City of Westminster

Committee Report

Decision Maker:	**PENSION FUND COMMITTEE**
Date:	**25 June 2020**
Classification:	**General Release**
Title:	**Strategic Investment Strategy Review**
Wards Affected:	**All**
Policy Context:	**Effective control over council activities**
Financial Summary:	**There are no direct financial implications arising from this report.**
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1. EXECUTIVE SUMMARY

1.1 This report details the revised investment strategy review undertaken by the Fund's investment adviser, Deloitte, shown as Appendix 1.

1.2 A review of the current investment strategy has been undertaken, highlighting observations and recommendations to contemplate when considering the new investment strategy.

1.3 Following the meeting on 13 May 2020, a revised investment strategy has been compiled, following discussion with the Committee and the Chairman of the Committee regarding the direction of the investment strategy and proposed future changes to be considered going forward.

2. RECOMMENDATIONS

The Committee is recommended to:

a) Agree the strategic benchmark allocation.

b) Agree to the proposed diversification of the equity portfolio, making use of active management.

c) Consider an alternative property investment to replace Hermes.

d) Reduce the equity allocation by 5% to 60%, with 5% invested within renewable infrastructure.

3. PROPOSALS AND ISSUES

Current Investment Strategy

3.1 The Fund's current strategic asset allocation is as follows:

- 65% allocated to equities;
- 20% allocated to fixed income;
- 10% to property; and
- 5% to infrastructure.

3.2 Whilst the 65% allocation to equities has contributed positively to the Fund's performance, this allocation has also increased the Fund's volatility.

3.3 The overall funding level of the Fund has improved by 18% to a 99% fund level at 31 March 2019 compared with 31 March 2016, with the Council's own funding level increasing by 16% during this period to 86%. The Council plans to pay off its deficit by 2021/22, with £22.7m deficit contributions expected in 2020/21 and £80m during 2021/22.

Proposed strategy and implementation

3.4 As per the attached Deloitte strategy review, there is scope to increase diversification within the portfolio as well as consideration of the overall risk level being taken. However, this should be balanced with the need to keep the cost of future accrual down with a higher returning investment strategy.

3.5 The proposed strategy, shown as Appendix 1, would result in a strategic asset allocation as follows:

- 60% allocated to equities;
- 20% to fixed income;
- 10% to property;
- 5% to infrastructure; and
- 5% within renewable infrastructure.

Equity Allocation

3.6 As at 30 April 2020, the actual allocation to equities was 66% (overweight by 1%). This comprises of 62% within the LGIM Global Passive fund, 32% within Baillie Gifford Alpha Growth fund and 6% within Longview Global Equity Unhedged fund. The Longview mandate will be gradually sold

down and transitioned into the Pantheon Global Infrastructure Fund over the next 24 months.

3.7 The Fund has a large allocation to equity, the majority of which is invested passively within the LGIM global fund index-tracker (FTSE All World). Given developments in markets over the past few months in reaction to the global COVID-19 pandemic, and possible dislocations among sectors going forward, the Committee should consider whether switching to actively managed funds would better position the Fund.

3.8 In order to improve diversification within this asset class, it is suggested that a third global equity manager is selected to complement the other two managers. When selecting a new equity manager, the Pension Fund Committee should consider the options available on the London CIV platform and may also want to consider funds with an ESG specific approach.

Fixed Income Allocation

3.9 The Fund's actual asset allocation as at 30 April 2020 to fixed income was 22% (overweight by 2%), with 16% invested within the Insight Buy and Maintain Bond portfolio and 6% to the LCIV CQS Multi Asset Credit fund.

3.10 The Insight bond mandate is expected to deliver a cash yield of 2% to 2.5% per annum and the nature of the Buy and Maintain fund means management fees are kept low. The average credit rating of the portfolio is A/BBB, with 95% allocated to investment grade bonds.

3.11 The LCIV CQS MAC fund is benchmarked against three-month Libor+4%. Given the large mark to market movements following the outbreak of COVID-19, the performance of the Fund has been relatively disappointing. However, it should be noted there were not any defaults within the portfolio during Q1 of 2020, and the default rate since inception to 31 December 2019 was 0.33%. In comparison, the default rate on the wider US high yield and European high yield market over the same period was 5.72% and 3.04% respectively.

3.12 The Insight mandate is a secure flow of steady income and offers protection in volatile markets, given the investment grade quality of the portfolio. Deloitte and the London CIV continue to monitor developments at CQS closely following volatile performance and changes to senior management within the business. Taking into account uncertainty around the business, the volatility in the market and the Fund's requirement for yield, it is recommended that any reduction to fixed income be funded from CQS rather than Insight.

