Public Document Pack

SUPPLEMENTARY AGENDA

PENSIONS INVESTMENT COMMITTEE

Date: TUESDAY, 7 FEBRUARY 2017 at 7.00 pm

Committee Rooms 1
Civic Suite
Catford Road
London SE6 4RU

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COUNCILLORS

Councillor
Councillor Liz Johnston-Franklin
Councillor Maja Hilton
Councillor Simon Hooks
Councillor Mark Ingleby
Councillor Paul Maslin
Councillor John Muldoon
Councillor Olurotimi Ogunbadewa

Observers

Independent
William Marshall

Officers
David Austin, Head of Corporate Resources
Janet Senior, Executive Director for Resources & Regeneration
Helen Glass, Principal Lawyer
Carol Eldridge, Group Manager - Pensions & Payroll

Members are summoned to attend this meeting

Barry Quirk
Chief Executive
Lewisham Town Hall
Catford
London SE6 4RU
Date: Thursday, 26 January 2017

The public are welcome to attend our committee meetings, however occasionally committees may have to consider some business in private. Copies of reports can be made available in additional formats on request.

ORDER OF BUSINESS – PART 1 AGENDA

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PENSIONS INVESTMENT COMMITTEE			
Report Title	**DECLARATIONS OF INTERESTS**		
Key Decision	No		**Item No. 1**
Ward			
Contributors	**CHIEF EXECUTIVE**		
Class	**Part 1**		**Date: 7 February 2017**

Declaration of interests
Members are asked to declare any personal interest they have in any item on the agenda.

Personal interests
There are two types of personal interest :-
(a) an interest which you must enter in the Register of Members' Interests*
(b) an interest where the wellbeing or financial position of you, (or a "relevant person") is likely to be affected by a matter more than it would affect the majority of in habitants of the ward or electoral division affected by the decision.

*Full details of registerable interests appear on the Council's website.

("Relevant" person includes you, a member of your family, a close associate, and their employer, a firm in which they are a partner, a company where they are a director, any body in which they have securities with a nominal value of £25,000 and
(i) any body of which they are a member, or in a position of general control or management to which they were appointed or nominated by the Council, and
(ii) any body exercising functions of a public nature, or directed to charitable purposes or one of whose principal purpose includes the influence of public opinion or policy, including any trade union or political party) where they hold a position of general management or control,

If you have a personal interest you must declare the nature and extent of it before the matter is discussed or as soon as it becomes apparent, except in limited circumstances. Even if the interest is in the Register of Interests, you must declare it in meetings where matters relating to it are under discussion, unless an exemption applies.

Exemptions to the need to declare personal interest to the meeting
You do not need to declare a personal interest where it arises solely from membership of, or position of control or management on:

(a) any other body to which your were appointed or nominated by the Council
(b) any other body exercising functions of a public nature.

In these exceptional cases, unless your interest is also prejudicial, you only need to declare your interest if and when you speak on the matter .

Sensitive information
If the entry of a personal interest in the Register of Interests would lead to the disclosure of information whose availability for inspection creates or is likely to create a serious risk of violence to you or a person living with you, the interest need not be entered in the Register of Interests, provided the Monitoring Officer accepts that the information is sensitive. Where this is the case, if such an interest arises at a meeting, it must be declared but you need not disclose the sensitive information.

Prejudicial interests
Your personal interest will also be prejudicial if all of the following conditions are met:

(a) it does not fall into an exempt category (see below)
(b) the matter affects either your financial interests or relates to regulatory matters - the determining of any consent, approval, licence, permission or registration
(c) a member of the public who knows the relevant facts would reasonably think your personal interest so significant that it is likely to prejudice your judgement of the public interest.

Categories exempt from being prejudicial interest

(a) Housing – holding a tenancy or lease with the Council unless the matter relates to your particular tenancy or lease; (subject to arrears exception)
(b) School meals, school transport and travelling expenses; if you are a parent or guardian of a child in full time education, or a school governor unless the matter relates particularly to the school your child attends or of which you are a governor;
(c) Statutory sick pay; if you are in receipt
(d) Allowances, payment or indemnity for members
(e) Ceremonial honours for members
(f) Setting Council Tax or precept (subject to arrears exception)

Effect of having a prejudicial interest
If your personal interest is also prejudicial, you must not speak on the matter. Subject to the exception below, you must leave the room when it is being discussed and not seek to influence the decision improperly in any way.

Exception
The exception to this general rule applies to allow a member to act as a community advocate notwithstanding the existence of a prejudicial interest. It only applies where members of the public also have a right to attend to make representation, give evidence or answer questions about the matter. Where this is the case, the member with a prejudicial interest may also attend the meeting for that purpose. However the member must still declare the prejudicial interest, and must leave the room once they

have finished making representations, or when the meeting decides they have finished, if that is earlier. The member cannot vote on the matter, nor remain in the public gallery to observe the vote.

Prejudicial interests and overview and scrutiny

In addition, members also have a prejudicial interest in any matter before an Overview and Scrutiny body where the business relates to a decision by the Executive or by a committee or sub committee of the Council if at the time the decision was made the member was on the Executive/Council committee or sub-committee and was present when the decision was taken. In short, members are not allowed to scrutinise decisions to which they were party.

Agenda Item 2

PENSIONS INVESTMENT COMMITTEE			
Report Title	MINUTES		
Key Decision	No		**Item No.** 2
Ward	All		
Contributors	CHIEF EXECUTIVE		
Class	Part 1	**Date:** 7 February 2017	

Recommendation

That the Minutes of the meeting of the Committee, held on 15 November 2016 be confirmed and signed.

MINUTES OF THE PENSIONS INVESTMENT COMMITTEE

Tuesday 15th November 2016

PRESENT: Councillors Ingleby (Chair), Hooks, Johnston-Franklin, Hilton, Maslin, Muldoon, Ogunbadewa

Also Present: David Austin, Albert Chen, Geoff Nathan and William Marshall (Hymans Robertson Consultants), Carolina Espanal, Olav Konig and Emily Archer (HarbourVest representatives), Digby Armstrong (UBS representative), Janet Senior and Helen Glass

Apologies: Councillor Best

1. **Declarations of Interest**

   Councillor Muldoon declared an interest as a substitute member of the Advisory Board for the Local Government and as a Councillor with preserved benefits in the LGPS.

2. **Minutes**

   RESOLVED that the Minutes of the meeting held on 9 June 2016 be agreed as a correct record

3. **Funding Manager Briefing- UBS**

   Digby Armstrong gave a presentation on the UBS Lewisham Pension Fund Mandate. The report covered the mandate, Lewisham performance, market context and UBS asset management.

   In regards to the mandate, Mr Armstrong mentioned that Lewisham is 77% invested in equities. He also stated that US election bears good news for the UK in terms of the negotiation position with Europe, hence why the pound rallied quite strongly.
   In regards to the performance of Lewisham, over the last year, the benchmark sat at 26% which demonstrates the current weakness of the GBP, but is still a good period. A 6/7% return (as demonstrated by the UK) per annum is what should be expected over long term performance.

   UBS run a lot of index tracking assets, in both equities and bonds. Tracking does not just include buying the index, waiting for it to change and then replicating it- there is skill involved in anticipating what changes to the index are taking place over a 2-3 week period. It is about stock lending, minimising trading costs, avoiding price distortions caused by index changes, adding value in corporate events and active corporate governance. Another efficient index tracking development on its way is Carbon Aware Investing. When considering investing and engaging with different companies, UBS will look at where they stand in terms of their carbon footprint

Mr Armstrong also discussed alternative indexation and smart BETA, which he described as passive investment, but investing money in companies that are ranked by different factors e.g. value, minimum volatility and quality. The UBS recommendation is a blended approach of different factor-based investment strategies

Albert Chen made the following observations of the points made in the UBS presentation:

- Regarding the alternative indices and smart BETA, the funds have not been in existence (shown on slide 13) and neither have the indices, so what has been demonstrated is regarding testing
- The performance of the smart BETA indices, the drop in equities (in value, quality, momentum etc.) are still quite volatile.
- Although, this does offer something different to the market gap. However, there are higher strategic priorities.

4. Fund Manager Briefing- HarbourVest

Olav Konig, Managing Director of HarbourVest Partners, Corilina Espinal, also Managing Director and Emily Archer, Vice President, gave a presentation on the Lewisham Pension Fund mandate. Their presentation gave an overview of HarbourVest, an overview of the commitments regarding the Lewisham Pension Fund and their 2017 Cycle 4 strategy. The following was mentioned in their presentation.

The company has extensive knowledge of private equity attracts a strong base of institutional investors worldwide and manage more than $4billion for 22 LGPS clients. The representatives pointed out that over the years, Lewisham's overall portfolio has performed well for a majority fraction of the time- with 2008 and 2009 being the only years it fell below the contribution line between 2006 and 2016.

Discussing the assets managed by HarbourVest as of June 30 2016, in cycles 1 and 3, Lewisham's status started at maturing and moved to 'investing' by the vintage year 2014. The total values have been above water and HarbourVest expressed that they are pleased with the performance.

