

# Pensions Committee

2.00 p.m., Wednesday, 16 December 2015

## Lothian Buses Pension Fund – Investment Strategy Review Update

|                   |     |
|-------------------|-----|
| Item number       | 5.5 |
| Report number     |     |
| Executive/routine |     |
| Wards             | All |

### Executive summary

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This report provides an update on the investments and the investment strategy review of the Lothian Buses Pension Fund.

The Fund's Investment Strategy 2012-17 is being implemented gradually. The Fund's risk reduced over the period since the last review in 2012 with a reduction in the equity weighting accompanied by an increased allocation to index-linked gilts and alternative investments.

Performance of the Fund during recent equity market volatility has illustrated that the strategy has positioned the Fund to achieve its objective of better preserving capital during periods of market weakness.

The Investment Strategy Panel's review of strategy post the 2014 Actuarial Valuation is underway. The outcome of the review and recommendations for the future strategy of the Fund are expected to be reported to Committee in March 2016.

### Links

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Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

## Annual Investment Update – Lothian Buses Pension Fund

### Recommendations

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- 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 and the progress of the investment strategy review 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 of Lothian Buses Pension Fund to 30 September 2015 and on its investment strategy review. Strategy is typically reviewed following the results of the triennial actuarial valuation and the most recent valuation was undertaken in 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 Strategy Implementation

- 3.1 The Fund adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. 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. Investment strategy includes Equities and Alternatives on the assumption that these assets will deliver better performance than Index-Linked Gilts in the long-term.
- 3.2 The Pensions Committee approved the Investment Strategy 2012-17 for Lothian Buses Pension Fund in October 2012.

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

- 3.3 The strategy reduces the allocation to equities (including private equity) from 65% at the end of 2012 (prior to Strategy Review) to 55% 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.
- 3.4 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.
- 3.5 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 has 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.
- 3.6 This is reflected in the table below. Progress towards the increased allocation to alternatives can be seen - the 26% exposure to alternatives only modestly below the 27.5% interim strategy allocation. The equity weighting has also reduced and at 60% is in line with the interim strategy allocation of 60.5%. Equity exposure is now split roughly equally between an externally managed (Baillie Gifford) portfolio and an internally managed Global High Dividend portfolio.

|                            | <b>Manager</b>  | <b>Interim<br/>Strategy<br/>Allocation<br/>31 March<br/>2012<br/>%</b> | <b>Interim<br/>Strategy<br/>Allocation<br/>30<br/>September<br/>2015<br/>%</b> | <b>Actual<br/>Allocation<br/>30<br/>September<br/>2015<br/>%</b> |
|----------------------------|-----------------|--|--|--|
| <b>EQUITIES</b>            |                 |  |  |  |
| Global Alpha               | Baillie Gifford |  |  | 30   |
| Global High Dividend Yield | Internal        |  |  | 29   |
| Private Equity             | Internal        |  |  | 1  |
| <b>Subtotal</b>            |                 | <b>65</b>  | <b>60.5</b>  | <b>60</b>  |
| <b>INDEX-LINKED ASSETS</b> |                 |  |  |  |
| Index-linked bonds         | Baillie Gifford |  |  | 8  |
| Index-linked gilts         | Internal        |  |  | 4  |
| <b>Subtotal</b>            |                 | <b>10</b>  | <b>12.0</b>  | <b>12</b>  |
| <b>ALTERNATIVES</b>        |                 |  |  |  |
| Property                   | Standard Life   | 10   |  | 10   |
| Other Real Assets [1]      | Various         | 15   |  | 8  |
| Other Bonds [2]            | Baillie Gifford |  |  | 8  |
| <b>Subtotal</b>            |                 | <b>25</b>  | <b>27.5</b>  | <b>26</b>  |
| <b>Cash</b>                | <b>Internal</b> | <b>0</b>   | <b>0</b>   | <b>2</b>   |
| <b>TOTAL</b>               |                 | <b>100</b>   | <b>100</b>   | <b>100</b>   |

[1] Includes infrastructure and timber

[2] Includes corporate bonds and loans

3.7 The main constraint to achieving the current strategic plan 2012-17 is that investing in illiquid alternative investments may prevent achievement of target allocations. Panel is clear that such investments should only be made if they fulfil their role as attractive investments in their own right and as diversifiers for the Fund. Having said that, significant progress was made towards the increased allocation to alternatives over the last 12 months with a notable increase in infrastructure investment.