Property Allocation

3.13 As at 30 April 2020, the actual allocation to property was 9% (1% underweight) with 5% within the Aberdeen Standard Long Lease Property fund and 4% in the Hermes Property Unit Trust.

3.14 Aberdeen Standard invests in long lease property assets, where much of the return comes from rental income. The average unexpired lease length of the fund is 25 years, with over 90% of the fund's income having fixed CPI or RPI-linked uplifts. However, it should be noted that as at 31 March 2020, the largest sector exposures were to offices (25.9%) and retail (23.2%).

3.15 The Hermes fund invests in core UK property, with returns driven by capital appreciation rather than rental income. The average unexpired lease length as at 31 March 2020 was seven years, with the largest sector exposures being offices (37%), industrial (30%) and retail (17%).

3.16 Following volatility in property markets caused by the COVID-19 outbreak, poor performance in Q1 of 2020 is unlikely to reflect the true capital depreciation in property values. With few transactions taking place in the market, valuers are reluctant to put a reliable valuation on properties, meaning the true impact is likely to be felt in the coming months.

3.17 Given the significant exposure to the office and retail sectors across both Aberdeen Standard and Hermes, the Committee should give consideration to reducing this and diversifying into another sector of the property market. During this period of uncertainty following the COVID-19 outbreak, the Aberdeen Standard strategy has appeared more robust with a collection rate of circa 90% for rents. It should also be noted that the long lease fund is currently "locked up".

3.18 There is potential within the real estate asset allocation, other than the core and long lease property mandates, which may be more attractive in the current market. Given that the core and long lease mandates are starting to look increasingly similar, moving into residential property or affordable housing could offer another form of diversification.

Infrastructure Allocation

3.19 The Fund had 1% (4% underweight) invested within the Pantheon Global Infrastructure Fund as at 30 April 2020, which is benchmarked against three-month LIBOR+8%. As at 30 April 2020, the Fund's commitment was 28% drawn (circa £20m), with the remainder expected to be drawn down over the next two years. Once fully invested, we would expect the Pantheon Infrastructure Fund to distribute a 5% cash yield.

3.20 Although still in its drawdown phase, the mandate remains on course to deliver its objectives. Given the large-cap assets in the fund and

diversification amongst primary and secondary transactions, there is scope to increase the overall allocation to infrastructure by 5%, investing in the renewable infrastructure sector, providing it is invested in brownfield assets with minimal leverage. This would also provide a stable, contractual income for the Fund from the outset of the investment.

3.21 With the UK government's pledge to target net zero greenhouse gas emissions by 2050, a significant amount of investment is required within the renewable infrastructure space. There are a number of specialist managers targeting renewable developments. Given the large commitments flowing into core infrastructure assets, these speciality managers can gain a competitive advantage. It should be noted that investors should be willing to accept the development risk that comes with this asset class, which can offer higher returns but with a greater risk of default.

4 PROPOSALS AND ISSUES

4.1 Following the global COVID-19 outbreak during Q1 of 2020, global equity markets have been significantly impacted and have seen the greatest fall in equity markets since the financial crisis of 2008.

4.2 As at 12 June 2020, the FTSE 100 index has fallen 19% from 31 December 2019. Globally, markets have also seen massive falls in market value, with the Dow Jones Industrial average index falling by 10% over the same period. However, global markets have recovered somewhat in the period following mid-March 2020, although this seems to have slowed with the Dow Jones falling 7% from 8 June 2020 to 12 June 2020.

4.3 Despite the market volatility of the last few months, equity markets have been calmer in recent weeks, with the "fear index", the Vix, falling back considerably from highs of 83 on 16 March 2020 to 28 at 31 May 2020.

4.4 Therefore, the Pension Fund Committee should take into consideration the timings of any potential transitions within equity allocations as the ongoing impact of the COVID-19 on global markets is currently unknown.

5 RECOMMENDATIONS AND NEXT STEPS

5.1 The Committee should discuss and agree the most appropriate strategic asset allocation for the Fund going forward. The following proposals, as recommended by the investment advisor, should be taken into consideration:

a) Agree the strategic benchmark allocation.

b) Diversify the equity portfolio, making use of active management.

c) Consider an alternative property investment to replace Hermes.

d) Reduce the equity allocation by 5% to 60%, with 5% invested within renewable infrastructure.

5.2 Upon agreement of the above recommendations, a timeline for implementation, setting out a plan for 2020 in order of preference, will be established.

If you have any questions about this report, or wish to inspect one of the background papers, please contact the report author:

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BACKGROUND PAPERS:

None

APPENDICES:

Appendix 1: Follow up Strategy Considerations