City of Westminster

Pension Board

Date:	**16 June 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.**
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1. EXECUTIVE SUMMARY

1.1 This report details the investment strategy review undertaken by the Fund's investment advisor, Deloitte, shown as Appendix 1. A review of the current investment strategy has been undertaken, highlighting observations and options to contemplate when considering the refreshed investment strategy.

1.2 The investment strategy presented has been revised from its original form due to the ongoing impact of the COVID-19 pandemic.

1.3 Also attached are the management fee schedules, which detail the management fee implications, including:

- a breakdown of current fees compared with expected fees;
- a comparison of passive equity versus active equity management; and
- annual fixed costs.

2. RECOMMENDATIONS

2.1 The Board is asked to note the revise investment strategy review, including the following options presented to the Committee:

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 to the addition of a new actively managed equity mandate to complement the existing portfolio.

c) Select renewable infrastructure as a new illiquid alternative asset class.

d) Consider the placing of an 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 Fund's strategic asset allocation, as at 30 November 2019, consisted of 65% allocated to equities, 20% to fixed income, 10% to property and 5% to infrastructure. Whilst the 65% allocation to equities has contributed positively to the Fund's performance, this allocation has also increased the Fund's volatility.

3.2 Based on the Fund's current strategic asset allocation, the best estimate of the median expected return is 5.4% per annum, with a volatility of 13.2% per annum. Deloitte also estimates, by using its worst case scenario modelling, the one-year 95% value at risk (VAR) to be £418m.

3.3 The overall funding level of the Fund has improved by 18% to a 99% fund level at 31 March 2019, compared with 81% at 31 March 2016, with the Council's own funding level increasing by 16% during this period to 86%. The Council plans to pay off its deficit by 2021/22, with £22.7m deficit contributions expected in 2020/21 and £80m during 2021/22.

Issues to consider

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

- Reliance on equity markets: almost two-thirds of the Fund's allocation is to equities. Given the improvement in funding level, the Committee should consider whether the structure and allocation to equities is still appropriate.

- Diversification: the Fund has minimal risk mitigation from diversification of asset classes. There is scope for further diversification, particularly with the use of more illiquid assets.

- Forward funding arrangement: deficit recovery contributions of circa £102.7m are expected in the next two years.

- Annual cashflow deficit: it is estimated that going forward, the Fund will operate an annual cashflow deficit (contributions received minus pensions paid) of circa £10m. This does not take in to account the contributions received from the forward funding agreement.

- Liquidity: the Fund holds circa £20m in cash with the global custodian, Northern Trust.

- Generating income: investment income (dividends and interest) from asset managers is currently redistributed back into each fund. It would be relatively easy to switch to the distributing share class with no additional cost.

Strategy Proposals

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

- **Strategy 1:** Reduce equities allocation to 60%, with the additional 5% going to fixed income: this has the benefit of reducing volatility to 12.8%. However, the expected return will reduce by 0.2%.

- **Strategy 2:** Reduce equities allocation to 55%, 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 equities allocation to 50%, 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 Deloitte strategy review, the recommended way forward would be to implement Strategy 2 and decrease the equity allocation by 10%, moving 5% to fixed income and 5% to illiquid alternatives. This would result in a decrease of 0.2% in expected return but volatility would decrease by 0.6% to 12.6% 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 diversification 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 Pension Fund 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 the Fund’s diversification, it is recommended that the additional 5% investment within fixed income is allocated 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 assist 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 This has come more into focus given the portfolio manager for the long lease property fund (Aberdeen Standard), Richard Marshall, has announced his retirement. Given the current illiquidity in property and the fact the long lease fund is currently “locked up”, this is not an immediate priority for the Fund.

3.11 The recommended 5% allocation to an illiquid alternative could provide an opportunity for the Fund to invest within renewable infrastructure. With the UK government’s pledge to target net zero greenhouse gas emissions by 2050, a significant amount of investment is required within the renewable infrastructure space.

3.12 There are a number of specialist managers targeting renewable developments. 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 MANAGEMENT FEE IMPLICATIONS

4.1 The Pension Board should note the management fee schedules, current fees compared with expected fees, passive versus active equity management fees and annual fixed costs relating to the Pension Fund.

