Report No. RES11093	London Borough of Bromley	Agenda Item No.
	PART 1 - PUBLIC	

Decision Maker:	**Pensions Investment Sub-Committee**
Date:	**14th September 2011**
Decision Type:	Non-Urgent Non-Executive Non-Key
Title:	**ABSOLUTE RETURN FUNDS**
Contact Officer:	Martin Reeves, Principal Accountant (Technical & Control) Tel: 020 8313 4291 E-mail: martin.reeves@bromley.gov.uk
Chief Officer:	Director of Resources
Ward:	All

1. Reason for report

In discussions on Fund performance at the last meeting on 10th May, the Sub-Committee agreed that a report be submitted to this meeting on Absolute Return Funds. The Finance Director has sought the views of the two Pension Fund investment managers, Baillie Gifford and Fidelity, and the Fund's actuary, Barnett Waddingham, and their comments and views are presented here for Members' consideration.

RECOMMENDATION(S)

The Sub-Committee is asked to:

2.1 Note the report and consider whether it wishes any further action to be taken.

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. Annual report required to be published under LGPS (Administration) Regulations 2008.

2. BBB Priority: Excellent Council.

Financial

1. Cost of proposal: No cost

2. Ongoing costs: Recurring cost. Pension Fund management fees £2.2m in 2009/10 and £2.3m in 2010/11

3. Budget head/performance centre: Pension Fund

4. Total current budget for this head: £33.4m expenditure in 2011/12 (pensions, lump sums, admin, etc); £39.6m income (contributions, investment income, etc); £494.1m total fund value at 30TH June 2011)

5. Source of funding: Contributions to Pension Fund

Staff

1. Number of staff (current and additional): 0.5 fte (current)

2. If from existing staff resources, number of staff hours: c18 hours per week

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Legal

1. Legal Requirement: Statutory requirement. Local Government Pension Scheme (LGPS) Regulations 2007 and LGPS (Administration) Regulations 2008

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

Customer Impact

1. Estimated number of users/beneficiaries (current and projected): 5,146 current employees; 4,616 pensioners; 3,943 deferred pensioners (as at 30th June 2011)

Ward Councillor Views

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

2. Summary of Ward Councillors comments: N/A

3. COMMENTARY

3.1 As was requested at the last meeting in May, this report looks at Absolute Return Funds as a possible investment vehicle. The report and its conclusions are based on the views of the two Fund managers, Baillie Gifford and Fidelity, and the Fund's actuary, Barnett Waddingham.

Baillie Gifford comments

3.2 Baillie Gifford provided a note on Absolute Return Funds and said their representatives would be more than happy to discuss this in November, when they are next scheduled to attend a Sub-Committee meeting. Their paper is attached at Appendix 1 and a summary of their comments/views is provided below:

- Absolute return is a term applied to a wide range of investment strategies, most commonly hedge funds. It is generally associated with targeting positive returns rather than a benchmark, and with having the freedom to invest in a wide range of asset classes and strategies.
- The potential returns are attractive, but investors' gains can be eroded by high fee structures and hedge funds can suffer from a lack of transparency and the risky use of financial leverage (i.e. using borrowed money to increase the scale of exposure).
- UK Pension Schemes are investing in strategies typically referred to as diversified growth or new balanced. These funds typically target cash plus or inflation plus returns over medium-term horizons.
- Baillie Gifford do not manage hedge funds, but do offer a Diversified Growth Fund, that targets equity like returns with lower volatility.

Fidelity comments

3.3 Fidelity provided brief, generic thoughts on Absolute Return Funds and their representatives will be happy to discuss further at this meeting. Their thoughts are attached at Appendix 2.

Barnett Waddingham comments

3.4 The Fund's actuary, Barnett Waddingham, provided a more detailed report on Absolute (Target) Return Funds, setting out advantages and disadvantages. Their report is attached at Appendix 3 and their conclusions are shown below. Again their representative would be happy to discuss this matter further.

