Report for: Pensions Committee and Board 5 March 2020

Title: Investment Strategy Review

Report authorised by: Jon Warlow, Director of Finance (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. The Pensions Committee and Board (PCB) has received a number of reports over the past 12 months in relation to the 2019 Valuation of the Fund - a three yearly exercise. This is now complete, and it is good and normal practice to review the Fund's investment strategy following on from this.

1.2. The Investment Strategy Review has been completed by the Fund's Investment Consultant, Mercer Ltd, at confidential Appendix 1. There are a number of policy decisions to be made in relation to this, and this initial paper is intended to help gather the views of the PCB members to help shape further pieces of work in coming months. This report will be followed by further reports in future meetings where changes to the Fund's Investment Strategy Statement may be made.

1.3. There are some matters on which the PCB is able to make decisions at this stage, and others where the views of the PCB are sought in order to progress work further. The recommendations in Section 3 below are broadly intended to set out the key points for the PCB to discuss or to make decisions on.

2. Cabinet Member Introduction

2.1. Not applicable.

3. Recommendations

3.1. That the PCB note the Investment Strategy Review appended as Confidential Appendix 1.

3.2. The PCB discuss/debate the below points and if deemed appropriate make in principle decisions on:

- Introducing a new allocation to residential property suggested at either 3% or 5% of total assets (likely funded by a reduction in index linked gilts).
- The level of index linked gilts* within the fund's long term investment strategy, which could be between 0%-15% (15% being the current level).
- Utilising RAFI's low carbon index when this is launched, subject to necessary due diligence, which would mean that all of the Fund's equity portfolio would be invested in low carbon strategies.

3.3. The PCB agree to a top up of the Aviva long lease property investment of £25m, to bring this in line with the Fund's Investment Strategy Statement allocation to the asset class.

3.4. The PCB agree to amend the London CIV - CQS mandate so that income is drawn from this portfolio.

3.5. The PCB agree to a further report specifically focussing on the Fund's private equity, renewable energy and property investments, including implementation options to maintain the current allocation being presented at the July PCB meeting.

*The Fund currently has a long term strategic allocation to index linked gilts. The PCB made a decision in January 2020 to switch its index linked gilts for fixed gilts due to ongoing uncertainty around RPI reform.

4. Reason for Decision

4.1. The Council is required by law to undertake an actuarial valuation of the Fund's liabilities, currently every three years. It is usual practice to review the Fund's investment strategy following the completion of the valuation.

5. Other options considered

5.1. None

6. Background information

6.1. In preparation for the review of the Fund's investment strategy, officers of the fund arranged for the Investment Consultant to meet with the Fund Actuary to thoroughly discuss all the assumptions used in the 2019 Valuation.

6.2. Following on from this, the Head of Pensions, Independent Advisor, Chair of the Pensions Committee and Board met with the Investment Consultant in December 2019 to discuss initial ideas, themes and points to review before work on the strategy review began in earnest.

6.3. A paper was then presented to the PCB in January discussing the Fund's allocation to index linked gilts; it was decided in this meeting to switch the Fund's index linked gilts allocation for fixed interest gilts until the uncertainty surrounding the RPI consultation concluded. The Fund's current allocation of 15% is understood to be high for an LGPS fund. Some members of the PCB expressed the view that they would like to consider this mandate more fundamentally, i.e. whether to hold a gilts allocation at all, or indeed whether to reduce this from 15%. If this allocation was reduced it would likely be replaced by allocations to other asset classes which have a high level of inflation linkage: residential property could potentially be one option. Views of the PCB are sought on this matter, and if the PCB deems appropriate a decision in principle could be made to help shape future work done on the investment strategy by officers and advisors.

6.4. The PCB has discussed residential property on a number of occasions, it being an asset class that has the potential to have strong positive responsible investment credentials. To facilitate further consideration of this asset class a training session was arranged on 28 February for members of the PCB. Following on from this training session, and the information in the report of Mercer, the views of the PCB are sought on this matter. If the PCB deems appropriate, a decision in principle could be made to help shape future work done on the investment strategy by officers and advisors.

6.5. The Fund's equity portfolio consists of three components: low carbon developed market equities, low carbon emerging market equities and RAFI multi factor equities. The fund has been seeking to decarbonise it's investment portfolio further in recent years to manage the investment risks posed by exposure to highly carbon intensive industries, and the report of Mercer highlights an additional potential option that the Fund may have in coming months to move the final part of its equity allocation (RAFI multi factor) into a low carbon version of the strategy, once this is launched by RAFI. This would be subject to usual due diligence, and would return to the PCB for final decision making once the product is launched. Again, the views of the PCB will be sought on this and a decision in principle could be made, subject to further due diligence.

6.6. The Fund is increasingly cashflow negative, the sum of all income from employer and employee contributions is outweighed by the sum of all pension benefits paid out, therefore the fund seeks to invest part of its portfolio in investment assets which provide a steady income stream to offset this so the Fund avoids having to be a forced seller of investments to pay pension benefits. Two actions are recommended by this report to partially address this issue (see recommendation 3.3 and 3.4):

- The Fund can top up its investment with Aviva for long lease property, by £25m to bring this in line with the existing 5% allocation. This would likely increase investment income by around £1m per annum. This action should only be agreed if the PCB are comfortable with the current 5% allocation to the long lease property asset class.

- The Fund's existing mandate with London CIV/CQS can be amended so that income is drawn from this portfolio rather than being reinvested: this is anticipated to increase investment income received by the Fund by approximately £4-5m per annum.

7. Contribution to Strategic Outcomes

7.1. Not applicable

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

Finance and Procurement

8.1. The Fund's 2019 Valuation showed overall improvement to the Fund's funding level. However the cost of ongoing accrual of pension benefits within the LGPS continues to rise, and the McCloud ruling is likely to increase ongoing costs further. Ultimately pension benefits in the LGPS are funded by 3 things: employee contributions, employer contributions and investment returns. Employee contributions are set centrally, however investment strategy and employer contributions are set locally. All else being equal, over the long term, if investment returns are higher, this will allow employer contributions to be lower. Higher investment returns are usually achieved by setting an investment strategy with higher allocations to asset classes that display more volatility or take higher levels of risk.

8.2. Given the increasing ongoing costs of servicing LGPS pensions, de-risking the Fund's investment strategy at this time would not be appropriate, nor is this suggested. The report of Mercer in fact highlights options which could potentially increase expected returns, however it should be noted that this does marginally increase overall risk. No final decision making on the Fund's overall strategy is suggested in this report.

Legal Services Comments

8.3. Under Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 the administering authority must, after taking proper advice, formulate an Investment Strategy (in accordance with guidance issued from time to time by the Secretary of State). It must also keep this under review (at least every three years) and if necessary revise it.

8.4. The Investment Strategy must include:
(a) a requirement to invest fund money in a wide variety of investments;
(b) the authority's assessment of the suitability of particular investments and types of investments;
(c) the authority's approach to risk, including the ways in which risks are to be assessed and managed;

(d) the authority’s approach to pooling investments, including the use of collective investment vehicles and shared services;
(e) the authority’s policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
(f) the authority’s policy on the exercise of the rights (including voting rights) attaching to investments.

8.5. The Investment Strategy must set out the maximum percentage of the total value of all investments of fund money that will be invest in particular investments or classes of investment. Therefore, any decision made by the PCB must not exceed the maximum percentage for that particular or class of investment.

<u>Equalities</u>

8.6. None applicable.

9. Use of Appendices

9.1. Confidential Appendix 1: Investment Strategy Review (pages 199 to 237).

10. Local Government (Access to Information) Act 1985

10.1. Not applicable.