**AGENDA ITEM 7**

# FALKIRK COUNCIL

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| **Subject:** | **INVESTMENT STRATEGY REVIEW – PROGRESS UPDATE** |
| **Meeting:** | **JOINT MEETING OF THE PENSIONS COMMITTEE & PENSION BOARD** |
| **Date:** | **24 SEPTEMBER 2015** |
| **Author:** | **DIRECTOR OF CORPORATE & HOUSING SERVICES** |

## 1. INTRODUCTION

1.1 The purpose of this report is to give the Committee and Board an update on the work of the Sub Group reviewing Investment Strategy. This is consistent with the report agreed at the Committee and Board meeting on 26 June 2015. Copies of the minutes of the three meetings held to date are appended.

## 2. BACKGROUND

2.1 The Pensions Committee, following consideration of several reports and presentations, agreed that a sub-group should be formed to take forward a de-risking plan within the context of a wider review of the Fund's Strategy. The sub-group will make recommendations to the Pensions Committee.

2.2 The sub-group comprise several members of the Pensions Committee, together with several Board members and is supported by officers & Hymans Robertson, the Fund's investment adviser.

## 3. PROGRESS STATUS

3.1 Three meetings have been held and they have proved to be very productive and allowed a wide image of inter-related topics to be ventilated and discussed. It did, however, become apparent at the first meeting that the work programme initially profiled over four meetings was too ambitious. To ensure due attention is given to the significant and frequently complex topics, more meetings and an extended time frame will be necessary.

3.2 **Meeting 1 - 11 August 2015**

3.2.1 Depute Provost John Patrick was agreed as Convener. The meeting re-affirmed the decision of the Pensions Committee that a de-risking plan be put in place, and there was discussion as to the practicalities of implementation, with an initial 5% to be withdrawn from equities. This discussion was informed by a paper presented by Hymans Robertson.

3.2.2 Contextual papers were also submitted on Risk, Return and Correlation and Fiduciary Duty and Responsible Investment. These facilitated useful discussion and it was recognised this content would resurface as the Review progressed.

3.2.3 Additional information was requested on previous reviews so that the context of this review could be better understood. It was also felt that Manager fee and performance data would help inform the Review. Papers on both these matters were submitted and discussed at Meeting 2.

3.3 **<u>Meeting 2 – 27 August 2015</u>**

3.3.1 Following consideration of the two papers noted at 3.2.3, this meeting focused on equities. The primary reference point was a wide ranging paper submitted by Hymans Robertson, supplemented by two focused papers on Private Equity and Smart Beta (rules based investment strategies that avoid using market capitalisation weighting) prepared by officers via the shared services arrangement with Lothian..

3.3.2 The discussion on Active V Passive investment revealed a strong feeling that Smart Beta offered an attractive avenue relative to the market cap approach of conventional indexing. It was noted that Lothian are active in this space in-house.

3.3.3 It was recognised that Private Equity was relatively high risk and Falkirk is aiming to lower risk. Moreover, fees are very high, particularly given the fund of fund route a scheme of Falkirk's scale is obliged to follow, and assessing performance is very difficult. There was consensus that an orderly wind-down of the existing Private Equity mandates was the way forward i.e. as returns came back they would not be re-invested there.

3.4 **<u>Meeting 3 – 9 September 2015</u>**

3.4.1 This meeting focused on the remaining primary asset classes namely, Bond/Debt, Property & Infrastructure. The main reference point was the Hymans Robertson paper used at the previous meeting, supplemented by a paper on Infrastructure prepared by officers via the shared services arrangement with Lothian..

3.4.2 The Hymans Robertson paper presented a spectrum of components of Debt, ranging from conventional gilts to mezzanine. In discussing this, there was a common feeling that moving towards the higher risk end of the range, with its more equity like features, was not what the Review was designed to do. There was of course market and timing constraints in moving to the more risk free end of the spectrum.

3.4.3 With respect to Property, Hymans Robertson noted in their paper that there is an attraction in moving to mandates which can provide inflation linked income. Long lease property and residential property offer this credential. There are issues with the current Schroder mandate and this will need to be considered as part of the way forward for this asset class.

3.4.4 There was some lively discussion around Infrastructure and surprise was expressed that there seemed to be so few investment opportunities in Scotland. It is anticipated that the Fund will look to increase its allocation to Infrastructure as part of its de-risking strategy. There are opportunities to do this with the existing manager's (Grosvenor) new Fund and/or through further direct fund exposure via collaboration with Lothian.

