

Pensions CIV Sectoral Joint Committee

Item no: 4

Quarterly Investment Report & Fund Update

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Summary: This report provides the Joint Committee with an update on the economic and investment background and outlook, a fund update including performance of the London CIV sub-funds and Stewardship activities.

Recommendations: The committee is recommended to:

- i. Note the contents of this report;

INVESTMENT REPORT, COVERING 1ST OCTOBER 2016 TO 5TH DECEMBER 2016

1. The trend of global political upheaval continued into December, as the UK's Brexit vote in the June referendum was followed by the surprise result in the US Presidential Election on November 8th 2016. This result has sent shockwaves through global markets.
2. Markets have reacted by pricing in a change of policy framework in the US, with the expected emphasis to move from a reliance on activist Central Banks (and monetary policy), towards a reliance on fiscal policy, bringing with it the prospects of reflationary policies (including the building out of infrastructure). These anticipated changes led to a global bond rout, with some US\$1.7 trillion wiped off the value of bonds, with the value of sovereign bonds the worst hit. Other asset classes, sensitive to actual or anticipated changes in interest rates, were also negatively impacted, although US equity markets have fared well, in anticipation of a pick-up in economic growth. However the question is far from settled, and politically-driven markets are likely to remain volatile in sympathy with the increasingly febrile global political backdrop.
3. The final shoe to drop was the result of the Italian referendum on the Italian constitution on December 4th, where the result led to the resignation of Prime Minister Renzi. The implications of this remain unclear.
4. 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 10.02% and 7.24% respectively (year to date), whilst the NASDAQ rose 4.96% (giving up some gains in 4Q in sympathy with the expectations of higher rates). Closer to home, the FTSE 100 rose by 7.87% whilst in Germany the DAX fell by 1.33% and in France the CAC fell by 2.08%. In Japan, the Nikkei 225 index fell by 3.99%, on the back of continued fears over the economy, allied to perceived policy missteps by the Bank of Japan (BoJ).
5. In the UK, the 2016 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 rallied to a record high of 6,941 in August. The drop in GBP gained headlines but many economists have argued that the currency was 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.
6. Throughout the year, global fears over the underlying health of economies were repeatedly addressed and smoothed over by concerted and aggressive Central Bank actions. At the start of 2016, fears over China's underlying economic health led to a sharp and prolonged period of market volatility. 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 to over US\$50 per barrel in early December, boosted by a putative OPEC deal.

7. Beijing's aggressive stimulus measures taken in early 2016 were estimated to amount to 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.
8. 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.
9. 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.
10. 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.
11. 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.
12. Emerging Markets (EM) had stabilised in early 2016. The USD rally from early 2014 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 abated, investors turned once again to EM debt as a higher-yielding alternative to developed market debt, 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. However, the US\$ rally was reignited by the US Presidential Election result, which has again led to dislocation in EM currencies and asset prices.

13. As we wrote at the end of September, “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....[a new policy framework] 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.”
14. The investment environment is likely to remain volatile, reflecting the global political upheavals, uncertain economic fundamentals, and continued increase in global leverage. Accessing suitable investments will likely involve greater cost and complexity than in the past, as many traditional “vanilla” asset classes are rendered unsuitable for pension funds by a combination of high prices and elevated volatility.

Fund Update

15. Details of London CIV's five sub-funds, including 3rd quarter performance, are given below:

GLOBAL EQUITY SUB-FUNDS

London LGPS CIV Global Equity Alpha Fund

ASSET CLASS	Global Equities
INVESTMENT MANAGER	Allianz Global Investors GMBH
INCEPTION DATE	2 December 2015
STRUCTURE	Delegated
NAV @ 30/09/16*	118.6
VALUATION @ 30/09/16*	£614m
INVESTMENT OBJECTIVE	Aims to achieve capital growth by outperforming the MSCI World Index Total Return (Net) GBP by 2% p.a. net of fees

*Data Source: Bloomberg

PERFORMANCE REPORT*

	QUARTER %	SINCE INCEPTION~ %
SUB-FUND	10.44	22.38
BENCHMARK - MSCI World Index Net GBP	7.27	21.88
RELATIVE PERFORMANCE	3.17	0.50

