Report for: Pensions Committee and Board 20 March 2018

Item number: **9**

Title: Equity Strategy Review and Tactical Rebalancing

Report authorised by: Jon Warlow, Chief Finance Officer, (CFO and S151 Officer)

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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. Following the 2016 Valuation of Haringey Pension Fund the Pensions Committee and Board commissioned a review of the fund's investment strategy. Work has been ongoing on this throughout 2017, and the last piece of work in relation to this strategy review is now presented within this report: a review of the fund's existing equity strategy, along with actions that can be taken in relation to this.

1.2. Haringey Pension Fund has increased in value by roughly £350m since the 2016 valuation, and the majority of this increase is attributable to continued global stock market growth. This has materially improved the fund's funding level at the time of writing, however, these gains could be reversed before the date of the next triennial valuation in 2019, should stock markets decline: this would impact on employer contribution rates.

1.3. The Fund's equity is currently all invested passively in market cap weighted index linked funds, with set percentages allocated to different geographic regions. 50% of the developed market equity is invested in global low carbon funds, this is also market cap weighted, however with a tilt away from certain stocks to create a significant decrease in exposure to carbon emissions and carbon reserves.

1.4. This paper considers potential changes to the strategy of investing only in line with market cap indices, as well as the use of fixed allocations to specific geographic regions, and considers both alternative index use and active equity management for the Committee's consideration.

2. Cabinet Member Introduction

2.1. Not applicable.

3. Recommendations

3.1. That the Committee consider this report and the recommendations outlined by Mercer in Confidential Appendices 1 and 2.

Equity Review

3.2. That the Committee approves a change to the fund's investment strategy to implement the 'strawman 3' equity portfolio as shown in Confidential Appendix 1, namely to:

- Allocate 22.2% of the equity portfolio to a sustainable equity strategy via the London Collective Investment Vehicle (CIV)
- Allocate 20.4% of the equity portfolio to a multi factor index
- Retain the current allocations to emerging market equity and low carbon equity, but to switch all of the low carbon portfolio into a currency hedged fund, to retain the fund's overall 50% currency hedged position in developed markets

Alternatively, the Committee and Board could choose to implement 'strawman 1' or 'strawman 2' as detailed in the Mercer paper.

3.3. Grant delegated authority to the CFO to implement this investment strategy change, including any due diligence necessary with the requisite fund managers, and to effect the movement of investment assets.

3.4. Grant delegated authority to the Head of Pensions to update the Fund's Investment Strategy Statement and republish this, consistent with any changes agreed, as detailed above.

Tactical Rebalancing:

3.5. That the committee agree to a tactical rebalancing of the portfolio, as detailed in Confidential Appendix 2 as 'option 3', but namely to complete a rebalancing of 75% of the fund's overweight equity position:

- Allocate 50% of the fund's overweight equity position to the fund's multi asset absolute return strategy
- Allocate 25% of the fund's overweight equity position to the fund's multi asset credit strategy
- Retain 25% of the fund's current overweight equity position as equity holdings.

Alternatively, the Committee and Board could choose to implement 'option 1' or 'option 2' as detailed in the Mercer paper.

4. Reason for Decision

Equity Strategy Review:

4.1. The fund has a commitment to investing in a manner which not only secures sufficient returns to meet the fund's strategy to increase the overall funding level, but which also takes serious consideration of environmental, social and corporate governance (ESG) factors. Mercer has previously reviewed the fund's low carbon strategy, and this was increased from 33% of developed market equity to 50% of developed market equity in the summer of 2017. This paper does not propose any change to this part of the equity strategy.

4.2. The equity portfolio is all invested in market cap index linked funds: this essentially means that the portfolio invests in line with the stock market as a whole, and therefore produces returns that should be equal to the average stock market performance. For example, the Fund's UK equity holdings track the FTSE All share index, so the returns are equal to the performance of the FTSE All share. Broadly, this means that the fund's equity portfolio is only exposed to one 'style' of equity investment. Utilising a number of different styles or factors in the portfolio which are complimentary and can counterbalance one another, could reduce the volatility of returns for the fund as a whole. This is detailed further in Mercer's report.

