SCOTTISH BORDERS COUNCIL
PENSION FUND COMMITTEE

MINUTE of MEETING of the PENSION FUND COMMITTEE held in the Council Chamber, Council Headquarters, Newtown St. Boswells on 11 December 2012 at 10.00 a.m.

Present:- Councillors B. White (Chairman), J. Campbell, G. Edgar, G. Logan, J. Mitchell, S. Mountford.

Apology:- Councillor M. Cook.

In Attendance:- Chief Financial Officer, Treasury and Capital Manager, HR Shared Services Manager, Business Partner – Corporate Finance, Senior Finance Technician, Mr Kenneth Ettles – AON Hewitt Consulting, Mr Euan Kinghorn (Scottish Borders Housing Association), Ms Laura Bottega and Mr Peter Escott – Morgan Stanley, Ms Yvonne Thomas and Mr Malcolm Gordon – UBS, Mr Gareth Roberts – Baillie Gifford, Committee and Elections Officer (V. MacMillan).

MINUTE

1. There had been circulated copies of the Minute of the Meeting of 13 September 2012.

DECISION
NOTED.

AUTO ENROLMENT BRIEFING

2. A verbal update was given by the HR Shared Services Manager on Auto Enrolment. Workplace Pensions law changed in October 2012, with all employers having to take action to fulfil the new legal duties as set out in the Pensions Act 2008. Under the new pensions law employers would need to automatically enrol certain workers into a pension scheme and contribute on their behalf. This requirement applied to all employers in the United Kingdom to help more workers to save for their retirement. The responsibility to comply with the new legal requirements would fall on employers and not the Pension Fund. However, through adherence with this new legislation it was likely that there would be an increase in membership of the Pension Fund. Within the new legislation each employers was given a staging date and date of commencement, based on the size of the employer's largest tax reference number. The implementation date of auto enrolment could be deferred for up to five years and this decision would have to be taken by the Council as an employer. New employees would be auto enrolled into the Pension Fund from July 2013.The Chief Financial Officer advised that other local authorities were considering deferring auto enrolment and the implications of doing so could be noted by Scottish Borders Council. Union Members had expressed interest in terms of when auto enrolment would commence and they had been informed that a decision had not been taken yet but they would be kept informed. Officers answered Members questions.

DECISION
NOTED.

PENSION ADMINISTRATION SYSTEM

3. There had been circulated copies of a report seeking approval to commence the procurement project to replace the Pensions Administration System for the Scottish Borders Council Pension Fund. The licence agreement for the existing system was due to expire in November 2013 and the current application would not be developed to meet with upcoming legislation changes due in 2014/15. The system was an essential administrative tool that supported the provision of a high quality administration service for the Pension Fund. This

was an opportunity to implement a modernised application with the functionality to provide an improved and efficient experience for members of the Pension Fund, through the implementation of Self Service functionality.

DECISION
AGREED to approve the commencement of a procurement project to replace the Pensions Administration System, with a further report to be submitted for consideration once actual costs were known.

URGENT BUSINESS

4. Under Section 50B(4)(b) of the Local Government (Scotland) Act 1973, the Chairman was of the opinion that the item(s) dealt with in the following paragraph(s) should be considered at the meeting as a matter of urgency, in view of the need to keep Members informed / make an early decision.

RISK REGISTER UPDATE

5. With reference to paragraph 2 of the Minute of 13 September 2012 the Corporate Finance Manager provided an update on the Risk Register. There were four red risks identified, which were:- Equity risk, Legislation changes, Changes in composition of Pension Fund membership, i.e. active/deferred/pensioners; and Employees who can no longer afford to participate in the scheme. There were measures in place to control the risk.

DECISION
NOTED.

PRIVATE BUSINESS
DECISION
AGREED under Section 50A(4) of the Local Government (Scotland) Act 1973 to exclude the public from the meeting during consideration of the business contained in the following items on the grounds that they involved the likely disclosure of exempt information as defined in paragraph 8 of part 1 of Schedule 7A to the Act.

