Investment strategy and structure

Addressee and purpose

This paper[1], addressed to the Pensions Committee of the Suffolk County Council Pension Fund, provides a high level briefing on the Fund's investment strategy and structure in advance of the strategy/structure review meeting on 16 July 2014.

Given the size of the Fund and the number of managers appointed, there can be a lot of 'noise' around the consideration of the fundamental strategy and structure of the Fund and what it is aiming to deliver. This paper, and the considerations at the 16 July 2014 Committee meeting will purposely take a step back from that 'noise' to look at the overall strategy and structure of the Fund from first principles to determine what it is aiming to deliver and how it will achieve that.

The Committee should therefore expect that the discussions at the 16 July meeting will be high level; we do not expect to delve into the detail of the managers' portfolios, funding or performance at that meeting. These more detailed considerations will be addressed at the following meetings once the fundamental building blocks have been discussed and agreed.

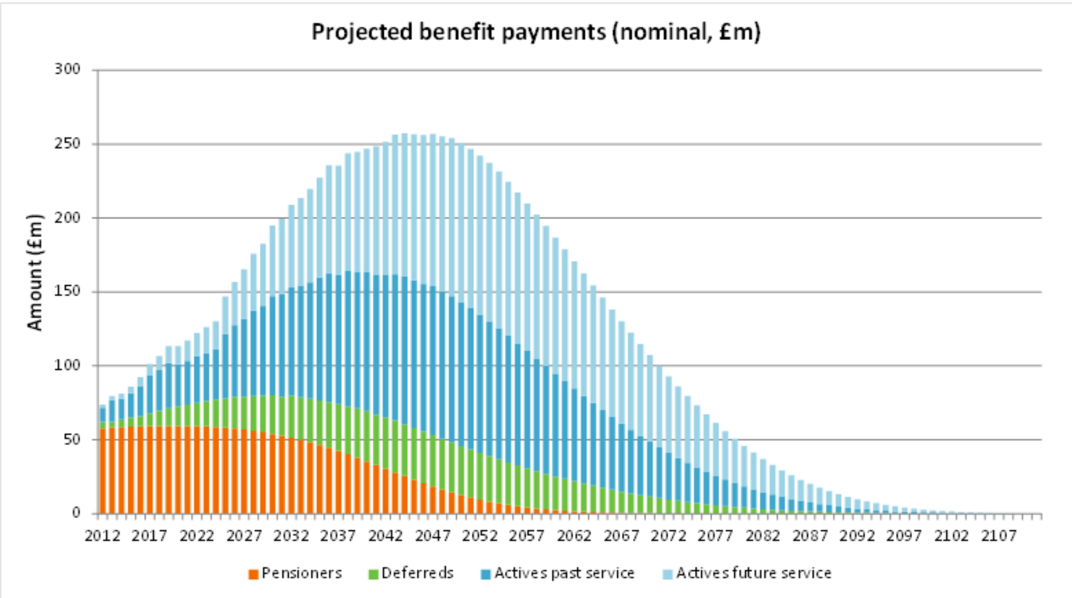
The purpose of the paper is therefore to set out the high level principles used to determine the current investment strategy and structure in order to facilitate a more detailed consideration at the meeting.

Objective

The primary objective of the Fund is to deliver the pension benefits promised to members as they fall due.

The benefits expected to be paid from the Fund, under a range of assumptions including future inflation and longevity, were projected as part of the 2013 actuarial valuation and funding discussions. The projected liabilities are summarised in the following chart.

Chart: Projected benefit payments



[1] It should not be released or otherwise disclosed to any third party without our prior written consent except as required by law or regulatory obligation. If that consent is provided, the report should be released in full, including all assumptions relied upon and risk warnings on the advice given. We accept no liability to any other party unless we have especially accepted such liability in writing.

The funding position

As part of the 2013 actuarial valuation, a 'present value' of these benefits was calculated. The 'present value' is essentially the amount of assets required now to pay all of the promised benefits as they fall due in the future.

A key assumption in undertaking this present value calculation is the assumed return on assets. For the purposes of the 2013 valuation, the assumed asset return used was the yield on gilts plus an additional outperformance assumption for investing in higher expected return assets (i.e. equities etc).

The additional outperformance assumption assumed at the 2013 valuation was 1.6% p.a.

