Pensions Committee

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Annual Investment Update – Lothian Pension Fund

Item number	5.4
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

This report provides an update on the investments and funding position of the Lothian Pension Fund to 31 March 2018.

Over the twelve months to 31 March 2018, investment market returns were generally strong, albeit hampered by volatility towards the end of the period. Returns for sterling investors were offset by the significant recovery in the currency over the year - global equities gained +11.3% in local currency terms, but only +2.4% in sterling. Meanwhile, government bond yields in the major markets remained broadly unchanged for most of the year before rising in early 2018. Long-dated index-linked gilts rose +1.1% over the year, while the UK property market returned +10.7%.

The Fund aims to achieve a return in line with its strategic benchmark, over the long term, with a lower level of risk. Over five years, the Fund has exceeded its target return, delivering returns above the benchmark with lower risk, having returned +10.3% per annum, ahead of benchmark by +1.0% per annum. Over the year, higher risk assets experienced strong underlying returns and the Fund returned +1.4%, behind the benchmark return of +3.6%.

The Fund's actuary completed the triennial valuation in 2018 and reported that Lothian Pension Fund's funding level (the ratio of assets to liabilities) was 98% at 31 March 2017, an improvement from 91% at 31 March 2014. The funding level at 31 March 2018 is estimated to have fallen slightly over the year.

Report

Annual Investment Update – Lothian Pension Fund

1. Recommendations

Committee is requested to:

1.1 Note the performance, funding update and asset allocation of the Lothian Pension Fund.

2. 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 2018.

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

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

2.4 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 Assets and Alternatives, which are the key determinants of investment risk and return.

2.5 The Fund's – Strategy 1 - 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.

2.6 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 as these employers approach exit from the Fund. The liabilities funded by Strategy 2 represent less than 1% of total liabilities.

2.7 The plan for the Fund's investment strategy was initially set during 2012, and reviewed again in 2015/2016, taking into account the results of the 2014 actuarial valuation. A review of investment strategy will be undertaken again over the coming months, taking into account the results of the latest 2017 actuarial valuation.

2.8 The Fund's strategy incorporates a gradually changing risk profile for the Fund, but retains significant exposure to real investments, such as Index-Linked Assets and Equities, which have a history of protecting or enhancing purchasing power, after the effects of inflation have been taken into account. Prior to the 2012-17 investment strategy, the targeted allocation was 71.5% Equities, 5% Index-Linked gilts, 22.5% Alternatives and 1% Cash. The 2012-17 strategy is shown in the table below.

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**	

2.9 Investments are made in Alternative asset classes due to the attractive expected long-term returns and the diversification they provide. Additionally, the low risk equity exposure is specifically designed to provide downside protection in times of market stress while participating in some, though not necessarily all, of any upward movement. Committee should expect returns to deviate meaningfully from the benchmark over shorter time periods.

2.10 Implementation of the investment strategy is delegated to the Executive Director of Resources, who in turn delegates to the Head of Finance, who takes advice from the Investment Strategy Panel which comprises independent advisers and the officers of the Fund. 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. 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.

3 Main report

Market Background to 31 March 2018

3.1 For the 12 months to 31 March 2018, UK and global equities delivered low signal-digit returns (UK +1.1%, global +2.4%). Equity market returns for sterling-based investors were dampened by the strength of the pound over the year (global equities returned +11.3% in local currency terms), which reversed much of the fall in value that followed the EU referendum in June 2016. The sharp pull-back in equity markets during Q1 2018 was also a factor, with markets falling as much as 10% from their January 2018 highs to their lows in late March.

3.2 Government bond yields in most major markets remained broadly unchanged for most of the year, before rising in early 2018. Stronger US inflation data pushed up expectations that the US Federal Reserve would raise rates faster than previously anticipated, having already raised interest rates three times over 2017. Credit and high yield bond yields (relative to government bonds) traded in a narrow range over the year, with high yield bond yields remaining close to their historic lows in both US and Europe.

3.3 In the UK, the Bank of England increased its base rate as expected in November 2017, though this was also accompanied by commentary at the time suggesting that further rate rises were less imminent given the Bank's cautious outlook for the economy as the path to the UK's exit from the EU remains unclear. In Europe, 2017 saw significant positive economic growth, though more recent data emerging in Q1 2018 suggested that this was beginning to slow.

3.4 The UK property market performed strongly, returning +10.7%, with more positive investor sentiment following the weaker period in the prior year following the EU referendum result.

3.5 Over the year, global economic growth forecasts were increased for 2017 and for 2018. While the latest global outlook has turned more positive, there remains significant dispersion at country level with the UK economic outlook the weakest of the major economies.

