PENSIONS INVESTMENT SUB-COMMITTEE

Minutes of the meeting held at 7.30 pm on 2 December 2014

Present

Councillor Simon Fawthrop (Chairman)
Councillor Alan Collins (Vice-Chairman)
Councillors Eric Bosshard, Peter Fookes, David Livett, Russell Mellor and Neil Reddin FCCA

Also Present

Alick Stevenson, AllenbridgeEpic Investment Advisers

12 APOLOGIES FOR ABSENCE AND NOTIFICATION OF SUBSTITUTE MEMBERS

There were no apologies.

13 DECLARATIONS OF INTEREST

Councillor Russell Mellor declared a personal interest by virtue of receiving a Pension from the Local Government Pension Scheme.

Councillor Eric Bosshard declared a personal interest as a former Member of the Local Government Pension Scheme.

14 CONFIRMATION OF MINUTES OF THE MEETING HELD ON 19TH AUGUST 2014 EXCLUDING THOSE CONTAINING EXEMPT INFORMATION

The minutes were agreed.

Members were also updated on certain matters.

In view of concerns related to the position of a number of Local Government Pension Schemes, and in the context of local decision making, it was suggested that an expected Government announcement might highlight an intention to require Local Authorities to take a passive investment approach for their pension funds. Such an approach was currently encouraged by Government.

Concerning proposals for Local Pension Boards, final Government guidance was awaited. There might be an option for two Local Authorities to join together to provide a Pension Board. Pension Board arrangements for L B Bromley would need to be agreed at Full Council on 23rd February 2015 and the Sub Committee would meet beforehand to consider proposals. Although a Local Pensions Board was expected to provide scrutiny, its need was questioned as a significant check/balance is already provided by a Fund's Actuary.

In relation to L B Bromley's Shadow Pension Fund, comprising £2.7m of the £10m allocated to Diversified Growth investment, any earnings or capital value changes on the £2.7m would be added to the earmarked reserve that had been set up.

For the Collaborative Investment Vehicle (CIV) proposed for boroughs by London Councils, some authorities had yet to commit to the initiative including L B Bromley.

15 QUESTIONS BY MEMBERS OF THE PUBLIC ATTENDING THE MEETING

There were no questions.

16 PENSION FUND PERFORMANCE Q2 2014/15

Report FSD14076

Report FSD14076 provided details of investment performance for Bromley's Pension Fund in the 2nd quarter of 2014/15. More detail was provided in an appended report from the Fund's Investment Adviser including commentary on developments in financial markets, their impact on the Council's Fund, and future outlook.

Information on general financial and membership trends of the Pension Fund was also outlined along with summarised information on early retirements. Financial information included historic data on the fund's value, previous allocations to fund managers, distributions of surplus revenue fund cash to fund managers, and movements in the value of the FTSE 100 index. Baillie Gifford also provided commentary on their performance and a view on economic outlook. Baillie Gifford representatives attended to discuss performance, economic outlook/prospects, and other matters concerning the portfolios under Baillie Gifford management.

Quarterly reports from all fund managers had been circulated to Sub-Committee Members with the meeting agenda.

At 30th September 2014 the fund value stood at £655.9m (and by 19th November 2014 this had risen to £688.8m). Overall, the fund returned +3.0% in the second quarter matching the benchmark return. This performance was in the 7th percentile of the local authority average.

Medium and long-term, the fund's returns have remained particularly strong, achieving overall local authority average rankings in the 29th percentile for 2013/14 and the 4th percentile for 2012/13 (the fund being subject to transition and change in both years).

In noting the fund's value, it was suggested the fund was not performing significantly better than the FTSE 100 Index. However, returns were helping to reduce the funding gap and passive investments would provide the necessary income. Returns were fed into the Pension Fund Revenue Account and amounts outstanding after funding liabilities were directed back into the Fund for investment. As such it was not possible to identify specific details of such returns as they are automatically re-invested and the need for a separate Pension Fund a/c to hold the re-investment sums was not considered necessary. There were also costs related to establishing a separate account. The actuarial target for overall returns to meet fund liabilities stood at 5.6% and the current level of returns should help reduce the fund deficit. It was also suggested that equivalent figures be provided for previous years to show a trend (seasonal comparisons).

