Appendix D - JLT Investment Strategy Positioning Report

London Borough of Barnet Pension Fund

Investment strategy

Contents

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1 Introduction

This report provides both a summary of the internal deliberations that resulted in the present investment asset allocation and some of the key issues for consideration by the Pension Committee in order that Members can review the current investment strategy in light of the 2013 Triennial Valuation.

The Triennial Valuation cycle provides a very effective point at which to periodically review the investment strategy because it provides the most up to date, detailed calculation of the liabilities of the London Borough of Barnet Pension Fund ('the Fund'). With that most accurate value of the liabilities it is then possible to compare the corresponding value of the Fund's assets and calculate with the greatest degree of confidence the funding level.

The changes in funding level between one triennial valuation and the next is effectively the best measure of how the Fund's liabilities are developing with respect to changing bond yields in the market, and how the investment strategy has performed, relative to expectations, in those same investment markets.

The Fund's current investment strategy was agreed by the Pensions Committee in December 2009; this agreement followed the engagement and deliberations of the Working Group that was formed in the latter part of 2009 to consider the previous asset allocation strategy and its response to the events of 2008. At that time the most critical concerns of the Pensions Committee and its Working Group were primarily that a revised investment strategy should seek to provide a reduction in funding level volatility, following the sharp asset falls seen in late 2008 and early 2009, and that any changes to the investment strategy should be achieved at as low a cost as possible.

This report will:

- Summarise how the current investment allocation was agreed in 2009.
- Consider the effectiveness of the current strategy.
- State a number of the issues that the current Pension Committee face with respect to investment strategy.
- Provide some recommendations for the Pensions Committee to consider.
- Suggest some potential next steps.

2 Executive summary

This report provides Members of the Pensions Committee with a summary of how the Fund arrived at the current investment strategy asset allocation. The key objective of the Working Group, set up to review the Fund's previous Balanced Mandate investment strategy, was to reduce funding level volatility and provide the most efficient risk-adjusted return. This was achieved by revising the asset allocation to 70%:30% Diversified Growth Fund (DGF):Corporate Bonds.

This revised investment strategy provided a bond allocation that matched the Fund's pensioner liabilities, and gave the Fund access to the potential risk and return benefits of active asset allocation through delegating these decisions to the DGF investment managers.

The implementation of this revised investment strategy was completed on a pragmatic and low-cost basis by effectively changing the mandates of the incumbent managers Newton and Schroders.

Within this report we also briefly consider the current issues facing pension funds of: asset volatility, low yields and correspondingly high valuations of pension fund liabilities; we then subsequently consider in summary four topics we are currently discussing with clients to address those issues. These are: liability management, infrastructure investment, bond yield changes and where future asset growth is likely to come from.

We provide our recommendations that Members should conduct either a modelling-led or a discussion-led investment strategy review *after* they have completed some investment strategy training; and conclude with what we believe are the next steps and timescales towards completing an investment strategy review.

3 Current investment strategy

3.1 2009 Working Group

Following the unprecedented market volatility of late 2008 and early 2009 at the 30 June 2009 meeting the Pension Committee convened a Working Group to sit in October and November of 2009 to review the Fund's investment strategy. JLT Employee Benefits (when we were still HSBC Actuaries and Consultants) were tasked with preparing discussion documents and facilitating the Working Group.

We presented to the Working Group on the 23 October 2009 our investment strategy review document (October 2009). Following discussions and agreement at the 23 October meeting we completed a proposed implementation strategy document that was then presented to a subsequent meeting of the Working Group on 12 November 2009. The implementation strategy was then agreed at that meeting.

The Working Group's strategy and implementation proposals were then presented and agreed by the Pensions Committee at the 21 December 2009 meeting.

3.2 2009 Working Group – strategy recommendation

The Fund's investment strategy leading up to the financial turmoil of 2008/9 was to hold all its assets in balanced funds, these were a widely utilised form of multi-asset pooled funds that were heavily weighted to equities, and that did not employ any form of active asset allocation. The major strategy recommendation from the Working Group's review of the asset allocation was two-fold:

- To split the assets into a growth portfolio and bond portfolio that equalled the split between pensioner and non-pensioner liabilities within the Fund.
- For the growth assets to be invested in diversified growth funds (DGFs) and the bond assets to be invested in investment grade corporate bonds.

