Pensions Committee

2.00 p.m., Monday, 27 June 2016

Annual Investment Update – Lothian Pension Fund

Item number	5.8
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an update on the investments and funding position of the Lothian Pension Fund to 31 March 2016.

Following completion of the 2014 Actuarial Valuation, the Fund's Investment Strategy was reviewed. The Pensions Committee agreed in December 2015 that the Investment Strategy 2012-17 remained appropriate.

Over the twelve months to 31 March 2016, investment market returns were generally low - global equities fell modestly, index-linked gilts rose modestly but property rose over 10%. The strategy of lowering risk was rewarded over 2015/16 as the Fund produced a return of +6.5%; the benchmark return was +0.2%. Over five years, the Fund returned 9.1% per annum, ahead of benchmark by 1.9% per annum.

The Fund's actuary completed the triennial valuation during 2014 and reported that Lothian Pension Fund's funding level (the ratio of assets to liabilities) was 91.3% at 31 March 2014. Despite good growth in the Fund's investments since then, liability values have grown faster as yields have fallen. Hence, the overall funding level is expected to be lower.

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Report

Annual Investment Update – Lothian 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 Committee notes the performance, funding update and asset allocation of the Lothian Pension Fund.

Background

2.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2016.

2.2 The investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required by employers.

Main report

Market Background to 31 March 2016

3.1 UK economic growth moderated somewhat in 2015, slowing from 2.9% in 2014 to 2.4% in 2015. The recovery in the labour market continued with unemployment falling to a 10 year low of 5%. Despite this, wage growth has remained subdued, with average earnings staying around 2%. The big surprise of 2015 was inflation falling below zero as oil and other commodity prices continued their slump. Other global economies showed quite diverse growth rates. Growth in developed economies has broadly returned to levels prior to the 2007/08 global financial crisis, around 2%. Growth in emerging markets on the other hand, has reduced significantly over recent years. Brazil and Russia are in recession and growth in China has slowed markedly.

3.2 Asset markets gave relatively lacklustre but volatile returns during 2015/16. Equity market returns were mainly negative, with only the US giving a positive return to UK investors, of 5%. The UK, Eurozone and Japan all gave returns of between -2 and -10% to a UK investor. The worst performing equity markets were those of the emerging markets, with Brazil and China returning -9% and -20% respectively in Sterling terms. The UK index-linked government bond market produced a modest positive return of 2%. Property returns were strongly positive, giving a return of +11%.

3.3 A positive outlook for asset markets relies on developed markets continuing to grow and for emerging markets to recover. In the US, the Federal Reserve has felt confident enough in the growth outlook to raise interest rates by 0.25%, the first monetary tightening in 9 years. Only a very slow and gradual further increase in interest rates is expected, due to low US inflation and the weakness of the global economy. Both the European Central Bank and the Bank of Japan have continued to ease monetary policy in the face of domestic economic weakness and falling inflation. Further easing in both areas is expected in 2016. Growth expectations in the UK lie between those in the US and the Eurozone. Brexit fears have weighed on the currency and investment intentions. UK monetary policy has been unchanged for over 7 years.

3.4 The outcome of the Brexit referendum, the speed of interest rate rises in the US and the performance of emerging economies will have a major impact on global assets. Longer term, asset returns are likely to remain low as global growth, inflation and interest rates all remain subdued.

Investment Strategy and Objectives

3.5 In order to provide suitable investment strategies for the differing requirements of employers, the Fund currently operates two investment strategies.

3.6 Most employer liabilities are funded under Strategy 1, which 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.

3.7 A small number of employers are funded in Strategy 2, which invests in a portfolio of UK index-linked gilts to reduce funding level and contribution rate risk to a level appropriate to their circumstances. The liabilities funded by Strategy 2 represent less than 1% of total liabilities.

3.8 Following completion of the 2014 Actuarial Valuation, the Investment Strategy Panel reviewed the Fund's investment strategy in light of developments in pension fund membership, expected cash flow, funding level, investment risk and return and employer covenant. The Pensions Committee agreed in December 2015 that the Investment Strategy 2012-17 (previously agreed in October 2012) remained appropriate for Strategy 1. It includes Equities and Alternatives on the assumption that these assets will deliver better performance than Index-Linked Gilts in the long-term.

