

Pensions Committee

2.00 p.m., Wednesday, 16 December 2015

Lothian Pension Fund – Investment Strategy Review & Update

| | |
|-------------------|-----|
| Item number | 5.4 |
| Report number | |
| Executive/routine | |
| Wards | All |

Executive summary

This report provides an update on the investments of the Lothian Pension Fund to 30 September 2015 and the outcome of the recent review of strategy undertaken by the Investment Strategy Panel.

The Fund's Investment Strategy 2012-17 is being implemented gradually. Fund risk has declined materially since 2012 due to the reorganisation of equity and bond mandates and small adjustments to asset allocation.

Performance during recent equity market volatility indicates that the changes to strategy have positioned the Fund to achieve its objective of better preservation of capital during periods of market weakness.

The review of strategy reaffirmed the existing strategy with the aim of achieving the strategic allocation by end 2017 subject to suitably attractive alternative investments becoming available in the market.

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Lothian Pension Fund – Investment Strategy Review and Update

Recommendations

- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 That Committee notes the investment update of strategy implementation and performance.
- 1.3 That Committee agrees that progress towards the investment strategy for 2012-17 should continue.
- 1.4 That Committee notes the recent Investment Strategy Panel discussion reviewing benchmarks, in particular for the Alternative investments with the decision to retain the existing benchmark of RPI +3.5%.

Background

- 2.1 The Fund's 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. Investment strategy includes Equities and Alternatives on the assumption that these assets will deliver better performance than Index-Linked Gilts in the long-term.
- 2.2 The Pensions Committee approved the Investment Strategy and Objectives 2012-17 for Lothian Pension Fund in October 2012.

| Asset Category | Investment Strategy 2012-17 % | Permitted Range % |
|-----------------------|--|----------------------------------|
| Equities | 65 | 50 - 75 |
| Index-Linked Assets | 7 | 0 - 20 |
| Alternatives | 28 | 20 - 35 |
| Cash | 0 | 0 - 10 |
| TOTAL | 100 | |

- 2.3 The strategy reduces the allocation to equities (including private equity) from 71.5% at the end of 2012 to 65% by the end of 2017 and increases the allocation to Index-Linked Gilts and Alternatives. It recognises a gradually changing risk profile for the Fund, but retains significant exposure to real investments, such as Index-Linked Gilts and Equities, which have a history of

protecting or enhancing purchasing power, after the effects of inflation have been taken into account.

- 2.4 The Fund's investment objectives 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.
- 2.5 Investment strategy is typically reviewed following the results of the triennial actuarial valuation and the most recent valuation was undertaken in 2014.
- 2.6 Investment Strategy Panel reviews the progress of the implementation of investment strategy at their quarterly meetings. An additional meeting was held in October 2015 to review the investment strategy of the Fund in the context of the results of the 2014 actuarial valuation.
- 2.7 The purpose of this report is to provide an update on the implementation of the current 2012-17 strategy implementation of the Lothian Pension Fund to 30 September 2015 and the conclusions of an interim review of its investment strategy recently undertaken by the Investment Strategy Panel.
- 2.8 An update on the investments of Lothian Pension Fund was provided to Committee in June 2015.

Main report

Investment Strategy Implementation

- 3.1 The implementation of the Investment Strategy 2012-17 has continued to proceed at a measured pace as investment opportunities have become available and as research on opportunities have been completed. Progress towards the long term strategy allocation involves the interim strategy allocation and the actual asset allocation changing gradually over time. The pace of change can be accelerated or slowed depending on asset prices, the availability of alternative investments and research conclusions on new strategies.
- 3.2 The interim strategy allocation to equities was reduced from 71.5% to 68.0% over the 3.5 year period. The long term target allocation for 2017 is 65%. A key objective of the Fund's investment strategy is to reduce risk, including risk within the equity pool of assets. Over the period, this has been achieved by shifting from regional to global and external to internal portfolios as well as a reduction in private equity exposure. Approximately three quarters 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.

