Deloitte.

City of Westminster Pension Fund

Investment Strategy Review

January 2020

Contents

Investment Strategy Review

Introduction

Investment Strategy Review

This report has been prepared for the City of Westminster Pension Fund Committee ("the Committee"). The Purpose of which is to provide a review of the City of Westminster Pension Fund's (the "Fund") current investment strategy, highlighting our observations that we believe the Committee should consider when deciding on a new investment strategy and detailing our recommendations given our findings.

In this report we provide an update on how the Funds asset portfolio has evolved since 2016, the results of the 2019 Actuarial Valuation and the current investment strategy. A review of the current investment strategy is given through our observations of issues that the Committee should consider and we provide our recommendation given these observations. Finally, a set of next steps the Committee could take is provided.

Recap of the Fund

Recap of the Fund

2016 asset allocation

Asset allocation 30 June 2016

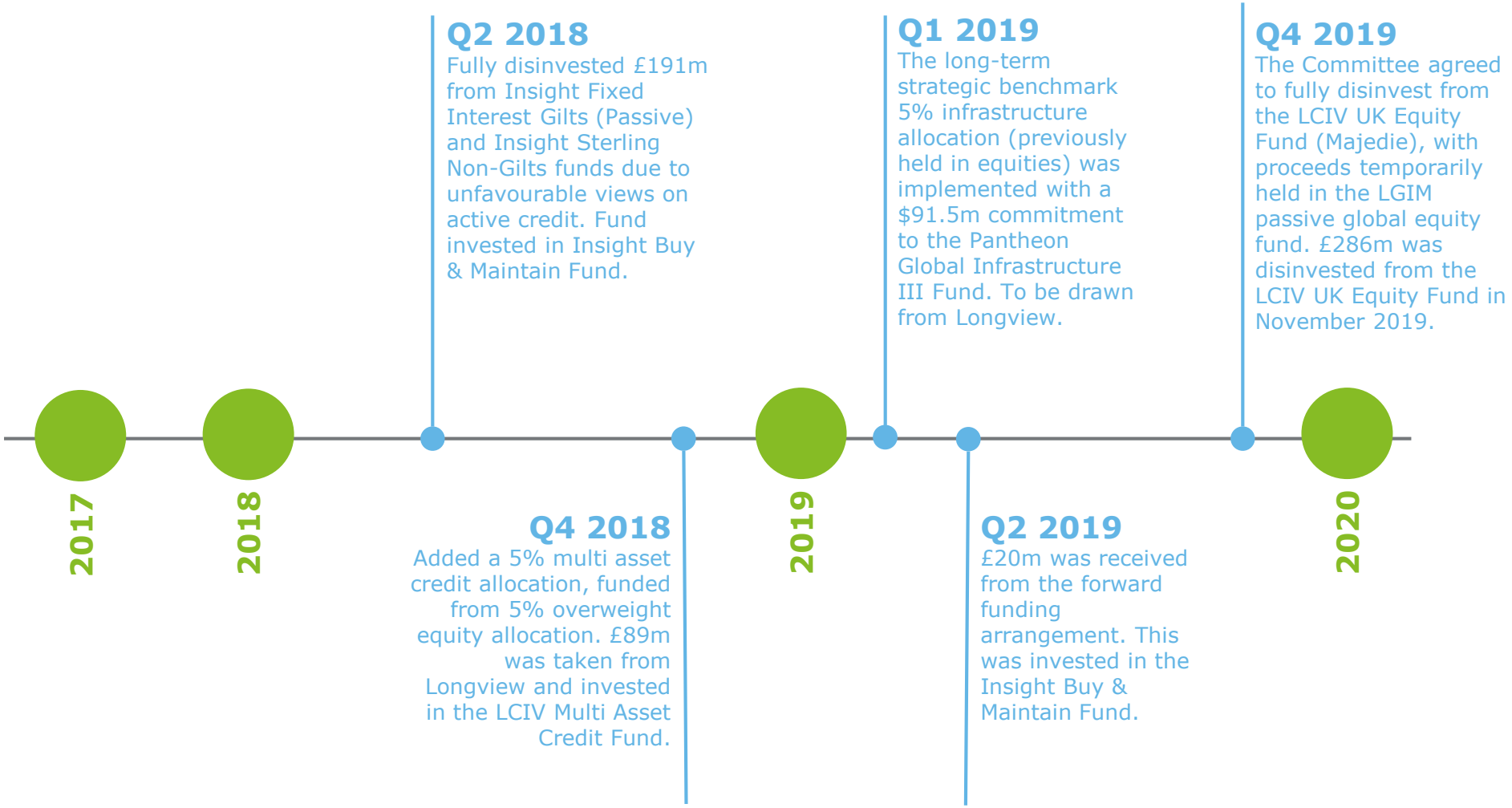
Manager	Asset Class	End Jun 2016 (£m)	End Jun 2016 (%)	Benchmark Allocation (%)
Majedie	UK Equity	250.6	22.8	22.5
LGIM	Global Equity (Passive)	243.2	22.1	22.5
Baillie Gifford	Global Equity	191.3	17.4	25.0
Longview	Global Equity	121.9	11.1	
	Total Equity	**807.0**	**73.4**	**70.0**
Insight	Fixed Interest Gilts (Passive)	18.8	1.7	20.0
Insight	Sterling Non-Gilts	163.2	14.8	
	Total Bonds	**182.0**	**16.6**	**20.0**
Hermes	Property	55.5	5.3	5.0
Standard Life	Property	51.8	4.7	5.0
	Total Property	**107.3**	**10.0**	**10.0**
Cash	In-House Cash	0.3	0.0	-
	Total	**1,096.3**	**100**	**100**

