Rebalancing options

Introduction

This paper is addressed to the Officers of the London Borough of Brent Pension Fund (“the Fund”) and has been prepared to set out options that could be considered to address two particular areas of the investment strategy:

1. The current split of the passive equity mandates between UK and Global (ex UK)

2. The split between the two multi-asset funds within the London CIV (Baillie Gifford and Ruffer)

Background and beliefs

The Fund adopts a diversified approach to investing in order to meet its long term funding objectives and carries out regular reviews to ensure the Fund remains on track. The last review was carried out in February 2020 when the Sub-Committee ratified the revised interim and long-term strategic target allocations. The interim allocation was subsequently refined in June 2020.

Integral to setting this long-term strategy is the Fund’s investment beliefs. They also play a role in monitoring the asset allocation and taking appropriate action to transition towards target. The Fund’s beliefs specific to the areas considered in this paper are:

- *Strategic asset allocation is a key determinant of risk and return, and thus typically more important than manager or stock selection*

- *Rebalancing policies are important*

- *Fees and transaction costs matter*

What these beliefs draw out is that investment strategy (the allocation between growth (equities), diversifiers, and protection assets) is the key driver of investment outcomes. Structural decisions (what makes up each of the aforementioned buckets) do not have as significant an impact, but they do still matter. Additionally, when undertaking any transition or rebalancing, it is advisable to seek the most cost efficient route of implementation as transaction costs are essentially a tax on returns.

With these principles in mind, the table in appendix 1 highlights the Fund is broadly in line with the interim strategic allocation but that structural imbalances prevail. The rest of the paper therefore covers how these imbalances can be addressed and whether further structural changes could be considered within the equity portfolio itself.

Rebalancing priorities

From a structural perspective the table in appendix 1 highlights the following:

1. Global equities are 4.2% underweight

2. UK equities are 5.9% overweight

3. Imbalance between Baillie Gifford and Ruffer – current allocations are 13.3% and 5.7% respectively

The global equity allocation will be increased by 3% once the initial investment in BlackRock’s low carbon fund has been completed. This suggests the priority rebalancing actions are to reduce exposure to UK equities and adjust the allocations to Baillie Gifford and Ruffer.

UK equities

Points to note:

- In the early 2000s, UK equities represented c10% of the global equity market. Today this stands at c4% and the reduction can be attributed in part to sector composition of the UK market and the depreciation of Sterling. Further details are set out in appendix 2.
- As summarised in appendix 2, UK equities have underperformed their global counterparts in recent times. Although there is a chance the UK may experience a recovery in relative performance, we remain comfortable with reducing its weighting as currently targeted (to 5%) on the basis of the expected benefits of further diversifying the Fund's equity exposure. Furthermore, the remaining UK equity allocation of 5% would still benefit should there be a domestic market recovery.
- Once the Fund has reached its interim target allocation of 5%, UK equities will still represent c10% of the Fund's total listed equities. A future consideration for Officers and Sub-Committee members therefore can be whether the long-term allocation to UK equities should be revisited, possibly looking to bring the Fund's exposure to UK equities more into line with the UK's share of the global equity market.
- The Sub-Committee could, if they feel appropriate, rationalise the Fund's equity holdings by disinvesting from the LGIM UK equity fund completely and investing all of the equity holdings in passive global equity instead.
- However, initially the focus is on the current imbalance relative to target. We therefore propose reducing the allocation to UK equities to the interim target allocation of 5% by selling down LGIM's UK equity holding in two steps, each of 3%, and reinvesting the proceeds as follows:

  1. Reinvest 3% in Ruffer for the reasons set out in the next section
  2. Reinvest 3% in LGIM global equity

  We would be happy to discuss the timing of these transactions with you.

