CITY OF WOLVERHAMPTON COUNCIL	**Pensions Committee** 27 March 2019

Report title	Quarterly Investment Report to 31 December 2018	
Originating service	Pension Services	
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Recommendations for noting:

The Committee is asked to note:

1. The global economic and market update paper prepared by the Fund's adviser, Hymans Robertson

2. Quarterly Performance Reporting for the West Midlands Pension Fund

3. Quarterly Performance Reporting for the West Midlands Integrated Transport Authority

4. The updated benchmarking information received in relation to the Fund's investment performance and costs

1.0 Purpose

1.1 The quarterly investment report covers the range of investment issues for consideration by the Committee, primarily the economic and investment background and the quarterly performance of both the West Midlands Pension Fund and the West Midlands Integrated Transport Authority. Supporting responsible investment activities are covered in a separate paper.

2.0 Background

2.1 This paper aims to bring together routine investment matters relevant to the management and implementation of the Fund's investment strategy and related policies:

I. The economic and market background environment in which the Fund operates and the outlook for different asset classes;

II. The Fund has a longstanding policy of supporting good corporate governance in the companies in which it invests. The Fund will also challenge companies who do not meet either the standards set by their peers or reasonable expectations as measured by best practice. The Fund's approach is part of its overall investment management arrangements and its active Responsible Investment Framework and Voting Principles. There are three pillars of responsible investment that we focus on: Selection of our assets, Stewardship of our assets and Transparency & Disclosure. Each plays a key role in protecting and enhancing Fund Asset Values

III. The requirement to deliver investment in accordance with the criteria laid down by the Secretary of State led to the creation of LGPS Central, a jointly owned investment management pool established by the West Midlands and seven partner Funds to deliver investment pooling. LGPS Central Ltd is the FCA authorised company operator established to help deliver investment pooling through the development and launch of collective investment vehicles designed to assist in delivering higher longer-term risk adjusted returns after costs and meet partner Funds' strategic investment objectives.

IV. The Fund's investment strategy is outlined in the approved Investment Strategy Statement (ISS), updated to March 2019 and subject to approval at this Committee, set in conjunction with the Funding Strategy Statement to target a return over the long term to deliver the asset values required to meet benefit payments due to members. The Strategic Investment Allocation Benchmark (SIAB) forms part of the ISS and includes the target asset allocation and the levels of returns investment policies will be benchmarked against.

V. WMITA Pension Fund's investment strategy is set out in its Investment Strategy Statement, which also contains the Fund's investment beliefs. An updated strategy as at March 2019 is subject to approval by the Committee at this meeting.

3.0 Summary

3.1 Over the 9-month period from the start of the Scheme year to 31 December 2018, the West Midlands Pension Fund's market value decreased from £15.4 billion to £15.1 billion and the West Midlands Integrated Transport Authority Funds value decreased from £494 million to £490 million. The final quarter of 2018 saw many global stock markets record their worst performance since the 2008 financial crisis due to increasing US-China trade woes and slower global growth. Bond markets were marginally positive over the quarter although flat over the year. Property, one of the strongest performing asset classes in the period, continued to advance on the back of positive gains in industrial property but offset by weakening retail and office demand towards the end of the year.

3.2 The Fund continues to benchmark well against LGPS and non-LGPS peers globally, both in terms of investment performance and cost effectiveness of implementation over the 5-year period to 31 March 2018.

4.0 Economic and Investment Background

4.1 The Fund's Investment Adviser, Hymans Robertson provides a quarterly update on the economic background and market performance over the quarter to 31 December 2018. The report further sets out the outlook for the Fund's key asset classes over the coming months. The report can be found in Appendix A.

4.2 Equities performed poorly during the fourth quarter of 2018 as many global stock markets fell into correction territory. US-China trade woes and slower global growth are among the key issues blamed for the poor showing. President Trump continued to regularly impact investor sentiment by escalating his tit-for-tat trade tariff battle with China. Analysts have also cited US political uncertainty and interest rate rises as contributing factors. The president has conflicted with the central bank, the Federal Reserve, over whether interest rates should be increased. Emerging market equities had the smallest decline of 3.9%, however Japanese equities was the worst regional performer as performance dropped by 12.4%. UK and European equities also suffered similar losses which has been rocked by political setbacks including Italy's budget row with Brussels, the "gilets jaunes" protesters in France and, of course, Brexit. Brexit uncertainty and political upheaval in the UK led to a fall in gilt yields across maturities over the fourth quarter of 2018, inflating valuations. Index-linked gilts outperformed conventional bonds, helped by their typical longer duration profiles. Gilts valuations continue to look overpriced with heightened risk of re-pricing.

4.3 After hitting repeated all-time highs over the course of 2018, uncertainty prevailed in many global stock markets over the final three months of 2018, leading to increased volatility. This saw a partial reversal in the positive sentiment toward the outlook for global growth, a booming technology sector and with the perception that the US stands to benefit the most from President Donald Trump's policies regarding trade.

4.4 Two big peak to trough falls occurred during 2018. The first was driven by concerns that inflation would force the Federal Reserve (Fed) to raise interest rates too far, too fast and choke off economic growth. The second was driven by concerns about the escalating China-US trade war.

4.5 In terms of the outlook, global growth is expected to slow during 2019, and US growth stabilising with the expectation that the U.S. Federal Reserve (the Fed) will follow its December 2018 rate rise with additional hikes in 2019. Furthermore, China's economy continues to slow, adding downward pressure on global demand, while uncertainty surrounding Brexit also shows no sign of abating. Consequently, markets are expected to remain volatile and have periods of flights to safety, with downward pressure on bond yields potentially impacting the effectiveness of tightening monetary policy. Among developing economies, growth prospects are hinged on the hopes that China and the U.S. will be able to clinch a trade deal in the coming months and that policy stimulus will avoid an economic downturn in China.

