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| COMMITTEE:<br><b>Pensions Committee</b>  | DATE:<br><b>16 February 2012</b> | CLASSIFICATION:<br><b>Unrestricted</b>  | REPORT NO. | AGENDA NO. |
| REPORT OF:<br><b>Corporate Director of Resources</b><br><br>ORIGINATING OFFICER(S):<br><b>Oladapo Shonola –<br/>Chief Financial Strategy Officer</b> |                                  | TITLE:<br><br><b>Report on Rebalancing Policy</b><br><br>Ward(s) affected:<br>N/A |            |            |

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| <b>Lead Member</b>          | <b>Cllr Anwar Khan, Chair of Pensions Committee</b> |
| <b>Community Plan Theme</b> | <b>All</b>  |
| <b>Strategic Priority</b>   | <b>One Tower Hamlets</b>                            |

## **1. SUMMARY**

- 1.1 The London Borough of Tower Hamlets Pension Fund has multiple managers with varied performance at different periods during the economic cycle and environment. This can create an imbalance between target and actual asset allocation.
- 1.2 Although each manager has been allocated a proportion of Fund assets based on the strategic allocation that was originally agreed in 2004 and was recently reviewed in January 2011, there is often deviation from these allocations due mainly to the reason outlined in 1.1.
- 1.3 Rebalancing of the Fund is currently done on an periodic basis due to costs involved and other complications associated with transfer of assets from one manager to another. This report sets out an approach to rebalancing the strategic asset allocation and allocation to fund managers and allows a formal policy to be adopted on rebalancing.

## **2. DECISIONS REQUIRED**

- 2.1 Members are recommended to adopt a formal rebalancing policy as follows:
  - 2.1.1 Use Legal & General (L&G) who currently manage two separate mandates (UK equities and index-linked gilts) as a swing manager in order to ensure that asset allocation within the portfolio remains consistent with that assumed in actuarial valuation.

## **3. REASONS FOR DECISIONS**

- 3.1 The Local Government Pension Scheme (LGPS) (Management and Investment of Funds) Regulation 2009 requires an administering authority to invest fund money that is not needed immediately to make payments from the Pension Fund.
- 3.2 The Pension Committee is charged with meeting the duties of the Council in respect of investing pension fund assets having taken professional advice. Therefore it is appropriate that the Committee formally adopts a policy on rebalancing to ensure that the actual allocation of assets within the Fund reflects the target strategic allocation of assets.

## **4. ALTERNATIVE OPTIONS**

- 4.1 The Council may choose not to adopt a policy on rebalancing, and instead continue to undertake ad-hoc review of asset allocation.

## **5. BACKGROUND**

- 5.1 The current strategic allocation of assets was reviewed and a new set of benchmark was agreed and adopted in January 2011. Although, a review of target allocation is undertaken periodically, a formal process for rebalancing the portfolio in between reviews has not been agreed by the Committee.
- 5.2 It is expected as part of normal day to day management of a portfolio of assets that is as well diversified in terms of asset class and fund managers as the London Borough of Tower Hamlets Pension Fund is, that there will be a drift away from benchmark targets for each asset class due to deviations in performance between managers and also between particular markets (equities, bonds, properties, etc).
- 5.3 Rebalancing is considered a good discipline and has been shown to add value over time by taking profit from markets that have recently gone up and buying assets that have recently gone down. Value can also be added in that the strategic allocations to growth assets such as equities and property relative to low risk assets such as bonds is maintained in a way that allows returns to be in line with actuarial assumptions.

## **6 REBALANCING APPROACH**

- 6.1 There are some issues with rebalancing allocations within a multiple manager Fund like London Borough of Tower Hamlets. These issues include:
- Complication around instructing multiple managers to transition assets to each other;
  - Delay between the date at which the allocation is measured and assets being rebalanced; and
  - Cost of buying and selling assets to rebalance to the benchmark.
- 6.2 A review of options has identified three approaches that could facilitate implementation of a rebalancing strategy with the Fund. They are as follows:
- 1 Regularly review allocations and instruct overweight managers to transition assets to underweight managers;
  - 2 Direct new cashflow to underweight managers to increase their allocation; and
  - 3 Utilise L&G swing manager service.

- 6.3 **Option 1** – Although instructing overweight managers to transfer assets to underweight managers is the most effective way of managing allocation to asset class and managers, it has significant drawbacks, including: the delay between getting up to date manager valuations and implementation; governance intensive in terms of monitoring of the allocation and instructing and coordinating manager trades; and transaction costs of transitioning assets between managers.
- 6.4 **Option 2** – Directing new cashflows to new managers although cheaper (as no requirement to realise assets before transfer can be facilitated and also in terms of governance and instruction), the net cashflow is only £500k per month. This equates to approximately 0.1% of assets, therefore negligible.
- 6.5 **Option 3** – this is the preferred option. L&G manage two separate mandates for the Fund, UK equities and index-linked gilts. If instructed, they could implement broad rebalancing of the allocation by monitoring the overall allocation of the managers and adjusting their allocation to either the UK equity or index-linked gilt fund to compensate for all managers who are above or below their strategic allocations – so it will be a net rebalancing for the whole Fund.
- 6.6 As swing manager for the Fund, L&G will have a mandate to monitor other manager allocations and automatically implement transitions within their own funds if ranges are breached.
- 6.7 The following practical issues should be noted as part of this arrangement being agreed:
- A swing mandate arrangement is only designed to quickly correct high level deviations in asset allocation between equities and bonds;
  - Asset allocation to index linked gilts would likely need to be increased by up to 2% to give more flexibility to the manager. Current allocation is 3%, but actual is closer to 5.8%;
  - A tolerance of +/-5% deviation from benchmark is reached before rebalancing is required and to rebalance to within +/-2%; and
  - L&G will charge a fee of £7,500 per annum for this service.

## **9. COMMENTS OF THE CHIEF FINANCIAL OFFICER**

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

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

- 10.1 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 preservation of Fund assets.

## **11. ONE TOWER HAMLETS CONSIDERATIONS**

- 11.1 Any losses arising from an imbalanced Fund relative to strategic asset allocation could impact on the Council through an increase in contributions in order to make good the Pension Fund's commitment to honour benefits that have been accrued by members of the Fund.
- 11.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

## **12. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT**

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

## **13. RISK MANAGEMENT IMPLICATIONS**

- 13.1 The use of any form of investment inevitably involves a degree of risk - Although rebalancing will minimise the risk of significant deviation from the Fund's strategic asset allocation which is the basis of actuarial valuation.

## **14. CRIME AND DISORDER REDUCTION IMPLICATIONS**

- 14.1 There are no any crime and disorder reduction implications arising from this report.

## **15. EFFICIENCY STATEMENT**

- 15.1 Rebalancing has been shown to add value over time, so should be considered a positive addition to that will help maximise returns.

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### **LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D**

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

*Brief description of "background papers"*

*Name and telephone number of holder  
And address where open to inspection*