In regards to the diversification of the Portfolio commitment, Lewisham are well diversified in the underlying company level. Vintage Year diversification is crucial for a successful private equity strategy- there has been a positive performance across vintages in the Lewisham portfolio.

Absolute returns have been strong- relative to the public markets- performance generally has been positive, although there have been some laggards from 2007 onwards due to some challenges faced during the financial crisis. During cycle 3, 2014 onwards, investment performance has improved.

Albert Chen and William Marshall observed that volatility in private equity can be higher but the investments are valuated every quarter. Private equity is viewed as a long term application which funds can invest in, however there are more attractive opportunities in other parts of the market and other asset classes without the exposure of the same level of volatility investing in equity.

5. Review of Investment Strategy and Statement of Investment Principles- Hymans Robertson

Geoff Nathan presented reports on the "Lewisham Pension Fund- Funding Strategy Statement (FSS)". The legislative basis and requirements of FSS can be found in regulation 58 of LGPS Regulations 2013- this regulation has regard to GIPFA guidance. The FSS documents must contain a clear and transparent strategy of how employers' liabilities are best met. It must also ensure solvency and Long Term Cost Efficiency is met- this essentially means that there should be enough assets to cover liabilities that may unexpectedly arise and implies that the rate must not be set at a level that gives rise to additional costs.
The key aspects of the funding strategy, as explained further in the report provided, are:

- Solvency & Long term Cost Efficiency (LTCE)
- Consider own valuation vs DCLG/GAD (section 13 analysis)
- How funding and investment strategies link
- Identify risks and counter-measures
- Employer database
- Involvement of Local Pension Board
- Employer consultation
- Clarity and transparency

Geoff Nathan went on further to discuss the initial results of the 2016 Actuarial Valuation. He discussed the following regarding 2016 assumptions;

Future investment returns are based on bond yields (plus allowance) for the fact that the investment is in an equity type investment. In 2013 the bond yields were around 3% plus 1.6% allowance for asset performance. In 2016, they had fallen to 2.2%, with an allowance of 1.8%, which was seen as a reasonable assumption (based on modelling to see if it was sustainable). There was also a drop in long term pay growth from 4.3% to 2.9% which is a blended rate allowing for 1% pa to 2020 and RPI +0.5% thereafter, and excluding promotional increases.

The actual results set out in the presentation showed that the funding level had risen to 78% from 71% in 2013. The bottom line here is that deficit has fallen from £348m to £288m. Membership data displayed that active member salary had increased to £133.5m in 2016 from £123.9m in 2013. The change in market conditions meant that falling bond yields have increased liabilities, but asset returns have been stronger than expected.

The whole fund valuation based on the SAB (School Advisory Board) have put out a funding level assumptions of 94%- a funding basis is required to be prudent by regulations

Mr Nathan then discussed the modelling results for the Council- the purpose of modelling is to consider the investment and contribution strategies that might be used within the Lewisham Pension Fund to help inform the Administering Authority of the level of risk associated with different combinations of funding and investment

strategy. For each outcome, 5000 projections per scenario, the position at each valuation during the 24-year period is calculated, using cash flows and membership data. In projecting forward future funding levels, projected market conditions at each future data are used to see where the Council is likely to be, in as far as 20 years' time. The assessment of the likelihood of different outcomes was displayed in the presentation.

In the decision making framework, the probability of achieving set target of 100% funding is considered, as well as the time horizon and the downside risk.

There are 3 investment strategies; current, diversified and lower growth. The inputs were modelled in the presentation as well as the outcomes. It was further explained that with the current strategy, the probability of achieving target in 2037 around 66%, the current diversified strategy at around the same% and the lower growth at just above 64%. The risk by 2037, based on the average of the worst 5% outcomes with the current strategy is at 31%, diversified at 38% and lower growth at 42%. The last 3 graphs displayed what would happen under the 3 strategies with contributions. Which steps up or down by 0.5% on average.

RESOLVED that the report be noted

6. Investment Performance Report- Hymans Robertson

Albert Chen and William Marshall, presented a report outlining the portfolio options for diversification. The following was presented by Hymans Robertson and discussed among the Committee.
The purpose of this paper is solely to provide overviews of a number of asset classes, to help inform the Council in deciding upon those that could be considered further for inclusion in the Fund's investment strategy. The paper was presented in 3 parts; Rationale for diversifying the Fund's portfolio, Overviews of asset classes (multi-asset, alternative credit, infrastructure, insurance linked bonds); and points for discussion and next steps for the Committee.

The consultants presented various explanations as to why Lewisham may want to diversify, including opportunities to improve the efficiency of the Fund's investment portfolio by maintaining or improving the level of expected return while reducing risk, equities have performed well over recent years and the market outlook for risky assets is fairly uncertain and there are always the possibilities of setbacks in the short or medium term. Regarding asset classes, reducing equity exposure and investing in assets offering illiquidity premiums and diversification from economic growth driven returns is likely to increase the resilience of the portfolio and help protect capital. The representatives also made the point and showed a graph that displayed that the Fund's strategic need for income is increasing over time.

Multi-asset strategies are seeking to deliver "equity-like" returns with lower volatility. The funds will typically be invested across a range of asset classes and strategies. A large range of different approaches and highly reliant on manager skill.
Speaking on alternative credit, credit is higher than equity in terms of the capital structure. However, within credit there are a different set of risks, mainly default risks and liquidity.

The representatives explained a graph in the presentation, which explained the investment stages of Infrastructure. There is a higher return opportunity in taking projects from the “greenfield” stage to operating stage, but with the trade-off of higher development risk. In the later stage, greenfield is not invested in until the financial close, reducing risk. The fundamental risk of Infrastructure, highlighted by Albert Chen was that of political and regulatory risk which can vary over time, impacting potential returns from affected infrastructure assets.
Specialist infrastructure funds typically focus on a particular sub-sector or region, and therefore typically to specific sector and/or regional risks, which require consideration relative to a core, diversified fund that invests across sectors and regions.
Insurance linked (IL) bonds are issued by insurers and re-insurers seeking to transfer catastrophe insurance risk. Cat-bonds will typically have a 3 year term (to 5 years) that pays coupons over the term and return principal upon maturity. The key risk for IL bonds is fundamentally disconnected from the Fund’s other investment risks.
In terms of the asset classes, in relation to the market environment, Alternative Credit in particular has been and are of interest over the last few years
It was recommended that the Committee discuss whether they believe in diversification and is there contentment in a 30% reduction in equity if adopting a lower-risk investment strategy.
It was recommended that for the February 2017 meeting that Hymans will present structure risk and return modelling for a range of portfolios based on Committee preferences. The potential for manager interviews, prior to, and at the next meeting, subject to agreement on asset classes and implementation process.

RESOLVED that the report be noted. The Committee agreed to look further into diversification.

7. Pension Fund Annual Report

Due to the over-running of time, this report will be presented at the February meeting

The meeting finished at 10:05pm

Pension Investment Committee			
REPORT TITLE	Pension Investment Committee Pensions update		
KEY DECISION	No	**Item No:**	
WARD	N/A		
CONTRIBUTORS	Head of Corporate Resources		
CLASS	Part 1	**Date:**	February 2017

Lateness: This report was not available for the original dispatch because officers needed additional time to complete their work.

Urgency: The report is urgent and cannot wait until the next meeting to enable the Pensions Investment Committee to effectively plan their work for the next period.

Where a report is received less than 5 clear days before the date of the meeting at which the matter is being considered, then under the Local Government Act 1972 Section 100(b)(4) the Chair of the Committee can take the matter as a matter of urgency if he is satisfied that there are special circumstances requiring it to be treated as a matter of urgency. These special circumstances have to be specified in the minutes of the meeting.

1. PURPOSE

1.1. This paper provides members with an update on pension related matters in the last period.

2. RECOMMENDATIONS

2.1. Members are asked to note this report.

3. BACKGROUND

3.1. This briefing will provide a summary of current topics and follows up on action requested in previous meetings.

4. CURRENT CONSIDERATIONS

Pension Board

4.1. The Pension Board has not met in the last quarter.

Actions arising from previous Pension Investment Committee:

4.3 An appointment has been made to the pension fund manager post. They start on the 16 February and will be attending future committees.

Collective Investment Vehicle (CIV)

4.4 The Joint Committee continue to meet, with the Chair of PIC attending. In addition, training is being arranged for the 3 March 2017.

4.5 As previously noted, none of the funds transitioned to the CIV to date have been ones Lewisham are invested in. The most likely next step will be the shift of the passive fund structures, at least for the equities elements, from life funds to ones that are permissible to be managed by the CIV as an ACS.

4.6 Following the withdrawal by State Street of their LGPS benchmarking offering, the CIV are considering procuring a replacement service for themselves and members to help maintain effective performance montoring across the sector. Lewisham have also registered with PIRC to join the replacement service being set up on behalf of LAPFF to ensure access to this comparative information is not lost.

