TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 5

TEESSIDE PENSION FUND COMMITTEE REPORT

21 DECEMBER 2017

STRATEGIC DIRECTOR FINANCE, GOVERNANCE & SUPPORT – JAMES BROMILEY

INVESTMENT ADVISORS REPORT

1. PURPOSE OF THE REPORT

1.1 To update Members with the current capital market conditions, and set an appropriate short term asset allocation to best take advantage of these conditions.

2. RECOMMENDATIONS

2.1 That Members note the report and approve with the short term asset allocation.

3. FINANCIAL IMPLICATIONS

3.1 Decisions taken by Members, in light of information contained within this report, will have an impact on the performance of the Fund.

4. BACKGROUND

4.1 At each Investment Panel meeting, the Panel's Independent Investment Advisors (the Advisors) provide an update to Members on current global economic, political and market conditions, and recommend an appropriate short term asset allocation for the Fund given these conditions.

4.2 As Members are aware, a review of Advisors was carried out and as part of the tender exercise the previous Advisors' last Panel meeting was March 2017. Progress has not enabled new Advisors to be present for this meeting to provide advice to Members.

4.2 Attached as Appendix A is a report from the Head of Investments and Treasury Management. The report sets out the political, economic and market background since the previous meeting.

5. SHORT TERM ASSET ALLOCATION ADVICE

5.1 In light of no Advisors to provide advice, it is considered appropriate to continue with the previous short term asset allocation. Also, it is proposed that at the next Committee meeting the results of an Asset/Liability Study, carried out by the Fund's Actuary, AON Hewitt, is presented with a recommendation for a new customised benchmark.

5.2 The current political, economic and market conditions are similar to previous advice provided at meetings and do not suggest any need to make any major strategy changes. Currently, the key component when setting the short term asset allocation is the Bond yield level. Most other asset classes are basing their levels from this yield and with yields still currently low, investors are seeking returns wherever they can find them.

5.3 Therefore, it is proposed that the Fund continues to favour growth assets over protection assets. It is considered that in the long run, Bond yields will rise, but following central banks past intervention in the Bond markets, yields do not meet the actuarial requirements for the Fund and should continue to be avoided at these yield levels unless they are held as a short term alternative to cash.

5.4 Cash has built up as divestments from other asset classes have occurred, and is primed to be invested when opportunities allow. It is always preferential for cash to be invested in higher returning assets, but at this time high cash levels can assist in protecting the Fund, as a diversifier, from Equity market downturns. However, at the current level of approx. 12%, cash should not rise too much further in the short term to above the maximum short term level set at the customised benchmark for protection assets (15%). It is accepted that if the value of other asset classes fall, particularly Equities, there is a possibility that the short term cash level will rise over the maximum set below.

5.5 Equity markets have been volatile over the past few years, with additional volatility in currency markets, both of which have recently been beneficial to the Fund at current equity and currency market levels with the Fund's high weighting in equities. The short term allocation strategy and range provides flexibility within this volatile asset class, however, reducing Equity levels is a big feature of the proposed new customised benchmark. It is with this in mind that the upper limit has been shaved slightly as a short term measure until a strategy has been fully developed to implement the proposed customised benchmark, should the Committee agree to it.

5.6 Investment in direct property to continue on the same basis as previously presented to the Panel; on an opportunistic basis where the property has a good covenant, yield and lease terms.

5.7 Investment in Alternatives, such as general and local infrastructure and private equity, offer the Fund diversification from equities and bonds. They come with additional risks of being illiquid, traditionally they have costly management fees and investment in the type of investment can be a slow process. However, the Fund is considerably underweight its customised benchmark and, providing suitable investment opportunities are available, the Fund should look to increase its allocation to this asset class up to the customised benchmark level. In addition, this is a big feature in the proposed new customised benchmark.

5.8 The Fund's long and short term asset allocation strategies (based on the existing customised benchmark before implementation of the proposed benchmark following the Asset Liability Study) are summarised below, together with the short term asset allocation ranges for each asset class:

Asset Class	**Customised Benchmark %**	**September Weighting %**	**LT Asset Allocation Strategy**	**ST Asset Allocation Strategy**	**ST Range %**
GROWTH:					
UK Equities	30	32	Reduce	Market dependent	29 – 34
Overseas Equities	40	47	Reduce	Market dependent	45 – 50
Property	10	7	Increase	Opportunistic increase	7 – 9
Alternatives	5	2	Increase	Opportunistic increase	1.5 – 5
PROTECTION:					
Bonds	12	0	Increase	Hold	0 – 2
Cash	3	12	Reduce	Hold/Reduce	5 – 15

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APPENDIX A

Investment Report December 2017

Geopolitical Background

The past quarter has been a busy one for geopolitical news, with major news stories from the US, Europe and here in Britain.

Theresa May's leadership came under pressure again due to Cabinet resignations, including close ally Michael Fallon. A reversal of fortune came about with news of a breakthrough in the Brexit negotiations and the so-called "*divorce*" settlement looks to be settled at approx. £50 billion.

In Europe, the Catalan's voted for independence in an unofficial election, which preceded with a warrant for the arrest of the President of the Government of Catalonia, Carlos Puidgemont. In Germany, Chancellor Merkel's attempts to form a coalition government failed, with a new attempt with the Social Democrats.

