Aon Hewitt
Consulting | Investment Consulting Practice

London Borough of Croydon Pension Fund

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Investment Strategy Review - Next Steps

Introduction

Aon Hewitt is in the process of carrying out a detailed investment strategy review for the London Borough of Croydon Pension Fund ("the Fund"). This investment strategy review, by way of an asset-liability modelling exercise, is being considered in conjunction with the Fund's funding position.

The modelling exercise is being carried out to provide a framework for assisting the Pension Committee to determine an appropriate long term asset allocation for the Fund.

The purpose of this paper is to provide an overview of the key issues which will be covered in the analysis from the strategic investment review and to provide a summary of the next steps.

Background

The Fund's assets have enjoyed strong growth since the last actuarial valuation with the assets of the Fund representing c. £805m as at 31 December 2014. The results of the Fund's actuarial valuation as at 31 March 2013 estimated a funding level of 66%.

As part of this review, we will consider the major economic risks facing the Fund and explore the possibility of reducing the level of investment risk with the aim of reducing the expected future funding level variability.

The main intention of the investment strategy review is to use the modelling of different strategies in the asset liability exercise to assess the appropriateness of the current investment strategy, against alternatives ones, with the aim of supporting the Fund's funding objectives in the most suitable way.

Investment strategies

The Fund's current investment strategy represents a 75% / 25% split between "growth" and "matching" portfolios.

- The growth portfolio comprises equities, hedge funds, property, private equity and infrastructure;
- The matching portfolio comprises gilts, corporate bonds and unconstrained bonds.

One of the main intentions of the different strategies to be modelled as part of the asset liability exercise is to ensure the current split between "Growth" and "Matching" assets remains appropriate and supports the Fund's funding objectives.

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In addition, the modelling will also consider alternative approaches to reduce the expected volatility profile of the Fund through diversification within the "Growth" portfolio and a greater focus on liability matching within the "Matching" portfolio.

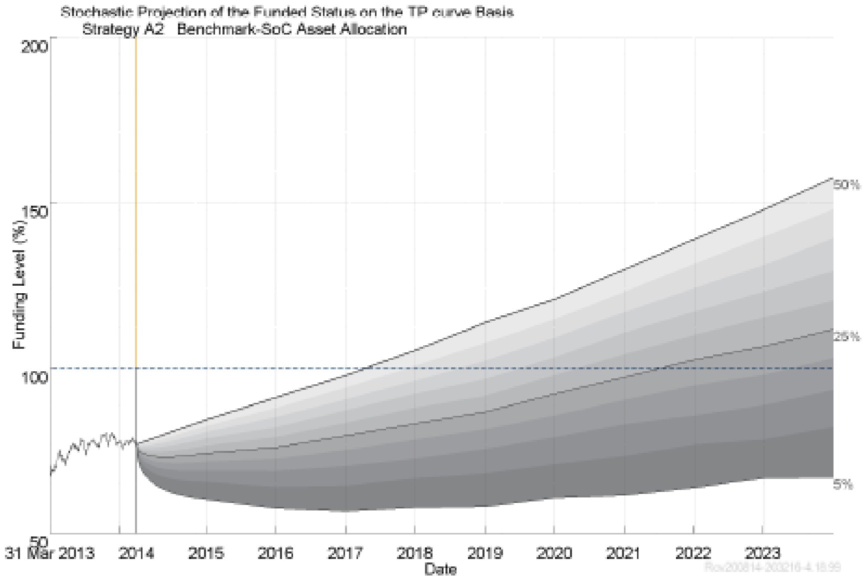
Setting the strategy

The future is unknown and different asset market and economic conditions will impact the performance of different strategic asset allocations. A strategy expected to meet your objectives may lead to unacceptable outcomes in poor scenarios. Conversely, a strategy with little downside risk may result in you never meeting your objectives if it does not have a sufficiently high expected return.

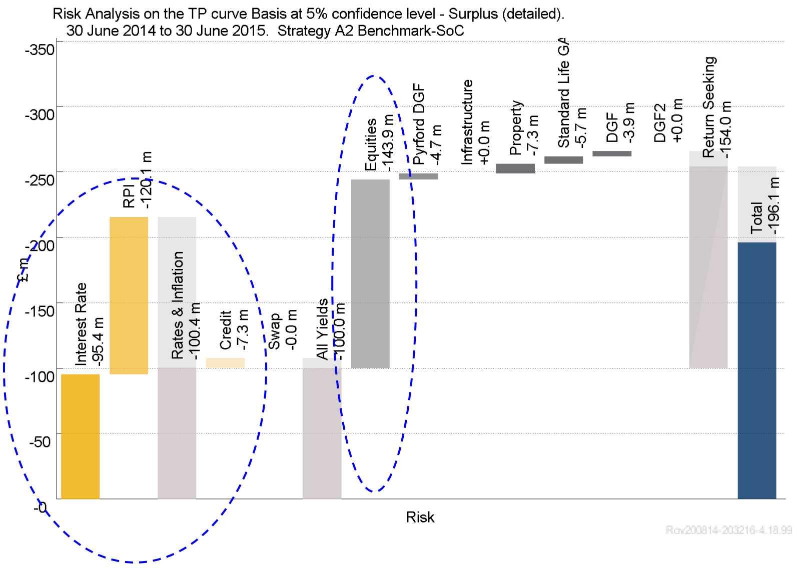
Assessing the likely impact of different strategies against your objectives and assessing the potential variability in outcomes is impossible without some form of quantitative analysis. To allow the Pension Committee to make an informed decision, we will use a quantitative asset-liability model. We are able to use this framework to model all the asset classes in which the Fund invests.

