Scottish Borders Council Pension Fund

Investment Strategy Review – Discussion Summary

—

August, 2016

Introduction

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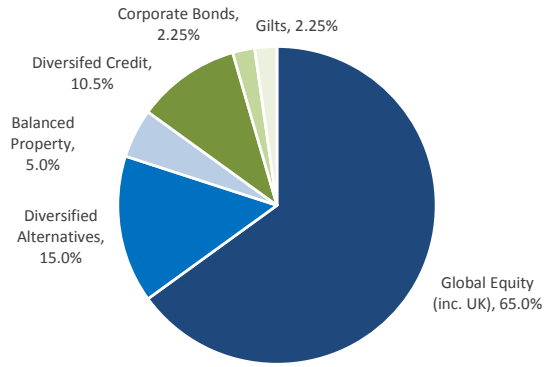
Addressee

- This report is addressed to Scottish Borders Council as administering authority of the Scottish Borders Council Pension Fund ("the Fund"). This paper summarises the Pension Fund Investment & Performance Sub-Committee's (the "ISC") discussions on the existing investment arrangements at the Committee meeting on 22 August 2016 and sets out the proposed strategy moving forward.

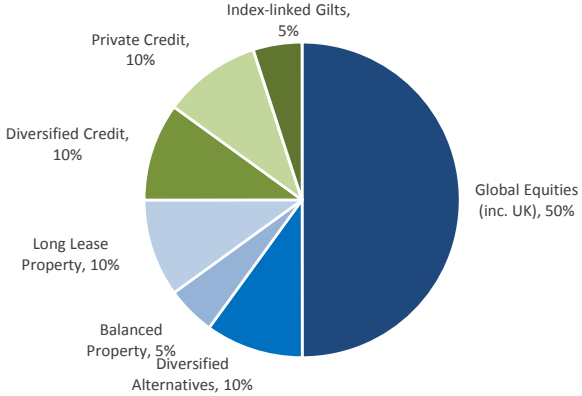
Background

- The Council has an explicit objective to maintain a strong funding position and ensure that sponsoring employer contributions are as stable as possible.
- Having considered the risks inherent within the Fund's existing investment strategy and market conditions post-Brexit, the ISC propose to refine the existing investment strategy to reduce downside risk, whilst broadly maintaining the level of expected return. Some upside risk is sacrificed to achieve this.
- The ISC agreed that the existing equity exposure (c. 65% of the Fund assets) remained a significant risk position. Given the significant rally in equity markets over recent years and, in particular, over the period since Brexit, the ISC agreed that 'banking' some of this gain would be sensible at this point in favour of more secure 'contractual' income and assets with direct inflation linkage, reflecting the risk/nature of the Fund's liabilities.
- Having considered a range of alternative investment structures, the ISC proposed to review the existing strategic asset allocation to take 15% out of equities and 5% out of diversified alternatives in favour of long lease property and private credit and to reshape the bond portfolio. The charts opposite illustrate the proposed changes to the strategy. The ISC wishes to implement this in a phased manner.
- The ISC also recommends that an element of delegation is provided to the Officers (within appropriate control ranges) to make changes to the asset allocation. The ISC also proposes to wind down the currency hedge in a phased manner based on KPMG's advice (see separate report).
- This short paper summarises the proposed changes to the Fund's investment strategy and sets out the next steps to implement the revised strategy.

Current Asset Allocation
(Benchmark Weights)

