SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **15 MAY 2014**

LEAD OFFICER: **SHEILA LITTLE, CHIEF FINANCE OFFICER**

SUBJECT: **INVESTMENT STRATEGY REVIEW**

SUMMARY OF ISSUE:

Following the actuarial valuation, Mercer has been requested to conduct an investment strategy review of the Surrey Pension Fund.

RECOMMENDATIONS:

It is recommended that the Pension Fund Board:

1 Give consideration to investing in a more risk aware manner relative to the Fund's liabilities with a view to the establishment of a liability driven investment strategy (LDI) portfolio. This should be set up on a relatively small scale initially with the level of liability protection increased as and when the funding level moves towards 100%.

2 Give consideration to setting up a framework for a leveraged gilt portfolio.

3 Give consideration to introducing more diversified sources of return with a view to introducing Infrastructure Debt as a new asset category and increasing the existing allocation to diversified growth funds (DGF).

4 Give consideration to setting up a framework for a synthetic equity portfolio.

5 Give consideration to implementing such changes in the short term, thus preparing a platform for the future strategy requirements, with the ultimate view to locking in some of the improvement in the funding level that has been seen since the valuation date of 31 March 2013.

6 Receive ongoing training and Board reports in order to facilitate a definitive decision making process on these strategy issues at future Board meetings.

REASON FOR RECOMMENDATIONS:

The Pension Fund Board must monitor and adapt its investment strategy according to its liability profile in a changing market environment.

DETAILS:

Background

1 This report provides both a summary of the deliberations that need to be considered by the Pension Fund Board in order that Members can review the current investment strategy in light of the 2013 Triennial Actuarial Valuation outcome and the current investment climate, with a year having elapsed since that valuation.

2 The triennial valuation cycle provides a good point at which to review the investment strategy as we have a current valuation of the liabilities of the Fund. 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 (investing primarily in active growth assets) has performed, relative to expectations, in those same investment markets.

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3 The Fund's current investment strategy was agreed by the previous Investment Advisory Group (IAG) in early 2012. At that time, the most critical concerns of the IAG were primarily that a revised investment strategy should seek to provide a reduction in investment return volatility, following the asset valuation falls seen in late 2008 and early 2009.

4 It should be noted that currently, the expected return (based on best estimate assumptions) on the Fund's assets in circa 3.2% per annum over gilts. The actuary assumes an excess return on 1.6% over gilts for the purposes of the actuarial valuation.

Revised Strategy

5 At the Board meeting of 14 February 2014, Mercer presented an investment review and this is included as Annex 1 to this report. The Strategic Finance Manager has since had one-to-one meetings with Board members to go over the specific points made in that presentation. Mercer will present the next stage of the review and additional training at the meeting of 15 May 2014. This document is included as Annex 2 to this report.

Liability Driven Investment

6 Mercer has recommended that the Fund establish a liability driven investment strategy (LDI) portfolio.

7 LDI is an investment style that seeks to match the movements in the value of a Fund'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 Fund's liabilities. Due to the historic low yields at present, an attempt to match all of the Fund's liabilities would be considered very 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.

8 Despite the current low yields and the resultant expensive switch, Mercer's advice is that it is time to set up such a LDI structure, given the level of training and due diligence required (a year's lead in is a reasonable expectation), so setting up this mechanism now could put the Fund in a better position where it could react relatively swiftly to capture what would be considered attractive future de-risking opportunities. Without the appropriate structure in place, the opportunity to de-risk when opportune could easily be missed. An opportunity to de-risk after the valuation of 2007 was generally missed by LGPS authorities.

9 The risk in not taking any action is that de-risking opportunities could be overlooked at the opportune time, i.e., as the funding level approaches its 100% target, and at the point when markets could be regarded as having the potential to experience levels of volatility.

Infrastructure Debt

10 There are benefits for LGPS funds to take on infrastructure investments. On the upside, infrastructure has the potential to offer stable, transparent and inflation-linked cashflows in order to address the inflation-indexed liabilities of the fund. The major drawback of the asset class is the illiquid nature of the investment, and the fact that funds are tied up for the long term. 17

Diversified Growth Funds

11 Further venture into DGF will assist with further return diversification and improved risk management. A separate report in the 15 May 2014 Board agenda discusses the possibility of the Fund partaking in the new Global Focused Strategies Fund launched by Standard Life.

Leveraged Gilt Portfolio

12 A leveraged gilt portfolio will provide protection against future movement in interest rates and inflation.

13 There will be an emphasis on putting the platform in first with a view to building up the allocation over time, based on funding improvements and also as real yields increase.

Synthetic Equities

14 It is likely that further commitments to protection assets will be funded from passive equity portfolios. A synthetic equity portfolio will bridge this gap and retain the commitment to active growth assets left by this transfer.

Further Reports and Training

15 Further training on leveraged gilt portfolios and derivatives will be provided at the 15 May 2014 Board meeting and at future meetings. Members will be invited to discuss with further reports due next time, subject to the outcome of those discussions.

CONSULTATION:

16 The Chairman of the Pension Fund has been consulted on the revised investment strategy and, subject to Board members being fully trained and having sufficient understanding of the principles involved, will take a consensus view at the Board meeting. Members being further trained in order to approve such a strategy when required is supported.

RISK MANAGEMENT AND IMPLICATIONS:

17 The risk related issues are addressed in the Mercer report in Annex 1.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

18 The financial and value for money implications are addressed within the Mercer report in Annex 1.

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CHIEF FINANCE OFFICER COMMENTARY

19 The Chief Finance Officer is satisfied that all material, financial and business issues have been considered and addressed, and is aware of all risks and benefits associated with the review. Training needs should be addressed further prior to any decisions on the implementation of the proposed strategy review recommendations. Members should be well informed and trained on the proposed structure for the way ahead and satisfied that the changes are relevant to the requirements of the Pension Fund.

LEGAL IMPLICATIONS – MONITORING OFFICER

20 There are no legal implications or legislative requirements associated with this report.

EQUALITIES AND DIVERSITY

21 The investment strategy review will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

22 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

23 The following next steps are planned:

- Decision on adoption of the principles of the investment strategy review.
- Further training provided to Board members at future meetings.
- Further reports to the Board at future meetings.
- Officers implement changes required as a result of specific Board recommendations.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Pension Fund Board Chairman

Annexes:
Annex 1: Mercer report of 14 February 2014
Annex 2: Mercer report of 15 May 2014

Sources/background papers:
None

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