London Borough of Harrow
Date: 13 November 2012
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Proposed Strategy

Introduction

In preparation for the forthcoming actuarial valuation, we have been asked to recommend a suitable strategic asset allocation for the London Borough of Harrow Pension Fund.

The strategic asset allocation plays an important role in determining the long term funding of any pension fund. Broadly, pension fund liabilities can only be met from either investment returns or contributions. If a pension fund's strategy generates high investment returns, the required contributions will be low and vice versa.

Every three years a detailed actuarial valuation is undertaken. The actuarial valuation updates expected future cash flows taking into account any changes in the membership base within the Fund. A prudent estimate of future expected investment returns is used to discount these liabilities and determine a suitable contribution rate. If the Fund's strategy is too cautious and implies low prospective investment returns the discount rate used will also be low, which in turn will put a greater burden on contributions.

The London Borough of Harrow Pension Fund has historically pursued a high investment return through a large allocation to equities. In recent years this strategy has delivered lacklustre long-term returns with a higher than expected volatility. Given the uncertain economic environment in most developed markets, there is a desire to take a more diversified approach. However, this is tempered by the recognition that the scope to reduce expected returns is limited given the potential impact that too cautious an approach might have on future contributions.

Against this background we have recommended a new strategic asset allocation based on the following criteria:

- It is imperative that the new strategy should not result in a reduction in the actuarial discount rate compared to the current strategy – this means retaining a similar expected long term investment return and dampening down volatility modestly
- The proposed strategy should not increase materially the governance required for implementation and monitoring – this means maintaining or reducing the number of manager relationships involved and simplifying the procurement process in respect of any proposed changes
- The proposed strategy should have sufficient flexibility to enable the Panel to introduce new asset classes cost effectively if such opportunities are appropriate in future

In this report we comment on the minimum changes in capabilities that

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would be required to achieve the proposed strategy. We do not, however, make recommendations on individual managers.

The current position

At the time of the most recent actuarial review on 31 March 2010 the Pension Fund had a funding level of 73.5%, implying a funding deficit of 26.5%. The exact funding level at 31st March 2013 will depend heavily on long term gilt yields on that date. Based on current yields, it is likely that the funding level will be materially lower (and the deficit higher).

The current funding strategy includes relatively demanding prospective investment returns. When determining the current level of employer contributions in 2010, the actuary assumed the Pension Fund could generate a long-term investment return of 6.1% pa (which was 1.6% pa above the long term yield available on gilts in March 2010).

To have a sufficiently high probability of achieving the discount rate, the Pension Fund has to take a high level of investment risk. This in turn means there is a high potential volatility in the funding level. It is difficult to avoid this. Meaningfully reducing the potential volatility relative to the Fund's liabilities would require a substantial allocation to long dated bonds. However, long dated bonds currently offer exceptionally low nominal and real yields, so any material increase in the bond allocation would also reduce the potential returns substantially. The actuary might then be forced to reduce the discount rate, which in turn would increase the required level of contributions.

The current strategy has an expected return relative to liabilities of 9.6% pa, which is comfortably higher than the discount rate required. However, the strategy has an expected volatility relative to the liabilities of 16.5%. This means there is a meaningful probability that the funding level will deteriorate rather than improve. Overall, though, the probability of achieving the actuary's current discount rate of 6.1% pa over a 10-year period is estimated to be about 73%. On this basis the current strategy has a reasonable chance of achieving its funding needs.

Scope for improvement

The current strategy is focused on return generation by investing close to 70% in equities. The single biggest determinant of the success or failure of the Pension Fund's funding strategy is whether or not equity markets perform better than bonds (as a proxy for the liabilities).

The main scope for improvement is to broaden the sources of return so that the Pension Fund's ability to achieve its long term funding target is less dependent on the direction of equity markets. The scope to do so is limited because the expected long term return (and expected volatility) from equities is higher than the return from most other asset categories. Any move to reduce the Pension Fund's dependency on equities will result in switching from equities into asset types with lower expected returns, although this can be offset by increasing the scope for active management in both stock selection and tactical asset allocation. The benefits of greater diversification should mean that the volatility of the funding level is reduced. Indeed one important measure of the relative attractiveness of different strategy allocations is the impact on the probability of achieving the required discount rate.

Governance efficiency

In designing a new investment strategy we have recognised that the Pension Fund has limited governance resources – in particular the time available for the Panel to monitor progress and implement changes. All pension funds have to balance the cost of the complexity they are willing to accept in their investment arrangements against the potential benefits in terms on enhanced returns. At the risk of over generalising, very large pension funds can tolerate greater complexity because it is economically viable for them to apply greater resources to governance.

In reviewing the strategy we have sought to avoid increasing the governance burden. We have not included complex liability matching strategies or made opportunistic allocations based on current market anomalies that would need to be adjusted regularly over time. The recommended strategic asset allocation described below is capable of being implemented with the same number of manager relationships than at present.

