A summary of the Strategy Review Day and Part 2 decision at Pension Committee, 29 September 2015

1. *Strategy Review Day*

Iain Stewart, Newton

Financial situation

1.1. The recent trend in investment returns has been characterised by high asset costs, more volatility and lower returns. This is evidenced by:

- historically low equity returns during December 2014, which were still low in May 2015;
- falling bond yields;
- a near record high Shiller PE rating – which correlates with lower equity returns – and median NYSE stock price.

1.2. The reason for this trend in investment returns is an economic climate that, since 2008, has been characterised by the continued following of a monetary policy in the developed world combined with excess capacity and high debt in the worldwide economy.

1.3. The monetary policy embarked on by developed countries was designed to drive economic growth by investing in financial markets. It involves central banks maintaining emergency interest rates and embarking on quantitative easing (QE).

1.4. This monetary policy has issues, because:

- It is a cyclical economic policy that should be used to kick-start economic recovery that is being used on a permanent basis to try to address structural economic issues, such as high debt and excess economic capacity.
- QE was meant to lower the cost of borrowing and increase consumption but it is based on an overly simplistic, domestic-based model that does not take into account global markets. However, in the context of the current financial climate it increases asset prices, but has a deflationary effect on the wider economy. Deflation can increase consumption but has a negative effect on indebted societies as it increases the cost of the debt.
- Maintaining low interest rates for a long period makes financial markets more unstable because it encourages speculation. Low interest rates increase the cost of safe assets and reduce their yields; this encourages people to invest in higher risk assets – such as corporate bonds – in search of higher returns. High risk assets become problematic if interest rates rise as they are more difficult to sell.

1.5. There are other issues with the current economic climate, including:

- A lot of credit has come via marketplace lending as banks have invested less capital into the economy since 2008.
- The current economic climate encourages companies to increase their value by investing capital into stock buyback rather than investing in productivity. In the short term this raises the value of the company as it increases stock prices – upon which its value is gauged – but it is not a sensible long term strategy.

- Asset valuations have risen – even several years after the last tranche of QE – but individual companies have begun to show signs of unravelling, for example, Glencore has lost 30% of its value on the UK stock market in recent weeks. Falling asset prices would not necessarily be a bad thing, as high asset prices only benefit the asset owner and demand is pushed elsewhere.
- Economies in the developing world– including China – now possess half of all debt and much of it has been misallocated, for example, on ill-thought out public infrastructure works and on building excess capacity. This debt burden was caused by a policy of currency devaluation designed to stimulate exports that has seen total debt increase by 40% worldwide since 2007. It was effective at stimulating developing economies for a while but is becoming problematic now that the economies have slowed.

Future outlook

1.6. Developments in the worldwide economy may include:

- China attempting to shift towards a more consumer-based economy (rather than export-based) – this will be difficult to do given the high amount of debt and the poor returns on equities. However, it is an opaque society so it is difficult to know with certainty what is going on. Some other emerging economies do look to be in better shape.
- A change from a monetary policy involving QE and low interest rates to a fiscal policy where governments print money and invest more in their domestic economies, such as in infrastructure.
- A gradual reversing of globalisation due to the introduction of protectionist policies to counteract the effects of high debt – signs of protectionism have begun to emerge in the developing world.
- A gradual shift in the percentage of company profits going towards capital (shareholders) rather than labour (workers). Over the past 20 years, returns to shareholders have been exceptionally high and real wages have stagnated. The Japanese government is already urging companies to pay staff higher wages.

Newton's strategy

1.7. The current financial environment does not favour an absolute return focussed investment strategy due to the high amount of risk in equities. However, Newton is confident it can still exceed its return strategy of "cash +4%" for the East Sussex Pension Fund (ESPF) in the next three to four years against this financial backdrop by adopting a strategy that emphasises patience.

1.8. Newton's current strategy involves:

- ensuring that the fund has low credit exposure – the return-seeking core is currently 38% of the total fund;
- holding high amounts of cash (21% of the fund) – in the long term this provides low returns, but in the short term it reduces credit exposure and allows speedy investment in lower risk/ high quality assets when the conditions are right;
- waiting for a better entry point into the equities market – the falling European stock markets could offer such an entry point;
- only buying securities directly, understanding why they have been purchased, and holding them to maturation – a lot of debt is issued with the expectation of keeping it to maturity, even though it is often sold early;
- mainly investing in European equities, with 15% from the US and 2% from Japan;

- holding 85% of cash in Sterling and the rest in Yen, Swiss Francs and the Dollar – the target is for 100% cash holdings in Sterling, as anything else is a risk;
- investing in precious metals in anticipation that they will rise in value once the economy becomes more inflationary.

1.9. This strategy would change if there was a sharp upwards movement in the equity market.

David Cullinan, State Street

Market environment

1.10. Market returns for 2014/15 have been strong:

- Bond annual returns were 20% for index-linked, 14.5% for UK government and 13% for UK corporations;
- There has been a noticeable equity risk premium over the last three years when compared to returns on bonds;
- Three quarters of all pension funds now have some investment in alternatives which now offer a return close to that of equities;
- Annual returns for property have recovered since 2008/9 and have been positive over the past seven years; the return over three years has been close to that of equities. Funds are largely allocated to direct or indirect UK property;
- The performance of assets in the pension scheme has been very good but it has been hurt by the cost of liabilities, i.e., the cost of purchasing the assets.

