Croydon Council

REPORT TO:	**PENSION COMMITTEE** **5 March 2013**
AGENDA ITEM:	9
SUBJECT:	**Croydon Pension Fund Investment Strategy**
LEAD OFFICER:	**Executive Director of Corporate Resources and Customer Services**
CABINET MEMBER	**Deputy Leader (Statutory) and Cabinet Member for Housing, Finance and Asset Management**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: Ensuring that the pension fund is being invested prudently and creates the optimal balance between risk and return in order to achieve the required funding level.	
FINANCIAL SUMMARY: There are no direct financial consequences for this report.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

For general release

1 **RECOMMENDATIONS**

1.1 That the Committee approve:
1.1.1 The allocation to asset classes set out in paragraph 3.11 below;
1.1.2 The establishment of an opportunistic investment sub-fund, as described in paragraph 3.13 below.

2. **EXECUTIVE SUMMARY**

2.1 The objective of the Pension Fund (the Fund) is to achieve long term returns on investments to meet all Fund liabilities, after taking employer and employee contributions into account, and to minimise the cost impact on Fund employers and local taxpayers. Any long term assumptions used in the setting the funding strategy must be consistent with the actuarial assumptions used in determining the funding level of the Fund.

2.2 This report details the recommended Croydon Pension Fund Investment Strategy (Investment Strategy) that has resulted from reviews and proposals presented by Aon Hewitt and subsequent discussions between officers, including the Executive Director of Corporate Resources and Customer Services, the Chairman and Vice Chairman of the this Committee.

3. DETAIL

Investment Strategy Review

3.1 This report provides an update on the continuous process of review and challenge that informs the strategic direction of the Croydon Pension Fund investment framework. It sits alongside and compliments other policy guidance, principally the Statement of Investment Principles. The Pension Committee exists to provide direction and guidance for the day-to-day management of the Fund so understanding this process is critical to the operation of the Committee. The Local Government Pension Scheme (LGPS) is a funded scheme which is to say that benefits are paid from returns generated from a pool of assets. The overarching duty of the Committee is to ensure that this pool of investments generates returns sufficient to meet the current and future liabilities of the scheme and as a secondary obligation to close the historic funding gap over a set period of years. To maximise the likelihood of meeting this target a risk budget has been established to ensure that volatility does not compromise the investment objectives of the Fund. This report details an investment view that shapes the expectations around the investment strategy and also describes the tools that allow effective management of these processes.

3.2 All investment processes are under-written by statutory Regulations that require that proper advice is sought. Although the Regulations do not offer a definition for proper advice this Committee has contracted with Aon Hewitt to provide such guidance but also gives consideration to the views of its independent advisor and of qualified investment professionals within various investment firms, banks and consultancies. Fundamental to this decision making process is an understanding of the context and changing dynamics governing the investment process. Aon Hewitt provided members of this Committee with training to augment the last two meetings of the Committee in 2012 (the 4th of September and the 20th of November 2012). The training included an overview of investment asset classes, risk and return modeling and modelling alternative portfolios. The training objective was to provide members with the necessary skills to agree an Investment Strategy that would provided the required returns within an acceptable risk parameter.

3.3 During the committee meeting held on the 20th of November 2012, Aon Hewitt tabled four portfolio models, each with different asset allocations. Broadly speaking the portfolio models comprised the Fund's current investment strategy which was agreed by the Committee in 2009 (minute A40/09 refers), a re-risking strategy, an alternative diversification strategy and a de-risking strategy.

A summary of asset classes and their characteristics are summarised at Appendix A.

3.4 Of the four models presented to the Committee, both the re-risking and de-risking models were discounted on the basis they did not result in the optimal balance between risk and reward. The alternative diversification model proved to be a cause for concern due to the 10% allocation to diversified growth. Subsequent considerations by officers have established areas where the features of this asset type generate The particular issues around diversified growth funds include high manager fees circa 60 -70 basis points, the potential for high transaction costs due the high level of turnover within the fund and the use of complex derivatives. The existing portfolio, composed of a range of investment classes and different fund managers, provides sufficient diversification across asset classes and investment styles and it could reasonably be argued that a 10% allocation to a diversified growth investment vehicle would not only unnecessarily and expensively duplicate this but the allocation would be too small to materially impact positively on the Fund returns.

3.5 As the name suggests, diversified growth funds seek to add diversification to investment portfolios. Whilst this may work well within a portfolio that otherwise is only exposed to tradition investments (such as equities and fixed interest) it is unclear what benefits it brings to an investment portfolio that is already sufficiently diversified across numerous asset classes. As the Croydon Pension Fund is currently invested across equities, fixed interest, property, private equity and hedge funds there is some doubt whether the benefits of investing in a diversified growth fund would warrant the extra fees and potential loss of transparency. For these reasons the proposed Investment Strategy does not include an allocation to diversified growth funds.

Proposed Investment Strategy

3.6 For the purposes of comparison the current strategy is provided below.

Asset Class	**Target Allocation Percentage**
Equities	50% +/- 3%
Bonds	30% +/- 3%
Property	7% +/- 3%
Private Equity	4%
Hedge Funds	4%
GTAA (now held as cash)	4%
Cash	1%
Total	**100%**

3.7 The proposed investment strategy is set out in the table below. The major changes proposed and the rationale supporting each change is set out here.

