Agenda item:

Pensions Committee **On 1 November 2010**

Report Title: **Investment Strategy Review**	
Report of **Director of Corporate Resources** Signed : Kevin Bartle for DoCR	
Contact Officer : **Nicola Webb – Corporate Finance** **Telephone 020 8489 3726**	
Wards(s) affected: **All**	Report for: Non key decision

1. Purpose of the report

1.1 To outline the proposed next steps for the investment strategy review including a summary of the possible methods for determining asset allocation options.

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 Not applicable.

4. Recommendations

4.1 That the Committee agree that the model of comparing the risk/return characteristics of different asset allocation strategies is the most appropriate way forward and Hewitts are commissioned on this basis.

5. Reason for recommendations

5.1. This option is the most cost effective way forward for a Fund with a positive cashflow which does not need to address it's liabilities in the short term. This model will allow the Committee to easily compare possible strategies in order to reach a decision.

6. Other options considered

6.1. Asset Liability Modelling was considered, as set out in paragraph 15.2, however it is believed the cost and complexity of the model in a changing landscape for the Pension Fund means it is not the best use of resources in reaching the decisions on investment strategy.

7. Summary

7.1 Two possible methods of determining recommendations for investment strategy have been proposed by Hewitts. Officers recommend that the less costly and complex method of determining the risk/return characteristics of a variety of options is most appropriate.

7.2 The actuary and the investment adviser will attend the Committee's next meeting in December to progress the strategy review.

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 that the Committee should give full consideration to the advice received concerning the recommendation on determining asset allocation options. Members are reminded of the duty on an administering authority to conduct a coherent overview of investment activity and performance of the Pension Fund in order to ensure the suitability of investments and types of investments.

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 use of the more costly and complex model does not appear to be justified in terms of the benefits it could bring in the current times of uncertainty for the pension scheme structure.

12. Use of appendices /Tables and photographs

12.1 Appendix A: Hewitts review of 4th October 2010 session

13. Local Government (Access to Information) Act 1985

13.1 None

14. Background

14.1 An investment strategy review for 2010/11 was set out in the Pensions Committee's business plan for the year. Formal reviews are undertaken every three years coinciding with the results of triennial valuations.

14.2 An informal meeting and training session with members, officers and the independent adviser to the Committee was held on 4th October 2010 and led by the Pension Fund's investment advisers, Hewitts.

14.3 This report outlines the proposed next steps for the review following on from that meeting including examining the different analytical methods of determining possible investment strategies for consideration by the Committee.

15. Methods for determining strategy recommendations

15.1 At the session on 4th October 2010, Hewitts suggested two possible analytical methods of determining asset allocation options for the Committee to consider. The methods are summarised here with the advantages and disadvantages of each.

15.2 The first possible method is to commission Hewitts to carry out Asset Liability Modelling. This technique runs a large number of scenarios for the Fund's assets and liabilities to determine what the most likely outcome is over the long term. This then determines the optimal asset allocation to meet this outcome. The advantage of this is that it is very detailed and covers many eventualities and it demonstrates a clear trail as to reasons for the asset allocation selected. However running the model is costly (approximately £55-60k), it assumes that relating the Fund's assets to the liabilities is the way the Committee wishes to determine asset allocation and the results could quickly become out of date depending on the recommendations of Lord Hutton's review of public sector pensions and the impact they have on the liabilities.

15.3 The second option is for Hewitts to draw up a number of possible strategies and determine what the expected return and risk level would be for each one. This could compare the current strategy to one invested in different asset classes, such as hedge funds, a more passive strategy, a more aggressive return strategy and so on. This would allow the Committee to compare the expected return and risk characteristics of different strategies to determine the way forward. This method is less expensive (approximately £25-30k) and easier to understand. It accepts the liabilities do not need to be met in the short term and accepts the need to focus on return. The disadvantage is that it is not so detailed and the link with the liabilities is not demonstrable.