There is also scope to minimise the governance burden in new manager appointments by using pooled vehicles rather than awarding mandates. A mandate to manage a segregated portfolio is a service contract that has to follow a full procurement process in accordance with EU guidelines. By contrast, a pooled fund is regarded as an investment that can be bought and sold by a pension fund without needing to apply the same onerous procedure. It is still sensible to have a rigorous selection process and there is a requirement to obtain written advise about the suitability of the vehicle for the fund, but the selection process can be significantly streamlined to reduce the time and cost involved. Many LGPS funds have chosen to use the streamlined approach for pooled fund investments.

Recommended strategic asset allocation

In the table below we show the strategic asset allocation that we believe is most suitable for the Pension Fund given the objectives and constraints outlined above

Asset class	Current %	Proposed %
Equities	69	57
Bonds	13	13
Property	9	10
Alternatives	5	20
Cash	4	0
Total	**100**	**100**

The proposed strategy has an expected long-term investment return relative to liabilities of between 9.6% pa and 10.1% pa depending on the composition of passive and active equity managers used. The expected volatility (or risk) ranges from 16.3% to 17.0%. The combination the return and risk profiles means the probability of achieving the current discount rate of 6.1% pa is between 73% and 76%.

The proposed strategy is capable of improving modestly the probability of achieving the discount rate without requiring a lower discount rate based on the current actuarial assumptions. It is also reasonable to expect the same features to apply when the actuarial valuation is undertaken at 31st March 2013.

The expected returns referred to above are based on retaining most of the existing managers. The assumption we have made is that only one equity manager is removed, with the range of potential returns reflecting whether this is a passive or an active mandate.

Equities

The current allocation of 69% is split between an index tracking UK equity portfolio (25%) and three actively managed global equities mandates (44%). The global equities are in turn divided so that 37% of the Pension Fund is invested in 'core' strategies seeking 2% pa above index gross of fees (which they have failed to achieve so far) and 7% is invested in an unconstrained mandate seeking 3% pa or more (which has been achieved).

The recommended strategy can be implemented by retaining the passive capability - the reduction in the equity allocation would be funded by removing one of the two 'core' global equity mandates. This would raise more than the required 14%, so we suggest the excess be added to the unconstrained equity mandate.

If we were starting afresh we would prefer to increase further the allocation to unconstrained active global mandates in preference to either the UK passive or the core global active portfolios. However, this may entail a more extensive reorganisation than is desirable at present given the governance implications.

Bonds

The existing bond holdings are mostly skewed to UK corporate bonds (11%), with a small allocation (2%) to UK index linked gilts. We have assumed this will remain for the time being.

While the additional yield offered by corporate bonds relative to gilts is still attractive, the overall level of yields from bonds is exceptionally low. This in part reflects the current extremely weak economic environment and in particular the monetary policy known as quantitative easing. We believe long-dated gilt yields will ultimately have to rise significantly from current levels, which in turn would result in very poor returns from bonds.

The problem for pension funds, however, is that long dated bonds are well aligned with liabilities, so they are owned more for risk mitigation than for return generation. Adding to the Fund's bond holdings would have the greatest impact in reducing liability risks, but we would not want to do so for two reasons. Firstly the returns offered are very low, so any substantial move in this direction could result in a significant reduction in the discount rate. Secondly we expect gilts to perform badly in the medium term, so such a change could be very detrimental to the Pension Fund's overall investment performance.

Against this background we would prefer to change the bond mandate from the current structure to an absolute return basis. This would make the portfolio much less vulnerable to the rises in long term yields that we expect to happen over the next few years. However, it would also reduce the liability matching characteristics of the overall Pension Fund.

We have sought to avoid changes in existing mandates where possible to minimise the potential time and cost involved in implementing change. However, if more change was possible we would suggest restructuring the bond mandate should be the first priority.

Property

The existing arrangements with Aviva have only recently been established and need no further changes. The additional allocation is modest and should be capable of being invested gradually as opportunities arise.

Alternatives

Alternative investments include a very broad range of asset types offering a diverse spectrum of potential returns and risk profiles. The attraction of a meaningful allocation to investments that do not fall within the traditional asset classes of equities, bonds and property, is that they can offer significant diversification benefits and thereby reduce the volatility of the funding level.

The existing allocation to alternatives (4.8%) is invested wholly in private equity through Pantheon pooled funds. Private equity can deliver very attractive long-term returns but it is a highly illiquid asset class that requires a long-term commitment. There is very little scope to reduce allocations until each pooled fund divests, which will take several more years. In the meantime we believe the allocation is quite sufficient and would suggest that no further commitments are made to this asset class.

We have modelled our proposed strategy based on allocating the remaining 15% to a Diversified Growth Fund (or DGF). The Panel will be familiar with the concepts underlying DGFs from the training session run earlier in 2012. While individual funds vary greatly in the processes and approach they use, they all seek to achieve absolute returns similar to equity markets (broadly cash +4% pa in the long-term) with considerably lower volatility.

Over time we would envisage the alternatives allocation would be broadened to include other asset types. In particular, we believe the emergence of pooled vehicles designed specifically for UK pension funds may make infrastructure an interesting opportunity. Any such investments would need to be assessed fully by the Panel.

