Croydon Council

REPORT TO:	**PENSION COMMITTEE** **8 September 2015**
AGENDA ITEM:	**7**
SUBJECT:	**Executing Revised Asset Allocation Strategy**
LEAD OFFICER:	**Richard Simpson, Assistant Chief Executive (Corporate Resources and Section 151 Officer)**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**

CORPORATE PRIORITY/POLICY CONTEXT:

Sound Financial Management: The Committee is charged with ensuring high standards of governance are applied in the management of the Fund. The asset allocation strategy is the prime driver of performance so this exercise is critical in ensuring the future viability of the Croydon Scheme.

FINANCIAL SUMMARY:

This report proposes a strategy governing the investment of the Fund. Costs of execution will be met by the Fund. Long-term performance of these investments will impact on the Council's finances through the actuarial valuation process.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

RECOMMENDATIONS

1.1 The Committee is asked to approve the asset allocation strategy as set out in paragraph 3.3.

1.1.1 This report notes that the process of Fund manager selection has been delegated to the Assistant Chief Executive (Corporate Resources and s.151 Officer), previously the Director of Finance and Assets, in consultation with the Pension Committee Chair.

1.1.2 The Committee is asked to note the provisional timeline for implementation of the Strategy as set out in paragraph 3.9.

1.1.3 The Committee is advised that because of the lengthy execution timeline associated with this transition to the new Strategy there may be occasions when the Fund is not compliant with this Strategy, as described in paragraph 3.10 above. These instances will be reported to the Committee.

2. EXECUTIVE SUMMARY

2.1 This report recommends adoption of an Asset Allocation Strategy (the Strategy) for the Fund, consistent with the discussions that have formed part of the Strategy's review. The report considers the issues relating to the adoption of certain assets into the portfolio and sets out a timetable for the adoption and execution of the Strategy.

3. DETAIL

3.1 This report draws together the threads of the discussions around the review of the Strategy for the Fund into a recommendation to take forward. The decision to set an asset allocation strategy is a complex issue and a number of factors need to be considered in coming to a view as to what needs to happen. Principal amongst these factors are those related to the aggregate target rate of return for the Fund, the level of risk inherent in the revised structure, practical matters relating to transition management and forecasting cash flows. The previous meeting of this Committee (minute A19/15 refers) agreed '*that a report is brought back to the next meeting of this Committee confirming options for new investment areas in alternatives and a timescale for implementing any changes*'. This report additionally incorporates the feedback from the Committee's discussions to provide a coherent and deliverable Strategy.

3.2 The next actuarial valuation will establish a target rate of return for the Pension Fund. For the last reported year, ending March 2015, the Fund generated an aggregate return of 14.6% (source: State Street, Local Authority Annual League Tables). This however, does not make any reference to the rate at which the Scheme liability has grown, nor the extent to which the deficit funding gap has been reduced in line with the long-term funding strategy. In the interim a prudent target rate of return for the portfolio, in aggregate, would be at least 5%. Based on the best estimates, discussed in previous reports on this review, it is possible to generate a forecast return relating to this recommendation.

3.3 Following the discussion at the last Committee meeting the Strategy proposes an allocation by broad asset class. This is as follows:

Equities (including a 5% allocation to EM)	42%	+/- 5%
Fixed Interest	23%	+/- 5%
Alternates	34%	+/- 5%
Cash	1%	

The variance is necessary to avoid the need to constantly re-balance the portfolio in response to market movements. The proposed strategy (see table in 3.4) breaks the alternates down to a more granular level. These are meant as indicative and it needs to be recognised that certain investments will not fit into a distinct category.

3.4 The table below shows the current strategy, actual allocation, strategy recommended by Aon Hewitt and the proposed Strategy.

