# Pensions CIV Sectoral Joint Committee

Item no: 5

## Investment Report and Fund Update

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| **Report by:** | Julian Pendock | **Job title:** | Chief Investment Officer |
| **Date:** | Date 18th October 2016 | | |
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**Summary:** This report provides the Joint Committee with an update on the economic and investment background and outlook, a fund updated including performance of the London CIV sub-funds and voting and engagement activities

**Recommendations:** The committee is recommended to:

i. Note the contents of this report;

# Investment Report and Fund Update

**Investment Report, covering 1st January 2016 to 30th September 2016**

1. Apart from Brexit, the performance of markets during the period was largely driven by Central Banks (CBs), although in recent months, there has been some more encouraging data out of the US. In terms of equity markets (in local currency terms, with Bloomberg as the data source), in the US, the Dow and S&P rose by 5.22% and 5.92% respectively (year to date), whilst the NASDAQ rose 6.45%. Closer to home, the FTSE 100 rose by 13.65% whilst in Germany the DAX fell by 1.11% and in France the CAC fell by 3.01%. In Japan, the Nikkei 225 index fell by 11.42%, on the back of continued fears over the economy, allied to perceived policy missteps by the Bank of Japan (BoJ).
2. In the UK, the news was dominated by the Brexit vote. The surprise outcome of the referendum hastened the decline in 10-year gilt yields, declining to a low of 0.52% in August, before rebounding in recent weeks. This move to record low yields is a source of deep concern for pension funds globally, and will have profound investment implications. The Brexit vote triggered a fall in the value of sterling against the USD, which helped to cushion the FTSE 100, as the value of overseas earnings in the constituent companies rose in GBP terms. The index reached rallied to a record high of 6,941 in August. The drop in GBP gained headlines but many economists have argued that the currency is overvalued, and a weaker exchange rate is one way of addressing the 7% current account deficit. For now, Brexit appears to have been the catalyst, rather than the cause, of asset price movements, but this could change.
3. Fears over China's underlying economic health led to a sharp and prolonged period of market volatility at the start of 2016. China's central bank, the People's Bank of China (PBOC) had cut rates six times since 4Q 2014, but this had not been enough to prevent growth from slowing. The fears over China's economy had global spill over effects, with commodity prices bearing the brunt of the impact, with far-reaching implications not just for commodity companies, but for oil-producing countries, notably the Middle East and Brazil. During the period, the price for Brent crude oil fell to below US$33 in January before rebounding towards US$50 per barrel at September end.
4. Beijing's aggressive stimulus measures were estimated at some US$ 1 trillion, exceeding measures taken at the depth of the financial crisis. The hope is that these measures will buy time in order to carry out reforms. Whilst the economy has stabilised in recent months, it is likely that the issues will reappear as they are structural in nature, much like the deep-seated problems in the Eurozone. However for the moment, global markets (including commodities) are enjoying the positive side-effects of the monetary morphine. The "old" economy remains structurally mired in surplus capacity, and the banks' balance sheets remain a cause for concern for some bodies such as the IMF. For now however there has been a rebound in profitability from a low base. Surplus liquidity is fuelling speculation in some housing markets.
5. Beijing was not alone in acting; coordinated CB actions once again saved the day, and global markets bottomed out in early February. The ECB's Mario Draghi entered the fray in mid-March, with a raft of measures which included more QE and more controversially, buying corporate bonds. The ECB therefore is following the path of the Bank of Japan (BoJ), but has not followed the BoJ's unfortunate flirtation with NIRP (Negative Interest

Rate Policy). The combined effect of these policies has been seen most keenly in fixed income markets. There is now approximately US$ 11 trillion of bonds globally which have a negative yield. Last month, two Eurozone corporate bonds were issued with a negative yield, marking a new milestone in the downward march of yields.

