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Agenda Item No: **16**

Wolverhampton City Council

Pensions Committee

25 June 2014

Report Title	Investment policy and performance report 2013/14	
Originating service	Pension Services	
Accountable officer(s)	Geik Drever	Director of Pensions
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Recommendation(s) for action or decision

1. Members are requested to endorse the Investment Advisory Sub Committee's approval to proposals for modifications to the strategic risk bands set out in section 4.0, which lead to an increase in the ranges for equities (to 50-70% of the Fund from 45-65%) and to a lowering of the ranges for alternative investments (to 15-25% from 20-30%). If approved, the changes will be implemented with effect from 1 July 2014.

Recommendation(s) for noting:

The Committee is asked to note:

1. The Fund's investment policy, investment strategy and investment returns for the year to 31 March 2014.

1.0 Purpose

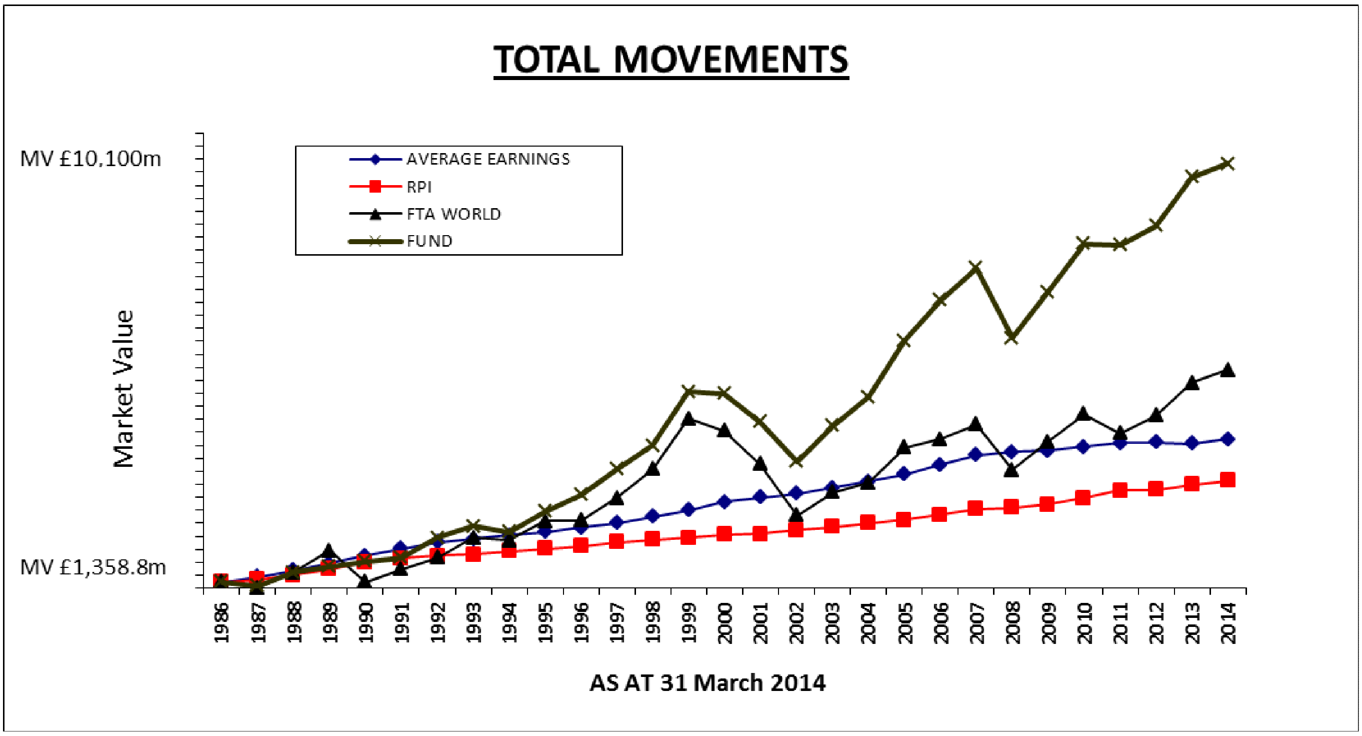
1.1 This report outlines details of the Fund's investment policy and performance for the year ending 31 March 2014 and proposed changes to strategic risk bands with effect from 1 July 2014.

