Pensions Committee

10am, Monday 24 June 2013

Investment & Funding Update - Lothian Pension Fund

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Executive summary

Investment & Funding Update - Lothian Pension Fund

Summary

The purpose of this report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2013.

Over the twelve months to 31 March 2013, most investment markets delivered very positive returns. Global equities, UK index-linked gilts and UK corporate bonds all produced double-digit returns. Lothian Pension Fund delivered a return of 13.9%, which was in line with its benchmark return.

The Fund's annualised performance over the year and longer-term periods are shown in the table below.

% per annum.	1 Year	3 Years	10 Years
Lothian Pension Fund	+13.9	+8.1	+10.3
Benchmark	+13.9	+8.1	+9.5
Relative	0.0	0.0	+0.8

Over the 3 years to 31 March 2013, the return was +8.1% per annum, which also matched the benchmark return. The Fund was behind its target of outperformance of +1.0% per annum ahead of the benchmark.

The Fund's performance over 10 years to 31 March 2013 was +10.3% per annum, ahead of its benchmark by 0.8% per annum.

The Fund's actuary has estimated that Lothian Pension Fund's funding level (the ratio of assets to liabilities) was 87% at 31 March 2013. The funding position has deteriorated since the last actuarial valuation at 31 March 2011 when it was 96%. Despite strong investment returns over the period, a meaningful reduction in real gilt yields has increased the value of liabilities by more than the increase in the value of assets.

The Pensions Committee agreed a revised investment strategy in October 2012. Implementation of the strategy is underway and will take place gradually.

Recommendations

That the Pensions Committee notes the performance, funding level and asset allocation of the Lothian Pension Fund at 31 March 2013.

Measures of success

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. Previously, investments targeted performance of 1% over the benchmark. As part of the adoption of the new investment strategy the Fund, new objectives for the investments were established:

- 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 Fund should perform better than the strategic allocation if markets fall significantly.

Financial impact

This report details the investment performance and funding level of the Lothian Pension Fund. The investment performance has a significant impact on the funding levels and potentially on the contributions required from employers.

Equalities impact

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

Sustainability impact

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

Consultation and engagement

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

None

Report

Annual Investment & Funding Update - Lothian Pension Fund

1. Background

1.1 The purpose of this report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2013.

1.2 The investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required from employers.

2. Main report

Market Background to 31 March 2013

2.1 Investment values fluctuated significantly over 2012/13. European equities, for example, suffered a loss of more than 15% in the early part of the year before ending up 13% in sterling terms over the twelve months. The FTSE All World benchmark for global equities rose even more, up 17% in sterling terms. Gilts and bonds also provided attractive high single/low double digit positive returns. In comparison, the return of less than 5% from emerging market equities was a little disappointing while UK property returned a paltry 2.5%.

2.2 A crucial moment for financial markets during 2012/13, particularly European equities, was a speech by European Central Bank (ECB) President, Mario Draghi, in July 2012. Yields on the sovereign bonds of peripheral European countries were soaring as investors worried about the implications of the break-up of the euro. Draghi addressed the concerns head on and announced that, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough". Investors believed him and financial markets have barely looked back in the expectation that central bank monetary policy would support asset prices. Regulatory developments, which encourage banks to own sovereign debt, have also been supportive of world bond markets.

2.3 After a buoyant 2012/13 in most financial markets, it is perhaps wishful thinking to expect the same again in 2013/14. As the weakening global economic environment undermines the case for austerity, markets appear to be pricing in more expansionary fiscal policy in developed markets. The combination of pro-growth monetary and pro-growth fiscal policies could support financial asset prices for a while longer. There are pockets of potential strength around the world: Japan is fighting deflation by doubling its monetary base through Quantitative Easing; and in the US, bank lending is once again growing. Yet, Europe's banking sector continues to contract as it slowly pays the price for past lending mistakes, while the North/South divide threatens political, social and economic stability.