- Target return funds can provide investors with a number of investment solutions contained within a single product. They are designed to give investors long term performance approaching that expected from equities, but with reduced volatility. Investors will also benefit from diversification of investments and dynamic asset allocation strategies.

- There are higher costs associated with this type of mandate and, coupled with tracking errors, this can become a distraction in the short term. In general, the returns from these funds have to be analysed over a longer period than funds using traditional benchmarks to give a more accurate view of their achievements.

- There are a large variety of funds available in this class of investment which permits investors to make choices about the level of risk and manager involvement. The decision about which, if any, of the funds to choose will be derived from considerations about the level of governance the Committee desire, the investment strategies and concepts the Committee are comfortable with and how much risk they are willing to take.

Further Steps

3.5 If Members were minded to pursue this further, it would probably be beneficial to discuss this with Fidelity's representatives at this evening's meeting and to then have similar discussions with Baillie Gifford and Barnett Waddingham, both of whom have given more detailed responses at this stage.

3.6 Broadly the considerations fall into the following categories and it would be for Members to determine if they wish to invest in these vehicles and then to consider factors such as risk appetite and manager involvement:

- Returns potentially attractive and less volatile;
- Good diversifier and flexible in that asset allocation changes can be made quickly;
- Fee structures can be high and can eradicate performance benefits;
- Less control for local authority and potential lack of transparency;
- Heavy reliance on manager's skill and investment acumen.

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. An Annual Report is required to be published under LGPS (Administration) Regulations 2008.

5. FINANCIAL IMPLICATIONS

5.1 None at present. If Members were minded to invest in Absolute Return Funds, competitive tenders would be sought for the service.

Non-Applicable Sections:	Legal and Personnel Implications
Background Documents: (Access via Contact Officer)	LGPS Regulations 2007 & LGPS (Administration) Regulations 2008. Report on "Pension Fund Performance" to Pensions Investment Sub-Committee 10/05/11.

APPENDIX 1

BAILLIE GIFFORD COMMENTS

Absolute Return Funds

When discussing absolute return funds, we are actually describing a diverse collection of investment strategies. There is no single definition, but characteristics typically include targeting, but not guaranteeing, absolute (ie positive) returns rather than being linked to a benchmark; and having the freedom to invest in a wide range of asset classes and strategies.

The range of absolute return funds is growing, partly because pension schemes are increasingly looking for ways to limit volatility and to implement their desire for greater diversification. Pension Schemes typically invest in 'diversified growth' or 'new balanced' strategies which share some characteristics with absolute return funds.

However, when we talk about absolute return, we are usually referring to hedge funds. Some very large pension schemes invest in hedge funds directly, but the majority of hedge fund clients are generally high net worth individuals or private wealth managers.

Hedge Funds

Hedge funds are often associated with investment techniques such as short-selling, with financial instruments such as derivatives, and with the use of leverage[1]. In reality, most individual hedge fund managers have a particular skillset or narrow market focus that they apply to a limited range of instruments and markets. Some examples are set out below.

Managed Futures Funds try to exploit trends in a range of investment markets, including currencies, commodities, equities and bonds. They aim to generate returns by buying in markets that are on a rising trend and selling those that are on a falling trend.

Rates & Currencies Funds look to generate returns through investing in government bonds and currency markets.

Market-neutral Funds take long and short positions across a range of stocks, and are meant to deliver positive returns no matter what the market conditions.

Lower-cost or Synthetic Funds aim to replicate overall hedge fund returns and / or focus on a specific investment strategy. An example would be a strategy which takes derivative positions to create a fund which generates positive returns when there is a sharp rise in equity markets.

The Rationale for Investing in Hedge Funds

In principle, hedge funds are a pure form of active investment management. They have the freedom to invest in a wide range of asset classes and (often complex) financial instruments in order to achieve returns. This maximises the potential to generate returns by using the investment skill of the managers, who are typically very experienced and can often lay claim to a strong investment track record.

However, hedge funds can polarise opinion, and have generated significant negative publicity in recent years. The factors leading to criticism of such funds include complexity, high fees and lack of liquidity.