Baillie Gifford and Ruffer

Points to note:

- Both funds have a target return of Cash + 3.5% p.a. and aim to deliver equity-like performance but with lower volatility by capturing returns when the markets are rising and protecting capital when markets are falling.
- The managers have different styles with Baillie Gifford regarded as more of a directional fund (i.e. it tends to follows the direction of broader markets) and Ruffer having more of a focus on capital preservation (i.e. Ruffer may not perform as well as Baillie Gifford in a rising market but may fare better in a falling market). Having such complementary styles offers an added element of diversification and suggests an equitable split between the mandates may prove beneficial over the longer term.
- The first 2 quarters of 2020 provided an illustration of these complementary styles. Baillie Gifford delivered returns of -14.0% in Q1 and of +8.4% in Q2 while Ruffer delivered returns of -2.3% in Q1 and +6.4% in Q2.
- As with equity investing, investment in multi-asset funds should be considered over appropriate timeframes. It is therefore informative to look at the performance of these funds over longer periods, including past performance from the equivalent versions of the Baillie Gifford and Ruffer funds that were in place before pooling. Appendix 3 illustrates this past performance.

- The Fund's interim target allocation is to have 10% each in Baillie Gifford and Ruffer. At end of August 2020, the actual allocations were 13.3% and 5.7% respectively. Therefore, we believe there is scope to redress the split between these two mandates through some form of rebalancing.
- One option is to disinvest c3% from Baillie Gifford and reinvest the proceeds in Ruffer. However, we believe a more cost-effective option is to disinvest 3% from UK equities (for the reasons set out on the previous page) and invest the proceeds with Ruffer.
- This would take the allocations to 13.3% and 8.7% respectively, more closely aligned to the interim target split of 10% each. As the Fund's allocations to private markets and property build up over time it will be necessary to monitor these multi-asset allocations and act accordingly in order to not only maintain an appropriate split but manage the gradual reduction in allocation to a combined 5%, the agreed current long-term target.

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22 September 2020

For and on behalf of Hymans Robertson LLP

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix 1 – Asset allocation as at 31 August 2020

Asset class	Fund	Value as at 31 Aug 2020 £m	Actual asset allocation	Interim strategic allocation
Global equities (ex UK)	LGIM passive	365.4	38.8%	43%
Global equities (inc UK)	BlackRock low carbon	-	-	
UK equities	LGIM passive	102.4	10.9%	5%
Emerging markets	LCIV (JP Morgan)	41.8	4.4%	5%
Private equity	Capital Dynamics	40.9	4.3%	5%
Total growth		**550.5**	**58.4%**	**58%**
Diversified growth	LCIV (Baillie Gifford)	125.4	13.3%	10%
Absolute return	LCIV (Ruffer)	53.7	5.7%	10%
Infrastructure	LCIV, Cap Dynamics, Alinda	33.1	3.5%	5%
Property	Aviva	0.0	-	-
Total diversifiers		**212.2**	**22.5%**	**25%**
Multi-asset credit	LCIV (CQS)	39.6	4.2%	5%
Government bonds	BlackRock	91.3	9.7%	10%
Cash		49.1	5.2%	2%
Total protection		**180.0**	**19.1%**	**17%**
Total		**942.8**		

