Leicestershire County Council

Meeting:	**Local Pension Committee**
Date/Time:	**Tuesday, 17 January 2017 at 9.30 am**
Location:	**Framland Committee Room, County Hall, Glenfield.**
Contact:	**Mr. M. Hand (Tel. 0116 305 6038)**
Email:	**matthew.hand@leics.gov.uk**

AGENDA

Item		Report By	Marked
1.	Appointment of Chairman		
2.	Election of Vice Chairman		
3.	Minutes of the meeting held on 15 November 2016.		(Pages 3 - 10)
4.	Question Time.		
5.	Questions asked by members under Standing Order 7(3) and 7(5).		
6.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
7.	Declarations of interest in respect of items on the agenda.		
8.	Market Outlook.	Independent Investment Advisor	(Pages 11 - 16)
9.	Strategic Investment Benchmark and Portfolio Structure of the Fund.	Director of Corporate Resources	(Pages 17 - 48)

10.	Draft Investment Strategy Statement.	Director of Corporate Resources	(Pages 49 - 58)
11.	Draft Funding Strategy Statement.	Director of Corporate Resources	(Pages 59 - 98)
12.	Any other items which the Chairman has decided to take as urgent.		
13.	Exclusion of the Press and Public. The public are likely to be excluded during consideration of the last item on the agenda in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information).		
14.	Potential Investment with Partners Group - Private Debt Investments. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Director of Corporate Resources	(Pages 99 - 142)

TO:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. P. C. Osborne CC

Leicester City Council

Cllr Deepak Bajaj and Cllr Lynn Moore

District Council Representatives

Cllr. Malise Graham MBE
Cllr. N. Frost

University Representative

Mr. J. Shuter

Staff Representatives

Mr. R. Bone
Mr. N. Booth
Ms. J. Dean

Leicestershire County Council

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Tuesday, 15 November 2016.

PRESENT:

Leicestershire County Council

Mr. P. C. Osborne CC (Chairman)
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. T. J. Pendleton CC

Leicester City Council

Cllr Lynn Moore

District Council Representative

Cllr. M. Graham MBE
Cllr. C. Frost

Staff Representatives

Mr. N. Booth
Mr. R. Bone
Ms. J. Dean

Independent Advisers and Managers

Mr. S. Jamieson Independent Investment Advisor

486. Minutes of the previous meeting.

The minutes of the meeting held on 2 September 2016 were taken as read, confirmed and signed.

487. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

488. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

489. Urgent Items.

There were no urgent items for consideration.

490. Declarations of interest.

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting. No declarations were made.

491. Summary Valuation of Pension Fund Investments and Investment Performance of Individual Managers.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present a summary valuation of the Fund's investments at 30 September 2016. A copy of the report is filed with these minutes, marked '6'.

The Director reported that, similar to the previous quarter, the Fund had grown during the three month period 30 June to 30 September with its value increasing by 6.2%. It was noted that overall, the performance of the Fund's investment managers over the last three years was encouraging, with the majority of investments on or above the expected benchmark performance.

RESOLVED:

That the report be noted.

492. Pension Fund Annual Report and Accounts 2015/16.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to present the Annual Report and Accounts of the Pension Fund 2015/16 for approval. A copy of the report is filed with these minutes, marked '7'.

Following discussion, the following points were noted;

- The Fund's membership had grown over the past year and was expected to continue to do so following the introduction of auto- enrolment;

- Every three years the Fund was required to undertake an Actuarial Evaluation (an independent valuation of the scheme's assets used to calculate the amount needed to pay the pension rights already accrued under the scheme). Although the 2016 valuation results were not yet known, there was an expectation that it would be necessary for the Fund's employer contribution rate to rise as the Actuary sought to bring the Fund closer to a fully funded position.

RESOLVED:

That the Pension Fund Annual Report and Accounts for 2015/2016 be approved.

493. Initial Indication of 2016 Actuarial Valuation Outcome and Results of Standardised Assumptions.

The Committee considered a report of the Director of Corporate Resources, the purpose of which was to provide members with an early indication of the funding level of the Leicestershire County Council Pension Fund at 31 March 2016 and to advise on the outcome of the valuation calculated using the standard assumptions required by the Local Government Pension Scheme (LGPS) Advisory Board. A copy of the report marked '8' is filed with these minutes.

Arising from discussion the following points were noted;

- Despite the Fund's overall funding position improving since the last Actuarial Valuation in 2013, negative impacts such as lower assumptions for future investment returns and increased liabilities had resulted in the estimated cost of paying for future service as it accrued increasing substantially from 18.2% to 21.8% of pay;

- When calculating the Fund's future funding ratio, the Actuary had assumed a future investment return of 4.1% whilst the standardised assumption valuation conducted by the LGPS Advisory Board presumed a return of just over 5%. This more optimistic assumption led to the Advisory Board calculating Leicestershire's funding level to be at 92% which compared favourably with the Fund Actuary's calculation of 76%.

RESOLVED:

That the report be noted.

494. Proposed Governance of LGPS Central Investment Pool.

The Committee considered a report of the Director of Corporate Resources the purpose of which was to seek approval for a proposed governance structure for the Local Government Pension Scheme Central Investment Pool which would hold the assets of eight midlands based Local Government Pension Scheme (LGPS) Funds including those of the Leicestershire Fund. A copy of the report marked '9' is filed with these minutes.

The Director reported that whilst there was still a considerable amount of work to complete before 1 April 2018 pooling deadline, the establishment of the Central Investment Pool was progressing well.

Arising from discussion the following points were noted;

- The governance proposals for the LGPS Central Pool had been developed in accordance with guidance issued by the Chartered Institute of Public Finance and Accountancy and complied fully with its operational principles;

- The proposed structure of the LGPS Central Pool, which would need to be approved by all eight member funds, would provide a transparent approach to managing the fund's investments, befitting its public sector nature;

- Whilst the new pooling arrangements would mean the Leicestershire Fund would no longer appoint its own investment managers which would become a responsibility of the pool, the Fund would still maintain total control over the types of asset it invested in and each investment amount.

RESOLVED

a) That the Chairman of the Local Pension Committee act as the Fund's representative on the Shareholders' Forum, with the Vice-Chairman acting as a substitute;

b) That the establishment of a Joint Committee for LGPS Central, comprising one representative from each of the eight Funds, plus an independent Chairman for at least the first year be supported, noting that its establishment will be subject to support from the other seven administering authorities which form LGPS Central;

c) That the Chairman of the Local Pension Committee act as the Fund's representative on the Joint Committee, with the Vice-Chairman acting as a substitute;

d) That subject to the establishment of a Joint Committee for LGPS Central, a Practitioners Advisory Forum be established, comprising of one officer representing each of the eight Funds and that the County Council's Section 151 officer or his nominee be appointed to serve on the Advisory Forum;

e) That the Constitution Committee and County Council be recommended to support the establishment of a Joint Committee and Shareholder Forum and agree to the Chairman of the Local Pension Committee acting as the Funds representative on both bodies with the Vice Chairman acting as a substitute.

495. Market Updates - Reports of the Independent Advisor and Kames Capital.

The Committee considered two presentations concerning global market conditions which were presented by the Fund's Independent Investment Advisor. A copy of the presentations, marked '10' are filed with these minutes.

RESOLVED:

That the updates be noted.

496. Exclusion of the Press and Public

RESOLVED:

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the remaining items of business on the grounds that they involve the likely disclosure of exempt information as defined in paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Act.

497. Kempen Capital Management - Manager Note by the Independent Investment Advisor.

The Committee considered an exempt report of the Independent Investment Advisor which detailed the investment programme operated by one of the Leicestershire Fund's investment managers, Kempen Capital Management. A copy of the report marked 13 is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

498. Kempen Capital Management Quarterly Report.

The Committee considered an exempt report by Kempen, a copy of which marked '14' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

499. Aspect Capital Quarterly Report.

The Committee considered an exempt report by Aspect, a copy of which marked '15' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

500. Stafford Timberland Quarterly Report.

The Committee considered an exempt report by Stafford Timberland, a copy of which marked '16' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

501. KKR Quarterly Report.

The Committee considered an exempt report by KKR Quarterly, a copy of which marked '17' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

502. Kleinwort Benson Investors Quarterly Report.

The Committee considered an exempt report by Kleinwort Benson, a copy of which marked '18' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

503. Ruffer Quarterly Report.

The Committee considered an exempt report by Ruffer, a copy of which marked '19' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

504. Pictet Quarterly Report.

The Committee considered an exempt report by Pictet, a copy of which marked '20' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

505. Millennium Global Quarterly Report.

The Committee considered an exempt report by Millennium Global, a copy of which marked '21' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

506. IFM Investors Quarterly Report.

The Committee considered an exempt report by IFM Investors, a copy of which marked '22' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

507. Delaware Investments Quarterly Report.

The Committee considered an exempt report by Delaware Investments, a copy of which marked '23' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

508. JP Morgan Quarterly Report.

The Committee considered an exempt report by JP Morgan, a copy of which marked '24' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

509. Aviva Investors Quarterly Report.

The Committee considered an exempt report by Aviva, a copy of which marked '25' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

510. Legal and General Investment Manager Quarterly Report.

The Committee considered an exempt report by Legal and General, a copy of which marked '26' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

511. Ashmore Quarterly Report.

The Committee considered an exempt report by Ashmore, a copy of which marked '27' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

512. Kames Capital Quarterly Report.

The Committee considered an exempt report by Kames Capital, a copy of which marked '28' is filed with these minutes. The report was not for publication by virtue of paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the report be noted.

10.30am – 12.20pm CHAIRMAN
15 November 2016

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Note: Market Outlook

This note is addressed to the Local Pension Committee of the Leicestershire County Council Pension Fund (the 'Fund') as part of the general review of the Fund's investment strategy. The note provides an economic and high level market outlook appropriate to that review. The form of the note is to capture current market thinking and to consider areas where the consensus may prove incorrect.

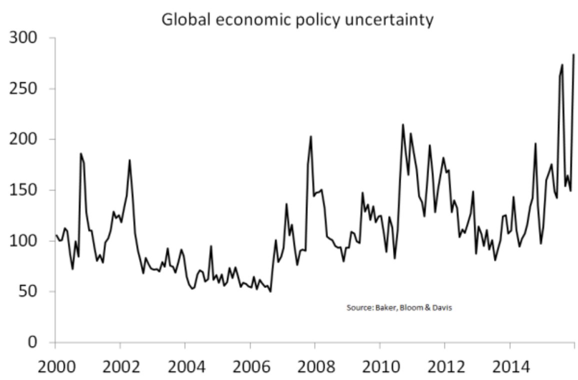
Economic Backdrop

The table below details the real economic growth outlook based on consensus data collated by Bloomberg. The projected growth rates for 2016 and 2017 are shown along with changes to the consensus that have occurred over the year; for the first time 2018 forecasts are available.

Notwithstanding the heady optimism that has gripped financial markets in the wake of Donald Trump's victory in the US Presidential Election, the story of 2016 generally is one in which economic growth within developed markets disappointed; nowhere more so than in the US. The decision of the UK to leave the European Union is most evident in the forecast of a slowing economy in 2017 – slower than both the US and Eurozone; relative improvement in 2018 is not expected. In contrast, 2017/18 for the US is expected to show that the economy will return to growth slightly above trend (according to the US Federal Reserve trend economic growth is 1.8% p.a.). Relative to the pace of activity observed in Q3, 2016 (and the +2.5% p.a. suggested by real-time measures for Q4) this may seem slightly disappointing however the stronger growth of H2 simply makes good the growth lost in H1. Even without the promise of the sharp fiscal expansion that lay at the heart of Trump's campaign, this has provided the platform for the Federal Reserve to raise rates. Japan's economy has struggled to grow – something that isn't expected to change (despite the recent sharp slide in its currency).

	2015	2016		2017		2018
GDP growth (% p.a.)		Consensus	Change past Year	Consensus	Change past Year	Consensus
US	2.4	1.6	-0.9	2.2	-0.2	2.3
Eurozone	1.5	1.6	-0.1	1.4	-0.3	1.5
UK	2.2	2.0	-0.3	1.2	-1.0	1.3
Japan	0.6	0.9	-0.2	1.0	0.4	0.9
China	6.9	6.7	0.2	6.5	0.2	6.1

Growth forecasts often prove inaccurate (as 2016 illustrates); the likelihood of material forecast errors in 2017/18 looks high. The challenge facing those tasked with projecting the economic outlook has – arguably – rarely been stronger; this is captured in the chart opposite. Uncertainty surrounding economic policy formulation across the globe is higher than it has been for many years. This is led by the UK and Europe – both of which have to confront the UK's departure from the European Union. Further, while economic policies generally matter more than political developments, should Le Pen triumph in France and Merkel lose in Germany then the (adverse) impact on corporate and consumer confidence across the Eurozone (and beyond) would be significant. Uncertainty is further fuelled by the potential for a sharp and substantial change to US fiscal and trade policy (which, by extension, has lifted uncertainty around Chinese economic policy).



Market participants (as opposed to economists) probably judge that the downbeat outlook for the UK is too pessimistic (economists generally expected a *Brexit*-induced slowdown to already be hitting the UK). This could be generating complacency that threatens current UK asset prices (UK equities recently hit an all-time high). The resilience of the UK economy in H2, 2016 however has been part of a lift in economic activity across the globe which was not expected (and which was driven by low bond yields, the improvement in commodity prices and ongoing job creation). Much as was the case a year ago, the US economy is entering 2017 with an above-trend growth momentum. It took the unprecedented (equity) market turbulence of last January to slow activity; that vulnerability likely remains. Beyond a market-induced slowdown, probably the major risk facing the US comes from the housing market where sharply higher mortgage rates are likely to slow activity. That said, the promise of a sharp fiscal expansion will bolster confidence.

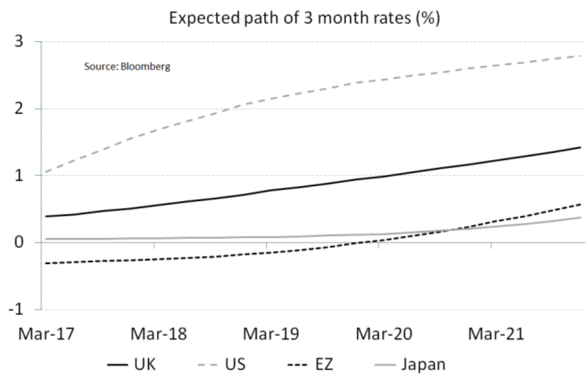
While uncertainties may surround the actual level of growth rates, it seems likely that the relative rates i.e. the US growing more rapidly than the UK, Europe or Japan, are much more likely to prove accurate. In broad terms therefore the US economy looks likely to prove more supportive of real assets with non-US markets being more supportive of nominal assets such as bonds (subject to price!)

The next table echoes the one above but this time applies to rates of inflation. Here economists correctly foresaw that US inflation in 2016 would be marginally below the central bank target (2.0%) but estimates were much too high in the UK, Europe and Japan. Everywhere current levels of inflation are either unlikely to induce a material tightening in monetary policy (the US) or require monetary policy to remain accommodative. A healthier economy should ensure that the 1.9% core inflation rate projected for the US is 2017 is broadly correct but there is downside risk to the Eurozone estimate of 1.3% (notwithstanding the rise in oil prices above $50pb). The failure of *Abenomics* (in Japan) to lift inflation to 2.0% is confirmed in the forecasts; the structural deflationary forces (led by an ageing population) are reasserting themselves.

	2015	2016		2017		2018
Inflation forecasts (% p.a.)		Nov Actual	Change in forecasts over 2016	Consensus	Change past Year	Consensus
US (Core PCE)	1.3	1.7	0.1	1.9	0.1	2.0
Eurozone	0.0	0.6	-0.8	1.3	-0.2	1.5
UK	0.0	1.2	-0.7	2.4	0.6	2.5
Japan	0.8	0.1	-1.0	0.6	-1.4	1.0
China	1.4	2.3	0.3	2.2	0.2	2.2

It is the UK where the changes have perhaps been more profound. *Brexit* has induced a sharp slide in £ which is lifting import prices (evident in sharply higher producer price inflation). The Office for National Statistics has guided that this has not yet fed through to consumer prices; this is what is driving the 2.4% and 2.5% inflation forecast for 2017 and 2018 respectively. A one year surge (due to base effects) is likely to ensure that the estimate for 2017 is more secure than the 2018 figure; much will depend on how £ reacts once Article 50 (to begin the process to leave the EU) is invoked.

The money markets' interpretation of the growth and inflation outlook is shown in the chart opposite (which depicts the expected path of short term interbank interest rates). European and Japan rates are expected to remain zero (or lower) for the rest of the decade. If correct, then Japanese rates will have been at or below 1% for more than 25 years. On one level this provides food for thought for those that expect interest rate normalisation, on another it underscores the appetite, in America and elsewhere, to now approach things differently. In the US the market expects that rates will rise slowly, but steadily, to a terminal rate around 3%. The chart makes clear, as a corollary, the degree of adjustment possible should Trump's economic plans fail to stimulate activity and US rates converge back to the global norm. In the UK support from a lower currency and an element of fiscal expansion (though short of what has been promised in the US) is expected to allow (require?) rates to rise (but not above 1% until the next decade); this profile looks wrong and the average of quite different scenarios. If inflation lifts as projected by economists (especially in 2018) then markets will look for more compensation than is currently priced. If £ weakens too much (under the burden of a still expanding external deficit) then defensive measures to protect the currency could see rates rise sharply. If *Brexit* goes badly then rates will remain stuck at current levels (or may fall further). In short, the forward curve of UK rates represents an unstable equilibrium.

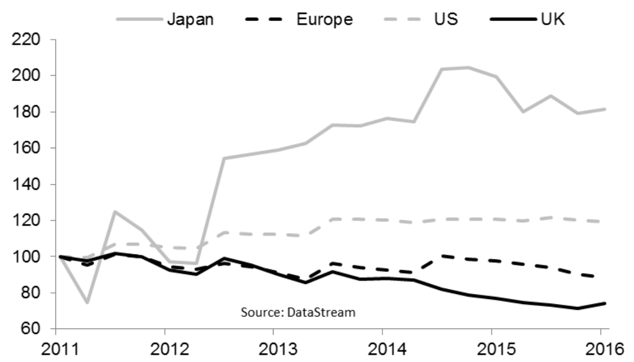


Overall the outlook is for more-of-the-same (subdued inflation, moderate growth) but with the possibility of a Trump induced policy 'shock' (the nature of which is currently very hard to determine but should be a lot clearer by mid-year). Risk markets look currently to giving Trump the benefit of the doubt; retaining doubt about the benefits is appropriate.

The potential read-through from the above on expected year-end risk-free bond yields is shown below (again is based on data collated by Bloomberg). Despite the weakness in bond prices in the latter part of 2016 (Gilt yields rose 0.5% and US Treasuries 1% in Q4), the forecasts broadly restore the levels that existed a year ago (with gilt yields down a touch on *Brexit* and treasury yields up a touch on *Trump*). The Bank of Japan has declared its determination to maintain 10-year yields at 0%; economists expect that the BoJ will be successful. A sharp rise in bond yields would be a surprise.

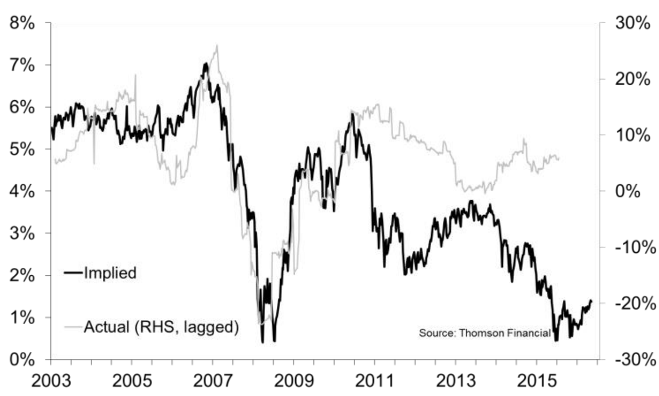
10y rates (%)	2015	2016	Latest	2017
10y US treasuries	2.3	2.4	2.5	2.7
10y German bunds	0.6	0.3	0.2	0.6
10y Gilts	2.0	1.4	1.3	1.6
10y JGB	0.3	0.0	0.0	0.0

In recent years bonds have appealed to investors because of the possibility for strong capital performance, not their yield; such a strategy is under threat. Key is whether equities emerge as a competitive alternative. For this and when valuations appear demanding by historic standards, an improvement in the earnings outlook is required. Sadly, as the chart opposite suggests, currently there is no earnings growth momentum (chart plots projected FY1 Earnings Per Share growth). While analysts expect a more positive platform in later years there is little evidence to support the accuracy of such forecasts (analysts tend to be perpetual 'bulls', wedded to +10% forecast growth rates). What is needed is a healthier pace of economic activity and this is where Trump's reflationary programme is crucially important. The risk to non-US equity markets is that Trump's programme contains the threat of protectionist measures intended to ensure that the US prospers even if at the expense of the rest of the world.



EPS (yoy change)	UK	US	Japan	Europe
FY2	15%	13%	11%	13%
FY3	13%	12%	8%	11%

That said, if economies can manage modest growth then companies should be able to grow their dividends at a pace sufficient ensure that equities offer value relative to bonds. [The chart opposite plots the history of the dividend growth rate needed for UK equities to be equivalent value to bonds; the current 1% shouldn't be that demanding. A similar conclusion can be drawn from the equivalent US comparison although the rise in US bond yields has raised the bar for US dividend growth to the level of actual Dividends Per Share change in recent years.]

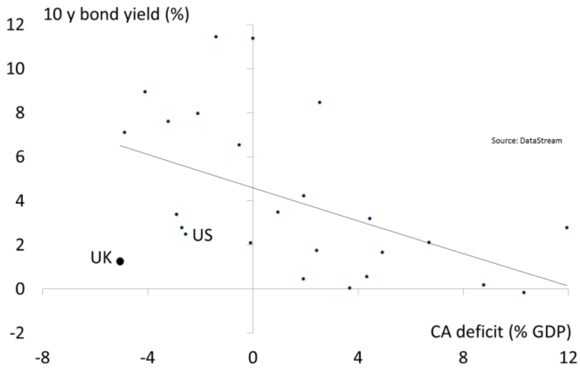


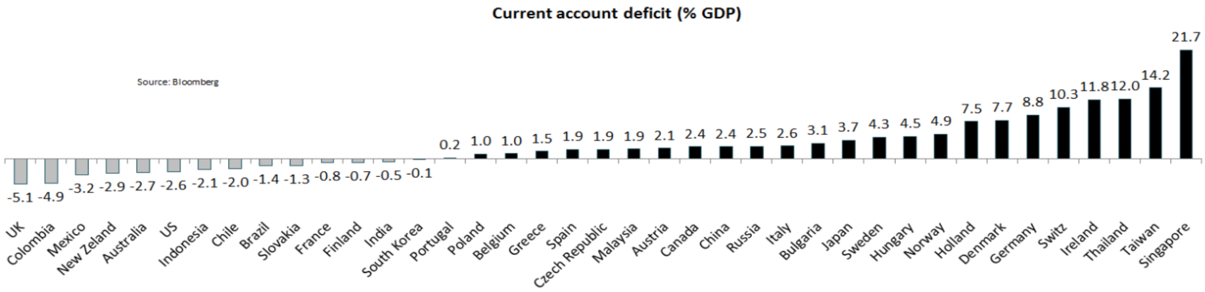
Finally on equities, the chart opposite could be judged a curiosity. It compares, over the long term, the relationship between the average US institutional fund allocation to US equity markets with the subsequent ten-year return (% p.a.). The inference is clear: US equity markets look set to return around 6% p.a. over the next decade. It also implies, after allowing for equity market levels in 2007 and 2008, double digit returns from US equities over 2017/18. This would imply a durable Trump 'feel-good' factor – this is not impossible.

The *real-world* backdrop for bond investors remains supportive: debt levels are too high, excess capacity remains, demographic pressures are driving real yields lower, technology-driven price disruption continues apace, final demand for credit remains subdued, limited compelling priced attractive alternatives and, outside the US, low yields remain part of the policy *answer*.

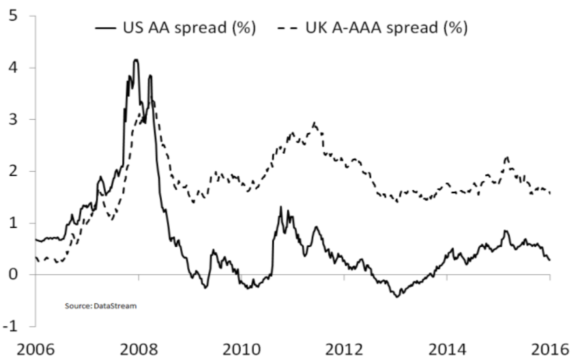
The challenge could come from a move, led by the US, away from monetary stimulation to fiscal expansion (that sees budget deficits balloon). Absent that challenge then bonds retain attractive defensive merits.

In such a scenario it looks less likely that Gilts will prove to be the superior defensive play. Gilt yields already reflect an inferior economic outlook and the UK's need to attract external capital (to balance a yawning current account deficit) remains acute; in this context, gilt yields increasingly look too low (see chart opposite).



