

EAST SUSSEX PENSION FUND



Annual strategy day

- Linda Selman, Partner
- William Marshall, Partner
- 29 September 2015

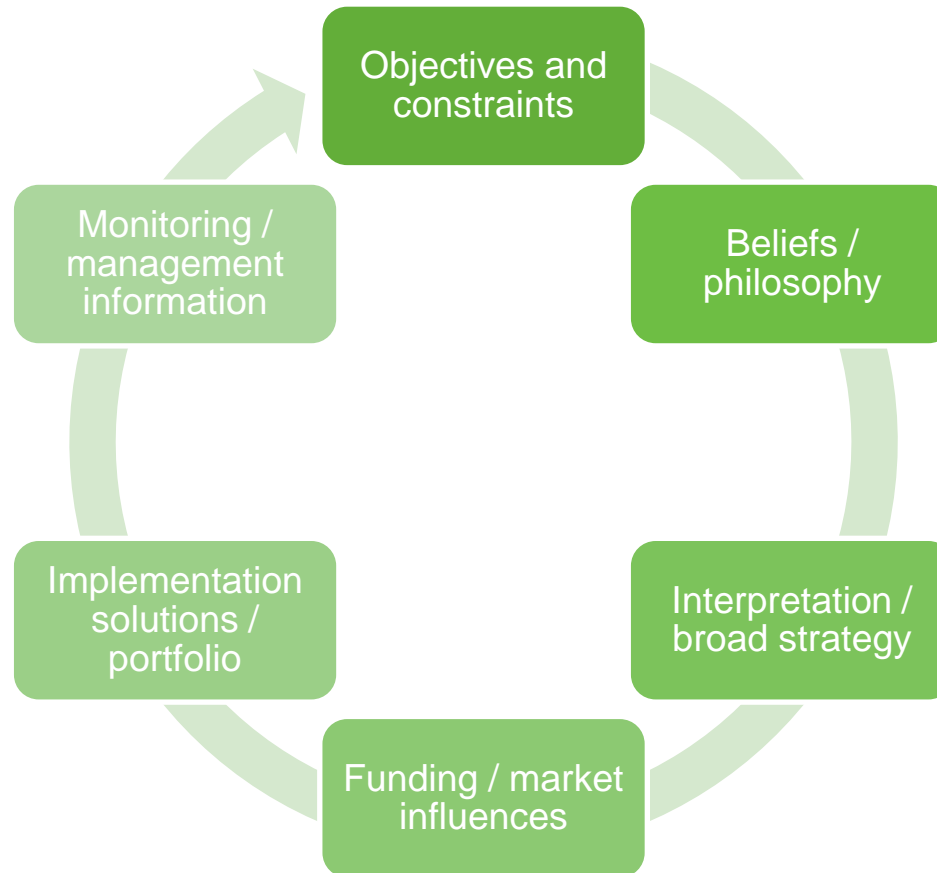
Vision

Characteristics of top performing funds (or businesses more generally) tend to include:

- Clarity of what they are trying to achieve.
- Clear objectives and targets and vision of what success looks like.
- A clear understanding of the constraints they are working within.
- A philosophy / set of beliefs (in businesses this may extend to culture) that act as a filter on the “how” things are achieved.
- A clear line of sight from this philosophy / beliefs to the actions taken – in investment terms this is a clear line of sight from beliefs to the portfolio structure. This usually requires some kind of interpretation of the beliefs and what they mean in practice.
- As a result, an ability to explain why things are the way they are – or even to be in a position where they don’t need to.
- They are dynamic in that they respond to changing conditions – whether that be market conditions, industry developments or funding level influencing the interpretation of objectives and beliefs into a portfolio or changing objectives or constraints impacting the portfolio structure.
- There are contingency plans – an element of hoping for the best, planning for the worst - in portfolio terms this can be translated into being as robust as is possible to a range of different economic scenarios (acknowledging that it is not possible to be fully robust to all potential outcomes).
- They are learning organisations in that they seek to improve, learn from experience (mistakes even) and don’t shy away from realising there may be a better way. This involves a strong feedback loop looking at outcomes (good management information, including focus on leakages) and re-testing the inputs (the objectives, constraints, beliefs, interpretation and ultimately the portfolio).
- Lastly, a quote often used about success – “Success without a successor is a failure” – for sustainable success it needs to be successful across generations or eras.

A useful tool in developing this approach is a strategy manual which captures the why, what and how of strategy for the Fund and is a live, reference document for Officers, Committees and Advisors when assessing potential changes to, and performance of, the Fund. It should be a goal to develop a clear manual.

Virtuous cycle



Aim is to develop clear line of sight around cycle

Investment structure of top 10 LGPS funds 2005-12

Characteristic	Implication	Caveat
Short manager roster	Reduced governance demands – time to focus on strategy	You need the right managers
Low manager turnover	Reduced costs (transitions)	You need the right managers and patience
Simple structure – equities, bonds and property	Reduced governance demands Avoid ‘fads’	‘Fads ‘ may add value Rebalancing discipline required
Some internal management	Better governance and familiarity with the issues	You need the right internal resources
Evidence of rebalancing 2008-09	Benefitted fully from equity recovery	Frequency and timing matters

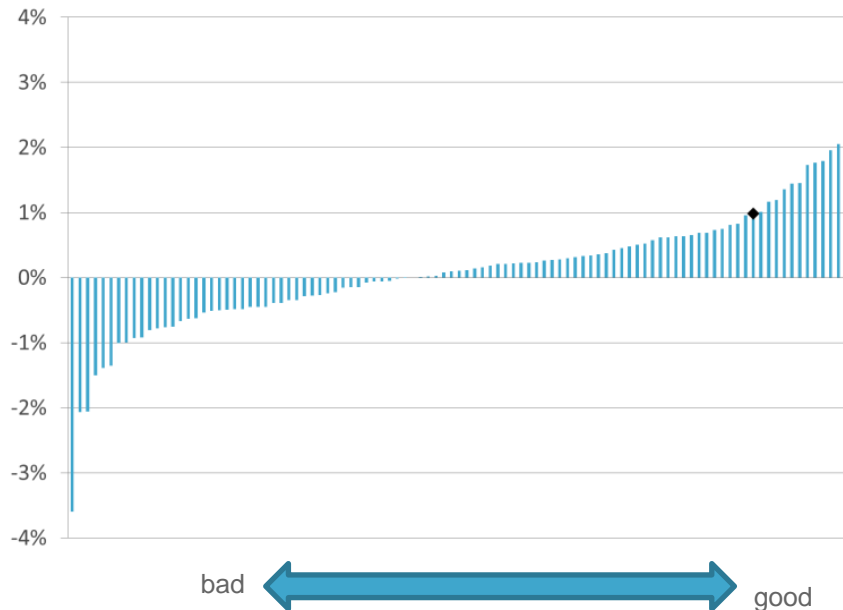
2005-12 an unusual period in markets
Did these make the difference?

