

# West Midlands Pension Fund

Asset allocation and investment performance report  
Quarter to 31 March 2017

*Jason Fletcher – Chief Investment Officer*

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# Contents

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page 4	Executive summary
page 7	Objectives
page 8	Fund values and allocation
page 9	Market review
page 10	Fund performance review
page 14	Fund risk review
page 15	Policy group reports
page 38	Environmental, social and governance

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## Appendices:

page 41	Full Fund asset allocation
page 42	Risk management
page 45	Team biographies

# Further information

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## Our investment strategy

<http://www.wmpfonline.com/Investments>

## Our Environmental and Social Governance beliefs

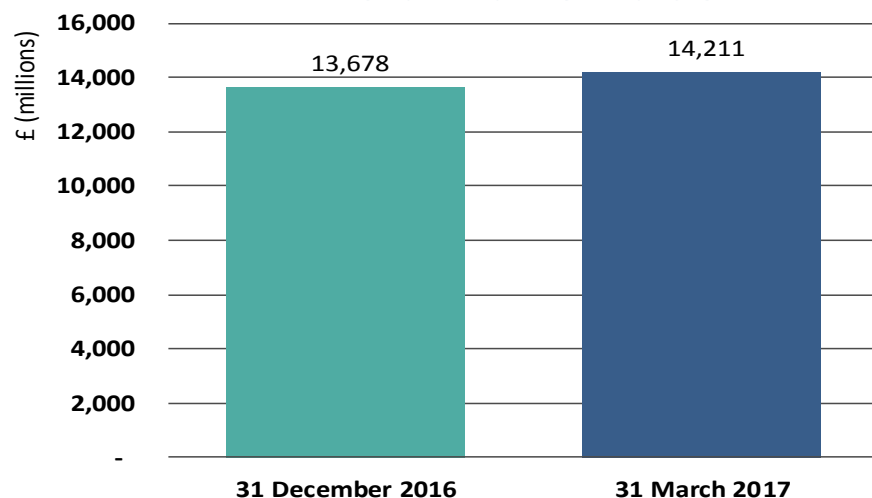
[www.wmpfonline.com/ri](http://www.wmpfonline.com/ri)

## Our Fund's website

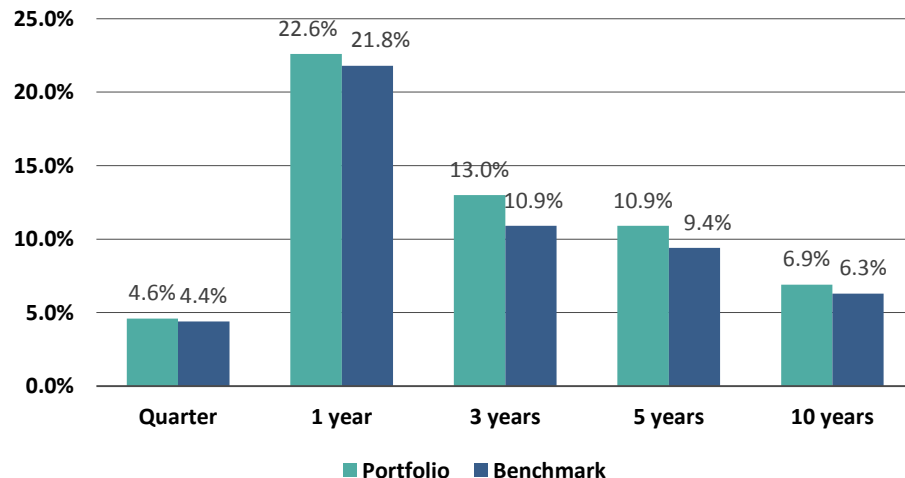
[www.wmpfonline.com](http://www.wmpfonline.com)

# Executive summary

## Total market value



## Total Fund performance<sup>[1]</sup> (in GBP)



[1] Returns are shown net of fees

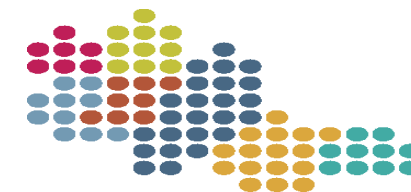
## Market summary

- Equity markets continued to make gains in the quarter with several leading indices reaching all-time highs
- Long-term government bond yields declined in the UK and US
- The Federal Reserve raised the US benchmark interest rate by 0.25%. The UK base rate remained at 0.25%
- Sterling strengthened as the US dollar weakened

## Performance summary

- The Fund returned 4.6% during the quarter, moderately outperforming its benchmark by 0.2%.
- Over the 12 months the Fund outperformed its benchmark by 0.8% and exceeded its annual performance objective, which is to outperform the benchmark by 0.5%.
- Special opportunities, insurance linked funds and real assets & infrastructure outperformed their respective benchmarks, while private equity and emerging market equities underperformed their benchmarks.

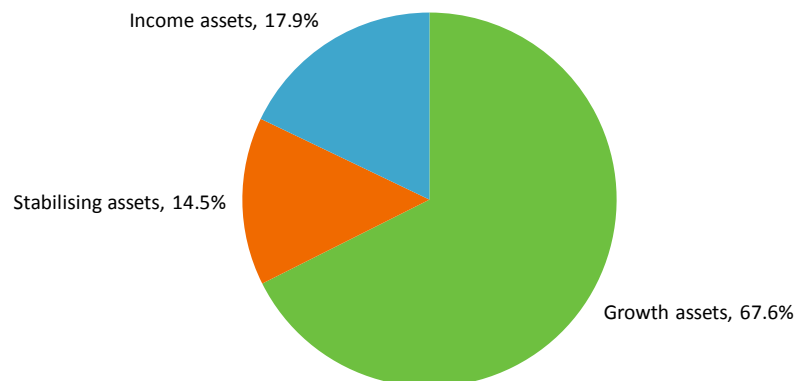
# Executive summary



West Midlands Pension Fund

## Asset allocation

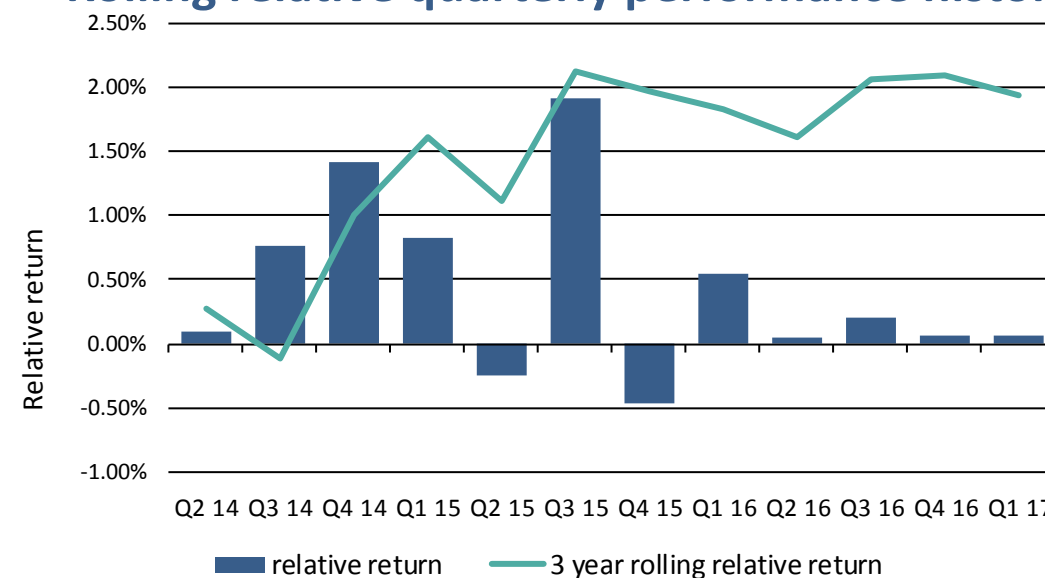
Asset class	Value (£m)	Fund allocation (%)	Policy target (%)	Difference (%)
Quoted equities	7,918	55.7	48.0	7.7
Private equity	1,345	9.5	10.0	-0.5
Special opportunities	348	2.4	2.0	0.4
<b>Total growth assets</b>	<b>9,611</b>	<b>67.6</b>	<b>60.0</b>	<b>7.6</b>
UK gilts	166	1.2	2.0	-0.8
Index linked gilts	769	5.4	5.0	0.4
Cash	389	2.7	2.0	0.7
Corporate bonds	388	2.7	2.0	0.7
Cashflow matching fixed interest	352	2.5	3.0	-0.5
<b>Total stabilising assets</b>	<b>2,064</b>	<b>14.5</b>	<b>14.0</b>	<b>0.5</b>
Specialist fixed interest	286	2.0	3.5	-1.5
Emerging market debt	379	2.7	3.5	-0.8
Property	1,080	7.6	10.0	-2.4
Insurance linked funds	380	2.7	3.0	-0.3
Real assets and infrastructure	411	2.9	6.0	-3.1
<b>Total income assets</b>	<b>2,536</b>	<b>17.9</b>	<b>26.0</b>	<b>-8.1</b>
<b>TOTAL</b>	<b>14,211</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>



## Quarterly Fund activity

- £45.2 million was generated from private equity fund distributions
- £4.3 million was allocated to the Fund's passive equity portfolios.
- The real assets & infrastructure portfolio returned £12.2 million through a number of distributions.
- A number of drawdowns resulted in a net investment of £5.6 million into the absolute return portfolio.

## Rolling relative quarterly performance history



## Main report

# Objectives

The primary objective of the Fund is to provide pension and lump-sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependents, on a defined benefits basis.

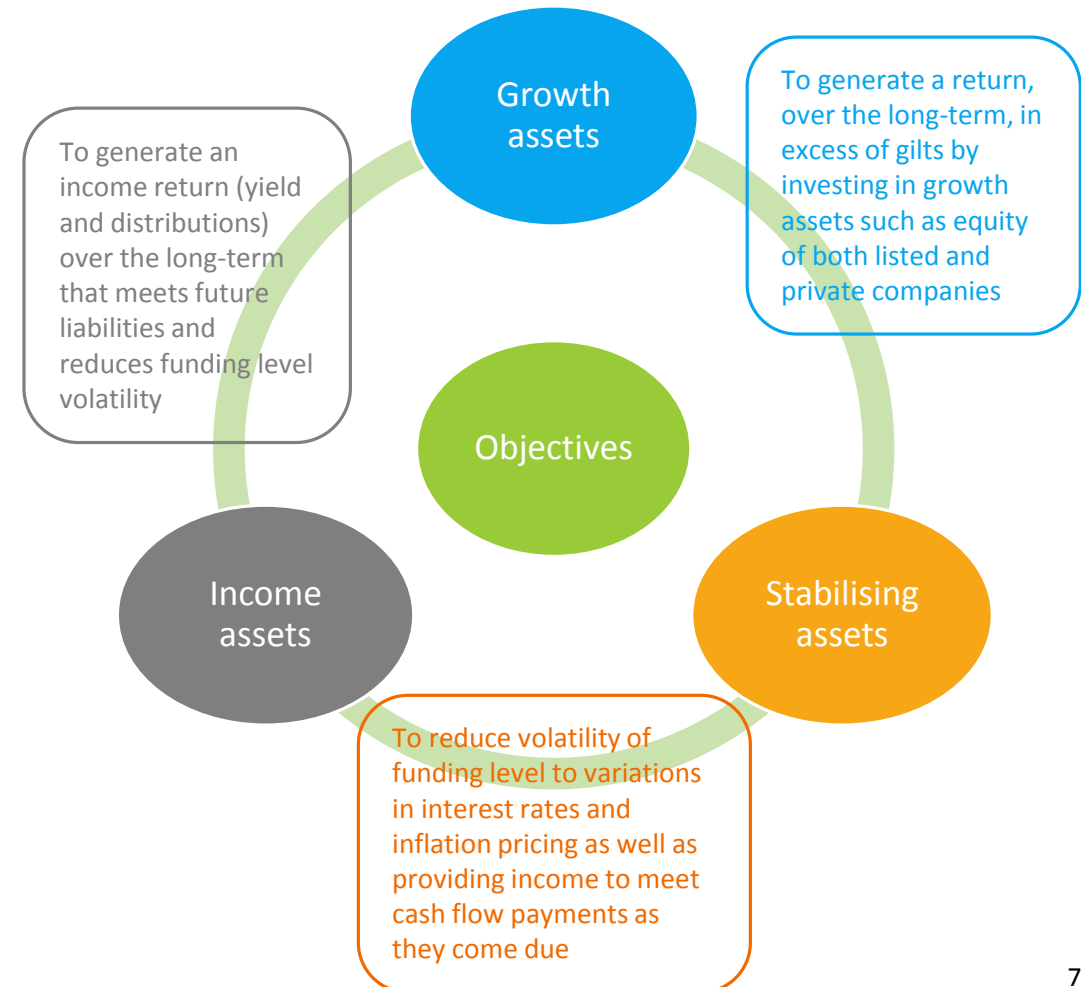
The Pensions Committee aims to fund the Fund in such a manner that, in normal market conditions and within a reasonable period, all accrued benefits are fully covered by the value of the Fund's assets and that an appropriate level of contributions is agreed by the employers to meet the cost of future benefits accruing. For employee members, benefits will be based on service completed but will take account of future salary increases. In addition, the Fund has the following objectives:

- To be a leading performer in the LGPS sector
- To provide excellent customer service
- To achieve target investment returns
- To ensure the solvency of the Fund and its ability to pay pensions

In aiming to be a leading performer within the LGPS the Fund is striving to achieve a fund management capability of institutional standard.

The Committee has translated its objectives into a suitable strategic investment allocation benchmark (SIAB) and structure for the Fund taking into account both the Fund's liability structure and the objectives set out above.

The key building blocks of the Fund's SIAB are shown below.



