LONDON BOROUGH OF BROMLEY PENSION FUND
NOTES OF ASSET ALLOCATION STRATEGY MEETING 21ST DECEMBER 2011

Present: Councillor Paul Lynch (Chairman, Pensions Inv Sub, LBB) - **PL**
Councillor Richard Scoates (Vice Chairman, Pension Inv Sub, LBB) - **RS**
Peter Turner (LBB) – **PT**
Martin Reeves (LBB) – **MR**
Marcus Whitehead (Barnett Waddingham) – **MW**
Nigel Morecroft (Baillie Gifford) – **NM**
Ken Barker (Baillie Gifford) – **KB**
Nick Birchall (Fidelity) – **NB**
Joo Hee Lee (Fidelity) – **JHL**
Paul Harris (Fidelity) – **PH**
Alick Stevenson (AllenbridgeEpic) – **AS**

1. Introductions.

PT opened the meeting by saying that the aim was for Bromley's Fund to move towards the best asset classes to ensure good returns in the future. We want to make the best possible use of the help and expertise of others and everyone present was urged to contribute fully.

2. Cashflow analysis by Barnett Waddingham (BW) (circulated by e-mail on 12th December)

MW advised that the figures BW had based their assumptions on had all been taken from our latest accounts and that nothing in the figures suggest that we have to change anything. The report concluded that the Fund is expected to be ok from a cashflow point of view for "the foreseeable future" (i.e. at least 10 years).
PT said there are lots of unknowns/variables (i.e. the Hutton effect, redundancies, etc) that are likely to lead to changes in the Fund's membership profile.
PT queried the projections in the report for investment (dividend) income. The figures in our accounts only include dividends from UK equities that are received as cash into our custodian account. They do not include dividend income from other investments (i.e. pooled vehicles) that are automatically reinvested. This would probably increase the income assumption in future years from c1.1% of fund value (between £5m and £6m pa) to c2.5% (around £12m).
MW acknowledged this and referred to the "higher income strategy" scenario in the report (para 3.5), which assumed an income yield of 2.0% (not far off the true position) and painted a much more "cashflow friendly" picture (positive through to the year 2032).

3. Future Return expectations.

PT asked for views on whether the rate of around 7% assumed by the actuary for future returns is reasonable?
JHL felt it depends on the investment time horizon – Fidelity's long-term house view is at or slightly above 7%.
NB circulated some modelling work Fidelity had done in which their assumptions are similar to the actuary's.
NM confirmed that Baillie Gifford would also make similar assumptions for future returns.
MW said they are comfortable with the assumed returns – equity returns over very long periods have been between 4% and 5% above inflation and gilt yields.
JHL pointed out the need to be aware of the downside risks and to consider contingency plans for short-term cashflow issues.

4. Consideration of Asset Classes

Is current structure fit for purpose?

PT asked for views on whether we should consider getting out of any of the current asset classes?
AS felt any change should involve regional shifts rather than complete asset classes.
NB pointed out that, although UK equities keep getting bad press, expected returns are still as good as those of other sectors.
MW said that a 30% allocation to UK equities feels about right, but he felt that the fund's 10% gilt holding was not serving any strategic purpose, although it has done fairly well. He felt we should move to index-linked gilts to give some inflation protection.
NM said we should look to move towards a global portfolio.
NB agreed that there needs to be a wider debate about globalisation.

Flexibility & the 80/20 split?

PT asked for views on whether our current asset classes were too rigid and whether the current structure was flexible enough to allow for tactical allocation decisions? With current financial uncertainty in the world, is now a good time to review this?
NB said that strategic asset allocation is for the long-term and our fund is not currently set up to take short-term tactical decisions.
JHL felt the 80/20 equity/bond split is reasonable, but should be reviewed regularly – it is not a bad time to look at other classes.
AS said that cashflow, returns and the 80/20 split all look reasonable on the current liability profile, but pointed out that demographics drive what you want to do.
On the 80/20 split, NB said we need to have a relatively robust growth element in the portfolio.
NM said we need to be clear what we are seeking to achieve as the client and referred to the returns v volatility scenarios modelled in the Fidelity handout.