*Data Source: Bloomberg as at 30/09/16 – Net before any disbursements

~ Inception Date: 2 December 2015

16. The recent performance of the Fund has been positive against the Benchmark over the quarter with 3.17% outperformance against the Benchmark MSCI World Index. This was a welcome rebound from the underperformance since inception to the 30th June 2016 where the Fund was 1.76% below benchmark for the period from 2nd December 2015.
17. Whilst the Fund is relatively concentrated in terms of the number of holdings, typically between 40-70 stocks in the portfolio at any one time with a target beta of 1, from which it strays very little.
18. The first half of the year had been impacted by a rebound in the lower growth areas of the market with both energy and utility companies performing strongly after a period of significant underperformance and the Fund had low exposure to these areas, although underweight positions in utility companies impacted positively in the third quarter. The Fund has an overweight exposure to the Information Technology sector and this was the biggest positive contributor to performance in the third quarter, adding just less than 1% to performance over the quarter.

GICS Sector Strategy

	GICS Sector ACTIVE WEIGHT	GICS Sector EXCESS RETURN	GICS Sector STRATEGY
Top 3 GICS Sector that HELPED			
Information Technology	10.7%	8.4%	0.87%
Utilities	-3.5%	-8.6%	0.32%
Telecom Services	-2.3%	-7.5%	0.18%
Bottom 3 GICS Sector that HURT			
Health Care	4.0%	-4.9%	-0.20%
Financials	-3.7%	2.1%	-0.16%
Materials	-0.8%	4.9%	-0.03%

Source: Allianz Global Investors 30/09/16

19. Whilst the Fund is underweight in financials, concerns have been raised with the manager over exposure in this area which had detracted from performance in the second quarter. It is clear that the manager regards these as value diversifiers in an otherwise quality portfolio. Having last met with the Manager in July and recognising that there might be some merit in this approach, we will, however, continue to monitor the position closely and challenge where appropriate.
20. The Fund is focused on 'quality growth' companies, where in general we have some concerns that companies regarded as growth company valuations have become stretched relative to history with investors paying up for perceived 'quality growth'. However at this stage the forwards looking earnings growth for the portfolio over the next 3-5 years at 18.5% is in excess of the market (source Allianz Global Investors). At the end of the quarter the fund was holding 4.6% in cash.

London LGPS CIV Global Alpha Growth Fund

ASSET CLASS	Global Equities
INVESTMENT MANAGER	Baillie Gifford & Co
INCEPTION DATE	11 April 2016
STRUCTURE	Delegated
NAV @ 30/09/16*	120.4
VALUATION @ 30/09/16*	£1,088m
INVESTMENT OBJECTIVE	Aims 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.

*Data Source: Bloomberg

PERFORMANCE REPORT*

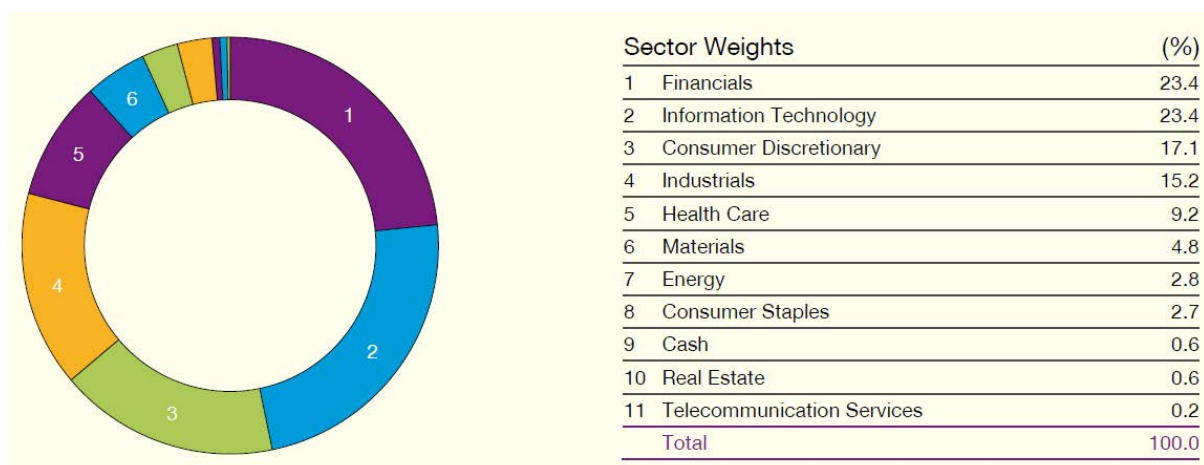
	QUARTER %	SINCE INCEPTION~ %
SUB-FUND	12.10	19.77
BENCHMARK - MSCI All Country World Index Net GBP	7.85	17.31
RELATIVE PERFORMANCE	4.25	2.41

