TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 5

TEESSIDE PENSION FUND COMMITTEE REPORT

19 SEPTEMBER 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.

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, however to provide an update the tender for the new Investment Advisors closed on Friday 14 September 2018, and Officers will work with the Chair and Vice Chair to select two Advisors from the tenders received.

4.2 Attached as Appendix A is a report from the Interim Head of Pensions Governance and Investments. 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 at the last meeting, and in light of no Independent Investment Advisors to provide Members with investment advice and propose short term asset allocation, it is considered appropriate to look at protecting the valuation of the Fund given recent volatility in bond and equity markets, following recent geopolitical and economic news.

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 looks into introducing 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 June 2018 was at 18% (£723 million). Cash balances have risen with divestment from Equities as part of the Fund's transformation plan ahead of pooling; some of this cash balance is to be redeployed at a future date. It is proposed that the controlled reduction of equities into cash continues over the next quarter with an upper target cash levels of £800 million (20% of the Fund).

5.4 In addition, investigations are already underway looking at an equity protection strategy. These are at a good stage with increasing clarity over an appropriate methodology. One issue to resolve is, when using derivatives as part of the strategy, 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, and 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 have been allowed to rise in the short term towards the maximum level set at the customised benchmark for protection assets (20%). Should cash be required for bonds, as part of a collateral account for equity protection purposes, then cash can reduce to lower levels. It is accepted that if the value of other asset classes fall, particularly Equities, there is a possibility that the short term cash level can rise 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 short term asset allocation range has been set to allow this flexibility until a strategy has been fully developed to implement the proposed new customised benchmark, should the Committee agree to it. The lower limit provide an opportunity to divest after equity market levels have performed so strongly and as part of the Fund's transformation plan ahead of implementing the proposed customised benchmark from the Fund's Asset Liability Study.

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 completed 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, and an asset class where Border to Coast Pension Partnership can assist in the future.

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	Current Customised Benchmark %	June Weighting %	LT Asset Allocation Strategy	ST Asset Allocation Strategy	ST Range %	Proposed New Benchmark %
EQUITIES:						
UK Equities	30	**31**	Reduce	Market Led	**26 – 36**	22
Overseas Equities	40	**42**	Reduce	Market Led	**37 – 47**	28
ILLIQUID ALTERNATIVES:						
Property & Property Debt	10	**8**	Increase	Opportunistic increase	**7 – 10**	15
Alternatives	5	**1**	Increase	Opportunistic increase	**1 – 7**	15
PROTECTION:						
Bonds	12	**0**	Increase	Hold / Increase	**0 – 7½**	18
Cash	3	**18**	Reduce	Hold / Increase	**5 – 20**	2

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APPENDIX A

Investment Report September 2018

Geopolitical Background

The summer saw more news on Brexit with the Chequers Agreement and the publication of the long awaited “The Future Relationship between the UK and EU”, laying out the following five key objectives:

- **Economy**: “developing a broad and deep economic relationship with the EU that maximises future prosperity and minimises disruption to trade between the UK and the EU, protecting jobs and livelihoods – at the same time making the most of trading opportunities around the world.”
- **Communities**: ending free movement with a new immigration system, support for farming and fisheries, and a so-called “shared prosperity fund”.
- **Union**: protecting the peace process in Northern Ireland, avoiding a hard Irish border, safeguarding the constitutional integrity of the UK and devolving appropriate powers.
- **Democracy**: leaving EU institutions and reclaiming UK sovereignty, ensuring laws are made in UK. The UK’s place in the world: promoting general principles such as openness and liberty.
- The final section of the White Paper calls for negotiations to accelerate, saying that once a deal is reached it will be considered by parliament.

All in all, it proposes that the UK remain, in effect, in the single market for goods (known as the “common rulebook”), and in a looser system of mutual recognition for services. In return the Prime Minister promises not to undercut EU standards for the environment, social policies or state aid. She proposes a dispute-resolution mechanism that implies a role for the European Court of Justice and suggests that the UK stay in a customs union until a smart new tariff-collection mechanism can be set up.

Following this “collective” cabinet agreement two senior ministers resigned in protest. David Davis stepped down first saying that the UK was giving away too much too easily ahead of negotiations, followed swiftly by Boris Johnson.

The WTO and other prominent business officials from around the world warned that a “no-deal” Brexit would result in uncertainty, causing disruption and consequences as overseas companies would be forced to implement emergency plans.

In Europe, there was a rare victory for free trade and in stark contrast to the Trump administration’s protectionism as the EU and Japan signed the world’s largest bilateral trade deal, covering almost a third of the world’s GDP and a market of 600 million people. The deal was established primarily last year, but the signing was delayed due to disastrous flooding in Japan. Once it gets legislative approval, Japan will see lower prices on European wines, cheese, pork, handbags, and pharmaceuticals while the EU will see lower price tags on Japanese machinery parts, tea, and fish; eventually about 99% of tariffs on all imports will be eliminated.

The deal with Japan, the EU's second largest trading partner after China, is just one of many the EU has in negotiations to improve trade relations. It signed a free-trade pact with Canada last year, is working to update a pact with Mexico this year, and is currently finalising deals with Vietnam and Singapore.

In Italy, the anti-establishment Five Star Movement and the far-right League set aside their differences and agreed on a new government ending almost three months of political gridlock. Giuseppe Conte was inaugurated as prime minister, heading Europe's first populist government. But while Conte will nominally hold the most powerful office in the country, the driving forces in his administration will be the leaders of the two political parties that gained the most votes in the inconclusive election – Luigi Di Maio and Matteo Salvini – who serve as deputy premiers. Additionally, Five Star's Di Maio serves as Labour and Economic Development Minister, a key position to fulfil his campaign promise of a universal basic income, while the League's Salvini serves as Interior Minister, a role in which he's expected to promote his campaign pledge to deport half a million undocumented immigrants.