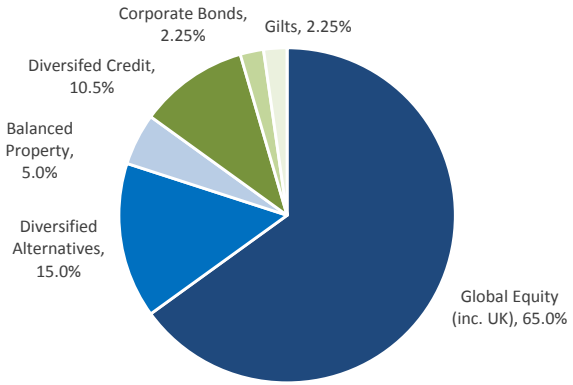


Proposed (Revised) Asset Allocation



Current strategy- recap

Asset allocation – Current benchmark



Expected return

- Based on KPMG's model assumptions, the current investment strategy has an expected return of Gilts + 4.0% p.a. (5.8% p.a. as at 30 June 2016) – this is a best estimate of the future return. We note that there is very significant uncertainty around the outcome given the return profile of the equity exposure.
- The valuation basis (which is required to make a prudent assessment of future investment return) requires a return of 5.5% per annum based on the 2014 actuarial valuation. At that point, this translated to a return of Gilts + 2%.
  - The expected return from the portfolio is only just meeting the discount rate set in 2014 (=5.5%). If the Actuary were to maintain this rate then there is no room to let the best estimate return fall without pushing cash contributions higher.
  - In practice, we expect that the Actuary will set a discount rate somewhere between Gilts+2% (the margin used in 2014) and Gilts+4%. Confirming the Actuary's view on the approach is critical to the long-term development of the strategy.

Initial thoughts

- Whilst not atypical for a Local Government Pension Scheme investment strategy, the strategy can evolve to target a similar return with a significantly lower level of downside risk, better reflecting the nature of the pension promises and increasing the contractual income delivered.
- The key changes required to achieve this would include.
  - *Reduce reliance on equities*: The Fund retains a reliance on equities for returns (c. 65% of Fund assets) and within this there is a significant bias to the UK equity market. We believe the Council should consider trimming the UK equity allocation.
  - *Exploit credit opportunities*: A well-diversified portfolio of credit instruments exploiting current opportunities can be constructed to deliver an "average expected" return similar to that of equities. This portfolio provides seniority in capital structure together with more certain income that is increasingly important for the Council.
  - *Earn an Illiquidity premium*: There is a premium available to long term investors (like pension funds) who are able to tie up capital in opportunities that are unattractive to banks due to liquidity stress test requirements. Local authorities are one of the few market participants able to exploit this. We strongly believe the Fund should consider a committing capital to long-term investments that provide relative secure future income flows.
  - *Increase inflation exposure*: A higher allocation to inflation linked assets would provide directional protection against inflation (a key risk for the Fund). The Fund could consider a range of long-term inflation-linked assets providing a premium over Gilts (e.g. long lease property, infrastructure debt etc).
- We believe that an evolution of the existing strategy rather than a revolution is preferable. These changes outlined above are in line with strategy refinements being made by our other LGPS clients.

Alternative strategies

Investment strategy

- The investment strategy will determine the risk and return profile for the Fund's investment. Different strategic splits between asset classes (equity, property, alternatives, diversified credit, public and private credit, direct lending, gilts, etc) will give rise to different levels of:
  - Expected investment growth (return); and
  - Expected levels of volatility - funding level variation and potential deficit that might arise (measured here by the Value at Risk[1] over 3 years). This funding level volatility will ultimately drive contributions.
- The ISC considered different asset allocations to vary the risk profile of the Fund.
- In terms of refinements to the current investment strategy, the ISC considered:
  - Reducing reliance on equity markets and increasing exposure to other sources of investment returns to increase the overall diversification;
  - Exploit wider credit opportunities with a focus on contractual income;
  - Increasing exposure to illiquid assets to better reflect the Fund's liquidity profile and exploit an illiquidity premium; and
  - Increasing long dated inflation-linked asset exposure to better match the sensitivity of the Fund's liabilities.
- The ISC also discussed the Fund's investment managers and agreed that some of the mandates should be reviewed – in particular refinements to the equity manager line-up and the selection of any new managers required to manage any new asset classes being introduced. It may be feasible to streamline the selection process.
- The ISC also considered the Fund's currency hedge and agreed that, based on current market conditions, the currency hedge should be gradually unwound.

[1] **Value at Risk ("VaR")** represents the increase in expected deficit in at a specified future time (i.e. 3 years) under a specific percentile (i.e. 95% or 1 in 20) worst investment outcome. Within ALM analysis a common risk measure used is a 3 year 95% VaR to quantify the level of risk being run.

