REPORT TO: PENSION COMMITTEE
14 September 2009

AGENDA ITEM:

SUBJECT: Pension Fund Asset Allocation Strategy

LEAD OFFICER: Executive Director of Resources and Customer Services

CABINET MEMBER Councillor Dudley Mead, Deputy Leader (Finance)

WARDS: All

CORPORATE PRIORITY/POLICY CONTEXT:

Sound Financial Management: The choice of asset classes determines between 60% and 80% of the returns generated by the Pension Fund investments. Consequently the approach taken to adopting an asset allocation stance needs to be open and transparent. It is critical that advice is available from appropriately qualified advisors and that members are given every opportunity to consider this decision in a timely fashion whilst in possession of the full range of considered professional opinion and advice.

FINANCIAL SUMMARY:

There are significant financial implications arising from this report. The allocation of the cash held by the Fund to different asset classes is the predominant factor in determining the level of returns generated. This in turn has an impact on the costs of the authority in influencing the level of contributions required.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

1. RECOMMENDATIONS

The Committee is asked to:

i. Note the progress detailed in this report.

ii. Agree to an annual review of the strategy as described in paragraph 3.6.

2. EXECUTIVE SUMMARY

2.1 This report provides a commentary on the process to date to implement the revised asset allocation strategy for the Croydon Pension Fund (the Fund). It also sets out a timetable for reviewing the progress of the strategy. A further
report in part B of this agenda details progress on procurement of fund managers in respect of this strategy.

3. **DETAIL**

3.1 Work on implementing the revised Asset Allocation Strategy for the authority’s Pension Fund (17 June 2008, Minute A18/08) is well advanced and a panel of fund managers for each of the asset classes specified by the strategy, unconstrained active global assets, active global corporate fixed interest and hedge fund of funds is in the process of being selected (reported in Part B of this agenda).

**Asset Allocation Strategy**

3.2 The recent history of returns on the investments comprising the Pension Fund (the Fund) is instructive. Up to the end of 2007 the Fund demonstrated steady growth year on year, peaking at an estimated valuation of £571.7m by December of that year. Since then the value of the Fund has fallen each quarter:

- Down £47.6 by March 2008;
- Down another £7.4m by the end of June 2008;
- Down £41.4m by the end of September 2008;
- Down £22.8m by the close of 2008; and
- Down a further £38.2m by the end of the financial year.

In all, the Fund decreased in value by £157.4m from the high at the close of 2008 to the end of the financial year in March 2009.

3.3 Although the implications of the current global recession were not fully understood at the time that the Committee agreed to revise the asset allocation strategy it was clear that the extent of investment in a very narrow asset class exposed the Fund to far too great levels of volatility. Given the profound impact of the triennial valuation on the authority’s General Fund this risk was and remains unacceptable. Further, the depth of the current recession has demonstrated that a lack of diversification means that the Fund has no ability to respond adequately to movement in the main equity indices. Recent research (Mercer's latest survey of asset allocation of European pension schemes) confirms this. Across Europe schemes are using diversification to manage investment risk.

3.4 The primary goal of the asset allocation strategy remains the same: to generate steady year-on-year returns such that, at the end of the 25-year recovery period, the assets in the Fund will meet the current and future liabilities of the scheme. In generating that level of return the Fund should be exposed to as low a level of volatility as is possible. That is to say, using the efficient frontier model, to keep the level of return constant whilst reducing the risk of missing that return target.

3.5 To achieve that goal in June 2008 (ref. Minute A18/08), the Committee agreed a revised asset allocation as follows:

| Unconstrained active global equities | 50% |

PEN
Active corporate fixed interest debt 30%
Property 7%
Private equity 4%
Hedge Fund of Funds 4%
Global Tactical Asset Allocation Fund 4%
Cash 1%

In order to offset the risk of inflexibility in responding to critical changes in manager relationships the panel concept has been introduced. Under this model the Committee retains the flexibility to transfer funds within and across asset classes without the time constraint of having to go through a lengthy procurement exercise. To ensure that the Fund is nimble enough to be able to respond to further changes in the investment environment a tactical asset allocation manager will be introduced to the mix of investment advice supporting the Committee.

3.6 The introduction of the tactical asset allocation component will allow for meaningful annual reviews of the progress of the Fund to recovery. The Committee will be able to take decisions on the effectiveness of

a) each fund manager’s performance; and
b) the appropriateness of the allocation of assets within separate classes.

Four sets of advice will inform these discussions:

Mercer, as the Croydon scheme’s investment advisors;
The tactical asset allocation manager;
The Committee’s independent investment advisor; and
Officers (backed by analysis from the WM Company, Inalytics and other relevant sources).

This structure will provide the Committee with the flexibility to respond in a timely basis to developments and changes in the environment. The base starting position for these discussions will naturally be the allocation described above. Most of the funds considered by this process are designed to deliver results over a three to five year timescale. Indeed many of those that showed negative yield during 2008 demonstrate reasonable results over three and five years. Nevertheless there are a number of good reasons why an investment in a fund should be terminated, including:

- The managed fund no longer has a role within the Fund’s strategy;
- The manager breaches risk parameters or changes style;
- The manager losses key staff;
- There is a breakdown in the relationship with the Committee; or
- The manager has merged its business or has been taken over.

