Investment structure update

Introduction

This note, addressed to the Pensions Committee (the Committee) of the Suffolk County Council Pension Fund, updates the Committee on the progress of two strands of work discussed at the investment strategy and structure review meeting on 27 November 2014.

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Structure of the bond portfolio

In order to reduce the costs of funding the Suffolk Fund, within appropriate risk constraints, the Fund should aim to maximise the expected return on assets over the long term.

Therefore, given the low level of yields available on bonds at the current time, the desire to protect the capital value of assets if yields rise and the investment opportunities available to investors who are not constrained by passive investment in standard indices, it was agreed by the Committee that they would like to understand what actively managed bond portfolio opportunities are available within their existing manager arrangements (as they do not wish to further proliferate the number of manager relationships within the Fund) in order to increase the expected yield on the bond portfolio.

The Committee therefore delegated an investigation of the above to the Officers and Advisers (O&A).

During January and February, the O&A met three of the Fund's existing managers (that Hymans Robertson would rate highly for their bond management capabilities) to understand the style of management that would be preferred and which managers might be able to provide the required services to the Fund.

Further training will be provided to the Committee at the March meeting, but the high level findings of the O&A were that the preferred approach should be:

- An approach unconstrained by index biases and avoids forced investment in unattractive assets;
- An approach that aims to protect capital value of assets;
- A diversified approach that allows investment in a wide range of investment opportunities whilst retaining a more secure rating; and
- A return target somewhere in the range of cash (libor) + 4% to 6% p.a. (significantly above current yields available on passive management of standard indices).

Having met with L&G, BlackRock and M&G, the O&A felt that both BlackRock and M&G offered credible solutions to achieve this objective.

Proposal

The O&A propose that M&G and BlackRock are asked to attend the 23 March Committee meeting to set out their credentials for managing the Fund's bond mandate.

In addition, at that meeting, final recommendations on the structure of the bond mandate will be proposed.

At that meeting, the Committee will be asked to agree both the structure of the bond mandate and the manager(s) that will manage those assets.

Rebalancing mandate

An area discussed towards the end of the November meeting was rebalancing. This was discussed at a relatively high level and therefore the O&A wish to take the opportunity to provide further detail on the operation of such a mandate which, assuming continued support from the Committee, can be implemented once all of the proposed investment structure changes are in place.

The basic premise of a rebalancing mandate is that it maintains the strategic target to growth and bond assets to maintain the agreed funding plan i.e. it would aim to rebalance any deviations from the target of 80% Growth (equities + alternatives) and 20% bonds, due to market moves, back to the central target.

In addition, rebalancing assets that have drifted from their strategic target (i.e. sell assets that have gone up in price and are overweight and vice versa so that the allocation is moved back to the central target) has been consistently shown to add value over the medium term.

The rebalancing mandate can be operated in two ways, by manual intervention from the Committee/Officers (which may miss the opportunity by the time that all data is available and transition can be implemented) or by a manager monitoring the allocation on a more regular basis who can implement rebalancing actions in a more timely manner, increasing the likelihood that any opportunity is captured.

The preference is for the latter.

However, implementing such a mandate on a large Fund with multiple managers requires some compromises if rebalancing is to be done effectively and at low cost. The most significant of these are:

- Although rebalancing could be implemented across the full complement of managers, it would likely be timely to arrange and costly in terms of trading costs. We would therefore favour L&G implementing what is referred to as a ‘swing mandate’. In a swing mandate, L&G monitor the overall Fund split between growth assets and bonds (including all manager mandates). However, if a rebalance is required, they will only switch assets within their own funds to correct this i.e. if, at the total Fund level, the Fund is 3% overweight equities (irrespective of which managers are overweight) L&G will switch the required proportion of their own assets from equities to bonds to correct this. This increases speed, lowers complication and lowers costs.
- The ‘Alternatives’ portfolio is currently underweight its target allocation, and the money is ‘parked’ in L&G equities pending draw down. Some allowance must be made for this in an L&G swing mandate as we would not want them to inadvertently rebalance these ‘parked’ equities into bonds. L&G must therefore make some estimate for the valuation of alternative assets.

  However, in reality, the value of alternatives that L&G would have to estimate is relatively small as c93% of the assets currently have relatively regular price information (the remaining c7% is invested in Private equity, Distressed Debt, Infrastructure and Timberland. Although, as further assets are drawn down, the level of estimation required would move towards 15%).
- Manager valuations are not always available immediately following quarter ends. There are two ways to address this, firstly any rebalancing can be delayed until all valuations are available or secondly L&G can estimate allocations based on market returns and implement rebalancing on these calculations.

  The preference is the latter as a manager’s performance tends to be 80 – 90% driven by the markets irrespective of their active positioning and L&G will update their calculations on a quarterly basis with actual manager valuations (meaning that estimations are unlikely ever to be more than 3 months out of date).

  Delaying action until all manager valuations are available risks missing opportunities and over-estimating or underestimating the level of rebalancing required as markets will have again moved.

Some concern within the Committee with regard to the use of estimation is understandable. However, to provide some comfort, this approach is commonly implemented by L&G in these types of mandates and the risks involved can be further managed by setting appropriate rebalancing (control) ranges.

An example of this is rebalancing only once the allocation is estimated to be more than 3% above the strategic target. By using such a wide range the likelihood that the estimate is so wrong that some level of rebalancing is not actually required is low. In addition, if the rebalancing is implemented by only rebalancing to 1% above the strategic target, the risk of overshoot can be significantly reduced.

Proposal

The Committee are asked to consider whether they remain comfortable with the proposed rebalancing mandate given the mechanism and compromises set out above.

For note, the O&A remain comfortable with the rebalancing proposal and the approach set out is common within L&G.

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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, and property, whether held directly or in a pooled or collective investment vehicle. Further, investment 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 amount originally invested.

Past performance is not necessarily a guide to future performance.