Complexity: while the ability to invest in complex financial instruments can be a key factor in the ability of hedge funds to generate returns, it is also one of the main detractors in the eyes of many investors. Hedge funds are unregulated, can lack transparency (making it difficult to know what you are really buying), and there has been the occasional high profile blow-up.

[1] Short-selling enables you to gain when prices fall; a derivative is a contract whose value is linked to the performance of an asset, rather than ownership of that underlying asset; leverage is using borrowed money to increase the scale of your exposures.

High Fees: there may also be high fees, typically an annual charge of 2% of assets under management plus 20% of the absolute return ('2 and 20'). These reward structures are often considered to encourage excessive risk-taking by the managers, who then collect much of the upside in performance fees.

Liquidity: can be an issue when considering many of the unlisted funds which have 'lock-in' periods (restrictions on when you can get your money back). However there is a wide range of listed, daily trading funds.

Pension Schemes: Diversified Growth and New Balanced

Diversified growth and new balanced funds can be thought of as an evolution of the 'balanced' approach. Balanced describes portfolios like the one we manage on your behalf, with the ability to invest in equities, bonds and cash. Balanced performance has been strong over the long-term, but some clients view diversified growth as an attractive addition to their overall asset mix.

Diversified growth funds typically target 'cash plus' (base rates or LIBOR plus a fixed amount) or 'inflation plus' (RPI plus a fixed amount), in addition to some element of downside protection or reduced volatility. The table below illustrates how a selection of diversified growth funds have performed when equity markets have been weak over the past few years (the FTSE All-World is a global equity index and thus representative of broad equity returns). The table shows that, on the whole, diversified growth funds have had some success in achieving their dual objectives.

	Annualised Returns		Performance in equity downmarkets		
	Jan 09–Mar 11 %	Jan 08–Mar 11 %	2008 %	Jan/Feb 2009 %	Q2 2010 %
FTSE All-World (£)	18	5	-19	-17	-11
FTSE All-World (hedged to £)	17	-4	-39	-14	-10
Average of DG funds below	**14**	**8**	**-3**	**-4**	**-2**
Fund A	21	na	na	-4	-1
Fund B	14	7	-5	-5	-3
Fund C	13	5	-11	-4	-3
Fund D	9	8	5	-6	-2
Fund E	11	14	21	-8	-1
Fund F	18	4	-21	-5	-4
Fund G	13	7	-4	0	2

Sources: Mercers MPA, Bloomberg, Baillie Gifford & Co.
The above funds have been chosen by the presenter as a representation of Diversified Growth strategies, it is not intended to represent the bottom or top rated funds.
Returns are net of fees.

Baillie Gifford and Absolute Return Funds

Baillie Gifford does not offer a fund which only invests in absolute return, or hedge funds, nor do we have expertise as hedge fund investors ourselves. We do, however, offer a Diversified Growth (DG) Fund, which is proving to be very popular with clients (private and public sector) who are seeking exposure to a diverse range of asset classes, and the potential for reduced volatility.

Our DG Fund uses diversification and tactical asset allocation to target good returns while reducing their variability. Roughly speaking this should mean equity-like returns (formally UK base rates plus 3.5%) with half the volatility. In addition to equities, bonds and cash, DG invests in assets such as property, high yield bonds, emerging market debt, commodities, infrastructure, forestry, insurance linked bonds and selected listed hedge funds.

While it has investment freedom similar to some hedge funds, our DG Fund does not share their '2 and 20' fee structure, it does not use leverage, and has a clear and transparent investment process. We'd be happy to give you more details about DG if you are interested, or discuss it in our next meeting.

Summary

— Absolute return is a term applied to a wide range of investment strategies, most commonly hedge funds. It is generally associated with targeting positive returns rather than a benchmark, and with having the freedom to invest in a wide range of asset classes and strategies.

— The potential returns are attractive, but investors' gains can be eroded by high fee structures, and hedge funds can suffer from a lack of transparency and the risky use of financial leverage (i.e. using borrowed money to increase the scale of exposure).