Asset Liability Modelling

An asset liability exercise provides a framework to assess the current investment strategy in light of the Funds objectives and quantify the likelihood of attaining the objectives in a given time frame. This can often be depicted as a funding level funnel, as shown in the chart below, by demonstrating the range of potential future paths for the funding level.



The analysis from the modelling will also highlight the key risks that the Fund is exposed to. The magnitude of these risks can be modelled on a Value at Risk (VaR) basis over different time periods as illustrated in the chart below. Considering alternative approaches to reduce the expected volatility profile of the Fund through diversification, perhaps including additional asset classes, or utilising a greater focus on liability matching assets.



The chart estimates risks on a VaR basis over a 1 year period, where VaR illustrates the worst 5% (i.e. 1 in 20) of outcomes and their impact on the value of the Fund's deficit relative to the central scenario. The biggest bars (circled) indicate the largest risks, dominated by interest rates and inflation (on the left hand side) and equities (in the middle) in this illustrative case.

In the remainder of this paper, we have set out the themes that will be considered as part of this investment strategy review

Theme 1: alternative asset class exposure

The primary driver of the Fund's growth portfolio is the allocation to equities which represents 50% of total Fund assets. This is the source of the single largest investment risk in the Fund. The Fund also has exposure to a range of alternative asset classes including Property, Hedge Funds and Infrastructure.

As part of modelling alternative strategies, consideration will be given to the impact of increasing the allocation to existing alternative asset classes such as Infrastructure given its inflation correlation and diversification benefits. In addition, the allocation to hedge funds within the Fund's growth portfolio will also be considered. While the existing allocation to hedge funds is expected to provide risk reduction benefits due to the low correlation of hedge funds with equities, recent performance has been disappointing. The focus of this element of the review will be on whether hedge funds should continue to form part of the Fund's future investment strategy.

Theme 2: emerging market equities

Previously the Fund had an allocation to Emerging Markets equities at the discretion of Fidelity. As at 30 September 2014 this allocation was approximately 4% and was actively managed, meaning that the fund manager selected the underlying companies to invest in based on an expectation of future relative outperformance (as opposed to replicating an index).

Following the move of the assets from the three active managers to Legal & General Investment Management there is no longer an opportunity for the Fund to potentially benefit from a discretionary allocation to Emerging Markets equities. Emerging Markets equities potentially offer the opportunity for greater rates of economic growth, and therefore investment return, than developed equity markets and therefore the Fund could benefit from an allocation. Further, Aon Hewitt believes that there is currently an opportunity to invest into Emerging Markets equities over the long term at relatively attractive valuations.

Please see our separate paper *'Emerging Markets Equities'* for further details.

Theme 3: greater liability matching

Two key economic risks faced by the Fund are interest rate and inflation risk. The analysis will consider the benefits of employing a greater focus on liability matching within the Fund's matching portfolio. Specifically, by structuring the bond portfolio to provide a closer match to the Fund's liabilities both in terms of fixed and inflation linked liabilities. This is commonly known as Liability Driven Investment ("LDI") and is an important approach for reducing the expected volatility profile of the Fund's assets relative to its liabilities.

The bond portfolio currently only makes up 25% of the Fund's assets. As the allocation to "matching" assets increases over time, the type and structure of these assets will become even more important.

In conjunction with a focus on greater liability matching, the benefits of a long term strategy for funding and investment, commonly known as a "Flight Path" will also be considered. A flight path will help provide a framework to reduce the risk inherent in the Fund's investment strategy in the future if the Fund's funding position were to improve.

Summary and next steps

We believe that a review of the Fund's investment strategy is an appropriate approach to take at the current time given the completion of the recent Actuarial Valuation.

As part of this review, we will consider the major economic risks facing the Fund and explore the possibility of reducing the level of investment risk with the aim of reducing the expected future funding level variability.

We look forward to discussing both this paper and our proposal on the Fund's allocation to emerging market equities with the Pension Committee at the upcoming 10 March 2015 meeting. We will then undertake the detailed asset liability modelling and will share the results with the Pension Committee at the June 2015 meeting.

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