Non-Executive Report of the: **Pensions Committee** 21st September 2017	
Report of: Zena Cooke, Corporate Director, Resources	**Classification:** Unrestricted
Investment Strategy Review / Strategic Asset Allocation Review 2017/18 and Carbon & Environmental Footprints Analysis Outcome of the Fund	

Originating Officer(s)	Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report presents the analysis and results of the asset liability modelling study and the strategic asset allocation review carried out by the Fund's advisers Mercer. This review follows on from the Fund's 2016 Triennial Actuarial Valuation.

The purpose of the review is to assess the ability of the current funding and investment strategy to close the deficit gap, as well as fund future benefits in an affordable and stable way.

The review encompassed an asset liability study which assesses the suitability of alternative investment strategies for the pension fund's liability profile.

The Fund's investment consultant, Mercer will expand on the points made in this paper in a presentation to the Committee.

This report also summarised the carbon and environmental footprint analysis carried out by Trucost, (Trucost is part of the S&P (Standard & Poor) Global family, operated by S&P Dow Jones Indices) for the Fund's aggregate equities portfolio with holdings data as at 31st March 2017. Morgan Stanley Composite Index (All Country World Index) MSCI ACWI was used as a benchmark for this analysis.

Recommendations:

Pensions Committee are recommended to:

1) Note the outcome of the carbon and environmental footprint analysis;
2) Note the outcome of the investment strategy review as presented by the Fund Investment Consultant, Mercer; and
3) Agree to make the following changes to the investment strategy and amend the Investment Strategy Statement (ISS) accordingly
    a) To agree to reduce Equities allocation from 60% to 50%
    b) To agree to disinvest from passive UK Equities
    c) To agree to invest into Low Carbon Passive Global Equity (15%)
    d) To agree to invest into Passive Global Equity (15%)

1. REASONS FOR THE DECISIONS

1.1 Following the outcome of the 2016 triennial revaluation of the Pension Fund, it is appropriate to consider the approach to both funding and employer contributions in order to determine whether the current investment strategy and strategic asset allocation remain appropriate for the Fund and its employers.

1.2 The role of the Pensions Committee (as quasi Trustees) means that it has to ensure that there are realistic strategies in place to meet funding goals; that strategies are affordable, prudent and provide stability for employers in the Fund. Understanding the impact of adopting different approaches to the investment strategy and the setting of employer contribution strategies enables the Committee to consider the longer term financial impact of such decisions and to take reasonable financial decisions when setting investment and contribution strategies.

2. ALTERNATIVE OPTIONS

2.1 The Committee could decide to continue with its existing strategy. It is however, considered best practice to carry out an assessment of the Fund's position following the triennial valuation, even if the conclusion is to remain with the current strategy thereafter.

3. DETAILS OF REPORT

3.1 The Fund's current investment strategy was agreed following a review in 2004. Although the strategy has been revised a number of times since it was implemented, the overall balance between growth seeking assets (82%) and lower risk matching assets (18%) has remained broadly similar to that agreed in 2004. This report summarises the views of the Investment Adviser, Mercer, as a consequence of the review of the strategy. The Adviser will be presenting at the Committee to expand on these further and deal with questions arising from the presentation.

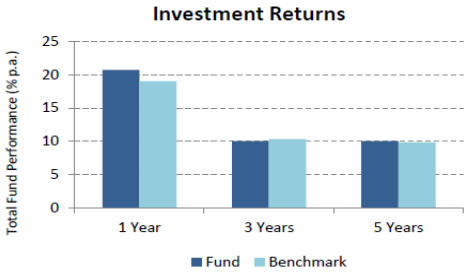
3.2 The funding level has improved significantly over the period shown, predominantly driven by strong asset returns over the past 5 years:

- Global Equity – GMO (13% p.a.), Baillie Gifford (16.1% p.a.)
- UK Equity – LGIM (9.9% p.a.)
- UK Index-Linked Gilts/Hedging portfolio – LGIM (10.0% p.a.)
- UK Property – Schroders (8.0% p.a.)