15.4 Officers recommend that the second option of comparing the risk and return characteristics of different strategies is used and that Hewitts are commissioned on this basis. Given the current uncertainty about the shape of the scheme and the lack of a requirement to meet the liabilities in the short term, the more costly and complex model does not appear to be cost effective.

16. Next steps

16.1 Hewitts have prepared a summary of the outcomes of the session on 4th October 2010 and this is attached at Appendix A. It is proposed that officers, in conjunction with the Chair, agree the detailed proposal discussed in the note for the next part of the review based on members' agreed way forward in respect of the model to be used. Hewitts are booked to attend the 20th December 2010 Pensions Committee meeting to report to the Committee their recommendations for future strategy.

16.2 The actuary will also be attending the 20th December 2010 meeting to present the results of the triennial valuation of the Fund, which will give members the ability to consider both the assets and the liabilities at the same meeting and ask questions of both the investment adviser and the actuary.

16.3 There is a further Pensions Committee meeting on 20th January 2011 which could be used to bring back any follow up work required for the Committee to reach a decision on the way forward for investment strategy.

APPENDIX A

Aon Hewitt

Awayday review and next steps

Date: 12 October 2010

Prepared for: London Borough of Haringey

Prepared by: David Page
David Crum

Awayday review and next steps

Introduction

The purpose of this paper is to summarise the key points that we gathered from the Awayday on 4th October and to propose the next steps in the process.

Key points to take from the meeting

Below are the key points that we took from the awayday:

- There will be little scope to change the employer contributions into the Fund, and so investment returns will be key to reducing the deficit over the recovery period
- As the Fund is currently open, the Committee felt that the investment horizon was open-ended and so investment strategy should be an efficient return seeking portfolio (although it was acknowledged that the investment strategy would need to meet the needs of the recovery plan)
- Due to the level of uncertainly over the valuation of the liabilities, especially with the Hutton review underway, it was felt that the focus of analysis should be on generating returns from the assets, rather that looking at the investment strategy in the context of the volatility of the funding position
- As a result of the above, it was felt that an asset liability study was not necessarily appropriate, and that any analysis commissioned should focus on identifying an efficient investment strategy to generate the required return.
- It was noted that there were essentially three key facets to the investment strategy
  - Long term investment strategy (long term asset allocation)
  - Medium term asset allocation – MTAA - to seek to add value/reduce risk from asset class overweights/underweights on an 18 month to three year timeframe. (This could be achieved either through investment advice received from Aon Hewitt, or by investment in a multi-asset investment mandate where the investment manager makes asset allocation decisions within the mandate to seek to add value
  - Once the asset allocation is agreed, the final consideration is the style of investment management to be used to implement the strategy. The key consideration here will be whether passive or active management (or a combination of both, perhaps as part of a core/satellite approach) is appropriate.
- Whilst the Committee believe that there are active managers who outperform, their experience of active management (with notable instances) has

not always been good, and the Committee will need to be comfortable in Aon Hewitt's ability to identify managers who will outperform in the future before committing to continued use of active managers

- It was noted that cap weighted benchmarks lead to increased holdings in 'expensive' stocks. Although not mentioned at the meeting, consideration could be given to non cap weighted passive management
- Further information regarding track record should include impact of frictional costs from any transition, as much as possible
- The Committee is receptive to a further diversified investment strategy if it meets their objectives. The Committee will need more information on alternative asset classes before committing to an asset allocation which includes these assets. Specifically, further information on the types of 'hedge fund' strategies and currency management would be useful.

Next Steps

The following next steps were identified at the meeting.

- An educational paper setting out what we mean by hedge funds and active currency (and other asset classes as agreed) and Medium Term Asset Allocation and how this can be implemented.
- Further information on Hewitt's record of identifying active equity managers who outperform (in conjunction with paper already provided answering Howard Jones' queries and any follow up information)
- To agree a detailed proposal for a strategy review in conjunction with the valuation, looking at appropriate investment strategies (including active and passive options), looking at expected returns and risk (expressed as standard deviation) and showing the impact of passive versus active management.

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.