2.4 So, despite the recent exuberance of equity and bond markets, it is important to note that financial markets are elevated because the UK and other Governments have engineered low interest rates through quantitative easing. Indeed, real interest rates are negative, which means future negative real returns for investors in bonds. This is a difficult environment for pension schemes because liabilities increase when real interest rates decline, and the cost of matching liabilities is high. While Government debt to nominal GDP levels remain elevated, it appears likely that Government policies will target negative real interest rates to erode the value of debt in real terms. These policies will favour the borrower over the saver making life very difficult for pension schemes.

Investment Performance to 31 March 2013 & Funding Level

2.5 The Fund's annualised performance over the year and longer-term periods are shown in the table below.

% per annum.	**1 Year**	**3 Years**	**10 Years**
Lothian Pension Fund	+13.9	+8.1	+10.3
Benchmark	+13.9	+8.1	+9.5
Relative	0.0	0.0	+0.8

2.6 Over the 3 years to 31 March 2013, the Fund's absolute performance was +8.1% per annum, in line with the benchmark return.

2.7 The funding level is the ratio of the pension scheme's assets to liabilities. It is monitored regularly by the internal team, and periodically by the Fund's Actuary and the Investment Strategy Panel. The Actuary has estimated a funding level of 87% as at 31 March 2013, which means that asset are insufficient to meet liabilities based on the assumptions made. The position has deteriorated from 96% at the date of the last actuarial valuation on 31 March 2011. This is despite the fact that the performance of the Fund's investments exceeded that assumed in the actuarial valuation. The primary reason for the fall in the funding level is that real gilt yields have declined significantly causing an increase in the value of liabilities.

2.8 Notable performance within each asset class is as follows:

- The Fund’s equity investments, managed by several managers, combined to produce a return of +16.6% over the year.

- The Fund’s Index-Linked Gilt investments delivered a return of +9.5% over the year, lagging its benchmark return by 0.7%. The portfolio was underweight longer maturity gilts, which are more sensitive to increasing inflation expectations, which rose over the year.

- The Fund’s Alternative investment performance was +10.1% over the year. It outperformed its long term objective of returns in excess of inflation by 3.3% over the year. Alternative investments include unlisted investments such as private equity, infrastructure and timber investments. As the benchmark is stable relative to the valuations of the assets, it is important to note that the true value and returns on the unlisted investments in the Alternatives portfolio will not be known until assets are realised, perhaps not for several years. Investments are made in Alternative asset classes due to the attractive expected long-term returns and the diversification they aim to provide. Short term relative performance data should be treated with caution.

2.9 In terms of relative performance, outperformance from the Alternative investments was offset by the effect of the hedging currencies. The equity investments marginally underperformed its benchmark - good performance from Aberdeen, Mondrian, Harris and Cantillon was offset by underperformance from Baillie Gifford. The underperformance from index-linked gilts had a negligible effect on the overall fund due to its small allocation.

2.10 The Investment Strategy Panel advises the Director of Corporate Governance on the appropriate investment management structure required to implement the Fund’s investment strategy and on the process for the appointment and monitoring of external investment managers. In addition, it is responsible for setting objectives and restrictions for internally managed portfolios. It monitors the risk and performance of all portfolios. Panel and the internal investment team monitor all managers on a regular basis using a traffic light system. Performance, continuity of investment process, philosophy, people and ownership, are considered in the monitoring process. Where there are concerns over a manager, more regular and in-depth monitoring is undertaken.

Investment Strategy and Asset Allocation

2.11 The Pensions Committee approved the revised Investment Strategy for Lothian Pension Fund in October 2012. The revised investment strategy is set at the broad asset class level of equities, index-linked gilts and alternatives, which are the key determinants of investment risk and return.

2.12 The revised strategy makes a small reduction in the allocation to equities (including private equity) and a small increase in the allocation to index-linked gilts and alternatives. It recognises the latent inflation potential at the heart of current central bank monetary policy and maintains significant exposure to real investments, such as index-linked gilts and equities, which have a history of protecting purchasing power, after the effects of inflation have been taken into account.

2.13 As part of the adoption of the new investment strategy the Fund, new objectives for the investments were established:

- 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 Fund should perform better than the strategic allocation if markets fall significantly.