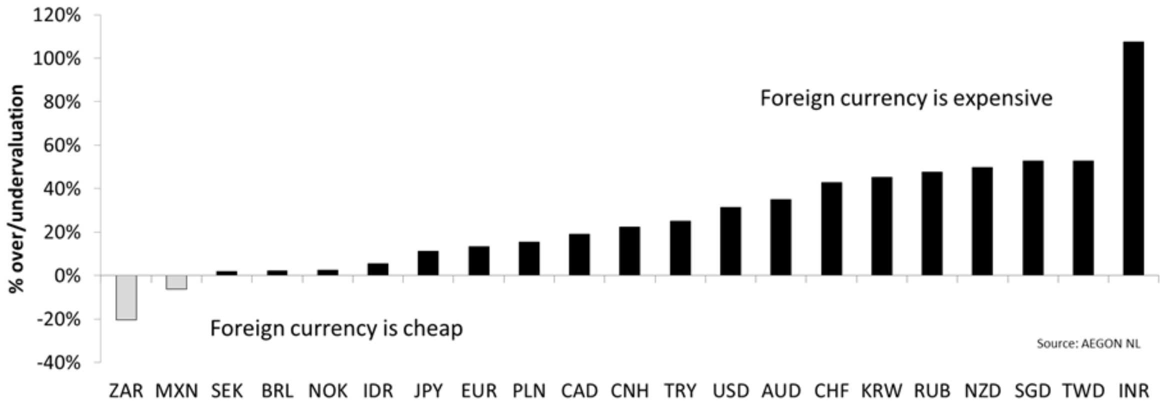


Away from government bonds, credit spreads contain little margin for any increase in corporate defaults; spreads having narrowed materially since Q1 2016 when the global economy looked to be stalling. In the UK the excess corporate bond yield fell after the Bank of England relaunched quantitative easing (incorporating buying of £10bn UK corporate bonds after *Brexit*). A more exaggerated move occurred in the US late in 2016 on the belief that the Trump-induced growth revival would materially lessen the threat of corporate failure.



Spreads on High Yield bonds look similarly tight. Non-government bond exposure should be taken away from the liquid markets, where the cost of (illusory) liquidity is high.

The slide in £ in 2016 has left the Pound looking cheap, particularly against its major trading partners (chart below). The reasoning behind the fall is easily understood. The UK has a very high external dependency on external capital and following the country's decision to leave the 'shelter' of the EU, in a manner that leads to an uncertain economic future, global investors need to see a price discount. Whether the 13% fall in £'s trade weighted value since the Referendum is sufficient compensation will remain to be seen. Purchasing power parity (PPP) metrics suggest that it should prove enough (unless the outlook for the UK deteriorates further).



Conclusion

For many years key in shaping market forecasts has been not to fall into the trap of expecting interest rates and bond yields to return to the levels of the period prior to the Great Financial Crisis of 2008/09. Remedial measures (for dealing with the aftermath of the GFC) were limited to monetary policy. Debt levels were still very high (and growing) while excess capacity and demographic pressures were maintaining dis-inflationary pressures. The challenge facing policy makers has been without precedent so, perhaps reasonably, their response had to be unprecedented – and so it was.

Perhaps the most significant developments over 2016 has been the broad acceptance that a different approach (to cutting interest rates etc) was needed and the pace at which something different is being embraced. In this sense we could be in the midst of a regime change capable of bringing to multi-year bond bull market to an end. At such times focusing too much on details (e.g. have bond yields risen too quickly and/or are equities cheap or dear?) risks missing the point: investing behaviours learned in the years since the GFC (and before) may prove inappropriate for the years ahead.

Monetary policy alone was never likely to lead to normalisation (as commonly understood) and fiscal expansion was the logical next (last available?) step. To be considered there needed to be fundamental political shifts – a new broom. To be credible, the fiscal experiment needed to occur within a major economic block (otherwise markets would move to penalise the profligate); the US is the ultimate petri dish. Trump's policy platform promises to use massive debt finance to fuel an above trend expansion that lifts 'blue collar' incomes and puts America first. This could prove a problem for shareholders (especially those of non-US companies) but it certainly disadvantages those currently owning long duration bonds – many of whom are not natural bond holders. If the experiment fails then we know what happens to bond yields etc – we've lived through this. If it succeeds then we have no model for what lies ahead. Current bond yields – government and non-government - offer poor compensation for a more expansionary fiscal approach and protectionism.

Biased to believe, equity investors are currently doing what they do best; travelling with the hope that Trump's programme will be enacted and will benefit everyone. Deprived of alternatives, they should prove willing to give Trump's policies time to work unless events in Europe (led by the French election) prove overwhelming. If, into the end of 2017, hopes are dashed then a much more extreme set of policies could emerge (negative interest rates, the widespread adoption of QE along with a sharp rise in public spending) is likely. Despite the general rise in government debt (as a % of GDP), bond yields had fallen because issuers were judged to remain credit-worthy. If politicians embrace unfunded fiscal expansion then this could force government credit risk premia higher; that will be messy and best avoided.

The above challenges are significant but in the meantime the world enters the year ahead in reasonable shape – as was the case last year. Economic growth has reasonable momentum across a broad base and policies remain supportive. Corporates and consumers appear moderately confident of the future and confidence goes a long way in the modern economy. Some will see this, somewhat ironically, as evidence that monetary policy was finally working; it isn't - not with the vigour and durability needed.

Real assets should be preferred though at the higher yield levels bonds have some defensive appeal – the optimism of last year was quickly undone by Chinese devaluation, fresh weakness in oil, a sharp reaction to higher (US) interest rates and ineffective policy developments in the EZ and Japan; variations on these risks remain. Bonds will always retain tactical utility; yield movements over 2016 should ensure that the best defensive bond market is in the US (especially if the epicentre of any market setback involves worries over the outlook for the US economy). £ is cheap but may remain so until the 'fog' around Article 50 etc begins to lift.

In January China enters the year of the Rooster. Over the course of 2017 we will find out whether this marks a new dawn for the rest of us and if bonds leave the era of the bull. If they do then the impact will be substantial.

Leicestershire County Council

LOCAL PENSION COMMITTEE – 17 JANUARY 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

STRATEGIC INVESTMENT BENCHMARK AND PORTFOLIO STRUCTURE OF THE FUND

Purpose of the Report

1. To recommend changes to the Fund's strategic investment benchmark, as outlined in the attached appendices to this report. The appendices have been written by Hymans Robertson (Appendix A) and by Scott Jamieson, the Fund's Independent Investment Advisor (Appendix B).

Background

2. The Pension Fund has long-term liabilities. The agreement of a strategic investment benchmark can, therefore, be based on the long-term expectation of returns within certain asset classes. Market fluctuations mean that the Fund's actual asset allocation will never exactly match the agreed strategic asset allocation and investment within asset classes in which funding is 'drawn down' over a period of time further confuses the position. The strategic benchmark should, therefore, be considered an 'anchor' around which the actual asset allocation is fixed.

3. Any decision on the appropriate investment benchmark split is fraught with difficulties, and will ultimately be a 'trade-off' between risk and return. Whilst historic measures for risk and return have some use and can be instructive about how different asset classes are correlated to each other, they clearly give no guarantee that these historic links will persist into the future. As a result it is futile to suggest that it is possible to design an 'optimal' asset mix; this should not, however, detract from the desirability to agree a strategic asset allocation benchmark that makes intuitive sense in terms of the risks being taken to achieve a required return.

Required Investment Return

4. Before a strategic investment return can be designed, it is important to be clear about the required future investment return. Without this clarity it would be possible to have a strategy that targets a return that is very high, but takes overly large risks and as a result has too high a possibility of failing to achieve its target – thereby putting unnecessary upward pressure onto employers' contribution rates. Likewise a target that is too low may be easily achieved, but has the disadvantage of having very little probability of producing the returns needed to lessen future employers' contribution increases.

5. The Leicestershire Fund has, for many years, set a required investment return that is sufficient to assist in controlling future employers' contribution rate increases, but not so risky that the actual outcome might have the opposite effect. This required return has generally been for an annual return of about 4% above Consumer Price

Inflation (CPI), and from this it is possible to arrive at a strategic asset allocation benchmark that gives sufficient diversification to mitigate some of the inherent risks to future investment returns. The required investment return is set in the full knowledge of the level of future investment returns that are allowed for within the Fund's actuarial valuation. By way of a comparator, the very long real return from equity markets is generally estimated at between 5% and 6%.

Recommended Changes

6. The outcome of the 2016 actuarial valuation saw a slight improvement in the funding level (i.e. the ratio of assets to liabilities), but the improvement was insufficiently large to suggest that an amendment to the Fund's overall appetite for risk was required. An annualised return of c.4% above CPI is still an appropriate target for returns.

7. Any assessment of whether a strategic investment benchmark is capable of achieving the target return requires assumptions to be made about expected future investment returns on an individual asset class basis. These asset class assumptions take into account current market levels so will not remain stable over time, but the strategic asset allocation benchmark agreed in January 2016 is still considered capable of achieving the target return.

8. Unlike many Pension Funds, Leicestershire formally considers its strategic asset allocation on an annual basis so changes are always likely to be 'evolution, not revolution'. There is no presumption that annual changes will be required, however if changes could be made that would improve the risk/reward trade-off then these should be seriously considered.

9. The attached appendices contain more detailed explanations about the reasons behind the recommended changes, but the remainder of this report will focus on the recommendations and the rationale behind them.

10. The most significant recommended change is that 2.5% of the Fund's strategic asset allocation benchmark be switched from equities into direct lending. This recommendation recognises that there are a number of factors that could potentially put pressure onto equity market values (in particular the fact that corporate profitability needs to improve to justify current valuations), and that direct lending is a less risky way of achieving similar returns. The switch exchanges valuation risk with liquidity risk, given that direct lending is an illiquid asset class. Equities will remain the Fund's largest asset class by some distance, and this recommendation could easily be construed as marginal. It is, however, one that is thought to be worthwhile.

11. The Fund is currently below its 5% benchmark weighting in credit (an asset class that includes direct lending), and this underweight is a function of other asset classes having outperformed over the last six months together with one of the existing credit investments returning capital in advance of expectations. Partners Group, with whom the Fund already has investments in direct lending, will present their available funds at today's meeting and if the Committee are comfortable with their credentials it is recommended that both the 2.5% proposed increase in direct lending (if agreed) and the current underweight credit position be invested into a mixture of their 2016 and 2017 funds.

12. In late August 2016 the Fund took action to reduce, on a tactical basis, its 7.5% benchmark weighting in index-linked gilts down to a 5% actual weighting. This reduction followed significant increases in prices that did not appear to be fully justified by fundamentals, and prices have since fallen to the point that increasing the weighting back to the full 7.5% weighting is considered appropriate. The exact timing of this increase is subject to agreement between Officers, investment consultants and Kames Capital; the repurchase of index-linked gilts (at a lower price than when the sales occurred) is not subject to any change in the Fund's strategic benchmark.

13. The benchmark index against which the index-linked portfolio has been managed by Kames Capital has, until now, been the over 15 year index. This was a deliberate choice by the Fund as it encouraged exposure to longer-dated index-linked bonds which are more sensitive to changes in the market's appetite for inflation protection. In recent months it has become clear that investors are currently willing to pay a very high price for very long-term inflation protection and, despite their price falls, long-dated index-linked gilts still appear to be expensive – if investors cease to be willing to pay such a high price, long-dated index linked capital values could fall substantially. As a result it is recommended that the benchmark against which Kames Capital are measured is amended to the Index-Linked All-Stocks index. This change will, from a strategic perspective, lower the price sensitivity and also give the manager the ability to run a much more balanced portfolio within the asset class.

14. Within the Fund's targeted return approach, Pictet currently has a very low target weighting. Their actual weighting is higher than target as a result of the Fund being below the lower end of its Opportunity Pool investments, so their portfolio is actually a meaningful size (c.£94m, or 2.6%). At its target weighting of ½% (when Opportunity Pool investments reach 4%), it does not have a sufficiently large impact to justify its retention. It is believed, however, that the portfolio has a useful role in diversifying the other targeted return managers (Ruffer and Aspect). Pictet's performance has been good and is expected to remain acceptable. As a result it is recommended that the intended weightings of all three portfolios are adjusted so that Pictet's portfolio does not become an irrelevance. Reducing the target weighting of Ruffer and Aspect's portfolio by ½% each, and adding the 1% total to Pictet will achieve this recommendation and will not require any actual transactions as both Ruffer and Aspect are c. ½% below their target weights.

15. The Fund maintains a distinct currency hedging programme over its overseas equity assets, the neutral position of which is to hedge 50% of the currency exposure caused by the benchmark equity weighting back to sterling. Kames Capital carry out hedging on behalf of the Fund but do not simply hedge back to the neutral position, as they take account of a number of things (for example 'fair value' of a currency relative to sterling, how currencies are correlated to the Fund's other risks – most notably how they are linked to equity market strength and volatility) when deciding the actual hedged position. As an example the Fund has historically had simultaneous positions of a 100% hedge against the Euro and no hedge against the US Dollar.

16. From an academic perspective hedging out all exposure to overseas currency actually increases risk to a sterling investor, as it nullifies one area of diversification.

Remaining unhedged is less ‘risky’ than a full hedge, but a partial hedge of somewhere around 50% gives the best outcome in terms of risk reduction.

17. The Leicestershire Fund’s decision to avoid a ‘blanket hedge’ that ALWAYS hedges a fixed amount of non-sterling exposure is based on the belief that there will be periods, and sometimes extended periods, when it is possible to form a reasonable judgment that a particular currency is mispriced. The ability to potentially take advantage of this perceived mispricing can add significant value; not hedging the US Dollar over a prolonged period in which it strengthened against sterling and have a 100% hedge on certain occasions against a weakening Euro are examples of this.

18. The neutral position given to Kames Capital (currently 50%) will influence their positioning; for example if they do not have a strong view about a particular currency’s ‘value’ against sterling it is reasonable to expect them to be 50% hedged as this is the neutral position. If they were given a 25% neutral position, it would be expected that they would be hedged at this level if they had no strong view.

19. The well documented fall in sterling following the Brexit vote has made it a ‘cheaper’ currency than it was. This fall may ultimately be prove to be justified by weaker future economic performance, but it might equally be a (predictable) knee-jerk market reaction to the UK entering a period for which there is no historic precedence. Above all things, markets dislike uncertainty.

20. Given sterling’s fall it is recommended that the Fund’s neutral hedging position be increased to 2/3rd of the currency exposure caused by its overseas equity benchmark position. The impact of this change will be that at a neutral position the Fund will retain a higher exposure to sterling, which is now ‘cheaper’ than it has been at any time since the Global Financial Crisis. Importantly this change will not remove the ability for Kames Capital to express an investment view on the value of other currencies relative to sterling – for example they can remain fully hedged against currencies that they feel will weaken, and unhedged against currencies that they think will strengthen.

Summary

21. The strategic asset allocation benchmark agreed as part of the January 2016 Local Pension Committee meeting is still considered to be generally ‘fit for purpose’. The changes that are being recommended are not particularly significant but should improve the overall structure of the benchmark.

Recommendations

22. The Committee is recommended to:

a) Approve a revised strategic benchmark for the Fund as detailed within paragraphs 10 and 11 of the report and Appendix A;

b) Approve a revised portfolio split within the Fund's targeted return portfolios of:

Ruffer	6.5% of total Fund assets
Aspect Capital	3.5% of total Fund assets
Pictet	1.5% of total fund assets

c) Approve a change in the benchmark, against which the Fund's index-linked gilt exposure will be managed, to the All Stocks Index-Linked Gilt Index;

d) Approve a change in the neutral hedging position in respect of the Fund's currency exposure created by its overseas equity benchmark position to 2/3rd.

Equal Opportunities Implications

None specific.

Appendices

Appendix A – Annual Review of Strategy, Assets and Structure – Report of Hymans Robertson

Appendix B - Reviewing the neutral currency hedge ratio – Report of the Independent Investment Advisor

Background Papers

Report to the Local Pension Committee – 22 January 2016 – Strategic Investment Benchmark and Portfolio Structure of the Fund

http://cexmodgov1/ieListDocuments.aspx?CId=740&MId=4490&Ver=4

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Annual review of asset strategy and structure

Addressee

This paper is addressed to the Local Pension Committee (LPC) of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to provide the 2017 annual assessment of the Fund's investment strategy.

The note has not been prepared for use for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent.

Executive Summary

Required return

The Fund's investment strategy is structured to deliver a blend of diversified return sources, with an emphasis on long-term investment and an element of inflation linkage. Our view of the expected real return over CPI is currently around 3.9% p.a.

Based upon the results of the 2016 valuation we estimate that the required return on Fund assets is between 3% to 3.5% p.a. above CPI inflation (after expenses) allowing for removing the deficit over a 20 year period and allowing for the difference between expected contributions and future service cost.

Hence, the expected return of the current strategy provides a small margin over the required return. This increases the chances of achieving the required return and we do not propose the need for any wholesale change in the target level of return.

Market Conditions

Our concerns remain that the level of future interest rates implied by long-dated gilt yields are too low, particularly relative to market implied RPI inflation, but equally that there is little expectation that UK rates are going to rise much more than they have in recent months (i.e. back to levels seen earlier in 2016) in the near-term. This applies equally to US treasury yields, which have risen faster than UK gilt yields, but still only to levels of 12 months' ago.

Over 2016 implied inflation pricing has also risen. Increases in short-term inflation can be expected both locally (Brexit) and globally (Trump policy). However, implied prices for longer-dated inflation have also risen.

2016 has been another strong year for equity market returns, which have been driven again by revaluation (i.e. a rise in Price/Earnings (P/E) ratio or how much investors are willing to pay for one year's profits) rather than earnings growth, which continues to flat-line globally, at least in local terms.

While US fiscal policy under Trump may evolve into a more persistent growth story for the US economy, it is not obvious that this will be to the benefit of wider global growth. As such forward looking expectations for global equities are caught between a rock and a hard place: either growth remains lacklustre, limiting future returns, or rates rise on the back of some more persistent growth, with the consequence of higher corporate borrowing costs and reducing the price to earnings investors should be willing to pay.

In this environment the outlook for both interest rates and equities remains uncertain. As a result we continue to consider the predictability of returns from shorter-dated debt and longer-dated secure real income assets provides relative attraction.

Recommendations

We do not see the need for any fundamental changes to the Fund's strategy at this time. The recommendations we make this year continue to be an evolution of the existing strategy.

As greater clarity emerges over the nature of the UK's exit from the EU and the policy direction of Trump it may be appropriate and opportune to adapt the Fund's strategy further, and therefore there may be a need to revisit the strategy ahead of 2018.

Based upon what we know today, we recommend the following:

Equities

- Given the dependency of equities on positive economic outcomes, coupled with comparatively strong returns over the last 3 years, **we recommend a 2.5% reduction in the strategic allocation to equities, which can be used to fund a higher allocation to private lending**. **We propose this reduction is applied broadly across the Fund's regional equity allocation**;
- As referred to last year, **we recommend the Fund consider the introduction of a global equity mandate with a growth bias to sit alongside the value bias of the passive RAFI mandate and the active income mandates**. This will give better diversification to sources of return in the equity portfolio than the current inherent factor biases. **However, we would expect that implementation be considered alongside proposals for equity investment in the Central pool rather than as a stand-alone exercise now**.

Income assets

- With market volatility and uncertainty over returns, we continue to favour the predictability of returns from relatively short-dated corporate lending. In particular we favour the characteristics of originated lending where the investor has more control over the terms of lending and where the expected return is not dissimilar to the expected return on global equities.
- We continue to prefer global managers such as Partners, who can tilt portfolios towards what they consider to be the most attractive markets. For example, through a combination of demand by European investors to lend capital coupled with better opportunities in the US, Partners are currently biasing their latest portfolio towards US lending, relative to their usual European bias.
- The Fund currently invests £100m in the Partners 2014 multi-credit private lending fund. **We recommend increasing the target allocation to private lending from 5.0% to 7.5% of Fund assets. To reach the higher recommended allocation we recommend splitting the capital required between Partners 2016 and 2017 multi-asset private lending fund programmes. Partners Group will present to the Committee at the meeting.**

Real Assets

- The Fund's strategic allocation to index-linked gilts is 7.5% of Fund assets, and the benchmark is the Over 15 year index, i.e. primarily ultra-long dated index-linked gilts.
- During the year the Fund's allocation to index-linked gilts was reduced tactically from 7.5% to 5.0%, reflecting the very strong returns that had been delivered by index-linked gilts, especially long-dated bonds. With yields having pulled back slightly from mid-year levels, this tactical positon has been favourable for the Fund. **We recommend closing the position and bringing the allocation back up to 7.5%, with the exact timing being dependent upon consultation between Officers, Investment Consultants and the manager (Kames Capital)**. This is not to say that index-linked gilts could not cheapen further, but is simply the application of disciplined portfolio management.

- With implied inflation having risen, yields on long-dated index-linked gilts look particularly low. Our preference is to use the additional 2.5% allocation to move the benchmark for the index-linked gilts from the Over 15 year index to a broader index. In particular, **we recommend using the Index-Linked Gilts All Stocks Index as the benchmark for the index-linked gilt allocation**.

Prepared by:-

Andy Green, Partner

January 2017, for and on behalf of Hymans Robertson LLP

Risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

1. Fund asset allocation and required return

Current strategic asset allocation

The strategic asset allocation and implementation of the Fund is structured to accommodate the need for both the long-term return requirements (primarily equities and alternatives) and a degree of inflation linked returns, given the nature of the liabilities.

Details of the current target allocation are shown in the table below:

Equities (50.5-52.5%)

	Manager	Target %
Listed		
UK	LGIM	8.5
Regional	LGIM	26.0
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	6.0
	Delaware	
Private		
	Adams Street	4.0

1. Actual allocation to Pictet is 2.6% due to underweight in Opportunity pool.

Real Income Assets (24.5%)

Inflation Linked (14.5%)

	Manager	Target %
Index-linked	Implemented	7.5
Infrastructure	IFM	5.0
	KKR	
	JPMorgan	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
Fund of Funds	Aviva	10.0
Smaller lots, active value	Kames	
Direct	Colliers	

Alternative (23-25%)

	Manager	Target %
Targeted		
	Ruffer	7.0
	Aspect	4.0
	Pictet	0.5[1]
Overlay	Millennium	-
Other opportunities		
EM Debt	Ashmore	2.5
Credit Opps	JPM	5.0
	UK Financing Fund	
	Partners	
Other opp. pool	M&G	4.0-6.0
	Markham Rae	

Under the current strategic allocation, the lower end of the equity range (50.5%) will only be reached if the opportunity pool investments reach the full weighting of 6% and until the opportunity pool investments exceed 4%, the strategic equity weighting to equities will be 52.5%.

The asset allocation outlined above contains a diversified range of sources of return. Across the strategies, the Fund has exposure to the following sources of return and risk:

- Corporate growth
- Government risk
- Interest rates
- Inflation
- Active management
- Illiquidity premium
- Complexity premium

Required rate of return on assets

The value placed on the Fund's liabilities is determined by measuring the discounted value of the benefits to be paid in the future for accrued benefits. The initial results of the 31 March 2016 actuarial valuation show an improvement in the funding level from 72% to 76% since 2013.

	31 March 2013 £m	31 March 2016 £m
Liabilities	3,652	4,153
Assets	2,628	3,164
Shortfall	(1,024)	(989)
Funding level	72%	76%

During the three year period the liabilities have grown by 13.7% and the assets by 20.3%, resulting in the improvement in funding.

The discount rate used to calculate the value of the 2016 liabilities in the above table is 4.0% p.a., which reflects an asset outperformance over gilts of 1.8% p.a. or a real return over CPI of 1.9% p.a. This means that if the Fund assets were equal to the value of the liabilities, then the Fund would only need to earn a return of 1.9% over CPI (assuming that contributions were sufficient to meet the cost of benefits accruing). However, the Fund assets are less that the value of the liabilities, so the Fund will need to earn a return on the assets higher than the discount rate, i.e. more than 1.9% over CPI, in order to remove the underfunding.

The extent of the excess return required will depend upon the time horizon over which the deficit is to be made good. Ignoring any difference between the value of contributions and the cost of benefits accruing, the required return to restore the funding level to 100% over 20 years is approximately 3.3% p.a. over CPI. This increases to 4.7% p.a. over CPI if looking to restore the funding over 10 years. In practice there will be other external factors such as movements in real yields that influence the discount rate used to value the liabilities and to determine future service costs.

Setting a strategic asset allocation with an expected return of 3.3% p.a. over CPI will by definition only give a 50% chance of achieving required level of return. By targeting a higher expected return, the Fund can increase the proportion of outcomes that deliver 3.3% over CPI or more. The downside is of course that by targeting a much higher expected return, there is likely to be greater variation in outcomes and hence more potential downside. Hence, there is a balance to be struck.