1.11. Over the past 20 years, there has been a modest equity risk premium: returns for UK and overseas equities have not been significantly higher than other asset classes, but they have had much higher variability of returns, i.e., they are more volatile. Consequently, there has been a long term trend towards diversifying the assets held by local government pension schemes (LGPS) away from equities. The amount of equities held has fallen from 75% to 60% of the value of the total fund, and the allocation in alternatives has increased from 1% to 11% (and is expected to rise to 15% in future years).

Performance of ESPF

1.12. The ESPF has a good diversity of asset classes and asset managers. The fund has a higher proportion of its value (30%) invested in alternative assets when compared to other LGPSs. The relative size of ESPF allows it to diversify its asset allocation and employ more asset managers.

1.13. The ESPF is performing very well, for example it has seen:

- A 15% return over the past 12 months compared to a benchmark of 11.9%.
- A relative return of 1.2% over the past five years compared to the benchmark; this represents an additional £170m added to the value of the fund.
- A high return at a low risk – compared to the median for LGPSs – over the previous three and 10-year periods both in absolute terms and relative to its benchmark.
- A performance against its benchmark of 0.3% over the past 20 years – which means it is ranked 23rd out of 89 LGPS funds.

1.14. The performance of asset managers, rather than the selection of asset classes, has added value to the ESPF. The allocation of funds to different asset classes has had 0-0.1%

impact on the value of the ESPF over the past 10 years. On the other hand, stock selection by asset managers has provided an additional 1.5% return in the past three years and 0.4% over the past 10 years. In 2015, stock selection – mainly in equities and bonds – had an impact on the benchmark of 1.5; the relative weighting of assets had an impact of 0.1. This picture is the same across all pension funds.

1.15. Looking at performance over the past 20 years is a useful exercise – even if the world has changed drastically – because it provides a good benchmark for what the fund should be aspiring to achieve. The average of 5% annual returns above inflation over the past 20 years is how the Pension Committee should judge the performance of the ESPF.

Linda Selman and William Marshall, Hymans Robertson

East Sussex Pension Fund strategy

1.16. The role of the Pension Committee should be to agree the long term strategy of the pension fund. The strategy should enable the pension fund to be self-sustaining and able to pay out benefits to its members.

1.17. The triennual evaluation of the ESPF – due to take place in March 2016 – is a very important activity as research shows that having a clear, deliverable strategy can help a pension fund achieve 1.2% extra returns per year.

1.18. The current ESPF pension strategy focuses on providing a balance between:

- generating returns;
- ensuring that there is sufficient protection against volatility; and
- ensuring the movability of funds so that they can be moved into assets that begin to perform well.

1.19. A lot of academic studies have been undertaken to look at what makes a good pension fund. The studies concluded that – whilst an element of luck can play its part – it is the possession of certain characteristics that dictate strong performance not the pension fund's size. The characteristics include:

- A short manager roster – there is no added value in having lots of asset managers but you also need the right managers;
- Low manager turnover – funds should be patient as changing managers can cost up to 1% of the asset value;
- Simple structure – traditional asset classes should be chosen and 'fads' avoided, and the structure must match the beliefs of the fund;
- Rebalancing – if the fund is veering away from its agreed strategy, there should be sufficient discipline to make proactive moves in order to rebalance asset weightings;
- Internal management – fund managers should work out what their governance structures are and then put in place a strategy to match available resources. There is no optimal number of asset managers, as the right number depends on the governance budget available to manage the asset managers.

1.20. Pension fund strategies can permit different investment strategies for the various employers that are members of the fund. However, there are too many employers for all of them to have their own strategy so a balance needs to be struck.

1.21. Setting a performance benchmark for a strategy is an important tool for pension funds as it demonstrates the value of fund managers who are able to exceed their

benchmark, and it helps to show to the Government the value of actively managed pension funds compared to passively managed.

Deciding on asset classes

1.22. A pension fund portfolio should aim to have a wide variety of assets and a smaller proportion of volatile assets, such as equities, so that any losses have a limited effect. This is because:

- The amount paid to pensioners increases as a fund matures which makes it less able to tolerate volatility and fluctuations in its value;
- It is difficult for assets to recover to their benchmark if they fall in value – an asset that falls in value by 50% in year one will have to double its performance during year two.

1.23. However, pension funds may still need to consider investing in more volatile, higher yield assets in order to remain self-funding when it has to contend with external factors such as:

- Growing inflation;
- Increasing life expectancy;
- a reduction in the number of contributing employees;
- the proportional cost of management fees that result from lower returns on investment.

1.24. Therefore, a pension fund strategy must strike a comfortable balance between investing in high yield/high risk assets that could potentially deliver 100% self-funding, but also significantly increase the risk of reductions in self-funding levels; and low yield/low risk assets that will not deliver 100% self-funding, but will not risk self-funding levels falling significantly.