2.14 The Fund's actual and strategy allocation to each manager and asset class at 31 March 2013 is shown in the table below, together with the long term strategy.

	Manager	Long Term Strategy Benchmark %	Actual Allocation At 31 March 2013 %	Interim Strategy At 31 March 2013 %
Listed Equities				
UK	Internal		14.9	15
US	Internal		7.3	6.5
Europe (ex UK)	Internal		6.3	7.1
Pacific	Baillie Gifford		7.8	8.1
Pacific	Invesco Perpetual		3.4	2.8
Emerging markets	Mondrian		2.7	2.5
Emerging markets	UBS		2.7	2.5
Global equities	Internal		5.0	5.5
Global equities	Lazard		6.4	5.5
Global equities	Harris Assoc		3.8	3.5
Global equities	Cantillon		5.4	5.0
Private Equity	Internal		6.6	7.5
Currency Hedge [1]	Internal		-0.5	
Subtotal		**65**	**71.8**	**71.5**
Bonds				
Index Linked Gilts	Internal	7	3.6	5.0
Subtotal		**7**	**3.6**	**5.0**
Alternatives				
Property	Internal and External		8.9	12.0
Infrastructure			5.6	4.5
Bonds and Loans			4.9	5.0
Other [2]			1.7	1.0
Subtotal		**28**	**21.1**	**22.5**
Cash	Internal		3.5	1.0
TOTAL		**100**	**100.0**	**100**

[1] Hedge covers £321m of currency exposures

[2] Includes timber and gold

2.15 Actual asset allocations relative to the benchmark will vary over time due to differential performance of asset classes and managers. The Investment Strategy Panel reviews asset allocation on a quarterly basis and the internal team reviews it monthly. Differences between actual and benchmark allocations need to be balanced against the cost of switching assets between managers.

2.16 At 31 March 2013, the Fund had an overweight position in equities and was underweight index-linked gilts and alternatives, specifically property, compared to the interim investment strategy at 31 March 2013.

2.17 There were a number of changes to investment management arrangements over the year:

- Cantillon Capital, one of 3 managers to be awarded global equity mandates in an EU tender, was funded in early April 2012. (The other 2 had been funded in late March 2012). The tender was triggered by the termination of a previous manager.

- The internal UK equity assets were split into two separate portfolios in May 2012. The mandate had a benchmark of the UK equity index, the FTSE 350 and exposure to the smaller 250 stock was achieved by holding an external Exchange Traded Fund. A new UK equity mid cap mandate was launched to replace this passive holding and the existing UK mandate was focussed on the largest companies, the FSTE 100 index.

- An internal global high yield portfolio was initiated in June 2012 with funds sourced from Legal and General's passively managed global equity portfolio. L&G had been managing the portfolio on a temporary basis. The new portfolio is targeting attractive returns with lower risk than the benchmark, which is one of the elements of the new investment strategy.

- As previously advised to Committee, the Fund's emerging markets equity mandate was tendered in the second half of 2012. Aberdeen Asset Management was replaced by two new managers, who were appointed to run emerging market equity mandates, Mondrian Investment Partners and UBS Global Asset Management.

- The Fund's property weighting was reduced in October 2012. The sale of the Standard Life Select (overseas) Property holding refocused the Standard Life mandate on direct investment in the UK, which reduces the volatility of returns and allows the manager to focus on the core mandate.

2.18 The role of passive currency management in the Fund was reviewed over the year. The review considered the volatility in the Fund's overseas asset values and the cash flow implications of currency hedging. As a result, the currency hedge was adjusted to attempt to reduce risk by hedging those currencies that are positively correlated with equity markets. At the end of the year, the Fund's listed equity exposure to two currencies - the Euro and the Australian Dollar - were hedged or partially hedged.

2.19 The Fund’s actual allocation to alternative investments (excluding private equity) fell slightly over the year. Property assets have been reduced, while commitments to infrastructure assets have been increased. The relative movements in asset prices have had an impact on the percentage allocation - equities rose more than Alternative investments over the year.