Targeting a real return over CPI of 3.9% provides some headroom over the minimum required return to restore funding – we estimate around a 60% likelihood[1] of achieving the required real return over 20 years. We also estimate that around 90%[1] of outcomes would be better than if the Fund adopted a strategy with an expected return of 3.3% over CPI. Hence, we do not propose the need for any wholesale change in the target level of return. (Note 1: estimated using a simplified model, and to be treated more as illustrative rather than based upon detailed modelling).

Strategic forecast return

As noted in previous reports, this real return target applies at the aggregate Fund level. It does not require every asset and mandate held by the Fund to deliver returns at this level, and the investment policy should reflect a combination of return sources that balance the need to generate return with the benefit of diversification of returns. In the table below we set out the target contribution from each component of the strategy to the overall objective.

	Benchmark weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (52.5%)			
Listed equity	48.5	4.3	2.1
Private equity	4	6.5	0.3
Real (24.5%)			
Inflation linked bonds	7.5	0.3	0.0
Infrastructure	5	3.8	0.2
Timber	2	3.3	0.1
Property	10	2.7	0.3
Alternatives/Diversifiers (23%)			
Targeted return	11.5	4.0	0.5
EMD	2.5	3.0	0.1
Global Credit	5	4.0	0.2
Opportunity Pool	4	4.3	0.2
Currency overlay (Notional weight)	(c10)	1.0	0.1
TOTAL	**100**		**3.9**

Although this is based on our subjective views of long-term strategic returns, it highlights the main source of return is listed equities, with much more limited contributions from other strategies.

In principle, we would prefer a more diversified contribution to the overall expected return, particularly if this increases the predictability of returns. However, this has to be offset against the relatively cheap cost of investing in listed equities.

LGPS Pooling

While the Fund has agreed to become part of a group of eight funds forming LGPS Central, investments will not be managed on a joined basis until April 2018. The approach that LGPS Central adopts for pooling assets is likely to differ from one asset class to another, and there may be different timelines for moving assets to a pooled basis.

Even once LGPS Central pool is fully operational, it will be the responsibility of the Local Pension Committee to set strategy for the Fund. However, during this interim period the Investment Subcommittee will also continue to be responsible for implementing the strategy.

Recognising that there will be a transition of assets into the LGPS Central pool at some point, we do not expect there to be substantial changes to the strategy or its implementation. Hence, as in previous years, the recommendations in this report are relatively modest.

2. Market Commentary

2016 is likely to be remembered as a year of political rather than economic upheaval. Following the US Presidential election, investors quickly put aside earlier doubts and chose instead to focus on certain aspects of the Trump agenda – infrastructure spending, corporate tax cuts – and, to some extent, have taken their implementation as a fait accompli. Implementation may prove more difficult of course, whether it is selling increased spending to Congressional Republicans or lower corporate tax to voters. These aspects chimed with bond investors' pre-election mood - US yields had been drifting higher since the middle of the year, as a pick-up in economic growth made an interest rate rise more likely. After a weak first half of 2016, the US bounced back in the third quarter with the fastest growth for two years and the pace in the fourth quarter seems to be similar.

Elsewhere, further threats to EU stability from Italy and France have not derailed an admittedly subdued recovery. Recession had seemed an imminent threat in Japan, but PMI survey data have picked up – recent yen weakness may have helped.

In the UK, November's Inflation Report from the Bank of England had a more sanguine assessment of near-term growth, although it remained downbeat about the prospects for later in 2017. Thoughts of a further rate cut may have been abandoned for the moment, and market-implied forward rates suggest that it will be two years before interest rates are back to pre-referendum levels.

Government bonds, and interest rates and inflation

Gilt yields continued their climb back from the depths of August – at the end of 2016 10-year gilt yields are 1.4% p.a., i.e. well above the lows of 0.6% p.a. In practice this has only taken them back to pre-EU referendum levels and the gilt yield curve still implies that interest rates will peak below 3%. All of this still suggests a pretty gloomy economic outlook for the next generation, but in reality the outlook from here is very uncertain - there is plenty of scope for the outcome to be a bit better with the result that gilt yields would be more likely to rise further. However, any setback could see yields revert to the low levels of mid-2016.

Inflation risk would seem to be equally uncertain, with signs of investors paying up for inflation protection. The price that investors are willing to pay for inflation protection, referred to as implied inflation, is the difference between the yield on fixed interest or conventional gilts and the yield on equivalent index-linked gilts. The increase in the long-dated implied inflation has risen 0.5% p.a. over 2016 (25-year gilt implied inflation is now 3.7% p.a. compared to 3.2% p.a. at the beginning of 2016) and looks unattractive. A similar picture can be seen in the US - breakeven inflation has risen but, in contrast to the UK, US 10 and 30 year implied inflation ended the years around 2.0% p.a., i.e. in line with the Fed's long-term target.

Other bond markets

In the US dollar high yield bond market, yield spreads edged a little higher in the run-up to the election but have contracted since. In absolute terms, yields remain largely flat over the final quarter because of the rise in risk-free yields, but are now c200bps lower than at the start of the year.

Our general view on high yield credit remains that it retains appeal as a diversifier from equities and is less dependent upon the extent of positive outcomes required to justify equities continuing to move higher. In the case of higher quality issues, absolute returns are likely to be low in the medium term reflecting low underlying Government yields.

Equities and currency

The immediate impact of the US Presidential election on global equity markets has been mixed. It has been unequivocally good for US equities, which have reached new highs despite another disappointing quarterly earnings season. In aggregate, earnings are well ahead of last year's numbers, but still lower than two years ago and short of pre-season expectations. Investors' enthusiasm reflects hopes of a fiscal boost in the US, the prospect of lower corporate taxes and the assumption of an "America first" tilt to trade policy.

Our main concern is that in an environment of growing economic optimism, global equities could be vulnerable to devaluation if bond yields start to rise. In terms of both high current valuations and the momentum of bond yields, the US appears particularly exposed.

In practice, we are slightly sceptical that the Trump economic agenda can be delivered quite as easily as the market seems to discount. Even if it is, the potential rise in protectionism that may be part of the same package could pose a risk to global growth. A post-election fall in emerging market equities is consistent with increased trade risk, although it does no more than unwind relative strength earlier in the year. While we would not ignore the risks that protectionism might bring to emerging markets, valuations here provide a better cushion than in most developed markets and we would not be looking to reduce exposure. Other developed markets were seemingly unaffected by trade concerns and have risen since the election; the main winner has been Japan, where a sharp downturn in the yen provided a potential boost to economic growth.

From a UK perspective, sterling had fallen another 5% in trade-weighted terms at the start of October, but recovered to finish only slightly lower over the quarter as a whole. Sterling weakness has boosted the return to global equities in every quarter of 2016, implying a return enhancement to unhedged sterling investors of nearly 20% p.a. over 2016.

A further currency boost to equity returns over the medium term might suggest that the UK was finding things tough outside the EU. If the longer-term economic impact of Brexit is limited (or even positive), it might be hedged investors whose returns are boosted in the future – on some measures sterling looks very cheap relative to history, particularly against the US dollar. We would hesitate to suggest that currency strategy should be determined by a favoured economic view but, given the scale of sterling's decline, the timing of a review of hedging policy is sensible to ensure it remains appropriate in the context of the overall management of risk and return.

Property

The disruption to the UK property market in the wake of the referendum vote proved to be short-lived. Across the market as a whole, as reflected in the IPD Monthly Index, capital values edged up in October and November. The correction from the peak earlier in the year has been modest and does little to allay our underlying concerns that prices are not cheap and rental growth will be hard to come by, but relative to other assets property provides attractive income yield and has a considerable buffer over Government bonds.

3. Credit Allocation

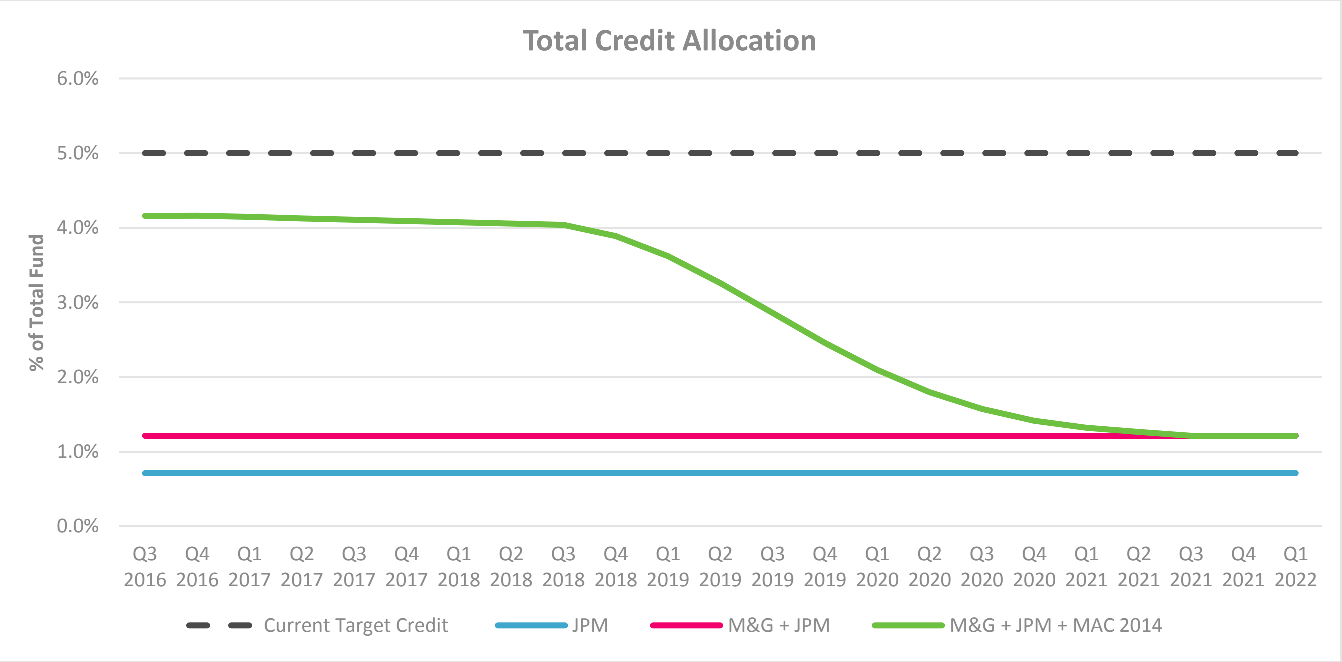
The Fund's global credit allocation is currently split as follows:

	Holding (£m)	Weight (%)
Partners Multi Credit 2014 Fund (originated private lending)	106.3	3.0%
M&G UK Financing Fund	18.3	0.5%
JPMorgan	25.5	0.7%
Total	**154.4**	**4.2**
Target		**5.0**

Although the Partners allocation is fully invested, distributions from the M&G UK Financing Fund mean that the allocation to credit is below target, and with further distributions from Partners MAC 2014, the actual allocation will continue to fall, all else being equal.

The return on Partners MAC 2014 fund has been 6.3% net, and we remain confident that the fund will continue to deliver returns in line with initial expectations of LIBOR + 4% p.a. net of fees.

Money will start to be distributed back from MAC 2014 in terms of income from loans and redemption proceeds when loans are repaid. This is expected to start in 2017, but accelerate into 2018 and beyond. The chart below illustrates the current projection of the Fund's allocation to credit using the projected distribution profile for MAC 2014 expected by Partners and assuming the allocation to JPM and M&G (or equivalent) is maintained.



With market volatility and uncertainty sitting over the return prospects of equity markets, we continue to favour relatively short-dated corporate lending, which offers greater predictability of returns.

In particular we favour the characteristics of originated lending where the investor has more control over the terms of lending and where the expected return is not dissimilar to the expected return on global equities.

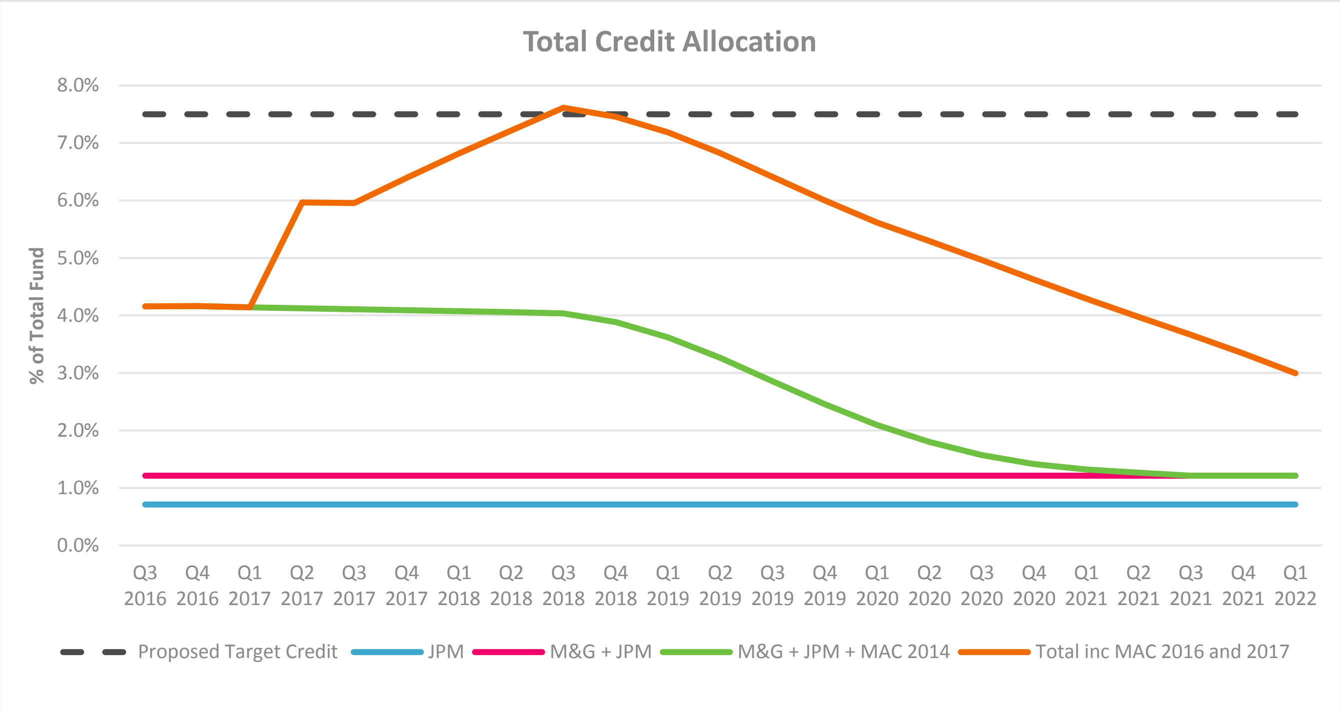
Reflecting this relative predictability we recommend increasing the allocation to corporate lending from 5.0% to 7.5% of the Fund's assets, and to target additional investment in Partners' multi credit strategies to fund this additional allocation.

Partners raise annual funds and are currently in the final stages of investing MAC 2016. The final close takes place in April 2017 when outstanding commitments will be drawn. This fund has already originated 12 loans, with more expected to be completed shortly.

Partners will then begin raising commitments for MAC 2017, which will be drawn in four equal instalments from July 2017 to April 2018.

In the appendix to this paper we provide more details on the Partners MAC 2014 and 2016 funds.

To reach the proposed 7.5% allocation to corporate lending, we recommend that the LPC commit £70m to MAC 2016 and a further £70m to MAC 2017. The chart below illustrates the projected investment assuming 2017 follows a similar profile to 2016.



We note that there is a subscription charge for being a late investor into the MAC 2016 fund. This is to protect earlier investors from any dilution caused by later investors coming into the fund. For an allocation of £70m the required charge would amount to £1.2m. Paying this amount simply puts the Fund in the same position as it would have been had it invested in MAC 2016 fund from the start, i.e. the Fund would benefit from its share of the returns on MAC 2016 since inception of the fund and would not be disadvantaged in any way relative to other investors.

4. Equities

The Fund's benchmark equity allocation is largely invested in listed equity markets (48.5%) with a further 4% of the Fund invested in private equity. The listed equity allocation comprises:

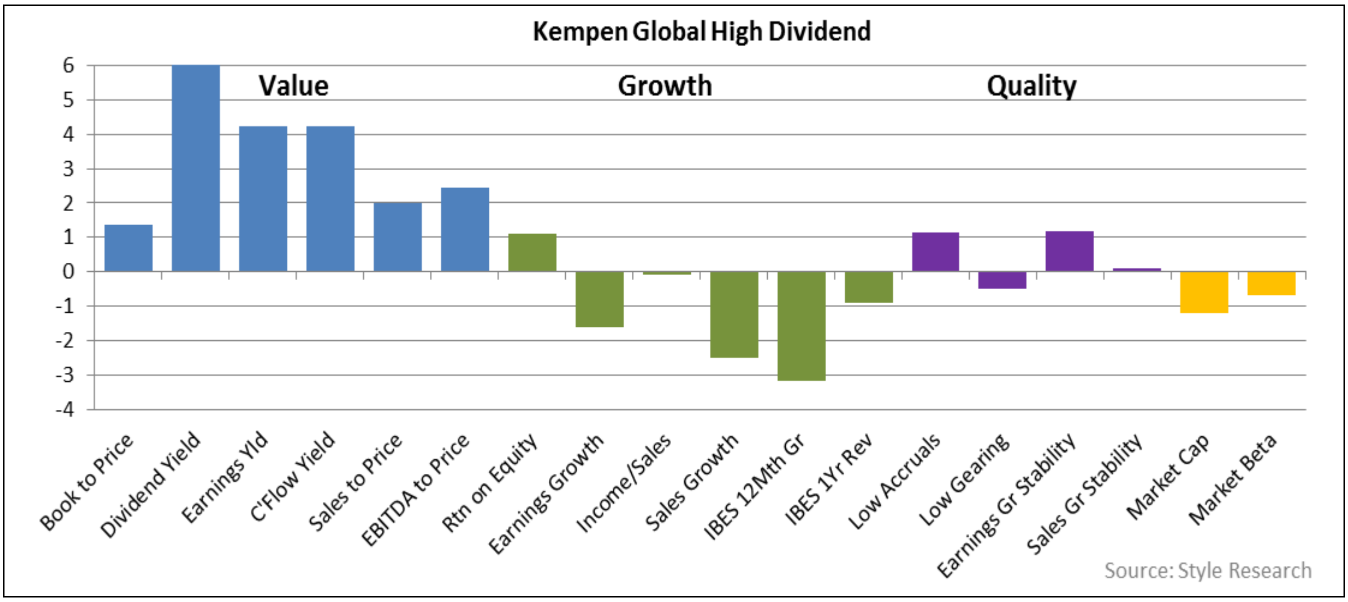
- a passive regional allocation;
- an allocation to passively managed fundamental indexation (i.e. valuation based) indices in US and Europe;
- 2 active global income managers;
- an active emerging markets manager.

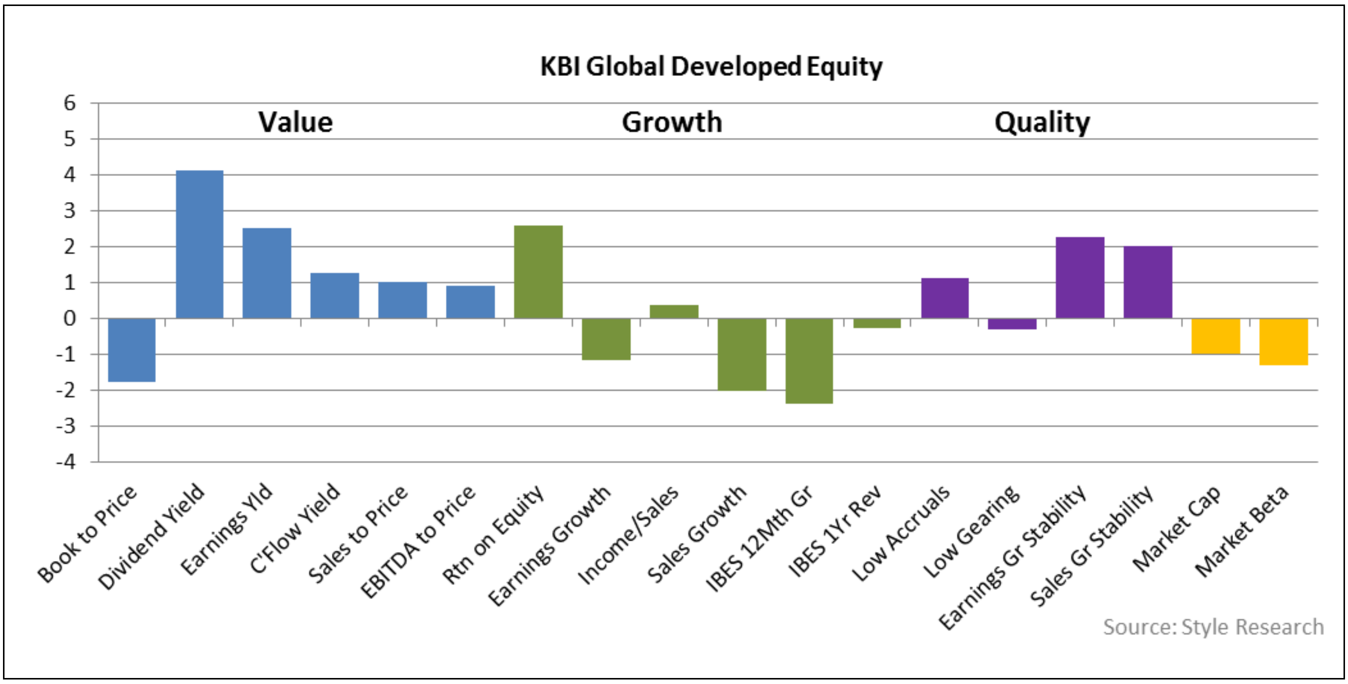
The two income managers have continued to deliver reasonable relative returns in strong markets (KBI are 1.3% ahead over the 12 months to 30 September, while Kempen are in line with the world index) and Delaware have materially outperformed in Emerging markets (+17.9% relative over the year to 30 September 2016).

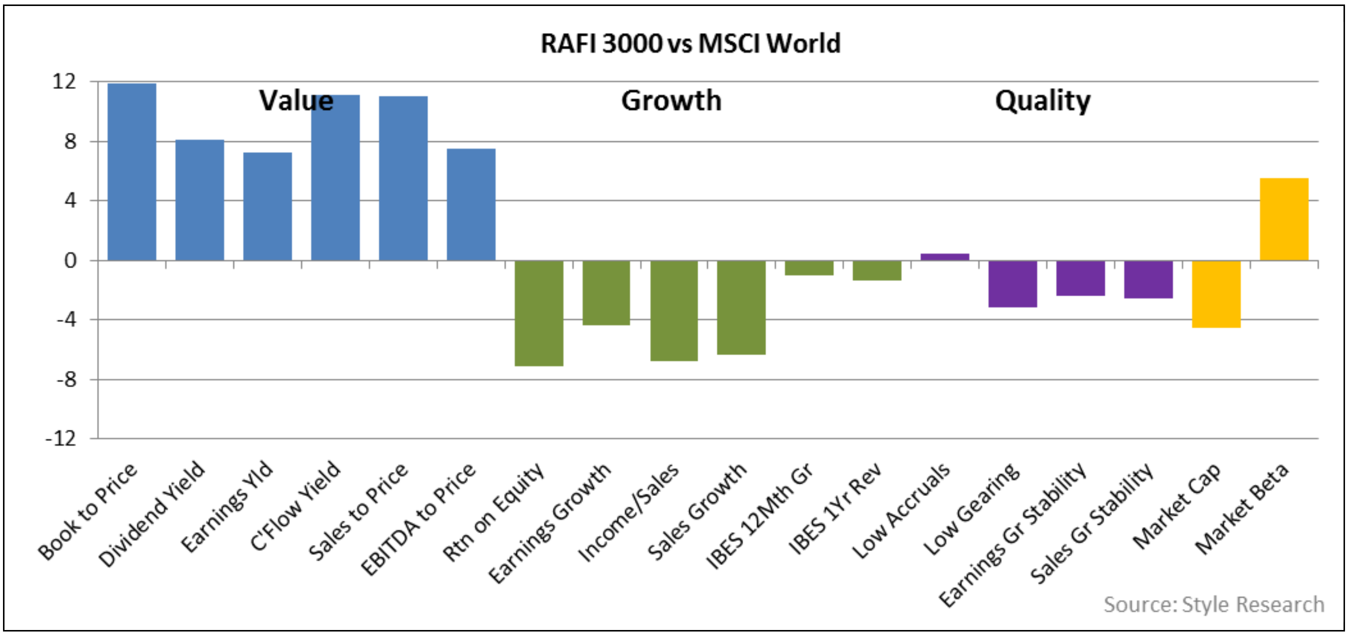
After underperforming in 2015, Fundamental Indices are also beginning to outperform broader markets as value stocks beginning to recover.

As noted last year the combination of the two income mangers and the Fundamental Index allocation provides a bias to value factors in the equity portfolio relative to the global market index (as shown by the positive blue bars in the charts below) and away from the largest companies (as shown by the first negative yellow bar). The KBI mandate also applies some sustainability or quality features in their portfolio. Over time we would expect these tilts to be rewarding. However, all three portfolios are also tilted away from growth factors (the green bars).