These revisions to the asset allocation allowed the Fund flexible control over its allocation to growth/bond assets, and gave the Fund access to a wider universe of growth assets where the allocation to the different assets was actively managed.

The pensioner and non-pensioner liabilities proportional split between DGF and corporate bonds equated to a 70:30 allocation. This represented a significant increase in the Fund's allocation to bond assets; this increase in less volatile, lower return assets was a direct result of the Working Group's aim to reduce funding level and asset volatility in the Fund.

3.3 2009 Working Group – implementation recommendation

The Fund's investment managers prior to the strategy review were Newton and Schroders – with assets held in their respective balanced funds. At the Working Group meetings there was considerable focus given to the issue of how the revised investment strategy could be implemented in the most cost effective manner possible. Potential costs that could have been incurred were:

- The structural bid/offer spread costs of selling assets no longer in the revised asset allocation and purchasing those new assets that were in the revised allocation.
- The procurement costs associated with the OJEU compliant search and selection exercise of new investment managers to allocate the revised asset allocation.

- Increased investment consulting costs and increased officer engagement.

As your investment consultants we have always sought to employ the most pragmatic of measures to any issues that the Fund might face. At that time both Newton and Schroders had DGFs with positive track records that would have met an OJEU selection exercise's criteria, and that would complement each other if appointed together. We raised with the Working Group the possibility that a search and selection exercise, with all its attendant costs, could effectively result in the same two managers appointed.

Our recommendation to the Working Group and agreed at Pensions Committee was to change the existing engagement of the two incumbent managers from a balanced mandate to that of a DGF mandate. This legitimate and non-contentious revision of Newton and Schroders investment management agreements provided the Fund with significant savings in all three areas outlined above. It also allowed for very favourable fee negotiations to take place, and for the Fund to invest in the two managers' DGFs and corporate bond funds at lower that the published fee rates; thus providing ongoing savings to the Fund from that point.

We highlighted to the Working Group and Pension Committee that the investment of any institutional allocation to a DGF should be judged over 'a market cycle' – thereby allowing a critical evaluation in both up and down markets; typically this is viewed as a five to seven year period.

3.4 Current investment strategy – interim review

Whilst the Fund's investments into the Newton and Schroders DGFs and corporate bond funds are only just coming up to their fourth anniversary, i.e. a shorter period than normally considered to be a market cycle, it is still appropriate to periodically review the performance of both the revised investment strategy, and that of the underlying managers. This represents good governance and is conducted as part of the quarterly performance monitoring cycle that we update Members on at every Pension Committee meeting.

The Working Group's objectives were to reduce funding level and asset performance volatility. Within our strategy review paper of October 2009 we highlighted within our modelling results with any planned reduction in volatility comes a commensurate reduction in the expected return of any specific asset allocation. What the agreed strategy of 70:30 DGF:corporate bonds sought to achieve was the best risk-adjusted return. We demonstrated that the previous balanced strategy was inefficient, and that by revising the old strategy we could either achieve the higher return for the same level of volatility (a measure of risk), or reduce volatility for the same level of return. As previously stated, the decision was agreed that reduced volatility was the primary objective.

So, is the revised investment strategy proving effective? A detailed investigation of this issue would form part of an investment strategy review; and the resulting data would require some interpretation. It is not question of simply comparing returns between asset classes, because the differences in asset price volatility and the subsequent impact on funding level volatility must also be considered. We would be keen to cover all of these considerations in an investment strategy review with Members.

4 Topical investment issues

4.1 Pension Committee decision making

Following the May 2013 elections there have been a number of new Members join the Pensions Committee. As they were not present at the discussions related to the findings and recommendations of the 2009 Working Group it is to be expected that points of clarification have been raised at recent Pension Committee meetings. For example, a question sought to understand why the Fund does not have the ability to make direct investments into illiquid growth asset classes, such as private equity/venture capital. This is an extremely valid question and encapsulates many of the issues considered by the Working Group.