2.20 The Fund makes commitments to unlisted investments and the timing of these investments is uncertain as it depends on the manager being able to purchase assets. Details of outstanding commitments as at 31 March 2013 were as follows:

	Commitment in Local Currency			**TOTAL**
	US$ m	**Euros m**	**£ m**	**£ m**
Private Equity	84	16	8	77
Infrastructure	20	69	5	77
Timber	6	-	-	4
	110	**85**	**13**	**158**

Implementation of Investment Strategy

2.21 Following the Committee’s agreement of the new investment strategy in October 2012, the work of Investment Strategy Panel and the internal team has focussed on its implementation, in order to reduce risk and deliver the objective of:

- 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 Fund should perform better than the strategic allocation if markets fall significantly.

2.22 The intention is to implement the new strategy at a measured pace, as investment opportunities become available and as research on opportunities is undertaken. Some changes have been put in place during the 2012/13 financial year and work is ongoing.

2.23 **Equities:** The main focus to date has been on equities given the Fund's significant exposure.

- The existing portfolios have been reviewed and options for the management of the Fund's equity exposure explored. The strategy will include reducing reliance on indices which are based on market-capitalisation (which the strategy review concluded were sub-optimal), reducing the amount of assets managed in dedicated regional portfolios in favour of global portfolios and increasing the allocation to portfolios whose investment philosophy is based on income and/or stability. The challenge is to reduce volatility without sacrificing long-term returns.

- The move away from market-capitalisation benchmarks mainly affects the internally managed UK, Europe and US portfolios, of which approximately 90% are invested in-line with an index based on market-capitalisation. Ways to achieve broad market exposure have been explored and the intention is to move to a global portfolio where holdings are based on the economic footprint of companies.

- With the intention of lowering absolute volatility, the Lazard global equity mandate was terminated during April 2013. The assets have been transitioned into the existing internally managed global high income portfolio and a new portfolio managed by Nordea. Nordea was appointed to the Fund's global equities framework in 2012 following an EU tender process. Both portfolios 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.

- Research on other aspects of the equity portfolio is ongoing.

2.24 **Index Linked Gilts and Bonds:** The Panel and the internal team have also reviewed the gilt and bond exposure. The strategy involves a small increase in index-linked gilt exposure, which provides diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund's liabilities. The benchmark will be changed to more accurately reflect the long-term nature of Fund liabilities. A review of the Fund's corporate bond exposure highlighted that the existing benchmark is quite highly correlated with the Fund's large equity exposure and options for the future are being explored. The internal team is also monitoring opportunities, which might arise from financial institutions selling assets.

2.25 **Property & Other Real Investments:** This section of the Fund's strategy includes investments in property, infrastructure and timber, where the target return is 3.5% in excess of inflation. The increase in the exposure to infrastructure is dependent on finding attractive investment opportunities. New infrastructure investments will focus on opportunities which aim to offer returns which have a strong linkage with inflation, focused on secondary fund interests, selective primary fund commitments and co-investments alongside the Fund's existing manager/fund relationships. The opportunity to invest in the Pensions Infrastructure Platform (PIP) will be considered once it is established. New timberland investments will continue to be appraised.

2.26 The implementation of the investment strategy requires a continuing assessment of internal and external management options, appraisal of the risks of internal and external management and the required resources and financial implications of greater internal management (including systems and staffing).

Conclusion

2.27 The absolute performance of Lothian Pension Fund over the 12 month period was +13.9%. Three-year performance is +8.1% per annum. Over 10 years, the Fund returned +10.3% per annum.

2.28 Despite strong investment returns in excess of expectations, the actual funding level has fallen from 96% at the time of the last actuarial valuation on 31 March 2011 to 87% at 31 March 2013, largely as a result of falling real gilt yields.

2.29 Implementation of the new strategy is ongoing and is focussed on ensuring the new objectives, introduced as part of the revised strategy, can be delivered.

3. Recommendations

3.1 That the Pensions Committee notes the performance, funding level and asset allocation of the Lothian Pension Fund at 31 March 2013.

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	None