Review of benchmark of Renfrewshire Common Good Funds

Addressee

This paper is addressed to the Investment Review Board of the Renfrewshire Council Common Good Funds

It is intended review the rationale for the current equity benchmark and the split between the UK and Global indices.

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Background

The Renfrewshire Council Common Good Funds comprise the Paisley Common Good Fund and the Renfrew Common Good Fund. As at 31 March 2016 the funds were valued as set out below and had the income targets shown.

Table 1: Value and target income

	Value £m	Target Income £m p.a.
Paisley Common Goods Fund	3.404	0.103
Renfrew Common Goods Fund	11.480	0.346

The manager of both funds has been set the benchmark shown below to meet this income target going forward without exhausting the Funds. The investment objective of the Funds is to achieve a return on the assets balanced between capital growth and income, through investing in a combination of UK and overseas equities, fixed interest securities and cash whilst meeting the income target set each year by Renfrewshire Council.

Table 2: Target benchmark weightings

	Target %
UK Equities	60
International Equities	20
UK Bonds	18
Cash / Other	2

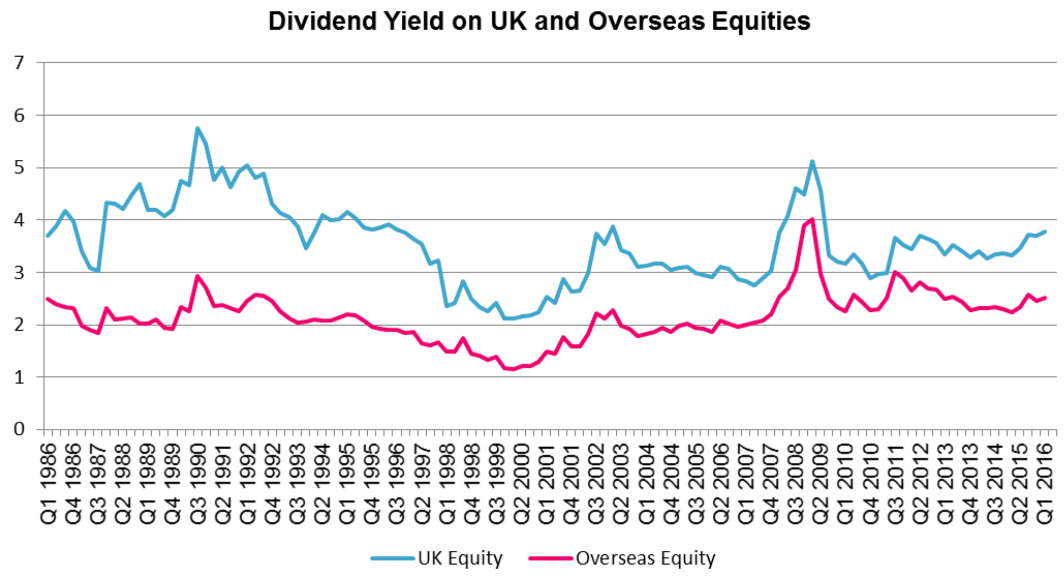
This paper looks at the suitability of the equity component of this benchmark for these purposes.

Income Requirement

Traditionally, UK companies have paid higher dividends than that of their overseas counterparts. Therefore, a benchmark with a higher weighting to UK equities has been most suited to the income requirement of the Funds. However, the manager has considerable freedom to depart from the set benchmark in order to achieve the best returns and so wide discretion has been permitted (there are no ranges around the benchmark targets and currently the manager has an overweight position to overseas equities and corresponding underweight to UK).

The chart below gives an indication of the historical dividend yield from UK and overseas equities – this provides a measure of the income level which each asset class has paid. Currently the dividend yield on UK equities is 3.8% versus 2.5% for overseas equities.

Chart 1: Dividend yields



Source: Datastream

The Funds have a current income requirement of c3% (based on current valuations). This level of income requirement supports the higher UK equity component of the benchmark. With a 75/25 UK / Overseas split, the current equity dividend yield is 3.5%.

Additional Return

Dividend income is not the only driver of the strategy and capital returns are also important. For example, if the lower dividend income from overseas equities was compensated by a higher total return there would be an argument for more to be invested in overseas equities. Table 2 below shows the total returns from UK and Overseas Equities over shorter and longer time periods.

