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City of Westminster Pension Fund

Follow-up strategy considerations

Introduction

This paper has been prepared for the City of Westminster Pension Fund (the "Fund") and follows-on from the Investment Strategy Review Report, presented by Deloitte to the Pension Fund Committee (the "Committee") at the Pension Fund Committee Meeting on 13 May 2020. This paper has been written following discussion with the Committee and the Chair of the Committee regarding the direction of the investment strategy and proposed future changes to be considered going forward.

At the last Triennial Funding Valuation, at 31 March 2019, the total Fund's funding position was 99%, with the Council's funding level at 86%, an increase from 80% and 70% respectively as at 31 March 2016. The Council also plans to pay off its deficit of c. £152m (as at 31 March 2019) in 2021/22 via a forward funding arrangement.

There is scope to increase diversification within the portfolio as well as consider 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.

Equity allocation

The Fund's strategic benchmark allocation to equity is 65%. As at 30 April 2020, the actual allocation was 66%. The equity allocation is invested in a passive mandate with LGIM, tracking the FTSE AW Index GBP hedged (c. 62% of the total equity exposure), an active mandate with Baillie Gifford that aims to outperform the MCSI AC World Index by 2% p.a. (c. 32% of the equities) and an active mandate with Longview that aims to outperform the MSCI World Index (c. 6% of the equities).

The c. £60m invested in Longview will be gradually sold as the infrastructure investment with Pantheon ramps up. Once fully allocated, this will leave the equity allocation at c. 62% (not allowing for market moves).

Considerations: *The Fund has a large allocation to equity, the majority of which is invested in a benchmark-tracking mandate. 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.*

The Committee should note that the equity allocation remains the significant driver of returns, noting the significant improvement in funding position. Our initial strategy recommendation in January advised a reduction in equity allocation from 68%, which has reduced with market movements this year. That said, diversification between two or possibly three actively managed funds would reduce manager-risk across the equity portfolio and using strategies with complementary styles would increase diversification and help support an overall equity allocation of 60%.

Fixed income allocation

The Fund's strategic benchmark allocation to fixed income is 20%, broadly invested two-thirds with an investment grade, buy and maintain credit mandate (Insight) and one-third with a multi asset credit mandate (LCIV, managed by CQS).

The Insight mandate is expected to deliver a cash yield of 2% - 2.5% p.a., taking a credit spread of c. 150bps above UK government bonds. The buy and maintain nature of the mandate means management fees, and running costs (such as transition and ongoing portfolio management) are kept low. The average credit rating of the portfolio is A/BBB, with vast majority being investment grade (c. 95%).

The LCIV multi asset credit mandate, managed by CQS, invests across US and European high yield bonds and leveraged loans, with the aim of delivering an absolute return of Libor + 4% - 5% p.a. over a 5 year cycle. The absolute return target has meant that relative performance has been disappointing, with mark-to-market movements being particularly volatile. That said, the strategy did not incur any defaults over the market falls in Q1 and since inception (January 2013) the fund outperformed a blended high yield/loan benchmark (4.8% p.a. vs 4.3% p.a.) to 31 December 2019. The default rate on the strategy since inception to 31 December 2019 was 0.33%, with an actual loss rate of 0.29%. 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%.

Considerations: *The Fund's overall allocation to fixed income is overweight (c. 22%). The Insight mandate is a secure flow of steady income and offers protection in volatile markets, given the investment grade quality of the portfolio.*

CQS was placed 'on watch' by the London CIV in July 2019, however in March 2020 LCIV confirmed that the mandate was no longer under review following an improvement in performance, although close monitoring would continue. CQS as a firm has seen significant change in recent months. It was reported that a number of CQS' hedge funds, managed by Sir Michael Hintze, incurred significant losses over March and April, and in May CQS announced the equity hedge fund business would spin-off from CQS into its own standalone firm. It was also reported that Serge Harry, Deputy CEO, was to step down in July with Sir Michael Peat, Chair of CQS' Board of Directors and Executive Committee assuming responsibilities.

We continue to monitor developments at CQS closely and are also discussing this matter with LCIV. Taking into account the uncertainty around the business, the volatility in the market and the Fund's requirement for yield, we would recommend that any reduction to fixed income be funded from CQS rather than Insight.

