

FALKIRK COUNCIL

Subject: INVESTMENT STRATEGY REVIEW
Meeting: JOINT MEETING OF THE PENSIONS COMMITTEE AND PENSION BOARD
Date: 26 JUNE 2015
Author: CHIEF FINANCE OFFICER

1. INTRODUCTION

- 1.1 This report provides the Committee and Board with an update on the progress of the Fund's review of investment strategy.
- 1.2 Appendix A to this report describes the current investment strategy, the opportunities for risk reduction and further areas for consideration.
- 1.3 Appendix B describes a draft terms of reference for the Investment Sub-Group which is expected to operate over the coming months.

2. BACKGROUND

- 2.1 At the joint meeting of Panel and Committee on 12 March 2015, an update on the progress of the Fund's review of investment strategy was presented, supported by a short paper from Hymans Robertson.
- 2.2 The Committee agreed to appoint a sub-group to make recommendations regarding the implementation of the strategy, the range of asset classes, asset allocation and managers to be deployed by the Fund.
- 2.3 The Committee agreed to defer appointment of the sub-group until the first joint meeting of the Pensions Committee and Pension Board on 26 June 2015.

3. INVESTMENT SUB-GROUP

- 3.1 It is suggested that the sub group consists of two/three individuals from the Committee supported by officers and advisers with two members of the Board also in attendance.
- 3.2 A meeting of the sub-group will be convened as soon as possible following the Committee meeting to plan the investment strategy review.

4. RECOMMENDATIONS

4.1 The Pensions Committee is asked:

- i) to agree that an investment strategy sub-group be established to work with officers and advisers to make recommendations on the review of investment strategy to the Committee; and
- ii) to appoint two/three Committee members to the sub-group.

4.2 The Pension Board is asked to nominate two members to attend the investment sub-group.

4.3 The Pensions Committee and Pension Board are asked:

- i) to note the investment strategy of the Fund and the various considerations set out in Appendix A to the paper;
- ii) to invite the sub-group to report to the Committee and Board in September on progress of the investment strategy review.

Chief Finance Officer

Date: 10 June 2015

Contact Officer: Alastair McGirr

LIST OF BACKGROUND PAPERS

Any person wishing to inspect the background papers listed above should telephone Falkirk 01324 506304 and ask for Alastair McGirr



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FALKIRK COUNCIL PENSION FUND – INVESTMENT STRATEGY

Introduction

This report provides an update on the Fund's strategy review and proposes some areas for further investigation.

Background

On 12 March 2015, the Chief Finance Officer presented a paper (item 7) to a joint meeting of the Panel and Committee providing an update on the progress of the Fund's review of investment strategy, supported by a paper (appendix to item 7) from Hymans Robertson.

The Committee agreed to appoint a sub-group of the Committee to make recommendations regarding the implementation of the strategy and the range of asset classes, asset allocations and managers to be deployed by the Fund. However, the Committee agreed to defer sub-group appointments until the first meeting of the Committee under the new governance arrangements.

This paper expands on some of the issues that will be considered in the review.

Work stream

Committee had previously agreed in December 2014 to proceed on the following basis sequentially:

- a) Determine the level of risk that the Committee was prepared to tolerate;
- b) Determine the mix of growth and defensive assets that the Fund should target;
- c) Determine the mix of assets that the Fund should hold in order to meet its objectives;
- d) Determine the managers who should manage these assets.

Level of Risk

The paper presented to the meeting of 12 March indicated that, based on the assessment of Hymans Robertson, the current investment strategy had the following risks:

- there was an 80% chance the Fund would be 100% (fully) funded after 20 years
- there was a 5% chance the funding level would be 50% or worse after 20 years

The paper also showed how these levels of risk changed with alternative investment strategies and how these compared with the Fund's existing strategy, which was assumed to consist of 10% defensive assets (i.e. bonds) and 90% growth assets.



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In essence, the modelling undertaken by Hymans showed that there would be no change to the probability of the Fund achieving fully funded status if it shifted to a strategy of 30% bonds and 70% growth assets. However, with this strategy the chances of not having a poor funding outcome were substantially reduced.

Hymans Robertson's view was that the Fund could take less risk and should not take more risk than it had to. It was therefore agreed to formulate a de-risking plan with implementation on a gradual basis to achieve a lower risk profile for the Fund.

