.
46. Kames I completed two sales in the quarter. A site in Leighton Buzzard purchased by the fund in 2014 for £3.16million has exchanged with Industrials UK for £7.2million with completion due 31/01/20. The manager obtained a full planning consent for an Industrial redevelopment scheme during the funds ownership.
47. The Kames II fund is fully invested. No new purchases were completed in Q4 2019. Kames II saw a better performance over the quarter delivering 0.7% vs benchmark of 0.3% and 3.3% over 12 months which is +0.8% vs benchmark. This fund has been supported by having a lower exposure to the 'High street' and absence of Department stores and shopping centre assets. Only 12% of the funds is invested in the retail sector. It is also worth noting that the Fund has retained very high occupancy levels and has not suffered from any tenant defaults across the retail sector over the quarter, and very few over the life of the Fund thus far.
48. Kames II sold one site in the period for £5.1million to Bellway homes for redevelopment to residential. The value achieved was £0.5million higher than the last valuation, the proceeds will be used to reinvest in refurbishment and redevelopment projects in line with the funds investment policy.

Targeted Return

49. The Fund currently employs three managers Aspect Capital, Ruffer and Pictet the total value of the Fund's holdings is £481million at December 2019. The three managers offer the Fund access the markets and strategies that other areas of the portfolio do not. The target return is 1-month libor + 4% per annum over a rolling three year period.
50. Over the quarter, general equity performance was positive, with the FTSE All-World index producing a +1.5% (in sterling terms).
51. The individual performances by manager are show in the table below:

	Qtr	1 year	3 year pa
Aspect	-2.1%	+20.9%	+2.5%
Pictet	+0.8%	+8.4%	+2.4%
Ruffer	+0.7%	+9.6%	+2.7%

52. The table below shows the performance of the Fund's targeted return portfolio versus the performance objective:

Period	LCC Targeted Return Fund (net)	Performance Objective
3 months	-0.1%	+1.2%
12 months	+11.7%	+4.7%
3 years*	+2.4%	+4.6%
5 years*	+3.6%	+4.6%

*3 and 5 year numbers are annualised

53. The combined assets of the targeted return portfolio produced a return of -0.1% over the quarter on a net-of-costs basis. In the nine months to the end of December, the return has been well ahead of the performance objective (6.9% vs. 3.5%), as it has for the 2019 calendar year. Longer term performance numbers are influenced by the weak returns of 2018 when both equity and bond markets both produced negative returns and also the modest return of 2017.

Pictet

54. Of the three managers Pictet was the best performing with +0.8% net performance. The major positive impacts came from foreign exchange positioning, including hedging most overseas currency exposure back to sterling. Equity and credit positions also added value, while the fall in the gold price was modestly negative and exposure to Australian and US government bonds was a significant drag on performance.

Ruffer

55. Ruffer also had a positive performance over the quarter with a +0.6% net return. The 'greed' holdings, primarily equities produced strong returns over the quarter with the combination of geographical and sector positioning leading to the broadly 40% equity exposure punching well above its weight in terms of contribution to return. The 'fear' holdings were detrimental to performance, with UK index-linked holdings being the major source of underperformance. During the quarter a combination of falling nominal bond yields, low inflation, markets adjusting to lower levels of future inflation linkage and the very long maturity of many of the index-linked bonds held by Ruffer proved costly, the longest dated UK index-linked bond (maturing in 2062) fell by 13% and the impact of Ruffer's index-linked bond holdings was to reduce portfolio performance by 2% over the quarter.

Aspect

56. The momentum based strategy performed poorly over the quarter, with a return of -2.3%. At the beginning of the quarter the portfolio had a high exposure to bonds and suffered as a result of rising global bond yields. Although the model adjusted position-sizing relatively quickly, this did not stop bonds having a highly negative impact during the quarter. This strategy will always struggle in environments when there are few trends or when trends reverse quite sharply, as was the case with bond yields. The Aspect strategy targets a level of volatility that is broadly in-line with long-term equity market volatility, so returns are always likely to be meaningfully different to the other two targeted return managers. They do, however, provide significant diversification and access to an investment strategy (momentum) that is not included elsewhere within the Fund. They are able to capitalise in market downturns by being 'short' the markets they trade in.

Inflation linked Bonds

Kames

57. The fund has a £329 million investment with Kames to invest in a global portfolio of index-linked bonds. The default position is to hold index-linked rather than fixed rate bonds

58. The Fund has a 7% allocation to indexed linked bonds via Kames. The quarter produced disappointing returns of -8.5% vs a benchmark of -8.5% also. The one year return 6.3% also produced returns in line with the benchmark of 6.4%. 3 year returns were 2.9% pa against a benchmark of 2.8%.
59. The last quarter of the year saw a sell-off in UK Index-linked government. This all came through in October when it became apparent that the UK has managed to avoid “no-deal” Brexit. This led to a sell-off in risk-free assets and index-linked as it has the relationship with the currency.

Recommendation

60. The Local Pension Committee is asked to note the report

Appendices

Appendix A - Portfolio Evaluation - Summary Valuation of Funds Performance.

Appendix B - Report of LGPS Central Limited – Strategic Asset Allocation (Market outlook and Performance).

Equality and Human Rights Implications

None.

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