NORTH YORKSHIRE COUNTY COUNCIL

PENSION FUND COMMITTEE

21 FEBRUARY 2013

PERFORMANCE OF THE FUND'S PORTFOLIO FOR THE QUARTER AND YEAR ENDING 31 DECEMBER 2012

Report of the Treasurer

1.0 PURPOSE OF REPORT

1.1 To report the investment performance of the overall Fund, and of the individual Fund Managers, for the Quarter to 31 December 2012 and the twelve months ending on that same date.

1.2 To seek a decision from Members on the approach to currency hedging.

2.0 PERFORMANCE REPORT

2.1 The Fund Analysis & Performance Report (**circulated as a separate document**) produced by BNY Mellon Asset Servicing (MAS) provides a performance analysis of the North Yorkshire Pension Fund for the quarter and year ending 31 December 2012.

2.2 The usual report produced by MAS has been replaced as it relied upon the legacy ABN Amro performance reporting platform which had been experiencing data integrity issues. MAS will present the new style report at the meeting.

2.3 The report highlights the performance of the total Fund by asset class against the customised Fund benchmark. It also includes an analysis of the performance of each manager against their specific benchmark and a comparison of performance levels over time.

3.0 PERFORMANCE OF THE FUND

3.1 The performance of the various managers against their benchmarks for the Quarter ended 31 December 2012 is detailed on **page 8** of the MAS report. This performance is measured on a time-weighted basis and expressed as a +/- variation to their benchmark.

3.2 **The absolute overall return for the quarter (+6%) was above the customised benchmark for the Fund (+3.9%) by 2.1%.**

3.3 **The 12 month absolute rolling return was +16.5%. This was 3.3% above the customised benchmark.**

3.4 Absolute and relative returns over the year to each of the last four quarter ends were as follows.

Year End	Absolute %	Relative %
31 December 2012	+6.0	+3.3
30 September 2012	+4.3	+0.7
30 June 2012	-4.0	-0.9
31 March 2012	+9.7	+2.1

Manager performance is detailed in **Section 4**.

3.5 Challenging market conditions have persisted since the worst of the crisis in 2008/09 but volatility in financial markets has gradually receded. In all but three quarters in the last three years the Fund's absolute performance has been positive; relative performance has been positive in seven out of the last twelve quarters.

3.6 The Appendices used in this report have been designed to present a fuller picture of recent investment performance.

Appendix 1 Fund Manager Performance over the five years to 31 December 2012 in absolute percentage terms from a starting point of "100"

Appendix 2 Performance of NYPF relative to other LGPS Funds over the last ten years

Appendix 3 Solvency position (in % and £ terms) since the 2001 Triennial Valuation; this Appendix also shows in absolute terms the +/- in the value of assets and liabilities of the Fund

Appendix 4 Solvency graph – this shows the key figures from **Appendix 3** in a simple graphical format

Appendix 5 Details of Rebalancing @ 31 December 2012

3.7 The separate reports of the Investment Adviser and Investment Consultant explain what has been happening in the financial markets, and looking ahead over the short, medium and longer term.

4.0 FUND MANAGER PERFORMANCE

4.1 In monetary terms, the positive absolute return of +6% in the Quarter increased the invested value of the Fund by £94.8m. Taking new money into account, the value of the Fund increased by £100.2m. In absolute terms this movement is primarily attributable to capital gains made by Standard Life (£41.9m), Amundi (£14m) and Fidelity (£13.5m).

4.2 Positive absolute performance in the Quarter was achieved by all managers except one. Relative performance was more mixed, however the majority produced positive returns. At the end of the December 2012 quarter the value of the Fund was £254m above the value at the end of December 2011, an increase of 18%.

Performance relative to other LGPS Funds

4.3 **Appendix 2** shows the **performance of NYPF relative to other Funds in the LGPS universe**. NYPF has shown a strong and consistent correlation to the performance of other LGPS funds over the last 10 years but has tended to relatively outperform when markets are rising and underperform in falling markets conditions. This reflects to a greater inherent potential for volatility in the NYPF Investment Strategy relative to many other LGPS funds. At the time of writing figures for the Local Authority average for December 2012 were not available.

Overseas Equities

4.4 **Fidelity** produced a positive relative return in the quarter (+4.3%) against a benchmark return of +3.9%. Performance over the year to December 2012 was +2.6% relative.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	10.2	-4.3	4.6	4.3	15.1
Benchmark	9.3	-5.1	4.3	3.9	12.5
Difference	0.9	0.8	0.3	0.4	2.6

Allocations to Europe and North America again outperformed, with investments in the Pacific region underperforming for the first time since September 2011. For the ninth time in the last ten quarters, relative performance fell below the benchmark in Emerging Markets. Despite this mixed performance, the 70% weighting to Europe and North America resulted in a good quarter. Since inception in November 2008 the manager has matched the benchmark (gross of fees).