- 3.3 The Fund's independent performance measurer, Portfolio Evaluation, shows that the actual equity volatility experienced by the Fund has fallen materially over the last 5 years from 17.0% to 11.2%, which largely reflects the lower market volatility over the period, but also reflects the changes in the table below. The Fund's equity volatility over the last year was 93% of the equity benchmark.
- 3.4 The following table illustrates the changes in the Fund's equities since March 2012.

| |
|-------------------------------|
| No change |
| Increased Strategy Allocation |
| Decreased Strategy Allocation |
| Mandate Terminated |
| New Mandate |

| LOTHIAN PENSION FUND | | Interim | Interim |
|---|-------------------------|-------------------|-------------------|
| 30 September 2015 | | Strategy | Strategy |
| Fund size £4,833m | | Allocation | Allocation |
| | | at end | at end |
| | | March | September |
| | | 2012 | 2015 |
| | | % | % |
| Manager | | | |
| UK All Cap | Internal | 15 | 2.0 |
| UK Mid Cap | Internal | | 1.8 |
| Europe (ex UK) | Internal | 7.1 | 2.1 |
| US | Internal | 6.5 | 2.1 |
| Asia Pacific | Baillie Gifford | 8.1 | 0.0 |
| Asia Pacific | Invesco Perpetual | 2.8 | 0.0 |
| EM | Aberdeen | 5.0 | 0.0 |
| EM | Mondrian | 0.0 | 2.3 |
| EM | UBS | 0.0 | 2.3 |
| Total Regional Listed | | 44.5 | 12.5 |
| Global | Lazard | 5.5 | 0.0 |
| Global | L&G | 5.5 | 0.0 |
| Global HDY | Internal | 0.0 | 14.3 |
| Global GLOVE | Internal | 0.0 | 17.5 |
| Global GLOVAL | Internal | 0.0 | 6.5 |
| Global | Nordea | 0.0 | 3.7 |
| Global | Cantillon | 5.0 | 5.0 |
| Global | Harris | 3.5 | 3.5 |
| Total Global Listed | | 19.5 | 50.5 |
| Private Equity (listed & LP) | Internal/Various | 7.5 | 5.0 |
| Currency Hedge | AG Bisset | 0.0 | 0.0 |
| Currency Hedge | Internal | 0.0 | 0.0 |
| Total Equities | | 71.5 | 68.0 |

- 3.5 The change to the index-linked asset strategy allocation is shown in the table below. The allocation has increased from 5.0% to 7.0% of Fund assets, which is the target allocation for 2017. This represents a small reduction in risk as index-linked gilts provide diversification from the Fund's dominant asset, equities, some insurance against an unexpected rise in inflation and a return broadly in

line with the Fund's liabilities. They are, however, priced to generate a negative real return over all timeframes.

| LOTHIAN PENSION FUND 30 September 2015 Fund size £4,833m | | Interim Strategy Allocation at end March 2012 % | Interim Strategy Allocation at end September 2015 % |
|---|-----------------|--|--|
| | Manager | | |
| Total Index-Linked Assets | Internal | 5.0 | 7.0 |

- 3.6 The increased allocation to the Alternatives is shown in the table below. Excellent progress has been made in making new infrastructure and timber investments over the past 3.5 years, but identifying attractive bond related investments has proved more difficult. The corporate bond mandate managed by Rogge was terminated during the first half of 2014 as bond yields fell and corporate bond spreads narrowed with proceeds invested in index-linked gilts and US Treasuries pending better credit opportunities arising. Since then, the Fund has made commitments to two private debt funds focused on direct lending in UK and European markets. The target allocation to Alternatives in 2017 is 28%.

| LOTHIAN PENSION FUND 30 September 2015 Fund size £4,833m | | Interim Strategy Allocation at end March 2012 % | Interim Strategy Allocation at end September 2015 % |
|---|-----------------|--|--|
| | Manager | | |
| SLI Property | SLI | 12.0 | 10.0 |
| Other Property (LP) | Internal | | |
| Property | | 12.0 | 10.0 |
| Infra Listed | Internal | 4.5 | |
| Infra LP | Various | | 8.0 |
| Timber & Agriculture | LPs | 0.5 | |
| Other Real Assets | | 5.0 | 8.0 |
| Corporate bonds | Rogge | 5.0 | 0.0 |
| Private Secured Loans | Internal | 0.5 | 0.0 |
| Other Bonds | Internal | 5.5 | 6.0 |
| Alternatives Cash | NT | 0.0 | 0.0 |
| Total Alternatives | | 22.5 | 24.0 |

