Pension Fund Committee
Thursday, 10 September 2020
Investment Strategy Review

For Decision

Local Councillor(s): All

Executive Director: A Dunn, Executive Director, Corporate Development

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Report Status: Public

Recommendation:

That the Committee:

i) Agree the proposed changes to the investment strategy and strategic asset allocation.
ii) Authorise officers to implement the changes to the investment strategy and strategic asset allocation.
iii) Authorise officers to update the Investment Strategy Statement (ISS) as necessary.

Reason for Recommendation:

To ensure that the pension fund has the most efficient and effective investment strategy with respect to risk-adjusted return and the funding position.

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require administering authorities of LGPS funds to formulate and to publish a statement of its investment strategy, in accordance with guidance issued from time to time by the Secretary of State. This statement must be reviewed by the administering authority at least every three years, or more frequently should any significant change occur.

1. Executive Summary

Following the results of the latest triennial actuarial valuation, investment consultants, Mercer, were engaged to review the pension fund's current investment strategy and strategic asset allocation

Mercer's concluded that the discount rate of 5.0% used by the actuary would be challenging to achieve with the current target asset allocation given the outlook for markets, and these concerns have been underlined by the uncertainty created by the global COVID 19 pandemic. Mercer therefore recommend making some changes to the strategic asset allocation in order to improve the chances of achieving this target rate of return without unduly increasing risk.

The main recommended changes are to:

- increase overall equity exposure from 45% to 50% of total assets;
- reduce the proportion of UK specific equity holdings;
- increase the proportion of actively managed equity holdings and reduce the proportion of passively managed equity holdings; and
- reduce the allocation to corporate bonds.

Following the declaration of a climate emergency by Dorset Council and Bournemouth, Christchurch and Poole (BCP) Council, Mercer were also asked to consider options to enable the pension fund to move towards a low carbon future.

Mercer's favoured option is decarbonisation as opposed to blanket divestment from all fossil fuel companies. Decarbonisation can deliver significantly greater reductions in the 'carbon footprint' of investments, it allows for continued influence with companies, and would be more straightforward to implement.

2. Financial Implications

Any changes to the pension fund's strategic asset allocation will have a financial impact on the pension fund and have therefore been considered before making these recommendations.

3. Climate implications

The pension fund's Investment Strategy Statement requires all external investment managers to consider and manage all financially material risks arising from environmental issues, including those associated with climate change.

This report specifically looks at how the pension fund can move to a low carbon future without sacrificing investment returns.

4. Other Implications

No other implications arising from this report have been identified.

5. Risk Assessment

The pension fund allocates investments across a variety of different asset classes in order to prudently diversify sources of investment return and risk. To be judged suitable for investment, asset classes must be consistent with the pension fund's risk and return objectives, improve diversification and be fully understood by officers and the Committee.

A key part of the pension fund's investment strategy is the management of risk and this is covered in some detail by the Investment Strategy Statement. It is necessary for an appropriate level of risk to be taken in order to target the required level of investment return.

6. Equalities Impact Assessment

There are no equalities implications arising from this report.

7. Appendices

Appendix 1: Investment Strategy Review (Mercer)

8. Background Papers

Investment Strategy Statement (March 2018)
Funding Strategy Statement (March 2020)

9 Background

9.1 The Local Government Pension Scheme (LGPS) is a national pension scheme administered locally. Dorset Council is the administering authority for the LGPS in Dorset which provides pensions and other benefits for employees of the Council, other councils and a range of other organisations within the county.

9.2 The LGPS is a 'defined benefit' scheme which means that benefits for scheme members are calculated based on factors such as age, length of membership and salary. Member benefits are not calculated on the basis of investment performance as they would be in a 'defined contribution' scheme.

9.3 Administering authorities are required to maintain a pension fund for the payment of benefits to scheme members funded by contributions from scheme members and their employers, and from returns on contributions invested prior to benefits becoming payable.

9.3 Contribution levels for scheme members are set nationally, and contribution levels for scheme employers are set locally by actuaries engaged by administering authorities. As scheme member rates cannot be changed locally and benefits are defined, the risk of investment underperformance is effectively borne by scheme employers.

9.4 Every three years, the actuary engaged by the administering authority undertakes a full assessment of the funding position for all scheme employers to set contribution rates for the following three years until the next valuation.

9.5 The last such actuarial valuation was undertaken by the pension fund's actuary, Barnett Waddingham, based on assets and liabilities as at 31 March 2019. Barnett Waddingham estimated the pension fund's deficit (assets less liabilities) to be £255m giving a funding level (assets divided by liabilities) of approximately 92%.

9.6 To determine the value of liabilities and derive future employer contribution requirements actuaries discount future payments to present day values. The discount rate used by Barnett Waddingham is the annual rate of expected return from the pension fund's long-term investment strategy, estimated by them at the last valuation to be 5.0%.

9.7 After each triennial valuation, the pension fund's investment strategy and strategic asset allocation is reviewed with the aim that the pension fund has the right mix of assets to give a good probability of meeting or exceeding the discount rate used in the valuation. Investment consultants, Mercer, were engaged to assist with this review after the latest valuation.

9.8 Following the declaration of a climate emergency by Dorset Council and BCP Council Mercer were also asked to consider options to allow the pension fund to move towards a low carbon future.

9.9 This report summarises the key conclusions and recommendations of this review, with Mercer's full report attached as Appendix 1

10. Strategic Asset Allocation

10.1 The table below sets out the existing target allocation, the current actual allocation at 30 June 2020, and the proposed new allocation.