What makes a good fund?

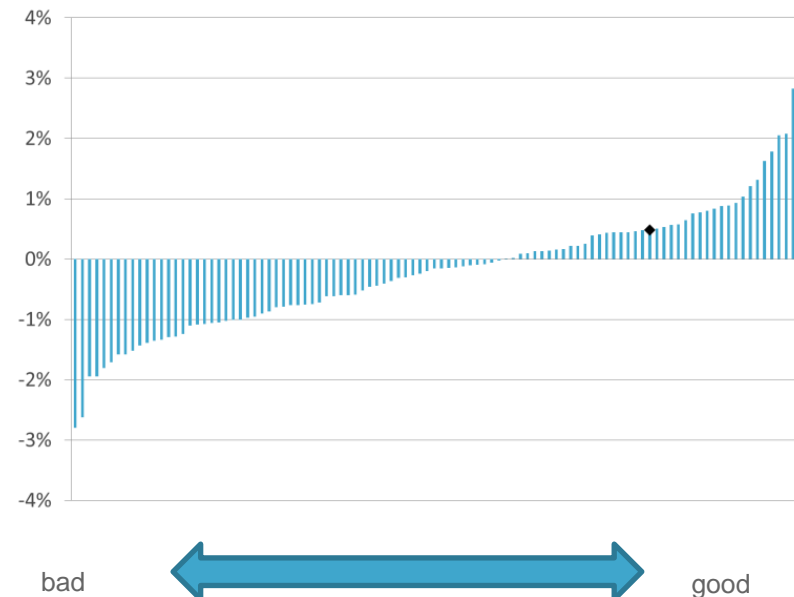
- A clear investment objective
- Clear and well understood investment beliefs
- A strategy that is aligned with those investment beliefs and objectives
- Avoid periods of very poor performance – they are difficult to recover from
- Over longer periods, this compounds to “above average” – there is no need to aim to shoot the lights out
- Employ discipline – you have a strategy, rebalance back to it when market moves cause you to drift
- Prioritise strategic matters

How does East Sussex look relative to its peers – performance relative to benchmark

Over 3 years



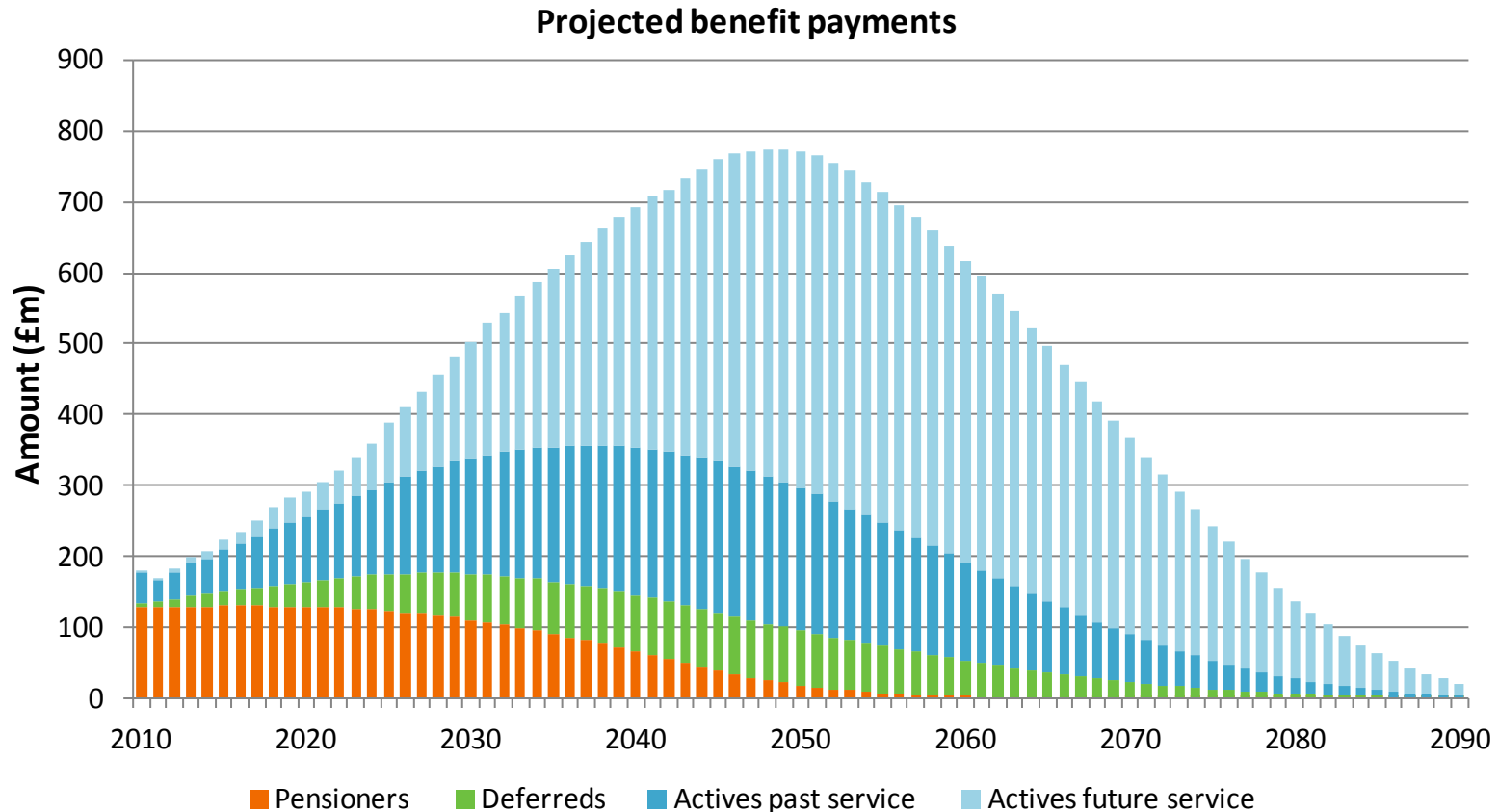
Over 5 years



Outperformance relative to benchmark over 3 and 5 years (to 31 March 2014)

