TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 5

TEESSIDE PENSION FUND COMMITTEE REPORT

7 MARCH 2018

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.

2.2 That Members agree the new strategy to protect the Fund's valuation through divestment from equity into cash and use of derivatives as part of an equity protection strategy.

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, and an update report is available for later in this Committee meeting.

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 With the initial results from the Fund's Asset/Liability Study being presented later this meeting, and in light of no Independent Investment Advisors to provide Members with investment advice and propose short term asset allocation, it is appropriate to look at protecting the valuation of the Fund given recent volatility in bond and equity markets.

5.2 The Fund's now has a zero position in bonds, with cash as the only protection asset available. It is proposed that the Fund introduces a short term protection strategy, looking at protecting recent rises in the Fund's valuation through divestment from equities and protect equity values through use of derivatives.

5.3 Cash levels at the end of December 2017 was at 11% (£460 million). This level has risen recently to £490 million (as at 23 February 2018) through further divestment from equities. A planned, controlled reduction of equities into cash is proposed over the next quarter with a target rise in cash levels up to £600 million (15% of the Fund).

5.4 In addition, investigations were already underway looking at the use of derivatives to protect equity valuations. These are at an advanced stage with increasing clarity over an appropriate methodology. One issue to resolve is, when using derivatives collateral is required to provide security against the possibility of payment default by the opposing party. It is usual for collateral to be in the form of bonds, however, as stated earlier the Fund has divested from bonds. In order to correct this, the Fund will look at options for collateral, but may need to acquire bonds as collateral.

5.5 It is considered that in the long run, bond yields will rise to levels that do 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 or as part of an equity protection strategy in a collateral account.

5.6 Cash has built up as divestments from other asset classes have continued. Previously, this cash 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 is assisting with protecting the Fund, as a diversifier, from Equity market downturns.

5.7 Cash levels should be allowed to rise in the short term towards the maximum level set at the customised benchmark for protection assets (15%). Should cash be required for bonds, as part of a collateral account for equity protection purposes, then cash can reduce to lower levels, but protection assets will remain at around the customised benchmark level of 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.

5.8 Equity markets have risen strongly over the past few years, with additional volatility in currency markets, both of which have been beneficial to the Fund since the date of the last Actuarial Valuation with the Fund's high weighting in equities. The short term allocation strategy and range provides flexibility within this asset class, however, reducing equity levels is a big feature of the proposed new customised benchmark.

5.9 It is with both these factors in mind that the upper limit has been reduced 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. The lower limit has also been lowered to provide an opportunity to divest after equity market levels have performed so strongly.

5.10 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. Further details on the property strategy will follow from the Fund's Property Advisors.

5.11 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.

5.12 The Fund is considerably underweight its customised benchmark in this asset class 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. Activity has stepped up recently, with due diligence complete in a number of investment opportunities and due diligence in progress for others. In addition, this is a big feature in the proposed new customised benchmark.

5.13 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 %	December Weighting %	LT Asset Allocation Strategy	ST Asset Allocation Strategy	ST Range %
GROWTH:					
UK Equities	30	32	Reduce	Hold / Reduce	27 – 33
Overseas Equities	40	48	Reduce	Hold / Reduce	43 – 49
Property	10	7	Increase	Opportunistic increase	7 – 10
Alternatives	5	2	Increase	Opportunistic increase	1½ – 5
PROTECTION:					
Bonds	12	0	Increase	Hold / Increase	0 – 7½
Cash	3	11	Reduce	Hold / Increase	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 most notably here in Britain.