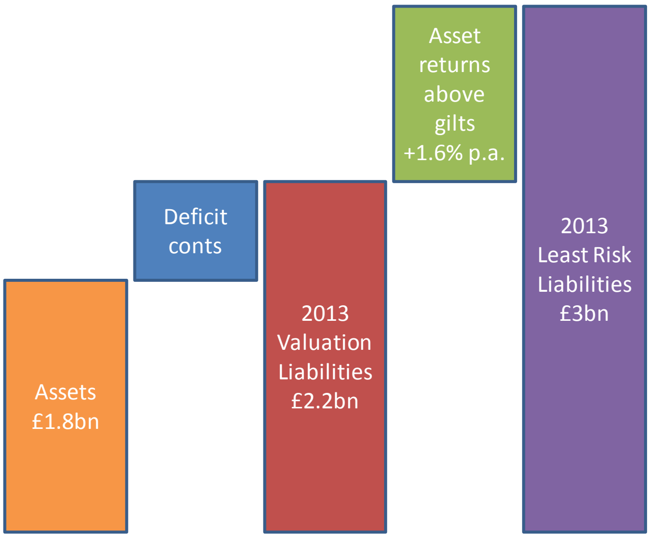
Therefore, assuming a return on assets of the gilt yield + 1.6% p.a. (gilt yields as at 31 March 2013 were 3.0% p.a., so the total return used was 4.6% p.a. [3 + 1.6]) the value of assets required today, to deliver all of the benefits assuming the assets would achieve a steady return of 4.6% p.a. for the life of the Fund, was £2.2bn.

This was £400m above the actual value of assets held as at 31 March 2013 of £1.8bn. The Fund was therefore assessed as being in deficit and a deficit recovery plan was required to address this.

Additionally, in order to quantify the level of excess return we are expecting from the assets (above the yield on low risk gilts), if we do not allow for the outperformance assumption (i.e. we value the liabilities on the assumption of only achieving an asset return of 3.0% p.a.) the present value of liabilities would have been £3bn, £1.2bn above the asset value. An alternative way of looking at this is that, as part of the 2013 actuarial valuation, we are assuming the assets will deliver an additional return above gilts of £800m over the life of the Fund.

These principles are summarised in the following chart.

Chart: Relative funding positions of the Fund



Achieving the required asset return

To achieve the additional return above gilt yields of 1.6% p.a., we need to invest in assets expected to deliver excess returns over the long term. The main asset class that pension funds use to achieve this is equities as:

- They the asset class expected to consistently deliver the highest returns over the long term whilst also being easily accessible in large scale, liquid and relatively cheap to manage and trade; and
- Multiple regions (US, Europe, Asia etc) and industries (Financials, Consumer staples etc) provide easy diversification.

Our best estimate assumption is that equities will outperform gilts by 3% p.a. over the long term (this is based on historic relative returns and current economic circumstances). Therefore, to achieve the +1.6% p.a. above gilt yields required by the 2013 actuarial valuation, this implies a required allocation of just over 50% of Fund assets in equities.

However, in reality, we wish to allocate more than 50% of assets to equities as:

1. We wish to be prudent and therefore target a higher level of return (increasing the chance that we deliver at least the required return over the long term); and
2. The Fund has a deficit and targeting a higher equity allocation may deliver additional returns (reducing the need for deficit contributions and therefore reducing the cost of funding).

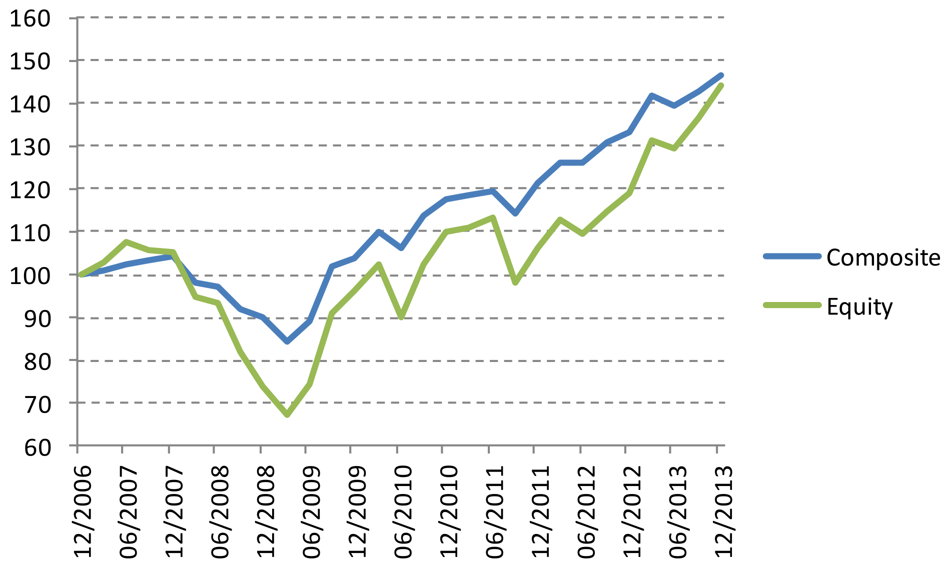
However, given the risks inherent in equities[2] we would prefer not to target this additional return purely via a further investment in equities and look to other 'diversified' sources of return that are broadly expected to deliver the same level of returns as equities, but in different cycles, smoothing the overall delivery of return.