3.4.5 A paper on Currency Hedging prepared by officers via the shared service arrangement with Lothian explained the options. There was no enthusiasm for taking forward currency hedging at this time, which was in line with Hymans' Robertson's previous recommendation on the matter.

## 4. SUMMARY AND WAY FORWARD

4.1 It will be evident from the above and attached minutes that the Sub Group is making good progress. The main asset classes have been considered and whilst some clear positions are emerging, further work is required to crystallise positions. The key strands may thus be set out:-

a) 5% from Equities but how and to where?
b) Potentially increase allocation to Property, but with regard to the position with Schroders
c) Pursue Smart Beta mandate but to what extent? This would involve Manager search with one possibility being an in-house option via an extension of the shared service arrangement with Lothian
d) Increase Infrastructure allocation, probably via Grosvenor's new Fund and/or further direct fund exposure via collaboration with Lothian
e) Passive wind-down of Private Equity
f) Reluctance to pursue Bond/Debt at this time.

4.2 There are significant work elements to be addressed beyond the above e.g. approach to Environmental, Social and Governance (ESG) issues, at future meetings of the Sub Group.

## 5. RECOMMENDATION

5.1 The Committee and Board are invited to note the report.

**pp Director of Corporate & Housing Services**

**Date: 11 September 2015**

**Contact Officer: Bryan Smail**

**LIST OF BACKGROUND PAPERS**

NIL

**APPENDIX**

**FALKIRK COUNCIL**

**MINUTE of MEETING of the PENSIONS COMMITTEE INVESTMENT REVIEW SUB GROUP in the MUNICIPAL BUILDINGS, FALKIRK on TUESDAY 11 AUGUST 2015 at 10.00 A.M.**

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| **SUB GROUP MEMBERS:** | Committee:<br>Councillor Tom Coleman<br>Andrew Douglas, Unison<br>Depute Provost John Patrick (Convener)<br><br>Officers:<br>Bruce Miller, Investment Manager, Lothian Pension Fund<br>Bryan Smail, Chief Finance Officer |
| **ATTENDING:** | Pensions Board:<br>Councillor Archie Drummond, Clackmannanshire Council<br>Sandy Harrower, UCATT<br>Jennifer Welsh, SEPA |
| **ALSO ATTENDING:** | Linda Selman, Hymans Robertson<br>Antonia Sobieraj, Committee Services Officer |

**INV1. APOLOGIES**

Apologies were intimated on behalf of Councillor Colin Campbell, Stirling Council and Alastair McGirr, Pensions Manager.

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**INV2. DECLARATIONS OF INTEREST**

No declarations were made.

**INV3. APPOINTMENT OF CONVENER**

In terms of the Terms of Reference of the Sub Group, the Clerk invited nominations for Convener from the Group's membership.

Councillor Callum Campbell had submitted apologies for the meeting but had advised the Clerk prior to the meeting of his willingness to serve as Convener. A further nomination was submitted at the meeting on behalf of Depute Provost John Patrick.

The votes cast were as follows:-

- Councillor Callum Campbell - No votes; and
- Depute Provost John Patrick - 2 votes.

Depute Provost John Patrick was duly elected as Sub Group Convener.

**Decision**

**The Sub Group agreed that Depute Provost John Patrick duly serve as Sub Group Convener.**

Depute Provost John Patrick then took the Convenership for the remainder of the meeting.

## INV4. STRATEGY REVIEW OVERVIEW

The Sub Group considered a report by the Director of Corporate and Housing Services on the establishment of a Sub Group to review the Fund's investment strategy.

The Pensions Committee had agreed on 26 June 2015 to the establishment of the Group to review the Fund's investment strategy and to make recommendations to the Pensions Committee on all investment strategy issues. This included:-

- the Fund's investment objectives and the associated strategy;
- the level of investment-related risk which was consistent with the Fund objectives;
- the identified possible asset classes and agreeing the appropriateness for the Fund;
- the appropriate investment management structure required to implement the Fund's investment strategy;
- the appropriate benchmarks for individual mandates/managers;
- the implementation plan for the investment strategy; and
- the parameters within which the Chief Finance Officer could implement the strategy under delegated authority.

The Sub Group at this meeting would aim primarily to reach a position on the implementation of a de-risking plan.