4.5 The Global Alpha fund managed by **Baillie Gifford** produced a positive relative return (+0.5%) continuing an exceptional run of outperformance of fourteen of the last fifteen quarters. The Fund was 1.6% above the benchmark for the year to December 2012.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	10.1	-4.9	5.3	3.0	13.6
Benchmark	9.0	-3.6	4.0	2.5	12.0
Difference	1.1	-1.3	1.3	0.5	1.6

The LTGG fund, also managed by **Baillie Gifford** produced a negative relative return (-0.1%) for the quarter. The fund was 5.5% above the benchmark for the year to December 2012 although relative performance has been below the benchmark over the last 9 months.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	14.7	-3.8	4.1	2.4	17.5
Benchmark	9.0	-3.6	4.0	2.5	12.0
Difference	5.7	-0.2	0.1	-0.1	5.5

Despite challenging market conditions both funds managed by Baillie Gifford have performed exceptionally well since the manager was appointed in 2006. Global Alpha and LTGG are 1.7% and 3% respectively ahead of the FTSE All World benchmark since inception.

UK Equities

4.6 **Standard Life** produced a positive relative return (+6.1%) in the quarter against the FTSE 350 equally weighted benchmark return of +6.1%. Relative performance for the year was 9.8% above the benchmark although since inception the fund is below the benchmark by 1.7%.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	19.3	-8.8	10.3	12.2	34.7
Benchmark	14.3	-5.2	8.5	6.1	24.9
Difference	5.0	-3.6	1.8	6.1	9.8

Compared to the FTSE All Share which was +3.8% for the quarter, the benchmark of the FTSE 350 Equally Weighted (excluding Investment Trusts), which focuses investment towards the UK economy, demonstrated much stronger performance.

4.7 The ethical equity portfolio operated by **R C Brown** underperformed the FTSE All Share by 0.2% over the quarter and was negative over the rolling 12 month period (-1.7%).

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	10.1	-8.2	5.6	3.6	10.6
Benchmark	6.1	-2.6	4.7	3.8	12.3
Difference	4.0	-5.6	0.9	-0.2	-1.7

4.8 These results give a combined absolute and relative performance in the quarter in global equities of +6.6% and +2.3% respectively.

Fixed Income

4.9 **ECM** produced +2.1% relative against the cash benchmark for the quarter and +8.3% relative for the year to December 2012. The manager also outperformed the most comparable corporate bond index, the Merrill Lynch ER00 index by 0.4% and 1.8% for the quarter and year respectively.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	4.5	-0.4	2.5	2.2	8.9
Benchmark	0.2	0.2	0.1	0.1	0.6
Difference	4.3	-0.6	2.4	2.1	8.3

4.10 Between July 2005 and May 2007 NYPF invested £125m with ECM. The valuation reached a peak of £141m in December 2007, dropped to a low point of £58m in February 2009. By the end of December 2012 the value of the investment stood at £119m. ECM's Information Ratio (see **paragraph 5.5**) is exceptionally high, although this will have been influenced by the recovery of asset values from a low base.

4.11 **Amundi** performed well ahead of the benchmark (+1.8%) in the quarter and was 3.3% above it for the year to December 2012 which is an exceptional result in a difficult trading environment.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	-1.9	2.1	-4.1	7.0	2.7
Benchmark	-3.2	1.4	-3.9	5.2	-0.6
Difference	1.3	0.7	-0.2	1.8	3.3

The investment with this manager has proven to be a helpful contributor to Fund performance when market sentiments are negative but this counterbalancing effect tends not to generate positive returns when markets are strong.

4.12 The investment in Gilts with **M&G** produced +6.7% against a rising benchmark (+5.2%). The manager however reported +5.5%, the difference due to alternative performance calculation methodologies, however the size of the difference is more than this would ordinarily explain so is being further investigated.

	Individual Quarters Ending				12 Months to
	31 Mar 12	30 Jun 12	30 Sep 12	31 Dec 12	31 Dec 2012
Portfolio	-3.6	1.4	-3.6	6.7	0.6
Benchmark	-3.2	1.5	-3.9	5.2	-0.6
Difference	-0.4	-0.1	0.3	1.5	1.2

4.13 These results give a combined relative performance in global fixed income of +1.7% in the quarter.

Property

4.14 The investments with **Hermes** and **Threadneedle** produced -1.4% and -0.2% respectively against the RPI benchmark. Performance figures will be available for the March 2013 quarter for the investment with **L&G** which commenced in November 2012.