4.6 Infrastructure and property assets have continued to see demand as investors search for income, with both asset classes offering investors stable income streams at a time when income is scarce in bond markets. The industrial property sector led the way to meet investors' appetite for UK commercial real estate, although concerns on retail and London-based office space continue to grow with risk of oversupply, pointing to the need for careful selection.

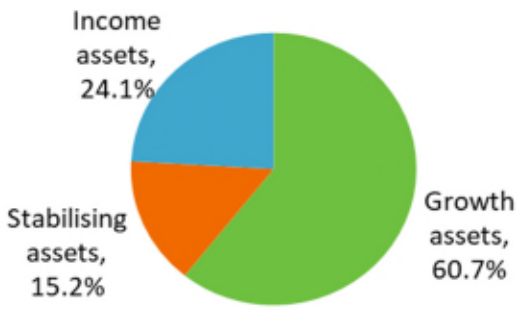
4.7 2018 was a transition year from the era of easy money, quantitative easing - characterised by low interest rates and bond-buying programs by major central banks - to a gradually tighter monetary policy. After nearly a decade of ultra-low short-term interest rates and central banks expanding their balance sheets, the trend is now toward tighter money, although that will depend on the outlook for growth and vary between the regions. The consequences of tighter money are also likely to exacerbate volatility and lead to a re-pricing of riskier assets, such as high-yield and emerging market bonds.

5.0 West Midlands Pension Fund Quarterly Performance

5.1 At the end of the third quarter of the financial year 2018/19, the value of the West Midland Pension Fund had fallen to £15.1 billion at the end of December 2018 from £16.1 billion at 30 September 2018. The asset allocation of the portfolio as at the end of the quarter, 31 December 2018, compared to the strategic targets is set out in the table below. This excludes net current assets, hence the difference to the £14.9 billion total value of the Fund quoted (note the later paper on more recent investment activity provides Committee with an updated asset allocation as at mid-February):

Asset class	Value (£m)	Fund allocation %	Policy target %	Difference %
Growth				
Quoted equities	7,519	50.5	48.0	2.5
Private equity	1,287	8.6	10.0	-1.4
Special opportunities	258	1.7	2.0	-0.3
Currency Hedge	(21)	-0.1	N/A	N/A
Total growth assets	**9,043**	**60.7**	**60.0**	**-0.7**
Stabilising				
UK gilts	167	1.1	2.0	-0.9
Index linked gilts	771	5.2	5.0	0.2
Cash	635	4.3	2.0	2.3
Corporate bonds	396	2.7	2.0	0.7
Cashflow matching fixed interest	297	2.0	3.0	-1.0
Total stabilising assets	**2,266**	**15.2**	**14.0**	**1.2**
Income assets				
Specialist fixed interest	460.5	3.1	3.5	-0.4
Emerging market debt	617	4.1	3.5	0.6
Property	1,311	8.8	10.0	-1.2
Insurance linked funds	366	2.5	3.0	-0.5
Real assets and infrastructure	832	5.6	6.0	-0.4
Total income assets	**3,586**	**24.1**	**26.0**	**-1.9**
TOTAL	**14,895**	**100.0**	**100.0**	**-**

The asset allocation between the core categories of investment strategy as at 31 December 2018 are shown in the chart below:



As at 31 December 2018 the Fund remained slightly overweight in growth and stabilising assets. The Fund's asset allocation target portfolio aims to increase income assets and as a result, the Fund continues to look for opportunities to deploy further investment in income assets and cash has been ringfenced for investment.

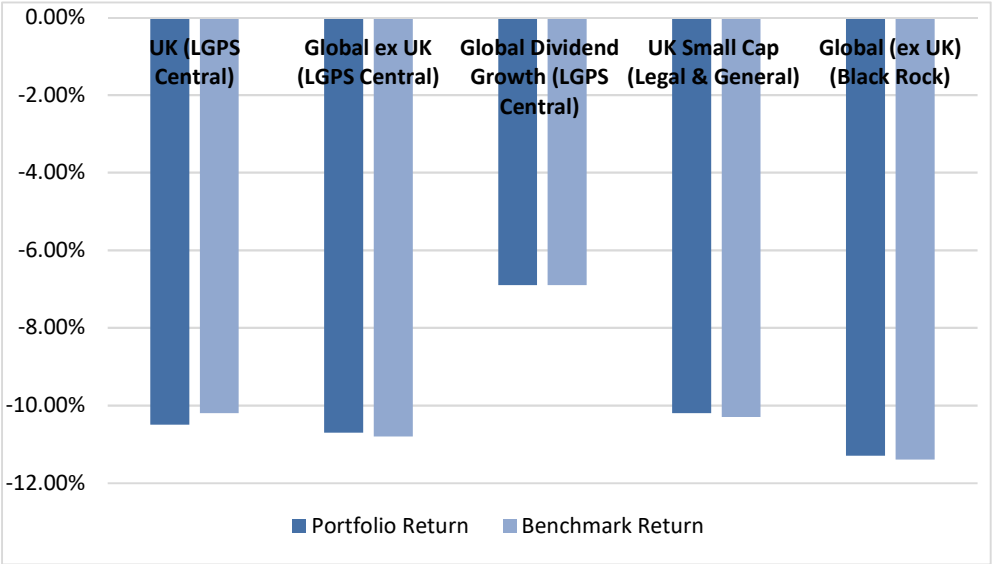
A commitment of £30 million into a property fund was during the fourth quarter of 2018. The investment offers the exposure to indirect property with a blend of both property and infrastructure investments. Furthermore, a £53.6 million direct investment was made into infrastructure through shared purchase of motorway service stations, bringing the Fund closer to its strategic target for infrastructure assets.

The Fund held relatively high levels of cash at the year-end following some divestment of growth assets and pending investment into income generating assets.

