Report No.
RES12031

London Borough of Bromley

PART 1 - PUBLIC

Decision Maker:	**Pensions Investment Sub-Committee**
Date:	**9th February 2012**
Decision Type:	Non-Urgent Non-Executive Non-Key
Title:	**PENSION FUND INVESTMENT STRATEGY REVIEW**
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Chief Officer:	Director of Resources
Ward:	All

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1. Reason for report

In September, the Sub-Committee agreed that "a review of the Fund's asset allocation strategy, including property and absolute return funds, be undertaken, with outcomes reported to the Sub-Committee in February 2012". This report includes an Investment Strategy Review report prepared by the Council's actuary, Barnett Waddingham LLP, and recommends a future investment strategy for the fund.

RECOMMENDATIONS

The Sub-Committee is asked to:

2.1 Note the report;

2.2 Agree changes to the asset allocation strategy to reflect the proposals detailed in the report; and

2.3 Subject to the changes agreed at the meeting, to receive a further report at the next meeting setting out the detailed arrangements required to implement the new asset allocation strategy.

Corporate Policy

1. Policy Status: Existing policy. The Council's Pension Fund is a defined benefit scheme operated under the provisions of the Local Government Pension Scheme (LGPS) Regulations 2007, for the purpose of providing pension benefits for its employees. These regulations allow local authorities to use all the established categories of investments, e.g. equities, bonds, property etc, and to appoint external investment managers who are required to use a wide variety of investments and to comply with certain specific limits.

2. BBB Priority: Excellent Council.

Financial

1. Cost of proposal: No cost

2. Ongoing costs: Recurring cost. Total administration costs estimated at £2.8m (includes fund manager/actuary fees, Liberata charge and officer time)

3. Budget head/performance centre: Pension Fund

4. Total current budget for this head: £33.4m expenditure (pensions, lump sums, etc); £39.6m income (contributions, investment income, etc); £462.1m total fund value at 31st December 2011)

5. Source of funding: Contributions to Pension Fund

Staff

1. Number of staff (current and additional): 0.4 FTE

2. If from existing staff resources, number of staff hours: c 14 hours per week

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Legal

1. Legal Requirement: Statutory requirement. Local Government Pension Scheme (LGPS) Regulations 2007

2. Call-in: Call-in is not applicable.

Customer Impact

1. Estimated number of users/beneficiaries (current and projected): 5,054 current employees; 4,608 pensioners; 4,094 deferred pensioners

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Ward Councillor Views

1. Have Ward Councillors been asked for comments? No.

2. Summary of Ward Councillors comments: N/A

3. COMMENTARY

3.1 At recent meetings of the Sub-Committee, there have been discussions about the merits of the Pension Fund investing in different asset classes. The current Fund managers, Fidelity and Baillie Gifford, have been employed for almost 14 years and over 12 years respectively and, for many years, the Fund has operated under a two manager, balanced mandate structure. This has served us well, as the long-term performance results in a report elsewhere on the agenda show, but has only comprised investments in equities (broadly 80%), bonds (18%) and cash (2%). The large equity content has inevitably led to increased volatility when world markets come under pressure. Other asset classes, such as property and absolute return, have been considered by the Sub-Committee at recent meetings and this, together with the statutory requirement that the administering body must review strategy on a regular basis, resulted in the decision of the Sub-Committee in September that a review of the Fund's asset allocation strategy be carried out, with a report back to the Sub-Committee in February 2012.

Pre-Review discussions

3.2 Since the September meeting, the Chairman, Vice-Chairman and officers have met separately with both fund managers to discuss future strategy and to ascertain their views on the best way forward to ensure that the value of the Fund's assets is preserved or improved. In December, following detailed discussions with the Fund's actuary, Barnett Waddingham, they were commissioned to undertake an Investment Strategy Review and produce a detailed report.

3.3 Shortly before Christmas, a meeting was convened in London involving all interested parties: the Chairman, Vice-Chairman, AllenbridgeEpic (Fund advisor), Barnet Waddingham, Baillie Gifford, Fidelity, the Finance Director and the Principal Accountant. This was intended to be a brain-storming session and, according to the external parties, was an innovative way to approach the review. All parties contributed fully to the discussion and it was pleasing to note, firstly, that there was a fair degree of consensus from all sides and, secondly, that the discussions and views matched fairly closely the thoughts and conclusions of the detailed report from Barnett Waddingham, which, although not available at the meeting, was nearing the first draft stage. Detailed Minutes of that meeting were produced and these are attached as Appendix 1.

Investment Strategy Review

3.4 The Investment Strategy Review report produced by Barnett Waddingham is attached at Appendix 2. The review process covered a number of stages, as follows, and makes clear recommendations on the potential future direction of travel of the Fund.

- Consideration of current status of the Fund, both assets and liabilities (section 2);
- Identification of key objectives (section 3);
- Analysis of cashflow profile (section 4);
- Examination of asset allocation, particularly the structure of growth/protection assets (section 5);
- Consideration of overall mandate structure and exact growth/protection asset structure (sections 6 to 8);
- Summary of proposals (section 9).

Marcus Whitehead, a Partner of Barnett Waddingham LLP, will give a presentation at the meeting detailing his considerations and recommendations. Representatives of Baillie Gifford and Fidelity will also be attending the meeting during this item and Members may wish to seek their comments.