#### **Investment Performance to 30 September 2015**

3.8 The Fund has achieved returns in excess of the strategic allocation over the short and long term timeframes shown in the table.

| <b>% per annum</b>         | <b>1 Year</b> | <b>5 Years</b> | <b>10 Years</b> |
|----------------------------|---------------|----------------|-----------------|
| Lothian Buses Pension Fund | +5.5          | +9.6           | +8.3            |
| Benchmark                  | +2.7          | +7.8           | +6.8            |
| Relative                   | +2.8          | +1.8           | +1.5            |

- 3.9 The benchmark shown in the table comprises equity, index-linked gilt and cash indices as well as an inflation-linked index for the alternatives allocation.
- 3.10 The Fund's return over the last five years is 9.6% per annum, comfortably ahead of the benchmark return of 7.8% per annum.
- 3.11 The Fund's return over the twelve month period is significantly ahead of benchmark, but there is less information content in this relative 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 (RPI +3.5%pa), and because of the low risk construction of the equity pool of assets. With that caveat, Alternatives contributed +1.3%, Equities +1.8% and Index-Linked Assets -0.3% to the total Fund's relative return of +2.7% over that one year period.
- 3.12 Global equity markets experienced a notable correction in recent months following the steady gains of the last three years. The global equity index (MSCI ACWI) declined by almost 11% in sterling terms between 31 March and 30 September 2015.
- 3.13 The strategic shift towards lower volatility equities, in the form of the internally managed Global High Dividend Equity portfolio, has helped to preserve capital and proved beneficial to relative returns. The dividend yield on this portfolio is currently 4.3% compared with the benchmark yield of 2.7%. In the six months to end September, the Global High Dividend portfolio declined by 7.4% compared to the benchmark decline of 10.9%. The overall Fund returned -4.9%, compared to the benchmark return of -6.1% over the same period.

### **Investment Strategy Review**

- 3.14 The Investment Strategy Panel reviews asset allocation and the progress to the new investment strategy on a quarterly basis and the internal team reviews it monthly. The Investment Strategy Panel also undertakes a strategy review every three years, typically following a triennial actuarial valuation.
- 3.15 Following the 2014 Actuarial Valuation, the Investment Strategy Panel has started to review the Fund's investment strategy in light of developments in pension fund membership, expected cash flow, funding level, fund maturity, historic and prospective investment risk and returns. An important consideration is also the employer covenant and the implications of funding level volatility on the company.
- 3.16 Net cash flow (excluding investment income) has been marginally negative. Investment income will become an increasingly important source of stability for the Fund.
- 3.17 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. This trend has continued during 2014/15.

- 3.18 The Fund's strategy is geared towards long term economic growth with the majority of the Fund invested in equities.
- 3.19 The largest funding risks identified were those driven by the liability value, which is a function of changes in long term interest rates and inflation, and the equity risk, which is expected to diminish over the very long term.
- 3.20 The Panel has undertaken scenario analysis, which highlights the importance of the covenant when making investment allocation decisions. In the context of a standalone transport company, the current strategic allocation contains significant funding level and contribution rate volatility, which could affect affordability. The implications of reducing the volatility of funding levels meaningfully are higher contributions. In the context of a company backed by the Council's covenant, a long-term funding approach can be considered with potential for contributions to be smoothed over longer periods of time, which allows for a higher risk/higher return (and therefore, cheaper) strategic allocation.
- 3.21 The review is ongoing and the Fund is working with Lothian Buses plc to ensure that the risks inherent in the strategy are understood and are acceptable. Meantime, it is clear that the current 2017 strategic allocation shown above remains appropriate, is heading in the correct direction, and changes can be accelerated if desired. The outcome of the review and recommendations for the future strategy of the Fund are expected to be reported to Committee in March 2016.

### **Conclusion**

- 3.22 The Fund's Investment Strategy 2012-17 is being implemented gradually. Since 2012, Fund risk has declined materially. This has been as a result of a reduction in weight and reorganisation of the equity exposure, combined with an increased allocation to alternative assets.
- 3.23 Performance of the Fund during recent equity market volatility has illustrated that the strategy has positioned the Fund to help it achieve its objective of preserving capital during periods of market weakness.
- 3.24 The Investment Strategy Panel's review of strategy post the 2014 Actuarial Valuation highlights the importance of the Council's covenant when making investment allocation decisions. In the context of a standalone transport company, the current strategic allocation contains meaningful funding level volatility. The Fund is working with Lothian Buses plc, its sponsor and its advisers to ensure that the risks inherent in the strategy are acceptable before concluding an appropriate investment strategy for the future.

## Measures of success

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- 4.1 The investment performance of the fund is crucial to the achievement of the required investment return which impacts on the funding level and employer contributions. The objectives for the investment 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 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 Fund's investments.

## Consultation and engagement

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- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund. The Pension Board includes a union representative from Lothian Buses.
- 9.2 Regular meetings are held with Lothian Buses plc to update them on the Fund and to consult on strategic issues.

## 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 partnerships to improve services and deliver agreed

**Single Outcome Agreement**

**Appendices** None