*Data Source: Bloomberg AS AT 30/09/16 – Net before any disbursements

~ Inception Date: 11 April 2016

21. The recent performance of the Fund has been positive against the Benchmark over the quarter with 4.25% outperformance against the Benchmark MSCI World Index. Since inception on April 11th 2016, the Fund outperformed the Benchmark by 2.41%. The sub-fund was impacted by a significant underweight exposure (approx. 1/3rd index weighting) to the energy sector in the quarter to 30th June, which had seen a significant bounce over the quarter as oil prices recovered from the depths of the sell off seen towards the end of 2015 and into 2016. Lack of holdings in the utility sector which similarly bounced back after a period of underperformance also impacted on the returns seen by the fund since inception. However, strong performances from the IT and Financial sectors over the second quarter, where the Fund was overweight meant that the fund recovered significantly over the quarter to September, meaning that overall the fund added value over the period since inception.

22. The sector breakdown of the portfolio is set out below:



Source: Baillie Gifford as at 30/09/16

23. The financial sector added value during the quarter, with the exposure focused away from banks and on financial service companies including insurance companies, this is an area that could be impacted by a sharp reversal in bond yields and is an area which we are closely monitoring with the manager. The manager has previously commented that they regard the financial exposure as being well diversified and away from the key stocks, such as mainstream banks which might be affected by a sharp reversal in bond yields.

24. The fund maintained an overweight exposure to Japan. Whilst Japan has often looked to be on the verge of offering value, it has on a number of occasions disappointed and there remain concerns as to whether Abenomics will deliver growth in Japan. However, Japanese exposure is due to the fact that the weighting is made up of positions in individual companies that offer attractive growth opportunities rather than them being a reflection of optimism on the economy. The manager also believes that recent improvements in corporate governance amongst Japanese companies should deliver value over time we seeing some merit in this argument which seems to be developing some traction. We remain to be convinced that the overall level of exposure will add significant value to the fund and will continue to monitor and challenge the manager on the overweight position.
25. The fund is focused on a bottom up stock-picking approach with a diversified portfolio (typically 90-110 stocks). The top 10 stocks in the portfolio at the end of the quarter were:

Top Ten Holdings

Company Name	Description of Business	% of Portfolio
Amazon.com	Online retailer	4.6
Naspers	Media and e-commerce company	3.3
Prudential	International financial services group	3.1
TSMC	Semiconductor manufacturer	2.8
Royal Caribbean Cruises	Global cruise company	2.8
SAP	Enterprise software provider	2.7
Alphabet	Online search engine	2.4
Moody's	Credit rating agency	2.1
CRH	Diversified building materials company	2.1
First Republic Bank	US retail bank	2.1
Total		28.1

Source: Baillie Gifford as at 30/09/16

MULTI-ASSET SUB-FUNDS:

London LGPS CIV Diversified Growth Fund

ASSET CLASS	Diversified Growth
INVESTMENT MANAGER	Baillie Gifford & Co
INCEPTION DATE	15 February 2016
STRUCTURE	Direct
NAV @ 30/09/16*	109.4
VALUATION @ 30/09/16*	£339m
PERFORMANCE TARGET	The Sub-fund's objective is to achieve long term capital growth at lower risk than equity markets.

