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:	**21 March 2019**
Subject:	**Investment Management Report**

Summary:

This report covers the management of the Lincolnshire Pension Fund assets over the period from 1 October 2018 to 31 December 2018.

Recommendation(s):

That the Committee:

a) note this report; and

b) consider if they wish officers to investigate further the use of an Environmental, Social and Governance focused index in respect of the Fund's passive UK equity holdings.

Background

This report is split into four areas:

- Funding Level Update
- Fund Performance & Asset Allocation
- Hymans Robertson Manager Ratings
- Individual Manager Update

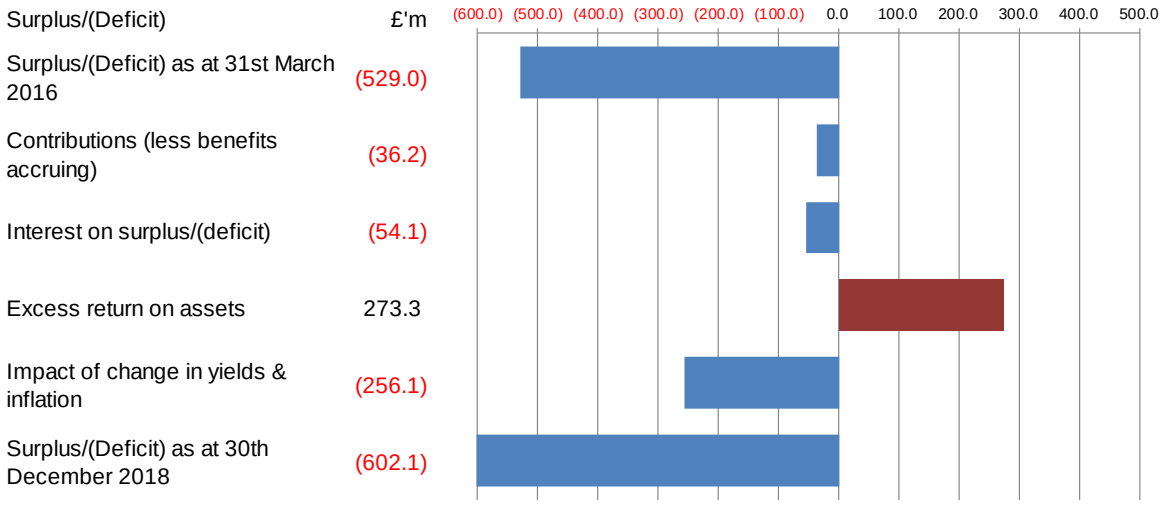
1. Funding Level Update

1.1 The funding update is provided to illustrate the estimated development of the funding position of the Lincolnshire Pension Fund from the latest formal valuation, 31 March 2016, to the current quarter end, 31 December 2018. The accuracy of this type of funding update is expected to decline over time, as the period since the last valuation increases. This is because the funding update does not allow for changes in individual members' data since the last valuation. It is, however, a useful tool to assist the Committee to identify whether the time is right to reduce the overall risk in the asset allocation of the Fund, as it approaches a 100% funding level.

1.2 The graph below shows the funding level at the latest formal valuation, at 76.9%, and its movement to 31 December 2018, where the funding level has increased to 79.0%.

Change in funding level since last valuation

1.3 Over the period 31 March 2016 to 31 December 2018 the deficit, in real money, has increased from £529.0m to £602.1m. The chart below shows the main impactors on the deficit. The excess return on assets no longer offsets the negative changes in yields and inflation, interest deficit and contributions (less benefits accruing) seen over this period.



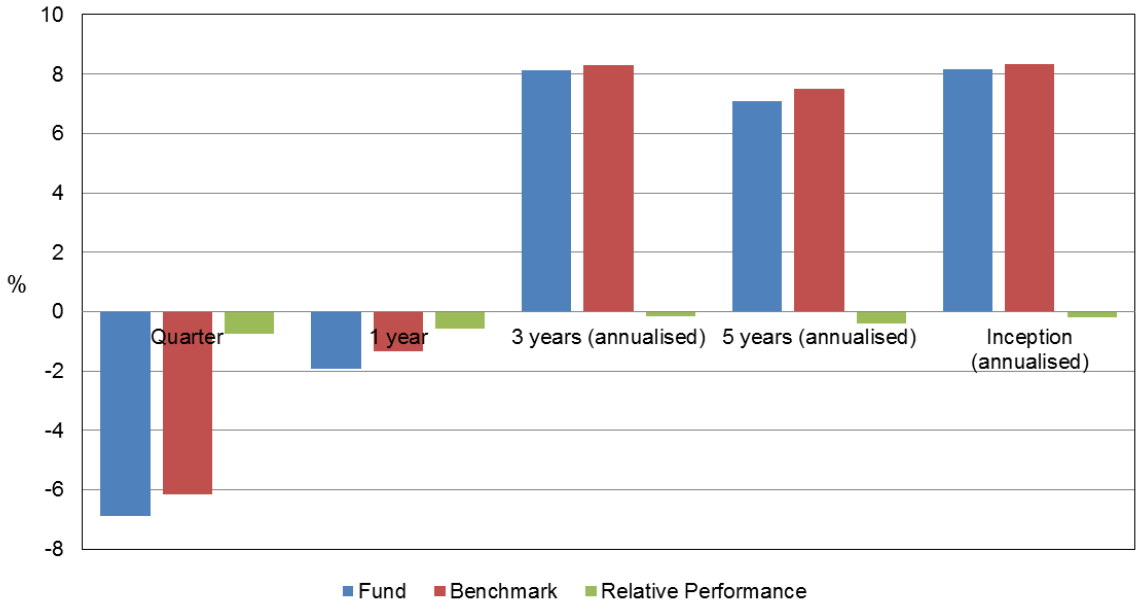
1.4 On a shorter term time horizon, looking at the last quarter, the funding level has reduced from 86.3% to 79.0% between 30 September 2018 and 31 December 2018. The deficit has increased from £384.5m to £602.1m, this is due to a significant reduction to the excess return on assets. At 30 September 2018 this was estimated to be £462.8m by 31 December 2018 this had reduced to £273.3m.

2. Fund Performance & Asset Allocation

2.1 The Fund decreased in value by £163.5m during the quarter from £2,363.4m to £2,199.9m, as the table below shows. The most significant movements in the quarter were seen on equities, both global and UK equity holdings which had reduced in value significantly. Global Equities by 11% or £121.0m, and UK Equities by 10% or £44.5m.

Asset Class	Q4 2018 £m	Q3 2018 £m	Asset Allocation %	Strategic Asset Allocation %	Difference %
UK Equities	392.9	437.4	17.9	20.0	(2.1)
Global Equities	955.4	1,076.4	43.4	40.0	3.4
Alternatives	322.0	323.9	14.6	15.0	(0.4)
Property	205.3	205.6	9.3	9.0	0.3
Infrastructure	41.8	38.5	1.9	2.5	(0.6)
Fixed Interest	274.6	273.0	12.5	13.5	(1.0)
Cash	7.9	8.6	0.4	0.0	0.4
Total	**2,199.9**	**2,363.4**		**100.0**	

2.2 The graph and table below shows the Fund's performance against the benchmark over the quarter, one year, three years, five years and since inception. The Fund has a target to outperform the strategic benchmark by 0.75% per annum.



