Pensions Committee

10am, Monday 24 June 2013

Investment & Funding Update - Lothian Buses Pension Fund

Item number	5.4
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Investment & Funding Update - Lothian Buses Pension Fund

Summary

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

Over the twelve months to 31 March 2013, most investment markets delivered strong, positive returns. Global equities, UK index-linked gilts and UK corporate bonds all produced double-digit returns. The Lothian Buses Pension Fund delivered a return of +16.4%, outperforming its benchmark by 2.6%.

The Fund's performance over the year and longer-term periods to 31 March 2013 are shown in the table below.

% per annum.	1 Year	3 Years	10 Years
Lothian Buses Pension Fund	+16.4	+10.4	+11.3
Benchmark	+13.8	+8.7	+10.1
Relative [1]	+2.6	+1.7	+1.2

[1] Performance is calculated to 2 decimal places. Rounding differences can occur.

Over the three years to 31 March 2013, the Lothian Buses Pension Fund delivered a return of +10.4% per annum, ahead of the benchmark by 1.7% per annum for this period. This exceeds the target of 1.5% per annum above the benchmark.

The Fund's return over the 10-year period to 31 March 2013 is ahead of the benchmark by 1.2% per annum.

The Fund's actuary has estimated that Lothian Buses Pension Fund's funding level (the ratio of assets to liabilities) on an ongoing basis is 102.5% at 31 March 2013. This has deteriorated since the last actuarial valuation at 31 March 2011 when it was 112.4%. (On a more prudent (gilts) basis, the funding level at 31 March 2011 was 86.9%). Despite strong investment returns over the period, a meaningful fall in real gilt yields has increased the value of liabilities by more than the increase in the value of assets.

Pensions Committee approved a new investment strategy in October 2012 to be implemented over 2012-17. The new strategy targets lower risk for the Fund in recognition of its increasing maturity and lower cash flow from contributions.

Recommendations

That the Pensions Committee notes the performance, funding level and asset allocation of the Lothian Buses 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

Financial impact

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

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. These include employer and member representatives from Lothian Buses.

Background reading / external references

None

Report

Annual Investment & Funding Update - Lothian Buses 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 Buses 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 Lothian Buses.

2. Main report

Investment Performance to 31 March 2013 & Funding Level

2.1 Over the 12 months to 31 March 2013, the Fund has returned +16.4% compared to the benchmark return of +13.8%. The Fund outperformed by +2.6% over the period.

2.2 Over the 3 year period to 31 March 2013, the Fund's performance is +10.4% per annum, outperforming its benchmark by +1.7% per annum. The target for this period is +1.5% per annum.

2.3 Over the 10-year period to 31 March, the Fund's performance is +11.3% per annum, outperforming its benchmark by +1.2% per annum.

2.4 The actuary has estimated a funding level of 102.5% as at 31 March 2013. The position has deteriorated from 112.4% at the date of the last actuarial valuation on 31 March 2011. (On a more prudent (gilts) basis, the funding level at 31 March 2011 was 86.9%). The fall in the funding level 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.

2.5 The annual accounts (considered elsewhere on the Committee's agenda) show that the Fund's outgoings exceeded incomings for the year to 31 March 2013. As the Fund is closed to new members and the liabilities are expected to mature further over time, the funding basis will be reviewed prior to the 2014 actuarial valuation.

2.6 Over the last 12 months, the Fund’s combined equity investments performed well, outperforming their benchmark due to good stock selection. The Fund benefited from its overweight position in equities.

2.7 The Fund’s bond investments, comprising index-linked gilts and corporate bonds, also produced returns ahead of the benchmark.

2.8 The Fund’s property investments lagged the benchmark, but the Fund benefited from its underweight allocation to property.

2.9 The Fund’s alternative investments outperformed their benchmark over the year, but returns should be assessed over much longer periods due to the nature of the investments. The benchmark return is inflation plus 3.5%, which is much more stable than the investment returns over annual periods.

Investment Strategy and Asset Allocation

2.10 At their meeting in October 2012, the Pensions Committee approved the revised Investment Strategy for Lothian Buses Pension Fund.

