City of Westminster Pension Fund
Market Update and Investment Opportunities

Executive Summary

This paper has been prepared for the City of Westminster Pension Fund Committee ("the Committee"). The note covers recent market movements, looking at some of the factors that have been driving markets and the potential implications for pension schemes.

A strategy review was undertaken in 2012 that was updated in 2015 that proposed a reduction in the Fund's reliance on equity markets, increasing the allocation to property and property-like investments. As part of the review of the investment strategy, the decision was taken to switch the Fund's investment in conventional gilts into Standard Life's Long Lease Property Fund. Relative to the target benchmark allocation agreed in 2015, the Fund currently has a 5% unfunded allocation to Property or Infrastructure, which is expected to be funded from the equity portfolio.

With the 2016 Actuarial Valuation in progress, it is an opportune time for the Committee to take a step back and reassess whether the strategy remains relevant in the light of the level of return required, the funding level for the Fund, the cashflow requirements, the prevailing market environment and the investment opportunities that are available.

In this paper we look at the asset mix at a high level and outline some investment opportunities which we believe are attractive in the current market, with a particular focus on improving the level of diversification and generating contractual income.

Brexit and Market Update

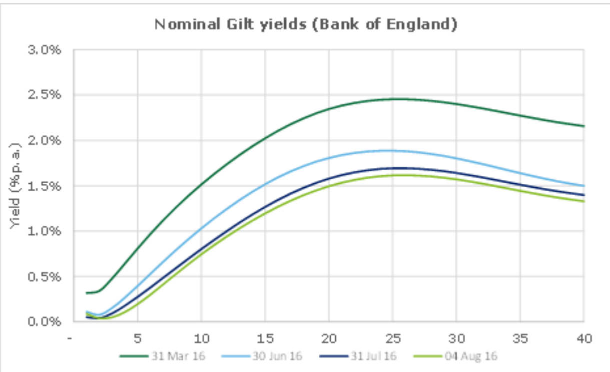
The key issue affecting markets in the UK and globally has been the UK's decision to leave the EU. With the nature and timeframe for Britain's exit of the EU remaining uncertain, it is difficult to comment on the longer term implications of the Brexit vote with any degree of confidence. That said, since the referendum result, markets have been volatile and the impact on most pension schemes has been marked.

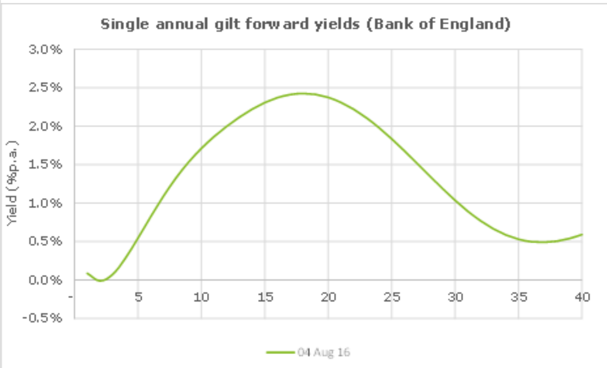
The market reaction to the EU Referendum result was perhaps not surprising. With a Remain victory 'priced in' there was a sharp correction in the immediate aftermath of the result, with sterling depreciating significantly, equity markets falling sharply and gilt yields declining to new lows.

It remains too early to assess the economic implications of Brexit. Financial markets have recovered from the short-term shock but there remains considerable uncertainty over the process by which UK might leave the EU, and the implications of this. Adding to the economic uncertainty are a range of political factors, not least of which being elections in the US and some European countries over the next 12 months. If the exit process is relatively benign, it should have mild impacts on the global economy, with more specific implications for UK and Europe. But even in this base case, global growth is likely to be lower and uncertainty higher over the next couple of years.

Yields

In the immediate aftermath of the EU Referendum, bond yields fell dramatically. Over the second quarter gilts yields fell by around 50bps (0.5%) across the curve, most of which happened after the result was announced. Yields fell further in July in the run up to the August Monetary Policy Committee ("MPC") meeting in anticipation of a rate cut and further quantitative easing and when these expectations were met by the Bank of England, cutting the base rate to 0.25%, the yield curve fell further still by another 10 – 15bps.





Equity

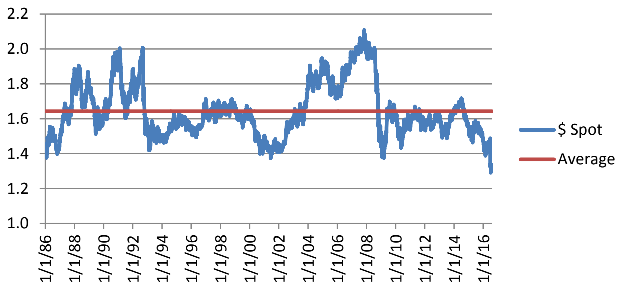
Interestingly, after an initial sharp fall, equity markets recovered quickly with the rise in the FTSE 100 largely reflecting that around three quarters of earnings from the larger companies come from overseas with the stocks benefiting from a weaker sterling. Averting one's gaze away from the UK's main index, the picture becomes less clear cut. UK centric stocks bore the brunt of the post referendum risk aversion. The FTSE 250 Index, which is dominated by such stocks, fell 6.1% between the 23 June and the quarter end, albeit it did recover in July.