Benchmark allocation set to 70% equity, 20% bonds and 10% property, however the long term benchmark allocation includes a 5% allocation to infrastructure, to be funded from the equity portfolio.

Recap of the Fund

Changes to portfolio since 2016 valuation

Changes since 2016 actuarial valuation



Recap of the Fund

2019 asset allocation

Asset allocation 30 November 2019

Manager	Asset Class	End Nov 2019 (£m)	End Nov 2019 (%)	Benchmark Allocation (%)
LCIV	UK Equity (Majedie, active)	9.0	0.6	22.5
LGIM	Global Equity (Passive)	646.9	42.4	22.5
LCIV	Global Equity (Baillie Gifford, active)	317.4	20.8	20.0
Longview	Global Equity (active)	71.4	4.7	0.0
	Total Equity	**1,044.7**	**68.5**	**65.0**
Insight	Buy and Maintain Credit	231.5	15.2	13.5
LCIV	Multi Asset Credit	93.8	6.2	6.5
	Total Fixed Income	**325.3**	**21.3**	**20.0**
Hermes	Core Property	67.1	4.4	5.0
Aberdeen Standard	Long Lease Property	67.1	4.4	5.0
	Total Property	**134.2**	**8.8**	**10.0**
Pantheon	Global Infrastructure	20.1	1.3	5.0
	Total Infrastructure Equity	**20.1**	**1.3**	**5.0**
Cash	In-House Cash	1.1	0.1	**-**
Total		**1,525.5**	**100**	**100**

Current investment strategy

Current investment strategy

2019 actuarial valuation

Current strategy

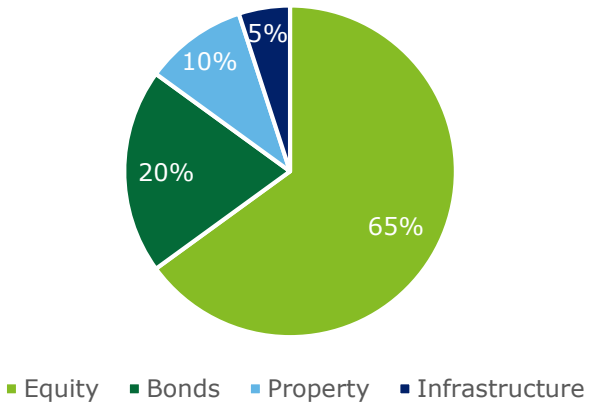
Based on the current strategic benchmark, the Fund's median best estimate expected return is 5.4% p.a., with a volatility of 13.2%. Whilst the 65% strategic allocation to equities contributes positively to the Fund's expected return, this allocation also has the impact of increasing Fund volatility.