<table>
<tr><th></th><th>Previous Long Term Strategy %</th><th>Revised Strategy for 2012-2017 %</th></tr>
<tr><td>(Equities ex PE)</td><td>(55)</td><td>n/a</td></tr>
<tr><td>Equities inc PE</td><td>59</td><td>55</td></tr>
<tr><td>Index Linked Gilts</td><td>10</td><td>15</td></tr>
<tr><td>Corporate Bonds</td><td>10</td><td>-</td></tr>
<tr><td>Property</td><td>10</td><td rowspan="2">30</td></tr>
<tr><td>Other</td><td>15</td></tr>
<tr><td>Alternatives</td><td>25</td><td>30</td></tr>
<tr><td>TOTAL</td><td>100</td><td>100</td></tr>
</table>

2.11 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. It reclassifies Private Equities (PE) into Equities and out of Alternatives and corporate bonds are reclassified as Alternatives.

2.12 The revised strategy reduces the allocation to equities (including private equity) and increases the allocation to index-linked gilts. It is designed to reduce investment risk as the Fund is closed to new members and the liabilities will mature over time. The investment strategy continues to recognise 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 The investment strategy will be phased over time to reduce risk and as investment opportunities become available.

2.14 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 benchmark;
- Over shorter periods, the Fund should perform better than the benchmark if markets fall significantly.

Lothian Buses Pension Fund Allocation

2.15 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.

	Actual	**Benchmark w e f**	**Target**	**Range**
	31/03/13 %	**01/04/13 %**	**2012 -17 %**	**2012 -17 %**
Equities (Baillie Gifford)	59.9			
Equities (internal)	5.0			
Total Listed Equities	**64.9**			
Private Equity *	2.1			
Total Equities	**67.0**	**62.5**	**55.0**	**45.0- 65.0**
Index-Linked Bonds (Baillie Gifford)	**7.5**	**10.0**	**15.0**	**10.0- 30.0**
Other Real Assets (infrastructure, timber)	5.7	7.5		
Other Bonds	7.7	10.0		
Property (Standard Life)	7.9	10.0		
Total Alternatives	**21.3**	**27.5**	**30.0**	**10.0- 35. 0**
Central Cash	4.2	0	0	**0.0-10.0**
Total Fund	**100.0**	**100.0**	**100.0**	

2.16 Actual asset allocations relative to the benchmark will naturally vary over time due to differential performance of asset classes and managers, as well as intentional asset allocation positions taken by Baillie Gifford.

2.17 The Investment Strategy Panel reviews asset allocation on a quarterly basis. Differences between actual and target manager allocations need to be balanced against the cost of switching assets.

2.18 At 31 March 2013, the actual allocation to equities was overweight as a result of Baillie Gifford's overweight position in its balanced mandate and the allocation to internally managed global equities. The actual allocation to corporate bonds and index-linked gilts was underweight as a result of Baillie Gifford's underweight to these assets. The actual allocation to property was underweight - property has significantly underperformed other asset classes over the last year.

Implementation of Investment Strategy

2.19 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.

2.20 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.

2.21 **Equities:** The main focus to date has been on equities given the Fund's significant exposure. The Fund's UK equities were transitioned to an internal global high-income equity portfolio (5%) and cash (2%) towards the end of March 2013. This completed the shift to a global equity structure and reduced the actual allocation to equities. Equity exposure will be reduced further to fund allocations to alternative investments and index-linked gilts over the next few years. The global equities will be realigned to deliver the Fund's objective.

2.22 **Index-linked gilts and other Bonds:** As the Fund is maturing, the strategy is targeting a greater proportion of the Fund in index-linked gilts, which provide diversification, some insurance against an unexpected rise in inflation and a core holding, which will provide a return broadly in line with the Fund's liabilities. There is also scope to increase the allocation to other bonds and the internal team is monitoring opportunities, which might arise from financial institutions selling assets.

2.23 **Property & Other Real Investments (infrastructure and timber):** This section of the Fund's strategy has a target return of 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, investing alongside Lothian Pension Fund. Opportunities to invest in the Pensions Infrastructure Platform (PIP) will be considered once it is established. New timberland investments will continue to be appraised.

Conclusions

2.24 The absolute performance of Lothian Buses Pension Fund was positive over the 12 month period with a return of +16.4%. Three year performance is 10.4% per annum. Over 10 years, the Fund returned +11.3% per annum.

2.25 New objectives for the Fund were introduced to reflect the revised strategy, which will be phased over the coming quarters:

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

2.26 Despite strong investment returns in excess of expectations, the actual funding level on an ongoing basis has fallen from 112.4% at the time of the last actuarial valuation on 31 March 2011 to 102.5% at 31 March 2013, largely as a result of falling real gilt yields.

3. Recommendations

That the Pensions Committee notes the performance, funding level and asset allocation of the Lothian Buses 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