	Fund %	Benchmark %	Relative Performance %
Quarter	(6.88)	(6.15)	(0.73)
1 year	(1.91)	(1.32)	(0.59)
3 years*	8.14	8.3	(0.16)
5 years*	7.10	7.49	(0.39)

Inception**	8.16	8.35	(0.19)

*Annualised from Yr 3. **Since Inception figures are from March 1987

2.3 Over the quarter, the Fund produced a negative return of -6.88% (as measured by JPMorgan), underperforming the benchmark by -0.73%. The Fund was also behind the benchmark over all periods, one, three and five year periods and since inception.

3. Hymans Robertson Manager Ratings

3.1 Hymans Robertson, as the Fund's Investment Consultant, regularly meets managers to discuss current issues, management changes and performance. Each manager is then allocated one of five ratings between replace and retain. The table below shows Hymans Robertson's rating of all managers that have been appointed by the Lincolnshire Pension Fund.

3.2 The Fund has nineteen managers. During the quarter there have been two changes to manager ratings (Morgan Stanley Alternative Investments and Aviva Pooled Property Fund). Officers continue to monitor managers closely and arrange meetings to discuss any potential issues.

Manager	Rating				
	Replace		Retain – suitable	Retain – positive	Retain – preferred
Invesco Global Equities (Ex-UK)				X	
Columbia Threadneedle Global Equity				X	
Schroders Global Equity				X	
Morgan Stanley Global Brands			X		
Morgan Stanley Alternative Investments			X		
Blackrock Fixed Interest					X
Standard Life European Property				X	
Innisfree Continuation Fund 2					X
Innisfree Secondary Fund					X
Innisfree Secondary Fund 2					X
Franklin Templeton European Real Estate				X	
Franklin Templeton Asian Real Estate				X	
Igloo Regeneration Partnership				X	
Aviva Pooled Property Fund			X		
Royal London PAIF				X	
Standard Life Pooled Property Fund				X	
Blackrock Property				X	
Infracapital Greenfield Partners I				X	
Pantheon Global Infrastructure				X	

<u>Morgan Stanley Alternative Investment</u>

3.3 Hymans Robertson have downgraded Morgan Stanley Diversified Alternatives from 'Positive' to 'Suitable'. This strategy offers exposure to a broad range of alternative assets. Morgan Stanley employs an open architecture approach, investing through both internal and external fund managers. For liquidity purposes the portfolio has historically maintained a high allocation to hedge funds. In addition, the strategy is designed to remain fully invested and the manager will not make active use of cash or fixed income to preserve capital during stress periods in markets.

3.4 In September Morgan Stanley announced that Joe McDonnell, one of the three portfolio managers on the strategy, was leaving the firm. McDonnell was the most senior member of the team in Europe and while Morgan Stanley does not plan to appoint another portfolio manager to replace McDonnell, Hymans believe London-based Steve Turner will effectively shoulder a lot of McDonnell's responsibilities. As a result of this change, Hymans has downgraded the strategy to 'Suitable'.

Aviva Pooled Property Fund

3.5 Aviva Investors has informed the Fund and Hymans Robertson that Luke Baker, Co-Fund Manager of the AIPL Property Fund, is leaving the firm to take up a role at an in-house fund manager. Baker has co-managed the fund alongside David Diemer since 2016 and leaves the firm after six years. As a result, Aviva has promoted its Assistant Fund Manager, Imogen Ebbs, to Co-Fund Manager alongside David Diemer. Ebb's is being replaced as Assistant Fund Manager internally by, Tom Goodwin, who moves from Aviva's UK strategy and research team.

3.6 The fund has been downgraded to 'Suitable – On Watch' as a result of this news. This is a significant development given the difficulties experienced by the fund over recent years, including poor performance and a deferred redemption policy since 2016.

Individual Manager Update

3.7 The manager returns and index returns for equity, fixed interest and alternative managers are shown in the table below. A detailed report on each manager outlining the investment process, performance, purchases and sales and Hymans Robertson's manager view can be found after the table at 4.2.

3.8 Over the quarter, two managers showed a positive return relative to their benchmark, Morgan Stanley Global Brands and Blackrock (fixed income). Two managers achieved the benchmark, Blackrock Interim and Legal and General. Over the 12 month period, only four managers have achieved their benchmark: Morgan Stanley Global Brands, Legal and General, Blackrock (Fixed Income) and Blackrock Interim.

	3 months ended 30th September 2018			Previous 12 months			
Manager	Manager Return %	Index Return %	Relative Variance %*	Manager Return %	Index Return %	Relative Variance %*	Target p.a. %
Legal & General (UK Equities)	(10.1)	(10.2)	0.0	(9.4)	(9.4)	0.0	Match Index
Invesco (Global Equities (ex UK))	(12.4)	(11.5)	(1.0)	(4.2)	(2.6)	(1.6)	+1.0
Columbia Threadneedle (Global Equities)	(12.2)	(10.6)	(1.9)	(3.8)	(3.3)	(0.5)	+2.0
Schroders (Global Equities)	(11.3)	(10.7)	(0.7)	(3.9)	(3.8)	(0.2)	+3.0
Morgan Stanley Global Brands	(7.4)	(11.4)	4.4	3.5	(3.0)	6.8	n/a
Blackrock (Fixed Interest)	1.2	1.1	0.1	(0.6)	(0.7)	0.1	Match Index
Blackrock Interim (Fixed Interest)	0.1	0.1	0.0	0.0	0.0	0.0	Match Index
Morgan Stanley (Alternative Investments)	(1.1)	1.2	(2.3)	1.9	4.9	(2.8)	3M LIBOR + 4%

**Note: Relative Variance is the scale of the performance achieved. This measures the proportional out/under performance of a portfolio relative to the benchmark.*

Lincolnshire Pension Fund
Global Equities – Invesco (Global Ex UK Enhanced)
Quarterly Report December 2018

Investment Process

This portfolio is mandated to track the MSCI World ex UK Index, with a performance target of +1% and a tracking error of 1%. The aim is to achieve long-term capital growth from a portfolio of investments in large-cap global companies. Active performance is generated through a quantitative bottom-up investment process, driven by stock selection and based on four concepts: Earnings Expectations, Market Sentiment, Management & Quality and Value.