# Fund values and allocation

## Asset allocation<sup>[1]</sup>

Asset class	Value (£m)	Fund allocation %	Policy target %	Difference %	Change from previous quarter %
<b>Growth</b>					
Quoted equities	7,918	55.7	48.0	7.7	1.1
Private equity	1,345	9.5	10.0	-0.5	-0.5
Special opportunities	348	2.4	2.0	0.4	0.0
<b>Total growth assets</b>	<b>9,611</b>	<b>67.6</b>	<b>60.0</b>	<b>7.6</b>	<b>0.6</b>
<b>Stabilising</b>					
UK gilts	166	1.2	2.0	-0.8	0.0
Index linked gilts	769	5.4	5.0	0.4	-0.1
Cash	389	2.7	2.0	0.7	0.1
Corporate bonds	388	2.7	2.0	0.7	-0.1
Cashflow matching fixed interest	352	2.5	3.0	-0.5	-0.1
<b>Total stabilising assets</b>	<b>2,064</b>	<b>14.5</b>	<b>14.0</b>	<b>0.5</b>	<b>-0.2</b>
<b>Income assets</b>					
Specialist fixed interest	286	2.0	3.5	-1.5	-0.1
Emerging market debt	379	2.7	3.5	-0.8	0.1
Property	1,080	7.6	10.0	-2.4	-0.1
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<b>Total income assets</b>	<b>2,536</b>	<b>17.9</b>	<b>26.0</b>	<b>-8.1</b>	<b>-0.4</b>
<b>TOTAL</b>	<b>14,211</b>	<b>100.0</b>	<b>100.0</b>	<b>-</b>	<b>-</b>

## Allocation comment

As at 31 March 2017 the Fund was significantly overweight in growth assets. Equities were used to deploy rising cash balances resulting from asset sales and private equity distributions. There is a corresponding underweight in income assets.

The Fund's asset allocation target portfolio aims to increase income assets and reduce stabilising assets. Whilst investments are found in property, infrastructure and credit assets the favoured asset class remains growth assets. The Fund is currently considering increasing its allocation to European equities to benefit from the resurging economic growth there and improving political outlook. The Fund is also seeking to raise its emerging market exposure.

The Fund is favouring credit assets over stabilising assets with additions to emerging market debt.

[1] A detailed Fund asset allocation is shown in Appendix 1



# Market review

## Returns for world markets (in GBP) to 31 March 2017



## Equities

Equity markets continued to advance in the quarter with several leading indices reaching new highs. The UK market performed well on the strength of robust economic growth data while US equities benefitted from the anticipation of lower tax rates and higher government spending following the US election. European markets were buoyant amid speculation that the ECB might consider tighter monetary policy. Emerging markets enjoyed particularly strong performance supported by an upturn in global growth and reduced fears of protectionist US trade policy.

## Property

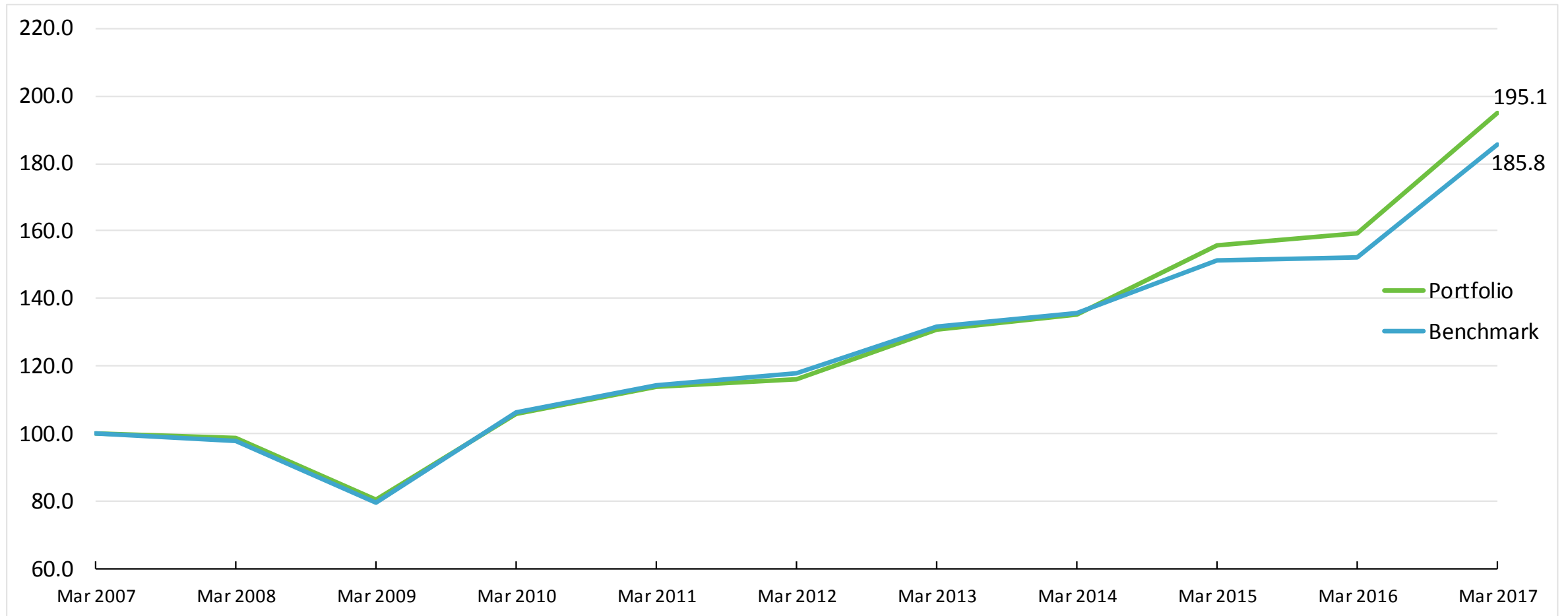
The first quarter of the year saw a continuation in the desirability of property to institutional investors and this, coupled with more limited transactional volumes supported capital values, resulting in further tightening of yields in most sectors. Occupier demand remains fairly robust, as CFO's have become less risk averse than in the immediate aftermath of the Brexit vote. However, the trend of rising rents, now 15 quarters old, is in danger of stalling as the balance in the market now seems to be returning to the tenant and away from landlords. Political and associated economic risks persist but feel more normal as time passes.

## Fixed interest

The 10-year UK gilt yield decreased from 1.24% to 1.14% over the quarter as investors grew concerned over the potential for a 'hard' Brexit. The equivalent US yield fell from 2.44% to 2.39% with the prospect of tighter monetary policy. The Federal Reserve raised its benchmark interest rate by 0.25% on stronger economic growth and inflation data while UK interest rates were kept on hold at 0.25%. Sterling investment grade corporate bonds outperformed gilts despite credit spreads narrowing over the quarter.

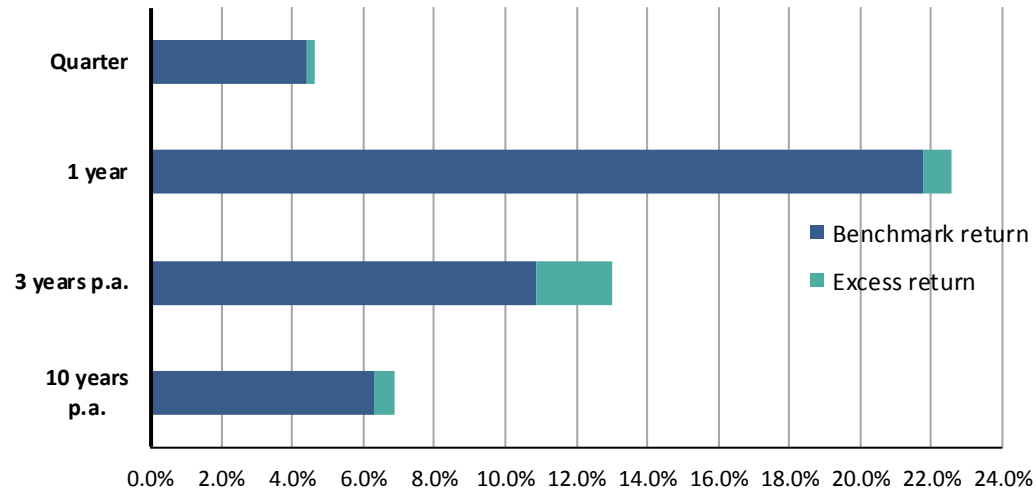
# Fund performance review

Long-term returns (in GBP; rebased at 100 at 31 March 2007)



# Fund performance review

## Benchmark and excess returns to 31 March 2017



	Quarter (%)	1 year (%)	3 years p.a. (%)	10 years p.a. (%)
Benchmark return	4.4	21.8	10.9	6.3
Excess return	0.2	0.8	2.1	0.6
Total absolute return	4.6	22.6	13.0	6.9

Source: Portfolio Evaluation Ltd

## Fund performance commentary

The Fund moderately outperformed its benchmark during the quarter. Strong relative returns from absolute return and real assets & infrastructure offset underperformance from the private equity and emerging market equity portfolios. As shown on p. 12, virtually all asset classes contributed positively to total Fund performance.

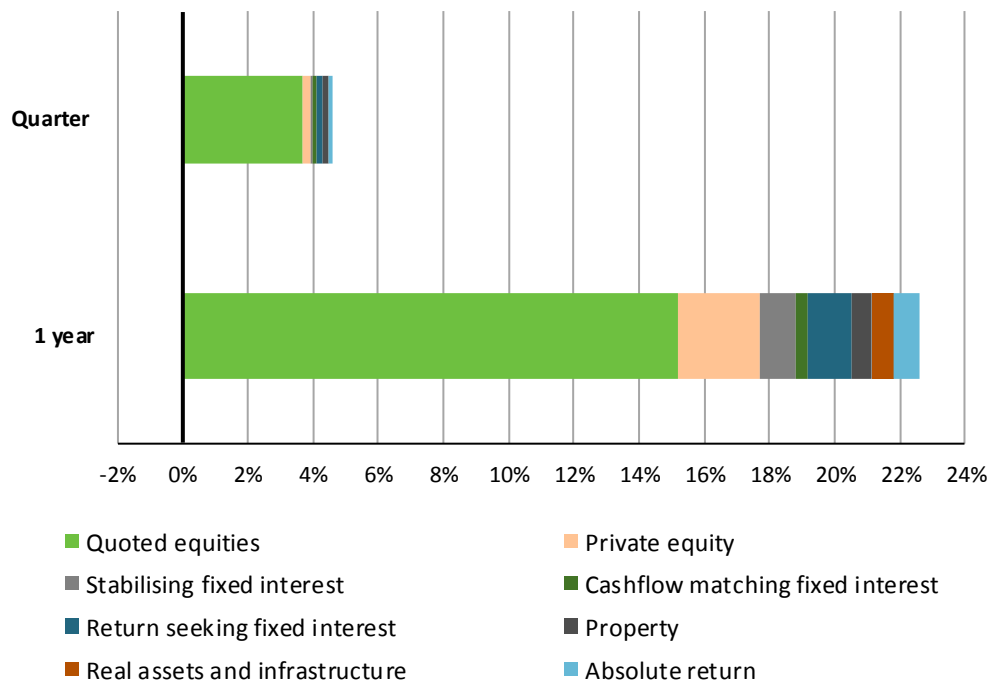
The Fund outperformed its benchmark over the year by 0.8%, returning 22.6% against the benchmark of 21.8%. The outperformance was driven by the Fund's property, absolute return and real assets & infrastructure portfolios, with the latter two enjoying particularly strong outperformance over the twelve months. The Fund's relative and absolute performance benefitted from the weakness of sterling over the 12 month period.

The Fund returned 13.0% p.a. for the three years to 31 March 2017 compared to the benchmark of 10.9%. Strong outperformance from the absolute return, private equity and real assets & infrastructure portfolios were the key contributors to good overall Fund returns. This was offset by some underperformance from the Fund's emerging market equity portfolio.

# Fund performance review



## Absolute performance attribution to 31 March 2017



Absolute performance attribution	Quarter	1 year
Quoted equities	3.7	15.2
Private equity	0.2	2.5
Stabilising fixed interest	0.1	1.1
Cashflow matching fixed interest	0.1	0.4
Return seeking fixed interest	0.2	1.3
Property	0.2	0.6
Real assets and infrastructure	0.0	0.7
Absolute return	0.1	0.8
Total absolute return	4.6	22.6

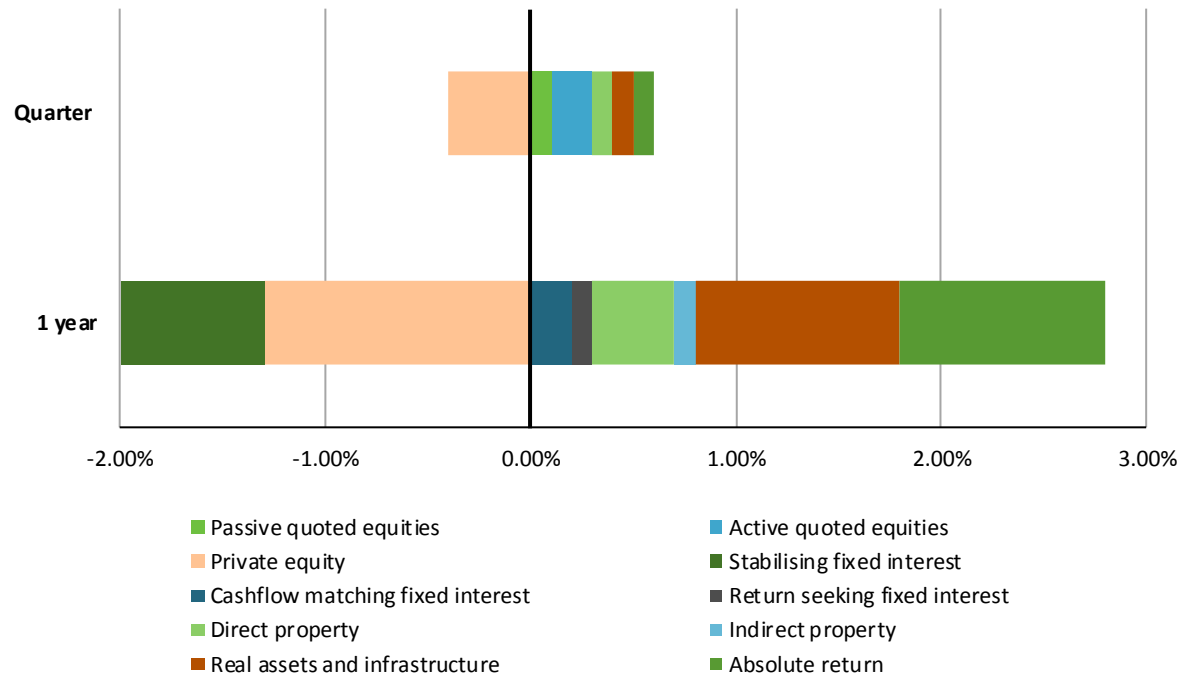
Source: Portfolio Evaluation Ltd

Note that the table above shows the weighted contribution of each asset class to the Fund’s absolute return.