4.3. One of the downsides of investment in market cap indices is that the fund is increasingly exposed to the largest and most expensive companies in each index. Over the past few years this has been strategy that has greatly benefitted the fund, due to prevailing market conditions, and sustained stock market growth. However, this strategy is unlikely to perform well if we enter a period of equity market decline, and in this scenario, the fund could actually suffer disproportionate losses: reversing some of the recent gains made.

4.4. It is therefore sensible to reconsider the current equity strategy of investing 100% in market cap indices, (albeit with a partial low carbon tilt), and consider other equity investment strategies with the aim of hopefully smoothing the fund's returns, and trying to reduce the fund's dependence on one particular style of equity investment. This is a move to diversify the fund's equity strategy further: in the best interests of the fund's membership, and particularly employer base, as investment returns impact on employer contributions to the fund.

4.5. The current equity strategy also has fixed allocations to specific geographic regions. This is problematic, as the allocations made in the strategy at one point in time are not agile, and do not allow for the fluctuating size of different geographies within the global economy. For example, the Fund's current allocation to UK equity is significantly overweight when considered within a global context, as the weighting to UK equity was determined prior to the Brexit vote in 2016, and the UK stock market has since shrunk as proportionally. This can be overcome by the use of a global index which automatically rebalances different geographic weightings. A global index is currently used by the fund currently within the low carbon portion of the portfolio. Strawman portfolios 2 and 3 in the paper produced by Mercer address this problem fully, strawman portfolio 1 partially addresses this.

Tactical Rebalancing:

4.6. Mercer have produced Confidential Appendix 2 with advice to the Committee and Board regarding the fund's current overweight position in equity.

4.7. The fund has appointed a number of private market or real asset fund managers in recent years: the long lease property and renewable energy infrastructure mandates. These mandates are illiquid and take a number of years to fully invest. The funds waiting to be drawn down to these investments are all currently held temporarily within the equity portfolio, and this equates to roughly £141.6m at the time of writing. This takes account two bulk transfers that will occur later in the year, and which will both be funded by equity drawdowns, estimated at £50m. However, as Mercer suggest in confidential appendix 2, this £141.6m figure should be updated in light of the 28 February valuation as soon as this becomes available (it was not at the time of writing).

4.8. The fund has allocated 5% to renewable energy infrastructure (with Copenhagen Infrastructure Partners and Blackrock), but it will take a number of years before this is all invested. The fund has also allocated 5% to a long lease property mandate (with Aviva). This is likely to be invested later in 2018. The funding for these investments is currently all held and invested within the fund's equity portfolio, on a temporary basis, until these fund managers have sourced appropriate assets, and are able to invest the funds.

4.9. The equity portfolio is the most volatile section of the investment portfolio overall. There is therefore a risk that equity markets may decline, and consequently the valuation of these funds temporarily allocated to equity will drop.

4.10. To hedge against this risk, it is therefore recommended that the Committee and Board consider a tactical rebalancing of the portfolio, in order to rebalance this temporary overweight position in equity, and to move a portion of this £141.6m into funds held with Ruffer and CQS, to hedge this risk that the equity holdings fall in value. Moving the funds would be a relatively quick exercise due to the liquidity of all three investments.

4.11. The paper produced by Mercer has looked at a number of options:

- Option 1 essentially rebalances 100% of the overweight position in equity, and splits this as follows:
    - 50% allocated to the fund's multi asset absolute return strategy (London CIV – Ruffer)
    - 50% allocated to the fund's multi asset credit mandate (CQS).
    - 0% remains within equity.

