

**CAMBRIDGESHIRE
PENSION FUND**

INVESTMENT SUB COMMITTEE
Date: 12th September 2019
Report by: HEAD OF PENSIONS

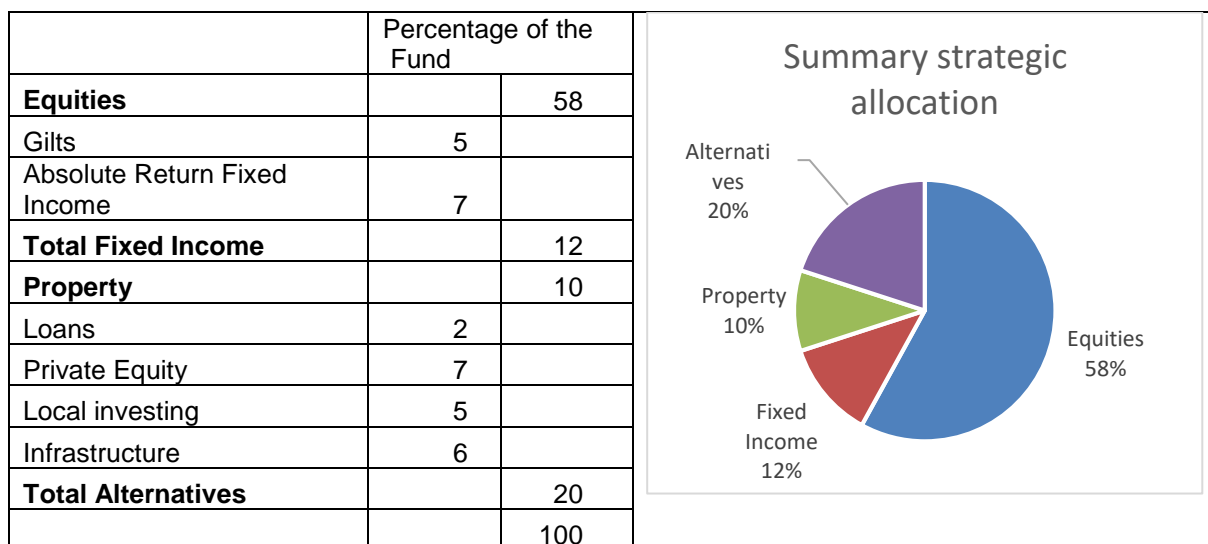
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|------------------------------|---|
| Subject | Equity Portfolio Review |
| Purpose of the Report | To review the Fund's equity portfolio in the context of the revised strategic allocation to ensure an appropriate balance of risk and diversification. |
| Recommendations | <p>That the Investment Sub Committee:</p> <ol style="list-style-type: none"> 1 Confirm that the strategic allocation to equities should be allocated: <ol style="list-style-type: none"> a. 23% to passive with UBS; b. 35% to active global managers, divided between either: <ol style="list-style-type: none"> i. Four managers equally (8.75% each), one UK and three global of which two will be Dodge & Cox and JO Hambro, or ii. Four global managers equally (8.75% each), of which two will be Dodge & Cox and JO Hambro, or iii. Four managers – three global managers of 10% each, of which two will be Dodge & Cox and JO Hambro, and one Emerging Markets manager of 5%. c. Confirm that any overweight to equities is held in UBS passive. 2 Instruct the Head of Pensions with support from advisers arrange a presentation day for the Investment Sub Committee to meet the prospective managers to ensure that they meet the Fund's strategic needs. |
| Enquiries to | Name: Paul Tysoe, Investment and Fund Accounting Manager Tel: 07867902436 Email: Phtysoe@Northamptonshire.gov.uk |

1. Purpose of the report

- 1.1. The purpose of this report is to review the Fund's equity portfolio in the context of the revised strategic allocation to ensure an appropriate balance of risk and diversification.

2. Background

- 2.1. During 2018-19 the Investment Sub Committee (ISC) reviewed the strategic asset allocation and the resulting proposal for a diversified allocation of Equities 58%, Fixed Income 12%, Property 10% and Alternatives 20% was approved by the Pension Fund Committee in March 2019, as shown below.



- 2.2. As part of the strategic review, the ISC acknowledged that the recently overweight value of equities of nearly 70% of the Fund would be slow to diversify into Alternatives, but the ISC did not request immediate action to de-risk from equities.
- 2.3. The ISC requested more details on implementing a risk management framework to provide access to tools that allow flexibility and agility to control the Fund's risk and return profile. This risk management "overlay" is seen to be complementary to the revised strategic asset allocation.
- 2.4. In May 2019, the ISC approved parameters for implementing a Protected Equity strategy focusing on managing the risks in the passive equity mandate, and selected River & Mercantile to be appointed as Risk Manager.
- 2.5. Subsequent to agreeing the new strategy, the ISC have made further decisions to commit to new Alternatives assets including Infrastructure Equity, Infrastructure Debt and a Local Economic Development Fund.
- 2.6. This paper introduces a review by Mercer of the equity allocation and how the reduced allocation under the new strategy should be focussed, for example, taking into account the optimum number of managers to provide diversification, geographic scope, manager style as well as concentrating on the equity sub-funds currently offered or expected to become available in the ACCESS pool ACS.

