Pensions Committee

2.00pm, Wednesday, 20 March 2024

Investment Strategy Review

Item number 6.6

1. Recommendations

The Pensions Committee (Committee) is requested to:

1.1 Approve amendments to the investment strategy as outlined in paragraphs 4.7 to 4.8 and 4.25.

1.2 Subject to approval of the amendments above, also approve updates to the Fund's Statement of Investment Principles (SIP) to reflect the agreed changes to strategy (separately included in Appendix 1).

David Vallery
Chief Executive Officer, Lothian Pension fund

Contact: Emmanuel Bocquet, Chief Investment Officer, Lothian Pension fund

E-mail: lpfgovernancecomms@lpf.org.uk | Tel: 0333 996 1900

Investment Strategy Review

2. Executive Summary

2.1 The purpose of this report is to provide the conclusions of the review of the investment strategy of the Lothian Pension Fund ("the Fund") and to ask Committee to approve the long-term investment strategy, more specifically the strategic asset allocation ("SAA") of the fund's assets.

2.2 The proposed SAA makes minor amendments to the current one, including name changes for two policy groups (paragraphs 4.7 to 4.8) and changes to the policy group weightings and permitted ranges (paragraph 4.25), including a 5% reduction in Equities, a 5% increase in Sovereigns (formerly LDI), and a 2% increase in Cash offset by a 2% reduction in Credit (formerly Non-Gilt Debt).

2.3 The SAA review has been undertaken in cooperation with the Falkirk and Fife Pension funds, taking advice from the Joint Investment Forum (JIF) and Hymans Robertson.

2.4 There are two sources for growing the assets to fund future pension payments: contributions and investment returns. The proposed SAA aims to balance the Committee's assumed aim for affordable contributions and contribution stability (which is affected by the actuarial assessment of funding level every three years), against the need to generate positive real returns from invested assets to pay pensions over a long time horizon.

2.5 The JIF independent advisers note that decisions on strategy should be taken with a long-term perspective, and that changes to SAA involve trade-offs between different risks.

2.6 The change in policy group weightings is in line with the views expressed by the Committee during consideration of the valuation results and proposed updated contributions and consistent with these.

3. Background

3.1 The fund undertakes an in-depth review of its investment strategy in conjunction with the completion of its triennial actuarial valuation. This enables consideration of the actuary's updated assumptions and any changes to contribution rates. The Committee is also reviewing the completed actuarial valuation dated 31 March 2023 at its meeting in March 2024.

3.2 The investment strategy of a pension fund has a significant impact on its investment performance, funding level and employer contribution rates. Setting SAA is therefore a major decision for the Pensions Committee.

3.3 The review has been undertaken in collaboration with Falkirk and Fife Pension funds, working with the JIF and Hymans Robertson. Initial results were presented and discussed at the JIF on 8 September 2023. This was followed by a joint training session for the Committees and Boards of the three funds on 15 September 2023 to provide information on the approach of Hymans Robertson to the asset liability modelling being undertaken. Additional results from Hymans Robertson were considered at the December 2023 JIF, with a subsequent joint training session for the three funds on 6 February 2024 to provide background information on policy groups, asset liability modelling and to discuss this review.

3.4 The Pensions Committee of each fund is responsible for determining its own investment strategy and monitoring implementation of that strategy and its success. Given that the funding position and cash flow outlook of each fund is different, the investment strategy of each fund may be different.

3.5 LPF ’s Committee delegates implementation of investment strategy through a scheme of delegation to the CEO of LPF who in turn delegates to the Fund’s Chief Investment Officer.

3.6 The Fund constituted the JIF to provide strategic advice. Its two external independent advisers, Kirstie MacGillivray and Stan Pearson, have been supported by Lothian’s internal investment team and Hymans Robertson in this investment strategy review. Hymans Robertson undertook asset liability modelling, which tests potential investment strategies and quantifies the probabilities of achieving objectives.

3.7 To provide suitable investment programmes for the differing requirements of employers, the Fund currently operates the four investment strategies detailed in Table 1.

Table 1

Investment Strategy	Assets (£m)	Weight*
Main	9,075	94.1%
Buses	513	5.3%
50/50	37	0.4%
Mature Employers	15	0.1%
Total	9,640	100%

Source: Northern Trust as of 31 March 2023
*Does not sum to 100% due to rounding

3.8 Most employer liabilities are funded under the Main strategy. This strategy maintains a significant exposure to real investments such as equities, which have a history of protecting and enhancing real purchasing power. This reflects the fact that the Fund is open to new entrants, so these employers have long duration liabilities that continue to grow. Indeed, without real investment growth, contributions would need to be significantly higher to meet these new liabilities. Volatility of returns associated with these real investments is less important when liabilities are long in duration and so funding level variability is less important.

