Report No. RES12075

London Borough of Bromley

PART 1 - PUBLIC

Decision Maker:	**Pensions Investment Sub-Committee**
Date:	**8th May 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

At the last meeting in February, the Sub-Committee considered an Investment Strategy Review report prepared by the Council's actuary, Barnett Waddingham LLP, and agreed a future investment strategy for the fund. As requested at that meeting, this report provides more information on active management versus passive and asks Members to approve the detailed arrangements required to implement the new asset allocation strategy.

RECOMMENDATION(S)

The Sub-Committee is asked to note the report and:

2.1 Agree that the Global Equities allocation in the new strategy be actively managed (see paragraphs 3.3 to 3.7);

2.2 Agree that tendering exercises be carried out for a) a Diversified Growth Fund (DGF) (Phase 1), b) two or more global equities managers (Phase 2) and c) two corporate bond/gilt managers (Phase 3) in line with the draft implementation timetable (see paragraph 3.18);

2.3 Approve mini-tendering exercises for specialist procurement advice for all 3 phases in line with the timetable. Approval of adviser(s) to be delegated to the Chairman and Finance Director; and

2.4 Consider and agree how the 10% allocation to the DGF (Phase 1) should initially be funded (see paragraph 3.12);

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); £499.5m total fund value at 31st March 2012)

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): 5,040 current employees; 4,628 pensioners; 4,165 deferred pensioners as at 31st March 2012

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 the last meeting in February, the Sub-Committee considered an Investment Strategy Review report produced by Barnett Waddingham, the Council's actuaries, which recommended a future investment strategy for the Fund. Broadly, the Sub-Committee agreed to maintain the high level 80%/20% split between growth seeking assets (representing the long-term return generating part of the Fund's assets) and protection assets (aimed at providing returns to match the future growth of the Fund's liabilities). The growth element would, however, comprise a 10% investment in Diversified Growth Funds (a completely new mandate) and a 70% allocation to global equities. The latter would involve the elimination of our current arbitrary regional weightings, which would provide new managers with greater flexibility to take advantage of investment opportunities in the world's stock markets, thus, in theory at least, improving long-term returns. A 20% protection element would remain in place for investment in corporate bonds and gilts.

3.2 In agreeing a future strategy for the Fund, the Sub-Committee asked for a report to this meeting outlining the detailed arrangements required to implement the new asset allocation strategy. With regard to the global equities element, this report was also to provide information to enable further consideration of active and passive management and this is covered in paragraphs 3.3 to 3.7 below.

Active versus passive management

3.3 In their report, Barnett Waddingham had recommended that "in order to counteract the increased costs and governance requirements associated with adding an unconstrained global equity mandate to the investment strategy, the Sub-Committee may wish to adopt a low cost passive core mandate to sit alongside the unconstrained active equity mandate". They proposed that the 70% global equities allocation be divided between a passive mandate (30%) and an unconstrained (active) mandate (40%). Following some discussion on this, it was resolved that the Finance Director would include consideration of the active/passive balance of the Fund's global equities mandate in this report.

3.4 Research suggests that, where active management is practiced, outperformance is more consistently achievable where the manager takes significant active positions away from the index. For over 12 years, however, our current managers, Baillie Gifford and Fidelity, have been subject to benchmark constraints and asset allocation control ranges as they have managed multi-asset portfolios with the objective of outperforming their respective composite benchmarks by 1.0%-1.5% and 1.9% per annum respectively over rolling three year periods. These constraints may have resulted in the managers sometimes holding stocks which they do not favour.

3.5 The main reason the Sub-Committee has decided to move into global unconstrained equities is to produce higher returns and the potential for higher returns will certainly be greater with active management than with passive. On the other hand, however, fees for passive managers will almost certainly be lower and there will be a lower risk of underperforming the chosen index. A successful active manager offers the potential to produce material outperformance, which passive does not, and this could be higher than the saving in fees from passive management. The key is to appoint the right active manager and this, as with other new mandates in the future strategy, will be subject to competitive tendering.

