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23 January 2009

To: All Members of the Pensions Committee

Dear Member,

Pensions Committee - Thursday, 29th January, 2009

I attach a copy of the following report for the above-mentioned meeting which was not available at the time of collation of the agenda:

5. UPDATE ON ASSET ALLOCATION ISSUES (PAGES 1 - 18)

Report of the Chief Financial Officer to provide an update on asset allocation issues for consideration by Trustees.

Yours sincerely

Helen Jones
Principal Committee Co-Ordinator

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Agenda Item 5

Haringey Council

Agenda item:

Pensions Committee **On 29/01/09**

Report Title. **Update on Asset Allocation issues**	
Report of **The Chief Financial Officer** Signed :	
Contact Officer : **John Hardy – Corporate Finance** **Telephone 020 8489 3726**	
Wards(s) affected: **All**	Report for: Non key decision

1. Purpose of the report

1.1. To provide an update on asset allocation issues for consideration by Trustees.

2. Introduction by Cabinet Member

2.1 Not applicable.

3. State link(s) with Council Plan Priorities and actions and /or other Strategies:

3.1. This report links in with the need to regularly monitor the performance of the Pension Fund.

4. Recommendations

4.1 That the Pension Fund's investment strategy be monitored on a quarterly basis, by way of a formal report to Pensions Committee.

4.2 That Members consider whether an asset allocation rebalancing strategy is necessary, and if so;

- what sort of strategy is appropriate;
- what the framework, mechanism and source of funding should be.

5. Reason for recommendations

5.1. Our external investment advisors, Hewitt, advise that an active asset allocation rebalancing strategy is an appropriate process to have in place. In addition markets can be very volatile in the short and medium term and whilst this is a concern this can also present opportunities.

6. Other options considered

6.1. None.

7. Summary

7.1. This report covers the purpose of asset allocation, looks at the Fund's asset allocation in 2008, considers the frequency of asset allocation decisions, considers the risks of such a course of action, and what sort of framework and mechanism could be put in place to make timely asset allocation decisions.

7.2. It is considered appropriate to review the balance of the Fund's asset allocation on a quarterly basis in between full reviews of investment strategy. It is suggested that decisions on asset allocation should be made as part of reports presented to the Committee each quarter with active rebalancing advice received from Hewitt. This is considered preferable to setting an overall structure for the Fund with limits for asset classes and decisions being made by a subsidiary body. This will ensure that Pensions Committee directly controls any changes to investment strategy on a quarterly basis.

8. Head of Legal Services Comments

8.1. The Head of Legal Services has been consulted on the content of this report and comments that nature and scope of its recommendations will assist the Committee in meeting its duties concerning the overview of investment activity and performance of the Pension Fund on behalf of the Authority.

8.2. The current recommendation at 8.2 above has no implications for the scheme of delegated authority within the Council, set out in its Constitution. If Members of the Committee were minded to explore a different model of decision making, such as a subsidiary Investment Advisory Panel mentioned in the Appendix, this will require an amendment to the scheme of delegated authority.

9. Equalities & Community Cohesion Comments

9.1. There are no equalities issues arising from this report.

10. Consultation

10.1. Not applicable.

11. Service Financial Comments

11.1. The cost of required advice from Hewitt will be subject to further discussion and be reported to the next meeting of the Committee. Any costs will be funded from the Pension Fund. The cost should be more than offset by additional performance returns made by the Fund. The financial implications of recommended decisions of asset re-balancing will need to be considered.

12. Use of appendices /Tables and photographs

12.1. Appendix 1 - report by Hewitt.

13. Local Government (Access to Information) Act 1985

13.1 Fund Performance report and presentation by Hewitt to Pensions Committee on 18 September 2008.

Background

14.1 A report is appended from our investment advisors. This report covers the purpose of asset allocation, looks at the Fund's asset allocation in 2008, considers the frequency of asset allocation decisions, considers the risks of such a course of action, and what sort of framework and mechanism could be put in place to make timely asset allocation decisions.

Purpose of asset allocation

14.2 The aim is to increase the funding level of the Pension Fund. Investment strategy is set for the long term. Considering asset allocation in the short and medium term is important in order to make adjustments to any prevailing economic conditions and reduce the risk of losses.

