Lincolnshire COUNTY COUNCIL
Working for a better future

Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**14 July 2016**
Subject:	**UK Equity Portfolio Annual Report**

Summary:

This is the annual report for the year ended 31st March 2016 covering the performance of the UK Equity index-tracking portfolio managed internally. The portfolio is managed within the Pensions Section of the Finance and Public Protection Directorate.

Recommendation(s):

That the Committee note the report.

Background

1 UK EQUITY INDEX TRACKING PORTFOLIO - INTRODUCTION

1.1 The objective of this portfolio is to deliver the total return of the MSCI UK IMI index +/-0.5% pa. This is to be achieved while maintaining a predicted portfolio tracking error (i.e. risk exposure) within 0.5% of the index.

1.2 The portfolio is managed through the Bloomberg system, which enables officers to see live valuations during the day and to monitor performance and tracking error. The number of stocks held in this portfolio normally varies between 250 and 270 (354 stocks constituted the MSCI UK IMI index as at 31 March 2016). The number of stocks held is much higher than would conventionally be held in an actively managed portfolio, to ensure limited deviation in performance relative to the total return produced by MSCI UK IMI index.

Table 1: Fund Statistics

All data to 31st March 2016

	Fund	Benchmark
Assets	£335m	-
No. of Stocks	267	354
Turnover	0.1%	-

2 MARKET BACKGROUND

2.1 The 2015/16 financial year was fairly flat for the first six months of the year before more volatile markets resurfaced in the following six months. This resulted in positive returns for half of the year and negative returns for the other half. The monthly index returns ranged from -3% to +3.75% and the index posted a total return (capital and income combined) of +5.6% for the year.

2.2 The main market features over the year were:

- The first quarter saw UK equities fall as uncertainty over the general election initially weighed on sentiment, although the more decisive result than expected allayed market concerns. Thereafter, news flow came to be dominated by the increasingly acrimonious Greek bailout extension negotiations, ensuring a volatile end to the quarter.

- The second quarter was a disappointing time for UK equities, despite a positive start in July. China's decision to devalue its currency was particularly detrimental, prompting fears that the economy was much weaker than assumed.

- Despite weakness as it drew to a close, the third quarter was a positive period for UK equities. The bulk of returns came in October, as large cap stocks in particular rebounded after prior falls related to China's growth outlook.

- Chatter around a possible UK Brexit became increasingly audible over the review period. This weighed on sentiment, with investors both at home and abroad reluctant to buy UK equities. Sterling also came under pressure. Worries about the state of the global economy further dampened spirits. Nonetheless, the market was able to recover somewhat, thanks to European Central Bank (ECB) stimulus measures, better Chinese data and hopes that rates in the US may not be hiked as aggressively as first thought.

3 PERFORMANCE

3.1 The market value of this portfolio at 31st March 2016 was £335m, representing 19.2% of the Fund's total investments (the value at 31st March 2015 was £348m). Over the year, the portfolio made purchases of £16.3m and sales of £5.6m. Cash redemptions of £1.7m were made in the year and a further investment of £5m was made in August 2015, following a rebalance of the Lincolnshire Pension Fund.