5.0 RISK INDICATORS

5.1 The Report (**pages 10 and 11**) includes three long-term risk indicators.

5.2 The Fund's annualised **Standard Deviation** for the rolling three year period to December 2012 (11.9%) is lower than the benchmark average (12.5%) and the average over the three year period to September 2012 (14.6%); this is essentially as a result of the extreme volatility during the second half of 2008 and the first half of 2009 gradually dropping out of the equation. This latest figure still reflects the relatively high level of volatility of the Fund's return which is not surprising given the recent market conditions. Before the financial markets crashed in 2008 the figure was around the 6-7% level.

5.3 The **Sharpe Ratio** is a measure of the return above the risk free return in the context of the Fund's variability (standard deviation). In other words, this indicates whether returns are due to smart investment decisions or as a result of excessive risk. Higher risk-adjusted returns result in a higher ratio. The ratio for the Fund for the rolling three year period to December 2012 is +0.7.

5.4 The **Tracking Error** figure is a consolidation of the difference between each Fund Manager's actual return versus their respective benchmark. The unprecedented increase since the middle of 2008 in this measure, rising from approximately 2% to 9%, reflected huge market volatility and the difficult financial market environment facing the Fund (and its investment managers). Although the figure had fallen significantly for the year to September 2012 to 2.8 MAS has reported it has increased to 11.4 for the year to December 2012. The reason is under investigation and will be explained at the meeting.

5.5 The **Information Ratio** is a measure of excess returns in relation to the benchmark and the consistency of those returns. A high IR is derived from a high portfolio return, a low benchmark return and a low tracking error. Beating the benchmark by a significant margin inconsistently generates a lower IR than beating the benchmark consistently but modestly. At the end of December 2012 the ratio for the Fund was +0%.

5.6 If the measures to reduce volatility (particularly regarding equities) inherent in the Investment Strategy (and the Fund's managers) are successful it will gradually have a positive impact on the four measures referred to above.

6.0 SOLVENCY

6.1 The **solvency position** is presented in **Appendices 3 and 4**. As at 31 December 2012 the estimated solvency increased in the last quarter from 60% to 61%.

6.2 The assets of the Fund increased by 5.6% in the Quarter (including new money), whilst liabilities (as modelled by the Actuary) rose by 4.8%, the two combining to produce a 1% increase in solvency in the Quarter. Yields remained relatively stable in the Quarter but expectations of rising inflation increased liability values. Yields on long-dated gilts are used as the proxy discount rate to value liabilities, hence lower yields result in higher liability values and vice versa; the effect of yields and inflation on solvency is referred to further in **paragraph 6.3 (f)** below.

6.3 The relative position, over time, between liabilities and assets is shown very clearly in **Appendix 4** which is a simple graph using data from **Appendix 3**. It is clear from this graph that

(a) "liability growth" was matched by "asset growth" for the period March 2004 to March 2007 (hence the steady improvement in solvency from 59% to 67% over that period)

(b) from March 2007 to March 2009 "liability value" accelerated and "asset value" fell, which had

(c) a significant and consequential impact on solvency – there is a point where the asset and deficit lines cross - this is effectively the 50% funding point (@ June / September 2008)

(d) during 2009/10 changes in assumptions on inflation and bond yields resulted in no overall change in the valuation of liabilities throughout the year whilst asset values improved strongly over the same period

(e) between March 2010 and December 2012 the overall improvement in asset values was achieved alongside a much more significant increase in liability values (as modelled by the Actuary), resulting in a fall in solvency of 6%

(f) the most significant factors affecting liability values over the period since the 2010 Triennial Valuation have been the fall in the discount rate and market expectations of future interest rates. In isolation, had these two factors remained the same since this date solvency would be around 70% as at December 2012, 9% above the reported level, ie what it was at the last Valuation date of March 2010. The “ex yield/inflation change” lines on **Appendix 4** illustrate the point in terms of liabilities and deficit in monetary terms.

6.4 What this analysis illustrates very clearly is that the Fund has no effective control over “liability value” because it is generated by market conditions, actuarial assumptions and political decisions regarding the macro economy. The Fund must therefore concentrate on the performance of its invested assets over the longer term.

7.0 REBALANCING

7.1 The rebalancing schedule is attached as **Appendix 5**. £20m was transferred to Legal & General on 1 November 2012 and a further £5m on 3 December 2012, funded in part from cash reserves with the majority through a temporary borrowing arrangement with NYCC. This arrangement was addressed by a transfer of £15m from Standard Life on 1 February 2013.

8.0 CURRENCY HEDGING

8.1 Currency hedging reduces or eliminates the impact of foreign exchange rate movements on the value of foreign investments. NYPF uses it as a volatility reducing strategy rather than an investment strategy.