Triennial fund valuation in 2016

4.7 The agreement of the Funding Strategy Statement, a subject of a separate report at this Committee, will conclude the valuations work. The focus moves onto the investment strategy and rebalancing the Fund in line with this (also discussed separately on this agenda).

Government policy changes

4.8 No specific changes. The government continues to progress proposals for LGPS investment activities to merge into six regional funds and adopt certain sovereign wealth fund characteristics. The London CIV was reviewed by the Department and a letter sent by the Secretary of State noting the good work done and encouraging an acceleration of the pooling on mandates through 2017.

Training

4.9 Officers continue to recommend the excellent training tools available via the Pensions Regulator at: http://www.thepensionsregulator.gov.uk/public-service-schemes/learn-about-managing-public-service-schemes.aspx. In addition, as members have feedback that this was also a helpful resource, copies (or links) to the Russell's Fiduciary Handbook are available.

4.10 In the last quarter officers have also highlighted training events that have come up with free spaces, in particular the SPS events. A more detailed list of upcoming events will be circulated at the meeting.

4.11 Should members have identified other training they would like to attend please can they keep the governance team or David Austin informed.

Other matters

4.12 None to note

5. LEGAL IMPLICATIONS

5.1. There are no legal implications arising directly from this report.

6. FINANCIAL IMPLICATIONS

6.1. There are no financial implications arising directly from this report.

7. CRIME AND DISORDER IMPLICATIONS

7.1. There are no crime and disorder implications directly arising from this report.

8. EQUALITIES IMPLICATIONS

8.1. The Equality Act 2010 became law in October 2010. The Act aims to streamline all previous anti-discrimination laws within a Single Act. The new public sector Equality Duty, which is part of the Equality Act 2010, came into effect on the 5 April 2011.

8.2. The Council’s Comprehensive Equality Scheme for 2012-16 provides an overarching framework and focus for the Council's work on equalities and helps ensure compliance with the Equality Act 2010. No direct equalities implications have been identified, in terms of adverse impact, with respect to the Council’s obligations under the Equality Act 2010.

9. ENVIRONMENTAL IMPLICATIONS

9.1. There are no environmental implications directly arising from this report.

10. BACKGROUND DOCUMENTS

10.1. None

For further information on this report please contact:

David Austin, Head of Corporate Resources on 020 8314 9114 or at david.austin@lewisham.gov.uk

HYMANS ROBERTSON

investment perspectives

Summer 2016

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Welcome

In the current environment, where achieving sustainable returns is critical, it is unsurprising that responsible investment is a topic gaining prominence amongst institutional investors. Pension schemes, as long-term investors, are potential beneficiaries of this integration of responsible investment into their strategy.

Reflecting the increasing importance being placed upon responsible investment, both amongst our clients and across the market as a whole, we are pleased that Simon Jones has taken on the role of Head of Responsible Investment within Hymans Robertson.

Responsible investment embraces a diverse range of subjects. As introduced in a previous Investment Perspectives, we believe responsible investment considerations have two key dimensions:

- **Sustainable investment**: investors should recognise the potential financial impact of Environmental, Social and Governance (ESG) factors in investment decision making; and
- **Stewardship and governance**: investors should act as responsible and active owners, through considered voting of shares, and engagement with company management when required.

Each of these factors has the potential to improve the financial return to investors or to give rise to risks that could compromise returns. The Pensions Regulator acknowledged such factors as part of the recently published DC Code of Practice, highlighting the fact that responsible investment should be considered by both DB and DC trustees.

In addressing responsible investment in this edition of Investment Perspectives, we highlight four topics which apply at various stages of the investment process (figure 1).

- In the first article William Marshall sets out the benefits a well-defined set of beliefs can bring and explores how investment beliefs can help you consider what sort of responsible investor you want to be.

Figure 1: Hymans Robertson investment process

- When considering asset allocation, to what extent are responsible investment considerations applicable to assets other than equities? In the second article Rebecca Craddock-Taylor explores the impact of the two key dimensions of responsible investment across an investment strategy.

- In previous Investment Perspectives we addressed how carbon exposure has been highlighted as a potential risk for investors. As part of the monitoring process, it is important to understand how carbon risk can be measured. In the third article, Simon Jones explores the use of carbon footprinting as a risk monitoring tool.

- Finally, beyond voting for political reform, there is growing evidence of the collective power of investors exercising their shareholder voting rights to achieve desired outcomes. Starting with the premise that equity ownership conveys a degree of responsibility, Nell McRae takes a closer look at voting and considers how you can both stay abreast of what your managers are doing and engage with your managers on their voting policies.

Responsible investment has often been considered by trustees as "a nice to have". However, by understanding how responsible investment can be integrated within an investment process, we believe trustees should regard responsible investment considerations as a component of their decision making process, rather than a decision in its own right.

Andy Green

Chief Investment Officer
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What do you believe in?

One feature of a successful investment strategy which is often cited, but frequently overlooked, is the set of investment beliefs around which decisions are made.

What purpose do beliefs serve?

Beliefs matter. They reflect the way in which trustees, be it implicitly or explicitly, translate their objectives into an actual set of investment arrangements.

The impact of beliefs can be observed across a range of investment decisions that need to be made, including the use of diversification, the willingness to employ active management and the approach to addressing responsible investment issues.

Documenting your investment beliefs could be considered as stating the obvious. However, having your beliefs well-defined and set out on record confers a number of advantages:

1. **Clarity** - Beliefs allow an investment strategy to be articulated and interpreted by internal and external stakeholders and therefore offer a means through which communication can be structured.
2. **Priority** - Beliefs allow trustees and sponsors to determine which decisions are important and question why a course of action may be being proposed. It helps facilitate areas of compromise and set "red lines" not to be crossed.
3. **Consistency** - Beliefs provide a defined framework within which investment decisions are taken. This means that all decisions can be assessed against the same overarching standards.
4. **Continuity** - Trustee bodies change over time which can lead to a loss of ownership of the underlying investment strategy. However, where strategy is reinforced by a set of investment beliefs, trustees may be better able to own both the beliefs and consequently the strategy through time.
5. **Long-term thinking** - Beliefs can help trustees to stand clear of short-term market noise and avoid knee-jerk reactions.

There is no right answer when it comes to setting beliefs. Each trustee body will have its own unique beliefs which depend both on their own circumstances and the views of individual trustees.

Once established, beliefs should be periodically reviewed to ensure that they continue to reflect the combined views of the trustee body.

CASE STUDY

A client had come under considerable scrutiny from members to take action on its investments in fossil fuels. Rather than taking immediate action to change, we worked with the client to help them frame their own policies by developing both a set of investment beliefs and a set of responsible investment beliefs. While the client was initially sceptical, this exercise subsequently allowed them to provide a more robust response to their members and has led to a broader understanding of engagement issues and more informed discussion with investment managers.

What sort of responsible investor are you?

As illustrated by the case study, trustees can use beliefs to address specific aspects of investing. This may include equity investment beliefs, incorporating some the principles we set out in a previous Investment Perspectives for example, or beliefs around responsible investment.

Given responsible investing decisions exist at each stage of the investment process, a key consideration for trustees is to determine the extent that they wish to explicitly address these issues within their investment arrangements. To do this, trustees need to determine what sort of responsible investors they want to be.

Beliefs around responsible investment may be driven at an organisational or an individual trustee board level. Some investors may believe they should seek to drive broader changes in behaviour and therefore adopt a leading position whereas others may have less strong beliefs around driving change, but still wish to remain active.

Discussion on investment beliefs provides avenues for engagement on responsible investment issues. Trustees can effectively use such discussions to make an informed choice as to the position that they want to adopt. Table 1 illustrates some of the actions that can be taken to reflect the chosen position.

Regardless of the position taken, developing investment beliefs gives trustees greater ownership of their investment decisions, and can consequently create more responsible investors.

Table 1: Possible trustee positions on responsible investment

Core position	Active position	Leading position
Developing a statement of investment beliefs	*Core position plus...*	*Active position plus...*
Engaging with investment managers on ESG policies	Understanding/reporting on potential ESG risk exposures	ESG issues embedded in all investment decision making
Regular reporting on manager voting and engagement activities	ESG factors explicitly considered in some investment decisions, e.g. manager selection	Active engagement with investee companies for value enhancement
Periodic training on responsible investment issues	Support for broader industry initiatives, e.g. UK stewardship code	Collaboration with other investors to create change

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More than a matter for equities

Responsible investment is not solely the domain of equity investors. In the pursuit of sustainable returns, we believe it is an issue that applies to the whole investment strategy.

As pension schemes mature and allocations to equities are increasingly replaced by income generating assets, such as property and bonds, trustees should not assume that responsible investment considerations can be ignored. For each asset class in which they invest, trustees should understand the potential relevance of ESG issues in investment decision making and be prepared to question their investment managers on how such factors are integrated into their investment processes.

