PAPER F

Purpose: For Decision

Committee report

Committee	**ISLE OF WIGHT PENSION FUND COMMITTEE**
Date	**22 JULY 2020**
Title	**INVESTMENT STRATEGY REVIEW STAGE 2**
Report of	**TECHNICAL FINANCE MANAGER**

EXECUTIVE SUMMARY

1. This report presents a paper from Hymans Robertson LLP setting out stage 2 of the review of the Isle of Wight Pension Fund's investment strategy, following the initial presentation at the Pension Fund Committee meeting on 14 February 2020.

2. The paper will be supplemented by a presentation from representatives of Hymans Robertson.

3. Members are asked to receive the paper and presentation and to agree the recommendations for the next stages of the review of the fund's investment strategy as follows:
   - Confirm the detail of the previously agreed high level changes to the strategic investment allocation.
   - Agree to a rebalancing of UK and Global Equity allocations.
   - Reaffirm the fund's investment beliefs.
   - Commit to undertake development sessions on:
     - the new infrastructure and private debt allocations, to be delivered by subject matter experts.
     - how the fund can improve its understanding of responsible investment (RI) and environmental, social and governance (ESG) risks, and improve the committees monitoring and reporting of the same.
     - how passive management strategies complement active management, and can support ESG considerations.

CONFIDENTIAL / EXEMPT ITEMS

4. The appendix to this report is exempt from disclosure by virtue of paragraph 3 of part 1 of schedule 12A of the Local Government Act 1972 (as amended) as it "relates to financial or business affairs of any particular person", (including the authority holding that information). The public interest in maintaining confidentiality outweighs the public interest in disclosing it. Disclosing the information could place the council at risk of legal challenge from individuals or other bodies identified in the report.

BACKGROUND

5. At its meeting in February 2020, the Committee discussed stage 1 of the investment strategy review, including the output from the supporting Asset Liability Modelling (“ALM”). As part of this review the following changes were agreed:
   - The allocation to growth assets (equities and diversified growth) should be reduced by 10% (proposed 5% from each) in favour of diversifying Income assets.
   - The final split between UK and Global equities would be considered as part of stage 2.
   - A new 5% strategic allocation to both private debt and infrastructure should be introduced, following further developments sessions to increase members’ understanding of those asset classes.

6. The high level strategic allocation agreed at the February 2020 committee meeting is summarised in the table below:

Asset class:	Current allocation %	New allocation %	Change %
UK Equity	22.5	50.0	-5.0
Global Equity	32.5		
Diversified Growth	15.0	10.0	-5.0
Total Growth	**70.0**	**60.0**	**-10.0**
Property	8.0	8.0	-
Infrastructure	0.0	5.0	+5.0
Private Debt	0.0	5.0	+5.0
Total Income	**8.0**	**18.0**	**+10.0**
Corporate Bonds	22.0	22.0	-
Total Protection	**22.0**	**22.0**	**-**
TOTAL FUND	**100.0**	**100.0**	**-**

7. The confidential report at Appendix 1 and the related presentation develop the themes agreed at stage one of the review, and identify areas of focus to progress the changes to the strategy.

8. The report covers each asset class within the proposed new strategic asset allocation detailed above and proposes development activities for the committee to build greater understanding of each of the proposed changes before implementation actions and timetables are agreed.

9. The various proposals within the report, and the resultant revised strategic asset allocation are summarised in the table below, with a summary of the proposals for each asset class in the subsequent paragraphs:

Asset class:	Current allocation %	Change %	New allocation %
UK Equity	22.5	-10.0	12.5
Global Equity	32.5	+5.0	37.5
Diversified Growth	15.0	-5.0	10.0
Total Growth	**70.0**	**-10.0**	**60.0**
Property	8.0	-	8.0
Infrastructure	0.0	+5.0	5.0
Private Debt	0.0	+5.0	5.0
Total Income	**8.0**	**+10.0**	**18.0**
Corporate Bonds	22.0	-	22.0
Total Protection	**22.0**	**-**	**22.0**
TOTAL FUND	**100.0**	**-**	**100.0**

10. This new strategic asset allocation is intended to be a long term direction of travel, to be implemented over the period to the next valuation, at March 2022. In practice it will take some time to access the relevant opportunities and build up the allocation to income assets.

Growth allocation: Equities

11. The report proposes rebalancing the agreed equity allocation of 50% of the fund's asset to give a more balanced regional split of 25% UK and 75% global equities.

12. The report also proposes moving a proportion of the global equity allocation away from active management into a passive fund, which has a specific focus on responsible investment criteria.

13. In support of these proposed changes, development sessions are suggested on active vs passive management styles, and on the proposed Climate Aware passive fund within the ACCESS pool.

