Agenda Item
1

Shetland Islands Council

Special Shetland Islands Council **21 May 2014**

Presentation from SOTEAG	
ISD-12-13-F	
Report Presented by Director of Infrastructure Services	**Infrastructure Services Department / Directorate**

1.0 Summary

1.1 The purpose of this report is to introduce a presentation from SOTEAG on their activities at Sullom Voe.

2.0 Decision Required

2.1 The Council are asked to NOTE the presentation.

3.0 Detail

3.1 Mike Richardson and David Paterson will give a presentation on SOTEAG's activities. The purpose of which is to keep the Council informed of any new developments at the terminal and its environs.

4.0 Implications

Strategic

4.1 Delivery On Corporate Priorities – None.

4.2 Community /Stakeholder Issues – None.

4.3 Policy And/Or Delegated Authority – None.

4.4 Risk Management – None.

4.5 Equalities, Health And Human Rights – None.

4.6 Environmental – None.

Resources

4.7 Financial – None.

4.8 Legal – None.

4.9 Human Resources – None.

4.10 Assets And Property – None.

5.0 Conclusions

5.1 Presentation provided by Mike Richardson and David Paterson of SOTEAG on the activities at Sullom Voe.

For further information please contact:
Maggie Sandison, Director of Infrastructure Services,
Tel: 01595 744851 / e-mail: Maggie.sandison@shetland.gov.uk
13 May 2014

Background Documents
Presentation by SOTEAG – copies will be issued on the day

END

Agenda Item
2

Shetland Islands Council

Special Shetland Islands Council **21 May 2014**

Shetland Islands Enterprise Fund (Aventa Capital Partners Ltd)	
Report No: DV022-F	
Report from: Director of Development Services	**Directorate: Development**

1.0 Summary of issue

1.1 The purpose of this report is for the Council to hear a presentation by Aventa Capital Partners Ltd (Aventa) regarding a 'Shetland Islands Enterprise Fund' which they intend to set up.

1.2 Specifically, Aventa have requested a Letter of Support from the Council, which is currently undergoing a due diligence process.

2.0 Decision Required

2.1 That Shetland Islands Council note the content of this report and receive a presentation from Aventa regarding their proposed fund.

3.0 Detail of Issue

3.1 Aventa are a Venture Capital company who are proposing to raise £500m investment capital for a Shetland based investment portfolio.

3.2 Representatives of Aventa visited Shetland on 25 April 2014 and met with various Council and HIE officers. The meeting was originally requested by Tavish Scott, MSP, but due to other commitments, Mr Scott was unable to attend the meeting on 25 April. A copy of the presentation given by Aventa at the meeting is attached as Appendix 1.

3.3 Aventa are keen to include public sector projects in their list of investible projects which the fund could invest in.

4.0 Implications

Strategic

4.1 Delivery on Corporate Priorities – None.

4.2 Community /Stakeholder Issues – None.

4.3 Policy and/or Delegated Authority - This report is for noting only.

4.4 Risk Management – None.

4.5 Equalities, Health and Human Rights - None.

4.6 Environmental - None.

Resources

4.7 Financial – None.

4.8 Legal - None.

4.9 Human Resources - None.

4.10 Assets And Property - None.

5.0 Conclusions

5.1 Aventa are proposing to set up a 'Shetland Islands Enterprise Fund', and will brief members directly on the details of their plans.

For further information please contact:
Neil Grant, Director of Development Services
Tel: 01595 744968, E-mail: neil.r.j.grant@shetland.gov.uk
13 May 2014

List of Appendices
Appendix 1 – Presentation

Shetland Islands Enterprise Fund

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Investment Overview

To participate as an active equity sponsor of regeneration focused development projects and related services companies in the Shetland Islands.

Focus on long term ownership and growth in operations with a bias towards internally generated transactions, leveraging Aventa's network and resources in Shetland.

- Combination of locally based senior management with global investment professionals. Team with a combined investment experience of over 200 years, extensive local industry knowledge and government network.
- Internally generated projects provide a robust investment pipeline and diversified risk. Aventa has an established track record of sourcing and executing on development projects.
- Total return fund combining equity and senior debt targeting £500m of private funding into Shetland Islands
- Targeted gross equity IRR of circa 14% - blended return of 10% plus.
- Projects with significant long term economic impact and sustainable benefits
- Multiple exit opportunities including IPO of the development company on recognised exchanges OR secondary equity sales.





Shetland Islands

The islands are 80 km to the northeast of Orkney and 280 km southeast of the Faroe Islands. The total area is 1,468 km^2 and the population totalled 23,167 in 2011.

- The main industries focus on
  - Aquaculture and fishing
  - Renewable energy to supply the new industries
  - Petroleum industry
  - Creative and tourism
- Vision
  - Invest wisely and share risk
  - Plan for long term growth
  - Attract industries
  - Diversify reliance on oil
  - Attract private capital for social investment

Demand for Regeneration Infrastructure

- 35% of the UKs offshore oil assets lying North of the Shetlands. Local infrastructure is already at capacity.
  - Regeneration of obsolete infrastructure
  - Expansion and modernisation of existing facilities
  - Renewable energy to supply the new industries
- Sullom Voe refinery and gas terminal demands better road, sea and air infrastructure.
- Need to provide sustainable long term investment for the islands post the oil boom
  - To grow the tourist market
  - Aid marine industries develpment





Contents





Infrastructure Characteristics

Two Classes of Infrastructure Assets

Development Capital

- *Involves construction of a specific asset with reversion at end of concession*
- *Bid costs material and long lead times (circa 2-4 years in procurement)*
- *Small equity investment even on large deals with upside limited to refinancing post construction and portfolio re-leverage*
- *No yield during construction (can take 5-10 years to build)*