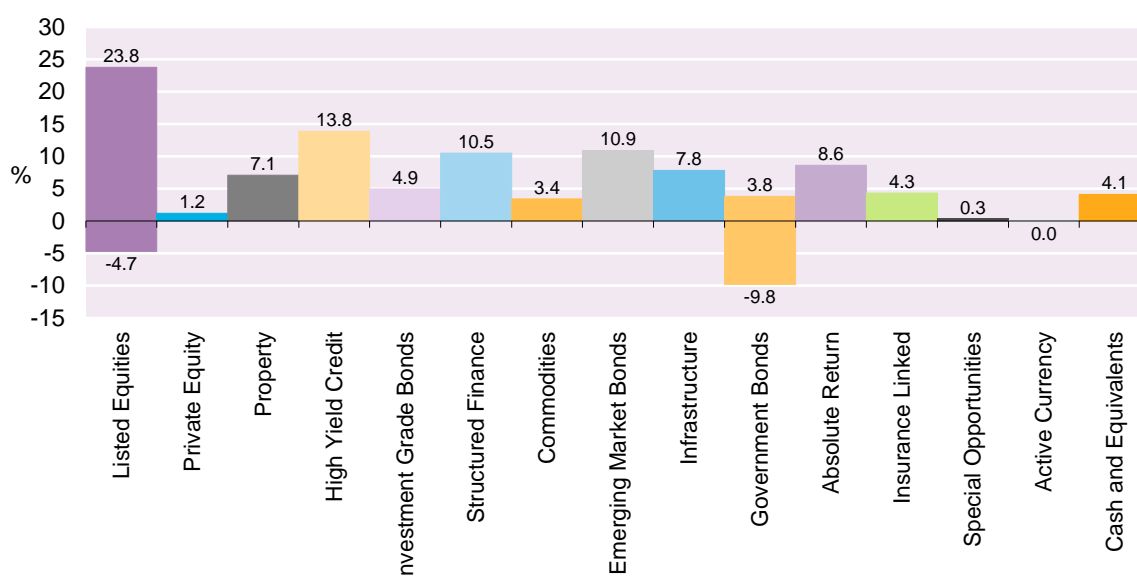
*Data Source: Bloomberg

PERFORMANCE REPORT*

	QUARTER %	SINCE INCEPTION~ %
SUB-FUND*	4.69	9.40

*Data Source: Bloomberg as at 30/09/16 – Net before any disbursements
~ Inception Date: 15 February 2016

26. Whilst the objective of the fund is to achieve long term capital growth at lower risk than equity markets and therefore does not have a direct benchmark, it is typically measured against the performance of cash or the base rate in the UK, aiming to exceed cash returns by 3.5%. Therefore with returns of 4.69% and 9.4% over the quarter and since inception, the fund has achieved capital growth over the two periods under review.
27. The fund invests in a diversified range of asset classes and the breakdown is shown below with the negative exposures being delivered through short futures positions:



Source: Baillie Gifford as at 30/09/16.

Total may not sum due to rounding

Any difference between asset class exposure and asset class weight relates to futures positions.

Active currency exposure reflects the net unrealised profit or loss of open positions in the Fund as at 30 September 2016.

In other asset classes, any negative exposures relate to futures positions.

28. The biggest contributor to performance over the quarter came from a strong equities return, in line with recovery in broader equity markets, reversing the negative performance from the previous quarter. High yield credit and structured finance exposures during the quarter also added positively to performance, with only active currency position detracting marginally from performance.

LCIV PY Global Total Return Fund

ASSET CLASS	Total Return
INVESTMENT MANAGER	Pyrford International Limited
INCEPTION DATE	17 June 2016
STRUCTURE	Direct
NAV @ 30/09/16*	106.7
VALUATION @ 30/09/16*	£200m
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.