6. The combination of CB stimulus and uncertainty has led to the disquieting outcome of equities (traditionally viewed as a risk and growth asset) at all-time highs in the US, whilst sovereign bond prices are, in many countries, near record highs, something which would normally result from a "risk-off" environment.

7. The fundamentals of the global economy remain fragile. Corporate earnings have been very mixed. In the US, economic data provided ammunition for bulls and bears alike, with indicators such as job creation painting a rosy picture until one considers that the labour participation rate has dropped, and the fact that many of the new jobs created are low-paying and part-time. Inflation is at last picking up, but much of this has been fuelled by the increase in costs, such as healthcare. Globally, the feeling of economic insecurity is feeding into political populism.

8. Corporates have to navigate a shifting economic landscape, where the price of risk and capital has been distorted by the CBs. This has given rise to fears that malinvestments may abound. Further, the disruptive power of new technology is making itself felt as old certainties no longer apply, leading to a scarcity in sustainable profit growth (apart from in the US markets, where share buybacks have been a key driver in profit growth and corporate debt issuance). Companies which can show pricing power and growth command lofty prices and are therefore vulnerable to a change in sentiment and/or outlook. Nonetheless, industry disruptors and innovators will probably continue to be handsomely rewarded.

9. Emerging markets (EM) have for the most part stabilised, and have moved from being in an acute condition to a chronic one. A key driver of the improvement in fortunes was the stabilisation in the USD, as measured in the USD trade-weighted index (TWI). Typically the USD and commodity prices move in opposite directions. The USD rally led to problems in EM where corporates had issued debt in USD. The currency mismatch led to a scramble to pay down debt, forcing local currencies and assets lower, and the USD higher. As these forces have abated, investors are turning once again to EM debt as a higher-yielding alternative to developed market debt, and taking solace from the fact that apart from China, most EM have retained financially orthodox policies and could therefore ultimately enjoy a more sound financial position than many developed countries.

10. Overall, asset markets globally have been driven by CB policies, whether first-round effects seen in the prices of sovereign bonds, or in the prices of asset classes driven by the ubiquitous search for yield. Within equities, this is seen in the prices of "bond proxies" such as utilities and consumer stalwarts. Asset classes such as infrastructure have seen vertiginous price rises as investors bid aggressively for long-term, predictable cashflows. All told, many asset classes are being driven ever-higher, whilst the global economy remains fragile and dependent on stimulus, leading to fears that the current period of calm will not endure.

11. There has been increasing talk of a new CB policy framework, as the limits of monetary policy are reached, and in the absence of any self-sustaining economic recovery. This

policy framework would involve injecting money directly into the economy without incurring a liability, and is popularly known as “helicopter money”. Such policies could have inflationary consequences, and have a negative impact on long-dated bonds, bond proxies and any long-dated cashflow-generating assets which do not have an in-built hedge. The investment environment is likely to remain challenging, and access to suitable investments will therefore involve greater cost and complexity than in the past, as many traditional “vanilla” asset classes are rendered unsuitable for pension funds.

**Fund Update**

12. Details of London CIV’s five sub-funds, including performance since inception, are given below:

**Global Equity Sub-funds**

I. **London LGPS CIV Global Equity Alpha Fund**

*Investment Manager:*

Allianz Global Investors GMBH

*Investment Objective:*

The Sub-fund aims to achieve capital growth by outperforming the MSCI World Index Total Return (Net) GBP by 2% p.a. net of fees.

*Investment Policy:*

The ACS Manager intends to achieve the objective by delegating portfolio management to Allianz who will be investing principally in equity securities of global companies selected from a cross section of both geographical areas and economic sectors.

The Sub-fund may participate in initial public offerings on any basis and private placements of securities in publically traded companies and issuers.