2.0 Investment Policy

2.1 Investment policy is reviewed annually with the next Strategic Investment Allocation Benchmark (SIAB) to be presented to the Committee in September 2014. The Fund's focus has been on a long term investment strategy focussing on three principal asset classes – quoted equities, fixed interest and alternative investments. These are combined to provide diversification and reduce volatility. In recent years, the key trend has been to reduce dependence on the equity risk premium and to increase exposure to alternative investments. The fund continues to have a return seeking strategy with a total return target of 6.9% per annum with returns predominantly generated from markets (6.0%) and the balance (0.9%) from active management.

2.2 Since 2012, the fund has not deployed tactical asset allocation and in December 2013, the Investment Advisory Sub Committee agreed that tactical asset allocation should cease as it would not add any value within the agreed SIAB framework.

2.3 At the beginning of the year, the Fund's market value was £9.812bn. By the end of March 2014, the value of the Fund was £10.100bn which reflects net cashflow and appreciation in market value. The graph below illustrates the cumulative movement of the Fund since 1986 resulting from the implementation of investment policies, market movements, unrealised profits and net cash inflows.



2.4 The Fund continues to have strong positive cash inflows, though future cash flows will be impacted over time by a reduction in contributions due to a fall in active membership as a result of redundancies, early retirements and members choosing to opt out. This may be countered by Automatic Enrolment by 2017.

3.0 Asset allocation

3.1 The following table shows a summary of the asset distribution for the year ended 31st March 2014 compared with the Strategic Risk Bands agreed by the Pensions Committee. The Fund's closing market value of £10.1bn reflects the appreciation of investments during the period and a net investment of £83.2m.

Portfolio	Strategic Risk Bands %	Opening Levels %	Closing Levels %	Closing Market Value £M	Net Investment £M
UK Equities		9.9	10.0	1,004	-17.1
Global Equities		5.0	5.2	526	-0.8
Total Overseas Equities		27.9	30.7	3,100	+303.4
North America		9.6	9.7	979	-42.2
Continental Europe		5.9	6.7	678	+5.6
Pacific Ex Japan		4.3	4.1	414	+32.1
Japan		1.9	1.8	183	+1.3
Emerging Markets		6.2	8.4	846	+306.6
Private Equity		12.6	12.3	1,240	-83.5
Total Equities	**45.0-65.0**	**55.4**	**58.2**	**5,870**	**+201.9**
UK Gilts		2.0	1.9	192	0.0
Specialist Fixed Interest		3.3	3.3	337	+9.0
Index Linked Gilts		6.8	6.3	639	0.0
Corporate Bonds		4.8	4.8	481	0.0
Emerging Market Debt		3.3	2.6	264	-29.8
Cash		3.3	2.6	264	-61.3
Total Fixed Interest	**15.0-25.0**	**23.5**	**21.5**	**2,177**	**-82.2**
Property		8.6	9.2	928	+36.9
Absolute Return		7.1	6.4	642	-55.1
Infrastructure		3.3	2.9	293	-20.9
Commodities		2.1	1.9	190	+2.6
Total Alternatives	**20.0-30.0**	**21.1**	**20.3**	**2,053**	**-36.5**
Total Non-Equities	**35.0-55.0**	**44.6**	**41.8**	**4,230**	**-118.7**
Total		**100.0**	**100.0**	**10,100**	**+83.2**

3.2 All main asset classes closed within their wider strategic risk bands.

3.3 The investment strategy allocation is determined in accordance with the regulations (LGPS - Management and Investment of Funds - Regulations 2009) and its formulation is set out in the Fund's Statement of Investment Principles. In accordance with the investment management regulations, the schedule of limits on investments is varied to an upper limit of 30% for commitments to partnerships and 15% for investments in unlisted securities of companies. These limits are kept under review and reviewed every time the SIP is reviewed.