Alternative strategies

Asset Classes	1. Current	2. 55% Equity	3(a). 50% Equity	3(b). 50% Equity	4. 45% Equity
UK and Overseas Equities	65.0%	55.0%	50.0%	50.0%	45.0%
Diversified Alternatives	15.0%	15.0%	15.0%	10.0%	10.0%
Balanced Property	5.0%	5.0%	5.0%	5.0%	5.0%
Long Lease Property	-	5.0%	5.0%	10.0%	10.0%
Diversified Credit Opportunities	10.5%	10.0%	10.0%	10.0%	10.0%
Private Credit Opportunities	-	10.0%	10.0%	10.0%	10.0%
Corporate Bonds	2.25%	-	-	-	-
Fixed Interest Gilts	2.25%	-	-	-	-
Index-linked Gilts	-	-	5.0%	5.0%	10.0%
Exp. Return (gilts + p.a.)	**4.0%**	**4.2%**	**4.0%**	**3.8%**	**3.7%**
Value at Risk (1 in 20 chance)	**£253m**	**£232m** (-8%)	**£217m** (-14%)	**£210m** (-17%)	**£192m** (-24%)
5% worse deficit in 3 years	**(£198m)**	**(£180m)**	**(£168m)**	**(£163m)**	**(£150m)**

Notes: All analysis based on the 31 March 2014 actuarial valuation. Value at Risk ("VaR") measure represents the increase in expected deficit in 3 years time under the 1 in 20 (5%) worst investment outcome. Private credit opportunities includes: Direct Lending, Semi-liquid credit, etc).

Investment strategy

- The table above illustrates the Funds current strategy and the four alternative investment strategies the ISC considered as part of the investment review.
- Each strategy targets a similar expected return to the current strategy with a lower risk profile, but has a different composition in terms of asset classes utilised.
- Following a detailed discussion on the alternative strategies, and the position of current markets, the ISC agreed that strategy 3b was their preferred alternative on the basis that: expected return could be broadly maintained; the risk profile could be reduced significantly; and the Fund could 'bank' some of the equity market gains made over recent periods in favour of more secure contractual income that better matched the Fund's liability profile.
- The ISC agreed that the alternative strategy should be implemented in a phased manner.

Transition summary

Asset Classes	1. Current
UK and Overseas Equities	65.0%
Diversified Alternatives	15.0%
Balanced Property	5.0%
Long Lease Property	-
Diversified Credit Opportunities	10.5%
Private Credit Opportunities	-
Corporate Bonds	2.25%
Fixed Interest Gilts	2.25%
Index-linked Gilts	-
Exp. Return (gilts + p.a.)	**4.0%**
Value at Risk (1 in 20 chance)	**£253m**
5% worse deficit in 3 years	**(£198m)**

Asset Classes	3. 50% Equity
UK and Overseas Equities	50.0%
Diversified Alternatives	10.0%
Balanced Property	5.0%
Long Lease Property	10.0%
Diversified Credit Opportunities	10.0%
Private Credit Opportunities	10.0%
Corporate Bonds	-
Fixed Interest Gilts	-
Index-linked Gilts	5.0%
Exp. Return (gilts + p.a.)	**3.8%**
Value at Risk (1 in 20 chance)	**£210m** (-17%)
5% worse deficit in 3 years	**(£163m)**

Asset movements

- To implement the revised strategy the following transition of assets will have to occur:
  - Reduce equity exposure by 15% in favour of Long Lease Property (10%) and Private Credit Opportunities (Direct Lending) (5%);
  - Reduce diversified alternatives by 5% in favour of Private Credit Opportunities (allocation to be agreed in due course);
  - Switch the Fund's existing Corporate Bonds (2.25%) and Fixed Interest Gilts (2.25%) allocations into a passive Index-linked Gilt allocation – the balance of this 5% allocation is scheduled to come from the Diversified Credit mandate (0.5%) – in practice, this won't require a physical change in the asset allocation.
- To implement this change, the Council should review; the Fund's existing equity portfolio to agree how this exposure should be reduced. We believe this should funded from a combination of UBS' UK Portfolio and Harris' Global Portfolio; carry out long lease property and private credit manager selection exercises (it should be possible to streamline these selection processes). The Council will also have to agree how the index-linked gilts holding would be implemented (there is scope for this to be invested with the Fund's existing managers.)

