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Investment Strategy Statement

February 2017

Introduction and background

This is the Investment Strategy Statement ("ISS") of the East Sussex Pension Fund ("the Fund"), which is administered by East Sussex County Council, ("the Administering Authority"). The ISS is made in accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 ("the Regulations").

The ISS has been prepared by the Pension Committee ("the Committee") having taken advice from the Fund's investment adviser, Hymans Robertson LLP. The Committee acts on the delegated authority of the Administering Authority.

The ISS, which was approved by the Committee on 27 February 2017, is subject to periodic review at least every three years and without delay after any significant change in investment policy. The Committee has consulted on the contents of the Fund's investment strategy with such persons it considers appropriate.

The Committee seeks to invest in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund's Funding Strategy Statement (dated 01 April 2017).

The suitability of particular investments and types of investments

The primary objective of the Fund is to provide pension and lump sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependants, on a defined benefits basis. This funding position will be reviewed at each triennial actuarial valuation, or more frequently as required.

The Committee aims to fund the Fund in such a manner that, in normal market conditions, all accrued benefits are fully covered by the value of the Fund's assets and that an appropriate level of contributions is agreed by the employer to meet the cost of future benefits accruing. For employee members, benefits will be based on service completed but will take account of future salary and/or inflation increases.

The Committee has translated its objectives into a suitable strategic asset allocation benchmark for the Fund. This benchmark is consistent with the Committee's views on the appropriate balance between generating a satisfactory long-term return on investments whilst taking account of market volatility and risk and the nature of the Fund's liabilities.

It is intended that the Fund's investment strategy will be reviewed at least every three years following actuarial valuations of the Fund. The approach that the Fund has taken to setting an appropriate investment strategy is set out in Appendix A

This approach helps to ensure that the investment strategy takes due account of the maturity profile of the Fund (in terms of the relative proportions of liabilities in respect of pensioners, deferred and active members), together with the level of disclosed surplus or deficit (relative to the funding bases used).

In addition, the Committee monitors investment strategy on an ongoing basis, focusing on factors including, but not limited to:

- Suitability given the Fund's level of funding and liability profile
- The level of expected risk
- Outlook for asset returns

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The Committee also monitors the Fund's actual allocation on a regular basis to ensure it does not notably deviate from the target allocation and has implemented a rebalancing policy Appendix B.

To help clearly define the strategic approach adopted by the Committee it has set out its investment beliefs Appendix C

Investment of money in a wide variety of investments

Asset classes

The Fund may invest in quoted and unquoted securities of UK and overseas markets including equities and fixed interest and index linked bonds, cash, property and commodities either directly or through pooled funds. The Fund may also make use of contracts for differences and other derivatives either directly or in pooled funds investing in these products for the purpose of efficient portfolio management or to hedge specific risks.

The Committee reviews the nature of Fund investments on a regular basis, with particular reference to suitability and diversification. The Committee seeks and considers written advice from a suitably qualified person in undertaking such a review. If, at any time, investment in a security or product not previously known to the Committee is proposed, appropriate advice is sought and considered to ensure its suitability and diversification.

The Fund's target investment strategy is set out below. The table also includes the maximum percentage of total Fund value that it will invest in these asset classes. In line with the Regulations, the authority's investment strategy does not permit more than 5% of the total value of all investments of fund money to be invested in entities which are connected with that authority within the meaning of section 212 of the Local Government and Public Involvement in Health Act 2007".

Table 1: Fund allocation

Asset class	Target allocation %	Maximum invested* %	Role within the Strategy
Listed equities	50.0	55.0	Growth Assets
Absolute Return	20.0	23.0	Growth Assets
Property	10.0	13.0	Growth Assets
Private Equity	5.5	7.5	Growth Assets
Infrstructure	2.0	4.0	Growth Assets
Absolute Return Bonds	3.0	4.0	Matching Assets
Fixed Interest Bonds	3.5	4.5	Matching Assets
Index-Linked Gilts	5.0	6.0	Matching Assets
UK Financing Fund	1.0	2.0	Matching Assets
Cash	0.0	2.0	Matching Assets
Total	100.0		

*The maximum invested figures is based on the rebalancing ranges agreed by the East Sussex Pension Committee within its rebalancing policy.