3. Mercer's review of equity portfolio

3.1. The current equity portfolio comprises the following:

| Manager | Region | Style | Strategic Allocation | Available through pool |
|---------------|----------------|---------|----------------------|------------------------|
| Schroders | UK Active | Value | 10.0% | tbc |
| JO Hambro | Global Active | Growth | 19.5% (Note) | tbc |
| Dodge and Cox | Global Active | Value | 12.5% | Yes |
| UBS | Global Passive | Passive | 23.0% | Yes |
| | | | 65.0% | |

Note: The high allocation to JO Hambro includes the Fund's previous allocation to Emerging Markets (EM) reallocated upon termination of the EM manager.

3.2. Mercer consider how the revised strategic equity allocation of 58% could be structured and consider a number of factors as summarised in the following paragraphs.

3.3. Number of managers. Mercer propose:

3.3.1.1. Retaining the 23% passive allocation with UBS as this was retendered recently in the build of the ACCESS pool and has extremely low fees;

3.3.1.2. Allocating the remaining 35% across four active managers in order to provide diversity of style and risk.

3.4. Geographic split. The Fund's current equity portfolio has a significant overweight to the UK versus the cap weighted global opportunity set. This is offset by underweight positions in North America and Emerging Markets. Mercer propose that a solution to this would be:

3.4.1.1. Removing a slot for a dedicated UK manager and awarding all mandates to global managers who will still have the scope to invest in the UK as and when they believe it is favourable to do so;

3.4.1.2. Potentially adding a dedicated Emerging Markets exposure.

3.5. The ISC will need to discuss whether to retain a UK allocation and whether an EM exposure is desirable.

3.6. Style. The overall portfolio currently has a relatively material bias to value stocks and away from growth. This bias is likely a contributing factor to the relative underperformance of the portfolio over the medium term, as value stocks have generally underperformed and growth stocks have generally outperformed. The portfolio also exhibits a bias away from quality stocks. Balancing these tilts shouldn't necessarily drive decision making (as other factors such as the skill of the investment manager are more important), but should still feed into the decision making process.

4. Managers

4.1. Mercer have reviewed the managers available as sub-funds in the ACCESS ACS.

4.2. The Fund's existing global managers, Dodge & Cox and JO Hambro, remain highly regarded so should be retained. The Fund transitioned into the Dodge & Cox sub-fund in February 2019 and the JO Hambro sub-fund is scheduled to be available in September 2019.

- 4.3. The third and fourth slots depend upon the ISC's decision on the need for a dedicated UK manager and whether a dedicated EM exposure is required:
- 4.3.1. The Fund's existing UK equity mandate managed by Schroder may not be available as an ACCESS sub-fund. An alternative Schroder UK fund has a significantly different risk and return profile. Of the UK equity sub-funds mentioned in Mercer's report, the preferred sub-fund is managed by Majedie which is highly rated by Mercer and is approved by ACCESS as a sub-fund.
- 4.3.2. Mercer have evaluated the global equity sub-funds available and recommend further investigation into Baillie Gifford Long Term Global Growth and Longview Partners Global Equity. A third option would be Newton Global Equity. It is noted that although this manager was previously held by the Cambridgeshire Fund, there was a strategic decision to exit this fund.
- 4.3.3. In EM equity the only current sub-fund is managed by Stewart, but there are questions about the capacity of Stewart to accept sizeable new allocations and therefore may not be available for subscription.
- 4.4. Mercer's evaluation of ACCESS sub-funds suggests the following options would meet the ISC's strategic choices:

| Strategic options Open Slots | Retain UK | Broad Global | Global with Emerging Markets |
|---|--------------------|---|--|
| | Longview or Newton | Two from Longview, Newton and Baillie Gifford | Longview or Newton (increased global active slots of 10% each to reflect EM) |
| Active Slot 4 | Majedie or UBS | | Stewart Investors (reduced allocation of c.5% to control risk) |

5. Implementation

- 5.1. The next step would be for the ISC to meet each of the prospective managers. If the available options do not meet the ISC's strategic needs then it may be necessary to lobby Link to select additional sub-fund managers.
- 5.2. There is currently a deliberate overweight to equities of approximately 11% reflecting both the recent reduction in strategic allocation and the recognising that it will take time to re-allocate funds to Alternatives. It is strongly recommended that the overweight retained to fund Alternatives is held in the UBS passive mandate outside the ACCESS ACS.

6. Summary

- 6.1. Mercer's findings can be summarised as follows:
- 6.1.1. The underlying building blocks of the current equity portfolio are best-in-class. However, the existing Schroders' UK mandate may not be available in ACCESS.
- 6.1.2. There are biases in the portfolio: geographically (overweight UK, underweight US and EM), style (to value) and to sources of manager skill. Whilst these are not

unreasonable the ISC should consider if the some of these biases should be reduced to help smooth expected returns.

