CITY OF WOLVERHAMPTON COUNCIL	**Pensions Committee** 25 September 2019

Report title	Quarterly Investment Report to 30 June 2019	
Originating service	Pension Services	
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Recommendations for noting:

The Committee is asked to note:

1. The global market and investment update paper prepared by the Fund's adviser, Redington

2. Quarterly Asset Allocation and Performance Reporting for the West Midlands Pension Fund

3. Quarterly Asset Allocation and Performance Reporting for the West Midlands Integrated Transport Authority Pension Fund

1.0 Purpose

1.1 The quarterly investment report covers the range of investment issues for consideration by the Committee, primarily the market and investment background and the quarterly performance of both the West Midlands Pension Fund and the West Midlands Integrated Transport Authority Pension Fund (WMITA). 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's investment strategy is outlined in the Investment Strategy Statement (ISS), approved at the March 2019 Pension 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.

III. WMITA Pension Fund's investment strategy is set out in its Investment Strategy Statement, which also contains the Fund's investment beliefs with the latest such statement approved by the Committee at its 27 March 2019 meeting.

3.0 Summary

3.1 Over the last financial year to 30 June 2019, the West Midlands Pension Fund's market value increased from £15.6 billion to £16.2 billion and the West Midlands Integrated Transport Authority Pension Fund value increased from £492 million to £499 million. Many Global stock markets made further gains in the second quarter of 2019, rounding off a solid start to the first half of the year. This was despite a significant downturn in May, when renewed trade war concerns after President Trump escalated disputes with China and Mexico spooked stock markets around the world. By the end of June, stock markets saw a recovery supported by increasingly accommodative central banks and hopes of progress in trade tensions. Global bond markets generally delivered positive results helped by solid performance in June. Performance was supported by dovish approach from the US Federal Reserve and on the possibility that the European Central Bank might renew monetary stimulus activity, including quantitative easing, in response to weaker economic growth.

4.0 Markets and Investment Background

4.1 The Fund's Investment Adviser, Redington provides a quarterly update on the market background and market performance over the quarter. The report for the quarter to 30 June which further sets out the outlook for the Fund's key asset classes over the coming months can be found in Appendix A.

4.2 Shares in developed markets gained in Q2, despite a steep fall in May due to concerns over the US-China trade war. Stock markets were supported by increasingly accommodative central banks and hopes of progress in trade tensions by the end of June. In the US, the Federal Reserve (Fed) did not cut interest rates at its June meeting, but indicated that there may be rate cuts ahead. In the same month, the US S&P 500 index achieved a new record high. UK shares underperformed against other global markets over the quarter, due to ongoing Brexit-related uncertainty and the resignation of Prime Minister Theresa May. Emerging market shares lagged their developed market counterparts as trade uncertainty weighed on Chinese and South Korean stocks.

4.3 With bond markets indicating a recession, trade-war uncertainty and global data weakness, the outlook remains uncertain. However, with U.S. Federal Reserve (Fed) easing, China stimulus and better news from a potential U.S.-China trade settlement, could mean market tensions dissipate. It would however seem clear that we are at the late stages of the economic cycle that has been extended by quantitative easing and a willingness of Central Banks to take whatever actions are necessary to support the wider economy, but there remain signs such as bond markets indicating a recession, weak manufacturing, trade wars and business confidence to invest which means that markets are likely to remain volatile.

4.4 It was a positive quarter for Global bond markets with growing dovishness among policymakers helping to drive market gains. Confronted by weaker economic data, risks to the trade outlook and low inflation, the Federal Reserve and the European Central Bank both signalled a looser monetary policy, including the possibility of US rate cuts. This prospect contributed to yields edging lower across regional markets. UK government bonds (gilts) also delivered small further positive gains in the second quarter of 2019 as the prospect of monetary stimulus from the world's central banks provided a supportive backdrop for fixed income markets. While gilts suffered weakness in April, assets recovered strongly the following month as resurfacing trade war tensions and concerns about slowing global growth helped drive demand for traditional safe-haven assets.

4.5 With the ongoing political turmoil, Q2 2019 proved a relatively subdued quarter for UK commercial property sector, albeit after a strong performance for an extended period of time. In Q2, the Industrial sector followed the trend of the previous two quarters and saw transactional volume fall. The retail sector continues to struggle as Investor confidence in the sector remains low; this continues to be amplified with the news of more retailers suffering, with Monsoon the latest major High Street name to enter into a Company Voluntary Arrangement. Q2 2019 has been dominated by further political uncertainty and this has had a significant impact on regional office investment volumes. While volumes