Appendix 2 – Background on UK equities

Sector composition

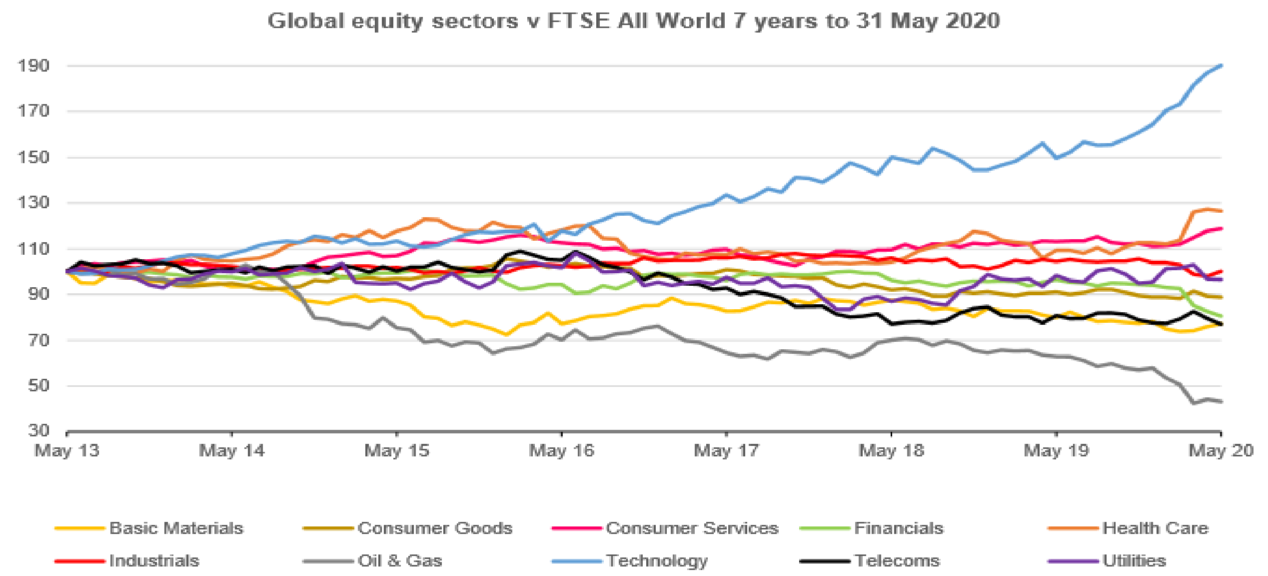
While there are many reasons that UK equities have underperformed the wider global equity index not limited to: economic growth, political factors, monetary policy and currency movements, one of the most commonly sighted reasons is the sector composition of the UK equity market. The UK market has less sector diversification when compared with the global index (see table below).

	FTSE All Share (%)	FTSE All World (%)	Relative (%)
Oil & Gas	7.7	3.5	**+4.2**
Basic Materials	8.9	4.0	**+4.9**
Industrials	12.2	12.0	**+0.2**
Consumer Goods	15.7	11.0	**+4.7**
Health Care	11.7	12.0	**-0.3**
Consumer Services	11.5	12.6	**-1.1**
Telecommunications	2.3	2.6	**-0.3**
Utilities	3.5	3.2	**+0.3**
Financials	25.2	17.6	**+7.6**
Technology	1.2	21.5	**-20.3**
Total	100.0	100.0	**-**

Source: FTSE Russell. As at 31 July 2020. Totals may not sum due to rounding.

Relative to the global index, the UK has a high weighting to Oil and Gas, Basic Materials, Financials and Consumer Goods sectors – most of which have a high degree of cyclicality and a very significant underweight to Technology – that has been delivering outstanding performance, particularly over the last 5 years.