3.9 The other three strategies are maintained because the duration of liabilities of some employers are shorter than those of the employers in the Main strategy.

3.10 The Mature Employer strategy is invested entirely in index-linked gilts and cash to match assets and liabilities and eliminate funding level variability as much as possible.

3.11 The 50:50 strategy combines the Main and Mature Employers strategies in 50:50 proportion, reflecting the relative maturity of those employers and the duration of their liabilities.

3.12 The Buses company has closed to new entrants and so the fund is maturing, and its strategy combines the Main and Mature Employers strategies in 55:45 proportion. Separate discussions have been held with the Buses company to agree a modest reduction in investment risk to change the proportion to 50:50.

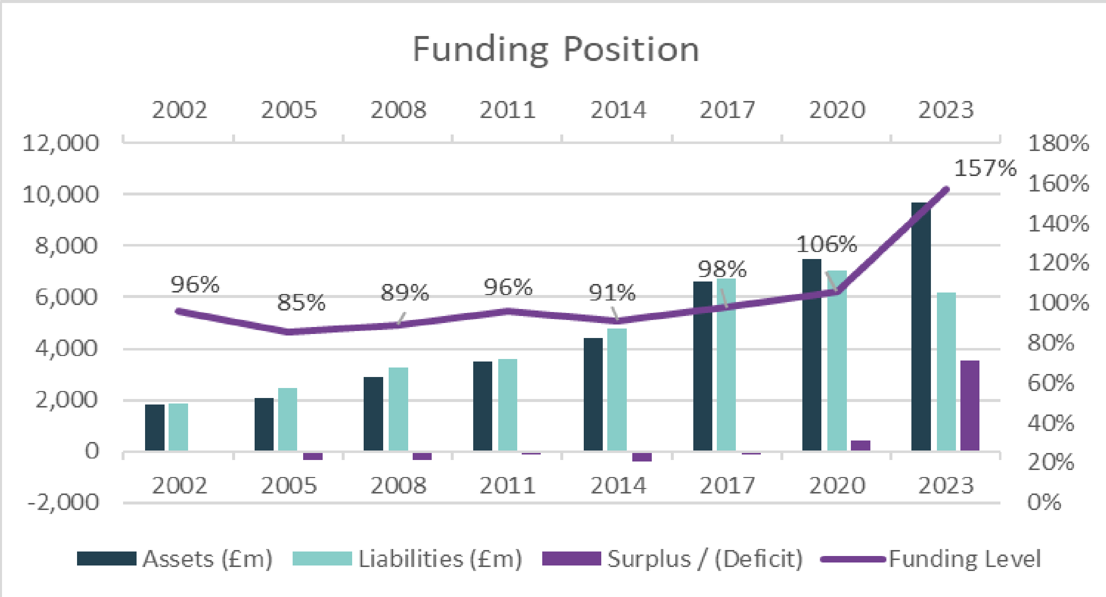
4. Main Report

Funding Position

4.1 The investment strategy (or strategic asset allocation, "SAA") of a pension fund has a significant impact on its investment performance, funding level and employer contribution rates. Setting SAA is therefore a major decision for the Fund.

4.2 Figure 1 below shows the actuary's assessment of the funding position over the last several actuarial valuations. This SAA review has been conducted alongside the 2023 actuarial valuation.

Figure 1



4.3 The actuary estimates that the funding level was 157% as of 31 March 2023, a significant improvement on the 106% as of 31 March 2020. Figure 1 shows that the improvement in funding level has been driven by both an increase in the value of assets (due to investment returns) and a reduction in the value of liabilities (due to higher interest rates).

4.4 Table 2 shows the cashflows into and out of the fund to 31 March 2023. It illustrates that net cashflow from dealing with members has been neutral to modestly negative. Income from investments has averaged £253m over the last five years, which means that the fund is cash flow positive on an overall basis.

