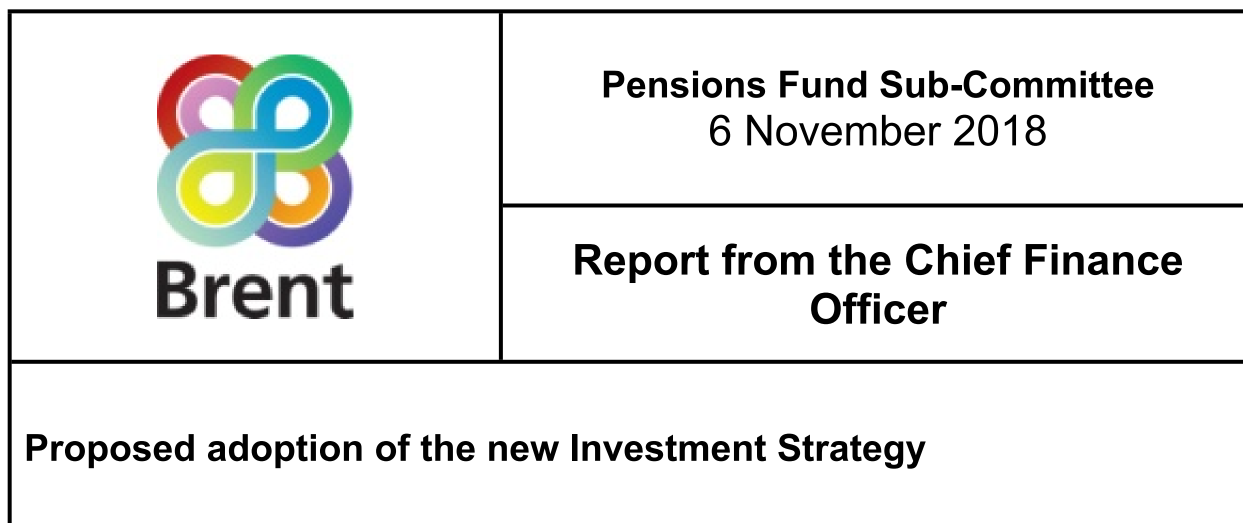


Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	OPEN
No. of Appendices:	
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Conrad Hall, Chief Finance Officer Ravinder Jassar, Head of Finance

1.0 Purpose of the Report

1.1 This report updates the committee on the further work undertaken since the presentation of the investment review in June 2018 and the decisions now proposed to implement the strategy over the short to medium term.

2.0 Recommendation(s)

2.1 Approves the Investment Beliefs as set out in Appendix A.

2.2 Approves the proposed target and interim asset allocation as set out in Appendix B.

2.3 Delegates authority to the Chief Finance Officer to sell holdings that are not consistent with the new strategy and to acquire new holdings. This includes the following:

2.3.1 To sell the Janus Henderson Total Return Bond and buy passive longer dated gilts with BlackRock and the London CIV Multi Asset Credit Fund, utilising some of the available cash held for investment (as set out in section five);

2.3.2 To sell Janus Henderson Small caps UK equities mandate (as set out in section seven);

2.3.3 To hold a more regionally diversified approach to global equities, by reducing the Fund's UK equity exposure and introducing an allocation to emerging markets (as set out in section four); and

2.3.4 To utilise part of the current cash balance available for investment in the interim while suitable investments become available to achieve the proposed Investment Strategy (as set out in section seven).

3.0 Background

3.1 The primary role of the Pensions Sub Committee is the strategic management of the assets of the Fund to ensure it is in a position to meet benefit payments as they fall due and to reach a position of full funding.

3.2 As at the last valuation in 2016, the funding position of the Fund was low, at 55%, with assets of £676m and liabilities of £1.238m. In order to ensure that the deficit does not increase, the assets of the Fund need to increase faster than the increase in liabilities. The objective to reach a position of full funding therefore has a significant effect on the investment strategy, where a large proportion of the asset allocation is weighted towards relatively higher risk and higher growth assets, in order to generate superior returns and growth in the long term, above other protection and liability matching assets, such as government bonds.

