Fund benchmarks and targets

Introduction

This paper is addressed to the Officers of the London Borough of Brent Pension Fund ("the Fund"). It reviews the Fund's investment benchmarks and performance targets at an individual asset class level. 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 accepted such liability in writing.

Executive summary

The table below shows our recommended benchmarks and performance targets. In many cases, these are in line with the current approach. This table is then separated by asset class, along with accompanying rationale, in the subsequent sections of the paper. The Fund's legacy holding with Aviva Property has not been included in our analysis due to its immaterial size (it has almost entirely been sold). Please see comment on page 5 in relation to property as an asset class.

Mandate	Current benchmark	Proposed benchmark	Proposed performance target
LGIM Global Equity	FTSE All-World Developed Markets ex UK	No change	No change
LGIM UK Equity	FTSE All-Share	No change	No change
LCIV Emerging Markets	MSCI Emerging Markets Index	No change	MSCI Emerging Markets Index +2.5% p.a.
Capital Dynamics Private Equity	Absolute Return of +8% p.a.	MSCI All World +1% p.a.	MSCI All World +3% p.a.
Baillie Gifford Multi Asset	BOE Base Rate +3.5% p.a.	BOE Base Rate +2% p.a.	BOE Base Rate +3.5% p.a.
Ruffer Multi Asset	BOE Base Rate +3.5% p.a.	BOE Base Rate +2% p.a.	BOE Base Rate +3.5% p.a.
Alinda Infrastructure	Absolute Return of +8% p.a.	CPI +2% p.a.	CPI +6% p.a.
Capital Dynamics Infrastructure	Absolute Return of +8% p.a.	CPI +2% p.a.	CPI +6% p.a.
LCIV CQS Multi Credit	LIBOR +4-5% p.a.	LIBOR +2% p.a.	LIBOR +4% p.a.
BlackRock UK Gilts Over 15 years	FTSE UK Gilts Over 15 years	No change	No change

We recommend that the above changes are discussed on our September monthly call with a view to incorporating any new benchmarks and targets with effect from Q3 2019 reporting.

Background

Benchmarks

A benchmark is a standard against which performance of a fund, a portfolio or another benchmark is compared. Most benchmarks are based on either market indices or peer group performance. Other types of benchmark are encountered, most commonly in alternative asset classes, where neither indices nor peer group results are readily available. These are typically expressed as premiums over cash or inflation – intended to describe the long-term returns expected rather than short- or medium-term patterns of performance.

Our general view is that indices are preferable to peer groups, although the overriding consideration is that the benchmark should be suitable for the purpose employed. Where some compromise needs to be made in benchmark selection, care has to be taken in the interpretation of returns. If, for example, an index based on listed assets is used as a benchmark for unlisted investments, the short-term performance of the benchmark is likely to be more volatile than that of the investments. Where a cash-based benchmark is used, it will not capture the short- to medium-term trends in the asset class.

Benchmarks can be used in various contexts. We distinguish a few of the possibilities below:

- At a strategic level, benchmarks can define the nature of the return and/or risk expected. So, for example, a broadly-based UK index, such as the FTSE All-Share Index, would be a suitable strategic benchmark for a UK equity exposure.
- Benchmarks can define the structure of the intended investment in a particular asset class. Thus, a Fund can have an aggregate equity benchmark for instance, made up of a combination of regional equity indices weighted by the target exposures to each region. We would describe this as a structural benchmark.
- Benchmarks can be portfolio-specific – used to test the performance of a particular manager. In this case, a performance target, a minimum level by which the manager is expected to outperform the benchmark over the long term, will also usually be specified.

Generally, suitable market indices (or appropriate combinations) make for the best benchmarks. For alternative asset classes, such indices are not always available. Our preference is then to search for a related index and, if necessary, adjust to reflect any systematic differences between the portfolio investments and the universe represented by the index.

Another approach is to use a proxy for the long-term return expected from the asset class, usually expressed as a premium over either inflation or cash returns, as a benchmark. The approached proposed later for the Fund’s multi-asset funds and private markets are examples of this.

Performance targets

For some asset classes, there is a choice between active and passive management; for others, active management is the only option. Nevertheless, whenever portfolios are actively managed, there will generally be an expectation that the manager will deliver performance in excess of the underlying market return (so-called 'alpha').

Where the targets are zero, the portfolios are passively managed. Where there are non-zero performance targets, we make some specific comments in the following section. This is a simpler process when looking at the more traditional asset classes, where the number of portfolios is smaller and there is a typical 'industry-standard' range of performance targets. It is also easier to specify a performance target when the actual returns from a portfolio or asset class can be tested against the underlying return on a suitable index.

The key principle is that the performance target should broadly reflect the nature of the investments selected rather than some predetermined number. That said, we would view a target in excess of 2-3% p.a. ahead of the benchmark across an asset class as a whole as representing a relatively high-risk approach to implementation. That may be perfectly acceptable, but it should certainly be deliberate.

For alternative asset classes, there may be no index available or it may be decided to adopt a non-index benchmark. In these cases, we think the most important thing is that the chosen benchmark should reflect expectations about the overall return expected from the asset class. It is more difficult to unbundle this overall return into an underlying market return and a return to manager skill.

However, it should be understood that the actual returns generated will include some contribution from the success or failure of the chosen managers. Generally, we think it is right to be cautious about the achievement of performance targets. They should certainly be seen as a guide to the riskiness of portfolios and the extent to which short-term returns might diverge from the benchmark. They should also reflect the genuine aspirations of the Fund and managers. But the returns implied by the targets should be seen as less reliable than the market returns implied by the Fund's benchmarks.