Investment Strategy 2012-17 (Strategy 1)

	Long term Strategy Allocation %	Permitted Range %
Equities	65	50 – 75
Index-Linked Assets	7	0 – 20
Alternatives	28	20 - 35
Cash	0	0 - 10
TOTAL	**100**	

3.9 Strategy 1 makes a small reduction in the allocation to Equities (including private equity), a reduction in risk within Equities and a small increase in 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.

3.10 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.

Asset Allocation and Strategy Implementation

3.11 As described above, Strategy 2 invests in a portfolio of index-linked gilts, which has been in place notionally since 1 April 2015. A new portfolio of these gilts was created during 2015/16.

3.12 The remainder of this section of the report focuses on implementation of the Investment Strategy 2012-17 (Strategy 1). It is proceeding at a measured pace as investment opportunities become available and as research on opportunities is completed. This is reflected in the interim strategy allocation shown in the table below.

Investment Strategy 2012-17 (Strategy 1)

Asset Category	Manager	Actual Allocation 31 March 2015 %	Actual Allocation 31 March 2016 %	Interim Strategy Allocation 31 March 2015 %	Interim Strategy Allocation 31 March 2016 %
EQUITIES					
UK All Cap	Internal	2.0	2.0	2.0	2.0
UK Mid Cap	Internal	2.0	2.0	1.8	1.8
Europe (ex UK)	Internal	2.0	2.0	2.1	2.1
US	Internal	2.3	2.2	2.1	2.1
Emerging Markets	Mondrian	2.1	0.0	2.3	0.0
Emerging Markets	UBS	2.4	0.0	2.3	0.0
Global High Dividend Yield	Internal	13.3	14.2	14.3	14.3
Global Low Volatility	Internal	17.5	18.0	17.5	17.5
Global Value	Internal	6.6	15.4	6.5	15.0
Global	Cantillon	5.2	0.0	5.0	0.0
Global	Nordea	4.0	4.1	3.7	3.7
Global	Harris	4.0	3.5	3.5	3.5
Private Equity	Various	4.8	4.2	5.0	5.0
Currency Hedge	Internal	0.6	-0.2	0.0	0.0
Transition Account	Internal	0.3	0.4	0.0	0.0
Subtotal		**69.1**	**67.8**	**68.0**	**67.0**
INDEX-LINKED ASSETS					
Index-linked gilts/gold	Internal	6.1	7.0	7.0	7.0
Subtotal		**6.1**	**7.0**	**7.0**	**7.0**
ALTERNATIVES					
Property	Various	8.4	8.8	10.0	10.0
Other Real Assets [1]	Various	7.6	10.1	8.0	9.0
Other Bonds [2]	Various	2.9	3.5	6.0	6.0
Alternatives Cash	Internal	2.1	1.6	0.0	0.0
Subtotal		**21.0**	**24.0**	**24.0**	**25.0**
CASH	Internal	3.8	1.0	1.0	1.0
TOTAL FUND		**100**	**100**	**100**	**100**

The table includes small rounding effects
[1] Includes infrastructure and timber; [2] includes sovereign bonds, corporate debt and private debt.

3.13 At 31 March 2016, the Fund had a small overweight position in equities and a small underweight position in Alternatives as a result of the Other Bonds weighting, compared to the interim strategy at 31 March 2016. The table below shows the changes in actual allocation over the financial year 2015/16 and the current interim strategy allocation at end of March 2016.

Equities

3.14 A key objective of the Fund's investment strategy is to reduce risk, including risk within the equity pool of assets, and involves a shift from a regional to a global manager structure. Further steps were taken during 2015/16 in this direction with the termination of the Fund's two emerging market mandates managed by Mondrian and UBS. The decision to terminate was strategic and unrelated to the underlying performance of the portfolios. The portfolios were transitioned into the internally managed Global Value equity portfolio, which is unconstrained and is able to own the shares of emerging market companies if their characteristics meet the mandate criteria.

3.15 One other significant change was made to the equity pool of assets, also in early 2016. A key personnel change at one of the external global equity managers, Cantillon, prompted a review and the decision to terminate the mandate. Cantillon had added value over its benchmark since inception. This portfolio was also transitioned to the internally managed Global Value equity portfolio.