Managers

The Committee has appointed a number of investment managers all of whom are authorised under the Financial Services and Markets Act 2000 to undertake investment business.

The Committee, after seeking appropriate investment advice, has agreed specific benchmarks with each manager so that, in aggregate, they are consistent with the overall asset allocation for the Fund. The Fund's investment managers will hold a mix of investments which reflects their views relative to their respective benchmarks. Within each major market and asset class, the managers will maintain diversified portfolios through

direct investment or pooled vehicles. The manager of the passive funds in which the Fund invests holds a mix of investments within each pooled fund that reflects that of their respective benchmark indices.

The approach to risk, including the ways in which risks are to be measured and managed

The Committee is aware that the Fund has a need to take risk (e.g. investing in growth assets) to help it achieve its funding objectives. It has an active risk management programme in place that aims to help it identify the risks being taken and put in place processes to manage, measure, monitor and (where possible) mitigate the risks being taken. One of the Committee's overarching beliefs is to only to take as much investment risk as is necessary.

The principal risks affecting the Fund are set out below, we also discuss the Fund's approach to managing these risks and the contingency plans that are in place:

Funding risks

- Financial mismatch – The risk that Fund assets fail to grow in line with the developing cost of meeting the liabilities.
- Changing demographics –The risk that longevity improves and other demographic factors change, increasing the cost of Fund benefits.
- Systemic risk - The possibility of an interlinked and simultaneous failure of several asset classes and/or investment managers, possibly compounded by financial 'contagion', resulting in an increase in the cost of meeting the Fund's liabilities.

The Committee measures and manages financial mismatch in two ways. As indicated above, the Committee has set a strategic asset allocation benchmark for the Fund. This benchmark was set taking into account asset liability modelling which focused on probability of success and level of downside risk. The results from the 2016 analysis highlighted the Fund utilising its current stabilisation parameters lead to a sufficiently high probability of success without being too prudent (71%). The downside risk measure (31% average funding level in the 5% of worst outcomes) highlights the wide range of future outcomes under the current stabilisation parameters. The Committee assesses risk relative to the strategic benchmark by monitoring the Fund's asset allocation and investment returns relative to the benchmark. The Committee also assesses risk relative to liabilities by monitoring the delivery of benchmark returns relative to liabilities.

The Committee also seeks to understand the assumptions used in any analysis and modelling so they can be compared to their own views and the level of risks associated with these assumptions to be assessed.

The Committee seeks to mitigate systemic risk through a diversified portfolio but it is not possible to make specific provision for all possible eventualities that may arise under this heading.

Asset risks

- Concentration - The risk that a significant allocation to any single asset category and its underperformance relative to expectation would result in difficulties in achieving funding objectives.
- Illiquidity - The risk that the Fund cannot meet its immediate liabilities because it has insufficient liquid assets.

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- Currency risk – The risk that the currency of the Fund's assets underperforms relative to Sterling (i.e. the currency of the liabilities).
- Environmental, social and governance ("ESG") – The risk that ESG related factors reduce the Fund's ability to generate the long-term returns.
- Manager underperformance - The failure by the fund managers to achieve the rate of investment return assumed in setting their mandates.

The Committee measure and manage asset risks as follows.

The Fund's strategic asset allocation benchmark invests in a diversified range of asset classes. The Committee has put in place rebalancing arrangements to ensure the Fund's "actual allocation" does not deviate substantially from its target. The Fund invests in a range of investment mandates each of which has a defined objective, performance benchmark and manager process which, taken in aggregate, help reduce the Fund's asset concentration risk. By investing across a range of assets, including liquid quoted equities and bonds, as well as property, the Committee has recognised the need for access to liquidity in the short term.

The Fund invests in a range of overseas markets which provides a diversified approach to currency markets; the Committee also assess the Fund's currency risk during their risk analysis. Details of the Fund's approach to managing ESG risks is set out later in this document.

The Committee has considered the risk of underperformance by any single investment manager and have attempted to reduce this risk by appointing more than one manager and having a large proportion of the Scheme's assets managed on a passive basis. The Committee assess the Fund's managers' performance on a regular basis, and will take steps, including potentially replacing one or more of their managers, if underperformance persists.