After months of negotiations the UK reached a historic deal on its EU exit terms, enshrining special rights for four million citizens and paying €40-60bn in a hard-fought Brexit divorce settlement that now clears the way for trade talks next year. UK PM Theresa May and EC President Jean-Claude Juncker signed off on a 'progress report' that allows EU negotiators to recommend opening a second phase of talks. The final terms are closer to the EU's opening gambit, including the size of the settlement, the breadth of protected citizen rights and commitments regarding the border between Northern Ireland and the Republic of Ireland. However, the UK won significant compromises, notably in rejecting EU demands that it submit in some areas to the direct jurisdiction of European courts after Brexit. In a summit in Brussels, the EU27 endorsed the EC's recommendation that the UK government had given enough guarantees on the key divorce issues of the Brexit bill after PM May won over the Democratic Unionist Party's concerns over the Irish border.

UK government ministers bowed to pressure and agreed to release a secret assessment of the impact of Brexit titled "EU Exit Analysis – Cross Whitehall Briefing" just hours after PM May refused to do so. The prime minister initially spurned calls for publishing a leaked government analysis about the economic impact of Brexit but it didn't take long for the Labour Party to tap an archaic parliamentary procedure known as a 'motion for return' to effectively force the publication of the analysis that was obtained by BuzzFeed. The leaked analysis claimed that all Brexit options would leave the UK worse off with economic growth cut by between 2% and 8%, depending on how close the UK remained to the EU. Following on from that, a second leak from the analysis emerged showing that tightening up the UK's immigration system after Brexit would cause more economic damage than could be balanced out by any trade gains. The main finding of the report was that almost every sector of the UK economy would be hit and that only agriculture would not be adversely affected. It also found that every UK region would be affected negatively. BoE Governor Carney told leaders at the World Economic Forum in Davos that Brexit would cost £10bn/year.

In the US, President Trump broke with decades of diplomacy by declaring, formal recognition of Jerusalem as the capital of Israel, provoking condemnation from US allies and the Muslim world. He indicated that he based his decision on ancient history and current political realities – that the Israeli legislature and many government offices are in Jerusalem. He also ordered the US state department to start the process of planning and building a new

US embassy in Jerusalem even though currently 86 countries have their Israeli embassy in Tel Aviv and none in Jerusalem.

Also in the US, the US government was forced into a shutdown for the first time since 2013, thus spoiling President Trump's one-year inauguration anniversary celebrations. Although the House of Representatives had passed a stopgap spending bill a little earlier, the Senate voted 50-49, stopping 10 votes shy of the margin required to keep the wheels of government turning. However, the shutdown lasted less than three days as Senate Democrats accepted a plan to fund the government, albeit only until 8 February in another example of the proverbial 'kicking the can down the road', on Senate Majority Leader Mitch McConnell's assurance that an immigration bill would be brought before the Upper House unless a bipartisan deal was reached first. The agreement leaves the fight over the contentious subject of immigration unresolved as the DACA (deferred action for childhood arrivals programme) issue wasn't resolved with President Trump maintaining that he would agree to a deal on immigration only if was beneficial to the US.

Economic Background

Much has been made recently of synchronised global growth with the global recovery growing at its fastest pace since 2010. This growth is accompanied by solid employment gains, a moderate upturn in investment and a pick-up in trade growth. Latest OECD predictions show global GDP growth at just over 3½% in 2017, strengthening slightly to 3¾% in 2018, before easing slightly in 2019.

However, eventually this growth brings with it tighter monetary policy which can be followed by recession and, as has happened before, financial and economic shock. Major central banks such as the U.S. Federal Reserve, the Bank of England and the Bank of Canada have already raised interest rates, while the European Central Bank is moving ever closer to unwinding its own ultra-easy monetary policy. So far, those banks have been reluctant to move rapidly, instead leaving the monetary taps open to try to drive up stubbornly low inflation and maintain growth. If monetary policy is tightened too soon or too fast, policymakers they risk choking off the synchronised global upturn that has recently delighted them.