5.2 Performance of the different asset classes is set out below in line with the allocation strategies for the Fund.

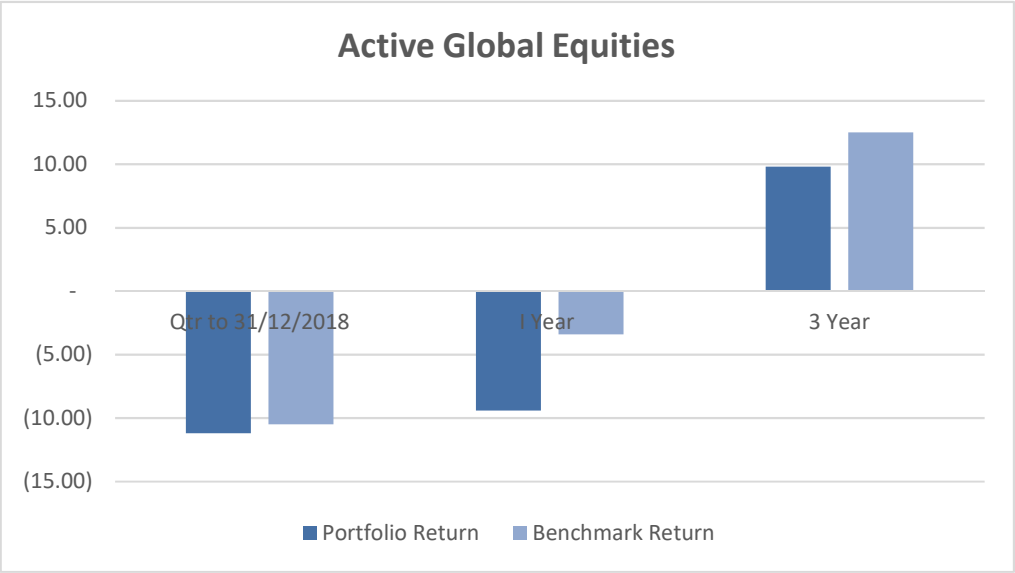
Growth Assets

5.3 Passive Equity performance: all passive in-house equity portfolios which transitioned to LGPS Central Ltd at the start of the financial year performed broadly in line with the respective benchmarks during the quarter.



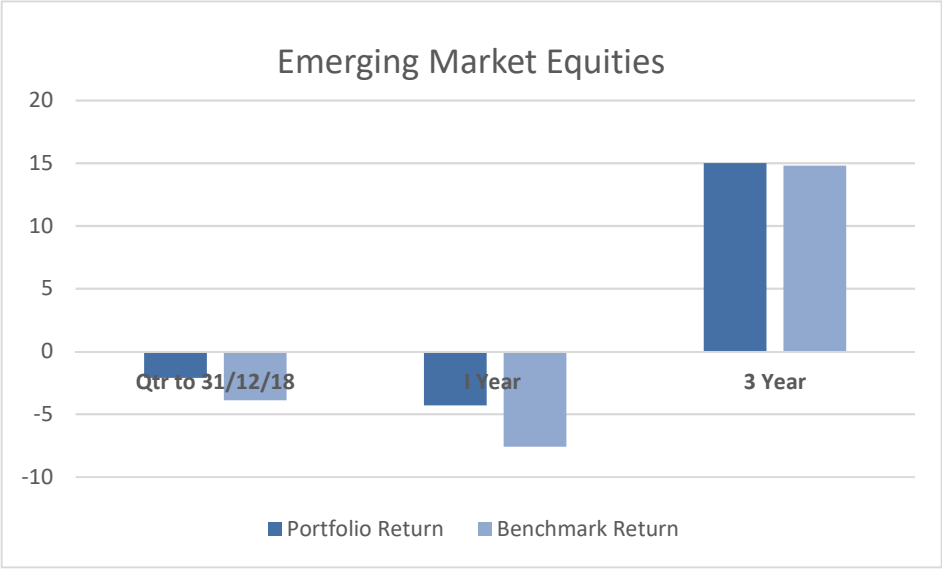
5.4 Global Active Equities performance: This portfolio comprises internal and external portfolios. The combined portfolio underperformed the index by 0.7% over the quarter (driven by both portfolios); over one year, the combined portfolio underperformed by 6.0%. Over the 3-year period, the returns for the Fund were 9.8% compared to a benchmark of 12.5%. This portfolio is in the process of being transitioned to new

management arrangements, partially within the LGPS Central investment pool and partially to the WMPF Sustainable Global equity mandate, with all transitions expected to have been completed early into the next financial year.

