Monitoring Total Fund performance

This paper is addressed to the Pensions Committee of the Lincolnshire Pension Fund ("the Fund"). It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

Background

Returns for the total Fund are currently monitored against the return on the Fund's strategic benchmark and also against a target return, incorporating an outperformance target over the benchmark return.

Where the Fund employs a manager to manage a portfolio of equities or bonds against a specific market index, it is possible to define for each mandate a benchmark return (i.e. the return on the market index) and a separate outperformance target (which the manager has agreed to aim for in their mandate in order to justify their fees).

When all of a fund's assets are managed in this way, these can be aggregated quite simply into a Total Fund benchmark return and outperformance target.

However, the position has become more complicated for many local authority funds as they have established new mandates which allow the manager to invest across a range of potential asset classes and have agreed a long term return target for the mandate expressed either as an absolute return or in terms of a margin over cash.

For example:

- Morgan Stanley invest for the Fund across a wide range of alternative asset classes in an attempt to produce a target return of Cash + 4% p.a. over the long term.
- F&C invest across a wide range of bond asset classes in an attempt to produce a target return of Cash + 3% p.a. over the long term.

It is not meaningful to try to split these target returns into a benchmark return (as there is no underlying market index) and a separate level of outperformance from the manager. We understand that the target returns for these mandates are incorporated into the calculation of the total Fund benchmark return with no additional outperformance target, which is consistent with the approach at many other funds.

Over 25% of the Fund's assets are now invested in mandates of this type.

Considering target returns

In the table below, we have considered each of the Fund's mandates and taken into account the additional level of outperformance expected from managers - in excess of the return used within the total Fund benchmark return.

This shows the extent to which the Fund would outperform if all of the investment managers delivered the returns which they have agreed to target.

Mandate	% of Fund	Outperformance Target % p.a.	Contribution to Total Fund % p.a.	Comments
UK equities – Internally managed	20	-	-	Passive
Global equities - Invesco	20	1	0.20	
Global equities - Neptune	5	3	0.15	
Global equities - Threadneedle	5	2	0.10	
Global equities - Schroder	5	3	0.15	
Global equities – Morgan Stanley	5	2	0.10	
Alternatives – Morgan Stanley	15	-	-	Target of cash + 4%
Bonds - Blackrock	6.75	-	-	Passive
Bonds F&C	6.75	-	-	Target of cash + 3%
UK Property funds	7.5	-	-	Peer group benchmark - market return after all fees and costs?
Specialist / overseas property and infrastructure investments	4	-	-	Target of 7%
Total			**0.70**	

The implied level of outperformance over benchmark is 0.70% p.a.

The outperformance targets for the global equity managers reflect the level of risk they will take in the portfolios. In practice, the level of outperformance that is likely to be delivered by the active managers can be debated – and the current targets do appear quite stretched. However, in our view, the aim of the outperformance target is to identify the level of return at which the Fund's appointed managers are – in aggregate – achieving the formal performance targets.

Impact on returns

It is important to note that changes to the total Fund outperformance target do not in any way impact on the returns likely to be achieved by the Fund. There are no proposed changes to the way that any individual manager runs their mandate nor are there any implied changes in asset allocation. The change in outperformance target reflects the increased use of absolute return mandates by the Fund, which have no separate identifiable outperformance element.

Conclusions

Based on the table above, we have recommended that the Fund should have a formal outperformance target of 0.75% p.a. This figure is based on outperformance targets gross of fees so should be compared with a gross Fund return or converted to a net basis if it is to be compared with a net of fees return.

However, we believe that the Fund returns should be assessed primarily on whether they are exceeding the benchmark return - with a separate focus on whether target returns from specific mandates are being achieved or likely to be achieved.

The focus also needs to be on medium / long term comparisons because the newer mandates from managers such as Morgan Stanley cannot be assessed on an annual basis in any meaningful way against a simple 'cash plus' benchmark. Their actual returns will deviate markedly from year to year from their target return – and these types of mandate now account for over a quarter of all the Fund's assets.

We look forward to discussing these issues further with the Committee.

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General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.
Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

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