

Report for: Pensions Committee 9th February 2017

Item number: 15

Title: Investment Strategy Review (Non-Directional Investments)

Report authorised by: Tracie Evans, Chief Operating Officer (COO)

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Ward(s) affected: N/A

**Report for Key/
Non Key Decision:** Non Key decision

1. Describe the issue under consideration

- 1.1. The Committee requested for a review of the Fund's strategy with a focus on potential non-directional investments that will offer some protection to the Fund against downside in equities. The attached report from the Fund's investment consultants, Mercer, outlines the ideas/strategies that could be implemented to achieve this.

2. Cabinet Member Introduction

- 2.1. Not applicable.

3. Recommendations

- 3.1. That the Committee note the content of this report and the attached appendices.
- 3.2. That the Committee decide on whether further diversification of Fund assets is required at this stage and, if so, which strategy/strategies to pursue (see below paragraph 3.3) – the Committee may also chose to defer a decision to another meeting.
- 3.3. That the Committee approve a currency hedging strategy for the Fund as follows:
 - Currency hedging on 50% of the developed markets overseas equities asset (see the Mercer Report attached as Appendix 2);
 - Implementation to be phased in over a six months period; and
 - Utilise existing relationship with L&G to implement strategy to ensure costs are kept low.

4. Reason for Decision

- 4.1. Members requested in November 2016 that a paper is brought to Committee that evaluates potential non-directional investments to equities as a way of potential further diversification of the Fund. Following training and review of the paper, a decision is required as to whether the Committee supports a shift in fund strategy and whether any of the options presented is acceptable to the Committee.
- 4.2. The Fund has benefited from the decline in sterling against the US dollar/Euro. Currency hedging could offer a way to bank some of the gains, but this will require a change to the Fund's strategic allocation. As this Committee is charged with making decisions on asset allocation, a decision is required on whether the Fund should add currency hedging to the strategy.

5. Other options considered

- 5.1. The paper presented by Mercer considers several ways that non-directionality can be achieved by the Fund. These will be considered at the training session and can be further discussed by members during the meeting.

6. Background information

- 6.1. One of the key roles of the Committee is setting of the Fund's asset allocation strategy. This sets out the desired allocation to various asset classes such as equities, bonds, property, etc. Different asset classes have different expected outcomes in terms of future returns, but together should provide the asset outperformance level required to enable the Fund to meet its future obligations to scheme members.
- 6.2. The current strategy has a high allocation to equities, property etc, whose values have a strong correlation to economic growth, the Committee is focused on funding the promised benefits primarily from investments returns while seeking to stabilise employer contributions. The Committee is required to keep the strategy under review considering the impact of funding levels and market conditions.
- 6.3. At its meeting in November 2016, the Committee requested that the Fund's investment consultants, Mercer, to research and evaluate non-directional asset classes that could offer some protection on equity downside and able to complement existing strategy.
- 6.4. The report by Mercer is attached at appendix 1. Mercer have identified these three areas that could help reduce directionality of the Fund and offer some downside protection against equities:

- Hedge Funds
- Multi-Asset Absolute Return
- Equity Protection
- Direct Lending/Private Debt

- 6.5. The paper also discusses **currency hedging** for the fund's overseas equities portfolio as a way to lock in gains made from the significant reduction in sterling; and briefly highlights the need to review the impact of expected rise in **inflation** on Fund obligations/assets.
- 6.6. It is estimated that the Fund has gained up to £140m in value as a result of the fall in the value of Sterling against all major currencies since the Brexit vote. Sterling is at a historic low against other major currencies, so the chances are it will start to appreciate at some point in the future.
- 6.7. As the uncertainty around the implementation of Brexit clears and investors confidence in the economic growth of the UK gradually returns, Sterling will likely start to recover some of the losses incurred in the post Brexit vote period.
- 6.8. Additionally, the award of a renewable energy mandate, both of which are non-Sterling denominated during commitment/investment period (up to 5 years), further highlights the need to have some form of protection should Sterling start to appreciate in value.
- 6.9. Initial enquiries has indicated specially designed product to hedge currency risk for these awards up to the end of the investment period will be expensive, costing as much as 5% of total value hedged over the duration. Hedging 50% of the overseas equities exposure over the same time period is estimated to cost approximately 0.06%.

7. Contribution to Strategic Outcomes

7.1. None.

8. Statutory Officers comments (Chief Finance Officer (including procurement), Assistant Director of Corporate Governance, Equalities)

Finance and Procurement

- 8.1. The Fund has benefitted from a period of significant growth in equities and index linked gilts due mainly to its overweight position in equities. A key responsibility of the Committee is to have a long term perspective when setting the Fund's investment strategy and ensuring that the appropriate level of diversification is maintained by the Fund.
- 8.2. The proposal to further diversify the Funds assets away from equities seems appropriate given the historic high level of valuation of equities.

Legal

8.3 Under Regulation 11 of the of the Local Government Pension Scheme (Management and Investment Funds) Regulations 2009 the administering authority must formulate a policy for the investment of its fund money and invest in accordance with that policy and the authority can vary its investment.

8.4 Members must in agreeing the currency hedging strategy set out in this report do so in accordance with the Fund's policy, investment statement and the funding strategy.

8.5 Members should note that Regulation 11 is no longer effective when the authority first publishes its investment strategy statement under Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

Equalities

8.6 There are no equalities issues arising from this report.

9. Use of Appendices

9.1. Appendix 1 - Investment Strategy Review (Non Directional Assets)
Appendix 2 – Currency Hedging Review

10. Local Government (Access to Information) Act 1985

10.1. Not applicable.