MERCER

LONDON BOROUGH OF HARINGEY PENSION FUND ("THE FUND")
PROPOSED CHANGES TO THE INVESTMENT POLICY

1. Executive summary

1.1. Although the preliminary actuarial valuation results have revealed that the Fund's funding level is relatively similar to that in 2010 (approximately 70%), the funding deficit has increased by nearly 25% from £296m to £369m. Whilst a return orientated investment policy is necessary to help tackle the funding deficit, we believe the increased pressure and attention on the affordability and stability of contributions now requires a much greater focus on risk management than before.

1.2. On the basis that the Fund requires a return orientated investment policy to help address the funding deficit, we believe it is important to focus on delievering the return in a risk aware manner, exploiting opportunities to invest in a diverse range of return sources, whilst reducing the risk relative to the Fund's liabilities. The proposed changes to the investment policy set out in this paper look to achieve both these key objectives in a consistent manner.

1.3. We support the Pension Working Group's recommendation for the first stage of the proposed changes to the investment policy, which introduces allocations to multi-asset credit and private debt with a corresponding reduction in the Fund's allocation to equities. These changes are achieved whilst maintaining broadly the same expected return overall, but delivering a meaningful reduction in risk relative to the liabilities.

1.4. The Pension Working Group believe it is worth considering leveraged index-linked gilts in more detail and will be undertaking further training and investigations in this area, which we believe would provide an important step in both the short and long term risk management for the Fund.

2. Introduction

2.1. The Pension Working Group has been considering a number of potential changes to the Fund's investment policy, and has recommended the first stage of these proposed changes.

2.2. In this paper, we set out the rationale, and consider the strategic case, for the proposed changes. We also provide our advice regarding implementation options and outline the potential next steps.

3. Background

3.1. At the Pension Working Group meeting on 22 October 2013, we presented a summary of some possible changes to the Fund's investment policy. These included the introduction of two new asset classes in the form of multi-asset credit and private debt, together with a change in the way in which the Fund's existing index-linked gilts are managed; switching the current traditional physical bond allocation to a more flexible and liability orientated

approach, which we refer to as leveraged index-linked gilts. These three areas are discussed in more detail later in this paper.

3.2. The overriding objective of our proposed changes is to achieve broadly the same expected return as the Fund's current benchmark investment strategy, but with the aim of reducing risk relative to the Fund's liabilities. This is achieved through the benefits of diversification away from equities into alternative asset classes providing different drivers of expected return, and a more efficient approach to managing the Fund's liability related risks through the use of leveraged index-linked gilts.

3.3. At the Pension Working Group meeting held on 2 December 2013, investment managers were invited to provide training on each of the three asset classes set out above.

3.4. The Pension Working Goup was comfortable to proceed with the recommendation to introduce allocations to multi-asset credit and private debt, with investments to both asset classes being funded by a corresponding reduction to the Fund's existing allocation to equities. The Pension Working Group decided that further training was required to understand the nature and mechanics of leveraged index-linked gilts.

3.5. Therefore, the Pension Working Group has recommended the initial changes set out in the "Proposed Policy – Step 1" below. If, and when, agreement is reached to proceed with the investment into leveraged index-linked gilts, this would allow capital (5% of total assets) to be released to invest in multi-asset credit. We describe this investment strategy as the "Proposed Policy – Step 2".

4. Current investment strategy and proposed changes

4.1. In considering potential changes to the investment policy, we recognise that although the preliminary actuarial valuation results have revealed that the funding level is relatively similar to that in 2010 (approximately 70%), the funding deficit has increased by nearly 25% from £296m to £369m. Whilst a return orientated investment policy is necessary to help tackle the funding deficit, we believe the increased pressure and attention on the affordability and stability of contributions now requires a much greater focus on risk management than before. We believe it is possible to combine these two aspects in a consistent manner by focusing on investment strategy decisions that consider the impact on both expected return and risk relative to liabilities.

4.2. The table below sets out a summary and analysis of the current investment strategy, together with the proposed changes.

	Current Strategy (%)	Proposed Policy – Step 1 (%)	Proposed Policy – Step 2 (%)
Equities	70.0	60.0	60.0
Private Equity	5.0	5.0	5.0
Property	10.0	10.0	10.0
Multi-Asset Credit	-	5.0	10.0
Private Debt	-	5.0	5.0
Index-Linked Gilts	15.0	15.0	10.0*
Total	**100.0**	**100.0**	**100.0**
Expected return over gilts (% p.a.)	3.5	3.4	3.5
Relative risk (% p.a.)	15.9	15.1	14.8

	Current Strategy (%)	Proposed Policy – Step 1 (%)	Proposed Policy – Step 2 (%)
3 Year estimated 1 in 20 Value at Risk (VaR) based on the preliminary valuation results**	£407m	£393m	£385m

Based on Mercer's central asset class assumptions.