Other provider risk

- Transition risk - The risk of incurring unexpected costs in relation to the transition of assets among managers. When carrying out significant transitions, the Committee seeks suitable professional advice.
- Custody risk - The risk of losing economic rights to Fund assets, when held in custody or when being traded.
- Credit default - The possibility of default of a counterparty in meeting its obligations.
- Stock-lending – The possibility of default and loss of economic rights to Fund assets.

The Committee monitors and manages risks in these areas through a process of regular scrutiny of its providers, and audit of the operations it conducts for the Fund, or has delegated such monitoring and management of risk to the appointed investment managers as appropriate (e.g. custody risk in relation to pooled funds). The Committee has the power to replace a provider should serious concerns exist.

A separate schedule of risks that the Fund monitors is set out in the Fund's Funding Strategy Statement.

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The approach to pooling investments, including the use of collective investment vehicles and shared services

The Fund is a participating scheme in the ACCESS Pool. The proposed structure and basis on which the ACCESS Pool will operate was set out in the July 2016 submission to Government.

Assets to be invested in the Pool

The Fund's intention is to invest its assets through the ACCESS Pool as and when suitable Pool investment solutions become available. An indicative timetable for investing through the Pool was set out in the July 2016 submission to Government. They key criteria for assessment of Pool solutions will be as follows:

1. That the Pool enables access to an appropriate solution that meets the objectives and benchmark criteria set by the Fund
2. That there is a clear financial benefit to the Fund in investing in the solution offered by the Pool, should a change of provider be necessary.

At the time of preparing this statement the Fund has elected not to invest the following assets via the ACCESS Pool:

Table 2 – Assets held outside the pool

Asset class	Manager	% of Fund assets	Benchmark	Reason for not investing via the ACCESS Pool
Private Equity	Harbourvest Partners / Adam Street Partners	5.5%	MSCI All Countries World	Existing illiquid asset programmes will run off at normal lifecycle to avoid crystallising exit costs and loss of illiquidity premium earned.
Infrastructure	M & G Infracapital / UBS Infrastructure	2.0%	GBP 3 Month LIBOR	Existing illiquid asset programmes will run off at normal lifecycle to avoid crystallising exit costs and loss of illiquidity premium earned.
Operational cash	East Sussex County Council	0.0%	N/A	East Sussex Pension Fund needs to manage its cash flow to meet statutory liabilities, including monthly pension payroll payments, therefore, a reasonable level of operational cash will be required to maintain efficient administration of schemes and would be held outside the Pool.

Any assets not currently invested in the Pool will be reviewed at least every three years to determine whether the rationale remains appropriate, and whether it continues to demonstrate value for money. The next such review will take place no later than 2018.

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Structure and governance of the ACCESS Pool

East Sussex is a member of the ACCESS pool along with the following 10 other pension funds:

Cambridgeshire	Kent
Essex	Norfolk
Hampshire	Northamptonshire
Hertfordshire	Suffolk
Isle of Wight	West Sussex

All eleven funds are committed to collaboratively working together to meet the criteria for pooling and have signed a Memorandum of Understanding to underpin their partnership (will be updated for IAA). ACCESS is working to a project plan in order to create the appropriate means to pool investments. The first investments to be pooled in 2017 will be passively managed investments.

The ACCESS Funds have set out how they meet the pooling criteria, the pool's structure, governance arrangements and services to be shared in the submission made to the Government in July 2016, which is available on ACCESS's website http://www.accesspool.org/

How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments

It is recognised that ESG factors can influence long term investment performance and the ability to achieve long term sustainable returns. The Committee consider the Fund's approach to responsible investment in two key areas:

- **Sustainable investment / ESG factors** – considering the financial impact of environmental, social and governance (ESG) factors on its investments.
- **Stewardship and governance** – acting as responsible and active investors/owners, through considered voting of shares, and engaging with investee company management as part of the investment process.

The Committee takes ESG matters very seriously and conducts a review of its policies in this area and its investment managers' approach to ESG.

At the present time the Committee does not take into account non-financial factors when selecting, retaining, or realising its investments. The Committee understand the Fund is not able to exclude investments in order to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

To date, the Fund's approach to Social investments has largely been to delegate this to their underlying investment managers as part of their overall ESG duties.