8.2 A fall in the value of foreign investments, if fully hedged will be matched by a corresponding increase in the value of the hedge, and vice versa. In such a case it would eliminate the effect movements in foreign currencies would have on investment values in British Pound (GBP) terms. A proportional hedge would proportionally eliminate the effect.

8.3 In 2006 the Fund introduced a policy of hedging 50% of its foreign currency exposure through the overseas equity investments. This was in response to the restructuring of the Fund’s equity allocation during that year, when the overseas component increased to two thirds of the total allocation to equity.

8.4 In 2009 the currency hedging policy was reviewed and reduced to 25% of the Fund’s foreign currency exposure through its overseas equity investments. This was following a review at Pension Fund Committee and was based on consideration on future currency exchange rate movements, reduced concern about the effect exchange rate volatility may have on the Fund, and the impact on monthly cash flow of funding adverse currency hedging trades.

8.5 NYPF overseas equity investments are denominated in a large number of individual currencies. For pragmatic administrative reasons, hedging only takes place for currencies where exposure is significant, being the US Dollar, Euro, Japanese Yen, Swiss Franc and Swedish Krona. These five currencies account for approximately 85% of total exposure.

8.6 Rolling three month Forward Exchange contracts are placed each month for these five currencies with a total value outstanding at any one time equal to 25% of the value of overseas equity investments.

8.7 Cash generated by or required for the hedging programme is managed by officers and distributed to investment managers when appropriate.

8.8 Prior to the end of 2009, currency movements occasionally necessitated disinvestment from investment managers to meet settlement costs. However, since then the change in policy combined with the relative stability in currency markets has meant this has not been necessary.

8.9 A report by the Investment Consultant “Hedging Overseas Currency Exposure” has been circulated to Members for consideration. The report covers all the key issues, as well as including advice based on forecasts for particular currencies. Members will need to consider the implications of incorporating this sort of advice in the policy in terms of an investment rather than a volatility reducing strategy.

8.10 Further advice will be provided by the Investment Consultant and the Independent Adviser at the meeting following which Members will need to decide whether the current policy for currency hedging is to continue, or if not what the new policy will be.

9.0 PROXY VOTING

9.1 Available on request is the report from PIRC summarising the proxy voting activity in the period September to December 2012. This report covers the votes cast on behalf of NYPF at all relevant company AGMs in the period and includes an analysis of voting recommendations at selected meetings and responses to company engagement.

10.0 RECOMMENDATIONS

10.1 Members are asked to note the investment performance of the Fund for the Quarter and 12 months ending 31 December 2012.

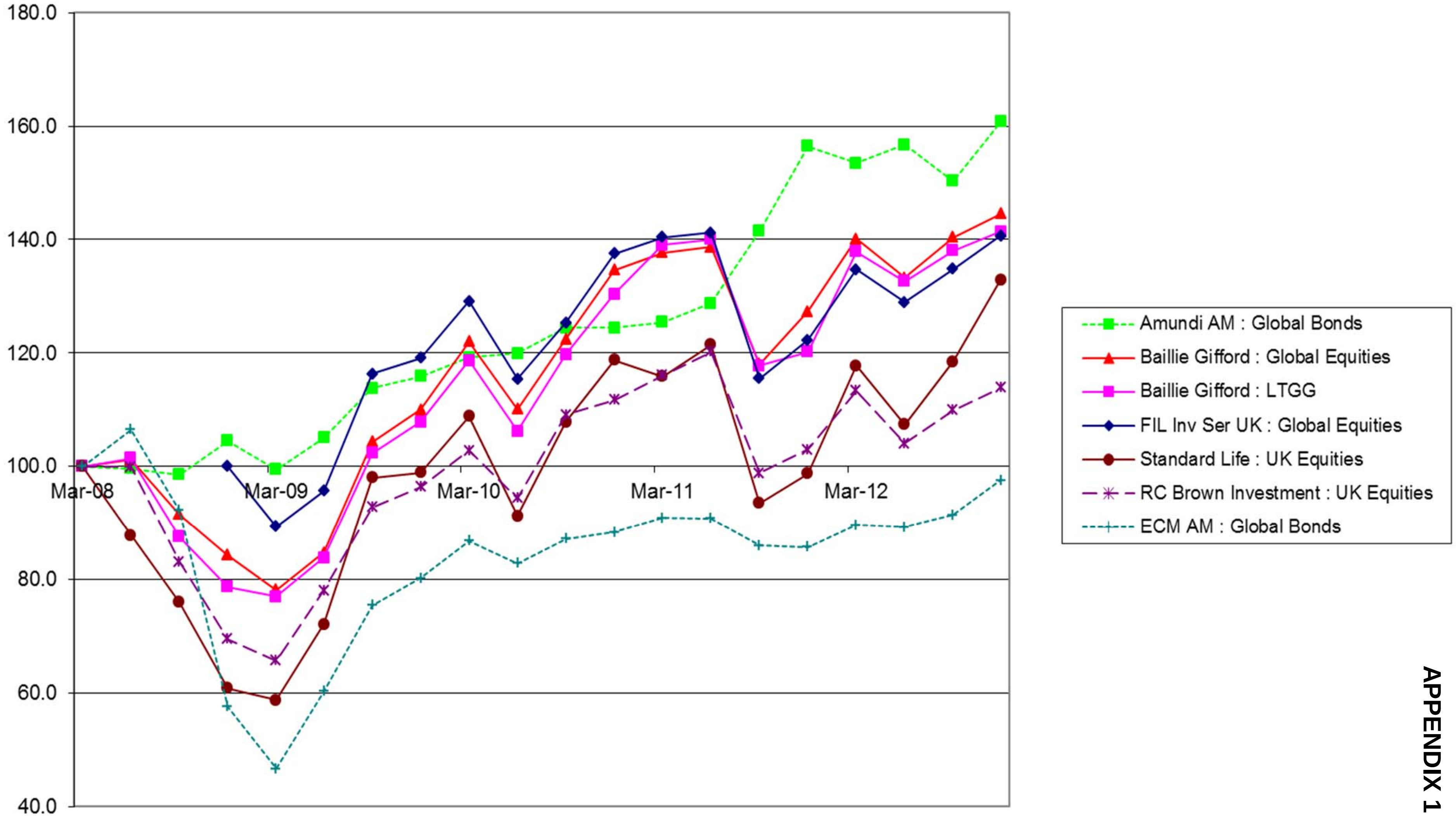
10.2 Members to decide whether the current policy for currency hedging is to continue, or if not what the new policy will be (see **paragraph 8.10**).

