Pension Fund Sub Committee
27th September 2011

Report from the Director of Finance and Corporate Services

For Decision	Wards Affected: None Specific

Report Title: Asset Allocation Review 2011

1. SUMMARY

This report reviews the asset allocation for the Fund (paras. 3.3 – 3.10), examines consultancy advice and issues for consideration (para. 3.11), and sets out a process for considering the revision of the asset allocation (para. 3.12)

2. RECOMMENDATIONS

2.1 Members are asked to

a) Comment on the current asset allocation
b) Note the process for review.

3. DETAIL

Background

3.1 The asset allocation for the Brent fund was initially agreed in 1996 following an Asset Liability Study (ALS) by the Fund actuary, then Watson Wyatt, and was confirmed after further studies in 1999 and 2002. The studies considered the likelihood of meeting fund liabilities on the basis of a number of asset allocation options. A number of changes have been made since 2002 to reflect the need to diversify out of equities to reduce risk, the high price of government bonds and new investment opportunities. It is apparent that the Brent asset allocation is very different to the average, with strong diversification out of equities and gilts – the average local authority fund has only 8% of the Fund invested in alternatives (4% in 2008), against 26% at Brent. There is strong evidence that other funds are gradually moving in similar ways, but it appears to be both a slow and a more limited process.

3.2 A review of the asset allocation is important in the light of poor investment performance relative to other local authorities and the recent Actuarial Valuation. The 2010 Valuation indicated that liabilities are only 61% funded, which is the second worst local authority outcome out of 89 funds nationally. As a result, employer contributions have been increased from, in the case of Brent Council, 22.9% in 2010 to 27.4% by 2013, with further increases predicted.

Additionally, staff numbers have been reduced by almost ¼ to around 2,800 (Brent only) as a result of severe reductions in government funding meaning that far less employees are paying into the fund in future. It is anticipated across local government that changes in pension contributions and benefits resulting from the Hutton review and other initiatives will lead to an increase in 'opt-outs' further depressing the number of future paying members.

A further consideration is that the Head of Exchequer and Investment will retire in 2012, so it will be important to consider such issues as the optimal number of managers as well as the investment strategy.

3.3 All of these factors lead to the conclusion that the fund is 'fragile' will need careful management to bring it back to a more stable position and will need to be underpinned by a long-term investment strategy that is sustainable, manageable and realistic.

2008 Asset Allocation Review

3.4 Table 1 below shows the past and current allocation against the local authority average (figures in brackets show the current benchmark)

Table 1 – Brent Fund asset allocation

	Brent Fund			
			30th June 2011	
	2005	2008	Actual (benchmark)	Local government average
	%	%	%	%
UK Equities – FTSE 350	25.5	18	14 (11.5)	31
UK Equities – Small Co's	4	4	3 (4)	-
Overseas Equities	22.5	21	32 (28.5)	34
UK Gov. & Corporate Bonds	20	8	9 (9)	19
Fixed interest – satellite fund	-	8	7 (9)	1
Global Tactical Asset Alloc.	-	4	4 (4)	1
Property	8	8	7(8)	6
Infrastructure	-	5	2 (5)	1

Private Equity	8	8	11(10)	3
Hedge Funds	5	10	9(10)	2
Currency	7	5	- (-)	-
Cash	-	1	2(1)	4

3.5 In 2008, members agreed the following proposals:

a) Exposure to infrastructure to be increased to 5% of the Fund either through direct investment or through a Fund of Funds - Alinda was appointed in 2009, but it is too early in the life of the fund to judge results.

b) Exposure to the Fauchier Partners hedge Fund of Funds to be increased from 5% to 10% of the Fund - Hedge funds performed relatively well for the period to March 2009, but have lagged during the equity rally from that date. Fauchier underperformed during 2010 as managers were caught out by the market upheaval surrounding the euro (May / June 2010), and did not take on sufficient risk thereafter.

c) Exposure to equities, fixed interest and currency to be reduced to allow a) and b) above - Exposure to equities was reduced, while the currency mandate was terminated as a result of poor performance and doubts about processes. The fixed interest asset allocation was maintained at a higher level than originally planned following the market gyrations of 2008.

d) There was to be further research into opportunities to diversify into property investment overseas - The collapse in the USA market, and the lack of market opportunities in Europe have left overseas property investment becalmed. The investment in infrastructure has filled the gap.

e) There was to be consideration of the fixed interest mandate managed by Henderson - The manager has made a number of changes to their funds and to their asset allocation, so that performance has improved. Henderson is now on a performance related fee basis, suggesting more confidence.