SUMMARY OF PRIVATE BUSINESS

Minute

1. The Committee noted the Private Minute of the meeting of 13 September 2012.

Quarter 3 2012 Investment Monitoring Report

2. The Committee noted a report by AON Hewitt Consulting.

Proposals for Procurement of Managers

3. The Committee approved a report by the Chief Financial Officer on Proposals for Procurement of Managers.

Update on Currency Hedging

4. The Committee noted an update by the Chief Financial Officer on the Currency Hedging Programme.

Admitted Body Engagement in the Pension Fund

5. The Committee approved a report by the Chief Financial Officer on Admitted Body Engagement in the Pension Fund.

Performance Update and Question Session – Morgan Stanley

6. The Committee noted a Performance Update and Question Session from Morgan Stanley.

Performance Update and Question Session – UBS

7. The Committee noted a Performance Update and Question Session from UBS.

Performance Update and Question Session – Baillie Gifford

8. The Committee noted a Performance Update and Question Session from Baillie Gifford.

Urgent Business – Delegation of Authority in Relation to Voting Rights

9. The Committee noted a report considered under Urgent Business on Delegation of Authority in Relation to Voting Rights.

The meeting concluded at 4.10 p.m.

BRIEFING NOTE: Pension Committee – 5/3/13

ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVC'S)

BACKGROUND

AVCs were introduced in the mid 1980s as an additional means for individuals to save for retirement. AVCs offered an attractive, tax advantageous, savings mechanism which was relatively unique at that time. It is a requirement (under the Social Security Act of 1986) for every UK pension scheme to have an arrangement in place whereby members can pay additional voluntary contributions to enhance their pension benefits.

An active member may elect to pay AVCs into a scheme established under an arrangement made between the administering authority and a body approved for the purposes of the Finance Act 2004. An employer may contribute to the AVC scheme and where they do the AVC scheme is known as a shared cost additional voluntary contributions arrangement and contributions to it as "SCAVCs". As direct costs would be incurred by Scottish Borders Council, **the policy of Scottish Borders Council is not to adopt this discretion** (see discretionary regulation A22 – published June 2009).

Historically (since 1989) the Council had two AVC providers, Halifax PLC and Standard Life.

Following its acquisition of Clerical Medical, Halifax PLC carried out a review of various activities associated with long-term savings products. One of the outcomes of the review was that Halifax ceased to operate its AVC Deposit Account product from 30 June 2002.

All members with Halifax accounts were compulsory transferred to Standard Life on 1 July 2002.

STANDARD LIFE

Standard Life allows investment in an agreed range of funds at the option of the employee. An optional death-in-service life assurance facility is available in conjunction with the AVC provision.

The present "restricted" range of funds agreed with Standard Life are:

- Deposit & Treasury Pension Fund (formerly called the "Managed Cash Fund")
- Ethical Fund
- Managed One Fund
- Money Market Pension Fund (formerly called the "Sterling Fund")
- Protection One Fund
- UK Equity One Fund
- With Profits Fund

Standard Life will provide financial advice to employees (who request it) on the above range of funds. Members are permitted to select a fund out with this selection, at their own discretion (and risk).

Standard Life provide an Annual Statement, sent directly to members (both active and deferred) who participate in AVC arrangements.

At 31 March 2012 the fund comprised of 140 members (both active and deferred), with a total fund value of £790,900.

CHARGES

Standard Life currently apply an “Annual Management” charge of 1% to members accounts. The Council have in place a discount of 0.375% - resulting in a net charge of 0.625%.

REVIEW OF AVC ARRANGEMENTS

In a report commissioned at the time of Halifax withdrawing from AVC provision, our (former) actuaries Hymans Robertson, stated:
“Given all of the other (investment) opportunities available, Schemes should not feel constrained to offer a wide choice of AVC provider or fund options, or the need to replace Halifax with another Cash Deposit provider”.

Hymans Robertson also stated, “We would prefer to offer Cash (deposit) as one of a range of fund options within an insured arrangement”

This resulted directly in the Council including a cash deposit fund (Sterling Fund) within the range of funds agreed with Standard Life (see Emergency Powers Report approved 18 June 2002).

ALTERNATIVE PROVISION

The Pensions Team have previously received presentations by Prudential, who already provide the AVC facility for several other Scottish Authorities, including Aberdeen, Orkney, Shetland and Strathclyde Pension Funds.