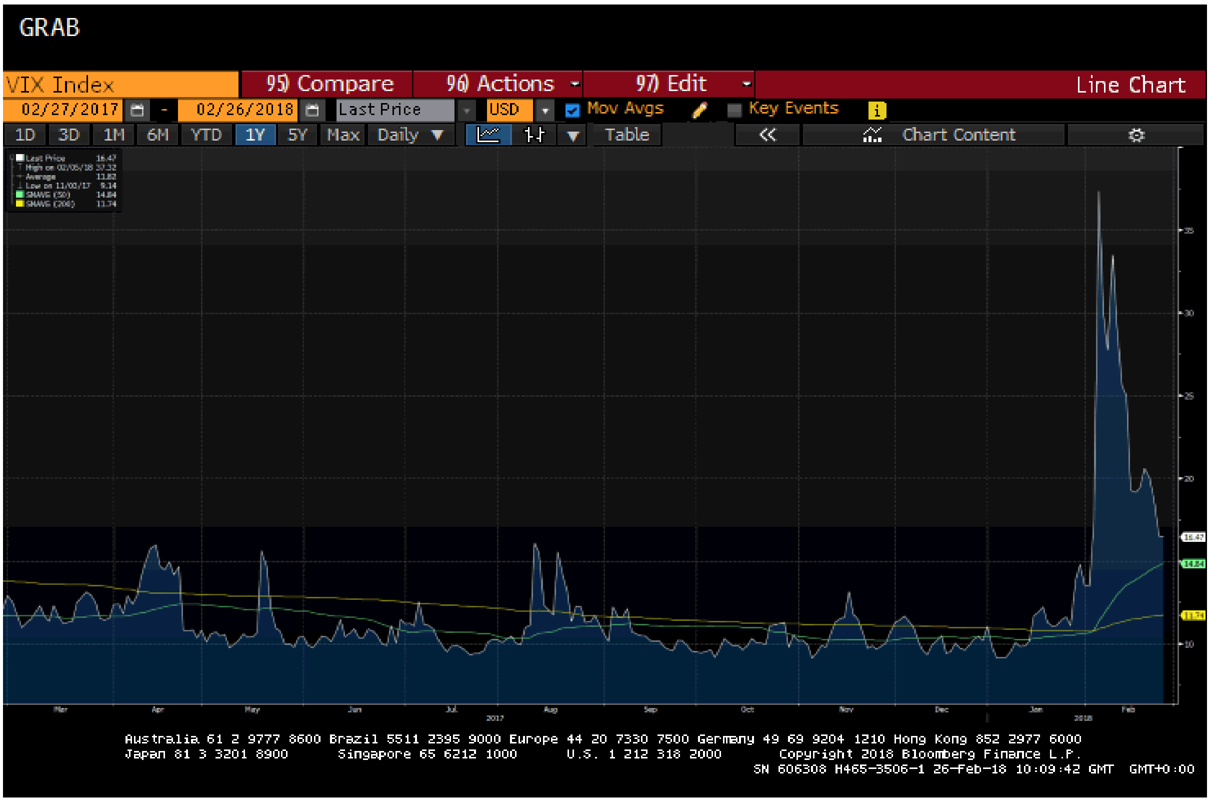
As is normally true, centre stage is reserved for the US. The Fed raised short-term interest rates for a three times in 2017 and predicted more to follow in 2018. The FOMC raised the target range for its Fed funds rate by 25bp to 1¼%-1½% and the median forecast among policymakers is for another three 25bp increases in 2018 followed by two 25bp increases in 2019.

At a time of global and US growth, the US also enjoys low unemployment and in January, US Congress (House 224 to 201, Senate 51 to 48) passed the Tax Cuts and Jobs Act. The final Republican tax bill is projected to add $1.455 trillion to the US fiscal shortfall over the next decade, according to a report by the non-partisan Congressional Budget Office. The centrepiece of the package is a big cut for corporations, who will see their headline income tax rate drop from 35% to 21%, bringing the US broadly into line with the average rate in the developed world.

Investors are also watching carefully to see if new Fed chair Jerome Powell takes a more aggressive stance than Janet Yellen, who was viewed as moving carefully to raise rates. At the January meeting, "almost all" Fed members (more than previously) said they expect inflation to hit the bank's 2% target over the medium term, bolstering the case for future rate rises.