Investment Performance to 30 September 2015

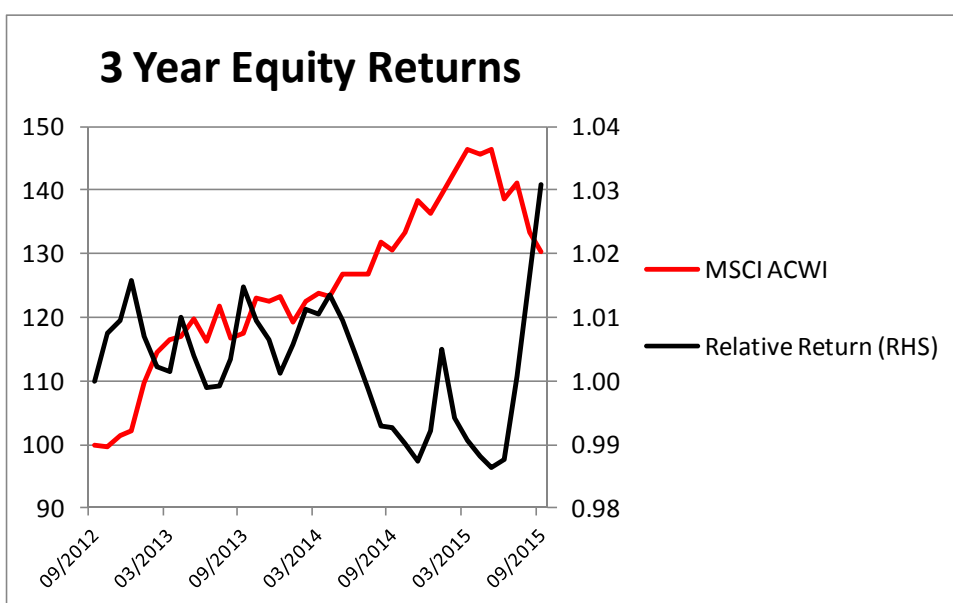
- 3.7 The Fund as a whole has achieved returns in excess of the strategic allocation over the short and long term timeframes shown in the table.

| % per annum | 1 Year | 5 Years | 10 Years |
|----------------------|--------|---------|----------|
| Lothian Pension Fund | +7.1% | +8.6% | +7.1% |
| Benchmark | +1.7% | +7.2% | +5.5% |
| Relative | +5.4% | +1.4% | +1.6% |

- 3.8 The benchmark in the table comprises equity, index-linked gilt and cash indices as well as an inflation-linked index for the alternatives allocation.
- 3.9 The Fund's return over the last five years is 8.6% per annum, well ahead of the benchmark return of 7.2% per annum despite exhibiting lower than benchmark risk.
- 3.10 The Fund's return over the twelve month period is significantly ahead of the benchmark by +5.4%, but there is less information content in this relative return number, not least because the development of asset prices is much more volatile than the development of the UK retail price index (RPI), which is the basis of the Alternatives benchmark, because of the low risk construction of the equity pool of assets and because the currency hedge is designed to reduce risk. With that caveat, stock selection in Alternatives contributed +1.2%, Equities +3.5% and currency hedging +0.7% to the total Fund's relative return of +5.4% over that one year period.
- 3.11 The Investment Strategy Panel assesses the underlying risks of the portfolios that make up the asset allocation to ensure that these are consistent with the long term objectives of the Fund. The direction of the Fund's relative performance when markets are increasing and decreasing is one way of measuring risk. It has been a relatively short time since the Fund adopted its strategy, which included a lower volatility objective, but after an extended period of relatively benign market conditions, the period from end March to end September 2015 brought significantly increased volatility to test the resilience of the strategy.
- 3.12 The first bout of serious anxiety for some time was caused by concerns over the potential timing and pace of interest rate rises in the US & UK, combined with worries over growth in China and lower commodity and oil prices. The performance of the Fund over this period and over the last 12 months does indicate that the Fund is delivering lower volatility and better capital preservation.
- 3.13 The structure of the equity pool of assets and the currency hedge were very helpful in achieving an outcome of lower volatility. The equity pool has a heavy

weighting to lower risk strategies that emphasise income generation and low volatility.