3.4 The most significant asset allocation changes made during the year were an increase in the allocation to equities (net investment of £201.9m) and a reduction in the allocation to cash, fixed interest and alternative investments (net disinvestment of £118.7m in aggregate).

3.5 Within equities, the decision was taken to increase the Fund's exposure to emerging markets equities, in conjunction with the introduction of new segregated investment management arrangements (with the appointments of AGF, Foreign & Colonial and Mondrian). In total £306.6m was allocated, taking advantage of relative weakness in emerging markets. The Fund's exposure to Pacific Basin equities was also increased (£32.1 million) and exposure to North American equities reduced (£42.2 million) in order to bring allocations closer to target levels.

3.6 In private equity, a net £83.5 million was realised with distributions exceeding drawdowns, in line with a profile of maturing funds and firm capital markets. Commitments to new funds totalled £217 million.

3.7 There were disposals of underperforming funds and some distributions in the absolute return and infrastructure portfolios. Funds were allocated selectively to property - £36.9m net – both directly and in indirect vehicles. A commitment was made to a fund specialising in agricultural investment.

3.8 Cash balances were reduced by £61.3 million and exposure to emerging markets debt was trimmed (£29.8 million).

4.0 Proposed changes in strategic risk bands

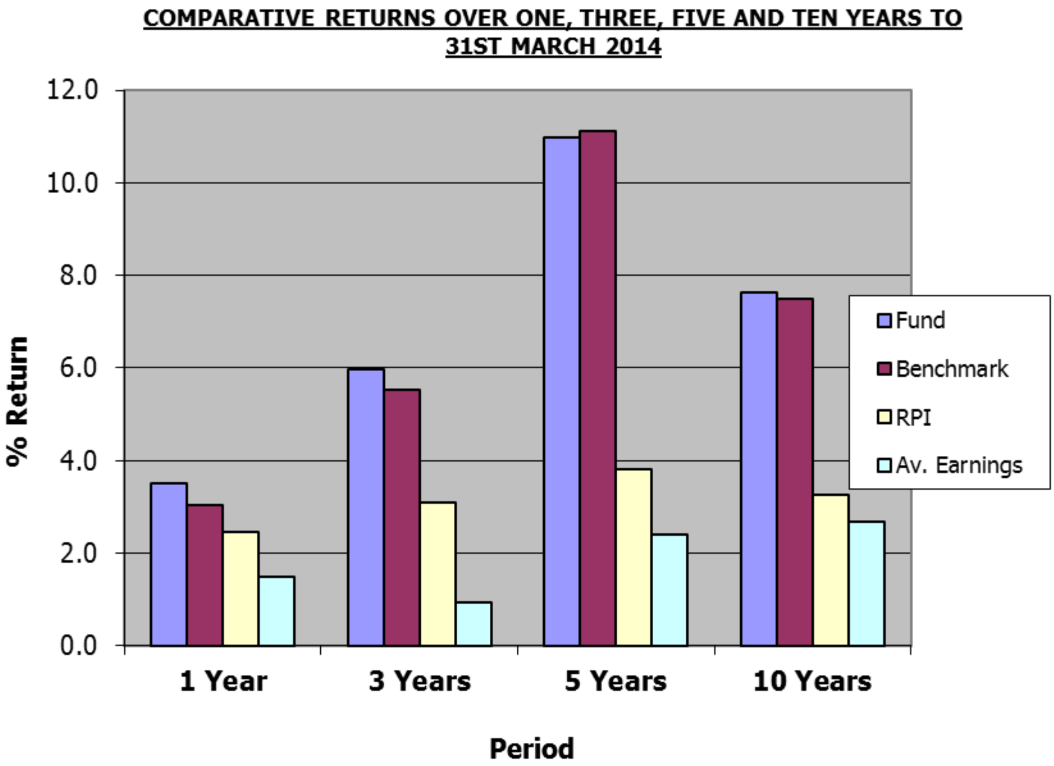
4.1 During April 2014, the Fund received £184 million from Councils in order to prepay a proportion of deficits arising from past service. It is planned also to reduce the exposure to commodities funds on a phased basis from June 2014 with a view to exiting from them entirely by the end of 2014.