Last year we recommended the LPC consider the introduction of a global equity mandate with a growth bias to sit alongside the biases of the RAFI mandates and the income mandates. We would expect exposure to be achieved through active management rather than a passive index, where growth biased solutions are limited. However, given decisions over the choice of equity managers is likely to sit within the LGPS Central pool in the relatively near future, we suggested that it would be sensible to consider this again as part of the restructuring of assets within LGPS Central or when there is greater visibility around what this will look like.







Recommendation

Reflecting the unpredictability of equity returns in the medium term, coupled with equities currently being the main source of expected return in the Fund's overall strategy, we propose that the 2.5% additional allocation to private lending is funded from listed equities. This has little impact on the overall return, but at the margin moves a proportion of the Fund from assets that are very dependent upon positive growth outcomes to assets with more predictable returns irrespective of economic conditions.

The private lending strategy is likely to be split equally between US and Europe, with a bias to the UK within Europe. This would suggest funding the additional allocation from a mix of UK, European and US equities. However, given UK, European and US equities form the majority of the listed equities, we propose disinvesting the 2.5% on a pro-rata basis across the regional equity portfolio, including UK equities.

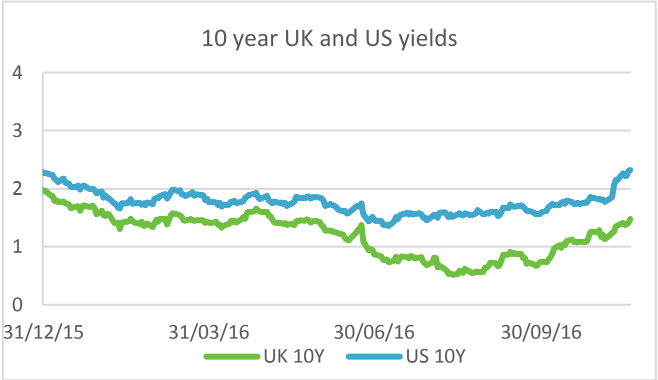
5. Inflation protection assets

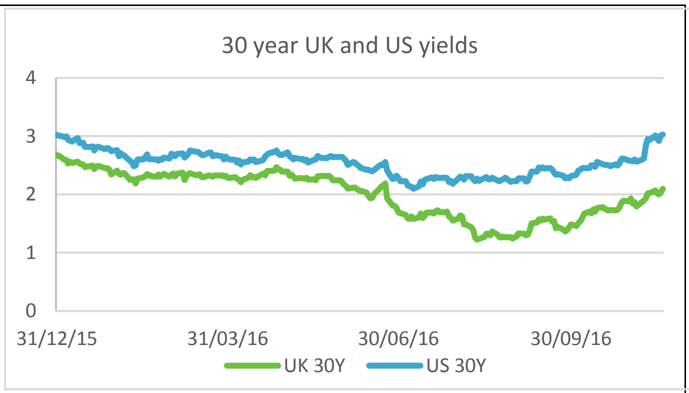
During the year the Fund increased the allocation to infrastructure from 3% to 5% by investing $90m in the JPMorgan Infrastructure fund.

In addition the Fund committed a further £25m to Kames active value property and re-categorised the Kames allocation into the core property allocation, rather than considering it as part of the Opportunity Pool.

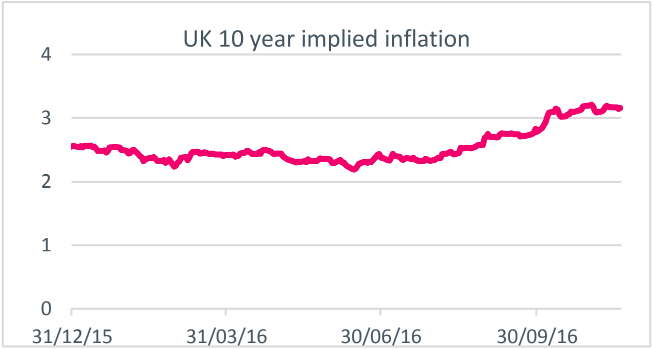
The strategic allocation to index-linked gilts is 7.5%, which represents one-third of the real asset allocation of the Fund. Following an action taken under the delegated powers available to the Director of Corporate Resources, the Fund's allocation to the index-linked gilt mandate was tactically reduced to 5% in August through sales of £65m, crystalizing a material profit on the mandate.

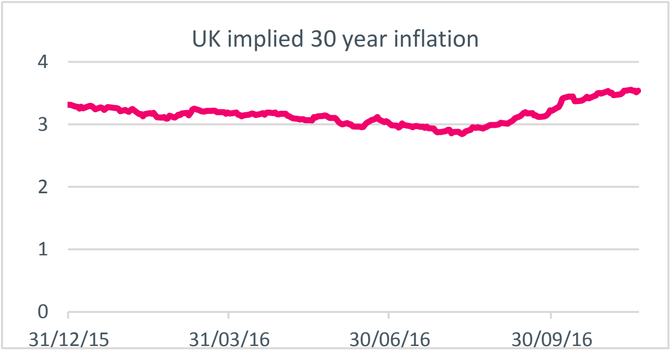
Since August, Government bond yields have risen reflecting higher interest rate expectations in the UK, and more recently in the US.





Real rates on index-linked gilts also rose, but the extent of the rise has been tempered by a continued rise in inflation expectations – real rates have risen by 0.3% and they remain persistently negative.





There are structural reasons why short-term inflation pricing has risen following the UK's vote to leave the EU and Trump's victory in the US Presidential election.

However, very long-term inflation pricing has also risen, and since 1 July 2016 implied inflation beyond 25 years has risen more than implied inflation between 15 and 25 years. In our view, this rise in longer term inflation pricing is more a reflection of investors paying a higher premium for long-term inflation protection than any significant rise in central expectations for long-term inflation levels.

Reflecting the rise in real yields, we propose removing the tactical underweight by bringing the allocation to index-linked gilts back up to the strategic allocation of 7.5%.

However, rather than reinstating the 7.5% allocation using the current Over 15 year index, we recommend the LPC adopt the All Stocks Index-Linked Gilt index as the strategic benchmark, i.e. a broader index which is less focused on the longest dated gilts, where we consider pricing to be relatively expensive.

The index-linked gilts with a term up to 15 years represent approximately one-third of the broad index. Hence, by adopting this broader index, the additional 2.5% allocation can be used to buy shorter dated index-linked gilts rather than buying more Over 15 year index-linked gilts. In practice, the manager will apply their discretion to purchase assets where they consider there to be most value.

6. Targeted Return

The current allocation to targeted return comprises the Ruffer, Aspect and Pictet portfolios.

Manager	Target	Actual (30 Sept 2016)
Ruffer	7.0%	6.6%
Aspect	4.0%	3.7%
Pictet	0.5%	2.6%
	11.5%	**12.9%**

Although the allocation to Pictet may be reduced over time, assuming investment in the Opportunity pool increases from the current allocation (c2.7% as at 30 September), it is not anticipated that this will occur in the near future, especially as the equity allocation is currently over 53%, i.e. above its target range, and provides another source of assets.

Due to relative returns, the allocation to Ruffer and Aspect are below target.

Hence, at a benchmark level we propose reducing the Ruffer and Aspect targets by 0.5% each, and increasing the Pictet benchmark allocation to 1.5%. No change to the actual allocation is proposed.

When the actual Opportunity pool allocation nears the lower end of its range (4.0%), the allocation between these three managers can be reviewed again.

7. Summary of recommendations

The table below sets out our higher level strategic recommendations. The changes are highlighted in red.

	Current Benchmark weight (%)	Proposed Benchmark Weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (48.0 – 50.0%, proposed)				
Listed equity	46.5-48.5	44.0 – 46.0	4.3	2.0
Private equity	4	4	6.5	0.3
Real (24.5%)				
Inflation linked bonds	7.5	7.5	0.3	0.0
Infrastructure	5	5	3.8	0.2
Timber	2	2	3.3	0.1
Property	10	10	2.7	0.3
Alternatives/Diversifiers (25.5 - 27.5%, proposed)				
Targeted return	11.5	11.5	4.0	0.5
EMD	2.5	2.5	3.0	0.1
Global Credit	5	7.5	4.0	0.3
Opportunity Pool	4-6	4 - 6	4.3	0.2
Currency overlay (Notional weight)	(c.10)	(c.10)	1.0	0.1
TOTAL	**100**	**100**		**3.9**

The main strategic change we propose is to reallocate 2.5% of Fund assets from equities to global credit. This has no material impact on the expected return but, at the margin, provides greater predictability to returns and further diversifies the portfolio's sources of return at a time when market direction is uncertain.

During the year the Fund's allocation to index-linked gilts was reduced tactically from 7.5% to 5.0%, reflecting the very strong returns that had been delivered by index-linked gilts, especially long-dated bonds. We recommend closing the position and bringing the allocation back up to the strategic allocation of 7.5%, but moving benchmark to the All Stocks Index-linked Gilt Index instead of the Over 15 year index.

At a benchmark level, we also propose increasing the target weight to Pictet by 1.0% to 1.5%, with a corresponding reduction of 0.5% in the target weight to each of Ruffer and Aspect, although this more closely reflects the actual allocation and so does not mean moving any assets.

Additional information

Appendix 1 – Partners 2016 MAC Fund

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Appendix 1 Partners Multi Asset Credit

Corporate capabilities

Partners Group was formed in 1996 by former Goldman Sachs investors and has grown rapidly to become one of the largest private market investment firms globally. It has over 800 employees, based in 18 locations. Partners Group employees remain the largest shareholders through an equity ownership programme. The firm manages some €42bn in a range of vehicles including private equity, private debt, real estate debt and infrastructure debt and has invested over $8.7bn in more than 350 private credits across markets since 2003.

People

Partners Group employs one of the largest private markets teams, including 120 experienced professionals dedicated to credit investing across corporate debt, private real estate, private infrastructure, distressed and public markets. Scott Essex and Rene Biner co-head the private debt team and are members of the investment committee responsible for the Fund, other members of the investment committee include Christopher Bone, head of private debt Europe, Christian Ebert, Alexander Ott, private debt Europe, Christopher Hardison, private debt Americas, Robin Thywissen, private debt Europe and Edward Tong, head of private debt Asia. The Fund will have the oversight of the Relative Value Committee, which is made up of the firm's CIO and co-founder, Marcel Erni as well as the firm's other co-founders and Chief economist. This group is responsible for taking a top-down view across regions, sectors and asset classes to determine the relative attractiveness of each providing focus for the research and sourcing teams. The manager also employs work-out expertise which the investment team can work with in the event of a loan defaulting.

Philosophy

Partners Group believes it can leverage its extensive network and knowledge of private equity markets in the equivalent debt markets. It employs a fully integrated way of working - there is no "silo mentality" at the firm. Further, incentives for investment professionals are structured in a way that enhances co-operation and communication across teams. All employees are expected to contribute to sourcing transactions, understanding underlying portfolios of potential acquisitions etc, and every employee is compensated based on the success of the whole company, not individual teams.

Process

Partners Group is flexible in how it deploys capital, allowing investors to exploit the entire credit opportunity set. Investments will be diversified across asset classes, instruments, sectors and geographies and typically include strong financial covenants, with a focus on floating-rate senior secured debt offering strong principal protection, with investments focused on capital preservation. On each investment the team works alongside members of the eight industry teams and has access to 60 senior external industry advisors as part of the due diligence process. In addition, the in-house tax, legal and structuring teams work closely on potential investments including advising on legal documentation.

MAC Program

The manager is in the process of raising capital for its third Multi-Asset Credit (MAC), MAC 2016. The fund will be managed in the same way as the other two funds in the MAC program range. MAC 2016 is targeting a final close in April 2017 after which the manager will begin raising capital for its MAC 2017 fund, targeting a first close in July 2017.

The MAC programs can invest across the private debt markets including corporate, real estate and infrastructure debt and on an opportunistic basis high yield debt and distressed. The target regional split is 30-70% Europe, 20-50% US and 0-30% Asia Pac. The targets asset split is 65-100% senior secured debt, 0-35% subordinated debt and 0-5% equity. The return target is 4% to 6% p.a. over LIBOR net of all fees with an expected running cash yield of 5% p.a. once fully invested.

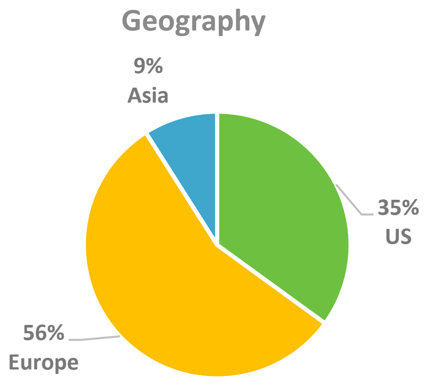
Partners Group is one of only a few managers who has the required resource, credentials and infrastructure to manage this type of MAC strategy on a global basis, allowing them to take advantage of increasing relative value opportunities in the US alongside opportunities in Europe, where deal terms have remained relatively static. The manager's approach also allows form the to make relative value allocation across asset classes, including corporate lending, real estate debt and infrastructure debt, although the manager expects

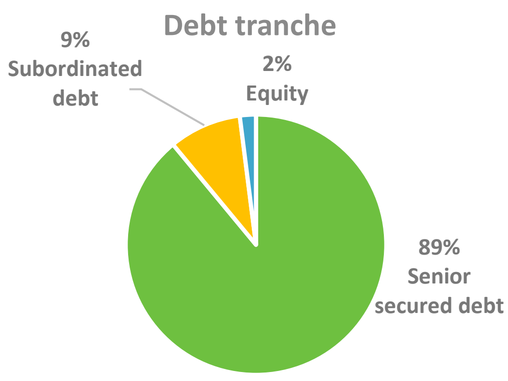
There is also an ease on governance requirements for Fund in appointing Partners for subsequent mandates, given the Investment Committee is familiar with the manager and have had a positive experience to date investing in the 2014 MAC fund.

The success of the MAC programs illustrate that the manager can get money invested in a timely way and that they can access a significant pipeline of investment opportunities.

MAC 2014 Program

The MAC 2014 fund has made 46 direct investments, diversified by geography, industry sectors and is focused on senior secured debt, split 80% corporate debt and 20% real estate and infrastructure debt (the majority in real estate debt). The fund was fully invested in July 2015 and is in harvest mode, making its first distribution in December 2015 and a further distribution in June 2016. Further distributions are expected to be on the 31st December 2016 and 30th June 2017. To date the fund has delivered in line with its objectives. The fund has experienced one credit event to date, however the credit represents less than 2% of the fund's holding and it is expected recovery will be over 80%, representing less than 50 basis point loss, which has already been covered by the income from the loan, i.e. the fund should not experience any capital loss from the event.





MAC 2014 Program	Program characteristics
Fund size	£255.3 m
Investments	46
Value creation	£25.9m
Distribution	£12.8m
NAV	£268.5m

	Portfolio statistics
Net IRR	6.3%
Net multiple	1.10x
Cash yield 1	3.76%
Gross running yield 2	7.3%
Equity cushion	48.0%
EBITDA margin 3	27.8%

1 The cash yield refers to the distributions made to investors and is calculated since inception.

2 The gross running yield is what the portfolio generates based on its current portfolio (i.e. when fully invested).

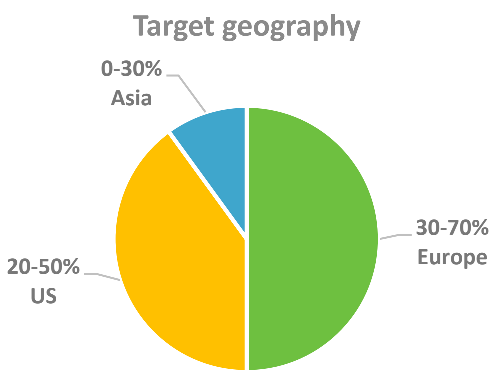
3 Weighted average adjusted EBITD margin.

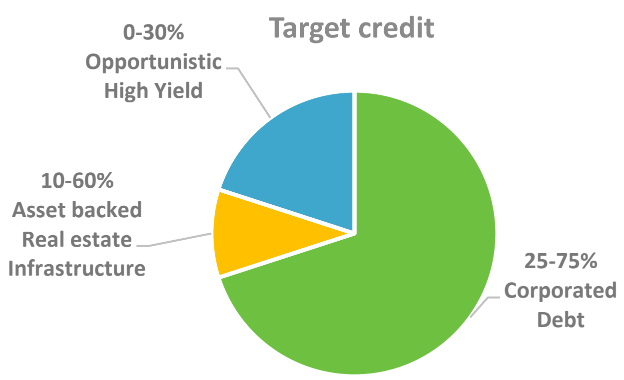
MAC 2016 Program

The manager is at the latter stages of raising capital for its MAC 2016 fund. The fund target size is up to £500m and currently the manager has £200m in fund commitments. The expected final close for the fund is in April 2017, however the manager has asked that investors need to confirm in January 2017 if they wish to come into the fund at the final close.

The MAC 2016 will be managed in line with the MAC 2014 and 2015 funds and is expected to invest predominately in senior secured corporate direct lending in Europe and the US, with a small allocation to Asia. As of the end of October 2016 the fund has originated 12 transaction and funded 6.

The manager is seeing increasing opportunities in the US market as a result of stricter regulatory requirements, including new lending guidelines reducing further banks' involvement in the leveraged lending market. This coupled with the risk retention rules which come into play in the US at the end of this year have reduced the demand for syndicated loans via Collateralised Loan Obligations (CLOs), creating a lending gap where larger companies have in the past financed through the syndicate market and are now looking to manager like Partners for financing. Partners expect the 2016 fund's exposure to the US market to be at the upper end of the (20 – 50%) range. Below we provided further details on the fund:





Program 2016	
Structure	Public Limited Liability company
Manager	Partners Group (Guernsey) Limited
Target Fund size	£500m (£200m capital committed)
Closing	1st close – July 2016, next close January 2017, final close April 2017 (manager has said they will need to know by January 2017 if investors wish to come in at final close)
Term	1-year build-up plus 5-year duration with 1-year wind-down period

	Fees
HR fee discount	Establishment charge on-off 0.30% (0.15% rebate) Management fee: year 1 0.425%, thereafter 0.85% p.a. until the 5th anniversary of the program and thereafter 0.85% p.a. on cost Average fee: 0.75% p.a. (0.05% discount).
Performance fee	7.5% of profits, subject to a 4% preferred return p.a. to investors with catch-up

Background: bank replacement lending opportunity

Historically banks have played an important role in funding the economy. In particular in Europe, where prior to the 2008 financial crisis close to 80% of corporate lending was done by banks. The reverse is the case in the US given its more developed non-bank lending market.

As a consequence of new bank legislation in the fallout of the financial crisis banks have been less active in the lending market. This new legislation is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage and has resulted in a significant increase in financing by non-bank lenders. In 2015, it was estimated that non-bank lending in the US and in Europe reached over 60% and 80% respectively. This coincides with a significant demand for financing from Private Equity sponsors which is keeping transaction terms at attractive levels relative to the traded leverage markets in both the US and Europe. Another dynamic in the US which is positively influencing pricing for non-bank lenders is the risk retention rule, requiring CLO managers to “keep skin in the game” which comes into force by the end of the year. This is reducing the formation of CLOs, which in turn is decreasing demand for syndicated loans. This is making banks less willing to do syndications, forcing larger leveraged companies, often arguably more robust than mid-cap companies, to target companies like Partners for financing.

We see this bank disintermediation (the withdrawal of lending) resulting in a longer-term structural shift in the financial industry which will continue to provided attractive risk adjusted return for longer term investors for a period of time.

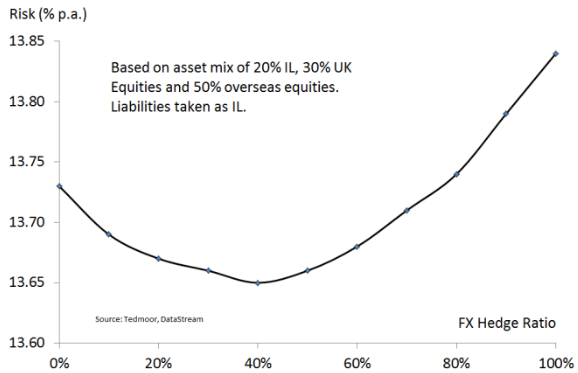
Note: Reviewing the neutral currency hedge ratio

This note is addressed to the Local Pension Committee of the Leicestershire County Council Pension Fund (the 'Fund') as part of the general review of the Fund's investment strategy. The note focuses on the neutral hedge ratio provided to the manager of the existing currency hedging programme.

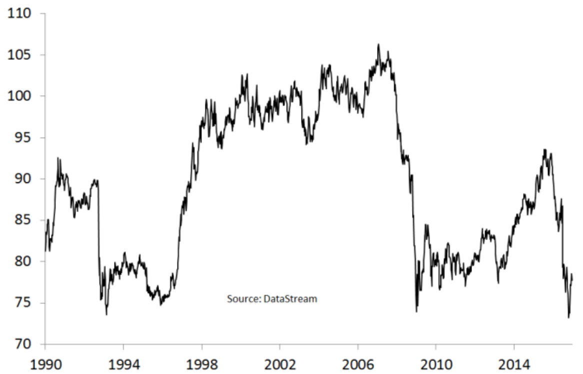
Background

The Fund maintains a significant weighting to non-UK financial markets; this generates foreign currency exposures that are often secondary to main investment rationale. To manage these associated risks, the Fund retains Kames Capital (the 'Manager') to operate a foreign currency hedging programme. Within the programme the Manager has full discretion to hedge all or none of the exposure generated by the Fund's overseas equity benchmark weighting based on their prevailing currency views and considering the risk impact on the Fund. Hitherto the Fund has advised the Manager that they should apply a neutral (or benchmark) hedge ratio of 50%.

The rationale for a neutral half-hedge ratio is illustrated in chart opposite (which applies to a simpler asset structure than that of the Fund). In short, maintaining some degree of currency exposure is appropriate though, from a risk perspective, precision is spurious (note the narrowness of scale risk scale). The principle factor against fully hedging all exposure is that, in 'risk events' (i.e. sharply falling markets), defensive currencies (often those with substantial current account surpluses) rise in value against £ (which is burdened by a substantial current account deficit).



The 50% hedge ratio is widely used within currency hedging programmes for the reason discussed above. In addition and put simply, 50:50 (or half-right, half-wrong) summarises most investors view on the likelihood of success from trying to manage currency risk (although the Fund can demonstrate that its currency hedging programme has been a success). After the sharp decline in the broad, trade-weighted value of £ (shown opposite), the 'odds' based on experience look to be skewed to the upside.

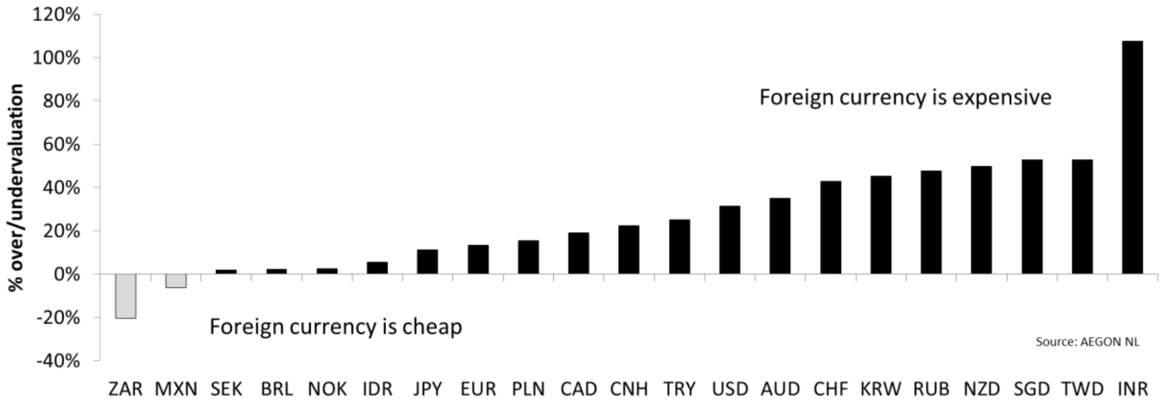


In this context the Fund would appear to be better served by a higher hedge ratio i.e. by increasing the default weighting of £ exposure. The remainder of this note examines this proposition.