It was also noted there would be fewer employees in the future and a reduced level of contributions. It would not be possible to take the same level of risk for the future as in previous years, the fund now technically having a negative cash flow, excluding returns from equities (these returns being re-invested back into the fund). It was also possible for employees to take pension benefits at age 55 and a cash flow problem could arise should there be a significant demand for early pensions. It might be necessary in future to merge with another pension fund having a positive cash flow to help meet liabilities. The level of employee contributions had also decreased in accordance with Government regulation.

RESOLVED that the report be noted.

17 PENSION FUND - INVESTMENT REPORT

In their presentation to the Sub-Committee, Baillie Gifford highlighted the valuations of their three portfolios – Global Alpha (global equities), Diversified Growth, and Fixed income – as at 30th November 2014, in comparison to valuation of the Portfolios at 30th September 2014.

For the Diversified Growth Portfolio, Baillie Gifford's objective was to outperform UK base rate by at least 3.5% per annum (net of fees) over rolling five year periods with an annualised volatility of less than 10% over the same periods. On performance to 30th September 2014 for Diversified Growth funds, Baillie Gifford had achieved a net return for the fund of 6% per annum since inception, outperforming the UK base rate by 4%. The presentation also highlighted the performance of Baillie Gifford's Diversified Growth Pension Fund between 31st December 2008 and 30th September 2014 to illustrate a positive performance delivered with low volatility. Performance attribution and commentary on certain DGF asset classes in the 12 months to 30th

September 2014 was also outlined, with an indication that the fund returned 7.8% gross of fees over the year. In discussion the impact of fees was outlined to Members. It was also noted that the Active Currency asset class had delivered a return of 1.3%. In theory it was possible to lose money on any one of the asset classes but the involvement of research was highlighted and currency as an asset class was suited to Baillie Gifford's investment approach. Overall performance of economies was the ultimate driver and a difference could be made over the long term. It was explained that a typical holding period by Baillie Gifford for a currency asset was six months rather than have a short term approach to the asset class. In terms of outlook for the future, Baillie Gifford was encouraged by improvements in economic data in parts of the developed world and improving fundamentals gave grounds for optimism. However, Baillie Gifford felt that risks remained. It was felt that the end of Quantative Easing (QE) and increase in interest rates might have a negative impact on higher yielding assets. The US in particular was curtailing its use of QE although it was suggested to Members that the extent of QE across other parts of the world could rise, with Europe in particular increasing QE.

Further detail on Baillie Gifford's Diversified Growth Fund Portfolio was appended to the presentation. This included details of asset types the Fund invests in, asset class returns within the fund, and asset attribution. The portfolio continued to be invested across a broad range of asset classes. There were substantial allocations to more defensive asset classes e.g. cash, investment grade bonds and structured finance. Baillie Gifford remained confident that the fund could deliver a worthwhile return in a range of environments. Returns had been supported by improving economic factors with most asset classes performing well. However, the pace of recovery remained modest, continuing to diverge across regions. Emerging market assets experienced sharp falls early during the 12 months to 30th September 2014, with some recovery in recent months.

However, on expectations for long term return, a number of assets looked to offer higher than average ten year expected returns against cash; Baillie Gifford continued to expect a particularly low return on cash. Nominal returns and returns relative to inflation were likely to be lower than average across all asset classes. Equity valuations were higher than 12 months previously, hence a lower return expectation. This also applied to a lesser extent for infrastructure, high yield credit, and insurance-linked allocations. Government bonds, investment grade bonds and emerging market bonds were on lower valuations.

It was noted that some 13% of the Diversified Growth fund was allocated to Emerging Market Bonds, including exposure in Mexico, Peru and Columbia. It was explained that Baillie Gifford focused on companies rather than countries, considering how companies can grow their earnings. For Mexico there was a new Government and the US was more confident. There appeared to be keenness on re-structures and the largest trading partner for Mexico was the US. Longer term Bonds issued by emerging market countries (in their local currencies) could be expected to achieve a real return of 2% over cash.