4.2 It is recommended that these cash flows are allocated in the main to quoted equities.

4.3 In light of these changes, it is recommended that the medium term strategic ranges for quoted equities are raised to 40-60% (from 35-55%) and for total equities to 50-70% (from 45-65%). Correspondingly it is also recommending that the medium term ranges for alternative investments are lowered to 15-25% from 20-30%. The ranges for the fixed interest segment are to remain unchanged. The Investment Advisory Sub-Committee approved these changes at its meeting in March 2014 and the Pensions Committee is now invited to endorse these changes, which will be implemented with effect from 1 July 2014.

5.0 Returns to 31 March 2014

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

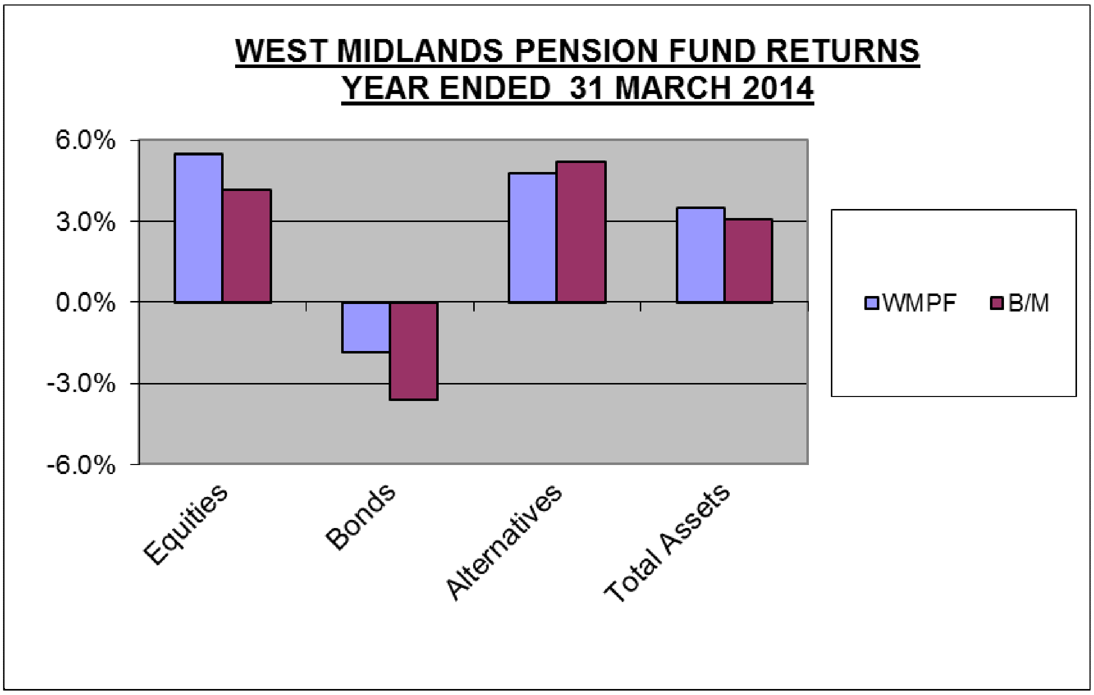


5.2 In the year to 31 March 2014, the Fund delivered a return of 3.5%, ahead of its bespoke benchmark of 3.1%. The main contributors to the outperformance were good relative performances from the quoted equities and fixed interest portfolios.

5.3 A return of 6.0% per annum was achieved by the Fund in the three years to 31 March 2014, ahead of the bespoke benchmark return of 5.5%. This was mainly due to strong returns from UK and Overseas equities portfolios.

5.4 The Fund's 10 year return of 7.6% per annum is slightly ahead of the benchmark of 7.5% but remains comfortably ahead of increases in RPI and Average Earnings.