1.25. LGPSs are able to invest more in higher risk assets, such as equities, than private pension funds because they have an implied covenant with the Government that they would be bailed out by public funds – although this has not been tested.

1.26. An Asset Liability Modelling (ALM) was undertaken during the triennual evaluation of the ESPF in 2013 to test the outcome of different strategies. The test concluded that there would be no material benefit in increasing the amount of equities held by the fund and, as a result, some of the risk contained in existing equities should be "taken off the table" by converting equities to index-linked bonds.

1.27. At the strategy day in May 2014 it was agreed that there should be a de-risking "trigger". This was agreed as a 5% reduction in equities at the point at which the fund achieved 85% self-funding.

1.28. The trigger was reached on 11 March 2015 and 5% of the ESPF's assets (£135m) were converted from equities to index-linked bonds. Based on the market fluctuations since then, this decision has added £20m to the fund's value. The fund is currently at 77.8% funding.

Role of Pension Committee

1.29. The Pension Committee will need to agree a number of aspects of the strategy at the triennual evaluation in April 2016. It will need to consider:

- De-risking triggers for when the fund has a high level of funding to "lock down" risk;
- Re-risking triggers for when the fund has a low level of funding;
- The risk of over-triggering a fund making it more complex and costly;
- How governance arrangements are implemented effectively and efficiently;

- The investment structure, including active versus passive investments, the choice of benchmark and the level of diversification.

1.30. **ACTION**: The Pension Committee may want to agree the formal rebalancing process for when asset classes are over or under weight, including the trigger points and what action hitting a trigger should entail.

Ethical investments

1.31. The Law Commission Report places a fiduciary duty on pension fund trustees to take into account – when considering whether to invest in an asset – the financial impact of the investment and the non-financial impact. An investment can be excluded on non-financial grounds only if it fulfils two tests:

- trustees have good reason to think that scheme members would share their concerns; and
- not investing would not make the fund significantly worse off financially.

1.32. The case is often made by action groups that a key driver for not investing in fossil fuel companies is that they pose financial risk because they will not be able to extract all of the assets that they have on their books.

1.33. The ESPF is drafting a letter to respond to action groups; the Pension Committee agreed its general tone.

Pooling and collaboration

1.34. The Government is committed to requiring LGPSs to pool their funds. The purpose of the pooling is to achieve savings faster than through formal mergers, and because the aggregate LGPSs have not outperformed their benchmarks – calling the value of asset managers and individual fund investment strategies into question.

1.35. It is expected that pooled funds will have fixed fund managers, but individual funds will be able to choose which asset classes they invest in. Hymans Robertson has argued that this proposal does not currently seem to take into account the complexity of asset classes – which are more varied than just bonds, equities, properties and infrastructure.

1.36. The Government has indicated that it is looking for a significant saving from LGPSs, but has not indicated what it will be. In anticipation, funds have been making savings since the proposal was first announced in May 2013. Hymans Robertson has successfully argued that any savings should, therefore, be measured against May 2013 budgets.

1.37. The Government is asking local authorities to submit their proposals for pooling LGPSs by November 2015. The pooling proposals will be measured by their scale, savings and governance. Pooling proposals that can be delivered quickly and are not complex are more likely to be accepted.

1.38. There is no one size fits all pooling model and the 89 LGPSs could submit 89 different proposals. Some pension schemes have already engaged in pooling, such as the London Pension Collective Investment Vehicle (CIV), and Hymans Robertson is advising the Government to consider these models as benchmarks to measure other proposals against.

1.39. Pooling certain assets could deliver significant savings, for example, infrastructure accounts for less than one percent of asset investment, but substantial savings could be delivered if investment assets were pooled due to the high cost of investing in infrastructure. On the other hand, pooling passive equities will deliver virtually no savings due to the already low management fees.

1.40. There could also be pools for specific assets, for example, the London Pension CIV could take in assets from other portfolios where it already has the same investment strategy and the same investment manager.

1.41. If all funds are divided into five pools, as initially proposed, then that would mean that the ESPF, valued at £2.7bn, would have to pool with multiple pension funds – the South East 7 group of local authorities have a collective pension fund value of only £15bn. It is also unclear what effect pooling budgets will have on the localism agenda and the decision making powers of Pension Committees.

1.42. The system is unlikely to be in place before 2020 and the Government is expected to announce in February 2016 which models will be accepted, based on the proposals submitted in November. However, ESPF officers recognise that doing nothing is not an option and discussions have been going on to form an understanding of what might need to happen.

1.43. **ACTION:** The Committee will be advised whether this means that the Government is fettering its discretion and could be challenged on its decision.

2. Part 2 decision

2.1. At the annual strategy day in September 2015 the Committee confirmed their agreement to terminate Lazard's active global equity mandate. The target size of the mandate is 15% of the Fund. The proceeds of the termination are to be split equally between the Fund's existing passive global equity mandate with L&G and the passive RAFI equity mandate with State Street.