The proposed framework of the review of the investment strategy and the associated work to be undertaken at future meetings was as undernoted:-

Meeting 2 - 27 August 2015

The main objective of the meeting was to agree a mix of assets and asset allocations and the expected issues to be considered included:-

- Active versus Passive;
- Smart Beta passive versus Market Cap passive;
- Currency Hedging;
- Future private equity commitments;
- Infrastructure;
- Private debt;
- Nature of Bond portfolio; and
- Property including social, affordable and residential.

Meeting 3 - date to be determined

The primary objective would be to consider whether to continue with existing Fund managers or make changes. The undernoted topics would be considered:-

- Reviewing manager appointments, including styles and philosophies;
- Costs of realignment;
- Considering manager environmental, social and governance (ESG) issues;
- Determining manager benchmarks;
- Opportunities for collaboration;
- Considering Tactical versus Strategic asset allocation; and
- Delegated power - authorising the Chief Finance Officer to act when triggers were met.

Meeting 4 - date to be determined

The meeting would be expecting to draw the work strands together and effectively have a strategy in place to recommend to the Committee. Focus would be directed to:-

- Agreeing acceptable tolerances across asset classes;
- Agreeing delegation to the Chief Finance Officer to authorise re-balancing; and
- Updating the Statement of Investment Principles.

In addition, periodic progress reports would be presented to Pensions Committee and Board.

**Decision**

**The Sub Group noted the report.**

## INV5. ORDER OF BUSINESS

Depute Provost Patrick agreed to a variation to the order of business from that detailed on the agenda for the meeting. The following items have been recorded in the order that they were taken.

## INV6. RISK, RETURN AND CORRELATION

The Sub Group considered a report by the Director of Corporate and Housing Services on the risk and return characteristics of various potential asset classes and the correlations amongst classes.

The information referred to included:-

- the expected returns in terms of the expectations of Baillie Gifford's Diversified Growth Investment Managers from each asset class at 31 December 2014;
- the actuary's valuation of the Fund's liabilities using a discount rate of 1.6% over the gilt yields and the assessment of the level of employer contributions;

- the long term overall level of investment return being expected to exceed the rate of return assumed by the actuary in valuing the Fund;
- the volatility being the degree of variation of the prices of the assets over time and the typical volatility estimates for the range of assets in which the Fund; and
- the reduction of risk by investment diversification and the correlations between asset classes.

The Fund currently diversified investments and the Sub Group would consider how to diversify risk, whilst still generating an adequate return to meet the Fund's liabilities. This work should take into account that the expected returns, expected risk as measured by volatility and the correlations between them were not static and varied over time.

The correlations of asset classes over the last 10 years were detailed. The report also confirmed the benefits from diversification from mixing positively correlated assets but highlighted that greater benefit resulted from mixing classes with a negative correlation. Further information was provided on the traditional "alternatives", such as private equity and infrastructure which had often been highly correlated.

The Statement of Investment Principles detailed the various types of investment in which the Fund had invested and the source of returns from these investments. The major types of investment and their characteristics were as undernoted:-

- UK Equities;
- International Equities;
- Bonds;
- Index Linked Bonds;
- Property;
- Cash; and
- Alternatives describing asset classes known as diversified growth, private equity, and infrastructure and credit markets.

The Fund was also required to comply with the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 and the issue of liquidity whereby the overall liquidity of assets must be considered in the light of potential demands for cash.

Detailed discussion included the importance of examining historical information, for the purposes of comparison, on the findings of the last review, the associated growth figures and the real returns as well detailed information on the benchmarks currently being used and the projections for the future.

**Decision**

**The Sub Group noted the report.**

**The Sub Group agreed the information presented to the next meeting would include the findings of the last review, the historical growth figures for the Fund, the real returns and the performance data on equity managers.**

## INV7. DE-RISKING FRAMEWORK

The Sub Group considered a report by Hymans Robertson on the recent modelling and analysis exercise undertaken in line with the Fund's long term and short term objectives, the framework for the future management of the Fund's investment strategy, and an exploration of the mechanisms for changing the investment strategy.

The information provided included:-

- the current asset allocation where the Fund's current benchmark asset allocation was 90% growth assets and 10% matching assets;
- the Fund having a relatively high reliance on equity assets which account for around 80% of the Fund's expected return despite only accounting for 60% of total assets;
- the Fund's investment objectives, the Statement of Investment Principles and the refined objectives for the long and short terms;
- the purpose of the adoption of the objectives to help set an appropriate investment strategy over time and the issues to be addressed by the Sub Group;
- the analysis of modelling;
- the objectives-driven investment;
- the steady state portfolio;
- the options for de-risking;
- the key risks for the Fund and associated strategies;
- the trigger points for change; and
- and the way forward.