Next steps

Next steps

- The Committee should consider the ISC's proposal to refine the Fund's existing investment strategy.
- Should the Committee agree the ISC's proposal, we suggest that the implementation is delegated to the Officers. The next steps to implement the revised investment strategy would be:
  - Review of the Fund's existing equity portfolio. KPMG will provide a short equity portfolio briefing paper reviewing the current portfolio, managers and providing clear proposal from KPMG on how to implement the reduction in equity exposure.
  - Carry out a long lease property selection exercise to appoint an investment manager to manage the Fund's 10% long lease property allocation.
  - Review the Fund's options for implementing the 10% private credit mandate and select an appropriate manager to manage the preferred strategy. KPMG will provide a briefing paper setting out our views on the most attractive private credit opportunities for the council to consider (we believe an allocation to direct lending should be considered). KPMG will provide advice on the manager selection.
  - A short report proposing how the currency hedge should be wound down including the changes required to accommodate the strategic changes (i.e. reduction in equity exposure) and a clear proposal on how the currency hedge should be gradually unwound.
- Once the strategy has been agreed, the asset transition should be implemented on a phased basis to 'average in' the changing market exposure. The private credit and long lease property allocation may take time to fund given the nature of these asset classes.
- As part of the strategy, we recommend that the Committee investigates options to increase cashflow generation by drawing income from investment mandates.

Decisions to be taken

1. Is the Committee happy to refine the existing strategy to implement the alternative investment strategy proposed by the ISC?

If so, the following steps are required:

2. Agree how the Fund's existing equity portfolio should be refined to facilitate the 15% equity reduction.
3. Select a long lease property manager for the Fund
4. Agree the preferred private credit strategies and select the required private credit manager(s)
5. Agree how and when the Fund's currency hedge should be unwound
6. Agree target timescales for phased implementation

Appendix

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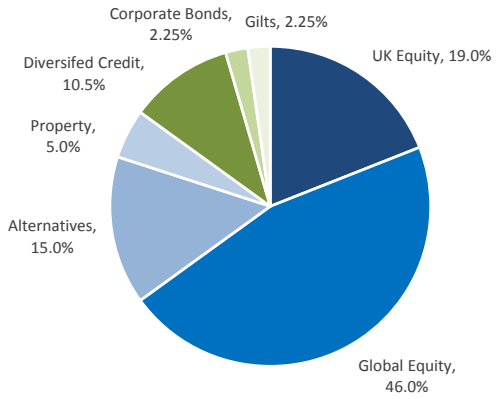
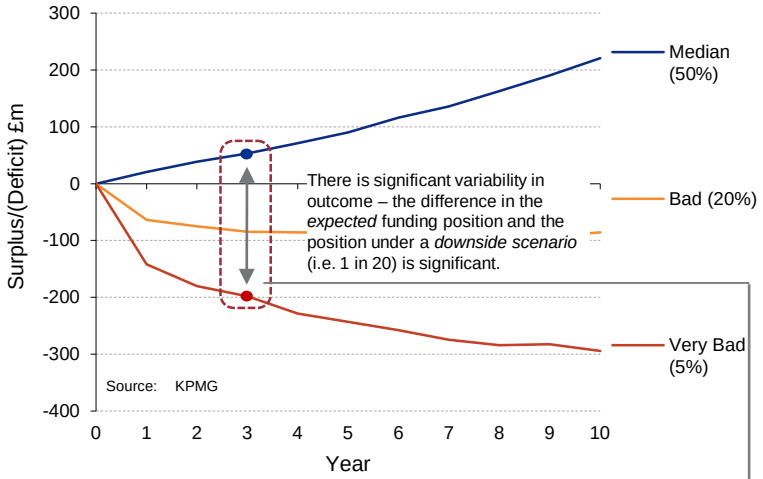
1. Current strategy

This page summarises the ALM output on the Fund's current strategy

Current Asset Allocation
(Benchmark Weights)



Expected funding level progression
(Funding basis)