Background Papers – Hymans Robertson Report 2002, SBC Employer Discretionary Policy 2009
Previous minute reference – 18 June 2002
Originator of Briefing note – Graeme Wilson HRSS Specialist (Pensions)

Risk Register: SCOTTISH BORDERS COUNCIL PENSION FUND ITEM NO 6

No.	RISK *Threat to achievement of business objective*	Scope/potential consequences of risk	Assessment of Risk (likelihood x impact) *Assume No Controls in Place* Likelihood	Impact	Risk Score	Risk Control Measures in Place	Are all Controls Operational?	Assessment of Residual Risk (likelihood x impact) With Control Measures Likelihood	Impact	Risk Score	Proposed Additional Control Measures	Assessment of Residual Risk (likelihood x impact) With Control Measures Likelihood	Impact	Risk Score
1	Failure to process pension payments and lump sums on time	Retiring staff will be paid late which may have implications for their own finances. Reputational risk for the Fund and a financial cost to the employers if interest has to be paid to members.	4	4	16	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff.	Y	2	2	4	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff.	2	2	4
2	Failure to collect and account for contributions from employers and employees on time.	Adverse audit opinion for failure to collect contributions on time, cash flow implications for Fund; potential delays to employer's FRS17 year-end accounting reports	4	4	16	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff.	Y	2	2	4	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff.	2	2	4
3	Insufficient funds to meet liabilities as they fall due to changes to active employment levels	Fund Matures more quickly than currently anticipated and this will require a complete review and potential change to the investment strategy and employers contribution levels.	4	5	20	Funding Strategy Statement, Statement of Investment Principles and Triennial Valuation all work together to identify funding requirements and how these are met. Use of an Investment Consultant and Actuarial services as and when required.	Y	2	4	8	Funding Strategy Statement, Statement of Investment Principles and Triennial Valuation all work together to identify funding requirements and how these are met. Use of an Investment Consultant and Actuarial services as and when required.	2	4	8
4	Inability to keep service going to loss of main office, computer system or staff - major operational disruption	Temporary loss of ability to provide service.	3	4	12	Robust business continuity processes in place across the Council around key business processes, including a disaster recovery IT site.	Y	3	2	6	Robust business continuity processes in place across the Council around key business processes, including a disaster recovery IT site.	3	2	6
5	Loss of funds through fraud or misappropriation by employee or employer within the Fund.	Financial loss to the Fund	4	5	20	Robust segregation of duties and other internal controls to mitigate against this risk. Internal & External Audit programme also picks up the monitoring of this risk.	Y	3	2	6	Robust segregation of duties and other internal controls to mitigate against this risk. Internal & External Audit programme also picks up the monitoring of this risk.	3	2	6
5	Loss of funds through fraud or misappropriation by an investment manager, custodian or other agent of the Fund.	Financial loss to the Fund	4	5	20	Fund Managers provide copies of annual Internal Controls report from their External Auditors. They are also required to operate to stringent FSA standards of operation. Legal recourse within contracts to Fund Managers	Y	3	4	12	Tolerate Risk. Enhance oversight role of pension by council officers.	3	4	12
6	Employers can no longer afford to participate in the scheme	Adverse impact on cash flow and Funding Levels, Fund reaches maturity more quickly.	4	3	12	Full actuarial valuation undertaken on Triennial Valuation. Low number of admitted and scheduled bodies and any new admitted bodies are carefully considered before admission.	Y	3	2	6		3	2	6