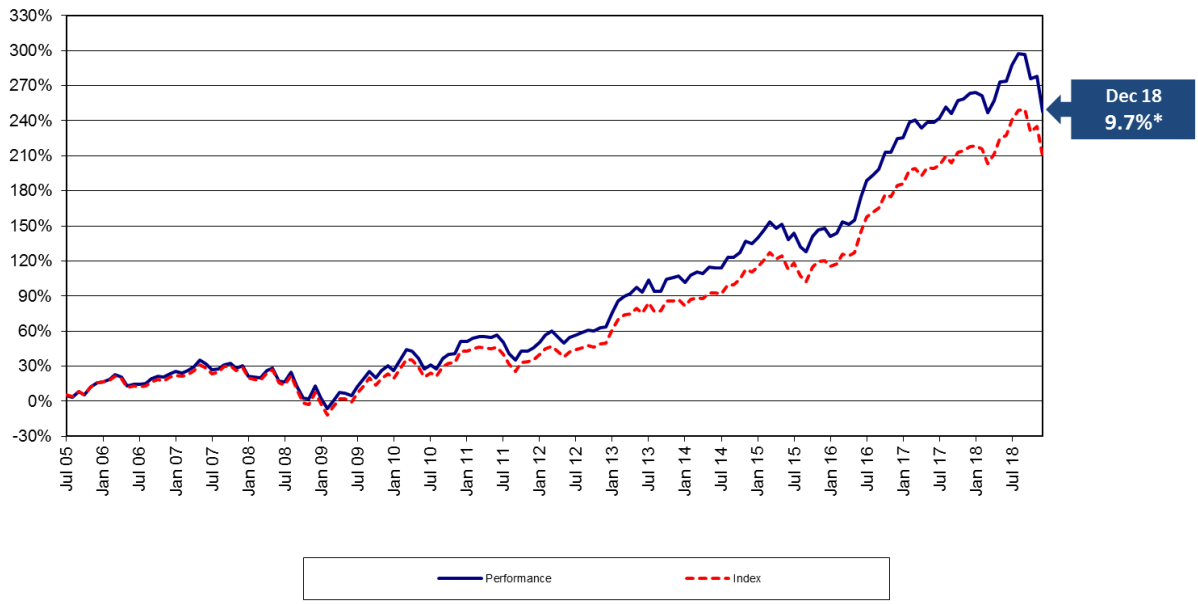
Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£573,876,747	£502,820,032

Performance

Stock selection had the largest negative impact on relative performance with an overweight in stocks with an attractive earnings momentum and price momentum delivering a negative contribution. Value and quality factors contributed positively. Stock-specific events, which are not attributable to any other factors, had an additional negative impact on return. Implied active sector exposures had a marginally negative impact to relative performance, with underweight in utilities being the main detractor and overweight in industrials adding to performance.

Invesco Performance Since Inception



* Annualised Manager Performance since inception

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Invesco	(12.4)	(4.2)	11.9	10.9	9.7
MSCI World ex UK	(11.5)	(2.6)	12.0	10.6	8.7
Relative Performance	(1.0)	(1.6)	(0.1)	0.3	0.9

* annualised, inception date 01/07/2005

Turnover

Holdings at 30.09.18	Holdings at 31.12.18	Turnover in Qtr %	Turnover in Previous Qtr %
476	476	9.0	8.9

Purchases and Sales

During the last quarter, a number of stock adjustments to the portfolio as a result of our stock selection process were made. Walgreens Boots Alliance, Starbucks, Athene Holdings and Popular were added with trade weights of 0.45%, 0.43%, 0.39% and 0.28%, respectively. Furthermore, the position in CP Railway with a trade weight of 0.31% was increased. On the other side, Invesco sold out of Verisign, BASF and Aristocrat Leisure with trade weights of 0.48%, 0.37% and 0.30%, respectively, and the positions in VMware and Cigna with trade weights of 0.29% and 0.28%, respectively were decreased.

Largest Overweights

Mitsui	0.91%
L'Oreal	0.76%
ConocoPhillips	0.65%
Peugeot	0.62%
Aflac	0.58%

Largest Underweights

Alphabet	(0.63%)
Abbott Labs	(0.38%)
DowDuPont	(0.37%)
Home Depot	(0.35%)
Netflix	(0.35%)

* Measured against MSCI World ex UK (NDR)

Top 10 Holdings

1	Apple	£13,397,620.61
2	Microsoft	£12,192,786.23
3	Amazon	£8,246,918.97
4	JP Morgan Chase	£7,592,607.26
5	Pfizer	£5,742,703.33
6	Procter & Gamble	£5,491,743.55
7	Alphabet	£5,266,644.15
8	Roche	£5,251,988.25
9	Cisco Systems	£5,051,844.10
10	Bank of America	£5,012,970.73

Hymans Robertson View

Invesco's Global Ex-UK Enhanced strategy is rated at 'Positive'. This is a quantitative global equity strategy run from Invesco's Frankfurt office. The team aims to implement a factor based strategy in a systematic manner – producing a well-diversified equity portfolio exhibiting a low level of volatility. The portfolio managers carry out a final check on the proposed portfolio / trades but the portfolio construction process is essentially carried out within the model. The strategy has been successful in generating modest levels of outperformance at very low levels of risk.

There were no significant developments over the quarter.

Risk Control

The ex-ante tracking error of the fund slightly increased to 1.06% (ex post target 1%). With 96%, the major part of our active risk was associated with our stock selection factors.

Lincolnshire Pension Fund
Global Equities – Schroders
Quarterly Report December 2018

Investment Process

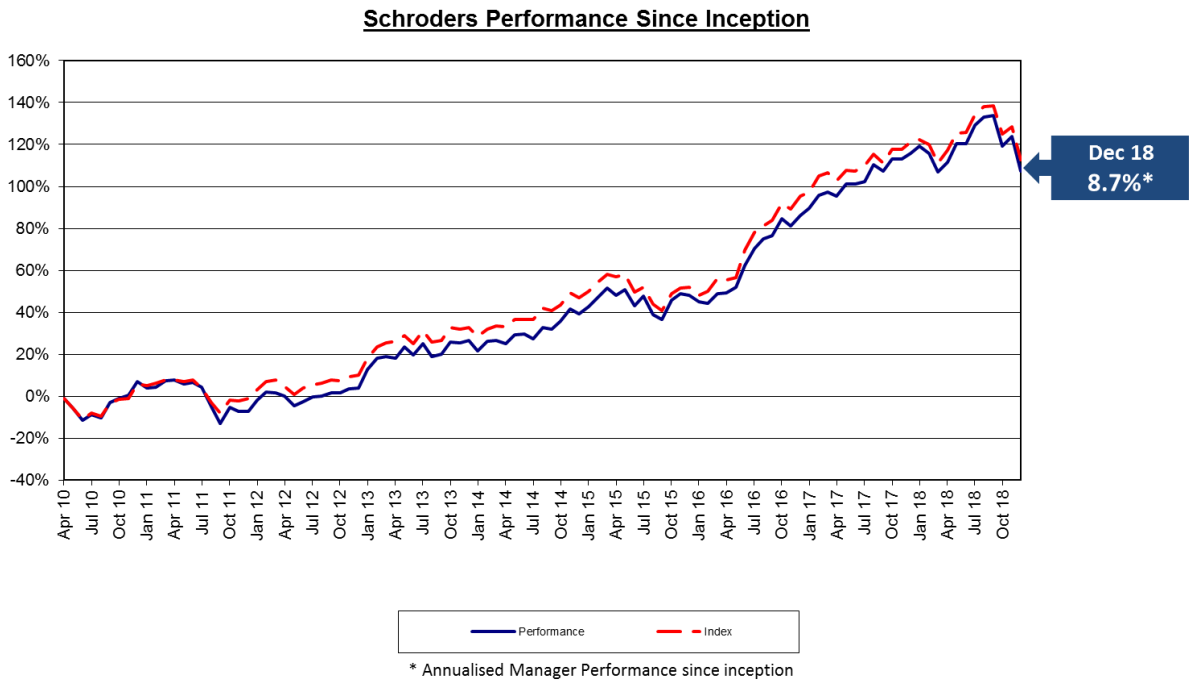
This portfolio is mandated to outperform the MSCI All Countries World Daily Net Index by 2% to 4% over rolling three year periods, gross of fees. This is achieved through an investment approach that is designed to add value relative to the benchmark through both stock selection and asset allocation decisions. Schroders believe that stock markets are inefficient and they can exploit this by undertaking fundamental research and taking a long term view.

Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£139,637,448	£123,911,170

Performance

The portfolio underperformed the benchmark during the quater. Zero weight in real estate and utilities, as well as positions in consumer discretionary weighed most on returns. Healthcare holdings proved to be more resilient. By region, our exposure to North America detracted the most, while UK and Pacific ex Japan holdings added value.



	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Schroders	(11.3)	(3.9)	11.9	10.3	8.7
MSCI ACWI (Net)	(10.7)	(3.8)	11.9	9.9	9.0
Relative Performance	(0.7)	(0.2)	0.0	0.4	(0.3)

*annualised, Inception date April 2010

Turnover

Holdings at 30.09.18	Holdings at 31.12.18	Turnover in Qtr %	Turnover in Previous Qtr %
91	82	15.7	7.5

Purchases and Sales

Amongst a number of trades enacted over the quarter, the position in Linde was sold as the merger with Praxair completed in line with the investment thesis. During the quarter, Drug manufacturer Eli Lilly (LLY) was purchased. Eli Lilly currently boasts industry leading growth, due in part to strong sales of new diabetes drug. They are a high quality, cash generative company with limited exposure to the economic cycle, strong operating leverage and – importantly – stronger earnings momentum than the market recognises.

Top 5 Contributions to Return

HDFC Bank	0.3%
Telefonica Brasil	0.3%
Procter & Gamble	0.2%
Comcast	0.2%
Diageo	0.2%

Bottom 5 Contributions to Return

Activision Blizzard	(0.4%)
Amazon.com	(0.2%)
Alcoa	(0.2%)
Schlumberger	(0.2%)
Occidental Petroleum	(0.2%)

Top 10 Holdings

1	Visa	£3,705,543
2	Alphabet	£3,636,398
3	United Health	£3,573,993
4	Novartis	£3,433,905
5	Amazon	£3,399,445
6	Comcast	£3,354,558
7	JPMorgan Chase	£3,253,318
8	Nestle	£3,061,406
9	Bank of America	£3,022,109
10	AIA	£2,915,120

Hymans Robertson View

Schroder's Global Alpha is rated at ‘Positive’. The Schroder's fundamental equity team has settled down under the leadership of Alex Tedder. We regard his actions in rebuilding the team as being a good foundation for the future and should improve consistency. There have been periods in recent years when portfolios focused on fundamental long term growth have struggled in markets dominated by low growth and risk aversion - and the commodity cycle has also been problematic - though we support the broad philosophy of the team. However, Schroder do need to demonstrate more consistent stock selection.

Schroders have announced that Head of Equities, Nicky Richards has moved to a Senior Advisor role within Schroders, effective March 2019. Rory Bateman, former Head of UK and European Equities will take over as Head of Equities and will also join the Group Management Committee. We do not have any concerns over this appointment. Bateman has been a core figure within Schroders’ equity business since he joined the firm in 2008 and has over 20 years’ experience of managing equity strategies. Schroders have stated they plan to appoint someone internal to fill the Head of UK and European Equities role.

Risk Control

The portfolio can have a maximum 10% off-benchmark exposure; any increase in this would require the consent of the Pension Fund.

Lincolnshire Pension Fund
Global Equities – Columbia Threadneedle
Quarterly Report December 2018

Investment Process

The portfolio is designed to outperform the MSCI All Countries World Index by 2% per annum, gross of fees, over rolling three-year periods. The team focus on quality growth companies with high or rising returns on investor capital, and sustained or improving competitive advantage. The focus is on stock selection, with a well-diversified portfolio designed to deliver superior risk adjusted returns.

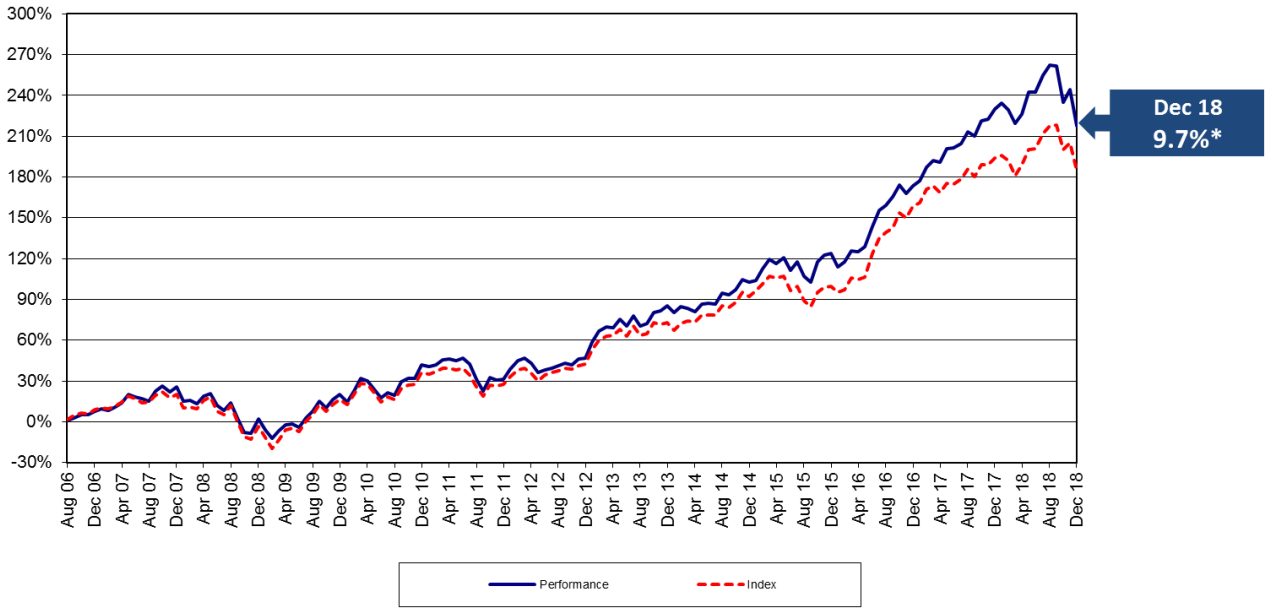
Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£150,700,695	£132,269,695

Performance

Gross of fees, the fund lagged its benchmark in the fourth quarter. Rotations out of high-duration growth stocks – and the outperformance of cheaper, defensive segments – worked against the investment approach. The zero weight in utilities detracted most in terms of allocation, while energy and healthcare holdings underperformed. By contrast, industrials underweight added value, as did positions in financials and technology.