*Data Source: Bloomberg

PERFORMANCE REPORT*

	QUARTER %	SINCE INCEPTION~ %
SUB-FUND	3.09	6.70

*Data Source: Bloomberg as at 31/09/16 – Net before any disbursements
~ Inception Date: 17 June 2016

29. As a total return portfolio, the objective of the fund is to seek to achieve its investment objective and will focus on capital preservation to achieve real total returns. The aim of the Fund's underlying managers is to invest in asset classes and securities which offer sound fundamental value and avoiding asset classes and securities which offer poor fundamental value, thereby offering downside protection in volatile markets.

30. The performance over the quarter was 3.09%, with performance since inception (17 June 2016) of 6.70%. The portfolio managers take a disciplined, unemotional approach to portfolio construction, which tends to lead to the inclusion of anti-momentum style assets.

At the end of the quarter the portfolio was positioned:

Asset Allocation	Weighting %
Global Equities	29.84
Total Bonds	66.01
Cash	4.19
Currency Hedging	0.05

Source: Pyrford International

31. At the recent quarterly review meeting with the manger, they were asked to explain their current positions; they have been steadily decreasing their allocation to equities to a level where it is as low as it was heading into the financial crisis in 2008. Management place great emphasis on liquidity and will only invest in highly liquid products such as AA

rated securities or above. They believe this offers significant protection on the downside relative to competing DGF products. A preferred liquidity measure for the fund is how long it would take to sell the fund based on 1/3 of volume data. Tolerance stands at 30 days. Relatedly, liquidity is becoming increasingly scarce across markets. They point to both recent government bond issuance and high quality corporates who have been able to issue debt with negative yields – investors are prepared to accept capital losses for perceived security.

32. They remain very concerned about the outlook, but inevitably market timing on a setback is impossible to pinpoint. They have completely lost faith in Central banks and their ability to influence what matters. In their view QE has failed, and as the commentary on investment markets demonstrates, this is a view that we would share with them. However they do not underestimate the ability of the central banks to continue to throw money at the problems facing the economy and to engage in more unorthodox policy. The manager expects the West to follow the asset hoarding evolutionary path of the Bank of Japan, but acknowledges that contrarian market timing is near impossible to determine when markets will react.

LCIV RF Absolute Return Fund

*Data Source: Bloomberg

ASSET CLASS	Absolute Return
MANAGER	Ruffer LLP
INCEPTION DATE	21 June 2016
STRUCTURE	Direct
NAV @ 30/09/16*	109.3
VALUATION @ 30/09/16*	£335m
PERFORMANCE TARGET	The 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.

PERFORMANCE REPORT*

	QUARTER %	SINCE INCEPTION~ %
SUB-FUND	6.94	9.82

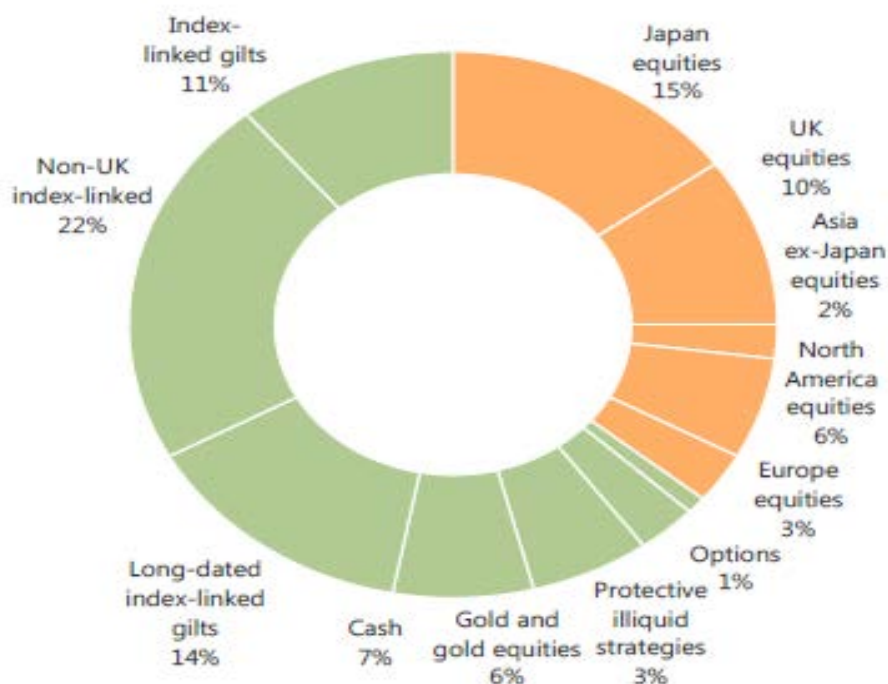
*Data Source: Bloomberg as at 30/09/16 – Net before any disbursements
~ Inception Date: 21 June 2016

