Agenda Item No: **13**

Wolverhampton City Council **OPEN INFORMATION ITEM**

Committee / Panel	**PENSIONS**	**Date**	**26 JUNE 2013**
Originating Service Group(s)	**PENSION SERVICES**		
Contact Officer(s)/ Telephone Number(s)	**GEIK DREVER** **2020**		
Title/Subject Matter	**INVESTMENT POLICY AND PERFORMANCE REPORT 2012/13**		

1. PURPOSE OF THE REPORT

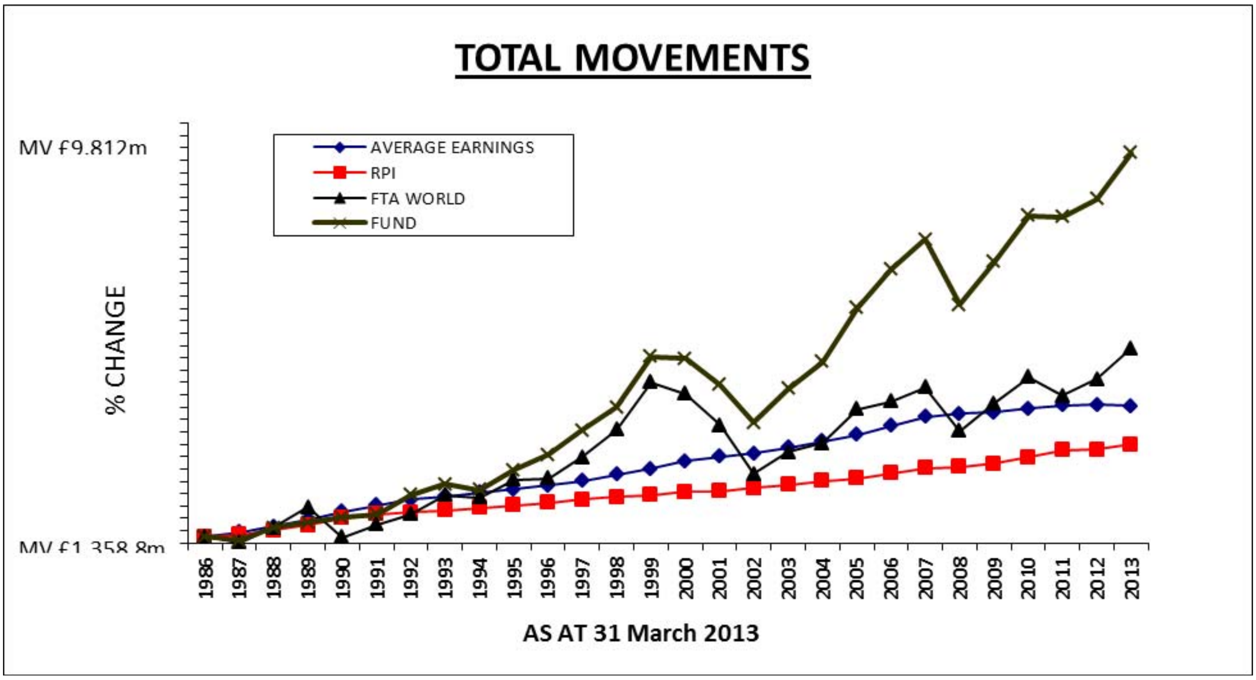
1.1 This report is submitted to inform Members of the investment policy, investment strategy and investment returns earned on the Pension Fund as at 31 March 2013 and earlier years.

2.0 INVESTMENT POLICY

2.1 Investment policy comprises two main elements: a) the Committee's longer-term asset allocation benchmark and b) the shorter-term tactical asset allocation. Following the unprecedented market turmoil of 2008, the Pensions Committee approved a new benchmark in January 2009 with a further review in 2011. The revised investment strategy quantified the investment risks being taken by the Fund and designed a benchmark that best balanced the risk and likelihood of improving the funding position over the medium- to long-term. Essentially, it was a continuation of the process of diversification which had evolved from the triennial actuarial reviews.

2.2 The 2009 benchmark involved a further 10% reduction in quoted equities, primarily UK. The 2012 SIAB review recommended no change to this asset allocation except for splitting the Fixed Interest Allocation (20%) into stabilising (10%) and return seeking (10%). A plan setting out the implementation of the 2012 SIAB on portfolio structure and better use of governance budget was agreed by IASC in October 2012. The 2012 SIAB also revised the target returns down from 9.6% (market return of 7.6% plus active return of 2.0%) to 6.9% (market return of 6.0% plus active return of 0.9%) in the medium term.