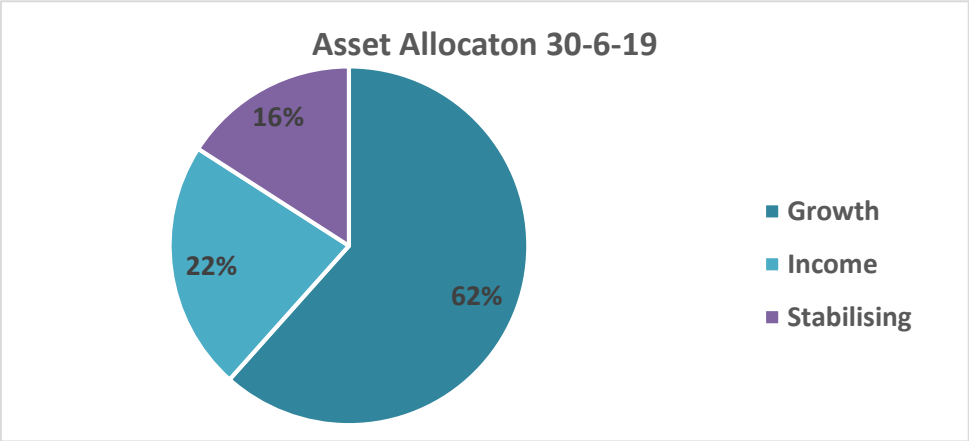
remain down on 2018, pricing has remained stable due to high demand/ low supply factors in the industrial space.

5.0 West Midlands Pension Fund Quarterly Performance

5.1 At the end of the first quarter of the financial year 2019/20, the value of the West Midlands Pension Fund had risen to £16.2 billion at the end of June 2019 from £15.6 billion at 31 March 2019. The asset allocation of the portfolio as at the end of the quarter to 31 March 2019, compared to the strategic targets is set out in the table below:

Asset class	Value (£m)	Fund allocation %	Policy target %	Difference %	Change from previous quarter %
Growth					
Quoted equities	8,612	53.2	48.0	5.2	6.4
Private equity	1,116	6.9	10.0	-3.1	0.3
Special opportunities	258	1.6	2.0	-0.4	0.1
Currency Hedge	(13)	-0.1	N/A	N/A	N/A
Total growth assets	**9,972**	**61.6**	**60.0**	**-1.6**	**6.8**
Stabilising					
UK gilts	326	2.0	2.0	0.0	-0.1
Index linked gilts	832	5.1	5.0	0.1	-0.1
Cash	525	3.2	2.0	1.2	0.0
Corporate bonds	423	2.6	2.0	0.6	0.0
Cashflow matching fixed interest	308	1.9	3.0	-1.1	-0.1
US TIPS	163	1.0	0.0	1.0	0.0
Total stabilising assets	**2,577**	**15.9**	**14.0**	**1.9**	**-0.3**
Income assets					
Specialist fixed interest	479.8	3.0	3.5	-0.5	-0.1
Emerging market debt	678	4.2	3.5	0.7	0.2
Property	1,322	8.2	10.0	-1.8	-0.3
Insurance linked funds	337	2.1	3.0	-0.9	-0.2
Real assets and infrastructure	835	5.2	6.0	-0.8	-0.3
Total income assets	**3,653**	**22.5**	**26.0**	**-3.5**	**-0.7**
TOTAL	**16,202**	**100.0**	**100.0**	**-**	**-**

The asset allocation between the core categories of investment strategy as at 30 June 2019 are shown in the chart below:



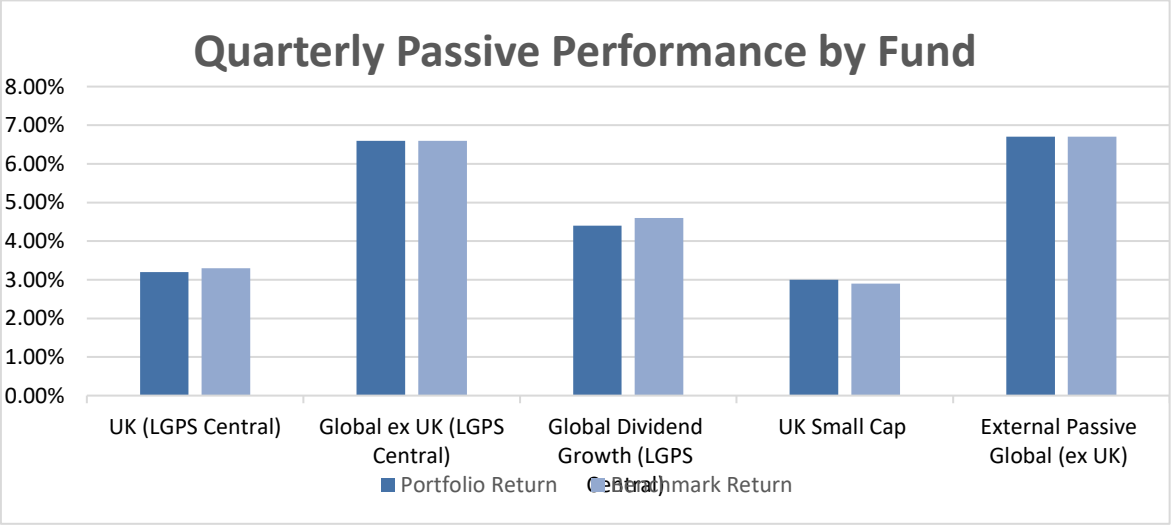
As at 30 June 2019 the Fund remained marginally overweight in growth and stabilising assets. The Fund's asset allocation target portfolio aims to increase income assets and as a result the Fund continues to look for opportunities in infrastructure and selected property assets.