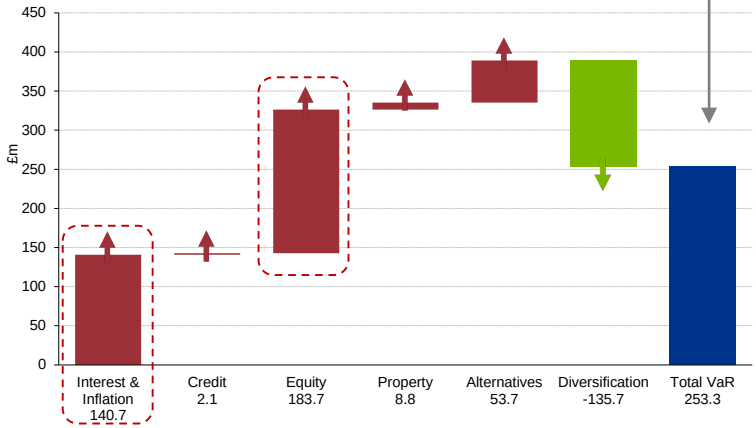


Summary

Key Characteristics	Funding Basis
Expected return (gilts plus)	4.0%
3 year 95% VaR	£253m
Deficit level in 3 years (95% worst outcome)	£198m

Notes: Calculations based on the 31 March 2014 actuarial valuation, rolled forward to 30 June 2016, asset valuations as at 30 June 2016 and KPMGs long term modelling assumptions.
VaR: 3 year 95% Value at Risk represents a the increase in expected deficit in 3 years time under the 1 in 20 worst investment outcome

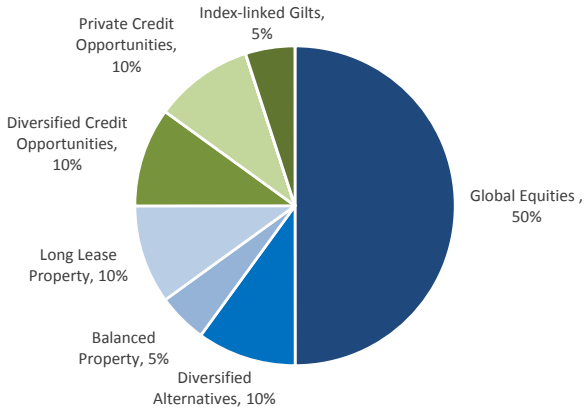
3 year 95% Value at Risk (VaR) decomposition
(Funding basis)



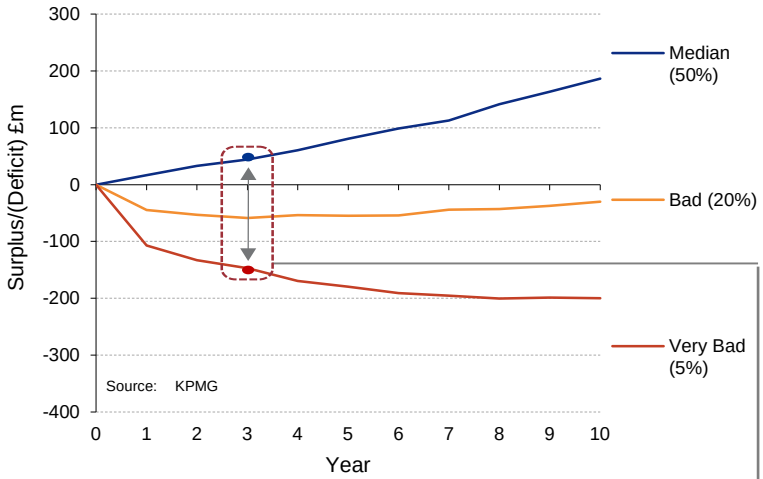
3b. 50% Equity strategy

This page summarises the ALM output on the alternative strategy with a reduced equity portfolio of 50% and a reduced diversified alternatives allocation.

