



Meeting of the

PENSIONS COMMITTEE

Thursday, 30 October 2008 at 6.30 p.m.

SUPPLEMENTAL INFORMATION

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7 .4 Partial Restructuring of the Pensions Fund (PC/003/089)	1 - 8	

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Zoe Folley, Democratic Services

Tel: 020 7364 4877 E-mail: Zoe.Folley@towerhamlets.gov.uk

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Agenda Item 74

COMMITTEE: Pensions Committee	DATE: 30th October 2008	CLASSIFICATION:	REPORT NO.	AGENDA NO.
REPORT OF: Corporate Director Resources ORIGINATING OFFICER(S): Service Head – Corporate Finance	TITLE: Partial Restructuring of the Pension Fund Ward(s) affected: N/A			

1. SUMMARY

- 1.1 The Pension Fund has an investment portfolio of £618 million. The investments are diversified across a number of investment classes in order to provide a balance between seeking higher returns and providing some stability in the funding level and contribution rate.
- 1.2 The current strategy was established after the actuarial valuation of the fund in 2003. In broad terms, 70% of the assets were allocated to equities. This allocation is expected to produce higher returns than bonds over the long term and so is expected to reduce the contributions required. The investment in equities comes with a higher corresponding risk. The balance of assets (30%) was allocated to property and bonds in order to provide some stability.
- 1.3 The strategy has been revised a number of times since it was implemented, but the overall balance between growth seeking assets and lower risk assets has remained broadly similar to that agreed following the review in 2004.
- 1.4 The investment advisors to the Fund consider that the structure of the LGPS means that a longer term investment view can be taken relative to private sector market participants.
- 1.5 The advisors believe that current market conditions provide an opportunity to reduce exposure to government bonds, which now offer low returns relative to those offered historically, in favour of global equities and corporate bonds which appear to offer higher potential returns in the long term. The Chair of the Investment Panel agrees with this assessment. Consequently, if the Committee is willing to increase the level of risk within the investment strategy, it would be an appropriate time to consider implementing a change.
- 1.6 It is therefore recommended that the 8.5% exposure to index linked gilts, which forms part of the bond element of the fund, should be liquidated and the proceeds used to increase the allocation to global equities. It is further proposed to reduce exposure to conventional government bonds by 2% and reinvest the proceeds in corporate bonds. It should be noted that markets are currently extremely volatile and that the position may change. The recommendation is therefore set out as a delegation to the Corporate Director – Resources to determine the precise timing of such a move after consultation with the Chair of the Investment Panel and advisors.

- 1.7 Officers have discussed this proposal with the professional advisers and the Chair of the Investment Panel and have come to the view that it should be recommended to the Committee.

2. RECOMMENDATIONS

Members are recommended to:

- 2.1 Adopt the following asset allocation for the pension fund investment portfolio

	Current Strategy (% of Total portfolio)	Proposed Strategy (% of Total Portfolio)
UK Equities	26.5	27.0
Overseas Equities	37.0	45.0
Currency	3.5	3.5
Conventional Government Bonds	6.0	4.0
Index Linked Government Bonds	8.5	0.0
Corporate Fixed Interest Securities	6.5	8.5
Property	12.0	12.0

- 2.2 To liquidate the indexed linked element of the portfolio currently managed by Aberdeen and transfer the proceeds to GMO (29% of proceeds) and Baillie Gifford (71% of proceeds) to invest in global equities.
- 2.3 To reduce the exposure to conventional government bonds in favour of corporate bonds.
- 2.4 To delegate the timing of the restructuring to the Corporate Director – Resources after consultation with the Chair of the Investment Panel and the professional advisors to the fund.

LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D

LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT

Brief description of "background papers"	<i>Name and telephone number of holder and address where open to inspection</i>
Hymans Robertson Note	Jim Ricketts Capital and Investments Manager Ext. 4733 Mulberry Place, 4 th Floor.

3. BACKGROUND

- 3.1 The Pension Fund has an investment portfolio of £618 million. The investments are diversified across a number of investment classes in order to provide a balance between seeking higher returns and providing some stability in the funding level and contribution rate..
- 3.2 The Fund's professional advisors consider that developments in the investment environment and the Fund since the current asset allocation was first established following the actuarial valuation in 2003 provide an opportunity to increase expected investment returns by reducing the proportion of the fund allocated to government bonds with a corresponding increase in global equities and corporate bonds.
- 3.3 The structure of the Local Government Pension Scheme (LGPS) enables a long term investment view to be employed.
- 3.4 The strategy is apposite at the current time because index linked securities are offering prospective levels of return which are low when compared to historic levels (though this picture could change quickly given current volatility in markets). This may be a result of demand from private sector pension schemes seeking to reduce risk within their pension schemes. Recent falls in world stock markets may provide an improved level of prospective returns from this asset class. The additional return offered by corporate bonds is currently at historically high levels and the advisors believe that this additional return is more than sufficient to compensate for the additional risks.

