Appendix 3

Corporate Committee – Pensions Working Group
Minutes of meeting held on Monday 2nd December 2013
Present:

Councillor George Meehan (Chair)
Councillor Kaushika Amin
Councillor Jim Jenks

Michael Jones – Pensioners' Representative
Keith Brown – Admitted and Scheduled Bodies' Representative
Roger Melling – Employees' Representative

John Raisin- Independent Advisor
Steve Turner – Mercer (Investment Advisor)
Marc Devereux – Mercer (Investment Advisor)

Kevin Bartle – Assistant Finance Director
George Bruce – Head of Finance (Treasury and Pensions)

Representatives from Wellington, AMP and BlackRock.

1. Apologies

Councillor Adje
Councillor Wilson

2. Minutes of the meeting of 22 October 2013

The minutes were agreed.

3. Matters Arising from meeting of 22 October 2013

There were no matters arising.

4. Absolute Return Bonds - Wellington

Mercer reminded the Group that at the last meeting they had introduced a model portfolio with two new asset classes (absolute return bonds and private debt) and a more efficient approach to inflation protection with leveraged index linked bonds. The training was intended to give insight into each of these approaches.

Mercer noted that Wellington had a vast experience of managing bond mandates. They referred to absolute return bonds as multi sector.

Paul Skinner and Nicola Staunton joined the meeting. Paul is responsible for oversight of Wellington's fixed income mandates. Wellington referred to their structure as an amalgamation of boutiques. The advantages of multi sector credit compared to gilts and investment grade credit are:

- High income,
- Lower sensitivity to changes in interest rates,
- Diversification of sources of return, and

- Opportunities for value to be added.

It was acknowledged that returns would be more volatile and the portfolio less liquid than a corporate bond mandate. Compared with equities, the 15 year picture was of similar returns but half the volatility. Although volatility was less of a concern for long term investors it did impact on the tri-annual actuarial valuations and had a real impact on contribution rates.

Gilt and Investment grade bonds are valued close to historic lows in terms of yield (and highs in terms of price), with expectation that interest rates will increase. In an environment of increasing rates, mainstream bonds will perform poorly. The sectors that such funds target have less sensitivity to changes in interest rates due to the relatively short portfolio duration and in some cases a libor plus return such that they will benefit from rising rates. The sectors that are targeted are:

- High yield corporate bonds – pay substantially higher yields that sovereign debt.
- Bank loans – these are loans that banks wish to sell. Covenants tend to be stronger and there is greater protection being higher up the capital structure compared to corporate bonds. Wellington prefers to avoid interest rate risk by investing floating rate notes.
- Emerging Market Debt (EMD) – one of the biggest growth markets.
- High yield securitised debt – a pool of mortgages. The ability to look through to the individual constituents has improved since the credit crisis.

Can expect 3-4% additional return over investment grade credit in exchange for the higher credit risk. The borrowers' names include many familiar companies with highly leveraged balance sheets.

Emerging market economies had survived the credit crisis in much better shape than developed economies, with higher growth, lower debt levels, fiscal surpluses and generally low inflation.

Multi sector credit potentially offered superior risk adjusted returns to equities and other asset classes and a powerful way of smoothing returns. Tactically they offered higher income in a low income environment and protection against rising rates. Wellington suggested a standard mix of 1/3rd allocations to high yield corporate, bank loans and EMD although actual allocations would vary according to anticipated and actual market conditions. Spreads over developed market debt were around the mid point of their trading ranges and offered scope for capital appreciation. Bank loans were purchased selectively and although banks would offer a range of names only those names deemed attractive would be purchased.

Total returns of 5-7% were anticipated, being 3-5% yields, 1% from rotation of sectors and 1% from security selection. The portfolio would be transparent and available for scrutiny. Derivatives were used to manage exposures and achieve rapid sector shifts. Passive investing was not suitable for multi sector bond mandates as sector rotation is applied to capitalise on relative value amongst sectors. Fees would be around 0.5% p.a., less than active equities.

In summary, a multi sector approach seeks diversified exposure to credit. Different forms of credit are advantageous at different times. Multi sector bond managers should flex exposure to different types of credit according to market conditions.