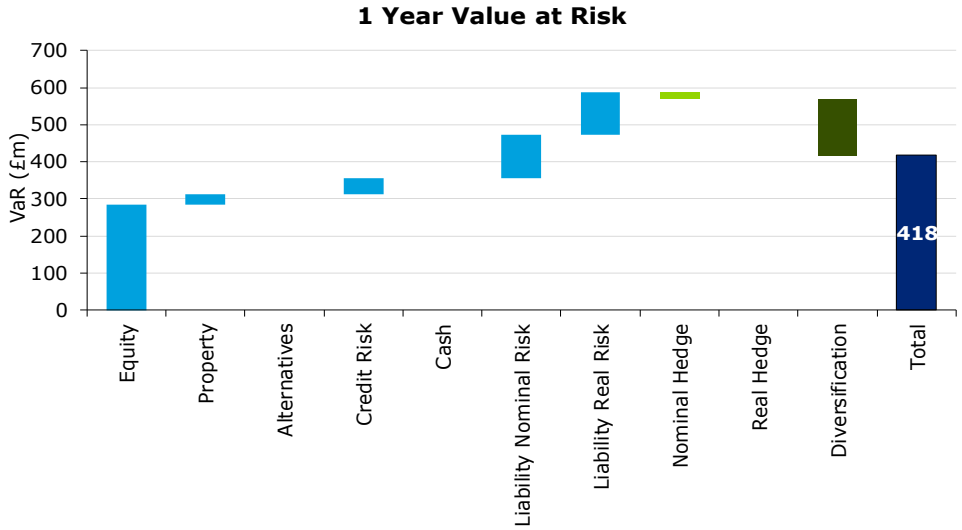
1 Year 95% Value at Risk ("VaR") is a representation of how the deficit/surplus could change given a 1 in 20 year worst case scenario. This analysis is useful as it allows us to quantify the risk within the portfolio and determine as to whether or not the Fund could withstand such an event.

Based on our stochastic model, we estimate the Fund to have a VaR of £418m.

Key metrics	
Expected return	5.4% p.a.
Volatility	13.2%
1 year 95% Value at Risk	£417.7m

Current benchmark allocation





Current investment strategy

2019 actuarial valuation

Funding level

As at 31 March 2019, the Council's funding level stands at 86% - increasing from 70% as at 31 March 2016. The Council plans to pay off its past deficit of c. £152m (as at 31 March 2019) in 2021/22.

The funding position of the whole Fund, including the Council, was 99% as at 31 March 2019. This represents an increase in funding level of 19% since 31 March 2016 where the funding position stood at 80%.

Funding position as at 31 March 2019	
Westminster City Council	86%
Total Fund	99%

Source: Copy of SLT Pensions Survey

Forward funding arrangement

The Fund received a £20m payment in Q2 2019 through a forward funding arrangement, which was invested in the Insight Buy & Maintain Fund. Through the same forward funding arrangement, it is expected that a further £100-110m will be received in April 2021. Approximately £10m of this figure will be used to pay pension payments, with the remaining c. £100m available to invest in the Fund's investment portfolio.

Current investment strategy

Issues to consider

Reliance on equity markets

The Fund's current strategic benchmark includes a 65% allocation to equities, however there is currently 68.5% of the Fund invested in equities. The Fund's infrastructure mandate with Pantheon is still in drawdown, with c. £50m still to be drawn. This is to be funded from equities, in particularly Longview, which had £71m as at 30 November 2019. We estimate that once Pantheon is fully drawn, the equity allocation will be c. 65%.