GARY FIELDING
Treasurer
Central Services
County Hall, Northallerton

6 February 2013

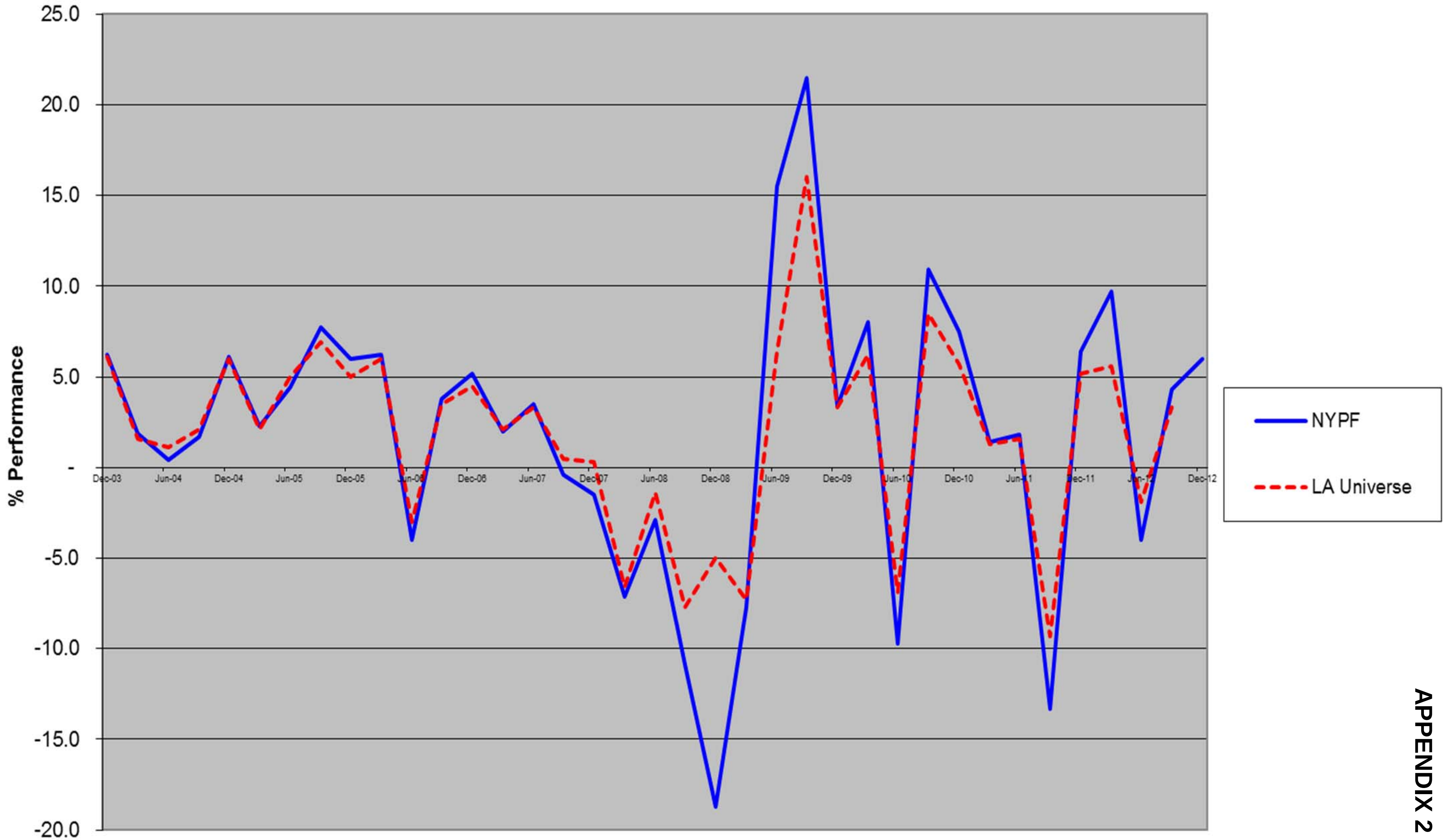
Background documents: None

Investment Manager Performance - cumulative absolute performance since March 2008