3.3 In light of the above, and other key regulatory changes within the LGPS such as asset pooling, the committee agreed in November 2017 to commission a project to review its investment strategy with the following objectives:

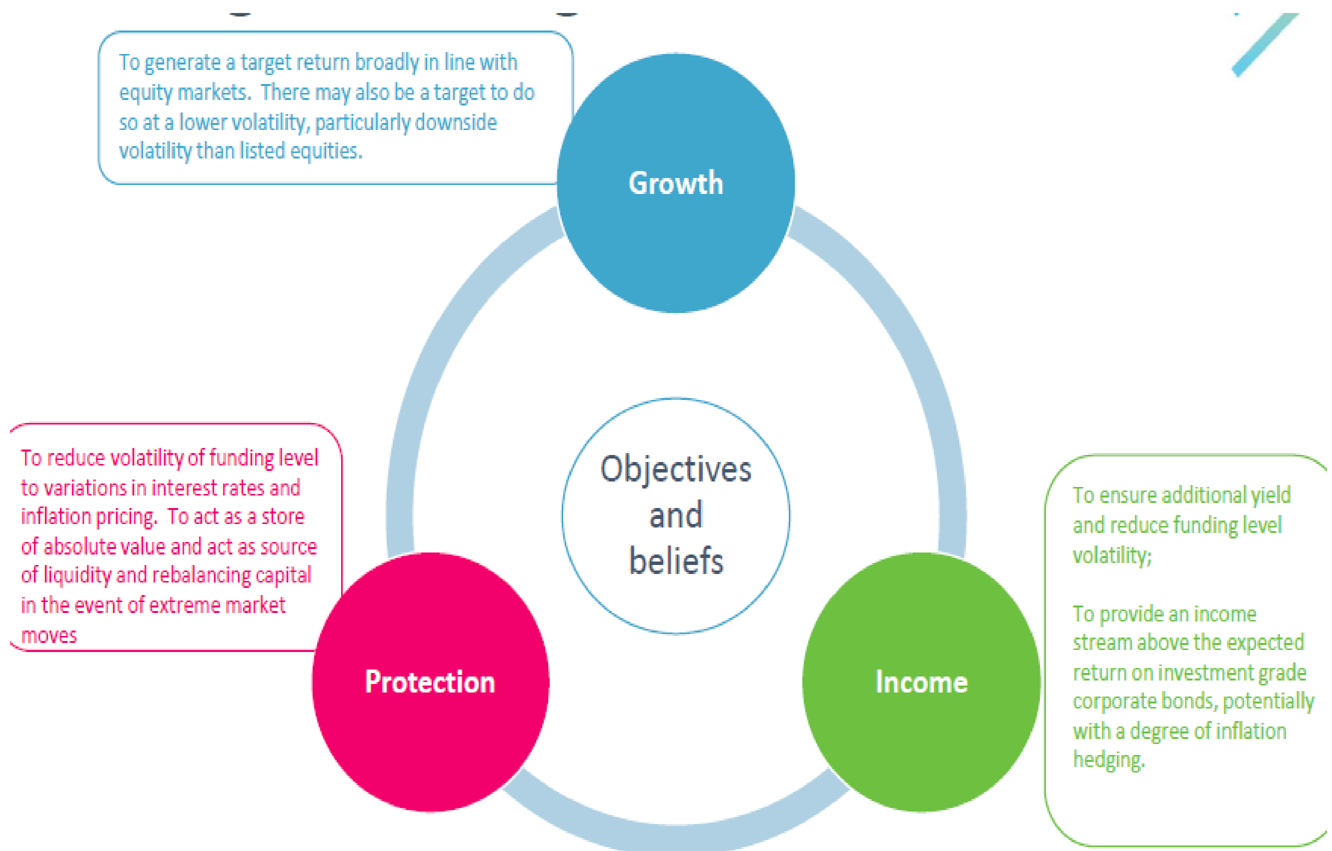
- To establish a set of Investment Beliefs that will support the long term strategic approach of the Pension Fund's Sub-Committee.
- To gain a broader understanding of the risk/return dynamics of the Fund's investment strategy and to ensure that the strategy remains fit for purpose in supporting the Fund's long term objectives.
- To set a medium term agenda and timetable on how the Fund might comply with the requirement to pool its assets, and to consider a process for mapping the existing portfolio across to the London CIV pool.

3.4 In June 2018, members were presented with the outcome of the strategy review, alongside a set of investment beliefs shaped by the committee. Well run pension funds tend to have a set of clearly defined investment beliefs that helps to clarify how they have translated their objectives into their underlying investment strategy. The investment beliefs are attached at Appendix A and it is intended that these beliefs are published alongside the investment strategy statement.

3.5 The strategy review included carrying out asset liability modelling to test the probability (and associated risks) of the Fund's current investment strategy achieving the long-term objectives. The current strategy's results were also compared with other investment strategies. The next stage of the review focused on the underlying components of the **Growth, Income and Protection** elements of the strategy, in particular testing these against the Fund's implicit investment beliefs. The results of the review highlighted that:

- a more diversified investment strategy maybe be more appropriate from an expected risk and return perspective;
- the move from the current strategy to the more diversified strategy should take place over time, taking into account the availability of suitable investment opportunities from the London CIV, the scope to access private markets, transition costs and the current market environment; and
- Appendix B provides a mapping table to show the previous asset allocation and how, over time, the proposed asset allocation will be achieved.

