City of Westminster Pension Fund

Investment Strategy Review

May 2020

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Introduction

Investment Strategy Review

This report has been prepared for the City of Westminster Pension Fund Committee ("the Committee"). The Purpose of which is to provide a review of the City of Westminster Pension Fund's (the "Fund") current investment strategy, highlighting our observations that we believe the Committee should consider when deciding on a new investment strategy and detailing our recommendations given our findings.

In this report we provide an update on how the Funds asset portfolio has evolved since 2016, the results of the 2019 Actuarial Valuation and the current investment strategy. A review of the current investment strategy is given through our observations of issues that the Committee should consider and we provide our recommendation given these observations. Finally, a set of next steps the Committee could take is provided.

Recap of the Fund

Recap of the Fund

2016 asset allocation

Asset allocation 30 June 2016

Manager	Asset Class	End Jun 2016 (£m)	End Jun 2016 (%)	Benchmark Allocation (%)
Majedie	UK Equity	250.6	22.8	22.5
LGIM	Global Equity (Passive)	243.2	22.1	22.5
Baillie Gifford	Global Equity	191.3	17.4	25.0
Longview	Global Equity	121.9	11.1	
	Total Equity	**807.0**	**73.4**	**70.0**
Insight	Fixed Interest Gilts (Passive)	18.8	1.7	20.0
Insight	Sterling Non-Gilts	163.2	14.8	
	Total Bonds	**182.0**	**16.6**	**20.0**
Hermes	Property	55.5	5.3	5.0
Standard Life	Property	51.8	4.7	5.0
	Total Property	**107.3**	**10.0**	**10.0**
Cash	In-House Cash	0.3	0.0	**-**
	Total	**1,096.3**	**100**	**100**

Benchmark allocation set to 70% equity, 20% bonds and 10% property, however the long term benchmark allocation includes a 5% allocation to infrastructure, to be funded from the equity portfolio.

Recap of the Fund

Changes to portfolio since 2016 valuation

Changes since 2016 actuarial valuation

2017

2018

Q2 2018

Fully disinvested £191m from Insight Fixed Interest Gilts (Passive) and Insight Sterling Non-Gilts funds due to unfavourable views on active credit. Fund invested in Insight Buy & Maintain Fund.

Q4 2018

Added a 5% multi asset credit allocation, funded from 5% overweight equity allocation. £89m was taken from Longview and invested in the LCIV Multi Asset Credit Fund.

2019

Q1 2019

The long-term strategic benchmark 5% infrastructure allocation (previously held in equities) was implemented with a $91.5m commitment to the Pantheon Global Infrastructure III Fund. To be drawn from Longview.

Q2 2019

£20m was received from the forward funding arrangement. This was invested in the Insight Buy & Maintain Fund.

Q4 2019

The Committee agreed to fully disinvest from the LCIV UK Equity Fund (Majedie), with proceeds temporarily held in the LGIM passive global equity fund. £286m was disinvested from the LCIV UK Equity Fund in November 2019.

2020

Recap of the Fund

2019 asset allocation

Asset allocation

Manager	Asset Class	End Nov 2019 (£m)	End Nov 2019 (%)	Estimated End March 2020 (£)	Estimated End March 2020 (%)	Benchmark Allocation (%)
LCIV	UK Equity (Majedie, active)	9.0	0.6	0.0	0.0	22.5
LGIM	Global Equity (Passive)	646.9	42.4	523.4	39.6	22.5
LCIV	Global Equity (Baillie Gifford, active)	317.4	20.8	276.4	20.9	20.0
Longview	Global Equity (active)	71.4	4.7	55.5	4.2	0.0
	Total Equity	**1,044.7**	**68.5**	**855.3**	**64.8**	**65.0**
Insight	Buy and Maintain Credit	231.5	15.2	219.1	16.6	13.5
LCIV	Multi Asset Credit	93.8	6.2	78.8	6.0	6.5
	Total Fixed Income	**325.3**	**21.3**	**297.8**	**22.0**	**20.0**
Hermes	Core Property	67.1	4.4	62.2	4.7	5.0
Aberdeen Standard	Long Lease Property	67.1	4.4	68.6	5.2	5.0
	Total Property	**134.2**	**8.8**	**130.8**	**9.9**	**10.0**
Pantheon	Global Infrastructure	20.1	1.3	17.8	1.3*	5.0
	Total Infrastructure Equity	**20.1**	**1.3**	**17.8**	**1.3**	**5.0**
Cash	In-House Cash	1.1	0.1	19.0	**1.4**	**-**
Total		**1,525.5**	**100**	**1,320.7**	**100**	**100**

End March allocations are estimated, based on available data.