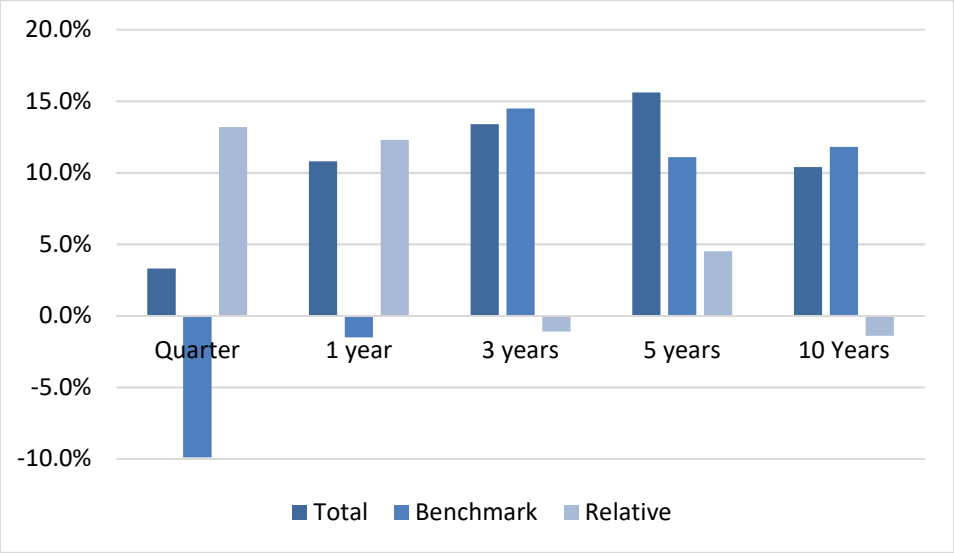


Over the one year, the internal portfolio underperformed the benchmark index by 9.0% in contrast to the external portfolio which marginally outperformed the benchmark by 0.1%. The internal portfolio had been heavily biased towards a value-based approach, a tilt, which would have caused around half the underperformance against the benchmark but was compounded by both a significant overweight in the UK which underperformed other global markets combined in particular the US where the Fund was significantly underweight. An underweight in oil and gas stocks was positive, but exposure to consumer stocks proved damaging and stock selection itself in the internal portfolio compounded asset and sector positioning underperformance. The Fund has taken steps to unwind this portfolio and around one quarter of the portfolio was liquidated in September 2018. Exposure to equity markets has been retained but has now moved to a more market neutral position to contain further risk exposure pending the onward transition to the sustainable equity portfolio.

5.5 Emerging Market Equities: the active emerging market equities portfolio is managed externally by three specialist managers offering complementary value, growth and quality strategies. All three managers outperformed against benchmark over the year, including the manager with a value biased portfolio that had hitherto struggled with performance. Over the quarter, the Fund outperformed against benchmark, by 1.7% and outperformed benchmark by 3.3% over the year. Outperformance has been dominated by stock selection which has been positive. An underweight position in the Asia Pacific region and overweight developed markets along with a large capitalisation bias and quality focus all added to the level of outperformance both over the quarter and the over the year as a whole.

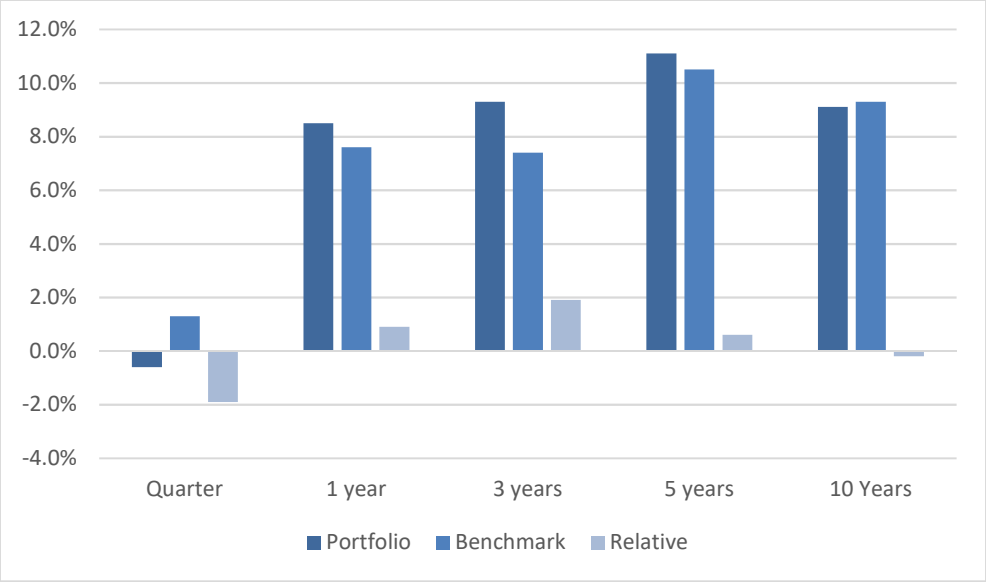


5.6 Private Equity: Whilst the portfolio showed a strong performance during the latest quarter, performance of private equity tends to lag that of quoted equity markets, so the one year and longer-term returns are a better mechanism for measuring performance. Exposure to the buyout sector at around 45% has been positive as has been the maturity of the portfolio which has seen assets being bid up as capital has flowed into private equity markets. The Fund has been looking at consolidating the portfolio given the strength of demand for private equity investments recognising the opportunity to consolidate the highly diversified nature of its holdings and this is now in progress. The quarterly, 1-year and longer-term performance of the portfolio is shown in the chart below:

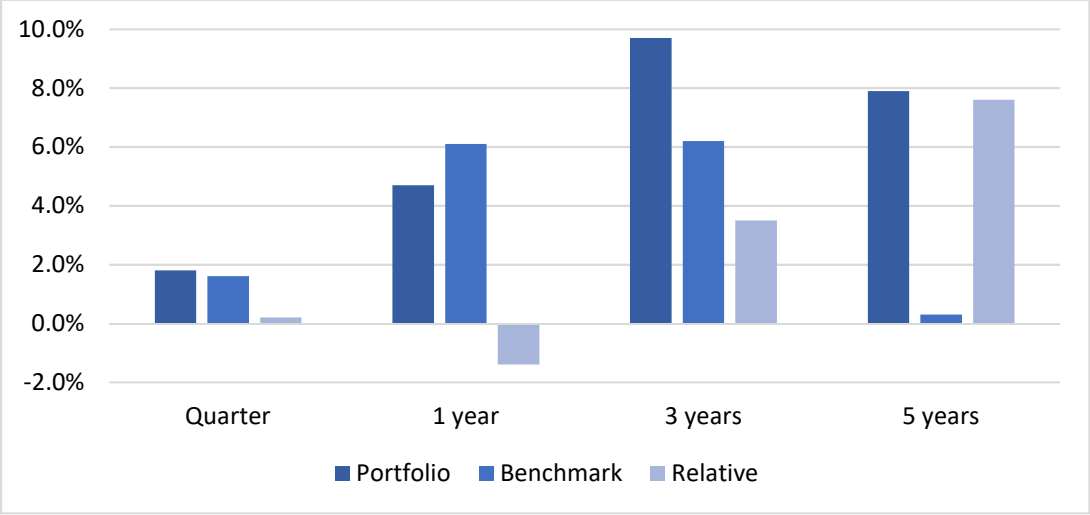


Income Assets

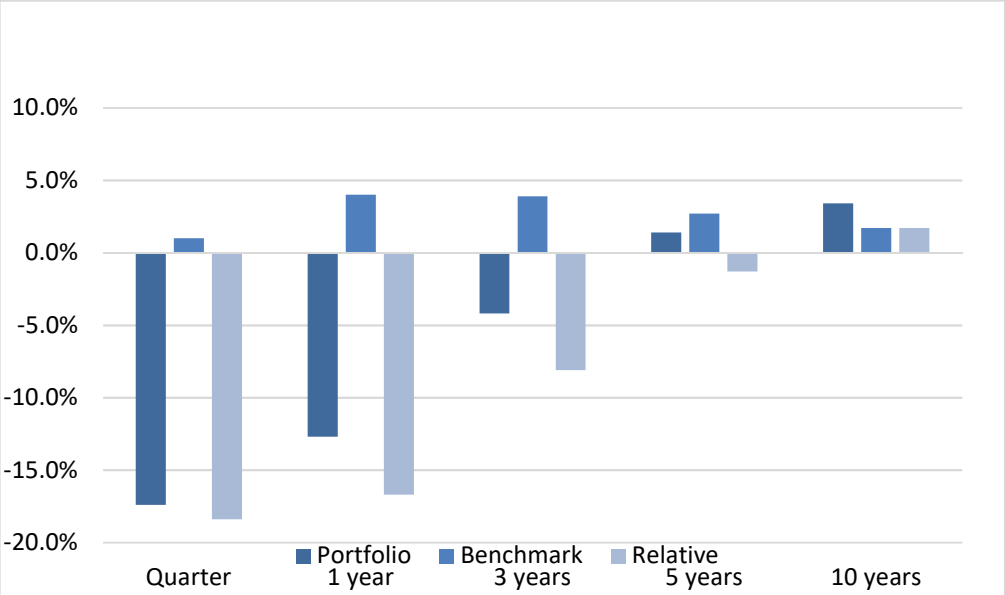
5.7 Property: Within the Direct Property portfolio, the sale of a small office in Manchester was completed for £1.7m. Whilst the Fund has an underweight position in this sector, given the uncertain outlook for UK property, the Fund is only looking at opportunities which offer significant value and yield premiums. Performance over both the medium and long-term has benefited from the Fund's exposure to the industrial sector of the market which has seen strong performance and being underweight in the retail sector which has performed poorly. Performance for the quarter was -0.6% compared to the benchmark of 1.3%, partly reflecting an aggressive write down for one of the Fund's retail assets, although with the expectation that this is in advance of further retail downgrades in the wider market. The year's performance of 8.5% for the Fund was above the 7.6% for the benchmark, with good relative performance over the 3 and 5-year periods, although flat over the 10 years, as can be seen from the chart below.



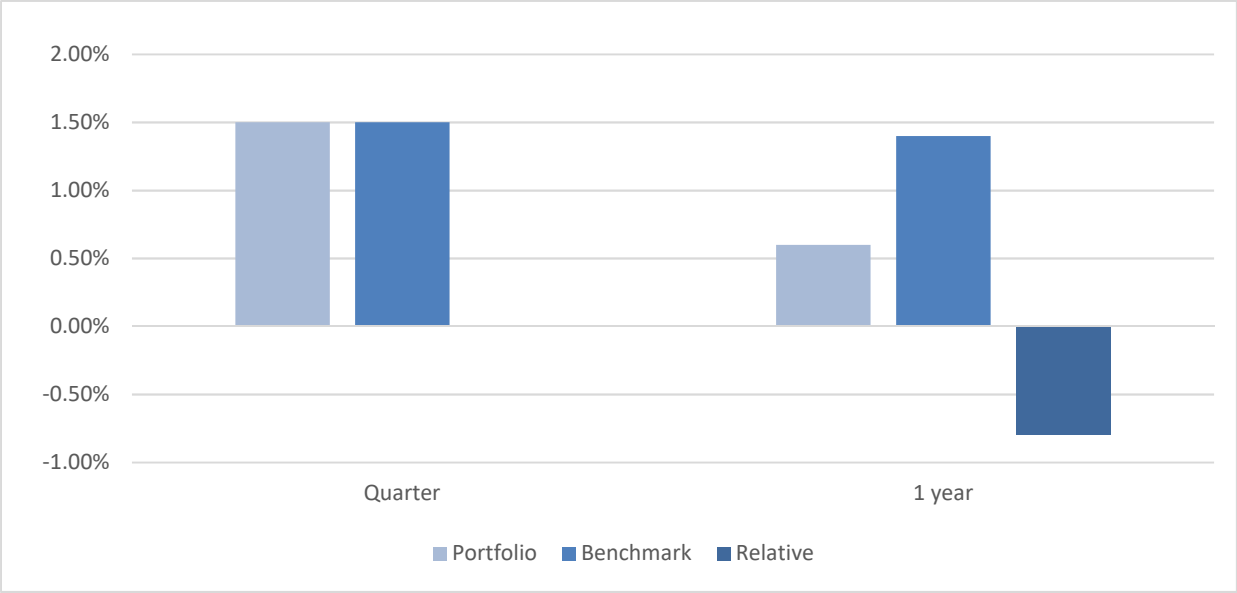
5.8 Infrastructure and Real Assets: The infrastructure portfolio marginally outperformed its benchmark during the quarter by 0.1%. The most significant positive performance came from the Thames Tideway Tunnel investment which had a good uplift in valuation and because of its size impacted the portfolio performance more significantly. The one-year performance at 4.7% versus benchmark of 6.1% was impacted by poor performance from some of the PFI projects which were exposed to the contracting sector which continues to face difficulties in the UK. The Fund made an acquisition alongside a partner into the Motorway Services Area for £53m to add diversification to the Fund's infrastructure exposure and to gain exposure to the long term cashflows from this investment. Over the 3-year period the Fund has delivered outperformance against benchmark as can be seen in the following chart:



5.9 Absolute Return: This covers the insurance linked funds and special opportunity investments. Performance for the quarter was significantly impacted by the insurance linked sector again suffering the effects of sever weather related events combined with Californian wildfires. Whilst it had been anticipated that this sector would have benefited from significant premium rate increases due to the previous year's weather-related incidents, these have not been sufficient to offset another year for high weather-related catastrophic events. Whilst recent experience in this sector has undoubtedly been very damaging in terms of performance over recent years, the 10-year performance is still showing a positive return, although clearly the level of volatility in the sector needs to be assessed. The Fund is undertaking a full assessment of the exposure to the insurance linked sector to be able to determine whether the level of risk/return given volatility is acceptable over the long term for the Fund.

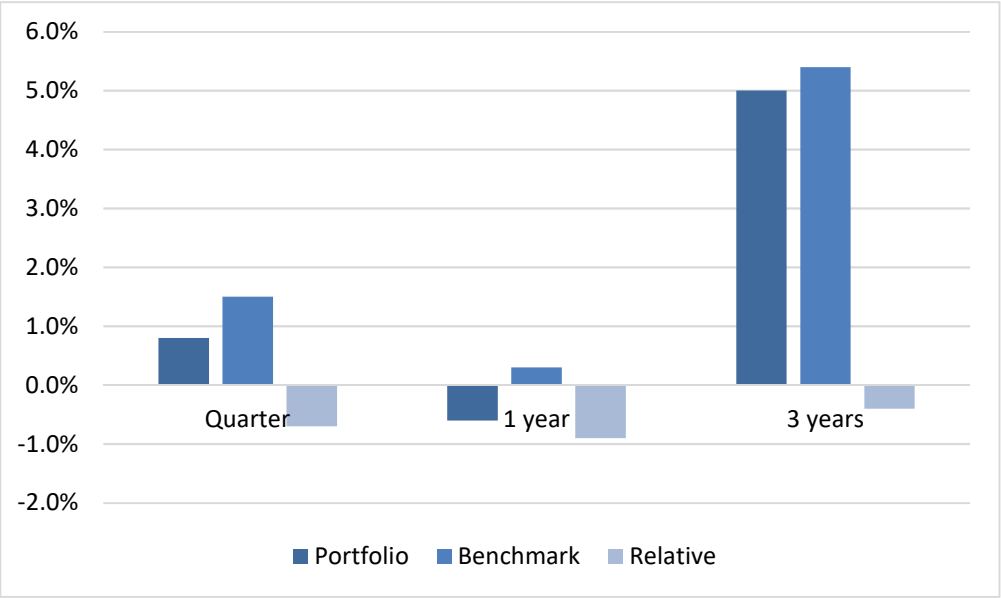


5.10 Fixed Income incorporating emerging market debt and specialist fixed income: The income element of the fixed income portfolio comprises a mix of emerging market debt, multi-asset credit and specialist debt funds. As the majority of holdings in the portfolio are relatively new, there are no longer term performance statistics for this segment of the portfolio. Over the quarter the portfolio performed in line with benchmark at 1.5%, although over the year underperformed against benchmark by 0.8%. On an individual basis, specialist fixed interest outperformed its benchmark by 2.4% with many of the constituent funds contributing, while emerging market debt underperformed its benchmark by 2.2%. The Fund has undertaken a focused review of emerging market debt and the managers selected and at this stage believe there is no strong case to review manager selection in the short term but will be reviewing the sector further over the coming months.



Stabilising Assets

5.11 Stabilising Fixed Income: The stabilising component of the fixed interest portfolio marginally underperformed its benchmark over the quarter by 0.6%. The largest detractor to performance was the cash flow matching segment, which underperformed its benchmark by 1.4%. This was principally attributable to buy and maintain corporate bond portfolio impacted by the unexpected rise in gilt yields and wider market volatility in December and impacted bond managers more broadly. Both the gilt and index-linked gilt funds performed in line with their respective benchmarks, but their performance was partially offset by an overweight position in cash, which yielded a lower return. The corporate bond portfolio, sitting in the stabilising segment of the portfolio moderately outperformed its benchmark due to the outperformance of its active manager. Over the year, performance again was impacted by the stabilising portfolio performance against benchmark. Over the 3-year timeframe the portfolio is only marginally behind benchmark as can be seen from the chart below.