3.6 Active management is favoured by the Council's external advisors, AllenbridgeEpic, who state that "we do not think the fund should move to a passive/active structure at the present time". Our current managers, Baillie Gifford and Fidelity, are strongly in favour of active management. Baillie Gifford point out that the term "Global unconstrained" does not have to mean "extremely punchy strategies with very concentrated portfolios and no regard for regional or industry concentrations". They go on to say, "the strategy we have in mind, Global Alpha, is quite diversified (in the range of 70-120 stocks) and has a risk framework around it based on maximum deviation from benchmark at stock, industry and regional levels. Our risk team also monitor risk metrics such as "active share", delivered tracking error (i.e. how the portfolio's returns are expected to vary from the benchmark's returns) and the spread of stock specific risk. So, this is very much a risk aware approach. The main benefit to Bromley would be that being given a freer hand on stock selection would help boost target performance compared to the current approach, albeit with slightly more volatility." Baillie Gifford did some modelling in which they substituted the Global Alpha portfolio for our actual equity holdings at year-end and found that "there was only a modest increase in both tracking error and absolute volatility".

3.7 Further clarification on their recommendation has been sought from Barnett Waddingham and they have advised that "either a passive equity mandate or a genuinely active equity mandate would be a reasonable approach". By "genuinely active" they mean managers who take significant positions away from the index. Their "key view is that investors should not place money with marginally active equity managers (i.e. closet trackers)". They based their original recommendation (to include a passive element) on the premise of seeking to minimise the increase in complexity of the Fund's investments following the change in the strategy. However, if Members are happy to accept the increased governance time and costs that will almost certainly result from a fully active approach (which would potentially be offset by improved investment returns), it is recommended that this be approved as part of the future strategy.

Next Steps

3.8 The new strategy agreed in February will require new mandates to be advertised for 3 separate portfolios:

Diversified Growth Fund (10% - broadly £50m based on the current total fund value)

Global Equities (70% - broadly £350m)

Corporate Bonds / Gilts (20% - broadly £100m)

3.9 In practice, LGPS committees normally delegate much of the procurement process to officers and advisers. There are a number of key steps:

- Advertisement for and appointment of adviser to assist in the process
- OJEU or general notice placed – tenderers register interest
- Pre-qualification questionnaire (PQQ) sent out
- Processing of PQQ submissions and shortlisting
- Invitation to Tender (ITT) sent out
- Processing of ITT submissions and shortlisting
- Tender clarification (beauty parade)
- Appointment of manger and legal agreement drawn up
- Feedback to unsuccessful applicants, if requested

3.10 External advice around the procurement process would fall outside AllenbridgeEpic's responsibilities under the current agreement, so it is recommended that specialist procurement advisors be appointed to assist in the evaluation and selection process. A mini-tendering exercise would be required for this. In order to keep the whole Fund transition and procurement process manageable, it is further recommended that the three elements be treated as separate phases and be addressed in the order set out in paragraph 3.8. A draft indicative timetable is set out in paragraph 3.17.

Phase 1 - Diversified Growth Fund

3.11 Diversified Growth Funds (DGF) are pooled investment funds that contain a wide range of assets, including alternative asset classes such as commodities and infrastructure, and are a good way of diversifying the Fund's risk. They aim to achieve similar returns to equities, but with less risk and, on average, around half the volatility. Most funds aim to return cash plus 3.5% to 4.5% over rolling three to five year periods and most fees are in the range of 0.75% and 1.2%.

3.12 In February, the Sub-Committee agreed an allocation of 10% to a Diversified Growth Fund mandate, which, based on the current market value of the Fund, would be around £50m and would have to be tendered competitively. In terms of funding for the new DGF mandate(s), we could make arrangements with our existing fund managers for the relevant sum to be made available for a new manager(s) once we have been through the tender process and chosen a manager(s). Members are asked to consider whether this funding should be taken from just one existing fund manager or from both managers. A report elsewhere on the agenda looks at the performance of our current two managers over the short, medium and long-term and Members may wish to use this to inform this decision.