Columbia Threadneedle Performance Since Inception



* Annualised Manager Performance since inception

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Columbia Threadneedle	(12.2)	(3.8)	14.4	11.3	9.7
MSCI ACWI	(10.6)	(3.3)	12.5	10.5	8.8
Relative Performance	(1.9)	(0.5)	1.6	0.8	0.9

* annualised, inception date 01/08/2006

Turnover

Holdings at 30.09.18	Holdings at 31.12.18	Turnover in Qtr %	Turnover in Previous Qtr %
77	76	6.7	3.3

Purchases and Sales

Positions were initialled in financial information services provider S&P Global, publishing software company Adobe and consumer credit-rating agency TransUnion. S&P's diversified sources of revenue growth, compelling margin outlook and strong track record of execution leaves it well placed to outperform. The outlook for Adobe's transition to a subscription-based cloud delivery model is positive and should enable it to capitalise on enterprises shifting away from legacy solutions. TransUnion's strong competitive position in a global oligopoly should enable it to continue delivering industry-leading organic growth.

To fund these purchases, investment bank Goldman Sachs was exited. After the stock performed strongly in October, capital was reallocated towards positions with more attractive risk/reward profiles as news flow around the Malaysia Development Berhad case escalated.

Top 5 Contributions to Return

PT Bank Rakyat	0.38%
HDFC Bank	0.27%
CME Group	0.16%
Tencent Holdings	0.07%
OSRAM Licht	0.06%

Bottom 5 Contributions to Return

Amazon.com	(0.82%)
Diamondback Energy	(0.60%)
Halliburton Company	(0.58%)
EOG Resources	(0.57%)
Activision Blizzard	(0.52%)

Top 10 Holdings

1	Alphabet	£5,198,843
2	Microsoft	£4,314,643
3	Amazon	£4,104,121
4	JPMorgan Chase	£3,766,013
5	Mastercard	£3,426,802
6	Visa	£3,343,496
7	HDFC Bank	£3,280,095
8	Alibaba	£3,074,380
9	Unilever	£3,034,538
10	Ping An	£2,972,875

Hymans Robertson View

Columbia Threadneedle Global Equity are rated at 'Positive.' The team's investment approach is based on fundamental research with a strong emphasis on inputs from the broader investment research resources at Columbia Threadneedle. The portfolios of around 60 – 70 stocks typically have a growth bias. The team is now well resourced and will hopefully enjoy a period of stability. William Davies is regarded as key to the operation of the team and we will be monitoring whether his expanded role as Head of Equities for EMEA has any detrimental impact in terms of his time spent on portfolio management.

There were no significant developments over the quarter.

Risk Control

The portfolio can have a maximum 10% off-benchmark exposure; any increase in this would require the consent of the Pension Fund.

Lincolnshire Pension Fund
Global Equities – Morgan Stanley Global Brands
Quarterly Report December 2018

Investment Process

The Global Brands Fund is an open-ended investment company incorporated in the United Kingdom. The aim of the Fund is to provide long term capital appreciation through investing in a concentrated high quality global portfolio of companies with strong "intangible assets". The Fund is benchmarked against the MSCI World Index. Managers aim to gain an absolute return to the Fund rather than a relative return against their benchmark index.

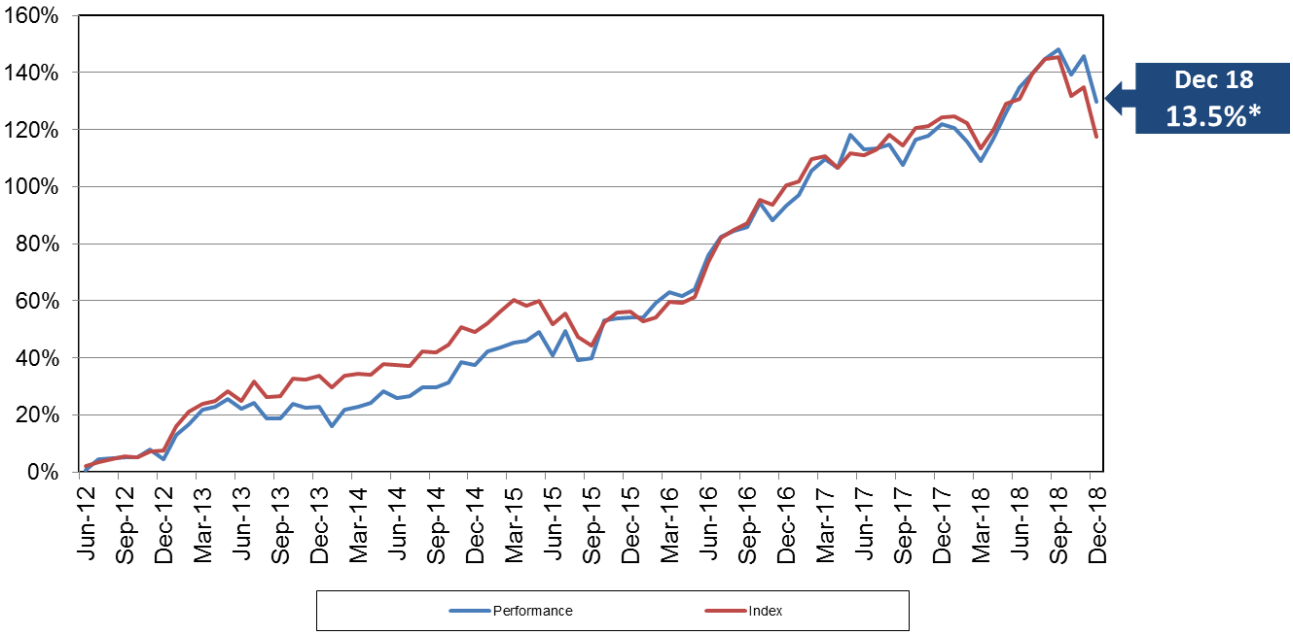
Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£212,166,714	£196,420,114

Performance

The portfolio outperformed in relative terms over the quarter, returning -7.44% versus -11.35% for the index. The quarters outperformance was driven by both sector allocation and stock selection. The large overweight in consumer staples was the main cause of the favourable sector allocation, while outperformance in information technology, communication services and industrials comfortably outweighed the effect of underperformance in consumer staples to deliver strong stock selection.