Each of the Fund’s asset classes contributed positively to the Fund’s absolute performance over the quarter with the exception of real assets and infrastructure, which marginally underperformed its benchmark. Over the 12 months to 31 March 2017 all asset classes made a positive contribution to performance. Strong equity markets were the largest contributor over both periods.

# Fund performance review

## Relative performance attribution to 31 March 2017



Relative performance attribution	Quarter	1 year	Benchmark
Passive quoted equities	0.1	0.0	Listed equivalent
Active quoted equities	0.2	0	Listed equivalent
Private equity	-0.4	-1.3	FTSE All World + 2% pa
Stabilising fixed interest	0.0	-0.7	Blended benchmark
Cashflow matching fixed interest	0.0	0.2	UK Gilts + 1.4% pa
Return seeking fixed interest	0.0	0.1	Blended benchmark
Direct property	0.1	0.4	IPD Properties Annual
Indirect property	0.0	0.1	CPI + 6% pa
Real assets and infrastructure	0.1	1.0	CPI + 4% pa
Absolute return	0.1	1.0	LIBOR + 3-4% pa
<b>Total relative return</b>	<b>0.2</b>	<b>0.8</b>	

Source: Portfolio Evaluation Ltd

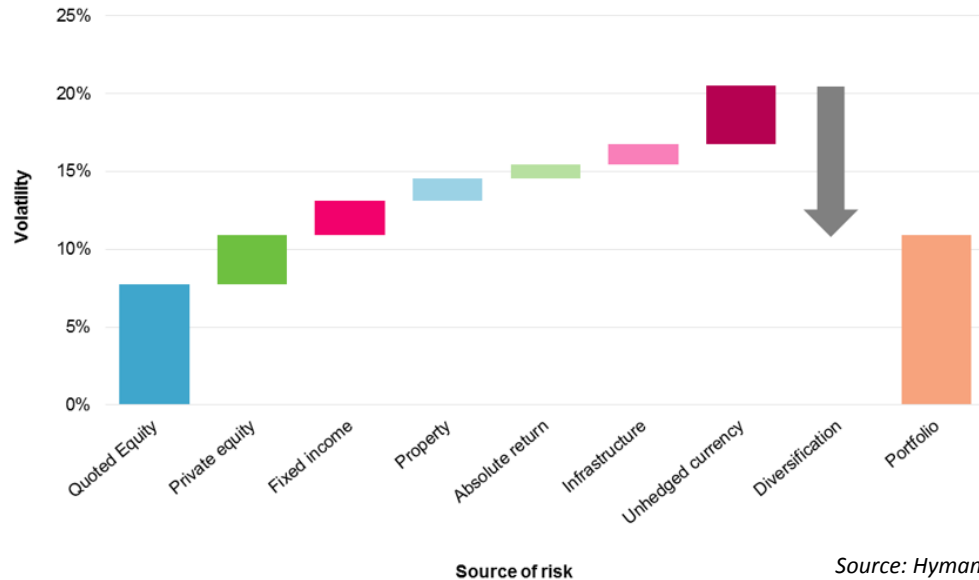
Note that the table above shows the weighted contribution of each asset class to the Fund's relative return.

During the quarter underperformance in the private equity portfolio partially offset gains made elsewhere in the Fund. This was due, in part, to a valuation lag with a number of private equity managers reporting their quarter-end figures after the Fund's reporting date.

Underperformance in the private equity and stabilising fixed interest portfolios was the largest detractor from performance over the 12 months, with the Fund's overweight cash position a notable laggard.

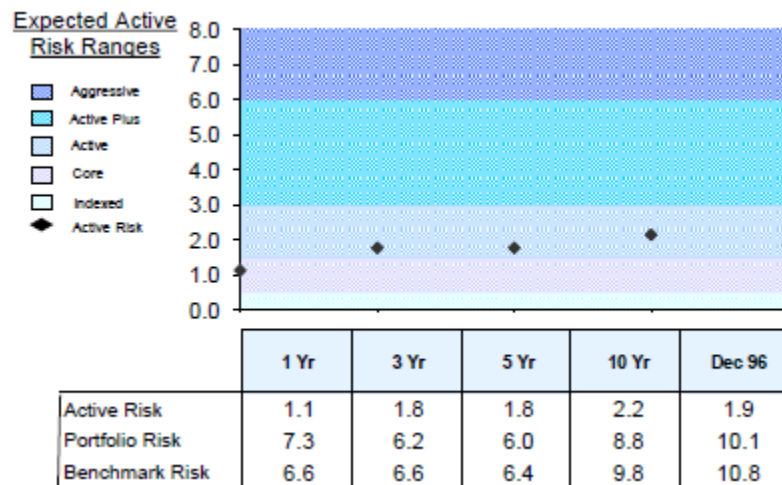
# Fund risk review

## Total 1 year Fund risk



Source: Hymans Robertson

## Fund ex-post active risk analysis



Source: Portfolio Evaluation Limited

## Fund risk commentary

The total one-year Fund risk chart depicts the expected 12-month volatility of the Fund's assets. The largest contributors to risk over the 12 months from 31 March 2017 are expected to be the Fund's equity, currency and private equity holdings. Even though fairly simplistic, the chart does give an overall picture of the risks the Fund is running and the benefits of diversification.

The Fund's international holdings have been unhedged which has benefitted the absolute return of the Fund.

The ex-post active risk analysis demonstrates that the total Fund has taken minimal active risk. This is in keeping with the Fund's asset allocation, which has a significant amount of assets in passive index funds which typically exhibit minimal tracking error. Over time, the Fund's alternative portfolios (in particular, private equity and infrastructure & real assets) have exhibited more aggressive active risk.

## Policy Group reports

page 16 – active global equities  
page 19 – active emerging market equities  
page 22 – passive quoted equities  
page 24 – private equity  
page 27 – property  
page 29 – real assets and infrastructure

page 31 – absolute return  
page 33 – return seeking fixed interest  
page 35 – cashflow matching fixed interest  
page 37 – stabilising fixed interest

# Active global equities - overview



## Active quoted equities policy group summary

- The active quoted equities portfolio comprises the in-house active global equity portfolio, and the externally managed global equity portfolio run by MFS.
- The in-house active global equity fund is a global, unconstrained portfolio with a medium term outlook and a value approach. It will tend to hold a concentrated portfolio of 50-60 stocks.
- The MFS portfolio is a global portfolio with a medium term outlook and 80-100 holdings. It does not have a stated style preference, but in practice tends to be tilted towards quality and growth stocks.
- The performance target for both portfolios is to outperform the benchmark FTSE All World index by 2% pa over a rolling 3 year period.

## Summary of activity and performance

There were no subscriptions or redemptions by the Fund over the quarter into either portfolio.

The internal portfolio increased its relative exposure to Europe ex-UK (+3.0%) and Asia ex-Japan (+1.4%) over the quarter, and reduced exposure to North America (-0.6%), and Japan (-3.8%).

MFS increased its relative exposure to Europe ex-UK (+0.8%), Asia ex-Japan (+0.1%) and Emerging Markets (+0.1%), and reduced exposure to North America (-0.9%).

The combined portfolio performed in line with the index over the quarter (with the internal underperformance offset by MFS outperformance); over 1 year the slight outperformance by the internal portfolio was more than offset by underperformance by MFS, resulting in overall underperformance of 0.6%.

## Regional allocation and performance

Internal portfolio	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)	Change from previous quarter (%)
UK	220.4	35.0	6.1	28.9	0.0
Europe (ex-UK)	144.0	22.9	14.9	8.0	3.0
North America	133.6	21.2	55.5	-34.3	-0.6
Japan	68.8	10.9	8.2	2.7	-3.8
Asia ex-Japan	45.8	7.3	6.0	1.3	1.4
Emerging markets	17.2	2.7	9.3	-6.6	0.0
<b>Total internal</b>	<b>629.9</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>
Externally managed (MFS)	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)	Change from previous quarter (%)
UK	44.7	9.2	6.1	3.1	0.0
Europe (ex-UK)	143.9	29.6	14.9	14.7	0.8
North America	279.8	57.6	55.5	2.1	-0.9
Japan	5.7	1.2	8.2	-7.0	0.0
Asia ex-Japan	5.3	1.1	6.0	-4.9	0.1
Emerging markets	6.2	1.3	9.3	-8.0	0.1
<b>Total external</b>	<b>485.7</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>
Performance					
	Q1 2017 (%)	1 year (%)	3 years (% p.a.)	Since inception (internal, % p.a.)	Since inception (MFS, % p.a.)
<b>Benchmark</b>	<b>5.8</b>	<b>33.1</b>	<b>16.4</b>	<b>16.5</b>	<b>10.4</b>
Relative performance:					
Internal portfolio	-0.8	0.2	N/A	-3.8	N/A
MFS	1.0	-1.7	1.0	N/A	2.4
<b>Combined</b>	<b>0.0</b>	<b>-0.6</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>

<sup>1</sup> FTSE All World Index

Note that the in-house and external active global equity funds form part of the wider global equity portfolio, which represented 12.0% of the Fund's assets at 31 March 2017 against a medium term target of 10.0%.



# Active global equities – return attribution

## Performance comment

The combined portfolio performed in line with the benchmark over the quarter, with the underperformance from the internal portfolio (-0.8%) balanced by the outperformance from the (smaller) MFS portfolio (+1.0%).

Currency and country allocation were negative for the internal portfolio (-0.5%), with the overweight to the UK and the underweight to Asia ex-Japan detracting from returns, but the underweight to the US was a positive contributor; asset allocation was broadly neutral for MFS, with the positive effects of the overweight to Europe offset by the underweight to the strongly performing Asia ex-Japan region.

Stock selection was negative (-0.5%) for the internal portfolio but positive (+1.0%) for MFS. The internal portfolio's strong performers in Hong Kong (Jardine Strategic and Hang Lung) were more than offset by poor performers in Japan (Subaru, Mitsui Fudosan). Akzo Nobel, Zimmer Holdings and Exxon Mobil were all strong performers for MFS during the quarter.

Although value stocks performed well in the second half of 2016, the value style underperformed in Q1 as bond yields fell back from recent highs.

These two portfolios have relatively little crossover, with only 5 stocks out of 145 held in both portfolios (Goldman Sachs, Time Warner, American Express, Standard Chartered and Kubota) with a combined weight of 7.0% of the portfolio.

## Return

Combined portfolio	% of Portfolio	% of Benchmark <sup>1</sup>	Portfolio return (%)	Benchmark return (%)	Contribution to excess return (%)
UK	23.7	6.1	4.2	3.7	-0.3
Europe (ex-UK)	25.8	14.9	7.3	7.1	0.0
North America	37.1	55.5	5.4	4.8	0.2
Japan	6.7	8.2	-0.1	3.6	-0.2
Asia ex-Japan	4.6	6.0	19.6	9.0	0.4
Emerging markets	2.1	9.3	8.3	8.9	-0.2
<b>TOTAL</b>	<b>100.1</b>	<b>100.0</b>	<b>5.7</b>	<b>5.8</b>	<b>-0.1</b>
Oil and Gas	0.6	7.0	-5.0	-4.7	0.7
Basic Materials	3.9	4.7	8.3	7.3	0.0
Industrials	24.7	12.6	6.6	6.4	0.1
Consumer goods	18.0	12.3	4.3	6.9	-0.4
Healthcare	12.3	10.3	8.4	7.1	0.2
Consumer services	16.8	10.2	3.4	5.6	-0.4
Telecommunications	1.0	3.5	5.0	1.0	0.2
Utilities	1.1	3.4	-7.3	5.5	-0.1
Financials	16.6	22.6	4.6	4.5	0.1
Technology	5.1	12.7	18.5	12.1	-0.3
Other	0.0	0.8	0.0	6.3	0.0
<b>TOTAL FUND</b>	<b>100.0</b>	<b>100.0</b>	<b>5.7</b>	<b>5.8</b>	<b>-0.1</b>

<sup>1</sup> FTSE All World Index

# Active global equities – risk and activity analysis



West Midlands Pension Fund

## Comment

Overall, risk levels in both portfolios remain below that of the benchmark whether measured by portfolio risk or portfolio beta.

Active risk is considerably higher for the internal portfolio, reflecting the more differentiated region and sector positioning; as would be expected, this results in a very high active share statistic of 95%. Active share in the MFS portfolio is also quite high at 90%, especially considering the lower levels of active risk.

Regionally, the internal portfolio's overweight to the UK and underweight to North America remain, and actually increased slightly during the quarter. This was mainly driven by opportunistically increasing and decreasing position sizes, in response to market movements. In terms of major transactions, two European names were purchased (Spanish infrastructure company Ferrovial, and French aircraft engine producer Safran), and no positions were fully sold. MFS also mostly just added and trimmed to existing positions; one US railway company (Union Pacific) was sold and replaced by another (Kansas City Southern).

Sector-wise, the combined portfolio is notably overweight Industrials and Consumer sectors, and underweight Oil & Gas, Financials and Technology. During the quarter the Consumer Goods overweight was increased by 0.8%, and the Technology underweight increased by 0.8% (driven by the trimming of strongly performing holdings, such as Apple).

Style-wise, neither portfolios noticeably changed over the quarter. The internal portfolio is tilted towards smaller sized value stocks, while the MFS portfolio is tilted away from value stocks and very slightly towards smaller stocks. The combined portfolio's only significant style tilt is towards less volatile stocks.