Detailed discussion included:-

- the importance of making real decisions based on real information underpinned with theoretical information;
- the steady state;
- the Consumer Price Index (CPI);
- the Fund's risk and return target;
- the equity exposure levels;
- the options for de-risking the Fund;
- the Fund manager fees and costs;
- the options for the initial reduction in risk in relation to equities currently held by the Fund;
- the opportunities for diversification and cash; and
- the opportunities for a fully funded Fund by 2035.

**Decision**

**The Sub Group noted the report.**

**The Sub Group agreed:-**

**(1) to the initial reduction in risk by 5% in relation to equities currently held by the Fund; and**

**(2) that the report submitted to the next meeting would provide information on the monitoring arrangements and the opportunities for further action as required over time.**

## INV8. FIDUCIARY DUTY AND RESPONSIBLE INVESTMENT

The Sub Group considered a report by Director of Corporate and Housing Services on the responsibilities of the Committee and the Fund in relation to Fiduciary Duty and responsible investment.

Fiduciary obligations ensured that those managing other people's money acted responsibly in the interests of beneficiaries rather than serving their own interests. The Pension Committee had a fiduciary obligation and was referred to in the Fund's Statement of Investment Principles (SIP).

The Fiduciary was expected to be loyal to the person to whom they owed the duty and the responsibility included:-

- not putting personal interests before the duty;
- avoiding conflicts as far as possible;
- where conflicts could not avoided they should be minimised, disclosed and carefully managed to prevent any breaches of loyalty obligations; and
- ensuring the duty did not conflict with other legal duties or their own interests, and should not profit unreasonably from their fiduciary position.

The influencing documents providing clarification of the duty included:-

- the Local Government Association (England and Wales) on behalf of the Local Government Pension Scheme (LGPS) Shadow Scheme Advisory Board obtained legal opinion legal in April 2014 providing clarification on the duty of the Committees to the Fund members, employers and the taxpayer and the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the Fund;
- the Law Commission (England and Wales) report on "Fiduciary Duties of Investment Intermediaries" in 2014;
- the UK government consultation on the Occupational Pension Schemes (Investment) Regulations ("The Investment Regulations") and the Government response during 2015; and
- the workplan for the LGPS Scheme Advisory Board in Scotland includes consideration of fiduciary duty.

In terms of the Fiduciary duty and responsible investment, the Fund's primary approach was to appoint investment managers who were expected to judge each investment on a number of factors including risk, return, environmental, social and governance (ESG). As regarded divestment and exclusion, the Fund appointed managers to invest in companies using a number of different investment strategies in order to achieve good diversification.

The Fund's approach was consistent with the principles of the UK Stewardship Code published by the Financial Reporting Council and consistent with the Fiduciary responsibilities. The Fund would continue to monitor developments in the interpretation of Fiduciary duty and the potential changes to investment regulations.

**Decision**

**The Sub Group noted the report.**

## INV9. DATE OF NEXT MEETING

The Sub Group noted that the next meeting would take place at 10 a.m. on Thursday 27 August 2015.

**FALKIRK COUNCIL**

**MINUTE of MEETING of the PENSIONS COMMITTEE INVESTMENT REVIEW SUB GROUP in the MUNICIPAL BUILDINGS, FALKIRK on THURSDAY 27 AUGUST 2015 at 10.00 A.M.**

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| **SUB GROUP MEMBERS:** | Committee:<br>Councillor Tom Coleman, Falkirk Council<br>Councillor Callum Campbell, Stirling Council<br>Andrew Douglas, Unison<br>Depute Provost John Patrick, Falkirk Council (Convener)<br><br>Officers:<br>Bruce Miller, Investment Manager, Lothian Pension Fund<br>Bryan Smail, Chief Finance Officer |
| **ATTENDING:** | Pensions Board:<br>Councillor Archie Drummond, Clackmannanshire Council<br>Sandy Harrower, UCATT |
| **ALSO ATTENDING:** | Simon Jones and Linda Selman, Hymans Robertson<br>Antonia Sobieraj, Committee Services Officer |

**INV10. APOLOGIES**

Apologies were intimated on behalf of Jennifer Welsh, SEPA.

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**INV11. DECLARATIONS OF INTEREST**

No declarations were made.

