

Pensions Committee

2.00 p.m., Wednesday, 16 December 2015

Scottish Homes Pension Fund – Investment Strategy Review & Update

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an update on the investments of the Scottish Homes Pension Fund and the review of strategy undertaken by the Investment Strategy Panel over the last few months.

The estimated funding level (the ratio of assets to liabilities) at 30 September 2015 was 90.6%, increased from 88.8% at the last actuarial valuation at 31 March 2014.

In December 2014 Pensions Committee agreed that the Fund's asset allocation would be adjusted according to changes in funding levels pending a review of investment strategy. Following improvements in the funding level, in January 2015, the equity allocation was reduced from 30% to 27.5% and following the end of the financial year, the equity allocation was further reduced to 25%. Subsequent market movements have led to a deterioration of the funding level and in October 2015 the equity allocation was increased to 27.5%.

Further discussion has taken place with the Scottish Government to review the funding approach. The Scottish Government has agreed to consider various options. Work is currently ongoing on the options and progress will be reported to Pensions Committee in due course.

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Scottish Homes Pension Fund – Investment Strategy Review & 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 update on the discussions with the Scottish Government on funding options, and the investment strategy review, investment performance, funding level 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, are 89.5%, 91.5% and 93.0% at 31 March 2011, 2014 and 2017 respectively. The actual funding levels were below the respective targets in 2011 and 2014. Therefore Scottish Government is 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 have been held with the Scottish Government. Options to change the funding approach, including an option where contributions would be determined by fund cash flows rather than funding level, were explored. The Scottish Government have now agreed to consider options for changes to 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 review of the investment and funding strategy of the Scottish Homes Pension Fund.
- 2.8 The investment strategy and performance have a significant impact on the funding level and potentially on the contributions required from the Scottish Government.

Main report

Funding Level and Investment Strategy

- 3.1 The funding level is monitored regularly by the internal investment team using an on-line system provided by Fund's actuary and the progression of the estimated funding level since 31 March 2015 is shown below:



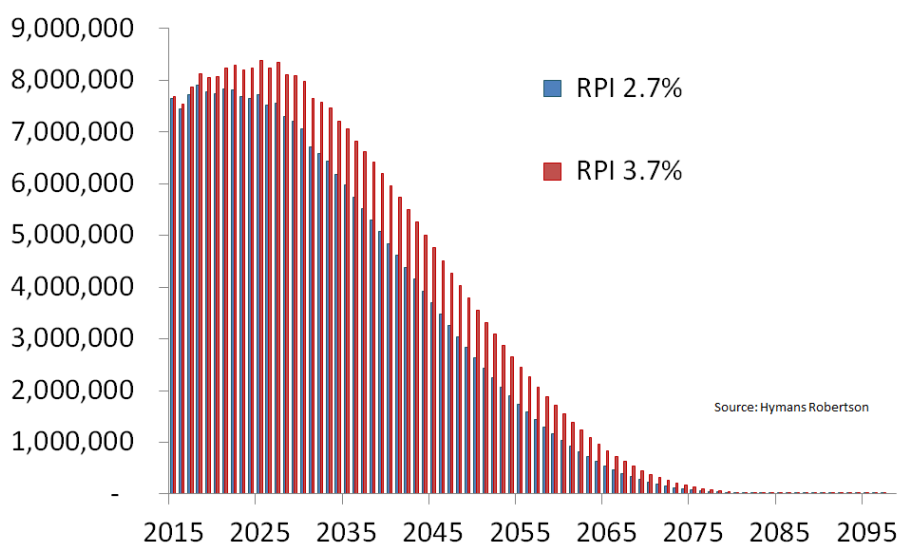
- 3.2 Based on the improved funding level, the strategic equity allocation was reduced from 30% to 27.5% in January 2015 with the bond allocation increasing from 65% to 67.5%.

- 3.3 During April 2015, with equity markets having continued to rally, the funding level estimate rose above the 2017 target funding level of 93%. As a result, the equity allocation was reduced further to 25% resulting in an increased bond allocation of 70%, up from 67.5%.
- 3.4 In the six months to 30 September 2015, global equity markets fell by approximately 10% and the Fund returned -3%. This resulted in a decrease in the estimated funding level to 90.6% and, following discussion with the Investment Strategy Panel, the equity allocation was increased to 27.5% with a corresponding decrease in the bond allocation in the middle of October.
- 3.5 Adjustments to the equity allocation are generally infrequent, but recent changes reflect volatility in financial markets and the fact that the funding level is close to target.
- 3.6 The changes in investment strategy are summarised below:

Scottish Homes Pension Fund – Evolution of Strategy				
	Strategy Allocation 31 March 2014	Strategy Allocation 31 March 2015	Strategy Allocation 30 April 2015	Strategy Allocation 14 October 2015
Asset Class	%	%	%	%
Equities	30.0	27.5	25.0	27.5
Bonds	65.0	67.5	70.0	67.5
Property	5.0	5.0	5.0	5.0
TOTAL	100.0	100.0	100.0	100.0

- 3.7 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 (£)



- 3.8 The Fund's strategic allocation to each manager and asset class following the most recent change in the equity allocation is shown in the table below.

Asset Class	Manager	Strategy Allocation 14 October 2015 %
Equities		
UK	State Street	6.2
US	State Street	8.4
Europe Ex-UK	State Street	5.5
Asia Pacific	State Street	2.2
Japan	State Street	3.0
Emerging Markets	State Street	2.2
Subtotal		27.5
Bonds		
Index-linked gilts	In-house	40.5
Index-linked gilts	State Street	13.4
Fixed income gilts	State Street	13.6
Subtotal		67.5
Property		
Property	Schroders	5.0
Subtotal		5.0
Cash		0.0
TOTAL		100.0

Review of Investment Strategy

- 3.9 Discussions regarding potential changes to the funding agreement were held with the Scottish Government during 2014/15 at the time of the actuarial valuation. However, at that time the Scottish Government preferred 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.
- 3.10 Further discussions have now taken place and the Scottish Government has agreed to consider various options. The investment team along with the Fund's advisors are now working on options for the funding approach and Guarantee. A formal review of the investment strategy will be undertaken as part of this work, including a review of the way in which the individual asset classes are managed. Updates to the Committee will be provided as this work progresses.

Conclusions

- 3.11 Funding levels are monitored regularly and changes to the investment strategy have been implemented following recent market volatility and changes in the funding level. The funding level at the beginning of November 2015 is broadly unchanged compared to that previously reported to Committee (92.8% at 31

March 2015). This is broadly in line with the target funding level of 93.0% for 2017.

- 3.12 Progress on the review of the investment strategy and the funding agreement of the Fund in consultation with the Scottish Government will be reported to Committee.

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 updates progress on the review of the investment strategy, the investment performance and funding level of the Scottish Homes Pension Fund. The investment strategy and performance have 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 Chief Operating Officer 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 Fund's 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 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