The role of the long-term investor

Equity owners, as direct shareholders in a company, have been perceived to have more influence over the company's future direction (and share price appreciation) than, say, debt holders. Having a long-term approach, especially as an equity investor, means company management should be more willing to negotiate with shareholders and make changes if they believe investors are in it with them for the long haul.

However, the same can be considered true for other asset classes. For example, while there is a contractual relationship between the investor (as landlord) and tenant for real estate investments, anecdotal evidence suggests that tenants are receptive to engagement from their landlord to ensure that their needs are being met. This mean that lease renewals are more likely.

For long-term investors, regardless of the asset class, relationships clearly have value!

Achieving sustainable returns means considering potential ESG risks

Investors often assume ESG factors are used solely to restrict the investment universe for ethical investors. However, the assessment of ESG factors can help all investors identify potential risks that could impact financial returns.

Most investors agree that relevant ESG factors should be assessed both prior to investing and throughout the holding period of any asset. However the expected holding period of an asset has a bearing on the significance of ESG factors - investment managers with high levels of turnover are likely to place less weight on ESG factors.

ESG factors can be embedded into fundamental equity analysis, but they can also be observed in other asset classes such as property. For example, with effect from 1 April 2018, any property that is assessed with an Energy Performance Certificate rating of F or G cannot be let until the property meets the required higher standard. This does not necessarily mean such properties should be excluded from portfolios or ignored as potential investments, but the costs of remediating this risk through asset management will need to be quantified as part of the property management process.

> *"Companies are more willing to engage with us because we are viewed as a long-term investor."*
>
> Baillie Gifford

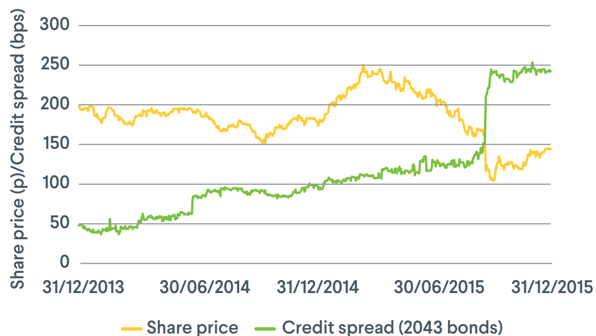
At a broader level, environmental factors such as energy efficiency, water usage and waste have an impact on the cost of occupying a property by tenants. Social factors such as employee wellbeing, which can be influenced by the choice of property, are also an issue of growing concern. Companies may therefore choose to occupy properties that are aligned with their own corporate sustainability objectives. In time, "greener" properties could command higher rents or better quality tenants.

Corporate governance is an issue for all investors

There is an increasing body of evidence that links corporate governance (implications of a company's culture, attitude and the people it hires) with financial returns in both equities and corporate bonds. This means bond managers should not just restrict their focus to financial metrics as it is clear that governance factors can impact the creditworthiness of a company.

This was perhaps most evident in the recent case of Volkswagen (VW). Over the course of September 2015, equity investors lost 36% in value, but bond holders also suffered a 17% decline in value as the credit spread on VW bonds widened significantly in the wake of the emissions scandal (Chart 1).

Chart 1: Volkswagen share price and credit spread



Source: Bloomberg, Datastream

There was evidence that should have concerned investors: credit spreads had widened by around 100bps over the preceding 21 month period while MSCI noted a declining governance score that led to VW being dropped from their ACWI ESG index in May 2015. Further, in downgrading the credit rating of VW in 2015, S&P cited 'general deficiencies in its management and governance and general risk management framework'.

With traditional valuation approaches being unable to take account of the broad range of ESG risks, many fixed income professionals acknowledge that integrating ESG factors into their fundamental credit analysis will result in a more comprehensive understanding of a company's risk factors.

Integrating responsible investment considerations

Investors, including trustees and investment managers, are increasingly recognising that ESG factors have relevance at all levels of decision making. The process of integrating responsible investment considerations into the whole investment strategy begins by understanding how it is currently addressed.

We suggest there are three key actions for trustees:

- **Education**. Trustees should ensure they have the necessary training on how responsible investment impacts their investment strategy. For example, carbon risk is likely to impact longer-term decisions.
- **Understanding**. Trustees should seek to understand the relevance of responsible investment issues for each of their investment managers and/or asset strategies. For example, the considerations for passive equities are different to active equities and the considerations for bonds are different to property.
- **Engagement**. Trustees should question all their investment managers on the actions they are taking to monitor and manage responsible investment factors effectively.

As pension schemes seek to invest in assets that will generate value over varying time horizons, trustees should be conscious of the different influences of ESG factors and corporate governance on achieving sustainable returns.

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What's your carbon footprint?

Institutional investors are facing growing pressure to disclose their exposure to carbon risk. Carbon footprinting can help trustees measure and manage carbon risk in their equity portfolios.

What is a carbon footprint?

A carbon footprint is, quite simply, a measure of the exposure of a company or an investment portfolio to carbon emissions. However, not all emissions are the same. Some relate to the direct actions of a company whereas others relate to indirect activity, for example, from consumers use of a company's products.

The box below sets out the different classifications of emissions as defined by the Greenhouse Gas Protocol.

Which emissions are being measured?

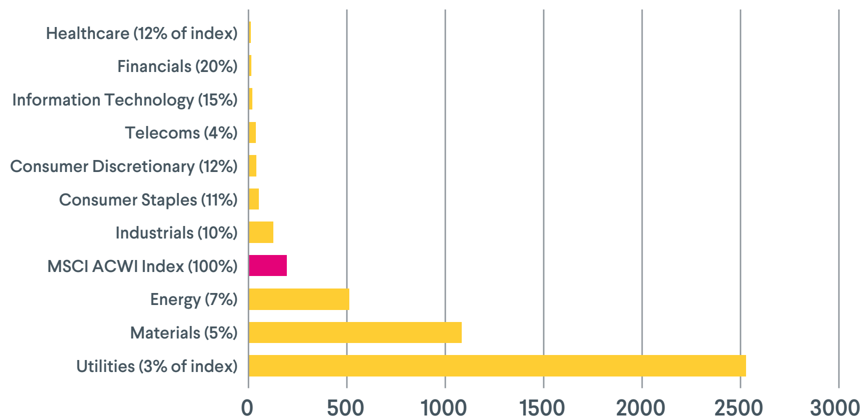
- *Scope 1 includes direct emissions from sources which a company owns or controls; for example, emissions from boilers, furnaces or company cars.*
- *Scope 2 covers indirect emissions relating solely to the generation of purchased electricity.*
- *Scope 3 covers all other indirect emissions. For example, emissions relating to the extraction and processing of purchased materials (supply chain) and emissions relating to the transportation and use of products sold (in use).*

Companies are subject to investor pressure and, increasingly, regulatory requirements to disclose emissions data. Indeed, the UK stock exchange recently became the first requiring listed companies to disclose emissions data. Improved access to data, albeit typically through specialist organisations, offers investors the ability to calculate their exposure to carbon emissions. Due to data availability, analysis typically focuses only on Scope 1 and Scope 2 emissions.

While absolute levels of emissions can be measured, a more common approach is to derive and report a "normalised" level of emissions such as carbon emissions per unit revenue, known as carbon intensity. A typical carbon footprint would therefore be calculated as the weighted average carbon intensity of the underlying investments: weights simply reflect the proportion each stock represents in a portfolio or index.

A carbon footprint can be calculated at an overall portfolio level, but can also be broken down by industry, sector or region. For illustration, chart 2 illustrates the carbon intensity of the global equity market by sector, as at 30 June 2016.

Chart 2: Carbon intensity (tonnes CO_2/Sales USDm) of equity market by sector



Source: MSCI

A carbon footprint is only a snapshot. It allows investors to judge the position of a portfolio relative to a benchmark measure at a given point in time and to identify areas of potential concern. Unsurprisingly, much focus is likely to be given to companies within utility, materials and energy sectors. However, a company is not "bad" simply because it happens to operate within a carbon intensive sector, and it is important to recognise that some sub-sectors will have very low carbon intensity. For example the utilities sector includes both water companies (low carbon intensity) and electricity companies (high carbon intensity).

How can trustees make use of carbon footprinting?

As with other risk assessments, carbon footprinting can inform various aspects of investment decision making - we have already seen some equity managers undertake exercises for their portfolios and report on carbon risk to clients. We see three ways that trustees can begin to make use of this tool:

1. As a tool to support engagement with investment managers. Improving the understanding of risks within equity portfolios should allow trustees to better hold their managers to account, by asking more informed questions and thus judging how managers are addressing this emergent risk in their activities.

2. As a benchmark for assessing investment manager activity. Trustees may increasingly expect investment managers to make use of carbon risk assessments in their own decision-making. For example, companies with clear management action plans to reduce carbon intensity, regardless of its absolute level, may be preferred to companies without such plans in place. The periodic measurement of carbon risk exposure allows trustees to judge the effectiveness of such activity at a portfolio level.