P/E ratios have continued to rise sharply and are now in excess of the historical highs of the "dot-com bubble". Declining corporate earnings at the same time as a rally in UK equities post the EU Referendum appear to indicate that UK equities are somewhat over-valued relative to earnings and are becoming increasingly reliant on the persistently cheap cost of capital. With the UK's economic fortunes uncertain, an earnings based reduction in P/E ratios looks unlikely.

Sterling

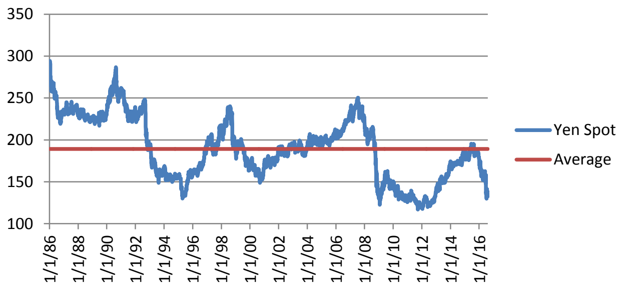
Sterling was one of the headline sufferers of the EU Referendum result as it fell 10.5% versus the US Dollar in the week following the result. Sterling continued to fall against the major currencies through July such that since the start of the year it has depreciated by roughly 12%, 15% and 25% against the dollar, euro and yen.

£ exchange rate vs US $



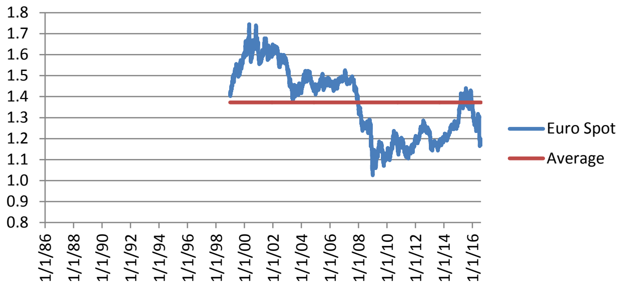
Source: Bloomberg

£ exchange rate vs Yen



Source: Bloomberg

£ exchange rate vs Euro



Source: Bloomberg

Impact for Pension Schemes

For many pension schemes, the fall in gilt yields has been a significant factor and continues to be the main area of concern.

The reasons a pension scheme typically holds gilts are to protect the scheme's funding level against movements in interest rates and (implied) inflation and to meet expected benefit cash flows.

Schemes that have not held gilts but where the liabilities are assessed on a gilts basis will have seen a substantial increase in their funding deficit and will now be faced with the challenge of whether to implement or increase hedging levels. With over 40% of the global government bond universe having negative yields, it should not be assumed that because UK yields are low that they will rise and return to historic levels. While analysis of the forward curve shows that the market has almost consistently got expectations of future gilt yields wrong for the last 40 years, we believe that bond yields and interest rates will remain low for even longer.

The low yielding environment creates challenges for schemes looking to generate income to match liability cash flows and has forced investors to seek alternative sources of income.

Current Investment Strategy

The table below shows the Target long term strategic allocation versus the Actual mix of the assets as at the end of June 2016 – it should be noted that the Committee agreed that for performance measurement purposes, the Fund's benchmark is assumed to be 70% equity, 20% bonds and 10% property.

Manager	Asset Class	Target (%)	Actual (%)	Benchmark	Outperformance Target
Majedie	UK Equity	20.0	22.9	FTSE All-Share Index	**+2.0 p.a. (net of fess)**
LGIM	Global Equity	20.0	22.2	FTSE World GBP Hedged	**Passive**
Baillie Gifford	Global Equity	25.0	17.4	MSCI AC World Index	**+2.0 p.a. (net of fess)**
Longview	Global Equity		11.1	MSCI World (GBP) Index	**To outperform the benchmark over a market cycle**
	Total Equities	**65.0**	**73.6**		
Insight	Fixed Interest Gilts	-	1.7	FTSE Gilts up to 15 Yrs Index	**Passive**
	Non-Gilts	20.0	14.9	iBoxx £ Non-Gilt 1-15 Yrs Index	**+ 0.90 p.a. (gross)**
	Total Bonds	**20.0**	**16.6**		
Hermes	Property	5.0	5.1	IPD UK PPFI Balanced PUT Index	**+0.5 p.a. (net of fess)**
Standard Life	Property	5.0	4.7	FTSE Gilts All Stocks Index +2% p.a.	**+0.5 p.a. (net of fess)**
	Property / Infrastructure	5.0	-		
	Total Other	**15.0**	**9.8**		
	Total	**100.0**	**100.0**		