3.6 Following the passing of Trump's tax reform programme in late 2017, equities continued to march higher through January, before resurgent volatility in late January sent risk assets sharply lower before stabilising somewhat in March. Looking ahead, investors face the prospect of further tightening of monetary policy in the US, alongside concerns around increased protectionism and ongoing geo-political tensions concerning Russia, the Middle East and Korea.

Asset Allocation and Strategy Implementation

3.7 As described above, Strategy 2 invests in a portfolio of index-linked gilts, which has been in place since 1 April 2015; investments in Strategy 2 were £54.6m at end March 2018.

3.8 Over the year, Strategy 1 has proceeded to its long term strategy allocation, as reflected in the interim strategy allocations, with reductions in the allocations to Equities (including private equity) and an increase in the allocation to Alternatives, as shown in the table below.

Investment Strategy – 31 March 2017 and 31 March 2018 (Strategy 1)

Asset Category	Manager	Actual Allocation 31 March 2017 %	Actual Allocation 31 March 2018 %	Interim Strategy Allocation 31 March 2017 %	Interim Strategy Allocation 31 March 2018 %
EQUITIES					
UK All Cap	Internal	2.0	2.1	2.0	2.0
UK Mid Cap	Internal	1.9	2.0	1.8	1.8
Europe (ex UK)	Internal	1.8	2.0	2.1	2.1
US	Internal	2.3	2.2	2.1	2.1
Global High Dividend Yield	Internal	14.3	13.0	14.3	14.3
Global Low Volatility	Internal	17.9	16.7	17.5	17.5
Global Stable Multi-Factor	Internal	15.1	14.2	15.0	15.0
Global	Nordea	4.3	4.1	3.7	3.7
Global	Harris	4.0	4.2	3.5	3.5
Private Equity	Various	3.2	2.3	4.0	3.0
Currency Hedge	Internal	0.0	0.2	0.0	0.0
Transition Account	Internal	0.4	0.0	0.0	0.0
Subtotal		**66.9**	**63.0**	**66.0**	**65.0**
INDEX-LINKED ASSETS					
Index-linked gilts	Internal	7.2	6.9	7.0	7.0
Subtotal		**7.2**	**6.9**	**7.0**	**7.0**
ALTERNATIVES					
Property	Various	7.0	7.5	10.0	9.0
Other Real Assets [1]	Various	12.6	13.1	9.0	11.5
Other Bonds [2]	Various	4.0	4.4	7.5	7.5
Alternatives Cash	Internal	1.5	4.2	0.0	0.0
Subtotal		**25.1**	**29.2**	**26.5**	**28.0**
CASH	Internal	1.0	0.8	0.5	0.0
TOTAL FUND		**100**	**100**	**100**	**100**

The figures include rounding, so subtotals and totals may not sum.
[1] Includes infrastructure and timber; [2] includes sovereign bonds and private debt.

3.9 At 31 March 2018, the Fund had a small underweight position in equities, offset by small overweight positions in Alternatives and Cash.

Equities

3.10 A key objective of the Fund's investment strategy is to reduce risk and this is largely achieved by reducing risk within the equity pool of assets. Implementation of the strategy has involved a shift from a regional to a global manager structure. Significant steps have been taken in this regard in prior years with the introduction of the internally managed global equity portfolios. As such, 2017/18 represented much more of a "steady state" in terms of the structure within the equity exposure.

3.11 The activity in recent years has been to increase the proportion of internally managed global equity strategies to reduce investment risk. 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.

3.12 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 at 31 March 2018 is approximately 93% of the risk of the equity benchmark. This compares with 98% as at 31 March 2012.

3.13 Almost 85% 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.

3.14 The Fund also hedges exposures to the currencies of overseas listed equities with the explicit aim of reducing volatility rather than seeking to generate improved returns. 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 tends to rise as equities rise.

3.15 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 financial leverage. As historic investments mature, cash is being returned from these investments at a faster pace than new money is being invested - as such, the portfolio exposure is reducing. Private equity has fallen from 3.2% of the Fund at end March 2017 to 2.3% at end March 2018.

3.16 The dividend income from the internally managed global equity portfolios has been withdrawn on a monthly basis to reduce the equity allocation while avoiding transaction costs. A net £116 million was withdrawn during 2017/18.

Index-Linked Assets

3.17 Index-linked assets provide 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. The Fund is broadly in line with its strategic allocation.

Alternative Investments

3.18 The Fund's strategy is to increase the actual allocation to alternative investments, which includes assets such as property, infrastructure, non-index-linked bonds 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 25.1% to 29.2% over the year, through a combination of further new investments in infrastructure assets and private debt as well as money invested in pre-existing commitments

3.19 The Fund's longstanding commitment to infrastructure investing bore further fruit over 2017/18 as a strong pipeline of opportunities allowed the Fund to make a number of investments and commitments, including a primary fund investment, two secondary fund interests and five co-investments alongside the Fund's existing manager/fund relationships. The investment value of the Fund's infrastructure assets increased from 10.6% to 11.4%.