No.	RISK *Threat to achievement of business objective*	Scope/potential consequences of risk	Assessment of Risk (likelihood x impact) *Assume No Controls in Place*			Risk Control Measures in Place	Are all Controls Operational?	Assessment of Residual Risk (likelihood x impact) With Control Measures			Proposed Additional Control Measures	Assessment of Residual Risk (likelihood x impact) With Control Measures		
			Likelihood	Impact	Risk Score			Likelihood	Impact	Risk Score		Likelihood	Impact	Risk Score
7	Poor/negative Investment Returns	Poor/negative investment returns leading to increased employer contribution rates. Significant rises in the employer contributions due to poor/negative investment returns. Cost involved in implementing changes to investment strategy	4	4	16	Continual monitoring of investment performance, engagement with Investment Adviser to update investment strategies and periodic review of strategic asset allocation. Scrutiny of Investment Manager performance by PFSC.	Y	3	4	12	Tolerate Risk. Enhance officer role in monitoring of investment returns to enable more timely action to be taken.	3	4	12
8	Failure of global custodian	Financial loss to the Fund; loss of information	2	4	8	Monitor custodian performance and credit rating. Covered by legal contract, Regulated by FSA, assets not on custodian balance sheet. Careful procurement selection processes.	Y	2	3	6		2	3	6
9	Failure of investment manager	Financial loss to the Fund	3	3	9	Robust procurement processes around the managers placed on short lists. Diversification of investment managers Continual monitoring of investment performance, engagement with Investment Adviser in relation to monitoring external environment in respect of the individual investment managers. Scrutiny of Investment Manager performance by PFSC. Monitoring of financial media.	Y	2	3	6		2	3	6
10	Equity risk	Financial loss to the Fund due to market sector falling substantially.	5	4	20	Continual monitoring of investment performance, engagement with Investment Adviser to update investment strategies and periodic review of strategic asset allocation. Diversification of asset classes and investment managers. Scrutiny of Strategic Asset Allocation and Investment performance by PFSC.	Y	4	4	16	Tolerate Risk. Long term view of investment growth is required and will continue to use existing controls for the Pension Fund.	4	4	16
11	Active manager risk	Financial loss to the Fund due to investment manager underperformance.	4	3	12	Robust procurement processes around the managers placed on short lists. Diversification of investment managers Continual monitoring of investment performance against benchmark, targets and tolerance, engagement with Investment Adviser in relation to monitoring external environment in respect of the individual investment managers. Scrutiny of Investment Manager performance by PFSC. Monitoring of financial media.	Y	3	3	9				0
12	Failure to comply with LGPS and other regulations	Wrong pension payments made or estimates given, breach of regulations leading to prosecution	3	2	6	Compliance with new accounting standards and pension fund regulations are subject to robust internal and external audit review and reporting. Participation in the active CIPFA networks	Y	2	2	4				0
13	Failure to hold personal data securely	Data lost or compromised; reputational risk	3	2	6	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff. Corporate data security policy adhered to.	Y	2	2	4				0

No.	RISK *Threat to achievement of business objective*	Scope/potential consequences of risk	Assessment of Risk (likelihood x impact) *Assume No Controls in Place*			Risk Control Measures in Place	Are all Controls Operational?	Assessment of Residual Risk (likelihood x impact) With Control Measures			Proposed Additional Control Measures	Assessment of Residual Risk (likelihood x impact) With Control Measures		
			Likelihood	Impact	Risk Score			Likelihood	Impact	Risk Score		Likelihood	Impact	Risk Score
14	Failure to keep pension records up to date and accurate	Incorrect records leading to incorrect estimates being issued and potentially incorrect pensions being paid	4	3	12	Robust maintenance and update of Pensions Administration System and Resourcelink. Revised staffing structure post implementation of HR Shared Services increases coverage of staff. Controls subject to Internal Audit review	Y	3	2	6				0
15	Lack of expertise on Superannuation Investment Sub-Committee or amongst officers	Detrimental decisions made in relation to the Fund	4	3	12	Members have access to Investment Managers, Investment Adviser and Council Officers to help advise and inform them in relation to decisions taken by the PFSC.	Y	2	2	4				0
16	Over reliance on key officers	If an officer leaves or falls ill knowledge gap may be difficult to fill	4	3	12	Finance re-structure introduced additional resources into officer support. Use of external Investment Adviser provides additional resilience and resources.	Y	3	2	6				0
17	Failure to communicate properly with stakeholders	Scheme members not aware of their rights resulting in bad decisions. Employers not aware of regulations, procedures, etc	3	3	9	Engagement in Scottish pension networks. Union and Admitted body representation on the PFSC. Publication of annual report via website and printed copies to all Scheduled and Admitted bodies.	Y	3	2	6				0
18	Lack of Member training in Pension Fund Management	Poor decision making	4	2	8	Training opportunities are made available to members as these are identified. Members have access to Investment Managers, Investment Adviser and Council Officers to help advise and inform them in relation to decisions taken by the PFSC.	Y	4	2	8				0
19	Legislation changes	Loss of independence; impact on Fund value and benefits	5	5	25	Active participation in Scottish pension investment and administration networks. Involvement with COSLA discussions on Pensions.	Y	4	4	16	Tolerate Risk. Seek to input into any of the legislative change through active membership of COSLA.	4	4	16
20	Changes in composition of Pension Fund membership i.e. active/deferred/pensioners	Fund Matures more quickly than currently anticipated and this will require a complete review and potential change to the investment strategy and employers contribution levels.	5	4	20	Limited measures in place	N	5	4	20	Treat Risk. New pensions administration strategy will incorporate an action plan to address aspects such as communication and auto enrolment requirements from May 2013. Close monitoring of early retiral decisions and quantification of impact on pension fund to be included as part of the Council report.	4	4	16
21	Inflation increases - Funds assets do not keep pace	Funding levels fall, SBC pay more contributions into Fund	5	4	20	Continual monitoring of investment performance, engagement with Investment Adviser to update investment strategies and periodic review of strategic asset allocation.	Y	4	3	12	Treat Risk. Regular dialogue with Fund Actuary. Attendance at Pension Fund Sub-Committee on an annual basis between triennial valuations.	3	3	9

