Consulting
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Scottish Borders Council Pension Fund Investment Strategy Review

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Prepared for

Pension Fund Sub-Committee

Prepared by

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1. Executive Summary

1.0 Main conclusions

- Since the 2008/9 full investment strategy review there have been no significant changes to our knowledge that could require a major change in strategy.
- In particular, :
  - our understanding is that the Fund continues to have a strong covenant and remains open to new members meaning it can take a long term view to investing with a focus on return seeking assets.
  - the maturity of the Fund has increased marginally with pensioner members representing 42% of the total liabilities at 31 March 2011 compared to 36% at 31 March 2008
  - the Fund remains cashflow positive (contribution income exceeds benefit outgo) but has become materially less positive in recent years (over the year to 31 March 2012 the Fund was around £2m cashflow positive compared to around £5m in the years to 31 March 2010 and 31 March 2011)
  - the Fund's actuarial deficit was broadly similar, increasing from £11m at 31 March 2008 to £17m at 31 March 2011
- Hence, the recommendations in this paper are effectively implementation of, or relatively small refinements to, the strategy agreed as part of the 2008/9 full review.
- The recommendations are based on changes to the maturity and cashflow profile noted above and also Aon Hewitt's current view on the outlook for different asset classes

- **In summary I recommend that given the strong rally in equity markets over the past few months which have brought equity markets to 5 year high points**
  - **the Committee implements the previously agreed further 5% reduction in the Fund's benchmark equity allocation now, reducing the equity allocation to 65%**
  - **the Committee considers underweighting the allocation to equities by disinvesting a further 5% to reduce the equity benchmark allocation to 60%**
  - **the current 2% underweight allocation to gilts and bonds which is invested in equities is also disinvested from equities and reinvested in alternative assets**

- If the Committee decide to reduce the equity allocation to 60%, then I believe the further 12% (around £48m) of assets to be invested in alternative assets merits consideration of procurement of a manager providing a different type of diversifying fund to LGT Partners, and I would recommend an infrastructure fund or pooled fund of inflation linked assets (such as infrastructure, social housing, index-linked property leases, or ground rents).

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- If the Committee decide to reduce the equity allocation only to 65%, or to 60%, but would not wish to undertake a procurement of a new manager at this point, then the further 7% or 12% of assets to be invested in alternative assets could be invested with LGT Partners as previously envisaged.

- **As the procurement of another manager would increase the total number of managers to five, and in light of the procurement exercises ongoing for new bonds and global equity managers, following initial discussions with Fund Officers it was felt that as an initial step moving to 65% equities now by investing a further 7% (around £28m) with LGT partners now, and further consideration given to reducing the equity allocation below 65%, potentially by adding another manager, over the course of 2013 may be the best approach. This is a strategy I would support.**

- The current target return of 2.9% above RPI inflation assumed as the real discount rate for the actuarial valuation as at 31 March 2011 could be expected to be achieved with a much larger allocation to bonds should the Committee wish to more closely match the income from assets with benefit outgo. However, given the current low level of bond yields we do not recommend the Fund increases its allocation to bonds at this time. I would recommend retention of the current allocation of 13% which is a tactical reduction below the strategic allocation of 15% to the bottom of the permitted range in the Statement of Investment Principles.

- The allocation to bonds is however a key driver of risk and return within the Fund and I recommend that consideration be given to whether, and by how much, the 15% strategic allocation to bonds should be increased at the next full investment strategy review.

- If the Committee decided to reduce the equity allocation to 65% by increasing the allocation to alternative assets managed by LGT Partners the Fund's overall asset allocation could be as follows :

Asset Class	Revised asset allocation (%)	31 December 2012 asset allocation (%)
Equities - UK - Global	65.0 - 19.0 - 46.0	71.8 - 21.8 - 50.0
Multi Alternative assets	17.0	9.3
Infrastructure and other inflation linked assets	0.0	0.0
UK Property	5.0	4.7
Gilts and Bonds	13.0	13.0
Cash	0.0	1.2
Total	**100**	**100**

- The 7% ie c £28m reduction from equities could be funded from all of the current managers to maintain diversification in equity manager style.