Growth allocation: Diversified Growth

14. No further changes to the fund's current diversified growth fund portfolio, with Baillie Gifford through the ACCESS pool, are proposed in the report.

Income allocation: Property

15. No changes are proposed to the fund's current property holding, the Schroder UK Real Estate Fund, at this time, given the general market uncertainty at this time.

16. It is proposed that the fund revisit the appropriateness of the current property allocation in 12-months' time, once the Covid-19 crisis has settled, Brexit negotiations have progressed, and the ACCESS pooling solution for alternative asset classes has been further developed.

Income allocation: Infrastructure and Private Debt

17. The report reiterates the recommendation from the February committee meeting that new allocations of 5% of total assets be created in both infrastructure and private debt.

18. Building on the initial development session delivered after the February committee meeting, it is proposed that further development sessions are held for the committee, delivered by specialists in each of the asset classes, to enhance understanding of the different characteristics of each class, and how each allocation can be implemented.

19. Further discussions are proposed with the council's procurement team around the method by which allocations in these asset classes can be achieved. It is suggested that if the fund were to invest directly, it would need to follow an OJEU-compliant procurement route; whereas if using pooled investments, either a short-list or long-list selection method could probably be used.

20. In the current absence of a suitable pooled solution through ACCESS, it is proposed that any investment is made out-with the pool, and that engagement is maintained with ACCESS to progress the development of suitable pooled investment opportunities.

Protection allocation: Corporate Bonds

21. There is no proposal to amend the fund's current corporate bonds portfolio, the Schroder Institutional Sterling Broad Market Bond Fund, as this fund has consistently outperformed its benchmark.

22. It is recommended that this holding be maintained out-with the ACCESS pool at this time, as there is no direct mapping for this fund into the pool, and the costs associated with transitioning bond portfolios are prohibitive. Engagement should continue with ACCESS to identify a suitable alternative provider in due course.

23. Although many LGPS funds have a separate allocation to Government Bonds, there is no proposal to implement a separate government bond mandate at this time, given the very unattractive valuations of UK bonds. The fund's current mandate includes a small allocation to government bonds, which is deemed sufficient at this time.

RESPONSIBLE INVESTMENT

24. A full section of the report at Appendix 1 is dedicated to responsible investment (RI) and environmental, social and governance (ESG) considerations for the revised investment strategy, as well as specific considerations built into the sections on all asset classes.

25. The committee has a fiduciary duty to act in the best interest of members of the fund. Within the context of these duties, which include controlling risks, they must aim to achieve the best realistic return over the long term; acting as responsible investors is consistent with this aim.

26. Responsible investment has two key dimensions:

    a) **Sustainable investment** – considering the financial impact of ESG factors on the fund's investments.

    b) **Effective stewardship** – through considered voting of shares and engaging with company management as part of the investment process.

27. As well as the asset-class specific proposals above, the report recommends that the committee should review its existing agreed RI objectives (contained in paragraph 40 below), and should consider how it monitors whether actions taken by existing investment managers reflect those beliefs. Members should ensure that they have a clear understanding as to how ESG risks are being managed and monitored by the appointed fund managers.

28. Development sessions are recommended on ESG-adjusted passive equity funds, and on how to better establish the Fund’s exposure to carbon and climate risk and consider the use of exclusions within their investment beliefs.

STRATEGIC CONTEXT

29. The primary objective of the fund is to provide pension and lump sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependents, in accordance with the Local Government Pension Scheme (LGPS) regulations and statutory provisions. The committee aims to operate the fund in such a manner that, in normal market conditions, all accrued benefits are fully covered by the value of the fund's assets and that an appropriate level of contributions is agreed by the employer to meet the cost of future benefits accruing.

30. The fund has agreed the following investment beliefs, which underpin the strategic modelling exercise being undertaken:

    a) The strategic benchmark should be consistent with the committee’s views on the appropriate balance between generating a satisfactory long-term return on investments whilst taking account of market volatility and risk and the nature of the fund’s liabilities.

    b) Strategic asset allocation is the most important component of decision making and it is here that the optimum risk and return profile should be designed and monitored regularly, ensuring managers and mandates remain appropriate for the fund.

    c) The fund's high-level investment strategy and asset allocation should be set by using asset liability modelling in conjunction with each triennial actuarial valuation.

    d) Fees and costs incurred within investment manager mandates are important though the focus is on achieving the best returns net of fees.

    e) Investors are rewarded for illiquidity in private markets. Future liquidity needs must be assessed at each review of asset allocation combined with cash flow projections from the fund actuary.

    f) High conviction active management can improve value over the long-term net of fees, but it is not guaranteed.

    g) Global markets are likely to outperform domestic markets in the long term.

CONSULTATION

31. At this stage, the committee is seeking to agree the methods by which the high level investment strategy will be implemented based on advice received by the fund’s

investment consultants. Once the implementation is agreed, and the investment strategy is finalised, the fund will consult with its stakeholders on the resulting investment strategy statement.