Alternative Asset Allocation



Expected funding level progression
(Funding basis)

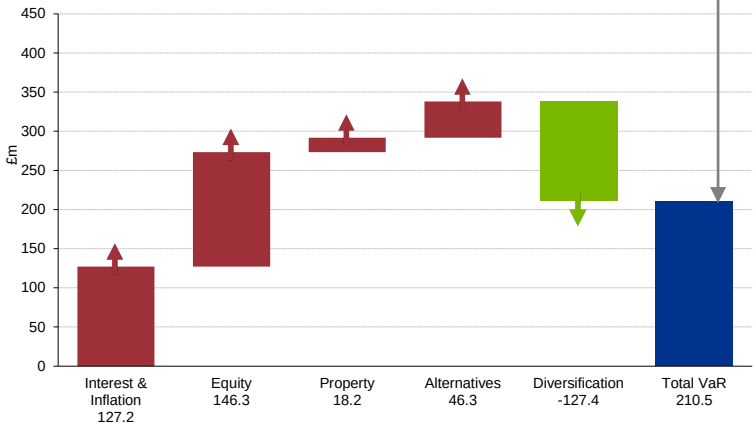


Summary

Key Characteristics	Funding Basis
Expected return (gilts plus)	3.8%
3 year 95% VaR	£210m
Deficit level in 3 years (95% worst outcome)	£163m

Notes: Calculations based on the 31 March 2014 actuarial valuation, rolled forward to 30 June 2016, asset valuations as at 30 June 2016 and KPMGs long term modelling assumptions.
VaR: 3 year 95% Value at Risk represents a the increase in expected deficit in 3 years time under the 1 in 20 worst investment outcome

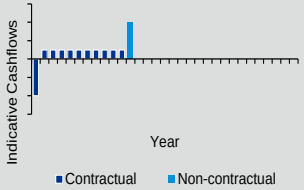
3 year 95% Value at Risk (VaR) decomposition
(Funding basis)



Long Lease Property

At a glance:

Expected returns	
Return	Gilts + 2.0% pa
Volatility	8% pa



Dispersion			
		✓	

0% Contractual — 100% Contractual

Liquidity		
Immediate		Medium
Short	✓	Long

Diversification	
	Highly Diversified
✓	Diversified
	Concentrated

Long lease property ("LLP") funds are designed to produce secure, long term, inflation proofed income streams, which are generally attractive to defined benefit pension schemes.

These funds act as a diversifier in a portfolio as well as providing contractual income to pension schemes.

A LLP portfolio would focus on a subset of properties expected to display the following characteristics:

- Long lease lengths, providing some interest rate sensitivity.
- Inflation-linked, rather than fixed income;
- Income streams agreed with new acquisitions are increasingly LPI rather than RPI linked i.e. with 0% floors and 5% caps. These better match LPI liabilities and also provide a floor in the case of deflation (which index-linked gilts do not);
- Potential for additional gain from increases in the value of the underlying properties;
- Underpin of property value and resumption of rental income should the tenant default

Investors should note that LLP funds are likely to be outperformed by most other property funds in normal/prosperous property market conditions as the bulk of the return will be driven by income and not capital gains.

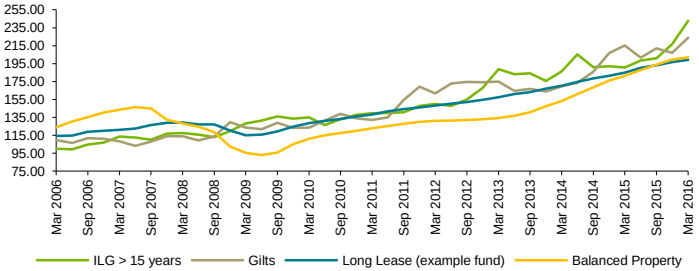
KPMG Summary

— We believe that LLP funds offer pension schemes an asset with similar characteristics to an index-linked corporate bond. This means they are able to offer some liability matching characteristics but also with some growth potential.

— We view LLP positively in the current market, where income is expected be the main component of property fund returns over the medium term.

— We believe LLP would be suitable for a wide range of pension schemes and would recommend an allocation of anywhere between 5-15%, depending on the individual requirements of the scheme.

