Pensions Committee

10.00 a.m., Tuesday, 17 June 2014

Investment & Funding Update – Lothian Pension Fund

Item number	5.7
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an update on the investments and funding position of the Lothian Pension Fund to 31 March 2014.

Over the twelve months to 31 March 2014, investment market returns were mixed (developed market equities positive; emerging market equities and bonds negative).

The Fund produced a return of 6.8% over the year. The benchmark return was 5.2%.

The Fund's actuary is currently undertaking the triennial valuation and will report Lothian Pension Fund's funding level (the ratio of assets to liabilities) later in the year. Market yields point to an improvement since the estimate at end March 2013 (87%).

The Fund's Investment Strategy 2012-17 is being implemented gradually. Fund risk was reduced over the year, primarily through a reorganisation of equity mandates.

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	

Report

Investment & Funding Update – Lothian Pension Fund

Recommendations

1.1 That the Pensions Committee notes the performance, funding update and asset allocation of the Lothian Pension Fund.

Background

2.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2014.

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

Main report

Market Background to 31 March 2014

3.1 UK investors in developed market equities and UK property were well rewarded over 2013/14; not so happy were investors in emerging market equities and UK gilts. UK, Europe ex-UK and US equities generated returns of 9%, 14% and 11% respectively in sterling terms; UK property returned 12%; emerging market equities fell more than 10% in sterling terms; and conventional and index-linked gilts were down 3% and 4% respectively.

3.2 2013/14 was a year of 'firsts' at the Bank of England and at the Federal Reserve in the US. The new governor at the Bank of England, Canadian Mark Carney, is the first non-British governor of the UK's central bank, while Janet Yellen is the first woman chair of the US central bank. If they had not known it before, both chairs discovered how investment market participants hang on the every word of key policymakers. Carney discovered that while 'forward guidance' sounds like a good idea, it can be a tricky concept; Yellen moved markets by suggesting that interest rates could rise six months after QE tapering was complete.

3.3 With the Bank of England's official interest rate pegged at 0.5%, the lowest rate in its 320 year history by some margin and quantitative easing (bond buying by the central bank) continuing, the new governor appears more concerned about the economy's growth potential than the risks of inflation. Carney is not alone amongst global policymakers, but 2013/14 was the year when outgoing chairman of the US central bank, Ben Bernanke, alerted the world that monetary policy had been so easy for so long that a change was overdue. The word tapering entered the financial market lexicon to describe a reduction in the pace of quantitative easing by central banks, effectively a tightening in monetary policy.

3.4 The price movements of equities, bonds and currencies over 2013/14 largely demonstrated the vulnerability of countries around the world to tapering. Worst affected were the prices of assets in countries with large current account deficits where central banks increased interest rates to defend their currencies. This tightening of monetary policy portends slower economic growth and potential repayment problems for issuers of foreign currency denominated debt.

Investment Performance to 31 March 2014

3.5 The Fund's investment objectives agreed by Pensions Committee in December 2012 are:

- 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.

3.6 The Fund has achieved returns in excess of the strategic allocation over the last year and over the longer term timeframes shown in the table.

% per annum	1 Year	3 Years	10 Years
Lothian Pension Fund	+6.8	+7.6	+8.3
Benchmark	+5.2	+7.2	+7.4
Relative	+1.6	+0.4	+0.9

3.7 Over 2013/14, the Fund performed better than the strategic allocation when markets were falling and outperformed by a smaller margin when markets were rising. The structure of the equity pool of assets and the currency hedge were helpful in achieving an outcome of lower volatility. The changes to investment management arrangements described in 3.19 below had the effect of lowering the expected volatility of the Fund and increasing diversification.

3.8 Notable performance within each asset class is as follows:

- The Fund’s Equity investments, managed by the internal team and several external managers, combined to produce a return of +7.2% over the year. Strong returns in most developed markets were offset by weak returns in Asian and emerging markets.
- The Fund’s Index-Linked investments delivered a return of -7.1% over the year with the index-linked gilt portfolio falling over 4% as real yields increased and gold falling by a quarter. The Fund’s small holding in gold correlates well with very long term index-linked gilts and is designed to provide protection against an unexpected rise in inflation.
- The Fund’s Alternative investment performance was +5.3% over the year. Within Alternatives, the Fund’s property assets provided a very strong return +13.8% while other real assets, including infrastructure and timber, and corporate bonds produced returns of +0.3% and +1.3% respectively.
- The target return for Alternatives is inflation plus 3.5% per annum. 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 performance data should therefore be treated with caution.

3.9 The Fund’s return over the year was ahead of the benchmark return. The main contributors were the equity portfolios and property assets. The emerging markets portfolios were behind their respective benchmark returns

3.10 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.