The Fund does not hold any assets which it deems to be social investments.

The exercise of rights (including voting rights) attaching to investments

Voting rights

The Committee has delegated the exercise of voting rights to the investment manager(s) on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. Accordingly, the Fund's managers have produced written guidelines of their process and practice in this regard, which is considered as part of the appointment of an investment manager process. The managers are strongly

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encouraged to vote in line with their guidelines in respect of all resolutions at annual and extraordinary general meetings of companies under Regulation 7(2)(f).

Stewardship

The Committee understands that stewardship aims to promote the long term success of comapines in such a way that the ultimate providers of capital also prosper. The Committee encourages it's investment managers to formally agreed to adhere to the Stewardship Code as published by the Financial Reporting Council. Asset manager signatories have been categorised in three tiers.

- **Tier 1** – Signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.
- **Tier 2** – Signatories meet many of the reporting expectations but report less transparently on their approach to stewardship or do not provide explanations where they depart from provisions of the Code.
- **Tier 3** – Significant reporting improvements need to be made to ensure the approach is more transparent. Signatories have not engaged with the process of improving their statements and their statements continue to be generic and provide no, or poor, explanations where they depart from provisions of the Code.

Investment Managers Stewardship Rating

Tier 1

- Legal and General Investment Managers
- State Street Global Advisors
- Newton Investment Managment
- Ruffer LLP
- Schroder Investment Manangment Limited
- M & G Investment Managment
- Longview Partners
- UBS Asset Management
- Northern Trust Global Investments

Tier 2

- None

Tier 3

- None

The Committee expects both the ACCESS Pool and any directly appointed fund managers to also comply with the Stewardship Code.

As part of its belief in the benefits of the Stewardship Code the Fund has adopted a set of Voting Intention Guidelines. The current guidelines can be found on the Fund's website.The Committee publishes an annual report of voting activity as part of the Fund's annual report. In addition to the Fund's views on the Stewardship Code, the Fund believes in collective engagement and is a member of the Local Authority Pension Fund Forum (LAPFF), through which it collectively exercises a voice across a range of corporate governance issues.

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Appendices

Appendix A – Investment Strategy Approach

Appendix B – Rebalancing Policy

Appendix C – Investment Beliefs

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Appendix A

Investment Strategy Approach

The investment strategy of the East Sussex Pension Fund is designed to guide the selection of its investment portfolio and is expressed as its asset allocation decisions. The various factors which the Fund uses to construct its investment strategy are split into two stages:

Stage 1 - high level decision

- long term funding objectives
- Broad level of risk and expected return
- Split between Growth (return-seeking) / Income / Protection Assets

Stage 2 – detailed allocations / mandates

- Specific allocations within growth, income and protection
- Allocations to other asset classes
- Nature of investment manager mandates
- Links with asset pooling

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Long term funding objectives

The long term funding objectives are considered in line with triennial actuarial valuation of the Fund. These objectives can be split into Medium and Long term objectives:

Medium term objectives

Close the deficit and get to a fully funded position:

- Pay in contributions towards the deficit
- Take an appropriate level of investment risk

To be fully funded by the year 2036 (determined as part of actuarial valuation process)

Long term objectives

To maintain the fully funded position once achieved (The steady state) and this is a balance between:

- An affordable level of ongoing contributions
- An appropriate level of investment risk (or "target return")

Appendix A

Broad level of risk and expected return

To assist the Fund in assessing its level of risk it employs Asset Liability Modelling this consits of generating forward projections with a range of potential outcomes and consider the chances of those outcomes happening. The key inputs and assumptions used in this modelling are:

The Fund's liability data - from the actuary

- Updated as at March 2016 (actuarial valuation)

Potential investment returns from asset classes

- Expected returns
- Variability of potential returns
- Correlations between types of investment

Future levels of inflation and interest rates

- Consider a wide range of scenarios
- Linked to expected investment returns

Split between Growth (return-seeking) / Income / Protection Assets

From the Asset Liability Modelling the level of risk that the Fund is confortable with to achive its objectives can then be used to devlop the split between growth and protection assets. Other factors are also taken into consideration at this point such as the fact that the Local Government Pension Scheme as a whole is maturing. Cash flow reflections need to be made to ensure that there is an appropriate level of Income being generated by the Funds investments to ensure it does not become a forced seller of assets to meet its liabilities.