3.2 The performance of the UK Index-tracking portfolio is set out in the table below.

Table 2: Fund Performance & Risk

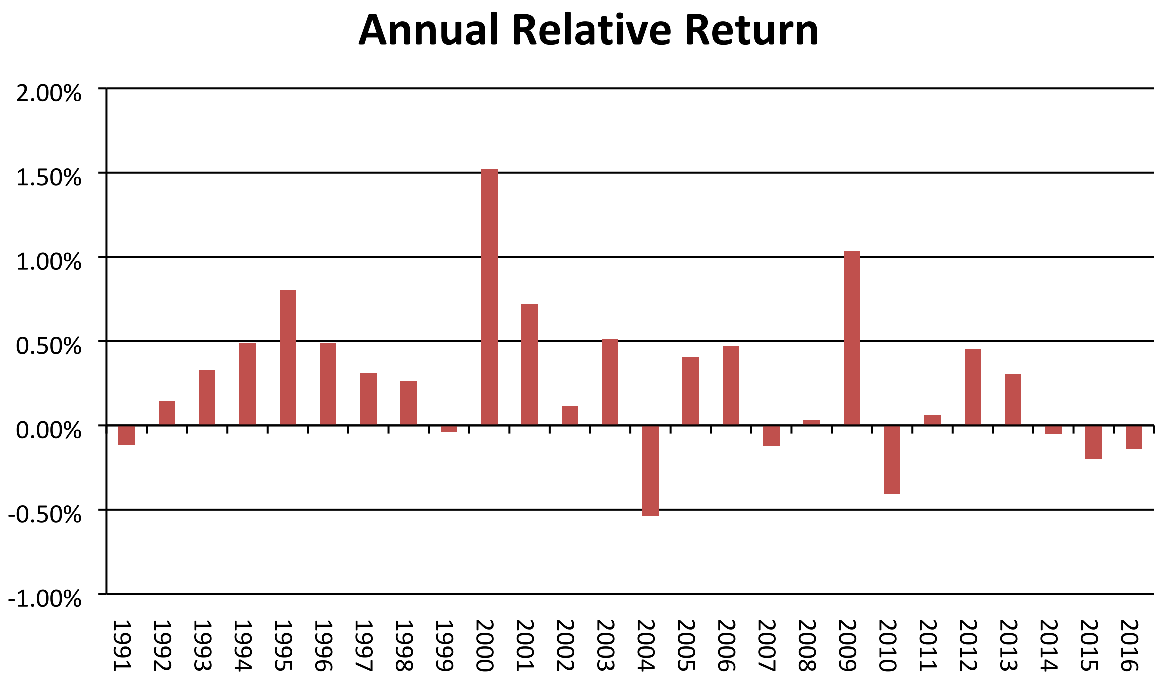
All data to 31st March 2016

Date	Portfolio (%)	Index (%)	Relative (%)
1 Year	(4.51)	(4.38)	(0.14)
3 Year *	2.98	3.12	(0.13)
5 Year *	5.47	5.39	0.07
Since Inception *	8.03	7.73	0.28
Tracking Error	0.41	-	-

*Annualised

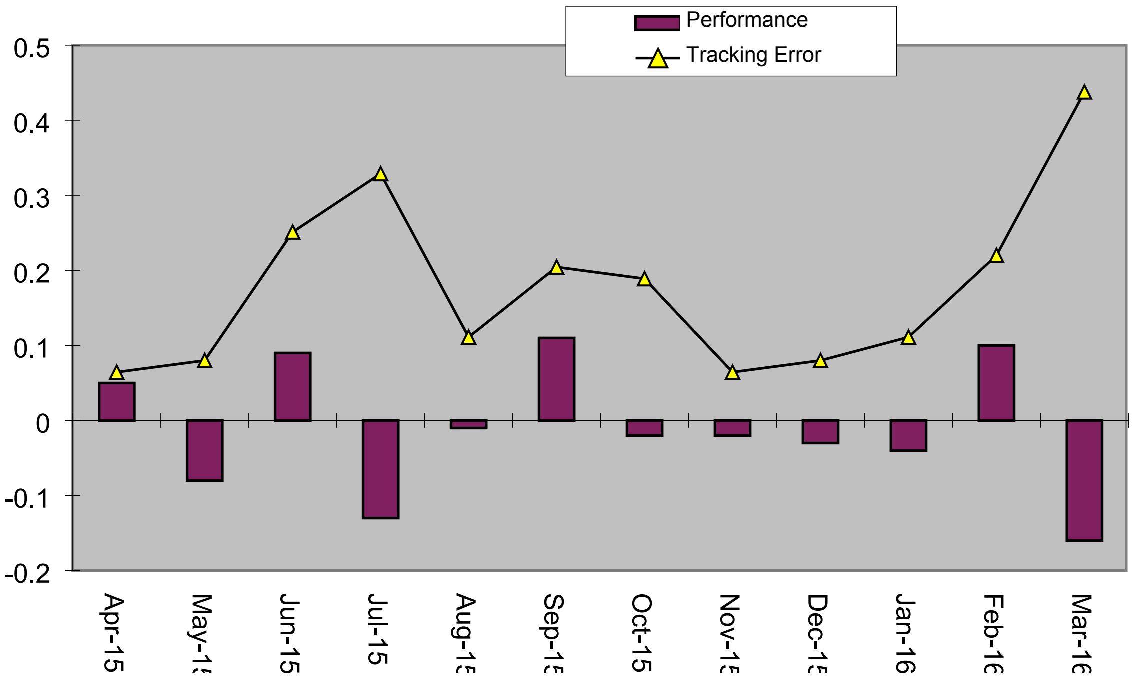
3.3 Chart 1 below shows the total return achieved for each year from 31st March 1991 relative to that of the index. In the 26 years since inception, the portfolio has out-performed the benchmark index in 18 years and under performed in 8 years. Performance is shown gross of fees, which equate to approximately 0.02% per annum.

