AGENDA ITEM: 8 Page nos: 25 - 38

Meeting	Pension Fund Committee
Date	21 March 2011
Subject	**Benchmark Setting**
Report of	Deputy Chief Executive
Summary	This report asks the Committee to note and comment on the recommendations regarding the setting of benchmarks.

Officer Contributors	John Hooton, Assistant Director of Strategic Finance Karen Bannister, Interim Treasury Manager
Status (public or exempt)	Public
Wards affected	None
Enclosures	Appendix A – Setting Benchmarks
For decision by	Pension Fund Committee
Function of	Council
Reason for urgency / exemption from call-in (if appropriate)	Not applicable

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1. RECOMMENDATIONS

1.1 That the Committee note and comment on the recommendation to adopt a composite Equity benchmark for the Return Seeking (Diversified Growth Fund) proportion of the portfolio consisting of 60% FTSE All Share index and 40% the Sterling FT AWI (ex UK).

1.2 That the Committee note and comment on recommendation to adopt a composite benchmark for the Duration (Bonds) proportion of the portfolio split between UK Government Over 15 year index and the UK Government Index-Linked (over 5 years) 3% index.

1.3 That the Committee agree to accept a further report on benchmarks at the next Committee meeting.

2. RELEVANT PREVIOUS DECISIONS

2.1 Council – 11th September 2007 – Minute 64.

2.2 Pension Fund Committee – 26 March 2008 – Dec. 1 – Exempt

2.3 Pension Fund Committee – 10 September 2008 – Dec 11 & exempt.

2.4 Pension Fund Committee – 4 February 2010 – Dec 6

2.5 Pension Fund Committee – 15 September 2010

3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS

3.1 To ensure that the pension fund is being invested prudently and to the best advantage in order to achieve the required funding level. Effective monitoring of the Pension Fund will provide support towards the Council's corporate priorities in providing better services, with less money.

4. RISK MANAGEMENT ISSUES

4.1 The primary risk is that of poor investment performance. Fund manager's performance is monitored by the committee every quarter. If fund manager performance is considered inadequate, the fund manager can be replaced.

4.2 The value of the pension fund assets at any point in time is determined by the market and a large movement in the markets could have a significant impact on the surplus or deficit of the fund.

5. EQUALITIES AND DIVERSITY ISSUES

5.1 Ensuring the long term financial health of the pension fund will benefit everyone who contributes to the fund.

6. USE OF RESOURCES IMPLICATIONS (Finance, Procurement, Performance & Value for Money, Staffing, IT, Property, Sustainability)

6.1 The funding objective of the London Borough of Barnet Pension Fund is to ensure the solvency of the Fund and ensure the sufficient funds are available to meet all the benefits as they fall due.

6.2 Therefore it is necessary to measure the performance not only of the investment managers but also of the Fund as a whole to ensure the investment strategy is fit for purpose.

7. LEGAL ISSUES

7.1 None other than contained in the body of the report and appendices.

8. CONSTITUTIONAL POWERS

8.1 Constitution – Part 3 Responsibility for Functions – Section 2 – Responsibility for Council Functions delegated to the Pension Fund Committee through the Pension Fund Governance Compliance Statement.

9 BACKGROUND INFORMATION

9.1 History

9.1.1 The Superannuation Act 1972 makes provision for local authorities to operation pension funds for their employees and employee of other employers who have either a statutory right or an admission agreement to participate in the funds The London Borough of Barnet's Pension Scheme Fund (The Fund) is set up under the Local Government Pension Scheme (Administration) Regulations 2008 (SI 2008/239); (ii) the Local Government Pension Scheme (Benefits, Membership and Contributions) Regulations 2007 (SI 2007/1166); and (iii) The Local Government Pension Scheme (Transitional Provisions) Regulations 2008.

9.2 Setting Benchmarks

9.2.1 The recommendations of The Fund's investment advisors, JLT Investment Consulting are attached at appendix A.

10. LIST OF BACKGROUND PAPERS

10.1 None.

Legal: TE
CFO:

Setting Benchmarks

London Borough of Barnet Pension Fund

JLT INVESTMENT CONSULTING

Executive Summary

In this short paper we discuss the use of benchmarks for pension funds and for fund managers. We then discuss what the most appropriate benchmark should be for the London Borough of Barnet Pension Fund.