CURRENT FUNDING POSITION

	31 March 2013 (£m)	31 March 2016 (£m)	31 March 2017 (£m)
Assets	928	1,126	1,361
Liabilities	1,293	1,361	1,584
Surplus/ (Deficit)	(365)	(235)	(223)
Funding Level	**71.8%**	**82.8%**	**85.9%**

Figures taken from Fund's actuarial reports and funding updates. Source Hymans

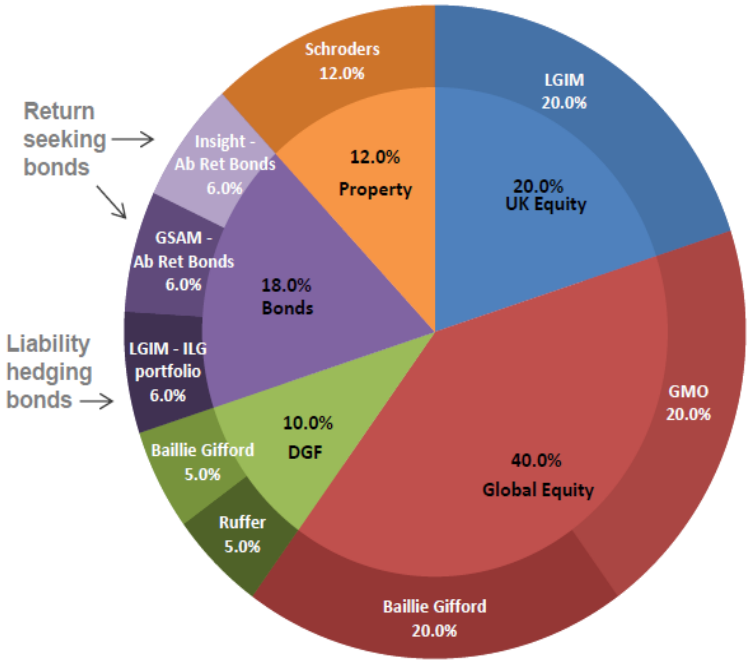


Source: State Street performance report

3.3 Liabilities have increased due to falling gilt yields over the period, but to a lesser extent than the Fund's assets. The increase in liabilities has also been offset to some extent by the performance of the index linked gilt portfolio.

3.4 The Adviser believes the current strategy has heavy reliance on equities (c. 75% of expected return) and low exposure to cashflow-generative real assets.

REVIEW OF THE CURRENT PORTFOLIO



Key features	
Best estimate expected return	Gilts + 4.1% p.a.
Probability of achieving Gilts + 2.0%*	73%
Level of liability hedging	7%
Currency hedging policy	None
Number of managers	7

** Fund's current actuarial discount rate. Hymans require a 66% chance of exceeding this figure*

3.5 Global equity markets are at or close to all-time highs, having performed well over 2016 and 2017, despite a period of high political uncertainty. Over the last27 years or so, the MSCI World has returned 8.5% p.a. It is expected to be rewarded for investing in equities, and has to tolerate the capital risk that comes with this. This risk is highlighted by a number of significant market falls observed over the last 20 years. Based on this, it may be reasonable to assume that an investor should be willing to tolerate a downside event equivalent to a 20-50% fall in equity market values, but this level of downside risk may not be desirable from a stability or affordability perspective. It may therefore be a sensible time to consider how to reduce this risk.

3.6 The investment review also provides the Committee with an update on the performance of the existing Fund Managers and the following recommendations and comments are made to the Committee;

a) The Adviser recommends reducing the allocation to equities from 60% to 50%, in light of strong performance, an increase in the funding level and the level of risk concentration in equities.

b) As the Fund has benefitted greatly from the lack of currency hedging, the Adviser believes there is an opportunity to bank some of these gains by introducing currency hedging.

c) The Adviser has high professional regards for both Ruffer and Baillie Gifford and believe them to be best in class managers therefore there is support for an increase in the allocation to both managers as it would secure additional diversification and be relatively quick and easy to achieve.

d) The Adviser has reservations around core UK property, particularly in the current climate. He believes that Long-Lease property is an attractive part of the property sector at present, and is likely to be appropriate for the Fund given it would achieve some direct inflation exposure and provide ongoing cashflows.

e) The expected returns from Absolute Return Bonds (ARB) are very dependent on the skills of individual managers which are difficult to predict and is wholly reliant on the investment managers. The Adviser believes that this could be complemented by an allocation to Multi-Asset Credit (MAC), where the returns are likely to be driven by markets rather than just manager skill.

f) The Adviser is in support of allocating more funds to index-linked gilts as these provide the only direct liability hedging in the current portfolio. Assuming that the current actuarial valuation approach is maintained, the Adviser would suggest increasing the exposure to index-linked gilts over time.