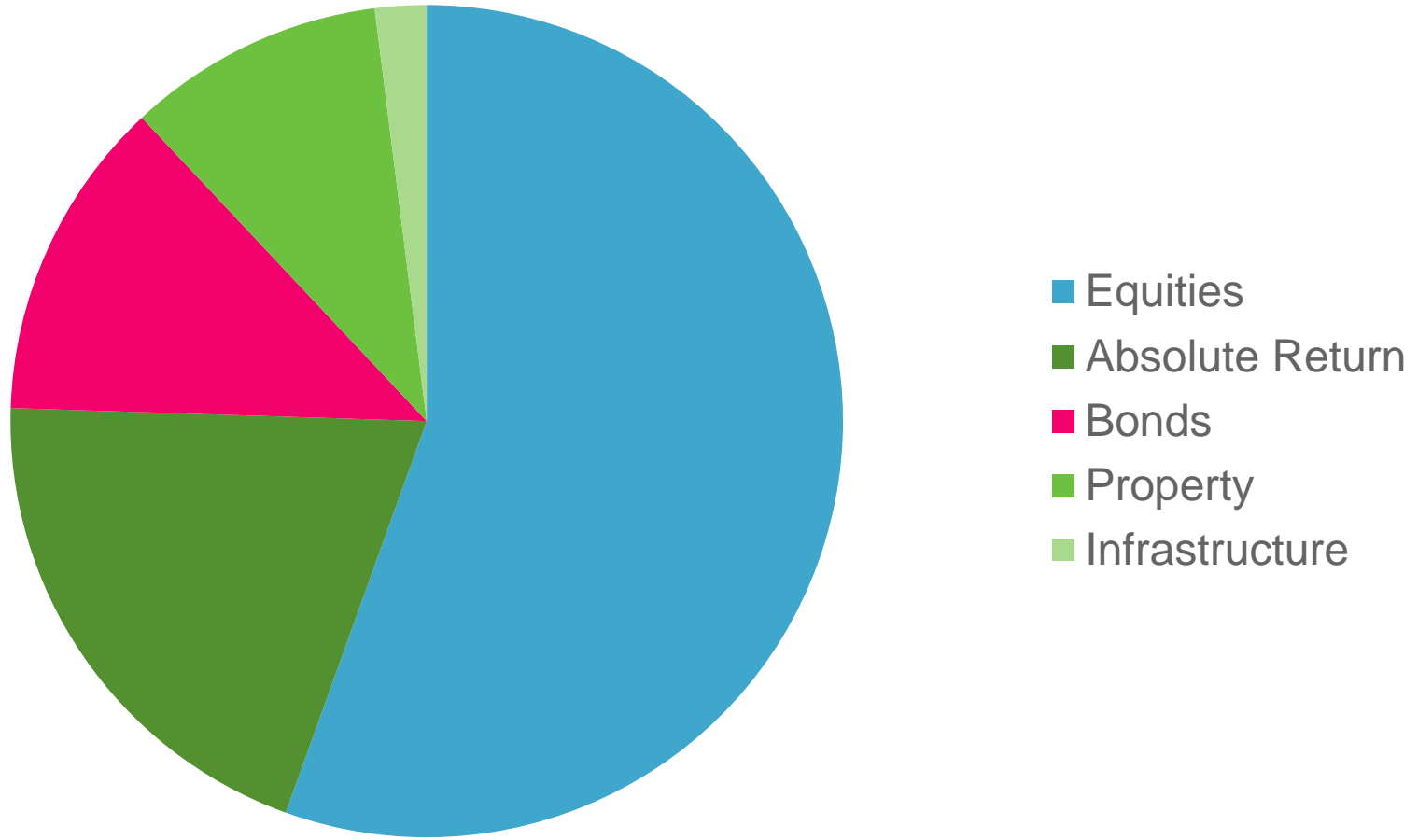
SETTING INVESTMENT STRATEGY

Ultimate objective – pay the benefits



- How much money do I need and how should it be invested in order to be able to meet the promised benefits?

Current high-level investment strategy



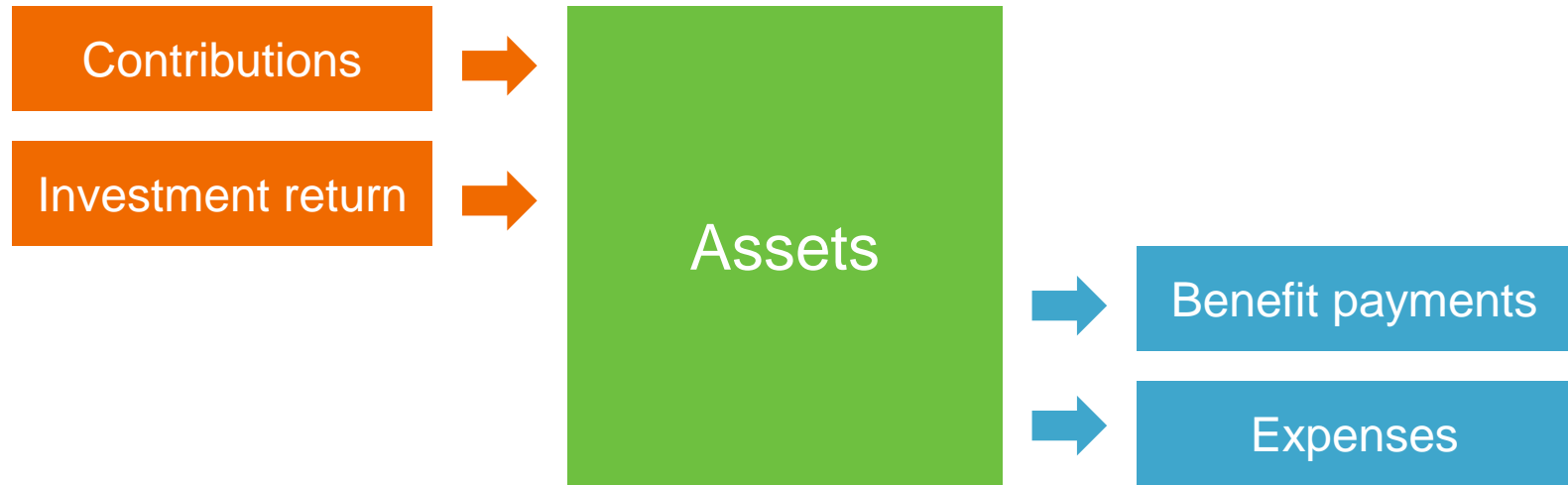
Why is strategy important?