3.6 The overall impact of the changes arising from the 2008 review has not improved performance to date. Exposure to hedge funds was increased in 2009, just before equity markets bottomed out and began their rapid rise. It is too early to judge the results of investment in infrastructure and increased investment in private equity

3.7 Various other changes have been made since 2008. In particular, the active global equity manager has been replaced by a passive manager (in developed overseas equity markets) and an active manager (in emerging market equities). The asset allocation has been revised to increase exposure to overseas equities as against UK equities. Also, the currency mandate has been terminated following poor performance.

Why is the asset allocation followed by the Brent Fund different to that used by the average local authority?

3.8 Although the asset allocation for the average local authority pension fund has changed since 2008 (UK equities down 6.1%, overseas equities up 2.5%, alternative investments up 3.5%), it is apparent that Bent has invested a substantially greater proportion of its fund in alternatives (mainly hedge funds, private equity, GTAA and infrastructure) than other funds. The increase in the use of alternatives arose for the following reasons:-

1) Consultancy advice. The consultancy house Watson Wyatt & Partners has previously published advice on investing more widely in alternative, absolute return assets so that <u>outperformance is obtained from a number of sources</u>. The house has examined asset allocation strategies, concluding that most risk is being taken through investment in equities (the equity risk premium) and advising that risk could be spread / reduced and returns enhanced by seeking premia for other types of risk. These may be:
    a) Premia for extra skill, as evidenced in commodity or hedge fund investment.
    b) Illiquidity premia as a reward for locking in an investment over a long period, as in private equity or investment in private finance initiatives (PFI) and infrastructure.
    c) Credit risk premia, where investment is made in lower quality investments such as high yield (lower grade) bonds or emerging market debt.

    Hewitt Consulting at the time suggested that the equity component of Funds should be reduced below 50%, with expanded exposure to such assets as hedge funds – using direct investment or delegation to consultants to reduce costs, and emphasising single strategies that are appropriate (distressed debt or macro) – infrastructure, property or private equity..

2) The lessons of the market crashes in 2000-03 and 2007-09, when it became apparent that equities had become overvalued, that there were other risk premia that could be accessed and that diversification may reduce some risks and volatility.

3) Experience in the USA indicates that alternative assets can offer higher returns and / or reduce volatility of returns and risk. Various colleges and public institutions have invested heavily in a range of alternatives, reducing exposure to equities, but improved returns. The approach followed by the Yale Fund – 20% in each of real estate, equities, bonds, hedge funds and private equity – has yielded excellent returns over twenty years.

Investment performance

Table 2 – Brent Pension Fund performance

	Brent Fund %	Brent Benchmark %	Average Local Authority %
12 months	6.7	6.9	8.2
3 years	0.6	3.1	5.4
5 years	0.3	2.3	4.0
10 years	2.7	3.8	5.3

3.9 The Brent Fund has underperformed both its benchmark and the average fund over the last against all time measures, although the last 12 months has seen a *relative* improvement. The main reasons for underperformance in the three year measure against the benchmark are:-

a) Asset allocation has assisted performance against the benchmark (+0.2%).

b) Stock selection - AllianceBernstein (-1.6%), the hedge fund manager (-0.3%) property (-0.3%) and GTAA (-0.2%) have underperformed their benchmarks. The issues of AllianceBernstein and GTAA have been resolved – the AllianceBernstein mandate was terminated, and Mellon has outperformed significantly over the last two years following improving processes and more favourable markets. The property underperformance relates to the absolute return benchmark followed by the European fund of funds – this should be resolved now that the market is recovering. On hedge funds, the manager underperformed in 2008 as a result of the Lehmans crisis (when all markets fell) and again in 2010 as a result of managers taking insufficient risk and the fund having insufficient exposure to credit markets (since resolved).

3.10 The main reasons for underperformance against the average local authority fund are:-

a) Asset allocation lost value in 2009/10 and 2010/11, when the fund had low exposure to equities and high exposure to hedge funds and private equity. The allocation to private equity is relatively immature but should begin to add value over the next three years.

b) Stock selection lost value in 2008/09 and 2010/11, when overseas equities, bonds (the allocation to the satellite fund lost value in 2008/09), hedge funds, currency (2008/09), and GTAA (2008/09) underperformed.

