

**SURREY COUNTY COUNCIL**

**PENSION FUND COMMITTEE**

**DATE: 15 SEPTEMBER 2017**

**LEAD OFFICER: SHEILA LITTLE, DIRECTOR OF FINANCE**

**SUBJECT: INVESTMENT STRATEGY REVIEW AND STATEMENT**



**SUMMARY OF ISSUE:**

Following the 2016 actuarial valuation, Mercer has advised the Pension Fund Committee to initiate an investment strategy review. As a first step in establishing this review, the Pension Fund Committee considered a scoping document framework at its meeting on 2 June 2017. This document was further refined post the 2 June meeting and is included as Annex 1. Mercer completed the strategy review on 31 August 2017 and this document is include as Annex 2.

The pension fund is required to publish and review regularly an investment strategy statement (ISS) as a result of new investment regulations. It is a statutory requirement that the Pension Fund Committee should regularly review and approve its ISS. The current draft (amended as a result of new private equity opportunities) is included as Annex 3.

**RECOMMENDATIONS:**

It is recommended that the Pension Fund Committee:

- 1 Consider the Mercer investment review report in Annex 2 with a view to requesting further work be implemented on some/all of the options included therein, specifically:
  - Allocation to long-term illiquid asset classes
  - De-risking through trigger levels
  - Downside protection with regard to equity risk
  - Alternative indexation reference passive investing
- 2 Approve the latest Investment Strategy Statement as shown in Annex 3.

**REASON FOR RECOMMENDATIONS:**

The Pension Fund Committee must approve and review all working documents produced for the Pension Fund.

**DETAILS:**

**Requirement for an Investment Strategy Review**

- 1 Such a review is carried out after every triennial actuarial valuation and is necessary as a result of:
- Improvements in the funding level as the journey to 100% funding gets closer to its destination.
  - Changes in legislation: the most recently enacted Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 came into force on 1 November 2016 and introduced wider, more flexible powers to LGPS administering authorities to invest.
  - New solutions: the investment backdrop is constantly developing and renewing itself and as the opportunity to reduce risk further via diversification becomes more relevant, new solutions are available to achieve that aim.
  - Pooling: the onset of Border to Coast and the resultant opportunities need to be taken into account within the investment strategy review.
  - Liability change: the 2016 valuation recalculated the actuarial liability with up-to-date data as at 31 March 2016. The funding strategy to pay for these future pensions outflows is the platform from which a future investment strategy will start. Cashflow considerations and the gradual move to maturity and therefore negative cashflow should also be a consideration.
  - Outlook change: the global investment backdrop has changed significantly as a result of events that took place 2016.
  - Changes to employers: the number of employers has increased significantly since the previous valuation in 2013 and the change in liability/maturity profile and significance of the change in overall employer risk has to be assessed within the investment strategy review.
  - Provide a clear plan: a clear roadmap for the investment strategy is essential for the pension fund.

### **Investment Beliefs**

- 2 The Pension Fund's approved investment beliefs are set out in Annex 4. Such beliefs will drive any change to the investment strategy. The Mercer report has summarised the Fund's beliefs in its report.
- 3 With regard to the investment beliefs, Mercer has recommended further refinement and has recommended consideration relating to a number of proposals:
- Consider allocations to long-term illiquid asset classes
  - De-risking through funding level triggers
  - Consider implementing downside protection with regard to equity risk
  - Consider appointing additional active managers
  - Take a more active role in ESG issues

- Utilise employer specific investment strategies
- Invest more in alternative real assets
- Utilise alternative indexation reference passive investing

#### **Consider allocations to long-term illiquid asset classes**

- 4 Mercer has suggested that consideration be given to making allocations to long-term illiquid asset classes which would be expected to return an equity like yield whilst reducing overall volatility relative to the value of the liabilities. The Fund has an important objective to achieve low, stable employer contribution rates, and this is achieved largely through the smoothing of contributions via the contribution stabilisation process. However, if there is future, significant volatility of the funding position via big changes in market valuations, then this may need to be reflected through higher employer contribution rates.
- 5 Mercer has suggested that the Committee could consider allocations to long term asset classes (such as other illiquid assets like private debt) which would be expected to perform in a similar manner as equities over the long term, with significantly lower volatility.
- 6 Such diversification opportunities will be available via the Border to Coast pooling solution but the committee should remember that they will not be available until 2019 or 2020 at the earliest.

#### **De-risking through funding level triggers**

- 7 Mercer has suggested that the pension fund committee consider agreeing what action would be taken in the event that the funding level improves beyond a particular level, with the intent that an investment strategy should evolve if an improvement in the funding level is achieved above expectations.
- 8 Such a process would be achieved through funding level triggers with overall risk controlled via the trigger on the principle that there is no need to take more investment risk than necessary. This would constitute a formal process for de-risking via the use of these triggers reported to the pension fund committee on a quarterly basis. It should be stated that the triggers will act as a means for starting a conversation rather than a hard and fast rule on required action for change.

#### **Consider implementing downside protection with regard to equity risk**

- 9 Mercer has suggested that consideration be given to implementing downside protection with regard to the management of equity risk. Equities account for around 75% of the current total risk and significant downward movement in this asset class could be partially protected through further diversification or possible hedging options.
- 10 To date, the most common approach with regard to the mitigation of equity risk has been through the use of diversified growth funds (DGFs) where Surrey has exposure to three such funds (Aviva, Ruffer and Baillie Gifford).
- 11 Equity hedging involves the use of derivatives to increase the predictability of the return profile in future market conditions. It is now easier to implement for

LGPS funds as a result of changes to Regulations and several of Border to Coast's administering authorities have employed this strategy.

