

Pension Fund Committee

Date: 27 November 2014

Agenda item 7

Committee:	Pension Fund Committee
Meeting Date:	27 November 2014
Lead Councillor/s:	Cllr Peter Bellfield
Local Councillor/s:	None
Director:	Geoff Dobson, Director of Resource Management 01473 264347
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TOBACCO INVESTMENTS

BRIEF SUMMARY OF REPORT

- 1 This report sets out the issues around disinvesting from tobacco holdings as reported by our investment managers and what alternative investments they would suggest.
- 2 The report also covers the likely costs of making the change and the implications on future investments returns, having regard to risk and return.

FOR DECISION BY THE COMMITTEE

The Committee is asked:

To decide whether to undertake further work to disinvest from Tobacco companies in line with the County Council's request.

SOURCES OF FURTHER INFORMATION

Agenda Item 11 – Report on tobacco investments (29 September 2014)

MAIN BODY OF REPORT

Background

- 3 At the County Council meeting on 17 July 2014, the following motion was debated and passed:-
“The Council hereby resolves to be a signatory to the Local Government Declaration on Tobacco Control, as endorsed by the Public Health Minister Jane Ellison MP and asks the Pension Fund Committee, having regard to its fiduciary duty and with the necessary agreement of the other employers of the Pension Fund, to replace investments in tobacco with other holdings, which are considered comparable in terms of the balance of risk and return”.

- 4 The Pension Fund has a fiduciary duty to invest assets in the best interests of members and beneficiaries and exercised in a manner to ensure the profitability of the portfolio as a whole.

- 5 The Pension Fund Committee in September received a report on the Fund’s Tobacco investments which set out the considerations the committee would need to explore should it wish to disinvest from Tobacco companies.

- 6 The Pension Fund Committee asked for a further report to be presented to the November committee meeting setting out the following:-
 - Whether it is possible to disinvest from all tobacco investments, or only those that are actively managed in the Direct Holdings portfolios.
 - Where it is possible to disinvest, what might the alternative assets look like.
 - What are the costs of making the change and what might it do for future investments returns, having regard to the balance of risk versus return.

Current Investment in Tobacco Companies

- 7 The Fund’s three active Equity Managers all have investments in Tobacco companies. The current holdings are set out in the table below and show total holdings of £40.0 million, which is about 2% of the Fund.

Investment Manager	Tobacco Company	Aug-14			Oct-14		
		Holding Shares	Unit Price	Holding £'m	Holding Shares	Unit Price	Holding £'m
Alliance Bernstein	British American Tobacco	229,000	35.54	8.1	229,000	35.47	8.1
	Imperial Tobacco Group	221,210	26.22	5.8	203,280	27.11	5.5
Blackrock	British American Tobacco	288,679	35.54	10.3	319,550	35.47	11.3
Newton	British American Tobacco	116,085	35.54	4.1	121,900	35.47	4.3
	Japan Tobacco	219,200	20.66	4.5	219,200	21.53	4.8
	Altria Group	194,015	25.94	5.0	194,015	31.16	6.0
	Total Investment			37.8			40.0

- 8 Alliance Bernstein has reduced the holding in Imperial Tobacco as a result of an increase in share price leading them to a decision to trim their overweight position.
- 9 BlackRock and Newton have both increased their holdings in British American Tobacco during the last two months. This is due to their continued belief that the stock will outperform.
- 10 As at 30 September 2014 the Pension Fund also had indirect investments in Tobacco stocks, through the following Pooled funds:

Investment Manager	Holding - £'m
Legal & General	6.6
Pyrford	2.0
Bluecrest	0.2
Winton	0.1
Total Investment	8.9

Ease of Disinvesting

- 11 For Alliance Bernstein, BlackRock and Newton, the three active managers, it is a simple process to disinvest from the tobacco stock held on behalf of the Pension Fund. However, a decision to disinvest at a point in time carries additional investment return risks. This is because making an investment manager sell tobacco stock on any given day and re-purchase alternative investments restricts the manager from making the change when they consider market conditions to be favourable. It would therefore be better to allow managers some discretion over the exact timing of disinvestment. It has been suggested by some managers that a period of 18 months is an appropriate time to allow for the exclusion.