However, risks varied by country and there was a limited correlation to equities. On a nearer term view, the current index yield at 6.4% was attractive. However certain countries were struggling with current account deficits and some selectivity amongst countries was appropriate. The purchase of the Baillie Gifford Emerging Market Bond Fund had been implemented and there was selective additional exposure to stronger economies.

It was noted that the Bromley Pension Fund could go cash negative in a further five to six years. It was explained that the Diversified Growth Fund aimed to beat base rates and there was a strong absolute return over the medium term. Diversified Growth was a better strategy. For Treasury Management, there would be no intention to invest in equity. Treasury management was different and it was necessary to rely on fund managers taking a long term approach.

Concerning Baillie Gifford's Global Alpha strategy focusing on long term global equity, this was described as "bottom up stock picking", well diversified and with a low turnover. The objective was to outperform the MSCI All Country World Index by 2 – 3% p.a. (before fees) over rolling five year periods. As at 30th November 2014 the Portfolio Value stood at £230,177,343 and the portfolio had returned 4.8% (gross of fees) since inception on 31st December 2013 against a benchmark of 6.4%. The intention was to hold investments in the portfolio for about five years to see real benefit. Details of the top ten stock contributors were provided for the portfolio along with the bottom ten stock contributors. A brief update was provided on Baillie Gifford's research related to the portfolio and the composition of the portfolio by stock holding.

Noting that Baillie Gifford's objective to outperform the MSCI All Country World Index by 2 – 3% p.a. over rolling five year periods was before fees, Members asked that the objective also be provided net of fees. As such Baillie Gifford was happy to provide performance figures gross of fees and net of fees. It was suggested that net of fees the return would change from 4.8% to about 4.5%. It was also explained that the actuarial assumption is long term and for actuarial purposes the expectation of return is about 7% per annum.

The presentation document included details of Baillie Gifford's investment philosophy for the Global Alpha portfolio along with a summary of the investment process. Growth profiles were also provided according to Stalwart, Rapid, Cyclical and Latent types with particular company characteristics attributed to each growth profile type. An outline of Global Alpha activity in companies identified new buys, additions, complete sales and reductions. The top ten holdings were highlighted as were sector weights and regional weights. A Global Alpha list of stock holdings identified the percentage holding in various stock as at 30th September 2014.

Concerning Bailie Gifford's Fixed Income Portfolio, this had an objective to outperform 50% Gilt / 50% Corporate Bond benchmark by 1.5% p.a. over rolling three year periods. The value of the Portfolio at 30th September 2014 stood at £48,144,437. Baillie Gifford's fixed income approach was outlined in respect of Corporate Bonds (bottom-up credit analysis), Government Bonds (Global approach covering interest rates and currencies) and Asset Allocation (Government versus credit – selective investment in high yield and emerging market bonds). The Fixed Income portfolio had achieved a return of 9% against a benchmark of 7% to 30th September 2014 from its inception on 9th December 2013. In terms of general outlook for Fixed Income the presentation advised that long term interest rates might not return to previous average levels in view of factors such as lower trend economic growth, ageing populations and excess global savings. In the short term, interest rates were influenced by continuing loose central bank policy. It was felt that yields might be lower for some time. In regard to Corporate Bonds, Baillie Gifford also felt that there were overweight securitised bonds with real assets. Reference was also made to underweight banks. On Government bonds, it was felt that yields were too high in some emerging markets; Baillie Gifford was also positioned to benefit from falling Eurozone inflation. Regarding currency, Baillie Gifford favoured recovering economies such as the U.S. and Mexico.

In view of the UK Government looking to provide the Scottish Parliament with increased tax raising powers and anticipating any possible increase to personal taxation rates in Scotland, the Chairman enquired whether there might be a risk of Bailie Gifford losing key personnel as a result. Additionally the Chairman enquired whether there might also be a risk that the Scottish Government might raise increased company tax levies on Bailie Gifford. It was explained that VAT continued to be controlled by the UK Government and Baillie Gifford had a keen focus on people in its business. There was a low turnover of staff. It was suggested there is only some 18,000 in Scotland paying the higher tax rate of 45%. Higher rate earners in the company could potentially have to pay a 50% tax rate were income tax levels to rise to that extent but the company would impress upon the Scottish Government that it would be foolhardy to make Scotland uncompetitive through such levels of taxation.