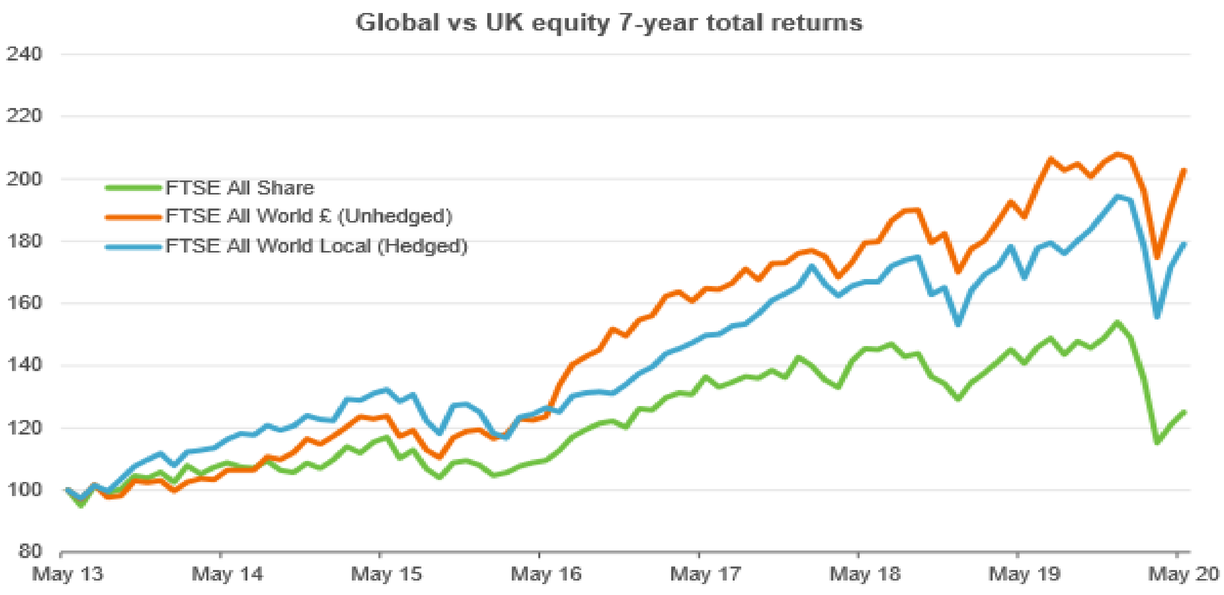
The reason for the sector-driven underperformance becomes clear when looking at the chart below showing relative sector performance over the last 7 years. All 4 of the most overweight UK sectors (Oil and Gas, basic Materials, Financials and Consumer Goods) are in the bottom 5 performing sectors relative to the Global index. Furthermore, technology – where the UK is underweight – has outperformed all other sectors over the period.



Source:DataStream

Impact of Sterling depreciation

A common challenge on the outperformance of the Global index vs UK is that this outperformance has been driven by currency effects. The chart below compares UK equity total returns vs global over the last 7 years.



Source:DataStream

Over the last 5 years sterling has weakened significantly. However, as the above chart shows, even if fully hedging foreign currency exposure the global index has still outperformed the UK market by some margin over the last 7 years. While decisions on foreign currency hedging do play a part in returns (certainly over the short and medium term) we would expect the regional allocation to have an even greater bearing on returns.

Concentration of holdings

A further observation is the high concentration of the largest companies in the UK index relative to that of the global index. This is illustrated in the below table which shows that the top 10 holdings in the UK represents c34% of the total index – more than double that of the global index. The UK index also has c1/7th of the total number of constituents: FTSE All Share = 613 and FTSE All World = 3,945 (as at 31 July 2020).

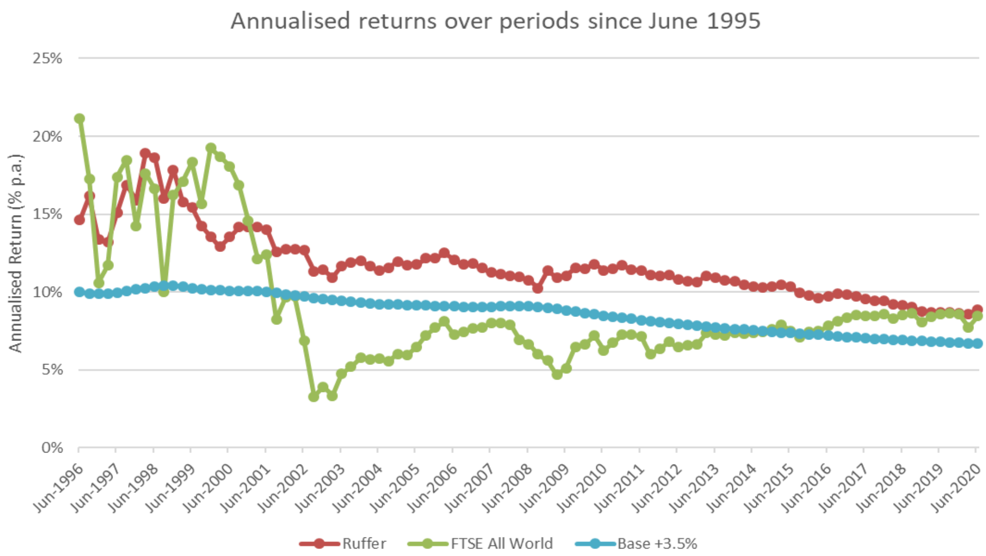
Position	FTSE All Share	Weight (%)	FTSE All World	Weight (%)	Country
1	AstraZeneca	6.0	Apple	3.5	USA
2	GSK	4.0	Microsoft	3.1	USA
3	HSBC	3.7	Amazon	2.7	USA
4	Diageo	3.4	Facebook	1.2	USA
5	British American Tobacco	3.1	Alphabet A	0.9	USA
6	BP	2.9	Alibaba	0.9	China
7	Rio Tinto	2.7	Alphabet C	0.9	USA
8	Unilever	2.7	Tencent	0.8	China
9	Reckitt Benchkiser Group	2.6	Johnson & Johnson	0.8	USA
10	Shell	2.5	Taiwan Semiconductor Manufacturing	0.7	Taiwan
Total		**33.6**		**15.4**	