With almost two-thirds of the Fund's allocation to equity, there is a significantly large reliance on equity markets to deliver the Fund's return. Furthermore, the equity portfolio has changed with one active and one passive mandate.

Given the change in funding level over the past three years, the Committee should consider whether the overall equity allocation and structure of the equity portfolio is still appropriate.

Diversification

As shown on the earlier VaR chart, the Fund has little risk reduction from diversification.

While the fund has allocations to credit, property and infrastructure, there is scope to add further diversification, particularly with the use of more illiquid asset classes.

Approximately 84% of the Fund's assets are daily liquid, with a further c. 15% in monthly liquid funds. Only 5% of the benchmark allocation is in a long term illiquid strategy and therefore benefitting from the illiquidity premium available to pensions schemes with a long term time horizon.

Current investment strategy

Cashflow considerations

Forward funding arrangement

As mentioned earlier in this paper, £20m was received in Q2 2019 and invested in the Insight Buy & Maintain Fund. A further £100-110m is expected to be received in April 2021.

Annual cashflow deficit

Based on estimations of the Fund's outgoing cashflows and projected contributions and receipts, the Fund is expected to be in an annual cashflow deficit of **£10-11m** in future years. This does not take into account funds received from the forward funding arrangement.

Next year, the Fund is expected to receive a £14m deficit recovery contribution. Approximately £10m of the £100-£110m forward funding arrangement to be paid in April 2021 is currently earmarked to be used to cover the expected annual cashflow deficit. Based on this, the Fund should have no requirement to take income from the investment portfolio for the next two years. However beyond this period, the Fund may need regular income distributions from its investments.

Currently, the Fund receives income from both Hermes and Pantheon. Hermes distributes a variable quarterly amount based on rents collected, whilst Pantheon distributes variable amounts at various timings dependent on the underlying investments. Based on Hermes' current running yield of 3.2% and Pantheon's expected yield of 5.0%, we estimate that the Fund currently receives an income of **c. £3.1m per annum**. If the Fund was invested in line with the strategic benchmark (i.e. the Pantheon mandate fully drawn) we estimate the Fund would receive an income of **c. £6.3m** each year.

Liquidity

The Fund holds c. £20m in cash within a Northern Trust account. This account is used to hold liquidity to cover transfer values and other miscellaneous payments.

Current investment strategy

Cashflow considerations

Generating income

The table below shows the potential income that could be received from each fund within the remainder of the portfolio, not including Hermes and Pantheon. Whilst income for the majority of the Fund's portfolio is currently re-distributed back into each fund, each strategy has a distributing shareclass or equivalent which can be "switched on" relatively easily with no added cost.

Fund	Estimated yield p.a.	Income p.a. if invested as strategic benchmark	Timing	How to switch on
LCIV Global Alpha	c. 1.0% (based on dividends)	£3.1m	Quarterly (end March, June, September and December)	Subscription form
LGIM Global Equity	c. 2.5% (via NIS facility)	£17.2m	Monthly	Signed instruction
Insight Buy & Maintain	c. 2.2%	£4.5m	Quarterly (up to 20 days after end February, May, August and November)	Subscription form
LCIV MAC	c. 0.5% (based on income, net of expenses)	£0.5m	Once per annum in February	Subscription form
ASI Long Lease Property	c. 4.1%	£3.1m	Quarterly (end January, April, July, November)	Side letter
Total		**c. £28.4m**		

Strategy proposal

Strategy proposal

Possible solutions

Strategic allocation

We modelled three alternative strategies alongside the current strategic benchmark, with a theme focussing on reducing the equity risk and increasing portfolio diversification. The three strategies' asset allocations are provided in the table below, alongside expected return, volatility and Value at Risk figures of each strategy:

	Current	Strategy 1	Strategy 2	Strategy 3
Equity	65%	60%	55%	50%
Fixed income	20%	25%	25%	25%
Property	10%	10%	10%	10%
Infrastructure	5%	5%	5%	10%
Illiquid Alternative	-	-	5%	5%
Expected return	5.4%	5.2%	5.2%	5.1%
Volatility	13.2%	12.8%	12.6%	12.3%
Value at Risk	£417.7m	£403.6m	£392.7m	£382.0m

As the table shows, all three alternative strategies have slightly lower best estimate returns. We feel a slight reduction in the expected return is appropriate given the current funding position. Importantly, each strategy has significantly lower volatility as a result of reducing the equity allocation and increasing diversification, in particular making use of illiquid alternatives.

