Pensions Investment Committee			
Report Title	**2010 Pension Fund Financial Modelling**		
Key Decision	**No**		Item No. 4
Ward			
Contributors	**Executive Director for Resources**		
Class	**Part One**	Date: **18th November 2010**	

1. SUMMARY

1.1 This reports the results of financial modeling undertaken by the Fund's investment advisors Hymans Robertson to determine if the stabilization mechanism outlined in the valuation report provides safe stewardship (in terms of the long term funding level) and assesses the implications of the revaluation for the broad strategy of the Fund's investment portfolio.

1.2 The full report and commentary will be provided by the investment advisor at the meeting.

1.3 The report comprises the following sections:

2. Recommendations

3. Background

4. Stabilisation Mechanism

5. The Implications of the Revaluation for the Investment Strategy

6. Conclusions

7. Financial Implications

8. Legal Implications

2. RECOMMENDATIONS

Committee is recommended to: -

2.1 Reduce the exposure to "growth" assets (principally equities) by 10% with the funds realised being re-invested in the fixed interest mandate.

2.2 Delegate the timing of the reduction to the Executive Director for Resources on the advice of the Council's investment advisor.

2.3 Instruct Officers to prepare a further report on the investment manager structure for the February 2011 Committee meeting.

3. BACKGROUND

3.1 The 2010 triennial revaluation of the pension fund introduced the concept of a stabilization mechanism to attempt to smooth the impact of

changes in employers' contribution rates resulting from revaluations over the effective life of the Fund. The justification for the stabilization is based on sophisticated financial modeling which assesses the risk that the operation of the mechanism will deliver the outcomes required in terms of achieving full funding and maintaining contribution rates within the parameters specified.

3.2 The revaluation had also identified that the adverse investment performance had significantly contributed to the deterioration in the funding position and that the proportion of pensioners and deferred members had increased as a proportion of total membership. In these circumstances the investment advisor has undertaken a review to determine if the current investment strategy is consistent with the stabilization mechanism adopted and appropriate for the liability profile of the fund.

3.3 This exercise is part of a comprehensive review of the structure of the investment portfolio with the next element being the management structure to be considered by Members at their meeting in February 2011.

4. STABILISATION MODELLING

4.1 As part of the 2010 revaluation the actuary modeled a number of alternative stabilization and asset allocation strategies to determine the likelihood that these would deliver a fully funded scheme at the end of the projection period (of 21 years) and that during this period employer contribution rate changes are within the ranges specified.

4.2 A summary of the modeling is as set out in Appendix 1. The actuary considers that the stabilization is acceptable for the 0.5% increase or decrease in contributions per annum with the maximum allocation to riskier assets of up to 75%.

5. THE IMPLICATIONS OF THE REVALUATION FOR THE INVESTMENT STRATEGY

5.1 The current asset allocation was established by Committee on the 16th June 2010 and is as set out below:

	Global Equities	UK Equities	Fixed Interest	Property	Commodities	Credit	Private Equity	Hedge Funds
Alliance Bernstein	22.0%							
ACV	22.0%							
JPM: Equity		16.70%						
JPM: Bonds			16.00%					
Schroders				17.0%				
Fauchier								7.0%
Herbert Vest							3.00%	
M&G						7.70%		
Investec					5.0%			
	44.0%	16.70%	16.00%	17.0%	5.0%	7.70%	3.00%	7.0%

5.2 This structure broadly equates to a 74% allocation to the relatively riskier assets, held in expectation that they will outperform the Fund liabilities over the longer term and hence assist in closing the funding gap.

5.3 The revaluation has identified three issues which have implications for the asset allocation:

- Adverse investment performance relative to that projected in the 2007 revaluation contributed to the 2010 deficit
- The stabilisation mechanism can be shown to have a limited impact on the long term security of the Fund provided contribution rates are maintained at an appropriate level.
- The fund membership has matured with the proportion of retired and deferred members increasing.

5.4 The rationale for accepting the stabilization mechanism is expected long term contribution levels remaining at a higher rate than is the case without stabilization. However, without stabilization there would be greater immediate pressure to increase contributions.

5.5 With stabilized contribution rates a modestly lower risk investment (with 10% less in growth assets – principally equities) is helpful in reducing investment risk and does not overly impact on the stewardship criterion. This will however necessitate these assets achieving a proportionately higher return.

6. CONCLUSIONS

6.1 Analysis of the revaluation results indicates that it is appropriate to reduce the risk profile of the asset allocation by reducing the exposure to growth assets by 10% and re-investing the funds in the fixed interest mandate.

6.2 The timing of the re-alignment is not urgent (given the current low level of real yields) and it is recommended that the Executive Director for Resources in conjunction with the investment advisor be given discretion to undertake this when appropriate.

7. FINANCIAL IMPLICATIONS

7.1 The comments of the Executive Director for Resources have been incorporated into the report.

8. LEGAL IMPLICATIONS

8.1 The investment of pension funds is a statutory function and is undertaken by the fund in accordance with the Local Government Superannuation Regulations. The regulations require administering authorities to have regard to the need for diversification of investment fund monies, the suitability of any investment proposed and proper advice, obtained at reasonable intervals. The aim of the investment is, acting prudently with regard to risk, to obtain the best return on the fund investments.

Appendix 1: Stabilisation Modelling

1. The key financial variables which will influence the outcomes for up to 20 years (and more) in the future are obviously unknown. The modeling uses known asset class characteristics to simulate future scenarios and illustrate the range of potential outcomes in terms of funding levels and contribution requirements.

2. The principal stabilization strategies and asset allocations are as set out below: with bold entries denoting the principle differences between the strategies.

Strategy	Current Rate Held Until	Maximum Annual Increase	Maximum Annual Decrease	Maximum Proportion of Investments in Riskier Assets
I	201[illegible]			75%
[illegible]	201[illegible]	1%	1%	75%
[illegible]	**2014**	1%	1%	[illegible]%
1	201[illegible]	**0.5%**	**0.5%**	75%
E	201[illegible]	1%	1%	**55%**
F	201[illegible]	1%	1%	**35%**

3. The strategies were tested against the requirement to achieve full funding at the end of the 21 year term, the range of contribution rates the application of the mechanism would entail and the stability of contribution rates.

4. The key conclusions from the modeling results are as follows:

    a. With no stabilization mechanism in place, a significant increase in contribution rates from their current levels would be required (at least in the short term).

    b. The stabilization mechanisms modeled do not have a significant adverse impact in terms of the stewardship (funding level) metric, however the price to pay for this stabilization is higher expected contribution levels over the long term, relative to the position with no stabilization of contribution rates.

    c. There is scope to reduce investment in “growth” assets by 10%, which has only a small impact on expected contribution rates and funding levels but a more meaningful reduction in risk in the event of poor investment outcomes.