“In the LGPS and other schemes where contributions are invested and managed to meet future liabilities, understanding investment risk and performance constitutes a major element of the role of finance professionals.”

“In funded schemes, the decision-making body will need to relate the longer term liabilities of the fund to the strategy for the investment of its assets to generate cashflows.”

Source: CIPFA Knowledge and Skills Framework

Meeting your obligations

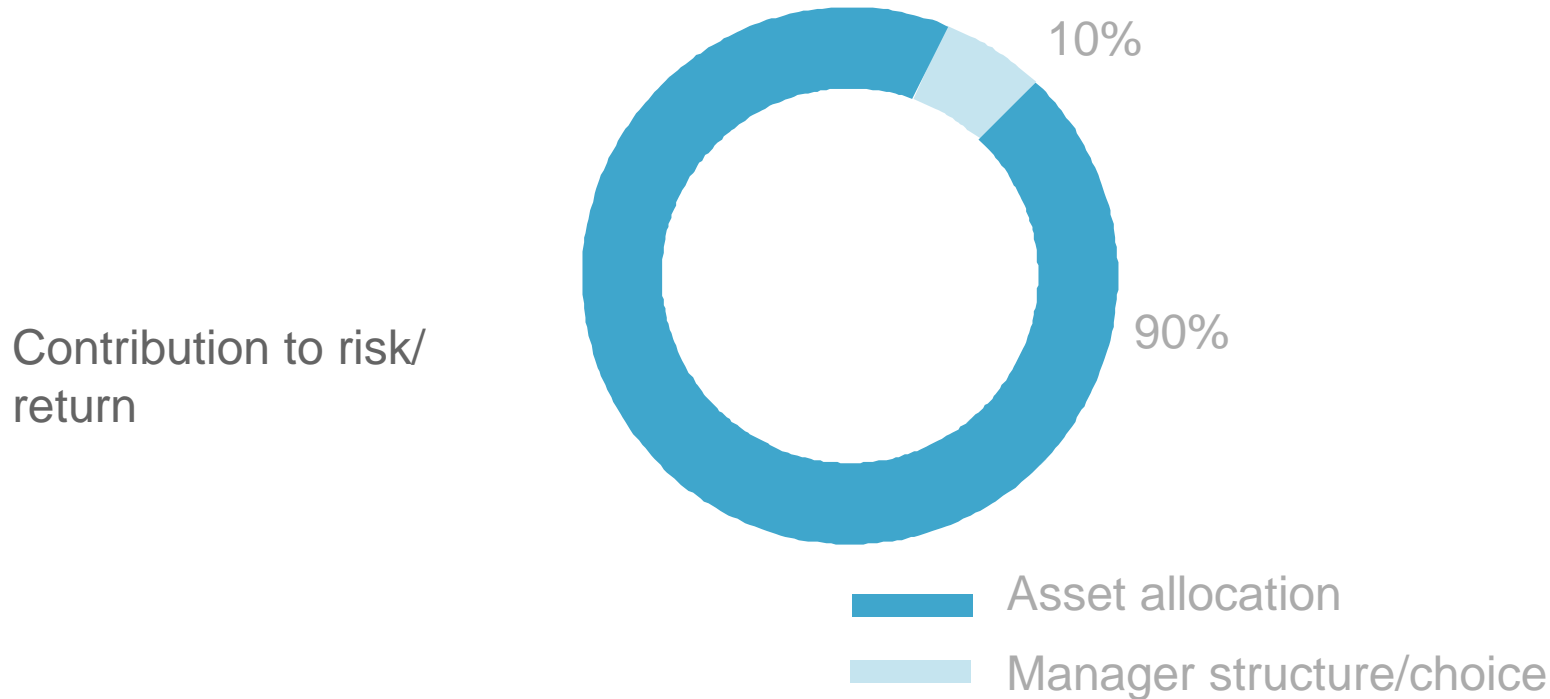


- Need to ensure that assets will be sufficient to meet all outgoings
 - Can vary amounts coming in (more contributions; higher return)
 - Little scope to change what is paid out

Factors that influence strategy, include

- Contributions
- Funding objectives and risk tolerance
- Funding position
- Fund maturity
- Employer covenant
- Combination of one or more of the above

