

Pensions Committee

2.30 p.m., Wednesday, 24 June 2015

Annual Investment Update – Scottish Homes Pension Fund

Item number	5.11
Report number	
Executive/routine	
Wards	All

Executive summary

Over the twelve months to 31 March 2015, the Fund produced a return of 19.7%. The Fund's actuary estimates that the Scottish Homes Pension Fund's funding level (the ratio of assets to liabilities) had increased to 92.8% at 31 March 2015, which is an increase over the 88.8% level recorded at the last formal valuation date of 31 March 2014.

Changes to the Fund's asset allocation based on funding level progress were agreed by the Pensions Committee in December 2014. During the last quarter of 2014/15, the equity allocation was reduced from 30% to 27.5% and following the end of the financial year, the equity allocation was reduced again from 27.5% to 25%.

Further engagement with the Scottish Government is planned during 2015 to review the funding approach and progress will be reported to Pensions Committee in due course.

Links

Coalition pledges

Council outcomes

[CO26](#)

Single Outcome Agreement

Annual Investment Update – Scottish Homes Pension Fund

Recommendations

- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 That the Pensions Committee notes the performance, funding update and asset allocation of the Scottish Homes Pension Fund.

Background

- 2.1 The City of Edinburgh Council took over the administration of the deferred and pensioner liabilities of Scottish Homes in July 2005. An agreement between the Scottish Government and the City of Edinburgh Council ('the Guarantee') was put in place in June 2005. The Scottish Government acts as the 'Guarantor' for the Fund liabilities.
- 2.2 The Guarantee and the investment strategy are designed to reduce investment risk as the Fund is closed to new members and the liabilities will mature over the time. They allow for acceleration in the sale of equities and property and purchase of bonds if the actual funding level improves to the target funding level.
- 2.3 The 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 strategy changes the allocation to equities, bonds and property dependent on the development of the actuary's estimate of the funding level.
- 2.4 The Target Funding Levels (TFLs), as set out in the Guarantee, were 89.5% and 91.5% at 31 March 2011 and 2014 respectively. The actual funding levels were below the respective targets at these dates. Therefore Scottish Government will be paying a contribution of £675,000 p.a. from April 2015 to March 2018.
- 2.5 As previously reported to Committee, discussions regarding potential changes to the funding agreement were held with the Scottish Government during 2014/15. Options to change the funding approach to one where contributions would be determined by fund cash flows, rather than funding level, were explored. However, the Scottish Government preferred that the 2014 actuarial valuation and contributions for the 3 years starting April 2015 are determined in accordance with the existing funding agreement.

- 2.6 Pending further engagement with the Scottish Government, Committee approved a change to the investment strategy in December 2014 whereby the equity and bond allocations are adjusted depending on the funding level in accordance with the following table:

Equity Allocation %	Funding level	Note [1]
35	89.5%	2011 TFL
30	91.5%	2014 TFL
25	93.0%	2017 TFL
20	94.5%	2020 TFL
15	95.5%	2023 TFL
10	96.5%	2026 TFL

[1] TFL: Target Funding Level

- 2.7 The purpose of the report is to provide an update on the investment and funding position of the Scottish Homes Pension Fund to 31 March 2015.
- 2.8 The investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required from the Scottish Government.

Main report

Investment Performance to 31 March 2015

- 3.1 The Fund's investment objectives agreed in December 2013 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's annualised performance over the year and longer-term periods is shown in the table below. The Fund has performed in line with its benchmark since inception, and has outperformed its benchmark by a small margin over the 1- and 5-year timeframes. The Fund's equity and bond assets are currently managed passively and the Fund's risk has been similar to that of the benchmark.

% per annum	1 Year	5 Years	Since Inception (July 2005)
Scottish Homes Pension Fund	+19.7	+10.9	+9.2
Benchmark	+19.4	+10.8	+9.2
Relative	+0.3	+0.1	+0.0

Funding Level and Investment Strategy

- 3.3 The funding level is monitored regularly by the Fund's actuary and the internal investment team. The progression of the estimated funding level since 31 March 2015 is shown below:

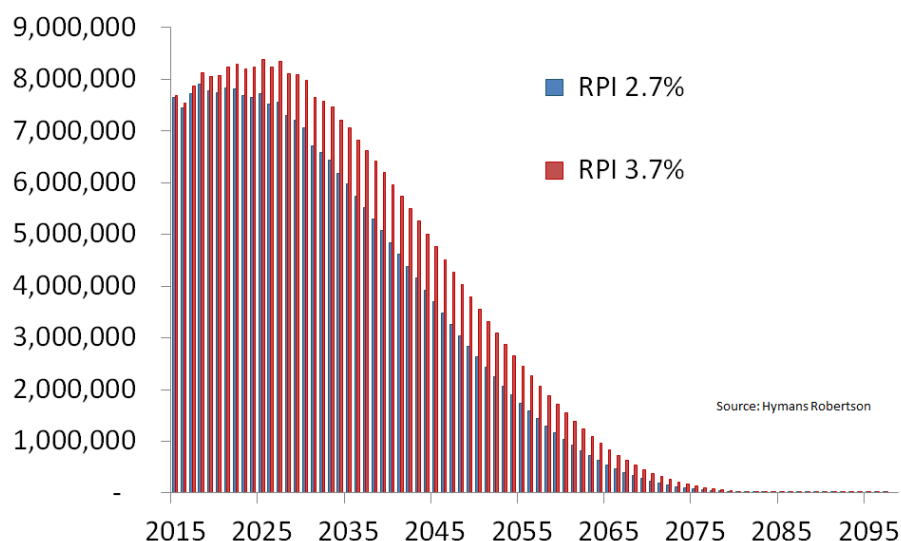


- 3.4 Based on the actuary's funding level, the strategic equity allocation was reduced from 30% to 27.5% in January 2015 with the bond allocation increasing from 65% to 67.5%.
- 3.5 The funding level at 31 March 2015 was estimated to be 92.8%.
- 3.6 During April 2015, with equity markets having continued to rally, the funding level estimate rose above the 2017 target funding level of 93%. The equity allocation was reduced further to 25% resulting in an increased bond allocation of 70%, up from 67.5%.
- 3.7 The changes in investment strategy are summarised below:

Scottish Homes Pension Fund – Evolution of Strategy 2014/15			
Asset Class	Strategy Allocation 31 March 2014 %	Strategy Allocation 31 March 2015 %	Strategy Allocation 30 April 2015 %
Equities	30.0	27.5	25.0
Bonds	65.0	67.5	70.0
Property	5.0	5.0	5.0
TOTAL	100.0	100.0	100.0

- 3.8 As part of the 2014 actuarial valuation, analysis of the Fund's liability cash flow projections was undertaken. A graph of the expected liability payments using two different inflation assumptions is shown below.

Figure 1: Projected cashflows at differing inflation rates (£)



- 3.9 The analysis highlighted significant differences between the term/duration of the Fund's investments (particularly the index linked gilts) compared to the liabilities. This has been partly due to the fact that the investments have tracked a standard market index of gilts and issuance of new government bonds over recent years has tended to be of longer duration. During September 2014, the duration of the Fund's investments was reduced accordingly and part of the Fund's holdings is now being managed internally. Approximately half of the bond portfolio was moved to in-house management. The equity and bond allocations did not change over this time. This change in duration should result in the investments providing a closer match to the liabilities in the future.
- 3.10 Over the year assets are also withdrawn from the investment manager(s) to pay pensions (approximately £650,000 per month).
- 3.11 The Fund's actual allocation to each manager and asset class at 31 March 2015 is shown in the table below, together with the strategic allocation at 31 March 2015. Also shown is the strategic allocation at 30 April 2015 following the most recent reduction in equity allocation.

Asset Class	Manager	Actual Allocation 31 March 2015 %	Strategy Allocation 31 March 2015 %	Strategy Allocation 30 April 2015 %
Equities				
UK	State Street	6.0	6.1	
US	State Street	8.3	8.5	
Europe Ex-UK	State Street	5.6	5.5	
Asia Pacific	State Street	2.3	2.2	
Japan	State Street	3.5	3.0	
Emerging Markets	State Street	2.3	2.2	
Subtotal		28.0	27.5	25.0

Bonds				
Index-linked gilts	In-house	35.9	35.6	
Index-linked gilts	State Street	16.9	17.8	
Fixed income gilts	State Street	14.0	14.1	
Subtotal		66.8	67.5	70.0
Property				
Property	Schroders	5.2	5.0	
Subtotal		5.2	5.0	5.0
Cash		0.0	0.0	0.0
TOTAL		100.0	100.0	100.0

- 3.12 Discussions regarding potential changes to the funding agreement were held with the Scottish Government during 2014/15 with the assistance of the Fund's investment advisers. However, the Scottish Government decided to make no changes, preferring that the 2014 actuarial valuation and contributions for the 3 years starting April 2015 be determined in accordance with the existing Guarantee.
- 3.13 The Scottish Government would like to further explore funding options previously discussed as part of the 2014 actuarial valuation. These discussions are expected to take place later in 2015. Irrespective of whether the Guarantee and funding approach are formally reviewed, a review of the investment strategy is required, particularly to review the way in which the individual asset classes are managed. Updates to the Committee will be provided as this work progresses.

Conclusions

- 3.14 The absolute performance of Scottish Homes Pension Fund is positive over the 12 month period to 31 March 2015 with a return of 19.7%. Five year performance is 10.9% per annum.
- 3.15 The returns for Scottish Homes Pension Fund since inception to 31 March 2015 are in line with the benchmark, and over one and five years are slightly ahead of the benchmark.
- 3.16 Funding levels are monitored by the Fund regularly. The estimated actual funding level has improved over the year and was 92.8% at 31 March 2015, which is broadly in-line with the target funding level of 93.0% for 2017.
- 3.17 The investment strategy (and potentially the funding agreement) of the Fund will be reviewed in consultation with the Scottish Government.

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 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.

Risk, policy, compliance and governance impact

- 6.1 Investment strategy is a key determinant of funding level, risk and volatility of employer contribution rates.

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 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 Fund's 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 Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.
- 9.2 Regular updates are provided to Scottish Government with ongoing liaison and consultation.

Background reading/external references

None

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Links

Coalition pledges

Council outcomes CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed

Single Outcome Agreement

Appendices None