3. As a basis for strategic decision making. An equity index (and hence an allocation to equities) brings with it an implicit level of carbon risk. Where trustees believe that carbon risk should be reduced relative to the index, they may choose to address this by directing passive equity exposure to low carbon index strategies or as a factor in manager selection decisions.

Ongoing global action is likely to see climate change remain a topic of importance to all. Carbon footprinting offers investors a mechanism for the measurement of, and consequently the management of, this risk. As policy and regulation develops, this is a tool that is likely to see greater use by institutional investors and managers alike.

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Your vote counts

The process of creating opportunities to vote – be it for individuals in a referendum or equity shareholders at an Annual General Meeting – can be long and hard fought. But if Brexit has taught us one thing, it is that exercising the right to vote can give rise to change.

Shareholder voting has gained increasing levels of media coverage with a number of high profile resolutions attracting particular attention. Fund managers investing assets on behalf of pension schemes are coming under increasing pressure to provide more information on how they vote. What can trustees do to exert the influence they hold as shareholders?

Understanding shareholder influence

Equity ownership typically conveys the right to vote on resolutions put before a company's Annual General Meeting. Resolutions can range from the routine – director elections, executive remuneration, and stock plan amendments – to more specific proposals including those submitted by shareholders. Over recent months there have been several high profile examples where shareholders have been successful in highlighting concerns.

"57% of managers said they had collaborated on engagements with other investors."

Hymans Robertson research

BP

In April 2016, 59% of BP shareholders rejected a proposed pay and benefits package that would have seen the firm's Chief Executive receive c£14m for 2015, despite record losses being reported. The world's largest asset manager BlackRock voted in favour of the deal and has received a significant level of press attention criticising their approach towards this and other remuneration issues it has voted on.

ExxonMobil

In May 2016, shareholders in ExxonMobil voted in favour of a resolution that would allow investors greater control over the nomination of board members, amid criticism surrounding the company's stance on climate change. Significant press coverage also surrounded a resolution requesting an annual assessment of the effect on the company of climate change policies. The proposal failed to win majority support but was backed by a substantial minority (c38%) of shareholders. A similar resolution at Chevron also failed, yet received a similar level of support.

Although the resolutions at ExxonMobil and Chevron were not passed, the strong level of support gained from a number of large investors, together with a recommendation to vote against management from two of the leading proxy voting advisors, suggests that shareholders exert significant influence, particularly when they act in concert.

Manager engagement

Many investors either choose, or given the manner in which they invest, are required, to delegate voting to their investment manager or another third party. Consequently, individual investors may find it difficult to influence a manager's voting stance. However, a petition launched by clients and shareholders of BlackRock in the wake of the BP remuneration vote has highlighted that asset managers cannot ignore investors.

We have also seen developments in industry policy and specific guidance in this area. Initiatives such as 'The Guide to Responsible Investment Reporting in Public Equity' created by a number of high profile UK asset owners and the Red Lines Voting initiative developed by the Association of Member Nominated Trustees serve to support investors in exercising their stewardship responsibilities.

The Red Lines are a set of tightly drawn voting instructions, initially focused on the UK stock market but covering a wide range of ESG issues. Adoption of such a centralised proxy voting policy could effectively allow trustees to collaborate with other investors and force managers to adopt a "comply or explain" approach in their voting activity.

Ultimately, investors should be aware that voting is a means through which investment managers can express their dissatisfaction with the actions of management. Voting is effectively a last resort with managers being potentially better served by engaging with management to effect change. For passive investors without the ability to disinvest, voting and engagement are the only tools available.

What should trustees do?

Trustees are required to document their policies on company engagement and voting within their Statement of Investment Principles. As a result it is important that trustees revisit their policies from time to time to ensure that internal governance structures are aligned with these policies and that they have the audit trail to be able to demonstrate compliance with their policies, if challenged.

- Where voting has been delegated, trustees should ensure that managers provide regular reporting on voting activity. Where managers are unwilling to disclose voting information, trustees should challenge their managers.
- Monitoring of voting and engagement activity can be incorporated into regular reporting and trustees should consider what information it may be helpful to receive.
- Bespoke manager voting policies should be reviewed on a periodic basis to ensure that they remain consistent with trustees' investment beliefs and intentions. Trustees unable to implement a bespoke policy can consider the merits of centralised proxy policies.

While the retrospective reporting of manager activity provides trustees with the ability to "tick the compliance box", a forward looking approach is likely to be more beneficial. By more actively discussing specific issues on which they expect their investment managers to engage, so trustees can play an effective role in emphasising the importance of voting and engagement.

> *"83% of managers said they reported on voting activity to clients at least quarterly"*
>
> Hymans Robertson research

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Market returns to 30 June 2016

	Yield % p.a.		Returns to 30 June 2016 (sterling, % p.a.)		
	31 Mar	30 Jun	1 year	3 years	5 years
Equities					
Global	2.6	2.7	14.0	11.3	9.9
UK	3.8	3.7	2.2	5.9	6.3
Developed markets ex UK	2.5	2.5	16.0	12.6	11.5
Emerging markets	3.1	3.2	3.7	3.8	0.7
Bonds					
Conventional gilts	1.9	1.4	13.5	8.1	7.4
Index-linked gilts	-1.0	-1.4	14.8	10.9	9.8
Sterling corporate bonds	3.7	3.2	9.1	7.7	7.8
High yield (US) *	8.6	7.6	1.7	4.2	5.7
Emerging market debt	6.9	6.8	19.2	0.6	0.9
UK Property	-	-	9.2	14.5	10.4
Hedge Funds *	-	-	-4.2	2.5	2.9
Commodities	-	-	5.4	-6.3	-5.3

* Return in $

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

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HYMANS ROBERTSON

investment perspectives

January 2017

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Welcome

Well, 2016 did not turn out as predicted, did it? 2016 saw unprecedented levels of political upheaval. The pollsters repeatedly got it wrong; so much so the people declared they "have had enough of experts" as Mr Gove put it. If that does not put pressure on those of us trying to look forward and make some predictions about the future I am not sure what will.

Of course in the real world, trustees and scheme sponsors still have to manage their way through this landscape of political change – threading a path through the chaos and capturing the opportunities. It may be that this brave new world provides a new stimulus for confidence and growth. However, I suspect that there will be some pretty big potholes in the road on the way, as we continue to look for strategies that will provide decent returns, but with some predictability.

Uncertainty provides volatility, but when managed this can be an investor's friend. The articles in this publication reflect the need to balance long-term strategic planning with capturing the gains and opportunities along the way.

On the next page Graeme Johnston provides an overview of the markets. In this issue we also provide some thoughts on three specific topics:

- On Page 6 William Chan looks at ways to improve the risk adjusted returns on your equity portfolio using factor investing;
- Anthony Ellis builds on this to set out his thoughts on how trustees and sponsors should construct efficient default strategies within defined contribution plans; and
- On page 12 Linda McAleer looks at what the new world means for infrastructure investing, and whether now might be the time to review your allocation to this asset class.

Best wishes for successful investing in 2017.

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Capital Markets

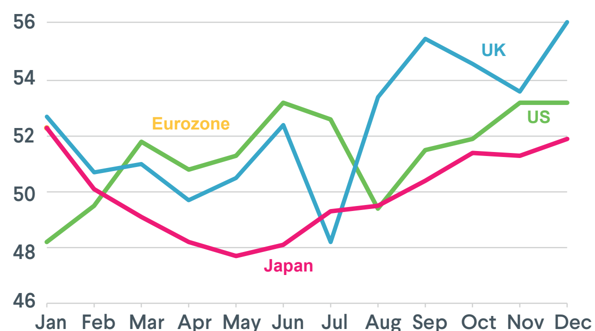
2016 is likely to be remembered as a year of political rather than economic upheaval. Following the US Presidential election, investors quickly put aside earlier doubts and chose instead to focus on certain aspects of the Trump agenda – infrastructure spending, corporate tax cuts – and, to some extent, 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. To some extent, bond investors were simply recapturing their 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 (Chart 1) – 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, but market-implied forward rates suggest that it will be two years before interest rates are back to pre-referendum levels.

Chart 1: PMI Manufacturing indicators

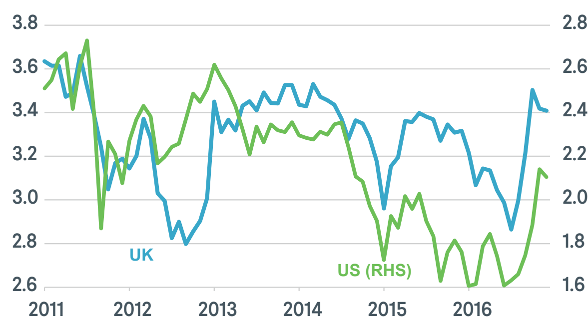


Source: Bloomberg

Government bonds and interest rates

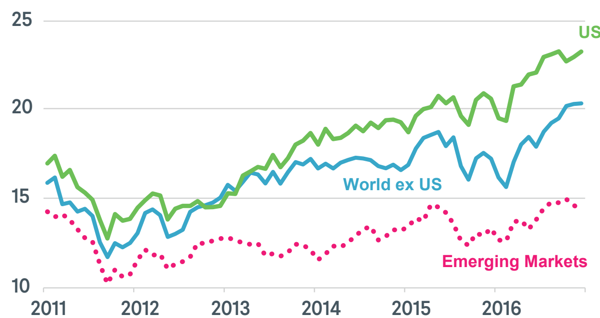
Gilt yields continued their climb back from the depths of August – 10-year gilt yields are now 1.4% p.a., well above the recent lows of 0.6% p.a. However, that has just taken them back to pre-referendum levels. The gilt yield curve still implies that interest rates will peak below 3%. All of this still suggests a pretty gloomy economic outlook for the next generation. We think yields may rise further, but the reality is that uncertainty remains high. That should be the watchword for those managing interest rate hedging programmes.