32. Such stakeholders will include employers and scheme members, as well as members of the Pension Fund Committee and Pension Board, members and officers of the council.

FINANCIAL / BUDGET IMPLICATIONS

33. The cost of the review of the investment strategy will be borne directly by the pension fund, and will have no impact on the council's budget. The cost is consistent with the value included in the pricing considerations when the investment consultancy services contract was procured in 2018.

34. The review of the investment strategy forms part of the outcome of the triennial valuation, a planning exercise for the fund, to assess the monies needed to meet the benefits owed to its members as they fall due. It estimates the cost of future liabilities for the members of the fund, and allows the fund to determine the appropriate investment strategy and employer contributions required to ensure that there are sufficient assets to meet those liabilities as they fall due.

35. Setting an appropriate investment strategy forms part of this exercise.

CARBON EMISSIONS

36. The committee believes that the pension fund is a long-term investor and the investments should be able to generate sustainable returns to pay pensions for scheme members. Environmental, social and governance (ESG) issues can have a material impact on the long-term performance of its investments.

37. Development sessions are recommended on how to better establish the Fund's exposure to carbon and climate risk and consider the use of exclusions within their investment beliefs.

RESPONSIBLE INVESTMENT

38. The fund has adopted the following investment beliefs in respect of environmental, social and governance investment considerations:

a) The fund is a long term investor and the investments should be able to generate sustainable returns to pay pensions for scheme members. ESG issues can have a material impact on the long-term performance of its investments.

b) The committee should focus on meeting its financial obligations to pay benefits to members. Financial considerations carry the same weight as non-financial considerations.

c) Long-term sustainable investment returns are an important consideration, even to the extent that the sustainability of returns extends beyond the expected investment horizon of the committee.

d) Responsible ownership of companies benefits long term asset owners. Companies with a clear responsible investment policy are expected to outperform companies without a responsible investment policy, over the longer term.

e) Once pooled the fund will work closely with ACCESS on stewardship and engagement issues including ESG issues and voting rights.

LEGAL IMPLICATIONS

39. Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 required each administering authority to prepare, maintain and publish a written statement of investment principles. With effect from 1 April 2017, following amendments to the 2009 regulations, the statement of investment principles was replaced by an investment strategy statement (ISS).

EQUALITY AND DIVERSITY

40. The council, as a public body, is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation.

41. Implementation of the strategic investment asset allocation has no implications for any of the protected characteristics.

OPTIONS

42. No detailed decisions on investment changes are being proposed at this stage, only the agreement of the next steps in the process for implementation of a new strategy.

43. This new strategic asset allocation is intended to be a long term direction of travel, to be implemented over the period to the next valuation, which will be at 31 March 2022.

RISK MANAGEMENT

44. The fund has adopted the following investment beliefs in respect of risk management:

a) Adopt a strategy to generate sufficient returns to keep the cost of new benefits accruing reasonable and maintain a balance of stable employer contributions and investment risk.

b) Risk should be employed efficiently with a view to generating a required level of risk adjusted return. While risk should be rewarded in the long-term current market conditions should also be a consideration.

c) Appropriate diversification reduces the overall level of dependence on any particular market or asset class and helps manage volatility, particularly in respect of equity markets.

d) The committee believes that it is appropriate to be aware of potential downside risks and consider the role of low risk matching assets within the strategy.

e) Foreign currency exposure is part of managing a global portfolio of investments. There is no strategic hedging of currency exposure from volatile asset classes such as equities as the fund believes this to be of limited benefit to long term investment returns.

f) Pooling represents significant risk to the fund and decisions made should aim to minimise this risk where possible.

g) Transitions between managers and asset classes can result in considerable transaction costs and market risks. It is important such transitions are carefully managed the fund aims to have this managed by the ACCESS pool.

45. Aspects of risk and return will be discussed at the committee meeting in respect of all scenarios considered, with a view to the committee adopting the most appropriate scenario for implementation.

RECOMMENDATION

46. The Committee is asked to receive the report and presentation from Hymans Robertson and to:

a. Confirm the detail of the previously agreed high level changes to the strategic investment allocation.

b. Agree to a rebalancing of UK and Global Equity allocations.

c. Reaffirmation of the fund's investment beliefs.

d. Commit to undertake development sessions on:

i. the new infrastructure and private debt allocations, to be delivered by subject matter experts.

ii. how the fund can improve its understanding of responsible investment (RI) and environmental, social and governance (ESG) risks, and improve the committees monitoring and reporting of the same.

iii. how passive management strategies complement active management, and can support ESG considerations.

APPENDICES ATTACHED

47. Appendix 1 (confidential): Investment strategy review – stage 2.

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