In the US, Robert Mueller continues with his investigation into the alleged Trump campaign coordination with Russia. The indictment and plea agreement of former national security adviser Michael Flynn now puts the investigation into the White House. More recently the decision to move the US Embassy in Israel to Jerusalem has increased tension in the Middle East.

Economic Background

With CPI at 3.0%, well ahead of the target rate of 2%, the recent inflation figures in the UK justified the Bank of England's Monetary Policy Committee first increase in interest rates since the financial crisis ten years ago; base rates are now 0.5%. Brexit negotiations are progressing following the impasse over the Northern Ireland/Ireland border which strengthened the GB Pound against the Euro.

In the Euro region, the President of the European Central Bank (ECB), Mario Draghi, underlined that the Governing Council doesn't see "encouraging" signs in wage growth and inflation. The ECB is planning to reduce its bond buying scheme from €60 billion per month to €30 billion per month in 2018 until September adding that it would continue with additional purchases if necessary until the Governing Council sees a sustained adjustment in the path of inflation.

In the US, the Federal Reserve is meeting just ahead of the Committee meeting with most speculators suggesting another 0.25% rise. This will be the third 0.25% rate in 2017 as the US economy rebounds and the Federal Reserve try to curb inflation.

This is towards the end of a busy US period. Agreement has been reached by both Houses to allow the US Tax Plan to proceed. The next Head of the Federal Reserve, Jeremy Powell was announced by the US President.

Market Background

Equity markets, in general, have performed positively since the start of this quarter (to 8 December 2017) but still positive from the beginning of 2017 (to 8 December 2017), as shown in the table below:

	YTD %	**QTD %**
FTSE All-Share (UK)	11.46	0.95
S & P 500 (US)	12.70	5.66
Euro Stoxx 600 Ex UK (Europe)	20.48	-0.03
Topix 500 (Japan)	13.84	6.98
MSCI Asia Pacific Ex Japan	27.00	4.64

The above returns are all rebased back to GB Pounds, and take into effect both the currency and index moves.

In the past it has been reported to the Panel that Bond yields are not sufficient to meet the actuarial rate of return, as calculated by the Fund's Actuary. The table below sets out the yields of the major market's 10 year bond yields for the 31 December 2016, 30 September 2017 and 8 December 2017:

10 Year Bond Yields	**31/12/2016**	**30/09/17**	**08/12/2017**
UK	1.235%	1.361%	1.278%
US	2.454%	2.318%	2.378%
Germany	0.204%	0.462%	0.305%
France	0.681%	0.742%	0.629%
Switzerland	-0.238%	0.043%	0.195%
Japan	0.041%	0.060%	0.045%
Australia	2.765%	2.839%	2.529%

As seen from the levels shown, European yields widened in the first half of the year, but have subsequently tightened. UK yields have also retracted in in this quarter to date, despite of the recent rate rise, and US yields have tightened across the year despite three rate rises. All markets are not close to the required rate of return of 4.7%.

Short Term Asset Allocation Advice

In light of no Advisors to provide advice, it is considered appropriate to continue with the previous short term asset allocation. Also, it is proposed that at the next Committee meeting the results of an Asset/Liability Study, carried out by the Fund's Actuary, AON Hewitt, is presented with a recommendation for a new customised benchmark.

The current political, economic and market conditions are similar to previous advice provided at meetings and do not suggest any need to make any major strategy changes. Currently, the key component when setting the short term asset allocation is the Bond yield level. Most other asset classes are basing their levels from this yield and with yields still currently low, investors are seeking returns wherever they can find them.

Therefore, it is proposed that the Fund continues to favour growth assets over protection assets. It is considered that in the long run, Bond yields will rise, but following central banks past intervention in the Bond markets, yields do not meet the actuarial requirements for the Fund and should continue to be avoided at these yield levels unless they are held as a short term alternative to cash.

Cash has built up as divestments from other asset classes have occurred, and is primed to be invested when opportunities allow. It is always preferential for cash to be invested in higher returning assets, but at this time high cash levels can assist in protecting the Fund, as a diversifier, from Equity market downturns. However, at the current level of 12%, cash should not rise too much further in the short term to above the maximum short term level set at the customised benchmark for protection assets (15%). It is accepted that if the value of other asset classes fall, particularly Equities, there is a possibility that the short term cash level will rose over the maximum set below.

Equity markets have been volatile over the past few years, with additional volatility in currency markets, both of which have recently been beneficial to the Fund at current equity and currency market levels with the Fund's high weighting in equities. The short term allocation strategy and range provides flexibility within this volatile asset class, however, reducing Equity levels is a big feature of the proposed new customised benchmark. It is with this in mind that the upper limit has been shaved slightly as a short term measure until a strategy has been fully developed to implement the proposed customised benchmark, should the Committee agree to it.

Investment in direct property to continue on the same basis as previously presented to the Panel; make purchases on an opportunistic basis where the property has a good covenant, yield and lease terms.

Investment in Alternatives, such as general and local infrastructure and private equity, offer the Fund diversification from equities and bonds. They come with additional risks of being illiquid, traditionally they have costly management fees and investment in the type of investment can be a slow process. However, the Fund is considerably underweight its customised benchmark and, providing suitable investment opportunities are available, the Fund should look to increase its allocation to this asset class up to the customised benchmark level. In addition, this is a big feature in the proposed new customised benchmark.

Paul Campbell – Head of Investments & Treasury Management

14 September 2017