Morgan Stanley Global Brands Performance Since Inception



* Annualised Manager Performance since inception

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Morgan Stanley Global Brands	(7.4)	3.5	14.2	13.3	13.5
MSCI World Index	(11.4)	(3.0)	11.6	10.2	12.5
Relative Performance	4.4	6.8	2.4	2.8	0.8

*annualised, inception date 18/06/2012

Purchases and Sales

The fourth quarter was a relatively quiet quarter for the portfolio, with no new buys or final exits. For the year as a whole, the bulk of the activity was valuation driven, with profits being taken in information technology communication services and consumer discretionary. The recipients of the funds were consumer staples and health care.

Top Contributors to Return

Twenty-First Century Fox	0.42%
Coca-Cola	0.20%
Church & Dwight	0.14%

Bottom Contributors to Return

Reckitt Benckiser	(1.30%)
British American Tobacco	(1.09%)
SAP	(0.79%)

Top Ten Holdings

Company	Industry	% Weighting
Reckitt Benckiser	Household Products	8.40
Twenty-First Century Fox	Entertainment	7.23
Microsoft Corp	Software	7.12
Unilever	Personal Products	5.26
Visa	IT Services	4.82
SAP	Software	4.28
Accenture	IT Services	4.20
Philip Morris	Tobacco	3.87
Coca-Cola Company	Beverages	3.84
Baxter International	Health Care Equipment & Supplies	3.73

Hymans Robertson View

Morgan Stanley Global Franchise (Brands) strategy is rated at ‘Suitable'. The manager runs concentrated portfolios of 20 - 40 stocks with a strong quality bias, low turnover and low volatility in absolute terms. Companies need to exhibit high returns on capital, be investing to protect their brands and have shareholder friendly management teams. There is a tendency for the portfolio to have large allocations to consumer and technology stocks, often with limited exposure to many other sectors of the market. On a regional basis the strategy is often overweight in UK listed stocks though high levels of revenue earned in emerging markets is a more important feature. The strategy is currently open but with limited capacity available. The long term track record is strong, performing well in relative terms in down markets and generally keeping pace in all but the most extreme up market phases. This provides stability when employed alongside other active equity managers.

There were no significant changes over the quarter.

Lincolnshire Pension Fund
UK Equities – Legal & General (LGIM)
Quarterly Report December 2018

Investment Process

This pooled fund employs a tracking strategy, aiming to replicate the performance of the FTSE All-Share Index to within +/-0.25% p.a. for two years out of three. The fund follows a pragmatic approach to managing an index fund, either investing directly in the securities of that index or indirectly through other LGIM funds. The fund may also hold index and single stock futures for efficient portfolio management.

Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£437,235,675	£392,746,958

Performance

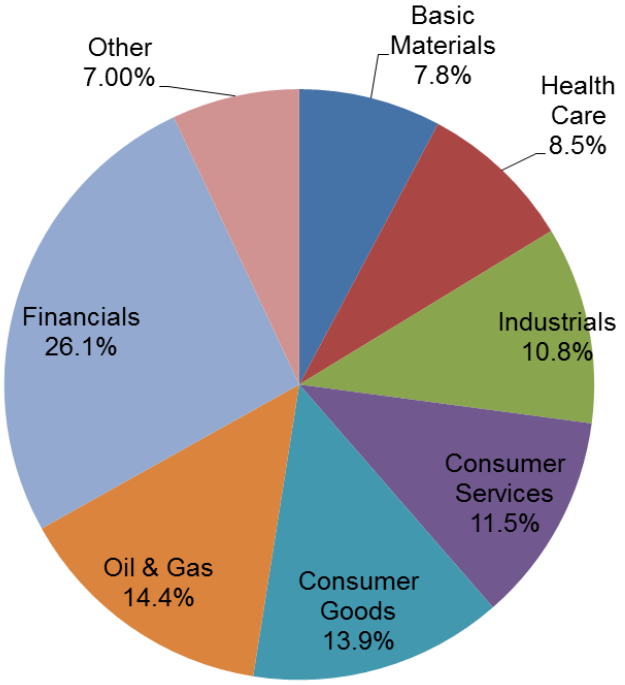
Over all periods the portfolio has performed as expected.

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception* %
LGIM	(10.1)	(9.4)	N/A	N/A	0.3
Benchmark	(10.2)	(9.4)	N/A	N/A	0.1
Relative Performance	0.0	0.0	N/A	N/A	0.1

*annualised, inception date February 2017

Top Ten Holdings	
Company	**% Weighting**
Royal Dutch Shell	9.2
HSBC Holdings	6.2
BP	4.6
AstraZeneca	3.6
Glaxosmithkline	3.5
Diageo	3.2
British American Tobacco	2.7
Unilever	2.2
Rio Tinto	2.0
Vodafone Group	2.0
Total	**39.2**

Whole Fund Sector Breakdown



Lincolnshire Pension Fund
Passive Bonds – Blackrock
Quarterly Report December 2018

Investment Process

Blackrock manage a passive bond mandate for the Pension Fund. The portfolio is made up of three pooled funds; an index-linked bond fund, a corporate bond fund and an overseas bond fund. All three funds are designed to match the return of their relevant benchmarks. The manager uses two methods to manage index-tracking funds; full replication and stratified sampling.

Full replication involves holding each of an index's constituent bonds in exactly the same proportion as the index. This method is used where the number of constituents in an index is relatively low and liquidity is above a certain level.

Stratified sampling is the method used when full replication is not possible or appropriate. This approach subdivides the benchmark index according to various risk characteristics, such as currency/country, maturity, credit rating, sector of issuer etc. Each subset of bonds is then sampled to select bonds for inclusion within the pooled fund.

The table below shows the indexing method for each of the three pooled funds in which the Fund invests.

Pooled Fund	**Indexing Method**
Aquila Life Corporate Bond All Stocks Index Fund	Sampled
Aquila Life Over 5 Years UK Index-Linked Gilt Index Fund	Full Replication
Aquila Life All Stocks UK Gilt Index Fund	Sampled

Portfolio Valuation

Portfolio	**30.09.18 £**	**31.12.18 £**
Corporate Bond All Stocks Index Fund	67,750,334	70,035,194
Over 5 Years UK Index-Linked Gilt Index Fund	41,190,052	39,805,842
All Stocks UK Gilts*	27,068,271	27,743,408
Cash (residual)	1	1
Total	**136,008,658**	**137,584,346**

*Switched from Overseas Bond Index Fund in February 17

Performance

Over all periods the portfolio has performed as expected.