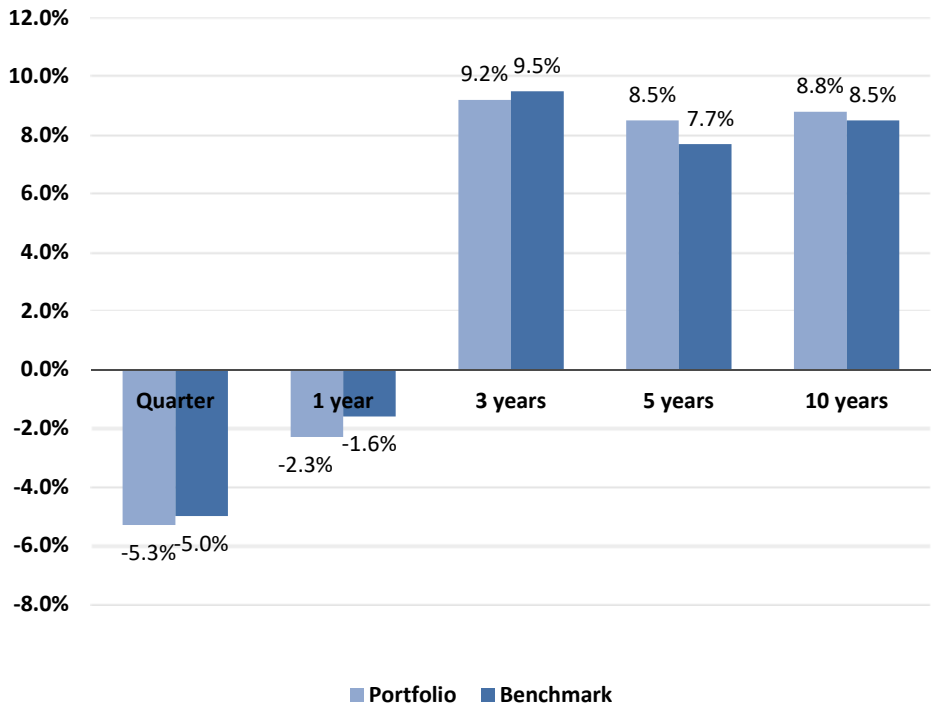
Currency

5.12 Having benefitted from the weakness of sterling during 2016/17, the Fund entered a passive currency hedging programme in September 2017 to protect returns in sterling terms and to reduce currency risk within the investment portfolio. The hedge is applied to the Fund's overseas quoted equity portfolios with a hedge ratio of 50% based on the strategic weights for each region.

During Q4 2018, whilst the hedge acted as a drag on the absolute return of the Fund due to sterling weakness on the back of Brexit concerns it has been performing in line with expectations.

Total Fund Performance

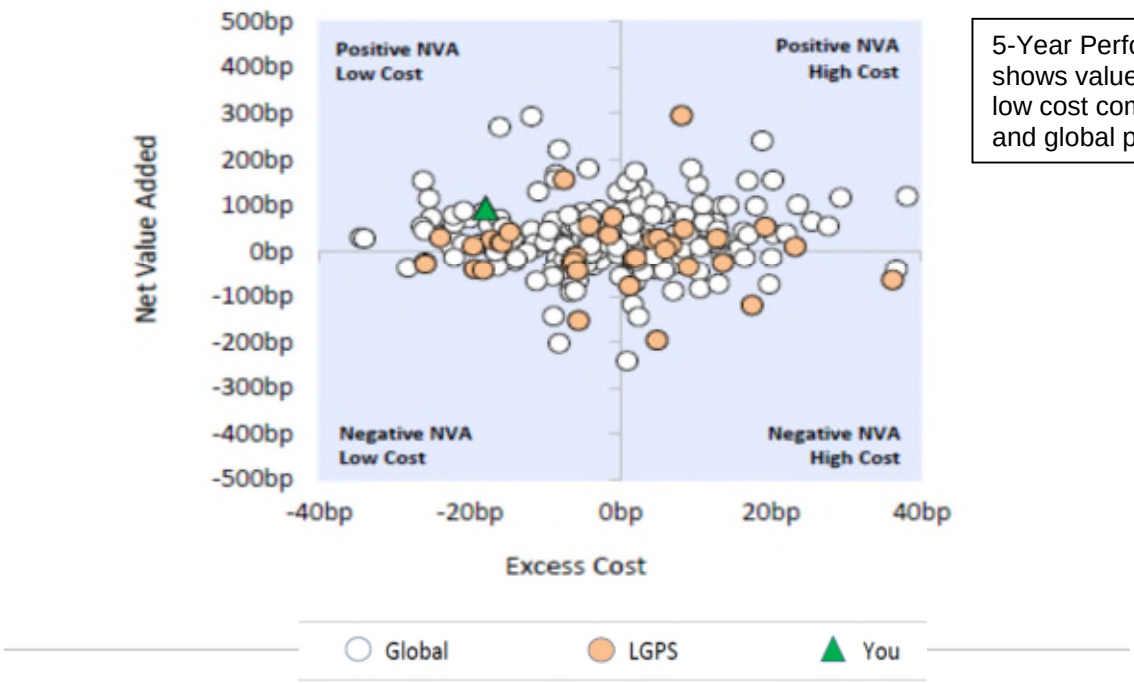
5.13 The performance of the Fund over the quarter was just under benchmark by 0.3%, with both the quarter and year's performance being impacted by a number of areas which the Fund is either addressing or has under review. The longer-term performance still looks positive compared with the benchmark as can be seen from the chart below.



Investment Costs

5.14 The Fund continues to review its internal and external manager performance and fees to ensure the effective implementation of its investment strategy in line with the Fund's Investment Strategy Statement. The latest benchmarking exercise with an external provider, CEM Benchmarking, compares the Fund with over 340 large global pension funds along with comparable LGPS funds concluding that the Fund's investments had added value above the median and at low cost relative to peers:

- The Fund's 5-year net total annual return of 8.9% was above both the LGPS median of 8.6% and the Global median of 7.9%.
- Investment costs have fallen from 91.2 bps in 2013/14 to 54.9 bps in 2017/18, with lower cost implementation driven by paying less than peers for similar services.
- The Fund's 5-year net value added (measure of cost effectiveness) was 0.9%. This was above the LGPS median of 0.1% and above the global median of 0.2%.



5-Year Performance to 31/03/18 shows value add performance at low cost compared to both LGPS and global peers

6.0 West Midlands Integrated Transport Authority Quarterly Performance

6.1 At the end of the fourth quarter of the financial year 2018/19, the value of the WMITA Fund has fallen from £503 million to £490 million at the end of the year to 31 December 2018 as global equity markets slumped against a backdrop of ongoing US-China trade tensions and a global slowdown. The table below sets out the asset allocation of the portfolio at the end of December (excluding the buy-in element of £238.3 million), the policy targets are those set in the Investment Strategy Statement, updated following changes agreed with Committee in September 2018.