Risk statistics	Internal portfolio	MFS	Combined (%)	Change from previous quarter
Portfolio risk	10.6	10.8	10.3	-1.1
Benchmark risk	11.6	11.6	11.6	-0.7
Active risk	5.9	3.1	3.9	-0.4
Predicted beta	81.0	93.0	86.0	-1.0
Active share	95.0	90.0	86.0	0.0
Turnover (annualised)	10.3	10.1	10.5	-2.6
<b>Areas with highest active risk</b>				
<b>By region:</b>				
UK	28.9	3.1	17.6	0.8
Europe ex-UK	6.2	14.0	9.6	1.5
North America	-34.2	2.4	-18.2	-0.9
Japan	4.0	-7.2	-0.9	-1.8
Asia Pacific ex-Japan	-3.4	-10.4	-6.5	0.3
<b>By currency:</b>				
UK £	34.1	2.6	20.5	1.1
US \$	-27.9	9.4	-11.7	-0.1
<b>By sector</b>				
Oil & Gas	-6.6	-5.3	-6.0	0.2
Industrials	18.7	5.0	12.7	0.8
Consumer Goods	1.6	9.7	5.1	-0.7
Consumer Services	8.6	4.2	6.7	0.0
Healthcare	-1.9	7.4	2.2	0.6
Financials	-4.0	-8.4	-5.9	-0.3
Technology	-9.8	-7.0	-8.6	-0.8
<b>By style<sup>1</sup>:</b>				
Size	-0.6	-0.1	-0.4	0.0
Growth	-0.3	0.0	-0.2	0.0
Volatility	0.6	-0.3	0.2	-0.1
Value	0.2	-0.3	0.0	0.0

<sup>1</sup> Measures variance from benchmark in terms of number of standard deviations

# Active emerging market equities - overview

## Active quoted equities policy group summary

- The active emerging market equities portfolio is managed externally by three specialist managers (Mondrian, AGF & BMO) offering complementary value, growth and quality strategies.
- The performance target for the portfolio is to outperform the benchmark FTSE All World Emerging Markets index by 3% pa over a rolling 3 year period.

## Active quoted equities portfolio activity

There were no subscriptions or redemptions by the Fund over the quarter into any of the three emerging market equities portfolios.

Taking the three portfolios together, the combined exposure to Asia Pacific (-1.4%) and developed markets (-0.3%) decreased over the quarter; Latin America (+0.9%) and EMEA (+0.8%) correspondingly increased.

The main driver of the increased underweight to Asia Pacific has been the increased weight of Asia Pacific in the benchmark (particularly India and China), resulting from strong performance during the quarter.

In addition, some developed listed stocks were sold (Mead Johnson and Unilever).

## Regional allocation

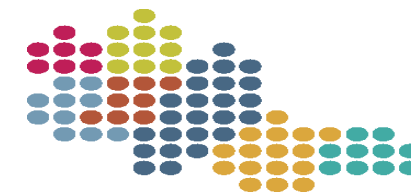
	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)	Change from previous quarter (%)
Externally managed:					
Asia Pacific	552.0	47.3	65.2	-17.9	-1.4
Latin America	221.6	19.0	16.6	2.4	0.9
EMEA	130.8	11.2	18.2	-7.0	0.8
Developed	263.3	22.6	0.0	22.6	-0.3
<b>TOTAL</b>	<b>1,167.8</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>

## Performance

	Q1 2017 (%)	1 year (%)	3 years (% p.a.)	Since inception (% p.a.)
<b>Benchmark</b>	<b>8.9</b>	<b>35.6</b>	<b>12.9</b>	<b>10.8</b>
Relative performance:				
AGF	1.0	-1.4	-1.4	-1.7
BMO (F&C)	4.8	-0.8	0.2	0.9
Mondrian	0.2	-7.4	-3.8	-3.0

<sup>1</sup> FTSE All World Emerging Markets Index

# Active emerging market equities – return attribution



West Midlands Pension Fund

## Performance comment

The combined emerging markets equities portfolio returned 11.0% over the quarter, outperforming the benchmark return by 2.1%.

All three managers outperformed, led by BMO (+4.8%), with AGF and Mondrian outperforming by 1.0% and 0.2% respectively.

In complete contrast to the last two quarters on 2016, all three emerging market managers outperformed in Q1 2017, mainly driven by good stock selection. Asset allocation was negative (-1.6%) driven by the non-benchmark allocation to developed markets, which underperformed emerging markets; however within emerging markets country and sector performance was broadly similar, allowing stock selection to come to the fore (+3.6%). BMO in particular delivered very strongly in this area (+6.5%), with Indian stocks such as Yes Bank and Titan the largest contributors.

Longer-term, the combined portfolio lags the benchmark over all periods; -2.9% over 1 year, -1.5% over three years and -0.8% since inception (December 2013). Stock selection has been the main driver of the negative returns, with stock-picking in China (AGF and Mondrian), Financials and Consumer Goods (all three managers). Stock-picking by Mondrian and BMO in Oil & Gas contributed positively, as did the decision by all three managers to underweight Oil & Gas and Basic Materials, and the overweight to Technology by AGF and BMO.

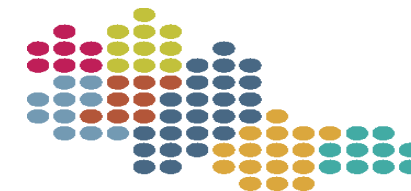
Taiwan Semiconductors and Tencent are major positions in the combined portfolio (over 4%), although these are both large positions in the index. The largest net exposures are to Samsung Electronics, AIA Group, Bank Mandiri, and the underweight to Naspers (all c.2% net).

## Return

Combined portfolio	% of Portfolio	% of Benchmark <sup>1</sup>	Portfolio return (%)	Benchmark return (%)	Contribution (%)
Asia Pacific	47.3	65.2	11.6	10.8	0.1
Latin America	19.0	16.6	11.8	10.6	0.3
EMEA	11.2	18.2	4.9	1.9	0.8
Developed	22.6	0.0	13.8	0.0	0.9
<b>Total Fund</b>	<b>100.0</b>	<b>100.0</b>	<b>11.0</b>	<b>8.9</b>	<b>2.1</b>
Oil and Gas	5.0	9.4	5.8	2.1	0.4
Basic Materials	3.6	6.8	9.2	9.8	0.0
Industrials	11.4	10.3	11.2	11.8	0.0
Consumer goods	9.1	7.9	13.6	8.9	0.4
Healthcare	2.6	2.1	4.3	3.4	0.0
Consumer services	10.9	6.8	11.5	10.5	0.2
Telecommunications	4.5	6.1	8.5	6.4	0.2
Utilities	3.4	3.2	9.7	9.2	0.1
Financials	34.2	32.4	11.8	9.9	0.6
Technology	14.1	13.0	13.7	11.9	0.3
Other	1.2	2.0	19.9	4.9	0.1
<b>TOTAL FUND</b>	<b>100.0</b>	<b>100.0</b>	<b>11.0</b>	<b>8.9</b>	<b>2.1</b>

<sup>1</sup> FTSE All World Emerging Markets Index

# Active emerging market equities – risk and activity analysis



## Comment

Absolute risk has been consistently below the benchmark, with the beta of the portfolio (i.e. the measure of risk and return of the portfolio versus the index) currently 0.88. For comparison, low volatility funds generally seek to achieve betas of 0.85 or below.

The portfolio continues to take considerable active risk, with a combined active share of 80% (the off-benchmark allocation to developed markets, in part driven by the synthetic exposure to India mentioned in the previous section is likely to be a significant contributor to this).

Annualised turnover has decreased from the unusually high 42% (annualised) in Q4 2016 to a more typical 24% (annualised) in Q1 2017. Mondrian were the most active, with turnover at an annualised rate of 31% during Q1.

The combined portfolio continues to be underweight the Asia Pacific region (although this makes up c.65% of the benchmark index), with all three managers underweight China (which accounts for 26% of the index) by c.10-15%.

Sector-wise, the combined portfolios are underweight the commodity-related Oil & Gas and Basic Materials sectors (reflecting the negative views on China), and overweight higher-quality, more defensive sectors such as the consumer and healthcare sectors.

The style tilts of the portfolio remained stable over Q4, with the combined portfolio exhibiting slight tilts towards smaller, more highly valued growth stocks.

Risk statistics	Combined portfolio	AGF	BMO (F&C)	Mondrian
Portfolio risk	14.0	14.4	14.1	14.5
Benchmark risk	16.3	16.3	16.3	16.3
Active risk	3.9	4.0	5.7	4.5
Predicted beta	88	90.0	85.0	89.0
Active share	80	85.0	87.0	93.0
Turnover	24.2	21.7	18.7	31.0
Areas with highest active risk	Combined portfolio	AGF	BMO (F&C)	Mondrian
<b>By region:</b>				
Asia Pacific	-16.6	-18.8	-18.4	-11.3
Latin America	1.7	1.5	6.5	-4.1
EMEA	-7.3	-8.5	-9.1	-3.5
Developed	22.2	25.9	21.1	18.9
<b>By currency:</b>				
Asia Pacific	-13.7	-3.1	-15.6	-24.1
Americas	22.1	9.9	28.7	28.3
<b>By sector</b>				
Oil & Gas	-4.7	-1.4	-9.2	-3.1
Basic Materials	-3.5	0.9	-6.9	-4.7
Consumer Goods	2.4	-2.6	4.2	6.3
Consumer Services	4.0	2.5	9.4	-1.0
Healthcare	1.3	2.7	1.7	-1.0
Telecoms	-1.6	-2.4	-6.1	5.2
Financials	1.9	-5.8	15.5	-5.7
<b>By style<sup>1</sup>:</b>				
Size	-0.1	-0.1	-0.2	0.1
Value	-0.2	-0.3	-0.5	0.2
Momentum	-0.2	-0.1	-0.2	-0.3

# Passive quoted equities

## Policy group summary

- The Fund manages five passive regional equity portfolios in-house. The portfolios are designed to replicate the performance of their underlying benchmark indices.
- Benchmarks and tolerance ranges are as follows:
  - UK: FTSE All Share ( $\pm 0.25\%$  pa)
  - North America: FTSE All World North America ( $\pm 0.5\%$  pa)  
S&P 500 US Dividend Aristocrats ( $\pm 0.5\%$  pa)
  - Europe (ex UK): FTSE World Europe (ex UK) ( $\pm 0.5\%$  pa)
  - Japan: FTSE World Japan ( $\pm 0.5\%$  pa)
  - Pacific (ex Japan): FTSE AW Developed Asia Pacific ex Japan ( $\pm 0.75\%$  pa)
- A passive global (ex UK) equity fund, designed to track the FTSE All World Developed ex UK index, is managed externally.

## Policy group activity

During the quarter £4.3 million was invested in the passive equity portfolios. This was largely made up of corporate events including a £2.6 million payment for rights in Italian finance company Unicredit following completion of the company's €13 billion rights issue. In the UK an additional £1.1 million was invested in the Legal & General UK Smaller Companies fund to maintain target index exposure to small cap UK stocks. A further £600,000 was invested across the portfolios as a result of the quarterly rebalance in March and in payment for other corporate actions.

## Regional allocation

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
Internally managed:				
UK <sup>2</sup>	1,182.2	8.3	8.0	0.3
North America	1,117.3	7.9	7.5	2.0
US Dividend Aristocrats	213.9	1.6		
Europe (ex-UK)	1,216.3	8.6	7.5	1.1
Japan	628.2	4.4	3.75	0.65
Pacific (ex Japan)	686.4	4.8	3.75	1.05
<b>Total internal</b>	<b>5,044.3</b>	<b>35.6</b>	<b>30.5</b>	<b>5.1</b>
Externally managed:				
Global (ex UK) <sup>3</sup>	591.0	4.2	N/A	N/A
<b>Total external</b>	<b>591.0</b>	<b>4.2</b>	<b>N/A</b>	<b>N/A</b>

<sup>1</sup> The Fund's medium term target allocation

<sup>2</sup> The allocation to UK equities includes a small (£42.9 million) holding in an externally managed UK small cap index fund

<sup>3</sup> The externally managed global equity fund forms part of the wider global equity portfolio, which represented 12.0% of the Fund's assets at 31 March 2017 against a medium term target of 10.0%.

# Passive quoted equities

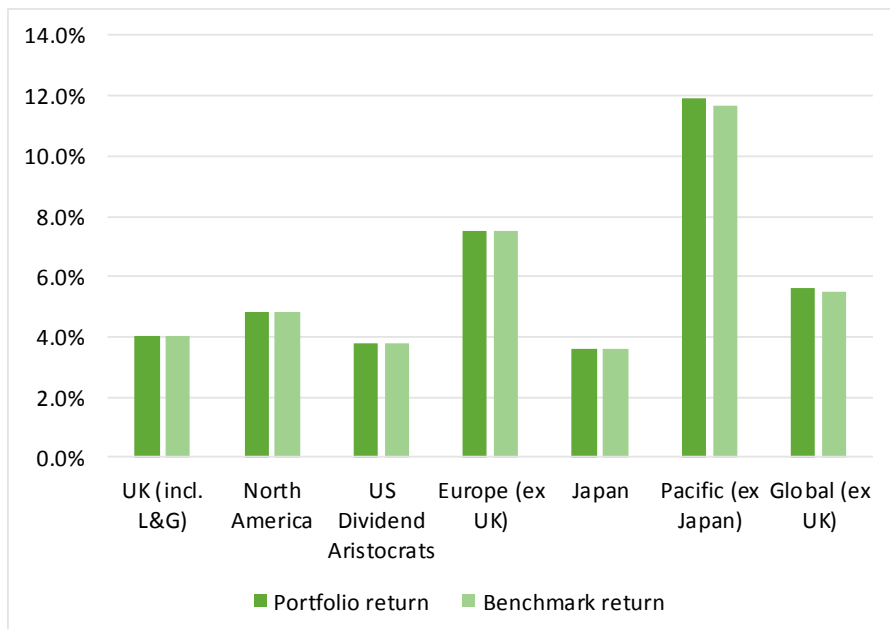
## Performance comment

All passive in-house equity portfolios performed in line with their respective benchmarks during the quarter. Note that since 30 June 2016 performance has been calculated using mid-price (rather than bid-price) valuations.