Operational Assets

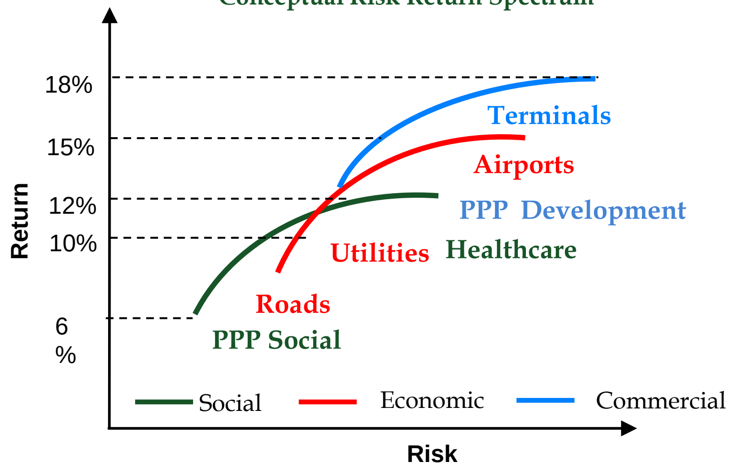
- *Significantly larger than asset based concession financing*
- *Real businesses with investment linked to capacity and operational growth*
- *Large equity investments with immediate yield*
- *Equity upside linked to growth, operating efficiency and financial restructuring*

Balanced Exposure

Infrastructure

Social	Economic	Commercial
Accommodation	Rail	Satellites
Healthcare	Road	Cable Networks
Education	Airports	Terminal facilities
Security	Ports	Mobile phone towers
Police	Bridges/Crossings	Industrial
Army	Energy	
Justice	Water	
	Communications	

Conceptual Risk Return Spectrum



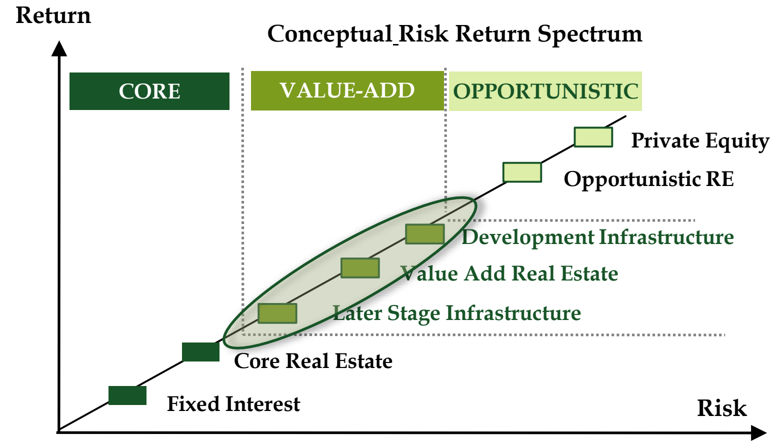
Focus and Return Profile

Infrastructure Characteristics

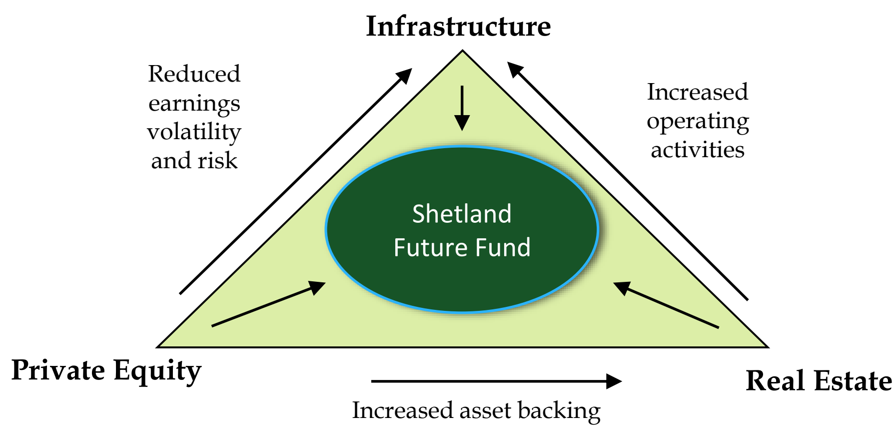
- Broadly, infrastructure recognised as between private equity and core real estate on the risk/ return spectrum
  - IRRs range from 8 to 15% depending on asset risk profile
  - Investors are also yield driven and seeking investments capable of generating average 6% cash yields
- Key defining characteristics

Extremely transparent, predictable and stable inflation linked cash flows

- Typically monopolistic or with high economic barriers to entry
- High degree of investment protection through legislation, regulation, contracts, environmental directives etc
- Defensive Investments - low correlation to equity markets
- Limited operational risk
- Potential for sustainable high levels of leverage
- Transactions tend to be sizeable
- Investors with extremely long term hold periods often in excess of 10 years



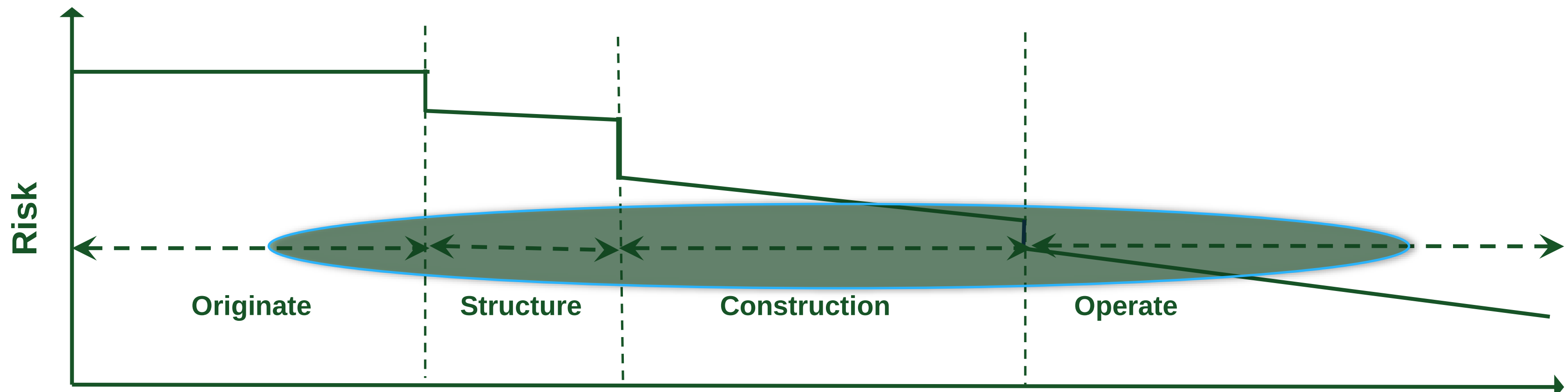
Differentiating Features of Infrastructure