— UK Pension Schemes are investing in strategies typically referred to as diversified growth or new balanced. These funds typically target cash plus or inflation plus returns over medium-term horizons.

— Baillie Gifford do not manage hedge funds, but do offer a Diversified Growth Fund, that targets equity like returns with lower volatility.

APPENDIX 2

FIDELITY COMMENTS

Absolute return funds have been receiving greater interest from investors but have been dogged by difficulties around the fact that they mean different things to different people. The universe may have funds within it that have absolute return benchmarks such as Cash Plus 5% or RPI plus 3% but the means by which they aim to achieve this can vary dramatically as a result of the underlying investments. For example an approach could be to manage a fund such as a Diversified Growth Fund- using a range of different asset classes, a hedge fund, a fixed income based portfolio or indeed an equity portfolio with dynamic asset allocation or a number of other approaches. Clearly some of the key factors to consider are the aims of the investor, the risk that the investor is prepared to take and the time period over which they are investing for. Clearly no one invests into any asset class with expectations of longer term negative returns but some absolute return funds may look to offset shorter term negative returns - but the various approaches and levels of success to achieve this can vary dramatically. Clearly there are some strategies that have worked very well and others that haven't - one of the disappointments in some absolute return strategies in the last five years is that they didn't protect on the downside as much as people had hoped, and did not really catch the upside terribly well either.

Many moons ago we presented the concept of a Diversified Growth Fund to the Officers - it has an RPI plus benchmark. These continue to find acceptance across the industry - in effect they are slightly more diversified balanced funds! I would be happy to cover the concept again with either the Officers or the Committee if it were deemed appropriate. As much as anything such a fund could give exposure to alternatives managed by an experienced PM without the Committee needing to become experts on hedge funds, arbitrage approaches and the vast number of funds out there.

APPENDIX 3

BARNETT WADDINGHAM COMMENTS

Introduction

The aim of this report is to provide an introduction to target return funds as requested by the Pensions Investment Subcommittee of the London Borough of Bromley. This report is addressed to the London Borough of Bromley Pension Scheme and Barnett Waddingham LLP does not accept liability to any third party in respect of the contents of this report.

Target Return Funds

Target return funds grew out of the once popular group of funds called balanced (or managed) funds. The stated aim of balanced funds was to alter the asset allocation of the funds within a pre-determined range of asset classes to benefit from market movements. Problems arose with balanced funds when they became benchmarked against a peer group benchmark which resulted in the majority of managers becoming herd like in their asset allocation strategies in fear of not performing in line with their peers.

Target return funds have sought to avoid these problems by focusing on a target return (hence the name!), rather than a benchmark asset allocation. They have, as a result, grown in popularity over the past decade and the range of funds available has grown with demand to give investors considerable choice. They come in a variety of guises and can provide Trustees with some attractive investment solutions.

"Target return", "diversified growth" and "absolute return" funds are all terms used to describe similar types of investment. There are differences in the investment style and level of risk associated with each variation which are examined in greater detail later.

Target return is used to describe the class of funds as a whole with absolute return referring to one end of a broad spectrum and diversified growth to the other.

The name "target return" is a reference to the performance based nature of the mandate. Most of these funds will not offer a traditional benchmark, such as an equity index, but instead will aim to provide returns related to interest rates, inflation rates or will simply aim for a straightforward percentage figure.

Regardless of the name there are some investment characteristics that define this class of funds as a whole:

- The most prominent of these is the use of a wide range of asset classes by the manager. Allocations are usually made to domestic and overseas equities, bonds and a range of alternative asset classes such as commodities and property. Derivative usage is also common for hedging risk but can also be used to generate returns in certain funds.

- The ability of the manager to change asset allocation is another concept key to this type of fund. This enables the manager to make investments based upon their view of markets.

- Most managers will also be permitted to invest in a combination of internal and external products. This allows the fund to benefit from the performance of external managers as well as any internal products or funds they deem to add value.