Strategy proposal

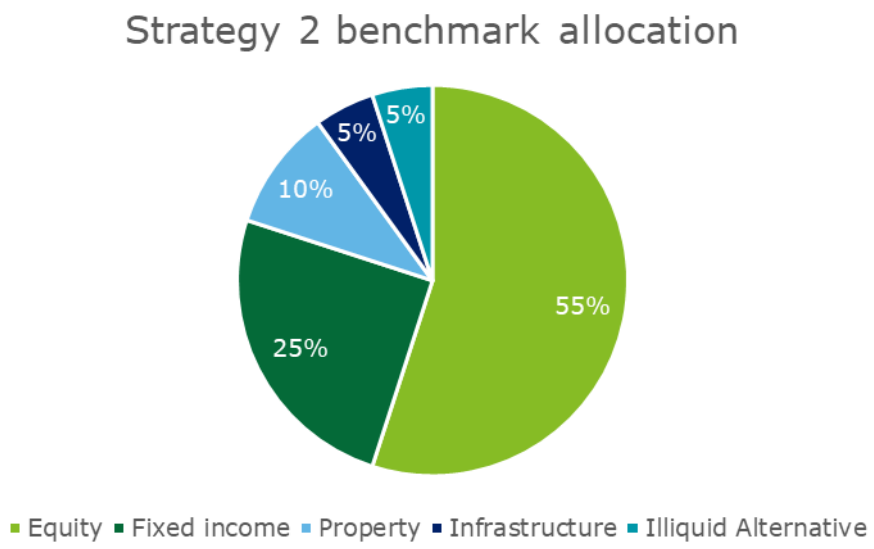
Strategy 2

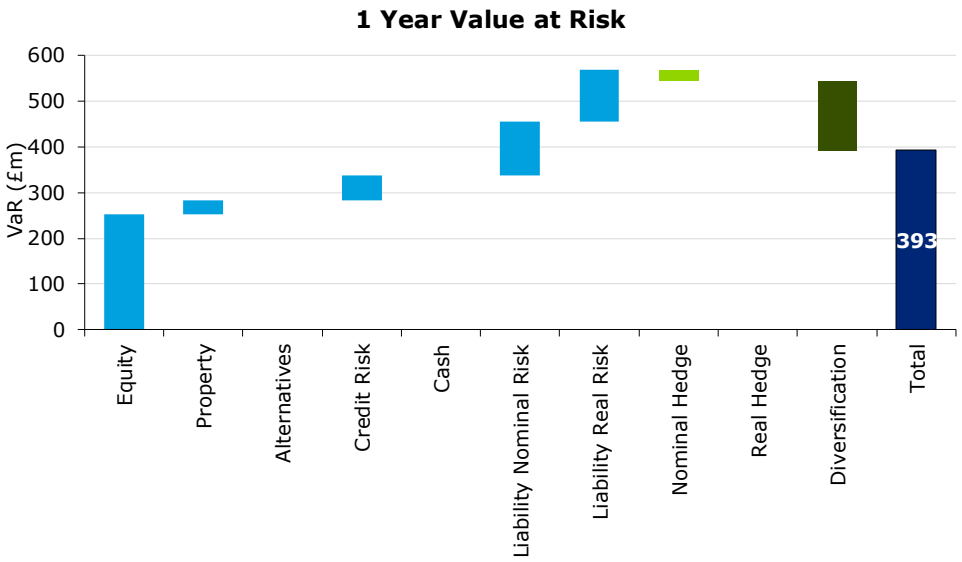
To implement Strategy 2, the Fund would be required to:

Decrease the equity allocation by 10%	Make a 5% allocation to a new fixed income strategy / rebalance the existing portfolio	Make a 5% allocation to a new illiquid alternative

This would result in:

A 0.2% decrease in expected return	A 0.6% decrease in expected volatility	A c. £30m decrease in equity portfolio Value at Risk



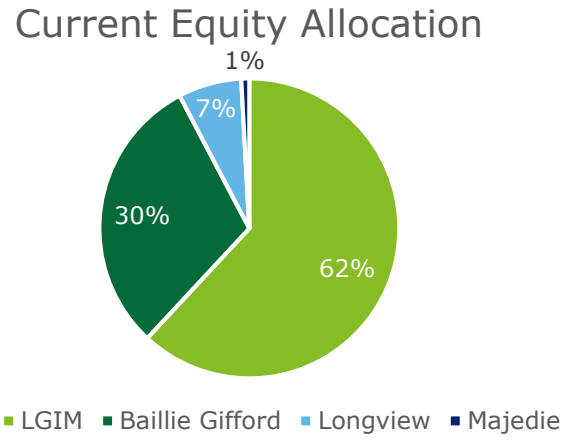


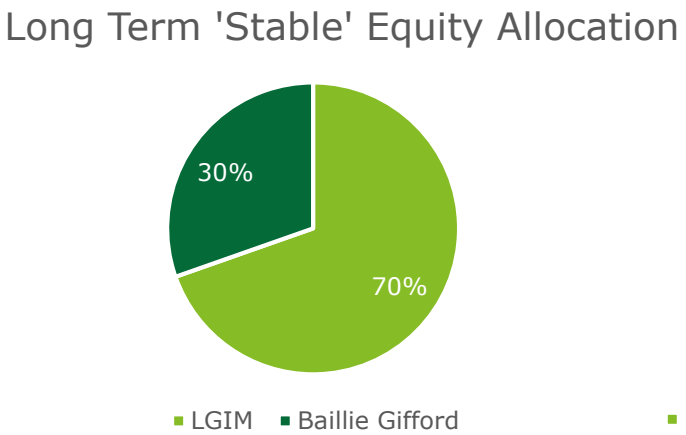
Strategy proposal

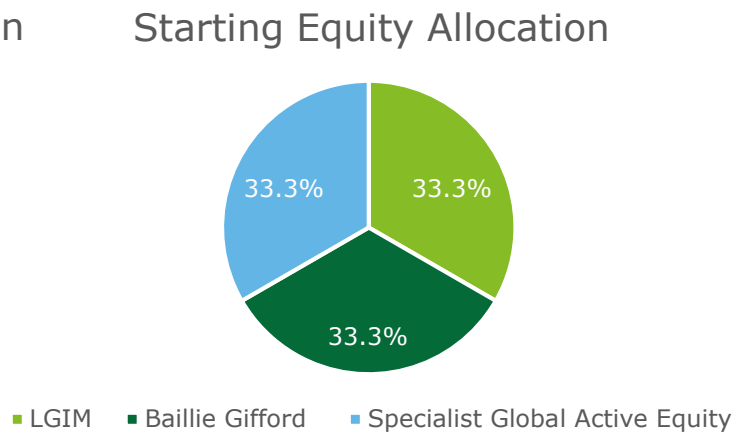
Equity portfolio

We have recommended that the Committee consider reducing the Fund's equity allocation to 55%. This would result in a 10% reduction. While the current allocation is 68.5%, as stated earlier, the long term 'stable' allocation is 65% after taking account the funds to be transferred to Pantheon once fully drawn down. Therefore we are recommending a 10% reduction to the equity allocation.

The current equity allocation as well as the current long term 'stable' equity allocation is shown in the charts below.







In order to improve diversification and provide less correlated returns, we suggest that a third specialist global active equity manager is selected to sit alongside both the LCIV and LGIM global equity strategies. This new strategy should exercise a different, complementary style to the LCIV Global Alpha Fund, with the LGIM fund's passive approach providing further diversification.