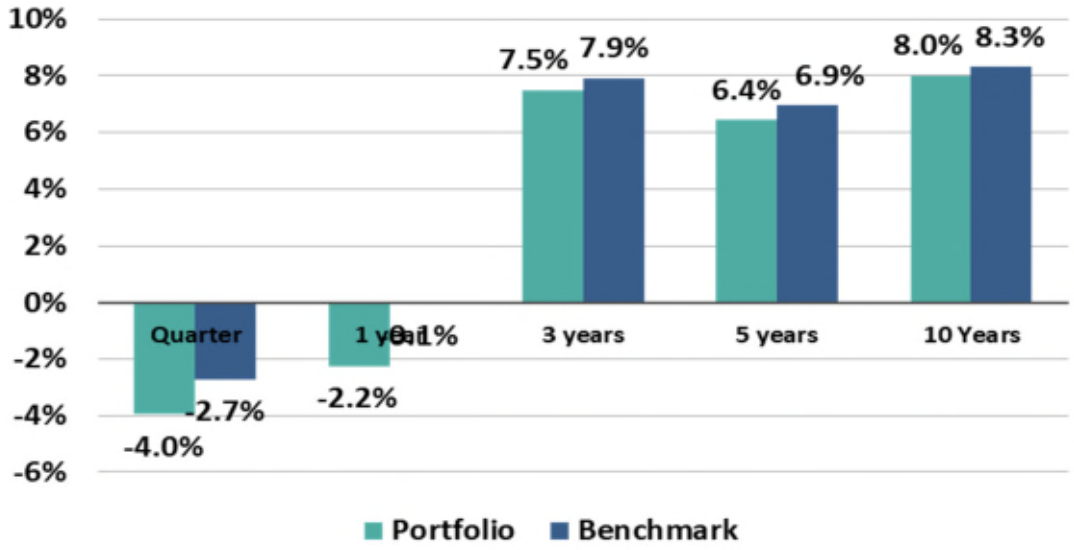
Asset class		Value (£)	Fund allocation	Policy target	Difference
Equities	£	67,213,912	26.7%	27.1%	-0.3%
Diversified Growth Funds	£	90,501,578	36.0%	35.5%	0.5%
Fixed Interest	£	41,355,605	16.5%	0.0%	16.5%
MAC	£	50,420,429	20.1%	20.3%	-0.2%
LDI	£	-	0.0%	17.1%	-17.1%
Cash	£	1,894,349	0.8%	0.0%	0.7%
TOTAL	**£**	**251,385,873**	**100.0%**	**100.0%**	**0.0%**

*Excludes Prudential buy-in £238.3 million

** Policy target shows the updated policy targets agreed by Pensions Committee in March 2018

6.2 The Fund has implemented the first part of the strategic changes by switching out of equities and into a multi-asset credit funds and work to implement the Liability Driven Investment is ongoing.

6.3 In the quarter ended 31 December 2018, the fund achieved a return of -4.0% against the benchmark return of -2.7%. Over the 12-month period the fund underperformed the benchmark by 2.1%, this was mainly due to the underperformance of the DGF's relative to equities and fixed interest portfolios. The chart below shows the gross performance of the portfolio over the last quarter and over the longer term.



6.4 The table below sets out the different components of the performance of the portfolio to periods to end December 2018. The passive equity portfolio has performed in line with the benchmark over all periods under review. The diversified growth portfolio has experienced mixed performances with one of the portfolios impacting on the overall performance of the DGF allocation. The fixed income allocation is split between passive index linked exposure (which has performed in line with benchmark) and an active corporate bond portfolio which has underperformed over the quarter but outperformed over the year.

	Absolute performance				Relative performance			
	Quarter	1 year	3 years p.a.	5 years p.a.	Quarter	1 year	3 years p.a.	5 years p.a.
Equities	-9.9%	-5.8%	11.5%	9.1%	0.0%	0.0%	0.0%	0.2%
Diversified Growth Funds	-2.9%	-2.2%	2.9%	2.8%	-4.0%	-6.6%	-1.3%	-1.4%
Bonds	-0.4%	-1.6%	6.1%	6.7%	-1.6%	-1.0%	-0.3%	-0.1%
Total return	**-4.0%**	**-2.2%**	**7.5%**	**6.4%**	**-1.3%**	**-2.2%**	**-0.4%**	**-0.5%**

7.0 Investment Pooling Update – LGPS Central

7.1 Following the launch of the Global Equity Active ACS Sub-Fund in November and approval to delegate the final decision to officers on transition by this Committee, the Fund along with four other Partner Funds committed and transitioned over £2bn to this sub-fund during February 2019 and this will feature within the reporting from the next quarter.

7.2 As noted at the December Committee, the private equity sub-fund was close to receiving approval. Legal set-up and documentation was completed and the sub-fund launched early in the new year, with five Partner Funds participating.

7.3 Work has also taken place alongside input from the Fund and other Partner Funds to develop emerging market equity and corporate bond sub-funds. A number of other sub-funds remain in development and the Committee will be kept updated of opportunities as they arise.

8.0 Financial implications

8.1 The financial implications are set out throughout the report.

9.0 Legal implications

9.1 This report contains no direct legal implications.

10.0 Equalities implications

10.1 This report contains no equal opportunities implications.

11.0 Environmental implications

11.1 This report contains no environmental implications.

12.0 Human resources implications

12.1 This report contains no direct human resources implications.

13.0 Corporate landlord implications

13.1 This report contains no direct corporate landlord implications.

14.0 Schedule of background papers

14.1 Investment Strategy Statement

14.2 Funding Strategy Statement

15.0 Schedule of appendices

15.1 Appendix A – Economic and Market Update February 2019