Market participants focused on the economic outlook for Italy as the country's populist Eurosceptic coalition government began negotiations on its inaugural budget. The collapse of a motorway bridge in Genoa raised alarms on the health of Italian infrastructure with Italy's Deputy Prime Minister Matteo Salvini blaming the EU's restrictive spending rules for the bridge collapse. The rising standoff with the European Commission with the potential for further escalation as the date of the final budget approaches has led to the highest borrowing costs for its latest bond auction in more than four years.

In the US trade tensions continued to mount over most of August with President Trump hardening his stance over China, and indicating that a new round of tariffs on $200bn of Chinese imports could be implemented on the Asian economic powerhouse soon. The US President now has domestic matters to attend to with the publication of a new book by Bob Woodward, *Fear: Trump in the White House*. In addition, the New York Times published an editorial sourcing a senior official claiming there was a "quiet resistance" in the White House working to frustrate parts of Trumps agenda.

Economic Background

The Bank of England sanctioned a second rate rise of ¼%, raising the base rate to 0.75%. It was commented after this rise that, providing the economy performs as the BoE expect, there will be further limited and gradual rises over the next few years.

In normal conditions, an interest rate rise would strengthen Sterling against other major currencies. However, Sterling is now considered a gauge for Brexit fears and continued to lose value against the Euro and only able to pare its losses after Michel Barnier, EU's chief Brexit negotiator, indicated that he was close to offering the UK a deal while adding that the UK "must respect" core structures of the EU. The talks however, soured once again as Mr Barnier said he strongly opposed parts of the Chequers plan and would require Britain to apply EU rules for goods and agriculture while staying out of the single market for services.

The US Fed Chair, Jerome Powell, spoke at the Jackson Hole symposium defending the Fed's stance of further rate rises in 2018 (albeit at a gradual pace). Speaking against a backdrop of increasing criticism, Powell commented that the central bank's decision to cautiously raise rates was a balancing act between twin risks. The first risk would be to raise rates too quickly prompting further appreciation in the dollar and risk cutting short the current economic expansion. It would also firmly place the Fed in the crosshairs of President Trump who has already criticized the central bank for raising rates and dampening economic growth. The other option of raising rates too slowly would risk overheating an economy that is already near full economic potential. A slower rate hike path would also call into question the independence of the bank.

Minutes from the most recent European Central Bank meeting held few surprises, reiterating views on the bloc's economy strengthening and the convergence of inflation to the ECB's target level in the medium term. The minutes however emphasised risks stemming from trade tensions representing "prominent" uncertainties but suggested that these risks had limited policy implications. Moreover, the minutes sought to answer critics who have recently argued that the central bank's forward guidance of rates remaining at their current levels "at least through the summer of 2019" was too vague by noting that the stance was "sufficiently precise to provide effective forward guidance and maintaining a suitable degree of flexibility".

Finally, after eight years of international bailouts, Greece finally exited its third successive bailout programme since 2010. The news of Greece's exit from the aid programme was heralded by European leaders as proof of the results of European solidarity while also cautioning that Athens would have to adhere to the policy commitments it had made as part of the programme. These conditions would restrict government spending in order to keep the country's debt profile sustainable.

Market Background

Equity market, have seen a mixed performed since the start of this quarter (to 6 September 2018) but still have very strong positive returns from the Fund's last Actuarial Valuation:

	From 31/03/2016	YTD	QTD
	%	%	%
FTSE All-Share (UK)	30.8	-1.3	-2.9
S & P 500 (US)	63.4	14.1	8.4
Euro Stoxx 600 Ex UK (Europe)	40.5	0.5	1.5
Topix 500 (Japan)	47.3	0.3	0.1
MSCI Asia Pacific Ex Japan	51.2	-3.8	-1.5

The above returns are all rebased back to Sterling (GB Pounds), and take into effect both currency and indices moves.

There was mixed returns and some volatility from most markets over the quarter to date with negative returns in the UK following Brexit news, and further news on trade sanctions from the US against China and contagion from Emerging Markets affecting Asia Pacific ex Japan. The US continues upwards breaking new highs on the main index over the quarter, and seeing a race to the first $1 trillion company between Apple and Amazon.

Sterling weakened against the Euro and US Dollar, mainly on negative Brexit news-flow. This assisted in the returns above for the US and Europe, increasing the asset values for equities in these markets.

Looking further afield, there is recent turmoil in many emerging market currencies and markets; Argentina, Turkey, South Africa, etc. It is felt this turmoil is the result of increasing trade tensions and, generally, less liquidity in markets with the ending of quantitative easing. This has a contagion effect, as seen in particular in the UK and Far East, as seen above. This volatility brings uncertainty, but can also bring opportunities as markets overreact and are oversold.

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 6 September 2018:

10 Year Bond Yields	31/03/2016	31/12/2017	6/09/2018
UK	1.414	1.188	1.231
US	1.770	2.406	2.903
Germany	0.152	0.423	0.372

10 Year Bond Yields	31/03/2016	31/12/2017	6/09/2018
France	0.485	0.780	0.708
Switzerland	-0.359	-0.178	-0.1.08
Japan	-0.035	0.043	0.106
Australia	2.489	2.630	2.565

With the exception of the Japan, all yields tightened this quarter to 6 September 2018. 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% and should only be considered as a proxy for cash (short-dated bonds) or as collateral as part of an equity protection strategy.

Paul Campbell – Interim Head of Pensions Governance & Investments

7 September 2018