Pensions Committee

2.00 p.m., Monday, 27 June 2016

Annual Investment Update – Lothian Buses Pension Fund

Item number	5.9
Report number	
Executive/routine	
Wards	All

Executive summary

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

As planned, the Fund's equity allocation was reduced over the year and allocations to index-linked, other real and fixed income allocations increased.

Over the twelve months to 31 March 2016, investment market returns were generally low – global equities fell modestly, index-linked gilts rose modestly and property rose over 10%. The Fund produced a return of 3.1% over the year, ahead of the benchmark return of 1.2%. Over five years, the Fund returned 9.6% per annum, ahead of benchmark by 1.8% per annum.

Despite good growth in the Fund's investments since March 2014 (the most recent actuarial valuation), liability values have grown faster as yields have fallen. Hence, the overall funding level is expected to have fallen.

The Fund's Investment Strategy was reviewed over the year and in March 2016 the Pensions Committee agreed a revised Investment Strategy for 2016-21 reflecting the increasing maturity of the scheme, which is closed to new members.

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Report

Annual Investment Update – Lothian Buses 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 Buses Pension Fund.

Background

2.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Buses 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 the employer, Lothian Buses plc.

Main report

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 2012-17 was agreed by Committee in October 2012.

3.2 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.

3.3 The implementation of the strategy progressed over the financial year 2015/16 as investment opportunities became available and as research on opportunities was completed. Progress involved the interim strategy allocation and the actual asset allocation changing gradually over time.

3.4 The changes to the interim strategy allocations and actual allocations over the financial year 2015/16 are shown in the table below.

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					
Global High Dividend Yield	Internal	30	30		
Global Alpha	Baillie Gifford	32	29		
Private Equity	Internal	1	1		
Subtotal		**63**	**60**	**60.5**	**58.5**
INDEX-LINKED ASSETS					
Index-Linked Bonds	Baillie Gifford	7	7		
Index-Linked Gilts	Internal	4	5		
Subtotal		**11**	**12**	**12.0**	**14.0**
ALTERNATIVES					
Property	Standard Life	9	10		
Infrastructure, Timber	Internal	6	9		
Other Bonds [1]	Various	7	8		
Subtotal		**22**	**26**	**27.5**	**27.5**
CASH	Internal	**4**	**2**	**0**	**0**
TOTAL		**100**	**100**	**100**	**118**

[1] Includes corporate bonds and loans

3.5 The Investment Strategy Panel reviews asset allocation and the progress to the long term investment strategy on a quarterly basis and the internal team reviews it weekly.

3.6 At 31 March 2016, the Fund has an overweight position in equities, other real assets and cash compared to the interim strategy allocation. The Fund has an underweight position in index-linked and fixed income assets.

3.7 The main changes made over 2015/16 are described below:

- As part of the move to reduce equity exposure towards the interim strategy allocation, £7.7m was withdrawn from Baillie Gifford's equity portfolio.
- Dividend income has also been withdrawn regularly from the internally managed global equity portfolio to further aid the targeted reduction in equities.
- The allocation to index-linked gilts was increased slightly, but the pace of investment has been gradual due to the high valuations/ reflected in low real yields available in the market.
- 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 'Other Real assets' assets increased from 15% to 18%, a combination of new commitments and valuation uplifts offset by strong distributions from some successful investments. Several UK, European and US infrastructure investments and two global

timber investments were made amounting to £10.2m, and distributions from existing investments were £1.9m, meaning that net investment was £8.3m.

3.8 The Fund makes commitments to unlisted investments and the timing of these is uncertain as they depend 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**
Infrastructure	-	2.7	1.7	3.9
Private Debt	-	-	0.7	0.7
Total	**-**	**2.7**	**2.5**	**4.6**

Investment Strategy Review

3.9 Following completion of the 2014 Actuarial Valuation, an in-depth review of Lothian Buses Pension Fund's investment strategy was undertaken by the Investment Strategy Panel supported by asset liability modelling from the Fund's investment adviser over 2015/16.

3.10 The review highlighted the potential impact of future funding level volatility on the company's balance sheet and contributions. In recognition of this and the increasing maturity of the scheme, Lothian Buses agreed to continue paying deficit contributions (if required) after the last active member has left the Fund. With this clarity, the Fund is able to adopt a long-term investment approach.