3.20 The other sub-category in Other Real Assets is timber, and the investment value declined modestly over the year from 2.0% to 1.7% as funds made distributions. There were no new investments over the period.

3.21 The allocation to commercial property increased over the year from 7.0% to 7.5%, on stronger performance relative to the broader portfolio (+8.2% vs +1.4%).

3.22 In the Other Bond category, the actual allocation remains below the interim strategy allocation of 7.5%. Research continues to identify attractive investments. It remains the case, however, that opportunities to achieve the target return of 3.5% in excess of inflation without excess investment risk or additional leverage are few and far between. During the year, an additional commitment of £50m was made to another private debt fund, which invests in corporate loans and aims to deliver the target return with acceptable risk. The credit cycle is maturing and public corporate credit spreads remain narrow. As such, the pace of investment has been measured and this will remain the case unless there is a dislocation in market prices. Meantime, the Fund continues to search for investments providing diversification and secure returns.

3.23 The Fund makes commitments to unlisted investments 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 2018 were as follows:

	TOTAL	
	£ m	**% of Fund assets**
Private Equity	40	0.6%
Infrastructure	90	1.4%
Real Estate	1	0.0%
Private Debt	91	1.4%
Total	**222**	**3.4%**

Investment performance

3.24 The performance of Strategy 2 was in line with benchmark over the year, returning +0.5%. Performance of this strategy has also been in line with benchmark since inception (29 March 2016), with a return of +10.1% per annum.

3.25 The following comments relate to Strategy 1. The Fund's performance over the last year and over longer-term timeframes is shown in the table below:

Strategy 1 - % per annum	**1 Year**	**5 Years**	**10 Years**
Lothian Pension Fund	+1.4%	+10.3%	+8.7%
Benchmark	+3.6%	+9.3%	+7.5%
Relative	***-2.1%***	***+1.0%***	***+1.2%***

Note: figures are rounded so numbers may not sum

3.26 The Fund's return has exceeded its objective of meeting the benchmark return over the economic cycle, with both the 5 and 10 year return ahead of benchmark.

3.27 The direction of the Fund's performance when markets are increasing and decreasing is one way of measuring volatility. The lower volatility objective and strategy for Strategy 1 was put in place in December 2013 and over this period market volatility has been relatively benign, for the most part. Nevertheless, performance since the change in structure (with the launch of the global low volatility equity portfolio and the shift from regional passive to active) indicates that the Fund is delivering returns with lower volatility than its benchmark.

3.28 For Strategy 1, fund performance since January 2014 to March 2018 has been:

- better than the strategic allocation when markets fell (17 out of 51 months) with average performance of 0.32% better than the strategic benchmark and,
- very marginally worse than the strategic allocation when markets were rising (34 out of 51 months) with average performance 0.03% behind the strategic benchmark.

3.29 Risk analysis also shows that the portfolio is positioned well if markets fall significantly.

3.30 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 (ex private equity)	-1.1%	+2.4%	+10.2%	+10.4%
Private equity	+3.8%	+2.4%	+14.7%	+11.0%
Index-linked gilts	+1.1%	+1.1%	+9.2%	+9.9%
Alternatives	+6.3%	+6.8%	+9.5%	+5.8%

3.31 The benchmarks shown in the table above include equities, private equity, index-linked gilts and an inflation-linked index for the Alternatives allocation. The weak relative returns over one year reflect weaker relative returns for equities than the market capitalisation weighted benchmark and modestly weaker returns for Alternatives than the inflation-linked index.

3.32 Over the year to 31 March 2018, notable performance within each asset class was as follows:

- The Fund's listed equity investments (ex private equity), managed by the internal team and two external managers, combined to produce a return of -1.1% over the year, behind the equity benchmark return of 2.4%. Sterling strength detracted from returns for both the fund and the equity benchmark as the majority of the Fund's overseas equity currency exposures is unhedged. Relative weakness in equities was mainly driven by underperformance from each of the global equity portfolios other than Harris. This was partially offset by the relative strength of the UK and European regional portfolios which outperformed their respective benchmarks and, unlike the global portfolios, did not suffer from the adverse impact of sterling appreciation (the euro appreciated modestly against the pound).
- The Fund's residual Private Equity allocation delivered positive returns relative to benchmark, returning +3.8% against the equity benchmark return of 2.4%.
- The Fund's currency hedge achieved its objective of reducing volatility over 2017/18, adding modestly to the Fund return (+0.2%). However, sterling strength did detract from the Fund's overall equity returns, as the Fund's largest equity related currency exposures (US dollar, Euro, Swiss franc, Japanese yen) depreciated against sterling over the year.
- The Fund's Index-Linked investments delivered a return of +1.1% over the year, broadly in line with benchmark as expected, with the holdings managed on a passive basis.