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Rebalancing Policy

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Assessment of Fund's rebalancing needs

Background

The long term investment strategy for the Fund is set by the Committee and is defined in terms of target allocations to a series of specific asset classes and manager mandates. It is the key decision in terms of the level of investment risk being taken and the returns which will be earned by the Fund.

Why rebalance?

The Fund's actual asset allocation can deviate from the strategic benchmark for a number of reasons including:

- Market movements

- Fund manager under/outperformance relative to benchmark

- Income distribution

Systematic rebalancing has proved over time to be a successful investment discipline. It encourages investors to sell assets which have performed well (thus crystallising profits and selling expensive assets) and to buy assets that have performed less well (thus purchasing favoured asset classes at attractive valuations). This generally improves performance because of the inherent volatility of growth assets. Rebalancing also helps retain the agreed risk profile of the investment portfolio.

Introducing a tolerance range around each component within the strategic asset allocation allows for a degree of flexibility in managing the investment strategy. For example, subject to ranges not being breached, a decision may be taken to rebalance to an asset class other than the most underweight if, say, the cost of investing in that asset class is considered to be particularly high or an appealing investment opportunity presents itself elsewhere.

Asset Allocation Drift

To illustrate the effects of rebalancing, we have analysed a generic portfolio initially split 50% / 50% between equities and bonds over the period from 1999 to 2015. The chart below shows how the asset allocation of this portfolio would have evolved over the period without any rebalancing being implemented.

Effect of market returns on asset allocation

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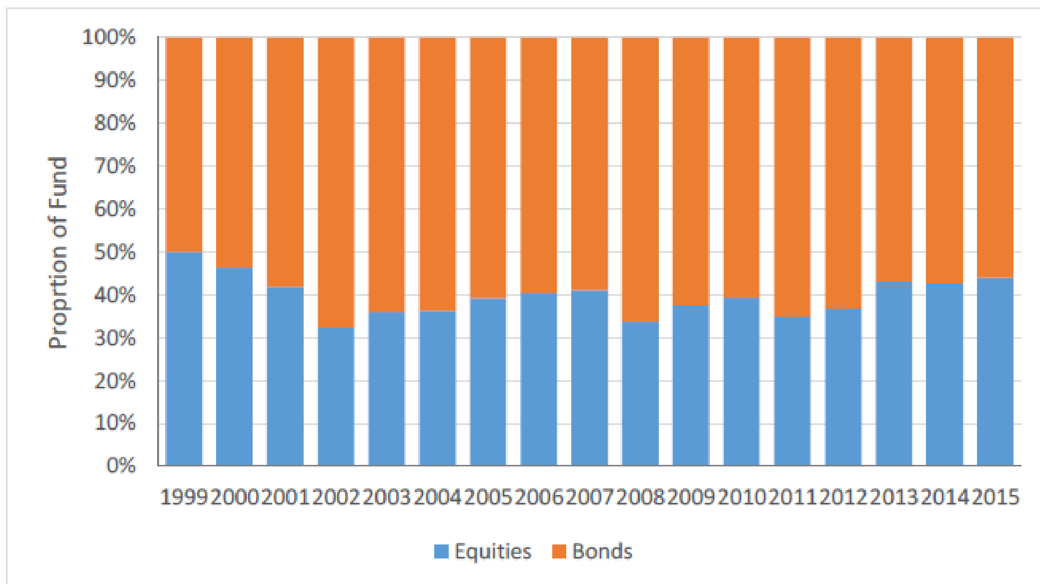

Note: Allocations are shown as at the end of each year.

Note that, by the end of 2002, our hypothetical portfolio would have become too conservative, with only 34% in equities and 66% in bonds ahead of the strong equity market rally starting in 2003, thereby not reaping the proper benefit. For similar reasons, many portfolios drifted overweight to equities over the period 2003-7, leaving investors over-exposed to the sharp equity market falls that were witnessed in 2008.

Over long periods of time, a portfolio will experience rising as well as falling markets, so the divergence from asset allocation will be mitigated over time. However, what is important is the effect these deviations will have on the return achieved by the portfolio over time. The table shows the effect of rebalancing on the returns from our hypothetical portfolio assuming it was invested over the period from 1 January 1999 to 31 March 2016.