Diversification

The Fund is a long term investment vehicle with a very strong covenant and therefore is able to manage the contribution rate volatility associated with the investment strategy. However, even if this is the case, we prefer to avoid unnecessary volatility where we can maintain overall expected asset return levels. This the fundamental reason for seeking diversification.

Although we would caution on drawing too strong a conclusion on the basis of a specific time period, the concept of diversification is demonstrated by the following chart that compares the equity market return to a diversified portfolio of assets comprising 45% equities, 15% gilts, 20% corporate bonds, 10% property and 10% hedge funds.

Chart: Impact of diversification



As demonstrated in the chart, the diversified portfolio has generated broadly the same level of return as the equity market whilst reducing the volatility of the delivery of the return through diversification i.e. it has been more efficient by delivering more return per unit risk.

[2] 'Normal' equity volatility is +/- 20% per year meaning that, whilst targeting a long term return of +3% p.a. above gilts, year on year equity markets can easily rise by 23% or fall by 17%, or even more in extreme circumstances.

In addition to diversification, given the long term nature of the Fund, it can afford to ‘tie up’ money in illiquid assets to benefit from any additional returns.

The Fund already invests in a broad range of diversified assets, including property, infrastructure, timber etc. However, we prefer to think of this as a single ‘pot’ of diversified assets expected to maintain the level of expected return and provide diversification from equities.

The actual detailed constitution of that ‘pot’ (i.e. split between property, infrastructure etc.) is a second order consideration and depends on market pricing and availability at the time of implementation. We will expand on this further at the 16 July meeting.

Bonds

Given the strong covenant, long term horizon and deficit to address, the Committee might ask itself why it invests at all in lower yielding bonds.

However, bonds do provide some benefits:

- A degree of stabilisation in funding volatility;
- More predictable cashflow; and
- A liquid, low risk asset class for rebalancing equities when they have performed strongly and we wish to take some profits.

Reflecting the low yields on bonds at the current time, the Fund has a relatively low allocation to them of c15% (when conventional gilts, corporate bonds and index linked gilts are taken into consideration).

Managers

The Fund splits the management of assets between passive and active mandates.

Approximately 32% of Fund assets are managed passively[3] by L&G (16% regional equities and 16% gilts and corporate bonds). A passive allocation gives the Fund exposure to market returns at a lower fee level. The 32% passive allocation is broadly in line with the LGPS average.

Remaining assets are managed actively for two reasons:

1. The equity portfolios managed by BlackRock, Newton and Alliance Bernstein could be managed passively. However, the Committee has taken the view that these managers have the skills to manage these assets actively and can deliver an additional return relative to the index once their fees have been taken into account. The use of multiple active managers increases diversification and therefore smooths some of the additional risks inherent in active equity management.
2. The alternative assets (property, infrastructure etc) are managed actively as there is no passive index to track and therefore must be managed actively.

[3] Based on the benchmark allocation

Bringing this together

The following table summarises the structure of the Fund (please note we have rounded allocations for simplicity).

Table: Summary Fund structure

Equities			Bonds			Alternatives (Diversification)		
	Manager	*Target %*		*Manager*	*Target %*		*Manager*	*Target %*
UK	BlackRock Bernstein	9.0 7.0	Index-linked gilts	L&G	4.0	Property	Schroder	10.0
Regional	L&G	16.0	Conventional gilts and corporates	L&G	12.0	Hedge funds	Pyrford Bluecrest Winton	6.0 2.0 2.0
Global	Newton	13.0				Infrastructure	KKR Partners	5.0
Private	Pantheon Wilshire	5.0	Cash	Internal	3.0	Emerging market debt	L&G	2.0
						Distressed debt	M&G	2.0
			-	-	-	Timber	Brookfield	2.0
Total		**50.0**	**Total**		**19.0**	**Total**		**31.0**

Conclusions

As set out in the introduction, the objective of this paper is to set out (from first principles) why the current investment strategy and structure is in place. The discussions at the 16 July meeting will further expand on the commentary in this paper to give more detail on the background to decisions and structure.

Given this, there are no specific decisions required from the Committee in relation to this paper. However, following review of the paper, and in advance of the discussions at the 16 July meeting, we ask the Committee to:

- Note this paper;
- Consider whether they view the broad strategy/structure of the Fund as appropriate given the high level points set out; and
- Note areas of perceived weakness in the structure for further discussion at the 16 July meeting.

Prepared by:-
Matt Woodman, Senior Investment Consultant
For and on behalf of Hymans Robertson LLP

Risk warnings

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, 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 investment. As a result, an investor may not get back the full amount originally invested.

Past performance is not necessarily a guide to future performance.