	Current Strategy	Actual Allocation as at 31 March 2015	Recommended by Aon Hewitt	Proposed Strategy
Equities	**50%**	**56%**	**41%**	**42% +/-5%**
Fixed Interest	**25%**	**21%**	**25%**	**23% +/-5%**
Alternates:	**24%**	**21%**	**33%**	**34% +/-5%**
Private Equity	*5%*	*5%*	*6%*	*8%*
Infrastructure	*5%*	*3.5%*	*11%*	*10%*
Traditional Property	*10%*	*9%*	*11%*	*10%*
PRS	*0%*	*0%*	*5%*	*6%*
Hedge Funds	*4%*	*3.5%*	*0%*	*0%*
Cash	**1%**	**2%**	**1%**	**1%**
Total	**100%**	**100%**	**100%**	**100%**

3.5 The proposed Strategy is broadly in line with the strategy recommended by Aon Hewitt although it proposes giving up 2% of the Fixed Interest allocation in place of Private Equity. The proposed Strategy will enable more flexibility, meaning that it will be possible to take advantage of any opportunities which might come up within the private equity space, without being in breach of the target asset allocation. When modelled, reducing the Fixed Interest allocation will increase the measure of Value at Risk, (VaR), although the specific Infrastructure investments which have been identified for potential investment have more 'matching' rather than 'growth' like characteristics, so it would be reasonable to expect these to reduce volatility, although this would not be apparent through the modelling.

3.6 This report is concerned primarily with the 'alternates' category of assets, '*confirming options for new investment areas in alternates and a timescale for implementing any changes*', but it should be noted that, as mandated by the Committee, other changes to the portfolio are already being implemented:

- unwinding the investments with BlueCrest;
- the selection of an emerging market fund manager; and
- the continuation of the private equity draw-down programme.

Delegated authority to make these decisions has been granted to the Assistant Chief Executive (Corporate Resources and s.151 Officer) in consultation with the Chair of the Pensions Committee.

3.7 Changing the asset allocation from the current strategy to the new proposed Strategy will require a carefully managed phased approach. Private Equity, Infrastructure and Private Rental Sector (PRS) investments involve investment periods of typically 3 to 5 years followed by a distribution period making cash flows extremely difficult to predict. The portfolio needs to be able to withstand any 'shock' which may occur to financial markets. Care needs to be taken to ensure the fund does not become over-committed at any point in the cycle to mitigate the risk of becoming forced sellers.

3.8 Previously, all Fund manager selection decisions have been delegated to the Director of Finance and Assets in consultation with the Committee Chair. With the restructuring of the Council's senior management structure this decision is now delegated to the Assistant Chief Executive (Corporate Resources and s.151 Officer), in consultation with the Pension Committee Chair. Officers, working with the Fund's professional advisors, Aon Hewitt, the London CIV and any other Local Government Pension Scheme administering authority, survey the universe of funds to identify interesting investment propositions. These opportunities are assessed against a number of criteria, including fit within the existing portfolio; robustness of the investment case; strength of the investment team and track record. A short list of potential investments are then presented to the Assistant Chief Executive with a recommendation. Once that recommendation is firmed up the Committee Chair is consulted before a final decision to commit.

3.9 A timeline for moving from the current to the proposed Strategy is set out below. It includes the following assumptions: that no more than two Private Equity investments are needed in addition to the current investment programme; that new infrastructure investment opportunities will need to be identified; that the existing property fund portfolio manager, Schroders, can identify further investment opportunities under the existing mandate if required; that two or more PRS funds will be needed; and that these investments will be made with cash realised from the L&G FTSE4Good Fund and from the proceeds from the BlueCrest funds.

The three stage process for implementing the new proposed Strategy is summarised in the following tables:

1. ***Identification of investment opportunities***

Private Equity:	Infrastructure:	Property:	PRS:
Identification of potential target funds for investment. Two new funds with commitments of £10m - £15m in addition to meeting requirements to maintain current programme	Identification of potential target funds for investment – New funds with commitments of £10m -£25m	Schroders have identified additional investment opportunities to take the allocation to the target 10%	Identification of potential target funds for investment.
August to mid - October 2015.	August to November 2015.	Complete	August - October 2015.

When identifying opportunities the fund will not only consider the traditional partnership and managed funds route, but also direct investment, co-investment options and any other shared working initiatives such as the London

CIV and the LPFA / Lancashire initiative, although these are unlikely to be established within this timeframe to allow investments in alternate asset classes. However should such an option present itself it will be evaluated if it provides a more efficient way for the fund to access the investment. This should also be viewed as a rolling process as once the initial target allocation has been reached new investments will be required to maintain the allocation.

2. ***Due diligence process***

Private Equity:	Infrastructure:	Property:	PRS:
Due diligence, assessment by Aon Hewitt, sign-off from the Assistant Chief Executive (Corporate Resources and s.151 Officer), in consultation with the Pension Committee Chair and legal review of documentation -			
October to November 2015.	December 2015 to January 2016.	Not required.	November 2015 to January 2016.