Portfolio	Cumulative return (%)	Average return (% p.a.)
Not rebalanced	220.2	5.0
Rebalanced	232.4	5.3

Note: Annual rebalancing to the 50% / 50% target is assumed. Transaction costs are ignored.

Rebalancing Approach

We have applied financial theory and some historical analysis to illustrate the potential benefits of rebalancing. In broad terms, these can be summarised as locking in gains from outperforming asset classes and, in the process, ensuring that the returns achieved remain close to those of the strategic asset allocation benchmark itself.

In practice, of course, there are a number of factors which need to be considered and which may influence the particular approach taken to establishing a rebalancing process. These include:

- **Liquidity** - while some asset classes are highly liquid and easily tradable (for example, quoted equities and bonds), many others are less easily traded and are more difficult and expensive to transact (for example, property and alternative assets). In addition, dealing opportunities may be limited by the available dealing dates for particular pooled funds.

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- **Dealing Costs** - as explained earlier, frequent rebalancing may simply incur additional costs. It is important to note that such costs vary between markets and over time so any process needs to be reviewed from time to time.
- **Administration** - irrespective of the approach taken, a simple set of rules needs to be implemented by one or more parties; this argues in favour of avoiding unnecessarily complex solutions.
- **Flexibility** – it is important to retain the option of amending the rebalancing process or indeed suspending it altogether, depending on changes in market conditions or practice. Many rebalancing programmes were suspended in 2008 in the light of the extreme market volatility and a sharply downward movement in equity prices seen at that time.

In general, the more complex the investment manager arrangements, the more difficult it becomes to implement rebalancing.

It may help to illustrate some of these concepts in a simple example, using a single scheme with one balanced mandate operated by a single investment manager. The table below summarises a possible rebalancing programme.

Asset Class	Target Asset allocation benchmark %	Rebalancing Ranges % (Simple)	Rebalancing Ranges % (Weighted)
UK Equity	30	25 – 35	25 - 35
Overseas Equity	30	25 – 35	25 - 35
Gilts	10	5 – 15	8.5 – 11.5
Corporate Bonds	20	15 – 25	17 – 23
Index Linked Gilts	10	5 – 15	8.5 – 11.5

In this case, the simple approach is to implement ranges of “+ or - 5%” around the central benchmark. Clearly, the sub-division of asset classes could be extended further to include regional equity markets and other assets. It would be possible to add a further limit on the total equity exposure, taking UK and Overseas together.

In the more complex approach on the right of the table, the ranges themselves vary according to the central benchmark allocation. If one of the principal benefits of a rebalancing programme is to capture the relative outperformance of one asset class versus another, then it makes sense for the permitted ranges to reflect the relative significance of each asset class within the strategic benchmark. In our example, starting from the central position, an outperformance of 20% from gilts relative to other assets would take the gilt weight to around 12% and would fail to trigger a rebalance under the simple ranges - but it would trigger a rebalance under the weighted approach. We are naturally attracted to the latter for this reason, but, in practice, we recognise the merits of the simpler approach.

Rebalancing for the Fund – General Rules

The following general rules will determine how a rebalancing process for the Fund will operate.

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- **Rebalancing would apply only to equities, absolute return funds and bonds** - Due to the transaction costs and illiquidity associated with the other investments such as property, we propose that rebalancing for those asset classes be considered on an annual/ad hoc basis; for the purposes of this document we consider rebalancing between equities, absolute return funds and bonds, rebalancing within bond allocations across bond categories and rebalancing within the equity allocation across different managers.
- **Rebalancing would be monitored on a quarterly basis**
- **Each benchmark allocation would have a weighted tolerance range –** A tolerance range will be defined for growth and matching assets and each underlying mandate; these tolerance ranges will be used in determining when rebalancing will occur; the tolerance ranges could be weighted relative to the absolute amount of the benchmark allocation or the simple approach set out above.
- **Cash holdings to be used for rebalancing**. Where possible any net investments or disinvestments should be used to manage allocations, for example, by investing any surplus cash into the most underweight asset class.
- **Rebalancing will occur at two levels; at the growth vs matching level, and at the mandate level –** The rebalancing process will determine if rebalancing is required between growth and matching assets, and separately if rebalancing is required between underlying mandates. However, it is more important to be willing to incur transaction costs if necessary to rebalance between bonds and equities, for example, than switching between managers with similar mandates (eg. Longview and L&G global equities).
- **Rebalancing transactions will aim to rebalance allocations outwith their tolerance ranges to the midpoint (at least) of the tolerance range –** The mid-point of the tolerance range is the mid-point between a benchmark allocation and its upper or lower tolerance limit. Assuming an asset class with a 60% allocation and a 54%-66% tolerance range, the upper mid-point would be the halfway point between 60-66% (i.e. 63%). The lower mid-point would be the halfway point between 54% and 60% (i.e. 57%). Analysis suggests that this is the best way of balancing the impact of transaction costs against returns.