2.3 At the beginning of the period, the Fund's market value was £8,801m. By the end of March 2013, the value of the Fund was £9,812m which reflects net cashflow and appreciation in market value. The graph below illustrates the cumulative movement of the Fund since 1986 resulting from the implementation of investment policies, market movements, unrealised profits and net cash inflows.



2.4 The Fund continues to have strong positive cash inflows, though future cash flows may well be impacted by a reduction in contributions due to a fall in active membership as a result of redundancies, early retirements and members choosing to opt out.

3.0 ASSET ALLOCATION

3.1 The following table shows a summary of the asset distribution for the period ended 31st March 2013 compared with the Strategic Risk Bands agreed by the Pensions Committee. The Fund's closing market value of £9.8bn reflects a net investment of £70.5m and appreciation of investments resulting from positive market returns and stock selection during the period

Portfolio	Strategic Risk Bands %	Opening Levels %	Closing Levels %	Closing Market Value £M	Net Investment £M
UK Equities		9.8	9.9	970	-2.1
Global Equities		5.4	5.0	494	-60.1
Total Overseas Equities		27.0	27.9	2,741	-15.9
North America		8.9	9.6	943	-0.8
Continental Europe		7.1	5.9	576	-128.1
Pacific Ex Japan		2.9	4.3	425	113.8
Japan		1.8	1.9	188	-0.8
Emerging Markets		6.3	6.2	609	0
Private Equity		12.7	12.6	1,232	-0.8
Total Equities	**45.0-65.0**	**54.9**	**55.4**	**5,437**	**-78.9**
UK Gilts		2.2	2.0	197	0
Specialist Fixed Interest		3.5	3.3	321	165.9
Index Linked Gilts		6.8	6.8	664	-2.6
Corporate Bonds		5.1	4.8	473	8.6
Emerging Market Debt		3.4	3.3	325	6.6
Cash		2.1	3.3	325	131.4
Total Fixed Interest	**15.0-25.0**	**23.1**	**23.5**	**2,305**	**309.9**
Property		9.0	8.6	838	-29.7
Absolute Return		7.5	7.1	699	-156.3
Infrastructure		3.3	3.3	326	14.6
Commodities		2.2	2.1	207	10.9
Total Complementary	**20.0-30.0**	**22.0**	**21.1**	**2,070**	**-160.5**
Total Non Equities	**35.0-55.0**	**45.1**	**44.6**	**4,375**	**149.4**
Total	**-**	**100.0**	**100.0**	**9,812**	**70.5**

3.2 The investment strategy allocation is determined in accordance with the regulations (LGPS - Management and Investment of Funds - Regulations 2009) and its formulation is set out in the Fund's Investment Strategy and Statement of Investment Principles. In accordance with the investment management regulations, the schedule of limits on investments is varied to the higher limit of 15% from 5% for the contributions to partnerships (rising to 30% from 01/04/13), and 15% from 10% for investments in unlisted securities of companies. These limits are kept under review and reviewed every time the SIP is reviewed.

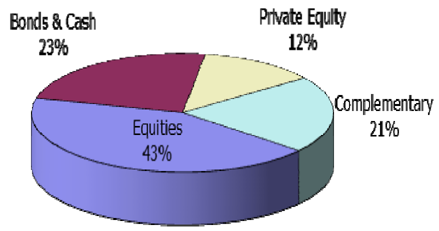
3.3 The table above highlights the direction of the Fund's investment strategy over the 12 months, which is an ongoing reduction in quoted equities and an increase in complementary assets.

3.4 All main asset classes closed within their wider strategic risk bands. In view of the investment project/transition plan agreed by the Investment Advisory Sub Committee (IASC) on 17 October 2012 to implement the 2012 SIAB it was agreed at the Pensions Committee meeting on 21 November 2012 that current tactical asset allocation decisions be temporarily suspended until full implementation of the SIAB has taken place. The asset allocation continues to be monitored on a regular basis and the Committee will be advised on a quarterly basis of any significant changes

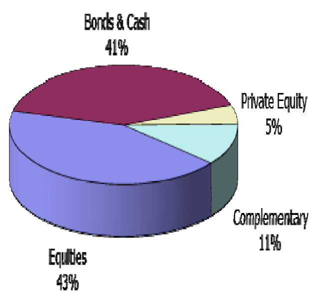
3.5 The difference in returns between the various funds are determined primarily by asset allocation. In fact, over 90% of returns are attributable to asset allocation rather than stock or manager selection.

