APPENDIX B

Aon Hewitt
Retirement & Investment

London Borough of Croydon Pension Fund

Date:	21 February 2017
Prepared for:	The Pension Committee
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Investment Considerations

Executive Summary

- As at the end of December 2016, it is estimated that the Fund's equity allocation has moved c.14% overweight to the strategic benchmark position. The Fund has also moved further underweight to bonds by 4.5% relative to the strategic benchmark allocation.
- The weakness of Sterling over the last couple of years has benefitted the Fund's allocation to overseas equities, as the appreciation of other currencies relative to Sterling has provided an additional contribution to returns for Sterling denominated investors. The Pension Committee may wish to consider hedging some of the Fund's overseas equity exposure in order to protect gains that have been experienced to date.
- With equities, firmer economic activity, higher commodity prices, and higher yields support earnings recovery and provide support to equity valuations in the near-term. However, a number of factors offer less support to equity valuations in the medium term. The difficulty for equities is that valuations still remain high, there is gradual loss of support from ultra-low bond yields and the interaction of politics with economics brings a list of potential risks for a market upset down the road. We therefore expect volatility for equities moving forwards. Consideration should therefore be given to trimming the overweight position as part of taking some profits and reducing equity risk.
- We are supportive of the Fund's bond portfolio structure in providing diversification and a certain level of capital protection in a rising yield environment. The bond position is currently c .4.5% underweight relative to its strategic benchmark; consideration should therefore be given to increasing the allocation from a risk reduction perspective.

Introduction

The London Borough of Croydon Pension Fund (the "Fund") has seen strong growth in assets over recent years driven by double digit returns in a number of asset classes including equity markets. In particular, the Fund's equity holdings have increased significantly as the appreciation of other currencies relative to Sterling has provided an additional contribution to returns for Sterling denominated investors.

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Aon Hewitt has been asked to consider the Fund's current asset allocation relative to the Fund's strategic benchmark allocation in light of recent market conditions and investment outlook.

Current asset allocation

The latest available Fund valuation is as at 31 December 2016. The asset allocation and positions relative to the strategic benchmark are shown in the table below. The Fund is estimated to be overweight to growth assets by 5.5% driven by a significant overweight position to equities and underweight positions in a number of alternative asset classes including Property and Infrastructure. The Fund is correspondingly underweight to bonds and cash by 5.5%.

The Fund has planned to increase its exposure to a number of alternative asset classes including infrastructure and property over the medium term as part of implementing a new investment strategy and remains on track to do so. The increased alternatives allocation is to be funded through a reduction in the Fund's equity holdings and as it is expected to take some time to achieve the desired exposure to infrastructure and property this is not expected to reduce the Fund's equity position in the near term.

Asset allocation 31 December 2016

Asset Class Allocations	Market Value		Benchmark		Difference		Permitted Ranges
	£m	%	£m	%	£m	%	%
Equities	**576.1**	**56.4**	**429.0**	**42.0**	**+147.1**	**+14.4**	**37.0 – 47.0**
Property	**104.2**	**10.2**	**163.4**	**16.0**	**-59.2**	**-5.8**	**13.0 – 19.0**
Private Equity	**82.7**	**8.1**	**81.7**	**8.0**	**+1.0**	**+0.1**	**15.0 – 25.0**
Infrastructure	**69.2**	**6.8**	**102.1**	**10.0**	**-32.9**	**-3.2**	**n/a**
Bonds	**189.0**	**18.5**	**234.9**	**23.0**	**-45.9**	**-4.5**	**18.0 – 28.0**
Cash	**0.2**	**0.0**	**10.2**	**1.0**	**-10.0**	**-1.0**	**n/a**
Total	**1021.4**	**100.0**		**100.0**	**-**	**-**	

Source: Officers.

Asset allocation relative to the strategic benchmark

- The equity allocation has moved c.14% overweight to the strategic benchmark position. The equity assets are largely held in local currency and therefore the portfolio has benefitted substantially from the significant weakening of Sterling relative to other major currencies.
- The Fund remains underweight to property and infrastructure by 5.8% and 3.2% respectively with commitments to new mandates in these areas expected to be drawn down over the next few years.
- The Fund has moved further underweight to bonds and is now c.5% underweight to the benchmark which represents the lower end of the permitted range to the asset class.

Aon Hewitt medium term asset allocation views

A summary of our Asset Allocation Team's latest views on the major asset classes are set out below.