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Blackrock	1.2	(0.6)	6.7	6.8	6.5
Composite Benchmark	1.1	(0.7)	6.6	6.7	6.5
Relative Performance	0.1	0.1	0.1	0.1	0.1

*annualised since inception 28/07/10

Hymans Robertson View

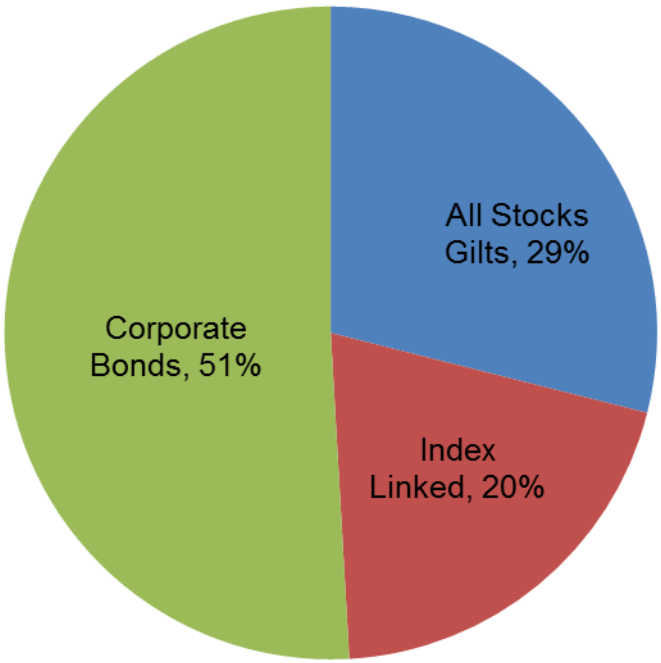
We rate BlackRock's index-tracking equity capability at 'Preferred'. There were no significant developments over the quarter.

Allocation

The target allocation between the three funds is:

Aquila Life Corporate Bond All Stocks Index Fund	50%
Aquila Life Over 5 Years UK Index-Linked Gilt Index Fund	30%
Aquila Life All Stocks UK Gilt Index Fund	20%

The pie chart below shows the allocation as at 31 December 2018.



Lincolnshire Pension Fund
Passive Bonds – Blackrock interim
Quarterly Report December 2018

Investment Process

Since the termination of BMO's Absolute Return bond fund, that element of the Fund's asset allocation has been temporarily housed in an interim Blackrock fund of short dated corporate bonds. The fund is managed passively, and aims to achieve index returns in line with the iBoxx Sterling Non-Gilts 1-5 Year Index.

Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£136,948,000	£137,042,880

Note: An additional £10m was invested in July 2018

Performance

Over all periods the portfolio has performed as expected.

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception* %
Blackrock Interim	0.1	0.0	n/a	n/a	0.9
Benchmark	0.1	0.0	n/a	n/a	0.8
Relative Performance	0.0	0.0	n/a	n/a	0.1

*annualised since inception 14/09/16

Hymans Robertson View

We rate BlackRock's index-tracking equity capability at ‘Preferred’. There were no significant developments over the quarter.

Lincolnshire Pension Fund
Alternative Investments – Morgan Stanley
Quarterly Report December 2018

Investment Process

Morgan Stanley manages a bespoke absolute return alternative investment mandate for the Fund. The portfolio is invested in alternatives only, with no exposure to traditional equities or bonds. Investments are made to complement the existing Fund allocation. The manager has a target to beat the return of 3 Month LIBOR + 4%. Morgan Stanley also manage the legacy private equity investments, however they are excluded from this report.

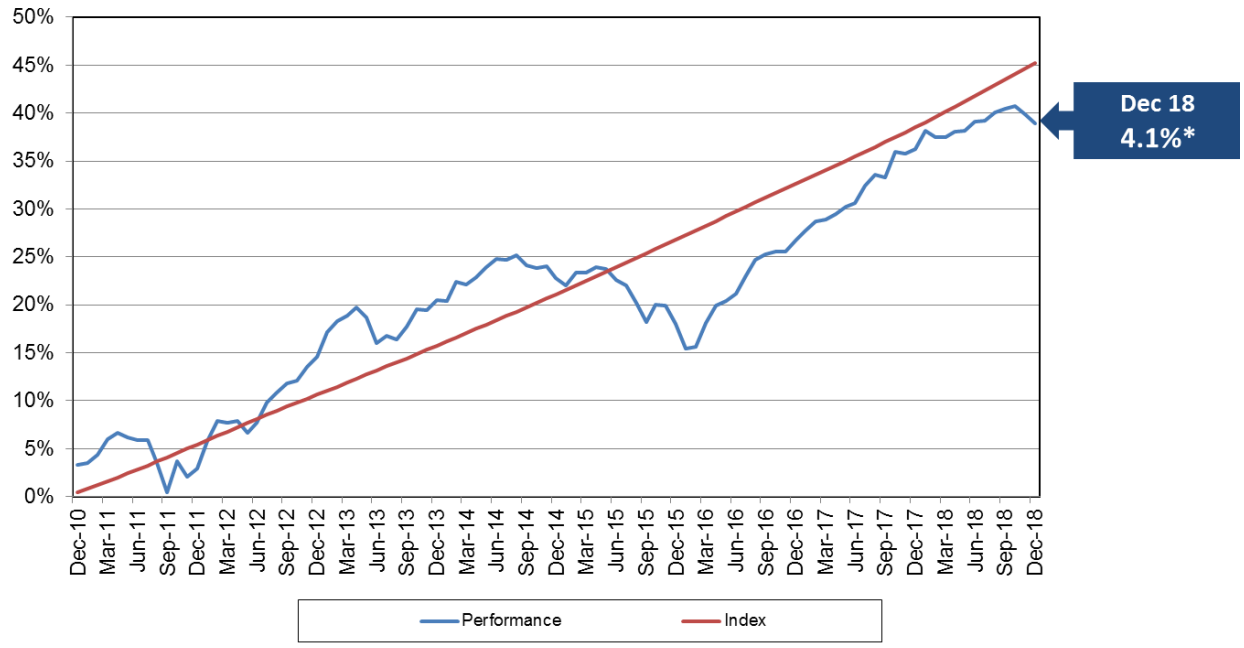
Portfolio Valuation

Value at 30.09.18	Value at 31.12.18
£293,974,628	£294,067,078

Performance

The total alternatives portfolio (including legacy private equity holdings) returned -0.43% during the fourth quarter. Positive contributions from the private market investments were not enough to offset declines across all other asset classes. Manager selection, particularly in hedge funds, senior loans, and real estate securities, added to returns, while tactical decisions modestly detracted.

Morgan Stanley AIP Performance Since Inception



* Annualised Manager Performance since inception

	Quarter %	1 Year %	3 Year* %	5 Year* %	Inception * %
Morgan Stanley	(1.1)	1.9	5.6	2.9	4.1
3 Month LIBOR + 4%	1.2	4.9	4.6	4.6	4.7
Relative Performance	(2.3)	(2.8)	0.9	(1.7)	(0.5)

* annualised since inception date 24/11/2010 (excludes legacy PE portfolio assets)

Allocation

Morgan Stanley has split out investments into a bespoke portfolio of alternatives comprising five different asset allocations:

- **Alpha** These are pure return seeking products based on Manager skill. The Alpha investments include Hedge Funds, Global Tactical Asset Allocation (GTAA) and Active Currency.