In any of these circumstances the Committee ought to consider whether it would wish to end that mandate and invest the funds with another manager. Under the current regulatory framework the authority has the ability to terminate any mandate without notice. To put this arrangement on a formal footing going forwards it is recommended that at the last Committee of the calendar year a report is taken that reviews the relationship with each fund manager, covering
these types of issues and any other that may be of concern to members. This annual review should also discuss the efficacy of the on-going investment strategy as described above.

3.7 To illustrate the potential benefits of this revised allocation it may be possible to recast the previous 12 months performance of the Fund.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Historic Allocation</th>
<th>Estimated yield from revised allocation at end May 2009</th>
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</thead>
<tbody>
<tr>
<td>Equities</td>
<td>£374.4m 81.2%</td>
<td>£220.8m 45.5%</td>
</tr>
<tr>
<td>Fixed Interest</td>
<td>£27.7m 6.0%</td>
<td>£162.9m 33.6%</td>
</tr>
<tr>
<td>Property</td>
<td>£11.7m 2.5%</td>
<td>£11.7m 2.4%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>£11.9m 2.6%</td>
<td>£11.9m 2.5%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>0 0</td>
<td>£21.7m 4.5%</td>
</tr>
<tr>
<td>GTAA</td>
<td>0 0</td>
<td>£20.8m 4.3%</td>
</tr>
<tr>
<td>Cash</td>
<td>£35.3m 7.7%</td>
<td>£35.3m 7.3%</td>
</tr>
<tr>
<td></td>
<td>£461.0m 100%</td>
<td>£485.1m 100% + £24.1m</td>
</tr>
</tbody>
</table>

This illustration shows the estimated value of the Fund should the revised asset allocation been in place for the last year. It is assumed that no rebalancing would have taken place, so, as the table shows, equities would be under-weight and the bonds component over-weight. In the same way those asset classes not affected by the revision to the strategy (property, private equity and cash) are shown in both valuations at the same level and value.

3.8 Looking forwards the revised strategy will continue to demonstrate stronger growth than the current allocation. The current allocation (that is to say the passive tracker fund managed by UBS) is benchmarked to follow the appropriate FTSE or MSCI index as closely as possible. The revised allocation requires each equities and each bond manager to outperform their benchmark: equities by 2% each year; net; fixed interest by 1% to 2% per annum, net; Hedge Fund of Funds by plus 3% to 5%; and the GTAA mandate by 15% to 30% per annum, net. Even though the allocation to corporate debt is greater than at current, the proportion of equity (and equity-like investments) and the fact that these mandates require that performance exceeds the benchmark should ensure growth in excess of the current benchmark. Indeed, the performance of the Merrill Lynch Sterling Broad Index to the end of July is up 4.54% over 6 months, up 7.88% over 9 months.

3.9 As a reality check it is worth comparing the direction of the Croydon Fund with other LGPS funds and the wider defined benefit universe. Mercer's latest survey of asset allocation of European pension schemes, shows that the average UK pension scheme has an allocation of 54% quoted equities (down from 68% in 2003), 40% bonds, 4% property and 2% 'other' (this includes private equity). For schemes that are open to future accrual, the average allocations are 55% quoted equities, 38% bonds, 2% property and 5% 'other'. In relation to UK local authority schemes in particular, WM carry out a review annually. Their latest review for the year 2008/2009 shows that the average UK local authority pension scheme has an allocation of 62% quoted equities, 20% bonds, 7% property, 3.5% private equity and 7.5% 'other'. As specified above
the Fund’s agreed long term investment strategy is 50% quoted equities, 30% bonds, 7% property, 4% private equity and 9% other (fund of hedge funds, GTAA and cash). The most important decision in setting investment strategy is the split between growth assets and bonds; the relevant comparison is as set out below:

<table>
<thead>
<tr>
<th></th>
<th>Mercer survey (open pension schemes)</th>
<th>WM survey (local authority schemes)</th>
<th>Croydon long term strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth assets</td>
<td>62%</td>
<td>80%</td>
<td>70%</td>
</tr>
<tr>
<td>Bonds</td>
<td>38%</td>
<td>20%</td>
<td>30%</td>
</tr>
</tbody>
</table>

As shown, the long term strategy falls midway between the average UK open pension scheme according to the Mercer survey and the average local authority pension scheme according to WM. The Fund’s investments will be more diversified under the new strategy compared to the current situation (in which 80% of assets are invested in quoted equities alone). Additionally, the 30% bond assets would be invested in an actively managed portfolio with a significant allocation to credit, and hence have a much higher expected return than passive gilts.

4. COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

4.1 The Council Solicitor and Monitoring Officer comments that there are no direct legal considerations arising from this report.

(Approved by: Gabriel MacGregor, Head of Legal Services (Corporate) on behalf of the Council Solicitor and Monitoring Officer).

5. OTHER CONSIDERATIONS

5.1 There are no Customer Focus, Equalities, Environment and Design, Crime and Disorder, and Human Rights and Freedom of Information/Data Protection considerations arising from this report.

6. FREEDOM OF INFORMATION/DATA PROTECTION CONSIDERATIONS

6.1 There are no specific Data Protection considerations arising from this report.

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Finance Department, ext. 88902.

BACKGROUND DOCUMENTS:
None