*Estimated, based on 10% write-down estimate from Pantheon. Accounts for £0.7m distribution in Q1.

Current investment strategy

Current investment strategy

2019 actuarial valuation

Current strategy

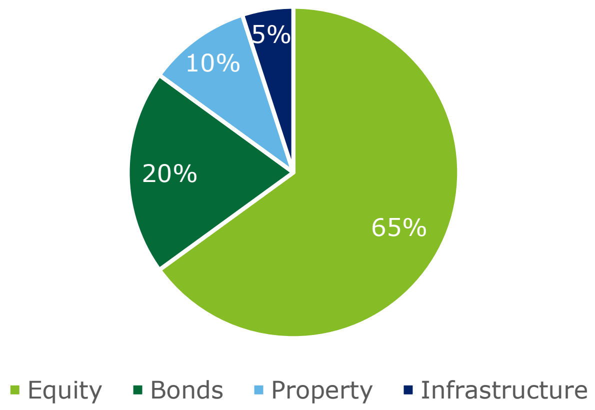
Based on the current strategic benchmark, the Fund's median best estimate expected return is 5.4% p.a., with a volatility of 13.2%. Whilst the 65% strategic allocation to equities contributes positively to the Fund's expected return, this allocation also has the impact of increasing Fund volatility.

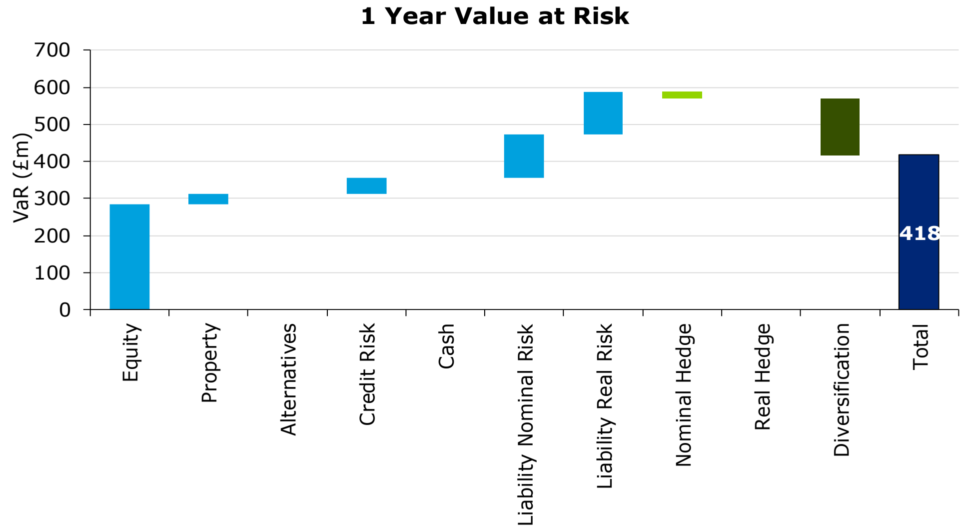
1 Year 95% Value at Risk ("VaR") is a representation of how the deficit/surplus could change given a 1 in 20 year worst case scenario. This analysis is useful as it allows us to quantify the risk within the portfolio and determine as to whether or not the Fund could withstand such an event.

Based on our stochastic model, we estimate the Fund to have a VaR of £418m.

Key metrics	
Expected return	5.4% p.a.
Volatility	13.2%
1 year 95% Value at Risk	£417.7m

Current benchmark allocation





Current investment strategy

2019 actuarial valuation

Funding level

As at 31 March 2019, the Council’s funding level stands at 86% - increasing from 70% as at 31 March 2016. The Council plans to pay off its past deficit of c. £152m (as at 31 March 2019) in 2021/22.

The funding position of the whole Fund, including the Council, was 99% as at 31 March 2019. This represents an increase in funding level of 19% since 31 March 2016 where the funding position stood at 80%.

Funding position as at 31 March 2019	
Westminster City Council	86%
Total Fund	99%

Source: Copy of SLT Pensions Survey

Forward funding arrangement

The Fund received a £20m payment in Q2 2019 through a forward funding arrangement, which was invested in the Insight Buy & Maintain Fund. Through the same forward funding arrangement, it is expected that a further £80m will be received in April 2021. Deficit recovery payments are expected to be £23m, c. £14m of which will be an upfront sum.

Current investment strategy
Issues to consider

Reliance on equity markets

The Fund’s current strategic benchmark includes a 65% allocation to equities, with the actual allocation being almost in line. The Fund’s infrastructure mandate with Pantheon is still in drawdown, with c. £50m still to be drawn. This is to be funded from equities, in particularly Longview, which had c.£55m as at 31 March 2020. We estimate that once Pantheon is fully drawn, the equity allocation will be c. 62%.