4.2 As set out in Appendix 2, the annual fixed costs charged to the Pension Fund relating to pooling and investment management advisory fees total £128k per annum.

4.3 The management fee schedule, within Appendix 2, sets out the annual management charge within each mandate, along with the additional London CIV management fees for those pooled in the LCIV and any performance fees. The London CIV management fee ranges from 5bps for active equity management to 0.5bp for passive equities.

4.4 A comparison of active and passive equity management fees is shown within Appendix 2. With funds invested with an active equity manager, up to 93% could be saved on fees annually if the cash were to be invested within a passive mandate. It should be noted that the performance volatility of the active equity asset managers should also be taken into consideration.

4.5 Using asset values as at 31 January 2020, the following table breaks down the management fees under the current investment strategy compared with the expected fees if Strategy 2 were to be implemented. It is anticipated that there would be a slight increase in fees of circa 3% if Strategy 2 was implemented. This is a result of a reduction in the allocation to equities moving to illiquid asset classes, which generally have a higher management cost associated with them.

Table 1

Asset Managers	Current Strategy	Current Fees	Strategy 2 Proposal	Estimated Fees
Equity	**65%**	**£3,409,074**	**55%**	**£2,242,416**
Passive Equities	22.5%	£178,091	18.3%	£145,111
Global Active	20.0%	£1,143,985	36.7%	£2,097,305
UK Active	22.5%	£2,086,999	0.0%	£0
Fixed Income	**20%**	**£730,836**	**25%**	**£1,271,910**
Multi Asset Credit	6.5%	£532,571	6.5%	£532,571
Bonds	13.5%	£198,265	13.5%	£198,265
Illiquid Strategy	0.0%	£0	5%	£541,074
Property	**10%**	**£1,164,877**	**10%**	**£1,164,877**
Property	5.0%	£306,889	5.0%	£306,889
Property	5.0%	£316,915	5.0%	£316,915
Infrastructure	**5%**	**£541,074**	**5%**	**£541,074**
Infrastructure	5.0%	£541,074	5.0%	£541,074
Illiquid Return	**0%**	**£0**	**5%**	**£772,963**
Renewable Infrastructure	0.0%	£0	5.0%	£772,963
	100%	**£5,845,862**	**100%**	**£5,993,240**

Please note the data above excludes performance fees.

5 TIMING CONSIDERATIONS

5.1 Following the global COVID-19 outbreak during the first quarter of 2020, global equity markets have been significantly impacted and have seen the greatest fall in equity markets since the financial crisis of 2008.

5.2 As at 31 March 2020, the FTSE 100 index has fallen 25% from 31 December 2019. Globally, markets have also seen massive falls in market value, with the Dow Jones Industrial average index falling by 23% over the same period. Since this fall, however, global markets have recovered, with the Dow Jones having recovered by 8.2% at the end of trading on 4 May 2020.

5.3 Since the Majedie UK Equities transition on 18 November 2020, the value of the UK Equities fund has fallen by 15.5% compared with the FTSE World which has dropped 10.4% during the same period to 9 March 2020. This has resulted in a saving of circa £14.4m by transitioning from UK active equities into global passive.

5.4 Despite the market volatility of the last two months, equity markets have been calmer in recent weeks, with the “fear index”, the Vix, falling back considerably from highs of 82 on 16 March 2020 to 32 at 5 May 2020.

5.5 As at 29 May 2020, markets have somewhat recovered with the Pension Fund market value increasing by 10% from 31 March 2020. The majority of this recovery has been seen within the global equity funds; Baillie Gifford and LGIM.

6 PENSION FUND COMMITTEE OUTCOME

6.1 The attached investment strategy review was taken to the Pension Fund Committee on 13 May 2020. Following the debate, the Committee requested further training on renewables and infrastructure, with the intention of agreeing a revised investment strategy at the next meeting on 25 June 2020.

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

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BACKGROUND PAPERS:

None

APPENDICES:

Appendix 1: Investment Strategy Review
Appendix 2: Management Fee Schedules