The S&P 500 US Dividend Aristocrats Index underperformed the wider FTSE North America benchmark by 1% during the quarter. Performance was impacted by an underweight exposure to technology stocks which performed particularly well during the period.

The Fund utilises two external managers to manage elements of the passive equity portfolio. Legal & General (L&G) manages a UK small-cap equity fund (valued at £42.9 million at 31 March 2017), which moderately outperformed its benchmark over the three years to 31 March. The global (ex UK) passive equity portfolio is managed by BlackRock and has enjoyed modest outperformance since inception (December 2014) due in part to the fund's reinvestment of stock lending revenue.

## Quarterly performance by region



## Medium term performance by region

	1 year		3 years		5 years	
	Portfolio %	Benchmark %	Portfolio %	Benchmark %	Portfolio %	Benchmark %
Internally managed:						
UK (incl. L&G)	22.2	22.0	7.7	7.7	9.8	9.7
North America	34.9	35.0	20.4	20.5	18.1	18.2
US Dividend Aristocrats*	-	-	-	-	-	-
Europe (ex-UK)	27.9	27.9	9.9	9.6	13.1	12.8
Japan	32.6	32.8	17.6	17.8	12.9	12.9
Pacific (ex Japan)	37.5	37.4	12.6	12.8	N/A	N/A
Externally managed:						
Global (ex UK)	33.3	33.1	N/A	N/A	N/A	N/A

\*Note that the US Dividend Aristocrats portfolio's inception date was 31 July 2016, hence it does not yet have a long term performance history.



# Private equity – policy group summary

## Target Geographic Diversification

USA:	25-35%
Europe:	30-35%
Asia:	30-40%
Rest of World:	0-10%

## Target Strategy Diversification

Venture:	10-15%
Growth and small buyout:	30-40%
Mid and large buyout:	35-45%
Secondaries, co-investments, special situations, listed, etc:	5-20%

## Targeted Net Returns

Venture:	2.0x – 2.5x
Buyout:	1.7x – 2.0x
Other:	1.5x – 1.8x

## Targeted Net IRR

Venture:	15-20%
Buyout:	17-20%
Other:	15-20%

The overall performance target for the portfolio is outperform the benchmark index (FTSE All World + 2% pa) by an additional 2% pa.

Note that these targets are being reviewed as part of the overall mandate review.

## Private equity allocation by region and strategy

	Committed (£m)	Called (£m)
USA	1,085.1	764.2
Europe	899.8	713.4
UK	292.9	232.6
Asia & ROW	412.1	254.2
<b>TOTAL</b>	<b>2,689.9</b>	<b>1,964.4</b>

	Committed (£m)	Called (£m)
Venture	411.1	290.1
Growth and small buyout	635.9	538.9
Mid and large buyout	827.5	579.4
Other	815.4	556.0
<b>TOTAL</b>	<b>2,689.9</b>	<b>1,964.4</b>



# Private equity - activity

## Mandate activity

Net cash returned during the period totalled £45.2 million, derived from distributions totalling £66.7 million and drawdowns totalling £21.5 million. Notable distributions included £4.1 million from Thoma Bravo IX following the sale of LANDesk for 7.1x invested capital; £3.7 million from CBPE VIII resulting from the IPO sell down of Medica for a 6.0x multiple and £3.2 million from Dominus Capital following the sale of Bentley Mills for 5.0x invested capital .

At the quarter-end the sector split was overweight Venture at 26% versus the target range of 10-15%. This was due in the main to increasing valuations for a number of investments including Uber and MatchesFashion. The allocation to Other (Secondaries, Co-Investments, Special Situations, Listed, etc.) was also overweight at 23% versus the target range of 5-20% due to the deliberate targeting of private equity secondary investments at the time of the global financial crisis and the current build-up of equity positions (from stock distributions). Mid-Large Buyouts and Growth/Small buyouts were underweight respectively at 26% and 25% versus the target ranges of 35-45% and 30-40% due largely to very strong exits benefitting from resilient valuations from a maturing portfolio of investments.

Asia at 16% was underweight relative to its target range of 30-40% due to lack of opportunities in the area. Consequently, both the USA and Europe (including the UK) at 41% each were overweight their respective target ranges of 25-35% and 30-35%. 'Rest of the World' investments represented 2% of the portfolio and were within the target range of 0-10%.

## Mandate outlook

The target asset allocation is for a 10% neutral weight in private equity. The portfolio manager is looking to reinvest distributions into a more concentrated number of managers and into adding co-investments.

## Regional split at 31 March 2017

	Target	Actual (31 March 2017)
USA	25-35%	41%
Europe	30-35%	41%
Asia	30-40%	16%
Rest of World	0-10%	2%

## Strategy split at 31 March 2017

	Target	Actual (31 March 2017)
Venture	10-15%	26%
Growth and small buyout	30-40%	25%
Mid and large buyout	35-45%	26%
Secondaries, co-investments, etc	5-20%	23%

# Private equity

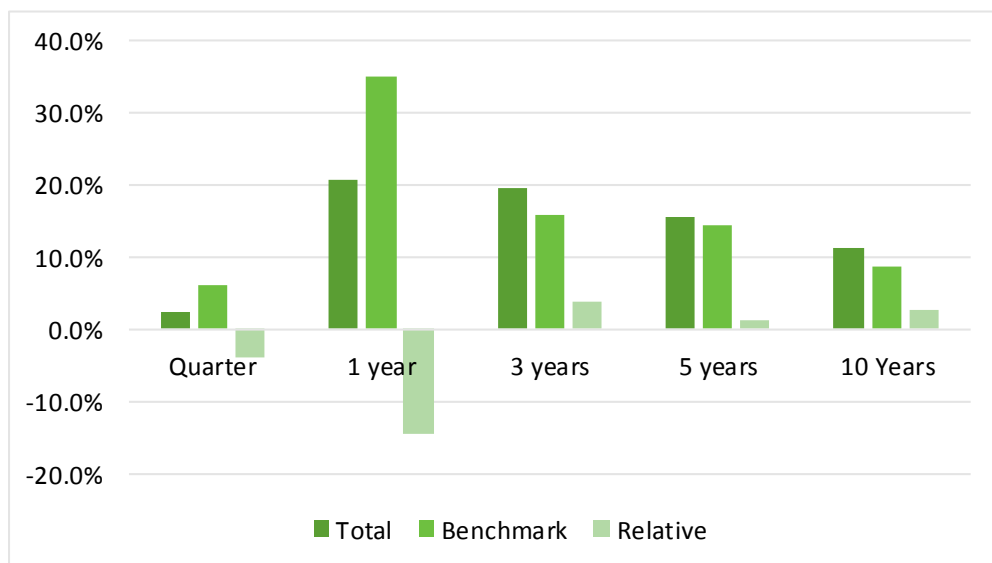
## Performance comment

The longer term measures of the private equity portfolio continue to show strong out-performance against the benchmark. Currency proved to be a headwind to relative performance over the 12 months due to the benchmark's significant exposure to USD-denominated assets.

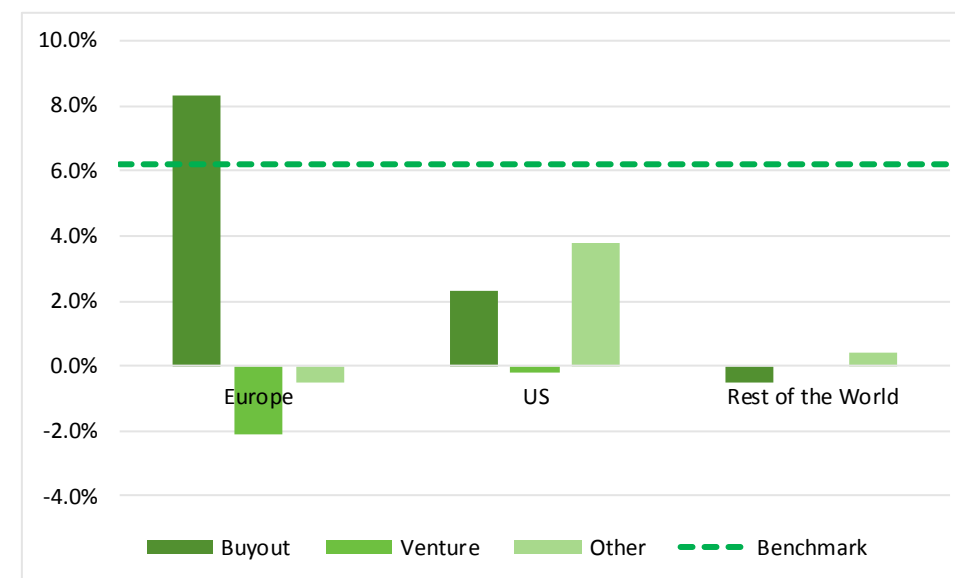
High purchase prices continue to prevail affected by buoyant public markets and the availability of alternative sources of lending. Mature funds continue to benefit from this environment and are actively selling assets, however deploying capital is more challenging.

Note that the Fund has no exposure to venture outside of Europe and the US.

## Performance<sup>[1]</sup> – total portfolio



## Absolute performance – for quarter



[1] Short term performance may be affected by late reporting of quarterly figures by managers

# Property

## Mandate summary

- The property portfolio comprises direct commercial UK property managed by CBRE and indirect global property managed in-house through specialist funds
- Performance targets for each element of the portfolio are:
  - Direct property: outperformance of 1% above the IPD Properties Annual Index
  - Indirect property: performance is expected to be in line with the benchmark (CPI + 6% pa)

## Mandate activity

The sale of the Virgin industrial/office unit in Edinburgh South Gyle St, was agreed in Q4 2016 but completed in Q1 2017 for a sale price of £2.9 million. Likewise terms were agreed in Q4 2016 for the purchase of 2 St Philips in Birmingham and completed in Q1 2017 for £27.8 million.

Within the indirect property portfolio, a combination of drawdowns totalling £5.3 million and distributions totalling £20.6 million contributed to a net cash return during the period of £15.3 million. The increased return was the result of an £8.9 million payment from RREEF and £6.9 million from Silk Road Asia.

## Mandate outlook

The asset allocation target portfolio is seeking to increase property to 10% of the Fund. The portfolio manager is looking at a number of property and fund investments but declining yields in many sectors is making acquisitions of quality properties more difficult.

## Property allocation

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
UK direct property	756.4	5.3	N/A	N/A
UK indirect property	154.8	1.1	N/A	N/A
Indirect US	16.1	0.1	N/A	N/A
Indirect Europe	25.3	0.2	N/A	N/A
Indirect Other	126.9	0.9	N/A	N/A
<b>TOTAL</b>	<b>1,079.5</b>	<b>7.6</b>	<b>10.0</b>	<b>-2.4</b>

## Direct portfolio weightings

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>2</sup> (%)	Difference (%)
Agricultural	10.2	1.3	N/A	N/A
Industrial	225.9	29.9	19.8	10.1
Offices	172.4	22.8	28.7	-5.9
Shops	11.6	1.5	11.7	-10.2
Shopping centres	82.5	10.9	8.4	2.5
Retail warehouses	147.3	19.5	15.4	4.1
Supermarkets	106.5	14.1	4.7	9.4
<b>TOTAL</b>	<b>756.4</b>	<b>100.0</b>	<b>N/A</b>	<b>N/A</b>

<sup>1</sup> The Fund's medium term target allocation

<sup>2</sup> The IPD Properties Annual Index

## Performance comment

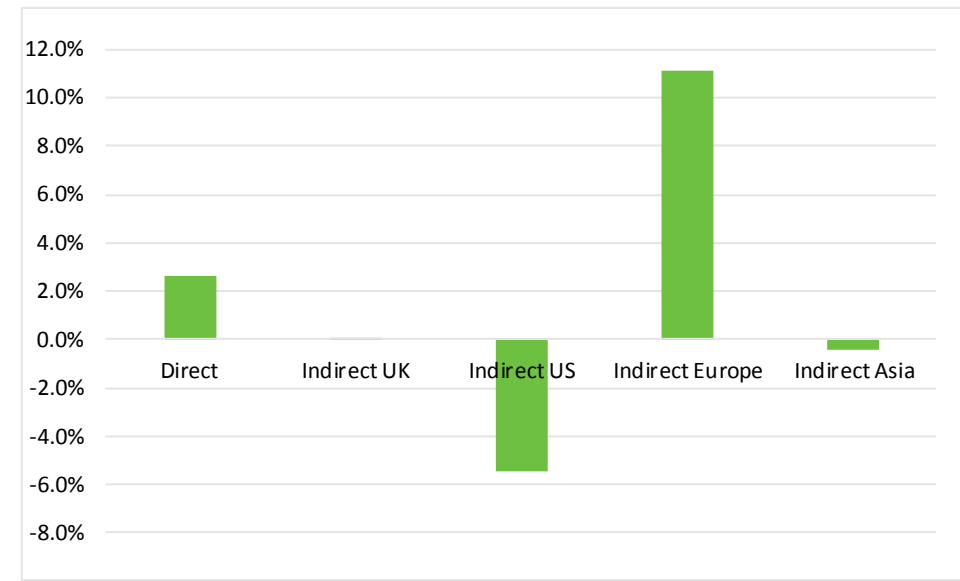
The economy continued to hold up well despite attention being focussed on the triggering of Article 50, which duly took place on 29 March. In turn, property continued to perform well in the quarter with all sectors delivering positive returns. Industrials continued to perform strongest, extending a theme played out in 2016 where the sector benefitted from a move to solid income, bolstered partially by changing dynamics in the retail sector. Transactional volumes were down across the market, with investors not motivated to sell, especially when the increased costs associated with stamp duty were factored into reinvestment decisions. Despite yields being low historically, property remains an attractive yield generating asset and this yield has enabled a new phenomenon of the 'carry trade' where Local Authorities have become major purchasers of commercial property, financed by cheap borrowing provided by the PWLB (Public Works Loan Board).

The overall portfolio underperformed its benchmark during the quarter despite direct property marginally outperforming its benchmark. Indirect property therefore caused the underperformance, with the US underperforming on a relative and absolute basis. Currency was beneficial over the 12 months given the portfolio's exposure to US assets and its UK benchmark.

