Initial Review of Investment Arrangements

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Prepared for

London Borough of Harrow Pension Fund

Prepared by

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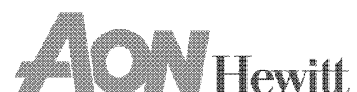

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Introduction

Introduction

This is the first report we have produced for the London Borough of Harrow Pension Fund since our appointment as Investment Adviser earlier this year. The objectives of this report are:

- To provide initial comments about the suitability of the existing strategic asset allocation in the context of the long term funding requirements of the Fund.
- To assess the suitability of the existing investment managers in the context of the mandates they have been awarded.
- To identify the priorities for further advisory work over the coming year and in doing so highlight potential training needs for the Panel.

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Executive Summary

- The current **strategic asset allocation** has a high probability of achieving the long term returns assumed by the actuary in assessing the long term funding of the pension fund. The expected return relative to a reasonable proxy for the scheme's liabilities is about 5.2% pa and the estimated probability of achieving the discount rate of 'gilts +1.6% pa' is over 70%.
- Replacing the passive equity mandate with an active approach and increasing the performance targets of the global equity managers would result in a higher expected return and improve the probability of achieving the required discount rate, but at a cost of increased volatility. Removing the currency hedge would also increase volatility, but would make very little difference to long term returns.
- The current strategic asset allocation implies a high level of volatility relative to liabilities. If the Panel wished to damp down volatility modestly to make future contributions more stable there is scope to do so without reducing the current discount rate.
- A detailed assessment of the existing **manager capabilities** is contained in the separate Manager Monitoring Report that accompanies this review document. The results are shown in the table below.

Asset category	Manager	Allocation	Rating
		%	
Passive UK equities	State Street	26	Buy
Active global equities	Fidelity	19	*Not rated*
	Longview	7	Buy
	Wellington	21	Hold
Active bonds	Blackrock	12	Buy
Private equity	Pantheon	5	Buy
Property	Aviva Fund of Funds	9	*Not rated*
	UBS	0	Hold
Currency	BNY Mellon	1	*Not rated*

- There are no existing capabilities which are rated Sell. Capabilities rated Buy account for 50% of the portfolio, with a further 21% in capabilities rated Hold.
- The remaining 29% is allocated to capabilities not currently rated by our manager research team. Each of the managers offers similar products which are rated. The Aviva real estate products are rated Hold or Buy, the Mellon currency product is rated Hold and the

Fidelity global equity products are rated Hold or Sell. Within the Pantheon range, while we do rate the Europe and USA funds as Buy, we do not have a current rating for the Secondary fund. In due course we will want to spend time with the managers for these specific products – the priority will be to assess the Fidelity capability.

- The priorities for **future advisory work** subject to cost are as follows:
  - Considering what steps could be taken to reduce volatility without changing the current actuarial discount rate.
  - Completing the coverage of the manager capabilities so that all the mandates are monitored and included in quarterly reports, undertaking complementarity analysis to assess the effectiveness of the mix of global equity managers in particular and assessing the manager fee charges to ensure that they remain competitive.
  - Widening the range of alternative asset choices to provide better strategic diversification and potentially more explicit protection against inflation and other risks and looking at the most effective way to gain exposure in each asset type.
  - Improving implementation through the timing of asset allocation moves in the context of medium term views on relative valuations.
  - Reviewing the governance arrangements both for the Panel's decision making processes and for monitoring the engagement activities of the appointed managers.
- The priorities for **future training** are as follows:
  - How the strategic asset allocation and the liabilities interact – how the liabilities are calculated, the potential costs of aligning strategy to liabilities and the potential consequences of not doing so.
  - How diversification can help smooth returns and how to decide which asset types to invest in and which to avoid.
  - The different ways to invest in alternative asset classes, including the asset types currently used by the pension fund (property, private equity and active currency).

Strategic Asset Allocation

Background

Strategic asset allocation is critically important to the ability of any pension fund to meet its long term funding needs. Different asset classes have different investment characteristics in terms of potential future returns, the volatility (or risk) associated with generating these returns and the correlation of these returns with those generated by different asset types. A strategic asset allocation determines a combination of assets that can be expected to generate a sufficiently high long term return with a sufficiently low degree of risk. The impact of strategic asset allocation decisions is likely to be far greater than the choice of different managers within each asset class.

Investment markets are inherently uncertain, so any strategic asset allocation is based upon carefully analysed and historically justified 'best guesses' about the future. The output of this analysis is usually three important numbers – the expected long term return, the expected volatility of returns and the expected probability of achieving the return required to meet the pension fund's funding needs.

