City of Westminster

Committee Report

Decision Maker:	**PENSION FUND COMMITTEE**
Date:	**23 January 2020**
Classification:	**General Release**
Title:	**Strategic Investment Strategy Review**
Wards Affected:	**All**
Policy Context:	**Effective control over Council Activities**
Financial Summary:	**There are no direct financial implications arising from this report.**
Report of:	**Phil Triggs** ***Tri-Borough Director of Treasury and Pensions*** **ptriggs@westminster.gov.uk** **020 7641 4136**

1. EXECUTIVE SUMMARY

1.1 This report details the review undertaken by the Fund's investment advisor, Deloitte, of the current investment strategy, highlighting their observations and recommendations to consider when devising the new investment strategy.

2. RECOMMENDATIONS

2.1 The Committee is recommended to:

a) Reduce the equity allocation by 10% to 55%, with 5% invested within fixed income and 5% in an illiquid alternative asset class.
b) Review the current equity portfolio and agree adding a new active equity mandate to complement the existing portfolio.
c) Select renewable infrastructure as a new illiquid alternative asset class.
d) Consider whether to place the additional 5% in fixed income across the existing portfolios or to allocate to a new mandate e.g. direct lending.
e) Consider Whether residential property would offer greater diversification than the existing long lease and core mandates.

3. PROPOSALS AND ISSUES

Current Investment Strategy

3.1 The Funds current strategic asset allocation, as at 30 November 2019, had 65% allocated to equities, 20% to fixed income, 10% in property and 5% to infrastructure. Whilst the 65% allocation to equities has contributed positively to the Fund this allocation has also increased the Fund volatility.

3.2 Based on the Funds current strategic asset allocation the best estimate median expected return is 5.4% p.a., with a volatility of 13.2% p.a. Deloitte also estimate, by using their worst-case scenario modelling, the 1 year 95% value at risk to be £418m.

3.3 The overall funding level of the Fund has improved by 20% to 100% funded in 2019 compared to 2016, with the Council's funding level increasing by 16% during this period to 86%. The Council plans to pay off it's deficit of circa £130m by 2021/22, with around £100m available to invest in the Fund's investment portfolio.

Issues to consider

3.4 The following issues have been highlighted for consideration when preparing the new investment strategy:

- Reliance on equity markets: Almost two thirds of the Fund's allocation is to equities, given the change in funding level the Committee should consider whether the structure and allocation to equities is still appropriate.
- Diversification: The Fund has little risk reduction from diversification, there is scope for further diversification, particularly with the use of more illiquid assets.
- Forward funding arrangement: Deficit recovery receipts of circa £130m are expected in the next two years.
- Annual cashflow deficit: It is estimated that going forward the Fund will operate an annual cashflow deficit of circa £10m, this does not take in to account the funds received from the forward funding agreement.
- Liquidity: The Fund holds circa £20m in cash with the custodian, Northern Trust.
- Generating income: Currently income from asset managers is re-distributed back into each fund, it would be relatively easy to switch on the distributing share class with no added cost.

Strategy Proposals

3.5 The investment advisor has set out three alternative strategy proposals going forward, with the aim of reducing equity allocation risk and increasing diversification:

- **Strategy 1:** Reduce equity allocation to 60% with the additional 5% going to fixed income, this has the benefit of reducing volatility to 12.8%, however expected return also reduces by 0.2%.

- **Strategy 2:** Reduce the allocation to equities by 10% and make a 5% allocation to fixed income and 5% to a new illiquid alternative. This would bring the volatility down to 12.6% with the expected return reducing by 0.2%.

- **Strategy 3:** Reduce equity allocation by 15% and increase the allocation to fixed income by 5%, infrastructure by 5% and 5% to a new illiquid alternative. This would reduce the volatility to 12.3%, however the expected return would fall by 0.3%.

Proposed Strategy and Implementation

3.6 As per the investment advisor review, the recommended way forward would be to implement strategy 2 and decrease the equity allocation by 10% moving in to fixed income and illiquid alternatives. This would result in a decrease of 0.2% in expected return, however volatility would decrease by 0.6% and value at risk would reduce by £30m.

3.7 The current equity allocation comprises of 70% within the LGIM global passive fund and 30% within Baillie Gifford Alpha Growth mandate. In order to improve diversity within this asset class it is suggested that a third global equity manager is selected to complement the other two managers. When selecting a new equity manager, the Committee should consider the options available on the London CIV platform and may also want to consider funds with an ESG specific approach.

3.8 To further increase Fund diversity, it is recommended that the additional 5% investment within fixed income is made to a new strategy where the Fund can benefit from an alternative source of return and illiquidity premium. An allocation to direct lending would be expected to deliver attractive returns and would aid in the Fund's ability to meet future cash flows.

3.9 Additionally, there is potential within the real estate asset allocation, other than the core and long lease property mandates, which may be more attractive in the current market. Given that the core and long lease mandates are starting to look increasingly similar, moving in to residential property or affordable housing could offer another form of diversification.

3.10 The recommended 5% allocation to an illiquid alternative could provide an opportunity for the Fund to invest within renewable infrastructure. With the UK government pledge to targeting net zero greenhouse gas emissions by 2050, a significant amount of investment is required within the renewable's infrastructure space. There are a number of specialist managers targeting renewable developments specifically, given the large

commitments flowing into core infrastructure assets these speciality managers can gain a competitive advantage. It should be noted that investors should be willing to accept the development risk that comes with this asset class, which can offer higher returns but with a greater risk of default.

4 RECOMMENDATIONS AND NEXT STEPS

4.1 The Committee should discuss and agree the most appropriate strategic asset allocation for the Fund going forward. The following proposals, as recommended by the investment advisor, should be taken in to consideration:

a) Reducing the equity allocation by 10% to 55%, with 5% invested within fixed income and 5% in an illiquid alternative asset class.
b) Review the current equity portfolio and consider adding a new active equity mandate to complement the existing portfolio.
c) Selecting renewable infrastructure as a new illiquid alternative asset class.
d) Whether to place the additional 5% in fixed income across the existing portfolios or to allocate to a new mandate e.g. direct lending.
e) Consider whether residential property would offer greater diversification than the existing long lease and core mandates.

4.2 Upon agreement of the above recommendations a timeline for implementation setting out a plan for 2020 in order of preference will be established.

If you have any questions about this report, or wish to inspect one of the background papers, please contact the report author:

Billie Emery bemery@westminster.gov.uk

BACKGROUND PAPERS:

None

APPENDICES:

Appendix 1 – Investment Strategy Review