CAMBRIDGESHIRE PENSION FUND

LGSS

INVESTMENT SUB COMMITTEE

20 NOVEMBER 2014

Report by: THE DEPUTY HEAD OF PENSIONS

Subject:	**Investment Strategy Review.**
Purpose of the Report	To consider proposals to improve the Fund's investment strategy.
Recommendations	**That the Investment Sub Committee:** ○ Approve the proposed allocations in table 8.2 as an update to the investment strategy. ○ Recommend the updated investment strategy to the Pension Board for approval. ○ Approve the outline delivery plan set out in 9.1 of this report.
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1 Background

1.1 The Investment strategy of the Fund is approved by the Pensions Board with the Investment Sub Committee being responsible for the delivery of the Strategy. This paper provides a health check of the current investment portfolio and recommends improvements.

1.2 The Committee reviewed the investment strategy of the Fund following the 2013 actuarial valuation and made a decision to reduce equities in order to increase the level of alternative assets

1.3 Following the appointment of a new investment consultant, Mercer Limited, the investment strategy has been reviewed and the attached paper sets out Mercer's views and recommendations.

2. Current strategy health check

2.1 Mercer expect the current strategy of 64.5% equities, 23.5% alternatives and 12% bonds to be supportive of the funding arrangements in place as part of the 2013 actuarial valuation

2.1 Mercer confirms the Hymans Robertson expectation, that the current investment strategy is likely to produce a return, over the long term of 3.4% p.a. above gilts (a proxy for the Fund's liabilities).

2.3 The Actuary, as part of the actuarial valuation as at March 2013, assumes a return of 1.6% p.a. over gilts. This highlights the degree of prudence in the Fund's actuarial valuation versus the "best estimate" approach we can take when setting investment strategy.

3. Equities

3.1 The current global equity structure (nine different managers / mandates) is complex with a mixture of regional and global equity mandates – and a degree of overlap.

3.2 The Committee should be clear on their long term "beliefs" around equities and equity managers. Most notably, including views on active versus passive; the "types" of active and passive, and the complexity of the structure given governance and fees.

3.3 In consideration of these views, Mercer's recommendation is to re-focus the portfolio by ensuring managers are "best in class" and focusing on the strategic rationale for each mandate in the Fund. In short, they believe this can be achieved by focusing on better use of passive and more focused high conviction active mandates and would suggest the following next steps:

- Review Newton Global Equity and Amundi European Equity mandates
- Consider moving regional Schroder equity allocations to a global mandate
- Appointment of a high conviction active global equity manager (should Newton and or Amundi be terminated)
- Consider the Fund's stance on currency hedging
- Decide on the structure of the passive portfolio (to compliment active managers in place).

3.4 A separate paper on the global equity portfolio has been provided as an agenda item.

4. Bonds

4.1 Bonds in the context of the Fund can have two roles, return generation or risk reduction. The current portfolio is structured with a significant focus on returns. Mercer advocates that the Fund looks to maximise returns, to the extent they are required as part of the funding strategy; but to achieve this at the lowest level of risk.

4.2 Mercer believes that two areas should be considered further:

1) *How to maximise returns* – The global fixed income mandate with Schroder is "absolute return" in nature and is therefore looking to achieve positive returns in a range of bond market conditions. Whilst the bond environment is changing (as a result of falling bond yields and narrowing credit spreads) this element of the bond portfolio has the flexibility to take advantage of the current opportunities in any market.

2) *How to reduce risk* – Mercer consider the structure currently has no protection against inflation (the Fund's largest investment risk). Mercer's recommendation is for a plan to be put in place to reallocate to index linked gilts, in order to provide this protection, as and when it becomes affordable to do so (i.e. bonds are more attractive and / or the funding level has improved). They also recommend that the UK element of the current bond portfolio is used as a basis for this change. Firstly, to switch the current UK fixed interest bonds into index linked gilts; and also to build up a degree of protection over time (e.g. from equities).

5. Alternatives / diversification

5.1 The Fund has already achieved a reasonable degree of diversification through the existing allocations to property, infrastructure, private equity and loans. Building out this diversification further (by reducing the existing equity allocation) has already been agreed.

5.2 Alternatives can have a place to add to the Fund's return expectations and / or to also improve the matching characteristics against the Fund's liabilities (in particular protection against inflation).

5.3 Mercer believes there are two options to consider:

1) To bring together the existing alternative holdings into a "real assets" portfolio and build this out over time, noting the intention to allocate an additional 9%.

2) Allocate to a Diversified Growth Fund ("DGF") to achieve broad asset diversification in one "wrapper".

5.4 Whilst the latter would provide a simple low governance solution, similar principles (equity like returns but lower volatility) can be achieved, at lower cost, through “smart beta” equity type products, which will be considered within the passive equity portfolio. It would also provide no protection against the Fund’s liabilities.

5.5 Mercer’s recommendation is that the current real assets portfolio is built out further and consideration is given to how to structure the portfolio (aims, roles etc) before considering individual asset classes.