Investment Scope



Timeline	18-30 months	6 months	up to 48 months	Ongoing
Shetland Future Fund	12-18%			





Scope of Activity

Originate	Structure	Construction	Operate
EXECUTE INJECT EQUITY	EXECUTE / MANAGE INJECT EQUITY & DEBT	MANAGE INJECT EQUITY & DEBT	MANAGE

Originate

- Source deals
- Liaise with Government
- Identify consortium partners
- Short list financial advisors, SPV management, project manager, contractor, operators and other consultants
- Initiate and monitor design and engineering
- Secure land
- Undertake legal and technical due diligence
- Secure Planning consents
- Implement Governance arrangements

Structure

- Negotiate and execute contractual agreement
- Arrange guarantee / bonding
- Structure equity (contractors, vendors, strategics)
- Structure debt
- Acquire Land
- Finalise SPV management
- Negotiate and sign project management contract
- Negotiate and sign construction contract
- Finalise operator
- Procure construction and pre-operational licences and permits

Construction

- Monitor design and engineering
- Purchase plant and equipment
- Procure completion certificates
- Procure final licences and permits

Operate

- Performance management
- Asset management
- Recruit operational Management
- Implement Governance arrangements





Investment Philosophy

- Focus on Opportunities with :
  - Strategic market position
  - Strong operating growth
  - Aligned to Industry growth
- Equity Oriented Approach
  - Internal origination
  - Access team's proprietary local network to identify and diligence
  - Aventa controls development and significant influence in op
- Investor Alignment
  - Aventa Principles invested in Fund
  - Mangers paid on performance
- Strong Investment Returns
  - Solid returns of 10%+
  - Asset backed and
  - Inflation correlated revenue
  - Contractually underpinned
  - Strong barriers to entry
- Approach To Financial Risk
  - Availability of Government grants
  - Low leverage
- Environment and Social Impact
  - UN Principles Responsible Investing
  - Triple Bottom Line
  - Supervisory Board
  - Catalytic and Impactful





Team Structure

- Management Advisors
- Board of Directors
- Investment Committee

- Chief Executive Officer
  - Chief Financial Officer
  - Chief Investment Officer
  - Head of Operations
    - Operations Team
  - Head of Business Development
    - Bus Development
  - Govt and Investor Relations
    - IR Team
  - Investment Director
    - Senior Debt Team
  - Investment Director
    - Social Infrastructure
  - Investment Director
    - Energy & Utilities Team
  - Investment Director
    - Transport and Tourism Team





Shetland Future Fund LP

Corporate Board

Chairman	Investor Appointed Chairman
TBC	Non Executive Director
TBC	Investor Appointed Director
David Bates	Aventa Appointed Director
Michael Carrick	Aventa Appointed Director

Executive Management

Frank Strang	Chief Executive Officer
Chris Grindal	Chief Financial Officer
Shaun Meadows	Investment Relations Director
David Bates	Investment Director
Phil Davies	Investment Director
Seamus Kealey	Operations Director
John Beer	Operations Director
Peter Thomas	Planning and Programme Director
Andrew Morpeth	Investment Manager
Marc Templer	Investment Manager
Will Bates	Investment Analyst





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Investment Limits

aventa

Social	Economic	Commercial

Economic: Energy, Transport

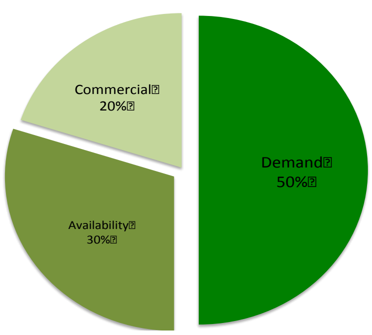
Social
- Accommodation
- Education
- Security
- Healthcare

Energy
- Power (thermal, hydro)
- Water
- Renewables
- Electricity transmission
- Distribution
- Pipelines

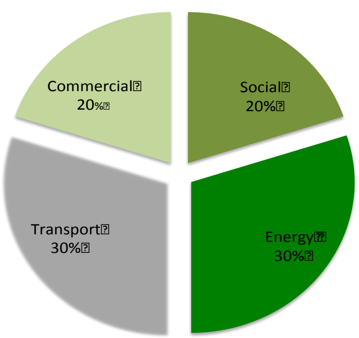
Transport
- Roads
- Railways
- Ports
- Airports
- Logistics

Commercial
- Storage and distribution
- Cable networks
- Mobile phone towers
- Industrial

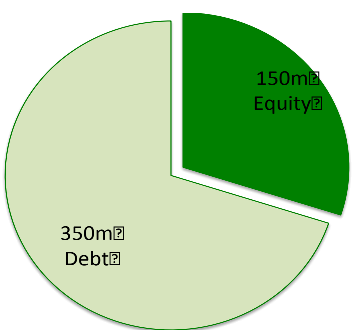
Anticipated Sector Concentration



Anticipated Risk Profile



Anticipated Funding Profile







Project pipeline

	Yell Bridge	Bressay tunnel	Viking Energy	Whalsay tunnel
Impact	Fixed transport link between Yell & Unst Tidal power generation	Fixed link between Bressay and Lerwick Allows port expansion	Large scale wind farm generating 370MW, 35 permanent jobs, 140 construction jobs	Fixed link from Main island to Whalsay
Multiple revenue streams	Bridge toll, Removal of ferry subsidy, Tidal power	Tolls Ferry subsidy	Electricity sales	Tolls Ferry subsidy
Alpha	High	High	High	High
Gov support	Grant + tariff	Grant + tariff	CFD	Grant + tariff
Infrastructure	Core	Core	Core	Core
Internally originated	Aventa	Aventa	Aventa	Aventa
Debt Capacity	Yes	Yes	Yes	Yes