The Fund's asset allocation in 2008

14.3 2008 was a very volatile year for the markets. As shown in the Appendix the Fund's allocation in equities started the year above benchmark and ended the year below benchmark. The allocation in bonds started the year above benchmark and ended the year above benchmark

Frequency of asset allocation decisions

14.4 Reviewing the balance of the fund on a quarterly basis is deemed appropriate as this means that the Fund's asset allocation can be compared to the approved benchmark regularly.

Options available for making timely asset allocation decisions

14.5 There are a number of options available; namely

- Using a passive rebalancing strategy. On a quarterly basis the Fund's over and under-weights would be adjusted to bring the Fund's strategy back to the approved benchmark. Adjustments can be made either by selling and buying assets or by using derivatives in an overlay manner;

- Using an active rebalancing strategy. Asset exposures would be looked at to decide which represent best value at that time. Hewitt are able to give Medium Term Asset Allocation advice. Hewitt would assess the relative prices of various asset classes and consider the prospects for the medium term (i.e. two to five years). In depth analysis would be undertaken and strong views given.

14.6 The Fund does not currently rebalance to benchmark in between the full reviews of investment strategy.

Risks of asset allocation changes

14.7 The largest risk is that the investment strategy does not close the funding gap. If the Fund is not rebalanced regularly then over time the strategy changes as the asset allocation varies from the benchmark and the associated risk taken changes.

Possible funding

14.8 Some assets could be transferred from an existing Fund Manager to fund the passive manager.

14.9 This will have the benefit of not incurring additional trading costs as the passive manager is likely to be able to absorb existing equities and bonds directly into the pooled funds, in exchange for units.

14.10 Another source of funding might be from our annual net gain as current employers and employee contributions exceed pension payments. Whilst this is currently earmarked for property and private equity calls it is considered that such investments will take longer to make in the current economic climate.

Conclusions

14.11 The Fund has a long term investment strategy in place with full reviews of strategy undertaken every three years.

14.12 The Fund does not currently rebalance to benchmark in between these full reviews of investment strategy. Markets can be very volatile in the short and medium term which is a cause for concern but can also present opportunities to the Fund.

14.13 It is considered appropriate to review the balance of the Fund's asset allocation on a quarterly basis in between full reviews of investment strategy. It is suggested that decisions on asset allocation should be made as part of reports presented to the Committee each quarter with active rebalancing advice received from Hewitt. This is considered preferable to setting an overall structure for the Fund with limits for asset classes and decisions being made by a subsidiary body. This will ensure that Pensions Committee directly controls any changes to investment strategy on a quarterly basis.

14.14 A preferred mechanism for making changes between asset classes would be to access pooled funds through the Fund's new passive manager rather than using derivatives (futures).

Considering Asset Allocation

London Borough of Haringey Pension Fund

21 January 2009

Prepared for

London Borough of Haringey Pension Fund Committee

Prepared by

David Crum

David Hager

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Contents

Introduction

Introduction

At the Pensions Committee meeting of 18th September 2008, discussion took place regarding the topic of the Fund's investment strategy. Considerable time is spent reviewing the Fund's investment managers, but historically less time has been spent considering the Fund's overall investment strategy on a regular basis.

Purpose of this report

This report aims to cover 5 specific areas:

1) What is the purpose of asset allocation
2) What did the Fund's asset allocation look like in 2008
3) Should asset allocation decisions be taken more frequently
4) What are the risks to the Fund of such a course of action
5) What sort of framework and mechanism could be put in place to make more timely asset allocation decisions

Aims of Asset Allocation

The Aim of Strategic Asset Allocation

How to invest the Fund's assets is the most important decision that the Pension Fund Committee will make. Whilst the overall Funding Policy is set with the Fund's investment strategy in mind, it is the success – or otherwise – of the asset allocation decisions that will drive the overall investment returns.

Generally speaking, almost all LGPS Funds have a funding deficit of some sort – some relatively small, some much larger. Given the enduring nature of local government, and the relative immaturity of LGPS Funds, it is generally accepted that there is little need to have assets invested in lower yielding investments that more closely match liabilities.

The hope over time is that by running a deliberate mismatch policy and investing predominantly in equities, deficits will be reduced, or even closed – allowing investment strategies to become more liability focussed in the future, and meaning that the Employers, Scheduled and Admitted Bodies in the Funds do not have to close the funding gap purely by paying in additional cash amounts (something which precious few can afford).