4. THE CURRENT ASSET ALLOCATION

- 4.1 For all investments there is a direct trade off between expected return and the associated level of risk. The asset allocation attempts to relate the level of risk to the requirements of the fund.
- 4.2 The current asset allocation is as set out in table 1.

Table 1: Current Investment Strategy

	Current Strategy (% of Total portfolio)
UK Equities	26.5
Overseas Equities	37.0
Currency	3.5
Conventional Government Bonds	6.0
Index Linked Government Bonds	8.5
Corporate Fixed Interest Securities	6.5
Property	12.0

- 4.3 The Fund's current strategy has 21% of its assets in relatively low risk fixed interest securities, 12% in property and the remaining 67% in equities (63.5%) and currency funds (3.5%) which have a higher level of volatility.
- 4.4 The current strategy was initially established in conjunction with Hymans Robertson in 2004 and reflected the circumstances at that time.

The strategy has been revised a number of times since it was implemented, but the overall balance between growth seeking assets and lower risk assets has remained broadly similar to that agreed following the review in 2004.

5. PROFESSIONAL ADVICE

- 5.1 The professional advisors consider that it is appropriate to review the asset allocation to reflect developments in the investment environment
- 5.2 It is considered that it is appropriate for the fund to switch to a higher risk/higher return strategy because of its longer term investment perspective and corresponding capacity to absorb risk.

6. THE REVISED ALLOCATION

- 6.1 The revised benchmark is as set out in table 2.
- 6.2 The principal change is the switch from indexed linked securities into global equities.

Table 2: Proposed investment strategy

	Current Strategy (% of Total portfolio)	Proposed Strategy (% of Total Portfolio)	Difference (% of Total Portfolio)
UK Equities	26.5	27.0	+0.5
Overseas Equities	37.0	45.0	+8.0
Currency	3.5	3.5	-
Conventional Government Bonds	6.0	4.0	-2.0
Index Linked Government Bonds	8.5	0.0	-8.5
Corporate Fixed Interest Securities	6.5	8.5	+2.0
Property	12.0	12.0	-

The effectiveness of the switch cannot be assessed for a number of years.

- 6.3 The volatility of returns for global equities is expected to be much higher than those of index linked gilts; the volatility of global equities is around five times that of index linked gilts.

7. OTHER CONSIDERATIONS

- 7.1 There are a number of other considerations associated with the strategy
- 7.2 The timing of the change will materially influence the potential result. The options are either to phase in the change or to change at one point in time. Both options involve risk and require technical advice. It is recommended that the Corporate Director Resources be authorised to determine the change having taken the advice of the professional advisors.
- 7.3 It should be recognised that the proposed equity exposure of 72% is higher than the Local Authority average (approximately 64% as at 31 March 2008). It should also be noted that whereas in the current financial environment other schemes may be reducing the risk exposure by reducing equity

exposure in favour of fixed interest this Council is adopting the opposite strategy.

- 7.4 The specialist mandate structure of the portfolio will necessitate funds being transferred between managers. Currently Baillie Gifford hold the lowest allocation of funds for investment in global equities and it is recommended that the opportunity be taken to increase their allocation. The remaining allocation to Global equities will be allocated to GMO.
- 7.5 The revised manager allocations are as set out in table 5.

		Current	Proposed	Change
Martn Currie	UK Equities	12.0%	12.0%	0.0%
Aberdeen	UK Equities	10.5%	10.5%	0.0%
GMO	Global Equity	25.0%	27.5%	2.5%
Baillie Gifford	Global Equity	16.0%	22.0%	6.0%
Aberdeen	Bonds	21.0%	12.5%	-8.5%
Schroder	Property	12.0%	12.0%	0.0%
Auriel	Currency	2.0%	2.0%	0.0%
Recoord	Currency	1.5%	1.5%	0.0%
		100.0%	100.0%	0.0%

8. COMMENTS OF THE CHIEF FINANCIAL OFFICER

- 8.1. The comments of the Corporate Director Resources have been incorporated into the report.

9. RISK MANAGEMENT IMPLICATIONS

- 9.1 There is inevitably a relatively high degree of risk associated with investment in financial markets and considerable expertise is required to operate within them.
- 9.2 The recommended strategy will increase risk but it is considered that the fund can absorb this because of the relatively long period before investments have to be realised to finance pension payments.

10. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)

- 10.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 require that proper advice be obtained and considered before investment decisions are made.
- 10.2 This report sets out the recommendations of the pension fund's professional advisors thereby fulfilling the statutory obligation.
- 10.3 The agreements with the individual managers enable funds to be withdrawn or deposited with no notice subject to settlement of outstanding transactions.

11. ANTI-POVERTY IMPLICATIONS

- 11.1 There is no specific anti poverty implications.

12. EQUAL OPPORTUNITIES IMPLICATIONS

12.1 There are no equality implications.

13. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

13.1 There is no Sustainable Action for A Greener Environment implications.

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