3.16 The activity described above follows the actions taken in recent years to fund internally managed global equity strategies to reduce investment risk. The latest evolution of the structure of the equity portfolio has lowered overall risk slightly. The resultant equity pool of assets is expected to perform relatively well when equity markets are weak and produce good positive absolute returns in rising equity markets.

a. None of the Fund's equity portfolios are constrained by market capitalisation indices, or the tracking error measurement of risk, which is regarded as a suboptimal approach to portfolio construction. Instead the focus is capital preservation and the sustainability of income generation. The Fund's independent performance measurer, Portfolio Evaluation, estimates that the Fund's equity risk is now approximately 94% of the risk of the equity benchmark. This compares with 98% as at 31 March 2012.
b. The transitions described above have increased the equity assets managed by the internal team. Almost 90% of the Fund's listed 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.
c. The Fund also hedges exposures to the currencies of overseas listed equities with the explicit aim of reducing volatility rather than making a return. The Fund therefore maintains exposure to currencies that are expected to reduce volatility, such as the US Dollar and Japanese Yen which tend to fall as equities rise, and hedges exposure to currencies that are expected to increase volatility, such as the Australian Dollar which tend to rise as equities rise. The hedge achieved its objective of reducing volatility over 2015/16, but it detracted modestly from Fund return (-0.2%). The Fund did not hedge most currencies, which was very beneficial to the Fund as its largest equity related currency exposures appreciated against sterling – the US Dollar by 3%, the Euro by 9% and the Japanese Yen by 10%.
d. Given the desire to reduce risk, the decision was made in 2012 not to make further private equity investments as they tend to be more volatile investments involving greater leverage. Rather than sell the private equity holdings, it was decided to allow the allocation to reduce gradually over time as the funds matured and returned capital. The proportion invested has reduced from 4.8% to 4.2% over the year.

Index-Linked Assets

3.17 The Fund’s strategy entails a small increase in index-linked assets (gilts, bonds and gold), which provides diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund’s liabilities. The prospective long term real return is, however, very low. Over 2015/16, the allocation to index-linked gilts increased to 7.0% from 5.9% largely due to new purchases. The Fund also hired an experienced bond portfolio manager to run a new active mandate, which was reviewed and approved by Investment Strategy Panel and implemented during the year.

Alternative Investments

3.18 The Fund’s strategy is to increase the actual allocation to alternative investments, which includes assets such as property, infrastructure, bond-like assets and timber, to provide greater diversification and attractive returns. Many of these investments are unlisted and increasing exposure is dependent on finding attractive opportunities. The Fund’s actual allocation increased from 21% to 24% as a result of investments being made in infrastructure, timber and bond-like assets as well as the relative strength of these investments compared with equities and index-linked gilts.

- The Fund’s longstanding commitment to infrastructure investing bore further fruit over 2015/16 as a strong pipeline of opportunities allowed the Fund to make a number of investments and commitments with a focus on secondary fund interests, selective primary fund commitments and co-investments alongside the Fund’s existing manager/fund relationships. The investment value of the Fund’s infrastructure assets increased from 6% to 8% despite strong distributions of £38million from several successful investments.
- The allocation to commercial property rose modestly over the year due to relative strength in the asset class.
- The other sub-category in Other Real Assets is timber. 2015/16 brought further opportunities to make small additions to the portfolio through secondary fund investments. The allocation rose modestly to 2.3%.
- In the Other Bond category, the actual allocation remains well below the interim strategy allocation of 6%. A considerable amount of research effort has been expended on identifying attractive investments. It remains the case, however, that opportunities to achieve the target return of 3.5% in excess of inflation without the use of leverage are few and far between. However, during the year, a further commitment was made to a private debt fund, which invests in corporate loans and promises such a return with acceptable risk. Further investments are being appraised. The backdrop of unusually low interest rates and narrow corporate credit spreads means that the pace of investment is likely to be slow unless there is a dislocation in market prices. Meantime, the Fund continues to search for investments providing diversification and secure returns.

3.19 The Fund makes commitments to unlisted investment and the timing of these can be uncertain as it depends on the manager being able to purchase assets. Details of outstanding commitments as at 31 March 2016 were as follows:

	Unfunded Commitments in Local Currency			**TOTAL**
	US$ m	**Euros m**	**£ m**	**£ m**
Private Equity	60	10	1	51
Infrastructure	14	48	23	72
Real Estate	-	2	-	1
Private Debt	-	-	10	10
Total	**75**	**60**	**34**	**133**

3.20 Implementation of the investment strategy is delegated to the Executive Director of Resources taking advice from the Investment Strategy Panel and the officers of the Fund. The Director reviews and considers the wide range of implementation options available in the market. Over recent years, the expansion of the internal team has enhanced the Fund's intellectual capital, improved the cost structure of the Fund and lead to the development and implementation of innovative and low cost investment strategies to meet the significant funding challenges faced by the pension funds. The Director will continue to focus on the best ways of achieving the required net investment returns.