Key changes over the quarter included a switch from UK equities to global dividend growth, taking some protection from possible further underperformance of the UK market against global markets as Brexit concerns continued to dominate. The Fund made a commitment to a special opportunities fund, investing with an existing manager that continues to deliver strong returns to the Fund. Drawdowns from the commitments made to the LGPSC Ltd private equity 2018 vintage fund were met from some of the sale proceeds from the private equity consolidation which took place during the last financial year.

5.2 As reported to the Committee in June, the Fund has been reviewing the benchmarks against which it measures performance and has aligned these more with industry standards, for example, measuring passive net performance against a net benchmark rather than a gross one. Performance of the different asset classes is set out below in line with the allocation strategies for the Fund.

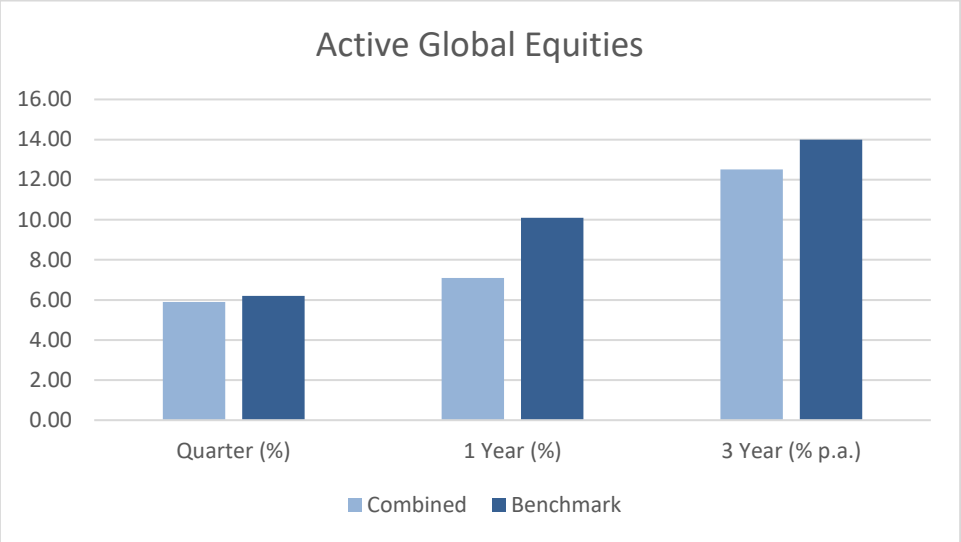
Growth Assets

5.3 The passive equity portfolio is now almost exclusively managed by the Investment Pool Company, LGPSC Ltd comprising three portfolios and are designed to replicate the performance of their underlying benchmark indices. In addition, a small residual holding in a passive global (ex UK) equity fund, designed to track the FTSE All World Developed ex UK index, is managed externally and an external UK smaller companies fund. As illustrated in the below chart, all passive funds performed broadly in line with the respective benchmarks during the quarter.