- The performance mandate is also a fundamental feature. They will typically target an interest rate or inflation rate with an additional outperformance target - a typical benchmark might be 3 month LIBOR (London Inter-Bank Offered Rate) +5%. The benchmark is unlikely to be directly linked to the markets in which the manager invests but will generally be related to the manager‟s long term view of developed equity market performance.

The significance of this benchmark is that it is unlikely that any negative performance will qualify as "outperformance". For instance, Trustees should never again hear that managers have delivered a successful return of -12% because the market returned -15%. This is not to say that target return funds will never generate negative returns but it does mean that this is very unlikely to be classified as a success.

The performance target chosen by a manager also gives an insight into the level of risk involved with their investment strategy. For example, to achieve a performance target of LIBOR + 5% will require a more aggressive and therefore riskier investment strategy than LIBOR + 2%.

Absolute Return Fund

Absolute return funds have a mandate that includes an explicit aim of capital preservation as well as including a performance target. The manager aims to use their investment acumen to determine asset allocation with the aim of preventing capital losses as well as generating returns over the long term. For example if they believe that stock markets are overpriced and are likely to decline they would reduce their equity position and invest in an alternative asset class.

The dual aim of targeting growth alongside downside protection leads to a large dependency on the manager's ability to time markets well. This is a notoriously difficult task and as such investing in these types of funds leads to a high degree of manager risk. There is likely to be greater use of derivatives in absolute return funds and they may use higher gearing to generate returns.

Diversified Growth Fund

These funds do not have the same explicit capital protection mandates as absolute return funds and instead will aim to invest in a broad array of asset classes and markets. In this way they are able to capture a variety of risk premia which in theory should generate smoother returns in the long term because of the exposure to a larger range of investments.

Asset allocation will generally be determined by reference to a model but there is also likely to be some subjective human input. The performance of diversified growth funds is more likely to be attributable to a variety of sources rather than just solely to the manager but the manager's decision making and foresight will still play a central role.

Advantages of Target Return

- The range of permitted investments gives managers greater access to market beta (market returns).

- Diversification is a central part of any sensible investment strategy and the use of multiple investment markets by target return funds is an effective way of diversifying a portfolio without the need for several separate investments.

- Managers are able to implement changes to asset allocation very quickly ensuring that perceived opportunities are not missed because of the governance structure of an investor.

- Pension fund liabilities are sensitive to changes in interest and inflation rates and so funds which target inflation and interest rate related returns are more relevant to the liabilities of the fund.

- Due to the diversification and dynamic asset allocation strategies employed the level of performance volatility should be reduced. Another result of these features is that Trustees should expect to underperform equity markets during periods of high returns but outperform equity markets during periods of negative returns.

- Certain target return managers offer downside protection which should mitigate the risk of capital losses.

Disadvantages of Target Return

- Performance targets such as 3 month LIBOR +5% are not correlated to the main investment markets making it more difficult to measure and control risk.

- It is likely that the investor will experience higher tracking errors against the stated investment benchmark than would be the case with traditional funds again because of the lack of correlation to the main investment markets.

- The manager has a large amount of control over the strategy and asset allocation. The performance of the fund is therefore heavily reliant on the manager’s skill and investment acumen.

- In general the manager’s fees for this type of mandate will be higher than an active equity mandate, which can sometimes serve to eradicate the performance benefits.

Conclusion

Target return funds can provide investors with a number of investment solutions contained within a single product. They are designed to give investors long term performance approaching that expected from equities, but with reduced volatility. Investors will also benefit from diversification of investments and dynamic asset allocation strategies.

There are higher costs associated with this type of mandate and coupled with tracking errors this can become a distraction in the short term. In general, the returns from these funds have to be analysed over a longer period than funds using traditional benchmarks to give a more accurate view of their achievements.

There are a large variety of funds available in this class of investment which permits investors to make choices about the level of risk and manager involvement. The decision about which, if any, of the funds to choose will be derived from considerations about the level of governance the Committee desire, the investment strategies and concepts the Committee are comfortable with and how much risk they are willing to take.

I am happy to discuss any of the information above with the Committee and I am able to provide further advice on investing in target return funds if requested.