3.8 The allocation to fixed interest has been decreased as the market outlook suggests that 2013 will be a year of relatively poor returns for fixed interest investments. Government bonds are expected to yield negative returns whilst investment grade credit is expected to produce small, positive returns. Fixed interest is used here as a label for a range of instruments dominated in major (US Dollar, GB Sterling and Euro) and local currencies and including government debt, corporate bonds and other debt instruments and derivatives providing exposure to these assets.

3.9 The reasoning behind the suggested increase in the property allocation from 7 to 10 percent is that property returns have a low correlation to equities and fixed income. Hence the asset class would provide greater diversification within the portfolio whilst reducing volatility.

3.10 The proposed asset allocation includes a specific allocation to infrastructure, an asset class that featured in the Aon Hewitt recommendation. Anticipated returns on the class are interesting and the Fund already has a small exposure through the first and second Equitix funds.

3.11 Continuing the existing established process, a tolerance of 3% is provided for the three largest asset classes. This reflects the volatility expected from investments in these assets and has been introduced to avoid the necessity for frequent rebalancing which is not only costly but has the effect of punishing successful managers. Minute A47/11 refers.

Proposed investment strategy

Asset Class	**Percentage**	**Change from Previous (%)**
Equities	50% +/- 3%	no change
Fixed Interest	25% +/- 3%	-5%
Property	10% +/- 3%	+3%
Infrastructure	5%	+5%
Hedge Funds	4%	no change
Private Equity	5%	+1%
Cash	1%	-4%
Total	**100%**	

Note that the movement in the cash figure includes 4% previously allocated to the GTAA strategy.

3.12 Appendix A provides a commentary on the particular features of each asset class and the extent to which they influence the performance of the portfolio. Besides that gloss a few comments are relevant. So that appropriate decisions are taken, the Committee needs to develop a view about critical macro-economic factors and their impact in the short and longer terms. At present these considerations are debated regularly by the Committee but in the future it would be preferable to formally document these to support investment decisions. The investment strategy is set out in terms of asset classes. If it is accepted that the current financial environment is difficult to interpret, and if it is likely that the scenario will persist for a number of years, it is a necessary corollary that these definitions cannot be inflexible. Therefore it should be understood that these labels are a convenient shorthand for assets with those characteristics. Therefore the 'property' label will incorporate ground rents funds; 'fixed interest' includes a range of fixed interest ideas such as various forms of debt; and 'infrastructure' will include different government backed schemes. Hedge Fund has always been an inexact term and incorporates a number of strategies.

3.13 An extension of this way of thinking would involve the creation of a pool of cash, derived from dividends, distributions and so forth that allows a more rapid deployment into investment ideas that fulfil the criteria required for inclusion in the Fund by meeting the broader definitions described above but at the same tie are time critical. This report recommends the creation of such a sub-fund with the discretion to invest these sums being equivalent to the existing discretionary powers around rebalancing within asset classes.

3.14 Going forwards, the process of perpetual review and challenge will continue and inevitably investment themes will establish themselves. Although it is difficult to establish individual voices from the market noise it is likely that those themes will feature exposure to emerging markets; the impact of Quantitative Easing on investment decisions; liquidity and scheme maturity; the influence of other LGPS employers; and the growing involvement of central government in the management of Fund investment decisions. As thinking around these themes develops suggestions as to how the investment strategy should be adapted will need to be discussed.

3.15 A general characteristic of medium-sized public pension funds is that resources are often an issue. It has been established that this Fund addresses this issue by partnership with external service providers who bring expertise and experience that would not be economic to retain in-house. These advisors provide an extra dimension to the management of the fund that elevates the quality of decision making. It has been long understood that whilst their are contradictory views about whether the size of funds has any bearing on the value of decisions it is very clear that the more professional the adopted approach, the better the relative returns on investment decisions. Officers will continue to manage the performance of the Fund by using a range of tools that will include:

- Investment Advisors, banks and consultants for market views and fund manager appraisals;
- WM and Inalytics for performance measurement;
- Sungard ATP for risk measurement and monitoring;
- Various independent bodies to monitor the performance of advisors, banks, transition managers and so forth;
- Liabilities by actuaries.

3.16 Central government has focused attention on the issue of pension scheme administering authorities saving money through more efficient procurement. This Committee has previously received reports of the success of both Croydon and National Frameworks in controlling costs associated with actuarial services, benefits consulting and investment advice. Croydon Council is also playing a lead role in exploring ways that equivalent savings could be delivered from more efficient procurement of fund managers. This work is in its infancy and there are a number of different options to explore.

3.17 This report recommends that:

The allocation to asset classes set out in paragraph 3.11 be agreed; and
The establishment of an opportunistic investment sub-fund, as described in paragraph 3.13.

4. CONSULTATION

4.1 Officers have consulted with investment advisors and committee members.

5. FINANCIAL CONSIDERATIONS

1.1 The report deals exclusively with the investment strategy for the Council's Pension Fund and the long term goal of reaching the required funding level.

6. COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

6.1 The Council Solicitor comments there are no direct legal implications arising from this report.

(Approved by: Gabriel MacGregor, Head of Corporate Law on behalf of the Council Solicitor and Monitoring Officer)

7. OTHER CONSIDERATIONS

7.1 There are no Human Resources, Customer Focus, Equalities, Environment and Design, Crime and Disorder, Human Rights, Freedom of Information or Data Protection considerations arising from this report.

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BACKGROUND DOCUMENTS: **None**