Leicestershire County Council

LOCAL PENSION COMMITTEE – 22 JANUARY 2016

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 appendix to this report which has been written by Hymans Robertson, the Fund's investment consultant.

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.

Recommended Changes

3. The Fund's strategic asset allocation is still considered capable of producing the long-term investment returns that are required in order to avoid further increases to the full level of employer contribution rates that were calculated at the time of the 2013 actuarial valuation of the Fund. It should be noted that many employing bodies are paying contribution rates that are below these full levels (because their increases are being phased in), so actual employer contribution rates are likely to continue to rise for a number of years to come.

4. As the current asset allocation is still considered 'fit for purpose' there is no need to increase the target for future investment return and with it the level of risk that the Fund is taking. Likewise, there is no scope to reduce the risk (and hence the expectation for future investment returns) as this would have a negative impact onto the funding level that would see future employer contribution rates rise.

5. The recommended changes to the Fund's strategic benchmark are, therefore, relatively modest. It should generally be expected that year-on-year benchmark changes will be modest, so small changes are not unusual.

6. The Fund's current benchmark is shown in page 5 of the appendix, with a detailed breakdown of the quoted equity weighting at the top of page 16. With the exception of a recommendation to increase the Fund's exposure to infrastructure assets (see

below), the majority of the recommended changes relate to the split of the equity weighting.

7. At the Annual Strategy Meeting held in January 2015 a long-term regional benchmark was agreed, as follows:

Region	Percentage of regional equities
United Kingdom	20
Europe (Ex. UK)	15
North America	35
Japan	7.5
Pacific (Ex. Japan)	7.5
Emerging Markets	15

8. It should be noted that the above benchmark relates only to the *regional* equity split of the Fund. The Fund's other quoted equity portfolios – two global dividend-focused mandates – are managed against global market capitalisation weighted benchmarks and are not part of the above split.

9. In January 2015 it was agreed that a move would be made from the previous global equity benchmark split towards the above, long-term split but that the new benchmark would not be fully implemented. The major reason for this was that there still remained some doubts about corporate governance standards in Japan (where the Fund had no weighting within its strategic benchmark for a couple of years), although there had been a clear government-led improvement. The Fund effectively implemented a 50% 'wait-and-see' approach.

10. Over the last year it has become clear that the corporate governance improvements being made in Japan are real, and that maximisation of shareholder value is increasingly becoming accepted within the Country. As a result, it is recommended that the full Japanese equity weight be implemented and that the other regions also be brought into line with the previously agreed long-term regional benchmark.

11. The impact of the recommendation to fully move to the long-term regional split is more easily seen when the benchmark is expressed as a percentage of total Fund assets, rather than as a percentage of regional equities:

Region	Current % of total assets	Recommended % of total assets
United Kingdom	11.0	8.1
Europe (Ex. UK)	6.5	6.1
North America	13.0	14.2
Japan	1.5	3.0
Pacific (Ex. Japan)	3.0	3.0
Emerging Markets	5.5	6.1
	40.5	**40.5**

12. Although all of the regions will see some change to their benchmark weightings, most of them are relatively small. In broad terms a reduction in the UK equity weighting will fund increases in Japan and North America, whilst a small reduction in Europe will be offset by a slightly larger increase in emerging markets. More

detail on the rationale behind the regional split and the recommended movements can be found within the appendix.

13. All of the above changes can be achieved by amending the benchmark of Legal & General Investment Management (LGIM), and without the need to disrupt other portfolios. LGIM run large, pooled indexed funds where there are often crossing opportunities with their other clients. It is expected that the change can be gradually implemented, using crossing opportunities wherever possible, over two months (so that the new benchmark is fully in place before the end of March) at a low cost.

14. The only other recommended benchmark change is to increase the Fund's target weighting in infrastructure from the current 3% to 5%, to be funded by a reduction in the targeted return weighting (specifically Pictet's portfolio). The appendix fully explains why this change is considered appropriate.

15. One of the problems with infrastructure is that it often takes a significant period of time between committing capital and actually getting the capital invested. Many infrastructure deals are also currently being transacted at prices that could be considered 'rich'. In order to try to alleviate these potential pitfalls, it is recommended that the Investment Subcommittee be asked to consider the options available in terms of increasing the weighting in the most effective way possible. Until such time as any additional monies are invested within infrastructure, the monies will remain invested with Pictet. It may ultimately be possible to finance some of the future additional infrastructure investments by utilising the Fund's normal cashflows, but this will depend on timing and the nature of how the future investment will be made.

Summary

16. The proposals included in the appendices to this report should be viewed as evolution rather than revolution. They take account of the short and medium-term outlook for markets, as well as the long-term outlook that is enshrined within the strategic benchmark.

Recommendations

16. The Committee is recommended to:

    a. Approve a revised strategic benchmark for the Fund as shown on page 15 of the appendix to this report;

    b. Approve a revised regional equity split for the Fund as shown in paragraph 11 of this report;

    c. Request that the Investment Subcommittee review the optimal manner to increase the Fund's infrastructure weighting from 3% to 5%.

Appendix

Annual review of asset strategy and structure – Hymans Robertson LLP

Equal Opportunities Implications

None specific.

Background Papers

None.

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