APPENDIX 1

Pension Fund Performance - NYPF vs Other Local Authorities



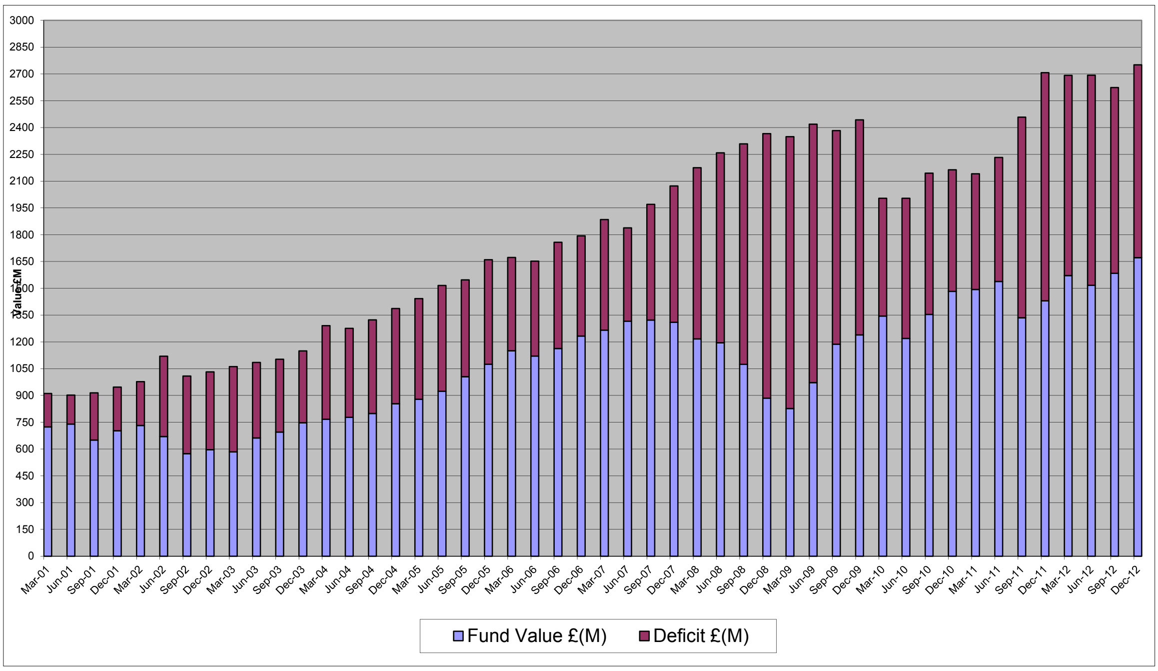
APPENDIX 2

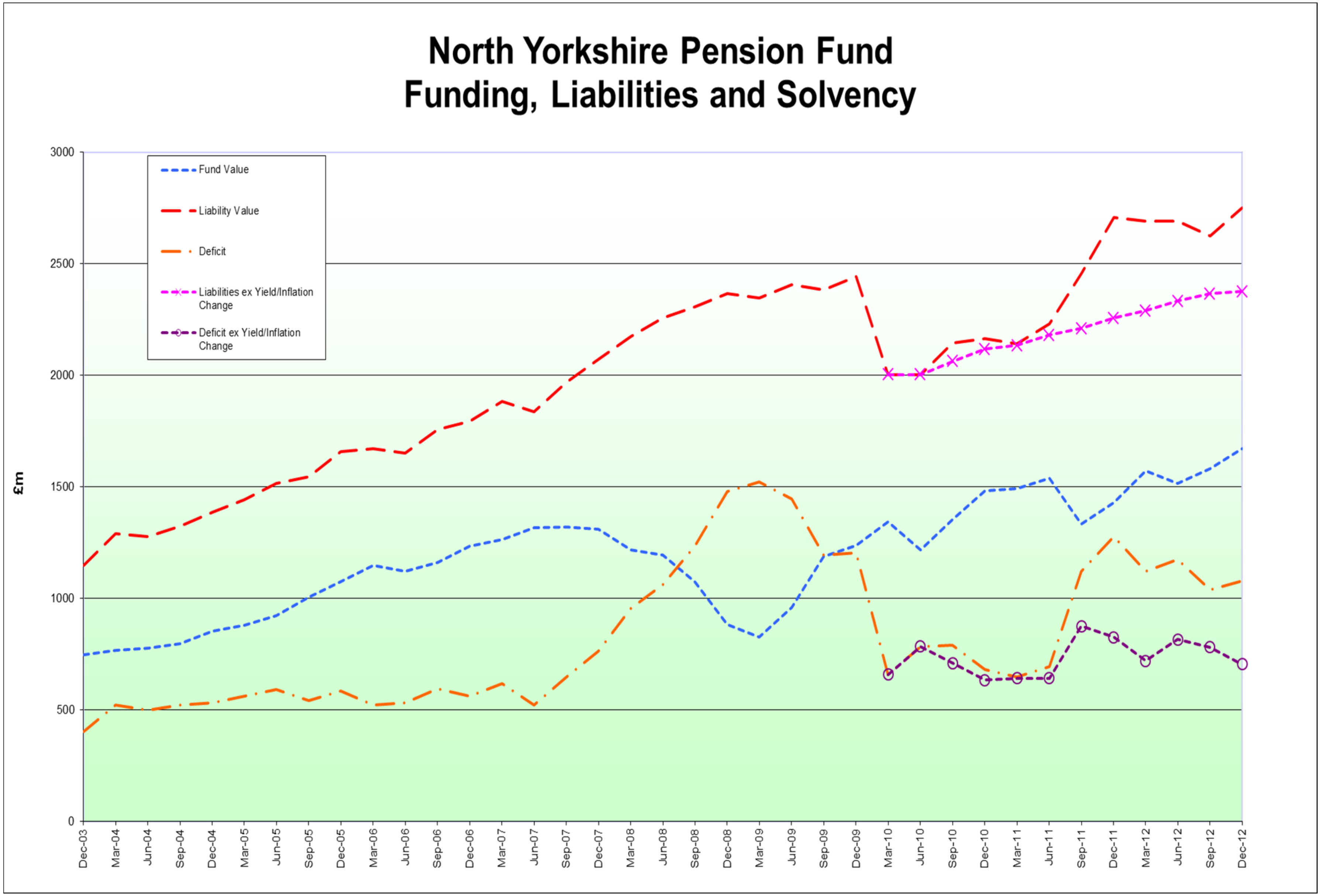
Actuarial Model of Quarterly Solvency Position

Date	Solvency	Deficit £(M)	Fund Value £(M)	FTSE 100
March 31, 2001	79%	187	724	5,634
June 30, 2001	82%	162	740	5,643
September 30, 2001	71%	265	650	4,903
December 31, 2001	74%	245	702	5,217
March 31, 2002	75%	245	732	5,272
June 30, 2002	60%	450	670	4,656
September 30, 2002	56%	435	574	3,722
December 31, 2002	58%	435	597	3,940
March 31, 2003	55%	478	584	3,613
June 30, 2003	61%	423	662	4,031
September 30, 2003	63%	408	695	4,091
December 31, 2003	65%	402	747	4,477
March 31, 2004	59%	524	767	4,386
June 30, 2004	61%	498	778	4,464
September 30, 2004	60%	524	799	4,571
December 31, 2004	62%	533	854	4,814
March 31, 2005	61%	563	879	4,894
June 30, 2005	61%	592	924	5,113
September 30, 2005	65%	542	1005	5,478
December 31, 2005	65%	585	1075	5,619
March 31, 2006	69%	523	1150	5,965