Investment Performance to 31 March 2016

3.21 The Fund's performance over the last year and over the longer term timeframes is shown in the table below:

% per annum	**1 Year**	**5 Years**	**10 Years**
Lothian Pension Fund	+6.5%	+9.1%	+6.9%
Benchmark	+0.2%	+7.1%	+5.1%
Relative	***+6.2%***	***+1.9%***	***+1.8%***

3.22 The Fund's return (+6.5%) over the year was substantially ahead of the benchmark return (+0.2%) despite significant restructuring activity affecting the equity pool of assets and the index-linked gilt portfolio. The returns from the underlying asset class benchmarks over 1 and 5 years are as follows:

% per annum	1 Year		5 Years	
	Fund	Benchmark	Fund	Benchmark
Equities	+4.9%	-1.9%	+8.6%	+7.1%
Index-linked gilts	+2.8%	+2.4%	+9.3%	+10.4%
Alternatives	+10.5%	+5.1%	+9.2%	+5.9%

3.23 The direction of the Fund's performance when markets are increasing and decreasing is one way of measuring the volatility. It has been a relatively short time since the lower volatility objective and strategy was put in place and markets volatility has been relatively benign. Nevertheless, performance over the last 3 years does indicate that the Fund is delivering lower volatility. Fund performance over the last 3 years was:

- better than the strategic allocation when markets fell (12 out of 36 months) with average performance of 0.67% better than the strategic benchmark and;
- marginally better than the strategic allocation when markets were rising (24 out of 36 months) with average performance 0.05% better than the strategic benchmark.

3.24 The structure of the equity pool of assets and the currency hedge were helpful in achieving this outcome of lower volatility. 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 2015/16, the impact of currency hedging on overseas equities exposure was in line with the strategy – although it generated a small negative return (0.2%), it succeeded in reducing Fund risk (volatility), which is its primary purpose. The negative return occurred because the Fund had two small hedges and sterling was notably weak over the year against most currencies.

3.25 Over 2015/16, asset allocation differences with the benchmark had a minor impact, detracting 0.2% from relative returns. The only significant effect came from the underweight in Alternatives – the underweight reflected the pace of building the portfolio of private market assets up to the strategy weight. The return of the Alternatives RPI-related benchmark was 5.1%, which was better than the 2.4% return of the Index-Linked Asset benchmark and the 1.8% decline in the Equity benchmark.

3.26 The asset allocation effect was overwhelmed by the very positive stock selection effect, which added 6.4% to relative performance. Notable performance within each asset class was as follows:

- The Fund's Equity investments, managed by the internal team and several external managers, combined to produce an exceptional return of 5.8% over the year, 7.7% ahead of the benchmark led by the global lower volatility portfolios and the internal UK Mid Cap. Private equity returned 19.4% over the year as existing holdings returned capital typically in excess of previously estimated valuations.
- The Fund's Index-Linked investments delivered a return of 2.7% over the year as real yields on index-linked gilts changed little over the 12 month period while the Fund's small gold holding rose 7% in sterling terms by virtue of being priced in US dollars.
- The Fund's Alternative investment performance was 10.5% over the year. Within Alternatives, both the unlisted infrastructure portfolio and the property portfolio returned double digit growth of 20% and 10% respectively. In contrast, bond-related assets returned only 2.7% from conventional sovereign bonds and private debt investments.

3.27 The benchmark shown in the table above comprises equity, index-linked gilt and cash indices as well as an inflation-linked index for the Alternatives allocation. The strong relative returns over one year reflect much better returns for equities than the market capitalisation weighted benchmark and much better returns for Alternatives than the inflation-linked index.

3.28 Returns relative to the benchmark over a one year period need to be placed in the context that there are no ideal benchmarks for many of the assets held in the Fund, especially the Alternatives. The true value and returns on the unlisted investments in the Alternatives portfolio will not be known until assets are realised, perhaps not for several years. Investments are made in Alternative asset classes due to the attractive expected long-term returns and the diversification they provide. Committee should expect returns to deviate meaningfully from the benchmark over shorter time periods. 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.

Scrutiny & Transparency of Investments

3.29 Details of the Lothian Pension Fund's investments are reported regularly, both in Committee reports and in the Report & Accounts, both of which are publicly available. The Fund is also subject to regular Freedom of Information requests to which it responds promptly. A complete list of holdings is also made available on the Fund's website.