3.6 The pie charts following highlight the difference in West Midlands Pension Fund asset allocation as at 31 March 2013:

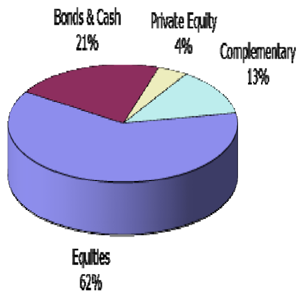
WMPF



WM50 AV. FUND

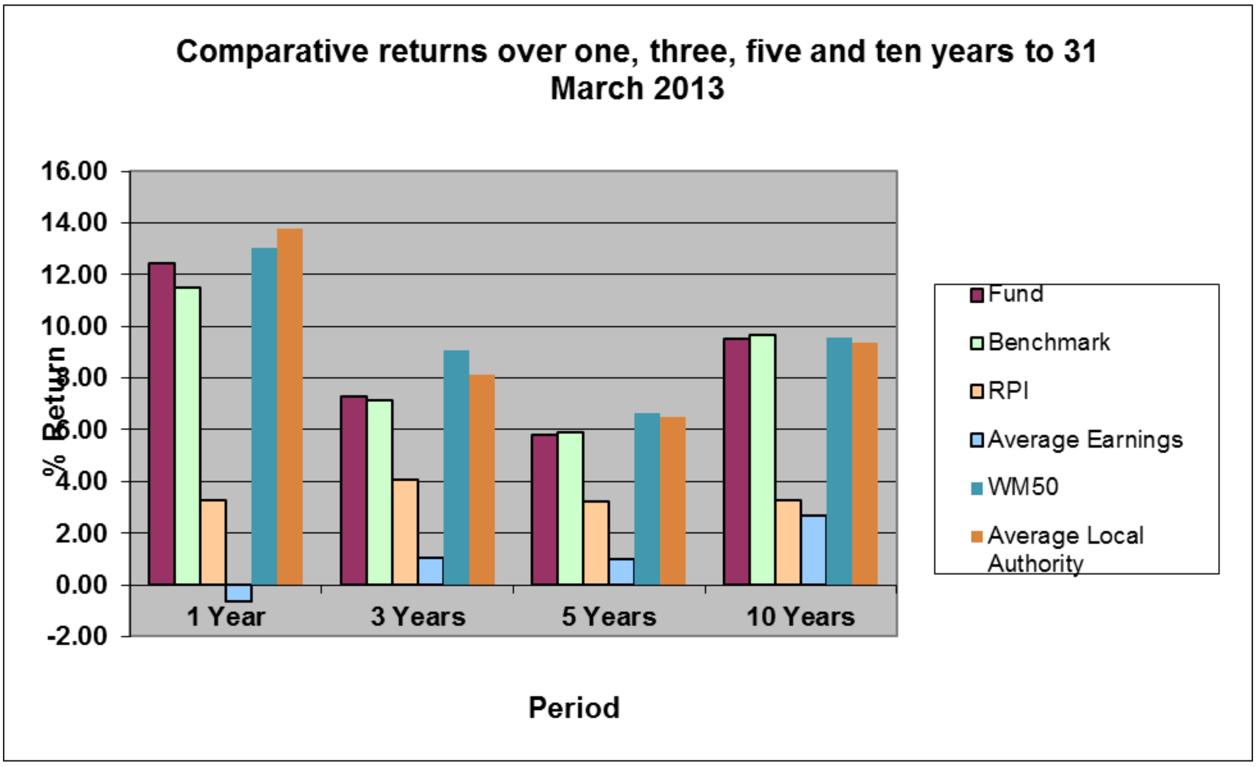


AV. LA FUND



4.0 RETURNS AS AT 31 MARCH 2013

4.1 The Fund's returns over one, three, five and ten years compared to its bespoke benchmark, retail prices index (RPI), average earnings and its peers are illustrated in the chart shown below.