- **Long Term Real Asset** These are long term investments that seek to access illiquidity premium. Investments include Private Equity, Infrastructure, Real Estate, Commodities and Inflation – linked strategies.

- **Credit** These are the purchase of the lower rated bonds where higher default is more likely. Manager selection is important to ensure the correct bonds are purchased that will appreciate following rating upgrades and merger and acquisition activity. Credit opportunities include Emerging Market Debt, High Yield Bonds, Senior Loans and Convertibles.

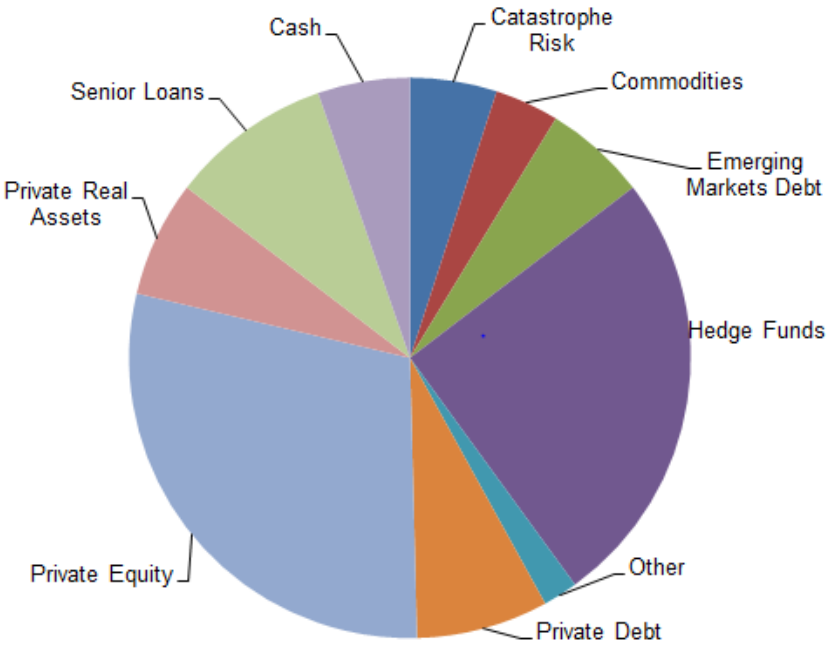
- **Discovery** These are new opportunities of investments and can include Frontier Markets, Distressed Opportunities and Volatility.

The table and pie chart below show the strategy and asset class positions of the Morgan Stanley portfolio as at 31 December 2018.

Strategy

Alpha	30.39%
Credit	15.17%
Real Assets	48.44%
Cash	6.00%

Asset Class



Portfolio Outlook

Going into 2019, there continue to be headwinds of slowing growth, tighter monetary policy and political uncertainty. The U.S. approach to trade policy has dampened sentiment, hurt U.S. capex and slowed growth prospects around the globe, worsening the situation in a number of key economies. Meanwhile, China's recent attempts to reduce leverage – a sensible policy with unfortunate timing – are at the root of the weakness there. It is not difficult to find dysfunctional policies in Europe, with Brexit in the U.K., a populist government bringing back fiscally unsustainable policies in Italy, riots in France and loss of political stability in Germany. This conjunction of dysfunctional policies has created a lot of volatility and corrected much of the excesses in pricing, but forward-looking volatility is unlikely to be as high. This backdrop is more supportive for alternatives.

This portfolio remains defensively positioned and relies on value creation from hedge funds and private markets. During the quarter, a private debt co-investment in a music publishing and production company with intellectual property rights to over 75,000 songs was made. The royalty stream associated with this content is considered to be of very high quality and is expected to benefit from the positive tailwinds in the music streaming sector. Other opportunities in private debt that can offer uncorrelated returns with sustainable cash yields continue to be pursued.

In real assets a commitment to a real estate fund that focuses on opportunistic investments in commercial and residential assets in the US was finalised. A further co-investment with this manager is being evaluated, and more broadly reflects a medium term preference across real assets for opportunities in capital constrained segments with earnings growth potential and limited sensitivity to macro factors.

In private equity, the acquisition of a distressed logistics investment with structural features that are expected to offer attractive returns was finalised. The approach in private equity is similarly cautious in relation to macro sensitivity, favouring opportunities that allow asset by asset diligence and stress testing for cyclical downturn robustness.

Hymans Robertson View

Morgan Stanley is rated at 'Suitable' for Diversified Alternatives. This strategy offers exposure to a broad range of alternative assets. Morgan Stanley employs an open architecture approach, investing through both internal and external fund managers. For liquidity purposes the portfolio has historically maintained a high allocation to hedge funds. In addition, the strategy is designed to remain fully invested and the manager will not make active use of cash or fixed income to preserve capital during stress periods in markets.

Morgan Stanley announced that Joe McDonnell, one of the three portfolio managers on the strategy, was leaving the firm. McDonnell was the most senior member of the team in Europe and while Morgan Stanley does not plan to appoint another portfolio manager to replace McDonnell, we believe London-based Steve Turner will effectively shoulder a lot of McDonnell's responsibilities. As a result of this change, we have downgraded the strategy to 'Suitable'.

Risk Control

Portfolio volatility since inception is 3.52%, within the guidelines specified by the mandate.

5. Environmental, Social and Governance (ESG) Indices for Investing

5.1 The Pensions Committee at its training meeting in February received a presentation from Legal & General Investment Managers (LGIM) on the use of Environmental, Social and Governance (ESG) Indices, particularly focusing on low carbon targets. The presentation detailed the work LGIM already undertake in respect of ESG factors for our passive UK equity holdings with them. They also provided the Committee with details of how investors with passive holdings could further build in ESG factors to their investing. This included using:

- Standard indices, plus specific customisation (first generation);
- Standard ESG indices (second generation); or
- An investor led options (third generation).

5.2 The Committee where then shown how each of these approaches could be applied and the benefits each approach brings.

5.3 The Committee are asked to consider, following the training received, if they wish officers to undertake further investigations into ESG indices which could be used for the Fund's passive UK equity holdings, and bring back to this Committee proposals during the financial year 2019/20.

Conclusion

Over the quarter, the Fund produced a negative return of (6.88%), underperforming the benchmark which returned (6.15%).

Consultation

a) Have Risks and Impact Analysis been carried out?

Yes

b) Risks and Impact Analysis

The Pension Fund has a Risk Register which can be obtained by contacting the author of this report.

Background Papers

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

This report was written by Claire Machej, who can be contacted on 01522 553641 or claire.machej@lincolnshire.gov.uk.