Messrs Skinner and Staunton left the meeting.

5. Infrastructure Debt – AMP

Louisa Yeoman and Richard Lane joined the meeting.

AMP was one of Australia's most experienced infrastructure managers. The attractions of infrastructure dent included:

- Stable cash flows. Investments were stable service companies with predictable cashflows. Preferred investments were existing in use assets with track records rather than greenfield developments,
- Majority of investments were regulated companies that offered stability,
- Life spans of the assets were long, although the investments may be of shorter duration.
- Opportunities in mature markets e.g. North America, Europe (north not south) and Australia are preferred.
- Default rates have been low across economic cycles.

Investments were in floating rate instruments offering a libor plus return. Depending on the risk profile, returns are between low to high single digit. Using AMP performance as a basis, returns are uncorrelated with mainstream asset classes. The range of gross returns is from 5-6% for the lowest risk social infrastructure through to 10%+ for unregulated assets. Returns are less sensitive to economic conditions than corporate bonds.

Durations are around 5-7 years. Once purchased, assets are not traded. Investments are sourced from government privatisations, project refinancing and sales by banks (partially arising because of new regulatory requirements). Current structures have excessive senior debt and on refinancing additional equity or subordinately debt is required. Recently RBS and Irish banks have been selling assets, with the opportunity for discounts when buying non distressed assets from distressed sellers.

Returns achievable are close to the 10-12% gross from core infrastructure subordinated debt and/or equity and far above senior loans yielding up to 2.5% over base. The structure is a 10 year closed end fund. Cash will be drawn down as investments are purchased, with the aim to be fully invested earlier than the 4 year investment period. Any sales in the first 4 years will be reinvested after that sales proceeds will be distributed. Normally 10-12 separate assets are purchased for each pool or account. Fund sizes are targeted at around £400 million. Segregated accounts require a minimum of £50 million.

Fees are approximately 1%, although discounts are available for larger mandates. Fees are charged on invested rather than committed capital. The value of invested capital will be lower than the value committed for much of the fund life. Interest is paid to the fund and distributed from commencement, although the yield does grow.

Messrs Lane and Yeoman left the meeting.

6. Leverage Index Linked – BlackRock

Mercer introducing the topic of inflation protection confirmed that they preferred to see greater levels of protection in pension funds to protect against funding levels deteriorating. Over time they expect pension funds to seek more protection but the supply of index linked bonds to remain constrained. The BlackRock approach allowed funds to react quickly to opportunities to increase inflation protection.

Sarju Mehta and Christopher Head joined the meeting. BlackRock manage most of the Fund's index linked portfolio.

BlackRock explained the impact of changes in future inflation on the value of future pension liabilities. If future inflation increases by 1%, BlackRock estimate that Haringey's liabilities will increase in value by £135 million, while assets by only £25 million. In the long run equities may well offer inflation protection but that was not guaranteed particularly in shorter periods.

The UK had suffered periods of rising inflation and there were concerns that the government and Bank of England were currently prioritising growth over inflation. Increased inflation protection can be achieved from buying more index linked bonds and selling growth assets e.g. equities, but that will detract from the returns required to reduce the actuarial deficit.

An alternative approach was to increase the level of inflation protection by using a levered index linked gilt fund. This involved using current index linked bonds as collateral to borrow cash and purchase additional index linked bonds. The BlackRock fund used that to achieve inflation protection of 2.9 times the value of the initial index linked holdings.

The borrowing involved was short term. The debt interest payable was based on libor rates and was funded from the income derived from the additional bonds purchased. BlackRock confirmed that this arrangement was not dependent on the continuation of unusually low interest rates.

BlackRock estimate that Haringey currently has an inflation hedge protection level of 19% and that switching to their levered index linked gilt fund would increase the hedge ration to 55%. The impact on the deficit of a 1% inflation increase would fall £110 million to £60 million.

If the situation were reversed then a higher inflation hedging ration will reduce the benefit but there still will be a benefit and that will offer an opportunity to switch growth assets into liability matching assets.