The investment strategy of any pension scheme is designed to ensure that the scheme is able to meet its liabilities over the short and long term. We believe that the optimum use of a benchmark for a pension scheme is to provide a measure of the likelihood of that specific pension fund being able to meet those liabilities. Therefore we recommend that a Liability Benchmark, as the prime measurement objective, is applied to the London Borough of Barnet Pension Fund, rather than a peer group benchmark.

We also consider the use of benchmarks when applied to an asset class and to a fund manager. When applied to an asset class it should represent the investable universe for that asset class, and we provide our recommendations for the two main portfolios of the London Borough of Barnet Pension Fund. Finally, we discuss how an individual fund manager's performance should be judged against their agreed benchmark. This benchmark should reflect the implementation of appropriate investment policies consistent with the manager's defined targets and prudent risk limits; this is because that benchmark will be used to judge the implementation of the investment strategy and the resulting risk-adjusted return achieved by that manager.

Contents

Section One - Introduction

1.1 The overall investment strategy of a pension scheme is, in general, designed to ensure that, over time, the scheme is able to meet its liabilities as they become due and that, taking into account contributions and any deficit payments, the scheme remains solvent.

1.2 For the London Borough of Barnet Pension Fund (the "Fund") a critical element of investment strategy is to ensure that both the assets in which the Fund invests and the investment firms who manage assets on a day to day basis achieve the level of results required to ensure that there are enough monies to meet liabilities. Benchmarks are a vital tool in the monitoring and governance of the Fund.

1.3 The key purpose of investment benchmarks is to allow the measurement of the performance of the assets (and indeed the liabilities) and the effectiveness of strategies and decisions as time progresses, to ensure that the fund is effectively and efficiently managed.

1.4 However, no single benchmark can monitor the investment aims of a pension scheme and simultaneously measure the performance of the investment managers, unless the manager has also been given the responsibility for asset allocation against the liabilities.

1.5 Therefore it is necessary to separate the various levels (or layers) of assessment required.

1.6 It is the view of JLT Investment Consulting that the assessments required fall in three key layers:

- The Fund benchmark
- The Asset portfolio benchmark
- The Manager benchmarks

1.7 The remainder of this report looks at each of these areas in turn, making suggestions as to potential benchmarks in each layer.

Section Two - The Fund Benchmark

Peer group benchmarks

2.1 It has been traditional for schemes to benchmark the investment performance of the scheme against the return achieved by a peer group, such as the CAPs or WM pension scheme universes.

2.2 However, such a benchmark does not reflect the unique characteristics of a particular scheme. The scheme may have a very different age distribution to the peer group in terms of both the average age of members and the numbers in each 5-year age band and the proportion of pensioners may also be very different. In addition, the funding deficits may vary significantly from scheme to scheme. Additionally, the Investment Committee from one scheme to another is likely to have very different attitudes to the levels of risk they are prepared to take or volatility they will accept.

2.3 The investment strategy, and hence the asset distribution, adopted for each scheme in the universe will reflect these characteristics and the asset distribution of the universe as a whole will be very different to that of many schemes in the universe.

2.4 If the scheme has a very different asset structure to that of the universe, the returns will, almost inevitably, be very different reflecting the relative proportions of bond and growth assets (equities, property etc).

2.5 The measurement of the investment performance of a scheme against such a benchmark does not, therefore, provide any useful information against which to assess the scheme's performance relative to other schemes or the funding objective.

2.6 In many cases, the investment performance of the fund managers is also measured against this benchmark. However, this can affect the investment strategy, which is a matter of particular concern.

2.7 As far as an asset manager is concerned, they are assessed on performance relative to the benchmark and would be taking a major risk position by going 15% overweight in any asset position. The manager's only concern is to outperform the benchmark at an appropriate level of risk - they have no interest in whether the strategy is appropriate for the scheme as that is the responsibility of somebody else.

2.8 Superficially, benchmarking the performance of a scheme against a peer group return may appear to be appropriate but it does not take any account of the liabilities and can have an adverse effect on investment strategy.