3.7 The Adviser highlights the significant overweight position of the Fund in respect of UK Equity, relative to a market cap weighted index, and hence a materially lower allocation to the US and other regions. Such a home bias is not uncommon, especially within the LGPS sector but looks increasingly outdated and difficult to justify from an investment perspective. The Adviser encourages the Fund to invest more globally over time, and as an interim measure, suggested to the Committee at its last the use of a passive global equity fund at LGIM. It was, also suggested that the Committee consider the use of new global equity strategies available from the London Collective Investment Vehicle (LCIV).

3.8 Following the consideration of the draft Investment Strategy at the last meeting and in addition to the Committee's previous decision to terminate the mandate with GMO, the Global Equities mandate, the Committee agreed to:

a. Appoint LGIM to manage the GMO portfolio on a transitional basis;
b. Increase the investment in the Council's Diversified Global Funds mandate from 10% to 20% by topping up the existing DGF fund mandates (Bailie Gifford and Ruffer) by 5% each; to be achieved through a reduction to the GMO Global Equities mandate as part of the LGIM transitional management arrangements; and
c. Reviews further all other aspects of the draft Investment Strategy at this meeting.

3.9 Arrangements were made to terminate GMO mandate, with Emerging Market redemption proceeds invested in the existing DG funds with Baillie Gifford DGF and Ruffer.

3.10 At this meeting the Committee has the opportunity to further consider the Equities position of the Fund as detailed in Mercer report and presentation. This may include a reduction of UK Equity from 60% to 50%. In the meantime Officers and the Advisor are exploring investment options around global equity, and are currently focusing on offerings that may allow the Committee to take account of their commitment to sustainable investments and lowering the Fund's carbon exposure along with currency hedging option. An update on outcomes of these meetings will be provided at the Committee meeting.

3.11 The Fund's investment advisers have been working with officers of the Fund to look at a range of further training for the Committee on the subjects of liability hedging, Multi Assets Credit and Long Lease Property.

Carbon and Environmental Footprints Outcome

3.12 The carbon and environmental footprint analysis was carried out on the Fund equity holdings with LGIM, GMO, BG (GEA), Ruffer and BG (DGF).

3.13 Carbon footprint analysis quantifies greenhouse gas emissions (GHG) embedded within the Fund presenting these as tonnes of carbon dioxide equivalents (tCO2e). This compares the total GHG emissions of each holding relative to annual revenue, gives a measure of carbon intensity that enables comparison between companies, irrespective of size or geography.

3.14 The carbon footprint of the equity holdings of the Fund is 336.94 tonnes CO2e per £1m of revenue. This is compared to the benchmark of is 468.58tonnes CO2e per £1m of revenue. The Fund is 28% more carbon efficient than the benchmark.

3.15 Each Equity mandate held by the Fund contributes to carbon efficient of the Fund as follows:

a) LGIM (Passive UK Equity) - The carbon footprint of the portfolio is 377.78 compared to the benchmark which is 376.74. The portfolio is 0.28% more carbon intensive than its benchmark, FTSE All Share.

b) GMO - The carbon footprint of this portfolio is 340.71 compared to the benchmark which is 468.68. The portfolio is 27.30% less carbon intensive than its benchmark, MSCI ACWI.

c) LCIV Baillie Gifford (Global Equity) - The carbon footprint of this portfolio is 253.15 compared to the benchmark which is 468.68. The portfolio is 45.99% less carbon intensive than its benchmark, MSCI ACWI.