**INV12. MINUTE**

**Decision**

**The minute of the meeting of the Pensions Committee Investment Review Sub Group on 11 August 2015 was approved.**

**INV13. PREVIOUS FUND REVIEW**

The Sub Group considered a report by the Director of Corporate and Housing Services providing information on the previous investment review to provide context to the current review exercise.

The previous full Asset Liability Management study (ALM) was completed in early 2009 and broadly concluded:-

- That there was no strong case for a radical change in investment strategy at the current time;
- That in the long term it would be desirable to reduce the current high level (75%) of equities (which is typical of many LGPS) when the funding level improves, and
- That it would be sensible to consider some diversification within the equities allocation, including exploiting short-term opportunities resulting from current market conditions, and longer term opportunities offered by the broad range of "alternative" assets.

The actions which followed included:-

- The reorganisation of the equity portfolio; - all equity assets were removed from capital international due to underperformance;
- That passive management was increased;
- That Aberdeen Asset Management were awarded in March 2010 a £150m mandate following a full manager search process;
- That the Baillie Gifford bond mandate was adjusted to increase exposure to corporate bonds and allow the advantage of opportunities in credit;
- That 2% of the Fund was allocated to the M&G Financing Funds;
- That diversification was increased by the introduction of infrastructure and Baillie Giffords Diversified Growth Fund (both after manager selection exercises) in 2011; and
- That currency hedging was reviewed but no action taken.

Although there had been no asset/liability review at the subsequent valuation, Hymans Robertson had highlighted the need to maintain a high level of return and suggested the following options for consideration:-

- The dividend approach to investing in equities;
- The introduction of a fundamental indexation mandate, implemented passively, to complement the market cap approach already in place;
- The widening of the the investment universe for the bond mandate to exploit the illiquidity premium; and
- The further diversification but being wary of timing and cost of implementation.

Since the above work the introduction of Social Housing within the portfolio resulting in the main change in the Strategy having taken significat Committee and Officer time in terms of implementation. There was also the implementation of a further segment of infrastructure investment with the Lothian Fund. This had resulted in the Hyman's Robertson issues for considerations not as yet having been pursued.

**Decision**

**The Sub Group noted the report.**

**INV14. FALKIRK COUNCIL PENSION FUND - INVESTMENT MANAGEMENT EXPENSES**

The Sub Group considered a report by the Director of Corporate and Housing Services on investment management expenses for the Fund.

The Fund's annual report 2014/15 had identified £11.7 million (£10.6m in 2013/14) of management expenses, of which £10.6 million (£9.9m in 2013/14) were designated as investment management expenses. Investment costs represented by far the largest proportion of the Fund's total expenses.

The Appendix to the report provided an update of cost data and the key points included:-

- The alternative assets (private equity, private debt, infrastructure and social housing) made up 8% of the value of the Fund, but account for 36% of the Fund's expenses;
- The private equity funds had performance related elements, but neither manager has reached the return hurdle to trigger payments; and
- That of the Fund's £10.2m of investment expenses, £3.7m related to the underlying costs of Fund of Fund structures.

In 2013 the Fund contributed to the CEM Investment Cost Benchmarking Analysis global database. It was currently in the process of contributing to the current year's data. The database comprised 357 Funds representing, £5.0 trillion in assets, three fifths of which were based in North America. This included 35 UK Pension Funds with aggregate assets of £196bn. Fund sizes ranged between £30 million and £510 billion. The median Fund size was £2.9bn, which compared with the Falkirk Fund assets of £1.6bn at 31 December 2013. The database, although providing comparable data, was unable to capture all investment costs from all Funds. It accordingly excluded transaction costs and private asset performance fees from its analysis.

The information relating to the Falkirk Fund included:-

- The calculation of the actual cost of the Fund of approximately 0.60% below the benchmark cost of 0.67%., a 0.07% difference amounting to approximately £1 million per year;
- The actual cost comprised asset management fees and costs plus oversight, custodial and other costs whilst excluding transaction costs, private asset performance fees and non-investment costs, such as actuarial and benefit administration costs;
- That 79% of the Fund was externally managed as compared to the global average of 68%;
- The use of the Fund of Funds for 93% of the real estate and private market investments compared with the global universe average of 58%;
- The products achieving a lower than average cost included UK active equities, global diversified growth and Fund of Funds; and
- The custodial and other investment costs of 0.03%, being 0.02% lower than the global median and amounting to £310,000.

CEM highlighted that investment costs should be taken in the context of a Fund's long term net returns and that the sufficient value for the costs incurred in the long term net of costs.