Return comparison 10years to March 2016



Key features

Asset Class	Property > UK Property
Governance	High due to active management
Typical fees	0.4% - 0.6% p.a.
Trading costs	approx. 5.0%
Turnover	Low turnover of underlying investments
Lock-ins	Typically none but newer funds may have initial lock-in periods
Availability	We currently recommend five investment managers
Active/Passive	Active
Geography	UK focused

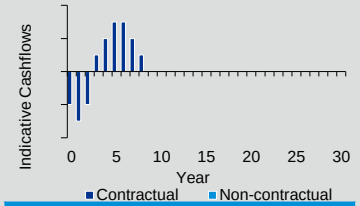
Past performance

Performance Indicator	Quarter	12 Months	3 years	5 Years
Example Fund	1.4%	7.8%	8.9%	8.8%

Direct lending

At a glance:

Expected returns	
Return	Senior / Unitranche: Libor + 4-7% Mezzanine: Libor + 7% to 10%
Volatility	8% - 14%



Dispersion			
			✓

0% Contractual — 100% Contractual

Liquidity			
	Immediate		Medium
	Short	✓	Long

Diversification	
	Highly Diversified
✓	Diversified
	Concentrated

Direct lending refers to loan investments made directly by a fund manager on behalf of a fund to a portfolio of borrowers, typically medium sized businesses. Returns from direct lending originate from coupon payments, origination fees and penalties in case of amendment to terms or prepayment of principal.

Traditionally middle market borrowers (with outstanding debt below £250m) rely on banks to raise capital for refinancing, acquisitions and restructuring. As banks have reduced lending, institutional investors like pension schemes have the opportunity to step into the role traditionally played by banks and capture the attractive returns for providing finance in private markets.

Key features of direct lending include:

- Senior position in capital structure leads to relative security in event of default;
- Access to illiquidity premium rewarding the investor for investing in an asset that cannot readily be sold;
- Customisation and regular monitoring (quarterly) of covenants (terms & conditions) means greater control to prevent defaults;
- Limitations on issuer activities which are not beneficial to the senior lenders (e.g. restriction on payment to junior debt holders prior to senior lenders being paid);

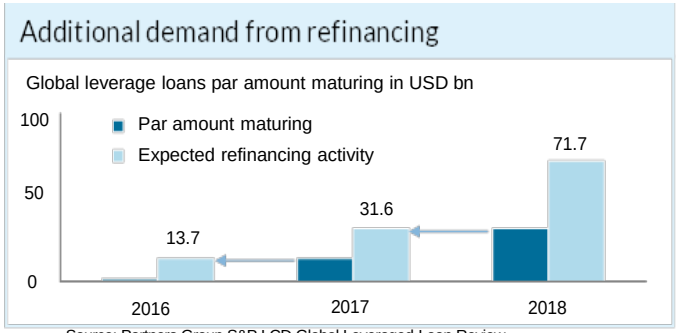
Key risks include:

- Default risk, although direct lending benefits from much better recovery rates than bond investors.
- Prepayment risk (capital being returned to investor sooner than expected), however this is partially mitigated by penalties.

KPMG Summary

The financing gap for Small and Medium Enterprises offers pension schemes an attractive opportunity to provide financing via pooled funds. Direct lending across the capital structure provides more attractive risk adjusted returns compared to the bank loan markets.

Global leveraged loans par amount maturing



Source: Partners Group S&P LCD Global Leveraged Loan Review

Key features

Asset Class	Bonds>Direct Lending
Governance	Medium, standard quarterly monitoring
Typical fees	0.8% to 1.25% p.a.
Performance fees	8% to 15% subject to return hurdle
Turnover	Low
Liquidity	None
Fund Life	6 to 10 years
Active/Passive	Active
Geography	Mixture of regional and global

Past performance

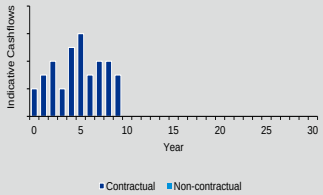
Performance Indicator	2015**	2014	2013	2012
Sample manager	4.2%	4.5%	5.0%	6.0%

*Sample Manager is Partners Group. Performance shown is net IRR as at 29 February 2016.
**The 2015 vintage is still in its investment period.

Semi-liquid credit

At a glance:

Expected returns	
Return	Gilts + 3-5% p.a.
Volatility	6% - 10% p.a.