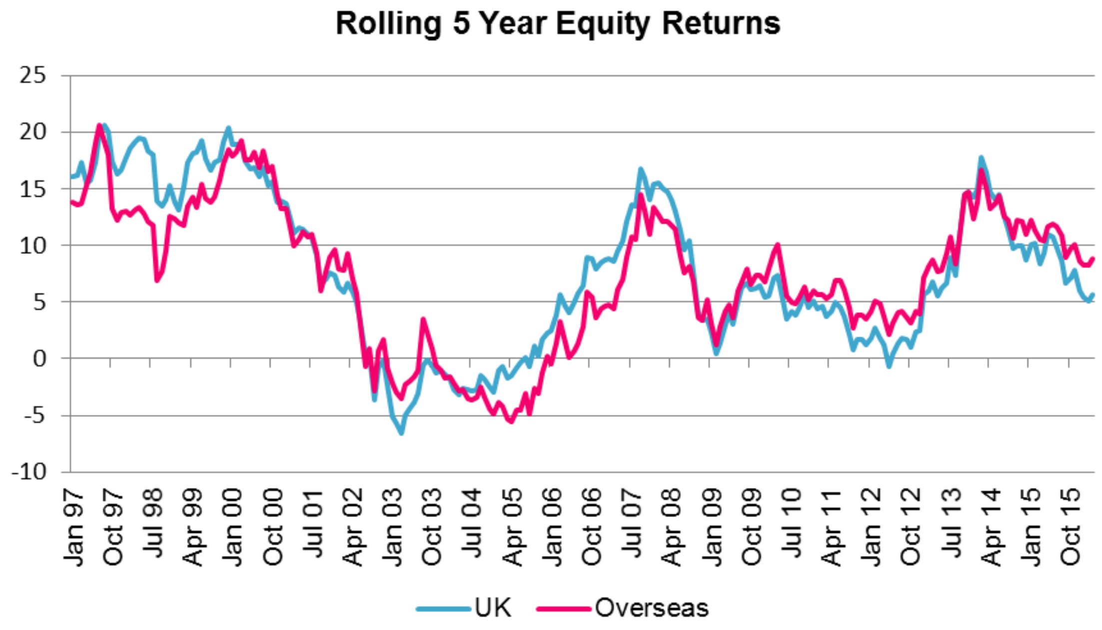
Table 2: Historical total returns to 31 March 2016

	1 Year %	3 Years %pa	5 Years %pa	10 Years %pa	20 Years %pa	30 Years %pa
UK Equity	-3.9	3.7	5.7	4.7	6.5	8.8
Overseas Equity	0.4	9.0	8.8	7.0	6.8	8.2

Source: Datastream

There is some evidence of stronger overseas equity performance in recent years (some of which will be due to currency movements and in particular a weaker sterling). Longer term performance (20 and 30 years show similar returns and indeed slightly stronger UK equity returns). Looking at rolling five year periods over the last 20 years, there is no strong evidence of consistent outperformance from UK or overseas equities. So, historical returns do not present a particularly compelling argument for a change in benchmark.

Chart 2: Equity returns



Source: Datastream

When considering the returns from different regions, it is also worthwhile considering the volatility of those markets. Higher returns but with higher volatility (variability of returns) may not necessarily be what is desired in a portfolio with an income seeking objective. Historically, a trade off with investing in overseas equities has been greater volatility (combined also with the impact of currency movements which historic evidence suggests can add to volatility, particularly in the shorter term). However, the difference in volatility in recent years between UK and Overseas equity has become less as the table below shows.

