

# Pensions Committee

2.00pm, Wednesday, 27 June 2018

## Annual Investment Update – Scottish Homes Pension Fund

Item number	5.6
Report number	
Executive/routine	
Wards	All
Council Commitments	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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This report provides an update for the year to end March 2018 on the evolution of the funding level of the Scottish Homes Pension Fund, its strategy allocation and the performance of its assets.

As reported at the March 2018 Pensions Committee meeting, the funding level of the Scottish Homes Pension Fund at 31 March 2017 was 104.7%, an increase from 88.8% at the 2014 valuation. The main factor causing the improvement was higher than expected investment returns.

In accordance with the Funding Agreement, there were several changes to strategy allocation over 2017/18 as the funding level improved. The Scottish Government declined to amend the Funding Agreement in early 2018 and with the funding level above 100%, the equity and property assets were sold between February and early April. The proceeds were reinvested in index-linked gilts to minimise future funding level volatility.

## Annual Investment Update – Scottish Homes Pension Fund

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the changes to the funding level, the strategy and actual asset allocations, and the asset returns of the Scottish Homes Pension Fund to end 31 March 2018. The Fund's assets now comprise index-linked gilts and cash, matching expected liability payments as closely as possible; and
- 1.2 Approve the following new investment objective:

*To match the cash flow from gilt income and redemption payments as closely as possible with the expected liability payments of the Fund.*

### 2. Background

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- 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 time.
- 2.3 The strategy, approved by the Pensions Committee in December 2014, changed the allocation to equities, bonds and property dependent on the development of the actuary's estimate of the funding level. The strategy anticipated that the equity and property allocations would reduce over time as the funding level increases to 100% by 2044.
- 2.4 The Target Funding Level (TFL), as set out in the Guarantee, was 93% at 31 March 2017, the date of the last formal actuarial valuation. The Actual Funding Level (AFL) was 104.7%. The main factor causing the improvement in the AFL was higher than expected investment returns over the three years between valuations.
- 2.5 As the AFL was above the TFL, no deficit contributions are required from the Scottish Government (as Guarantor) for the period April 2018 to March 2021. The Guarantor will meet the cost of administration costs, but investment expenses will be met out of the current funding surplus.

- 2.6 The main body of this report provides an update on the funding level progression and associated changes to strategy and actual allocation in the year to 31 March 2018.

### 3. Main report

#### Funding Level and Investment Strategy

- 3.1 As reported at the March 2018 Pensions Committee meeting, the funding level of the Scottish Homes Pension Fund at 31 March 2017 was 104.7%, an increase from 88.8% at the 2014 valuation.
- 3.2 The Fund's actuary monitors the intra-valuation fluctuations in the funding level using a system that reflects movements in interest rates and asset markets. Over the year to 2018, these fluctuations have been small as the mix of assets owned by the Fund are mostly index-linked gilts, which move proportionately with liability values.
- 3.3 The strategy allocation of the Fund is altered based on the actuary's estimate of the funding level. Over the year to 31 March 2018, there were significant changes to the strategic allocation. The Equity allocation was reduced from 17.5% to 0%, Property was reduced from 5% to 0% and Bonds were increased from 77.5% to 100%. These changes to investment strategy occurred in stages over 2017/18 and are summarised in the table below:

<b>Scottish Homes Pension Fund Evolution of Strategy 2017/18</b>				
<b>Asset Class</b>	<b>Strategy Allocation March 2017</b>	<b>Strategy Allocation June 2017</b>	<b>Strategy Allocation Sept 2017</b>	<b>Strategy Allocation March 2018</b>
Equities	17.5%	15%	10%	0%
Bonds	77.5%	80%	85%	100%
Property	5%	5%	5%	0%
<b>TOTAL</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

- 3.4 The initial changes to the strategy allocation were triggered by movements in interest rates and asset prices that affected the actuary's funding level estimate. However, the final change increasing Bonds to 100% was prompted by the results of the triennial Actuarial Valuation at 31 March 2017, which indicated that the funding level was higher than previously estimated. This was partly because the actuary made some revisions to the financial and demographic assumptions to reflect actual experience over the intervening three years.
- 3.5 The Fund's Equity and Bond portfolios were managed by the internal team over the last year. The Property portfolio was managed by Schroder in a pooled fund of UK commercial real estate. Over the year, the Equity allocation was invested in a portfolio of shares of global companies that generate robust and growing dividends. The Bond allocation was invested in a portfolio of UK index-linked gilts designed to match the liability payments of the Fund as closely as possible.

- 3.6 The Fund's actual allocation to each asset class at 31 March 2017 and 2018 is shown in the table below, together with the strategic allocation at 31 March 2017 and 2018.

<b>Asset Class</b>	<b>Strategy Allocation 31/03/2017</b>	<b>Actual Allocation 31/03/2017</b>	<b>Strategy Allocation 31/03/2018</b>	<b>Actual Allocation 31/03/2018</b>
<b>Equities</b>				
<b>(Global High Dividend Yield)</b>	17.5%	17.2%	10.0%	0.0%
<b>Bonds</b>				
<b>(UK Index-Linked Gilts)</b>	77.5%	76.4%	85.0%	91.9%
<b>Property</b>				
<b>(UK Commercial Real Estate)</b>	5.0%	4.8%	5.0%	2.7%
<b>Cash</b>	0.0%	1.6%	0.0%	5.4%
<b>TOTAL</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

- 3.7 Following the Scottish Government's decision not to amend the Funding Agreement, plans were made to sell the remaining 10% equity held in the internally managed Global High Dividend Yield portfolio. These are highly liquid assets, which were sold in March. Property assets are less liquid and the 5% held in the pooled property fund managed by Schroder was sold in two tranches, the second of which completed in early April. The table below shows the impact of the sale at 3 April 2018, from which date all investments are index-linked gilts and cash.