- 3.14 Global equity markets experienced a notable correction in recent months (see red line in chart below) following the steady gains of the last three years. While the Fund's equity exposure also experienced declines, the focus on capital preservation resulted in outperformance of the broader market (black line on the right-hand side scale). In the 3 months to end September 2015, the Fund's equity exposure (excluding private equity) fell by 1.9% compared to a fall of 6.4% in the index.



- 3.15 The Fund hedges exposure to overseas equities where hedging is expected to reduce Fund risk and does not hedge exposure where hedging is expected to magnify Fund risk. Over the last 12 months, the impact of currency hedging on overseas equities exposure was significantly positive - it generated a positive return as well as reducing Fund risk, its primary purpose.

Investment Strategy Review

- 3.16 Following the 2014 Actuarial Valuation, the Investment Strategy Panel has reviewed the Fund's investment strategy in light of developments in pension fund membership, expected cash flow, funding level, fund maturity and historic and prospective investment risk and returns.
- 3.17 Following a dip in active membership between 2008 and 2011, membership resumed a rising trend between 2011 and 2014. Beyond 2014, there are considerable uncertainties related to Council cost-cutting.

| | 2002 | 2005 | 2008 | 2011 | 2014 | Trend |
|-------------------|---------------|---------------|---------------|---------------|---------------|--------|
| Active | 26,940 | 28,446 | 30,726 | 30,031 | 31,536 | Rising |
| Deferred | 9,756 | 11,770 | 14,668 | 15,102 | 17,094 | Rising |
| Pensioners | 17,945 | 18,905 | 20,223 | 21,930 | 24,055 | Rising |
| TOTAL | 54,641 | 59,121 | 65,617 | 67,066 | 72,865 | |

3.18 Net cash flow (excluding investment income) has continued to be positive, but increasingly, investment income will be an important source of stability for the Fund.

| Financial Year | 2002/03 | 2005/06 | 2008/09 | 2011/12 | 2013/14 | Trend |
|---------------------|------------|------------|------------|------------|------------|----------------|
| Income | 117 | 154 | 163 | 188 | 186 | Recently Flat |
| Expenditure | 84 | 95 | 121 | 151 | 173 | Increasing |
| Net Cashflow | +33 | +59 | +42 | +37 | +13 | Falling |

3.19 The funding level declined between the 2011 and 2014 valuations, due to liabilities growing at a faster pace than assets, largely the effect of falling gilt yields.

| Valuation as at 31 March | 2002 | 2005 | 2008 | 2011 | 2014 | Trend |
|--------------------------|-------|-------|-------|-------|-------|------------|
| Assets £m | 1,793 | 2,092 | 2,903 | 3,477 | 4,379 | Increasing |
| Liabilities £m | 1,867 | 2,450 | 3,259 | 3,619 | 4,796 | Increasing |
| Deficit £m | 74 | 358 | 356 | 142 | 417 | Volatile |
| Funding Level % | 96 | 85 | 89 | 96 | 91 | Volatile |

3.20 The Fund's strategy is geared towards long term economic growth with the majority of assets invested in equities. Given the relative immaturity of the Fund and the strong covenant of the majority of the employers, the review reaffirmed that the Fund's existing strategy remains appropriate and that implementation should continue along its planned path to 2017. The Committee are asked to agree that progress towards the investment strategy for 2012-17 should continue.

| Asset Category | Investment Strategy 2012-17 % | Permitted Range % |
|---------------------|-------------------------------|-------------------|
| Equities | 65 | 50 - 75 |
| Index-Linked Assets | 7 | 0 - 20 |
| Alternatives | 28 | 20 - 35 |
| Cash | 0 | 0 - 10 |
| TOTAL | 100 | |

3.21 The review did recognise that investing in illiquid alternative investments could affect the achievement of targeted allocations. Such investments should only be made if they fulfil their role as attractive investments in their own right and as diversifiers for the Fund. The Fund will continue to hold equities, index-linked gilts or cash if attractive alternative investments cannot be sourced. The Investment Strategy Panel reviews the relative attractiveness of the major asset classes every quarter to determine which assets to hold within the constraints of the permitted limits.