d) LCIV Baillie Gifford (DGF) - The carbon footprint of this portfolio is 587.77 compared to the benchmark which is 468.68. The portfolio is 25.41% more carbon intensive than its benchmark, MSCI ACWI.

e) LCIV Ruffer (AR) - The carbon footprint of this portfolio is 284.51 compared to the benchmark which is 468.68. The portfolio is 39.30% less carbon intensive than its benchmark, MSCI ACWI

3.16 The four sectors that contribute the highest levels of carbon intensity to the Fund are Materials (1,304.46 tCO2e/GBPmn), Utilities (1,285.18 tCO2e/GBPmn), Energy (705.49 tCO2e/GBPmn), and Industrials (355.32 tCO2e/GBPmn).

3.17 The two sectors that have the greatest positive effect on carbon efficiency are Utilities and Materials, which together contribute 27.46% of the increased carbon efficiency. The two worst performing sectors in the Fund are Health Care and Industrials, which contribute to 3.03% of reduced carbon efficiency.

3.18 The environmental footprint of the Fund is 2.98% per £ million revenues, compared to the benchmark, which is 3.73%. This means that £29,800 in environmental costs is linked to every £1m generated by the holdings. The Fund is 20.19% more environmentally efficient than the benchmark.

3.19 Environmental footprints quantify the greenhouse gas (GHG) emissions; water; waste; land & water pollutants; air pollutants; and natural resource use associated with the Fund. To enable comparison between different environmental impacts, Trucost assigns an environmental cost to each resource and pollutant.

3.20 The Fund carbon and environmental footprints position will be improved if it disinvests from passive UK Equities and incorporates into the investment strategy a Low Carbon Passive Global Equity (15%) which are designed to track broad market indices but with lower carbon footprints; in some cases significantly lower. Low carbon indices can offer a relatively low cost solution to reducing exposure to carbon intensive companies.

3.21 The Investment adviser as part of its investment strategy review suggested that the most appropriate index for the fund is the MSCI Low Carbon Target index, which reduces the carbon footprint (relative to the MSCI World) by around 70%.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 There are no direct immediate financial implications arising as a consequence of this report. At the last meeting the Fund's Investment Adviser recommended a reduction of Equity weight as an approach of decreasing the level of risk in the investment strategy. The governance role of the Pensions Committee requires that they ensure that there are realistic strategies in place to meet funding goals; that strategies are affordable, prudent and provide stability for employers in the Fund.

4.2 Understanding the impact of adopting different approaches to the investment strategy and the setting of employer contribution strategies enables the Committee to consider the longer term financial impact of such decisions and to take reasonable financial decisions when setting investment and contribution strategies. The costs of obtaining the advice are minimal in comparison to the benefits that could be derived from having an appropriate strategy in place to achieve full funding.

5. LEGAL COMMENTS

5.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 govern the way in which local authorities are expected to deal with investment of pension funds. The main thrust of the Regulations is for local authorities to take a prudential approach to investment, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse

portfolio of assets and have ensured an appropriate approach to managing risk. The regulations require the Administering Authority to obtain proper advice at reasonable intervals about it investments and consider that advice before making any decisions. In this regard the Council has complied with its duty by taking advice from Mercers, its appointed advisers.

5.2 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate having regard to these matters, for the Committee to receive information about asset allocation and the performance of appointed investment managers.

5.3 The contents of this report and the recommendations are intended to ensure that the Administering Authority is compliant with the LGPS Regulations.

5.4 When reviewing the Pension Fund Investment Performance, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty). The Committee may take the view that good, sound investment of the Pension Fund monies will support compliance with the Council's statutory duties in respect of proper management of the Pension Fund.

6 ONE TOWER HAMLETS CONSIDERATIONS

6.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1 This report helps in addressing value for money through planning to have a rigorous and robust investment strategy in place to aid in bridging the Fund's funding gap.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

9.1 Any form of investment inevitably involves a degree of risk.

9.2 To minimise risk the Investment Panel attempts to achieve a diversification portfolio. Diversification relates to asset classes and management styles.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- [None]

Appendices

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report

Officer contact details for documents:

- Bola Tobun Investment &Treasury Manager x4733