Given the change in funding level over the past three years, the Committee should consider whether the overall equity allocation and structure of the equity portfolio is still appropriate.

Diversification

As shown on the earlier VaR chart, the Fund has little risk reduction from diversification.

While the fund has allocations to credit, property and infrastructure, there is scope to add further diversification, particularly with the use of more illiquid asset classes.

Approximately 84% of the Fund’s assets are daily liquid, with a further c. 15% in monthly liquid funds. Only 5% of the benchmark allocation is in a long term illiquid strategy and therefore benefitting from the illiquidity premium available to pensions schemes with a long term time horizon.

Current investment strategy
Cashflow considerations

Forward funding arrangement

As mentioned earlier in this paper, £20m was received in Q2 2019 and invested in the Insight Buy & Maintain Fund. A further £100-110m is expected to be received in April 2021.

Annual cashflow deficit

Based on estimations of the Fund's outgoing cashflows and projected contributions and receipts, the Fund is expected to be in an annual cashflow deficit of **£10-11m** in future years. This does not take into account funds received from the forward funding arrangement.

Next year, the Fund is expected to receive a £23m deficit recovery contribution, £14m of which will be an upfront sum. Approximately £10m of the £80m forward funding arrangement to be paid in April 2021 is currently earmarked to be used to cover the expected annual cashflow deficit. Based on this, the Fund should have no requirement to take income from the investment portfolio for the next two years. However beyond this period, the Fund may need regular income distributions from its investments. This is also under the assumption that current income from the portfolio continues to be distributed.

Currently, the Fund receives income from both Hermes and Pantheon. Hermes distributes a variable quarterly amount based on rents collected, whilst Pantheon distributes variable amounts at various timings dependent on the underlying investments. Based on Hermes' current running yield of 3.2% and Pantheon's expected yield of 5.0%, we estimate that the Fund currently receives an income of **c. £3.1m per annum**. If the Fund was invested in line with the strategic benchmark (i.e. the Pantheon mandate fully drawn) we estimate the Fund would receive an income of **c. £6.3m** each year.

It should be noted that Hermes have the discretion to defer income for up to three quarters.

Liquidity

The Fund holds c. £20m in cash within a Northern Trust account. This account is used to hold liquidity to cover transfer values and other miscellaneous payments.

Current investment strategy
Cashflow considerations

Generating income

The table below shows the potential income that could be received from each fund within the remainder of the portfolio, not including Hermes and Pantheon. Whilst income for the majority of the Fund's portfolio is currently re-distributed back into each fund, each strategy has a distributing shareclass or equivalent which can be "switched on" relatively easily with no added cost.

Fund	Estimated yield p.a.	Income p.a. if invested as strategic benchmark	Timing	How to switch on
LCIV Global Alpha	c. 1.0% (based on dividends)	£3.1m	Quarterly (end March, June, September and December)	Subscription form
LGIM Global Equity	c. 2.5% (via NIS facility)	£17.2m	Monthly	Signed instruction
Insight Buy & Maintain	c. 2.2%	£4.5m	Quarterly (up to 20 days after end February, May, August and November)	Subscription form
LCIV MAC	c. 0.5% (based on income, net of expenses)	£0.5m	Once per annum in February	Subscription form
ASI Long Lease Property	c. 4.1%	£3.1m	Quarterly (end January, April, July, November)	Side letter
Total		**c. £28.4m**		

Strategy proposal

Strategy proposal
Possible solutions

Strategic allocation

We modelled three alternative strategies alongside the current strategic benchmark, with a theme focussing on reducing the equity risk and increasing portfolio diversification. The three strategies' asset allocations are provided in the table below, alongside expected return, volatility and Value at Risk figures of each strategy:

	Current	Strategy 1	Strategy 2	Strategy 3
Equity	65%	60%	55%	50%
Fixed income	20%	25%	25%	25%
Property	10%	10%	10%	10%
Infrastructure	5%	5%	5%	10%
Illiquid Alternative	-	-	5%	5%
Expected return	5.4%	5.2%	5.2%	5.1%
Volatility	13.2%	12.8%	12.6%	12.3%
Value at Risk	£417.7m	£403.6m	£392.7m	£382.0m

As the table shows, all three alternative strategies have slightly lower best estimate returns. We feel a slight reduction in the expected return is appropriate given the current funding position. Importantly, each strategy has significantly lower volatility as a result of reducing the equity allocation and increasing diversification, in particular making use of illiquid alternatives.