Chart 2: 30-year breakeven inflation (% p.a.)



Source: Bloomberg

Chart 3: MSCI indices - price-earnings ratios



Source: Datastream

Investors in the UK have been paying up for inflation protection. This is understandable at shorter maturities given a likely spike in inflation following sterling depreciation. The more distant outlook may be uncertain here, too, but long-dated inflation protection does not look particularly attractive. Prices have drifted higher (Chart 2), towards the top end of the five-year range and well above the Bank of England's target. An increase in market-based inflation measures is not just a UK phenomenon: a similar picture could be seen in the US. But, in contrast to the UK, US 10- and 30-year breakeven inflation ended the year around 2% p.a., in line with the Fed's long-term target.

Other bond markets

Global credit markets recovered quickly from a wobble in the run-up to the US Presidential election and, in general, yield spreads finished the year as narrow as they have been since the middle of 2014. The rise in US Treasury bond yields meant that the absolute yield on the major US dollar high yield bond indices fell only a little over the last quarter, but it is still more than 2.5% p.a. lower than it was at the start of 2016. The yield on euro high yield bond indices fell, with spreads over treasuries a little below 4% p.a. Adjusted for differences in credit quality, that represents a similar spread to US high yield.

Our general view on high yield credit remains that it retains appeal as a diversifier from equities. In particular, it should be less sensitive than equities to any general devaluation of risky assets. Nevertheless, in the mainstream markets at least, absolute returns from current yield levels are likely to be low in the medium term.

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 (Chart 3) 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 would 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.

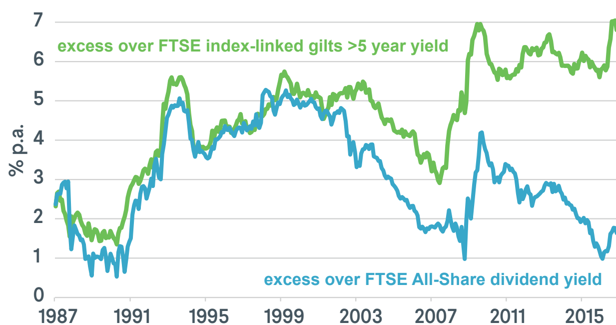
In practice, we are sceptical that the Trump economic agenda can be delivered quite as easily as the market seems to discount. Even if it is, the potential rise in protectionism that may be part of the same package could pose a risk to global growth. A post-election fall in emerging market equities is 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.

Sterling had fallen another 5% in trade-weighted terms at the start of October, but recovered to finish only a little lower over the quarter as a whole. Sterling weakness has boosted the return to global equities in 2016 for unhedged sterling investors from an impressive 10% to a spectacular 30%. 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. While the absolute level of income yield may look attractive relative to low gilt yields, the premium over UK equity dividend yields is still low by historic standards (Chart 4). There does look to be more scope for cyclical recovery in property income – much more than there seems to be for UK equities – but the momentum of rental growth continues to weaken. Nevertheless, even if it is a hold rather than an outright buy, property's appeal as a diversifier has only increased after a year in which it has significantly underperformed equities.

Chart 4: IPD Monthly initial yield



Source: IPD, Datastream

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Enhancing equity portfolios:
factor based investing

We have all heard the collective arguments of active equity managers in expressing the shortcomings of passive market capitalisation-weighted (market cap) investing.

Many of these criticise the constituents of the market cap index at a point in time, such as the high allocation to the Information Technology sector in 1999 or to Japanese stocks in 1988. Closer to home, active UK equity managers will also cite the heavy concentration to the 10 largest stocks by market cap. On the other side of this debate, advocates of passive market cap investing have commented on the inability of the median active equity manager to outperform a passive market cap index after fees over the long term.

From the 1990s, alternatives to market cap indices were developed, which focus on creating more 'efficient' indices. These rely on identifying factors that either deliver a forward-looking premium relative to the market cap index or deliver a less volatile return series.

Over the past few years, institutional and retail money has flowed into these factor-based equity index products, attracted by the "passive-like" fee levels, the historical track record of these factors and often coinciding with the underperformance and subsequent termination of one or more of their active equity managers.

Defining the factors

Factor-based equity index investing allocates a different weight to stocks that is not determined by market capitalisation. The method of allocation must be objective and replicable – otherwise, it becomes active equity investing. Some of the most common factor-based alternatives are described below:

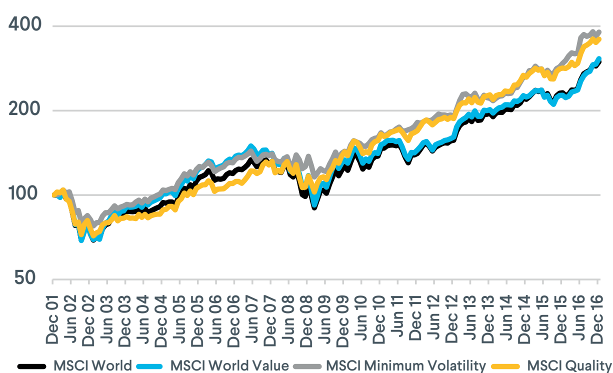
1. **Value** – These strategies give more weight to "cheaper" companies (relative to its intrinsic value, as assessed by certain metrics).
2. **Quality** - High quality stocks exhibit metrics such as higher return on equity, more stable and persistent earnings growth and lower leverage. These strategies also typically exhibit lower volatility than the market over the long term.
3. **Low volatility / minimum variance** – These strategies select a portfolio of stocks that exhibits lower volatility than the overall market.

Arguably an element of systematic return enhancement or lower volatility for the majority of factor tilts is due to "smart" rebalancing, i.e. the principle of disciplined buying low, selling high. There are plenty of academic studies supporting the existence of this "rebalancing premium". The key is ensuring you have the right balance between enhancing return from rebalancing and low enough turnover for transaction costs not to erode this value. Having a multi-factor approach, rather than relying on a single factor, introduces another form of rebalancing benefit – others have labelled this a "diversification premium".

The history certainly looks good…

Chart 5 shows the cumulative performance of each factor described above over the past 15 years, implemented via the index provider, MSCI. Quality and the minimum variance indices have outperformed, and value was in line with the market cap index over the last 15 years.

Chart 5: Cumulative performance of factor-based indices (Dec 2001 - Dec 2016)



Source: Datastream, Bloomberg

… but we would caution on relying on backtests

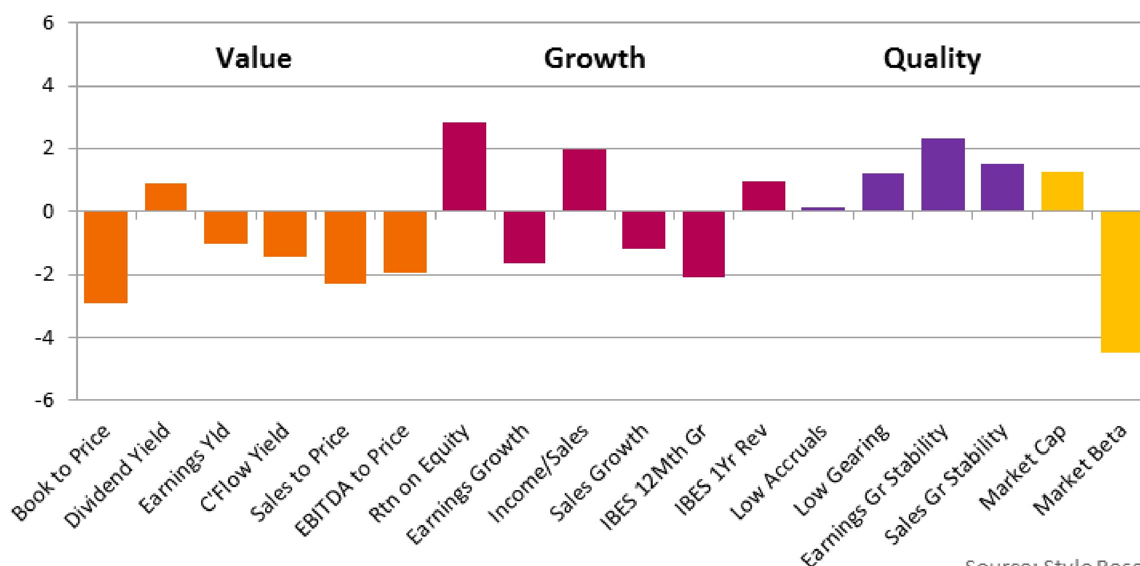
An investor could be forgiven for concluding that a strategic allocation to any of the above factors results in long term outperformance against the market cap index. After all, 15 years is a long time horizon and there have been a variety of market cycles and scenarios over that period. We would caution against relying too much on historical performance data:

- The start and end points matter. For example, if you had analysed performance of Value from 2001 to 2007, it outperformed the developed market cap index. If you consider performance from 2007, it has underperformed.
- Many of the factor indices are actually theoretical backtests, not live performance data. For example, the MSCI World Quality Index was only launched in late 2012 but has a backtest track record going back to 1994 (replicating its index construction methodology).