Funding Level Update and 2017 Actuarial Valuation

3.30 The funding level is the ratio of the pension scheme's assets to liabilities. At the last actuarial valuation at end March 2014, the funding level was 91.3%. The key financial assumptions included in the actuarial valuation were:

- the return which will be generated by the assets i.e. the rate used to discount the liabilities. This was 3.5% on the gilts basis and 5.0% p.a. on the ongoing basis and;
- the rate at which pension liabilities increase, the Consumer Price Index (assumed to be 2.7%p.a., the market's expectation for Retail Price Index less 0.8%).

3.31 The table below compares these assumptions with the actual experience of the Fund in the two years since the actuarial valuation.

	2014/15 %	**2015/16 %**	**Two years 2014-2016 % p.a.**	**Assumed % p.a.**
Pension Increase[1]	+1.2	-0.1	+0.7	+2.7
Investment Return – Strategy 1	+15.1	+6.5	+10.8	+5.0
Investment Return – Strategy 2	+15.1	+2.4	+8.8	+3.5

[1] CPI applied to pensions in April 2015 and 2016

3.32 Inflation has been lower than expected and investment returns for both strategies have been in excess of that assumed. These would be expected to increase the funding level.

3.33 The following table shows the current market-based assumptions at 20 May 2016 (as if the Actuary was undertaking a valuation now) and compares them with the market-based assumptions at the 2014 actuarial valuation.

	31 March 2014 %	**Current [1] %**	**Change %**
Pension Increase	2.7	2.3	-0.4
Investment Return – Strategy 1	5.0	3.7	-1.3
Investment Return – Strategy 2	3.5	2.2	-1.3

[1] As at 20 May 2016

3.34 The net discount rate used to value the liabilities has fallen by 0.9% (i.e. 1.3% - 0.4%) since 31 March 2014. This is expected to have increased the value of the liabilities by approximately 15-18%.

3.35 In summary, despite good growth in the Fund's investments since March 2014, liability values have grown faster as yields have fallen. Hence, the overall funding level is expected to be lower.

3.36 A preparatory meeting has been held with the Actuary ahead of the 2017 actuarial valuation. Committee will recall the Contribution Stability Mechanism put in place for large, financially secure employers ahead of the 2014 actuarial valuation. The Mechanism set unchanged contribution rates for 2015-2018 for these employers and provided an indication of rates for 2018-2021 limiting the annual increases and decreases. For most employers, this was an increase of 0.5% per annum from April 2018 onwards. Before the end of 2016, work will be undertaken with the Actuary to review the sustainability of the Contribution Stability Mechanism and other key assumptions for the 2017 actuarial valuation. A report on the review will be provided to the Pensions Committee.

Conclusion

3.37 Implementation of Investment Strategy 1 has progressed steadily over the last twelve months. Three external equity portfolios were transitioned to an internal global equity portfolio targeting improved risk-adjusted returns; exposure to index-linked gilts was increased and a new active mandate reviewed and approved; the allocation to the other bonds portfolio was increased through a private debt commitment; and a strong pipeline of real asset opportunities in both infrastructure and timber were converted into investments. Strategy 2 is invested in a portfolio of index-linked gilts to minimise funding risk.

3.38 The absolute performance of Lothian Pension Fund over the twelve month period was 6.5%. Five year performance is 9.1% per annum. Over ten years, the Fund returned 6.9% per annum.

3.39 The context for the one year mid-single digit return for the Fund was a period of generally weak investment markets with the Fund’s largest asset class, equities falling. The Fund’s equity investments provided protection in falling markets and Alternative investments provided strong performance over the year.

3.40 At the 2014 triennial actuarial valuation, the funding level at 31 March 2014 was 91.3%. Despite good growth in the Fund’s investments since March 2014, liability values have grown faster as yields have fallen. Hence, the overall funding level is expected to be lower.

3.41 The Investment Strategy Panel and internal team continue to focus on implementation of the two investment strategies with a focus on increasing the allocation to alternative investments in Strategy 1 where possible and on researching and funding complementary strategies.

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 details 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 Funds' investment strategies are 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 Executive Director of Resources, who takes advice from the Investment Strategy Panel. The Investment Strategy Panel is an important element of the governance of the Pension Fund investments. In addition, active engagement with the companies in which the Fund invests should reduce risk and enhance the sustainability of investment performance.

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 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

None

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