Investment strategy – why it is important

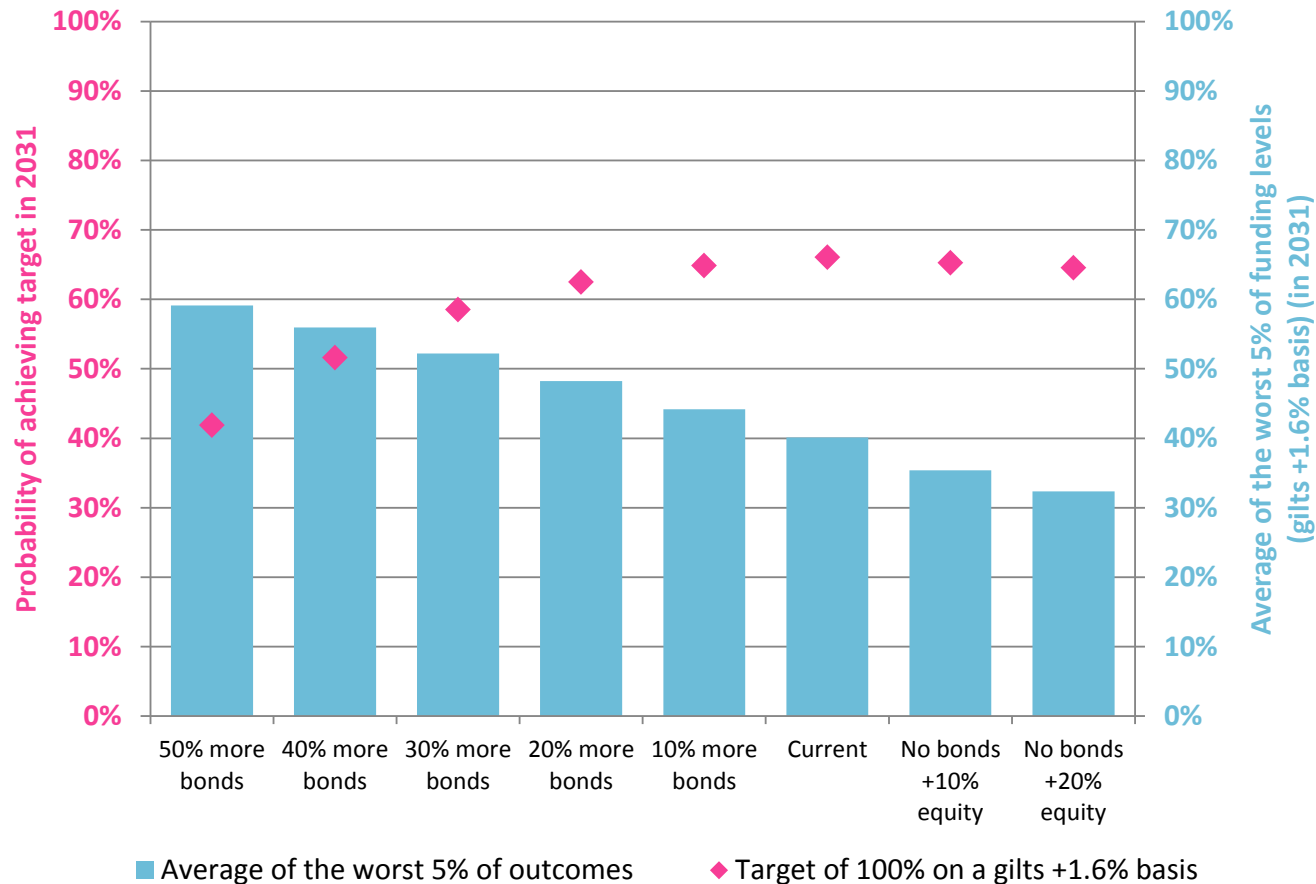


- Asset allocation - dominates risk and potential success
- Supports Myners' focus on strategy
- Agree high level strategy then think about structure of assets

Observations from 2013 ALM

- Analysis supported strategy at the time
- Suggested no material benefit from adding to “growth” assets.
 - Adding equities would reduce diversification and probability of “success”.
 - This does not preclude changing the mix of growth assets.
- There was potential scope to de-risk small amount for slight improvement in risk measure, however this also resulted in a small reduction in the probability of success

Ongoing basis – probability of success versus risk at 2031



- Criteria for “success”: 100% funding on ongoing basis by 2031.

Changed market conditions 2013 - 14

- Funding level increased from 79% at the 2013 valuation to c 89% at May 2014
- De-risking discussed at Strategy Day (25 June 2014)
- Funding level fell back before action could be taken
- Trigger set at 85% for a 5% reduction in equities
- “3DAnalytics” introduced to allow Officers to monitor the position

Last year's de-risking

- The funding level trigger of 85% was breached on 11 March 2015.
- LGIM were instructed to switch 5% of Fund assets (£135m) from the Fund's UK and Global equity holdings into the LGIM Over 5 Years Index Linked Gilt fund.
- The impact of this has been positive for the Fund as equity markets have fallen over the period since the de-risking took place. The table below looks at index returns for each of the funds involved over the period 11 March 2015 to 21 August 2015. It sets out the monetary impact of the de-risking.

Fund	Index return 11/03 – 21/08	Value added
L&G UK equity	-4.5%	‑£3.7m
L&G Global equity	-7.6%	‑£4.1m
L&G Over 5 Year Index Linked Gilts	9.3%	+£12.6m

Strategy summary

- One of the most important investment decisions
- 2016 valuation opportune time to revisit existing arrangements
 - Fund and employer level
- Ensure governance arrangements are implemented effectively and efficiently

After investment strategy, focus on investment structure aspects

Investment structure

- Using the risk budget “efficiently”
- Factors include
 - Active versus passive
 - Level of diversification
 - Choice of benchmark
 - Ability to access asset classes
 - Market conditions

Actual relative to benchmark

Asset class	Actual weight %	Benchmark weight %	Over/under weight %	Approx £value
Global equities	38.8	38.0		
UK equities	10.1	12.0		
Private equity	5.6	5.5		
Total equity	54.5	55.5	-1.0	-£27m
Property	11.5	10.0	+1.5	+£42m
Multi-asset	21.0	23.0		
Infrastructure	1.6	2.0		
Total alternatives	22.6	25.0	-2.4	-£65m
Fixed Income	4.0	3.5		
Index-linked gilts	5.3	5.0		
UK Financing	0.4	1.0		
Cash	1.6	0.0		
Total bonds and cash	11.3	9.5	+1.8	+£50m

Rebalancing

- Key part of “governance dividend”
- Selling assets that have outperformed to buy underperforming assets
- Cost implications must be understood
- Strategic rebalancing key priority
- Manager rebalancing second-order

PERFORMANCE AND FEES

WM PRESENTATION

Manager mandates and objectives (listed)

Manager	Mandate	Benchmark	Performance objective
Legal & General	Global equities	FTSE All World	Track index
Legal & General	UK equities	FTSE All Share	Track index
Legal & General	Index-linked gilts	FTSE IL Over 5yr index	Track index
Lazard	Global equities	FTSE All World	Outperform benchmark by c3%p.a.
State Street	Fundamental indexation	FTSE RAFI All World 3000	Track index
Longview	Global equities	MSCI AC World	Outperform benchmark by c3%p.a. (indicative)
Newton	Absolute Return Fund	LIBOR	Outperform benchmark by 4%p.a.
Ruffer	Absolute Return Fund	LIBOR	Outperform benchmark by 4%p.a.
M&G	Bonds	Bespoke	Outperform benchmark by 0.8%p.a. (indicative)
Schroders	Property	IPD All Balanced funds	Outperform benchmark by 0.75%p.a.