*Under the Propsoed Policy – Step 2, the allocation to index-linked gilts is switched to leveraged index-linked gilts, which are assumed to provide £3 of exposure to index-linked gilts for every £1 invested.

** The VaR is based on the initial actuarial valuation results as at 31 March 2013, and represents an estimate of the increase in expected deficit in three years given a 5% probability.

4.3. Our main observations regarding the current investment policy, and our key objectives for potential changes to the policy, are as follows:

- The Fund's investment policy is currently heavily reliant on equities, which dominate the expected sources of return and risk (equity markets represent approximately 90% of the expected excess return);
- The Fund needs to target a relatively high level of expected return, relative to the liabilties, to help repair the funding deficit;
- We believe the Fund should therefore concentrate on ways to deliver a broadly similar target expected return, whilst seeking to reduce risk (relative to the liabilities).
- The Fund currently has no explicit exposure to the credit risk premium, i.e. the expected additional reward (over the return available on a government bond) an investor can expect to receive for taking on the associated risk of lending to a corporate, including the risk of default, downgrade and illiquidity. The credit risk premium, which along with the equity risk premium, is argualbly the most commonly recognised (and reliable) source of return, and in our opinion should play a strategic role in the investment policy.

4.4. The results of our analysis show that the proposed changes are not expected to have a material impact on expected return, but would importantly lead to a meaningful reduction in risk relative to the Fund's liabilities. The table also shows that Step 2 allows risk to be reduced further, whilst the expected return would also increase modestly from Step 1, and in line with the current strategy. The introduction of leveraged index-linked gilts provides a higher level of liability matching (which is risk reducing), whilst capital is released and available to invest in multi-asset credit (increasing expected return). The policy following Step 2 would remain heavily reliant on equity markets, but the contribution of equities to the total excess return over gilts would reduce to approximately 80%.

4.5. We note that our analysis has been based on the current strategic benchmark. The actual current asset allocation is overweight equity and underweight property. A separate decision has been made to undertake an exercise to rebalance the property allocation back to the strategic benchmark weight of 10% of assets. We are supportive of this decision, given we hold a positive medium term (e.g. 3 to 5 years) outlook for property. We are also supportive of the timing of the proposed changes, which will allow the Fund to crystallise some of the recent strong gains in equity markets.

4.6. In the following sections we set out the key characteristics and rationale for each of the new recommended asset classes.

5. Multi-asset credit

5.1. The table below sets out a summary of the key characteristics of the asset class and the rationale for investment.

		Mercer Comment
What is it?	A single fund offering diversified exposure to a wide range of credit sectors. The approach is actively managed and the allocation to sectors can be adjusted according to a manager's views of their relative attractiveness. Sectors include, but are not limited to, corporate bonds (investment grade and non-investment grade), loans, emerging market debt, asset-backed securities and cash.	We believe multi-asset credit is the most effective, and governance friendly means of accessing a diverse range of credit sectors. We believe the risks associated with credit investing are best managed through an active approach, and therefore passive management is not appropriate for this asset class.
Why invest?	Provides access to higher yielding credit opportunities, with freedom for the manager to rotate between sectors which are cyclical in nature and are expected to behave differently at different stages in the cycle.	Offers good diversification benefits relative to equities. We believe the asset class can play a long term stratgeic role in the portfolio.
Expected return	Typically return objectives are set relative to cash, e.g. LIBOR + 3-5% p.a.	Generally, multi-asset credit managers aim to deliver attractive returns across market cycles by rotating across sectors. Although many funds target absolute returns, there is no guarantee of preserving capital in all environments, for example investors should expect to experience negative returns during periods of market stress.
Key risks	Credit investors are exposed to the risk of default and credit rating downgrades, which may result in loss of capital. There is also an element of illiquidity risk, as it may prove more difficult to realise assets within certain sectors.	We believe active management is an important means of managing default and downgrade risks.
Liquidity profile	Some sectors offer reasonable liquidity, but investors should not expect to be able to realise assets efficiently at short notice in all circumstances. Dealing is commonly available on a monthly or quarterly basis.	Whilst we believe the asset class offers a reasonable level of liquidity, we believe the Fund can afford to take on some illiquidity, which can be expected from certain sectors, and during certain periods of market stress.
Ongoing fees	Typical annual management charges can range from 0.5% to 0.75% p.a. Performance related fees can also apply.	Fees are higher than traditional passive investment grade and government bond funds, reflecting the necessary active management of these mandates.