3.13 Procurement regulations relating to the Local Government Pension Scheme are available in a CIPFA guidance document: "Buying Time: A CIPFA Pensions Panel Guide to Procuring Efficiency in Public Sector Pensions Administration (2011)". Procurement by LGPS pension funds is subject to the same legal framework as applies to general procurement by local authorities. Local authorities must comply with the European procurement rules and potential contracts must be advertised in OJEU (the Official Journal of the European Union) to ensure that contracts are awarded on the basis of commercial, non-discriminatory and transparent criteria. The requirement to comply applies to all contracts over £173,456 over the life of the contract.

3.14 DGF investments, however, would all be in pooled funds and these fall outside the EU procurement rules because they are considered to be direct investment decisions (there is an exemption for financial instruments). Accordingly, although we would have to tender for the mandate(s), we would not have to follow the OJEU route, which may shorten the tender process. We would still, however, have to comply with the 2009 investment regulations, which require us to obtain "proper advice" from someone whom the authority reasonably believes to be qualified by their ability in and practical experience of financial matters.

3.15 As is stated in paragraph 3.10 above, procurement advice is not covered by the current agreement with AllenbridgeEpic, so it would be necessary to employ external advisers to assist with the process. It is recommended, therefore, that the Sub-Committee approve a mini-tendering exercise for specialist procurement advice for a Diversified Growth Fund and that approval of tenderers be delegated to the Chairman and the Finance Director. The successful advisers will initially be required to create, with officers, a long list of up to 8 DGF fund managers and will then advise on tenders received and on appointment(s) prior to final decisions being made by the Sub-Committee. It is estimated that the adviser role for the DGF will cost in the region of £10,000 and a minimum of three quotes would be required. A draft specification for a DGF adviser is attached as Appendix 1.

Phase 2 – Global Equities

3.16 In February, the Sub-Committee agreed an allocation of 70% to an unconstrained global equity mandate, which, based on the current market value of the Fund, would be around £350m. The main change here is that the managers would no longer be constrained by the current regional weightings, so we could, in theory, amend the mandates with the existing fund managers and leave the assets under management with Baillie Gifford and Fidelity. As is outlined above, however, this mandate will almost certainly lead to higher fees (hopefully more than offset by increased returns), even if Baillie Gifford and Fidelity were to continue to manage this part of the portfolio, so it is important to test the market to ensure that the Council obtains best value. It is, therefore, recommended that the global equity mandate be tendered competitively (under EU procurement rules) after Phase 1 (DGF) has reached a conclusion. In view of the sum involved, it would be prudent to appoint two specialist managers (or perhaps more) to manage this part of the portfolio and it would again be necessary to employ specialist advice to assist in the process.

Phase 3 – Corporate Bonds and Gilts

3.17 In agreeing a new strategy in February, the Sub-Committee also agreed an allocation of 20% to corporate bonds and gilts, which would equate to around £100m based on the current total fund value. Again we could, in theory, amend the mandates with the existing fund managers and leave the assets in the hands of Baillie Gifford and Fidelity, but again it is recommended that we test the market to ensure that the Council obtains best value. It is recommended, therefore, that the bond/gilt mandate be tendered competitively (under EU procurement rules) after Phase 2 (Global Equities) has reached a conclusion. In view of the sum involved, it would probably be prudent to appoint two managers to manage this part of the portfolio and it would again be necessary to employ specialist advice to assist in the process.