Manager performance relative to benchmark

		L&G - Global Equities	Lazard - Global Equities	Longview - Global Equity	State Street - Fundamental Indexation	L&G - UK Equities	Newton - Absolute Return	Ruffer - Absolute Return	L&G - 5yr ILG	M&G - Bonds	Schroder - Property	Total Fund
3 Months (%)	Absolute Benchmark	-5.0 -5.0	-4.1 -5.0	-3.8 -5.3	-4.9 -4.8	-1.5 -1.6	-2.8 0.1	0.2 0.1	-3.3 -3.3	-3.2 -3.5	3.4 3.3	-2.0 -2.9
	Relative	0.0	0.9	1.6	-0.1	0.1	-2.9	0.1	0.0	0.3	0.1	0.9
12 Months (%)	Absolute Benchmark	10.3 10.2	10.7 10.2	21.1 9.5 10.6	6.5 6.4	2.7 2.6	2.5 0.5	11.5 0.5 11.0	3.7 3.7	5.5 4.0	16.1 15.5	9.4 6.5
	Relative	0.1	0.4		0.0	0.1	2.0		0.0	1.5	0.5	2.7
3 Years (% p.a.)	Absolute Benchmark	13.7 13.6	12.4 13.6	18.6 8.5 9.3	6.7 6.8	11.2 11.0	3.7 0.5	8.8 0.5 8.3	N/A N/A	6.8 3.9	12.3 10.8	10.9 9.3
	Relative	0.1	-1.1		-0.1	0.1	3.2		N/A	2.8	1.4	1.5
10 Years (% p.a.)	Absolute Benchmark	9.2 9.1	8.6 9.9	N/A N/A	N/A N/A	5.4 5.2	5.0 0.6	6.7 0.6	N/A N/A	5.9 4.2	9.3 8.9	7.1 6.6
	Relative	0.1	-1.1	N/A	N/A	0.2	4.4	6.1	N/A	1.6	0.4	0.5

Manager fees – market rates

Equities

% p.a.	UK	N America	Europe (ex UK)	Japan	Asia (ex Japan)
Passive	0.04 – 0.1	0.08 – 0.2	0.08 – 0.25	0.08 – 0.25	0.18 – 0.28
Active	0.45 – 0.65	0.5 – 0.8	0.5 – 0.8	0.5 – 1.0	0.6 – 1.0

Source: eVestment, individual managers

Other asset classes

% p.a	UK Bonds	UK index-linked	Infra (LP)	Infra. (FOF)	Private Equity (FOF)	Property (FOF)
Passive	0.09	0.03	n.a.	n.a.	n.a.	n.a.
Active	0.25	0.12	1.35	1.65	2.30	0.90

Source: CEM analysis 2013

NEW IDEAS AND TOPICAL THEMES

ESG – RESPONSIBLE INVESTMENT

What is Responsible Investment?

“Responsible investment isn’t about changing the world; it’s about understanding how the world is changing and how companies will be affected”

Jane Ambachtsheer, Mercer

What it is not

≠ ethical investment

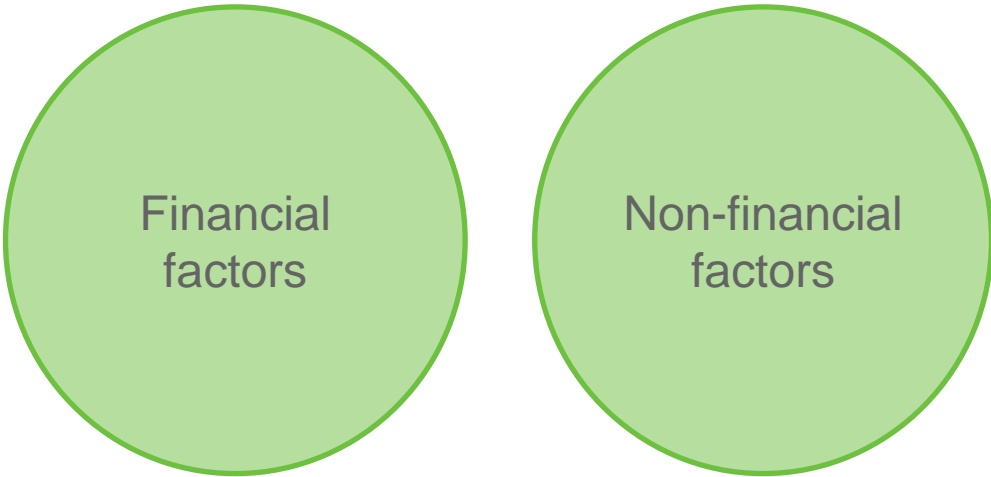
≠ values driven

≠ Shariah compliant



Law Commission Report & Fiduciary Duty

- “The most important distinction is between the factors relevant to increasing returns or reducing risk (financial factors) and those which are not (non-financial factors)”



Financial
factors

Non-financial
factors

Test 1 - Trustees should have good reason to think that scheme members would share their concerns

Test 2 - The decision should not involve a risk of significant financial detriment to the Fund

MPS' PENSION FUND AT RISK FROM FOSSIL FUEL INVESTMENTS

17 February 2015, The Guardian

ANS  ROBERTSON

GREENWICH POLITICIANS SIGN OPEN LETTER URGING GREENWICH COUNCIL TO PULL £17M INVESTMENT FROM COMPANIES ASSOCIATED WITH FOSSIL FUELS

NewsShopper 5 May 2015

EXPOSED: THE WORST (AND BEST) UK SCHEMES FOR MITIGATING CLIMATE CHANGE RISK

Professional Pensions 28 Apr 2015

WEBSITE LAUNCHED TO HELP MEMBERS PRESSURE SCHEMES ON HIGH-CARBON ASSETS

Professional Pensions 14 May 2015

POOLING AND COLLABORATION POST THE BUDGET

Pooling and collaboration

➤ Budget (8 July) –

‘the government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments.’