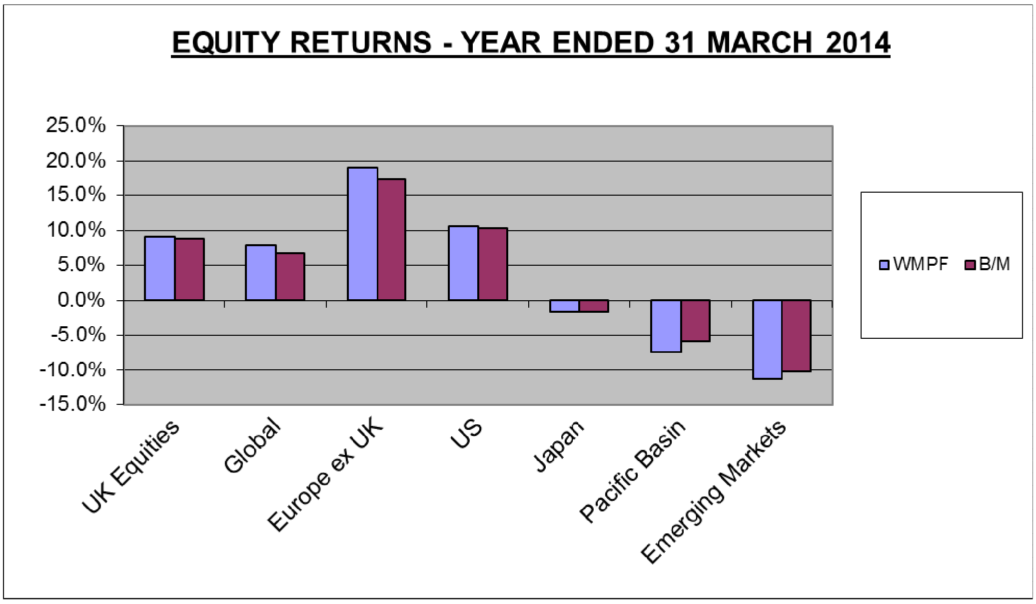
5.5 The graph following illustrates the returns of the Fund's main asset classes for the year ended 31 March 2014 and compares them to the returns from its bespoke benchmark.



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

5.6 The Fund's total return outperformed its scheme specific benchmark by +0.4% for the year. The outperformance was achieved mainly because of outperformance in quoted equities and fixed interest. Performance was mixed in the absolute return portfolios – private equity fared well but commodities, property and infrastructure were weak. Directly held property also contributed positively to the Fund's return for the year. Further details on the performance of the different segments of the fund are set below.

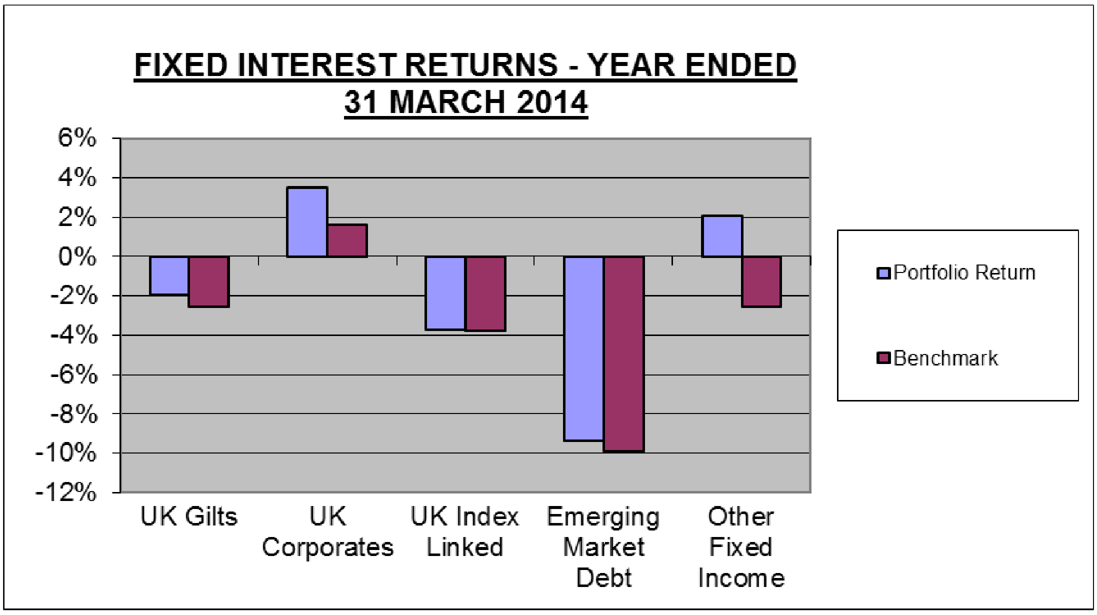
5.7 The graph below illustrates the returns of the different quoted equity markets:



5.8 Developed market equities posted positive returns, with Europe (ex UK) faring notably well. Emerging markets equities, by contrast had a poor year, as did Pacific Basin markets and Japan (due to Yen weakness).

5.9 The Fund's quoted equities portfolio outperformed, with a return of 5.5% achieved compared with a benchmark return of 4.1%. The Europe (ex UK) and global equities portfolios performed notably well.

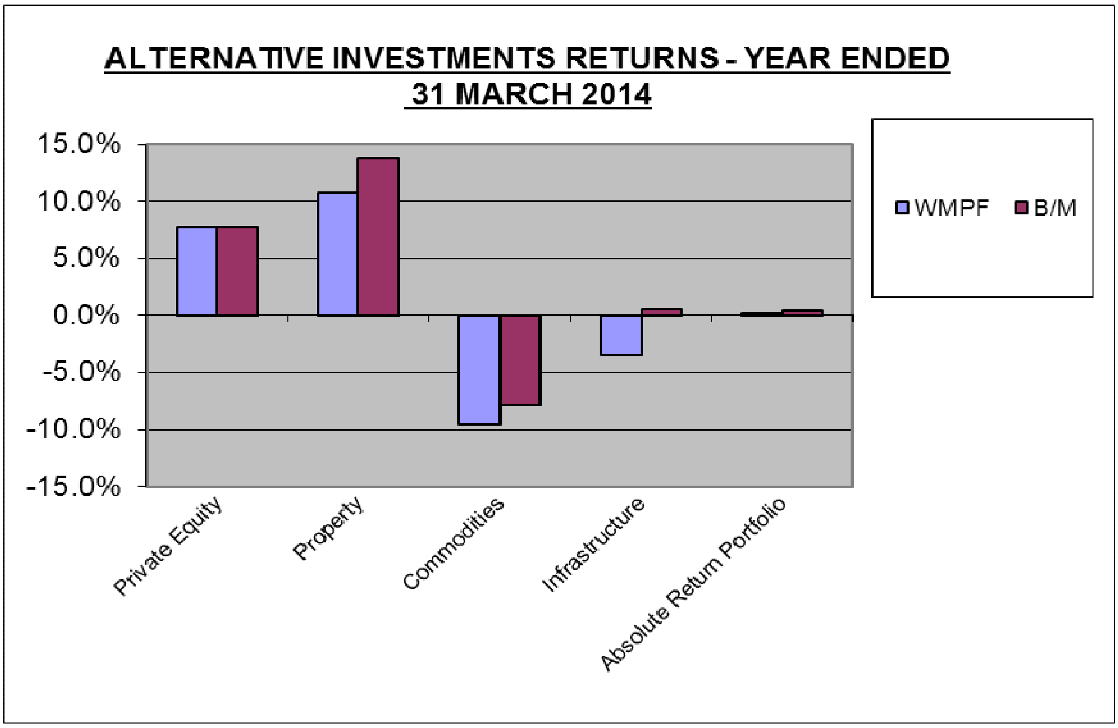
5.10 The graph below illustrates the returns of the different bond markets:



5.11 Fixed interest markets had a difficult year, in particular emerging market debt and gilts (both conventional and index linked), reflecting the prospect of the ending of quantitative easing measures and the possibility of interest rate rises.