- 12 Legal & General currently offer three 'ex tobacco' index tracking equity pooled funds; FTSE All Share, FTSE World Developed and FTSE World Developed GBP Hedged. The Pension Fund would need to disinvest from their current Legal & General overseas holdings of £415 million to comply with a tobacco free investment strategy. Moving between Legal and General pooled Funds is an easy process and can be achieved with minimal transaction costs. However, these are different products to what the Fund currently invests in and we would need to seek investment advice on the implications of making this change.
- 13 In addition the £234 million holdings in corporate bonds would also require disinvestment. There isn't currently a suitable alternative to this investment. The options are to invest in Government bonds only which would require the buying and selling of £234 million worth of assets or a segregated bond account which would incur additional brokerage and custodian fees. There is the possibility that Legal & General would be willing to open a pooled ex-tobacco bond fund but this would take time to set up and operate.
- 14 Pyrford can only accommodate an exclusion of tobacco stocks by requiring the Fund to hold their investments on a segregated basis rather than the current Pooled fund structure. This would incur additional custodian costs because of the segregation, and additional work to open overseas accounts. The segregated account would be based on the same investment model as held by the pooled fund but would exclude tobacco.
- 15 Pyrford would also be willing to launch a new pooled fund that excludes tobacco. However, this isn't straightforward as there are issues with the Pension Fund being the major investor in a fund, and an increase in costs until additional investors are attracted to the pooled fund.
- 16 There are two underlying funds in the Bluecrest holdings which have direct exposure to tobacco stocks, the remaining stocks are unlikely to have an exposure. However whilst the direct and indirect exposure is likely to be very small it is impossible to exclude it in its entirety.
- 17 The investment currently held with Winton cannot be replicated with restrictions placed upon stock selection because the investment decisions are derived from complex statistical formula without manual intervention. An investment can remain with Winton on a segregated basis but this will incur additional custodian and brokerage costs and will be removed from the original investment mandate.

- 18 Should the committee decide that it wishes to remove tobacco stocks from its portfolio, then the main holdings are relatively easy to disinvest, however, the smaller pooled holdings would be more challenging.

Alternative Assets

- 19 Tobacco stock investments exhibit a number of characteristics that make them attractive to longer term investors. These include strong balance sheets, sustainable cash generation, good dividends and global diversification. The alternative investments would depend upon the prevailing market conditions, relative valuations and the opportunities that arise at the time of disposal.
- 20 Food and beverage companies are the closest substitutes in fundamental business characteristics but typically trade at higher valuations.
- 21 Some managers in the short term have indicated that they would increase their investment in existing holdings, thereby increasing the concentration of their investment portfolios. This has the potential of increasing the risk level of the portfolio and does not necessarily meet the criteria of a comparable alternative investment based on risk and return.

The Costs Associated with Excluding Direct Tobacco Exposure

	Estimated Cost
	£
Trading Costs	170,000
Legal Advice	30,000
Investment Advice	15,000
Officer Time	10,000
Change in Returns	Unknown
Total	225,000

- 22 Trading costs are the direct transaction costs incurred in the selling and purchasing of shares, which is typically in the region of 0.03%. Additionally there would also be 0.5% stamp duty charge in the event that the proceeds of tobacco stocks were used to purchase UK shares.
- 23 Legal advice would be required to ensure the Fund is making an appropriate decision (within its powers) and has correctly applied the route to disinvestment, including the necessary consultations. Additional legal costs are also likely to be incurred should we need to revisit investment management mandates.

- 24 Change in future returns cannot be estimated. This is a permanent change and has the potential to have the largest impact in terms of either costs or savings. Only a half percentage change in investment returns on £40 million alters the return by £0.2 million per annum. However, all current managers who actively select equities to hold all are investing in tobacco companies. Active managers only hold tobacco shares because they believe they will outperform. If market sentiments towards these companies changes then the active managers would not necessarily hold these shares.
- 25 Officer's time would be incurred in consulting with the employers and collating the results. Further time will be incurred in liaising with the advisers, in regards to policy development and implementing the changes to the investment agreements with the investment managers. Ongoing costs with regards to monitoring of compliance may also be incurred.
- 26 The one off costs of making the change are not necessarily significant but the potential change in investment returns could be.

The Change in Risk Return

- 27 Alliance Bernstein have produced an analysis of the risk/return ratio for all the industry groups within the FTSE index with a continuous history back to the inception of the Suffolk portfolio in 2005. This is shown in **Appendix 1**. This shows that over the full period tobacco has been the single best performing industry within the UK market from a risk-adjusted return perspective.
- 28 The past is, of course, a limited guide to the future: over the last ten years investors have probably placed more emphasis on stability of earnings than is usually the case, supporting the equity performance of companies in more stable industries. Nonetheless, the numbers highlight the difficulty that managers will have in finding close substitutes for tobacco with similar historical risk and return characteristics at equivalently attractive valuations.
- 29 Excluding companies with exposure to tobacco increases expected risk as measured by portfolio volatility and decreases the expected returns based on portfolio and benchmarks achieved.
- 30 The Sharpe ratio characterizes how well the return of an asset compensates the investor for the risk taken. When comparing two assets versus a common benchmark, the one with a higher Sharpe ratio provides a better return for the same risk (or, equivalently, the same return for lower risk).