Table 2

Cash Flow (net additions / withdrawals from dealing with members)

	2017/18	2018/19	2019/20	2020/21*	2021/22	2022/23
Income	196	227	240	305	271	265.8
Expenditure	214	241	279	247	265	284
Net Cash Flow	(18)	(15)	(39)	58	6	(18)

* A one-off transfer in of assets by Visit Scotland amounted to £58.3m in 2020/21

Policy Groups

4.5 To support effective strategy determination, the JIF continues to recommend that Committee defines the fund's SAA using five policy groups. These classify assets into categories with similar risk and return characteristics, which are not completely correlated with one another. The weighting of these groups in a portfolio is the key determinant of expected return and risk. Table 3 below shows the policy groups in descending order of expected return and risk.

4.6 The JIF has recommended minor amendments to the existing five policy groups which condense the vast array of investment choices into a manageable number of investment groups. The proposed policy groups are shown in Table 3.

4.7 The name of the LDI policy group has been amended to **Sovereigns** to reflect the fact that this policy group may invest in high quality sovereign bonds (e.g. UK and US government bonds) which offer diversification to the equity policy group. These assets provide interest rate and potentially inflation exposure that offsets similar exposures within the fund's liabilities.

4.8 The name of the Non-Gilt Debt policy group has been changed to **Credit** to reflect the fact that this policy group has exposure to debt issued by non-sovereign issuers (e.g. corporates) that typically offer a higher rate of return (via a 'credit' spread) than sovereign government bonds.

Table 3

Policy Group	Objective	Permitted Assets
Equities	The principal driver of the Fund's growth and, in the long term, expected to outperform liabilities, albeit with periods of volatility.	Listed equities; private equities; forward currency contracts; equity futures.
Real Assets	Positive real returns with an income stream, in some way, linked to inflation. Likely to deliver some diversification from equity returns.	Property; infrastructure; timberland; agriculture; commodities.
Credit (formerly Non-Gilt Debt)	Assets likely to offer diversification from equity returns, strategic funding level protection and/or a superior yield to that available from, and where returns may have a positive correlation to, sovereign bonds.	Investment grade bonds; high yield bonds; loans; private credit; emerging market bonds.
Sovereigns (formerly LDI)	Assets likely to offer diversification from equity returns and strategic funding level protection by having interest rate and potentially inflation exposure that offsets exposures of the liabilities and so reduces funding level variability.	Index-linked gilts; nominal gilts; gilt futures; overseas sovereign bonds.
Cash	Liquidity function mostly avoiding credit and duration risks.	UK Treasury assets; overseas Treasury assets; local authority loans; bank or building society deposits (all short term).

4.9 Under the governance structure of the Fund, the implementation of the investment strategy within these policy groups is delegated by Committee to nominated officers with advice from the JIF.

4.10 The modelling results from Hymans Robertson indicate that the size of the allocation to equities is by far the key determinant of investment risk and return. Variation in the types of investment managers within each policy group is typically less significant to the overall risk and return than strategic policy group allocations over the long term.

Asset Liability Modelling

4.11 An Asset Liability Model (ALM) is a tool which projects how the Fund's assets and liabilities might perform in the long term. The primary aim is to indicate the degree of uncertainty associated with a particular strategy; the ALM is not a forecasting tool. It describes how likely different investment strategies are to deliver returns that achieve the Fund's objective of paying pensions as they fall due. Investment strategies with higher expected returns are likely to require lower employer contributions. However, such strategies will be accompanied by more variability in funding level and the risk that employers will be required to make larger contributions if investments experience significant downside movements.

4.12 ALMs include many assumptions about how the economy and investment markets might change in the future, highlighting the uncertainty in projecting future outcomes. Hymans Robertson has tested the current and potential SAA, which are expected to deliver sufficient returns with a high probability of success over an 18-year timeframe (2 years on from the past review conducted as of March 2021). There is, however, a wide range of possible outcomes, which reflects the need to generate returns in excess of the return generated by gilts, the matching asset for a pension fund. There is less certainty associated with the future returns from other financial assets.

4.13 The assumption for future gilt yields is one of the most critical inputs to the model. The level of gilt yields does not impact the actual pensions which will fall due. But it greatly affects the current value of these liabilities calculated by the actuary, as discounted by this rate. The higher the assumed discount rate (or level of gilt yields), the lower the current value of liabilities, as calculated by the actuary's model.

4.14 Hymans Robertson's asset liability model assumes, on average, that nominal gilts will return c.4.1% p.a. over the next 20 years, with nominal 17-year yields falling from 3.9% (at 31 March 2023) to 3.4% at the end of the projection period. This is a major assumption because nominal 15-year gilt yields as of 13 February 2024 are c.4.4% and expected to decline. Nominal 30-year gilt yields are c.4.6%, consistent with 15-year gilt yields in 15 years' time rising to 4.8% pa. The difference between the Hymans model calibrated at the valuation date and current market levels illustrates the limitation of single point in time valuations and supports the need for a long-term approach and moderate changes.