Property allocation

The Fund has a 10% strategic benchmark allocation to property, split equally between Aberdeen Standard Investments (ASI) and Hermes. ASI's mandate 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. As at 31 March, the largest sector exposures were to offices (25.9%) and retail (23.2%).

Hermes invests in UK core property, where expected return is driven more by capital appreciation than income. The average unexpired lease length as at 31 March 2020 was 7 years with the largest sector exposures being offices (37%), industrial (30%) and retail (17%).

Considerations: *Headwinds affecting the UK property market are strengthening. UK commercial property was already in decline during 2019, with consistent capital depreciation throughout the year led by the retail sector which fell 12%. Unsurprisingly, UK property was not immune to the volatility caused by the Covid-19 outbreak, resulting in negative returns in Q1 of this year. However, poor performance in Q1 is unlikely to reflect the true extent of capital depreciation. 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.*

There is also potential for a longer term impact on valuations, particularly to certain sectors such as offices and supermarkets, where valuations were particularly high and assets are rather 'uniquely' vulnerable to a change in dynamics and/or occupier demand going forward. The retail sector in particular has been evolving in recent years in response to changes in consumer behaviour. These trends may well accelerate as a result of the Covid-19 outbreak.

Given the significant exposure to the office and retail sectors across both ASI and Hermes, the Committee should give consideration to reducing this and diversifying into another sector of the property market. We would suggest ASI's mandate as being more 'robust' to withstand valuation pressures given the length of leases and demand for this area of the market. The strategy has also

appeared stronger than Hermes' throughout the Covid-19 outbreak, with ASI collecting c. 90% of rents in Q2 and Hermes collecting closer to 70%.

There are other opportunities, such as residential housing and/or affordable living, which the Committee may want to consider. While still exposed to the UK property market, this would offer some diversification from commercial property and in particular, the office and retail sector. This may also support the Fund's Responsible Investment Policy.

Infrastructure allocation

The Fund currently has a 5% strategic benchmark allocation to infrastructure, invested with Pantheon's Global Infrastructure Fund III ("PGIF"). PGIF invests across infrastructure primary, secondary and co-investment assets. As at 30 April, the Fund's $91.5m (c. £73m) commitment was 28% drawn (c. £20m), with the remainder expected to be drawn down over the next 24 months. Once fully invested, we would expect PGIF to distribute a 5% cash yield.

Considerations: *Although still in 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 investing in the renewable infrastructure sector, provided it was investing in brownfield assets (i.e. taking no development risk) with minimal leverage. This would also provide a stable contractual income for the Fund from the outset of the investment.*

With Governments around the world having pledged to tackle climate change, development in renewable power sources is in high demand and requiring investment. Whilst core infrastructure funds have been investing in renewable assets over many years, and are doing so increasingly, there are a number of specialist managers and funds that are targeting renewable developments specifically.

In the UK alone, BloombergNEF estimates that £188bn of investment is required in renewable infrastructure. With the UK now targeting net zero greenhouse emissions by 2050 (the first G7 nation to legislate for this objective), the Committee on Climate Change targets indicate that the investment required may be as high as £660bn. Regardless of the number, there is obvious demand for renewable infrastructure and private investors will play a key role in funding projects. At the same time, the cost of leading renewable technologies has decreased significantly since 2010 (for example, the cost of solar technology has fallen 85%) further increasing the availability of investment opportunities.

Conclusion

In summary, the funding position has improved significantly and given the forward funding arrangement, the Fund should be in a very healthy funding position. We believe the three key points of discussion are:

- Agree the strategic benchmark allocation for the strategy as a whole.
- Diversify the equity portfolio, potentially making use of active management.
- Consider an alternative property investment to replace Hermes.
- Consider a 5% allocation to renewable infrastructure. This could be funded by reducing overweight positions in the portfolio such as Longview and CQS.

We look forward to discussing this with the Committee on 25th June 2020.

Deloitte Total Reward and Benefits Limited

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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 will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

Our advice will be specific to your current circumstances and intentions and therefore will not be suitable for use at any other time, in different circumstances or to achieve other aims or for the use of others. Accordingly, you should only use the advice for the intended purpose.

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