The Aims of Medium Term Asset Allocation

When setting the investment strategy, the Committee will consider the long term expected returns of asset classes. As the Committee knows all too well, both good years and bad years make up the long term.

There are points in time where particular asset classes look more attractive than others, and we would argue that it is sensible to consider possibly moving cash between mispriced asset classes – with mispricing working both ways, giving some overpriced and some underpriced asset classes.

When the Fund sets its investment strategy, it is plotting a course for the long term. Medium term asset allocation can be considered to be 'trimming the tiller'. It is not just about seeking better returns – it is equally valuable in trying to avoid losses.

Fund Asset Allocation Movements in 2008

Asset movements during the year

As is the case with most LGPS Funds, the Haringey Pension Fund invests predominantly in equities. Whilst there is no readily accessible information sources that shows the estimated funding level of all LGPS funds, we can compare the Fund's asset allocation policy to the WM Local Authority Index, which is an index comprised of the asset allocations and investment returns of the majority of local authority pension funds in the UK.

The approximate asset allocation of the Fund as shown in the Northern Trust custody reports as at the end of each quarter was as follows:

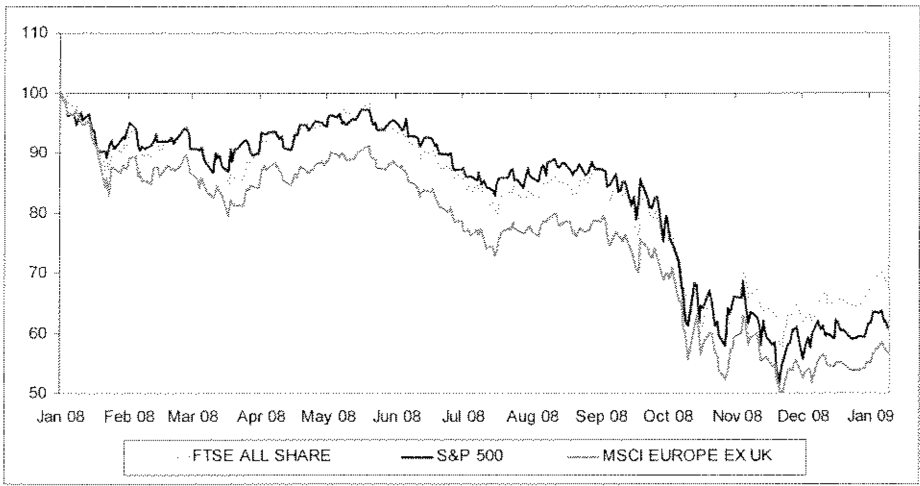
Asset Class	Benchmark %	Fund at 31/03/08 %	Fund at 30/06/08 %	Fund at 30/09/08 %	Fund at 31/12/08 %
Equities	65.0	67.8 *(65.1)*	67.4 *(64.5)*	64.7 *(62.3)*	63.5
Bonds	20.0	21.8 *(18.1)*	22.4 *(18.1)*	24.3 *(19.7)*	26.0
Property	10.0	8.6 *(7.4)*	8.3 *(7.2)*	7.9 *(7.5)*	7.9
Private Equity	5.0	0.5 *(*5.0)*	0.6 *(*5.4)*	1.2 *(*5.9)*	2.3
Cash	-	1.3 *(4.4)*	1.3 *(4.8)*	1.9 *(4.6)*	0.3
Total Fund	100.0	100.0	100.0	100.0	100.0

(WM Local Authority index weights shown in brackets in italics above)

** - includes allocations to Hedge Funds and other alternatives*

Market movements during the year

Markets had an incredibly volatile year. We show below the movement of some major equity indices - the FTSE All Share Index, S&P 500 Index and the MSCI Europe excluding UK Index. These merely demonstrated that equities – generally speaking – fell between 35-45% during the year.