The fees for the BlackRock pool are 15bp (0.15%) of the value of the assets invested, which equates to 5bp of the inflation protection. We currently pay 4pb of value / exposure.

The Working Group agreed that this was a complex proposition that required more training. Scenario based analysis to illustrate what happened in different situations will help. It would not be easy to explain this proposition to the Corporate Committee and approval may take longer than the two new approaches to credit. The strategy proposition to Corporate Committee should initially retain the 15% exposure to index linked gilts pending additional training.

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7. Property Allocation

Mercer explained that the currently property portfolio was below the benchmark weighting and that the timing after a period of strong equity returns was favourable to sell equities and increase the property holdings.

The Working Group agreed that this proposal should be recommended to Corporate Committee.

Members of the Working Group also recommended that the proposed new strategy in respect of bonds/fixed income refer to multi sector credit rather than absolute return bonds. It was noted that a strategy that involved less in equities would need careful explanation

8. Responsible Investing

At the last meeting, a request was made for a discussion on the funds policy for ethical investing, in particular it was noted that there was an increased interest in tobacco related holdings.

The fund's current approach to ethical, responsible and similar issues is set out in the responsible investment policy and also the SIP, both of which are attached to the paper. The policy is:

- Companies that adopt good ESG practices will enhance their long term returns,
- The priority is generating the returns required to fund pensions,
- Both the Council and fund managers will use their influence to ensure that companies follow best practice.
- That it is not appropriate to exclude particular stocks or sectors.

The Haringey Legal team commented on the duties of the Administering Authority and the factors that should be considered:

- The need for diversification,
- The suitability of each investment
- Considering proper advice
- Ensuring the security, quality, liquidity and profitability of the portfolio,
- Obtaining a sufficient return to pay future pensions and
- A duty to invest in the best interest of beneficiaries.

The legal advice concludes that ESG issues are part of the process of determining financial returns and where the anticipated returns are similar, can be used to differentiate between competing opportunities.

As well as legal advice, we received a report from Aon Hewitt which is attached. They clearly state that ESG risks need to be managed via a dialogue between the Administering Authority, fund managers and portfolio companies. There preferred route is engagement rather than exclusion and Aon have concerns that excluding stocks will impact negatively on the members. Based on both the directly received legal advice and that of our previous investment consultant, our current policy as expressed in the SIP and Responsible Investment Policy remains appropriate.

Saying that the current approach is appropriate doesn't mean that we can't strengthen our engagement activities. There would be additional costs to operate a passive equity strategy excluding tobacco and thus to meet the best interests of beneficiaries test will require evidence that excluding tobacco will in fact enhance returns. We don't as yet have that advice, in fact the evidence is to the contrary. In recent years tobacco stocks have marginally added to returns.

The Chairman suggested that we take a wider look at the impact of tobacco and consider the public health issues. More work was required on the impact of a tobacco prohibition. It was also agreed that the current feedback on engagement by fund managers to the Corporate Committee lacked detail on the impact of the engagement, in particular what action had companies taken. This issue should be reconsidered at a future Working Group meeting.

9. Any Other Business

There was no other business.

10. Outcomes

a. The Officers in consultation with Mercer and the Independent Advisor to present a new Investment Strategy (Strategic Asset Allocation) to the Corporate Committee on 28 January 2014 recommending that the Committee reduce the allocation to Listed Equities and incorporating allocations to Multi Sector Credit and Infrastructure Debt. In principle the 15% allocation to Index Linked Gilts to be amended to a 10% allocation to Leveraged Index Linked Gilts. This amendment, however to be dependent upon approval following the provision of further training for the Corporate Committee in respect of Leveraged Index Linked Gilts.

b. Further training on Leveraged Index Linked Bonds be provided to members of the Pensions Working Group and Corporate Committee.

c. The next meeting of the Corporate Committee to be recommended to approve rebalancing the Actual Asset Allocation to 10% Property to be funded from the present overweight Listed Equity allocation to Blackrock.

d. Further consideration be given to the wider issues relating to tobacco related investments and that this issue be further discussed at a future meeting of the Pensions Working Group.

e. Improvements be sought to the reporting of the impact of engagement activities carried out by Blackrock and Legal & General.