Market Background

The outcome from all the economic noise around tightening monetary policy through rising interest rates saw both bond and equity markets saw volatility introduced for the first time on some time. The CBOE Volatility Index, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P500 index options, calculated and published by the Chicago Board Options Exchange (CBOE). It is colloquially referred to as the *fear gauge*. The chart below shows how this moved from relative stability to big swings:



Source: Bloomberg

Equity markets, in general, have performed negatively since the start of this quarter (to 23 February 2018) but still strong positive returns from the Fund's last Actuarial Valuation:

	From 31/03.2016 %	QTD %
FTSE All-Share (UK)	26.7	-4.9
S & P 500 (US)	40.1	-0.3
Euro Stoxx 600 Ex UK (Europe)	37.1	-1.9
Topix 500 (Japan)	49.1	-0.8
MSCI Asia Pacific Ex Japan	53.7	-0.8

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 as at 31 March 2016, 31 December 2017 and 23 February 2018:

10 Year Bond Yields	31/03/2016	31/12/2017	23/03/2018
UK	1.414	1.188	1.521
US	1.770	2.406	2.868
Germany	0.152	0.423	0.650
France	0.485	0.780	0.930
Switzerland	-0.359	-0.178	0.085
Japan	-0.035	0.043	0.048
Australia	2.489	2.630	2.848

As seen from the levels shown, all yields widened in this quarter to date in anticipation of the US rate rise. Whilst bonds are normally at the heart of pension fund investment assets, at these yields they are still well short of the required rate of return of 4.7% they should only be considered as a proxy for cash (short-dated bonds) or as collateral as part of an equity protection strategy.

Short Term Asset Allocation Advice

With the initial results from the Fund's Asset/Liability Study being presented later this meeting, and in light of no Independent Investment Advisors to provide Members with investment advice and propose short term asset allocation, it is appropriate to look at protecting the valuation of the Fund given recent volatility in bond and equity markets.

The Fund's now has a zero position in bonds, with cash as the only protection asset available. It is proposed that the Fund introduces a short term protection strategy, looking at protecting recent rises in the Fund's valuation through divestment from equities and protect equity values through use of derivatives.

Cash levels at the end of December 2017 was at 11% (approx. £460 million). This level has risen recently to approx. £490 million (as at 23 February 2018) through further divestment from equities. A planned, controlled reduction of equities into cash is proposed over the next quarter with a target rise in cash levels up to £600 million (15% of the Fund).

In addition, investigations have been on-going for some time looking at the use of derivatives to protect equity valuations. These are at an advanced stage with increasing clarity over an appropriate methodology. One issue to resolve is, when using derivatives collateral is required to provide security against the possibility of payment default by the opposing party. It is usual for collateral to be in the form of bonds, however, as stated earlier the Fund has divested from bonds. In order to correct this, the Fund will look at options for collateral, but may need to acquire bonds as collateral.

It is considered that in the long run, bond yields will rise to levels that do 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 or as part of an equity protection strategy in a collateral account.

Cash has built up as divestments from other asset classes have continued. Previously, this cash 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 is assisting with protecting the Fund, as a diversifier, from Equity market downturns.

Cash levels should be allowed to rise in the short term towards the maximum level set at the customised benchmark for protection assets (15%). Should cash be required for bonds, as part of a collateral account for equity protection purposes, then cash can reduce to lower levels, but protection assets will remain at around the customised benchmark level of 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 risen strongly over the past few years, with additional volatility in currency markets, both of which have been beneficial to the Fund since the date of the last Actuarial Valuation with the Fund's high weighting in equities. The short term allocation strategy and range provides flexibility within this asset class, however, reducing equity levels is a big feature of the proposed new customised benchmark.

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Paul Campbell – Head of Investments & Treasury Management

23 February 2018