In the long term a pension fund's liabilities can be met from one of two sources – investment returns or contributions. If investment returns are higher, contribution levels can be lower and vice versa. When the fund's actuary recommends the appropriate level of future contributions as part of the triennial actuarial review, a future level of investment returns is assumed in the rate at which future pension liabilities are discounted back to the present. Typically the discount rate will be expressed as 'gilts +x%' or 'liabilities +x%'. In setting a discount rate the actuary will usually take a prudent view of the likely future returns achievable given the strategic asset allocation. Typically the actuary will want the probability of the strategic asset allocation achieving the assumed investment return to be at least 60%.

When considering a strategic asset allocation we can look at the outcomes in one of two ways. The first is to consider the absolute level of returns and volatility. This is the approach that is most often used when reporting pension fund returns in the annual accounts. The second way is to consider the returns and risks relative to the scheme's liabilities. This is the approach that will best express the potential changes to the funding position of the scheme, so it is a key determinant of the potential future size of the funding deficit.

The funding position of a pension fund at the outset is an important component of establishing a suitable strategic asset allocation. A fully funded pension fund will need to generate returns similar to the future growth in liabilities, which is broadly determined by the future returns from long dated bonds. By contrast, a fund with large deficit relative to its liabilities has to generate much higher long term returns both to catch up with growth of the larger liability base and to close the funding gap. This requires a strategic asset allocation that seeks much higher investment returns and consequently takes much greater investment risk.

Current Position

The London Borough of Harrow is broadly typical of most LGPS funds in having a large funding deficit – at end March 2010, the pension fund was 73.5% funded on an ongoing basis. The investment objective for the strategic asset allocation is therefore highly skewed towards return generation rather than risk reduction.

The current strategic asset allocation is shown in the table.

	%
Equities	**71**
UK (passive)	26
Global	45
Bonds	**13**
Alternatives	**16**
Property	10
Private equity	3
Active Currency	3

Initial High Level Modelling Results

Our modelling suggests the current strategic asset allocation is capable of generating a high investment return in the long term. The bulk of the assets are in assets that we believe will generate long term returns in excess of 8% pa – this includes equities, private equity and property. By contrast, bonds are likely to generate much lower returns at about 4% pa.

In addition to the choice of asset classes, the bulk of the assets are in actively managed mandates seeking returns above their respective market indices – the only passive (or index tracking) component is UK equities. Within equity markets the emphasis is on global markets rather than the UK both to diversify exposure to global economic growth and to maximise the opportunity set for the active managers. In order to limit the currency risk of the portfolio there is an additional currency mandate not included in the strategic asset allocation above that hedges 50% of the currency exposure back to sterling.

Based on the current strategy and taking into account the out-performance targets of the existing managers, we would expect the strategic asset allocation to generate a long term total return of about 9.6% pa, with a volatility of 15.9%. It would be possible to adopt an even more active approach to equity management to boost the return further – a fully unconstrained approach in all markets would increase the 'expected' return to 10.5% pa – but at a cost of increasing the volatility to 16.5%. If instead we remove the currency hedge we would increase risk (to 16.2%) and not gain much extra return (9.7% pa).

These figures are all based on absolute measures and take no account of the scheme's liabilities. As such they do not fully express the potential volatility of the scheme's funding position. The scheme's liabilities are a mix of nominal and inflation linked future cash payments, with most being linked to inflation through wages. A detailed analysis of the liabilities

would take many months, but a good approximation for LGPS funds generally is to consider a basket of 80% long dated index linked gilts and 20% long dated conventional gilts as a proxy for the liabilities.

Using this proxy we can establish that the existing strategic asset allocation and manager mandates are expected to generate a return of about 5.2% pa above the liabilities, but with a volatility of 18.2%. This is an approach designed to close the deficit quite quickly over time, but with a high level of volatility along the way. Tweaking the structure either to increase the performance objectives of the equity mandates or remove the currency hedges would have relatively little effect (see table below).

In calculating the current contribution rates the actuary used a discount rate of 'gilts +1.6% pa'. Our modelling suggests the current strategic asset allocation has a probability of achieving this return in excess of 70%.

