

# Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

## Investment Strategy Update

Item number	5.3
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### Alastair Maclean

Director of Corporate Governance

Contact: Bruce Miller, Investment Manager

E-mail: [Bruce.Miller@edinburgh.gov.uk](mailto:Bruce.Miller@edinburgh.gov.uk) | Tel: 0131 469 3866

# Executive summary

## Investment Strategy Update

### Summary

The Pensions Committee agreed the Lothian Pension Fund's investment strategy in October 2012.

	<b>Strategy 2012-17</b>	<b>Permitted Range</b>
	<b>%</b>	<b>%</b>
<b>Equities (1)</b>	65	50-75
<b>Inflation-linked assets (2)</b>	7	0-20
<b>Alternatives (3)</b>	28	20-35
<b>Cash</b>	0	0-10
<b>Total</b>	100	

(1) Includes listed and private equity; (2) Includes index-linked gilts & bonds and gold; (3) Includes property, infrastructure, timber and corporate credit

The strategy targets lower risk and a move away from portfolios that are constrained by market capitalisation indices. This is reflected in a reduction in exposure to equities and an increase in exposure to index-linked bonds and alternatives.

### Equities

An important element of the risk reduction comes from a shift within the equity allocation. The Fund appointed an external transition manager in November 2013 to reshape the equity allocation to reduce risk.

The Fund is moving decisively away from portfolios that are constructed along market capitalisation lines. A balance between capital preservation and growth are more important for the Fund than tracking error relative to a market capitalisation index.

The table below shows the change in the interim strategy benchmark between March 2013 and December 2013. It demonstrates how the transition will reduce the assets under management in regional equity portfolios and increase the assets under management in global equity portfolios. These global portfolios are characterised by significantly lower risk.

	<b>Long Term Strategy 2012-17 %</b>	<b>Interim Strategy at 1 April 2013 %</b>	<b>Interim Strategy at 31 Dec 2013 %</b>
<b>Equities</b>			
Regional Listed		44.5	19.7
Global Listed		19.5	44.3
Private Equity		6	6
<b>Subtotal</b>	<b>65</b>	<b>70</b>	<b>70</b>
<b>Inflation-linked Assets</b>			
Index Linked Gilts	7	5	5
<b>Subtotal</b>	<b>7</b>	<b>5</b>	<b>5</b>
<b>Alternatives</b>			
Property		10	10
Other Real Assets		8	8
Other Bonds		6	6
<b>Subtotal</b>	<b>28</b>	<b>24</b>	<b>24</b>
<b>Cash</b>		<b>1</b>	<b>1</b>
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>

In addition, the transition increases the equity assets managed by the internal team. Approximately one third of the Fund's equities will be invested in the two internally managed global portfolios – one in high quality income-producing equities and the other in low volatility equities. Both portfolios will invest in companies with low volatility compared with the global equity benchmark and are expected to perform relatively well when equity markets are weak and produce positive absolute returns in rising equity markets. Over the long term, they are expected to enhance the Fund's risk-adjusted returns.

The transition is targeting a meaningful reduction in risk, and so, its scale is significant – purchases and sales of equities are approximately £1bn each, and involve a large number of securities.

An external transition manager from the Fund's panel has been appointed to carry out the transition. Members of the panel are selected because of the adequacy of their resources and their ability to minimise risks, which include maintaining the correct market exposure throughout the transition period and trading carefully to reduce market impact.

At the time of writing, equity assets are being transitioned. A verbal update will be provided to the Committee.

The internal team and the Investment Strategy Panel continue to research and review complementary equity strategies that can provide a suitable risk-adjusted return for the Fund.

## Non-equity Assets

There have been no changes to the interim strategy allocations for inflation-linked assets and alternatives since 1 April 2013.

The Fund is continuing to identify and invest in attractive assets within the Alternative category, which includes assets with attractive yields and inflation protection, such as infrastructure, bond-like assets and timber. Recent investments have been made in UK Private Finance Initiative (PFI) projects, such as schools and hospitals, which offer stable income over the term of the concession periods and some protection against inflation.

## Lothian Buses Pension Fund

The Fund's actual and benchmark allocation to each manager and asset class is shown in the table below together with the new investment strategy.