There may be concern that broadening the range of asset types within the alternatives allocation would increase the governance burden for the Panel both in monitoring and changing capabilities. However, it is possible to minimise this by delegating the choice of alternatives to a third party within a clearly defined framework. Aon Hewitt's Delegated Consulting Service, for example, offers a single vehicle that provides a broad exposure to alternatives using only capabilities we have assessed as 'buy' rated. If the Panel were to make use of such an approach their relationship would be only with Aon Hewitt, with the monitoring and changes to the underlying alternatives capabilities delegated to Aon Hewitt.

Implementation in outline

The proposed strategy could be achieved by making just two manager changes. One of the existing equity managers (either passive or 'core' active) would be removed and the assets re-allocated to a DGF and an increase in the global unconstrained mandate.

The appointment of a DGF manager will require a selection process, which will take time. A full OJEU process would take up to 6 months and cost a minimum of £50,000 in advisor fees. A streamlined process based on making an investment rather than appointing a mandate would take roughly half this time and cost roughly half as much.

Given it will take at least 3 months to complete an adequate selection exercise it is worth considering whether to divest from equities immediately and retain the assets in cash until the selection is complete. Equity markets are highly volatile and face a number of significant macro-economic risks in the next few months, notably in resolving the fiscal position in the US. Selling into cash would reduce the potential volatility of the funding level in the run up to the actuarial valuation.

We would caution against such an approach for three reasons.

Firstly, while equity markets are volatile, they do not appear over-valued from a long-term perspective, especially in comparison to bonds. Investors are well aware of the uncertainties around a broad range of macro-economic and geo-political factors, so they should already be reflected in market ratings. For markets to fall substantially from current levels there would have to be new negative 'shocks'. While this is possible it is inherently dangerous to take on 'out of market' exposure in the meantime.

Secondly, the Pension Fund does not have a strong current funding level to 'lock in' and needs to retain its exposure to return seeking assets in order to close the current funding deficit and ensure the discount rate applied in the next actuarial valuation is appropriate. Cash does not achieve either the long-term return generation or the liability risk mitigation that the Pension Fund seeks, so should only be regarded as a short-term safe haven or source of liquidity for short-term expenditure.

Finally, it is not clear what the catalysts for re-investment would be. If the equity markets did fall significantly it is probable that economic prospects would then be even worse than today. Timing the re-investment would be particularly difficult in such an environment.

Our preference would be to complete the selection exercise for the DGF manager and to implement a transition from global equities to the DGF at the same time.

Cost implications

There are two aspects of cost – transition costs and on-going management fees. Both will depend to some extent on the details of the changes to be made, so the estimates here are by their nature fairly approximate

Transition costs

These encompass fees for our work, which we can estimate reasonably accurately, and market related transaction costs, which are much more variable dependent on market conditions at the time. It may also be possible to minimise the transaction costs when buying new pooled fund units by phasing an investment programme to avoid triggering a dilution levy.

On the assumption that a limited selection exercise was required Aon Hewitt would charge a fixed fee of £22,500 to select a DGF manager –

the fee would be about £25,000 more if a full OJEU process was required. In addition we would charge about £12,500 to oversee the transfer of assets. We estimate the fee costs of implementation are therefore about £35,000.

The market transaction costs for selling global equities are indicatively about 0.25%. Our assumption is that if any global equities were to be switched from a core manager to Longview these would probably be able to be crossed at minimal cost. There would nonetheless be £75m to sell to fund the purchase of the DGF, which are unlikely to be able to be crossed in this way. The estimated cost of these sales is therefore about £190,000.

It is possible that the purchases of the DGF units would be able to be implemented in a phased manner to avoid transaction costs. If this is not possible the cost would be indicatively 0.4%, or about £300,000.

Overall, then the transition costs could be as much as £490,000, which amounts to 0.65% of the assets involved.

On-going management costs

The difference in on-going management costs will depend on which manager is removed and which DGF is selected. Of the existing 'core' global managers, Fidelity charges a performance related fee if they achieve their objective of 0.6% pa and Wellington charges a scale fee of 0.7% pa. A typical DGF will charge a fee of about 0.65% pa. The difference in fee charge could therefore be approximately 0.05% pa (or £37,500 pa). The impact on fees would obviously be much more significant if the passive equity capability is used to fund the DGF purchase.

Conclusion

Conclusion

The current strategic asset allocation remains ‘fit for purpose’ in that it is expected to generate the long-term returns required to achieve the Pension Fund’s funding objectives. It is therefore entirely possible to continue with this strategy.

The problem with the current strategy, however, is that it relies very heavily on equity markets to generate the required returns, which means it is vulnerable if equity markets perform poorly for a sustained period and subject to high volatility in funding level along the way.

It is possible to construct a strategic asset allocation that achieves similar return objectives with less reliance on equity markets, although the scope to make meaningful improvements is constrained by need to generate high returns to address the Pension Fund’s current low funding level. The proposed strategy is designed to achieve this in the least disruptive way possible in order to minimise the cost and time involved.

We believe the proposed strategy is better placed to meet the needs of the Pension Fund both for the next actuarial valuation and in the longer term.

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