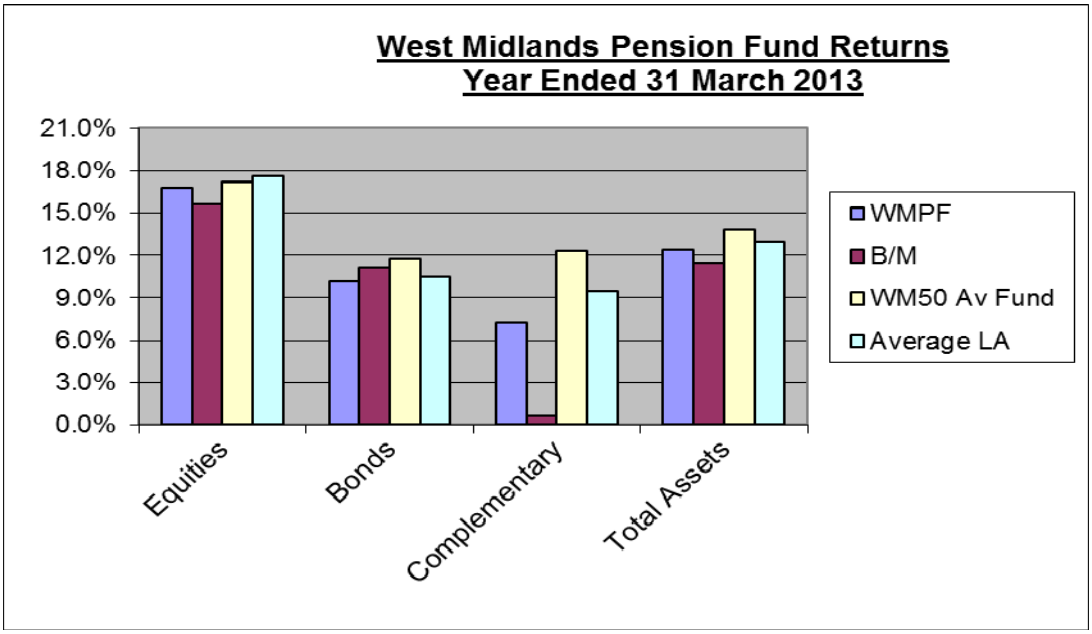


4.2 The Fund delivered a return of 12.4%, ahead of its bespoke benchmark of 11.5%. The main contributors to this strong outperformance were the Absolute Return and Property portfolios. The positive attribution from Absolute Return was due to a combination of upward market movements and good stock selection. Strong stock selection also resulted in the positive contribution from Property.

4.3 A positive return of 7.3% was achieved over the medium term by the Fund outperforming its bespoke benchmark return of 7.1% by 0.2%. This was mainly due to stronger returns from UK and Overseas equity portfolios.

4.4 The Funds long term performance of 9.52% is slightly below the benchmark of 9.64% but remains comfortably ahead of increases in RPI and Average Earnings.

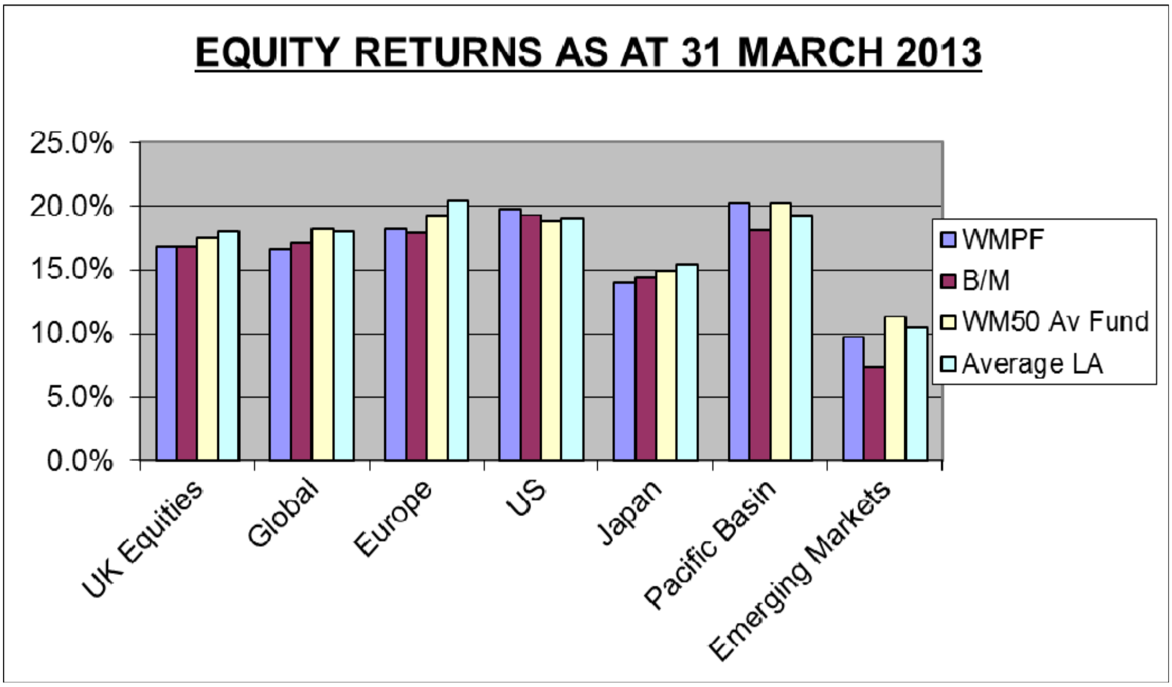
4.5 The graph following illustrates the returns of the Fund's main asset classes for the year ended 31 March 2013 and compares them to the returns from its bespoke benchmark and its peers, the WM50 average fund and the average local authority fund:



Note: the scheme-specific benchmark for individual asset classes are recognised indices, but for the wider asset classes is a combination of weighted indices.

4.6 The Fund's total return outperformed its scheme specific benchmark by +0.9%, but underperformed the average WM Local Authority Fund and WM50 fund by 1.4% and 0.6% respectively. With the exception of bonds, the Fund's asset classes outperformed their benchmarks, demonstrating that the Fund's choice of funds contributed strongly to performance. Both the WMPF and WM50 Fund have a similar allocation to quoted equities, which is significantly lower than that of the average local authority. The WMPF has a much higher allocation to complementary assets compared to its peers whilst the WM50 Fund has a larger percentage allocation to fixed income, which was by far the stronger performing asset classes during the period, accounting for the very strong performance of the average WM50.

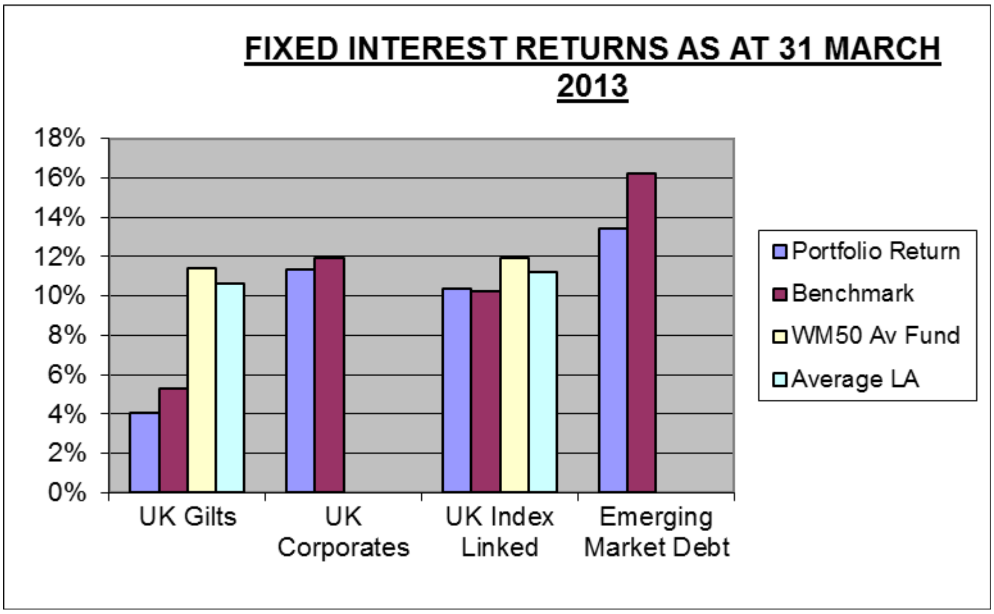
4.7 The graph below illustrates the returns of the different quoted equity markets:



4.8 The Fund’s quoted equities portfolios benefitted from the overall rally within equity markets, delivering a return of 16.8% over the year. Initial concerns over the Eurozone sovereign debt crisis receded as the European Central Bank announced plans for large-scale bond purchases. Performance in the US was driven by strong economic data and a partial resolution to the fiscal cliff while markets in Japan benefitted from the election of Prime Minister Abe and his plans for more aggressive stimulus measures.