Members will be aware that the Fund's funding level has fallen from 85% in March 2014 to 79% at March 2015. In these circumstances, whilst it is still prudent to have the de-risking plan in readiness, it is unlikely that the plan would be implemented in the short term.

The sub-group of the Committee should first consider the appropriate level of risk that the Fund should take to achieve the full funding objective.

Risk should be viewed in the context of both volatility and permanent capital impairment. The table below provides return expectations of one of the Fund's external managers as at 31 December 2014. It shows that some assets are expected to produce negative real returns over the next 10 years.

| | 10-year |
|----------------------------------|----------------|
| Expected return on cash | |
| (UK base rate) | 2.25% |
| Expected UK CPI inflation | 2.00% |
| Expected return over cash | |
| UK Government Bonds | |
| (Gilts) | -0.45% |
| UK Index-linked Govt | |
| Bonds (Gilts) | -0.35% |
| Investment Grade | |
| (sterling) | 0.55% |
| High Yield | 1.65% |
| Senior Loans | 2.50% |
| Equities | 3.50% |
| UK Property | 3.40% |
| Infrastructure | 3.65% |
| Emerging Market Bonds | 3.65% |
| Commodities | 1.00% |
| Insurance-linked | 2.75% |

Source: Baillie Gifford, Dec
2014



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The next table shows estimated volatility for the Fund's assets.

| Asset | Strategic Asset Allocation | Volatility |
|------------------------|-----------------------------------|-------------------|
| | % | % |
| UK Equities | 23 | 20 |
| International Equities | 37 | 22 |
| Private Equity | 5 | 30 |
| UK Bonds | 10 | 9 |
| Diversified Growth | 10 | 10 |
| Property | 10 | 14 |
| Infrastructure | 5 | 18 |
| | 100 | |

Asset Mix

The Fund's objective is to return to a fully funded status over a 20 year period.

The current strategic asset allocation adopted for the Fund by the Committee is contained in the Statement of Investment Principles (SIP) and is shown in the table below.

| Asset | Strategic Asset Allocation | Underlying Assets |
|------------------------|-----------------------------------|--------------------------|
| UK Equities | 23 | Growth |
| International Equities | 37 | Growth |
| Private Equity | 5 | Growth |
| UK Bonds | 10 | Bonds |
| Diversified Growth | 10 | Mix |
| Property | 10 | Mix |
| Infrastructure | 5 | Growth |
| | 100% | |

In considering the growth and defensive attributes of the various asset classes, it worth bearing in mind that the allocation to 'Diversified Growth' does contain a proportion of assets which are defensive in nature. Also, it could be argued that the property allocation is not entirely a growth asset as returns are derived in part from income rather than capital growth.

The table overleaf introduces a different view of the Fund using a 'look-through' basis where the underlying assets of each manager's portfolio are allocated to an asset class. There are various ways of categorising asset classes. Most simply, assets are either equity or debt ('owned' or 'loaned'). Equities have growth potential, while the returns on debt are fixed in nature. Financial market participants have introduced the term 'Alternatives' to describe a plethora of investments that they argue have different return/risk profiles than equities and bonds, although whether this is truly the case is perhaps less clear and is something that the sub-group of the Committee could consider when reviewing the Fund's asset allocation.



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| Falkirk PENSION FUND 31 Mar 2015 Fund size £1.785m | | | | |
|---|---------------------|--------------------------|---------------------------|--|
| | Manager | Permitted Ranges % | Actual Allocation % | Long Term Strategy Allocation % |
| Equities | | | | |
| Passive Equity (UK 36%/O'seas 64%) | L&G | | 21.6 | |
| Active UK Equity | Schroder | | 12.7 | |
| Active Global Equity | Newtons | | 14.0 | |
| Active Global Equity | Aberdeen | | 12.7 | |
| Listed Equity | Baillie Gifford DGF | | 2.7 | |
| Total Listed Equities | | | 63.7 | |
| Global Private Equity | SLI/Wilshire | | 3.8 | |
| Total Equities | | ? | 67.5 | ? |
| Index-linked gilts (20% of pooled bond fund) | Baillie Gifford | | 1.6 | |
| Total Index-Linked Assets | | ? | 1.6 | ? |
| Property (Fund of funds) | Schroder | | 7.0 | |
| Listed Property | Baillie Gifford DGF | | 0.2 | |
| Total Property | | | 7.2 | ? |
| Global Infrastructure | Grosvenor Capital | | 2.6 | |
| UK Infrastructure | Internal | | 0.0 | |
| Listed Infrastructure | Baillie Gifford DGF | | 0.5 | |
| Total Other Real Assets | | | 3.1 | ? |
| UK Corporate Debt | M&G | | 0.7 | |
| Corporate bonds (50% of pooled fund) | Baillie Gifford | | 7.0 | |
| Listed bonds | Baillie Gifford DGF | | 5.2 | |
| Hearthstone Social | HEARTHSTONE | | 1.0 | |
| Total Other Bonds | | | 13.8 | ? |
| Others* | | | 2.2 | |
| Total Alternatives | | ? | 26.3 | ? |
| Cash | | ? | 4.6 | ? |
| TOTAL | | | 100.0 | 100 |

