Pensions Committee

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Annual Investment Update – Lothian Buses Pension Fund

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Executive Summary

This report provides an update on the investments and funding position of the Lothian Buses Pension Fund to 31 March 2017.

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. As part of the initial phase of the implementation of the new Investment Strategy, the Fund's equity allocation was reduced over the year and the allocation to index-linked gilts was increased.

Over the twelve months to 31 March 2017, investment market returns were very strong, driven in no small part by the devaluation of Sterling following the UK's decision to leave the EU – global equities rose over 32%, index-linked gilts rose more than 26%, corporate bonds gained 9% and Property rose around 4%. The Fund produced a return of 23.7% over the year, just behind the benchmark return of 24.2%. Over five years, the Fund returned 13.2% per annum, ahead of benchmark by 1.7% per annum.

Although there has been good growth in the Fund's investments since March 2014 (the most recent actuarial valuation), liability values have also grown as yields have fallen. Progress is being made on the 2017 actuarial valuation.

Report

Annual Investment Update – Lothian Buses Pension Fund

1. Recommendations

Committee is requested to:

1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider; and

1.2 Note the performance, funding update and asset allocation of the Lothian Buses 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 Buses Pension Fund to 31 March 2017.

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.

3. 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. A new Investment Strategy 2016-21 was agreed by Committee in March 2016. This aims to better align the risk assets held by the Fund with its maturing liability profile by reducing equity exposure to 40%, increasing the index-linked asset allocation to 20%, and increasing investments in real and fixed income assets to 40% (18% and 22% respectively) in a phased manner over the 5-year time horizon.

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 2016/17 as investment opportunities became available and as research on selected individual opportunities was completed. Any assessment of implementation progress should consider that both the interim strategy allocation and the actual asset allocation will change over time.

3.4 The actual allocations at 31 March 2016 and 31 March 2017, along with the corresponding interim strategy allocations, are shown in the table below:

Asset Category	Manager	Actual Allocation 31 March 2016 %	Actual Allocation 31 March 2017 %	Interim Strategy Allocation 31 March 2016 %	Interim Strategy Allocation 31 March 2017 %
EQUITIES					
Global Alpha	Baillie Gifford	28.6	25.7		
Global High Dividend Yield	Internal	29.6	29.4		
Private Equity	Internal	1.2	1.3		
Subtotal		**59.4**	**56.3**	**58.5**	**57.0**
INDEX-LINKED ASSETS					
Index-Linked Gilts	Baillie Gifford	7.2	0.0		
Index-Linked Gilts	Internal	5.0	15.2		
Subtotal		**12.2**	**15.2**	**14.0**	**15.0**
REAL ASSETS					
Property	Standard Life	10.2	7.9		
Infrastructure	Internal	6.3	8.9		
Timber	Internal	2.1	1.8		
Subtotal		**18.7**	**18.6**	**17.5**	**18.0**
FIXED INCOME ASSETS					
Corporate Bonds	Baillie Gifford	6.9	6.2		
Private Debt	Internal	0.7	1.4		
Subtotal		**7.6**	**7.6**	**10.0**	**10.0**
CASH	Internal	**2.1**	**2.3**	**0.0**	**0.0**
TOTAL		**100.0**	**100.0**	**100.0**	**100.0**

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

3.6 At 31 March 2017, the Fund had small overweight positions in index-linked assets, real assets and cash compared to the interim strategy allocation. The Fund had underweight positions in equities and fixed income assets.

3.7 The main changes made over 2016/17 are described below:

- As part of the move to reduce equity exposure, £24m was withdrawn from Baillie Gifford's equity portfolio in two tranches (£10m in May 2016 and a further £14m in January 2017).
- Dividend income has also been withdrawn regularly from the internally managed global equity portfolio to help reduce equity exposure.
- The allocation to index-linked gilts was increased by approximately 3% during the year to bring the fund closer to its new interim strategy allocation of 15%. Within the index-linked allocation, the assets managed by Baillie Gifford (approximately £28m) were transferred into the internally-managed index-linked gilt portfolio in May 2016, along with around £8m of cash proceeds withdrawn from the Baillie Gifford Equity portfolio.