3.11 The Pensions Committee approved in March 2016 a revised Investment Strategy 2016-21, which is shown in the table below, together with the Fund's previous strategy:

Asset Class	**PREVIOUS Long Term Strategy Allocation 2012-17**	**REVISED Long Term Strategy Allocation 2016-21**
Equities [1]	55%	40%
Index-Linked Assets [2]	15%	20%
Other Real Assets [3]	30%	18%
Fixed Income Assets [4]		22%
Cash	0%	0%
TOTAL	100%	100%

[1] Includes listed & unlisted equities

[2] Includes index-linked gilts & gold

[3] Includes property, infrastructure & timber

[4] Includes corporate bonds and loans

3.12 The revised strategy reduces the long term allocation to equities (including private equity) from 55% to 40% by the end of 2021 and increases the allocation to index-linked gilts from 15% to 20% within the same timeframe.

3.13 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.

3.14 The Investment Strategy Panel will be reviewing the implementation of the strategy, together with a review of the potential to merge the Lothian Buses Pension Fund into Lothian Pension Fund over the summer of 2016. Updates will be provided to Committee in due course.

Investment Performance to 31 March 2016

3.15 The Fund has achieved returns in excess of the strategic allocation over the last year and over the longer term timeframes shown in the table.

% per annum	**1 Year**	**5 Years**	**10 Years**
Lothian Buses Pension Fund	+3.1	+9.6	+7.8
Benchmark	+1.2	+7.8	+6.3
Relative	***+1.9***	***+1.8***	***+1.5***

3.16 The Fund's return (+3.1%) over the year was ahead of the benchmark return (+1.2%). The five year return was 9.6% per annum and the 10 year return was 7.8% per annum.

3.17 The Fund's equity investments delivered marginally positive returns (+1.4%) against the backdrop of a falling benchmark (-1.2%) over the year. All three equity portfolios contributed positively: the internally managed Global High Yield Equity portfolio rose 2.9%; Baillie Gifford's Global Alpha portfolio was flat (but better than benchmark) and the much smaller Private Equity portfolio rose 1.6%.

3.18 The Fund's Index Linked assets gained 1.9% over the year, lagging their benchmark return of 2.1%. Following the recruitment of an experienced bond manager, a new active mandate was approved and implemented during the year. After the end of the financial year, the Baillie Gifford index-linked gilt fund was sold due to ongoing performance concerns and the proceeds were reinvested in the new internal mandate.

3.19 The Fund's Alternative assets gained 8.1% over the year, which compares with the inflation-linked benchmark return of 5.1%. Within Alternatives, returns were positive for infrastructure (+18.4%) and timber investments (+6.9%) - the double digit gain from the infrastructure portfolio was by far the largest contributor to the excess return. Property investments produced a return of almost 10% while investment grade bonds generated a disappointing zero return.

3.20 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. 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 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. 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.

Funding Level

3.21 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 116.7% on an ongoing basis and 88.2% on a more prudent gilts basis.

3.22 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 (assumed to be 5.0% p.a., based on 1.5% in excess of the return available on government bonds) 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%).

3.23 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
Fund Return	+16.5	+3.1	+9.8	+3.5 or +5.0

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

3.24 Inflation has been lower than expected and investment return has been in excess of that assumed. These would be expected to increase the funding level.

3.25 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 – Ongoing basis	5.0	3.7	-1.3
Investment Return – Gilts basis	3.5	2.2	-1.3

[1] As at 20 May 2016

3.26 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 at least 10%.

3.27 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.

Conclusion

3.28 Implementation of the Investment Strategy 2012-17 progressed over the year with a decrease in the actual allocation to equities and cash and an increase in the actual allocation to index-linked gilts and alternatives.

3.29 A revised investment strategy has been agreed for the period 2016-21 recognising the increasing maturity of the Fund, which demands a lower risk investment approach over time. Implementation will be planned over the summer together with a review of the option to merge Lothian Buses Pension Fund into Lothian Pension Fund.

3.30 The absolute performance of Lothian Buses Pension Fund over the twelve month period was +3.1%. Five year performance was +9.6% per annum. Over ten years, the Fund returned +7.8% per annum.

3.31 Despite good performance of the Fund's assets since the 2014 actuarial valuation, the reduction in gilt yields has increased the value of liabilities, leading to a reduction in the funding level.

Measures of success

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

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

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 Acting 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.

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 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

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