Discussion included the undernoted issues:-

- The reduction in risk through diversification;
- The opportunities from non correlation;
- The modelling of future outcomes and projections;
- The risks associated with the Fund;
- The costs associated with internal and external management;
- The Fund's performance and the benchmark;
- The operation of the Fund of Funds; and
- The importance of the long term approach to investment.

**Decision**

**The Sub Group noted the report.**

The following reports were considered in conjunction prior to a decision being taken.

## INV15. REVIEW OF EQUITY CLASS OPTIONS

### (a) DEVELOPMENT OF INVESTMENT STRATEGY

The Sub Group considered a report by Hymans Robertson on the development of the Investment Strategy on the monitoring arrangements and the opportunities for future action.

The information provided included:-

- The issue of active and passive management, particularly in relation to equity investment and also introduce the concept of passive management against equity indices that are not constructed by reference to the market capitalisation of the underlying stocks;
- The consideration of the Fund's equity portfolio in more detail, particularly exploring the overall characteristics of the combined portfolio and considering the impact on the portfolio of the proposed equity derisking. This provides some "scene setting" for the future exploration of changes to the structure of the overall equity portfolio; and
- The next steps for the Sub Group and discussion of the various strategies including equity structure, in order to further explore the potential benefits of a Smart Beta Strategy.

**(b) SMART BETA (NON-MARKET CAPITALISATION WEIGHTED, SYSTEMATIC STRATEGIES)**

The Sub Group considered a joint report by the Investment Manager and Portfolio Manager, Lothian Pension Fund on Smart Beta Non-Market Capitalisation Weighted, Systematic Strategies.

Smart Beta investment was described as a category of valuation-indifferent strategies that consciously and deliberately broke the link between the price of an asset and its weight in the portfolio, seeking to earn excess returns over the cap-weighted benchmark by no longer weighting assets proportional to their popularity, while retaining most of the positive attributes of passive investing.

Smart Beta aimed to be low cost, transparent and systematic. It was a lower cost than active management due to less day-to-day manager decision making for the manager. It had however higher trading costs than traditional passive management and was a more expensive option when externally managed.

The investment industry had historically used market capitalisation weighted indices to measure the performance of managers. The benchmarks for all Falkirk's equity managers were market capitalisation weighted and the rationale had been increasingly challenged in recent years. Benchmark indices for all asset groupings or mandates are imperfect and require to be selected carefully. This paper focuses on equity strategies, but the simple example of bond indices makes the point: these are often highly weighted to the largest borrowers, who may not always be the best credits.

The most important component of any Smart Beta Strategy was to break the link with price. It should retain some of the benefits of passive investing and take cognizance of the following:-

- Transparency - the portfolio construction and sources of excess return should be clear and easy to understand;
- Being rules-based – the methodology should be disciplined, systematic and mechanically executed; and
- Being low cost - achieved through either lower fees, lower due diligence/monitoring costs or lower trading/implementation costs.

The Smart Beta Strategy should complement the characteristics of the other equity mandates within the Fund and be able to generate similar returns to the market cap weighted benchmark indices with lower risk, or higher returns with similar risk. The Lothian alternative model to RAFI Smart Beta was noted.

**(c) PRIVATE EQUITY**

The Sub Group considered a joint report by the Investment Manager and Finance Manager, Lothian Pension Fund on characteristics of Private Equity.

The characteristics included:-

- The higher leverage than listed equity and the high correlation;
- The requirement for active management;
- The high level of management fees being a standard annual rate of 2%;
- The difficulty in assessing performance as return information was not known until the return of all cash and the winding up of the Fund;
- The relatively high risk (high leverage and high valuation) and current valuations had revealed them to be cyclically high and expensive;
- The expectation of the delivery of equity-linked returns over the long-term;
- The differences between venture capital funds and buy-out funds;
- The structure as a partnership and the governance by a limited partnership agreement with limited partners having little management control;
- The illiquidity of the investment through the fixed life and closed end structure; and
- The typical fund being of a 10 year term with the option for extension of usually three years.

The Falkirk Fund was aiming for lower risk and it may be appropriate to consider reducing the risk by reducing investment in Private Equity. This measure could be easily implemented by ceasing to make future commitments and allowing the allocation to fall over time.

The Falkirk Fund's use of the Fund of Funds was deemed an expensive way of accessing private equity opportunities. Should a reduction in the private equity allocation to take place lower equity risk would be achieved.