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2.Introduction

2.0 Introduction

The Pension Fund Sub-Committee ("Committee") for the Scottish Borders Council Pension Fund ("the Fund") has asked Aon Hewitt to undertake a mini review of the Fund's investment strategy, in light of the results of the actuarial valuation as at 31 March 2011 and current investment market conditions.

The key objective of the Fund is to ensure the Fund's assets are invested to provide the benefits for members. An investment strategy should aim to:

- Optimise the anticipated return consistent with a prudent level of risk
- Ensure that there is sufficient income or liquid assets to meet the pension and cash benefit outgo as it falls due
- Ensure the suitability of assets in relation to the needs of the Fund

The Fund's investment strategy was last reviewed in detail in 2008/09. This review involved detailed asset liability modelling of risk and returns from different investment strategies.

In particular different allocations to bonds, which is a key contributor to relative investment risk and returns, were modelled which we have not considered as part of this mini review.

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3. Background

3.0 Most recent actuarial review

The key objective of the Fund is to ensure that the assets are invested to provide the pension and cash benefits to members (i.e. the liabilities).

In the actuarial valuation as at 31 March 2011 the Fund Actuary assumed a long-term investment return of 2.9% above RPI inflation, which can be referred to as the real rate of return or the real discount rate of 2.9% per annum. This assumption was the Fund Actuary's prudent assessment of the expected return from the Fund's assets on the valuation date.

On this assumption for future investment returns the Fund, had a funding level of 96% and a deficit of £17m. A period of 12 years was set as the deficit recovery period.

The Committee could reduce the risk within the investment strategy for example, by decreasing the allocation to return seeking assets like equities and increasing the allocation to bonds, and still be expected to achieve the real return target of 2.9% per annum. Based on Aon Hewitt's latest Capital Market Assumptions as at 31 December 2012 (appended to this paper for reference) an asset allocation of around 50% bonds : 50% return seeking assets would be expected to achieve a real return of 2.9% per annum if Aon Hewitt's assumptions are borne out.

Increasing the allocation to bonds is a key way to control volatility in the Fund's actuarial funding position. For example, in extremis, investing the whole fund in a portfolio of gilts would be expected to reduce the funding level volatility to a very low level both on the up and downside. However, the Fund would not be able to fund the benefits accrued to date and accruing without increasing the Employer's contribution rates as the real return of 2.9% per annum would not be achieved.

Hence, to have a sufficiently high probability of achieving this real discount rate of 2.9%, the Fund has to take a higher level of investment risk than investing solely in gilts. This, in turn, means that we would expect variation in the disclosed funding position.

The approach taken to set the discount rate for each triennial actuarial using the yield on assets like equities helps smooth the volatility in the disclosed funding position and hence helps the Fund maintain a high allocation to return seeking assets.

If returns in excess of a real return of 2.9% per annum are achieved then these returns would go towards building up a surplus or be used to meet other experience items like increasing life expectancy.

3.1 Most recent investment strategy review

The most recent full investment strategy review was conducted in 2008/2009 following the actuarial review at 31 March 2008. Following the review the Committee agreed to make an initial allocation to alternative assets (like private equity, commodities, hedge funds) of 10% of Fund assets increasing over time to 15% when the Committee became comfortable with the new alternative assets manager and market conditions were considered reasonable.

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Investing 10% to 15% in a range of alternative assets was intended to diversify the Fund's assets without overly disrupting the Fund's current structure.

The Fund's overall asset allocation was agreed to be as follows

Asset Class	Shorter term asset allocation (%)	Longer term asset allocation (%)
Equities - UK - Global	70.0 - 21.0 - 49.0	65.0 - 19.0 - 46.0
Alternative assets	10.0	15.0
UK Property	5.0	5.0
Gilts and Bonds	15.0	15.0
Total	**100**	**100**

The Committee decided to appoint

- a single multi asset manager to manage the allocation to alternative assets to avoid having managers in each of the individual alternative asset classes
- a third global equity manager in order to diversify the Fund's equity manager style risk

These changes were implemented through the appointment of LGT (multi asset alternatives manager) and Morgan Stanley Investment Management (global equities with a focus on capital preservation and absolute returns)