* Commodities, Absolute Return, Insurance Linked, Special Opportunities, Active Currency, Recoverable Taxes within BG Diversified Growth Fund

The table highlights that there are a few key decisions to be made:

- The question marks in the right hand column suggest where a strategic allocation might be made – the broad asset classes of equities, index-linked gilts and alternatives are the main drivers of risk/return. Within the alternatives category, property, infrastructure and other bonds do have different risk/return profiles, so there could be an allocation for these too.
- The question marks in the middle column are there to suggest that permitted ranges would be a useful guide as asset values do fluctuate and the discipline of automatic rebalancing can add value. However the ranges would need to be determined at a manager level and should not be too tight, to avoid making too many unnecessary (and potentially costly) changes.
- There are two types of bond highlighted – index-linked bonds and other bonds. The former protect investors from unexpected inflation, while the latter's value erodes in real terms because of inflation. The allocation to each should be considered.



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- Private equity is separate from listed equities to highlight the different risk profile – part of the return from private equity comes from its use of leverage. The appropriate allocation should be considered in a de-risking fund.

Manager Mix

The strategic benchmark is reflected in the investment structure adopted by the Committee; this comprises a mix of segregated and pooled, and active and passive, manager mandates:

| Manager | Asset | Strategic Asset Allocation |
|---------------------------|-----------------------------|----------------------------|
| | | % |
| Schroder | UK Equities | 14 |
| Legal & General | UK & International Equities | 18 |
| Aberdeen Asset Management | International Equities | 14 |
| Newton | International Equities | 14 |
| SL Capital | Private Equity | 5 |
| Wilshire | Private Equity | |
| Baillie Gifford | UK Bonds | 10 |
| M&G | UK Debt | |
| Baillie Gifford | Diversified Growth | 10 |
| Schroder | Property | 10 |
| Grosvenor Capital | Infrastructure | 5 |
| Internal | Infrastructure | |
| Hearthstone | Social/Affordable Housing | |
| | | 100 |

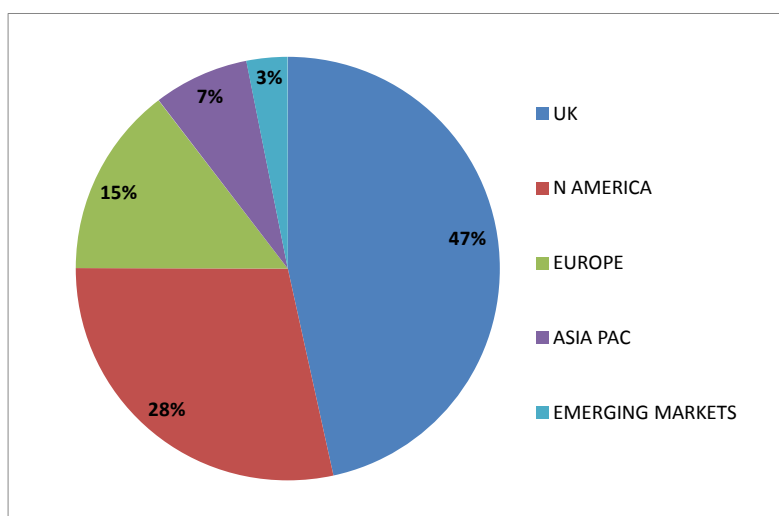
Geographic Mix

The nature of the Fund's strategic benchmark means that the geographic mix will vary over time dependent on the investments held on the Fund's behalf by the managers. What is clear is that the Fund invests globally to achieve good diversification, which improves the risk/return outcome. What is not clear is the precise geographic mix at any point in time because of the investments that are pooled with other investors, including Baillie Gifford's Diversified Growth Fund and the Private Equity and Infrastructure investments. This is not a concern as the Fund does not allocate by geography. Indeed, much has been written about listed equities and how irrelevant the geography of listing is compared with the geography where companies earn their profits. This tends to focus on companies that are listed in developed markets but earn substantial profits from developing markets, which have higher growth rates. Some investors prefer to invest in developed markets where governance standards are higher than in developing markets.