Project pipeline

	Yell Bridge	Bressay tunnel	Viking energy	Whalsay tunnel
Returns	12%-14%	12%-14%	14%-18%	12%-14%
Asset backed	700 acres 1.2 km sheet piled quay	830 acres	140 acres	1,100 acres
Contracts	Availability + Shadow Toll	Availability + Shadow toll	PPA	Availability + shadow Toll
Commercial uplifts	Advertising Communications	Advertising	Education	Advertising
Control	100%	100%	50%	100%





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Investment Offering Structure

- Structure UK Limited Partnership Fund (LP)
- Listed Feeder UK LSE Listed Feeder Partner
- Mandate Shetland Islands Future Fund Ltd
- Size £ 500m
- 1st Close £ 200m
- Target returns 12% - 14%
- Fund Manager Aventa Capital Partners
- Fees 1.25% management, 15% performance fee
- Asset class Infrastructure, Regeneration
- Legal Advisors Stephenson & Harwood
- Bankers Santander
- Auditors BDO
- Administrators Langham Hall





Shetland Islands Council

Shetland Islands Council **21 May 2014**

Pension Fund Management Annual Review 2013/14	
F-018-F	
Report Presented by Executive Manager - Finance	**Corporate Service**

1.0 Summary

1.1 The purpose of this report is to inform Members on the position and performance of the Council's Pension Fund external investments, with fund managers for the financial year 2013/14.

1.2 This report also fulfils a requirement under The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 for the Council, as administering authority for the Pension Fund, to keep investment managers' performance under review.

1.3 From this report there are recommendations to note fund manager performance during 2013/14. To note performance as either satisfactory where a manager's performance is above benchmark and target, or to just note performance where the manager's performance was above benchmark but below target, or to note performance as unsatisfactory where the manager's performance was below benchmark.

2.0 Decision Required

2.1 It is recommended that the Council:

- note with satisfaction the performance of BlackRock (equity and bond fund) in 2013/14; and
- note with dissatisfaction the performance of Schroders (property fund) in 2013/14.

3.0 Detail

3.1 The Pension Fund has two fund managers, with total investments under management at the end of March 2014 of £333 million. These investments are split between the following managers and asset classes as follows:

Funds under Management at 31 March 2014

Manager	Fund	% of Reserves
BlackRock	Equity and Bond	93
Schroders	Property	7

3.2 BlackRock and Schroders will both give presentations at this Council meeting concerning their investment performance over the year to end March 2014.

3.3 Karen Thrumble will attend the meeting from WM Company, which is part of State Street. WM Company are a performance analyst company, and they independently monitor and report to the Pension Fund on each investment manager's performance. Karen will analyse each fund manager's performance relative to the markets they invest in, before that Fund Manager's presentation to the Council.

3.4 Along with this report are attached the presentational documents from BlackRock and Schroders plus a pension performance report from the WM Company covering the relevant funds.

3.5 The external investments of the Pension Fund are co-ordinated by the Council's Treasury function. The Council's reserves and Charitable Trust's reserves (as per Service Level Agreement) are also co-ordinated by the Council's Treasury function. This approach delivers a unified approach; ensures that all the funds benefit from the knowledge and experience of Council Officers; and provides useful comparisons.

3.6 The Council's Pension Fund is in a growth phase where incomes from Council and Employee contributions are projected to exceed benefits paid for some time to come. Consequently, a long-term investment strategy is appropriate. This allows us to have a higher percentage of equity investments, which in itself produces a greater volatility of returns over the short to medium term, i.e. 1-3 years, but is less evident over longer periods. Over the long term this investment policy has proved beneficial with the Pension Fund up 84% over the last 5 years.

3.7 At the last actuarial review in 2011 the Pension Fund was 91% funded, with employer contributions set at 18.7% for Council employees in 2013/14.

3.8 The managers, type of mandate and market value are listed below:

Manager	Mandate	Market Value £ million 2014	Market Value £ million 2013
BlackRock	Equities and Bonds	310	285
Schroders	Property	23	21
		333	306

3.9 During 2013/14 the market value of the Pension Fund increased by £27 million, an increase of 8.8%.

3.10 In this report I will review each fund manager in turn and compare their performance in 2013/14 against the market performance where they were asked to invest, and also against the additional out performance target we asked them to achieve.

3.11 Due to the nature of the investments these managers are investing into, we take a long term investment view, generally a five year period. I will therefore not only look at each manager's performance over 2013/14 but I will also look at their performance over a five year period, or from inception of the mandate if that is shorter.

3.12 In the main, this report concentrates on manager performance relative to the markets but we also need to consider the effect of any cash withdrawals or injections to the funds and the performance of the markets themselves. These influences can easily alter the absolute fund value.

3.13 The following table shows the effect on the fund due to withdrawals/additions and the investment return.

	Pension Fund £ million
As at 31.03.13	306
(Withdrawals)/Additions	7
Investment Return	20
As at 31.03.14	333

3.14 The figures show how an investment return of £20 million has benefited the overall investments during the year. This equates to an investment return of 6.5%. The £7 million of additions is in main due to the difference between the employer and employee contributions (Council and admitted bodies) versus the pension payments during the year.