Both the previous investment strategy and the revised current strategy effectively delegate the asset class investment decisions to the Fund's investment managers. Previously under the balanced mandate this was a relatively narrow, equity focused, peer group benchmark allocation, whilst under the DGF strategy the managers now have the flexibility to invest in any growth asset class they believe to be appropriate.

Therefore the Fund does have potential exposure to many illiquid growth asset classes, but it is at the managers' discretion. This is a fundamental difference to a direct investment in an illiquid asset class as decided, and essentially managed, by the Pensions Committee. If the Pensions Committee wish to make such asset allocation decisions we would highlight both the increased governance burden this would place on the Committee, and the increased officer time that would also be required (to manage capital calls and cashflows, etc.).

We believe the engagement of Members in these types of investment decisions would represent a major shift in how the Pensions Committee has previously conducted its business. If this is something the Members wish to consider we would recommend that time is set aside to discuss all the potential implications.

4.2 Investment issues facing pension funds

Since the financial crisis of 2008 there have been a number of issues facing all pension funds, significantly:

- Increased asset value volatility.
- Very low yields on government and investment grade corporate bonds.
- The corresponding low discount rates applied to pension fund liabilities reducing the funding level value.

All of these factors have made it very difficult for all final salary, defined benefit schemes such as the Local Government Pension Scheme (LGPS) – i.e. the Fund. With many corporate pension schemes closing we have seen these schemes effectively maturing, focusing on the ultimate buy-out of their pension fund liabilities and a greater emphasis being placed on both cashflow management and a desire to invest in yielding assets. Therefore we are currently engaging with our clients on a number of very relevant topics, which we will briefly consider below.

Liability management – specifically liability driven investment (LDI)

As the calculation of the value an actuary has to place on a pension scheme's liabilities is so sensitive to yields in the prevailing bond markets there is now a lot of focus on what can be done towards the management of a scheme's liabilities. Many of the options open to the corporate pension schemes are not possible within the public sector, but there is one liability management tool that is increasingly being taken up by the LGPS.

LDI is an investment style that seeks to match the movements in the value of a specific pension scheme's liabilities with a basket of investments whose value will be affected by prevailing bond yields in exactly the same way as the value of the scheme's liabilities. Due to the historic low yields at present an attempt to match all of the pension scheme's liabilities would be considered expensive; however, the decision to match a scheme's inflation-linked liabilities is much more attractive – especially for the LGPS as there are direct inflation linkages to the pension liabilities.

JLT have been at the forefront of the LGPS inflation-only LDI manager selection exercises and have significant experience in discussing with Members and officers this specific asset class.

Infrastructure investment – effect of the Pensions Infrastructure Platform (PIP)

There is a lot of discussion and comment amongst pension schemes, investment managers, the trade press and Government about the benefits of institutional/pension fund investment into, specifically, UK infrastructure assets and projects. There are some clear and unequivocal benefits for UK based pension funds into such investments; in essence these investments have the potential to offer stable, transparent and, most attractively, *inflation-linked* cashflows. This is another method of addressing inflation indexed liabilities.

The National Association of Pension Funds (NAPF) is in the process of structuring a PIP which is intended to provide investor-friendly access to this asset class, which has a very broad definition. There was hope that the detail of the PIP's investment proposition would be known, and in whatever form it took, would be investable in 2013. Unfortunately this has not been the case, and we are seeing LGPS investors, who were waiting to potentially make an infrastructure allocation to the PIP, now begin to consider alternative arrangements.

We are firm believers in the appropriate nature of specific parts of this asset class for all potential investors and we have conducted the only open market LGPS selection exercise for an infrastructure manager. We have also completed many training sessions on this asset class, and your investment consultant has personally spoken at a number of infrastructure conferences.

What will happen when we see yields return to more normal levels?

Many investors are very concerned about the implications of a reversal of the historic lows we are seeing in the bond markets back towards more normal long term averages. This very rational anxiety is due to the fact that investors will see the capital erosion of the current (historically very high) value of their bond portfolios when yields rise.

Addressing this known and calculable risk is a huge investment strategy consideration; we are seeing some investors selling down their bond assets, especially gilts, and moving into assets whose values are not so negatively sensitive to upward moves in bond yields. Examples of such assets are secured loans and absolute return bond funds.