6. Private Debt

6.1. The table below sets out a summary of the key characteristics of the asset class and the rationale for investment.

		Mercer Comment
What is it?	Privately negotiated lending to 1) corporates, 2) real estate and 3) infrastructure assets. Loans can be issued across the capital structure offering a broad risk/return profile. Terms are typically up to 10 years and investment is usually through closed-ended fund structures.	The Fund already has exposure to property, and would have exposure to corporate debt under a multi-asset credit mandate. Therefore, we believe infrastructure debt offers additional diversification and a potentially complementary exposure for the Fund.
Why invest?	The general withdrawal of bank lending to this market (in the wake of the financial crisis) makes this a particularly attractive opportunity for pension schemes (especially LGPS) to provide funding on terms which offer attractive risk-adjusted returns.	We believe private debt can form a long-term strategic role in the Fund's portfolio, but now offers a particulary opportune time tor investment.
Expected return	Depends on the nature and where the loans sit within the capital structure. Expected net of fee returns can vary significantly from 3-18% p.a., depending on the target risk/return profile.	Mezzanine, or subordinated infrastructure debt funds currently offer prospective returns of c. 8-12%, net of fees.
Key risks	Investors are exposed to the risk of default, which may result in a loss of capital. Private debt is also illiquid, and so investors should be prepared to "lock up" assets for an extended period.	We believe active management is an important means of managing default risk. The illiquidity means the asset class is only appropriate for investors with a long term investment horizon, such as the Fund.
Liquidity	Private debt should be viewed as an illiquid asset class, offering little or no opportunity to realise assets prior to maturity. The typical term of each loan is up to c.10 years with income from interest being paid immediately. In practice, many loans are repaid/refinanced prior to legal maturity, making the liquidity profile relatively more attractive than private equity.	For pension schemes willing and able to take on illiquidty, we believe private debt offers an attractive opportunity, but investors can reasonably expect income and capital to be reapid from a relatively early stage of an investment.
Ongoing fees	Annual management charges vary and are broadly proportional to the target return/risk profile. Typical base fees can range from 0.3% to 1.5% p.a., and performance fees are also common.	The fees reflect the bespoke nature of these investments and the intensive research and due diligience required. For transparency, manager return targets are often set net of fees.

7. Leveraged Index-Linked Gilts

7.1. The table below sets out a summary of the key characteristics of the asset class and the rationale for investment.

		Mercer Comment
What is it?	Funds that use a combination of traditional physical index-linked gilts and derivative based instruments to achieve a higher level of economic exposure to index-linked gilts than is possible through the purchase of traditional physical bonds alone. Typically, it is possible to achieve around three times the exposure to index-linked gilts than through a traditional physical bond fund.	Funds providing leveraged exposure to gilts and other liability matching assets have become mainstream investments for many pension schemes. We believe these funds provide a compelling means for managing liability related risks in a capital efficient manner. These are readily available in pooled fund format and most funds essentially follow a passive management style.
Why invest?	The capital efficiency of these funds means that pension schemes can achieve a higher level of exposure to index-linked gilts (which are the best matching asset for the liabilities) based on their existing allocations. This allows capital to continue to be invested in growth assets to generate the required returns, whilst the increased exposure to index-linked gilts provides increased protection against interest rate and inflation risks, which are some of the largest risks facing most schemes.	Leveraged gilt funds offer flexibility and increased effectiveness for managing interest rate and inflation risks, which can not be achieved to the same extent through investment in physical bonds alone. Leveraged funds allow schemes to address these fundamental risks, whilst continuing to invest in return seeking assets.
Expected return	The return on these funds will be expected to mirror the change in value of the total exposure to index-linked gilts (and in line with changes to the value of the liabilities), less the funding cost associated with achieving leveraged exposure (which will be in line with short term cash rates).	The price of long dated index-linked gilts, and hence the value of the Fund's liabilities, is volatile (and typically will exhibit higher risk than equities).. Leveraged index-linked gilts provide exposure to assets that behave in a similar fashion to the liabilities. Overall, we expect this to result in a meaningful reduction in risk relative to the liabilities.
Key risks	Leveraged exposure is economically equivalent to borrowing cash to buy index-linked gilts. To the extent that this borrowing is arranged over a short period, there are risks associated with the rolling of these positions and the terms for future borrowing. Where transactions are agreed with counterparties, and an exchange of cashflows agreed, there is a credit risk.	A continual process of collateralisation helps to contain counterparty risk to a minimal level. A wide range of instruments and counterparties means that managers are expected to be able to maintain exposure, and manage funding costs appropriately. Sound operational systems and processes ensure that managers are able to manage these risks appropriately.
Liquidity profile	The derivative markets are often much deeper and more efficient than the physical equivalent. Liquidity is generally good, and these funds are typically traded on a regular basis, for example, daily or weekly.	The liquidity and terms for dealing are generally good.