Fund specific benchmarks

2.9 The funding objective of the London Borough of Barnet Pension Fund ('Fund') is to ensure the solvency of the Fund and ensure that sufficient funds are available to meet all the benefits as they fall due.

2.10 Within this funding objective, the investment return is to be maximised for an appropriate level of risk and the need to minimise employer contribution rates.

2.11 To meet these objectives, the overall benchmark for the assets of the Fund should be that changes in the value of the assets should reasonably mirror changes in the value of the liabilities. The Fund needs, therefore, to set an overall Fund benchmark that takes full account of changes to the liabilities of the Fund.

2.12 In terms of deciding how the liabilities will behave, the building blocks for measurement of the liabilities are contained within the draft 2010 actuarial valuation results from the Scheme Actuary.

2.13 The principal assumptions that affect the behaviour of the liabilities (from an investment perspective) within the draft 2010 valuation commissioned by Barnett Waddingham are:-

- The discount rate(s) assumed for members both pensioner and non-pensioner liabilities is 6.7%. This is a risk adjusted discount rate.
- The rate of increase for pensions is at the annual rate of RPI inflation less 0.5% per annum, where RPI inflation is assumed to be the difference between the yields on fixed and index-linked Government bonds.
- pensionable salaries are assumed to increase at an annual rate of 1.5% per annum above the assumed rate of RPI inflation described above.

2.14 Monitoring would also have to take into account the fact that the existing deficit (which is not matched by any assets) will change as interest rates change.

Recommendation

2.15 Measurement of the progress of the London Borough of Barnet Fund, as a whole, can only be properly done against changes in the value of the liabilities – a Liability Benchmark. From such a benchmark it will be clear to see progress against:

- The funding position
- The impact of decisions in the areas of asset strategy and manager selection
- The impact of advice received on strategy from advisors

2.16 Importantly, by setting a Fund specific benchmark, the London Borough of Barnet ensures that it meets with best practice under the CIPFA guidelines and Myners Principles and can be clearly seen to be meeting Good Governance standards.

2.17 As an example, all things being equal and ignoring the impact of matured and new liabilities, the value placed on the liabilities would be expected to increase over a year by the discount rate, 6.7% in this case. However, there are additional factors involved which will affect the value of the liabilities such as changes in the discount rate, which will change with changes in long term interest rates, and changes in the future expectation of inflation, which is also based on market conditions. Comparing how the Fund's assets have performed against the estimated change in the liabilities as a result of these factors will allow for a better assessment of the success, or otherwise, of the investment strategy.

Section Three - The Asset Portfolio Benchmark

3.1 The asset portfolio of any pension arrangement broadly falls into two parts:

- The Return Seeking portfolio
- The Duration portfolio

3.2 The Return Seeking portfolio is typified by investment such as Equities and Property but can include a wide variety of assets ranging from Commodities, through Hedge Funds to High Yield Debt and Currency.

3.3 The purpose of such a portfolio is to do what is in its name – seek Returns.

3.4 The Duration portfolio on the other hand has a totally different role. Its role is primarily to provide the Fund with sensitivity to changes in interest yields.

3.5 This sensitivity is particularly important within the framework of the actuarial valuation of liabilities (as was in part discussed in section two) and is a topic that was require discussed when the current investment strategy was reviewed and amended.

3.6 The Duration portfolio, also performs a second function. This is to provide a counter balance to the Return Seeking portfolio, as the assets typically held in this area are Gilts (both conventional and index-linked) and good quality Corporate Bonds. Typically these provide a strong behavioural contrast to investments such as equities.

The Return Seeking Benchmark

3.7 Given that often the assets for the Return Seeking portfolio are equities, the starting point for defining a benchmark for this area is invariably a Global Equity index.

3.8 The weightings between the UK and Overseas Equity markets is a topic for debate and agreement but such discussion helps formulate the rationale behind investment strategy decisions and therefore clarifies what the strategy in this area is trying to achieve and why.

3.9 Over the last few years, we have seen the usage of two other benchmarks for this area.

3.10 Firstly, the use of either inflation or Libor basis plus a margin for expected outperformance of up to 6%. Secondly, there are benchmarks that are specific to the assumptions within the actuarial valuation (particularly in relation to the assumption for pre-retirement members). This would normally be shown as a Bond yield plus a margin of outperformance (often around 2%).