Returns in individual asset classes in the Brent fund (over three years) were as follows:-

	Return %	Benchmark %
UK equities	6.2	5.4
Overseas equities	-5.1	1.9
Core bonds	6.3	5.2
Satellite bonds	4.9	5.3
Property	-6.6	-2.4
Private equity	-0.1	1.5
Hedge funds	1.3	5.9
GTAA	-2.7	5.1

Issues for consideration

3.11 There are a number of issues for consideration in an asset allocation review:

a) The performance measurer WM has also analysed the strategies followed by the most and least successful funds over twenty years. The generalised findings are that:

1) Internally managed funds are among the best performers

2) Taking a long view and not changing managers frequently assisted returns. This recognised that managers have a performance cycle and that they will not be successful in all markets.

3) Most funds underperform benchmarks.

4) Most returns come from asset allocation, not stock selection.

b) The 2010 Actuarial Valuation indicates that the fund is mature and that liabilities are only 61% funded. To ensure that funds are available to pay benefits, and provide more certain returns, it may be argued that the fund considers increased investment in bonds and gilts, which are better matching assets to pension liabilities. The actuary has also drawn attention in the Valuation to the risks that are evident – that the Fund deficit is being reduced over twenty five years, payroll is falling, and that markets are volatile. Caution is therefore necessary in setting the asset allocation – volatile returns may lead to even higher contribution rates. The market events of 2007 - 2009 are instructive, but most attention should be paid to the long-term.

c) Following the stock market crashes of March 2000 - March 2003 and 2007-09, there has been continued interest in 'liability led investment', which emphasises that index linked gilts are the best match for pension liabilities (they grow with inflation and offer a real return to match rising salary levels). It

is suggested that funds start any asset allocation review by considering a 100% allocation to bonds, thus reducing risk. The problems with a large switch to bonds are threefold. First, selling equities and going into expensive gilts fixes the current deficit, meaning much higher employer contributions in future. Second, yields on index linked gilts are low partly because pension funds have been urged to purchase for liability matching reasons, thus exacerbating the cost of funding. Third, equities have historically given better returns than gilts over the longer term (an average of 4.5% per annum over 100 years), thereby reducing the cost of funding benefits.

d) The outcome of the Hutton review. Although the current proposals would maintain a defined benefit scheme, taxation changes, the exclusion of private contractors (fairly minor for Brent) and increased employee contributions may result in staff leaving / not joining the scheme. The reduction in active members would increase the maturity of the Fund, which may reduce investment horizons or risk appetite, leading to additional investment in bonds or less volatile assets.

e) Asset allocation is the most important investment decision taken by the fund. It is responsible for around 85% of returns. It must be emphasised that asset allocation is a long-term decision and that the allocations should not be changed too frequently. This is because market timing can be poor, and transaction costs high. There is always a temptation to chase the best performing markets, which then fall in value. This is particularly pertinent for the Brent Fund, which has made a number of changes over the last ten years.

f) Although around 85% of returns have been generated by asset allocation, it is important that managers are allowed to use their skills to increase returns although the poor Brent fund performance is in no small part due to the failure of professional managers to do this. It has been suggested that more unconstrained mandates be given to encourage managers to seek absolute rather than relative returns. [1]The sub-committee has previously supported this viewpoint in allowing increased discretion to Henderson Global Investors.

g) Diversity of the fund across a number of markets and asset classes can reduce the dangers of specific market events causing losses. It is also important to diversify across investment styles – active, passive, value, growth etc. Until recently in UK the main decision was between bonds and equities. However, the asset allocation and investment manager structure should remain simple to facilitate overall management and monitoring. It should be noted that the Brent fund has eleven fund managers (including in-house), making monitoring and regular contact increasingly complex and time-

[1] Studies by Goldman Sachs indicate that returns could be increased with little risk by allowing managers to use more diversified instruments that seek return from new sources (a concept known as using the efficient frontier in investment). Research by AllianceBernstein identifies similar themes – that some constraints will distort investment and reduce returns.

consuming. Diversification can also be expensive, especially using specialists in alternative markets (hedge funds, private equity, currency etc).

h) Markets have become increasingly global so that the bulk of profits earned by British firms are generated overseas. It is also apparent that the UK equity market has become dominated by a small number of large companies so that investment is dangerously concentrated – 10 stocks comprise more than 50% of the FTSE100. The decline in the holding of UK equities – as funds increase global holdings – may reduce market values. A number of consultants have argued for increased overseas equity exposure, suggesting global mandates so that opportunities in UK are compared with those overseas. The Brent Fund has increased exposure to overseas equities relative to UK.

i) Emerging market equities have produced some of the best equity returns over the last 20 years, and emerging market economies are growing much faster than developed markets. The Brent Fund increased exposure to emerging markets in 2010, but will need to keep exposure under regular review. This remains a higher risk market.