Rebalancing Options

Given that the success of the investment strategy is key to the success of the Fund, it is desirable that 'course corrections' are regularly made to the strategy. There are essentially two ways this can be done:

- Via a passive rebalancing strategy - simply put, this means that the asset allocation over and underweights are corrected every quarter, bringing the Fund's strategy back to benchmark. This can be done either by selling actual assets and moving the realised cash to the appropriate area, or by using derivatives in an 'overlay' manner. (Elected Members may have some reservations about the use of derivatives, but we would be happy to reassure them that using these instruments in this manner is a relatively simple way of managing exposure and risk, undertaken by many institutional investors).
- Via an active rebalancing strategy – this involves looking at the asset exposures in the strategy, and deciding which areas represent best value at that point in time. Whilst it has not yet confirmed its full requirements of Hewitt, by appointing us the Fund has access to our Medium Term Asset Allocation advice. We discuss this later on in this report.

Why is rebalancing important?

The Fund does not currently have a specific policy when it comes to asset allocation movements. As can be seen from the table at the top page 3, the Fund's equity exposure was greater than the benchmark at the start of the year, and remained that way until market losses brought it lower.

There are two points we would make here:

1) Having a passive asset allocation rebalancing strategy in place would have seen the Fund with less cash in equities. This would have resulted in less of a loss by the year end. However, a passive strategy would have also reduced the exposure to bonds, and increased the exposure to Property and Private Equity – which would not in our opinion have been particularly beneficial. Bonds specifically were more of a safe haven in the recent past.
2) Having an active asset allocation rebalancing strategy in place would have allowed the Fund to reduce the equity weighting whilst maintaining the overexposure to bonds. We had been advising our clients to be neutrally weighted on equities at best – i.e. keeping the exposure in line with benchmark – but were recommending clients underweight this asset class.

What are the potential savings?

Using data from Northern Trust, we have carried out a simple exercise to see what a passive rebalancing exercise would have meant for the Fund, in terms of changes in assets invested in each area, and subsequent asset values. Whilst we only have data from Northern Trust covering the 6 month period from end March 2008 to end September 2008, the simple calculation we carried out indicated that the total Fund value at the end of September 2008 would have been approximately £520 million under a total fund passive rebalancing strategy, instead of £517 million. This assumes that the Fund moved backed to benchmark asset weights at the end of each quarter. For the likes of property and private equity, this is not entirely plausible, but as an exercise it does demonstrate the potential results of having a rebalancing strategy.

Sources of Advice

Existing Sources of Advice

The Fund currently draws on the services of Howard Jones, an independent investment advisor, in addition to receiving advice from Hewitt Associates Limited.

Both the independent advisor and Hewitt are in agreement that an active asset allocation rebalancing strategy is an appropriate process to have in place for the Haringey Pension Fund.

Our Experience of Giving This Advice

We believe this is an area where Hewitt can add significant value to our clients. We have a medium asset allocation team in the Investment Practice, consisting of 6 professionals led by Colin Robertson. The team is able to make an assessment on the relative price of various asset classes and consider the prospect on a more medium term horizon (e.g. two to five years). This is of particular value when advising on:

- timing of asset allocation changes;
- re-balancing exercises; and
- identifying opportunities in valuation extremes.

The team carries out significant in-depth analysis of different asset classes in order to give strong views. As mentioned, prior to falls in equities in 2008, the team believed equity valuations were underpinned by record earnings and profit margins which were likely to come under pressure and lead to significant falls in the markets. For some time we had been advising clients to be underweight in their equity exposure. We estimate that our asset allocation advice has saved clients many tens of millions of pounds over the past couple of years.

What Are The Risks?

Risks Associated With Asset Allocation Issues

Whilst we view regular asset allocation moves as standard, Elected Members and Officers may be concerned what this might do to the Fund in terms of risk.

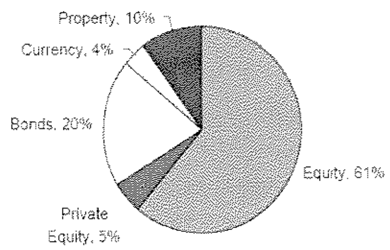
Risk is a word that, when mentioned with regard to pension funds, can have many different meanings. When discussing investment strategy and asset allocation moves, the biggest risk to the Fund is that the investment strategy does not succeed in the objective of closing the funding gap. For example:

- If the Fund chose not to rebalance its investment strategy, then market movements would change the strategy over time, pulling it away from the benchmark. Indeed, assets that do well would become overweight and assets that do less well would become underweight. Whilst this seems like a winning combination, care and judgement are needed to decide when to reduce overweight/underweight positions – since winners do not keep on winning, and losers do not keep on losing.