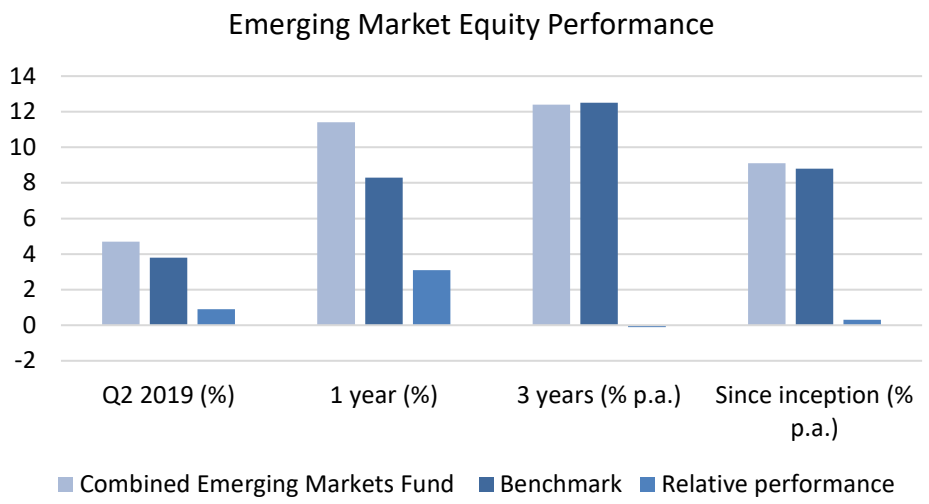
5.4 The Global Active Equities portfolio is currently comprising a broad basket of global equity exposures pending the transition to the sustainable mandates and externally managed global active equity portfolio. The previously managed external active equity portfolio was transitioned at the end of the last financial quarter of the 2018/19 financial year into the newly launched LGPSC Ltd active external equity ACS fund comprising 3 managers with a blend of style approaches.

Over the quarter to end June, there was a slight underperformance against benchmark, with the 1-year and 3-year performance being impacting by having a very value orientated tilt along with heavy exposure to UK, both of which did poorly against the broader global market indices. The Fund has taken action as noted above to protect further downside by investing more broadly and decreasing exposure to the overweight exposure to UK.

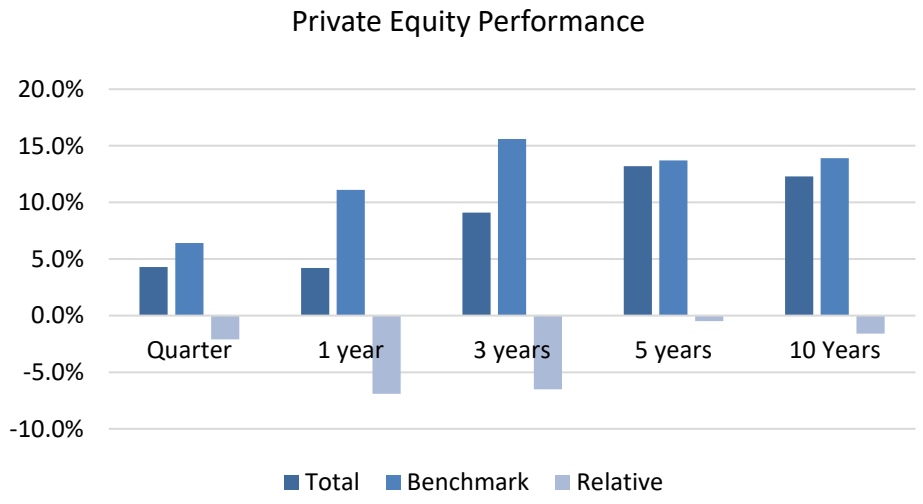


5.5 Emerging Market Equities: the active emerging market equities portfolio is managed externally by three specialist managers offering complementary value, growth and quality strategies. Over the quarter the Combined Emerging Market Equity Fund outperformed against benchmark by 1.0%. Performance was driven by strong returns from one manager offsetting marginal underperformance from the other 2 managers. The last year saw a strong outperformance as all three managers generated positive returns against benchmark by some margin. Collectively the funds outperformed benchmark by 3.1%. as shown in the below table:

Over the three-year period the Combined Emerging Market Equity Fund has generated a return of 12.4% performing almost in line with benchmark. Since inception (6 December 2013) the Combined Emerging Market Equity Fund has outperformed the benchmark (FTSE All World Emerging Market Index) by 0.3% with a portfolio return of 9.1% p.a.