3.15 The 2013/14 market performance by asset class is set out below:

		%
Equities:	UK	8.8
	North America	10.3
	Europe (Ex UK)	17.3
	Japan	-1.6
	Pacific (Ex Japan)	-5.8
	Emerging	7.7
Bonds:	UK Index Linked Gilts	-3.8
	UK Corporate	-2.6
Property		14.0
Cash		0.4

3.16 As can be seen from the asset returns in 2013/14 there were large differences between the major equity sectors, bond markets were generally negative while property had a very good year producing double digit returns. The fund manager has negligible influence over the market's return but they may be required by the mandate agreement to invest into these markets. The main constituent of a fund's performance is the market return, i.e. where the fund is invested. A fund manager is only asked to outperform the market return, i.e. a UK equity scenario in 2013/14 where a fund manager is asked to outperform the market by 2% would equate to a 10.8% target return.

3.17 This report reviews performance in 2013/14; a quick update for the start of this financial year sees continued uncertainty surrounding the political situation in Ukraine, which creates concern within the equity markets. Improved economic figures from the UK, Europe and America have helped the markets but there are still real economic problems to be faced.

3.18 During 2014/15 a new investment strategy, which was approved by the Council in March 2014, will be put into place. This strategy will focus on achieving a 100% funding level over a period of time, which is before the Pension Fund's contributions equal benefits payable. The new strategy will add three new mandates to the current two with BlackRock and Schroders. The tender processes for the new mandates will be conducted by Hymans Robertson in conjunction with Finance. The final selection for each mandate will be made by the Council later this year.

4.0 Fund Manager Review

4.1 The rest of this report takes each mandate in turn and discusses manager performance.

4.2 A Fund Manager's performance is measured against a specific fund benchmark, which is made up of market indices of the countries where they invest.

4.3 A Fund Manager's target is a level of outperformance above the benchmark that is seen as achievable with a low level of measured risk on a given mandate. The Manager will actively seek to produce investment returns in order to achieve the stated target. Performance at or above target is desirable but any returns above the benchmark will add value to the fund above the market return.

Schroders - Property Fund

4.4 Schroders were awarded a £20 million Property Mandate in March 2007 with the first investments commencing in July 2007. It was agreed that Schroders would be allowed time to invest, to give added protection to the capital value of the investment. Schroders have therefore only invested when good opportunities arose, to the extent that they achieved full investment of the fund during the later part of 2010/11.

4.5 The benchmark for this fund is based on a 100% UK property investment. The fund manager does however have the scope to invest up to a maximum of 30% of the fund in overseas property if attractive investment opportunities exist. The performance target for this fund is to beat a specific benchmark by 1.0% per annum.

4.6 Schroders have used the flexibility in the mandate to invest in their European property fund. This investment is currently about 12% of the overall mandate. This investment initially outperformed but over the last few years has been a drag on performance due to the general European economic climate.

4.7 The following table sets out in summary the performance of Schroders versus the benchmark and the performance target in 2013/14, on a cumulative basis over a five-year investment period and since inception of the mandate in July 2007.

Fund Performance versus Benchmark and Target

	Fund Return (%)	Performance v Benchmark (%)	Performance v Target (%)
2013/14	8.6	-2.9	-3.9
Five years 08/09 to 12/13	-15.7	-19.4	-23.3
Since Inception July 2007	6.7	17.1	9.5

The performance v benchmark figure gives the percentage that the fund has out or underperformed the benchmark return (market indices).

The performance v target figure gives the percentage that the fund has out or underperformed the set target.

4.8 The Property Fund with Schroders in 2013/14 increased in value by 8.6%, which was 2.9% below the benchmark return and 3.9% below the target. The UK property market investment outperformed but the European investment struggled and dragged down the overall return.

4.9 On a cumulative basis over the five year rolling monitoring period Schroders are below the benchmark return by 19.4%. Over this period the UK property investments have outperformed the benchmark but it is the European investment, due to the economic climate, that has pulled down the five year return figure.

4.10 The fund's cumulative performance from inception (July 2007) is above the benchmark by 17.1%. This performance is due to initial cash holdings and the European property investment.

4.11 Over the first couple of years The European property investment produced very good returns but due to the economic climate in Europe over the last 5 years this investment has struggled and pulled overall returns down. Property is a long term investment and fits well into a Pension strategy.

4.12 Schroders initially received £10 million in July 2007, since then they have periodically requested funds until full investment of the mandate (£20 million) was achieved in the later part of 2010/11. Since July 2007 property markets have fallen about 9% but Schroders has maintained the fund value, which stood at £22.7 million at the end of March 2014. Schroders have used the time well during difficult markets to achieve exposure to the property market. They invested when good opportunities arose to avoid incurring capital losses.

BlackRock - Equity and Bond Fund

4.13 BlackRock was initially a large US fund management business but over the past few years they have acquired Merrill Lynch and BGI, to become one of the largest global fund managers.

4.14 BGI (now BlackRock) was initially appointed as the Pension Fund's transition manager and in that role they have the capability to hold funds on a passive basis, i.e. track the market indices. The Pension Fund is currently making use of this facility, after the decision (min ref 160/08) to terminate Capital International's management of the mandate. BGI conducted the transfer of the fund's assets near the end of 2008, with performance monitoring commencing 1st January 2009.

4.15 BlackRock's benchmark for this fund is based on 45% UK Equities, 45% Overseas Equities and 10% bonds. As the fund is passively invested the benchmark and the target are the same, i.e. one aim the index return. For performance comparison purposes the fund return is only compared against the index return. As the fund is trying to achieve the index return, it is the closeness of the performance to the index that is important. A passive investment takes away the manager risk leaving just the market risk.

4.16 The following table sets out in summary the performance of BlackRock versus the benchmark return for 2013/14 and also on a cumulative basis over a five-year investment period.

Fund Performance versus Benchmark

	Fund Return (%)	Performance v Benchmark (%)
2013/2014	6.4	0.2
Five years 09/10 to 13/14	91.0	0.4

The performance v benchmark figure gives the percentage that the fund has out or underperformed the benchmark return (market indices).

4.17 The equity and bond fund with BlackRock increased in value by 6.4% in 2013/14, which is 0.2% above the benchmark return. This shows the fund has mirrored the market return very closely.