3. ***Transfer of cash from existing to new funds***

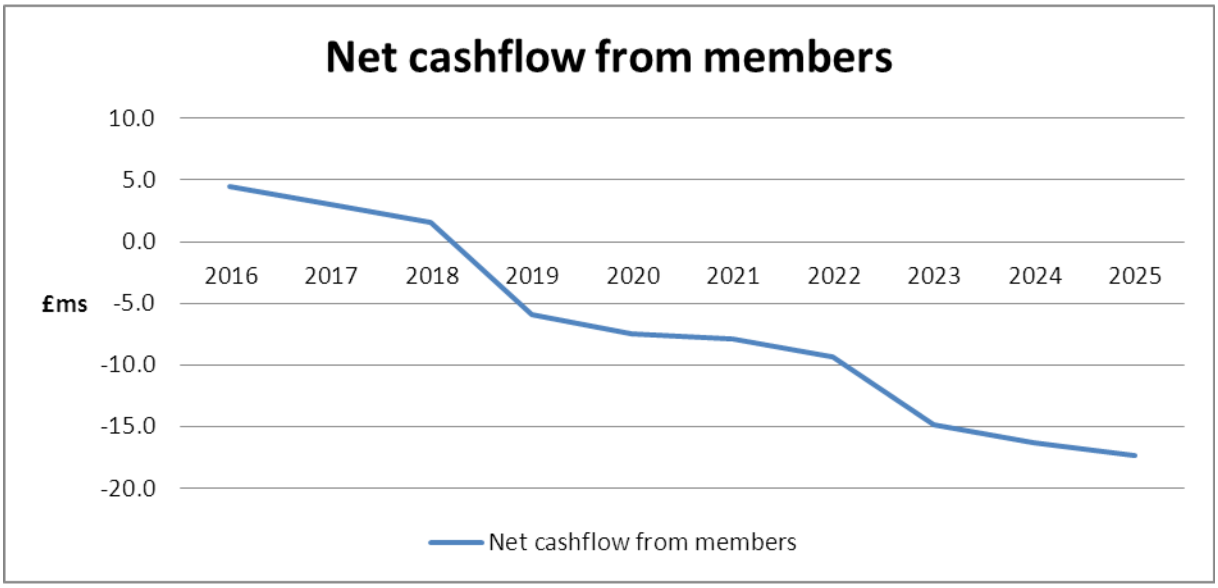
Private Equity:	Infrastructure:	Property:	PRS:
Seed cash can be made available from the target equity and fund of Hedge Funds within a time-frame that accommodates these moves.			
From January 2016 expected to reach target allocation by end 2018	From January 2016 expected to meet target allocation by end 2019	Target allocation to be reached by end of 2015.	From January 2016 target allocation to be reached by end of 2018.

Proceeds from winding up the Fund's investments with BlueCrest will be available for reinvestment by November 2015.

3.10 There will be a number of staged changes to the existing Asset Allocation Strategy, as mandates are filled by disinvesting from current allocations. The Committee should note that there may be occasions when the spread of investments is not compliant with the strategy. These occasions will be reported to the Committee. The variations allowable within the proposed strategy - =/- 5% for both equity and fixed interest and +/- 5% for alternates should reduce the frequency of such occasions.

3.11 As this Strategy is enacted the Committee shall be kept informed through periodic updates contained in the quarterly progress report.

3.12 The chart below shows that net cash flows from dealings with members (contributions less benefits) are expected to turn negative at around 2018. This means that the Fund's cash flow will need to be managed carefully as income from investments will be needed to pay benefits and finance the expansion to the PRS, Private Equity and Infrastructure programmes.



4. FINANCIAL CONSIDERATIONS

4.1 There is a risk that this allocation option does not represent the most efficient mix of assets. The recommended strategy has a higher level of explicit risk when compared to the Aon Hewitt recommendation meaning that there will be more volatility of returns. This has an unpredictable potential impact on the 2016 Actuarial Valuation.

5. OTHER CONSIDERATIONS

5.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

6. COMMENTS OF THE SOLICITOR TO THE COUNCIL

6.1 The Council Solicitor comments that there are no specific legal considerations arising from this report.

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

CONTACT OFFICER:

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BACKGROUND DOCUMENTS: none