

# Pensions Committee

10.00 a.m., Tuesday, 17 June 2014

## Investment & Funding Update – Lothian Buses Pension Fund

<b>Item number</b>	5.8
<b>Report number</b>	
<b>Executive/routine</b>	
<b>Wards</b>	All

### Executive summary

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This report provides an update on the investments and funding position of the Lothian Buses Pension Fund.

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 8.9% over the year. The benchmark return was 5.1%.

The Fund's actuary is currently undertaking the triennial valuation and will report on Lothian Buses Pension Fund's funding level (the ratio of assets to liabilities) later in the year. Market yields point to an improvement since the funding level estimates at 31 March 2013 (80% and 103% on a gilts and ongoing basis, respectively).

The Fund's Investment Strategy 2012-17 is being implemented gradually. Fund risk was reduced over the year through a reorganisation of the Fund's equities and increased allocation to index linked gilts.

### Links

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#### 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

## Investment & Funding Update - Lothian Buses Pension Fund

### Recommendations

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

### Background

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- 2.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Buses 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 the employer, Lothian Buses plc.

### Main report

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#### Investment Performance to 31 March 2014

- 3.1 The Fund's investment objectives agreed 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.
- 3.2 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 Buses Pension Fund	+8.9	+10.0	+9.9
Benchmark	+5.1	+7.7	+8.4
Relative	+3.8	+2.3	+1.4

- 3.3 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.
- 3.4 Over 2013/14, asset allocation has proved very beneficial to performance. The fund was overweight high returning equity assets (+11.8%) and underweight negative returning index-linked gilts (-6.0%). This contributed to the performance being more volatile than the strategy. (The Fund reduced risk in mid-February 2014 by reducing equities and restructuring the equity assets as described below.)
- 3.5 The Fund's Alternative investments, which include property, infrastructure and timber, rose 6.3% over the year. However, returns from Alternatives should be assessed over much longer periods due to the nature of the investments. The target return is inflation plus 3.5% per annum.

### **Funding Level**

- 3.6 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 on an ongoing basis was estimated to be 112% at 31 March 2011, and last year, the actuary estimated the funding level to be 103% at 31 March 2013. The positive performance of asset values and the increase in real gilt yields over 2013/14, which causes the value of liabilities to fall, will have caused the funding level to improve all other things being equal at 31 March 2014.
- 3.7 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.
- 3.8 As the Fund is closed to new members and the liabilities are expected to mature further over time, the funding basis will be reviewed during the 2014 actuarial valuation. On the more prudent 'gilts basis', the funding levels were 87% and 80% at 31 March 2011 and 31 March 2013 respectively. As the Fund is likely to be a deficit on a 'gilts' basis at 31 March 2014, the assets do not over the liabilities, so the Fund continues to invest in growth assets, such as equities, to achieve full funding in the future.

### **Investment Strategy**

- 3.9 The Pensions Committee approved the Investment Strategy 2012-17 for Lothian Buses 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.

	<b>Long Term Strategy Allocation 2012-17 %</b>	<b>Permitted Range %</b>
<b>Equities</b>	55	45-65
<b>Index-Linked Assets</b>	15	10-30
<b>Alternatives</b>	30	10-35
<b>Cash</b>	0	0-10
<b>TOTAL</b>	<b>100</b>	

- 3.10 The strategy reduces the allocation to equities (including private equity) and increases 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**

- 3.11 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 efforts during 2013/14 on reducing risk and delivering the performance objectives of the Fund described above.
- 3.12 The Investment Strategy Panel reviews asset allocation on a quarterly basis and the internal team reviews it monthly. Differences between actual and strategy allocations need to be balanced against the cost of switching assets between managers.
- 3.13 At 31 March 2014, the Fund had an overweight position in equities, index-linked assets and cash compared to the interim strategy allocation. Alternative investments are underweight the interim strategy allocation partly because of the relative movement in the Fund's assets as equities outperformed the alternatives by a significant margin. In addition, many of these investments are unlisted and increasing exposure is dependent on finding attractive opportunities.

3.14 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.