4.18 On a cumulative basis over the five year rolling monitoring period the fund is 0.4% above the benchmark return, which is close to the fund's investment aim. During this five year period the fund has increased in value by 91.0%, which equates to a return of 13.9% per annum.

5.0 Implications

Strategic

5.1 Delivery On Corporate Priorities – This report links to the Council's corporate priorities, defined in its Corporate Plan, specifically in relation to assisting the Council in ensuring the financial resources are managed so that the Council can sustain and develop the economy.

5.2 Community /Stakeholder Issues – None.

5.3 Policy And/Or Delegated Authority – In accordance with Section 2.2 of the Council's Scheme of Administration and Delegations, the Executive Committee has delegated authority to secure the co-ordination, control and proper management of the financial affairs of the Council. However, the performance of Fund Managers is a matter reserved for the Council.

5.4 Risk Management – All investments carry some degree of investment risk but these risks are actively managed and minimised through diversification of fund managers, assets, benchmarks, markets, size of holdings etc..

5.5 Equalities, Health And Human Rights – None.

5.6 Environmental – None.

Resources

5.7 Financial – The long-term performance of the Pension Fund is one of the criteria that can affect the overall funding level of the Pension Scheme. This funding level then influences the contribution rate the Council is required to make into the Pension Scheme.

5.8 Legal – As required by The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010, where investment managers have been appointed their performance is to be kept under review by the Council.

5.9 Human Resources – None.

5.10 Assets And Property – None.

6.0 Conclusions

6.1 Schroders underperformed their benchmark by 2.9% in 2013/14, during a positive returning UK property market. Over the five year period Schroders are below the benchmark but since inception of the mandate in July 2007 they are above the benchmark. These returns are reflective of the volatility of the European investment.

6.2 BlackRock is 0.2% above their benchmark for 2013/14, and over the five year period they are 0.4% above their benchmark. An index tracking fund tries to replicate the market performance and this performance is very close to that aim.

6.3 Returns from equity, bond and property markets were mixed with some markets producing good returns while others reduced in value. This along with the fund managers' management of the funds helped to contribute £20 million in value to the Pension Fund during 2013/14.

For further information please contact:
James Gray, Executive Manager of Finance
Telephone: 01595 744607
E-mail: james.gray2@shetland.gov.uk

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Shetland Islands Council

Shetland Islands Council **21 May 2014**

Fund Management Annual Investment Report 2013/14	
F-017-F	
Report Presented by Executive Manager - Finance	**Corporate Service**

1.0 Summary

1.1 The purpose of this report is to inform Members on the position and performance of the Council's external investments with fund managers for the financial year 2013/14.

1.2 This report also complies with the consent issued by the Scottish Ministers under the Local Government Investments (Scotland) Regulations 2010, and with the requirements of the CIPFA Code of Practice for Treasury Management in Public Services, in respect of the requirement to report to the Council an annual investment report, which evaluates the Council's investment performance for the previous financial year.

1.3 From this report there are recommendations to note fund manager performance during 2013/14. To note performance as either satisfactory where a manager's performance is above benchmark and target, or to just note performance where the manager's performance was above benchmark but below target, or to note performance as unsatisfactory where the manager's performance was below benchmark.

2.0 Decision Required

2.1 It is recommended that the Council:

- approve the Annual Investment Report for 2013/14 for the purposes of the consent issued by the Scottish Ministers by virtue of section 40 of the Local Government in Scotland Act 2003;

- note the performance of BlackRock (passive equity fund) in 2013/14; and

- note the performance of Insight (bond fund) in 2013/14; and

- note with satisfaction the performance of Baillie Gifford (diversified growth fund and equity fund) in 2013/14.

3.0 Detail

3.1 The Council has three fund managers, with total investments under management at the end of March 2014 of £204 million.

3.2 During 2013/14 the Council approved a new investment strategy. This new strategy resulted in one fund manager change; GMO's active equity mandate was replaced with a passive equity mandate managed by BlackRock. A Diversified Growth Fund mandate was added to the strategy, which is managed by Baillie Gifford.

3.3 The reorganisation of the Council's Reserves occurred at the end of September 2013, with performance monitoring of the new strategy commencing at the start of October 2013. One requirement of the new investment strategy was a reduction in overall fund manager fees. This was achieved as the fees in 2012/13 were £925,000, this will be reduced to around £830,000 for 2013/14, with the new strategy implemented during 2013/14. The fees should fall to around £650,000 for 2014/15 based on the current level of Council Reserves.

3.4 As per the new investment strategy the Council's Reserves are now invested with three fund managers Baillie Gifford, BlackRock and Insight. Their specific mandates and benchmark percentage allocations are as follows:

Manager	**Fund**	**% of Reserves**
Baillie Gifford	Active Equities Diversified Growth Fund	25% 17.5%
BlackRock	Passive Equities	30%
Insight Investment Management	Bonds Liquid Bond Fund	15% 12.5%

These allocations were set when the investment strategy was put in place at the end of September 2013. Since then markets have moved and funds have been recalled, which has altered these percentages but not sufficiently to warrant any corrective action. As the investments are in assets whose values are constantly changing there has to be flexibility around these initial levels.

3.5 The managers, percentage of Reserves and market value at the end of March 2014 are as shown below:

Manager	% of Reserves	Market Value £ million 2014	2013
Insight	23%	47	53
BlackRock (GMO 2013)	30%	61	66
Baillie Gifford	47%	96	87
		204	206

3.6 Baillie Gifford, BlackRock and Insight will all give presentations at this Council meeting concerning their investment performance over the year to end March 2014.

3.7 Karen Thrumble will attend the meeting from WM Company, which is now part of State Street Global Services. WM Company are performance analysts, and they independently monitor and report quarterly the performance of each fund manager. Karen will analyse the performance of each fund manager relative to the markets they invest in, before that Fund Manager gives a presentation to the Council.

3.8 You will also receive along with this report a presentational document from Baillie Gifford, BlackRock and Insight, plus a performance analysis report from WM Company on each of the fund managers mandates.