Asset Class	Current Target	Actual 31.06.20	Proposed
Listed Equities	45%	48.6%	50%
Diversified Growth Funds (DGF)	8%	5.7%	6%
Corporate Bonds	6%	7.9%	4%
Multi Asset Credit (MAC)	5%	4.5%	5%
Property	12%	10.0%	10%
Infrastructure	5%	7.3%	8%
Private Equity	5%	3.0%	5%
Inflation Protection (LDI)	14%	12.0%	12%
Cash	0%	1.0%	0%
Total	**100%**	**100.0%**	**100%**

10.2 For most asset classes it is proposed that the target be revised broadly in line with the actual position as at 30 June 2020 in order to minimise unnecessary transition costs without a clear benefit. The exceptions are summarised in the paragraphs below.

10.3 **Listed Equites:** It is proposed that the overall target allocation for listed equities is increased from 45% to 50% to provide a boost to expected returns. The increased risk this would bring is considered necessary in order to improve the chances of the pension fund's investment targets being met.

10.4 Mercer believe there are also opportunities to increase returns by adjusting the mix of holdings within the overall allocation to equities. Mercer see such opportunities from reducing the UK bias and by allocating more to Brunel portfolios where active managers can add value such as High Alpha, Small Cap, Emerging Markets and Sustainable equities.

10.5 The table below sets out the proposed breakdown of the allocation to equities.

	Current Target	Actual 31.06.20	Proposed
Global Equities:			
Global Passive (LGIM)	0.00%	6.7%	5.0%
Global Smart Beta (LGIM)	8.50%	9.3%	7.5%
Global Core (Brunel)	8.50%	0.0%	0.0%
Global High Alpha (Brunel)	4.25%	4.6%	7.5%
Global Small Cap (Brunel)	2.25%	0.0%	5.0%
Sustainability (Brunel)	0.00%	0.0%	10.0%
Emerging Markets (Brunel)	3.00%	3.3%	5.0%
Global Active (Wellington)	0.00%	6.9%	0.0%
Total Global Equities	**26.50%**	**30.8%**	**40.0%**
UK Specific Equities:			
UK Passive (LGIM)	12.25%	11.2%	3.0%
UK Active (Brunel)	6.25%	4.9%	5.0%
UK Small Cap (Schroders)	0.00%	1.7%	2.0%
Total UK Specific Equities	**18.50%**	**17.8%**	**10.0%**
Total	**45.00%**	**48.6%**	**50.0%**
Total Passive (inc. Smart Beta)	**20.75%**	**27.2%**	**15.5%**
Total Active	**24.25%**	**21.4%**	**34.5%**

10.6 All Brunel and LGIM portfolios listed above are already available for investment or will become available shortly. It should, therefore, be relatively straightforward to implement these changes but it will be necessary to agree a full transition plan with Brunel. The performance of this 'mix' of holdings will be monitored closely and over time it is likely that some changes will be considered.

10.7 **Corporate Bonds:** It is proposed that the target allocation is reduced from 6% to 4%. Mercer believe that expected returns from investment grade corporate bonds are significantly below the discount rate and that better returns could be achieved by reinvesting capital elsewhere.

10.8 The target allocation will be achieved by partial divestment from the existing mandate with Royal London Asset Management (RLAM) timed to meet the cash requirements of the other changes proposed.

10.9 **Private Equity:** It is proposed that the target allocation is maintained at 5%, compared to 3% actual as at 30 June 2020. Private Equity offers investors good opportunities for returns in excess of those from listed markets but it is an illiquid asset class and often takes a long time for commitments to be drawndown. Officers will need to closely manage

commitments and drawdowns with its two legacy managers, Aberdeen Standard and HarbourVest, and Brunel.

11. Moving to a low carbon future

11.1 Mercer were also asked to consider options to allow the pension fund to move towards a low carbon future, and their report includes a comparison of two potential approaches - disinvestment and decarbonisation.

11.2 Both approaches aim to create an investment portfolio with a lower carbon footprint than the market but without sacrificing returns.

11.3 Disinvestment requires completely divesting from those companies involved in the sourcing and refining of fossil fuels. Decarbonisation means a reduction in allocations to those companies which are high carbon emitters and looks to influence the demand for fossil fuels not just their supply.

11.4 Mercer favour the decarbonisation approach as there is evidence that it can deliver significantly greater reductions in the 'carbon footprint' of investments. The MSCI World excluding Fossil Fuels index (a proxy for disinvestment) has a carbon intensity 19% lower than the MSCI World index, whereas the MSCI World Low Carbon index (a proxy for decarbonisation) has a carbon intensity 64% lower than the MSCI World index.

11.5 Mercer also highlight that blanket disinvestment removes the potential to influence companies and help them transition to a lower carbon future. Also, a fossil fuel free portfolio is not straightforward to implement and could result in higher ongoing management fees compared to a decarbonisation approach.

11.6 Mercer's conclusions are consistent with the "engagement with teeth" approach explained by Faith Ward, Brunel's Chief Responsible Investment Officer, at the last meeting of the Committee in March 2020. Whilst Brunel do not favour blanket divestment from all companies in a sector, targeted divestment from individual companies not engaging positively in the transition to a low carbon future remains part of their 'toolkit'.

Footnote:
Issues relating to financial, legal, environmental, economic and equalities implications have been considered and any information relevant to the decision is included within the report.