LGPS Collectivisation

Date	Initiative	Implication
May 2013	Brandon Lewis speech at NAPF LGPS conference	Fund merger – 5 groups nationally – seemed likely
June-Sept 2013	DCLG/LGA Call for Evidence	Consultation on objectives <ol style="list-style-type: none"> 1. Managing deficits 2. Investment efficiency
Nov-Dec 2013	DCLG commissions research from Hymans Robertson	Cost benefit analysis on 3 options including asset pooling <ol style="list-style-type: none"> 1. Savings can be achieved faster using pooling rather than merging funds 2. In aggregate the LGPS has not outperformed the benchmark
May-July 2014	Further DCLG consultation	Merger ruled out. Consulting on asset pooling and the greater use of passive
July 2015	Summer Budget pooling announcement	The LGPS needs to identify a viable, holistic solution which delivers significant savings within a defined time period

2015 Budget - Mythbusters

- Active vs passive argument?
 - Government will not mandate passive investment
 - Need to improve poor performance, not “level down”
- Collectivisation means losing local control?
 - No. Strategy setting and accountability will remain local
- We need to find £xm in savings
 - Substantial demonstrable savings will be required
- Aim is 5 regional pools
 - No. Government open minded about alternatives
- Government trying to grab money for infrastructure
 - Not true. But pooling some LGPS money for infrastructure could be part of the overall package

2015 Budget – What does government want?

- Engagement by all
- Proposals on pooling with appropriate **scale**
- A clear picture of **how various initiatives fit together**
- **Significant savings** - quantified and evidenced
- Savings able to be **monitored** and enforced
- Explain governance for individual initiatives
- **“pooling” is wider than CIVs** – could be a mixture of CIVs, joint procurement, co-investment
- A fall back or **default for underperformers?**

Proposals must be “sufficiently ambitious”

DIVERSIFICATION – OTHER ASSET CLASSES

Tangible investment objectives

The investment strategy is best framed around achieving the desired balance between three broad objectives of any pension fund:

1. Delivering sufficient return to meet the funding target and target level of contributions - **“growth”**
2. Generating income required or structuring the assets to meet the Fund's income requirements – **“income”**
3. Employing investment strategies that provide some downside protection or diversification benefit to maintain stability in the level of contributions – **“protection”**

We expect that the emphasis will (and should) remain on generating return, but a better sense of other aspects increasingly important



Growth






Income



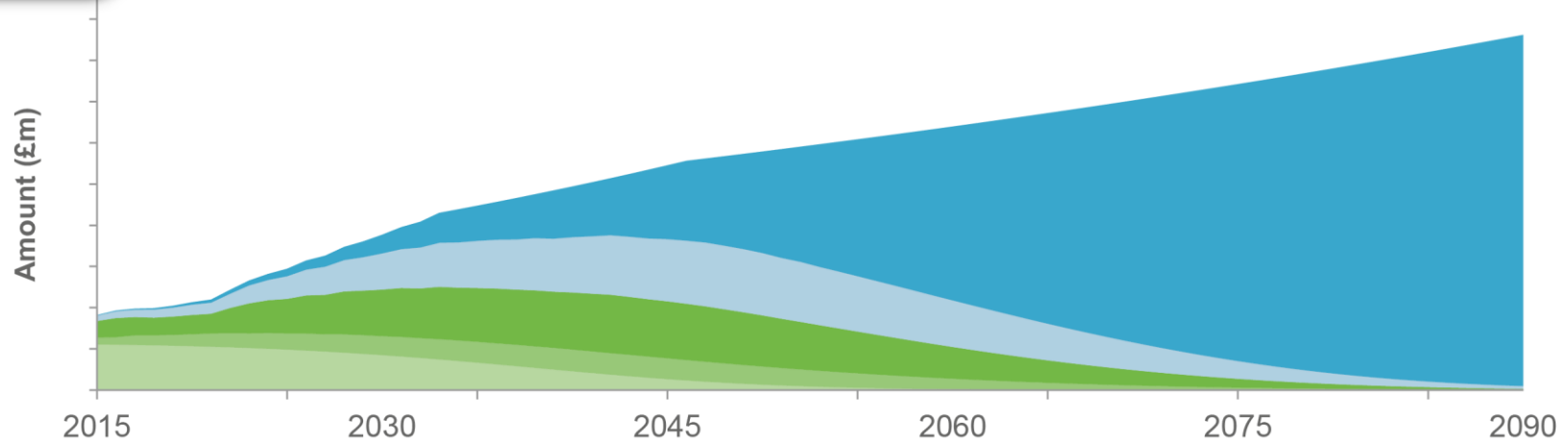
Protection

Populating the building blocks

Current exposure	
	<p>Growth</p> <p>Primarily</p> <ul style="list-style-type: none">• Equities• Private equity• DGF
	<p>Income</p> <p>Primarily</p> <ul style="list-style-type: none">• Property• Debt related investments• DGF <p>Increasingly important as the Fund matures & deficits repaired</p>
	<p>Protection</p> <p>Primarily</p> <ul style="list-style-type: none">• Index-linked gilts