However, aligned to our Equity Investment Beliefs (see summer 2015 edition of Investment Perspectives), we believe that by choosing a combination of factors and implementing them in a disciplined way, you can tilt your equity portfolio towards favoured characteristics and mitigate some of the shortcomings of applying a single factor bias to deliver added value relative to a market cap approach.

By combining an equally weighted portfolio to value, quality and low volatility indices, and monthly rebalancing between the three, an investor would have achieved an excess return of 1.1% p.a. over the developed market cap index for the past 15 years. Other combinations may be equally compelling, which is particularly relevant for trustees looking to use off the shelf products.

Chart 6: Style tilts of equally-weighted factor portfolio



Source: Style Research

Our analysis has been based on standard (i.e. large and medium cap) indices in developed markets, which in our view, is the most practical way in which to implement factor exposure.

As illustrated in chart 6 above, this aggregate equally weighted factor portfolio currently displays a mixed exposure to value and growth (reflecting the current strength of the factor tilts) and has a tilt towards stocks with less leverage, greater earnings stability and lower volatility (measured by the above average market beta).

In constructing an equity portfolio we would also include exposures to emerging market equities and potentially to small cap. Both exposures should benefit from a risk premium, but have a limited impact on portfolio risk as they benefit from further portfolio diversification.

Conclusion - Our views on factor-based equity investing

In line with our Equity Investment Beliefs, we believe that an appropriately constructed portfolio of factor tilts can provide a more efficient way of investing, net of fees and costs, than a market cap index.

Those schemes with larger governance budgets will be able to construct a blended multi-factor equity portfolio themselves and monitor this on an ongoing basis, making changes to the tilts as they see fit. Schemes with less assets or lower governance budgets may prefer to use an off the shelf product from a manager, where the manager constructs the multi-factor portfolio within a single fund, and charges accordingly.

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Improving DC members' outcomes through smarter default investing

Following the EU referendum in June and then the US election result in November, we have seen sizeable swings in markets, with yields on government debt exhibiting a particularly roller coaster ride over 2016.

We now find ourselves in a world where traditional "low risk" asset classes are exhibiting significant month to month volatility and where traditional "risky" asset classes have climbed higher and higher defying most expectations.

Equity volatility is very low. When we combine market uncertainty with increasing longevity and poor member engagement we have a pretty treacherous landscape for defined contribution (DC) members.

So what can you do about it?

By considering your investment strategy in phases, as illustrated in chart 7, and optimising the asset allocation for each of these phases to meet members' objectives, we believe it is possible for you to deliver significantly improved member outcomes.

Growth phase

Since the introduction of Freedom and Choice in April 2015 there has been a significant increase in the attention that is now given to DC Schemes and, in particular, the construction of the "default" investment strategy. Much of the focus has been on how to adjust the default strategy in the years close to retirement to align investment strategy with a member's decision at retirement.

Chart 7

The three phases of the DC member investment journey

This change is necessary and important and we comment on it below. Potentially more important is to ensure that member's assets are working as hard as they can in the long period that they are invested before the new flexibilities become relevant (for many this will perhaps be a period of 30 years). We see many default strategies in the market place that are much too focussed on short term volatility management in the growth phase. In our view, this emphasis on short term risk management is to the detriment of long term returns for members. During the growth phase, when contributions dominate, members should prioritise seeking returns. This could lead to higher short-term volatility, but we feel that this is relatively unimportant in the context of a member's final pot size. Moreover, there is no evidence that market volatility leads to increased member opt outs.

As a result of the introduction of the charge cap, DC investment strategies have relied more on passive funds. Whilst a typical market cap weighted passive global equity fund provides the cheapest way to generate the long-term returns close to the level members require, it is generally accepted that it is unlikely to be the most efficient way to structure equity investment. We believe a member's investments can be 'worked' even harder to make up for the lower return environment we find ourselves in.

Our approach as described in our article "Enhanced equities: Factor based investing" is to make use of factor based (or "smart beta") strategies to achieve higher expected returns than simply investing in market cap weighted equities. An example portfolio might be as shown in chart 8 below.

This approach brings together factor-based investing (value, quality and low volatility) and higher-beta (small cap and emerging markets) strategies into a single portfolio, aiming to capture risk premiums combined with risk control in a cost effective way.

We can then combine this equity portfolio with diversifiers such as High Yield Debt, Global REITS, listed private equity and infrastructure, which can offer returns similar to those from equities.

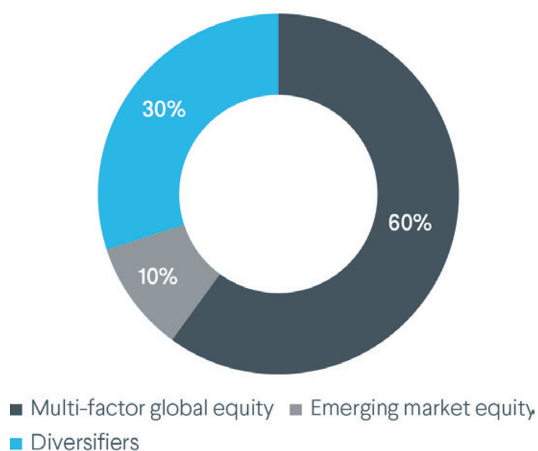
Consolidation phase

We expect members to be more engaged with their DC savings later in life when the value of their savings is larger and the prospect of drawing benefits approaches. There is a greater need to focus on risk management as a large fall in value may not be recouped.

During this phase, there is a need to diversify the growth portfolio, bringing in other asset classes to spread risks and reduce volatility whilst also maintaining growth. A typical portfolio might be as shown in chart 8 below.

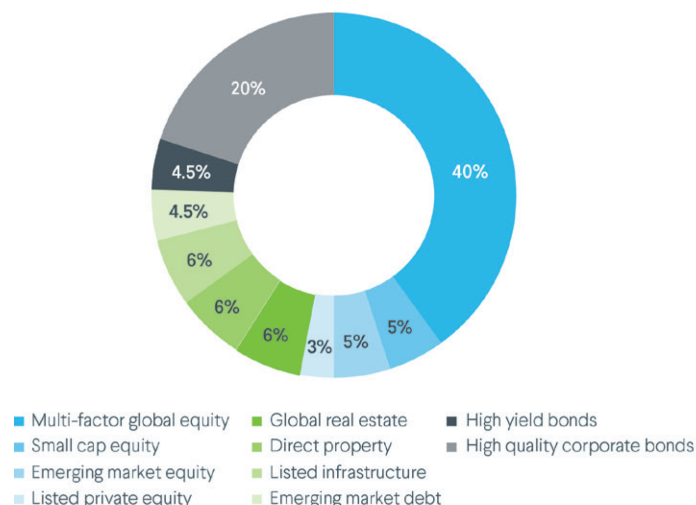
Diversified Growth Funds ('DGFs') have typically been used to implement this type of approach but we are now seeing alternative implementation options become available to DC investors. Pure alternatives funds that meet DC liquidity requirements are now available as are standalone funds covering the alternative asset classes included in chart 9. These can be combined in a blended fund alongside the equity factor funds to deliver the investment characteristics required in this phase (strong, stable returns, diversification and liquidity) for a lower price.

Chart 8: Factor based equities + Diversifiers



Source: Hymans Robertson

Chart 9: Sample blended fund for consolidation phase



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Pre-retirement phase

The appropriate pre-retirement portfolio for a default strategy depends on some non-investment factors such as membership profile and attitude to risk. In particular, where a single default strategy is offered, it will be necessary to identify the expected balance between members who will take cash, use income drawdown or buy an annuity.

Cash and income drawdown are becoming increasingly important, so when designing this phase we look to achieve three key features:

- Growth above inflation;
- Capital preservation; and
- Liquidity.

For those members who still wish to use their fund to purchase annuity it is still important to provide investment options or strategies that help to mitigate the risk of mismatch when converting a fund to an annuity. There are a number of "pre-retirement" funds consisting of a mix of government and corporate bonds that can usefully be employed for this task.