3.5 Current status of Fund

The current status of the Council's Pension Fund is set out in Section 2 of the report (pages 3 and 4). As at 30th September 2011, the Fund held 81% of its investments in "growth" assets (equities) and 19% in "protection" assets (bonds and cash). At the last actuarial valuation in 2010, the funding level was assessed at 84%, the employer contribution rate was certified at 23% of payroll and a deficit recovery period of 12 years was set.

3.6 Key objectives (section 3, pages 5 and 6)

The objectives of the Fund, as set out in the Funding Strategy Statement approved by the Sub-Committee in September 2011 are:

- To ensure sufficient resources to meet liabilities as they become due;
- To keep employer contribution rate as stable as possible; and
- To maximise investment returns within reasonable risk parameters.

3.7 Cashflow analysis

Section 4 of the report (pages 7 to 13) looks at the future evolution of the Fund in cashflow terms and concludes that the fact that the Fund is still open to new members and has a very long-term investment horizon lends itself to a strategy with a high allocation to growth assets. Assuming the Fund continues in its present form, this is expected to be the case for the foreseeable future.

3.8 Growth/protection split

Section 5 (pages 14 to 16) considers the relative merits of growth and protection assets. Growth assets are normally expected to produce a higher return over the longer term, but are more volatile and do not have a direct link to liability values, which are assessed by reference to gilt yields and future inflation rates. The 2010 actuarial valuation calculated the discount rate (the rate at which liabilities are expected to grow in the future) at around 7% and the report concludes that the current 80%:20% growth:protection split is still appropriate in order to generate this rate of return on the Fund's assets. The report recommends that the Sub-Committee should consider the separation of the current multi-asset briefs into explicit growth and protection mandates.

3.9 Overall mandate structure – growth investments

Sections 6 and 7 (pages 17 to 33) looks at various options for the future structure of the growth part of the Fund, including:

- active management v passive management (section 6.1 on pages 17 and 18) and core v satellite management structures (section 6.2, pages 19 and 20) – here the report recommends that the Sub-Committee should consider adopting a core/satellite management structure, including an assessment of the merits of active v passive management;
- regional equity (growth) exposure (section 7.1, pages 21 to 25) – here the report recommends the use of an unconstrained global equity mandate; and

- alternative investments, including property (section 7.2, pages 26 and 27), commodities (section 7.3, pages 28 and 29), diversified growth funds (section 7.4, pages 30 and 31) – here the report recommends no separate allocation to “new” asset classes, but instead, to introduce diversification away from equities, it recommends the use of a diversified growth mandate.

3.10 Overall mandate structure – protection investments

Section 8 (pages 34 to 37) looks at gilts and bonds and concludes that the broad 20% allocation to protection assets is appropriate, but that equal weighting should be given to government and corporate bonds and that the fixed interest gilt exposure should be replaced with index-linked gilts to protect the Fund against inflation.

3.11 Conclusion

The report concludes that a 40%:60% core:satellite strategy is a good starting point, with asset allocation broadly as follows:

Allocations as a % of total Fund assets

	80% Growth	20% Protection
Core: 40%	30% passive global equities	10% passive index-linked gilts
Satellite: 60%	40% allocated between an unconstrained equity mandate and the Fund’s existing mandates. 10% diversified growth fund	10% active corporate bonds

3.12 The Fund’s asset allocation strategy has not been reviewed since 2005/06. The proposals seek to retain an 80%/20% growth/protection profile similar to the existing strategy. They also seek to improve the underlying long-term investment return by eliminating arbitrary regional weightings (e.g. UK, Europe, US, etc), thus providing more flexibility for Fund managers to take advantage of investment opportunities in the world’s stock markets. This approach to improving long-term investment returns is endorsed by the Fund managers and the Council’s external advisers, AllenbridgeEpic. The fee profile will change, but this is expected to be offset by higher investment returns.

3.13 The proposals also include investment in Diversified Growth Funds, which is expected to provide a proportion of investment in property assets as well as in a variety of other investment opportunities. A 20% proection profile remains for investment in corporate bonds and gilts.

3.14 There will need to be transitional arrangements to reflect the move from the existing asset classes to any final strategy agreed by Members. There will also be procurement arrangements to consider as well as the need to ensure that investment returns are maximised as much as possible during the transitional period. Dependent on any changes agreed, a detailed implementation programme will be reported to the next meeting.

3.15 As is stated in the Pension Fund Performance report elsewhere on the agenda, medium and long-term performance is of much greater importance than short-term returns. There will be other changes on the horizon relating to the implementation of the Hutton Report recommendations from April 2014 (a verbal update on these will be provided at the meeting) and the ongoing implications arising from the reduction in the proportion of active Fund members. There will need to be ongoing periodic review of the investment strategy to reflect these changes as well as any long-term changes arising from economic events.

4. POLICY IMPLICATIONS

4.1 The Council's Pension Fund is a defined benefit scheme operated under the provisions of the Local Government Pension Scheme (LGPS) Regulations 2007, for the purpose of providing pension benefits for its employees. These regulations allow local authorities to use all the established categories of investments, e.g. equities, bonds, property, etc, and to appoint external investment managers who are required to use a wide variety of investments and to comply with certain specific limits.

5. FINANCIAL IMPLICATIONS

5.1 None at this stage, but there will be additional costs if new mandates are required to be advertised. These will all be chargeable to the Pension Fund as administration costs.

Non-Applicable Sections:	Legal and Personnel Implications
Background Documents: (Access via Contact Officer)	Investment Strategy Review report by Barnett Waddingham 17/01/12. Actuarial Valuation report as at 31/03/10. Minutes of “all party” meeting 21/12/11.