Proposed equity allocations

Introduction

This paper is addressed to the Pensions Committee ("the Committee") of the East Sussex Pension Fund ("the Fund"). It should not be disclosed to any third parties without our prior written permission. We accept no liability to any third party relying on the advice or recommendations in this paper.

Background

In this paper, we have reviewed the target allocations for the Fund's equity investments against the background of the following:-

- The appointment by ACCESS of UBS as the provider of passive (index tracking) management services to funds as part of pooling. The intention is for each participating fund to arrange transfer of their passively managed assets to UBS in the first half of 2018.
- The discussions with the Committee on potentially introducing 'low carbon' equity funds into the Fund's structure, particularly for equity assets managed on a passive basis.
- The discussions with the Committee regarding the scale of exposure to the US stock market and US dollar in the current structure.

Current equity allocation

The Fund's current equity mandate allocations are as follows:-

		Target allocation (% of equities)	Target allocation (% of Total Fund)	Actual allocation* (% of Total Fund)
Longview	Active Global Equity	10	**5.0**	7.1
Legal & General	Passive – UK Equity	24	**12.0**	9.8
Legal & General	Passive – Global Equity	31	**15.5**	16.7
State Street	Passive – Global Equity – RAFI 3000 Index	35	**17.5**	19.9
		100	**50.0**	**53.5**

*As at 30 September

The split between active and passive management within equities is currently 10%/90%. However, we have recommended previously that the Committee look to increase the relative allocation to active management when funds are available through the ACCESS pool.

Market movements over the last year have led to an overweight allocation to the global mandates and an underweight allocation to the UK mandate. A rebalancing from global equities into absolute return funds is being implemented this quarter.

If we take the benchmarks for each of the mandates, then we can calculate the benchmark allocations to each of the regional equity markets on the basis of (1) allocations being in line with targets and (2) the actual position at 30 September, as follows:-

	At target allocations (%)	Actual allocations at 30 September (%)		*% global market capitalisation (for reference) – FTSE All World*
UK	29.7	24.5		*6.2*
N America	37.5	40.3		*54.3*
Europe ex UK	14.0	15.0		*15.7*
Japan	7.0	7.5		*8.3*
Asia ex Japan	4.5	4.8		*5.9*
Emerging Markets	7.3	7.9		*9.6*

Proposals

Low carbon equity funds

In our discussions at the last Committee meeting, we highlighted a number of passively managed equity funds which attempted in various ways to reduce the 'carbon footprint' of the underlying investments. Some of these funds adopted different indices – constructed using an alternative methodology; others attempted to track 'conventional' market cap based indices whilst exercising a form of 'low carbon' overlay. The UBS fund which we featured falls into the latter category.

The **UBS Climate Aware World Equity fund** aims to deliver returns broadly in line with the global FTSE Developed Index, though holdings in the underlying constituents of the index will be varied depending on their expected contributions to climate change. The anticipated tracking error around the index of the fund is +/-0.5% p.a. If these objectives are achieved, then the Committee can expect the same long term returns from this fund as they would from a conventional market cap based investment in developed market equities. A fuller explanation of the fund's approach is contained within the UBS brochure – attached as an appendix.

The UBS fund is relatively new, as are many in this specialist area. Its inception date was February 2017 and at the end of September it had only £200m of assets. Over its (very short) life, it has delivered a return 0.22% above its benchmark index. UBS are still to confirm the annual charges for investing in this fund as it did not form part of their tender submission to ACCESS.

Further to our previous discussions on carbon exposure – proposing that active managers retain responsibility for stock selection and review the Fund's approach to passive investment, an allocation to this fund would be a positive way of implementing change within the Fund's equities.

US exposure and regional weights

In terms of achieving a better balance of investment across regions, we would have a preference for a lower allocation to UK equities than implied under current target allocations (29.7% above) – preferring the 20%-25% level as held at the moment.

The high US allocation is consistent with the large market capitalisation of the US stock market. However, we believe there is an argument for equity portfolios being more evenly balanced over time between regions based on relative economic weights rather than pure stock market size. This would argue for a lower US weighting in the 30%s rather than the current 40%, and a slightly higher allocation to Europe.

Elsewhere, we would want to ensure a material allocation to emerging markets is maintained. The FTSE Developed index (the UBS benchmark) has no exposure to emerging markets so any new investment in the Climate Aware fund would require an increased emerging markets allocation elsewhere in mandates.

We also need to bear in mind that the Committee may decide to fund a new active global equity manager within the ACCESS pool, funded from the passive equity investments, which may be managed against a market cap based global index.

Potential allocations

We have set out allocations below which comprise investment in three types of passive equity fund with UBS:-

- Market cap based regional index funds
- RAFI 3000 World index fund
- Climate Aware World Equity fund (subject to Committee discussion and clarity on fees)

In terms of implementation, the Committee can agree target allocations to the Longview mandate and the RAFI 3000 and Climate Aware funds, and those mandates will be invested in line with the relevant benchmarks. The Committee can then agree overall target allocations on a regional basis, and the investments in the regional index funds with UBS can be determined in order to achieve the overall targets.

- We propose that the allocation to Longview is maintained at the current level – namely 7% of the Fund (and 14% of total equities).
- We have proposed that the current State Street RAFI allocation is divided equally between the UBS RAFI product and a holding in the Climate Aware fund – maintaining the combined allocation of 20% of the total Fund.
- We have suggested a new target regional split in line with our comments above as follows[1]:-

	At current target allocations (%)	Actual allocations at 30 September (%)	Proposed new target allocations (%)
UK	29.7	24.5	25
N America	37.5	40.3	35
Europe ex UK	14.0	15.0	20
Japan	7.0	7.5	7
Asia ex Japan	4.5	4.8	5
Emerging Markets	7.3	7.9	8

[1] Target at time of investment. The underlying regional split of the global benchmark move over time, reflecting market movements.

The implied breakdown of investments arising from the above is shown below.

		New target allocation (% of equities)	New target allocation (% of Total Fund)
Longview	Active Global Equity	14	**7.0**
UBS	Passive – Global Equity – RAFI 3000 Index	20	**10.0**
UBS	Passive - Climate Aware World Equity fund	20	**10.0**
UBS	Passive – Regional (market cap) index funds	46	**23.0**
		100	**50.0**

We are aware that a number of different iterations are possible with the above but regard this as a useful starting point to aid discussions.

We will be able to calculate and reconfirm detailed allocations and benchmarks for implementation of alternative targets following discussions at the meeting.

We look forward to discussing these issues with the Committee.

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For and on behalf of Hymans Robertson LLP

Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.