The allocations to private equity and infrastructure (and to a lesser extent property) will vary with general market movements and are not easily altered, due to the illiquid nature of the asset classes. Therefore we would not recommend any rebalancing to be carried out in relation to the Fund's private equity or infrastructure investments. We also note that Schroders have been instructed to distribute income from the underlying property funds from Q2 2016 onwards and this should help towards reducing the current overweight to property over time. Taking into consideration the time it takes to undertake property transactions and the associated transaction costs, we suggest that any further rebalancing is carried out on an ad-hoc basis taking into account market conditions at the time.

Rebalancing Ranges

The following ranges have been agreed by the committee to set as points as to which rebalancing should take place.

Asset class	Strategic target (%)	Range
Listed Equities	50.0	+/-5
Private Equity	5.5	+/-2

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Absolute Return	20.0	+/-3
Property	10.0	+/-3
Infrastructure	2.0	+/-2
Growth Assets	**87.5**	**+/- 5**
Absolute Return Bonds	3.0	+/-1
Fixed Interest Bonds	3.5	+/-1
Index-Linked Gilts	5.0	+/-1
UK Financing Fund	1.0	+/-1
Cash	0.0	+/-2
Matching Assets	**12.5**	**+/-5**
Total	**100.0**	

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Investment Beliefs

February 2017

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Investment beliefs

Background

Good governance

A number of studies have been carried out to help define what makes a good pension fund. Many of these studies have cited clarity of objectives, focus on investment strategy and understanding and managing key risks as being core attributes. However, one other feature often cited, but often overlooked by decision makers, is having a well-defined set of investment beliefs in place.

Investment beliefs

Beliefs are, by definition, unique to each pension committee or trustee body. They reflect the way in which committees (explicitly or implicitly) translate a fund's objectives into its actual investment arrangements. For example, you can have two funds, with broadly similar characteristics and objectives, but very different investment arrangements e.g. the extent of their use of diversification, active and passive management, regional equity exposures, approach to environmental, social and governance matters etc. all because the committees' beliefs are very different.

Having a well-defined set of investment beliefs offers a number of advantages, including:

1. **Clarity of why each mandate is held and the role it performs in the Fund's arrangements** – this clarity is of benefit to committees and the underlying members. It also offers a basis for framing external communication on investment strategy which is of particular relevance where decisions are subject to public scrutiny.

2. **Prioritisation** - having identified which investment decisions are most important, advice can be sought and meetings scheduled around these key priorities.

3. **Long-term thinking** - having a set of stated beliefs, committees are better able to avoid being unduly influenced by short-term market noise and "fads".

4. **Consistency, both of advice and decision-making** – meaning all decisions are reached using the same consistent framework.

5. **Continuity of understanding in decision-making** – having a decision making framework based on a set of beliefs allows decisions to be contextualised which is particularly valuable if there is regular turnover of committee members, i.e. the committee may not "own" the decision on a certain element of the investment strategy, but as they own the framework, they can better understand why the decision was taken.

There is no right answer when it comes to setting beliefs, with each scheme's beliefs being unique, depending on their specific circumstances and their trustees' views. A scheme's beliefs should be revisited on a regular basis to ensure they remain appropriate. It is also important that these beliefs are reflected in the underlying portfolio of assets and in the scheme's ways of working.

