Pensions Committee

10am, Monday 24 June 2013

Annual Investment & Funding Update – Scottish Homes Pension Fund

Item number	5.5
Report number	
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Executive summary

Annual Investment & Funding Update – Scottish Homes Pension Fund

Summary

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

Over the twelve months to 31 March 2013, both bonds and equities delivered positive double-digit returns while property eked out a low single-digit gain. The Scottish Homes Pension Fund delivered a return of +13%, in line with its benchmark.

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

% per annum	1 Year	3 Years	Since Inception (July 2005)
Scottish Homes Pension Fund	13.0	11.2	8.8
Benchmark	13.0	11.1	8.8
Relative	+0.0	+0.1	0.0

Over the three years to 31 March 2013, the Scottish Homes Pension Fund delivered a return of +11.2% per annum, slightly ahead of the benchmark. Since the Fund's inception in July 2005, the Fund has delivered a return of +8.8% per annum in line with its benchmark.

The Fund's actuary has estimated that Scottish Homes Pension Fund's funding level (the ratio of assets to liabilities) was 85% at 31 March 2013. The funding position has deteriorated slightly since the last actuarial valuation at March 31 2011 when it was 86%. 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 funding level remains below the target funding level as specified in the funding agreement with the Scottish Government.

Over all periods shown, the Fund has not achieved its performance target of +0.5% per annum, largely because most of the Fund's assets have been run passively since Q4

2010 pending the actuarial valuation and investment strategy review. Following the Committee's approval of the new investment strategy in October 2012, Fund has new objectives:

- 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.

Recommendations

That the Pensions Committee notes the performance, funding level and asset allocation of the Scottish Homes 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 Scottish Homes Pension Fund. The investment performance has a significant impact on the funding level and potentially on the contributions required from the Scottish Government.

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. There is a dedicated place on the Consultative Panel for the Scottish Government.

Background reading / external references

None.

Report

Annual Investment & Funding Update – Scottish Homes Pension Fund

1. Background

1.1 The purpose of this report is to provide an update on the investments and funding level of the Scottish Homes 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 the Scottish Government.

2. Main report

Scottish Homes Pension Fund Performance to 31 March 2013

2.1 Over the 12 months to 31 March 2013, the Fund has returned +13.0%, in line with its benchmark of +13.0%.

2.2 Over the 3 year period to 31 March 2013 the Fund's absolute performance is +11.2% per annum, compared to its benchmark of +11.1% per annum. The Fund failed to meet its target of +0.5% per annum ahead of the benchmark, largely because most of the Fund's assets have been run passively since Q4 2010 pending the actuarial valuation and investment strategy review..

2.3 Over the year to 31 March 2013, there was slight outperformance from the equity and bond assets run by State Street, offset by slight underperformance from the property assets.

Scottish Homes Pension Fund - Funding Level at 31 March 2013

2.4 The funding level and its position relative to its target (as specified in the funding agreement with the Scottish Government) is monitored quarterly by both the Fund's actuary and the Investment Strategy Panel.

2.5 The actuary has estimated a funding level of 85% as at 31 March 2013, which means that asset are insufficient to meet liabilities based on the assumptions made. The position has deteriorated slightly from 86% 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.

2.6 Over the same period, the target funding level has increased from 89.5% to 90.8%. (It has been agreed that the target funding level will increase gradually over time to reach 100% by 2044). The shortfall of the funding level relative to target has therefore increased over the 2 year period since the last actuarial valuation despite strong investment returns over the period.

Scottish Homes Pension Fund Asset Allocation at 31 March 2013

2.7 The Fund's actual and benchmark allocation to each manager and asset class at the start and end of the financial year 2012/13 is shown below:.

		Actual 31/03/2012	**Actual 31/03/2013**	**Benchmark 01/04/2013**
Asset Class	**Manager**	**%**	**%**	**%**
Equities	State Street	40	41.6	40
Bonds	State Street	50	49.9	50
Property	Schroder	6.1	5.5	5
	Standard Life	3.9	3.0	5
TOTAL		**100**	**100**	**100**

2.8 Actual asset allocations relative to the benchmark will vary over time by virtue of relative market movements of different asset classes and relative performance of managers. There have been no changes to the benchmark allocation during the year and actual asset allocation remained very close to the benchmark until Q1 2013.

2.9 Over the year assets are withdrawn from the investment manager(s) on a regular basis to pay pensions (approximately £650,000 per month). In Q1 2013, there was also a disinvestment of £1m from the Standard Life property portfolio in line with the revised strategy to reduce the property allocation. Disinvestment of these property assets and outperformance of equities relative to bonds and property accounted for the underweight property and overweight equities position at 31 March 2013.

Investment Strategy and Asset Allocation

2.10 Pensions Committee approved a new investment strategy in October 2012 to be implemented over the following 5 years. The revised investment strategy is set at the broad asset class level of equities, bonds and property, which are the key determinants of investment risk and return. The revised strategy for the next 5 years is set out in the table below:

	Previous Strategy %	Revised Strategy 2012-2017 %	Asset Allocation Range relative to Strategy
Equities			
UK	8.8	**30**	
US	12.4		
Europe (ex UK)	8		
Pacific inc Japan	7.6		
Emerging markets	3.2		
Sub-total	**40**		-10% to +5%
Bonds			
UK Fixed Interest Gilts	10	**65**	
UK Index Linked Gilts	40		
Subtotal	**50**		+10% to -5%
Property	**10**	**5**	**+5%**
Cash	**-**	**-**	**+5%**
TOTAL	**100**	**100**	**100**

2.11 The revised strategy reduces the allocation to equities and property and increases the allocation to bonds. It is designed to reduce investment risk as the Fund is closed to new members and the liabilities will mature over time. The new 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.

2.12 The changes to the investment strategy will be phased over time as research is undertaken, though the sale of equities will be accelerated if the funding level exceeds the target funding level.

2.13 New objectives were introduced to reflect the revised strategy. In December 2012, Committee agreed that the future objectives of the Fund should be:

- 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.

2.14 The main focus to date has been on equities given that the exposure is the major determinant of the Fund's risk. The future strategy will include reducing reliance on indices which are based on market-capitalisation (which the strategy review concluded were sub-optimal) and a move to global management of the equities, rather than regional. The challenge is to reduce volatility but not sacrifice long-term returns.

2.15 The Fund's bond exposure and investment management arrangements will be reviewed over the course of the year.

Conclusions

2.16 The absolute performance of Scottish Homes Pension Fund was positive over the 12 month period to 31 March 2013 with a return of +13.0%. Three year performance is 11.2% per annum.

2.17 Funding levels are monitored by the Fund actuary and Investment Strategy Panel quarterly. The actual funding level at 31 March 2012 was 85%, below the target funding level of 90.8% at 31 March 2013.

2.18 The returns for Scottish Homes Pension Fund over the 1 and 3 years to 31 March 2013 are broadly in-line with the benchmark. Performance since inception is also broadly in-line with the benchmark. The Fund has not achieved its target relative performance of +0.5% per annum, largely because most of the Fund's assets have been run passively since Q4 2010.

2.19 New objectives for the Fund were agreed by Committee in December 2012:

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

2.20 The new investment strategy targets reduced risk in the Fund over time. The Fund will accelerate the sale of equities if the actual funding level exceeds the target funding level.

3. Recommendations

3.1 That the Pensions Committee notes the performance, funding level and asset allocation of the Scottish Homes 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