- The Fund's Alternative investment allocation returned +6.3% over the year. Within Alternatives, returns from infrastructure limited partnerships and property were strong at +13.2% and +8.2% respectively, while timber returns were offset by sterling strength, returning -5.1%. Private debt performed as expected returning +6.7%.

3.33 The structure of the equity pool of assets and the currency hedge were helpful in achieving the 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 2017/18, the impact of currency hedging on overseas equities exposure was in line with the strategy and generated a small positive return (+0.2%), reducing overall Fund risk (volatility), which is its primary purpose. The positive return occurred because the Fund had two small hedges (against the Australian and Canadian dollars) and sterling was stronger against these currencies over the year.

3.34 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 within the Alternatives allocation. 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.

3.35 Over 2017/18, asset allocation differences between the Fund and its benchmark had a minimal net impact on relative returns. The overweight to Other Real Assets was a minor positive as infrastructure limited partnership assets outperformed (+13.2%), though this was offset by a marginal negative contribution from the underweight to property, which also delivered strong returns (+8.2%) relative to the Alternatives benchmark.

Scrutiny & Transparency of Investments

3.36 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

3.37 The funding level is the ratio of the pension scheme's assets to liabilities. During the year, the 2017 actuarial valuation was completed, with an improvement in the funding level to 98% at 31 March 2017, from 91% at 31 March 2014.

3.38 The key financial assumptions included in the 2017 actuarial valuation were:

- the return which will be generated by the assets i.e. the rate used to discount the liabilities. This was 1.7% on the gilts basis (for Strategy 2) and 3.2% p.a. on the ongoing basis (for Strategy 1, reflecting the higher risk/return asset mix) and;
- the rate at which pension liabilities increase, the Consumer Price Index (assumed to be 2.4%p.a., the market's expectation for Retail Price Index less 1.0%).

3.39 The table below compares the actual experience of the Fund over the past three years to 31 March 2018, against the actuarial assumptions ("Assumed % p.a.").

	2015/16 %	2016/17 %	2017/18 %	3 yrs to 31 Mar 2018 % p.a.	Assumed % p.a.[2]
Pension Increase[1]	-0.1	+1.0	+3.0	+1.3	+2.6
Investment Return – Strategy 1	+6.5	+21.7	+1.4	+9.5	+4.4
Investment Return – Strategy 2	+2.4	+19.9	+0.5	+7.3	+2.9

[1] CPI applied to pensions in April 2016, 2017 and 2018
[2] Reflects 31 March 2017 valuation assumptions for year 2017/2018, and prior valuation for periods prior.

3.40 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, all other things being equal.

3.41 The funding level at 31 March 2018 is estimated to have fallen slightly over the year.

Investment Strategy Review

3.42 Preparations for an investment strategy for the Fund, in collaboration with Falkirk Council Pension Fund are underway, taking into account the 2017 actuarial valuation results.

3.43 A report on the investment strategy review will be provided to the Pensions Committee in due course.

Conclusions

3.44 The final stages of the implementation of Investment Strategy 1 have taken place over the last twelve months. As the private equity investments mature and distribute cash, this has allowed a modest reduction in the overall allocation to equities; while the overall allocation to alternatives has increased with further investment in infrastructure and a modest increase in other bonds through further commitment to private debt. Strategy 2 is invested in a portfolio of index-linked gilts to minimise funding risk.

3.45 The absolute performance of Lothian Pension Fund over the twelve-month period was 1.4%. Five-year performance is 10.3% per annum. Over ten years, the Fund returned 8.7% per annum.

3.46 The context for the modest single-digit return for the Fund has been a year of strong returns for most risk assets, offset by significant recovery in sterling, while government bonds have been stable.

3.47 At the 2017 triennial actuarial valuation, the funding level at 31 March 2017 was 98%, an improvement from the 2014 valuation funding level of 91%. The funding level at 31 March 2018 is estimated to have fallen slightly over the year.

3.48 The Investment Strategy Panel and internal team continue to focus on the monitoring and management of existing investments and increasing the allocation to alternative investments in Strategy 1 where possible and on researching and finding complementary strategies.

4 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.

5 Financial impact

5.1 The report details the investment performance and funding position of the Lothian Pension Fund. The investment performance has a significant impact on the funding levels and potentially on the contributions required from employers.

6 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 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 in turn delegates to the Head of Finance, 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.

7 Equalities impact

7.1 There are no equalities implications as a result of this report.

8 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 Fund's investments.

9 Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

10 Background reading/external references

10.1 None.

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11 Appendices

None.