Net Asset Value: as at 30 June 2016 - **£559.84m.**

Number of Investors: 3

*Performance:*

| **Returns to 30 June 2016** | **SINCE INCEPTION*** |
|---|---|
| Sub-fund | 8.65% |
| Benchmark – MSCI World Index Net GBP | 10.41% |
| Relative Performance | -1.76% |

** Inception Date 2 December 2015*

*Portfolio returns net of fees*

**II. London LGPS CIV Global Alpha Growth Fund**

*Investment Manager:*

Baillie Gifford & Co

*Investment Objective:*

The objective of the Sub-fund is to exceed the rate of return of the MSCI All Country World Index (the “Index”) by 2-3% per annum on a gross fee basis over rolling five year periods.

*Investment Policy:*

The ACS Manager intends to achieve the objective delegating portfolio management to Baillie Gifford who will be investing the portfolio primarily in global equities and equity-like instruments including convertible securities, preference shares, warrants, rights, exchange traded funds and depositary receipts.

The Sub-fund may also invest in cash and near cash, deposits, money-market instruments and other collective investment schemes. The Sub-fund will ordinarily not hold a cash balance greater than 15% of the Sub-fund.

The Sub-fund may participate in initial public offerings on any basis and private placements of securities in publically traded companies and issuers.

Net Asset Value: as at 30 June 2016 - **£976.80m.**

Number of Investors: 6

*Performance:*

| **Returns to 30 June 2016** | **SINCE INCEPTION***|
|---|---|
| Sub-fund (gross) | 6.10% |
| Benchmark – MSCI All Countries World Index | 7.75% |
| Relative Performance | -1.65% |

** Inception Date 11 April 2016*

*Portfolio return gross of fees*

## Multi-asset sub-funds:

### I. London LGPS CIV Diversified Growth Fund

*Investment Manager:*

Baillie Gifford & Co

*Investment Objective:*

The Sub-fund's objective is to achieve long term capital growth at lower risk than equity markets.

*Investment Policy:*

The ACS Manager aims to achieve the objective by investing solely in the Baillie Gifford Diversified Growth Fund, a Sub-fund of Baillie Gifford Investment Funds ICVC, an FCA authorised open-ended investment company and cash and near cash.

The investment objective of the Baillie Gifford Diversified Growth Fund is set out below:

*Investment Objective:*

The objective is to achieve long term capital growth at lower risk than equity markets by investing in a diversified portfolio of assets. It may gain exposure to a broad range of traditional and alternative asset classes which may include but is not limited to equities, investment grade and high yield bonds, property, private equity, infrastructure, commodities and currencies.

In order to gain exposure to these asset classes the Sub-fund may invest in transferable securities, money market instruments, collective investment schemes, derivatives and deposits.

Up to 100% of the Baillie Gifford Diversified Growth Fund may be invested in other collective investment vehicles and the Sub-fund may use derivatives for both investment purposes and in the management of risk.

Net Asset Value: as at 30 June 2016 - **£324.31m.**

Number of Investors: 5

*Performance:*

| **Returns to 30 June 2016** | **SINCE INCEPTION*** |
|---|---|
| Sub-fund | 4.50% |

** Inception Date 15 February 2016*

*Portfolio returns net of fees*

## II. LCIV PY Global Total Return Fund

*Investment Manager:*

Pyrford International Limited

*Investment Objective:*

The Sub-fund's objective is to provide a stable stream of real total returns over the long term with low absolute volatility and significant downside protection. Capital invested in the Sub-fund is at risk and there is no guarantee that total returns will be delivered over any period.

*Investment Policy:*

The ACS Manager aims to achieve the objective by investing solely in the Pyrford Global Total Return (Sterling) Fund, a Sub-fund of BMO Investments (Ireland) plc, an authorised open-ended investment company authorised by the Central Bank of Ireland as a UCITS, and cash and near cash.

The investment objective and policy of the Pyrford Global Total Return (Sterling) Fund is set out below:

*Investment Objective:*

To provide a stable stream of real total returns over the long term with low absolute volatility and significant downside protection

The Pyrford Global Total Return Fund will seek to achieve its investment objective and will focus on capital preservation to achieve real total returns. By investing in asset classes and securities which offer sound fundamental value and avoiding asset classes and securities which offer poor fundamental value, the Pyrford Global Total Return Fund will seek to achieve real total returns.