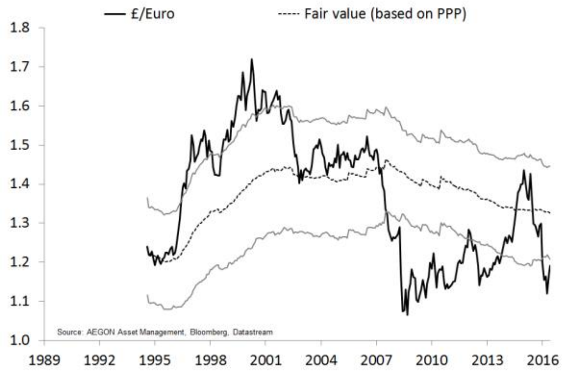
Discussion

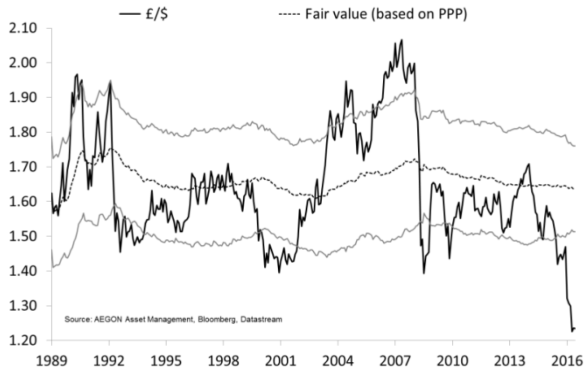
Just because its price has fallen does not mean that an investment has become cheaper; there could be myriad good reasons for the price decline. The Appendix to this note repeats views provided by Kames Capital on the medium term outlook for £. In it the Manager highlights the political and economic issues that lie behind the sharp slide in £ in 2016 and which will continue to confront the UK going forward.

In setting any programme's benchmark position, valuation should be the principle consideration (beyond the broader assessment of risk contribution and objective attainment). Valuation, in currencies as in all asset classes, is notoriously problematic. In this context nonetheless the chart overleaf summarises the latest valuation measurements of a wide range of foreign currencies (relative to £). The calculations have been based on purchasing power parity (PPP) and attempt to capture the interplay between currency movements and evolving inflation differentials. The inference echoed across a range of other valuation approaches is clear: against almost all other currencies, £ is cheap – and materially so against the major exposures of the Fund.



Currencies can remain mis-aligned for long periods - shown in the two charts below which plot the evolution of £/$ and £/€ against their 'PPP' fair value since 1989 (also shown are the +/- 10% deviation bands). Reversion to fair value does occur but it can be a multi-year process – this should be the timescale upon which the benchmark should be set. The charts also highlight the extent of the current mis-valuation of £ against both currencies – the pricing of £ against US$s looks particularly extreme[1].





The inference is clear: looking beyond the issues that are currently weighing heavily on £, the prospect is for £ to recover naturally from current levels, unless economic fundamentals alter materially and durably; the hedge ratio should be therefore be increased. Of course developments in 2016 – involving Brexit and Trump's victory in the US, have the potential to ultimately deliver these material and durable changes but at the current time it is not possible to be certain that these changes will occur; it is this lack of certainty that has seen markets refuse to give £ the benefit of the doubt. Evidence that shows that Trump's fiscal expansion will be less extreme than proposed or that European politics will deliver sharp changes in 2017 will see markets take a more balanced view on £ that should lead £ higher.

Beyond the investment wisdom of maintaining a higher currency hedge proportion, there are practical implications to be considered. Most importantly a higher hedge ratio means larger forward currency positions used to neutralise the exposure in the underlying assets. The value of these contracts will oscillate each day according to the fluctuation of currency rates; the Fund is subject to these profit & loss swings. In practice these cash movements are handled by the Manager and the cash balances they maintain are for this purpose. If the movements are large then the Fund could be required to sell assets to fund marked-to-market losses. The Manager acts to minimise these strains by managing the hedge exposures on a discretionary basis, trying to avoid owning foreign currencies that are rising in value. Perfect foresight cannot however be guaranteed! Officers are confident that this issue is manageable.

[1] It should also be noted that fair value itself evolves (in line with contrasting inflation experience) – the 'fair value' of £/€ has fallen because inflation in the UK has been persistently greater than that in the EuroZone.

Summary

As the Manager's note in the Appendix reminds, there are still risks to £ but unless those risks develop and deepen then £ should be cheap enough to support a higher hedge ratio. The Manager's caution offers some protection against a premature increase in the neutral weight to £ in the Fund. The Manager could prove too cautious however and they could mis-time a broad revival in £. A higher neutral ratio, set by the Fund in recognition of the long term valuation support, would better serve the Fund in this scenario.

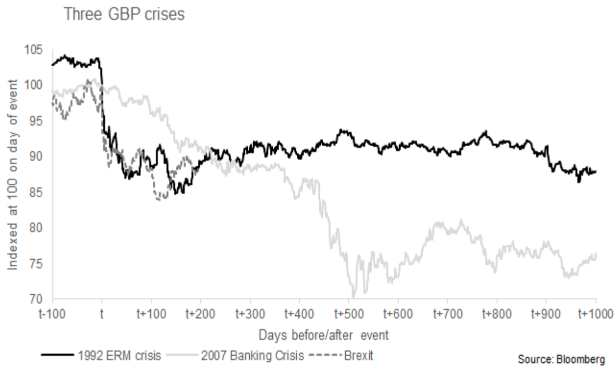
Out of the above the question is then, to what level should the neutral hedge ratio be increased? The calculation of the optimal risk calculation (first chart) argues against spurious precision and a ratio of 2/3rds is suggested. This ensures that some non-£ exposure is maintained (delivering a risk offset) and retains scope to increase the ratio further should £ fall even further.

Appendix – the outlook for £ (provided by Kames Capital)[2]

This note is addressed to the Members and Officers of the Leicestershire County Council Pension Fund (LCCPF) and relates to the currency hedging programme operated by Kames Capital. Below we discuss the strategic outlook for sterling over the medium term against US dollar, euro, yen and emerging markets.

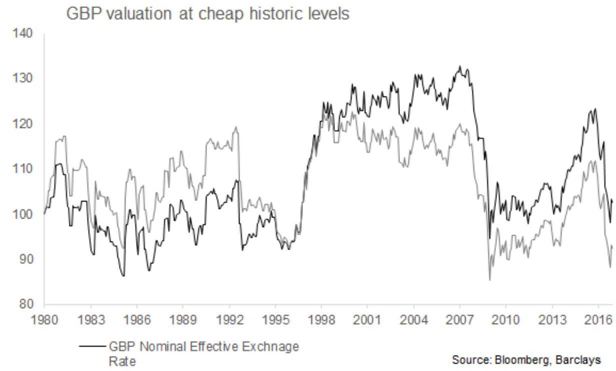
Detail

The vote to leave the European Union ('Brexit') has induced the second worst Sterling (GBP) crisis of the last four decades, currently in between the ERM crisis of 1992 and the banking crisis of 2007-08 (chart 1). Whilst the currency is ending the year on a slightly better note, the GBP remains one of the weakest major currencies this year.



Five months after the vote, the prospects for GBP are still shrouded in legal and political uncertainties. The major factor putting pressure on GBP exchange rates is uncertainty about how the UK and the EU-27 will work together in the future, in particular access to the single market, and therefore sterling will remain sensitive to the distinction between a 'hard' and a 'soft' Brexit.

Valuation is the second most relevant factor after politics in formulating the outlook for the Pound over the medium term. Sterling does look cheap over the long term on a both the Real Effective Exchange Rate (REER), the exchange rate adjusted for inflation (chart 2) and on a trade weighted basis. Sterling's REER fell to a recent low in October after the Conservative Party Conference, and is approximately 15% below its average since 1980 despite the recent modest rebound. However, in isolation this is not sufficient reason to believe in a recovery in the currency over the medium term, as UK economic growth will probably not be powerful enough to justify a bounce in GBP, particularly as the Brexit-related uncertainties will restrain growth and suppress investor appetite for GBP assets. For example the UK economy is currently growing at a 2.3% p.a., a growth rate, based on consensus forecasts, that is expected to fall to 1.1% in 2017 before rising slightly in 2018 to 1.3%. Finally the triple deficit (in budget, current account and domestic savings) will sustain downward pressure on the currency.



The UK economy is entering the later stages of the economic cycle with unemployment falling and capacity utilisation increasing - this should increase inflationary pressures in the future. We expect interest rates to be at the current level for some time, as monetary policy should act as a stabiliser for the exchange rate, for example inflation will be too high for the Bank of England to tolerate a further easing in rates, and growth too weak to warrant a tightening.

The overall message for sterling is consolidation, and we remain negative of the currency given the growth risks, reduced capital inflows and political uncertainty. Whilst sterling is cheap, we do not believe it is cheap enough to attract inflows amid the risks mentioned.

Overleaf we provide a short summary on sterling verses US dollar, Euro, Japanese Yen and Emerging Markets (the major exposures within the LCCPF currency hedging programme).

[2] The standard disclaimers apply

US dollar

We judge that the US dollar will generally remain strong. In the medium term the US economy should strengthen further once the Trump administration enacts significant fiscal stimulus measures (albeit we expect this to be lower than what was announced in Trump's campaign) and US bond yields to climb marginally higher with rising inflation expectations. Against sterling the dollar is likely to trade in a relatively tight range of 10 cents between 1.20 and 1.30 over the medium term. There will be sporadic periods of instability and the pound could reverse direction several times driven by political developments in the UK, US and Europe; we are wary of dips in £/$ below 1.20. Whilst the current programme has a neutral US$ hedge there will be opportunities to trade between these two extremes over the medium term.

Euro

The euro is back to where it was in early July following the surprising Brexit vote. The monetary policy of ECB remains very accommodative, and recently, the Governing Council extended the ECB`s buying programme from March to December 2017, although at a reduced pace. The ECB also expanded the scope of securities eligible for purchase. Thus easy monetary policy will continue to be a headwind for the Euro and this should be supportive for sterling.

The biggest concern for the euro continues to be political uncertainty, as such we see two scenarios that are very difficult to predict given the surprising political developments in the UK and US in 2016. Firstly there is scope for a sharp sell-off in EUR/GBP should European electorates embrace their own populists; the risk premium in GBP/EUR might vanish and the currency pair could rise towards 1.35 (from 1.17 currently). Secondly, there is a strong possibility of a rebound in EUR/GBP as UK suffers from higher inflation, and political headwinds facing the euro fade. Therefore over 2017 we will continue to monitor this closely and adjust the currency mandate accordingly.

Yen

Monetary policy will likely continue to be accommodative for the foreseeable future. For example, the Bank of Japan's willingness to anchor the 10-year yield around zero in September while global bond yields were still close to their lows. The recent surge in global bond yields is now causing a sharp widening in rates differentials, pushing the Yen lower. Also the current account surplus has been increasing since 2014; this should provide support for the yen as demand for Japanese exports also means demand for yen.

We expect sterling to outperform yen over the medium term however we are cautious of a rise in US and European political risks that could make the markets more volatile and lead the Yen to strengthen. The hedge programme is currently neutral on yen.

Emerging markets

Fed rate hikes, rising US Treasury yields and the strengthening US dollar are all likely to reverse the strong flow into emerging markets seen in 2016 – we have already witnessed negative outflows on EM assets. We are bearish on Asian emerging markets as they will be negatively impacted by moves towards trade protectionism, de-globalisation, an unfavourable trend on policy rate differentials, and proximity-to-China macro risks, for example Taiwan and South Korea. We are also alert to those currencies that have global trade policy uncertainties and growing domestic risks, for example Mexico, and those currencies with heighted domestic political risks including Turkey and Philippines. There will be pockets of opportunity. Those countries that have high interest rates and which will benefit from improvements in commodities, one example is Brazil, should perform well particularly if there is a reduction in the political risk.

As such over the medium term we expect sterling to outperform those currencies (typically Asian) that are low yielding and are highly dependent on exports, and favour those currencies against sterling that are high yielding, face limited impact on global trade and have increasing political stability.

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Leicestershire County Council

LOCAL PENSION COMMITTEE – 17 JANUARY 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

DRAFT INVESTMENT STRATEGY STATEMENT

Purpose of the Report

1. To recommend the approval of an Investment Strategy Statement (ISS) for the Leicestershire County Council Pension Fund, a copy of which is attached as the appendix to this report.

Background

2. For many years Local Government Pension Funds have been required to maintain a Statement of Investment Principles (SIPs). In broad terms this document laid out the things that were considered by the Fund when making investment decisions and included such things as the types of investment that could be held, how the various risks were taken into account and what the Fund's objectives were.

3. New Local Government Pension Scheme (LGPS) Investment Regulations became effective on 1st November 2016. These Regulations removed the restrictions on investments that were formerly in place for the LGPS (none of which had any practical impact onto the Leicestershire Fund) and, in effect, allowed individual Funds complete discretion about where and how to invest. The Regulations also introduced a requirement for administering authorities to formulate, publish and maintain an Investment Strategy Statement and this needs to be approved by 1st April 2017. The ISS is simply a more detailed version of the SIPs, with the SIPs being no longer necessary.

Statutory Background

4. The Investment Strategy Statement must include:

a) A requirement to invest money in a wide variety of investments;
b) The authority's assessment of the suitability of particular investments and types of investments;
c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

f) The authority's policy on the exercise of rights (including voting rights) attaching to investments

5. As with all policy documents it would be possible for the ISS to go into great depth, but this could potentially be counterproductive. Ideally a Pension Fund should have flexibility to be able to take into account changes in the market situation in order to be able to enhance or protect returns. Within the Leicestershire Fund there is clearly defined governance around the setting of a Strategic Benchmark for the Fund by this Committee, with this strategy being implemented based on decisions agreed either by this Committee or the Investment Subcommittee. There is the ability to utilise the Director of Corporate Resources' delegated powers, subject to consultation with the Chairman, but this is used sparingly and generally only within the parameters provided by the Strategic Benchmark. As a result it is considered preferable that the ISS is written in such a way that it does not require amendment unless there are fundamental changes to the Fund's approach.

6. The appendix to this report is a draft version of the recommended ISS. The document has to be approved before 1st April 2017, so there is one further Local Pension Committee meeting at which this could be done (17th March), but it is hoped that it can be agreed at today's meeting.

7. The draft ISS is based on a template produced by Hymans Robertson, the Fund's investment advisor, and covers all the necessary areas. For ease it has been written as if it has already been approved at this meeting; if it is not, then the dates can be changed.

Recommendation

8. The Committee is recommended to approve the Investment Strategy Statement that is attached as the appendix to this report.

Equal Opportunities Implications

None specific.

Background Papers

None.

Appendix

Draft Investment Strategy Statement

Officers to Contact

Colin Pratt, Investments Manager, telephone 0116 3057656. Email colin.pratt@leics.gov.uk

Chris Tambini, Director of Finance, telephone 0116 3056199. Email chris.tambini@leics.gov.uk

Investment Strategy Statement (Published January 2017)

Introduction and background

This is the Investment Strategy Statement ("ISS") of the Leicestershire County Council Pension Fund ("the Fund"), which is administered by Leicestershire County Council, ("the Administering Authority"). The ISS is made in accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 ("the Regulations").

The ISS has been prepared by the Fund's Local Pension Committee ("the Committee") having taken advice from the Fund's investment adviser, Hymans Robertson LLP. The Committee acts on the delegated authority of the Administering Authority.

The ISS, which was approved by the Committee on 17th January 2017, is subject to periodic review at least every three years and without delay after any significant change in investment policy. The Committee has consulted on the contents of the Fund's investment strategy with such persons it considers appropriate.

The Committee seeks to invest, in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund's Funding Strategy Statement (dated 17th January 2017).

The suitability of particular investments and types of investments

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 dependants, on a defined benefits basis. This funding position will be reviewed at each triennial actuarial valuation, or more frequently as required.

The Committee aims to fund 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 set for each employer to meet the cost of future benefits accruing. The funding level and the cost of benefits accruing will be based on service completed and will take account of expected future salary and/or inflation increases. If necessary an adjustment is made to the employers' contribution rate to take account of any surplus/deficit within their sub fund.

The Committee has translated its objectives into a suitable strategic asset allocation benchmark for the Fund. This benchmark is 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.

It is intended that the Fund's investment strategy will be reviewed annually at a meeting of the Committee that will focus almost exclusively on the strategy. Information available from a number of sources, including the triennial actuarial valuation, will be used to guide the setting of the investment strategy but the strategy does not look to match assets and liabilities in such a way that their values move in a broadly similar manner. Asset/liability matching in this way would lead to employers' contribution rates that are too high to be affordable, so there will inevitably be volatility around the funding level (i.e. to ratio of the Fund's assets to its liabilities).

The Fund will seek to maintain an investment strategy that is expected to produce a long-term investment return that is at least in line with the assumptions made within the actuarial valuation for future investment returns, and in all probability will set a strategy that is expected to produce a marginally higher return than this. The setting of the target investment return to be in-line with, or marginally above, the assumption on which the present value of accrued liabilities are discounted within the actuarial valuation produces a framework around which the level of risk can be based.

It is recognised that the maturity profile of the Fund (in terms of the relative proportions of liabilities in respect of pensioners, deferred and active members), together with the level of disclosed surplus or deficit have a role to play in the setting of investment strategy. As the Fund grows more mature it is likely that a more defensive investment strategy will be adopted, whereby a lower level of return is considered an attractive 'trade off' as it should be achieved at a lower level of volatility. These issues do not currently have a material influence on the investment strategy adopted.

In general terms the investment strategy approved will be a blend of asset classes that are diverse enough to dampen down some volatility (e.g. if equity markets fall, some of the other assets may rise), without being so diverse that the strategy become unmanageable and costly. Expected long-term returns, levels of volatility and correlation in the performance of different asset classes will all have a role to play in setting the strategy.

By their very nature investment markets are unpredictable and it is impossible to have any certainty around future returns and volatility, so the setting of any investment strategy can never be more than an imprecise way of arriving at an 'appropriate' split of assets. As strategy is, however, the biggest driver of future investment returns it is important that sufficient time is spent in designing and implementing a strategy that is considered to be sensible for the Fund.

The Committee sets an investment strategy that focuses on factors including, but not limited to:

- Suitability given the Fund's level of funding and liability profile
- The level of expected risk
- Outlook for asset returns

The Fund's actual allocation is monitored by Officers on a regular basis to ensure it does not notably deviate from the target allocation.

The Fund has a number of investment beliefs that are taken into account when agreeing an asset allocation policy. These are:

- A long term approach to investment will deliver better returns
- The long term nature of the Fund's liabilities is well suited to a long term approach to investment
- Asset allocation policy is the most important driver of long term returns
- Risk premiums exist for certain types of asset and taking advantage of these can help to improve investment returns
- Markets can be inefficient, and sometimes 'mispriced' for long periods of time, and there is a place for both active and passive investment management
- Diversification across investments with low correlation improves the risk/return profile, but over-diversification is both costly and adds little value
- The Fund should be flexible enough in its asset allocation policy to take advantage of opportunities that arise as a result of market inefficiencies, and also flexible enough to protect against identifiable short-term risks when this is both practical and cost-effective
- Responsible investment can enhance long term investment performance and investment managers will only be appointed if they integrate responsible investment into their decision-making processes

- Investment management fees are important and should be minimised wherever possible, but it is ultimately the net return to investors (i.e. the return after all fees and costs) that is the most important factor

Investment of money in a wide variety of investments

Asset classes

The Fund may invest in quoted and unquoted securities of UK and overseas markets including equities and fixed interest and index linked bonds, cash, property, infrastructure and commodities either directly or through pooled funds. These asset classes are only examples of the types of investments that may be held, and are not intended to be an exhaustive list. The Fund may also make use of contracts for differences and other derivatives either directly or in pooled funds investing in these products for the purpose of efficient portfolio management or to hedge specific risks.

The Committee reviews the nature of Fund investments on a regular basis, with particular reference to suitability and diversification. The Committee seeks and considers written advice from a suitably qualified person in undertaking such a review. If, at any time, investment in a security or product not previously known to the Committee is proposed, appropriate advice is sought and considered to ensure its suitability and diversification.

The Fund's target investment strategy is set out below. As far as is practical and cost-effective, attempts will be made to maintain an actual asset allocation split that is close to the target strategy. In line with the Regulations, the authority's investment strategy does not permit more than 5% of the total value of all investments of fund money to be invested in entities which are connected with that authority within the meaning of section 212 of the Local Government and Public Involvement in Health Act 2007".

Table 1: Fund allocation

Asset class	Target allocation*
Quoted equities	46.5%- 48.5%
Private equity	4%
Targeted return	11.5%
Property	10%
Index-Linked bonds	7.5%
Credit	5%
Emerging Market debt	2.5%
Infrastructure	5%
Timberland	2%
Other opportunities	4% - 6%

*the target allocation shown is based on the asset allocation strategy approved on January 2016 and this table will be updated when the target allocations change.

In January 2016, the expected return of this portfolio was 4%p.a.above Consumer Price Inflation.

Restrictions on investment

The Regulations have removed the previous restrictions that applied under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. Given that the Fund's approach to setting asset allocation policy takes account of the various risks involved as an integral part of the decision-making process, it is not felt necessary to impose any specific investment restrictions.

Managers

The Committee has appointed a number of investment managers all of whom are authorised under the Financial Services and Markets Act 2000 to undertake investment business.

The Committee, after seeking appropriate investment advice, has agreed specific benchmarks with each manager so that, in aggregate, they are consistent with the overall asset allocation for the Fund. The Fund's investment managers will hold a mix of investments which reflects their views relative to their respective benchmarks. Within each major market and asset class, the managers will maintain diversified portfolios through direct investment or pooled vehicles. The manager of the passive funds in which the Fund invests holds a mix of investments within each pooled fund that reflects that of their respective benchmark indices.

The approach to risk, including the ways in which risks are to be measured and managed

The Committee is aware that the Fund has a need to take risk (e.g. investing in growth assets) to help it achieve its funding objectives. Officers and investment consultants manage, measure, monitor and (where possible) mitigate the risks being taken, in order that they remain consistent with the overall level of risk that is acceptable to the Committee. One of the Committee's overarching beliefs is to only take as much investment risk as is necessary.

The principal risks affecting the Fund are set out below, as is the Fund's approach to managing these risks and the contingency plans that are in place:

Funding risks

- Financial mismatch – The risk that Fund assets fail to grow in line with the developing cost of meeting the liabilities.
- Changing demographics –The risk that longevity improves and other demographic factors change, increasing the cost of Fund benefits.
- Systemic risk - The possibility of an interlinked and simultaneous failure of several asset classes and/or investment managers, possibly compounded by financial 'contagion', resulting in an increase in the cost of meeting the Fund's liabilities.

The Committee measures and manages financial mismatch in two ways. As indicated above, the Committee has set a strategic asset allocation benchmark for the Fund. This benchmark was set after taking into account expected future returns from the different asset classes, and also took into account historic levels of volatility of each asset class and their correlation to each other.

The Committee assesses risk relative to the strategic benchmark by monitoring the Fund's asset allocation and investment returns relative to the benchmark.

The Committee also seeks to understand the assumptions used in any analysis so they can be compared to their own views and the level of risks associated with these assumptions to be assessed.

The Committee seeks to mitigate systemic risk through a diversified portfolio but it is not possible to make specific provision for all possible eventualities that may arise under this heading.

Asset risks

- Concentration - The risk that a significant allocation to any single asset category and its underperformance relative to expectation would result in difficulties in achieving funding objectives.
- Illiquidity - The risk that the Fund cannot meet its immediate liabilities because it has insufficient liquid assets.
- Currency risk – The risk that the currency of the Fund's assets underperforms relative to Sterling (i.e. the currency of the liabilities).

- Environmental, social and governance ("ESG") – The risk that ESG related factors reduce the Fund's ability to generate the long-term returns.
- Manager underperformance - The failure by the investment managers to achieve the rate of investment return assumed in setting their mandates.

The Committee measure and manage asset risks as follows:

The Fund's strategic asset allocation benchmark invests in a diversified range of asset classes. The Committee has put in place rebalancing arrangements to ensure the Fund's "actual allocation" does not deviate substantially from its target. The Fund invests in a range of investment mandates each of which has a defined objective, performance benchmark and manager process which, taken in aggregate, help reduce the Fund's asset concentration risk. By investing across a range of assets, including liquid quoted equities and bonds, as well as property, the Committee has recognised the need for access to liquidity in the short term.

The Fund invests in a range of overseas markets which provides a diversified approach to currency markets; the Committee also assess the Fund's currency risk during their risk analysis. This currency risk is managed through a variable currency hedging programme, designed to take account of both the risks involved with holding assets that are not denominated in sterling and also the perceived value of overseas currencies relative to sterling. Details of the Fund's approach to managing ESG risks are set out later in this document.

The Committee has considered the risk of underperformance by any single investment manager and have attempted to reduce this risk by appointing multiple investment managers and by having a large proportion of the Fund's equities managed on a passive basis. The Committee assess the investment managers' performance on a regular basis and will take steps, including potentially replacing one or more of their managers, if underperformance persists. The Committee also recognises that individual managers often have an investment 'style' that may be out-of-synch with market preference for prolonged periods, and that this could lead to meaningful periods of underperformance relative to the relevant benchmark. If the Committee remain convinced by the quality of the investment manager, and the fact that their views remain relevant, underperformance will not necessarily lead to their replacement.

Other provider risk

- Transition risk - The risk of incurring unexpected costs in relation to the transition of assets among managers. When carrying out significant transitions, the Committee seeks suitable professional advice.
- Custody risk - The risk of losing economic rights to Fund assets, when held in custody or when being traded.
- Credit default - The possibility of default of a counterparty in meeting its obligations.
- Stock-lending – The possibility of default and loss of economic rights to Fund assets.