4.9 The Emerging Markets portfolio enjoyed particularly strong outperformance against the bespoke benchmark over the year due to the performance of some of the underlying managers. A number of externally managed funds within the Global and European portfolios were redeemed because of persistent underperformance

4.10 The graph below illustrates the returns of the different bond markets:



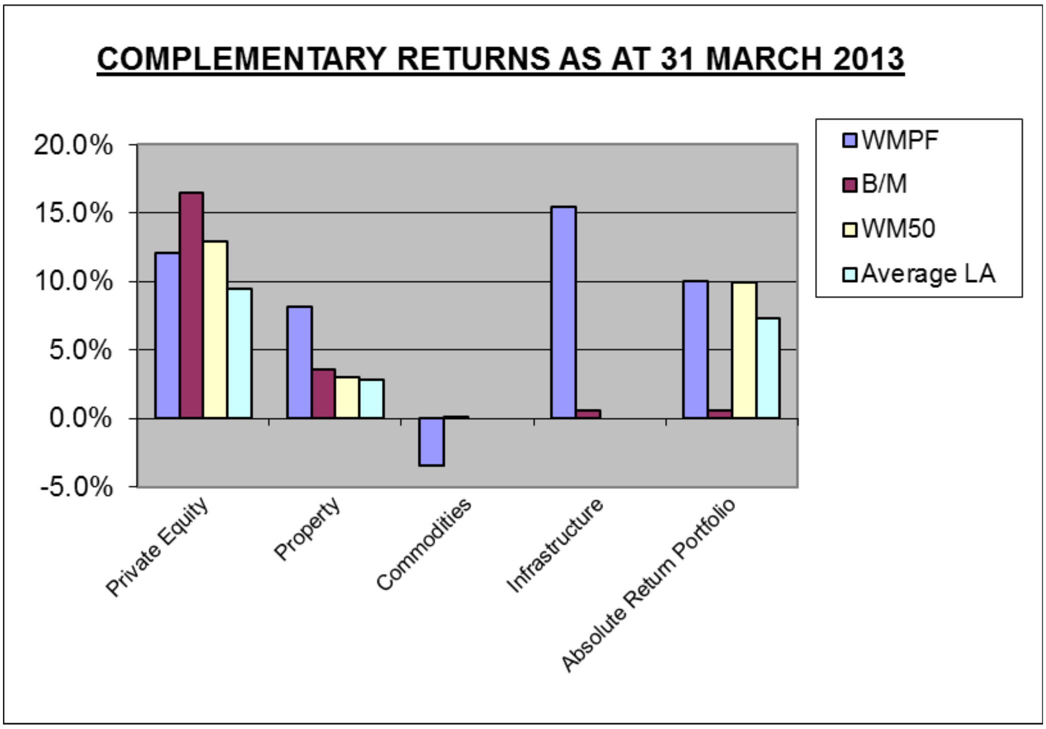
WM do not publish separate figures for corporate bonds or emerging market debt in respect of average industry returns.

4.11 During the year ending 31 March 2013 fixed interest markets were once again dominated by uncertainty surrounding the Eurozone area. A rally in the gilt market part way through the year was not sustained as positive sentiment returned to risk markets causing a sell off in gilts and a narrowing of credit spreads. The competing forces of high inflation and a challenging economic environment continued to create volatility in the UK market and investing in gilts remained challenging as yields fell towards historically low levels. Concerns over Cyprus in March saw a return to risk aversion and gilts once again rallied. UK inflation as measured by the Consumer Prices Index (CPI) began the year at 3.5% and fell steadily to 2.2% by September before rising again to reach 2.8% at the year end. The Bank of England maintained the base rate at 0.5% for the whole of the year. The asset purchase program, Quantitative Easing, (QE) has reached £375bn with the possibility of more to come in 2013-14 following the appointment of Mark Carney as the new Governor.

4.12 Positive returns were achieved across the range of fixed interest sectors with Emerging Market Debt performing particularly strongly returning 13.5%. Despite this performance the sector underperformed its benchmark by 2.7% due to poor country selection by two of the mangers. Conventional UK gilts was the worst performing sector but still managed a positive return of 4.1%. The fund underperformed its benchmark by 1.2% due to an overweight position in short dated gilts which in turn underperformed the broader All

Stocks Index. Also the Fund only has a relatively small, passive allocation in index-linked,an asset class which performed well over the period, this resulted in the average fund out-performing the Fund.

4.13 The graph below shows the returns from the Fund's investments that make up the complementary assets:



4.14 There was mixed performance from the complementary assets over the 12 months to 31st March 2013. Infrastructure was the best performing asset class returning 15.4% with notable contributions from the Aqua Resources, Innisfree PFI III and First Reserve Energy funds. Strong returns from the distressed credit funds underpinned the performance in the Absolute Returns portfolio which returned 10.0% for the year. Private Equity increased by 12.1% for the year against the benchmark return of 16.9%. Performance was affected by the strong US dollar and valuations lagged the recovery in the US stock market. Property returned 8.2% for the year against a benchmark return of 3.6% as global real estate markets continued to recover. Commodities were again the worst performing asset class, resulting in a loss of 3.4% against a benchmark gain of 0.1%.