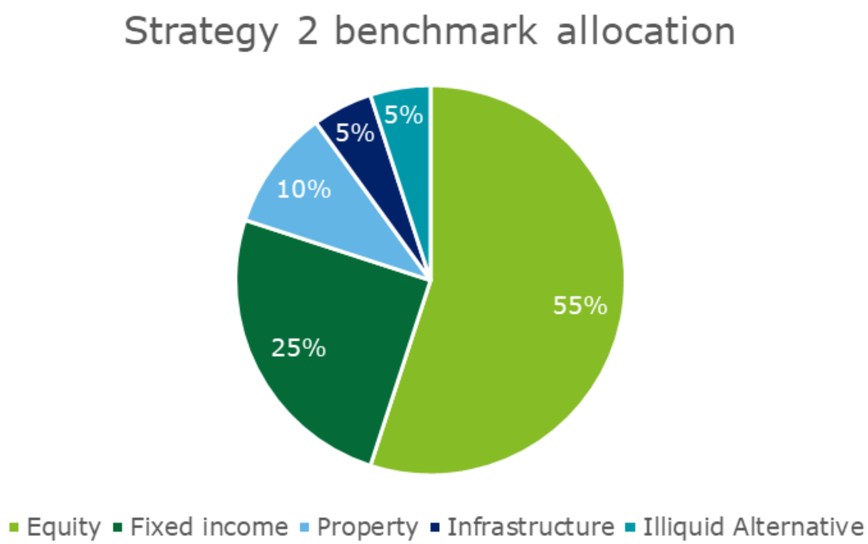
Strategy proposal
Strategy 2

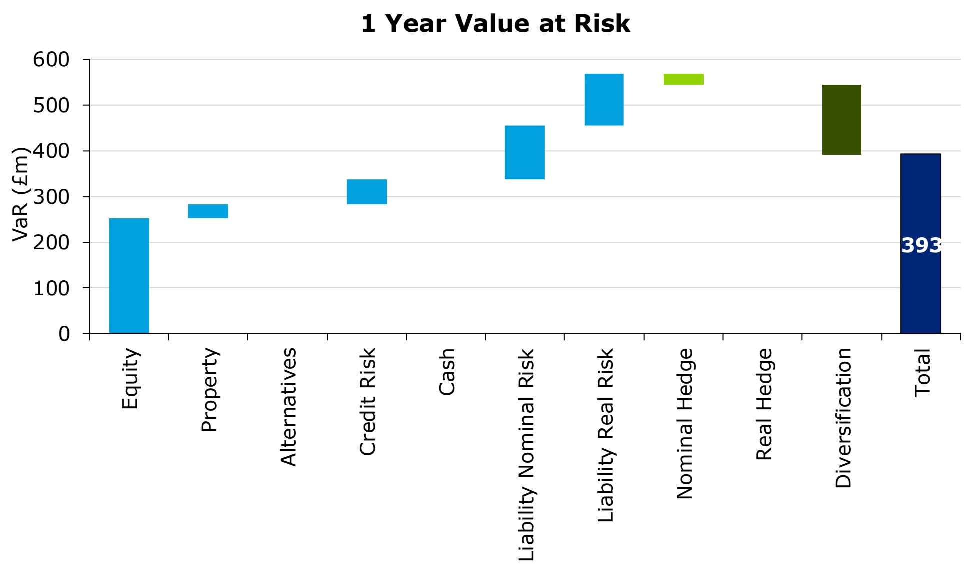
To implement Strategy 2, the Fund would be required to:

Decrease the equity allocation by c. 7%	Make a c. 3% allocation to a new fixed income strategy / rebalance the existing portfolio	Make a 5% allocation to a new illiquid alternative

This would result in:

A 0.2% decrease in expected return	A 0.6% decrease in expected volatility	A c. £30m decrease in equity portfolio Value at Risk





Conclusion

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Recommendations and next steps

Investment strategy

The Committee should discuss and agree the most appropriate strategic allocation for the Fund going forward. We have recommended a strategy which we believe is suitable for Fund given the funding position and current investment markets. Specifically we have suggested:

1. Reducing the strategic equity allocation by c. 10% to 55%, increasing the fixed income allocation to 25% and introducing a 5% allocation to a new illiquid alternative.
2. Consider Renewable Infrastructure as a new illiquid alternative. This may require training on the asset class ahead of assessing suitable strategies.
3. Consider whether the 5% increase to fixed income should be to a new mandate or to rebalance the existing portfolio.
4. Following the real estate training session, review the appropriateness of the current property portfolio and agree next steps and consider whether a residential property allocation may offer more diversification than the current long lease mandate.
5. Review the equity portfolio and in particular, give consideration to adding a new mandate that would compliment the Baillie Gifford fund.

Risk Warnings

- Past performance is not necessarily a guide to the future.
- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy would incur some costs.
- Any recommendations in this report should not be viewed as a guarantee of future performance.

Deloitte.