## Performance – total portfolio



## Absolute performance – for quarter



# Real assets and infrastructure

## Mandate summary

- The portfolio is managed in-house through specialist funds.
- The portfolio targets performance in line with the benchmark (CPI + 4% pa).
- The portfolio is made up of a variety of infrastructure funds from core to opportunistic, covering most asset classes and geographies but with a bias toward UK assets, along with some global agricultural funds

## Mandate activity

No new commitments were made during the period.

Drawdowns totalling £20.1 million and distributions totalling £32.3 million contributed to a net cash return in the portfolio of £12.2 million. The strong returns were aided by a distribution of £15.9 million from the JPMorgan AIRRO fund.

## Mandate outlook

The Fund's asset allocation target portfolio is seeking to raise the weight in infrastructure to 6%. The portfolio manager is looking at a number of co-investment opportunities, most of which are in conjunction with PiP. There is a strong pipeline but not all opportunities will make it through to investment .

## Real assets and infrastructure allocation

	Committed (£m)	Called (£m)	Portfolio (£m)	Portfolio (%)
Infrastructure UK	207.5	167.0	153.8	1.1
Infrastructure Euro	123.4	95.8	16.5	0.1
Infrastructure US	414.5	297.2	162.8	1.1
Total Real Assets	99.5	55.5	77.4	0.5
<b>TOTAL</b>	<b>844.9</b>	<b>615.5</b>	<b>410.5</b>	<b>2.9</b>

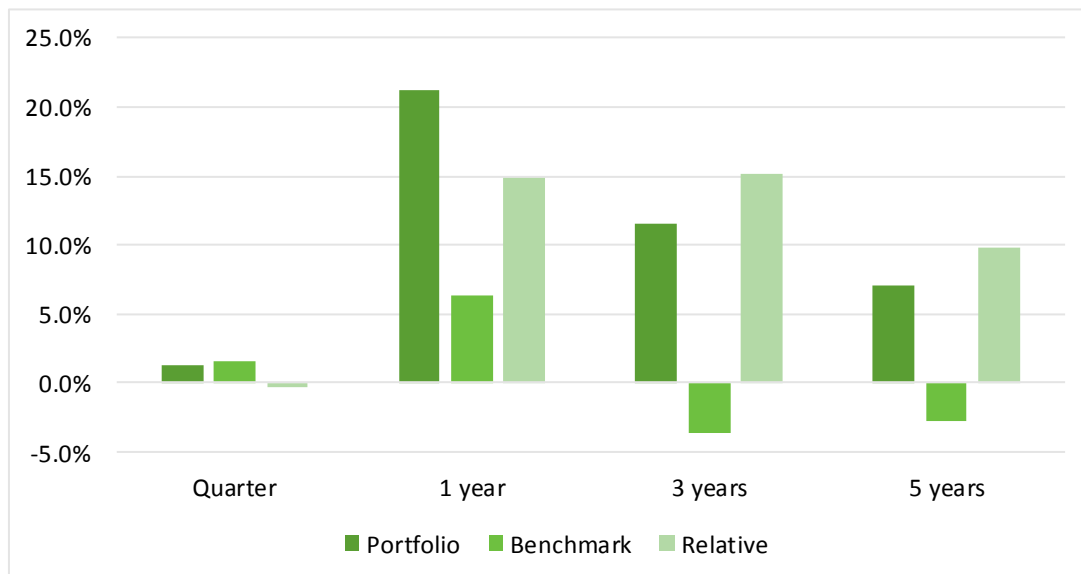
# Real assets and infrastructure

## Performance comment

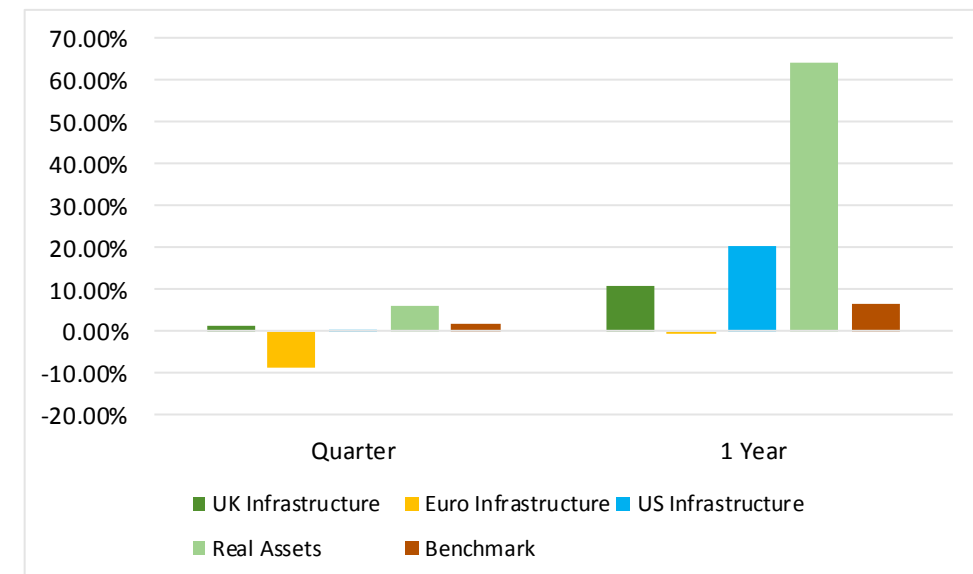
Performance from infrastructure was slightly below benchmark across all geographies, although UK infrastructure fared much better in this respect. The largest single contributor to negative performance was the Eiser European Infrastructure fund which had a notable markdown after a disappointing sales process to its remaining assets. Over longer time periods the portfolio remains comfortably ahead of its benchmark, with continued high demand for quality infrastructure assets from a range of institutional investors. The 12-month performance was boosted by the weakness in sterling since the portfolio has exposure to US assets and is measured against a UK benchmark.

The agricultural funds continued posting strong returns with a further positive quarter from the Black River agricultural fund.

## Performance – total portfolio



## Absolute performance – for quarter



# Absolute return

## Mandate summary

- The portfolio comprises insurance linked funds and special opportunities
- Performance is expected to be in line with the respective benchmarks for the two components (LIBOR + 3% pa for the insurance linked segment; LIBOR + 4% pa for the special opportunities segment)

## Mandate activity

The total net investment during the period totalled £5.6 million, derived from drawdowns totalling £11.5 million and distributions totalling £5.9 million.

There were no new investments during the period, however Dorchester Capital Secondaries IV, which sits in the opportunistic segment, called down £10 million for new investments within the fund.

Note that for performance purposes, the Fund's three diversified growth funds are included within the special opportunities segment of the portfolio.

## Mandate outlook

The asset allocation target portfolio is seeking to raise weightings in absolute return. The portfolio manager is looking at direct/co-investments. The DGFs are under review and likely to be exited when alternative investment opportunities are identified.

## Absolute return allocation

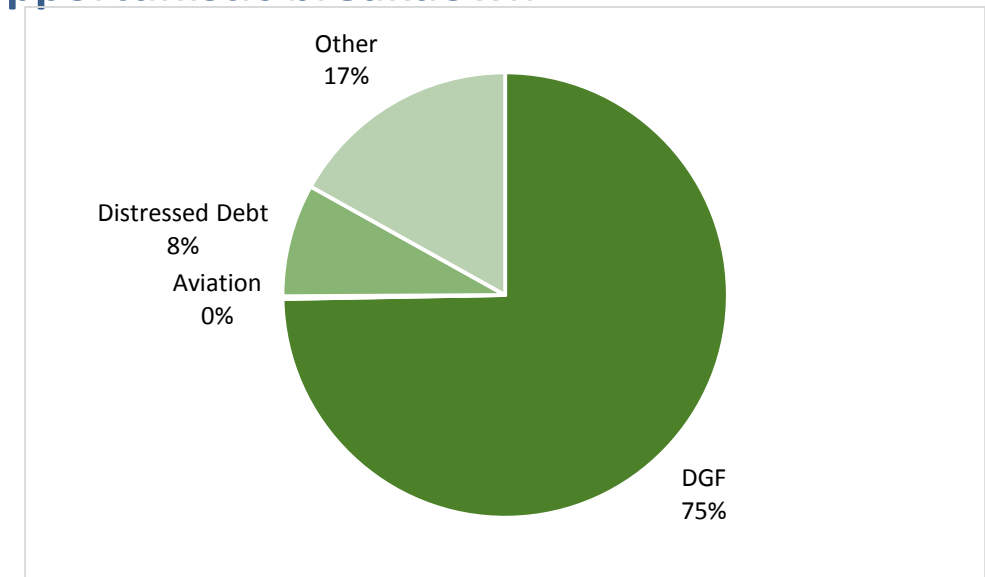
	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
Insurance linked	379.6	2.7	3.0	-0.3
Opportunistic <sup>2</sup>	348.0	2.4	4.0	-1.6
<b>TOTAL</b>	<b>727.6</b>	<b>5.1</b>	<b>7.0</b>	<b>-1.9</b>

<sup>1</sup> The Fund's medium term target allocation

<sup>2</sup> Includes diversified growth funds

NB: Following the 2017 SIAB review insurance linked forms part of the 'income' segment of the overall Fund and special opportunities forms part of the 'growth' segment

## Opportunistic breakdown



# Absolute return



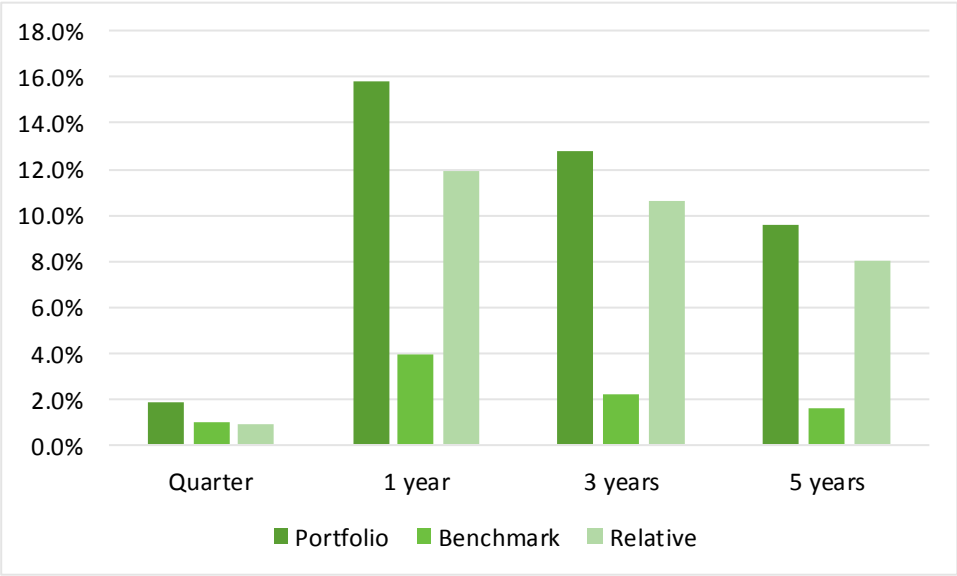
## Performance comment

The performance for the quarter was good from both elements of the portfolio with most investments outperforming the benchmark. The most notable contributors to the positive performance were, once again, the Dorchester funds, where all four funds posted very strong returns. Insurance funds all had a positive quarter, albeit not as strong as in Q4 2016. The 12-month performance was boosted by the weakness in sterling since the portfolio has exposure to US assets and is measured against a UK benchmark.

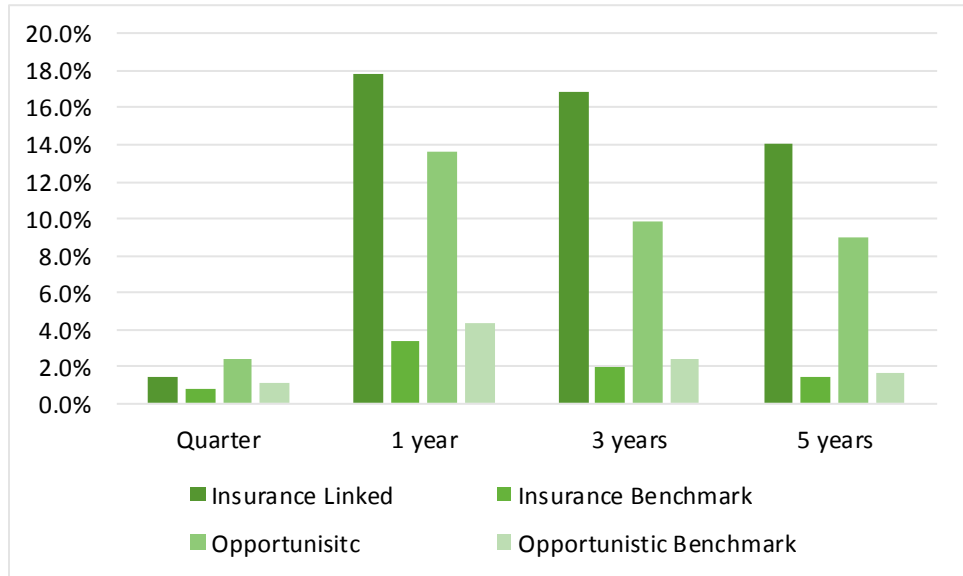
The diversified growth funds had differing performances that led to a neutral contribution to overall returns.

There were no new investments made in the period although the Fund continues to monitor potential investments for inclusion in the portfolio .

## Performance – total portfolio



## Absolute performance





# Return seeking fixed interest

## Mandate summary

- The return seeking element of the fixed interest portfolio comprises corporate bonds, emerging market debt and specialist fixed interest investments. This mandate is seeking to achieve superior returns to fixed income assets whilst maintaining a low correlation with growth assets.
- Performance targets for each element of the portfolio are:
  - Corporate bonds: outperformance of 1% above the Merrill Lynch GBP Non-Gilts All Stocks Index
  - Emerging market debt: outperformance of 2% above a blended benchmark (50/50 JPM EMBI Global Diversified Index/JPM GBI EM Global Diversified Index)
  - Specialist fixed interest: outperformance of 2.5% above the Merrill Lynch GBP Non-Gilts All Stocks Index
- Following the 2017 SIAB review investment grade corporate bonds will, in future, be included in 'stabilising assets'

## Mandate activity

Five distributions during the period resulted in a net disinvestment during the quarter of £1.1 million.