The Committee expects Officers to monitor and manage risks in these areas through a process of regular scrutiny of the Fund's providers, and audit of the operations it conducts for the Fund, or has delegated such monitoring and management of risk to the appointed investment managers as appropriate (e.g. custody risk in relation to pooled funds). The Committee has the power to replace a provider should serious concerns exist.

A separate schedule of risks that the Fund monitors is set out in the Fund's Funding Strategy Statement.

The approach to pooling investments, including the use of collective investment vehicles and shared services

The Fund is a participating scheme in the LGPS Central Pool. The proposed structure and basis on which the LGPS Central Pool will operate was set out in the July 2016 submission to Government.

Assets to be invested in the Pool

The Fund's intention is to invest its assets through the LGPS Central Pool as and when suitable Pool investment solutions become available. An indicative timetable for investing through the Pool was set out in the July 2016 submission to Government.

It is expected that virtually all of the Fund's assets will be transferred to the Pool on 1st April 2018, although it will take some time for the Pool to restructure the assets into appropriate sub-funds within the Pool. These sub-funds are likely to be set-up over a period of 2 – 3 years, with the timing being dependent on market conditions and operational circumstances, and until such time as the appropriate sub-fund is set up the assets transferred into the Pool will be overseen by LGPS Central on behalf of the Fund. It is not expected that any significant decisions (e.g. replacement of a manager) will be taken on the assets transferred over to the Pool without prior consultation with the Fund, unless it is part of the process that leads to the setting up of a sub-fund.

At present it is expected that any transitory cash will be held outside the Pool (but not strategic cash holdings), and it is possible that currency management will continue to be carried out at an individual Fund level.

Structure and governance of the LGPS Central Pool

The eight administering authorities of LGPS Central will all be equal shareholders of the company. A Shareholders' Forum, comprising of one elected member from each administering authority, will fulfil the shareholders' role in ensuring that the company is managed efficiently and effectively and in the best interests of the Funds.

A Joint Committee, also comprising one elected member from each administering authority, will be formed that will hold the company to account on all investment-related issues. The Joint Committee will have no decision-making powers and all actions that are felt to be appropriate will ultimately require approval at an individual fund level.

A Practitioners' Advisory Forum, comprising of Officers of the administering authorities, will also be set up. The intention of this forum is to provide support and guidance to elected members on some of the practical issues, and to act as a conduit between the Joint Committee and the Committees of individual Funds.

How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments

It is recognised that ESG factors can influence long term investment performance and the ability to achieve long term sustainable returns. The Committee consider the Fund's approach to ESG in two key areas:

- **Sustainable investment / Environmental and social factors** – considering the financial impact of environmental, social and governance (ESG) factors on its investments.
- **Stewardship and governance** – acting as responsible and active investors/owners, through considered voting of shares, and engaging with investee company management as part of the investment process.

In combination these two matters are often referred to as 'Responsible Investment', or 'RI' and this is the preferred terminology of the fund.

The Committee takes RI matters seriously and will not appoint any manager unless they can show evidence that RI considerations are an integral part of their investment decision-making processes. Following appointment managers are required to report any changes in their approach to RI to Officers.

At the present time the Committee does not take into account non-financial factors when selecting, retaining, or realising its investments. The Committee understand the Fund is not able to exclude investments in order to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

To date, the Fund's approach to Responsible Investment has largely been to delegate this to their underlying investment managers as part of their overall duties.

In its July 2016 submission in respect of investment pooling within the LGPS, the eight administering authorities of LGPS Central agreed to a common Responsible Investment Framework.

The exercise of rights (including voting rights) attaching to investments

Voting rights

The Committee has delegated the exercise of voting rights to the investment manager(s) on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. Accordingly, the Fund's managers have produced written guidelines of their process and practice in this regard. The managers are strongly encouraged to vote in line with their guidelines in respect of all resolutions at annual and extraordinary general meetings of companies under Regulation 7(2)(f).

Stewardship

The Committee supports the Stewardship Code as published by the Financial Reporting Council. The Committee expects both the LGPS Central Pool and any directly appointed fund managers to comply with the Stewardship Code as published by the Financial Reporting Council.

Prepared by:-

Chris Tambini

For and on behalf of the Local Pension Committee of the Leicestershire County Council Pension Fund

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Leicestershire County Council

LOCAL PENSION COMMITTEE – 17 JANUARY 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

DRAFT FUNDING STRATEGY STATEMENT

Purpose of the Report

1. The purpose of this report is to seek the Committee's approval for a revised Funding Strategy Statement.

Background

2. There is a statutory requirement upon the Fund to maintain, and update, a Funding Strategy Statement (FSS). The FSS is a statement of the factors and policies that have been taken into account when calculating individual employers' contribution rates, and also how the findings of the actuarial valuation interact with the setting of the Fund's investment strategy.

3. There is an obligation on the part of the actuary to take account of the contents of the Funding Strategy Statement before he can formally 'sign off' the 2016 actuarial valuation. The actuary is aware of the contents of the FSS and all of the policies included in it have been agreed with him.

Updated Funding Strategy Statement

4. The draft FSS that is attached as the appendix to the report is an updated version of the Fund's existing FSS. By way of summary, the major changes from the existing document are:-

   (i) Changes to dates etc. to reflect the 2016 actuarial valuation;
   (ii) Expanded explanations about the Fund's policy in certain areas, in order to reduce the possibility of future confusion.

5. The FSS is a lengthy document but this is necessitated by the increasingly diverse group of employers who make up the scheme, and the resultant inability to have 'one-size-fits-all' policies.

6. A draft copy of the FSS was sent to all of the approximately 200 employing bodies in mid-December 2016, with a request for any comments by 5th January 2017. The period of consultation was relatively short, but this was necessitated by a wish to bring the draft FSS to this meeting for approval. The next meeting of this Committee is on 17th March 2017 and if the FSS is not approved until then, there could be significant practical problems around the sign-off for the actuarial valuation (which is required by 31st March). There were no significant comments received by 5th

January or by the time that this report was written, but if any comments of note are received before the meeting the Committee will be informed verbally.

7. For practical reasons the FSS has been written as if it has already been approved at this meeting. There are still a number of places within the FSS that require updating (mainly links to website addresses). These will be completed in due course, once the Committee has approved the document.

Recommendation

8. The Board is asked to approve the Funding Strategy Statement included as the Appendix to this report.

Equal Opportunities Implications

None specific.

Background Papers

Report to the Local Pension Committee – 21 February 2014 –

http://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MID=4091

Appendix

Draft Funding Strategy Statement

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HYMANS ROBERTSON

Leicestershire County Council Pension Fund

Funding Strategy Statement

January 2017

PUBLIC SECTOR

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1 Introduction

1.1 What is this document?

This is the Funding Strategy Statement (FSS) of the Leicestershire County Council Pension Fund ("the Fund"), which is administered by Leicestershire County Council , ("the Administering Authority").

It has been prepared by the Administering Authority in collaboration with the Fund's actuary, Hymans Robertson LLP, and after consultation with the Fund's employers and investment adviser. It is effective from 17th January 2017.

1.2 What is the Leicestershire County Council Pension Fund?

The Fund is part of the national Local Government Pension Scheme (LGPS). The LGPS was set up by the UK Government to provide retirement and death benefits for local government employees, and those employed in similar or related bodies, across the whole of the UK. The Administering Authority runs the Leicestershire County Council Pension Fund, in effect the LGPS for the Leicestershire area, to make sure it:

- receives the proper amount of contributions from employees and employers, and any transfer payments;
- invests the contributions appropriately, with the aim that the Fund's assets grow over time with investment income and capital growth;
- uses the assets to pay Fund benefits to the members (as and when they retire, for the rest of their lives), and to their dependants (as and when members die), as defined in the LGPS Regulations. Assets are also used to pay transfer values and administration costs.

The roles and responsibilities of the key parties involved in the management of the Fund are summarised in Appendix B.

1.3 Why does the Fund need a Funding Strategy Statement?

Employees' benefits are guaranteed by the LGPS Regulations, and do not change with market values or employer contributions. Investment returns will help pay for some of the benefits, but probably not all, and certainly with no guarantee. Employees' contributions are fixed in those Regulations also, at a level which covers only part of the cost of the benefits.

Therefore, employers need to pay the balance of the cost of delivering the benefits to members and their dependants.

The FSS focuses on how employer liabilities are measured, the pace at which these liabilities are funded, and how employers pay for their own liabilities. This statement sets out how the Administering Authority has balanced the conflicting aims of:

- affordability of employer contributions,
- transparency of processes,
- stability of employers' contributions, and
- prudence in the funding basis.

There are also regulatory requirements for an FSS, as given in Appendix A.

The FSS is a summary of the Fund's approach to funding its liabilities, and this includes reference to the Fund's other policies; it is not an exhaustive statement of policy on all issues. The FSS forms part of a framework of which includes:

- the LGPS Regulations;
- the Rates and Adjustments Certificate (confirming employer contribution rates for the next three years) which can be found in an appendix to the formal valuation report;
- the Fund's policies on admissions, cessations and bulk transfers;
- actuarial factors for valuing individual transfers, early retirement costs and the costs of buying added service; and
- the Fund's Investment Strategy Statement (see Section 4).

1.4 How does the Fund and this FSS affect me?

This depends who you are:

- a member of the Fund, i.e. a current or former employee, or a dependant: the Fund needs to be sure it is collecting and holding enough money so that your benefits are always paid in full;
- an employer in the Fund (or which is considering joining the Fund): you will want to know how your contributions are calculated from time to time, that these are fair by comparison to other employers in the Fund, and in what circumstances you might need to pay more. Note that the FSS applies to all employers participating in the Fund;
- an Elected Member whose council participates in the Fund: you will want to be sure that the council balances the need to hold prudent reserves for members' retirement and death benefits, with the other competing demands for council money;
- a Council Tax payer: your council seeks to strike the balance above, and also to minimise cross-subsidies between different generations of taxpayers.

1.5 What does the FSS aim to do?

The FSS sets out the objectives of the Fund's funding strategy, such as:

- to ensure the long-term solvency of the Fund, using a prudent long term view. This will ensure that sufficient funds are available to meet all members'/dependants' benefits as they fall due for payment;
- to ensure that employer contribution rates are reasonably stable where appropriate;
- to minimise the long-term cash contributions which employers need to pay to the Fund, by recognising the link between assets and liabilities and adopting an investment strategy which balances risk and return (**NB** this will also minimise the costs to be borne by Council Tax payers);
- to reflect the different characteristics of different employers in determining contribution rates. This involves the Fund having a clear and transparent funding strategy to demonstrate how each employer can best meet its own liabilities over future years; and
- to use reasonable measures to reduce the risk to other employers and ultimately to the Council Tax payer from an employer defaulting on its pension obligations.

1.6 How do I find my way around this document?

In Section 2 there is a brief introduction to some of the main principles behind funding, i.e. deciding how much an employer should contribute to the Fund from time to time.

In Section 3 we outline how the Fund calculates the contributions payable by different employers in different situations.

In Section 4 we show how the funding strategy is linked with the Fund's investment strategy.

In the Appendices we cover various issues in more detail if you are interested:

A. the regulatory background, including how and when the FSS is reviewed,

B. who is responsible for what,

C. what issues the Fund needs to monitor, and how it manages its risks,

D. some more details about the actuarial calculations required,

E. the assumptions which the Fund actuary currently makes about the future,

F. a glossary explaining the technical terms occasionally used here.

If you have any other queries please contact Colin Pratt in the first instance at e-mail address colin.pratt@leics.gov.uk or on telephone number 0116 305 7656.

2 Basic Funding issues

(More detailed and extensive descriptions are given in Appendix D).

2.1 How does the actuary calculate a contribution rate?

Employer contributions are normally made up of two elements:

a) the estimated cost of future benefits being built up from year to year, referred to as the "*future service rate*"; plus

b) an adjustment for the difference between the assets built up to date and the value of past service benefits, referred to as the "*past service adjustment*". If there is a deficit the past service adjustment will be an increase in the employer's total contribution; if there is a surplus there may be a reduction in the employer's total contribution. Any past service adjustment will aim to return the employer to full funding over an appropriate period (the "deficit recovery period").

2.2 How is a deficit (or surplus) calculated?

An employer's "funding level" is defined as the ratio of:

- the market value of the employer's share of assets, to
- the value placed by the actuary on the benefits built up to date for the employer's employees and ex-employees (the "liabilities"). The Fund actuary agrees with the Administering Authority the assumptions to be used in calculating this value.

If this is less than 100% then it means the employer has a shortfall, which is the employer's deficit; if it is more than 100% then the employer is said to be in surplus. The amount of deficit or shortfall is the difference between the asset value and the liabilities value.

A larger deficit will give rise to higher employer contributions. If a deficit is spread over a longer period then the annual employer cost is lower than if it is spread over a shorter period.

2.3 How are contribution rates calculated for different employers?

The Fund's actuary is required by the Regulations to report the *Common Contribution Rate*, for all employers collectively at each triennial valuation, combining items (a) and (b) above. This is based on actuarial assumptions about the likelihood, size and timing of benefit payments to be made from the Fund in the future, as outlined in Appendix E.

The Fund's actuary is also required to adjust the *Common Contribution Rate* for circumstances specific to each individual employer. The sorts of specific circumstances which are considered are discussed in Section 3. It is this adjusted contribution rate which the employer is actually required to pay, and the rates for all employers are shown in the Fund's Rates and Adjustments Certificate.

In effect, the *Common Contribution Rate* is a notional quantity, as it is unlikely that any employer will pay that exact rate. Separate future service rates are calculated for each employer together with individual past service adjustments according to employer-specific circumstances.

Details of the outcome of the Actuarial Valuation as at 31 March 2016 can be found in the formal valuation report dated xx March 2017, including an analysis at Fund Level of the *Common Contribution Rate*. Further details of individual employer contribution rates can also be found in the formal report.

2.4 What else might affect the employer's contribution?

Employer covenant, and likely term of membership, are also considered when setting contributions: more details are given in Section 3.

Leicestershire County Council Pension Fund will only allow pooled contribution rates in extreme circumstances, see 3.4.

Any costs of non ill-health early retirements must be paid by the employer, see 3.6.

If an employer is approaching the end of its participation in the Fund then its contributions may be amended appropriately, so that the assets meet (as closely as possible) the value of its liabilities in the Fund when its participation ends.

Employers' contributions are expressed as minima, with employers able to pay contributions at a higher rate. Account of the higher rate will be taken by the Fund Actuary at subsequent valuations.

2.5 What different types of employer participate in the Fund?

Historically the LGPS was intended for local authority employees only. However over the years, with the diversification and changes to delivery of local services, many more types and numbers of employers now participate. There are currently more employers in the Fund than ever before, and a significant number of the newer employing bodies are academies.

In essence, participation in the LGPS is open to public sector employers providing some form of service to the local community. Whilst the majority of members will be local authority employees (and ex-employees), the majority of participating employers are those providing services in place of (or alongside) local authority services: academy schools, contractors, housing associations, charities, etc.

The LGPS Regulations define various types of employer as follows:

Scheduled bodies - councils, and other specified employers such as academies and further education establishments. These must provide access to the LGPS in respect of their employees who are not eligible to join another public sector scheme (such as the Teachers Scheme). These employers are so-called because they are specified in a schedule to the LGPS Regulations.

It is now possible for Local Education Authority schools to convert to academy status, and for other forms of school (such as Free Schools) to be established under the academies legislation. All such academies, as employers of non-teaching staff, become separate new employers in the Fund. As academies are defined in the LGPS Regulations as "Scheduled Bodies", the Administering Authority has no discretion over whether to admit them to the Fund, and the academy has no discretion whether to continue to allow its non-teaching staff to join the Fund. There has also been guidance issued by the DCLG regarding the terms of academies' membership in LGPS Funds.

Designating employers - employers such as town and parish councils are able to participate in the LGPS via resolution (and the Fund cannot refuse them entry where the resolution is passed). These employers can designate which of their employees are eligible to join the scheme.

Other employers are able to participate in the Fund via an admission agreement, and are referred to as 'admission bodies'. These employers are generally those with a "community of interest" with another scheme employer – **community admission bodies** ("CAB") or those providing a service on behalf of a scheme employer – **transferee admission bodies** ("TAB"). CABs will include charities, TABs will generally be contractors. The Fund is able to set its criteria for participation by these employers and can refuse entry if the requirements as set out in the Fund's admissions policy are not met.

2.6 How does the Fund recognise that contribution levels can affect council and employer service provision, and council tax?

The Administering Authority and the Fund actuary are acutely aware that, all other things being equal, a higher contribution required to be paid to the Fund will mean less cash available for the employer to spend on the provision of services. For instance:

- Higher pension fund contributions may result in reduced council spending, which in turn could affect the resources available for council services, and/or greater pressure on council tax levels;
- Contributions which Academies pay to the Fund will therefore not be available to pay for providing education;
- Other employers will provide various services to the local community, perhaps through charitable work, or contracting council services. If they are required to pay more in pension contributions to the LGPS then this may affect their ability to provide the local services.

Whilst all this is true, it should also be borne in mind that:

- The Fund provides invaluable financial security to local families, whether to those who formerly worked in the service of the local community who have now retired, or to their families after their death;
- The Fund must have the assets available to meet these retirement and death benefits, which in turn means that the various employers must each pay their own way. Lower contributions today will mean higher contributions tomorrow: deferring payments does not alter the employer's ultimate obligation to the Fund in respect of its current and former employees;
- Each employer will generally only pay for its own employees and ex-employees (and their dependants), not for those of other employers in the Fund;
- The Fund strives to maintain reasonably stable employer contribution rates where appropriate and possible;
- The Fund wishes to avoid the situation where an employer falls so far behind in managing its funding shortfall that its deficit becomes unmanageable in practice: such a situation may lead to employer insolvency and the resulting deficit falling on the other Fund employers. In that situation, those employers' services would in turn suffer as a result;
- Council contributions to the Fund should be at a suitable level, to protect the interests of different generations of council tax payers. For instance, underpayment of contributions for some years will need to be balanced by overpayment in other years; the council will wish to minimise the extent to which council tax payers in one period are in effect benefiting at the expense of those paying in a different period.

Overall, therefore, there is clearly a balance to be struck between the Fund's need for maintaining prudent funding levels, and the employers' need to allocate their resources appropriately. The Fund achieves this through various techniques which affect contribution increases to various degrees (see 3.1). In deciding which of these techniques to apply to any given employer, the Fund will consider a risk assessment of that employer to include such information as the type of employer, its membership profile and funding position, any guarantors or security provision, material changes anticipated, etc. This helps the Fund establish a picture of the financial standing of the employer, i.e. its ability to meet its long term Fund commitments.

For instance, where an employer is considered relatively low risk then the Fund will permit greater smoothing (such as stabilisation or a longer deficit recovery period relative to other employers) which will temporarily produce lower contribution levels than would otherwise have applied. This is permitted in the expectation that the employer will still be able to meet its obligations for many years to come.

On the other hand, an employer whose risk assessment indicates a less strong covenant will generally be required to pay higher contributions (for instance, with a more prudent funding basis or a shorter deficit recovery period relative to other employers). This is because of the higher probability that at some point it will fail or be unable to meet its pension contributions, with its deficit in the Fund then falling to other Fund employers.

The Fund actively seeks employer input, including to its funding arrangements, through various means: see Appendix A.

3 Calculating contributions for individual Employers

3.1 General comments

A key challenge for the Administering Authority is to balance the need for stable, affordable employer contributions with the requirement to take a prudent, longer-term view of funding and ensure the solvency of the Fund. With this in mind, there are a number of methods which the Administering Authority may permit, in order to improve the stability of employer contributions. These include, where circumstances permit:-

- capping of employer contribution rate changes within a pre-determined range ("stabilisation")
- the use of extended deficit recovery periods
- the phasing in of contribution rises
- the use of some form of security or guarantee to justify a lower contribution rate than would otherwise be the case.

These and associated issues are covered in this Section.

The Administering Authority recognises that there may occasionally be particular circumstances affecting individual employers that are not easily managed within the rules and policies set out in the Funding Strategy Statement. Therefore the Administering Authority may, at its sole discretion, direct the actuary to adopt alternative funding approaches on a case by case basis for specific employers.

3.2 The effect of paying contributions below the theoretical level

Employers which are permitted to use one or more of the above methods will often be paying, for a time, contributions less than the theoretical contribution rate. Such employers should appreciate that:

- their true long term liability (i.e. the actual eventual cost of benefits payable to their employees and ex-employees) is not affected by the choice of method,
- lower contributions in the short term will be assumed to incur a greater loss of investment returns on the deficit. Thus, deferring a certain amount of contribution will lead to higher contributions in the long-term, and
- it will take longer to reach full funding, all other things being equal.

Overleaf (3.3) is a summary of how the main funding policies differ for different types of employer, followed by more detailed notes where necessary.

Section 3.4 onwards deals with various other funding issues which apply to all employers.

3.3 The different approaches used for different employers

Type of employer	**Scheduled Bodies**			**Community Admission Bodies and Designating Employers (including Parish/Town Councils)**		**Transferee Admission Bodies**
Sub-type	**Local Authorities (except Parish/Town Councils)**	**Police, Fire, Colleges etc**	**Academies**	**Open to new entrants**	**Closed to new entrants**	**(all)**
Basis used	Ongoing, assumes long-term Fund participation (see Appendix E)			Ongoing, but may move to "gilts basis" - see Note (a)		Ongoing, assumes fixed contract term in the Fund (see Appendix E)
Future service rate	Projected Unit Credit approach (see Appendix D – D.2)				Attained Age approach (see Appendix D – D.2)	Attained Age approach, unless open to new membership (see Appendix D – D.2)
Stabilised rate?	Yes - see Note (b)	Yes - see Note (b)	Yes- see Note (b)	No, expect Parish/Town Councils	No, expect Parish/Town Councils	No
Maximum deficit recovery period – Note (c)	20 years	20 years	20 years	17 years	15 years	Outstanding contract term
Deficit recovery payments – Note (d)	% of payroll / monetary amount	% of payroll / monetary amount	% of payroll	% of payroll	% of payroll/monetary amount	% of payroll/monetary amount depending on circumstances
Treatment of surplus	Covered by stabilisation arrangement	Covered by stabilisation arrangement	Covered by stabilisation arrangement	Preferred approach: contributions kept at future service rate. However, reductions may be permitted by the Admin. Authority		Reduce contributions by spreading the surplus over the remaining contract term
Phasing of contribution changes	Covered by stabilisation arrangement	Covered by stabilisation arrangement	Linked to previous education authority rate	3 years - Note (e)	3 years - Note (e)	None, unless increases are particularly large
Review of rates – Note (f)	Administering Authority reserves the right to review contribution rates and amounts, and the level of security provided, at regular intervals between valuations					Particularly reviewed in last 3 years of contract
New employer	n/a	n/a	Note (g)	Note (h)		Notes (h) & (i)
Cessation of participation: cessation debt payable	Cessation is assumed not to be generally possible, as Scheduled Bodies are legally obliged to participate in the LGPS. In the rare event of cessation occurring (machinery of Government changes for example), the cessation debt principles applied would be as per Note (j).			Can be ceased subject to terms of admission agreement. Cessation debt will be calculated on a basis appropriate to the circumstances of cessation – see Note (j).		Participation is assumed to expire at the end of the contract. Cessation debt (if any) calculated on ongoing basis, unless cessation is caused by deliberate action taken by the employer. Awarding Authority will be liable for future deficits that arise.

Note (a) (Basis for CABs and Designating Employers closed to new entrants)

In the circumstances where:

- the employer is a Designating Employer, or an Admission Body but not a Transferee Admission Body, and
- the employer has no guarantor, and
- the admission agreement is likely to terminate, or the employer is likely to lose its last active member, within a timeframe considered appropriate by the Administering Authority to prompt a change in funding,

the Administering Authority may vary the discount rate used to set employer contribution rate. In particular contributions may be set for an employer to achieve full funding on a more prudent basis (e.g. using a discount rate set equal to gilt yields) by the time the agreement terminates or the last active member leaves, in order to protect other employers in the Fund. This policy will increase regular contributions and reduce, but not entirely eliminate, the possibility of a final deficit payment being required from the employer when a cessation valuation is carried out.

The Administering Authority also reserves the right to adopt the above approach in respect of those Designating Employers and Admission Bodies with no guarantor, where the strength of covenant is considered to be weak but there is no immediate expectation that the admission agreement will cease or the Designating Employer alters its designation.

Note (b) (Stabilisation)

Stabilisation is a mechanism where employer contribution rate variations from year to year are kept within a pre-determined range, thus allowing those employers' rates to be relatively stable. In the interests of stability and affordability of employer contributions, the Administering Authority, on the advice of the Fund Actuary, believes that stabilising contributions can still be viewed as a prudent longer-term approach. However, employers whose contribution rates have been "stabilised" (and may therefore be paying less than their theoretical contribution rate) should be aware of the risks of this approach and should consider making additional payments to the Fund if possible.

This stabilisation mechanism allows short term investment market volatility to be managed so as not to cause volatility in employer contribution rates, on the basis that a long term view can be taken on net cash inflow, investment returns and strength of employer covenant.