3.6 The graphic below sets out the strategic building blocks of the proposed asset allocation:



3.7 In defining the building blocks described above the proposed asset allocation is shown below compared to the current asset allocation.

	Current strategic allocation	Potential alternative (over medium-term)
Growth (Equities/DGF)	76%	60%
Income (Yield)	8%	25%
Protection (Hedging)	16%	15%

4.0 Growth assets

"To ensure additional yield and reduce funding level volatility. To provide an income stream above the expected return on investment grade corporate bonds, potentially with a degree of inflation hedging"

4.1 In the recent strategy review it was recommended that the Fund adopts a 45% target allocation to listed equities. It was also recommended that the geographical allocation of this equity allocation is considered.

4.2 The Fund's growth assets are dominated by listed Equities and Diversified Growth funds. The Fund also includes allocations to Small Caps and Private Equity. This is contrary to the Investment Beliefs set out in this report, in terms of governance and passive management. Therefore it is recommended that these allocations are removed from the Fund's Investment Strategy (for Private Equity this will take time as the existing investments run-off).

4.3 The Fund's regional listed equity allocation currently has a notable bias toward UK equities and no exposure to emerging markets. As at June 2018, UK equities accounted for around 6% of the overall global equity market whereas emerging markets accounted for around 10%. In order to gain exposure to returns generated in emerging markets, as well as considering diversification as one of the key investment beliefs of the Fund, it is recommended that a more regionally diversified approach is taken to equities by (in the first instance) reducing the UK equity exposure by removing the existing Henderson UK small cap equity mandate and investing the proceeds in emerging markets.

4.4 The current listed Equity split is one third UK and two thirds developed market equities. The recommended split (as discussed in 4.2 above) would change this to broadly 25% UK, 66% Developed and 9% Emerging Market Equities and be in line with the Investment Belief on the need for diversification. The impact of this change would be a c.0.67% p.a. saving on the annual investment management fee (c£220k p.a. based on the current mandate size and assuming emerging markets are managed passively). Based on the information provided by the managers, a one-off cost of change of c£160k is expected.

4.5 In terms of Active vs Passive for Equities, given the desire to minimise governance, it is recommended to continue with the current strategy of passive

management for Listed Equities as this is most aligned to the Fund's beliefs. However, with regards to emerging markets, these markets are typically less regulated and can be volatile and unpredictable.

4.6 Emerging markets include Chinese listed state owned enterprises with complicated ownership structures that offer foreign minority shareholders little or no legal protection. This state control can sometimes lead to poor outcomes for shareholders. One way of limiting exposure to state owned enterprises is to invest in an actively managed fund that avoids mimicking the index and invests selectively. However these funds are typically more expensive than passive trackers.

4.7 If there is a strong view of adding active management to the portfolio, then Emerging Market Equities is an area to consider this, given the reduced transparency and perceived lower efficiency in this part of the market. If the Committee agree to invest passively in Emerging Market Equities, Blackrock could be used in order to diversify away from LGIM. Otherwise, an active option with the LCIV is available for consideration, which is managed by Janus Henderson.

4.8 It is anticipated the regional diversification within the listed Equity portfolio will be discussed further during 2019, alongside potential other aspects relating to the Equity mandate, for example, environmental, social and governance ("ESG") benchmarked funds. Considering this move to more global diversified and ESG benchmarks in tandem will reduce potential transition costs.

5.0 Protection assets

"*To reduce volatility of funding level to variations in interest rates and inflation pricing. To act as a store of absolute value and act as source of liquidity and rebalancing capital in the event of extreme market moves*"

5.1 At present the only fixed income mandate within the Fund is with Janus Henderson's Total Return Bond (TRB). Brent purchased the TRB in 2012 and as at September 2018 it has achieved returns of 3.01% gross of fees since inception. The three year rolling return is 2.68% and five year return is 2.37%. The objective of the fund is to achieve a return within a range of 3-5% p.a., gross of fees. As reported to the committee in June 2018, following a procurement process of fixed income providers, Janus Henderson have not been put forward to be on the London CIV platform and therefore the TRB will not be transitioning to the London CIV. As a result of this, together with performance not meeting the Fund's expectations, the committee is asked to consider selling the TRB.