		Mercer Comment
Ongoing fees	On average, fees for passive orientated mandates are not disimilar to the fees payable for traditional passive physical bond mandates (based on total exposure).	Fee levels can start at relatively low levels and are generally competitive, reflecting the passive nature of these mandates.

7.2. Allocations to the alternative asset classes of multi-asset credit and private debt are expected to provide diversification benefits by accessing different drivers of return, which help to reduce overall investment related risk.

7.3. Leveraged index-linked gilts are most effective in reducing liability related risks, i.e. the risks that changes to long term interest rates and inflation (i.e. gilt yields) pose to movements in the value of the liabilities relative to the Fund's assets. To illustrate the magnitude of this risk, we estimate that a 0.5% p.a. fall in interest rates (or equivalently a 0.5% p.a. rise in expected inflation) would be expected to result in an increase in the deficit of approximately £115m, all else equal. The increase in deficit is equivalent to the impact of a fall in the Fund's strategic allocation to equities of approximately 20%, again, all else equal.

7.4. The example above illustrates how relatively small changes in interest rates can have a material impact of the Fund's funding position. In order to better manage and reduce risk, we believe it is important to consider the implementation of leveraged index-linked gilts, which offer a tool for effective risk management both now, and in the future. For example, when the Fund reaches full funding it would make sense for the Fund to look to reduce risk where possible in order to help protect the funding position. Based on the initial actuarial valuation results, the current allocation to index-linked gilts provides a match (or hedge) to approximately 10.5% of the Fund's liabilities.

8. Implementation options and possible next steps

8.1. All of the potentially new asset classes mentioned above are available for investment in pooled fund vehicles. We suggest that the Fund carries out a manager selection process for each asset classes. We believe the selection of a pooled fund manager does not require the Fund to carry out the search and appointment through an OJEU exercise; a view which we understand is supported by CIPFA guidance (since, in the case of pooled funds, these are "off the shelf" products rather than being "investment management services"). We believe that avoiding an OJEU process would be preferable as it will allow the manager appointments to be carried out using a more cost effective selection process using Mercer ratings to form a longlist / shortlist. The timeframe also reduces dramatically. However, we understand that some Funds' procurement teams take a different view; we can work on the basis of full OJEU selections, if required.

8.2. Under our preferred approach, a long list of suitable highly rated candidates could be discussed with the aim of selecting a short list of potentially 3 or 4 candidates. We would be happy to provide a paper setting out detailed analysis and information regarding each of the shortlisted strategies. A manager selection presentation exercise would normally follow to allow a final decision to be made. We believe this process could be carried out over a relatively short period, depending on the timing of meetings.

9. Summary

9.1. On the basis that the Fund requires a return orientated investment policy to help address the funding deficit, we believe it is important to focus on delievering the return in a balanced manner, exploiting opportunities to invest in a diverse range of return sources, whilst reducing the risk relative to the Fund's liabilities.

9.2. We support the Pension Working Group's recommendation for the first stage of the proposed changes to the investment policy, which introduces allocations to multi-asset credit and private debt with a corresponding reduction in the Fund's allocation to equities. These changes are achieved whilst maintaining broadly the same expected return overall, but delivering a meaningful reduction in risk relative to the liabilities.

9.3. Following the implementation of the changes outlined to the investment policy, we believe it is appropriate to review the existing structure of the Fund's equity holdings. We are comfortable with the passive management of equities, but we believe it would be sensible to review the regional structure, assess whether the traditional market capitalisation based indices remain appropriate, and consider the rebalancing arrangements.

9.4. The Pension Working Group believe it is worth considering leveraged index-linked gilts in more detail and will be undertaking further training and investigations in this area, which we believe would provide an important step in both the short and long term risk management for the Fund.

Important Notices

© 2014 Mercer LLC. All rights reserved

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

Steve Turner and Marc Devereux
January 2014