Funding Level

3.11 The funding level is the ratio of the pension scheme’s assets to liabilities. At the last actuarial valuation three years ago, the funding level was 96% at 31 March

2011, and last year, the actuary estimated the funding level to be 87% at 31 March 2013. Work has commenced on the triennial actuarial valuation at 31 March 2014. The actuary will be assessing the need to make changes to assumptions based on the latest and best data available, such as changes to mortality assumptions, to make the most accurate assessment of the funding level. The results are expected to be considered by the Pensions Committee in March 2015.

3.12 Over 2013/14, the positive performance of asset values and the increase in real gilt yields, which causes the value of liabilities to fall, will have caused the funding level to improve *all other things being equal*. However, the Fund is very likely to remain in a deficit position, which means that assets are insufficient to meet liabilities based on the assumptions made. This is why the Fund invests in growth assets, such as equities, to achieve full funding in the future. It is worth noting that the monetary value of the deficit is expected to have increased since the 2011 actuarial valuation because the Fund and the liabilities have increased.

Investment Strategy

3.13 The Pensions Committee approved the Investment Strategy 2012-17 for Lothian Pension Fund in October 2012. The 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.

	Long Term Strategy Allocation 2012-17 %	Permitted Range %
Equities	65	50-75
Index-Linked Assets	7	0-20
Alternatives	28	20-35
Cash	0	0-10
TOTAL	100	

3.14 The 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.

Asset Allocation and Strategy Implementation

3.15 The implementation of the Investment Strategy 2012-17 is planned to proceed at a measured pace as investment opportunities become available and as research on opportunities is completed, and this is reflected in the interim strategy allocation shown in the table below. The Investment Strategy Panel and the internal team have focussed their efforts during 2013/14 on reducing risk and delivering the performance objectives of the Fund described above. The Investment Strategy Panel reviews asset allocation on a quarterly basis and the internal team reviews it monthly.

3.16 Actual asset allocations relative to the strategic allocation will vary over time due to differential performance of asset classes and managers. Differences between actual and strategy allocations need to be balanced against the cost of switching assets between managers.

3.17 At 31 March 2014, the Fund had an overweight position in equities and cash, and was underweight index-linked assets and alternatives, especially Other Bonds, compared to the interim strategy at 31 March 2014. The table below shows the changes in actual allocation over the financial year 2013/14 and the current interim strategy allocation at end March 2014.

	Manager	Actual Allocation 31 March 2013 %	Actual Allocation 31 March 2014 %	Interim Strategy Allocation 31 March 2014 %
EQUITIES				
UK All Cap	Internal	12.9	2.3	2.0
UK Mid Cap	Internal	2.0	2.3	1.8
Europe (ex UK)	Internal	6.3	2.3	2.1
US	Internal	7.3	2.3	2.1
Pacific	BG	7.8	3.5	3.9
Pacific	Invesco Perpetual	3.4	3.2	2.8
Emerging Markets	Mondrian	2.7	2.1	2.5
Emerging Markets	UBS	2.7	2.1	2.5
Global High Dividend Yield	Internal	5.0	14.8	14.6
Global Low Volatility	Internal	0.0	17.1	17.5
Global	Lazard	6.4	0.0	0.0
Global	Cantillon	5.4	5.5	5.0
Global	Nordea	0.0	3.7	3.7
Global	Harris	3.8	4.1	3.5
Private Equity	Various	6.6	5.6	6.0
Currency Hedge [1]	Internal	-0.5	0.2	0.0
Subtotal		**71.8**	**71.2**	**70.0**
INDEX-LINKED ASSETS				
Index-linked gilts/gold	Internal	4.1	3.9	5.0
Subtotal		**4.1**	**3.9**	**5.0**
ALTERNATIVES				
Property	Various	8.9	8.8	10.0
Other Real Assets [2]	Various	6.8	7.6	8.0
Other Bonds [3]	Rogge	4.9	4.6	6.0
Subtotal		**20.6**	**21.0**	**24.0**
Cash	Internal	3.5	3.8	**1.0**
TOTAL		**100.0**	**100.0**	**100.0**

Equities

3.18 A key objective of the Fund’s investment strategy is to reduce risk. The Fund took a major step in this direction within its equity holdings during 2013/14 by transitioning assets into three global mandates, two managed internally and one managed by Nordea, which was appointed to the Fund’s global equities framework in 2012 following an EU tender process. The mandates were funded from three internal regional portfolios, the Lazard global equity portfolio, which was terminated, and the Baillie Gifford Pacific portfolio, which was reduced in size. The new mandates have lowered Fund risk and are expected to perform relatively well when equity markets are weak and produce positive absolute returns in rising equity markets.