### **Consider appointing additional active managers**

- 12 Mercer has suggested possible additional active managers, possibly at the expense of terminating current incumbents.
- 13 Officers regard this as unadvisable, given the closeness of pooling and the commencement by Border to Coast of investment manager rationalisation within equity sub funds. Pooling will take over the role of investment manager selection in the future and any such work could be made uneconomical by future pooling strategies employed by Border to Coast.

### **Take a more active role in ESG issues**

- 14 Environmental, Social and Governance (ESG) issues and responsible investment are currently being considered by the Pension Fund Committee in partnership with the Local Pension Board.
- 15 Options for the pension fund committee of adopting a target of investment in passive low carbon indexation, sustainable infrastructure niche opportunities such as water supply/storage solutions and social impact investing.
- 16 As the Surrey Fund moves to implement pooling with Border to Coast, these matters will be addressed on a pooling level rather than on an individual fund level.

### **Utilise employer specific investment strategies**

- 17 The Pension Fund's current investment strategy is a "one size fits all" approach and this does not give regard to the specific circumstances of the underlying employers.
- 18 The Committee should consider whether this is still appropriate, or whether it wants to offer different employers with different covenant strengths and different funding positions, more bespoke investment strategies which are more suited to their own positions.
- 19 Officers are currently working with the Fund actuary to offer alternative investment strategies that take account of the differing circumstances of the 230 plus employers within the Surrey Fund. This could result in the creation of a number of core investment strategies as opposed to the current single fund strategy. This will be the subject of a future report.

### **Invest more in alternative real assets**

- 20 Such an approach will offer additional protection to inflation and offer enhanced annual dividend flows.
- 21 Real assets include property, infrastructure, long lease property, social housing and shipping.
- 22 The Fund should have enhanced opportunities to invest in infrastructure via the national pooling structure, but this will not be available for a couple of

years. Small inroads into private equity infrastructure have been achieved via the Goldman Sachs West Street opportunity approved at the 2 June 2017 committee meeting and a further opportunity is available via the Pantheon infrastructure private equity to be considered at the 15 September 2017 committee meeting.

### **Utilise alternative indexation reference passive investing**

- 23 Currently, around 40% of the Fund's total equity allocation is invested via traditional FTSE market capitalisation index-tracker (passive) equities. By market capitalisation, this means that the size of the investment in a company within in the index is driven by the total market valuation of the company. The drawback to this scenario is that the shape of the index is driven heavily by the past successes of each company within the index.
- 24 Alternative indices exist and the various options are listed:
- Equal weighting (equal weighting/emphasis is applied to all stocks within the index)
  - GDP weighting (countries are weighted by GDP and stocks within the country are market capitalisation weighted)
  - Fundamental size weighting (stocks are weighted on factors such as book value, sales, dividend and cash flow)
  - Quality weighting (stocks are weighted on measures such as profitability and stability)
  - Minimum variance (portfolios are optimised to the lowest possible volatility)
  - Risk-weighted (consists of a reweighted index, overweighting low risk shares and underweighting high risk shares)
- 25 Officers are of the view that the alternative indices are worth exploring. The advantage to the pension fund is a further diversification benefit that arises from the choice of an alternative method of indexing and thus reducing the risk that market cap valuations impose on the fund, especially where bear markets are about to commence.

### **Committee discussion**

- 26 The Committee is invited to discuss the above considerations and a series of questions that the committee could ask is included within the Mercer report.

### **Revised Investment Strategy Statement**

- 27 In accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, as an LGPS administering authority, the Council must prepare and maintain a written investment strategy statement (ISS) of the principles governing its decisions on the investment of the pension fund. It also has to review the policy from time to time and revise it if considered necessary.
- 28 The latest statement is shown as Annex 3.

## Monitoring and Review

- 29 The statement will be kept under constant review and will be submitted for approval to future Committee meetings when any revision is required.

### **CONSULTATION:**

- 30 The Chairman of the Pension Fund has been consulted and offered full support for the proposals.

### **RISK MANAGEMENT AND IMPLICATIONS:**

- 31 There are risk related provisions detailed within the Mercer report and the revised ISS.

### **FINANCIAL AND VALUE FOR MONEY IMPLICATIONS**

- 32 There are no financial and value for money implications.

### **DIRECTOR OF FINANCE COMMENTARY**

- 33 The Director of Finance is satisfied that the Mercer report provides a good platform for discussion within the pension fund committee for the future investment strategy of the pension fund.
- 34 The Director of Finance is satisfied that the latest ISS offers a clear structure, reflecting the current investment strategies and beliefs approved by the Pension Fund Committee.

### **LEGAL IMPLICATIONS – MONITORING OFFICER**

- 35 The approval of an ISS is a statutory requirement.

### **EQUALITIES AND DIVERSITY**

- 36 The consideration of the Fund's investment strategy and the approval of the most recent ISS will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

### **OTHER IMPLICATIONS**

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

### **WHAT HAPPENS NEXT**

- 38 The following next steps are planned:
- Further work by officers and Mercer on furthering the investment strategy following discussions and decisions taken by the Pension Fund Committee
  - Continued review and approval of the ISS by the Pension Fund Committee
  - Investment Strategy Statement Document to be kept under continuous review

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**Contact Officer:**

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

**Consulted:**

Pension Fund Committee Chairman

**Annexes:**

Annex 1: Mercer Scoping Document for Investment Strategy Review

Annex 2: Mercer Investment Strategy Review

Annex 3: Investment Strategy Review

Annex 4: Investment Beliefs

**Sources/background papers:**

None

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