

SURREY COUNTY COUNCIL**PENSION FUND BOARD****DATE: 19 SEPTEMBER 2014****LEAD OFFICER: SHEILA LITTLE, DIRECTOR OF FINANCE****SUBJECT: INVESTMENT STRATEGY REVIEW: LIABILITY DRIVEN INVESTMENT****SUMMARY OF ISSUE:**

Following the actuarial valuation, Mercer has advised the Board to establish a liability driven investment framework. As a first step in establishing this framework, the Pensions Fund Board's external advisor recommended that we consider investing in a leveraged gilt portfolio. Following training from four expert fund managers in this sector, this report seeks approval to invest £90m from our existing passive and index-linked gilt portfolios to a three times leveraged gilt portfolio with Legal and General Investment Management.

RECOMMENDATIONS:

It is recommended that the Pension Fund Board approve:

- 1 the setting up a framework for a liability driven investment strategy (LDI) with the establishment of a leveraged gilt portfolio. It is recommended that this be funded by the existing passive and index-linked assets held with Legal & General, amounting to £90m.
- 2 the appointment of Legal and General Investment Management with the intention of eventually implementing an LDI strategy. This will serve as a platform for future strategy requirements as the Fund approaches full funding. The appointment should be subject to final full diligence being completed in terms of the legality of the LGIM solution within the LGPS Regulations.
- 3 the level of liability protection to be increased as the funding level moves further towards 100% with triggers set for consideration of these future decisions, and further Board training to be provided.

REASON FOR RECOMMENDATIONS:

The Pension Fund will eventually be fully funded. In preparation for this event, the Pension Fund Board must adapt and monitor its investment strategy according to its liability profile in a changing market environment. Adopting a liability driven investment framework and, as a first step, a leveraged gilt portfolio will help reduce deficit volatility through better protection against adverse changes in long-term interest rates and inflation.

DETAILS:**Background to Liability Driven Investment**

- 1 At the Board meeting of 15 May 2014, the Board agreed to consider the introduction of a liability driven investment framework. This would further enhance the Fund's approach to risk management and reduce the inherent volatility of the funding level that results from changes in long-term interest rates and inflation expectations. At the meeting, the Pension Fund Board agreed to put the platform in first with a view to building up the allocation over time, as the funding level improves and also as real yields increase.
- 2 The Pension Fund Board's external advisor has suggested that the Fund introduce LDI, with a framework in place, thus enabling future dynamic changes to be achieved efficiently. It will be important to ensure that the initial structure of the new framework is both robust and flexible in the near and longer term. There are a number of implementation considerations that are important to bear in mind when setting up a LDI framework for the Fund, as set out below.

Implementation Considerations

- 3 One of the foremost considerations for the LDI framework will be the structure of the solution. Special attention needs to be paid here due to the nature of the regulatory environment, namely, the LGPS Investment Regulations 2009. A pooled fund solution will fall within the LGPS Regulations.
- 4 Such a solution can come in the form of investing in standard pooled funds offered by an investment manager (structured in a way that is specific to the Fund). Pooled funds can be structured in a number of ways, including:
 - Qualified Investor Funds (QIFs);
 - Sociedad de Inversión de Capital Variable (SICAVs); and
 - Insurance policies.
- 5 The Pension Fund's officers have taken advice in determining from a legal perspective the suitability of the available structures of pooled funds. The Pension Fund's officers appointed Sackers (specialists in LGPS law) in order to take advice on the legal issues of the new mandate.
- 6 The Fund has sought clarification from Sackers concerning permissible structures, and Sackers' advice is that a liability hedging mandate can be implemented with one of the above structures. The Sackers advice is attached as Annex 1 (in a separate Part 2 paper).
- 7 The most common solution amongst the preferred fund managers is the QIF. Based on past legal discussions relating to other LGPS funds, it is understood that a QIF structure may fall under the definition of an "unlisted" asset, which would be subject to a 10% investment limit under the relevant investment regulations quoted above.

- 8 Given that the Pension Fund currently has a target 5% allocation to unlisted assets in the form of Private Equity holdings, a QIF structure on its own is not likely to provide sufficient flexibility for future investment, given that the level of liability hedging will need to increase over time. A potential solution to the 10% cap on unlisted assets is to “wrap” a QIF in a unit trust (which has an upper investment limit of 35%). This would ensure that the solution would be future-proof, but would involve a greater level of complexity at the initial implementation stage, should a QIF solution be selected.
- 9 As part of the selection process, fund managers attended a training meeting of the Pension Fund Board on 12 September 2014 to discuss leveraged gilts. The manager list was derived from Mercer’s liability hedging “Preferred Provider” list and takes into account other specific considerations for the Fund.
- 10 Managers were assessed according to the following criteria:
- (1) Manager capability
 - (2) Value for money (fees)
 - (3) Dynamic Instrument Selection
 - (4) Ease of compliance with LGPS Regulations
- 11 The Pension Fund Board’s external advisor had previously assessed the shortlisted four managers with LGIM scoring highest in criteria (1), (2) and (4). LGIM’s managers also presented very well at the 12 September 2014 meeting, in terms of presenting a competent solution and having a very good understanding of the liability structure of the Surrey Fund and how the proposed solution would meet the risks pertaining to it.
- 12 The Pensions Fund Board’s external advisor has advised of the high level of capability within the LGIM team and the competitiveness of the fee quote, as well as the lack of any complications associated with the solution (an insurance policy) in terms of the LGPS regulations, and LGIM being a significant market player. This solution overrides the concerns associated with a QIF solution.
- 13 It is recommended that LGIM be appointed to implement a leveraged gilt portfolio, using the Fund’s existing passive and index-linked gilts with LGIM, thus preparing a platform for the future strategy requirements. It is recommended that the mandate would be funded by restructuring the existing entire passive gilts portfolio and a proportion of the index-linked gilt portfolio held with Legal & General, amounting to £90m.

<u>CONSULTATION:</u>

- 14 The Chairman of the Pension Fund has been consulted on the establishment of a leveraged gilt portfolio and, subject to Board members’ agreement is in full support of the recommendations.

RISK MANAGEMENT AND IMPLICATIONS:

- 15 The risk related issues are addressed in the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

- 16 The financial and value for money implications are addressed within the report.

DIRECTOR OF FINANCE COMMENTARY

- 17 The Director of Finance is satisfied that the adoption of a leveraged gilt strategy will address the risks associated with interest rates and inflation to the pension fund. The Director of Finance notes that a final due diligence will be completed, ensuring that all legal, material, financial and business issues have been considered and addressed, prior to the implementation of the recommendations within this report.

LEGAL IMPLICATIONS – MONITORING OFFICER

- 18 The Monitoring Officer notes that specialist advice has been obtained from external lawyers in this matter. Given the specialist nature of the legal context and the very recent referral to the Monitoring Officer of this matter, she is not in a position to offer any additional advice. The Board will need to consider the advice that Sackers have provided but should also be aware that Sackers have indicated that:

“This is an area where views diverge widely between different lawyers. There is currently no authority (that we are aware of) to determine the matter one way or another. It would, in our view, be reasonable for the Council to rely on our interpretation, but this is a regrettably an area where there is considerable uncertainty.”

EQUALITIES AND DIVERSITY

- 19 The adoption of a leveraged gilt portfolio will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

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

WHAT HAPPENS NEXT

- 21 The following next steps are planned:
- Decision on implementing the recommendations within the report.
 - Further training provided to Board members at future meetings.
 - Further reports to the Board at future meetings.

Contact Officer:

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

Consulted:

Pension Fund Board Chairman

Annexes:

None

Sources/background papers:

None

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