## Mandate outlook

The asset allocation target portfolio is looking to reduce weightings in stabilising fixed interest through gilts and corporate bonds and looks to raise return seeking fixed interest (credit). In May 2017 the Fund increased its emerging market debt exposure by investing £250 million in hard and local currency funds managed by Amundi.

## Allocation

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
Corporate bonds	388.4	2.7	2.5	0.2
Emerging market debt <sup>2</sup>	379.0	2.7	2.5	0.2
Other fixed interest	286.4	2.0	2.0	0.0
<b>TOTAL</b>	<b>1,053.8</b>	<b>7.4</b>	<b>7.0</b>	<b>0.4</b>

<sup>1</sup> The Fund's medium term target asset allocation

<sup>2</sup> Excludes the £250 million invested in May 2017

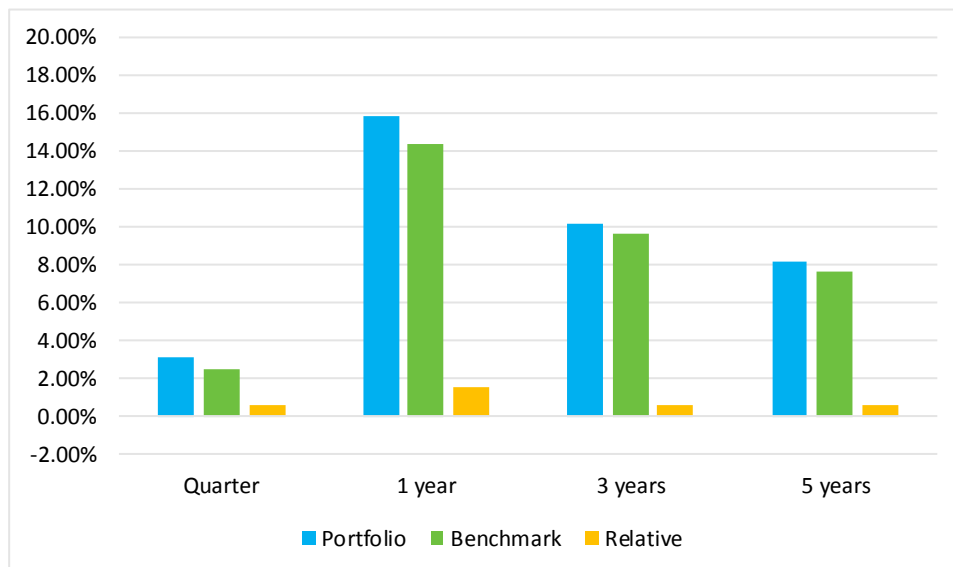
# Return seeking fixed interest

## Performance comment

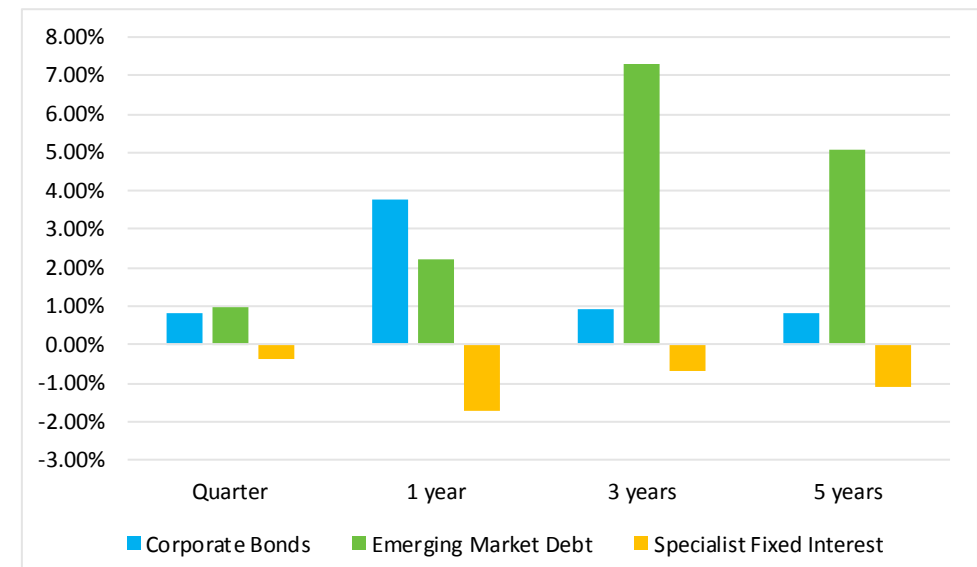
The return seeking fixed interest portfolio outperformed its bespoke benchmark over the quarter aided by outperformance from two of its three underlying components. The corporate bond component outperformed its benchmark due to strong performance from Schroder, an active manager, while the emerging market debt portfolio enjoyed strong outperformance from its sole manager, Capital. Specialist fixed interest, the third component of the overall portfolio, underperformed its benchmark due in the part to the presence of a passive fund which tracked a lower yielding benchmark over the quarter.

The portfolio outperformed its benchmark over the 12 month period to 31 March 2017 despite some underperformance from the specialist fixed interest component. Emerging market debt enjoyed particularly strong performance over the period and the active corporate bond mandate also contributed to performance.

## Performance – total portfolio



## Relative performance



Source: Portfolio Evaluation Ltd

# Cashflow matching fixed interest

## Mandate summary

- The cashflow matching element of the fixed interest portfolio was established in October 2015 to match future liability cash flows for the Fund's orphan liabilities.
- Performance is expected to be in line with the benchmark (UK Gilts + 1.4% pa).
- Following the 2017 SIAB review it is proposed that this mandate be dissolved and reallocated between stabilising assets and income.

## Mandate activity

Three distributions and a drawdown contributed to a net disinvestment during the quarter of £10.7 million.

## Allocation

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
Index-linked gilts	97.8	0.7	0.0	0
Specialist fixed interest	61.4	0.4	0.0	0
Corporate bonds	192.4	1.4	0.0	0
<b>TOTAL</b>	<b>351.6</b>	<b>2.5</b>	<b>3.0</b>	<b>-0.5</b>

<sup>1</sup> The Fund's medium term target allocation

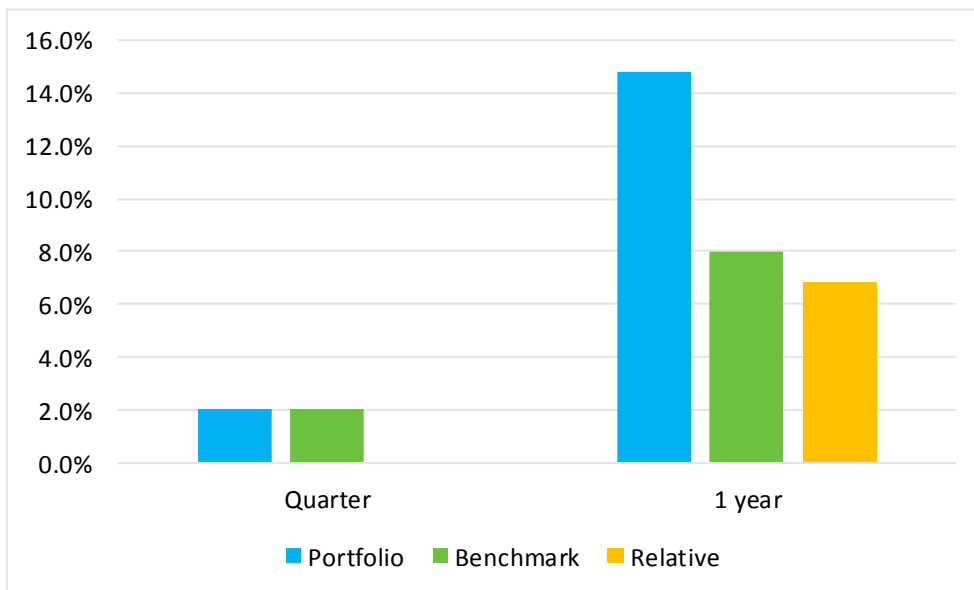
# Cashflow matching fixed interest

## Performance comment

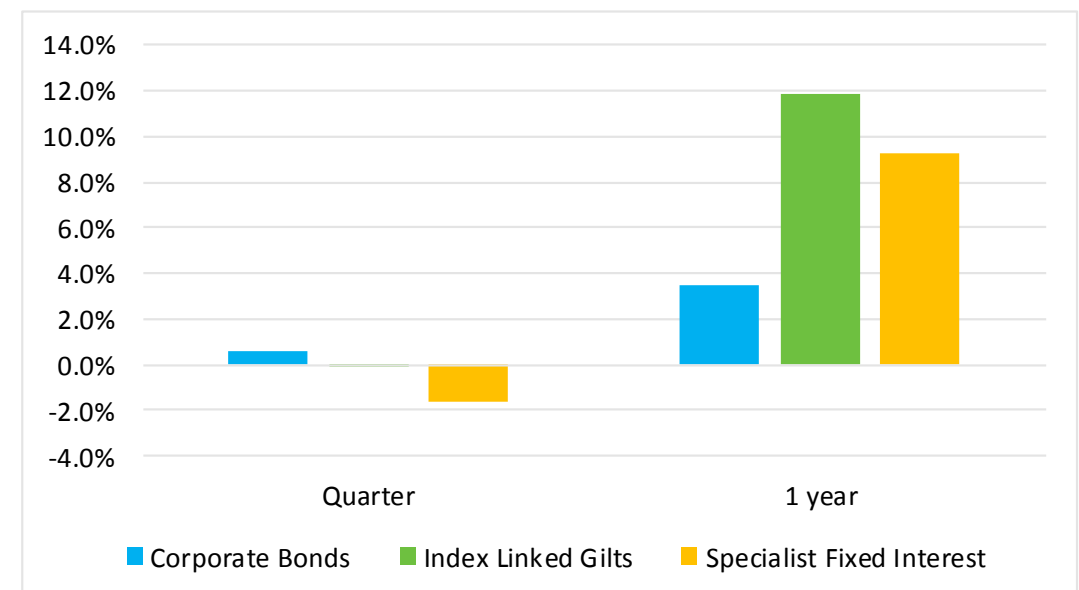
Portfolio performance was flat over the quarter with underperformance from the specialist fixed interest component offsetting outperformance from Royal London, the Fund's active corporate bond manager. All three elements of the portfolio (index linked gilts, corporate bonds and specialist fixed interest) outperformed the cash flow matching strategy's benchmark over the 12 months to 31 March 2017. Index linked gilts enjoyed particularly strong outperformance amid concerns about inflation while the specialist fixed interest component benefitted from several distributions from Highbridge Specialty Loan Fund III.

Note that the portfolio's inception date was 1 October 2015, hence it does not yet have a long term performance history.

## Performance – total portfolio



## Relative performance



# Stabilising fixed interest

## Mandate summary

- The portfolio comprises UK gilts, index linked gilts and cash.
- Performance is expected to be in line with the individual benchmarks of the portfolio (FTSE Actuaries UK Index Linked Gilts All Stocks Index for index linked gilts, FTSE Actuaries UK Conventional Gilts All Stocks Index for UK gilts and GBP 7 Day LIBID for cash).
- Following the 2017 SIAB review, investment grade corporate bonds will be included in 'stabilising assets'

## Mandate activity

There was no activity within the gilt portfolios during the quarter. Both the gilt and index linked gilt funds performed in line with their respective benchmarks.

The portfolio moderately underperformed its benchmark during the quarter due to the Fund's overweight position in cash, which yielded a lower return than conventional and index-linked gilts. Of the £111.8 million held in current accounts, £101.8 million was held in interest bearing accounts. Interest is not generally paid by banks on current accounts and the balances on those accounts are maintained for instant access and trading purposes. Performance of cash as a whole, which includes sterling and foreign currency balances, was ahead of the benchmark at 0.49% for the 12 months ending 31 March 2017.

During the quarter the Fund received £536,000 in net revenue from securities lending. In the 12 months to 31 March 2017, a net amount of £2.5 million was received from securities lending and the average utilisation was 9.43%, exceeding the average of the Fund's peer group (UK Pension Funds) by 3.22%. The net revenue generated from securities lending has increased by 54% compared with the preceding twelve months. The stock lending mandate was updated on 31 August 2016 to bring it into line with the market, thereby increasing the competitiveness of the Fund's programme. The Fund also entered into a term lending programme to increase overall lending income.

## Mandate outlook

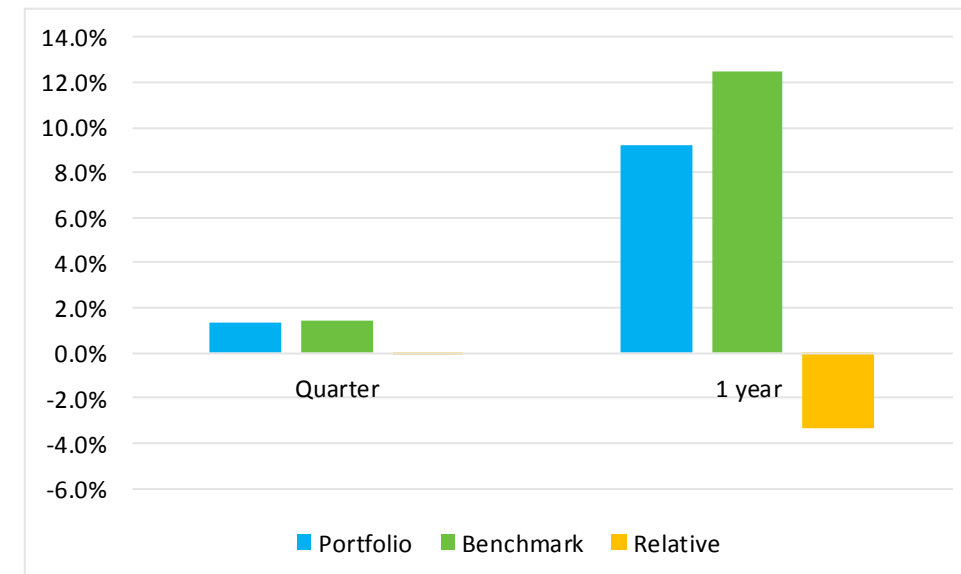
The asset allocation target portfolio is looking to reduce weightings in stabilising fixed income. The portfolio manager is considering positions in corporate bonds and gilts. The manager might look at buying US Treasuries and index linked assets.