3.18 Draft timetable

The following draft timetable sets out the steps that would be required to fully implement the new strategy:

Estimated Date	Action
May 2012	Members approve tendering for management of new strategy (all 3 phases)
	Members approve mini-tendering for procurement advice (all 3 phases)
June 2012	Advertise for specialist procurement advice for DGF (Phase 1)
July 2012	Appoint specialist procurement adviser for DGF
Aug – Oct 2012	Agree manager shortlist, advertise, evaluate and shortlist tenderers for DGF
Nov 2012	"Beauty parade" at Pensions Investment Sub-Committee
Nov 2012	Agree appointment of DGF manager(s)
Jan 2013	Potential DGF start date
Feb – Sept 2013	Phase 2 – Global Equities (repeat steps in Phase 1)
Oct 2013	Potential global equity start date
Nov 2013 – Apr 2014	Phase 3 – Corporate Bonds & Gilts (repeat steps in Phase 1)
May – June 2014	Potential bond/gilt start date

3.19 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 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. LEGAL IMPLICATIONS

5.1 The statutory provisions relating to the administration of the Local Government Pension Scheme are contained in the Local Government Pension Scheme (LGPS) Regulations 2007 and LGPS (Administration) Regulations 2008, which are made under the provisions of Section 7 of the Superannuation Act 1972. The main legislative provisions on procurement are set out in the Public Contracts Regulations 2006 (as amended) and the procurement process proposed is compliant both with these and with the Council's own procedures.

6. FINANCIAL IMPLICATIONS

6.1 There will be additional costs from the advertising and award of new mandates and for procurement advice. Initially, the fee payable to a provider of procurement advice for Phase 1 of the new strategy (the Diversified Growth Fund mandate) is estimated at around £10,000 and a minimum of 3 quotes will be sought. Fund management fees will, in all likelihood, be higher than those we currently pay, but it is anticipated that higher returns would more than compensate for these. All costs will be chargeable to the Pension Fund as administration costs.

Non-Applicable Sections:	Personnel Implications
Background Documents: (Access via Contact Officer)	Investment Strategy Review report by Barnett Waddingham 17/01/12. Report to Pensions Investment Sub-Committee 9/2/12. Actuarial Valuation report as at 31/03/10. Minutes of "all party" meeting 21/12/11.

APPENDIX 1

DRAFT SPECIFICATION FOR PROCUREMENT ADVICE FOR DIVERSIFIED GROWTH FUND(S)

The London Borough of Bromley is a defined benefit pension fund operated under the provisions of the Local Government Pension Scheme (LGPS) regulations. It currently has assets under management of around £500m, invested in equities, bonds and cash. The London Borough of Bromley now wishes to diversify its asset base and to appoint one or two Diversified Growth Fund managers, up to a maximum of £50m, as part of a revised strategy for managing its Pension Fund investments. At this stage, it is seeking to appoint an Investment Adviser to advise on and manage this procurement process.

The Funding Strategy, Statement of Investment Principles and latest accounts of the Fund are available to download at www.bromley.gov.uk/downloads/200130/lbb_bromley_pension_fund

The adviser will be expected to draw up procurement documentation, the specification and evaluation methodology, and produce a long list of up to 8 providers, and assist in shortlisting for final evaluation by Bromley members and officers.

Failure to complete all the information asked for will result in the bid being declared non-compliant.

The award criteria are as follows:

AWARD CRITERIA	WEIGHTING	WEIGHTING
Price		**30%**
To includes details of number of meetings at LBB		
Fee to include at least 1 fixed price option		
Details of methods of working		**40%**
Recommended procurement route - to be consistent with procurement legislation applicable to LGPS	5	
Specific methodology for identifying long list, with example report of long listed providers	10	
Details of database to be used	5	
Evidence of understanding of requirements and strategic investment objectives of London Borough of Bromley	10	
Approach to due diligence	10	
Timetable		
Experience of comparable service provisions		**30%**
Two examples of previous successful searches	20	

Details (including CVs) of personnel to be involved in the search	10	
TOTAL	**100%**	**100%**

Two references are required, together with the last 3 years' audited accounts of the contracting body.