The main recommendations from the previous investment strategy reviews were:

- In 2010 to reduce the reliance on equities being the main source of excess return, with the proposal to cut the allocation from 72% to 50% and to introduce a 10% allocation to alternatives – in the work carried out in 2012, this was revised to a reducing the equity allocation to 65%;
- Increasing the bond allocation from 20%;
- Increasing the allocation to property and property-like investments from 8% to 18% which was subsequently revised to 15%.

In the event, the decision was taken in 2013 to switch out of conventional gilts into long lease property, reflecting concerns about the reduction in bond yields and the additional yield that was available from property with bond-like properties. Steps were also taken to introduce further diversification to the equity portfolio, transferring assets from Newton to a combination of Baillie Gifford and Longview.

Expected return

The 2013 Actuarial Valuation report assumed an expected return on the investment portfolio of 6.2% p.a. The table below shows the expected return, based on our current expected return for the asset class.

<table>
<tr><th>Mandate</th><th>Benchmark Allocation</th><th>Expected Return</th></tr>
<tr><td>Majedie</td><td>22.5%</td><td>7.5%</td></tr>
<tr><td>LGIM</td><td>22.5%</td><td>7.3%</td></tr>
<tr><td>Baillie Gifford</td><td rowspan="2">25.0%</td><td rowspan="2">7.3%</td></tr>
<tr><td>Longview</td></tr>
<tr><td>Insight Gilts</td><td rowspan="2">20.0%</td><td>2.2%</td></tr>
<tr><td>Insight non Gilts</td><td>3.9%</td></tr>
<tr><td>Hermes</td><td>5.0%</td><td>6.5%</td></tr>
<tr><td>Standard Life</td><td>5.0%</td><td>5.0%</td></tr>
<tr><td></td><td>Total</td><td>6.4%</td></tr>
</table>

The actual return on the Fund over the three years to 31 March 2016 (i.e. since the last Actuarial Valuation) was 7.7% p.a.

Points to consider

- While equities have in general delivered strong returns over the last 3 and 6 year periods (approximately 10% and 9% per annum for global equities respectively) – albeit with a reasonable level of volatility, the UK bond market has been stronger (12% per annum for both periods) as yields have continued to fall. Given the Fund’s continued reliance on equities, as the 2016 actuarial valuation process is in train, now would be an appropriate point to look at whether this remains relevant – particularly given the increased focus on income generation.
- The Fund’s agreement with Insight has expired and the Fund is restricted on the extent to which the agreement could be extended further. Although Insight has agreed to continue to manage the assets as per the previous agreement, this is still something which should be reviewed by the Committee. Last year, alternative approaches to bond management were discussed with the Committee, such as Buy and Maintain Credit.

Investment Opportunities

In this section, we outline some of the areas that we believe could be of potential interest to the Committee when considering the investment strategy.

Infrastructure

Over the past few decades, infrastructure investment by governments in developed economies has slowly reduced with a steady trend from public to private financing of infrastructure projects. The 2008 financial crisis added to the problem, weakening economies and increasing regulation.

There is a real need for infrastructure investment with the European Commission forecasting that Europe will need €2 trillion in new infrastructure projects by 2020. The UK government has also set up the first ever National Infrastructure Plan which forecasts a £483bn pipeline between now and 2020-21.

While there is some blurring between some types of property and infrastructure, the characteristics associated with infrastructure investments typically include high barriers to entry, economies of scale, regulated industries, long term cash flows often linked to inflation and inelastic demand relatively immune to the fortunes of the underlying economy.

Key risks tend to be regulatory/political in nature. With barriers to entry so important, there is always a risk of some form of competition diluting returns. In addition, a lot of investments carry with them development risk. However it is important to highlight that the characteristics and key risks within infrastructure can be vary by mandate type.

UK versus Global

The infrastructure investment opportunity and attractiveness within a country is dependent on numerous factors such as the relative ease of doing business, tax rates, the availability of capital, government policy and quality of existing infrastructure. The UK has been an attractive location for institutional investment due to its stable risk/return profile and the existence of well-regulated financial markets. Most of the opportunities available have tended to be around regulated utilities or, more recently, focused around renewable energy projects encompassing wind and solar power.

Greenfield versus Brownfield

Greenfield assets are assets at the construction phase, before they become operational. Greenfield assets can require substantial capital and time to construct and are therefore subject to completion risk and usage risk. Given these factors, we would expect the returns from Greenfield assets to be more "equity-like". In the current climate, weaker outlook for GDP is likely to adversely affect the returns from Greenfield assets.