5.2 The investment review has recommended that the current target allocation of 15% to Fixed Income assets is retained, with 10% managed passively in government bonds and the remaining 5% managed in a Multi Asset Credit fund. The former is aligned to the Fund's beliefs in respect of risk and return being considered relative to liabilities, it is also low cost and provides a source of capital preservation and liquidity. With regards to Multi Asset Credit, these

funds typically invest across a range of credit opportunities including high yield bonds, corporate bonds and asset backed bonds to deliver risk adjusted returns in a diversified way. It is considered a defensive investment choice particularly in times of rising interest rates.

5.3 With regards to the passive bond fund mandate, the London CIV have LGIM and BlackRock products under their oversight on a reduced fee basis. Whilst products will be reviewed with both fund managers as part of our due diligence, there is a preference for this mandate to be managed by BlackRock given the significant amount of mandates already being managed by LGIM for Brent (c.40% of passive UK and global equities). Investing with BlackRock therefore should provide some diversification by manager, and avoid greater concentration of fund assets with LGIM.

5.4 There is a preference towards longer dated UK government bonds for the passive bond mandate. The recommendation is to invest in BlackRock's Over 15 year gilt fund. An investment of this nature can be thought of a portfolio insurance for the Fund for the following reasons:

- Nominal gilts tends to act a strong hedge for periods of slower economic growth;
- They should perform strongly in an environment when the valuation of liabilities is increasing due to low yields; and
- These assets are highly liquid and low cost which provides flexibility, most notably, at time of market stress.

5.5 London CIV launched a Multi Asset Credit fund (MAC) earlier this year and so far has secured the investment of £600m from seven London Local Authorities (LLAs). The fund will initially invest with the CQS Credit Multi Asset fund. The aim of this fund is to utilise a range of long term strategies across a range of Fixed Income strategies to generate returns during different market cycles. The fund generates returns in conditions where interest rates are rising through holdings in loans and asset backed securities. In terms of both the number of boroughs invested and the assets raised for the fund, this is one of LCIV's most successful fund launches to date.

5.6 MAC mandates are now commonly used by institutional investors and give exposure to debt such as Loans, Convertible bonds, Asset-backed securities, and Higher Yielding and Investment Grade Corporate bonds. These asset classes tend to offer a greater yield and better risk-adjusted returns to investors than government bonds when held in a diversified portfolio. A MAC investment, when held alongside the passive government bond mandate, should therefore help increase expected return and diversify overall returns generated by the fixed income allocation.

5.7 The fees on the existing Janus Henderson TRB mandate amount to c0.35% pa and it is proposed to replace this with the passive government bond mandate and the MAC fund which will have a weighted average fee of c0.18% pa. Based on the information provided by the manager, there may be a one off fee of c£130,000 in making this transaction.

5.8 The other available bond options via the London CIV that could be considered are limited at present. The London CIV is currently seeking commitments for a Global Bonds and Global Liquid Loans sub-fund but as we understand, have no investors as yet. As the MAC fund via the London CIV already has seven LLAs invested and offers a broader range of asset class exposure, it is reasonable to invest in the MAC fund, rather than wait for further options to made available by the London CIV.

6.0 Income assets

"To ensure additional yield and reduce funding level volatility. To provide an income stream above the expected return on investment grade corporate bonds, potentially with a degree of inflation hedging"

6.1 The investment review recommended that the strategic direction of travel is to increase allocation to income assets and that the Fund add to build up its existing infrastructure exposure, but also consider other yielding assets such as property. In testing this strategy against the Fund's investment beliefs, there are clear links with regards to diversification (infrastructure provides this) and achieving risk and return relative to liabilities in terms of holding long-term real assets.

6.2 The target allocation has been recommended to increase from 8% to 15% and the current actual allocation is 4% (3% Alinda and 1% Capital Dynamics). There is currently £16.5m of undrawn capital commitments with regards to these mandates, however, all other things being equal, if all of this was immediately called upon the actual allocation would increase to 5%.

6.3 The London CIV is expected to have an infrastructure funds available for investment by the end of 2018 and will be holding an Infrastructure Forum in November 2018 where further information will be provided. It is envisaged that decisions on investment in infrastructure will be made at the next committee meeting in February 2019 in order to plan towards achieving the 15% over time.

6.4 The investment review also recommended a 10% allocation to property, from having no allocation previously. The fund had legacy investments with AVIVA which have almost entirely been sold.

6.5 The London CIV will have two property funds available for investment in early 2019. There will be a UK property fund (both residential and commercial) and a global property fund. It is envisaged that decisions in such yielding assets, i.e. property, will take place over the course of 2019 and as the CIV's fund offering evolves.