6. Banking funding level improvements / building inflation protection

6.1 The Fund currently has limited protection in place against the Fund’s liabilities. As the funding level improves, Mercer’s view is that the Fund does not need to take the same level of investment risk. They therefore recommend that a “plan” is developed to “bank” funding level improvements and build up the level of inflation / liability protection as and when the Fund can afford to do so. This has clear links to the index linked gilts and real assets portfolios mentioned earlier.

7. Cost of change

7.1 Any change to the Fund’s investment strategy will need to make a meaningful difference to the Fund’s overall return expectations (to the extent they are required); or to reduce the overall level of risk. Transaction costs should of course be taken into account, but changes should have a meaningful enough impact for these to be quickly absorbed.

8. Proposals for Change.

8.1 In terms of proposals for change, at a high level Mercer suggest:

- The equity portfolio is reviewed and simplified.
- The bond portfolio is split into return seeking and risk reduction portions, with the latter looking to provide a degree of protection against the Fund’s liabilities.
- The alternatives portfolio is maintained and added to with a focus on “real assets” and also to incorporate an allocation to sustainable investing.
- Put a “plan” in place to reduce the level of investment risk (by “banking” funding level improvements and building in a degree of inflation protection) as the funding level improves.

8.2 The current and proposed allocations are set out below:

Asset Class	Current %	Proposed %	Range %
Equities	**64.5**	**64.5** (initially but noting the desire to reduce in favour of alternatives)	**59.5 – 69.5** (noting that there will be initial ranges around UK until the passive portfolio is restructured)
Passive	21	22.5	
UK	10	10	
Regional	5	-	
Global	12	25	
European	12	-	
Emerging Markets	5	7	
Bonds	**12**	**12**	**9-15**
Global	7	7	
UK Fixed Interest	5	-	
UK Index Linked	-	5	
Alternatives	**23.5**	**23.5** (initially but noting the desire to increase)	**No formal range** **(**noting the costs of trading illiquid assets)
Total	**100**	**100**	

9. Delivery Plan.

9.1 The proposed delivery plan:

Q4 2014: Review of Global Equity Portfolio structure (20 November ISC)

Q1 2015: Confirmation of Global Equity decisions (focus on active funds)
Consideration of funding level improvements and building up the Fund's inflation protection

Q2 2015: Decisions on passive equity (following decisions on actively managed funds earlier in the year)
Further work on funding level and inflation protection

Q3 2015: Decision on real assets

Q4 2015: Annual review of strategy – 2016 actuarial valuation planning

10. Recommendation

10.1 To approve the proposed allocations in table 8.2 as an update to the investment strategy.

10.2 To recommend the updated investment strategy to the Pension Board for approval.

10.3 To approve the outline delivery plan set out in 9.1 of this report.

To recommend the update to the investment strategy to the Pension Board for Approval

11. Relevant Pension Fund Objectives

Perspective	Outcome
Funding and Investment	• To ensure that the Fund is able to meet its liabilities for pensions and other benefits with the minimum, stable level of employer contributions. • To ensure that sufficient resources are available to meet all liabilities as they fall due. • To maximise the returns from its investments within reasonable risk parameters.

12. Finance & Resources Implications

12.1 There will be transitions related cost if the investment strategy is approved by the ISC. Officers will work on budgets once the strategy is agreed.

13. Risk Implications

a) Risk(s) associated with the proposal

Risk	Mitigation	Residual Risk
That the proposals do not improve the risk and return profile of the Fund.	Professional advice has been sought with an evaluation of the proposals with the rationale for change explained.	Amber

b) Risk(s) associated with not undertaking the proposal

Risk	Risk Rating
That the Fund is operating less efficiently in terms of risk / return profile and cost. Operating more risk than necessary could have downside implications for funding levels.	Red

14. Communication Implications

14.1 Any changes to the investment strategy will be reflected in the publicly available Statement of Investment Principles, Business Plan and Annual Report.

15. Legal Implications

15.1 There are no legal implications with the recommendations. Legal advice will be sought as appropriate when implementing asset allocation changes required by the Investment Sub Committee.

16. Consultation with Key Advisers

16.1 The report was produced in consultation with Mercer Limited.

17. Alternative Options Considered

17.1 No applicable.

18. Background Papers

18.1 Previous papers presented to the Investment Sub Committee at its meeting on 11th of September 2014.

19. Appendices

19.1 .Mercers presentation, Investment Strategy Considerations.

Checklist of Key Approvals	
Is this decision included in the Business Plan?	Yes.
Will further decisions be required? If so, please outline the timetable here	Yes. 19th of February 2014 ISC
Is this report proposing an amendment to the budget and/or policy framework?	No.
Has this report been cleared by the Deputy Head of Pensions?	Yes. 11th of November 2014
Has this report been cleared by the Section 151 Officer / Director of Finance?	Yes.7th of November 2014
Has the Chairman of the Pension Fund Board been consulted?	Papers will be circulated before the ISC
Has this report been cleared by Legal Services?	NA