33. Over the quarter to end September, the fund was up by 6.94%, with a strong performance since inception on 21st June 2016 of 9.82%.
34. The Fund benefited from having defensive positions with significant exposure to index linked bonds which added positively to performance being pushed higher by Brexit, further quantitative easing and ongoing low rates. The manager also took advantage of

weakness in UK domestic stocks following the Brexit vote, such as house builders which subsequently bounced quite strongly.

35. The fund also has an above average exposure to Japan, having taken the view that Abenomics would help to deliver stronger growth, but this has been an area of concern to us and we have questioned the manager over the size and conviction of this exposure. During our quarterly meeting, the portfolio manager confirmed that their level of conviction in Japanese holdings is perhaps less strong than it was and they are currently reviewing their allocations to equities (including financials) and the yen – subject to the findings of their chief economist who is currently visiting the country. We will follow up with the manager to understand any change in their position and how they follow this through.
36. From our meeting with the portfolio managers, in summary the portfolio is set for two possible economic paths:
1. **Normalisation of policy:** Benign growth, end of Quantitative Easing, steadily rising interest rates.
 2. **Failure of policy:** Global economy too weak to withstand higher rates and/or debt deflation. Policy baton handed to over to fiscal, complemented by debt monetization.
37. The impact of this means that they retain a very defensive portfolio, which from a macro perspective we are not uncomfortable with as central banks struggle to create the right environment for sustainable economic growth. The defensive nature of the portfolio can be seen from the asset allocation chart below:

Asset allocation



Source: Ruffer as at 30/09/16

Sub Fund Openings

38. London CIV continues to press ahead with opening new sub-funds under the initial CQC strategy (bringing together existing London authority assets where there is Commonality, Quantum, and Conviction).
39. On that basis the next sub-fund to open will be a direct investment real return fund where the underlying manager will be Newton Investment Management. This fund has now received approval from the FCA and will be opening in mid-December. This will deliver significant savings for the 3 invested boroughs that will be transitioning their holdings across to the London CIV. It is anticipated that the fund will open with approximately £327m assets under management and annualised savings estimated to be in the region of £376k.
40. A further 3 sub-funds are currently being developed, comprising 2 global equity and 1 UK equity funds, and it is anticipated that two will open by the end of the financial year with the third opening shortly afterwards. The openings will be dependent on obtaining London Funds agreements to transition assets, due diligence being completed with managers and FCA approval for the new funds.
41. In addition, it is anticipated that a number of global equity sub-funds with managers who tendered as part of the global equity process will be opening in the second half of next year. These will be based on where the London CIV see strongest demand from the London Funds and subject to finalising commercial negotiations with the managers and carrying out due diligence. More information on the progress of the global equity tender can be found in another Committee paper coming before the Joint Committee at the meeting.

Stewardship Activities

42. There has been little activity in this area since the last meeting of the Joint Committee, due to other projects underway. However, Officers of the CIV and a Pension Fund have met with the Financial Reporting Council (FRC) to discuss the approach to the Stewardship Code for the London CIV to be able to demonstrate that it is meeting the requirements under the Code.
43. There have been no LAPFF voting alerts during the reporting period to alert external managers to.
44. Officers of the CIV and the Officer Stewardship working group are also giving consideration to a form of wording to assist authorities in compiling their Investment Strategy Statements when covering aspects surrounding stewardship.

Recommendations

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

Financial Implications

46. There are no financial implications for London Councils.

Legal Implications

47. There are no legal implications for London Councils.

Equalities Implications

48. There are no equalities implications for London Councils.