The current stabilisation mechanism applies if:

- the employer satisfies the eligibility criteria based on tax raising status, financial security and time horizon in the Fund set by the Administering Authority and;
- there are no material events which cause the employer to become ineligible, e.g. significant reductions in active membership (due to outsourcing or redundancies), or changes in the nature of the employer (perhaps due to Government restructuring).

Type of employer	"Standard" Council	Parish Council	Academy*	Other
Max cont increase	+2% of pay	+3% of pay	+2% of pay	N/A
Max cont decrease	-1% of pay	-1% of pay	-1% of pay	-1% of pay

*please note that for the period 1/4/17 – 31/3/20 academy rates are linked to those rates in payment of the respective education authority the academy used to belong to, subject to their being no reduction from the rate payable at 31/3/17. For the majority of academies their rate will be exactly in line with their former education authority, although for a handful there was no increase required from the rate they were paying at 31/3/17. For a small number an increase of 1% p.a. (which would have tied in with the increase of their former education authority) was insufficient to get them within an acceptable level of their full required rate, so their increases were set at 2% p.a.

For the avoidance of doubt, academies will fit into one of the following 'brackets' for the three years commencing 1st April 2017. The rates are quoted RELATIVE to their former education authority:

Period	Academies requiring no increase	Academies following the contribution rate of former LEA	Academies requiring higher increases
1/4/17 – 31/3/18	-1%	0%	+1%
1/4/18 – 31/3/19	-2%	0%	+1%
1/4/19 – 31/3/20	-3%	0%	+1%

The stabilisation criteria and limits will be reviewed at the 31 March 2019 valuation, to take effect from 1 April 2020. This will take into account the employer's membership profiles, the issues surrounding employer security, and other relevant factors.

Note (c) (Deficit Recovery Periods)

The deficit recovery period starts at the commencement of the revised contribution rate (1 April 2017 for the 2016 valuation). The Administering Authority would normally expect the same period to be used at successive triennial valuations (for open employers), but would reserve the right to propose alternative spreading periods, for example where there were no new entrants.

Where stabilisation applies, the resulting employer contribution rate would be amended to comply with the stabilisation mechanism.

For employers with no (or very few) active members at this valuation, the deficit should be recovered by a fixed monetary amount over a period to be agreed with the body or its successor, not to exceed the expected future working lifetime of active members.

Note (d) (Deficit Recovery Payments)

The preferred method of the actuary is to collect contributions on the basis of a percentage of payroll to cover the cost of future service, with an additional cash sum to cover deficit recovery payments. There are a number of employing bodies for whom this method is impractical, so in reality only the following types of employer will be required to make any contribution that will be included in the actuarial certificate as a monetary amount:

Tax-raising bodies (except those that are education authorities or Parish/Town Councils. Ashby Town Council will, however, be required to make a contribution as a monetary amount);

Universities;

Community Admission Bodies that are closed to new entrants (except Voluntary Action Leicester, who will instead be subject to a minimum cash sum in employers' contributions);

Transferee admission bodies whose sub-fund was in deficit at 31/3/16.

For the majority of employers where stabilisation is not being applied, the deficit recovery payments for each employer covering the three year period until the next valuation will often be set as a percentage of salaries. However, the Administering Authority reserves the right to amend these rates between valuations and/or to require these payments in monetary terms instead, for instance where:

- the employer is relatively mature, i.e. has a large deficit recovery contribution rate (e.g. above 15% of payroll), in other words its payroll is a smaller proportion of its deficit than is the case for most other employers, or
- there has been a significant reduction in payroll due to outsourcing or redundancy exercises, or
- the employer has closed the Fund to new entrants.

Note (e) (Phasing in of contribution changes)

All phasing is subject to the Administering Authority being satisfied as to the strength of the employer's covenant.

Note (f) (Regular Reviews)

Such reviews may be triggered by significant events including but not limited to: significant reductions in payroll, altered employer circumstances, Government restructuring affecting the employer's business, or failure to pay contributions or arrange appropriate security as required by the Administering Authority.

The result of a review may be to require increased contributions (by strengthening the actuarial assumptions adopted and/or moving to monetary levels of deficit recovery contributions), and/or an increased level of security or guarantee.

Note (g) (New Academy employers)

At the time of writing, the Fund's policies on academies' funding issues are as follows:

a) The new academy will be regarded as a separate employer in its own right and will not be pooled with other employers in the Fund. The only exception is where the academy is part of a Multi Academy Trust (MAT) in which case the academy's figures will be calculated as below but can be combined with those of the other academies in the MAT;

b) The new academy's past service liabilities on conversion will be calculated based on its active Fund members on the day before conversion. For the avoidance of doubt, these liabilities will include all past service of those members, but will exclude the liabilities relating to any ex-employees of the school who have deferred or pensioner status;

c) The new academy will be allocated an initial asset share from the ceding council's assets in the Fund. This asset share will be calculated using the estimated funding position of the ceding council at the date of academy conversion. The share will be based on the active members' funding level, having first allocated assets in the council's share to fully fund deferred and pensioner members. The asset allocation will be based on market conditions and the academy's active Fund membership on the day prior to conversion;

d) The academy will pay contributions initially in line with the rate payable by their former education authority, unless they become part of a Multi Academy Trust that crosses education authority boundaries. In these cases the rate will be determined in the most appropriate manner to the circumstances, but it will be in line with the rate of one of the relevant education authorities and all establishments within the City, County or Rutland that are part of the same MAT will have the same contribution rate. Ultimately, all academies remain responsible for their own allocated deficit.

The Fund's policies on academies are subject to change in the light of any amendments to DCLG guidance. Any changes will be notified to academies, and will be reflected in a subsequent version of this FSS. In particular, policy (d) above will be reconsidered at each valuation.

In the future it is likely that the linking of the contribution rates payable by academies to their former local education authority will become inconsistent with the setting of contribution rates that are relevant to the circumstances of individual academies. It is, however, considered likely that there will be groups of academies that will pay the same rate as this is administratively simpler than having (potentially) hundreds of slightly different contribution rates. Paying the same contribution rates in NOT the same as pooling, and there will be no cross-subsidy caused by this policy.

Note (h) (New Admission Bodies)

With effect from 1 October 2012, the LGPS 2012 Miscellaneous Regulations introduced mandatory new requirements for all Admission Bodies brought into the Fund from that date. Under these Regulations, all new Admission Bodies will be required to provide some form of security, such as a guarantee from the letting employer, an indemnity or a bond. The security is required to cover some or all of the following:

- the strain cost of any redundancy early retirements resulting from the premature termination of the contract;
- allowance for the risk of asset underperformance;
- allowance for the risk of a fall in gilt yields;
- allowance for the possible non-payment of employer and member contributions to the Fund;
- the current deficit.

For all new Transferee Admission Bodies, the security must be to the satisfaction of the Administering Authority as well as the letting employer, and will be reassessed on an annual basis.

The Administering Authority will only consider requests from Community Admission Bodies (or other similar bodies, such as section 75 NHS partnerships) to join the Fund if they are sponsored by a Scheduled Body with tax raising powers, guaranteeing their liabilities and also providing a form of security as above.

The above approaches reduce the risk to other employers in the Fund, of potentially having to pick up any shortfall in respect of Admission Bodies ceasing with an unpaid deficit.

Note (i) (New Transferee Admission Bodies)

A new TAB usually joins the Fund as a result of the letting/outsourcing of some services from an existing employer (normally a Scheduled Body such as a council or academy) to another organisation (a “contractor”). This involves the TUPE transfer of some staff from the letting employer to the contractor. Consequently, for the duration of the contract, the contractor is a new participating employer in the Fund so that the transferring employees maintain their eligibility for LGPS membership. At the end of the contract the employees revert to the letting employer or to a replacement contractor.

Ordinarily, the TAB would be set up in the Fund as a new employer with responsibility for all the accrued benefits of the transferring employees; in this case, the contractor would usually be assigned an initial asset value equal to the past service liability value of the employees’ Fund benefits. The quid pro quo is that the contractor is then expected to ensure that its share of the Fund is also fully funded at the end of the contract: see Note (j).

Employers which “outsource” have flexibility in the way that they can deal with the pension risk potentially taken on by the contractor. In particular there are three different routes that such employers may wish to adopt. Clearly as the risk ultimately resides with the employer letting the contract, it is for them to agree the appropriate route with the contractor:

i) Pooling

Under this option the contractor is pooled with the letting employer. In this case, the contractor pays the same rate as the letting employer.

ii) Letting employer retains pre-contract risks

Under this option the letting employer would retain responsibility for assets and liabilities in respect of service accrued prior to the contract commencement date. The contractor would be responsible for the future liabilities that accrue in respect of transferred staff. The contractor’s contribution rate could vary from one valuation to the next. It would be liable for any deficit at the end of the contract term in respect of assets and liabilities attributable to service accrued during the contract term and actions wholly attributable to the new employer for example excessive pay awards.

iii) Fixed contribution rate agreed

Under this option the contractor pays a fixed contribution rate and doesn’t pay any cessation deficit.

The Administering Authority is willing to administer any of the above options as long as the approach is documented in the Admission Agreement as well as the transfer agreement. The Admission Agreement should ensure that some element of risk transfers to the contractor where it relates to their decisions and it is unfair to burden the letting employer with that risk. For example the contractor should typically be responsible for pension costs that arise from;

- above average pay increases, including the effect in respect of service prior to contract commencement even if the letting employer takes on responsibility for the latter under (ii) above;
- redundancy and early retirement decisions.

Employers which outsource should be aware that all actuarial costs relating to the outsourcing (which will include any work that is required at the end of a contract) will be charged to either the outsourcing employer or the contractor, and will NOT be met by the Fund. The exception will be the setting of employer contribution rates as part of a normal actuarial valuation, where the Fund pays actuarial fees as the work covers all employing bodies.

Note (j) (Admission Bodies Ceasing)

Notwithstanding the provisions of the Admission Agreement, the Administering Authority may consider any of the following as triggers for the cessation of an admission agreement with any type of body:

- Last active member ceasing participation in the Fund;
- The insolvency, winding up or liquidation of the Admission Body;
- Any breach by the Admission Body of any of its obligations under the Agreement that they have failed to remedy to the satisfaction of the Fund;
- A failure by the Admission Body to pay any sums due to the Fund within the period required by the Fund; or
- The failure by the Admission Body to renew or adjust the level of the bond or indemnity, or to confirm an appropriate alternative guarantor, as required by the Fund.

On cessation, the Administering Authority will instruct the Fund actuary to carry out a cessation valuation to determine whether there is any deficit or surplus. Where there is a deficit, payment of this amount in full would normally be sought from the Admission Body; where there is a surplus it should be noted that current legislation does not permit a refund payment to the Admission Body.

For Transferee Admission Bodies any cessation valuation would normally be carried out on an on-going basis, as this will be the basis on which their opening position was calculated. Where a Transferee Admission Body has taken, in the view of the Administering Authority, action that has been deliberately designed to bring about a cessation event (stopping future accrual of LGPS benefits, for example) then the cessation valuation will be carried out on a gilts basis.

Any cessation valuation, whether carried out on an on-going or a gilts basis, will calculate the surplus or deficit at the point of the cessation and full payment of any deficit amount will release the Transferee Admission Body from any further liability to the Fund. In the event that the sub-fund of the Transferee Admission Body subsequently falls into a deficit position, the outsourcing organisation will become responsible for the deficit even if they did not act as a guarantor for the admission agreement. At no stage will the Fund, and hence all ongoing employing bodies within it, bear any financial risk in respect of any Transferee Admission Body.

For non-Transferee Admission Bodies whose participation is voluntarily ended either by themselves or the Fund, or where a cessation event has been triggered, the Administering Authority must look to protect the interests of other ongoing employers. The actuary will therefore adopt an approach which, to the extent reasonably practicable, protects the other employers from the likelihood of any material loss emerging in future:

a) Where there is a guarantor for future deficits and contributions, the cessation valuation will normally be calculated using the ongoing basis as described in Appendix E;

b) Alternatively, it may be possible to simply transfer the former Admission Body's liabilities and assets to the guarantor, without needing to crystallise any deficit. This approach may be adopted where the employer cannot pay the contributions due, and this is within the terms of the guarantee;

c) Where a guarantor does not exist then, in order to protect other employers in the Fund, the cessation liabilities and final deficit will normally be calculated using a "gilts cessation basis", which is more prudent than the ongoing basis. This has no allowance for potential future investment outperformance above gilt yields, and has added allowance for future improvements in life expectancy. This could give rise to significant cessation debts being required.

Under (a) and (c), any shortfall would usually be levied on the departing Admission Body as a single lump sum payment. If this is not possible then the Fund would look to any bond, indemnity or guarantee in place for the employer.

In the event that the Fund is not able to recover the required payment in full, then the unpaid amounts fall to be shared amongst all of the other employers in the Fund. This may require an immediate revision to the Rates and Adjustments Certificate affecting other employers in the Fund, or instead be reflected in the contribution rates set at the next formal valuation following the cessation date

As an alternative, where the ceasing Admission Body (whether a Transferee Admission Body or a Community Admission Body) is continuing in business, the Fund at its absolute discretion reserves the right to enter into an agreement with the ceasing Admission Body. Under this agreement the Fund would accept an appropriate alternative security to be held against any deficit, and would carry out the cessation valuation on an ongoing basis: deficit recovery payments would be derived from this cessation debt. This approach would be monitored as part of each triennial valuation: the Fund reserves the right to revert to a “gilts cessation basis” and seek immediate payment of any funding shortfall identified. The Administering Authority may need to seek legal advice in such cases, as the Body would have no contributing members.

3.4 Pooled contributions

The Administering Authority will only allow employer pools to be set up if it legally required (perhaps as a result of LGPS Regulations) or where a request is received from a group of employers that they wish to become a pool.

Even if such a request is received, the Administering Authority will only agree to an employer pool if it is satisfied that the relevant employers have adequately considered the consequences of the pool and that there is a legal agreement in place which makes it impossible for the pool to be dissolved without the agreement of all parties, which will include an agreement on how the assets and liabilities will be split upon dissolution. Allowing pooling is entirely at the discretion of the Administering Authority.

Maintained schools do not have a separate legal identity so are not pooled with the relevant local authority; they are part-and-parcel of it. However there may be exceptions for specialist or independent schools.

Those employers which have been pooled are identified in the Rates and Adjustments Certificate.

3.5 Additional flexibility in return for added security

The Administering Authority may permit greater flexibility to the employer’s contributions if the employer provides added security to the satisfaction of the Administering Authority.

Such flexibility includes a reduced rate of contribution, an extended deficit recovery period, or permission to join a pool with another body (e.g. the Local Authority).

Such security may include, but is not limited to, a suitable bond, a legally-binding guarantee from an appropriate third party, or security over an employer asset of sufficient value.

The degree of flexibility given may take into account factors such as:

- the extent of the employer’s deficit;
- the amount and quality of the security offered;
- the employer’s financial security and business plan;
- whether the admission agreement is likely to be open or closed to new entrants.

3.6 Non ill health early retirement costs

It is assumed that members' benefits are payable from the earliest age that the employee could retire without incurring a reduction to their benefit (and without requiring their employer's consent to retire). (**NB** the relevant age may be different for different periods of service, following the benefit changes from April 2008 and April 2014). Employers are required to pay additional contributions ('strain' or 'capitalised costs') wherever an employee retires before attaining this age. The actuary's funding basis makes no allowance for premature retirement except on grounds of ill-health.

For any early retirements that occur after 31/3/17, and where the Administering Authority had not previously agreed to payment in instalments, all costs must be met by way of a single payment in the year of retirement.

3.7 Ill health early retirement costs

Each employer has an 'ill health allowance' built into the full contribution rate that is set at each actuarial valuation. If an employer decides to insure against the risk of ill-health retirements there will be a reduction to the employer's contribution rate that is the equivalent of the insurance premium rate.

The Administering Authority receives a cash figure from the actuary for the cost of ill-health retirements that is built into each employer's contribution rate for the three years covered by the actuarial valuation (i.e. for the period 1/4/17 – 31/3/20 for the 2016 valuation). Where an employer does not take out ill-health insurance, they will be invoiced for any cumulative ill-health retirement costs over the three year period that are above their allowance.

3.8 Ill health insurance

If an employer provides satisfactory evidence to the Administering Authority of a current insurance policy covering ill health early retirement strains, then:

- the employer's contribution to the Fund each year is reduced by the amount of that year's insurance premium, so that the total contribution is unchanged, and
- there is no need for monitoring of allowances.

The employer must keep the Administering Authority notified of any changes in the insurance policy's coverage or premium terms, or if the policy is ceased.

3.9 Employers with no remaining active members

In general an employer ceasing in the Fund, due to the departure of the last active member, will pay a cessation debt on an appropriate basis (see 3.3, Note (j)) and consequently have no further obligation to the Fund. Thereafter it is expected that one of two situations will eventually arise:

a) The employer's asset share runs out before all its ex-employees' benefits have been paid. If this employer was a former Transferee Admission Body, the outsourcing employer will become responsible for any deficit (even if they did not act as a guarantor within the admission agreement). If the employer was not a Transferee Admission Body the other Fund employers will be required to contribute to pay all remaining benefits: this will be done by the Fund actuary apportioning the remaining liabilities on a pro-rata basis at successive formal valuations, but it should be noted that all surpluses in respect of non-Transferee Admission Bodies will be netted off any deficits so that it is only the net deficit position that will be apportioned;

b) The last ex-employee or dependant dies before the employer's asset share has been fully utilised. If this employer was a former Transferee Admission Body, the outsourcing employer will receive the benefit of the surplus (even if they did not act as a guarantor within the admission agreement). If the employer was not a

Transferee Admission Body, any surplus will be netted off the deficit of similar types of employers as described in 3.9 a). In the event that the net position is a surplus the net surplus will be apportioned;

In exceptional circumstances the Fund may permit an employer with no remaining active members to continue contributing to the Fund, as opposed to paying a cessation deficit amount. This would require the provision of a suitable security or guarantee, as well as a written ongoing commitment to fund the remainder of the employer's obligations over an appropriate period. The Fund would reserve the right to invoke the cessation requirements in the future, however. The Administering Authority may need to seek legal advice in such cases, as the employer would have no contributing members.

3.10 Policies on bulk transfers

Each case will be treated on its own merits, but in general:

- The Fund will not pay bulk transfers greater than the lesser of (a) the asset share of the transferring employer in the Fund, and (b) the value of the past service liabilities of the transferring members;
- The Fund will not grant added benefits to members bringing in entitlements from another Fund unless the asset transfer is sufficient to meet the added liabilities;
- The Fund may permit shortfalls to arise on bulk transfers if the Fund employer has suitable strength of covenant and commits to meeting that shortfall in an appropriate period. This may require the employer's Fund contributions to increase between valuations.

4 Funding strategy and links to investment strategy

4.1 What is the Fund's investment strategy?

The Fund has built up assets over the years, and continues to receive contribution and other income. All of this must be invested in a suitable manner, which is the investment strategy.

Investment strategy is set by the Local Pension Committee of Leicestershire County Council, after taking investment advice. The precise mix, manager make up and target returns are set out in the Investment Strategy Statement (ISS), which is available to members and employers.

The investment strategy is set for the long-term, but is reviewed annually. The Fund's liability profile is one of the considerations taken into account when setting investment strategy.

The same investment strategy is currently followed for all employers.

4.2 What is the link between funding strategy and investment strategy?

The Fund must be able to meet all benefit payments as and when they fall due. These payments will be met by contributions (resulting from the funding strategy) or asset returns and income (resulting from the investment strategy). To the extent that investment returns or income fall short, then higher cash contributions are required from employers, and vice versa

Therefore, the funding and investment strategies are inextricably linked.

4.3 How does the funding strategy reflect the Fund's investment strategy?

In the opinion of the Fund actuary, the current funding policy is consistent with the current investment strategy of the Fund. The asset outperformance assumption contained in the discount rate (see E3) is within a range that would be considered acceptable for funding purposes; it is also considered to be consistent with the requirement to take a "prudent longer-term view" of the funding of liabilities as required by the UK Government (see A1).

However, in the short term – such as the three yearly assessments at formal valuations – there is the scope for considerable volatility and there is a material chance that in the short-term and even medium term, asset returns will fall short of this target. The stability measures described in Section 3 will damp down, but not remove, the effect on employers' contributions.

The Fund does not hold a contingency reserve to protect it against the volatility of equity investments.

4.4 How does this differ for a large stable employer?

The Actuary has developed four key measures which capture the essence of the Fund's strategies, both funding and investment:

- Prudence - the Fund should have a reasonable expectation of being fully funded in the long term;
- Affordability – how much can employers afford;
- Stewardship – the assumptions used should be sustainable in the long term, without having to resort to overly optimistic assumptions about the future to maintain an apparently healthy funding position;
- Stability – employers should not see significant moves in their contribution rates from one year to the next, and this will help to provide a more stable budgeting environment.

The key problem is that the key objectives often conflict. For example, minimising the long term cost of the scheme (i.e. keeping employer rates affordable) is best achieved by investing in higher returning assets e.g.

equities. However, equities are also very volatile (i.e. go up and down frequently, and often in fairly large moves), which conflicts with the objective to have stable contribution rates.

Therefore a balance needs to be maintained between risk and reward, which has been considered by the use of Asset Liability Modelling: this is a set of calculation techniques applied by the Fund's actuary, to model the range of potential future solvency levels and contribution rates.

The Actuary was able to model the impact of these four key areas, for the purpose of setting a stabilisation approach (see 3.3 Note (b)). The modelling demonstrated that retaining the present investment strategy, coupled with constraining employer contribution rate changes as described in 3.3 Note (b), struck an appropriate balance between the above objectives. In particular the stabilisation approach currently adopted meets the need for stability of contributions without jeopardising the Administering Authority's aims of prudent stewardship of the Fund.

Whilst the current stabilisation mechanism is to remain in place until 2020, it should be noted that this will need to be reviewed following the 2019 valuation.

4.5 Does the Fund monitor its overall funding position?

The Administering Authority monitors the relative funding position, i.e. changes in the relationship between asset values and the liabilities value, quarterly. It reports this to the regular Local Pension Committee meetings.

Appendix A – Regulatory framework

A1 Why does the Fund need an FSS?

The Department for Communities and Local Government (DCLG) has stated that the purpose of the FSS is:

- *"to establish a **clear and transparent fund-specific strategy** which will identify how employers' pension liabilities are best met going forward;*
- *to support the regulatory framework to maintain **as nearly constant employer contribution rates as possible**; and*
- *to take a **prudent longer-term view** of funding those liabilities."*

These objectives are desirable individually, but may be mutually conflicting.

The requirement to maintain and publish a FSS is contained in LGPS Regulations which are updated from time to time. In publishing the FSS the Administering Authority has to have regard to any guidance published by Chartered Institute of Public Finance and Accountancy (CIPFA) (most recently in 2012) and to its Investment Strategy Statement (ISS).

This is the framework within which the Fund's actuary carries out triennial valuations to set employers' contributions and provides recommendations to the Administering Authority when other funding decisions are required, such as when employers join or leave the Fund. The FSS applies to all employers participating in the Fund.

A2 Does the Administering Authority consult anyone on the FSS?

Yes. This is required by LGPS Regulations. It is covered in more detail by the most recent CIPFA guidance, which states that the FSS must first be subject to "consultation with such persons as the authority considers appropriate", and should include "a meaningful dialogue at officer and elected member level with council tax raising authorities and with corresponding representatives of other participating employers".

In practice, for the Fund, the consultation process for this FSS was as follows:

a) A draft version of the FSS was issued to all participating employers in December 2016 for comment;

b) Comments from employers were requested before January 5th 2017, so that they could be reflected in a report to the Local Pension Committee prior to their approval of the FSS;

c) Following the approval of the FSS by Local Pension Committee, it was published in January 2017 and became effective immediately upon publication.

A3 How is the FSS published?

The FSS is made available through the following routes:

- Published on the website, at http://www.leics.gov.uk/pensions;
- A copy sent by email to each participating employer in the Fund;
- Copies made available on request.

A4 How often is the FSS reviewed?

The FSS is reviewed in detail at least every three years as part of the triennial valuation. This version is expected to remain unaltered until it is consulted upon as part of the formal process for the next valuation in 2019.

It is possible that (usually slight) amendments may be needed within the three year period. These would be needed to reflect any regulatory changes, or alterations to the way the Fund operates (e.g. to accommodate a new class of employer). Any such amendments would be consulted upon as appropriate:

- amendments affecting only one class of employer would be consulted with those employers,
- other more significant amendments would be subject to full consultation.

In any event, meaningful to the FSS would need agreement by the Local Pension Committee and would be included in the relevant Committee Meeting minutes.

A5 How does the FSS fit into other Fund documents?

The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues, for example there are a number of separate statements published by the Fund including the Investment Strategy Statement, Governance Strategy and Communications Strategy. In addition, the Fund publishes an Annual Report and Accounts with up to date information on the Fund.

These documents can be found on the web at http://www.leics.gov.uk/pensions.

Appendix B – Responsibilities of key parties

The efficient and effective operation of the Fund needs various parties to each play their part.