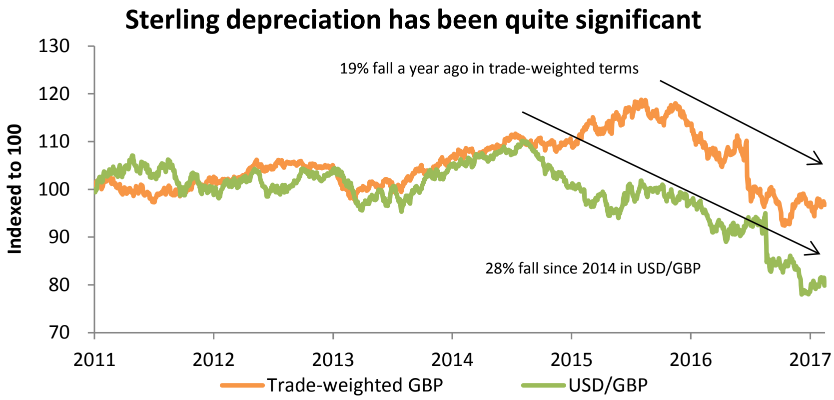
- There are many unknowns, with uncertainties around the impact of Brexit, the Trump US Presidential win as well around how Central Banks will move away from ultra-easy monetary policy. These uncertainties are interrelated and it is difficult to be certain of the impact they will have on investment markets.
- With equities, firmer economic activity, higher commodity prices, and higher yields support earnings recovery and thus provide support to equity valuations in the near-term. However, a number of factors offer less support to equity valuations in the medium term. Equity market returns in 2016 for UK investors were flattered by sterling declines. The difficulty for equities is that valuations still remain high, there is gradual loss of support from ultra-low bond yields and the interaction of politics with economics brings a list of potential risks for a market upset down the road. We therefore expect volatility for equities moving forwards.
- We see the underlying upward direction in gilt yields seen through the latter part of 2016 continuing. We expect yields may rise a little faster than current yield curves anticipate as the impact of the Trump economic agenda will push global economic activity higher and drive larger rises in US interest rates. The UK's more gradual upward path for policy interest rates implies lower yields and a slower climb than the US, but the direction is still the same.
- UK corporate bond spreads have held steady at tight levels, supported by Bank of England buying. Although we did not expect much more spread compression, we have held a preference for corporate bonds given their higher yield up until now. As the broader credit rally nears an end and Brexit and liquidity concerns weigh on the market, we are now moving to a more neutral stance vs gilts.
- Globally, investment grade credit spreads have continued to compress helped by firmer economic activity, higher commodity prices and corporate earnings recovery. We have now downgraded our view on US investment credit as the large fall in credit spreads makes the reward to credit risk look less secure. This follows our downgrade in our Eurozone corporate bond view last quarter based on political risks, tight spreads and only a moderate economic recovery.
- UK property felt some Brexit impact last year and although we expect the UK economy to soften, commercial property is showing signs of resilience and we think it continues to be attractive on a medium-term basis.
- Sterling looks to be in a bottoming out process, though this hardly excludes the possibility that Brexit process upsets take it lower still. Valuations are now arguing for a recovery, but news flow and market concerns are pulling the other way. Our view is that though further falls are possible, they have a good chance of being recouped over

time. All in all, these are now good levels for hedging overseas exposures.

Currency hedging

The weakness of Sterling over the last couple of years has benefitted the Fund's allocation to overseas equities, as the appreciation of other currencies relative to Sterling has provided an additional contribution to returns for Sterling denominated investors.

Sterling has fallen by almost 16% against the US dollar (US$1.48 to US$1.24 at the time of this report) and a little less against the euro, with a 10% drop (€1.30 to €1.17 at the time of this report), since the EU referendum result was announced on 24 June 2016.



Source: Bloomberg

However, Sterling's weakness pre-dates the EU referendum. The pound has now depreciated by 25% against the US dollar since 2014, due to a tighter US monetary stance, concern over a widening UK current account deficit and, in the past year, by Brexit worries. In broad trade-weighted terms, the fall is smaller but still a sizeable 19% since its 2015 peak (see chart above).

We now regard an exchange rate against the US dollar of US$1.20 as cheap, while levels below US$1.30 could attract some hedging. A fall to US$1.20 is 30% below 2014 highs, 19% below Brexit announcement levels and broadly 3% below current levels. For other major currencies, €1.10 (6% from levels at the time of this report) and the current ¥140 level appear attractive to hedge euro and yen exposure respectively.

Sterling's ultimate floor is highly uncertain as it is so dependent on the trade deals the UK agrees and how long negotiations take. It is possible that sterling overshoots on the way down. However, given that the US weight in the MSCI World Index is as high as 59% (c. 50% for the FTSE 4 Good Index), the threshold for having some initial hedging in place is closer to current levels.

The Pension Committee may wish to consider hedging some of the Fund's overseas equity exposure in order to protect gains that have been experienced to date. A shift from unhedged to hedged share classes is usually the simplest way to hedge, however this option is not available to the Fund. Alternatively, the hedging can be provided either through the investment manager (Legal & General Investment Management) or the custodian (BNY Mellon), as long as there are best execution checks. We can work with the Officers to explore the most appropriate implementation mechanism from both an efficiency and cost perspective.

Investment considerations

- The Fund has a material overweight position to equities versus the strategic benchmark due to the strong performance of global equities over 2016. Global equity holdings have benefited from Sterling weakness, which has provided higher returns to sterling denominated investors.
- Firmer economic activity, higher commodity prices and higher yields are supporting a corporate earnings recovery. However, we have doubts about the equity market strength and expect volatility moving forwards. The Fund has made commitments to a number of alternative mandates which are due to be funded through a reduction in the Fund's equity holdings. However, the timing for funding these new mandates will be spread over the next few years which potentially exposes the Fund to increased equity risk over the medium term. Consequently, the Pension Committee may wish to consider trimming the overweight position to equities as part of taking some profits and reducing equity risk.
- The weakness of Sterling over the last couple of years has benefitted the Fund's allocation to overseas equities, as the appreciation of other currencies relative to Sterling has provided an additional contribution to returns for Sterling denominated investors. The Pension Committee may wish to consider hedging some of the Fund's overseas equity exposure in order to protect gains that have been experienced to date.
- We are supportive of the Fund's bond portfolio structure in providing diversification and a certain level of capital protection in a rising yield environment. The bond position is currently 4.5% underweight relative to its strategic benchmark; consideration should therefore be given to increasing the allocation from a risk reduction perspective.
- We look forward to discussing this paper further with the Pension Committee at the upcoming meeting on 7 March 2017.

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