Dispersion			
		✓	

0% Contractual — 100% Contractual

Liquidity			
	Immediate	✓	Medium
	Short		Long

Diversification	
	Highly Diversified
✓	Diversified
	Concentrated

A Semi-Liquid Credit strategy aims to fill the gap in terms of risk, return and liquidity between the illiquid and liquid credit ideas that pension schemes typically invest in. Managers will combine relatively liquid asset classes, such as High Yield, with illiquid asset classes such as Real Estate Debt. Managers have a high degree of flexibility in terms of strategies and allocations.

A Semi-Liquid Credit strategy aims to deliver returns normally associated with High Yield strategies, without taking the same level of credit and interest rate risk. A Semi-Liquid Credit manager instead aims to achieve these returns by allocating to less liquid strategies (benefitting from an illiquidity premium) and to strategies that are less understood by wider capital markets (benefitting from a complexity premium).

Characteristics that we look for in a Semi-Liquid Credit strategy include:

- Core holdings of credit and loans plus allocations in asset backed securities, distressed debt, private credit and hedging strategies
- Little or no fund leverage
- Lower credit risk than pure High Yield / Loans allocation
- Low correlation with other major asset classes

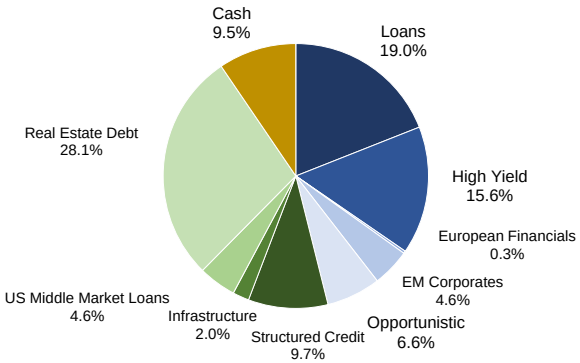
KPMG Summary

— We believe that Semi-Liquid Credit offers a diversified portfolio with holdings across the traditional and non-traditional areas of credit and looks to generate relatively high risk adjusted returns without relying solely on credit risk.

— We see Semi-Liquid Credit as an equity alternative for clients unwilling to bear the illiquidity of our more illiquid ideas, such as Direct Lending and Real Estate Debt. This may also be suitable for clients who are looking to extend exposure to illiquid assets.

— This strategy can also be seen as a higher risk-return, lower liquidity option in the diversified credit space.

Example manager asset allocation



Key features

Asset Class	Bonds
Governance	Low, standard quarterly monitoring
Typical fees	0.6% - 0.9% p.a.
Trading costs	Fund specific
Turnover	High turnover of underlying investments
Lock-ins	Quarterly liquidity, some initial annual lock ups
Availability	Limited number of pooled funds currently available
Active/Passive	Active
Geography	Global

Past performance

Performance Indicator	2015	2014	2013
Example manager performance	2.6%	5.3%*	13.4%*

Risk warnings

Limitations of modeling

- When considering the modeling output for each structure, and in particular the risk measures, the following limitations of modeling should be noted
- This report has been prepared for the sole benefit of Scottish Borders Council and is based on their specific facts and circumstances and pursuant to the terms of KPMG LLP's Services Contract. It should not be relied upon by any other person. Any person who chooses to rely on this report does so at their own risk. To the fullest extent permitted by law, KPMG LLP accepts no responsibility or liability to that party in connection with the Services.
- The outcomes illustrated in this report are not intended to be the best possible, or worst possible outcomes. The actual outcome could be better than the 5th percentile, or worse than the 95th percentile.
- The output from our modelling is based on a large number of underlying assumptions. Changes to these assumptions can have a material impact on the results of the modelling.
- The only risk factors we have considered in our modelling are those that affect the values of pension schemes' assets and the financial assumptions used to value schemes' liabilities. Some of the risks we have not considered include demographic risks such as the life expectancy of pension schemes' members and future changes to members' benefits.
- The work carried out for this exercise is compliant with the applicable Technical Actuarial Standards in force published by the Financial Reporting Council. In particular the standards for Reporting Actuarial Information, Data, Modelling, and Pensions have been followed so far as their requirements are material for this work.

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