- The Fund's longstanding commitment to infrastructure investing continued to bear fruit over 2016/17 as a continued strong pipeline of opportunities allowed the Fund to make further 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 real assets rose from £73.5m at 31 March 2016 to £90.0m at 31 March 2017 as a combination of new commitments and valuation uplifts were offset by strong distributions from some successful investments. Several UK and European infrastructure investments were made amounting to £17.4m, while distributions from existing investments were £2.9m. There were no new investments in timberland, though there were distributions of £0.9m. Therefore, total other real asset net investment was £13.6m over the year.
- Within the real assets allocation, the Fund's allocation to property is below its interim allocation weight partly due to the poor relative returns of the asset class.

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 2017 were as follows:

	Unfunded Commitments in Local Currency			**TOTAL**
	US$ m	**Euros m**	**£ m**	**£ m**
Infrastructure	1.7	4.0	1.7	6.4
Private Debt	-	1.4	2.7	3.8
Timber	-	-	-	-
Total	**1.7**	**5.4**	**4.4**	**10.2**

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 can adopt a long-term investment approach.

3.11 In March 2016, the Pensions Committee approved a revised Investment Strategy 2016-21, which is shown in the table below:

Asset Class	Long Term Strategy Allocation 2016-21
Equities [1]	40%
Index-Linked Assets [2]	20%
Other Real Assets [3]	18%
Fixed Income Assets [4]	22%
Cash	0%
TOTAL	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% and fixed income assets from 12% to 22% 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 reviewed the implementation of the investment strategy and agreed to progress the Fund strategy along the following lines pending the decision on whether the fund is merged within the Lothian Pension Fund (see later in this report):

- Retain the current interim strategic allocation.
- Continue to make new real assets (including infrastructure/timber) investments where appropriate for the Fund, with a focus on income-producing assets.
- Continue to make new private debt investments where appropriate
- Sell listed private equity on an opportunistic basis
- Retain global alpha equities and corporate bonds managed by Baillie Gifford.

Investment Performance to 31 March 2017

3.15 The Fund produced an extremely strong investment return of 23.7% over the year to 31 March 2017, which is well above historical averages. Although the return fell slightly short of the strategy allocation benchmark over the last year, which can be entirely attributed to the Fund holding approximately 2% of its assets in cash throughout the year, it has returned more than its benchmark over longer-term timeframes as shown in the table below:

% per annum	1 Year	5 Years	10 Years
Lothian Buses Pension Fund	+23.7	+13.2	+9.6
Benchmark	+24.2	+11.5	+8.0
Relative	***-0.5***	***+1.7***	***+1.6***

3.16 The five-year return was 13.2% per annum and the 10-year return was 9.6% per annum (compared to benchmark returns of 11.5% and 8.0% respectively). The Fund therefore continues to meet its main objective of achieving a return consistent with that of its strategic allocation over long-term economic cycles.

3.17 The overall Fund benchmark returns shown in the table on page 6 comprise the relevant benchmark index returns from equity, index-linked gilts and an inflation-linked index for the real assets and fixed income allocations. Returns relative to the benchmark over a one year period need to be considered against the fact that there are no ideal benchmarks for a significant portion of the assets held in the Fund, especially for the real assets. That the return over 12 months has been close to benchmark this year disguises significant deviations (from benchmark) within the constituent assets, particularly within the real assets part of the portfolio. 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.

3.18 The Fund reduced equity risk over the period around the UK's referendum on EU membership by selling a portion of its equity exposure and reinvesting it in bond futures contracts. This "hedge" contributed 0.1% to the excess return at the Total Fund level despite being in place for just a short (10 day) period.

3.19 The Fund's equity investments delivered very strong positive returns (+32.0%) against a broadly similar return for the benchmark (+32.2%) over the year. All three equity portfolios provided strong absolute returns: the internally managed Global High Yield Equity portfolio rose 27.7% (although this was behind the benchmark); Baillie Gifford's Global Alpha portfolio returned 35.6% (better than benchmark) and the much smaller Private Equity portfolio rose 36.4% (better than benchmark).

3.20 The Fund's index-linked assets gained 26.3% over the year, slightly lagging their benchmark return of 26.5%. The Baillie Gifford index-linked gilt fund was sold in May 2016 and the proceeds reinvested in the internal index-linked gilt mandate to lengthen the duration of the portfolio.