3.9 The external investments of the Council (i.e. other than those invested in the local economy) are co-ordinated by the Council's Treasury function. The Pension Fund and Charitable Trust's reserves (as per a Service Level Agreement) are also co-ordinated by the Council's Treasury function. This approach delivers a unified approach; ensures that all the funds benefit from the knowledge and experience of Council Officers; and provides useful comparisons.

3.10 At section 4 in this report I will review each fund manager in turn and compare their performance in 2013/14 against the market's performance where they were asked to invest, and also against any additional out performance target we may have asked them to achieve.

3.11 Due to the nature of the investments the fund managers are investing into, a long term investment view is appropriate, generally a five year period. I will therefore not only look at each manager's performance over 2013/14 but I will also look at their performance over a five year period, or from inception of the mandate if that is shorter.

3.12 In the main this report concentrates on fund manager performance relative to the markets but we also need to consider the effect of any cash withdrawals or injections to the funds, and the performance of the markets themselves. These influences can easily alter the absolute fund value.

3.13 The following table shows the effect on the fund due to withdrawals/additions, the investment return over the financial year to March 2014 and as a comparison the previous financial year.

	SIC Funds £ million	
	2013/14	2012/13
Opening Value	206	193
(Withdrawals)/Additions	(16)	(16)
Investment Return	14	29
Closing Value	204	206

3.14 During 2013/14 the value of the Council's reserves decreased by £2 million.

3.15 The figures show an overall investment return of £14 million for the financial year 2013/14. This equates to an investment return of 6.8% on the opening fund value. This return was predominately from equity markets, plus active fund management in those markets.

3.16 The withdrawals from the SIC Funds totalled £16 million; £7 million from Insight and £9 million from GMO/BlackRock during the financial year to March 2014. This equates to 7.8% of the opening fund value. These withdrawals are required to cover the Council's revenue deficit and capital works programme.

3.17 The Council aims to keep a working balance in its Bank Account, i.e. a minimum balance of £2 million. Withdrawals from the investments were intended to cover payments while maintaining the minimum balance. The decision on where to withdraw funds was based on the investment strategy, performance of managers, asset class returns and from profit positions.

3.18 Cash withdrawals from the Council's reserves of £16 million are unsustainable. Withdrawals of this size over the long term would reduce the reserves further, and are greater than long term average expected returns, on the current reserve's value.

3.19 The 2013/14 market performance by asset class is set out below:

		%
Equities:	UK	8.8
	North America	10.3
	Europe (Ex UK)	17.3
	Japan	-1.6
	Pacific (Ex Japan)	-5.8
	Emerging	7.7
Bonds:	UK Index Linked Gilts	-3.8
	UK Corporate	-2.6
Property		14.0
Cash		0.4

3.20 As can be seen from the asset returns in 2013/14 there were large differences between the major equity sectors, bond markets were generally negative while property had a very good year producing double digit returns. The fund manager has negligible influence over the market's return but they may be required by the mandate agreement to invest into these markets. The main constituent of a fund's performance is the market return, i.e. where the fund is invested. A fund manager is only asked to outperform the market return, i.e. a UK equity scenario in 2013/14 where a fund manager is asked to outperform the market by 2% would equate to a 10.8% target return.

3.21 This report reviews performance in 2013/14; a quick update for the start of this financial year sees continued uncertainty surrounding the political situation in Ukraine, which creates concern within the equity markets. Improved economic figures from the UK, Europe and America have helped the markets but there are still real economic problems to be faced.

4.0 Fund Manager Review

4.1 The rest of this report takes each mandate in turn and discusses manager performance.

4.2 A Fund Manager's performance is measured against a specific fund benchmark, which is made up of market indices of the countries where they invest.

4.3 A Fund Manager's target is a level of outperformance above the benchmark that is seen as achievable with a low level of measured risk on a given mandate. The Manager will actively seek to produce investment returns in order to achieve the stated target. Performance at or above target is desirable but any returns above the benchmark will add value to the fund above the market return.

BlackRock

4.4 BlackRock has managed this fund since October 2013, when it was transferred from GMO. This fund transfer was part of the changes required as per the new investment strategy.

4.5 GMO managed an active equity fund (60% UK equities and 40% overseas equities) for the first 6 months of the financial year. Over this 6 month period GMO's investment performance returned 4.0%, which outperformed their benchmark by 0.3%.

4.6 BlackRock was initially a large US fund management business but over the past few years they have acquired Merrill Lynch and BGI, to become one of the largest global fund managers.

4.7 BlackRock's benchmark for this fund is based on 75% Global Equities and 25% Emerging Market Equities. As the fund is passively invested the benchmark and the target are the same, i.e. one aim the index return. For performance comparison purposes the fund return is only compared against the index return. As the fund is trying to achieve the index return, it is the closeness of the performance to the index that is important. A passive investment takes away the manager risk leaving just the market return risk.

4.8 The following table sets out in summary the performance of BlackRock versus the benchmark return for the six month period from October 2013 to end of March 2014.

Fund Performance versus Benchmark

	Fund Return (%)	Performance v Benchmark (%)
6 Months Oct – Mar 2013/2014	2.7	-0.3

The performance v benchmark figure gives the percentage that the fund has out or underperformed the benchmark return (market indices).

4.9 BlackRock returned 2.7% during the 6 month period, which was 0.3% below the benchmark return. This is a very short period of time to look at any performance figures, and there would have been initial transaction costs at the start of the mandate.

Insight

4.10 Insight has managed this fund since 2001. Insight is owned by Bank of New York Mellon (BONYM). BONYM have various investment businesses throughout the world but generally leave the companies alone to continue with their specialist services.

4.11 Insight's fund was reorganised within the new investment strategy at the end of September 2013. Insight's mandate was invested for the first 6 months of 2013/14 against a benchmark comprising 40% in UK Government Gilts, 40% in Corporate Bonds and 20% in a bond fund benchmarked against a 3-month cash index.