A key factor in generating real total returns is utilising an investment approach designed to avoid negative returns when markets fall through both strategic asset allocation between equities, sovereign Debt Securities and cash and investment selection on a global basis.

Investment decisions will be determined through fundamental analysis on the basis of the long-term value offered by equities, sovereign Debt Securities and cash.

The Pyrford Global Total Return Fund will seek to achieve significant downside protection by avoiding equities which are perceived to be high risk on the basis of established fundamental value metrics (such as dividend yields, return on equity and P/E ratios).

Net Asset Value: as at 30 June 2016 - **£194.13m.**

Number of Investors: 3

*Performance:*

| Returns to 30 June 2016 | SINCE INCEPTION* |
|---|---|
| Sub-fund | 3.50% |

** Inception Date 17 June 2016*

*Portfolio returns net of fees*

**III. LCIV RF Absolute Return Fund**

*Investment Manager:*

Ruffer LLP

*Investment Objective:*

The Sub-fund's objective is to achieve low volatility and positive returns in all market conditions. Capital invested in the Sub-fund is at risk and there is no guarantee that a positive return will be delivered over any one or a number of twelve-month periods.

*Investment Policy:*

The ACS Manager aims to achieve the objective by investing solely in the CF Ruffer Absolute Return Fund, a Sub-fund of Asperior Investment Funds, an FCA authorised open-ended investment company, and cash and near cash.

The investment objective of the Ruffer Absolute Return Fund is set out below:

*Investment Objective:*

To achieve low volatility and positive returns in all market conditions from an actively managed portfolio of equities or equity related securities (including convertibles), corporate and government bonds and currencies.

The Ruffer Absolute Return Fund may also invest in collective investment schemes, cash, money market instruments and derivatives and forward transactions.

Pervading this objective is a fundamental philosophy of capital preservation. In selecting investments the Ruffer Absolute Return Fund will adopt a stock picking approach and will not adopt any investment weightings by reference to any benchmark.

Net Asset Value: as at 30 June 2016 - **£309.08m.**

Number of Investors: 4

*Performance:*

| Returns to 30 June 2016 | SINCE INCEPTION* |
|---|---|
| Sub-fund | 2.68% |

** Inception Date 21 June 2016*
*Portfolio returns net of fees*

13. The London CIV is also currently working with a number of managers on a programme to open a number of further sub-funds based on the CQC criteria. Terms have been agreed with Newton Real Return Fund which will see a sub-fund opened scheduled for December 2016 with 3 Pension Funds seeing savings being delivered from the current mandates.

14. Further work is ongoing with a UK Equity Manager and 2 Global Equity Managers which if successful should be open as sub-funds in the first quarter of next year.