Benchmark and Target Rationale

Quoted Equities

Mandate	Current Benchmark	Current Target	Suggested Benchmark	Suggested Target
LGIM Global Equity	FTSE All-World Developed Market ex UK	-	No change	No change
LGIM UK Equity	FTSE All-Share	-	No change	No change
LCIV Emerging Markets	MSCI Emerging Market Index	MSCI Emerging Markets +2.5% p.a	No change	MSCI Emerging Markets +2.5% p.a.

- Both FTSE and MSCI provide a consistent series of broadly-based indices – the best approach for strategic and structural purposes. There is no particular reason to prefer either MSCI or FTSE and as such, we are comfortable with the current selection of benchmarks.
- Both LGIM funds are passive mandates and are designed to match their given benchmarks. Therefore, there is no need for an additional target return.
- There will be greater tracking error on the LCIV Emerging Markets Fund, due to the active nature of the portfolio. We are comfortable with the current benchmark and also agree with the current additional target to measure the manager's ability to generate alpha.

Private equity

Mandate	Current Benchmark	Current Target	Suggested Benchmark	Suggested Target
Capital Dynamics Private Equity	Absolute return of +8% p.a.	-	MSCI All World +1% p.a.	MSCI All World +3% p.a.

- Rather than an absolute return benchmark, we think that the use of a quoted equity index as a strategic benchmark is the best approach. It reflects the strategic rationale that private equity is an extension of the universe of equity opportunities rather than a significant diversifier.
- A global index reflects the global nature of the Fund's private equity programme. Alternatively, it would be possible to use a weighted combination of regional indices that more closely approximates the desired allocation of the private equity portfolio, although we doubt that any resulting improvement in fit between the "benchmark" and the Fund's investments would be worthwhile.
- We think that an expected outperformance of 3% p.a. over listed equities is broadly appropriate. This is typical of the level targeted by private equity investors. However, any added value will represent a combination of a return to illiquidity (a strategic decision) and the relative success of the managers and funds selected (alpha).
- It is impossible to analyse the contributions from these two factors precisely, but we suggest that an approximate solution may be considered by adding a premium of 1% p.a. for the strategic benchmark and a 3% premium for the target. This broadly matches the assumptions within our asset-liability modelling, which assumes a 1% outperformance over quoted equities over time.

Multi-asset

Mandate	Current Benchmark	Current Target	Suggested Benchmark	Suggested Target
Baillie Gifford	BOE Base Rate +3.5% p.a.	-	BOE Base Rate +2% p.a.	BOE Base Rate +3.5% p.a.
Ruffer	BOE Base Rate +3.5% p.a.	-	BOE Base Rate +2% p.a.	BOE Base Rate +3.5% p.a.

- Multi-asset (also known as “Diversified Growth” strategies) are comprised of several underlying asset classes with the aim of smoothing returns through diversification. There is therefore no obvious appropriate market index to act as a benchmark.
- Typical benchmarks are therefore cash or inflation. These funds then target a premium over this.
- The challenge in setting an appropriate benchmark and target then boils down to agreeing upon the correct risk premium to allocate to these funds. Based on the underlying allocation of typical diversified growth funds, we suggest BOE Base Rate + 2% p.a. is set as a benchmark, and BOE Base Rate + 3.5% p.a. as the target. This will help differentiate between expected return given risk, and alpha generated by the manager.

Income Assets: Infrastructure and Property

Mandate	Current Benchmark	Current Target	Suggested Benchmark	Suggested Target
Alinda Infrastructure	Absolute return of +8% p.a.	-	CPI +2% p.a.	CPI +6% p.a.
Capital Dynamics Infrastructure	Absolute return of +8% p.a.	-	CPI +2% p.a.	CPI +6% p.a.

Infrastructure

- Infrastructure is often predicated on some long-term return above inflation. Considering the nature of these funds, we suggest that an appropriate risk premium over inflation is 2% p.a. and any outperformance of this reflects manager skill. We have therefore suggested a benchmark of CPI +2% p.a. and target of CPI +6% p.a.

The Fund currently has a legacy property holding with Aviva that has almost entirely been wound down. However, property is an asset class the Fund is committed to and will likely seek to deploy funds through the London CIV as and when the property offering becomes available to meet their target strategic allocation to this asset class. We will address the appropriate benchmark and target for this allocation at a later date, once the exact mandate is known.

Protection: Multi-Asset Credit and Gilts

Mandate	Current Benchmark	Current Target	Suggested Benchmark	Suggested Target
CQS Multi Credit	LIBOR +4.5% p.a.	-	LIBOR +2% p.a.	LIBOR +2% p.a.
BlackRock UK Gilts Over 15 years	FTSE UK Gilts Over 15 years	-	No change	No change

Multi – Credit

- Given the CQS benchmark for the fund is LIBOR +4-5% p.a. over a 4 year rolling period, we suggest that LIBOR +2% p.a. is an appropriate benchmark and LIBOR +4% p.a. is an appropriate target over the same 4 year rolling period structure.

Gilts

- The BlackRock mandate is a passively managed bond fund. Therefore, there is no need for an additional target return.
- The FTSE UK Gilts Over 15 Years benchmark is appropriate for a basket of over 15 year gilts.

Recommendation

As stated previously, we recommend that the above changes are discussed on our September monthly call with a view to incorporating any new benchmarks and targets with effect from Q3 2019 reporting. This will include updating Northern Trust, the Fund's performance measurer.

We look forward to discussing this paper with you.

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For and on behalf of Hymans Robertson LLP

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.