- The Fund has also moved decisively away from portfolios that are constructed along market capitalisation lines, which are regarded as suboptimal. All the equity mandates are now unconstrained by the tracking error measurement of risk, and the focus will be on capital preservation and the sustainability of income generation.
- The transition to the new portfolios has increased the equity assets managed by the internal team. Approximately two thirds of the Fund's equities are managed internally with the majority of these in low cost, low turnover strategies, which are expected to enhance the Fund's risk-adjusted returns over the long term.
- 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.
- The Fund also hedges exposures to the currencies of overseas listed equities with the explicit aim of reducing volatility rather than making a return. The Fund therefore maintains exposure to currencies that are expected to reduce volatility - fall as equities rise - and hedges exposure to currencies that are expected to increase volatility – rise as equities rise.

Index-Linked Assets

3.19 The Fund's strategy entails a small increase in index-linked assets (gilts, bonds and gold), which provides diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund's liabilities. With index-linked gilts offering investors with negative real yields, the Fund increased exposure to index-linked assets by only £13m over 2013/14. However the duration of the portfolio was extended by purchasing gilts of longer maturities to reflect the long-term nature of Fund liabilities.

Alternative Investments

3.20 The Fund's actual allocation to alternative investments, which includes assets such as infrastructure, bond-like assets and timber, increased over 2013/14. Many of these investments are unlisted and increasing exposure is dependent on finding attractive opportunities. Exposure to infrastructure assets was increased by £45m with a focus on secondary fund interests, selective primary fund commitments and co-investments alongside the Fund's existing manager/fund relationships. 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. The Fund continues to monitor developments with the Pensions Infrastructure Platform (PIP), which will be considered once it becomes available. New timberland investments also continue to be appraised.

- Despite the new investments in 2013/14, there was little change in the percentage of Fund assets in alternative investments because of the growth in the Fund size due to relative movements in asset prices. Equity investments provided stronger returns than most alternative investments in the Fund.
- The Fund has a strategic allocation to bond assets within Alternatives because there may be opportunities to use its strong, long-term capital position to purchase sound assets at attractive prices from sellers, such as financial institutions who are rebuilding balance sheets in deleveraging economies. However attractive bond investments have become increasingly difficult to find as yields are low and yield spreads have narrowed dramatically. With a target return of 3.5% in excess of inflation for the Alternatives portfolio, most bond related investments require the use of leverage to achieve such a target and are generally relatively risky. However, the Fund is actively reviewing and assessing investment opportunities.
- A review of the Fund's corporate bond exposure has been undertaken and since the end of the year, the Fund's manager of corporate bonds, Rogge, has been terminated. The assets have been transitioned into index-linked gilts and US Treasuries.

3.21 The Fund makes commitments to unlisted investments and the timing of these is uncertain as it depends on the manager being able to purchase assets. Details of outstanding commitments as at 31 March 2014 were as follows:

	Unfunded Commitments in Local Currency			**TOTAL**
	US$ m	**Euros m**	**£ m**	**£ m**
Private Equity	77	14	6	64
Infrastructure	15	74	2	72
Timber	-	-	-	-
	92	**88**	**8**	**136**

3.22 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). The Fund's investment operations were reviewed during 2013/14 and the findings reported to the Pensions Committee in March. Progress to implement the key recommendations and address the key risks for the Fund is continuing in

2014/15. In addition, preparatory work is in progress to make an application to gain FCA authorisation.

Conclusion

3.23 The absolute performance of Lothian Pension Fund over the twelve month period was +6.8%. Three year performance is +7.6% per annum. Over ten years, the Fund returned +8.3% per annum.

3.24 The triennial actuarial valuation, which reassess all the inputs and assumptions involved in determining the funding level, is currently underway. Based on the performance of the Fund's assets and the rise in real gilt yields, which affect the value of liabilities, the funding level is expected to have improved over the last 12 months.

3.25 Implementation of the investment strategy has progressed over the last twelve months with a reorganisation the Fund's equity assets into lower risk mandates including a new global portfolio managed internally. Restructuring of the index-linked asset portfolio is well advanced. The Investment Strategy Panel and internal team continue to focus on implementation of the investment strategy with a focus on increasing the allocation to alternative investments where possible and on researching and funding complementary equity strategies.

Measures of success

4.1 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 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

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

Risk, policy, compliance and governance impact

6.1 Investment strategy is a key determinant of funding level, risk and volatility of employer contribution rates. The Fund's investment strategy is aimed at reducing the risk without sacrificing returns.

There is no governance impact as a result of this report. Committee delegates the implementation of investment strategy to the Director of Corporate Governance, who takes advice from the Investment Strategy Panel. The Investment Strategy Panel is an important element of the governance of the pension fund investments.

Equalities impact

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

Sustainability impact

8.1 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

9.1 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

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Links

Coalition pledges	
Council outcomes	CO26 –The Council engages with stakeholders and works in partnership to improve services and deliver on agreed objectives.
Single Outcome Agreement	
Appendices	None