	<b>Manager</b>	<b>Actual Allocation 31 March 2013 %</b>	<b>Actual Allocation 31 March 2014 %</b>	<b>Interim Strategy Allocation 31 March 2014 %</b>
<b>EQUITIES</b>				
Global Alpha	Baillie Gifford	60	32	
Global High Dividend Yield	Internal	5	32	
Private Equity	Internal	2	1	
<b>Subtotal</b>		<b>67</b>	<b>65</b>	<b>62.5</b>
<b>INDEX-LINKED ASSETS</b>				
Index-linked bonds	Baillie Gifford	8	7	
Index-linked gilts	Internal	0	4	
<b>Subtotal</b>		<b>8</b>	<b>11</b>	<b>10</b>
<b>ALTERNATIVES</b>				
Property	Standard Life	8	9	
Other Real Assets [1]	Various	6	5	
Other Bonds [2]	Baillie Gifford	8	8	
<b>Subtotal</b>		<b>21</b>	<b>21</b>	<b>27.5</b>
Cash	Internal	4	2	0
<b>TOTAL</b>		<b>100</b>	<b>100</b>	<b>100</b>

[1] Includes infrastructure and timber

[2] Includes corporate bonds and loans

3.15 The Investment Strategy Panel and the internal team have focussed their efforts during 2013/14 on reducing the actual allocation to equities, restructuring the equity pool of assets and increasing the exposure to index-linked assets. These changes should reduce risk and deliver the return objectives of the Fund described above. A small increase was also made to property exposure. Opportunities to increase the Fund's investment in infrastructure were appraised including primary and secondary opportunities, but no new investments were made.

3.16 The changes made in 2013/14 are described below:

- The Fund reduced the actual allocation to equities in mid-February 2014 by switching 4% of assets from equities into an internally managed index-linked gilts portfolio. This has increased the diversification of the overall Fund and lowered risk.

- At the same time, the Fund altered the structure of the existing investment mandates by increasing the amount invested internally in high quality income-producing equities and reducing the proportion allocated to the Baillie Gifford global equity mandate. This has increased the diversification of the equities, increased income generation and lowered risk. The equity assets are expected to perform relatively well when equity markets are weak and produce positive absolute returns in rising equity markets.
- The transition has increased the equity assets managed by the internal team. Half of the Fund's equities are now managed internally in a low cost, low turnover strategy.
- The increased allocation to index-linked gilts is in line with the Fund's long term strategy. They provide diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund's liabilities.
- The Fund's actual allocation to Alternatives was stable over the year. Investment in property, however, was increased by approximately 1%. Many of the alternative investments are unlisted and increasing exposure is dependent on finding attractive opportunities. The Fund continues to appraise investment opportunities in infrastructure and timber assets.

3.17 The Fund makes commitments to unlisted investments and the timing of these is uncertain as they depend 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
Infrastructure	0	3.0	0.1	2.6

3.18 The general thrust of strategy implementation going forward will be a gradual reduction in the equity allocation and an increase in index-linked gilts and alternative investments when they become available.

## Conclusion

3.19 The absolute performance of Lothian Buses Pension Fund over the twelve month period is +8.9%. Three year performance is +10.0% per annum. Over ten years, the Fund returned +9.9% per annum.

3.20 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 movement of real gilt yields, which affect the value of liabilities, the funding level is expected to have improved over the last twelve months. As the Fund is closed to new members and the liabilities

are expected to mature further over time, the funding basis will be reviewed during the 2014 actuarial valuation.

- 3.21 Implementation of the investment strategy has progressed over the last twelve months with an increase in the actual allocation to index-linked assets and a significant reorganisation of the Fund's equity assets, both designed to lower overall risk in the Fund. Future changes are planned at a gradual pace with a focus on increasing the allocation to index-linked gilts and alternative investments and reducing the equity allocation.

## Measures of success

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- 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

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

## Risk, policy, compliance and governance impact

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- 6.1 Investment Strategy is the main determinant of funding level and volatility of employer contribution rates. The 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

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

## Sustainability impact

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- 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

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- 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

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None

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## Links

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### 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