<b>Asset Class</b>	<b>Strategy Allocation 31/03/2018</b>	<b>Actual Allocation 31/03/2018</b>	<b>Strategy Allocation 03/04/2018</b>	<b>Actual Allocation 03/04/2018</b>
<b>Equities</b>				
<b>(Global High Dividend Yield)</b>	10.0%	0.0%	0.0%	0.0%
<b>Bonds</b>				
<b>(UK Index-Linked Gilts)</b>	85.0%	91.9%	100.0%	91.9%
<b>Property</b>				
<b>(UK Commercial Real Estate)</b>	5.0%	2.7%	0.0%	0.0%
<b>Cash</b>	0.0%	5.4%	0.0%	8.1%
<b>TOTAL</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

- 3.8 As the Scottish Homes Pension Fund is mature, it must sell assets to pay pensions. The portfolio of index-linked gilts is structured so that gilt redemptions are matched with those pension payments as closely as possible. Cash or cash equivalents are also held to enable pensions to be paid in between the dates that gilts redeem. Over 2017/18, £7m was sold to pay pensions, which compares with the Fund value of £162m at the end of March 2018.

## Investment Performance to 31 March 2018

- 3.9 The Fund's investment objectives agreed in December 2013 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.
- 3.10 The Fund's benchmark comprises global equity, index-linked gilt and property indices. Over 2017/18, these returned +2.4%, -0.2% and +11.3% respectively.
- 3.11 The Fund's annualised performance over the year and longer-term periods is shown in the table below.

<b>Return (% per annum)</b>	<b>1 Year</b>	<b>5 Years</b>	<b>10 Years</b>
Scottish Homes Pension Fund	0.3	8.2	8.5
Benchmark	0.7	8.2	8.5

- 3.12 The Fund has performed in line with its strategic allocation (benchmark) over the long run. The difference between the Fund return and the benchmark over the last year reflects the fact that the equity allocation was invested in a portfolio of low risk shares that lagged the higher risk benchmark. This equity portfolio was funded during 2016/17 to generate higher income with which to pay pensions, following analysis of the Fund's cash flow requirements. Over 2017/18, it generated a significantly higher income yield (3.8%) than the benchmark (2.5%).

### **New Investment Objective**

- 3.13 Now that the Fund has achieved full funding faster than expected and the Fund is fully invested in index-linked gilts to minimise funding level risk, it is appropriate to change the investment objectives.
- 3.14 The Pensions Committee is asked to approve the following new investment objective:

*To match the cash flow from gilt income and redemption payments as closely as possible with the expected liability payments of the Fund.*

### **Conclusions**

- 3.15 Despite very modest investment returns from the Fund over 2017/18, improvements to the estimated funding level of the Scottish Homes Pension Fund triggered reductions in the strategy allocations to Equity and Property assets.
- 3.16 The results of the 2017 Actuarial Valuation at 31 March 2017 revealed that the funding level was higher than expected, above target and above 100% - it was 104.7%, an increase from 88.8% at the 2014 valuation. The actuary estimates that the funding level has not changed significantly over the year to end March 2018.
- 3.17 As the Scottish Government decided not to change the Funding Agreement, the Equity and Property assets were sold in their entirety towards the end of the year to meet the mandate requirements with the proceeds now invested in index-linked

gilts and cash. This minimises funding level risk from investment markets in the future.

- 3.18 The internal team now manages all of the Fund assets and will focus on structuring the index-linked gilt portfolio to match liability payments as closely as possible, in line with the proposed new investment objective.

#### **4. Measures of success**

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- 4.1 The City of Edinburgh Council's primary requirement is to ensure appropriate funding arrangements for the Scottish Homes Pension Fund to ensure there are, or will be, sufficient assets to pay the liabilities.
- 4.2 Now that full funding has been achieved and the Fund is now invested in index-linked gilts, the key measures of success will be continuing full funding and payment of pensions as they fall due. Implementation of the proposed investment objective (*to match the cash flow from gilt income and redemption payments as closely as possible with the expected liability payments of the Fund*) should ensure success. Funding levels will continue to be subject to the actuary's financial or demographic assumptions for future experience.

#### **5. Financial impact**

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- 5.1 This report details the investment performance and funding level of the Scottish Homes Pension Fund. The investment performance has a significant impact on the funding level and potentially on the contributions required from the Scottish Government.
- 5.2 The financial impact for the Scottish Government is a key consideration. The decision not to change the funding agreement provides greater certainty of the funding level, but at a potentially higher long-term cost.

#### **6. Risk, policy, compliance and governance impact**

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- 6.1 Investment strategy is a key determinant of funding level, risk and volatility of employer contribution rates.
- 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 delegates in turn to the Head of Finance, who takes advice from the Investment Strategy Panel. The Panel is an important element of the governance of the pension fund investments.

## 7. Equalities impact

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

## 8. Sustainability impact

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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 Funds' investments.

## 9. 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 and they are invited to comment on the relevant matters at Committee meetings.

9.2 Regular updates are provided to Scottish Government with ongoing liaison and consultation.

## 10. Background reading/external references

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10.1 None

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## 11. Appendices

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