Brownfield assets are those which have completed construction and are in the operational phase. This allows cash flow projections to be more accurately estimated, particularly in the case of regulated assets, and investors are able to see value opportunities by monitoring the asset's current management and business development plans.

Open ended versus closed ended

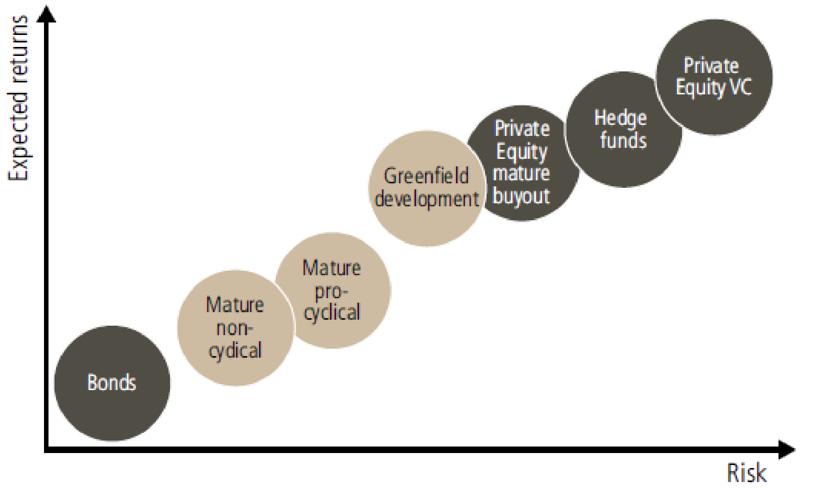
A closed ended fund operates within a set lifespan, similar to the typical Private Equity fund model. The manager collects capital commitments from investors over a set period and will then look to deploy this capital during the investment phase (usually up to four years). The total fund term tends to be at least 10 years with a further couple of years giving the manager time to realise the investments. An open ended fund does not have a time horizon, and usually offers quarterly/annual liquidity (subject to an initial lock-in), allowing managers to buy and sell assets at the most appropriate time and market conditions. Open ended funds also offer investors an immediate source of income as well as giving some transparency into the fund before investing.

In some cases we are seeing a hybrid approach being offered where the fund starts off as a closed ended vehicle which then becomes more open ended after an initial investment period.

Returns will depend on a number of factors – not least of which being geography, industry and whether the fund is targeting Brownfield or Greenfield opportunities.

The diagram below gives an indication of the risk/return relationship between elements of infrastructure and other alternative assets.

Infrastructure risk-return expectations



Source: UBS Asset Management. For illustrative purposes only

We are aware of a number of products that are currently open to investors where the focus is more on regulated utility related assets that are expected to deliver IRRs in the region of 8 – 10% per annum.

Fees for infrastructure investment vary tremendously, ranging from the private equity level of 1.5% - 2% plus a performance element for funds offered by some of the longer established players, to a limited number of providers looking to build credentials offering flat fees of 0.8% - 1.0%.

Private lending

Private financing to corporate borrowers was historically an area which banks dominated. However following the financial crisis, the profitability issues in the banking sector as well as increased regulation have meant that banks' capacity to lend has reduced, creating an opportunity for institutional investors.

While there are banks still lending in this space, private lending offers other advantages for corporate borrowers given the more bespoke terms on offer. The ability to offer non-amortizing debt and larger loans provides borrowers with more flexibility and lower governance requirements.

Loans are typically for a period of 5 – 7 years, where our preference is for the senior secured part of the capital structure. We are aware of a number of products available where the manager is focusing on loans to middle market companies, partnering with private equity firms, where the expectation is that returns will be in the region of Libor plus 6% per annum.

As with infrastructure, while there are organisations offering funds in this space looking to charge private equity type fees, there are also funds available where the fees are below 1%, albeit with a performance kicker for any return above a hurdle rate.

Real estate debt

Along similar lines to private lending, we continue to see some investment opportunities in the real estate debt market for pension schemes to step into the space vacated by the banks, financing real estate.

Investment opportunities exist in the real estate debt space, typically falling into either the senior part of the capital structure (where returns are typically Libor plus in nature) or where the focus is more on mezzanine debt (where more of an absolute level of return is expected).

Reflecting that there has been interest from both pension funds and annuity funds in this sector of the market, focusing primarily on senior debt, the premiums available have contracted from those seen 4 years ago.

Recognising that there are additional governance issues involved with introducing allocations across a number of the areas touched on above, we have seen a handful of investment organisations offering funds that look to invest in opportunities across a number of these areas.

Deloitte Total Reward and Benefits Limited
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- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

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