4.12 In line with the new investment strategy Insight's mandate was reorganised with a new benchmark from October 2013. This benchmark comprises a bond portfolio with 33.3% in Corporate Bonds, 33.3% in Index Linked Gilts and 33.4% in a bond fund benchmarked against a 3 month cash index.

4.13 Insight also has another portfolio, which is invested in a cash and short dated bond fund. This fund is benchmarked against a cash benchmark. This fund will be used for any future cash recalls from Reserves, which will leave the long term investments alone.

4.14 Insight's performance target for this fund is to beat the specific benchmark by 1.2% per annum. Prior to October 2013 the target was 1.5%.

4.15 The following table sets out in summary the performance of Insight versus the benchmark and the performance target in 2013/14, also on a cumulative basis over a five-year investment period.

Fund Performance versus Benchmark and Target

	Fund Return (%)	Performance v Benchmark (%)	Performance v Target (%)
2013/14	1.1	1.0	-0.4
Five years 09/10 to 13/14	34.4	7.0	1.3

The performance v benchmark figure gives the percentage that the fund has out or underperformed the benchmark return (market indices).

The performance v target figure gives the percentage that the fund has out or underperformed the set target.

4.16 Insight returned 1.1% in 2013/14, which was 1.0% above the benchmark return and 0.4% below the target. The Fund has produced a positive return during 2013/14 in a flat bond market.

4.17 On a cumulative basis over the five-year rolling monitoring period Insight are 7.0% above the overall benchmark return, and 1.3% above the target. The fund has over the five-year period increased in value by 34.4%, which equates to 6.1% per annum.

4.18 Insight has over the long term outperformed the benchmark, added value to the fund, and outperformed the set target.

Baillie Gifford

4.19 Baillie Gifford has managed this fund since 2001.

4.20 Baillie Gifford's fund was reorganised in line with the new investment strategy at the end of September 2013. Baillie Gifford's mandate was therefore invested for the first 6 months of 2013/14 against a benchmark comprising two of their funds, the UK Alpha Fund 39% (UK equities), and the Global Alpha Fund 61% (overseas equities).

4.21 In line with the new investment strategy Baillie Gifford's mandate was reorganised with a new benchmark from October 2013. This benchmark comprises 30% UK Alpha Fund, 30% Global Alpha Fund and 40% in a Diversified Growth Fund.

4.22 The performance target for this fund is to beat a specific benchmark by 2.5% per annum. Prior to October 2013 the target was 1.5%.

4.23 The following table sets out in summary the performance of Baillie Gifford and Co versus the benchmark and the performance target in 2013/14, also on a cumulative basis over a five-year investment period.

Fund Performance versus Benchmark and Target

	Fund Return (%)	Performance v Benchmark (%)	Performance v Target (%)
2013/14	11.0	4.6	2.6
Five years 09/10 to 13/14	135.4	14.8	6.6

The performance v benchmark figure gives the percentage that the fund has out or underperformed the benchmark return (market indices).

The performance v target figure gives the percentage that the fund has out or underperformed the set target.

4.24 Baillie Gifford returned 11.0% in 2013/14, which was 4.6% above the benchmark return and 2.6% above the target return. The fund has not only produced a good return in 2013/14 but Baillie Gifford has outperformed in a rising equity market.

4.25 On a cumulative basis over the five-year rolling monitoring period Baillie Gifford are 14.8% above the overall benchmark return, and 6.6% above the target. The fund has over the five-year period increased in value by 135.4%, which equates to a return of 18.7% per annum.

4.26 Baillie Gifford has over the long term outperformed the benchmark and added value to the fund, and outperformed the set target.

5.0 Implications

Strategic

5.1 Delivery On Corporate Priorities – This report links to the Council's corporate priorities, defined in its Corporate Plan, specifically in relation to assisting the Council in ensuring the financial resources are managed so that the Council can sustain and develop the economy.

5.2 Community /Stakeholder Issues – None.

5.3 Policy And/Or Delegated Authority – In accordance with section 2.2 of the Council's Scheme of Administration and Delegations, the Executive Committee has delegated authority to secure the co-ordination, control and proper management of the financial affairs of the Council.

However, in accordance with section 2.1.3 of the Council's Scheme of Administration and Delegations, the approval of any annual investment strategy or annual investment report required by any consent issued by Scottish Ministers by virtue of Section 40 of the Local Government in Scotland Act 2003, is reserved to the Council.

5.4 Risk Management – All investments carry some degree of investment risk but these risks are actively managed and minimised through diversification of fund managers, assets, benchmarks, markets, size of holdings etc.

5.5 Equalities, Health And Human Rights – None.

5.6 Environmental – None.

Resources

5.7 Financial – Performance by a Fund Manager will have long-term financial consequences for the Council. There are no decisions from this report, so there are no immediate financial consequences.

5.8 Legal – This report complies with the consent issued by the Scottish Ministers under the Local Government Investments (Scotland) Regulations 2010, to give an Annual Investment Report after the year end on the investment position to the Council.

5.9 Human Resources – None.

5.10 Assets And Property – None.

6.0 Conclusions

6.1 The implementation of the new investment strategy at the end of September 2013 made changes to every fund manager's mandate, plus a new fund manager BlackRock replaced GMO. All of the fund managers coped well with the changes.

6.2 Due to the new investment strategy BlackRock have only managed their passive equity mandate for 6 months, and over this period they are close to their benchmark. During 2013/14 Insight outperformed their bond benchmark but they did not achieve their target. Baillie Gifford outperformed their benchmark and target in 2013/14. Over the five year period both Insight and Baillie Gifford are above their benchmark and target.

6.3 During 2013/14 equity markets produced mixed returns and the bond markets were generally flat. These markets along with the fund managers' management of the funds helped to contributed £14 million in investment returns to the Council's reserves during 2013/14.

For further information please contact:
James Gray, Executive Manager Finance
Telephone: 01595 744607
E-mail: james.gray2@shetland.gov.uk

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