3.2 Experience from the 2008 to 2011 valuations

A summary of how the Fund's liability profile has changed from the 2008 and 2011 valuations is provided below:

Class	Liability Amount (£'m) at 31/3/11	Liability Amount (£'m) at 31/3/08
Active members	197.7	168.3
Deferred members	37.1	31.3
Pensioner members	167.3	110.5
Total	**402.2**	**310.1**

Class	Number of Members at 31/3/11	Number of Members at 31/3/08
Active members	4371	4260
Deferred members	2430	1987
Pensioner members	2108	1768
Total	**8909**	**8015**

We can note from the tables above the following:

- The total amount of pensioners and deferred pensioner members is now greater than the amount of active members.
- The proportion of total liabilities represented by pensioner members has increased from 36% in 2008 to 42% in 2011, so the Fund has matured.

The increase in the proportion of pensioner members could be a driver for increased bond investment to provide income to pay members' pensions. However, contribution and other income currently exceeds benefit outgo (by around £2m per annum over the year to 31 March 2012).

Changes in demographics since 2011 will have had an impact on the liabilities however that impact will be assessed at the next actuarial valuation date.

3.3 Risk budget and covenant

When determining the Fund's investment strategy two important factors that need to be considered are the strength of the employer covenant and the Committee's attitude to risk.

Our understanding is that the Fund continues to have a strong covenant and can also continue to take a long term view to its investment strategy as it is open to new members and volatility in asset values is partly smoothed by the funding approach.

As a result, we believe the Fund can continue to have an investment strategy that favours return seeking assets classes like equities, property, etc rather than bonds.

However, we would recommend that the Committee continues to progress with diversifying some of the risk within the return seeking assets away from equities to avoid over reliance on equities.

3.4 Employer specific investment strategies

Some local authority funds are considering potentially allowing different Employers to pursue different (lower risk) investment strategies to provide protection from funding level volatility. The quid pro quo would be that the protected employer may have to pay a higher contribution rate in lieu of lower expected investment returns.

This could be considered at the next full investment strategy review.

4. The Current Strategy

4.0 The current strategy

The table below we summarize the Fund's investment strategy:

Class	Value at 31 December 2012 (£m)	Allocation at 31 December 2012 (%)	Benchmark Allocation at 31 December 2012 (%)
UK Equities (UBS and BG)	£88.7	21.8	21.0
Global Equities (UBS, BG and MS)	£203.2	50.0	49.0
Gilts (UBS)	£15.9	3.9	7.5
Corporate Fixed Interest Bonds (UBS)	£37.0	9.1	7.5
Multi Asset Alternatives Fund (LGT)	£38.0	9.3	10.0
UK Property (UBS)	£19.0	4.7	5.0
Cash (Bank)	£4.9	1.2	0.0
Total	£406.7	100	100

4.1 Characteristics of the current strategy

The current strategy is focused on return generation, with a benchmark allocation of 85% invested in return seeking assets and only 15% invested in 'liability matching' gilts and bonds. The primary driver of this is the 70% allocation to equities.

As a result of this high allocation to equities, the single biggest determinate of the success or failure of the Fund's investment strategy is whether or not equity markets return more than 2.9% above inflation.

The Fund is currently 2% underweight gilts and bonds in total at present on a tactical basis.

We have not carried out updated risk analysis. However, given the relatively low allocation to bonds at present we see the two main risks as being :

- equity risk – given 72% of the Fund is invested in equities an economic downturn or political shock to markets could result in significant loss of capital value
- inflation risk - significant liquidity has been injected into economies in recent years by central banks (such as the Bank of England's Quantitative Easing programme) and within Aon Hewitt we believe there is the risk this could result in higher than expected inflation in the future. Although the Fund's equities, multi-asset and property assets may be expected to provide some indirect hedge against inflation over the longer term, we see inflation as a key risk for the Committee to consider. Given the Fund has all of the pensions linked to CPI or RPI inflation and the

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bonds that are currently held are fixed rather than inflation-linked bonds, inflation is potentially also a large risk.

Again a full risk analysis could be considered in more detail at the next full investment strategy review.