4.15 The ALM helps to demonstrate, on its assumptions, whether the SAA is likely to deliver the funding objectives, associated risks, and the impact of amending the SAA. However, model assumptions need to be considered when interpreting the results.

Results

4.16 Results from Hymans showed that the strong funding position provides a high degree of flexibility in terms of adjusting the SAA and/or the approach to contributions, due to the large past service liability surplus.

4.17 However, we and Hymans Robertson have highlighted that the funding position can vary materially between measurement dates because of changes in market conditions, with the results being particularly sensitive to gilt yields and the implied future expected returns from asset classes and policy groups.

4.18 As part of the review, Hymans Robertson state that "a key consideration is therefore to set an investment strategy and contribution rate that is sustainable in the long term".

4.19 They suggest that a suitable SAA (on a sustainable basis) is one that meets future service accrual only, at an affordable level of contributions, without relying on the past service funding surplus.

4.20 On this basis, the Fund's actuary has confirmed that the current SAA (60% equity weight) is consistent with a long term 19.3% contribution rate (excluding 0.3% allowance for administration expenses). Because the assets to pay benefits can only be generated by a combination of investment returns and contributions, adopting a SAA with a lower expected investment return would entail higher sustainable contributions, and vice versa.

Recommended Strategy (Main Strategy)

4.21 The proposed SAA for the Main Strategy is presented in Table 4 below. It is based on expectations that the asset mix will generate long-term returns comfortably in excess of liabilities.

4.22 The proposed strategy considers the expected reduction in contributions resulting from the actuarial valuation. It modestly reduces overall investment risk, via a 5% reduction in the weight of the Equity policy group and a 5% increase in the allocation to the Sovereigns policy group, while maintaining sufficient levels of investment return to support a long-term affordable contribution rate.

4.23 The 5% reduction in central equity weighting is lower than the 10% reduction discussed during the valuation consultations. However, it is consistent with the Committee's desire to modestly reduce equity risk as well as the long-term return requirements of the Fund.

4.24 The modest 2% allocation to the Cash policy group recognises the operational cash requirements of the Fund.

4.25 The permitted ranges are the constraints within which nominated officers can implement strategy under delegated authority without referral to the Committee.

These ranges are wide enough to avoid unnecessary and potentially costly rebalancing under normal financial conditions but enable prompt action in fast moving markets.

Table 4

Policy Group (%)	Current Strategy	Proposed Strategy	Current Permitted Ranges	Proposed Permitted Ranges
Equities	60	55	50 -70	45 - 65
Real Assets	20	20	10 - 30	10 - 30
Credit	10	8	0 - 20	0 - 20
Sovereigns	10	15	0 - 20	5 - 25
Cash	0	2	0 - 15	0 -15
Total	**100**	**100**		

4.26 The investment team will continue to monitor actual asset weightings and adjust policy group exposures within the constraints of the permitted ranges where required or to make tactical investment decisions, with regular reporting on strategy implementation at the quarterly JIF meetings. The team will refer to Committee for direction should there be a recommendation to operate out with the permitted ranges or to adjust the strategic weights. The Committee will continue to receive periodic updates on asset allocation and performance.

Updates to Statement of Investment Principles

4.27 Subject to the above changes being approved, Committee is also asked to approve updates to the Fund's Statement of Investment Principles (SIP) to reflect the agreed changes. These changes are provided in a separate Appendix 1, which shows:

4.27.1 Changes to the policy group names and underlying asset classes (pages 7 and 8 of the SIP), and

4.27.2 Changes to the target allocation and permitted range for the Main strategy, and the consequent target allocation changes for 50:50 and Buses strategy (Appendix A of the SIP, pages 13 and 14).

4.28 The proposed updates to the SIP only include those changes being approved as part of this review. A full review of the entire SIP document (as part of the annual SIP review cycle) will be included for consideration at the June Committee.

5. Financial impact

5.1 The investment strategy has a significant impact on the investment returns of the pension fund and hence impacts on the funding level and employer contribution rates.

6. Stakeholder/Regulatory Impact

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

6.2 There are no adverse health and safety, governance, compliance, or regulatory implications as a result of this report.

7. Background reading/external references

7.1 None

8. Appendices

Appendix 1 – SIP proposed changes