5.12 The Fund's fixed interest portfolio outperformed, with a return of -1.9% ahead of the benchmark return of -3.6%. The corporate bond fund holdings fared notably well, as did the specialist fixed interest funds (categorised as "other fixed interest").

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



5.14 There were varying performances from the alternative investments portfolios during the year. The private equity portfolio posted a return of 7.7%, reflecting profitable distributions and firmer stock markets. It was a good year for direct property, too. The Fund's consolidated property portfolio's return of 10.8% lagged its benchmark at 13.8% but within the overall picture, the directly held UK property holdings fared well with a return of 14.1%. The indirect holdings – predominantly overseas – posted a modest 3.9% return.

5.15 There were weak performances from commodities (-9.5%) and infrastructure (-3.5%), reflecting poor market conditions in the former and underperformance in certain funds in the case of the latter. In absolute return, performance was dull (0.2%), but within the overall picture, there were good performances from insurance linked funds and special opportunities, offset by a weak performance from hedge funds.

6.0 West Midlands Pension Fund historical returns

6.1 The returns as at 31 March 2014 achieved by the Fund in the main asset classes in which it invests are shown in the table below, as are the three and five year annualised returns where available.

	1 Year %	3 Year %	5 Year %
UK Equities	9.04	8.92	16.35
European Equities	19.09	7.32	14.69
US Equities	10.55	12.29	17.78
Pacific Basin Equities	(7.79)	2.03	13.38
Japanese Equities	(1.56)	4.34	7.59
Emerging Markets Equities	(11.29)	(3.69)	12.13
Global Equities	7.76	8.86	14.33
Gilts	(1.98)	5.36	4.38
Index Linked	(3.74)	7.90	8.15
Corporate Bonds	3.53	7.48	10.45
Property	10.80	8.68	9.74
Private Equity	7.73	8.51	7.49
Commodities	(9.50)	(7.02)	0.47
Emerging Market Debt	(9.41)	3.11	9.83
Infrastructure	(3.49)	2.17	2.32
Absolute Return Strategies	0.18	4.04	5.79
Total Fund	3.51	5.97	10.90

6.2 The above table clearly highlights the strong performances delivered by stock markets since 31 March 2009, which have been the most important driver of the Fund's returns over that period. March 2009 marked the start of the recovery in stock markets following the policy measures taken by the authorities in the wake of the financial crisis of 2008. Returns over the past three years have been lower and it is suggested that these better reflect how markets will fare over the long term in the future.

6.3 Returns from other asset classes have been lower over the past five years but have been less volatile, too – with the exception of commodities, which have delivered negative returns accompanied by high volatility.

6.4 Following the market turmoil of 2008, a new investment strategy was adopted in 2009, with a reduction in the target allocation to quoted equities (from 60% to 45% currently) and a corresponding increase in the allocation to alternative investments. Against the backdrop of stronger stock markets since 2009, the change in strategy has not to date enhanced returns but the increased diversification has been designed to protect the portfolio in tougher market conditions.

7.0 Investment management and portfolio construction

7.1 The investment policy of the Fund is considered at each quarterly meeting of the Investment Advisory Sub-Committee and implemented by the Investments Division. The Division consists of a number of specialist teams which reflect the asset allocation and functions of the Fund. These teams currently cover quoted equities, alternative investments and fixed interest.

7.2 The Division manages approximately 85% of total investments in-house, with the balance managed via external segregated management arrangements.

7.3 The Fund recognises that the mainstream quoted equities and fixed interest markets are the most efficient, thus passive management dominates within these asset classes. Although most use of specialist managers is within alternative assets, the Fund uses active management in mainstream liquid assets where inefficiencies and market opportunities exist. Examples of this are found in global and emerging market equities.

8.0 Financial implications

8.1 This report demonstrates the Fund's primary objective of maximising financial returns.

9.0 Legal implications

9.1 This report contains no direct legal implications.

10.0 Equalities implications

10.1 None identified.

11.0 Environmental implications

11.1 None identified.

12.0 Human resources implications

12.1 None identified.

13.0 Corporate landlord

13.1 None identified.

14.0 Schedule of background papers

14.1 There are no background papers except those listed in the report.