Table 3: Volatility of returns

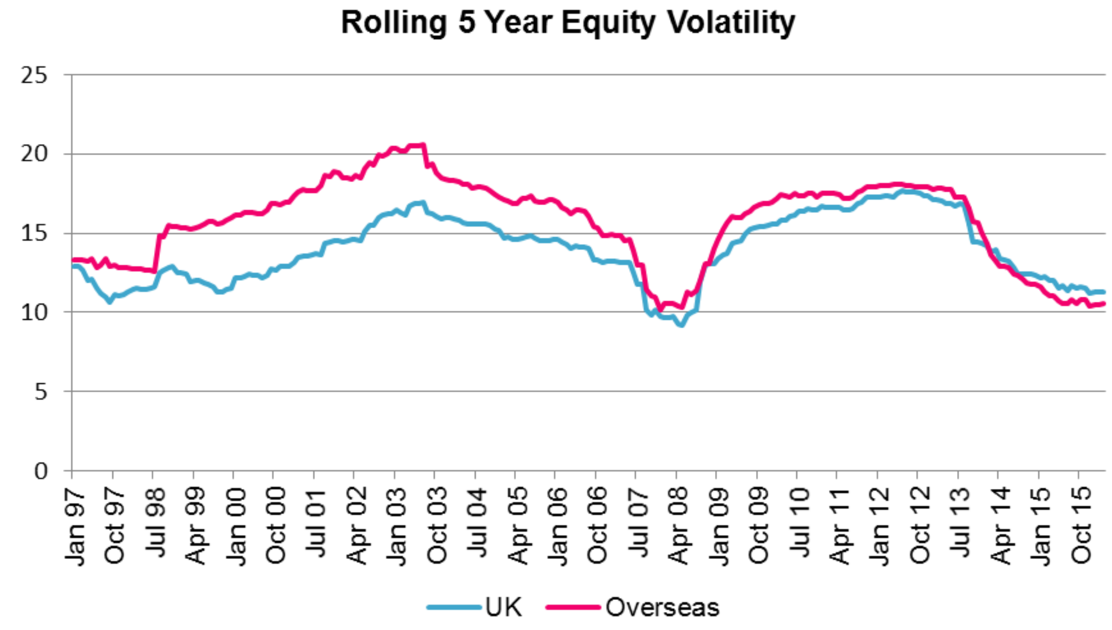
	1 Year %	3 Years %pa	5 Years %pa	10 Years %pa	20 Years %pa	30 Years %pa
UK Equity	11.6	10.6	11.3	14.1	14.0	15.4
Overseas Equity	11.8	9.6	10.6	14.4	15.7	15.9

The table shows the annual standard deviation of equity returns (calculated using monthly returns). This gives a measure of the volatility of returns i.e. that there is a two-thirds chance that over the next year the return would be very broadly expected to fall within the range of +/- one standard deviation of the expected (average) return, with a 1 in 6 chance of being above and a 1 in 6 chance of being below this range over the year (i.e. a two third chance that the annual return would be within one standard deviation (or 11.3%) of the average (8.1%) (i.e. between -3.2% and 19.4%).

Source: Datastream

Again, looking at rolling 5 year periods, there is no significant evidence (especially more recently) of a trend for higher or lower volatility from either equity region. Volatility concerns would not, on their own, preclude consideration of a less domestic centred benchmark.

Chart 3: Equity volatility



Source: Datastream

Manager Skill

As there are periods where the performance of UK equities and overseas equities can diverge, there is an argument for allowing the manager wide or unfettered discretion to exercise skill to select equities without any benchmark constraint (for example, a benchmark of the All World index as opposed to fixed weights across UK and Overseas).

In practice, the manager already has wide discretion as there are no set ranges around the benchmark targets so effectively they have the ability to move their asset allocation as they see fit (from a central point of the benchmark which they are measured against).

Given that the manager already has fairly wide discretion, the existing benchmark is a reasonable compromise between domestic UK equity with their higher dividend yield (income) and the freedom for the manager to allocate as they see fit when they believe returns will be stronger in particular regions.

Concentration and Globalisation

The UK is a small part of the world market (7% of global market capitalisation). It increasingly bears less and less resemblance to the UK economy (as companies on the UK market become increasingly dominated by those with large overseas earnings). It is also very concentrated, with 20% of the market represented by 5 companies. There are 643 companies in the UK FTSE All Share, of which 24 each represent greater than 1% of the index and in aggregate over 56% of the index. A global equity benchmark is much less concentrated. These factors do tend to suggest that a greater proportion invested in overseas equities provides a greater spread of company risk and opportunities (and would support a more global, less UK centric benchmark).

Conclusion

There is an argument for allowing the manager to have a less UK focussed benchmark and to invest more in overseas regions where, from time to time, the manager may see more value. However, the current benchmark does provide a good framework around which the income needs of the funds can be met. The manager already has wide discretion around the benchmark targets to allow them freedom to enhance returns.

A move to a new benchmark would mean some portfolio reconstruction and incur transaction costs. The stable benchmark going forward with wide ranges allows the manager a fairly unconstrained approach to generate income and capital gains. Keeping the wide ranges also reduces portfolio churn and transaction costs (as the manager is not forced to continually rebalance the portfolio to keep it within a narrow benchmark).

So in conclusion there is no immediate need to change the benchmark but it should be reviewed on a regular basis to ensure it remains suitable.

Prepared by:-

David Millar — Senior Investment Analyst

Allison Galbraith — Research Consultant

For and on behalf of Hymans Robertson LLP