	Long Term Strategy 2012-17 %	Interim Strategy wef 01/04/13 %	Actual Allocation 31/03/13 %	Estimated Allocation Post Transition 31/12/13 %
Equities (Baillie Gifford)			59.9	31.1
Equities (internal)			5.0	31.1
<b>Total Listed Equities</b>			<b>64.9</b>	<b>62.2</b>
Private Equity (internal)			2.1	2.0
<b>Total Equities</b>	<b>55.0</b>	<b>62.5</b>	<b>67.0</b>	<b>64.2</b>
Index-linked Bonds (Baillie Gifford)	15.0	10.0	7.5	6.9
Index-linked Gilts (internal)				4.0
<b>Total Index-linked Bonds</b>	<b>15.0</b>	<b>10.0</b>	<b>7.5</b>	<b>10.9</b>
Other Real Assets (internal)		7.5	5.7	5.3
Other Bonds (Baillie Gifford)		10.0	7.7	7.3
Property (Standard Life)		10.0	7.9	9.0
<b>Total Alternatives</b>	<b>30.0</b>	<b>27.5</b>	<b>21.3</b>	<b>21.6</b>
Central Cash (internal)	0	0	4.2	3.3
<b>Total Fund</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

The main focus of the implementation of investment strategy to date has been on equities given the Fund's significant exposure. After the shift away from UK equities to a global equity structure in March 2013, the focus has been on reducing the risk within the equities. The proportion of the Fund invested internally in high quality income-producing equities is expected to be increased in December to approximately 31%. At the same time the index-linked exposure will be increased by approximately 4% in an internal portfolio. These increases will be funded from the Baillie Gifford equity portfolio.

New investments have also been made in property and the exposure has increased by 1%. Opportunities to increase the Fund's investment in infrastructure continue to be explored.

The equity allocation will be reduced further over time as suitable alternative assets become available.

### Scottish Homes Pension Fund

The Fund's strategic allocation is set out in the table below:

	<b>Long Term Strategy 2012-2017 %</b>	<b>Interim Strategy wef 01/04/13 %</b>	<b>Current Strategy wef 30/11/13 %</b>
<b>Equities</b>			
UK	<b>30</b>	8.8	6.6
US		12.4	9.3
Europe (ex UK)		8	6
Pacific inc Japan		7.6	5.7
Emerging markets		3.2	2.4
<b>Sub-total</b>			<b>40</b>
<b>Bonds</b>			
UK Fixed Interest Gilts	<b>65</b>	10	13
UK Index Linked Gilts		40	52
<b>Subtotal</b>		<b>50</b>	<b>65</b>
<b>Property</b>	<b>5</b>	<b>10</b>	<b>5</b>
<b>Cash</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>

Over the last year, the funding level of the Scottish Homes Pension Fund has increased gradually. As a result, the sale of equities and the move to the long term strategy has been accelerated.

In September 2013, the equity allocation was reduced to 35%. At the end of November 2013, the funding level increased further and was estimated to be in-line with the target funding level as prescribed in the agreement with Scottish Government (approximately 91%) and the equity allocation was reduced to 30%.

In addition, the property allocation of the Fund was reduced in the third quarter of 2013.

As at the start of December, the investment allocation of the Fund is in-line with the revised investment strategy for 2012-2017.

Further work to reduce the risk within the Fund's equities is the outstanding element of the implementation of the strategy. Further progress will be made once discussions with the Scottish Government on funding issues ahead of the 2014 actuarial valuation are complete.

## Other Issues

Given the increase in assets under management by the internal team, the Fund has appointed an external, independent consultant to appraise the current risks for the Funds. The review will cover the following ten factors across operations, execution, and control functions:

- Governance
- Organisational structure and operating model
- Regulation ,compliance and audit
- Technology
- Risk Management
- Execution and controls
- Administration and controls
- Human capital
- Third party relationships and outsourced services
- Business continuity and disaster recovery plans.

The conclusions will be reported to Committee.

As part of the Fund's efforts to ensure industry best practice, it is also investigating whether there would be any benefits to the Fund becoming authorised by the Financial Conduct Authority (FCA).

## Recommendations

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The Committee is asked to note the progress made in implementing the Investment Strategy 2012-17, in particular the transition to lower risk equities.

## Measures of success

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The investment performance of the funds is crucial to the achievement of the required investment return which impacts on the funding level and employer contributions. The objectives for the investments are:

- Over long-term economic cycles (typically 5 years or more), the achievement o the same return as that generated by the strategic allocation;
- Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.

## Financial impact

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This report provides an update on investment strategy. The investment strategy has a significant impact on the funding levels and potentially on the contributions required from employers.

## Equalities impact

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There are no equalities implications as a result of this report.

## Sustainability impact

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The Statement of Investment Principles sets out the Funds' approach as responsible asset owners, and details how voting, engagement and other Environmental, Social and Governance activity is undertaken. Compliance with it is expected to contribute to the sustainability of the Funds' investments.

## Consultation and engagement

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The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

## Background reading / external references

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None

## Links

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### Coalition pledges

**Council outcomes** CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.

### Single Outcome Agreement

**Appendices** None