Source:FTSE Russell. As at 31 July 2020. Totals may not sum due to rounding.

Appendix 3 – Past performance of multi-asset funds

Ruffer

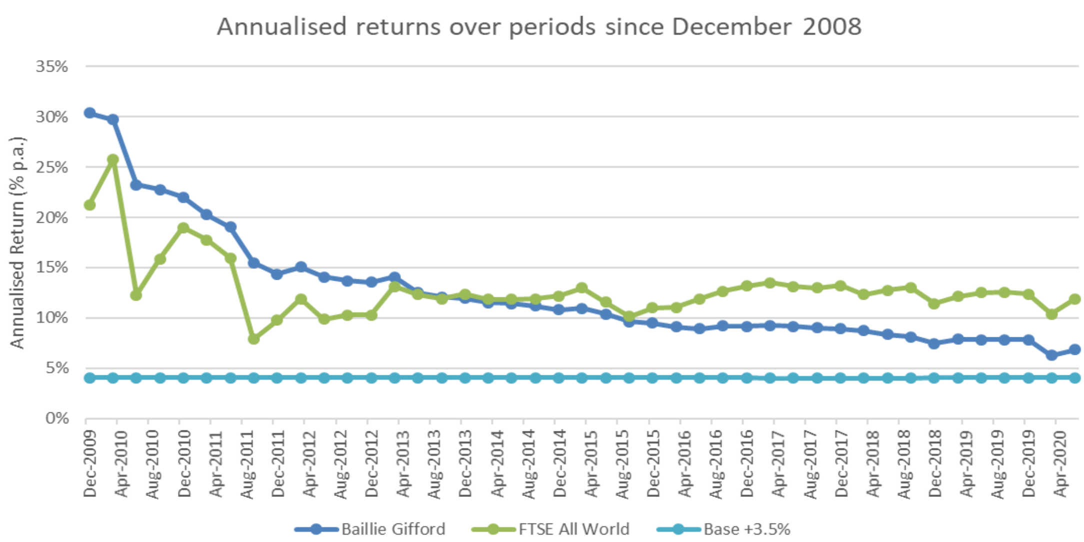
The chart below shows the annualised return over various time periods, all starting from 30 June 1995. As an example, this shows that the return achieved by Ruffer over the 10 year period to June 2005 is around 12% p.a. Over the same time period, the FTSE All World index produced a return of around 6% p.a. This chart shows that Ruffer have achieved a return broadly in line with the FTSE All World Index over the last c25 years.



Source: eVestment

Baillie Gifford

The chart below shows the annualised return over various time periods, all starting from 31 December 2008. As an example, this shows that the return achieved by Baillie Gifford over the 10 year period to December 2018 is around 7% p.a. Over the same time period, the FTSE All World index produced a return of around 11% p.a. The chart also shows that over the period since December 2008, the return achieved by Baillie Gifford has lagged behind the return on the FTSE All World Index.



Source: eVestment