Chart 1: Returns Relative to the Index on an Annual Basis
31st March 1991 to 31st March 2016



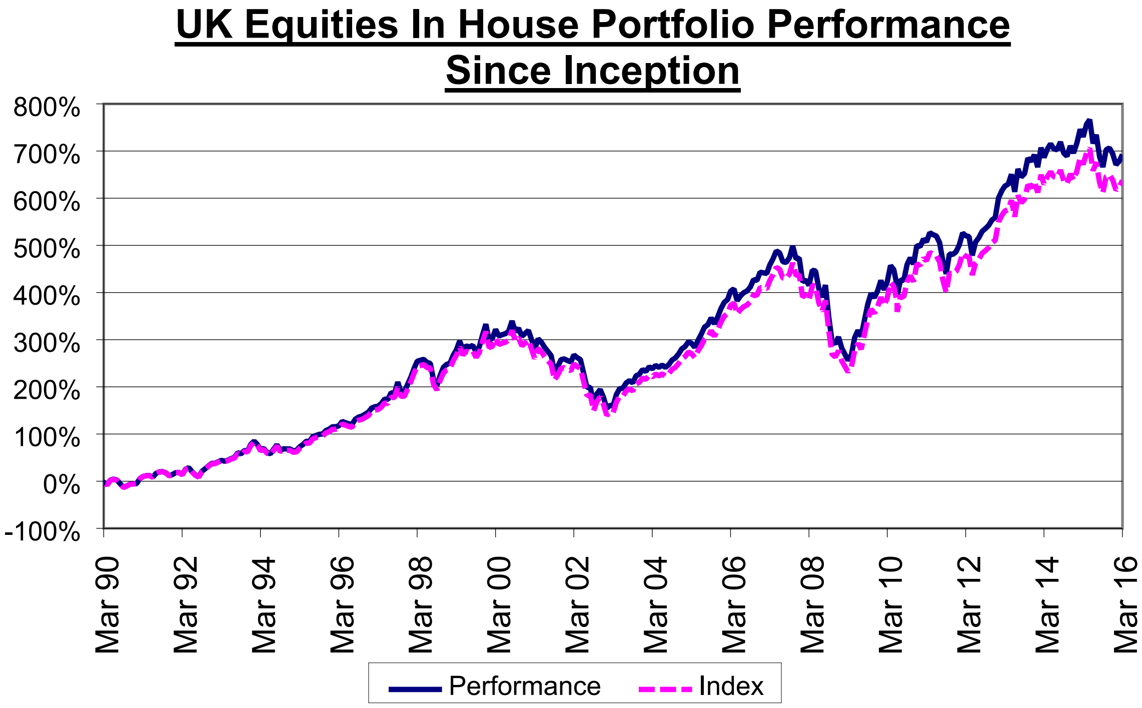
3.4 Over the year, the portfolio performance ranged from -5.9% in June to +4.8% in October and the relative return to the benchmark from -0.13% in July to +0.11% in September. The predicted risk (tracking error) of the portfolio was maintained within the permitted range of 0.5% for the whole year. Chart 2, below, shows the monthly forecast tracking error of the portfolio, plotted against the actual monthly performance relative to the benchmark (index). The tracking error is the predicted annual volatility of the actual return compared to the benchmark return. This means that with a forecast tracking error of 0.20%, the return of the portfolio would statistically be expected to be +/-0.20% around the index return, e.g. if the index returned +10%, the portfolio should return between +9.80% and +10.20%. Statistically, this outcome is expected to happen in two years out of three.

Chart 2: Tracking Error and Monthly Portfolio Performance 2015/16



3.5 Portfolio performance over the year was -0.14%, which is within the target range of +/-0.5%. During the year the first two quarters were very volatile and the portfolio generally outperformed the benchmark when the market return was negative and underperformed when returns were positive. This was due to holding a higher than normal cash positon until August, at which point £11.5m of trades were actioned, taking advantage of a drop in the market which saw the index return -5.5% in the month. The third quarter saw a positive return for the portfolio but an underperformance against the benchmark, due to the large underweight position the portfolio had in financials. The fourth quarter saw the index fall slightly. The portfolio initially outperformed the benchmark in February as an underweight position in financials and an overweight position in materials proved positive, though these returns were reduced due to the portfolio having an underweight position in energy which outperformed during the month. The outperformance in February was wiped out in March as financials rallied and the underweight position of the portfolio produced a negative return.

3.6 The chart below shows the portfolio's performance around the relevant index benchmark since inception. On an annualised basis the portfolio has returned gross performance of 0.28% and net performance of 0.26%. The performance return is within the performance target of +/- 0.5%.



Conclusion

4. The UK Equity portfolio underperformed the benchmark over the last 12 months by 0.14% but was still within the target of +/- 0.5%. Since inception the Fund has outperformed the benchmark by 0.28% annualised.

Consultation

a) Policy Proofing Actions Required

n/a

Background Papers

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

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