During discussion of the three reports at paragraphs INV15 (a), (b) and (c) above, consideration took place of the merits of active versus passive management, risk, private equity investment, the benefits of Smart Beta growth and value oriented investments and the opportunities for growth of the Fund against a background of financial pressures. The potential to redirect resources to Smart Beta for cash and an equal sum from each existing equity manager was noted.

**Decision**

**The Sub Group noted the reports at INV15 (a), (b) and (c) above.**

**The Sub Group agreed:-**

**(1) the running down of private equity investment;**

**(2) to progress some form of Smart Beta investment financed from cash resources and also potentially taking equal amounts from equity;**

**(3) the subjects to be covered at future meetings would be reviewed to allow sufficient time at each meeting for appropriate consideration of each area; and**

**(4) that following consideration of the remaining asset classes and currency, the next meeting would include consideration of (a) the**

**asset classes for investment; (b) the reconfiguration of the Fund and the equity structure, and (c) the initial reduction in risk by 5% in relation to equities currently held by the Fund.**

## INV16. DATE OF NEXT MEETING

The Clerk to the Sub Group would email all members and seek availability on the optional dates for the next meeting as discussed during the meeting and confirm the date as soon as possible.

**DRAFT**

**FALKIRK COUNCIL**

**MINUTE of MEETING of the PENSIONS COMMITTEE INVESTMENT REVIEW SUB GROUP in the MUNICIPAL BUILDINGS, FALKIRK on WEDNESDAY 9 SEPTEMBER 2015 at 2.00 P.M.**

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| **SUB GROUP MEMBERS:** | Committee:<br>Councillor Tom Coleman, Falkirk Council<br>Councillor Callum Campbell, Stirling Council<br>Andrew Douglas, Unison<br><br>Officers:<br>Bruce Miller, Investment Manager, Lothian Pension Fund<br>Bryan Smail, Chief Finance Officer |
| **ATTENDING:** | Pensions Board:<br>Councillor Archie Drummond, Clackmannanshire Council<br>Sandy Harrower, UCATT |
| **ALSO ATTENDING:** | Simon Jones, Hymans Robertson<br>Antonia Sobieraj, Committee Services Officer |

**INV17. CONVENERSHIP OF MEETING**

The Clerk presided at the start of the meeting in the absence of the Convener and invited a member of the Committee to take the Chair for the duration of the meeting. Councillor Callum Campbell, Stirling Council thereafter took the Chair with the consent of members present.

**INV18. APOLOGIES**

Apologies were intimated on behalf of Depute Provost John Patrick, Falkirk Council and Linda Selman, Hymans Robertson.

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**INV19. DECLARATIONS OF INTEREST**

Councillor Callum Campbell, Stirling Council declared a non financial interest in the items on the agenda, in consequence of him being Chair of Stirlingshire Enterprise Park Ltd (STEP), but did not consider that this required him to recuse himself from consideration of the item, having regard to the objective test in the Code of Conduct.

**INV20. MINUTE**

**Decision**

**The minute of the meeting of the Pensions Committee Investment Review Sub Group on 27 August 2015 was approved subject to amendments (i) at paragraph INV15. (b) last sentence of third paragraph to be added 'when externally managed'; and (ii) at paragraph INV15. (c) (2) to read 'to progress some form of Smart Beta equity investment financed from cash resources and also potentially taking equal amounts from equity.'**

**INV21. REVIEW OF EQUITY CLASS OPTIONS - DEVELOPMENT OF INVESTMENT STRATEGY**

The Sub Group considered a report by Hymans Robertson on the development of the Investment Strategy on the monitoring arrangements and the opportunities for future action.

Following on from discussions at the meeting on 27 August 2015, the Sub Group continued consideration of the report in relation to:-

- The consideration of investment in bonds, including both private and public debt markets. Bank de-leveraging has provided an opportunity for institutional investors and given the low level of long-term interest rates, we see particular attraction in floating rate strategies at this time; and
- The exploration of investment in commercial and residential property. Although property is primarily a growth asset within the current strategy, certain property strategies can offer a long-term real income stream that would sensibly form a component of the lower risk portfolio.

**Decision**

**The Sub Group agreed to:-**

**(1) defer further consideration of bonds in view of concerns that yield pick-up would require investing in bonds of lower quality; and**

**(2) review how best to invest in property giving consideration to an increased allocation over time.**

Bryan Smail left the meeting during consideration of the foregoing item of business.

**INV22. INFRASTRUCTURE**

The Sub Group considered a report by the Director of Corporate and Housing Services proving information on infrastructure investments.