The Duration Benchmark

3.11 The impact of duration on the liabilities of the Fund is firmly linked to the discount rate assumptions underpinning both the Pre and Post retirement discount rates, and inflation increases.

3.12 In the case of the London Borough of Barnet Pension Fund, these are the yield on UK Government Over 15 year stock and the yield on UK Government Index-Linked (Over 5 years) 3% inflation stock.

Recommendation

3.13 For the Return Seeking portfolio, the benchmark should be a Composite Equity benchmark consisting of 60% UK Equities and 40% Overseas Equities.

3.14 The UK Equity portion should be based on the FTSE All Share index, with the Overseas component being the Sterling FT AWI (ex UK).

3.15 For the Duration portfolio, the benchmark should be based on the returns on the UK Government Over 15 year index and the UK Government Index-Linked (over 5 years) 3% index. The proportions between these will require some additional work on the breakdown of the liabilities.

Section Four - The Manager Benchmarks

4.1 Benchmarks for managers are the ones with which Panel members are most likely to be familiar.

4.2 When appointing a portfolio manager, the Fund will have agreed an investment mandate that meets the needs of the Fund for a particular asset class.

4.3 The mandate will take into account the risk appetite of the Fund, such as maximum exposures to individual counterparties/sectors, the use of derivatives etc. The investment performance of the investment manager will then be measured against a benchmark index that reflects the agreed investment mandate and any significant constraints.

4.4 The manager will then seek to outperform the benchmark index and will not normally be concerned about absolute return.

4.5 There are a plethora of indices available allowing almost any brief to be covered. For equity, property and other growth assets, the fund manager's performance can be measured against an appropriate index.

4.6 For a UK gilt and corporate bond managers, the most common benchmarks include the FTSE Government Fixed Interest and FTSE Government Index-Linked Gilt Indices and the iBoxx (Corporate Bond) Indices for the most relevant maturity dates.

4.7 To a large extent, the benchmark can be easily tailored to meet the risk requirements of a portfolio – for example to match the Fund's required duration profile, the benchmark return might be (⅓ return on the iBoxx 10-15 yr Index plus ⅔ return on the iBoxx Over15 yr Index). Similarly if the Fund does not wish to hold corporate bonds with a BBB-rating, an appropriate composite benchmark index can be derived.

Recommendation

4.8 Measurement of manager portfolios should be judged against indices appropriate to the brief for the manager mandate. We include information on each of the Fund's current manager portfolios in the Appendix.

4.9 The exact benchmark indices to be used should be agreed as the final piece in the investment structure.

Appendix

Summary of current funds

Manager	Fund	Date of Appointment	Management Style	Monitoring Benchmark	Target
Newton Investment Management Limited (Newton)	Real Return	December 2010	Active, pooled	1 month LIBOR plus 4% p.a.	To achieve significant real rates of return in sterling terms predominantly from a portfolio of UK and international securities and to outperform the benchmark over rolling 5 years
Newton	Corporate Bond	December 2010	Active, pooled	Merrill Lynch Non Gilt Over 10 Years Investment Grade Index	To outperform the benchmark by 1% p.a. over rolling 5 years
Schroder Investment Management Limited (Schroder)	Diversified Growth	December 2010	Active, pooled	Retail Price Index plus 5% p.a.	To outperform the benchmark over a market cycle (typically 5 years)
Schroder	All Maturities Corporate Bond	December 2010	Active, pooled	Merrill Lynch Sterling Non-Gilts All Stocks Index	To outperform the benchmark by 0.75% p.a. (gross of fees) over rolling 3 years
Legal and General Investment Management (L&G)	World (ex UK) Equity Index Fund	September 2008	Passive, pooled	FTSE AW World (ex UK) Index	Track within +/- 0.5% p.a. the index for 2 years in every 3
L&G	Active Corporate Bond – All Stocks	December 2008	Active, pooled	iBoxx Sterling Non-Gilts All Stocks Index	Outperform by 0.75% p.a. (before fees) over rolling 3 years
Internal	Property	N/a	Active, property unit trust portfolio	UK IPD Property Index	Outperform the index

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