June 30, 2006	68%	531	1121	5,833
September 30, 2006	66%	595	1163	5,961
December 31, 2006	69%	561	1233	6,221
March 31, 2007	67%	619	1266	6,308
June 30, 2007	72%	522	1316	6,608
September 30, 2007	67%	648	1322	6,467
December 31, 2007	63%	763	1310	6,457
March 31, 2008	56%	958	1217	5,702
June 30, 2008	53%	1064	1195	5,625
September 30, 2008	47%	1235	1074	4,902
December 31, 2008	37%	1481	885	4,434
March 31, 2009	35%	1522	827	3,926
June 30, 2009	40%	1447	972	4,249
September 30, 2009	50%	1196	1187	5,134
December 31, 2009	51%	1204	1239	5,413
March 31, 2010	67%	659	1345	5,680
June 30, 2010	61%	785	1219	4,917
September 30, 2010	63%	791	1354	5,549
December 31, 2010	69%	681	1483	5,900
March 31, 2011	70%	648	1493	5,909
June 30, 2011	69%	695	1538	5,946
September 30, 2011	54%	1123	1335	5,129
December 31, 2011	53%	1277	1430	5,572
March 31, 2012	58%	1121	1571	5,768
June 30, 2012	56%	1176	1517	5,571
September 30, 2012	60%	1040	1584	5,742
December 31, 2012	61%	1079	1672	5,898

