

Pensions Committee

11.00am, Wednesday, 27 September 2017

Annual Investment Update – Scottish Homes Pension Fund

Item number	5.9
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

Over the twelve months to 31 March 2017, the Scottish Homes Pension Fund produced a return of 18.9%. The Fund's estimated funding level (the ratio of assets to liabilities) has increased to 96.2% at 31 March 2017 from 88.8% at the last formal valuation date of 31 March 2014.

Changes to the Fund's asset allocation based on funding level progress were agreed by the Pensions Committee in December 2014. During 2016/17, there were a number of changes to asset allocation reflecting further improvements in the estimated funding level. The equity strategic allocation was decreased over the year from 30% to 17.5%.

The portfolio structure has also been revised, resulting in a portfolio where the expected cash flows will more closely match the expected liability outflows for the Fund. The bulk of the Fund's assets are also now managed in-house, resulting in reduced ongoing investment manager fees.

Committee has previously agreed that the Executive Director of Resources should progress an updated funding agreement with Scottish Government, in consultation with the Actuary, Investment Strategy Panel and Convener of the Pensions Committee. Further engagement with the Scottish Government is ongoing and will be progressed as the draft results of the 2017 actuarial valuation are discussed with Scottish Government.

Annual Investment Update – Scottish Homes 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 Scottish Homes Pension Fund.

2. Background

- 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 ('the Guarantee') between the Scottish Government and the City of Edinburgh Council 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 the volatility of the funding level as the Fund is closed to new members and the liabilities will continue to mature over time.
- 2.3 The investment strategy is set at asset class level between equities, bonds and property, on the basis that the high-level asset class characteristics will drive overall Fund investment risk and return. The strategy incorporates progressive changes to the allocation to equities and bonds dependent on the development of the actuary's estimate of the funding level.
- 2.4 The Target Funding Level (TFL), as set out in the Guarantee, was 91.5% at 31 March 2014, the date of the last formal actuarial valuation. The actual funding level was below target at this date. Therefore, Scottish Government will pay a contribution of £675,000 p.a. from April 2015 to March 2018.
- 2.5 Discussions regarding potential changes to the funding agreement have been held with the Scottish Government reviewing options to change the funding approach, including an option where contributions would be determined by fund cash flows rather than funding level. Work is currently ongoing and progress will be reported to Pensions Committee in due course.
- 2.6 Pending further engagement with the Scottish Government, Committee approved a change to the investment strategy in December 2014 whereby the equity and bond

allocations are adjusted depending on the funding level in accordance with the following table:

**Scottish Homes Pension Fund
Strategic Allocation Targets**

Equity Allocation	Target Funding Level	Year
35%	89.5%	2011
30%	91.5%	2014
25%	93.0%	2017
20%	94.5%	2020
15%	95.5%	2023
10%	96.5%	2026

- 2.7 The purpose of the report is to provide an update on the investment and funding position of the Scottish Homes Pension Fund to 31 March 2017.
- 2.8 Under the current funding agreement, the investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required from the Scottish Government.

3. Main report

Investment Performance to 31 March 2017

- 3.1 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.
- 3.2 The Fund's annualised performance over the year and longer-term periods is shown in the table below. The Fund has delivered performance that is broadly in line with its benchmark over all the time periods shown and consistent with the Fund's primary investment objective.

% per annum	1 year	5 years	10 years
Scottish Homes Pension Fund	18.9	10.8	9.1
Benchmark	18.7	10.7	9.1
Relative	0.2	0.1	0.0

- 3.3 Over the past one, five and ten year periods to 31 March 2017, broad indices of global equities (MSCI ACWI in GBP) returned +32%, +14% and +9% per annum; UK index-linked gilts (FTSE All Stocks) +20%, +9% and +9% per annum; and UK property +4%, +10% and +4% per annum.

Funding Level and Investment Strategy

- 3.4 The funding level is monitored regularly by the internal team using an on-line system provided by the Fund's actuary. The progression of the estimated funding level since 31 March 2014 in the chart below shows there has been a relatively steady improvement in the measure since January 2016. Positive returns from the Fund's assets have more than offset increases in the valuation of the Fund's liabilities from falling gilt yields.



Source: Hymans Robertson

- 3.5 The funding level at 31 March 2017 was estimated to be 96.2%, an improvement upon the funding level estimate of 92.3% as at 31 March 2016. (The most recent funding level estimate of 96.4% at 15 August 2017 is shown in the graph above.)

- 3.6 The estimated funding level of 96.2% at 31 March 2017 is well ahead of the 2017 target funding level of 93.0%.

Note that the funding levels referred to above are based on the 2014 actuarial valuation, allowing for market movements since then. The 2017 actuarial valuation is currently underway and will be reported to Committee before 31 March 2018.