For interest, the chart overleaf shows a recent **estimate** of the Fund's geographical exposure:



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Other considerations

- Current market valuations and expected returns for different assets
- What triggers should be used to instruct changes to strategy
- Delegated authority to make changes
- The composition of the bond portfolio
- The balance between active and passive management
- The importance of benchmarks and arguments for a non-market cap passive mandate
- The review of existing managers and mandates to ensure the best alignment with the Fund's objectives. Can the Fund's overall de-risking strategy be delivered with the existing managers?
- The costs of realigning the portfolio
- The potential for further collaboration with other funds, and potentially making more internal investment, to reduce fees or to access otherwise inaccessible investments
- Scope for tactical vs strategic asset allocation

Next steps

| | |
|--------------|---|
| Summer 2015 | Investment Sub-Group to consider the level of risk the Fund should take and to discuss considerations highlighted above – internal team to liaise with Hymans Robertson to create an agenda |
| 24 September | Pensions Committee and Board meeting |
| Autumn 2015 | Sub-group meets to plan evolution of Fund to new strategy, including discussion of manager mix |
| 10 December | Pensions Committee and Board meeting |

Investment Strategy Sub-Group Terms of Reference

1. Establishment

The Pensions Committee has established an Investment Sub-Group (the “Investment Advisory Group” or “IAG”) to advise the Pensions Committee (“Committee”) of Falkirk Council Pension Fund (“the Fund”) on the 2015 investment strategy review.

2. Membership

Membership of the Investment Advisory Group will comprise:

- The Chief Finance Officer;
- The Pensions Manager;
- The Investment Manager and, if necessary, a further supporting officer of Lothian Pension Fund in their respective roles as secondees to the Fund;
- A minimum of 2 members of the Pensions Committee.

(2 members of the Pension Board may also attend the Investment Advisory Group)

The sub-group will agree a chair.

3. Meetings

Frequency: The IAG will meet on an ad hoc basis until the investment strategy review is complete and investment strategy implementation has been agreed.

Attendees: The IAG may invite any persons to attend all or part of any meeting but such invited persons shall not have a right to vote on any matter before the IAG.

Quorum: A minimum of three members is required to be present including one officer.

Decisions: The IAG should reach its decisions by consensus, however, in the event of a vote, the Chair will have a casting vote.

Papers: Papers are distributed to members at least one week in advance of any meeting (unless a shorter period is agreed by the Chair).

Minutes: Draft minutes are forwarded to members for agreement within five working days and thereafter circulated to the Convener of the Pensions Committee. These will in turn be presented at the subsequent meeting of the Pensions Committee and Board.

4. Responsibilities

The IAG is responsible for ensuring that the investment strategy review is progressed and for making recommendations to the Pensions Committee on all investment strategy issues.

This entails:

- Recommending to the Committee, the Fund's investment objectives and strategy;
- Recommending to the Committee a level of investment-related risk that is consistent with the Fund objectives;
- Identifying possible asset classes and agreeing their appropriateness for the Fund;
- Recommending to the Committee the appropriate investment management structure required to implement the Fund's investment strategy;
- Recommending to the Committee appropriate benchmarks for individual mandates/managers;
- Recommending to the Committee an implementation plan for the investment strategy;
- Recommending the parameters in which the Chief Finance Officer can implement the strategy under delegated authority.

Training

The IAG will consider the training needs of the Committee and Pension Board relating to investment strategy and recommend any training to aid discussion and decision making.

Reporting

The IAG will report to the Pensions Committee and Board quarterly until the review is complete.

5. External Investment Advice

The IAG will utilise the services of the Fund's investment adviser, Hymans Robertson as required.

Pensions Section

18th June, 2015