3.21 The Fund's "alternative" assets were reclassified as real assets (comprising timber, infrastructure and property) and fixed income assets (comprising corporate bonds and private debt) at the beginning of April 2016. Overall, the combined real and fixed income assets (formerly the "alternatives" portfolio) returned 7.2% compared to the inflation-linked return of 6.9%. The real assets portion rose 6.2% over the year, which fell short of the inflation-linked benchmark return of 6.9% as relative underperformance from property more than offset outperformance from infrastructure and timber. Within the real asset allocation, returns were positive for infrastructure (+18.7%) and timber investments (+16.5%), with the gain from infrastructure again being by far the largest contributor to the excess return. Property investments (managed by Standard Life) produced a negative return of -5.4% compared to a (specialist property) benchmark return of +3.9%. This was due to having a large allocation to the retail segment of the market which performed poorly, and because of the high exposure to the London office market, which suffered in the wake of the Brexit vote.

3.22 The return on fixed income assets was a healthy 10.0%, considerably ahead of the inflation-linked benchmark return of 6.9%. Within this segment, the corporate investment grade bond portfolio managed by Baillie Gifford returned 10.2%, ahead of its benchmark of 9.3%. The private debt portfolio returned 7.6%, also ahead of its inflation-linked benchmark of 6.9%.

Funding Level

3.23 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 88.4% on a more prudent gilts basis.

3.24 The key financial assumptions included in the actuarial valuation were:

- the return which will be generated by the assets, that is 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%p.a.).

3.25 The table below compares these assumptions with the actual experience of the Fund in the three years since the actuarial valuation:

	2014/15 %	**2015/16 %**	**2016/17 %**	**3 years 2014-2017 %p.a.**	**Assumed %p.a.**
Pension Increase [1]	+1.2	-0.1	+1.0	+0.7	+2.7
Fund Return	+15.1	+3.1	+23.8	+13.7	+3.5 or +5.0

[1] CPI applied to pensions in April 2015, 2016 and 2017

3.26 Inflation has been lower than expected and Fund investment returns have been greater than assumed in the 2014 actuarial valuation. All else equal, these two factors would be expected to increase the funding level.

3.27 The following table shows the current market-based assumptions at 31 March 2017 and compares them with the assumptions at the 2014 actuarial valuation.

	31 March 2014 %	31 March 2017 %	Change %
Pension Increase	2.7	2.6	-0.1
Investment Return – Ongoing basis	5.0	3.2	-1.8
Investment Return – Gilts basis	3.5	1.7	-1.8

3.28 The net discount rate used to value the liabilities has fallen by 1.7% (i.e. 1.8% - 0.1%) since 31 March 2014. As an estimate, this can be expected to have increased the value of the liabilities by at least 30%.

3.29 Preparations are underway for the 2017 actuarial valuation and draft results are expected in the Autumn. We will also take forward our discussions with Lothian Buses and its stakeholders over a possible merger with the Lothian Pension Fund to reduce the administrative burden of and difficulty in progressing the new investment strategy. This will be facilitated by the new employer unitisation accounting system.

3.30 In summary, despite good growth in the Fund's investments since March 2014, liability values have also grown as yields have fallen.

Conclusion

3.31 The current investment strategy was agreed in March 2016 to be implemented over the period 2016-21. This recognises the increasing maturity of the Fund, which demands a lower risk investment approach over time.

3.32 Implementation of the Investment Strategy 2016-21 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, fixed income and other real assets.

3.33 The absolute performance of Lothian Buses Pension Fund over the twelve-month period was +23.7%. Five-year performance was +13.2% per annum. Over ten years, the Fund returned +9.6% per annum.

3.34 Despite good performance of the Fund's assets since the 2014 actuarial valuation, the reduction in gilt yields has increased the value of liabilities.

3.35 Preparations are underway for the 2017 actuarial valuation, which will require a review of the underlying assumptions. An analysis of the merits of a merger with the Lothian Pension Fund is also ongoing, the results of which are expected to be presented to stakeholders during the year. The results of the 2017 actuarial valuation are expected to be presented to Committee by March 2018.

4. 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.

5. 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.

6. 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 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.

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 (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.

9. Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund.

9.2 Regular meetings are held with Lothian Buses plc to update them on the Fund and to consult on strategic issues.

10. Background reading/external references

10.1 None

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11. Appendices

None