## Voting and Engagement

15. Since the date of the last Joint Committee meeting there has been one LAPFF voting alert covering the Sports Direct AGM. This was not a company held within the portfolios on the London CIV. Whilst the CIV is not responsible for passive funds held by Legal and General, Members will be aware of the negotiations which LCIV has effected resulted in London Funds being offered lower fees, albeit outside of the CIV structure. The Government has said that Life Funds can remain outside pools for the time being, but that “management and reporting regarding these life funds is done within the pool”, without providing guidance as to what this entails. Whilst the CIV is still reviewing with the IAC what this means in practice, LGIM are working with the CIV to monitor LAPFF voting alerts and confirmed that they voted in accordance with the alert and for the shareholder resolution.
16. One of the recommendations from the Stewardship and Voting paper presented at the Joint Committee meeting in June was the establishment of a Member working group on Stewardship. The working group met on 22nd July 2016 to discuss terms of reference for the working group, voting policy, approach to the Stewardship Code and consideration of a dedicated seminar to cover responsible investment and stewardship. The minutes of the meeting are attached as an appendix to this report, but the key decision on voting was to maintain the existing policy to use LAPFF Voting Alerts.
17. As noted in the IAC update report, there is also an officer ESG Sub-Group and this has met to look more broadly at the CIV approach to responsible investment, engagement and voting. The sub-group is working closely with officers of the CIV to consider the Stewardship Code and also the new Investment Strategy Statements requirements on voting and engagement for individual Pension Funds. Further updates will be provided to this Committee within the IAC update papers on the work of this sub-group.
18. The CIV as a fund manager is required to issue a statement in respect of the Stewardship Code on a comply or explain basis and it had been hoped to bring a draft statement to this Committee for consideration. However, time constraints and the need to better understand the new categorisations issued by the FRC (Financial Reporting Council), has meant that officers have not been able to draft a statement at this time. Following a round table meeting with the FRC, it has become clear that there are now 3 categories of statement for fund managers rather than the 2 which apply to asset owners. CIV officers will be meeting with the FRC in the near future to consider the implications of this for the CIV and an update on progress will be provided to a future meeting of the Joint Committee.

## Recommendations

19. The Committee is recommended to note the contents of this report

## Financial Implications

20. There are no financial implications for London Councils.

## Legal implications

21. There are no legal implications for London Councils.

## Equalities implications

22. There are no equalities implications for London Councils.

## Appendix

Minutes of the Member led Stewardship Working Group

APPENDIX

# PENSIONS SECTORAL JOINT COMMITTEE – LONDON CIV

## Stewardship Working Group

## 22nd July 2016 – Minutes

**Attendees:**

| **Borough** | **Representative** |
|---|---|
| Ealing | Cllr Yvonne Johnson (YJ) |
| Enfield | Cllr Toby Simon (TS) |
| Islington | Cllr Richard Greening (RG) |
| Richmond | Cllr Thomas O'Malley (TOM) |
| Wandsworth | Cllr Maurice Heaster (MH) |
| | |
| **London CIV** | |
| Chief Executive | Hugh Grover (HG) |
| AD, Client Management | Jill Davys (JD) |

| Agenda Item Number | Agenda Item | Actions |
|---|---|---|
| 1. | **Apologies:**<br>Cllr Robert Chapman (Hackney) | |
| 2. | **Appointment of Chair and Vice Chair**<br>Unanimously Agreed:<br>Cllr Yvonne Johnson – Chair<br>Cllr Maurice Heaster – Vice Chair | |
| 3. | **Stewardship Working Group Terms of Reference**<br>The draft terms of reference were agreed by the Stewardship Working Group. | |
| 3. | **Voting Policy**<br>Cllrs Richard Greening and Toby Simon declared an interest in this agenda item as members of the LAPFF Executive Group.<br><br>The Working Group considered the options proposed for the voting policy of the London CIV, noting that the current policy agreed by the Pensions Sectoral Joint Committee (May 2015) was to vote in accordance with the LAPFF voting alert.<br><br>Discussion took place around the need to be flexible and to what extent consensus opinion was achievable across all the London Authorities. RG commented on the need to recognise that not all London Funds were signed up to LAPFF and RG would like to achieve a consensus approach. Inevitably there will be individual issues that might difficult to agree on.<br><br>The option of appointing an individual voting provider to the CIV was discussed, but it was recognised that this would lead to additional costs. MH noted that the purpose of the CIV is to | Agreed to maintain approach of LAPFF voting alerts for London CIV<br><br>London CIV Officers to manage and monitor voting alerts to ensure fund managers receive and action accordingly where feasible to do so |