B1 The Administering Authority should:-

- operate the Fund as per the LGPS Regulations;
- effectively manage any potential conflicts of interest arising from its dual role as Administering Authority and a Fund employer;
- collect employer and employee contributions, and investment income and other amounts due to the Fund;
- ensure that cash is available to meet benefit payments as and when they fall due;
- pay from the Fund the relevant benefits and entitlements that are due;
- invest surplus monies (i.e. contributions and other income which are not immediately needed to pay benefits) in accordance with the Fund's Investment Strategy Statement (ISS) and LGPS Regulations;
- communicate appropriately with employers so that they fully understand their obligations to the Fund;
- take appropriate measures to safeguard the Fund against the consequences of employer default;
- manage the valuation process in consultation with the Fund's actuary;
- prepare and maintain a FSS and a ISS, after consultation;
- notify the Fund's actuary of material changes which could affect funding (this is covered in a separate agreement with the actuary); and
- monitor all aspects of the fund's performance and funding and amend the FSS/ISS as necessary and appropriate.

B2 The Individual Employer should:-

- deduct contributions from employees' pay correctly;
- pay all contributions, including their own as determined by the actuary, promptly by the due date;
- have a policy and exercise discretions within the regulatory framework;
- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain; and
- notify the Administering Authority promptly of all changes to its circumstances, prospects or membership, which could affect future funding.

B3 The Fund Actuary should:-

- prepare valuations, including the setting of employers' contribution rates. This will involve agreeing assumptions with the Administering Authority, having regard to the FSS and LGPS Regulations, and targeting each employer's solvency appropriately;
- provide advice relating to new employers in the Fund, including the level and type of bonds or other forms of security (and the monitoring of these);
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters;
- assist the Administering Authority in considering possible changes to employer contributions between formal valuations, where circumstances suggest this may be necessary;

- advise on the termination of Admission Bodies' participation in the Fund; and
- fully reflect actuarial professional guidance and requirements in the advice given to the Administering Authority.

B4 Other parties:-

- investment advisers (either internal or external) should ensure the Fund's ISS remains appropriate, and consistent with this FSS;
- investment managers, custodians and bankers should all play their part in the effective investment (and dis-investment) of Fund assets, in line with the ISS;
- auditors should comply with their auditing standards, ensure Fund compliance with all requirements, monitor and advise on fraud detection, and sign off annual reports and financial statements as required;
- governance advisers may be appointed to advise the Administering Authority on efficient processes and working methods in managing the Fund;
- legal advisers (either internal or external) should ensure the Fund's operation and management remains fully compliant with all regulations and broader local government requirements, including the Administering Authority's own procedures.

Appendix C – Key risks and controls

C1 Types of risk

The Administering Authority has an active risk management programme in place. The measures that it has in place to control key risks are summarised below under the following headings:

- financial;
- demographic;
- regulatory; and
- governance.

C2 Financial risks

Risk	Summary of Control Mechanisms
Fund assets fail to deliver returns in line with the anticipated returns underpinning valuation of liabilities over the long-term.	Only anticipate long-term return on a relatively prudent basis to reduce risk of under-performing. Assets invested on the basis of specialist advice, in a suitably diversified manner across asset classes, geographies, managers, etc. Analyse progress at three yearly valuations for all employers. Inter-valuation roll-forward of liabilities between valuations at whole Fund level.
Inappropriate long-term investment strategy.	Overall investment strategy options considered as an integral part of the funding strategy. Used asset liability modelling to measure 4 key outcomes. Chosen option considered to provide the best balance.
Fall in risk-free returns on Government bonds, leading to rise in value placed on liabilities.	Stabilisation modelling at whole Fund level allows for the probability of this within a longer term context. Inter-valuation monitoring, as above. Some investment in bonds helps to mitigate this risk.
Active investment manager under-performance relative to benchmark.	Quarterly investment monitoring analyses market performance and active managers relative to their index benchmark.
Pay and price inflation significantly more than anticipated.	The focus of the actuarial valuation process is on real returns on assets, net of price and pay increases. Inter-valuation monitoring, as above, gives early warning. Some investment in bonds also helps to mitigate this

Risk	Summary of Control Mechanisms
	risk. Employers pay for their own salary awards and should be mindful of the geared effect on pension liabilities of any bias in pensionable pay rises towards longer-serving employees.
Effect of possible increase in employer's contribution rate on service delivery and admission/scheduled bodies	An explicit stabilisation mechanism has been agreed as part of the funding strategy. Other measures are also in place to limit sudden increases in contributions.
Orphaned employers give rise to added costs for the Fund	The Fund seeks a cessation debt (or security/guarantor) to minimise the risk of this happening in the future. If it occurs, the Actuary calculates the added cost spread pro-rata among all employers – (see 3.9).

C3 Demographic risks

Risk	Summary of Control Mechanisms
Pensioners living longer, thus increasing cost to Fund.	Set mortality assumptions with some allowance for future increases in life expectancy. The Fund Actuary has direct access to the experience of over 50 LGPS funds which allows early identification of changes in life expectancy that might in turn affect the assumptions underpinning the valuation.
Maturing Fund – i.e. proportion of actively contributing employees declines relative to retired employees.	Continue to monitor at each valuation, consider seeking monetary amounts rather than % of pay and consider alternative investment strategies.
Deteriorating patterns of early retirements	Employers are charged the extra cost of non ill-health retirements following each individual decision. Employer ill health retirement experience is monitored, and insurance is an option.
Reductions in payroll causing insufficient deficit recovery payments	In many cases this may not be sufficient cause for concern, and will in effect be caught at the next formal valuation. However, there are protections where there is concern, as follows: Employers in the stabilisation mechanism may be brought out of that mechanism to permit appropriate contribution increases (see Note (b) to 3.3).

Risk	Summary of Control Mechanisms
	For other employers, review of contributions is permitted in general between valuations (see Note (f) to 3.3) and may require a move in deficit contributions from a percentage of payroll to fixed monetary amounts.

C4 Regulatory risks

Risk	Summary of Control Mechanisms
Changes to national pension requirements and/or HMRC rules e.g. changes arising from public sector pensions reform.	The Administering Authority considers all consultation papers issued by the Government and comments where appropriate. The results of the most recent reforms have been built into the 2016 valuation. Any changes to member contribution rates or benefit levels will be carefully communicated with members to minimise possible opt-outs or adverse actions.

C5 Governance risks

Risk	Summary of Control Mechanisms
Administering Authority unaware of structural changes in an employer's membership (e.g. large fall in employee members, large number of retirements) or not advised of an employer closing to new entrants.	The Administering Authority has a close relationship with employing bodies and communicates required standards e.g. for submission of data. The Actuary may revise the rates and Adjustments certificate to increase an employer's contributions (under Regulation 38) between triennial valuations Deficit contributions may be expressed as monetary amounts.
Actuarial or investment advice is not sought, or is not heeded, or proves to be insufficient in some way	The Administering Authority maintains close contact with its specialist advisers. Advice is delivered via formal meetings involving Elected Members, and recorded appropriately. Actuarial advice is subject to professional requirements such as peer review.
Administering Authority failing to commission the Fund Actuary to carry out a termination valuation for a departing Admission Body.	The Administering Authority requires employers with Best Value contractors to inform it of forthcoming changes. Community Admission Bodies' memberships are

Risk	Summary of Control Mechanisms
	monitored and, if active membership decreases, steps will be taken.
An employer ceasing to exist with insufficient funding or adequacy of a bond.	The Administering Authority believes that it would normally be too late to address the position if it was left to the time of departure. The risk is mitigated by: Seeking a funding guarantee from another scheme employer, or external body, where-ever possible (see Notes (h) and (j) to 3.3). Alerting the prospective employer to its obligations and encouraging it to take independent actuarial advice. Vetting prospective employers before admission. Where permitted under the regulations requiring a bond to protect the Fund from various risks. Requiring new Community Admission Bodies to have a guarantor that is a tax-raising body. Reviewing bond or guarantor arrangements at regular intervals (see Note (f) to 3.3). Reviewing contributions well ahead of cessation if thought appropriate (see Note (a) to 3.3).

Appendix D – The calculation of Employer contributions

In Section 2 there was a broad description of the way in which contribution rates are calculated. This Appendix considers these calculations in much more detail.

The calculations involve actuarial assumptions about future experience, and these are described in detail in Appendix E.

D1 What is the difference between calculations across the whole Fund and calculations for an individual employer?

Employer contributions are normally made up of two elements:

a) the estimated cost of future benefits being accrued, referred to as the "future service rate"; plus

b) an adjustment for the funding position of accrued benefits relative to the Fund's solvency target, "*past service adjustment*". If there is a surplus there may be a reduction in the employer's contribution rate. If there is a deficit there will be an increase in the employer's contribution rate, with the surplus or deficit spread over an appropriate period. The aim is to return the employer to full funding over that period. See Section 3 for deficit recovery periods.

The Fund's actuary is required by the regulations to report the *Common Contribution Rate*[1], for all employers collectively at each triennial valuation. It combines items (a) and (b) and is expressed as a percentage of pay; it is in effect an average rate across all employers in the Fund.

The Fund's actuary is also required to adjust the Common Contribution Rate for circumstances which are deemed "peculiar" to an individual employer[2]. It is the adjusted contribution rate which employers are actually required to pay. The sorts of "peculiar" factors which are considered are discussed below.

In effect, the *Common Contribution Rate* is a notional quantity. Separate future service rates are calculated for each employer together with individual past service adjustments according to employer-specific past service deficit spreading and increased employer contribution phasing periods.

D2 How is the Future Service Rate calculated?

The future service element of the employer contribution rate is calculated with the aim that these contributions will meet benefit payments in respect of members' **future** service in the Fund. This is based upon the cost (in excess of members' contributions) of the benefits which employee members earn from their service each year.

The future service rate is calculated separately for all the employers, although employers within a pool will pay the contribution rate applicable to the pool as a whole. The calculation is on the "ongoing" valuation basis (see Appendix E), but where it is considered appropriate to do so the Administering Authority reserves the right to set a future service rate by reference to liabilities valued on a more prudent basis (see Section 3).

The approach used to calculate each employer's future service contribution rate depends on whether or not new entrants are being admitted. Employers should note that it is only Admission Bodies and Designating Employers that may have the power not to automatically admit all eligible new staff to the Fund, depending on the terms of their Admission Agreements and employment contracts.

[1] See LGPS (Administration) Regulations 36(5).
[2] See LGPS (Administration) Regulations 36(7).

a) Employers which admit new entrants

These rates will be derived using the "Projected Unit Method" of valuation with a one year period, i.e. only considering the cost of the next year's benefit accrual and contribution income. If future experience is in line with assumptions, and the employer's membership profile remains stable, this rate should be broadly stable over time. If the membership of employees matures (e.g. because of lower recruitment) the rate would rise over time.

b) Employers which do not admit new entrants

To give more long term stability to such employers' contributions, the "Attained Age" funding method is normally adopted. This measures benefit accrual and contribution income over the whole future anticipated working lifetimes of current active employee members.

Both approaches include expenses of administration to the extent that they are borne by the Fund, and include allowances for benefits payable on death in service and ill health retirement.

D3 How is the Solvency / Funding Level calculated?

The Fund's actuary is required to report on the "solvency" of the whole Fund in a valuation which should be carried out at least once every three years. As part of this valuation, the actuary will calculate the solvency position of each employer.

'Solvency" is defined to be the ratio of the market value of the employer's asset share to the value placed on accrued benefits on the Fund actuary's chosen assumptions. This quantity is known as a funding level.

For the value of the employer's asset share, see D5 below.

For the value of benefits, the Fund actuary agrees the assumptions to be used with the Administering Authority – see Appendix E. These assumptions are used to calculate the present value of all benefit payments expected in the future, relating to that employer's current and former employees, based on pensionable service to the valuation date only (i.e. ignoring further benefits to be built up in the future).

The Fund operates the same target funding level for all employers of 100% of its accrued liabilities valued on the ongoing basis, unless otherwise determined (see Section 3).

D4 What affects a given employer's valuation results?

The results of these calculations for a given individual employer will be affected by:

- past contributions relative to the cost of accruals of benefits;
- different liability profiles of employers (e.g. mix of members by age, gender, service vs. salary);
- the effect of any differences in the valuation basis on the value placed on the employer's liabilities;
- any different deficit/surplus spreading periods or phasing of contribution changes;
- the difference between actual and assumed rises in pensionable pay;
- the difference between actual and assumed increases to pensions in payment and deferred pensions;
- the difference between actual and assumed retirements on grounds of ill-health from active status;
- the difference between actual and assumed amounts of pension ceasing on death;
- the additional costs of any non ill-health retirements relative to any extra payments made;

over the period between each triennial valuation.

Actual investment returns achieved on the Fund between each valuation are applied proportionately across all employers, to the extent that employers in effect share the same investment strategy. Transfers of liabilities between employers within the Fund occur automatically within this process, with a sum broadly equivalent to the reserve required on the ongoing basis being exchanged between the two employers.

D5 How is each employer's asset share calculated?

The Administering Authority does not account for each employer's assets separately. Instead, the Fund's actuary is required to apportion the assets of the whole Fund between the employers, at each triennial valuation.

This apportionment uses income and expenditure figures for all cash flows that are specific to an individual employer, which are provided to the actuary on the basis of calendar months for each employer. The Fund also provides a whole Fund asset value at the end of each month, and the combination of income/expenditure and asset values allows the actuary to accurately calculate the value of each employer's assets. The actuary also adjusts for transfers of liabilities and assets between employers participating in the Fund, for example following the movement of staff (individually or en bloc) from one Fund employer to another.

The Fund actuary does not allow for certain relatively minor events, including but not limited to:

- the actual timing of employer contributions within any financial year;

These effects are swept up within a miscellaneous item in the analysis of surplus, which is split between employers in proportion to their liabilities.

The methodology adopted means that there will inevitably be some difference between the asset shares calculated for individual employers and those that would have resulted had they participated in their own ring-fenced section of the Fund, but these differences will be very minor.

The asset apportionment is capable of verification but not to audit standard. The Administering Authority recognises the limitations in the process, but it considers that the Fund actuary's approach addresses the risks of employer cross-subsidisation to an acceptable degree.

Appendix E – Actuarial assumptions

E1 What are the actuarial assumptions?

These are expectations of future experience used to place a value on future benefit payments ("the liabilities"). Assumptions are made about the amount of benefit payable to members (the financial assumptions) and the likelihood or timing of payments (the demographic assumptions). For example, financial assumptions include investment returns, salary growth and pension increases; demographic assumptions include life expectancy, probabilities of ill-health early retirement, and proportions of member deaths giving rise to dependants' benefits.

Changes in assumptions will affect the measured value of future service accrual and past service liabilities, and hence the measured value of the past service deficit. However, different assumptions will not affect the actual benefits payable by the Fund in future.

The combination of all assumptions is described as the "basis". A more optimistic basis might involve higher assumed investment returns (discount rate), or lower assumed salary growth, pension increases or life expectancy; a more optimistic basis will give lower liability values and lower employer costs. A more prudent basis will give higher liability values and higher employer costs.

E2 What basis is used by the Fund?

The Fund's standard funding basis is described as the "ongoing basis", which applies to most employers in most circumstances. This is described in more detail below. It anticipates employers remaining in the Fund in the long term.

However, in certain circumstances, typically where the employer is not expected to remain in the Fund long term, a more prudent basis applies: see Note (a) to 3.3.

E3 What assumptions are made in the ongoing basis?

a) Investment return / discount rate

The key financial assumption is the anticipated return on the Fund's investments. This "discount rate" assumption makes allowance for an anticipated out-performance of Fund returns relative to long term yields on UK Government bonds ("gilts"). There is, however, no guarantee that Fund returns will out-perform gilts. The risk is greater when measured over short periods such as the three years between formal actuarial valuations, when the actual returns and assumed returns can deviate sharply.

Given the very long-term nature of the liabilities, a long term view of prospective asset returns is taken. The long term in this context would be 20 to 30 years or more.

For the purpose of the triennial funding valuation at 31 March 2016 and setting contribution rates effective from 1 April 2017, the Fund actuary has assumed that future investment returns earned by the Fund over the long term will be 1.8% per annum greater than gilt yields at the time of the valuation (this is the same as that used at the 2013 valuation). In the opinion of the Fund actuary, based on the current investment strategy of the Fund, this asset out-performance assumption is within a range that would be considered acceptable for the purposes of the funding valuation.

b) Salary growth

Pay for public sector employees is currently subject to restriction by the UK Government for the immediate future. Although this pay restriction does not officially apply to local government and associated employers, it is strongly expected that they are likely to show similar restraint in respect of pay awards. Based on long term historical analysis of the membership in LGPS funds, the salary increase assumption at the 2016 valuation has been set at the expected future level of increase in the retail prices index (RPI) per annum. This is a change from the previous valuation, which assumed long term pay growth of RPI + 1% p.a.

c) Pension increases

Since 2011 the consumer prices index (CPI), rather than RPI, has been the basis for increases to public sector pensions in deferment and in payment. Note that the basis of such increases is set by the Government, and is not under the control of the Fund or any employers.

As at the previous valuation, we derive our assumption for RPI from market data as the difference between the yield on long-dated fixed interest and index-linked government bonds. This is then reduced to arrive at the CPI assumption, to allow for the "formula effect" of the difference between RPI and CPI. At this valuation, we propose a reduction of 1.0% per annum. This is a larger reduction than at 2013, which will serve to reduce the value placed on the Fund's liabilities (all other things being equal).

d) Life expectancy

The demographic assumptions are intended to be best estimates of future experience in the Fund based on past experience of LGPS funds which participate in Club Vita, the longevity analytics service used by the Fund, and endorsed by the actuary.

The longevity assumptions that have been adopted at this valuation are a bespoke set of "VitaCurves", produced by the Club Vita's detailed analysis, which are specifically tailored to fit the membership profile of the Fund. These curves are based on the data provided by the Fund for the purposes of this valuation.

It is acknowledged that future life expectancy and, in particular, the allowance for future improvements in life expectancy, is uncertain. There is a consensus amongst actuaries, demographers and medical experts that life expectancy is likely to improve in the future. Allowance has been made in the ongoing valuation basis for future improvements in line with CMI projections (assuming the current rate of improvements has reached a peak) and a long term minimum rate of 1.25% per annum (or around 1 year per decade). This is the same allowance for future improvements than was made in 2013.

e) General

The same financial assumptions are adopted for all employers, in deriving the past service deficit and the future service rate: as described in (3.3), these calculated figures are translated in different ways into employer contributions, depending on the employer's circumstances.

The demographic assumptions, in particular the life expectancy assumption, in effect vary by type of member and so reflect the different membership profiles of employers.

Appendix F – Glossary

Actuarial assumptions/basis	The combined set of assumptions made by the actuary, regarding the future, to calculate the value of **liabilities**. The main assumptions will relate to the **discount rate**, salary growth, pension increases and longevity. More prudent assumptions will give a higher liability value, whereas more optimistic assumptions will give a lower value.
Administering Authority	The council with statutory responsibility for running the Fund, in effect the Fund's "trustees".
Admission Bodies	Employers which voluntarily participate in the Fund, so that their employees and ex-employees are **members**. There will be an Admission Agreement setting out the employer's obligations. For more details (see 2.5).
Common contribution rate	The Fund-wide **future service rate** plus **past service adjustment**. It should be noted that this will differ from the actual contributions payable by individual **employers**.
Covenant	The assessed financial strength of the employer. A strong covenant indicates a greater ability (and willingness) to pay for pension obligations in the long run. A weaker covenant means that it appears that the employer may have difficulties meeting its pension obligations in full over the longer term.
Deficit	The shortfall between the assets value and the **liabilities** value. This relates to assets and liabilities built up to date, and ignores the future build-up of pension (which in effect is assumed to be met by future contributions).
Deficit repair/recovery period	The target length of time over which the current **deficit** is intended to be paid off. A shorter period will give rise to a higher annual **past service adjustment** (deficit repair contribution), and vice versa.
Designating Employer	Employers such as town and parish councils that are able to participate in the LGPS via resolution. These employers can designate which of their employees are eligible to join the Fund.
Discount rate	The annual rate at which future assumed cashflows (in and out of the Fund) are discounted to the present day. This is necessary to provide a **liabilities** value which is consistent with the present day value of the assets, to calculate the **deficit**. A lower discount rate gives a higher liabilities value, and vice versa. It is similarly used in the calculation of the **future service rate** and the **common contribution rate**.
Employer	An individual participating body in the Fund, which employs (or used to employ) **members** of the Fund. Normally the assets and **liabilities** values for each employer are individually tracked, together with its **future service rate** at each **valuation**.
Funding level	The ratio of assets value to **liabilities** value: for further details (see 2.2).

Future service rate	The actuarially calculated cost of each year's build-up of pension by the current active **members**, excluding members' contributions but including Fund administrative expenses. This is calculated using a chosen set of **actuarial assumptions**.
Gilt	A UK Government bond, ie a promise by the Government to pay interest and capital as per the terms of that particular gilt, in return for an initial payment of capital by the purchaser. Gilts can be "fixed interest", where the interest payments are level throughout the gilt's term, or "index-linked" where the interest payments vary each year in line with a specified index (usually RPI). Gilts can be bought as assets by the Fund, but their main use in funding is as an objective measure of solvency.
Guarantee / guarantor	A formal promise by a third party (the guarantor) that it will meet any pension obligations not met by a specified employer. The presence of a guarantor will mean, for instance, that the Fund can consider the employer's **covenant** to be as strong as its guarantor's.
Letting employer	An employer which outsources or transfers a part of its services and workforce to another employer (usually a contractor). The contractor will pay towards the LGPS benefits accrued by the transferring members, but ultimately the obligation to pay for these benefits will revert to the letting employer. A letting employer will usually be a local authority, but can sometimes be another type of employer such as an Academy.
Liabilities	The actuarially calculated present value of all pension entitlements of all **members** of the Fund, built up to date. This is compared with the present market value of Fund assets to derive the **deficit**. It is calculated on a chosen set of **actuarial assumptions**.
LGPS	The Local Government Pension Scheme, a public sector pension arrangement put in place via Government Regulations, for workers in local government. These Regulations also dictate eligibility (particularly for Scheduled Bodies), members' contribution rates, benefit calculations and certain governance requirements. The LGPS is divided into 101 Funds which map the UK. Each LGPS Fund is autonomous to the extent not dictated by Regulations, e.g. regarding investment strategy, employer contributions and choice of advisers.
Maturity	A general term to describe a Fund (or an employer's position within a Fund) where the members are closer to retirement (or more of them already retired) and the investment time horizon is shorter. This has implications for investment strategy and, consequently, funding strategy.
Members	The individuals who have built up (and may still be building up) entitlement in the Fund. They are divided into actives (current employee members), deferreds (ex-employees who have not yet retired) and pensioners (ex-employees who have now retired, and dependants of deceased ex-employees).
Past service adjustment	The part of the employer's annual contribution which relates to past service **deficit** repair.

Pooling	Employers may be grouped together for the purpose of calculating contribution rates, so that their combined membership and asset shares are used to calculate a single contribution rate applicable to all employers in the pool. A pool may still require each individual employer to ultimately pay for its own share of **deficit**, or (if formally agreed) it may allow **deficits** to be passed from one employer to another. For further details of the Fund's current pooling policy (see 3.4).
Profile	The profile of an employer's membership or liability reflects various measurements of that employer's **members**, ie current and former employees. This includes: the proportions which are active, deferred or pensioner; the average ages of each category; the varying salary or pension levels; the lengths of service of active members vs their salary levels, etc. A membership (or liability) profile might be measured for its **maturity** also.
Rates and Adjustments Certificate	A formal document required by the LGPS Regulations, which must be updated at least every three years at the conclusion of the formal **valuation**. This is completed by the actuary and confirms the contributions to be paid by each employer (or pool of employers) in the Fund for the three year period until the next valuation is completed.
Scheduled Bodies	Types of employer explicitly defined in the LGPS Regulations, whose employers must be offered membership of their local LGPS Fund. These include Councils, colleges, universities, academies, police and fire authorities etc, other than employees who have entitlement to a different public sector pension scheme (e.g. teachers, police and fire officers, university lecturers).
Solvency	In a funding context, this usually refers to a 100% **funding level**, ie where the assets value equals the **liabilities** value.
Stabilisation	Any method used to smooth out changes in employer contributions from one year to the next. This is very broadly required by the LGPS Regulations, but in practice is particularly employed for large stable employers in the Fund. Different methods may involve: probability-based modelling of future market movements; longer deficit recovery periods; higher discount rates; or some combination of these.
Theoretical contribution rate	The employer's contribution rate, including both **future service rate** and **past service adjustment**, which would be calculated on the standard **actuarial basis**, before any allowance for **stabilisation** or other agreed adjustment.
Valuation	An actuarial investigation to calculate the liabilities, future service contribution rate and common contribution rate for a Fund, and usually individual employers too. This is normally carried out in full every three years (last done as at 31 March 2013), but can be approximately updated at other times. The assets value is based on market values at the valuation date, and the liabilities value and contribution rates are based on long term bond market yields at that date also.

By virtue of paragraph(s) 3, 10 of Part 1 of Schedule 12A of the Local Government Act 1972.

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