No.	RISK *Threat to achievement of business objective*	Scope/potential consequences of risk	Assessment of Risk (likelihood x impact) *Assume No Controls in Place*			Risk Control Measures in Place	Are all Controls Operational?	Assessment of Residual Risk (likelihood x impact) With Control Measures			Proposed Additional Control Measures	Assessment of Residual Risk (likelihood x impact) With Control Measures		
			Likelihood	Impact	Risk Score			Likelihood	Impact	Risk Score		Likelihood	Impact	Risk Score
22	Currency Management risk	Impacts on value and inability to meet future liability - negative impact on cash flow	5	3	15	Passive Currency hedge in place for Equity investments on major currencies. Monthly review of hedge levels.	Y	4	3	12	Treat Risk. Consider an element of more active management of currency hedging by procuring an external manager.	3	3	9
23	Poor investment Advice	Wrong decisions - poor return as a result of Investment Consultant advice	4	5	20	Robust procurement processes around the recruitment and appointment process. Continual review of Investment Adviser performance. Benchmark performance against other LAs. Use other information sources to validate advice and performance of Fund. Use independent Performance monitoring company.	Y	3	4	12	Treat Risk. Regular benchmarking and cross verification of advice with other local authorities through the CIPFA Scottish Pensions Network. Ongoing training for elected members of the PFSC. Utilise independent performance monitoring service to provide an independent annual review/health check to the PFSC.	3	3	9
24	Employees can no longer afford to participate in the scheme	Reduced income into Fund	4	4	16	Limited measures in place. National negotiations on minimising employee contribution increases.	N	4	4	16	Treat Risk. Ensure regular information is issued to employees setting out the continued benefits of scheme membership e.g. tax relief on contributions/employers contribution. Build into the Pension Administration Strategy the requirement to enhance the Communication Strategy in relation to this.	4	4	16

Consulting
Investment Consulting Practice

Scottish Borders Council Pension Fund Investment Strategy Review

February 2013

Prepared for

Pension Fund Sub-Committee

Prepared by

Kenneth Ettles, FFA

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Registered office: 8 Devonshire Square London EC2M 4PL
aonhewitt.co.uk
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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).

- 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.

Aon Hewitt

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.

AON Hewitt

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.

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.

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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

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.

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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.

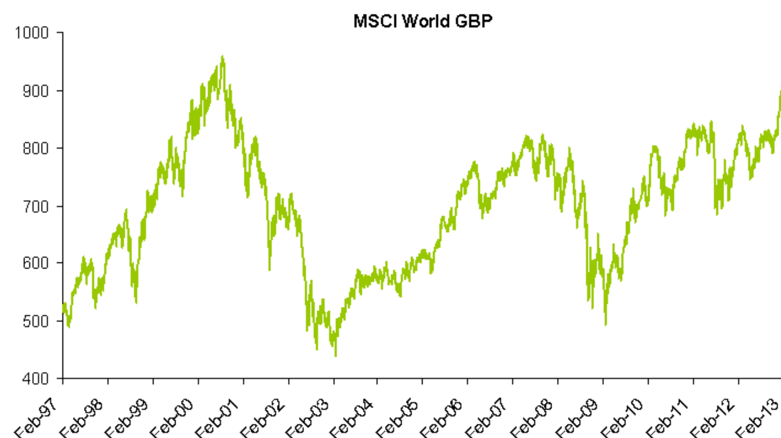
Therefore in our analysis we have considered ways the equity allocation could be diversified, within return seeking assets, while maintaining a broadly similar expected return to the current strategy.

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

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

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.

AON Hewitt

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