- 3.7 As the Fund's estimated funding level improved over the year, the allocation to equities was reduced from 30% to 17.5% over several stages, with corresponding increases in the allocation to bonds. The changes in investment strategy over 2016/17 are summarised in the table below:

Scottish Homes Pension Fund Evolution of Strategy 2016/17					
Asset Class	Strategy Allocation 31 March 2016	Strategy Allocation 16 June 2016	Strategy Allocation 26 Oct 2016	Strategy Allocation 11 Jan 2017	Strategy Allocation 22 March 2017
Equities	30%	25%	22.5%	20%	17.5%
Bonds	65%	70%	72.5%	75%	77.5%
Property	5%	5%	5%	5%	5%
TOTAL	100%	100%	100%	100%	100%

Manager allocation changes

- 3.8 Following analysis undertaken by the Investment Strategy Panel of the Fund's current and future cash flow requirements, changes to the Fund's investment manager structure were implemented in March 2017 prior to the year end.
- 3.9 Alongside the reduction in the allocation to equities in March 2017, the passive equity and bond mandates managed by State Street were transitioned to be managed internally by the in-house investment team.
- 3.10 The equities were transitioned to the Global High Dividend Yield equity mandate, for its higher income generation, mirroring the portfolios managed for Lothian Pension Fund and Lothian Buses Pension Fund.
- 3.11 The bond assets were transitioned into a buy-and-hold portfolio of index-linked gilts, structured such that the expected coupon and redemption payments of the individual gilts will, in aggregate, more closely match the profile of expected future liability payments.
- 3.12 Following the above asset transitions to internal management, ongoing external investment manager fees have been reduced.
- 3.13 Over the year, assets were also withdrawn from the Fund for pensions expenditure. The amount withdrawn over 2016/17 was £7.5m.
- 3.14 The table below shows the Fund's actual allocation to each manager and asset class at 31 March 2016 and 31 March 2017, alongside the corresponding strategic allocation.

Asset Class	Manager	Actual Allocation 31/03/2016	Strategy Allocation 31/03/2016	Actual Allocation 31/03/2017	Strategy Allocation 31/03/2017
Equities					
UK	State Street	6.8%	6.8%		
US	State Street	9.2%	9.1%		
Europe ex-UK	State Street	6.0%	6.0%		
Asia Pacific	State Street	2.4%	2.4%		
Japan	State Street	3.3%	3.3%		
Emerging Markets	State Street	2.5%	2.4%		
Global High Dividend Yield	In-house			17.3%	17.5%
Equities Subtotal		30.2%	30.0%	17.3%	17.5%
Bonds					
Index-linked gilts	In-house	40.3%	41.0%	76.4%	77.5%
Index-linked gilts	State Street	10.9%	10.9%		
Fixed income gilts	State Street	13.3%	13.1%		
Bonds Subtotal		64.5%	65.0%	76.4%	77.5%
Property					
Property	Schroders	5.3%	5.0%	4.8%	5.0%
Property Subtotal		5.3%	5.0%	4.8%	5.0%
Cash Subtotal		0.0%	0.0%	1.6%	0.0%
TOTAL		100.0%	100.0%	100.0%	100.0%

Conclusions

- 3.15 The absolute performance of Scottish Homes Pension Fund has been strongly positive over the 12month period to 31 March 2017 with a return of +18.9%. Five year and ten year performance is +10.8% and +9.1% per annum respectively.
- 3.16 Returns for the Fund over the past year, five years and ten years to 31 March 2017 have been in line with benchmark, consistent with the Fund's primary investment objective.
- 3.17 The Fund's funding level continues to be monitored on a regular basis, with the estimated funding level having improved over the past year to 96.2% at 31 March 2017, well ahead of the 2017 target funding level of 93.0%.
- 3.18 As the Fund's funding level has improved over the past year, the Fund's allocation to equities has also been reduced (in stages), from 30% to 17.5%, resulting in a reduced level of Fund investment risk.
- 3.19 The portfolio structure has also been revised, resulting in a portfolio where the expected cash flows will more closely match the expected liability outflows for the Fund. The bulk of the Fund's assets are also now managed in-house, resulting in reduced ongoing investment manager fees.
- 3.20 Work is ongoing on the 2017 actuarial valuation and discussions will progress on the funding agreement with the Scottish Government. Progress will be reported to Committee before end March 2018.

4. Measures of success

- 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 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 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 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 proposed change to the funding guarantee could provide greater certainty for the

contributions required from the Scottish Government, but with a more volatile funding level.

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

10. Background reading/external references

- 10.1 None.

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11. Appendices

None