RESOLVED that in the context of Baillie Gifford's Global Alpha strategy, Baillie Gifford provide performance returns (i) gross of fees and (ii) net of fees.

18 REVISED INVESTMENT STRATEGY - PHASE 3

Report FSD14077

Members considered a report which included information related to illiquid fixed income assets, potentially part of the 20% protection allocation under Phase 3 of the investment strategy.

An update from the Fund's Investment Advisers, AllenbridgeEpic was appended to Report FSD14077. A copy of the Advisers' paper on Options for Phase 3 of the Investment Strategy (Fixed Income), as presented to the Sub Committee's previous meeting, was also appended to the report.

An approach for funding any new investments was covered in a further appendix to the report provided under Part 2 of the agenda. In view of this and the likelihood of discussions on the report involving exempt information, it was agreed to move consideration of this item to Part 2 of the agenda.

19 LOCAL GOVERNMENT ACT 1972 AS AMENDED BY THE LOCAL GOVERNMENT (ACCESS TO INFORMATION) (VARIATION) ORDER 2006 AND FREEDOM OF INFORMATION ACT 2000

RESOLVED that the Press and public be excluded during consideration of the items of business referred to below as it is likely in view of the nature of the business to be transacted or the nature of the proceedings that if members of the Press and public were present there would be disclosure to them of exempt information.

The following summaries
refer to matters
involving exempt information

20 REVISED INVESTMENT STRATEGY - PHASE 3

Report FSD14077

Members considered what investment approach (or otherwise) should be taken in regard to illiquid fixed income assets as any potential part of the 20% protection allocation under Phase 3 of the investment strategy.

This matter was previously heard in private, but it was agreed by the Pensions and Investment Sub Committee and Senior Officers (at the meeting of the Sub Committee on 24th February 2015) that the minutes relating to this matter could now be made public. These are noted below.

Mr Stevenson outlined benefits and risks associated with illiquid assets.

Illiquid assets could deliver predictable cash flows at higher returns than those currently available in sovereign credit markets. The assets offered inflation protection and longer investment horizons to meet long term liabilities. Stagflation could result from the current fall in oil prices - inflation was falling and interest rates were low. There would be no growth without consumer demand and interest rates could stay low for a considerable period.

Risks centred around any future possibility that the pension fund might need to pay out benefits e.g. due to change in Government/LGPS regulations, or transfer of assets related to an admitted body or bodies. Any future Council driven voluntary redundancy programme could also pose liquidity risk. The advantages of illiquidity could also be lost if interest rates were to rise. A more cautious approach could involve stepping “a toe in the water” of illiquid assets and additionally considering other investments involving different risks.

A particular illiquid fund was recommended involving no “queues”. It was suggested the opportunity be strongly considered, the fund closing to new business at the end of March 2015. The alternative approach would be to make existing assets work harder.

Illiquid investment could involve infrastructure, including renewable energy e.g. wind and solar projects, and it was confirmed that the fund AllenBridgeEpic had in mind owned wind farms. A Member was pessimistic on most renewables in view of the industry’s need for Government subsidy.

Members had concerns about the illiquid investment suggested by AllenBridgeEpic, and instead asked for approaches to be made to Baillie Gifford and Fidelity to explore options for achieving a higher return on existing fixed income assts. In the meantime, AllenBridgeEpic agreed to continue searching for illiquid asset options at an appropriate level of risk which could be attractive to the Sub-Committee.

RESOLVED that:

(1) report FSD14077 be noted;

(2) in view of Member concerns for the illiquid asset fund highlighted by AllenBridgeEpic, existing conventional fixed income assets be retained, and Baillie Gifford and Fidelity be approached to explore options for a higher return from the assets; and

(3) AllenBridgeEpic continues to search for illiquid asset options at an appropriate level of risk, reporting back to the Sub-Committee in due course.

The Meeting ended at 9.53 pm

Chairman