4.15 WM returns for a number of complementary assets are not available; with scheme-specific benchmarks being separately measured. As more funds continue to diversify, average industry figures are more likely to be measured, for example, WM now publish an average fund return for private equity, infrastructure and hedge funds. It should be noted however that these returns are only an indication of direction as they include returns from listed vehicles which perform very differently to direct investments in such asset classes.

5.0 WEST MIDLANDS PENSION FUND HISTORICAL RETURNS

5.1 The returns as at 31 March 2013 from the Fund's main asset classes are shown in the table below, as are the three and five year annualised returns where available.

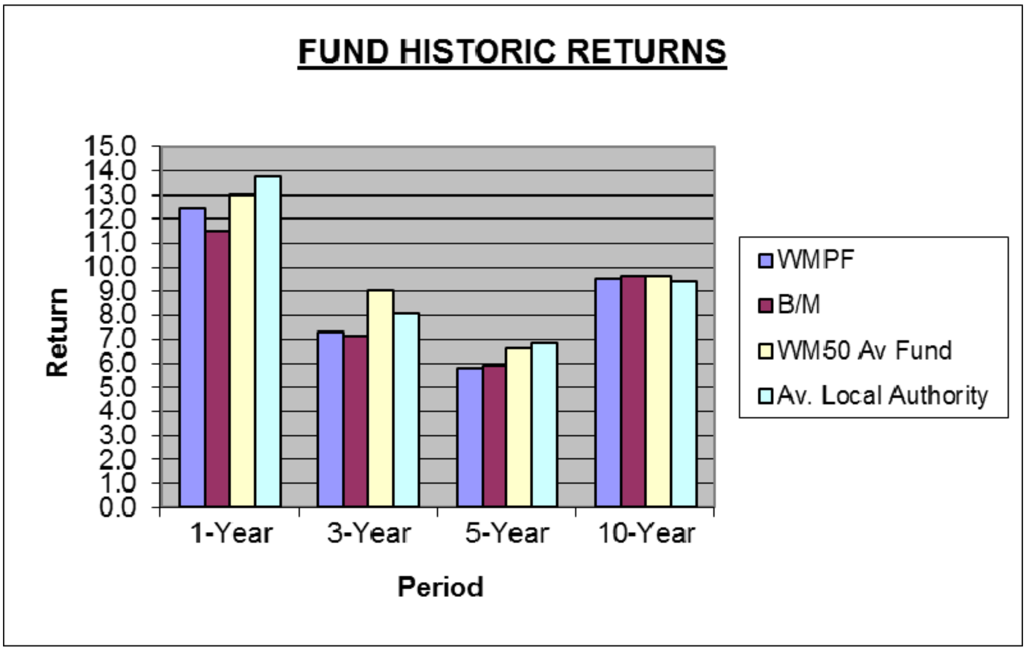
	31/03/13 %	3-year %	5-year %
UK Equities	16.84	9.04	7.00
European Equities	18.21	4.01	3.00
US Equities	19.75	12.16	12.23
Pacific Basin Equities	20.24	8.89	9.79
Japanese Equities	13.93	3.90	5.40
Emerging Markets Equities	9.74	4.22	7.74
Global Equities	16.61	8.10	7.45
Gilts	4.07	7.91	6.89
Index Linked	10.39	11.57	8.64
Corporate Bonds	11.37	8.29	7.37
Property	8.19	7.58	1.76
Private Equity	12.11	8.80	5.20
Commodities	(3.42)	1.85	(7.11)
Emerging Market Debt	13.45	9.11	12.59
Infrastructure	15.42	2.17	(0.88)
Absolute Return Strategies	9.99	5.85	N/A
Total Fund	12.44	7.30	5.80

5.2 The five-year returns, as expected, are mixed with a couple of asset classes generating negative returns Both of these classes are in alternative investments which, historically, have a more volatile performance record.. The second highest returning asset class was US Equities which returned +12.23%, closely following emerging market debt which returned +12.59%.

5.3 The strongest one-year performance came from Pacific Basin Equities, which returned a remarkable +20.24%, followed by returns of +19.75% and +18.21% from US and European equities respectively.

5.4 The poorest performance during the 12 month period came from Commodities, which returned -3.42%, with UK Gilts being the second poorest despite returning a positive performance of +4.07%.