Other asset classes

Property

PT asked if now is a good time to get into other asset classes and, in particular, property?
NB said that lots of clients have a property allocation – it has diversification and high return/low volatility benefits, but is relatively illiquid and costly. It's definitely appropriate to consider property. If so, you should keep the bond protection and reduce equities. Fidelity assuming 7.5% future returns.
NM agreed – property is an alternative to equities as a growth asset, but with less volatility, and has real exposure to the economy. Baillie Gifford assuming 6.5% future returns.
KB felt that property was unlikely to be a game-changer and would not be given a high weighting. He reiterated that high transaction costs and management fees made it costly.
AS felt that property is a very long-term investment – capital growth would be a bonus, but essentially you are looking for rent income. Even a 10% allocation (£40m-£50m) would not be big enough for direct investment – it would have to be in a pooled fund/unit trust.
JHL said property sits between equities and bonds and is an attractive asset class on the strategic side.
MW felt that pricing issues can be a nightmare and suggested looking into investing in long-term lease funds – here you invest in long-term leases with attractive clients with the aim of a stable long-term income.
All agreed that, if we go for, say, 5% or 10% in property, we should reduce the allocation to equities.

Commodities
NB/JHL said commodities offer inflation protection, but advised investing via funds.
KB said we are used to seeing commodities prices going up, but it has not always been that way.
MW said commodities are a good diversifier, but they have to be managed actively.
PT asked how commodities compare to equities?
NM said they are a good diversifier, but returns are not as good as equities. They offer better protection against inflation.

Globalisation / Equities Fund/Unconstrained Global Equities Mandate
NB said a global mandate would not be very different in terms of expected returns – we need to be clear on the acceptable level of volatility. He suggested moving to an ACWI benchmark (All Countries World Index).
MW said the fund has to pay pensions, so inflation should be the main concern – there is more volatility around an equity benchmark, but that's a bit of a red herring.
NM said they would expect to achieve outperformance of around 2.5% (i.e. 1% higher than the current target).
NB said expected returns would be around 8% and they could live with 2% to 2.5% over that. Stockpickers would be more comfortable with an unconstrained approach.
PT asked if the fund managers would diversify under a global mandate?
NM said yes, they would run a portfolio of around 100 stocks.
PT asked if global equities is the way forward?
NM said it's Bromley's choice, but a halfway house might be better.
NB agreed, pointing out that there is always a degree of loyalty to UK equities and it would be a big step to cut drastically.
For info, the current ACWI benchmark comprises 50.3% USA, 15.6% Europe, 12.6% Emerging Markets, 8.5% UK, 7.9% Japan, 4.9% Pacific and 0.2% Middle East.

Bonds
NM said bonds are safe, but they will probably have a negative real return over the next 10 years – hold for diversification.
MW said a global bond portfolio offers good opportunities, but can become a growth portfolio and you are then looking for gains.
KB said most people are buying bonds because they have to (regulators, cash flow, etc.
PT asked if the current 20% allocation to bonds is about right?
Everyone agreed this felt right – in spite of a lower return, bonds are safer.
MW suggested investing in index-linked gilts rather than fixed interest – liabilities are inflated each year and we need some protection. Corporate bonds should be actively managed and capital preservation is important.
AS said we should leave the 20% allocation as it is and change the equity portfolio.

Hedge Funds
MW said hedge funds are a trading strategy, not an asset class. Maybe consider dipping our toe in the water before taking the big leap?

Diversified Growth Funds (DGF)
MW – around 50 out there, all taking different approaches.

Transition issues
PT said the joint view seemed to be to stick with the 80/20 split, with the 80 becoming a kind of global DGF with a bit of property If that is the direction of travel, how quickly should we look to get there?
KB said it's up to us – Baillie Gifford could go as quickly or as slowly as we want – but we need to make sure we take the Council Members with us.
NB said a DGF is very similar to an equity fund, so transition would not be a problem.
NM added that the fund managers would both have transition teams and would just get on and do it.
MW said he would be happier about transitions within managers than from one manager to another. A DGF can invest in property, so there may not be a need to have property as a separate asset class, but it can add considerably to the governance bill re monitoring, etc.
PL asked if we should go for a separate property fund?
All agreed a DGF would offer a better return and would probably include an element of property. Commodities would also probably be included within a DGF.

5. Next steps and timetable

PT said Barnett Waddingham hoped to complete the first draft of their strategy review report tomorrow (22nd December). MW advised that its conclusion would not be a million miles away from the conclusions of this meeting.
Pensions Investment Sub-Committee meets on 9th February and both Baillie Gifford and Fidelity will attend. An initial report, together with the Barnett Waddingham report, will be put to that meeting. The aim is to consider asset classes at February meeting and agree final asset classes at the May meeting (8th May), with possibly a special meeting to discuss and provide training support if required.
PL is keen that reports to the Sub-Committee should include firm recommendations.
Baillie Gifford and Fidelity were asked to send through a DGF factsheet with some history of asset allocations.
Fidelity to send details of ACWI.