## Allocation

	Portfolio (£m)	Portfolio (%)	Benchmark <sup>1</sup> (%)	Difference (%)
Gilts	165.7	1.2	2.0	-0.8
Index-linked gilts	769.3	5.4	5.0	0.4
Cash	389.3	2.7	2.0	0.7
<b>TOTAL</b>	<b>1,324.3</b>	<b>9.3</b>	<b>9.0</b>	<b>0.3</b>

<sup>1</sup> The Fund's medium term target allocation

## Performance



# Environmental, social and governance

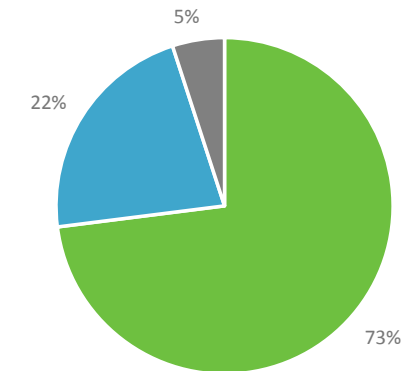
## Corporate voting summary – 3 months to March 2017

	UK			Overseas				
Number of companies voted at	51			370				
Total number of votes	715			3,974				
	For	Against	Abstain	For	Against	Abstain	Non-voting	Withhold
% of resolutions	73	22	5	47	30	17	5	1

During the quarter the Fund voted at a total of 421 company meetings – 51 UK, 74 European, 61 North American, 61 Japanese, 136 Asia (excluding Japan), 2 Australasian/ South African and 36 in the rest of the world. During this period there were 11 meetings where the Fund supported all the resolutions put forward by companies.

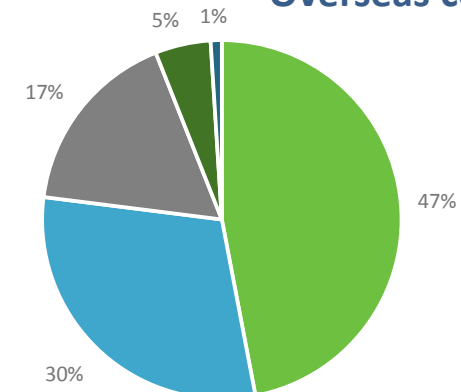
Approximately 28% of the resolutions were not supported by the Fund. The largest number of resolutions that were opposed related to the independence of directors, annual reports that failed to meet best practice and issuances of share capital.

### UK corporate voting



■ For ■ Against ■ Abstain

### Overseas corporate voting



■ For ■ Against ■ Abstain ■ Non-voting ■ Withhold

# Environmental, social and governance

## Engagement summary

Engagement via the Local Authority Pension Fund Forum (LAPFF):

*The Fund's engagement strategy is to engage with its investee companies and other key stakeholders through partnerships and on its own. The Fund aims to protect and increase shareholder value by engaging on a range of financially material ESG investment factors.*

Engagement via the Principles for Responsible Investment (PRI):

Through LAPFF, the Fund engaged with 15 companies during the quarter. Most engagements concerned Governance issues. Rio Tinto, BP, Anglo American and Shell were engaged on their preparedness for climate change risk. Summary data are presented here.

Through the PRI, the Fund is currently a support investor to two engagement topics, each of which concerns a number of holdings. One topic is water scarcity risk in the supply chains of food & beverage and apparel companies. Water scarcity and potential supply shocks are material for businesses whose value chains depend on soft commodities. A second topic is human rights risks in companies involved in the extractives sector. The Fund will join a collaborative engagement on cyber security risk from June 2017.

Other engagement:

The Fund is a participant in an engagement with one of its investees on the adequacy of succession planning for a key individual. The RI Officer attended a meeting with the company's Chair and Company Secretary and will review ongoing objectives for the engagement in May 2017. The RI Officer participated in a roundtable with the FRC ahead of expected corporate governance reform. Through LAPFF the Fund continues to engage on cluster munitions and human rights in the Israeli Occupied Territories. The RI Officer attended the AGMs of National Express and Carillion, asking questions of management at each.

## LAPFF Data



Q1 2017 ENGAGEMENT DATA			
Company	Topics	Activity	Outcome
1 Aberdeen Asset Management plc	Sent Letter	Social Risk	Governance (General)/ Awaiting Response
2 Anglo American plc	Meeting	Climate Change/ Human Rights	Change in Process
3 AstraZeneca plc	Sent Letter	Governance (General)	Dialogue
4 BP plc	Sent Letter/Meeting	Climate Change/ Remuneration	Substantial Improvement
5 British American Tobacco plc	Sent Letter	Social Risk	Dialogue
6 Easyjet plc	Sent Letter/ Attended AGM	Other/Governance (General)	Dialogue
7 Euromoney Institutional Investor plc	Alert Issued	Board Composition	No Improvement
8 HSBC Holdings plc	Sent Letter/Meetings	Employment Standards/ Finance and Accounting	Change in Process/ Dialogue
9 Lloyds Banking Group plc	Sent Letter	Finance and Accounting	Dialogue
10 Rio Tinto Group	Meetings	Climate Change	Substantial Improvement
11 Royal Dutch Shell plc	Meeting	Climate Change	Dialogue
12 Shire plc	Sent Letter	Governance (General)	Dialogue
13 Sports Direct International plc	Sent Letters/ Received Letter	Employment Standards/ Governance (General)	Awaiting Response/ No Improvement
14 Standard Life plc	Sent Letter	Governance (General)/ Social Risk	Awaiting Response
15 Vodafone Group plc	Sent Letter	Governance (General)	Dialogue

# Appendices

- Appendix 1 – Full Fund asset allocation
- Appendix 2 – Risk management
- Appendix 3 – Team biographies



# Appendix 1 – Full Fund asset allocation

Asset class	Value (£m)	Fund allocation %	Policy target %	Difference %	Change from previous quarter %
UK equities	1,182	8.3	8.0	0.3	-0.1
Overseas equities	5,030	35.4	30.0	5.4	1.0
North America	1,331	9.4	7.5	1.9	0.0
Europe (ex UK)	1,216	8.6	7.5	1.1	0.3
Japan	628	4.4	3.75	0.75	-0.1
Pacific (ex Japan)	686	4.8	3.75	0.75	0.3
Emerging markets	1,169	8.2	7.5	0.7	0.5
Global equities	1,706	12.0	10.0	2.0	0.2
Private equity	1,345	9.5	10.0	-0.5	-0.5
Special opportunities	348	2.4	2.0	0.4	0.0
<b>Total growth assets</b>	<b>9,611</b>	<b>67.6</b>	<b>60.0</b>	<b>7.6</b>	<b>0.6</b>
UK gilts	166	1.2	2.0	-0.8	0.0
Index linked gilts	769	5.4	5.0	0.4	-0.1
Cash	389	2.7	2.0	0.7	0.1
Corporate bonds	388	2.7	2.0	0.7	-0.1
Cashflow matching fixed interest	352	2.5	3.0	-0.5	-0.1
<b>Total stabilising assets</b>	<b>2,064</b>	<b>14.5</b>	<b>14.0</b>	<b>0.5</b>	<b>-0.2</b>
Specialist fixed interest	286	2.0	3.5	-1.5	-0.1
Emerging market debt	379	2.7	3.5	-0.8	0.1
Property	1,080	7.6	10.0	-2.4	-0.1
Insurance linked funds	380	2.7	3.0	-0.3	-0.1
Real assets and infrastructure	411	2.9	6.0	-3.1	-0.2
<b>Total income assets</b>	<b>2,536</b>	<b>17.9</b>	<b>26.0</b>	<b>-8.1</b>	<b>-0.4</b>
<b>TOTAL</b>	<b>14,211</b>	<b>100.0</b>	<b>100.0</b>	<b>-</b>	<b>-</b>

# Appendix 2 – Risk management

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The Fund is exposed to a number of risks which pose a threat to the Fund meeting its objectives. These risks are set out and monitored as part of a formal risk register. In summary, the principal risks affecting the Fund are as follows:

## *Funding Risks*

a) The risk of a deterioration in the funding level of the Fund. This could be due to assets failing to grow in line with the developing cost of meeting liabilities or economic factors such as unexpected inflation increasing the pension and benefit payments.

The Fund manages this risk by setting a strategic asset allocation benchmark that seeks to achieve the appropriate balance between generating a satisfactory long-term return, while taking account of market volatility and the nature of the Fund's liabilities. It assesses risk relative to that benchmark by monitoring the Fund's asset allocation and investment returns relative to the benchmark. It also assesses risk relative to liabilities by monitoring the delivery of benchmark returns relative to liabilities.

b) The risk of changing demographics such as improvement in longevity and other demographic factors, increasing the cost of benefits.

The Fund monitors this by reviewing mortality and other demographic assumptions which could influence the cost of the benefits. These assumptions are considered formally at the triennial valuation.

c) Systemic risk, i.e., the possibility of failure of asset classes and/or active investment managers results in an increase in the cost of meeting the liabilities.

The Fund mitigates systemic risk through a highly diversified portfolio with exposure to a wide range of asset classes, portfolio holdings and different management styles.

# Appendix 2 – Risk management (continued)

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## *Asset Risks*

- a) Concentration risk that a significant allocation to any single asset category and its underperformance relative to expectation would result in difficulties in achieving funding objectives.
- b) Illiquidity risk that the Fund cannot meet its immediate liabilities because it has insufficient liquid assets.
- c) Currency risk that the currency of the Fund's assets underperforms relative to sterling (i.e., the currency of the liabilities).
- d) Manager underperformance when the fund managers fail to achieve the rate of investment return assumed in setting their mandates.

The Fund manages asset risk as follows:

- It provides a practical constraint on Fund investments deviating greatly from the intended approach by setting itself diversification guidelines.
- By investing in a range of investment mandates each of which has a defined objective, performance benchmark and manager process which, taken in aggregate, constrain risk within the Fund's expected parameters.
- By investing across a range of assets, including quoted equities and bonds, the Fund has recognised the need for some access to liquidity in the short term.
- Robust financial planning and clear operating procedures for all significant activities including regular review and monitoring manager performance.
- The Fund is aware that investing in overseas assets introduces an element of currency risk, but given the level of diversification within the Fund, it is comfortable taking this risk in general but may take action to mitigate potentially significant risks as and when they are identified.
- In appointing several investment managers, the Fund has considered the risk of underperformance by any single investment manager.
- The Fund recognises and measures the liquidity risk of some assets and ensures it has significant liquidity to meet future cash requirements.
- The operator exercises oversight and monitoring over internal and external funds.

## Appendix 2 – Risk management (continued)

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e) Environmental, social and governance (ESG) risks that are not given due consideration by the Fund or its investment managers. The Fund actively addresses this potential risk through implementation of its Responsible Investment (RI) Framework and its compliance with the UK Stewardship Code for Institutional Investors and engaging with selective investments where appropriate. Both documents are available on the Fund's website.

### *Operational Risk*

a) Transition risk of incurring unexpected costs in relation to the transition of assets among managers.

When carrying out significant transitions, the Fund takes professional advice and considers the appointment of specialist transition managers in order to mitigate this risk.

b) Custody risk of losing economic rights to Fund assets, when held in custody or when being traded.

These risks are managed by:

- The use of a global custodian for custody of assets.
- The use of formal contractual arrangements for all investments.
- Maintaining independent investment accounting records.

c) Credit default with the possibility of default of a counterparty in meeting its obligations. The Fund monitors this type of risk by means of:

- Maintaining a comprehensive risk register with regular reviews.
- Operation of robust internal compliance arrangements.
- In-depth due diligence prior to making any investment.

The Fund monitors and manages risks in all areas through a process of regular scrutiny of its providers and audit of the operations they conduct for the Fund.

# Appendix 3 – Team biographies

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## **Jason Fletcher – Chief Investment Officer**

Jason assumed the role of Chief Investment Officer at West Midlands Pension Fund in September 2016. He has 25 years experience of successfully managing equity portfolios across Asia, emerging markets and the Americas with two of the largest UK pension funds (British Airways and USS). As Deputy CIO at USS he built investment teams, introduced new asset classes, managed external mandates and led initiatives in trading, graduate recruitment, ESG integration and research unbundling.

Jason graduated with a BSc in Economics from the London School of Economics in 1990. He passed the IIMR exams in 1994 which has since merged to become the CFA Society of the UK.

## **David Evans – Head of Portfolio – Passive Equity**

David first joined West Midlands Pension Fund in 1993 initially working within the Accounting and Treasury team. He attained the Investment Management Certificate in 1996 which led to a number of appointments within the investment management team culminating in David's appointment in May 2005 to the post of Senior Investment Manager which also saw him gain oversight of the larger UK index equity fund.

In 2007, David left West Midlands to assume the role of Portfolio Manager at State Street Global Advisors (SSGA) in London where he managed index funds across all regions, before finally returning to West Midlands where he has led the expansion of the Fund's in-house passive capability and overseen the transition of a number of externally managed active equity mandates.

# Appendix 3 – Team biographies (continued)

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## **Mike Hardwick – Head of Portfolio – Fixed Interest and Alternatives**

Mike joined the West Midlands Pension Fund from an accounting background in July 1995 and has worked in a number of roles within the Fund, covering all asset classes in which the Fund invests.

Mike now heads up the Fixed Interest and Alternatives team but retains primary responsibility for the Fund's property and infrastructure investments.

Mike holds an MBA from the University of Warwick.

## **Mark Hodges – Head of Portfolio – Active Equity**

Mark joined the Fund in September 2014 having spent most of his career at Fidelity as both an analyst and a fund manager. He is responsible for managing the Fund's in-house active global equity portfolio and for the oversight of the Fund's externally managed active equity portfolios.

Mark has an undergraduate degree in philosophy, politics and economics from Oxford University and an MSc in Investment Analysis from the University of Stirling. He has passed the IIMR exam which has since merged to become the CFA Society of the UK.