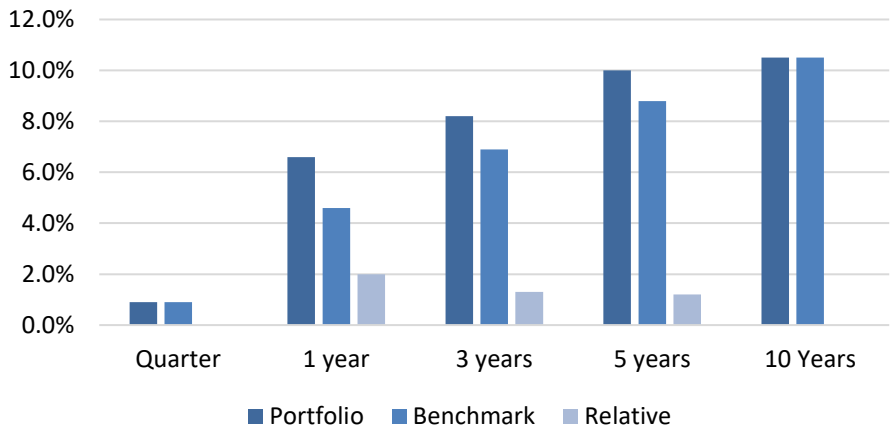


5.6 Private Equity: In Q2 2019 the portfolio returned 4.3% underperforming the benchmark by 2.1% due to the on-going strong public market performance but also from the weak GBP given the benchmark's significant exposure to USD and EUR denominated assets. The one-year performance has been impacted by the consolidation exercise, which saw a large number of legacy assets being sold at a discount to NAV, although this has freed up capital to invest in a range of expected higher returning assets. Over the longer term, the portfolio has marginally underperformed its benchmark due to an overweight position in venture capital which has not performed as strongly as the returns generated by buyout and other funds. The quarterly, 1-year and longer-term performance of the portfolio is shown in the chart below:

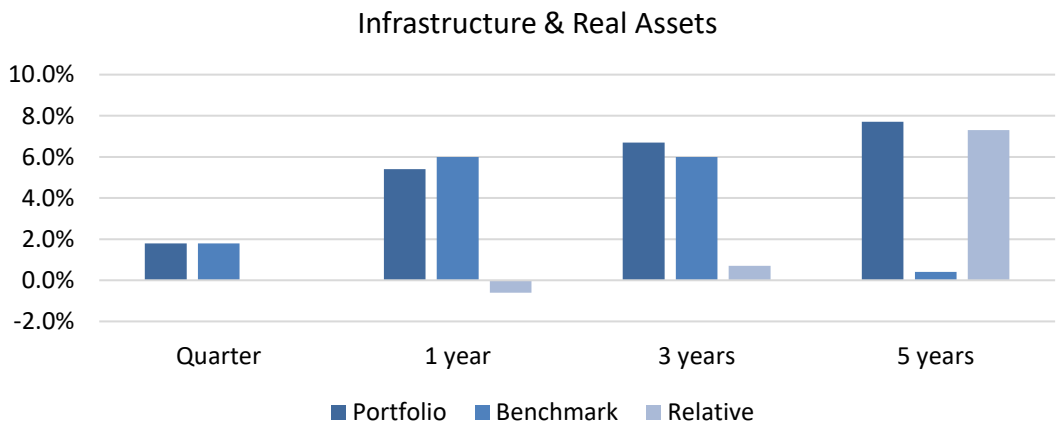


Income Assets

5.7 Property: Whilst the Fund has an underweight position in this sector, given the uncertain outlook for UK property, the Fund is 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. The overall portfolio matched its benchmark (+1.8%) during the quarter, the year's performance of 6.6% for the Fund was above the 4.6% 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:

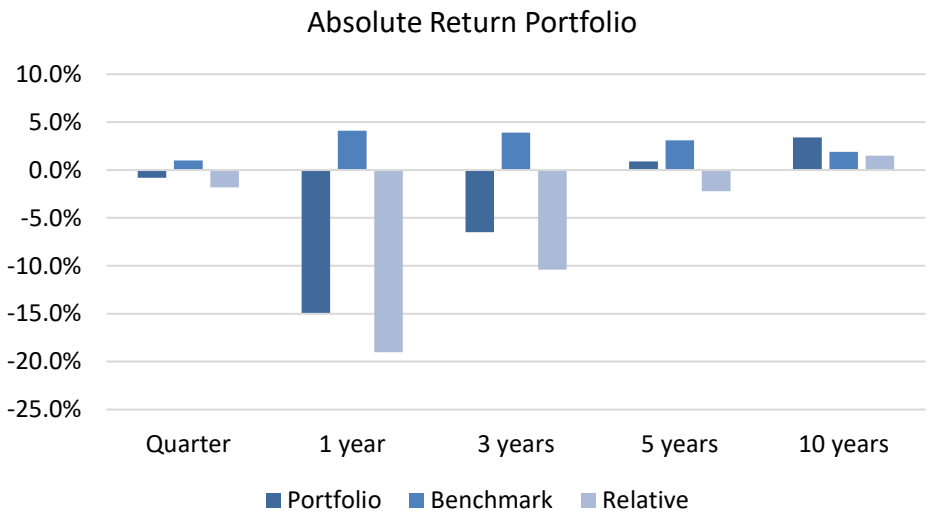


5.8 Infrastructure and Real Assets: The infrastructure portfolio performed broadly in line with benchmark over the quarter. As with property, continued uncertainty surrounding Brexit has had a drag on sentiment, particularly with regard to foreign investors, where some investors are paring back UK exposures. We continue to monitor the opportunity set within infrastructure for investments that are attractive on both a fund and more direct basis. Over the longer term, the Fund has delivered good levels of outperformance. Over the 3-year period the Fund has delivered outperformance against benchmark as can be seen in the following chart:

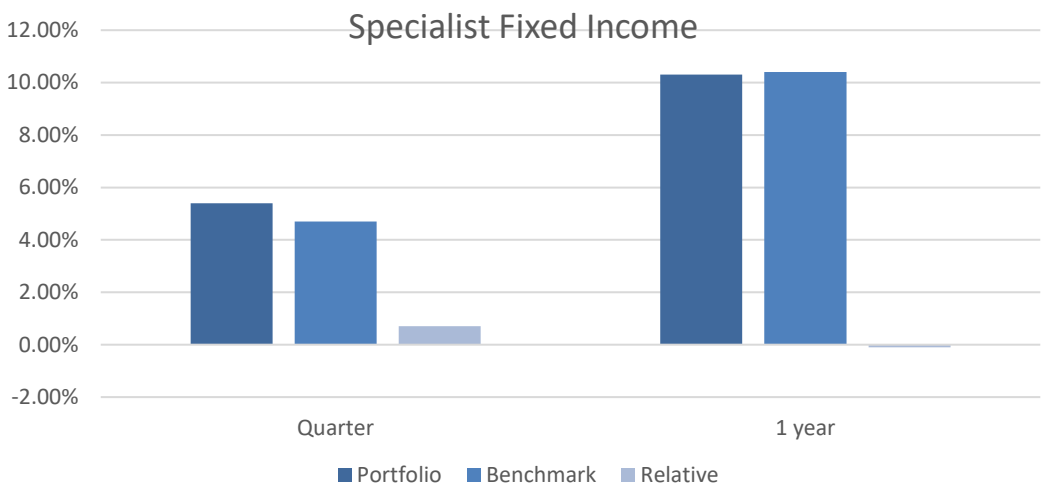


5.9 Absolute Return: This covers the insurance linked funds and special opportunity investments. Performance for the quarter was significantly impacted by the insurance linked sector again suffering the effects of severe weather-related events combined with Californian wildfires. Whilst it had been anticipated that this sector would have benefited from significant premium rate increases due to the previous year's weather-related incidents, these have not been enough 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 and is undergoing a fundamental review with the Fund's investment advisers.

The performance for the quarter was below the benchmark (-0.8% vs. 1.0%) and this was entirely down to the poor performance within insurance-linked, which came as a result of significant increases in expected losses from previous years' event, which included Typhoon Jebi which hit Japan, Californian wildfires and US hurricanes. The opportunistic portfolio produced strong performance offsetting some of the weakness in the insurance linked sector, with one of the holdings being bid for and ongoing strong performance from a number of specialist funds within special opportunities.

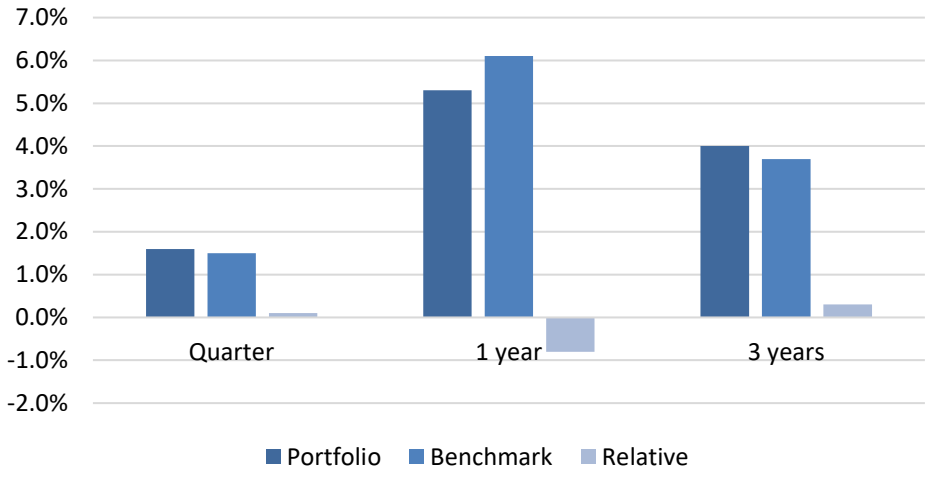


5.10 Fixed Income incorporating emerging market debt and specialist fixed income:
The income element of the fixed income portfolio comprises a mix of emerging market debt, multi-asset credit and specialist debt funds. As the majority of holdings in the portfolio are relatively new, there are no longer term performance statistics for this segment of the portfolio. The income element of the fixed interest portfolio outperformed its bespoke benchmark over the quarter driven mainly by the outperformance of the specialist fixed interest segment of the portfolio. On an individual basis, specialist fixed interest outperformed its benchmark by 1.4% with the majority of the constituent funds contributing, with minor outperformance coming from emerging market debt of 0.4% and multi-asset credit outperformance of 0.3%.