	Current %	Unconstrained equities %	Currency hedges removed %
Absolute basis			
Expected annual return	**9.6**	10.5	9.7
Expected volatility	**15.9**	16.5	16.2
Relative to liabilities*			
Expected annual return	**5.2**	5.9	5.1
Expected volatility	**18.2**	18.8	18.5
Probability of achieving gilts +1.6% pa	**72**	76	73

* based 80% index linked gilts/20% conventional gilts

Overall, we believe the current strategic asset allocation is capable of achieving the long term returns required to maintain the funding of the pension fund, albeit with a high degree of volatility both in absolute terms and more importantly relative to liabilities. The implication of high volatility is that the funding position could either improve or deteriorate significantly between each triennial valuation, which in turn means future employer contribution rates will be less stable. It is not possible to eliminate this volatility entirely while maintaining sufficient investment return to satisfy the current funding assumptions.

Having said this, the discount rate currently used is conservative and there is scope to dampen down volatility modestly while not reducing the discount rate assumptions. In other words it should be possible (by reducing volatility relative to the liabilities) to reduce the probability of needing to increase contribution rates in future while (by retaining the same the actuarial discount rate) maintaining the current contribution rate.

Manager Assessment

Aon Hewitt has a well resourced manager research capability comprising over 70 investment professionals with expertise in all the main asset categories used by our clients. We currently monitor over 11,000 products offered by over 4,000 managers and undertake over 2,000 manager visits each year.

Our research team is familiar with all the managers currently employed by the pension fund, but in three cases we have not researched the specific product relevant to the mandate you have awarded - the Fidelity global equity mandate, the Aviva property fund of funds and the BNY Mellon active currency capability.

A detailed Manager Monitoring Report accompanies this review and provides in-depth analysis of the manager capabilities that have been rated fully by the team.

The table below summarises our overall ratings for the managers.

Asset category	**Manager**	**Allocation %**	**Rating**
Passive UK equities	State Street	26	Buy
Active global equities	Fidelity	19	*Not rated*
	Longview	7	Buy
	Wellington	21	Hold
Active bonds	Blackrock	12	Buy
Private equity	Pantheon	5	Buy
Property	Aviva Fund of Funds	9	*Not rated*
	UBS	0	Hold
Currency	BNY Mellon	1	*Not rated*

There are no existing capabilities which are rated Sell. Capabilities rated Buy account for 50% of the portfolio, with a further 21% in capabilities rated Hold.

The remaining 29% is allocated to capabilities not currently rated by our manager research team. Each of the managers offers similar products which are rated. The Aviva real estate products are rated Hold or Buy, the Mellon currency product is rated Hold and the Fidelity global equity products are rated Hold or Sell. In due course we will want to spend time with the managers for these specific products – the priority will be to assess the Fidelity capability first.

Priorities for further advisory work and training

The existing strategic asset allocation is geared to generating high investment returns, but with high volatility relative to the liabilities. This strategy is essentially one focused on narrowing the deficit as quickly as possible. While there is some strategic diversification through the allocations to real estate and other alternatives, the biggest concentrations of risk arise from investing heavily in equity markets and from having very little protection against some of the most important drivers of pension cost – notably inflation.

Looking forward there is scope to hone the investment arrangements to better suit your needs. Specifically we would suggest further work in the following areas:

- Considering what steps could be taken to reduce volatility without changing the current actuarial discount rate. This would involve understanding better the relationship between the liabilities and the investment strategy.
- Completing the coverage of the manager capabilities so that all the mandates are monitored and included in quarterly reports, undertaking complementarity analysis to assess the effectiveness of the mix of global equity managers in particular and assessing the manager fee charges to ensure that they remain competitive.
- Widening the range of alternative asset choices to provide better strategic diversification and potentially more explicit protection against inflation and other risks and looking at the most effective way to gain exposure in each asset type.
- Improving implementation through the timing of asset allocation moves in the context of medium term views on relative valuations.
- Reviewing the governance arrangements both for the Panel's decision making processes and for monitoring the engagement activities of the appointed managers – the Panel's time is usually very limited, so in order to ensure it is used most effectively it is important periodically to review and prioritise the issues that should be considered by Panel, the scope for delegation and the information required to ensure effective direction and control.

Some of these issues will involve investment concepts and techniques that are not straightforward. To enable the Panel to fully understand, direct and monitor progress, we anticipate some training will be required. The exact format of the training will need to be discussed in due course, but the areas we think are most likely to be needed are as follows:

- How the liabilities are calculated, the potential costs of aligning strategy to liabilities and the potential consequences of not doing so.
- How diversification can help smooth returns and how to decide which asset types to invest in and which to avoid.
- The different ways to invest in alternative asset classes, including the asset types currently used by the pension fund (property, private equity and active currency).

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