

Pensions Committee

2pm, Tuesday, 18 December 2012

Investment Benchmarks and Objectives

Item number	5.3
Report number	
Wards	All

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Alastair Maclean

Director of Corporate Governance

Contact: Clare Scott, Investment & Pensions Service Manager

E-mail: Clare.Scott@edinburgh.gov.uk | Tel: 0131 469 3865

Executive summary

Investment Benchmarks and Objectives

Summary

In October 2012, the Pensions & Trusts Committee agreed the revised investment strategies for the pension funds and requested clarity in relation to investment objectives.

The Investment Strategy Panel has undertaken more detailed analysis of investment income and volatility, overall fund investment objectives and the implementation of the revised strategies. In addition, the Director of Corporate Governance has reviewed the budgetary and staffing implications of the revised investment strategy.

This report provides an update and recommends the Funds' investment objectives for the new investment strategies.

Recommendations

Committee is asked to:-

1. agree the Funds' objectives as outlined in paragraph 2.5;
2. note the need for a long-term investment perspective, and continuity and consistency in the internal investment team;
3. approve the recruitment of an additional Portfolio Manager to assist with the implementation of the new investment strategies.

Measures of success

The Funds' performance will be measured against the strategic benchmark to measure the success of the new investment strategies.

Financial impact

The investment strategy has a significant impact on the investment returns of the pension funds, the funding levels and employer contribution rates. The revised investment strategies will focus on income and capital preservation, aiming to reduce the volatility of the funding level.

Equalities impact

There are no equalities impacts arising from this report.

Sustainability impact

There are no sustainability impacts arising from this report.

Consultation and engagement

Employers were consulted during the review of investment strategies.

Background reading / external references

None

Investment Benchmarks and Objectives

1. Background

- 1.1 In October 2012, the Pensions & Trusts Committee agreed the revised investment strategies for the pension funds. Committee requested clarity in relation to investment objectives.
- 1.2 The Investment Strategy Panel met on 5 December to consider more detailed analysis of investment income and volatility, overall fund investment objectives and the implementation of the revised strategies. In addition, the Director of Corporate Governance has reviewed the budgetary and staffing implications of the revised investment strategies.
- 1.3 This report provides an update to the Committee, asks for approval of the Funds' objectives and for approval to progress with changes to staffing ahead of the budget review for 2013/14.

2. Main report

Investment Objectives

- 2.1 The strategy reviews concluded that the focus for the investments should be on risk, income and capital protection. In addition, the Fund should identify and utilise benchmarks other than market-cap weighted benchmarks where possible, to ensure that the objectives and risk tolerances of individual portfolios within the Fund are as closely aligned with the overall objectives of the Fund as possible.
- 2.2 An analysis of Lothian Pension Fund's historic income receipts was undertaken to provide perspectives. It simply showed that equity income growth has exceeded the inflation rate over the last 5 and 10 years. However, Investment Strategy Panel concluded that the analysis was not helpful in setting specific income objectives.
- 2.3 The Investment Strategy Panel also considered the historic volatility (risk) of the pension funds' investments. Statistical measures used to predict volatility can be unreliable and experience of risk measures suggests that specific targets for volatility would be inappropriate.
- 2.4 Panel felt that setting specific targets for income and/or volatility could also lead to unintended consequences, for example stretching for income yield which might result in poor income capture and/or sacrifice of total return, which will continue to be important for the Funds. While it is recommended that specific

targets for income and volatility are not appropriate, a pragmatic approach will be used to manage these issues, particularly in designing investment mandates and benchmarks.

- 2.5 The Investment Strategy Panel have also considered the strategic benchmark for the Lothian Pension Fund and the recommend benchmark indices are set as follows:

	Strategy for 2012-17 %	Benchmark Index
Equities	65	Global market capitalisation weighted index
Index Linked Gilts	7	FTA Brit. Gov. I-L All Stocks
Alternatives	28	UK RPI +3.5%
TOTAL	100	

- 2.6 The Funds' performance will continue to be monitored and reported. It will be compared against that of the strategic benchmark.
- 2.7 It is recommended that the objectives of the Funds should be:
- ◆ Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
 - ◆ Over shorter periods, the Funds should perform better than the strategic allocation if markets fall significantly.
- 2.8 The investment strategy review concluded that the Fund should identify and utilise indices other than those based on market-capitalisation. The benchmark index for equities (above) is based on market capitalisation and is one of the most commonly used in the investment markets. It is felt important to retain such an index against which performance can be assessed to provide evidence of the success of the Funds' investments. However, alternative indices more suited to the Fund's objectives will be used to manage portfolios.
- 2.9 Measuring the Fund's performance against an index based on market capitalisation, but utilising alternative indices to manage portfolios, is expected to result in greater deviation of performance from the benchmarks in the short term for reasons other than 'traditional' manager performance. Decisions by the Investment Strategy Panel and the internal investment team (such as the choice of alternative benchmarks) will influence the Fund's return to a greater extent than previously. It will be important to ensure performance is attributed correctly.

Implementation of Strategies & Resource Implications

- 2.10 The Investment Strategy Panel has considered the priorities for the implementation of the new strategies and the work of the internal team. This will initially focus on the equity holdings of the Funds (particularly those which are

highly constrained and based on market cap indices) and the future of the individual mandates.

- 2.11 As noted above, the new investment strategies mean that decisions by the Investment Strategy Panel and the internal investment team will influence the Funds' returns to a greater extent than previously. This reinforces the critical need for a long-term investment perspective as changes in investments can be costly and frequent change should be avoided. Continuity and consistency in the internal team is therefore vital. There are concerns relating to potential turnover in the team, and implications for the investments, which are being considered further. A further update will be given to Committee in 3 months.
- 2.12 In considering the implications of the revised investment strategy, the following conclusions are drawn:
- ◆ There are opportunities to reduce external manager fees (which make up the majority of the Funds' budget) and to focus resource on the delivery of the Funds' revised objectives. This will be explored further as work on the implementation progresses and conclusions will be reported to Committee in March 2013 as part of the budget setting for 2013/14.
 - ◆ There is a need for additional resource in the Alternatives investments area, specifically in the area of Bonds, where the team lacks depth of expertise.
 - ◆ Continuity and consistency in the investment team is required and potential options to address this are being considered.

3. Recommendations

3.1 Committee is asked to:-

1. agree the Funds' benchmark and objectives as outlined in paragraph 2.5 and 2.7;
2. note the need for a long-term investment perspective, and continuity and consistency in the internal investment team;
3. approve the recruitment of a Portfolio Manager to assist with the implementation of the new investment strategies.

Alastair Maclean

Director of Corporate Governance

Links

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