Stabilising Assets

5.11 Stabilising Fixed Income: The stabilising portfolio comprises the Fund's exposure to government bonds and index linked securities, corporate bonds, cashflow matching and cash. The longer-term target returns from this part of the portfolio are expected to average CPI + 0-2% over the longer term with lower volatility. The stabilising component of the fixed interest portfolio marginally outperformed its benchmark over the quarter by 0.1%. The corporate bond portfolio sitting in the stabilising segment of the portfolio moderately outperformed its benchmark due to the outperformance of its active managers. The largest contributor to performance was the UK Corporate Bond Fund, which outperformed its benchmark by 0.8%. Both the gilt and index-linked gilt funds performed in line with their respective benchmarks. Over the year, the absolute performance of the stabilising portfolio was 5.3% resulting in an underperformance of (-0.8%). Over the 3-year timeframe the portfolio is only marginally ahead of its benchmark by 0.2% as can be seen from the chart below:



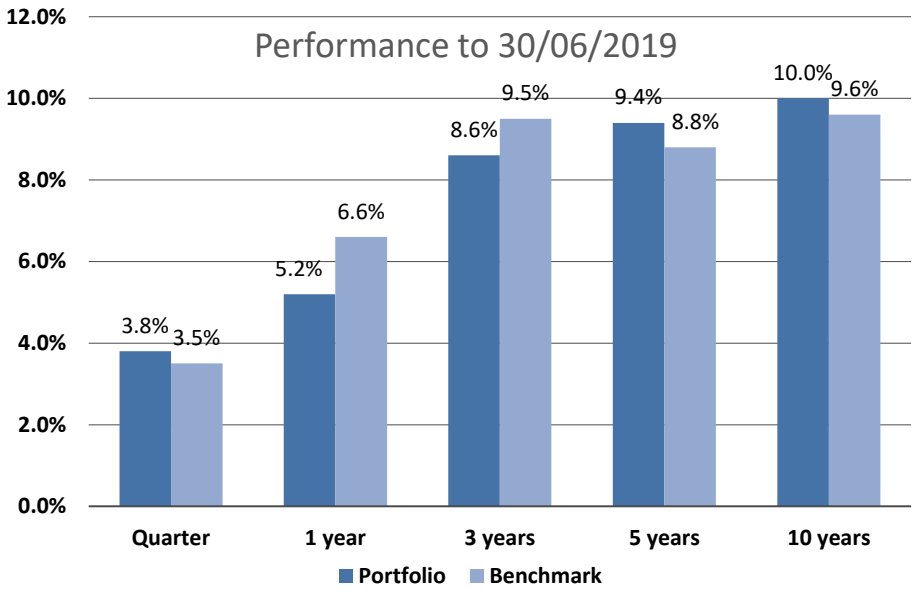
Currency

5.11 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 Q2 2019, the Fund implemented a currency hedge of just over £3.0bn of equity exposure (£0.7bn in EUR, £0.3bn in JPY and £2.0bn in USD). Over the quarter, Sterling depreciated against all three of the currencies that are hedged and reduced the Fund's overall return by 0.2%. Over the 1-year period, the hedging programme also had a negative impact of (-0.5%). However, the ex-post risk profile identifies that the Fund is relatively low risk and is lower risk than in recent years partly due to the hedging programme currently in place.

Total Fund Performance

5.12 The performance of the Fund over the last financial year delivered returns of 5.2% compared to the benchmark return of 6.6%. Contributors to underperformance were private equity (although recognising that performance for this sector tends to lag broader market performance), but also included the consolidation of the PE portfolio where the Fund accepted a discount to NAV for some of its legacy assets and the insurance linked securities, the biggest negative contributor which is currently undergoing a review by the Fund. Over the 3-year period since the last actuarial valuation the Fund has seen returns of 8.6% p.a. This level of investment returns exceeds the rate required over the long term to support the funding of Scheme benefits.



Investment Costs

5.13 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.

5.14 As previously documented, the Fund has led on the cost transparency initiative to uncover hidden costs in an effort to be as transparent with the full costs of managing the portfolio as possible. Work during the previous financial year to participate in a pilot study with the PLSA (Pensions & Lifetime Savings), the Investment Association and the LGPS Scheme Advisory Board meant that the Fund was one of the first to trial new templates to capture as far as possible all cost data. This did lead the Fund to report higher costs than had been budgeted during the year, but the greater clarity this provides the Fund on its full costs of managing assets enables informed decisions to be made going forwards.