However, many investors hold bond portfolios to match their pensioner liabilities (similar to LDI) and will accept a reduction in the value of their bond funds because it will be matched by a commensurate fall in the value of their liabilities when yields rise. A discussion of the original rationale for the Fund holding a separate corporate bond allocation would be very timely; only then could any wider investment be conducted.

Where will future growth come from? – frontier markets

We have seen the developed equity market regain much of the considerable value lost in 2008/9 economic downturn. As such investors are focusing on where there is likely to be sustained and predictable growth from this point.

We are discussing frontier markets with a number of our clients. These rapidly developing economies, for example Qatar and Argentina, are effectively the 'new emerging markets' as investors seek to find the next growth opportunity.

We believe there are a number of reasons why an investment in the companies listed in these rapidly developing countries can deliver an appropriate risk-adjusted, growth asset return. These markets are capacity constrained and JLT is utilising its position in the market to provide our clients with a time-limited opportunity in these uncorrelated, growth markets.

5 Investment strategy recommendations

5.1 Investment strategy review - options

The 2013 Triennial Review of the Fund's liabilities provides an excellent opportunity for the Pensions Committee to consider the current investment strategy, and as your investment consultants we would wholeheartedly recommend that you take this opportunity to complete an investment strategy review.

There are a variety of different ways that the Members can conduct this review, and there are some standard ways in which you can engage with your investment consultant.

- Full stochastic asset liability model (ALM) – this is a very detailed, forward-looking modelling exercise that incorporates a large number of potential future economic outcomes and considers the liabilities in the most thorough manner possible.

  We would recommend this large strategy piece of work if the client was keen to make wholesale changes to their current investment strategy.

- Sensitivity analysis of investments and liabilities (SAIL) exercise – this is effectively a 'lighter' version of our ALM that utilises long term return and volatility relationships to analyse the risk of different investment strategies in relation to a pension scheme's specific liabilities, but at a summary level. This is an exercise that can be carried out with live input from the client and is able to quickly accommodate client specific requirements/asset allocations.

  We recommend this robust exercise for clients who are either periodically reviewing their investment strategy, or on appointment in order that our investment consultant can better understand the appetite for risk and return of a new client.

- Consultant-led review – this is the lowest engagement option and effectively provides the client and consultant to test and challenge the understanding and commitment to an existing long term investment strategy.

  We ideally conduct these on an at-least annual basis. These are normally part of an established and long-standing client relationship and are effectively an extension of the performance monitoring effort towards a long term, previously agreed goal.

5.2 Pension committee investment strategy training

Ongoing training of LGPS members and corporate trustees is considered to be a crucial element of pension scheme governance best practice. With all the recent economic turmoil and rapidly developing investment options and markets we would strongly recommend some dedicated training for the Fund's Members.

We consider this to be particularly relevant at the moment with the recent additions to the Fund's Pension Committee. Some dedicated and focused investment training would have three very significant benefits:

- It would provide a baseline of understanding for all Members of the Pensions Committee with respect to understanding how the current investment strategy was arrived at, and the issues, risk and opportunities that currently face the Fund.
- This understanding would better equip Members to both challenge any current assumptions/decisions and, make better, more informed investment decisions in the future.
- It would provide an auditable opportunity for continuing professional development for Members.

6 Investment strategy next steps

6.1 Investment strategy discussion at December 2013 Pension Committee

The results of the 2013 Triennial Review of the Fund's liabilities combined with the discussion of this paper at the December 2013 Pensions Committee meeting provides an excellent and timely opportunity for the Members to consider how best to:

- Review their understanding of the current investment strategy.
- Consider their training needs.

6.2 Dedicated investment strategy training

In order that Members can better consider the current investment strategy success and whether it has had enough time to meet its objectives we believe a completely separate training session should be convened. This would also cover some of the topical investment issues covered in this report and enable the Members to decide on the appropriate manner to undertake an investment strategy review of the Fund.

We would suggest that this session be scheduled for as soon as conveniently possible in 1Q2014.

6.3 Investment strategy review

Following on from the decision made at the training session, any work that is agreed upon can be conducted towards a presentation back to the Pensions Committee as soon as possible.

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