7.0 Cash Holdings

7.1 There is a current cash balance of £108.5m which has been mainly generated from distributions from mature funds (Capital Dynamics, Alinda II and AVIVA)

which are approaching the end of their terms and are therefore returning cash which has been previously invested. Although part of this cash balance is being held for outstanding capital commitments and the circa £31m being held for the asset transfer in relation to the College of North West London, there remains a large balance which is becoming a drag on performance.

7.2 Officers have carried out a cash flow analysis in respect of commitments due over the next year (e.g. member benefits) and income (e.g. employer and employee contributions and distributions) in order to estimate the proportion of the cash that can be used for investment. This is currently estimated at £60m.

7.3 Therefore, the following options (or combination of options) are proposed in order to utilise part of the cash which is not immediately required for existing commitments (fees, cost and impact on expected returns and risks will be considered with each option).

7.4 **Option 1:** As noted in more detail in section five above, there is a proposal to sell the Janus Henderson Total Return Bond (£92m as at 30 September 2018) and purchase BlackRock Passive Gilts and LCIV MAC.

At 30 June 2018, the Janus Henderson Fund was c10.6% of total assets. Option 1 would be to take the Fund closer to its target allocation of 15% of total assets. This would involve, in total, £77m (9% of the current size of the Fund) being invested in BlackRock Passive gilts and £35m (4% of the current size of the Fund) in LCIV MAC. This option would utilise a significant proportion (£20m) of the cash available for investment.

7.5 **Option 2:** There is a long-term objective to reduce the Fund's target exposure to DGFs to 15% of total assets and build up the Fund's exposure to income assets. However, it will take considerable time (years) to build up allocations to income assets, in the interim it is expected that the Fund will have a higher than target allocation to DGFs which will be reduced gradually as the income allocation increases. Investing a proportion of the cash (c£40m) in the DGFs, will provide the Fund with a balanced exposure to return-seeking assets while the London CIV's investments in Income assets (Infrastructure and Property) become available in early 2019. This option will be the most expensive (potentially one off cost of 0.3% on investment, and annual management fee of c0.47%-0.725% depending on the manager), but offer the greatest expected returns.

7.6 As at 30 June 2018, the Baillie Gifford DGF mandate has achieved returns of 7.6% since inception (15/02/2016) and the one year performance is 1.9%. Likewise, the Ruffer DGF has achieved returns of 6.1% since inception (21/06/2016) and the one year performance is 1.6%. Clearly, the Baillie Gifford fund has achieved superior returns (net of fees).

7.7 **Option 3:** As in option 1, allocate further cash into Protection assets (Fixed Income). This option will increase the asset allocation to 17% (2% above the target) however as this is a liquid asset with low fees, part of the asset can be

sold off when Income assets (Infrastructure and Property) become available for investment through the LCIV (described in section 6 above).

7.8 The recommendations by way of this report are options 1 and 2. In summary this is to invest £40m into Growth assets via the existing DGF manager, Baillie Gifford, and £20m into Protection assets via the London CIV. This will achieve the goal of getting closer to the target allocation in respect of Protection assets as well as utilising a large proportion of the cash currently available for investment into DGF's to provide the Fund with a balanced exposure to return-seeking assets while investments within Income assets become available.

7.9 As noted in section 4.2, it is proposed to sell the Janus Henderson Small caps UK equities fund as it does not align to the Fund's investment beliefs. However, selling this holding in the short term will only add to the large cash balance noted above in the short term.

7.10 That said, officers have recently been notified of a planned change in management structure by the fund manager, effective from 1 November 2018. The plan is to bring the management of the Janus Henderson UK and Irish Smaller Companies fund in house. This may lead to significant transition costs as assets are liquidated and new ones acquired. Therefore, in order to avoid incurring these transition costs it is recommended to sell as soon as possible.

7.11 In line with the options described above, the proceeds from this sale could be used to invest in protection assets (as described in option 3, above) or growth assets (as described in option 2, above). Alternatively, the proceeds could be used to fund the proposed allocation to Emerging Markets, as described in section 4.7. If the recommendation to sell the mandate is agreed, it is expected that cash will be returned in early 2019 where decisions on utilising the cash can be discussed at the next committee meeting in February 2019.

8.0 Financial Implications

8.1 These are set out throughout the report

9.0 Legal Implications

9.1 Not applicable.

10.0 Equality Implications

10.1 Not applicable.

11.0 Consultation with Ward Members and Stakeholders

11.1 Not applicable.

12.0 Human Resources

12.1 Not applicable.

<u>Report sign off:</u>

Conrad Hall
Chief Finance Officer
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