6.0 West Midlands Integrated Transport Authority Pension Fund Quarterly Performance

6.1 In the first quarter of the financial year 2019/20, the value of the WMITA Pension Fund rose from £492 million to £499 million as global equity markets made further gains in the second quarter of 2019. The table below sets out the asset allocation of the portfolio at the end of June (excluding the buy-in element of £224.5 million, revalued as at 31.03.19), the policy targets are those set in the Investment Strategy Statement, updated following changes agreed with Committee in March 2019.

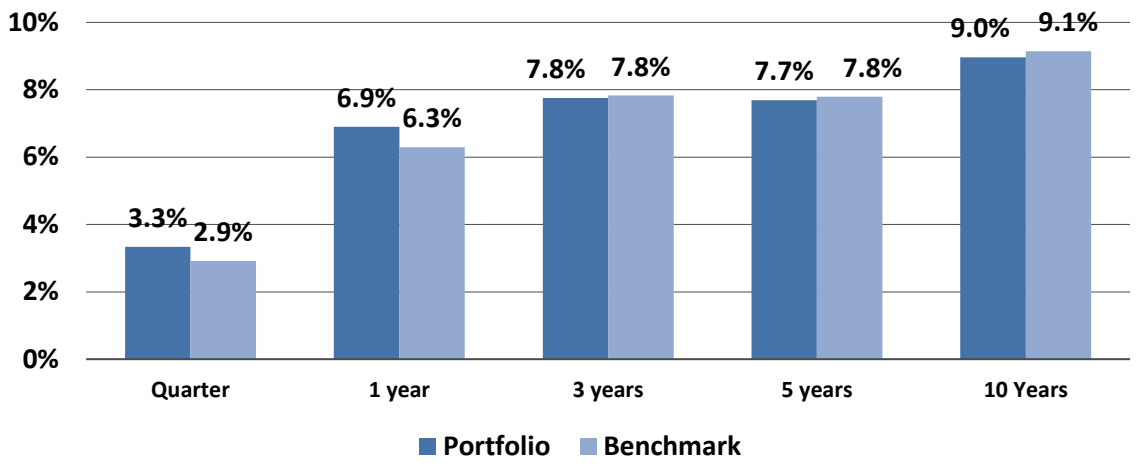
Asset class		Value (£)	Fund allocation	Policy target	Difference
Equities	£	76,694,036	28.0%	27.1%	0.9%
Diversified Growth Funds	£	98,004,606	35.8%	35.5%	0.3%
Fixed Interest	£	44,096,070	16.1%	0.0%	16.1%
MAC	£	53,408,570	19.5%	20.3%	-0.8%
LDI	£	-	0.0%	17.1%	-17.1%
Cash	£	1,777,190	0.6%	0.0%	0.6%
TOTAL	**£**	**273,980,472**	**100.0%**	**100.0%**	**0.0%**

*Excludes Prudential buy-in £224.5 million

** Policy target shows the updated policy targets agreed by Pensions Committee in March 2019

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 30 June 2019, the fund achieved a return of 3.3% against the benchmark return of 2.9%. Over the 12-month period the fund marginally outperformed the benchmark by 0.6%, this was mainly due to the outperformance of the DGF's relative to equities and fixed interest portfolios. The chart below shows the gross and relative 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 June 2019. The passive equity portfolio has performed in line with the benchmark over all periods under review. The diversified growth portfolio has experienced mixed performances over the long term with one of the portfolios impacting on the overall performance of the DGF allocation. However, this has recently started to change in the last 12-months with particular strong performance coming from one of the DGF managers that had previously experienced significant underperformance. The fixed income allocation is split between passive index linked exposure (which has performed in line with benchmark) an active corporate bond portfolio and a multi-asset credit fund.

	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	6.1%	8.2%	13.2%	11.6%	0.0%	0.1%	0.1%	0.2%
Diversified Growth Funds	2.9%	6.3%	4.1%	11.6%	1.8%	1.8%	-0.2%	-0.2%
Bonds	1.8%	5.3%	4.2%	7.0%	0.2%	-0.3%	0.0%	0.1%
Total return	**3.3%**	**6.9%**	**7.8%**	**7.7%**	**0.4%**	**0.6%**	**-0.1%**	**-0.1%**

7.0 Investment Pooling Update – LGPS Central

7.1 The Fund continues to work closely with its investment pool company LGPSC Ltd and Partner Funds to look for opportunities to transition assets where it can see value add from doing so including the opportunity to make cost savings.

7.2 Work has taken place alongside input from the Fund and other Partner Funds to develop corporate bond and a low carbon factor based sub-funds, with the sub-funds in the process of being launched and transition arrangements being finalised. A number of other sub-funds remain in development including emerging market debt, active UK equity and multi-asset credit sub-funds and the Committee will be kept updated of other 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 – Redington Economic and Market Update August 2019