5.5 The Fund's historic returns against its benchmark and other funds over one, three, five and ten years are shown in the following bar chart:



5.6 Over the 12 month period WMPF returned +12.44%, outperforming the benchmark return of +11.48% but underperforming the average local authority return of +13.80% and the WM50 average return of +13.01%.

5.7 The Fund's lower allocation to quoted equities contributed to its underperformance against the average local authority fund. At year end its allocation stood at 42.8% which is equivalent to that of the WM50, compared to the average local authority fund's allocation of 61.7%.

5.8 The WMPF underperformed against the average WM50 fund due to the lower allocation to bonds. The WM50 fund had an allocation of 37.5% at the 31 March 2013, compared to 18.6% for the Fund.

5.9 There are some small differences in returns between the Fund, its benchmark, the WM50 and the average local authority fund over three, five and ten years but nothing material.

5.10 The major investment highlights over recent years are as follows:

- The use of equity futures during the latter half of 2005 and during 2006 to maintain the Fund's equity allocation while new managers and mandates were being established.
- Restructuring of UK gilts portfolio in May 2006, followed in October 2007 by a move to external passive management of the index-linked portfolio.
- Decision during 2006 to make initial allocation to a number of new complementary investments including emerging market debt, commodities, active currency, and indirect overseas property.
- Risk budget developed in 2006/2007 identifying and separating out target returns for beta (market returns) and alpha (active management). The Fund's allocation to complementary assets modestly reduced the overall risk while maintaining, or ideally increasing the Fund's overall target return.
- In September 2007, the Fund implemented a phased passive hedging programme, appointing JP Morgan as its FX partner, completing in March 2008. In October 2008, the programme was cancelled as the cash transfers out were negatively impacting the Fund's liquid assets due to the unprecedented volatility of the currency markets.

- The extreme market conditions also made it difficult for the active currency managers to deliver positive returns, and two of the three mandates were ended in 2008, the third mandate being terminated during 2010.
- In December 2008, the stocklending programme was temporarily suspended due to worries over counterparty risk, but was reinstatetd using HSBC in December 2009 following the return of less turbulent market conditions.
- Following the unprecedented turmoil in the 2008 markets, the Fund reviewed its benchmark and risk budget with a revised investment strategy going to Committee in early 2009, further de-risking the Fund's exposure to quoted investments in order to develop an 'all weather fund'. Essentially, a further 10% was taken out of UK equities and reinvested in emerging market equities (2%) and absolute return strategies (8%).
- During 2009/2010 the mandates of seven equity managers were terminated, partly on grounds of performance and partly in response to the revised investment strategy of reducing equities.
- Since 2010 the absolute return strategies portfolio has exceeded Fund's expectaions, delivering a return over 3 years of 5.9% against a benchmark return of 0.7%.
- A further reduction in quoted Equities continued during 2011 to fund an increased allocation to the Absolute Returns, Private Equity and Property portfolios.
  Since the end of 2008 the fund has increased the use of Money Market Funds as opposed to Short Term Deposits for its' sterling cash balances. This is due to the low interest rate environment and the poor credit ratings of the banking sector. It also allows cash to be readily accessible for funding investments

6.0 INVESTMENT MANAGEMENT AND PORTFOLIO CONSTRUCTION

6.1 The investment policy of the Fund is approved at each quarterly meeting of the Pensions Committee and implemented by the Investments Division within Pension services. The Division consists of a number of specialist teams which reflect the asset allocation and functions of the Fund. These teams currently cover quoted equities, complementary investments with fixed interest, treasury management and investment accounting.

6.2 The Division manages approximately 45% of total investments in-house, with the balance invested in external pooled vehicles or specialist segregated funds. The proportion of the Fund managed externally is in direct response to the Fund's increased allocation to complementary assets which require external specialist investment skills.

6.3 The Fund recognises that the mainstream quoted equities and fixed interest markets are the most efficient, thus passive management tends to dominate within these asset classes. Although most use of specialist managers is within complementary assets, the Fund still uses active management in mainstream assets where inefficiencies and market opportunities exist. Examples of this are found within emerging market equities and emerging market debt both managed on an active basis by external specialists.

7.0 ENVIRONMENTAL AND EQUAL OPPORTUNITIES IMPLICATIONS

7.1 There are no direct implications for the environmental and equal opportunities policies arising from this report. The Fund has an engagement policy towards gaining improvements in company's governance, employment and environmental practices, which are reported upon separately