Clearly, Officers and Elected Members would not wish to take any action regarding investment strategy that would 'increase' the risk of not achieving the targeted investment return.

We did examine some risk issues at the Pensions Committee Meeting in June 2008 after we carried out some modelling of the Fund's investment strategy:

Current Investment Strategy



Expected Return	9%
Risk relative to liabilities	14.8%
Value at Risk	£141m

- The assumed return in the actuarial valuation was 7.3%pa. Achieving this return would allow full funding in 20 years.
- The current portfolio is expected to return c.9%. The additional return should allow the recovery to full funding within half the time.

Our figures then showed that the current strategy is aiming to return 9% per annum, which is greater than the actuaries assumed return of 7.3%. If the Fund were to manage its asset allocation more closely, then the actual return targeted would vary over time, but we believe such an intelligent approach to managing strategy would benefit the Fund without reducing the expected return significantly – and indeed would actually help to reduce risk.

An important point

A very important point to make when discussing a more dynamic asset allocation process is that we are not suggesting trying to predict the absolute top and bottom of market movements. Nor are we talking about regularly changing the Fund's asset allocation on a daily basis. We believe that a process can be put in place that works within the existing regular cycle of Committee meetings.

Framework, Mechanism & Funding

A possible framework

We work with a number of clients, and are aware of several different models of governance structure. Indeed, we discussed some of them in a previous paper to this Committee.

Some Committees prefer to take all decisions themselves, where others are happy to set an overall structure for the Fund, including limits for asset classes, and allow a subsidiary body to have some control over how the assets move between asset classes, depending on market outlooks

If the Committee decides that creating an asset allocation rebalancing strategy is an appropriate step for the Fund, it would be possible for the Committee to either take any decisions to move assets itself – or to create a subsidiary Investment Advisory Panel (IAP) to take such decisions.

We are aware of a model used in the LGPS where an IAP, comprised of Officers, Independent Advisors and Consultants, consider asset allocation rebalancing decisions. Elected Members attend this Panel as observers, and a formal report detailing the activity of the IAP is submitted to the Committee every quarter.

A possible mechanism

Moving between asset classes has the potential to be costly – especially if it is done frequently. However, there are two obvious options available to help manage such movements:

1) by using derivatives (futures) to increase or reduce exposure to specific asset classes; and
2) by accessing pooled funds through a passive manager

Whilst we are very comfortable in using derivatives for this purpose, we believe that – since the Fund is currently in the process of appointing a passive manager – that option 2 seems more appropriate. When the Fund makes any investment with a passive manager, it receives units in pooled funds. These are relatively easy to trade when moving between asset classes.

Passive investment management fees also tend to be lower than active management fees – for example, for passive global equities, the investment management fee would be somewhere in the region of 10-15 basis points (0.10%-0.15%) of the value of the assets under management, compared to 60-100 basis points for active management. For passive global bonds, the fees would be in the region of 5-10 basis points, compared with 20-30 basis points for active management.

Possible funding

There are two obvious options available to the Committee with regards to funding the passive mandate. The Committee could transfer some assets from an existing investment manager to fund the passive manager, once their appointment is confirmed.

This has the added benefit of being able to be completed without incurring trading costs, as the passive manager is likely to be able to absorb existing equities and bonds directly into the pooled funds, in exchange for units.

Also, the Haringey Pension Fund is cashflow positive, receiving more contributions and investment income that pensions payments going out. This could also be a source of funding for any possible future asset allocation moves.

Conclusion

Conclusion

The Fund has a long term investment strategy in place, but has historically spent relatively little time monitoring it between formal reviews. As recent history has shown, markets can be very volatile in the medium term. Whilst being a source of concern, this can also present opportunities to the Fund.

We recommend that the Fund:

1) monitor the investment strategy on a quarterly basis, by way of a formal report to Committee;
2) consider whether an asset allocation rebalancing strategy is necessary, and if so;
   a) what sort of strategy is appropriate
   b) what the framework, mechanism and source of funding should be

We look forward to discussing this report in more detail with the Committee at the meeting of 29th January 2009.