3.22 Implementation of the investment strategy requires assessment of internal and external management, including the risks and financial implications of each

option. The Investment Strategy Panel has also reviewed the internal/external balance looking at diversification, governance and market intelligence issues alongside the well-recognised cost benefits of internal management. Panel concluded that there is scope for further increasing the assets to be managed internally provided that staff retention risks can be managed to ensure sustainability. The internal team currently manages over £3bn, approximately two thirds of the Fund's assets.

Investment Strategy Benchmark

- 3.23 The Investment Strategy Panel reaffirmed the existing strategy and also reassessed and reaffirmed the appropriateness of the existing benchmark against which the Fund is monitored with the caveat that it is relevant over the long term, not the short term. Unfortunately, there are no ideal benchmarks given the nature of Alternative assets, whose market values are calculated intermittently rather than continuously.

| Asset Category | Strategic Allocation Strategic Benchmark | |
|---------------------|--|---|
| | 2012-17 | 2012-17 |
| Equities | 65 | MSCI All Countries World Index |
| Index-Linked Assets | 7 | FTSE Index-Linked Gilts > 15 year Index |
| Alternatives | 28 | UK Retail Price Index +3.5%pa |
| | <u>100</u> | |

- 3.24 Panel has debated the relevance of the RPI +3.5% benchmark for Alternatives at length. While noting that this benchmark is imperfect, its relevance stems from the fact that Fund liabilities are tied to inflation and so the required return from Fund assets is related to inflation. Unfortunately, RPI does not behave in the same way as asset prices, except over extended periods of several years. Panel, however, concluded that a perfect benchmark does not exist and so the existing benchmark for Alternatives should be retained.
- 3.25 The weakness of the benchmark is that it is not investible and that it is much less volatile than the market values of the assets in the Fund. Committee should note that recent strong relative performance is partly attributable to the fact that Alternative asset market values have grown at a faster rate than the benchmark of RPI+3.5% per annum. When Alternative asset values fall, as they inevitably will over some timeframes, relative performance will be weaker. Scenario analysis shows that a wide range of relative returns over short term timeframes is likely going forward.
- 3.26 Panel also concluded that the MSCI ACWI benchmark for equities was still appropriate while recognising that it creates a challenging objective given the Fund's current strategic configuration with the majority of the internal equity investments in low risk/low leverage strategies. The Fund is targeting good risk-adjusted returns and measurement of returns in the context of risk, as well as against a benchmark such as the MSCI ACWI, will be important. With this perspective, recent strong relative performance by the equity pool of assets in the weak equity markets of the third quarter of 2015 is encouraging and points to

good risk-adjusted returns. It should be noted that in very strong equity markets, absolute returns should be positive but are likely to lag the benchmark.

- 3.27 Committee should also note that the Investment Strategy Panel utilises other specialist benchmarks at the sub-asset class level to help assess the success of the various investment strategies employed by internal and external managers. For example, a US equity index is used to assess performance of the internal US equity portfolio. In addition, the principles of each internally managed portfolio are reviewed in detail periodically to ensure they remain sound and relevant. Comparisons with external options are made where applicable.

Conclusion

- 3.28 The Fund's Investment Strategy 2012-17 is being implemented gradually. Fund risk has declined materially since 2012 due to the reorganisation of equity and bond mandates and the adjustments to asset allocation.
- 3.29 Performance of the Fund's equity pool of assets during recent equity market volatility has illustrated that strategic changes have positioned the Fund to achieve its objective of better preserving capital during periods of market weakness.
- 3.30 The Investment Strategy Panel's review of strategy post the 2014 Actuarial Valuation reaffirmed the existing strategy with the aim of achieving the strategic allocation by end 2017 subject to suitably attractive alternative investments becoming available in the market.
- 3.31 Panel also reaffirmed the benchmark against which the Fund's investments are monitored, recognising that there is no perfect benchmark given that some assets are infrequently valued.

Measures of success

- 4.1 The investment performance of the Lothian Pension Fund is crucial to the achievement of the required investment return which impacts on the funding level and employers' 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 The report provides an update of 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.
- 6.2 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 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 Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

Alastair D Maclean

Director of Corporate Governance

Contact: Bruce Miller, Investment Manager

E-mail: bruce.miller@edinburgh.gov.uk | Tel: 0131 469 3866

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