Analysis must be carried out to better understand the most appropriate equity portfolio, as this will largely depend on the preferred type of strategy to be added, however as a starting point, the Committee may want to consider whether a standard one-third in each mandate is most appropriate, shown above.

Lastly, when selecting a new manager, the Committee should consider options available on the London CIV platform. The Committee may also want to consider funds with a specific ESG theme, in-keeping with the Fund's responsible investment philosophy.

Strategy proposal

Fixed Income portfolio

The Insight Buy & Maintain Fund and LCIV Multi Asset Credit Fund mandates make up the fixed income allocation, representing 13.5% and 6.5% of the strategic benchmark respectively. Both funds invest in assets that have a low correlation with mainstream equities, with the Insight Buy & Maintain Fund seeking to generate returns by investing primarily in a portfolio of debt securities and the LCIV Multi Asset Credit Fund, managed by CQS, investing across a broad spectrum of bond and debt related investments.

We have recommended increasing the Fund's fixed income allocation by 5% to 25%. This could be achieved by investing across the Fund's current fixed income portfolio, however in keeping with aim to increase diversification, we recommend that a 5% allocation is made to a new fixed income strategy where the Fund can benefit from an alternative source of return and illiquidity premium.

Direct Lending

Direct lending has seen a lot of interest in recent years. New players have entered the market and some existing managers have raised more capital and larger funds.

Credit risk is dependent on the position in the capital structure. We have a strong preference for Senior secured debt to provide investors with greater protection in a default event. However, we are increasingly seeing instances where asset quality is being weakened to preserve return levels. Reduced covenants on loans, higher leverage levels and a willingness to move down the credit spectrum are all tools being used by managers. Investor demand for this asset class has also resulted in 'mega-funds' being raised, which can have an impact on how strategies are managed and the sub-market from which deals are sourced.

In addition to providing additional diversification to the strategic benchmark, a direct lending allocation would be expected to deliver attractive yields and returns. This would aid the Fund's ability to meet expected future cashflows, as eluded to earlier in this paper.

Strategy proposal

Property portfolio

The 10% benchmark property allocation, consisting of a 5% allocation to the Hermes Property Unit Trust Fund and a 5% allocation to the Aberdeen Standard Investments Long Lease Property Fund, provides returns to the Fund through rental income and future resale of property whilst providing a hedge against inflationary environments.

UK and long lease property market view

In the face of economic uncertainty and Brexit, returns in the property sector have so far remained robust and yields have been falling, driven by investor demand. Overseas investors continue to be attracted to central London trophy assets and there has been significant demand for long lease assets in particular from institutional investors and pension schemes. While the market as a whole has been rising, this has been largely driven by the industrial sector, with demand for logistical assets increasing. The growth of online retail has been at the heart of this trend which has contributed to the decline of the UK high street.

The headwinds affecting the UK market are strengthening. Brexit related uncertainty remains and there are signs that global growth is slowing and economic conditions are becoming more challenging. Should the UK leave the EU on less favourable terms, regions and sectors reliant on cross-border operations, or particularly sensitive to the fortunes of the UK economy, will no doubt struggle.

Property has often been used as a diversifier away from equities and bonds, due in part to its less liquid nature. Long lease property has the added advantage of providing a secure income stream, often inflation-linked, at real yields which are greater than those available from traditional fixed income assets.

Property markets are not without their challenges. Performance has been strong but there is increased evidence that future returns are unlikely to mirror the significant gains made over the last few years. This shouldn’t necessarily bother current pension scheme investors with long term investment horizons.

Other opportunities

There are alternatives opportunities within real estate that may be more attractive than core and long lease property in the current market. Residential property, for example, could offer some additional diversification to the portfolio as core and long lease mandates are beginning to look increasingly similar. We have provided detail on residential, social/affordable housing and real estate debt in the training session presented to the Committee on 23rd January 2020, and have provided a comparison between UK, Europe and global strategies.