j) Before the sharp correction in values after 2008 (UK property prices fell by over 40%) property had been the best performing main asset class over all periods to 10 years, producing good rental earnings (income yield), supported by long leases and improved management, and being a good investment diversifier. As against these 'plus points', property is expensive both to invest in and to sell – although secondary markets may reduce costs - and has proved to be vulnerable in the periods 1989 – 1991 and 2007 - 09. The UK market fell sharply from summer 2007 before recovering in 2009. The Brent Fund has also invested in Europe, where falls were smaller but recovery slower. Overseas investment opportunities have not developed as expected, so there may be better opportunities in infrastructure. It is expected that UK property may return around 7% over the longer term.

k) Equities are amongst the best performers in the longer term but have a tendency towards volatility in the short term. Equities produced excellent returns throughout the 1980's and 1990's (an average of 17% per annum for the period 1983 - 2000), but have underperformed since then. The FTSE 100 remains well below the level it reached at December 1999. Although it is anticipated that equity returns will be higher than those for government bonds, reduced growth in values has three main implications. First, the additional income from equities against bonds may be insufficient for the risks involved. Second, equity exposure may be reduced as funds invest in other asset classes with (possibly) better prospects, such as (perhaps) commodities, hedge funds and private equity. Third, equity exposure could be sought in areas that are less well researched, such as small companies and emerging markets. It should, however, be emphasised that equities should continue to outperform gilts and property (6.5%/7%) in the longer term. Hedge funds may

return around 7.5%, and private equity 10%/15%. However, the fund manager GMO forecasts that only emerging market equities will offer good long term returns over the next ten years because equity markets have become seriously overvalued.

l) The Myners report proposed that trustees should consider investment in all asset classes, and publish reasons for non-investment if appropriate. The Brent fund currently invests in all the main asset classes.

m) It is likely that corporate bonds will continue to offer better returns than government bonds over the longer term as a reward for risk. It is believed that gilts are currently overvalued and that the market will eventually correct, but the high savings levels in Asia and bond investment by pension funds are supporting prices.

n) Commodities. Members have previously considered the issues around investment in commodities. It is suggested that commodities are more volatile than is desirable, and that the asset class can go long periods with poor performance. As against this, they give good diversification benefits against equities and are enjoying excellent returns as emerging markets seek to improve their infrastructure. It is anticipated that this may be a continuing trend as sources of supply are constrained.

o) Infrastructure. The Brent Fund has invested in two funds and is awaiting results. The Henderson fund has suffered severe falls, but the Alinda fund appears to be developing successfully. The advantage of Infrastructure investment is that income yields may be well above gilt yields and inflation proofed, thereby matching expenditure flows. However, further investment may be restricted by investment regulations specifying that LGPS funds can only commit 15% of their Fund to limited partnerships.

p) Global Tactical Asset Allocation (GTAA) – Brent invested in GTAA (which involves currency, bond and equity market views) in July 2007, suffering severe losses as markets became very volatile. Performance has improved following improvements to processes and the recovery of equity markets.

Process for the asset allocation review

3.12 In order to support the asset allocation review process, the consultancy firm Mercer Ltd has been appointed to provide advice on asset allocation and to lead a training session with members to examine the main issues surrounding asset classes, risk, the fund deficit and the maturity of the Fund. Following the training session, a further report will be prepared to recommend options for any changes to the asset allocation.

4. FINANCIAL IMPLICATIONS

4.1 There will be additional transaction costs arising if changes are made to the asset allocation.

5. STAFFING IMPLICATIONS

5.1 None directly.

6. DIVERSITY IMPLICATIONS

6.1 The proposals in this report have been subject to screening and officers believe that there are no diversity implications arising from it.

7. LEGAL IMPLICATIONS

7.1 There are no legal implications arising from the report.

8. BACKGROUND

8.1 Statement of Investment Principles – Pension Fund Sub Committee 24th Feb 2008

JP Morgan – Alternative Investment Strategies – 2005

Goldman Sachs – Perspectives – Active Risk and Active Alpha investing

Myners' report on Institutional Investment – 2001

Actuarial Valuation 2010 – AonHewitt

Pension Fund Sub Committee – Asset Allocation review 2008 – September 2008

Persons wishing to discuss the above should contact the Exchequer and Investment Section, Finance and Corporate Resources, on 0208 937 1472/74 at Brent Town Hall.

CLIVE HEAPHY
Director of Finance & Corporate Services

MARTIN SPRIGGS
Head of Exchequer & Investment