4.2 Market outlook

We continue to remain cautious about the economic outlook and whilst equities look good value (particularly on valuation grounds) relative to expensively priced bonds we are sceptical that the recent equity market rally will be sustained.

With equities market levels at 5 year highs and given the Fund's large concentration in equities we recommend that the Committee considers further diversifying the Fund's return seeking assets at this time.

However, bonds yields remain at or near historically low levels (i.e. high capital value) and given the Fund's long term investment horizon and we do not recommend diversifying by increasing the allocation to matching assets (bonds) at this time.

Given the nature of the Fund's liabilities and the link to inflation we believe that the Committee should consider investing in assets that either have an implicit or explicit contractual link to inflation in order to protect the Fund against inflation being higher than expected in future.

Asset classes that we currently favour in this area include infrastructure, social housing and ground rents. In the next section we consider alternative investment strategies.

5. Alternative Investment Strategies

5.0 Overview

As noted previously we do not believe now is likely to be the most favourable time for the Fund to increase its allocation to bonds.

Therefore in our analysis we have considered ways the equity allocation could be diversified, within return seeking assets, while maintaining a broadly similar expected return to the current strategy.

5.1 Recap on reasons to diversify return seeking assets

The Fund's return seeking assets are currently invested in equities (UK and Global mandates), UK property and a multi alternative assets mandate managed by LGT Partners which provides exposure to a range of alternative asset classes.

As a recap, the reasons for further diversifying the Fund's return seeking assets by considering alternative assets are:

- **Equity concentration** – at present equities comprise around 70% of the Fund's return seeking assets, although the Committee’s intention is to reduce this to 65%. Therefore the value of the Fund's assets is significantly exposed to equity markets falling in the short-term and longer term. Equity market risk is mitigated to an extent by the Fund’s investment in the Morgan Stanley Global Franchise Fund which is focussed on capital preservation, (although would not necessarily be expected to maintain capital in a significant market reversal). Although equities are generally expected to provide a relatively high rate of return in real terms over the long term, there are potential dangers of excessive reliance on any one asset class to deliver consistent returns.
- **Maintain return expectations but reduce risk** – through further diversification of the Fund's return seeking assets away from equities it is possible for the overall risk of the Fund to be reduced but for the expected long term return to be maintained at broadly current levels as a result of increased diversification.
- **Equity market outlook** – In the medium term we question whether the recent strong return in equity markets can continue. As noted in the following chart global equity indices have reached 5 year highs.

We believe that market levels are ahead of the underlying economic fundamentals and reversal is a possibility. Therefore from a timing perspective the Committee could reasonably make the reduction in the Fund's allocation to equities at this point.

5.2 Recommendations

My recommendations are :

1. given equity markets are at 5 year highs and Aon Hewitt's cautious outlook for equities, that the Committee reduce the Fund's allocation to equities to the previously agreed benchmark allocation of 65% in the short term.

2. given the relative outlook for equities if the Committee wished to take an approach based on medium term outlook I would recommend that Committee considers reducing the equity allocation below 65%, to say 60%. The allocation could then be increased back to the benchmark 65% in due course from future cashflow. Reducing the equity allocation would also be consistent with the increasing maturity of the Fund, and the likely need for increased investment income.

5.3 Options for increasing diversification

Should the Committee agree to reduce the equity allocation to 65% or 60% we see the main options for the investment of the additional 7% or 12% as being :

- Increasing multi alternatives asset allocation with LGT. A 5% increase in the allocation to 15% was previously agreed by the Committee so this would simply be implementing, and slightly extending, a previous decision.
- Invest in a pooled portfolio of inflation linked assets such as infrastructure, index-linked long term property leases, social housing, ground rents and infrastructure which provide cashflows **contractually** linked to RPI inflation. These funds offer an annual yield of inflation plus 2%-4% backed up with very good security.
- Invest in an infrastructure fund. Two broad types of fund available :

  (a) social infrastructure : these funds invest in PFI projects such as schools, hospitals, roads, military barracks, etc. Funds can invest at the development stage where the school, hospital are not yet built, or the operational stage where the school, hospital, etc are built and operational. These funds are typically closed ended with an investment time horizon of around 25 years on average and at the end of the term the asset is typically passed back to the UK government.