Triennial valuation results highlighted in grey

Movement in Assets and Liabilities





North Yorkshire Pension Fund
Funding, Liabilities and Solvency
Fund Value
Liability Value
Deficit
Liabilities ex Yield/Inflation Change
Deficit ex Yield/Inflation Change
£m
3000
2500
2000
1500
1000
500
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APPENDIX 4

REBALANCING OF NYPF ASSETS AS AT 31 DECEMBER 2012

Asset Class	Minimum Allocation to Non-Equities	Maximum Allocation to Non-Equities	Allocation as at Sept 2012	Current Allocation as at Dec 2012	Allocation After Rebalancing
Equity + Cash	75%	50%	72.3%	72.2%	72.2%
Bonds	15%	30%	18.0%	17.0%	17.0%
Alternatives (ex property)	5%	10%	7.4%	7.1%	7.1%
Property	5%	10%	2.4%	3.6%	3.6%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

		30-Sep-12 Value £m	31-Dec-12 Value £m	actual %	Min %	Min £m	Max %	Max £m	Under	Over			
Global Equity Managers													
Baillie Gifford Global Alpha		256.27	264.02	15.8%	11.0%	183.70	16.7%	278.89	0.00	0.00	0.00	264.02	15.8%
Baillie Gifford Global Growth		162.22	166.11	9.9%	5.6%	93.52	8.3%	138.61	0.00	-27.49	0.00	166.11	9.9%
	(a)	418.49	430.12	25.8%	16.6%	277.22	25.0%	417.50	0.00	-27.49	0.00	430.12	25.8%
Global (ex UK) Equity Managers													
Fidelity		351.32	366.46	21.9%								366.46	
	(b)	351.32	366.46	21.9%	16.7%	278.89	25.0%	417.50	0.00	0.00	0.00	366.46	21.9%
UK Equity Managers													
Standard Life		371.20	416.52	24.9%	20.4%	340.68	27.0%	450.90	0.00	0.00	-15.00	401.52	24.0%
Yorkshire Fund Managers		0.87	0.87	0.1%	0.0%	0.00	0.2%	3.34	0.00	0.00		0.87	0.1%
	(c)	372.07	417.39	25.0%	16.7%	278.89	25.0%	417.50	0.00	0.00	-15.00	402.39	24.1%
Equity sub-total	(a+b+c)=(d)	1141.88	1213.98	72.7%	50.0%	835.01	75.0%	1252.51	0.00	0.00	-15.00	1198.98	71.8%
Amundi		201.25	215.28	12.9%								215.28	
M & G		64.55	68.83	4.1%								68.83	
Fixed Income sub-total	(e)	265.80	284.11	17.0%	15.0%	250.50	30.0%	501.00	0.00	0.00	0.00	284.11	17.0%
ECM		116.52	119.09	7.1%								119.09	
Alternatives sub-total	(f)	116.52	119.09	7.1%	5%	83.50	10%	167.00	0.00	0.00	0.00	119.09	7.1%
Hermes		23.54	23.47	1.4%								23.47	
LGIM Property		0.00	24.74	1.5%								24.74	
Threadneedle		12.54	12.65	0.8%								12.65	
Property sub-total	(g)	36.08	60.85	3.6%	5%	83.50	10%	167.00	22.65	0.00	0.00	60.85	3.6%
Cash													
Internal Cash (Barclays a/c)		3.89	-11.04								15.00	3.96	
Currency Hedge Cash		5.72	3.01									3.01	
Cash sub-total	(h)	9.62	-8.02	-0.5%	0.0%	0.00	0.0%	0.00	8.02	0.00	15.00	6.98	0.4%
	(d+e+f+g+h)=(i)	**1569.90**	**1670.01**	**100.0%**									**100.0%**
RC Brown	(j)	2.43	2.52										
Total Assets	(i+j)=(k)	**1572.33**	**1672.53**										
Mellon Asset Servicing Report Total		1572.33	1672.53										