Protection – the LGPS

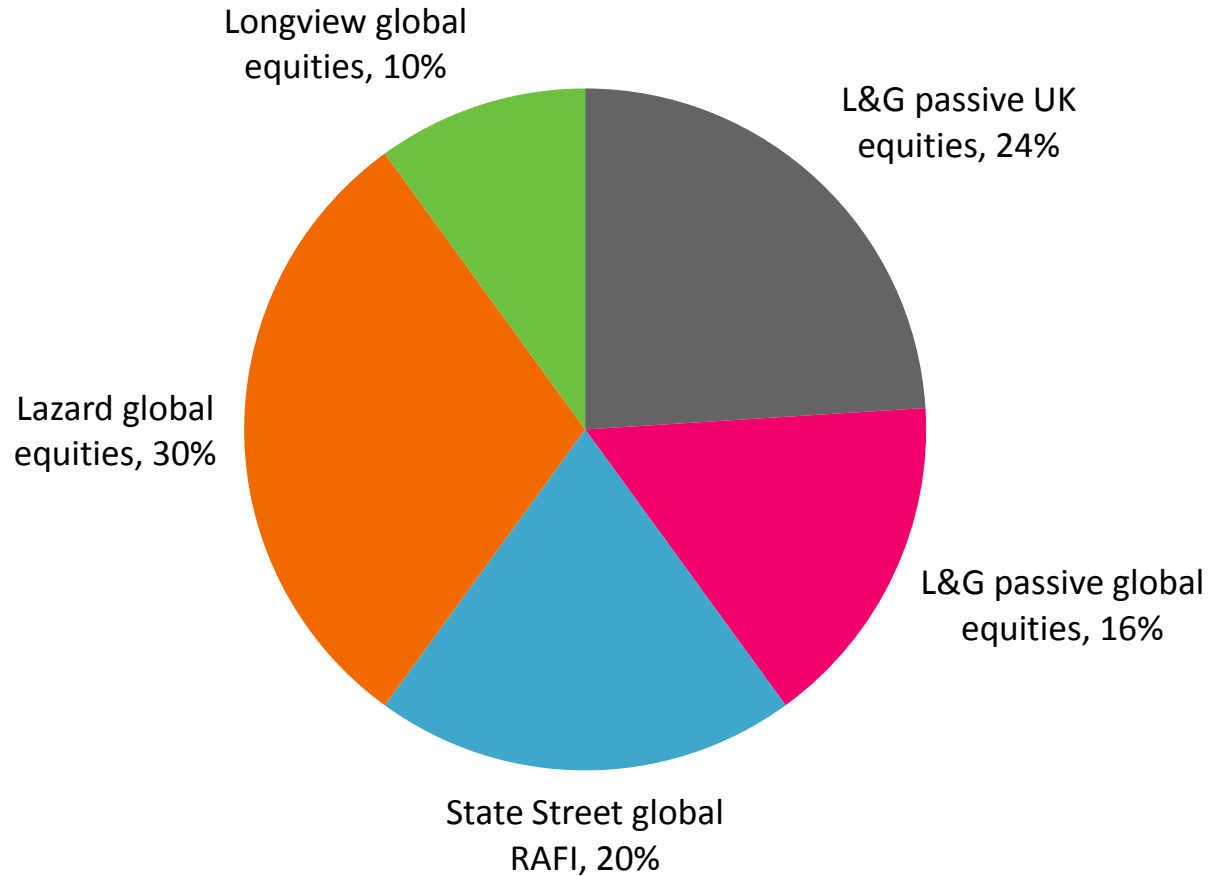


Priorities	<ul style="list-style-type: none">• Achieve affordability and stability• Generate sufficient long-term real returns
Market risks	<ul style="list-style-type: none">• Inflation (CPI/Uncapped)• Growth assets
Main forms of protection	<ul style="list-style-type: none">• Growth asset diversification• Income generating real assets• Low risk liquid assets• Inflation hedging

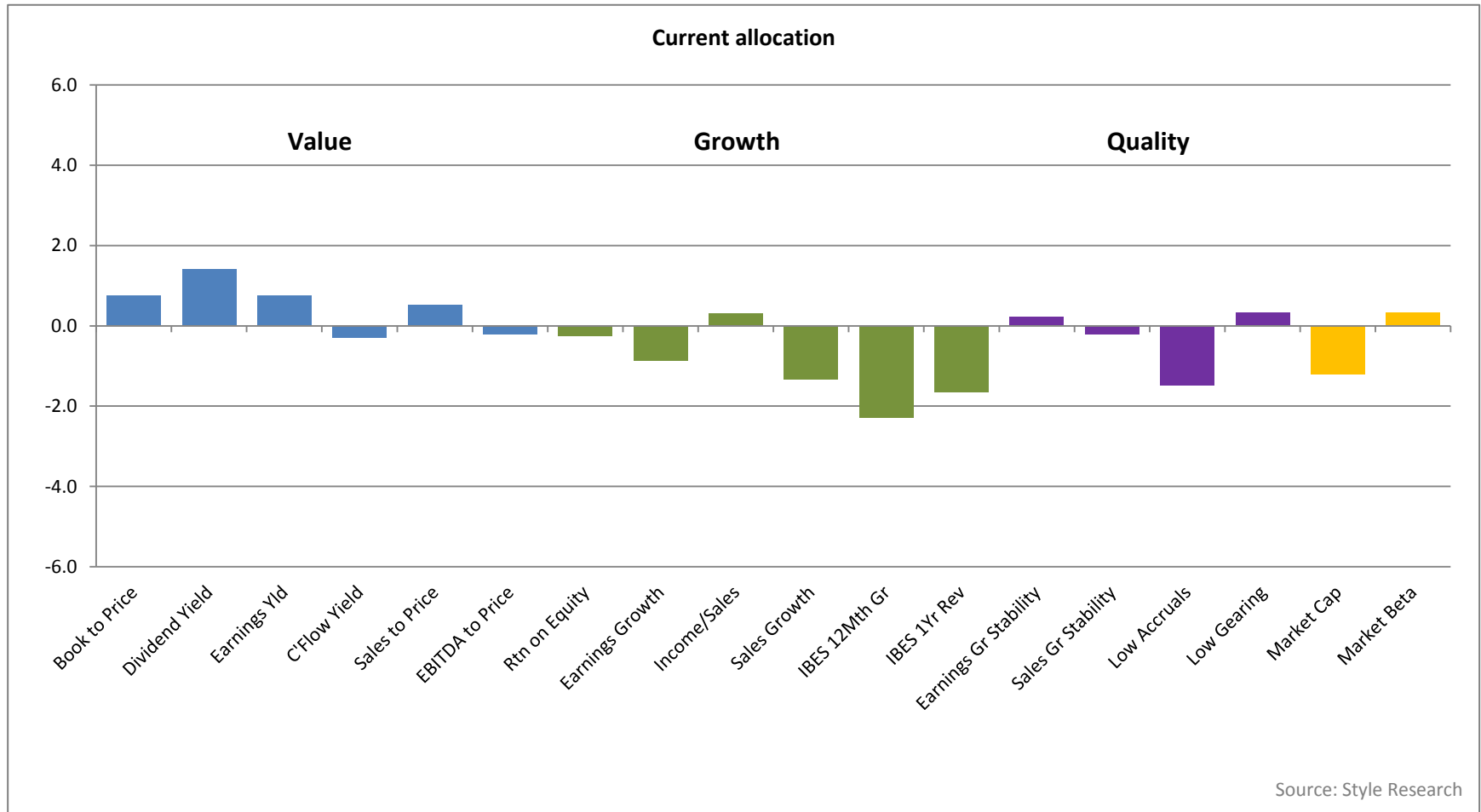
...your protection should reflect the Fund's priorities

THE EQUITY PORTFOLIO

Current portfolio allocation



Current portfolio style characteristics



Equity portfolio observations

- Currently the portfolio has a moderate positive tilt towards stocks with “value” characteristics and a slightly stronger tilt away from stocks with “growth” characteristics compared to the benchmark;
- There is a modest tilt away from quality measures and also a tilt towards smaller size stocks.

Options

- See separate papers

SUMMARY OF DECISIONS

Summary

- What are we happy to retain and what do we want to change
- Confirm the decisions on rebalancing
- Confirm the decisions on the equity portfolio
- Agree priorities and training requirements
- Set timetable



Thank you

Any questions?