The report highlighted that infrastructure investments were typically equity-type investments, often with low risk characteristics. They could, however, also be debt related.

The main attractions for the Fund included:-

- project returns often being nlinked to inflation, directly or indirectly, and so, weree more closely aligned with the liabilities of the Fund than some other asset returns;
- asset returns were often lower risk, due to the predictability of their cash flows (and inflation linkage) and of longer duration than other assets (depending on deal structure); and
- notwithstanding a fairly high fee structure, prospective returns for the asset class appeared relatively attractive and publically listed funds promised returns of around 3.5% above inflation.

The Falkirk Fund's current infrastructure exposure comprised:-

- the global infrastructure commitment of $80m (£51m) to the Customised Infrastructure Strategies (CIS) Fund managed by the Grosvenor Capital Customised Fund Investment Group (CFIG) - 95% funded with distributions of 35%; and
- the UK and Scottish infrastructure commitment of £30m in a shared service arrangement with Lothian Pension Fund.

The current use of Fund of Funds related to the function of the Fund's size and governance structure. It was an expensive way of accessing investments. The arrangement with Lothian Pension Fund helped to limit exposure to the Fund of Funds, reduce fee drag and diversify manager and asset exposure.

There were opportunities to aid the Fund in its diversification and risk reduction efforts by increasing the allocation to infrastructure.

**Decision**

**The Sub Group noted the report.**

**The Sub Group agreed:-**

**(1) to make an allocation to the existing external manager's new fund of funds, subject to completion of due diligence; and**

**(2) to explore further collaborative opportunities with Lothian Pension Fund.**

## INV23. CURRENCY HEDGING

The Sub Group considered a report by the Director of Corporate and Housing Services on hedging the currency exposure in overseas assets into sterling.

Currency hedging had the potential to protect the Fund from changes in currency exchange rates.

Active currency hedging (to make a profit) was not regarded as an appropriate strategy for the Fund. Passive currency hedging (to reduce risk) was regarded as more appropriate. The timing of placing currency hedges (the purchase of currency forward contracts) however was important due to their being potentially negative cash flow implications of hedging. In addition, there were relatively long periods when hedging could be detrimental to returns.

The report highlighted that Lothian Pensions Fund's currency approach was focused on risk minimisation by not hedging those currencies with returns tending to be negatively correlated with equities (which offset fund risk) and hedging those currencies with returns tending to be positively correlated with equities (which compounded fund risk).

The introduction of a hedging programme could potentially reduce risk slightly for the Fund but it was recognised that a suitable governance structure would be required to implement the hedging process. The report concluded that there was no need to expedite a hedging programme at this time.

**Decision**

**The Sub Group noted the report.**

## INV24. REVIEW OF ASSET CLASS OPTION

The Sub Group received an update from Simon Jones, Hymans Robertson on the work covered to date in relation to asset class options.

The Group had agreed on 11 August 2015 to the initial reduction in risk by the sale of 5% of equities from the Fund.

At the meeting on 27 August 2015 the decision was taken to commit no further capital to private equity, which would reduce the allocation, and to progress some form of Smart Beta equity investment financed from cash resources and also potentially taking equal amounts from equity managers.

At this meeting the Group agreed to defer consideration of investment in bonds and review how best to invest in property. Discussion also included the possibility of progressing investment where possible into local social housing, researching investment opportunities within the private rental sector and reviewing responsible investment practice.

**Decision**

**The Sub Group agreed to progress further discussions on asset class investment at future meetings.**

## INV25. THE NEXT MEETING

The Sub Group received an update from the Clerk confirming that the subjects covered at the next meeting (meeting 4) would be those issues originally suggested at the first meeting for consideration at meeting 3. These were as follows:-

- Reviewing manager appointments, including styles and philosophies;
- Costs of realignment;
- Considering manager environmental, social and governance (ESG) issues;
- Determining manager benchmarks;
- Opportunities for collaboration;
- Considering Tactical versus Strategic asset allocation; and
- Delegated power - authorising the Chief Finance Officer to act when triggers were met.

A progress report on the work of the Sub Group would be presented to the meeting of the Pensions Committee/Board on 24 September 2015.

**Decision**

**The Sub Group noted the information presented.**

## INV26. DATE OF NEXT MEETING

The Clerk would email all members and seek availability on the optional dates during early October 2015 for the next meeting as discussed during the meeting and confirm the date as soon as possible.