- Option 2 essentially rebalances 50% of the overweight position in equity, and splits this as follows:
    - 25% allocated to the fund's multi asset absolute return strategy (London CIV – Ruffer)
    - 25% allocated to the fund's multi asset credit mandate (CQS).
    - 50% remains within equity.

- Option 3 essentially rebalances 75% of the overweight position in equity, and splits this as follows:
    - 50% allocated to the fund's multi asset absolute return strategy (London CIV – Ruffer)
    - 25% allocated to the fund's multi asset credit mandate (CQS).
    - 25% remains within equity.

4.12. Mercer have indicated that they have a marginal preference for option 3, however that they are also supportive of option 2.

5. Other options considered

5.1. The paper from Mercer considers a number of options for the fund's equity strategy.

6. Background information

6.1. The most important investment role for the Committee and Board is the setting of an asset allocation strategy. This is the desired allocation to the various asset classed e.g. equities, bonds, property, cash etc. Different assets allocations will have different expected outcomes in terms of future returns and also the predictability of returns.

6.2. In setting the current strategy that has a high allocation to equities, whose values have a strong correlation with economic growth, the Committee and Board is focused on funding the promised benefits primarily from investments returns while seeking to minimise / stabilise employer contributions. The Committee and Board is required to keep the strategy under review considering the impact of funding levels and market conditions.

6.3. It should be noted that the 5% allocation to renewable energy infrastructure was made in 2017 after significant gains within the portfolio were made, and this investment has been agreed at a total of £70m (subject to foreign exchange fluctuations). At the time of writing this £70m will make up roughly 5% of the fund's total investments.

6.4. However, the 5% allocation to long lease property was made in 2016, and at the time when the fund was significantly smaller than its current value, and at that time, 5% of total assets equated to £50m. £50m was therefore agreed to be invested in the long lease property fund with the chosen fund manager: Aviva. Even after the fund has completed its initial investment of £50m, the fund will very likely be underweight to this long lease property allocation, and will have to consider how to address this going forward.

7. Contribution to Strategic Outcomes

7.1. None.

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

<u>Finance and Procurement</u>

8.1. The Fund has enjoyed strong returns in recent years primarily from rising equity valuations. The Pension Committee and Board's responsibility is to look to the long term when setting an investment strategy, ensuring an appropriate degree of diversification.

8.2. The report from Mercer highlights a number of options for the fund's equity strategy which are proposed with the aim of diversifying the portfolio further.

8.3. Whilst commitment to ESG issues is clearly a key consideration for Haringey Pension Fund, the overriding aim of the fund's investment strategy must be to improve the funding position with the aim of reaching fully funded status, whilst maintaining stability of employer contributions. Any future changes to the Fund's investment strategy must be consistent with these principles. The proposal from Mercer to include an allocation to an actively managed sustainable equity strategy is consistent with this principle.

8.4. Before any new fund managers or asset classes are introduced to the pension fund, proper due diligence will be undertaken, and sound professional advice will be sought. Officers will ensure that the Pensions Committee and Board receive adequate and appropriate training on any new investment techniques or asset classes prior to these being undertaken by the pension fund.

8.5. As part of the regular triennial valuation process, it is best practice to review the Fund's investment strategy: this is the final step in this process following on from the 2016 valuation.

Legal

8.7 The Council as administering authority for the Haringey Pension Fund has the power to invest fund monies as set out in Local Government Pension Scheme (Management & Investment Funds) Regulations 2016.

8.8 The authority must review and if necessary revise its investment strategy from time to time and at least every 3 years, and publish a statement of any revisions. Any allocations recommended in this report must comply with the Pension Fund Investment Strategy Statement .

Equalities

8.9 There are no equalities issues arising from this report

9. Use of Appendices

9.1. Confidential Appendix 1 – Equity Portfolio Review
9.2. Confidential Appendix 2 – Tactical Rebalancing

10. Local Government (Access to Information) Act 1985

10.1. Not applicable.