- 6.2. Mercer's recommendations from the review that the ISC should decide on are as follows:
 - 6.2.1. Retain the current 23% allocation to UBS passive and implement equity protection;
 - 6.2.2. Divide the remaining 35% allocation to listed equities between 4 active managers available through the ACCESS pool;
 - 6.2.3. Retain JO Hambro and Dodge & Cox as best-in-class global equity managers with complementary styles, but reduce fund manager risk with the appointment of additional fund managers.
 - 6.2.4. ISC to decide which strategic direction the portfolio should take (UK bias, global foot print or global with EM at market weight) whilst being aware of the overall style bias of the portfolio. This decision will narrow down the choice of managers (allowing for Mercer's quality screen) to three or four possibilities.
- 6.3. Following these decisions, the next step is for the ISC to meet the possible managers to assess if they fit the Fund's strategic needs. The intention would be to do this at the next ISC meeting.

7. Recommendation

- 7.1. That the Investment Sub Committee:
- 7.2. Confirm that the strategic allocation to equities should be allocated:
 - 7.2.1. 23% to passive with UBS; and
 - 7.2.2. 35% to active equity managers, divided between either:
 - 7.2.2.1. Four managers equally (8.75% each), one UK and three global of which two will be Dodge & Cox and JO Hambro, or
 - 7.2.2.2. Four global managers equally (8.75% each), of which two will be Dodge & Cox and JO Hambro, or
 - 7.2.2.3. Four managers – three global managers of 10% each, of which two will be Dodge & Cox and JO Hambro, and one Emerging Markets manager of 5%.
 - 7.2.3. Confirm that any overweight to equities is held in UBS passive.
- 7.3. Instruct the Head of Pensions with support from advisers arrange a presentation day for the Investment Sub Committee to meet the prospective managers to ensure that they meet the Fund's strategic needs.

8. Relevant Pension Fund Objectives

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|---|
| <i>Objective 1</i> Have robust governance arrangements in place, to facilitate informed decision-making, supported by appropriate advice, policies and strategies, whilst ensuring compliance with appropriate legislation and statutory guidance. |
| <i>Objective 3</i> Ensure the relevant stakeholders responsible for managing, governing and administering the Fund, understand their roles and responsibilities and have the appropriate skills and knowledge to ensure those attributes are maintained in a changing environment. |
| <i>Objective 5</i> Continually monitor and manage risk, ensuring the relevant stakeholders are able to mitigate risk where appropriate. |
| <i>Objective 18</i> Put in place a Strategic Asset Allocation ensuring it is appropriately maintained taking into account the Funding Strategy. |

9. Finance & Resources Implications

- 9.1. The financial and resource requirements are contained in the existing budgets and activities of the Fund.
- 9.2. Investment performance is reviewed by the ISC on a quarterly basis and where necessary appropriate action is taken to address concerns or weaknesses.

10. Risk management

- 10.1. The ISC have the Authority to review and maintain the asset allocation of the Fund within parameters agreed with the Pension Fund Committee and the authority to appoint and terminate investment managers to the Fund. In both proposing the strategy to the Pension Committee and implementing the strategy the ISC are advised by external profession Investment Consultants, Mercer Ltd.
- 10.2. The risks associated with implementing the strategy have been captured in the Fund's risk register as detailed below.

| Risk register | Risk mitigated | Residual risk |
|----------------------|--|----------------------|
| Investment (Risk 3) | Investment decisions and portfolio management may not maximise returns or be performed in accordance with instructions provided. | Green |
| Investment (Risk 5) | Fund assets are not sufficient to meet obligations and liabilities as they become payable. | Green |
| Investment (Risk 11) | Mismatch in asset returns and liability movements result in increased employer contributions. | Green |
| Investment (Risk 15) | Failure to act upon expert advice or risk of poor advice. | Green |

- 10.3. The Fund's full risk register can be found on the Fund's website at the following link:
<https://pensions.cambridgeshire.gov.uk/governance/key-documents/cambridgeshire/>

11. Communication Implications

11.1. Policy documents will be updated as appropriate and published on the Fund's website.

12. Legal Implications

12.1. Legal advice will be sought as required.

13. Consultation with Key Advisers

13.1. This paper has been produced in conjunction with the Fund's Investment Consultants, Mercer.

14. Alternative Options Considered

14.1. Included in the paper.

15. Background Papers

15.1. None.

16. Appendices

16.1. Appendix A – Mercer paper – Equity portfolio review – August 2019 (**Exempt paper**).

| Checklist of Key Approvals | |
|--|----------------------|
| Is this decision included in the Business Plan? | Not applicable. |
| Will further decisions be required? If so, please outline the timetable here | Yes. |
| Is this report proposing an amendment to the budget and/or policy framework? | No. |
| Has this report been cleared by Chief Finance Officer/Section 151 Officer? | Yes. Sarah Heywood. |
| Has this report been cleared by Head of Pensions? | Yes. Mark Whitby. |
| Has the Chairman of the Pension Fund Committee been consulted? | Yes. Cllr Rogers. |
| Has this report been cleared by Legal Services? | Yes. Fiona McMillan. |