Renewable infrastructure

With Governments around the world having pledged to tackle climate change, development in renewable power sources is in high demand and requiring investment. Whilst core infrastructure funds have been investing in renewable assets over many years, and are doing so increasingly, there are a number of specialist managers and funds that are targeting renewable developments specifically.

In the UK alone, BloombergNEF estimates that £188bn of investment is required in renewable infrastructure. With the UK now targeting net zero greenhouse emissions by 2050 (the first G7 nation to legislate for this objective), the Committee on Climate Change targets indicate that the investment required may be as high as £660bn. Regardless of the number, there is obvious demand for renewable infrastructure and private investors will play a key role in funding projects. At the same time, the cost of leading renewable technologies has decreased significantly since 2010 (for example, the cost of solar technology has fallen 85%).

Historically the bulk of returns in this sector have been driven by feed-in-tariffs, where contractual cashflows are secured by the government. However, such arrangements are almost non-existent in the current market. While it would be unlikely for any government (certainly in the UK) to remove any current standing tariff arrangements, this still creates a degree of risk. This places greater emphasis on the fundamental assessment and asset management of renewable assets.

Key to return profile will be the willingness to accept development risk. Those funds willing to invest a greater proportion of commitments in development opportunities will ultimately offer higher returns but greater default risk as well.

Large volumes of commitments are flowing into core infrastructure assets, particularly the larger funds. As a result, we prefer strategies at the small and mid-market end of the market, or where managers' specialties can gain a competitive advantage. In this regard, targeting specialist renewables funds with more understanding of the sector and greater expertise in asset origination may be preferable.

Conclusion

Conclusion

Recommendations and next steps

Investment strategy

The Committee should discuss and agree the most appropriate strategic allocation for the Fund going forward. We have recommended a strategy which we believe is suitable for Fund given the funding position and current investment markets. Specifically we have suggested:

1. Reducing the equity allocation by 10% to 55%, with 5% being invested in the fixed income portfolio and 5% invested in an illiquid alternative asset class.
2. Consider Renewable Infrastructure as a new illiquid alternative. This may require training on the asset class ahead of assessing suitable strategies.
3. Consider whether the 5% increase to fixed income should be to a new mandate (such as Direct Lending) or to rebalance the existing portfolio.
4. Following the real estate training session, review the appropriateness of the current property portfolio and agree next steps and consider whether a residential property allocation may offer more diversification than the current long lease mandate.
5. Review the equity portfolio and in particular, give consideration to adding a new mandate that would compliment the Baillie Gifford fund.

Conclusion

Example portfolio

Manager	Asset Class	Benchmark Allocation (%)
LGIM	Global Equity (Passive)	18.3
LCIV	Global Equity (Baillie Gifford, active)	18.3
	Global Equity (active)	18.3
	Total Equity	**55.0**
Insight	Buy and Maintain Credit	13.5 (16.7)
LCIV	Multi Asset Credit	6.5 (8.3)
	Direct Lending	5.0
	Total Fixed Income	**25.0**
Hermes	Property	5.0
Aberdeen Standard	Property	5.0
	Total Property	**10.0**
Pantheon	Global Infrastructure	5.0
	Renewable Infrastructure	5.0
	Total Infrastructure Equity	**10.0**
Cash	In-House Cash	**-**
Total		**100**

Risk Warnings

- Past performance is not necessarily a guide to the future.
- 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 would incur some costs.
- Any recommendations in this report should not be viewed as a guarantee of future performance.

Deloitte.

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte Total Reward and Benefits Limited accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte Total Reward and Benefits Limited is registered in England and Wales with registered number 03981512 and its registered office at Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

Deloitte Total Reward and Benefits Limited is a subsidiary of Deloitte LLP, the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

Deloitte Total Reward and Benefits Limited is authorised and regulated by the Financial Conduct Authority.

© 2019 Deloitte Total Reward and Benefits Limited. All rights reserved.