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East Sussex Pension Fund

Investment Beliefs

September 2019

Fund specific investment beliefs

The Pension Committee has 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 holds a proportion of the Fund's assets in this asset class.

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 focuses on the benchmark's underlying characteristics and considers 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 believes that companies with a responsible ESG policy are expected to generate better sustainable returns than companies with either a weak or no ESG policy, over the longer term. The Committee is reviewing its approaches to engagement and voting and will consider its ESG aims when constructing the Fund's investment portfolio. Divestment will remain the ultimate sanction for the Committee but will only be considered if prolonged engagement is viewed as being unsuccessful. The Committee intends to make use of collaboration with other funds to pursue their ESG objectives, including through being members of various bodies where this is felt to be effective. The Committee is also committed to an ongoing and continuous development of its ESG policy to ensure it reflects latest industry developments and regulations.

In addition, the Committee has agreed a set of beliefs in relation to the potential impact of climate change on the Fund's investments.

Belief: Climate change presents a financial risk to the future investment returns from the Fund.

The Committee recognises that climate change issues can impact the Fund's returns and reputation. The impacts of climate change on the returns from the Fund in the future are unknown at this point but the Committee recognises that they need to allocate sufficient time and resource to monitor the possible risks and also identify any investment opportunities which may become available as a result. A carbon measurement report will be commissioned periodically from a specialist provider.

The Committee believes that Climate change is a long-term material financial risk for the Fund, and therefore has the potential to impact our beneficiaries, employers and all our holdings in the portfolio. As a long-term investor, the Committee is aware that a transition to a low-carbon economy brings with it opportunities/risks and at all times the Committee need to balance that with having a clear focus on the financial performance of our portfolio.

The Committee recognises the need to integrate our climate goals with our wider programme of responsible investment, in particular the social impacts of transition, and will look for investment opportunities to support the Sustainable Development Goals and the Paris commitment for an orderly and just transition.

Belief: Close engagement with - and challenge to - the investment managers will improve understanding of these risks.

The Committee believes that investors with long term time horizons are more exposed to certain risks and requires that its investment managers are aware of and consider these when making investments. It is acknowledged that investment managers carry out detailed research on the prospects for individual companies and industries and have access to company management. The Committee meets with investment managers at their regular meetings and has the opportunity to discuss relevant developments in detail. To challenge investments to ensure these are being followed and that all relevant risks have been considered.

Belief: Individual stock selection decisions will be delegated to active managers but the Fund will retain the right to sell holdings in exceptional circumstances.

The Committee believes that it is the role of its active managers to do the necessary due diligence on each individual stock selection they make. The Committee requires that its active managers provide on request the investment rational for each investment that the have made. Where the Committee has determined through this engagement with the active manager that the risks posed by a stock outways the potential gain they will retain the right to instruct its active managers to sell those holdings. As a result, no restrictions are currently placed on the Fund's active investment managers.

Belief: The Fund will aim to collaborate with other investors where this is expected to have a positive impact

The Committee recognises that through active shareholder engagement it can get those companies it is invested in to improve their corporate behavior. Improvements made by these engagements lead to an increase in the long term value of the Fund's investments. The Committee believes that these can be maximized by collaborating with other like minded investors to increase the pressure for change and encourages improvements to be made.

Belief: The nature of the underlying benchmark is an important consideration, most notably for passive mandates.

The Committee understands that the underlying benchmark they set their investment managers will drive the behavior of the managers and the investment risks they will take. The Committee also recognises that for its passive mandates the manager will only buy the stocks within the benchmark they are tracking. The Committee understands that to ensure it is investing in the way that meets the needs of the Fund it needs to ensure it provides suitable benchmarks for each investment mandate. Therefore, the choice of benchmark index by the Committee is very important, it continue to explore the potential for using low carbon indices.