  (b) core infrastructure : these funds invest in assets such as airports, ports. Again funds can invest at the development stage where say the airport is not yet built, or the operational stage where the airport is built and operational. These funds are typically closed ended with an investment time horizon of around 10 years on average and at the end of the term the asset such as the airport is typically sold in the market and proceeds passed back to investors.

  We recommend investing in operational funds in both of the types as

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these do not have the development risk.

Investing in the LGT Partners Fund would be expected to provide a broad, rather than, contractual link of returns to RPI inflation.

Both the pooled portfolio of inflation linked assets and infrastructure will be expected to provide inflation linked income each year which will be beneficial given the increasing maturity of the Fund and the likelihood of moving to a cashflow negative position at some point in the future. The capital returned is also expected to be inflation linked and thus help manage inflation risk.

However, both of these fund would require procurement of new managers.

If the Committee did not wish to undertake a further procurement exercise at this point, then the LGT Partners Fund could reasonably be used.

5.4 Impact on return and risk of different strategic asset allocations

We set out below the portfolios modelled

- Current – this is the current Fund's current strategic allocation

The three alternative strategies all reduce the equity allocation and diversify into other asset classes.

- Strategy 1 – Increases the Fund's allocation to the multi asset alternatives mandate by disinvesting 5% of total assets from equities
- Strategy 2 – Introduces an allocation to infrastructure assets by disinvesting 10% of total assets from UK and Global equities (a multi inflation asset fund would have lower returns)
- Strategy 3 – Is purely for illustrative purposes. In order to illustrate the impact of de-risking, we have shown a portfolio with a higher (50%) allocation to bonds.

The allocations to each asset class modelled along with the projected risk return profile are provided below.

Asset Class	Current Strategy	Strategy 1	Strategy 2	Strategy 3
UK equities	21%	19%	18%	10%
Global equities	49%	46%	42%	20%
Govt Fixed Interest Bond	7.5%	7.5%	7.5%	10%
Corporate Bonds	7.5%	7.5%	7.5%	25%
Index-linked Gilts	0.0%	0.0%	0.0%	15%
Alternatives				
Property	5%	5%	5%	5%
Multi Asset Fund	10%	15%	10%	10%
Infrastructure	0%	0%	10%	5%
Expected Return from market (nominal)	8.8%	8.8%	9.0%	5.4%
Targeted manager return	1.0%	0.7%	1.2%	0.5%
Total targeted manager return	9.8%	9.5%	10.2%	5.9%
Total return above inflation	6.6%	6.6%	7.0%	2.7%
Expected risk	19.0%	17.8%	17.2%	9.9%

- The Current Strategy allocation has an expected real return (above inflation) of 6.6% which is well in excess of the real discount rate of 2.9%.
- The alternative strategies modelled have broadly similar returns but with less volatility (expected risk) than current strategy. For example, with an expected real return of 6.6% per annum and an expected risk of 19.0%, the Current Strategy can be expected to provide a real return between – 12.4% and + 25.6% in 2 years out of 3.
- Strategy 3 with a 50% allocation to bonds is close to providing the 2.9% real discount rate

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6. Conclusion and Recommendation

6.0 Conclusions

From the modelling we can conclude there is benefit from reducing the reliance on equities within the portfolio and diversifying into alternative asset classes.

We recommend that the Committee considers further diversifying the Fund's return seeking assets in order to reduce the reliance on equity returns.

Following the recently strong returns in equity markets (currently at 5 year highs) we recommend the Committee reduces the benchmark equity allocation to 65% (Strategy 1 in section 5.4) or 60% (Strategy 2 in section 5.4) and invests the proceeds in the multi asset fund managed by LGT, or a new inflation linked assets fund if the Committee agree to procure a new manager.

As the procurement of another manager would increase the total number of managers to five, and in light of the procurement exercises ongoing for new bonds and global equity managers, following initial discussions with Fund Officers it was felt that as an initial step moving to 65% equities now by investing a further 7% (around £28m) with LGT partners now, and further consideration given to reducing the equity allocation below 65%, potentially by adding another manager, over the course of 2013 may be the best approach. This is a strategy I would support.

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