- 31 The Sharpe ratio reported by our active managers currently stands at about 0.34. If the same portfolio was held but just with tobacco stocks removed, the Sharpe ratio would fall to 0.30. This therefore means the future return would either be lower, or would be achieved taking a slightly higher level of risk.
- 32 Our managers have indicated that the removal of tobacco stocks from their portfolios would be detrimental to the Fund's risk adjusted return.

Next Steps

- 33 Should the Committee decide to continue the process of disinvesting from tobacco stocks the next steps would be to:
- Commission external legal advice
 - Consult with the employers in the Fund

The progress of which will be reported in February 2015.

Appendix 1

Risk-Adjusted Return Analysis for Suffolk Pension Fund

The annualised volatility has been calculated using GBP monthly returns from 1 July 2005 to 31 October 2014.

The Global Industry Classification Standard (GICS) Industry Returns have been calculated using the start of the month FTSE All-Share Holdings but excludes those industries that doesn't have data for the full period that has been calculated.

Source: FTSE and Alliance Bernstein.

Annualised				
Return	Volatility	Ret./Vol.	GICS Industry	
16.58%	14.23%	1.17	Tobacco	
17.38%	15.58%	1.12	Beverages	
15.30%	14.03%	1.09	Pharmaceuticals	
16.39%	15.53%	1.06	Water Utilities	
21.73%	22.32%	0.97	Chemicals	
17.91%	19.79%	0.91	Software	
13.86%	15.33%	0.90	Insurance	
19.18%	24.38%	0.79	Textiles, Apparel & Luxury Goods	
10.26%	13.24%	0.77	Multi-Utilities	
11.24%	15.02%	0.75	Electric Utilities	
14.51%	19.51%	0.74	Wireless Telecommunication Services	
11.87%	16.70%	0.71	Diversified Telecommunication Services	
19.92%	28.10%	0.71	Energy Equipment & Services	
15.46%	22.82%	0.68	Containers & Packaging	
17.29%	26.44%	0.65	Machinery	
12.59%	19.86%	0.63	Health Care Equipment & Supplies	
10.21%	16.13%	0.63	Food Products	
16.66%	26.76%	0.62	Electronic Equipment, Instruments & Components	
11.73%	19.04%	0.62	Capital Markets	
11.69%	19.17%	0.61	Household Products	
10.17%	17.49%	0.58	Aerospace & Defense	
13.19%	22.72%	0.58	Independent Power and Renewable Electricity Producers	
14.66%	25.68%	0.57	Transportation Infrastructure	
11.07%	21.70%	0.51	IT Services	
13.68%	28.10%	0.49	Trading Companies & Distributors	
11.09%	24.20%	0.46	Industrial Conglomerates	
13.15%	31.08%	0.42	Electrical Equipment	
6.28%	15.33%	0.41	Food & Staples Retailing	
7.33%	18.79%	0.39	Diversified Financial Services	
7.94%	20.91%	0.38	Hotels Restaurants & Leisure	
11.69%	31.51%	0.37	Semiconductors & Semiconductor Equipment	

10.04%	29.98%	0.33	Household Durables
6.75%	20.34%	0.33	Construction & Engineering
6.37%	22.27%	0.29	Oil, Gas & Consumable Fuels
8.12%	30.36%	0.27	Leisure Products
4.31%	18.49%	0.23	Commercial Services & Supplies
5.46%	25.01%	0.22	Air Freight & Logistics
7.40%	35.11%	0.21	Marine
7.24%	36.39%	0.20	Internet & Catalog Retail
7.12%	36.11%	0.20	Consumer Finance
3.75%	23.43%	0.16	Media
3.94%	29.15%	0.14	Airlines
3.12%	24.15%	0.13	Communications Equipment
3.34%	28.12%	0.12	Distributors
3.54%	42.95%	0.08	Technology Hardware, Storage & Peripherals
2.44%	32.85%	0.07	Metals & Mining
3.09%	43.42%	0.07	Auto Components
1.57%	25.66%	0.06	Multiline Retail
1.37%	26.07%	0.05	Specialty Retail
1.55%	35.50%	0.04	Road & Rail
-2.60%	41.32%	-0.06	Thrifts & Mortgage Finance
-5.21%	32.43%	-0.16	Commercial Banks
-5.44%	30.45%	-0.18	Health Care Providers & Services
-7.00%	35.58%	-0.20	Building Products
-13.34%	37.66%	-0.35	Construction Materials
-16.98%	30.79%	-0.55	Biotechnology
4.26%	15.76%	0.27	SUFFOLK
7.09%	14.20%	0.50	FTSE All-Share