The introduction of bond-based absolute-return funds and a greater weighting to more stable, income producing asset classes can also help to achieve the features required in this phase.

Improving outcomes

We believe that by taking a smarter approach to the design of DC investment strategies, and focussing on embedding the right investment characteristics at the right time, we can improve the chances of members achieving adequate outcomes. How much we can improve outcomes will depend upon the length of period to retirement. However, for a member investing over a 40 year period it would take an improvement of under 0.5% in annual returns to boost pot size by 15%.

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Time to revisit infrastructure?

In an environment of prolonged low interest rates, the search for stable income to provide more predictable returns has been at the top of the agenda for many pension funds, particularly those that are already, or are facing the prospect of becoming, cashflow negative.

Naturally short term income solutions have been a higher priority, not least because the opportunities in these markets have been more compelling. However, with inflation on the rise at a time when index linked gilts are offering negative real yields, there should be a growing desire amongst pension funds to plan for investing in assets that will meet their longer term real income requirements.

Theoretically infrastructure ought to be the perfect asset class for pension funds, providing long term, inflation-linked, cashflows to match liabilities. Whilst there has been a chronic need for both new and upgraded infrastructure globally, projects have not been available to satisfy the weight of capital that has been allocated to the asset class in recent years. This has resulted in relatively expensive pricing, which, combined with suboptimal access routes and high fees, has meant slow allocations to the asset class from UK pension funds.

There are a number of factors which should now make infrastructure more attractive for many pension schemes: inflation linked income to protect returns from any rise in the current low cost of borrowing; and a potential easing of pricing pressure if Governments commit to an increased programme in public infrastructure. We are also seeing further development around implementation solutions, leading to lower management fees.

Market dynamics

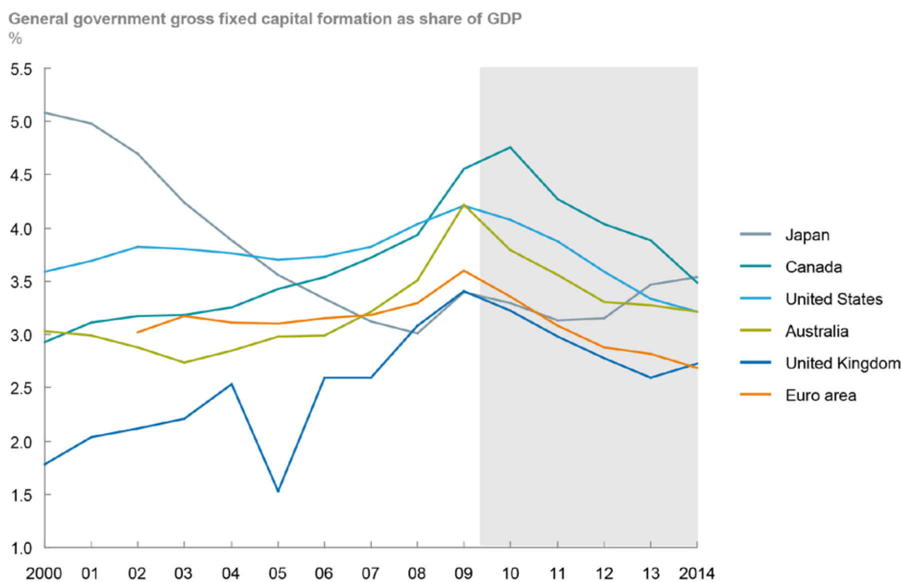
Macquarie estimates the value of managed institutional infrastructure capital to be over €350bn, a good proportion of which is still to be invested; as at September 2016, Preqin reported dry powder of almost $140bn, half of which is to be deployed in the US and a quarter in Europe. This number is higher than it has ever been.

Preqin reports an average annual net return of c10% across all vintages. Typically, around half of the return is generated from income, although this varies across strategies. Indeed, the open-ended funds we see investing in developed markets globally are currently distributing between 4% and 6.5% p.a. to investors.

Demand and supply

Core infrastructure assets are highly sought after and will rarely trade cheaply due to their attractive and stable income return. However, the sheer weight of money chasing operational assets coupled with the decline in Government spending over recent years (Chart 10) has made it tough to find even reasonably priced deals, particularly through auction processes.

Chart 10: Government spend on infrastructure projects



Source: McKinsey Global Institute, Bridging Global Infrastructure Gaps, June 2016

According to research undertaken by the McKinsey Global Institute around $3.3tn of global infrastructure investment is needed annually from now until 2030 to justify current economic growth forecasts. It has been highly publicised that UK and US governments are looking to be more active in the near term.

The UK Government has released its updated National Infrastructure Plan, with 720 projects needing £500bn of investment, over half of which it expects to be funded by private capital. President-elect Trump has also committed to spend $500bn on new projects and the upgrading of existing US infrastructure in order to accelerate economic growth and productivity. There may be little clarity to his plans, but private capital will be required and energy infrastructure and the transport sector are expected to benefit.

The good news is these political forces will increase the supply of deals globally, which should reduce the pressure on pricing. It is difficult to imagine a situation of oversupply - current allocations from institutional investors globally are so low, and at these levels there will still be a significant shortfall according to McKinsey's forecasts.

Good fund managers will continue to find attractive deals in pockets of the market. Usually this means working directly with potential sellers to avoid competitive auctions in order to achieve higher yields, including working directly with companies to take non-core assets off their balance sheet, or buying funds in the immature, but growing, secondary fund market.

There are a number of developments in implementation routes that also make the asset class more attractive for pension funds looking for access to long term, inflation-linked cashflows.

- Open-ended funds. There are a very small number of open-ended funds in the market. As these funds have matured, they have become a more attractive proposition for investors looking to invest in infrastructure, since the assets are already delivering income and management fees have been reduced. These funds also can have opportunities to provide additional capital to existing assets at favourable prices.
- Collaborations. There are a number of new groups that have been set up to help UK pension funds achieve higher allocations to infrastructure at lower cost. The level of fees is one of the principal factors that has held back investment in the past. The most prominent of these groups are the GLIL fund (a joint venture set up by Greater Manchester Pension Fund and the London Pensions Fund Authority) and the Pensions Infrastructure Platform, (the founding investors of which are a mixture of private and public sector pension schemes). Both started to invest directly in infrastructure deals in the second half of 2016. We expect more collaboration in the future, particularly as the Local Government Pension Scheme pools make more use of collective investment vehicles.

In summary

Many UK pension funds have increased their exposure to assets delivering short term income, but gaining access to assets that provide longer term index-linked cashflows has proved more challenging. Infrastructure can provide these longer income streams, delivering a long-term income higher than bonds.

The weight of money allocated to operational infrastructure assets has meant it has been viewed as expensive in recent years. However, there are a number of factors at play which should make the asset class more attractive for pension funds to invest in the future. Supply of opportunities should increase and, as the market has developed, there is now a greater range of suitable implementation options available to investors.

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Market returns to 31 December 2016

	Yield % p.a.		Returns to 31 December 2016 (sterling, % p.a.)		
	30 Sep	31 Dec	1 year	3 years	5 years
Equities					
Global	2.6	2.5	29.6	14.3	15.3
UK	3.5	3.5	16.8	6.1	10.1
Developed markets ex UK	2.4	2.4	29.9	15.8	16.8
Emerging markets	3.0	3.0	35.4	9.4	6.9
Bonds					
Conventional gilts	1.2	1.6	10.1	8.0	4.5
Index-linked gilts	-1.8	-1.7	24.3	13.6	8.2
Sterling corporate bonds	2.5	2.9	11.8	8.1	8.3
High yield (US) *	6.6	6.5	17.5	4.7	7.4
Emerging market debt	6.7	7.3	33.3	5.8	3.2
UK Property *	5.2	5.3	1.4	11.3	9.4
Hedge Funds *,**	-	-	0.3	1.2	4.1
Commodities	-	-	36.0	-1.0	-3.2

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

* Return in $
**Property and Hedge Funds to end November.

If you would like to find out more about any of the topics discussed in this publication please contact your usual Hymans Robertson consultant or:

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PENSIONS INVESTMENT COMMITTEE			
Report Title	Exclusion of the Press and Public		
Key Decision	No		Item No. 4
Ward			
Contributors	Head of Corporate Resources		
Class	Part 1		Date: 7 February 2017

Recommendation

It is recommended that under Section 100(A)(4) of the Local Government Act 1972, the press and public be excluded from the meeting for the following items of business on the grounds that they involve the likely disclosure of exempt information as defined in paragraphs 3, 4 and 5 of Part 1 of Schedule 12(A) of the Act, as amended by the Local Authorities (Executive Arrangements) (Access to Information) (Amendments) (England) Regulations 2006 and the public interest in maintaining the exemption outweighs the public interest in disclosing the information:-

5 Fund Manager Briefing – Blackrock
6. Investment Performance JReport – Hymans Robertson
7. Valuation and Investmetn Strategy – Hymans Robertson

Agenda Item 5

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

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

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Agenda Item 6

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Agenda Item 7

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