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| | drive out costs not add to them with additional overlays.<br><br>If voting delegations are given to mangers, we need to find reason why they have taken particular decisions where they have not voted in accordance with LAPFF. Where Fund Managers are not able to adopt LAPFF voting alerts it would be better to use a comply or explain approach in order to understand why. MH favoured continuing with the LAPFF route<br><br>TS pointed out that in some instances managers will cancel out the CIV's votes by voting differently.<br><br>Will look at extra costs, e.g. to have a separate voting agent, but would be offset.<br><br>YJ proposed that the CIV copes with alerts from LAPFF for the time being. RG noted that this has been seen as a reasonable compromise over the past year, particularly as LAPFF is a cross party organisation. TOM proposed that we do follow through the use of voting alerts from LAPFF. CIV to ensure these are managed and monitored. Position to be reviewed in a year or so. | |
| 4. | **Stewardship Code**<br>The Working Group reviewed the Stewardship Code and the compliance statements provided which covered London Funds and the managers currently in place on the CIV platform. TOM has responsibility for this area in his employment and commented that the FRC (Financial Reporting Council) was raising the bar by bringing in a 2 tier system for assessing Compliance Statements. TOM felt that the London CIV should adopt a pragmatic route at this time to compliance and target a Level 2 Compliance Statement. It was also noted that the FCA require Fund Managers to make a statement in relation to the Code on a comply or explain basis.<br><br>Agreed that London CIV officers would prepare a Compliance Statement for consideration at the PSJC | London CIV officers agreed to draft a Compliance Statement that would target a Level 2 Statement |
| 5. | **Responsible Investment / Stewardship Seminar**<br>The Working Group questioned whether there was likely to be sufficient appetite for a dedicated seminar on this area. RG commented that it would be worthwhile discussing the types of issues that might be covered with companies and in particular issues raised by LAPFF, e.g. climate change and member representation on Boards – these issues are important and also reflect words of new Prime Minister. TS would be in favour of a seminar particularly where there might be interest in new funds e.g. low carbon as it would provide the opportunity to have a considered debate. The seminar should be open to Committee Members, borough officers, London CIV Board Members and Pension Board members. HG suggested that the seminar would be a useful | LCIV Officers to arrange a dedicated RI/Stewardship Seminar, timing to be agreed but probably January 2017 |

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| | sounding board to understand where clients are.<br><br>It was proposed that a meeting date in early 2017 be set.<br><br>TS commented that it would be good for the group to reflect on any outcomes from the seminar event at its next meeting. | |
| 6. | **Dates of Future Meetings**<br>It was agreed that the Working Group was a useful forum to consider issues of stewardship and responsible investment and that it should continue to meet. It was agreed that twice a year would be best initially. Dates to be agreed but provisionally in late February and October. | LCIV Officers to propose dates for future meetings |
| 7. | **A.O.B**<br>RG felt it would be good to offer opportunities where there are a range of managers rather than just generic asset classes, such as global equity e.g. low carbon manager. JD confirmed that the global equity search will include ESG managers and that where appropriate these will be included on the LCIV platform. How far can LCIV go in offering choice without impacting on cost? Clearly adding too much choice will impact on the costs and won't deliver economies of scale benefits.<br><br>RG also raised the question - do we envisage LCIV being able to sack a manager, HG confirmed that LCIV would remove managers when funds no longer wanted to invest. Also RG noted that in general larger funds have ability to switch more easily.<br><br>TS raised the question of passive managers as to where LCIV is with them. HG said there had been a number of challenges, but more recently the CIV with the LGIM passive these had come down to 2 final challenges. Because of wider pooling agenda, LGIM want to continue with life fund model and despite withholding tax benefits it wasn't clear the LCIV could deliver best value continuing with the ACS path with LGIM. Further the Government had also exempted life funds as part of the pooling process, at least initially. Another issue causing a major problem was rebalancing – everything happening under the bonnet of the life fund making rebalancing appear costless and transition free. Under the ACS model, it would also mean that funds were out of market for a period. One last option LCIV was looking at in connection with rebalancing, but almost certain to continue with life funds for LGIM clients. BlackRock was operating a different model and options were still being worked through here. | |