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Fund specific investment beliefs

The Pension Committee have prepared a set of investment beliefs based on their experience of the workings of the Fund and the nature of the underlying investments held. These are set out below:

Belief: Clear and well defined objectives are essential to achieve future success

The Committee is aware that there is a need to generate a sufficient level of return from the Fund's assets, while at the same time having a clear understanding of the potential risks and ensuring there is sufficient liquidity available to pay members' benefits as they fall due.

Belief: Strategic asset allocation is a key determinant of risk and return, and thus is typically more important than manager or stock selection

The Committee understands that having the appropriate strategy in place is a key driver of the Fund's future success. As a result, priority is given to more strategic investment matters.

Belief: Funding and investment strategy are linked

The Committee understands that a number of funding related aspects feed into investment strategy decisions, including maturity, sponsor covenant and level of required return. Given this, actuarial and investment matters, most notably setting investment strategy, are looked at in tandem by the Committee.

Belief: Long term investing provides opportunities for enhancing returns

The Committee believes that investors with long term time horizons are typically less constrained by liquidity requirements and able to better withstand periods of price volatility. As a long term investor, the Fund may choose to gain additional compensation by investing in assets that are illiquid (e.g. property, infrastructure and private equity) or may be subject to higher levels of volatility (a premium return is required for any such investments). Having this long-term focus also helps the Fund tolerate periods of active manager underperformance when the manager's investment style is out of favour with the market.

Belief: Equities are expected to generate superior long term returns

The Committee believes that, over the longer term, equities are expected to outperform other liquid assets, in particular government bonds. The Committee is therefore comfortable that the Fund maintains a significant allocation to equities in order to support the affordability of contributions..

Belief: Alternative asset class investments provide diversification

The Committee believes that diversification across asset classes can help reduce the volatility of the Fund's overall asset value and improve its risk-return characteristics. The Committee believes that investing across a range of asset classes (including, but not restricted to, equities, bonds, absolute return funds, infrastructure and property) will provide the Fund with diversification benefits.

Belief: Government bonds provide liquidity and a degree of liability matching

Government bonds have characteristics that are similar to the assumptions used in valuing pension liabilities e.g. sensitive to changes in interest rates and (for index-linked) to changes in market-implied inflation. This makes them a suitable asset for reducing the Fund's funding risks. In addition, this asset class has proven to be highly liquid at times of market stress, enabling it to be used for rebalancing and to help meet any outflows that may fall due. Given this, the Committee hold a proportion of the Fund's assets in this asset class.

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Appendix C

Belief: Fees and costs matter

The Committee recognises that fees and costs reduce the Fund's investment returns. The Committee considers the fees and costs of its investment arrangements to ensure the Fund is getting value for money and to minimise, as far as possible, any cost leakages from its investment process.

Beliefs: Rebalancing can add value

Academic studies show that regular rebalancing can help add value over the long-term. As a result, the Fund has put in place agreed tolerance ranges for their liquid assets, with the intention that assets will be rebalanced, at least towards target, should these ranges be breached.

Belief: Active management can add value but is not guaranteed

The Committee recognises that certain asset classes can only be accessed via active management. The Committee also recognises that active managers may be able to generate higher returns for the Fund (net of fees), or similar returns but at lower volatility, than equivalent passive exposure. The Committee will aim to minimise excessive turnover in its active managers. By carefully selecting and monitoring active managers and recognising that periods of underperformance will arise, the Committee seeks to minimise the additional risk from active management, and continue to monitor active managers to ensure their mandates remain appropriate for the Fund.

Belief: Passive management has a role to play in the Fund's structure

The Committee recognises that passive management allows the Fund to access certain asset classes (e.g. equities) on a low cost basis and when combined with active management can help reduce the relative volatility of the Fund's performance.

Belief: Choice of benchmark index matters

The Committee recognises that, for each asset class, there is a range of benchmark indices that they could use. As a result, the Committee focus on the benchmark's underlying characteristics and consider how they may be appropriate for the Fund. Choice of benchmark is particularly relevant for passive mandates where the manager's job is to track the index as closely as possible.

Belief: Environmental, social and corporate governance ('ESG') issues can have a material impact on the long term performance of its investments

The Committee recognises that ESG issues can impact the Fund's returns and reputation. Given this, the Committee aims to be aware of, and monitor, financially material ESG-related risks and issues through the Fund's investment managers. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations.

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