Pensions Investment Committee			
Report Title	**Review of Fund Investment Structure**		
Key Decision			**Item No. 5**
Ward			
Contributors	**Executive Director for Resources**		
Class	**Part One**		Date: **24 February 2011**

1. SUMMARY

1.1 This report sets out the broad outline of the future structure of the management of the Pension Fund's investments and recommends that the Council's investment advisors Hymans Robertson be instructed to prepare a detailed report on implementation for the next meeting of this Committee.

1.2 The report comprises the following sections:

2. Recommendations
3. Background
4. Existing Structure of Fund
5. Passive and Active Management
6. Implementation
7. Financial Implications
8. Legal Implications

2. RECOMMENDATIONS

Committee is recommended to ;

2.1 Instruct the Council's investment advisors, Hymans Robertson, to prepare a detailed report on the implementation of an investment structure which corresponds to the principles as set out in section 6.1 of this report.

3. BACKGROUND

3.1 Members had requested a briefing on the alternative arrangements for the management of the Fund's investments principally because of the continuing disappointing performance of the existing active managers.

3.2 A Member briefing conducted by the Fund's advisors, Hymans Robertson, was held on 18th January 2011 with the objective of determining Members' requirements, and on the basis of this devising a broad investment strategy and structure for the Fund.

3.3 A summary of the presentation and the conclusion of Members is the subject the remainder of this report.

4. EXISTING STRUCTURE OF FUND

4.1 The current structure of the fund is as set out below. The structure has evolved over a period of ten years as a result of various reviews conducted by the Fund's investment advisors, the last of which was undertaken in June 2009.

Table 1: Current Portfolio

Manager	Mandate	Appointed	Target Value £ Million	Relative Performance Since Inception
Alliance Bernstein	Global Equity	1 Nov 2004	154.8	-2.50%
RCM	Global Equity	18 Sep 2008	154.8	-5.00%
UBS	UK Equity (Passive)	27 Feb 2008	112.6	0.20%
UBS	Fixed Interest	28 Feb 2008	112.6	-0.60%
Schroders	Property	12 Oct 2004	70.4	-0.80%
Fauchier	Hedge Fund	28 Jun 2008	21.1	-5.50%
Investec	Commodities	25 Feb 2010	35.2	-2.50%
Harbourvest	Venture Capital	29 Jun 2006	21.1	-0.80%
M&G	Credit	1 May 2010	21.1	
			703.7	

4.2 The table indicates that all the managers with the exception of the UBS tracker fund have failed to achieve their benchmarks. The underperformance of the Lewisham Fund, relative to other LGPS funds, is largely attributable to stock selection by individual managers rather than the asset allocation of the overall Fund.

4.3 It should be recognised that the managers have been appointed for relatively short periods of time and that it is arguably more appropriate to measure manager performance over a full economic cycle. In addition, a study by Hyman Robertson into the performance of their (global equity) manager recommendations has indicated that the economic environment in 2008, when a number of the appointments were made, was particularly difficult for a number of their preferred active managers.

4.4 The current structure is based on a number of principles which may be summarised as:

- Diversification is beneficial;
- Targeted active management can add value, and;
- Specialist managers are preferable to generalists.

4.5 The key issue for debate is the Committee's view of active versus passive investment management.

5. PASSIVE AND ACTIVE MANAGEMENT

5.1 Passive investment management involves structuring a portfolio that is designed to "track" a specific index. The passive approach achieves average returns and essentially incorporates the composite investment strategies of active managers within the particular asset class. The advantages and disadvantages of passive management may be summarised as :

- Advantages
  Lower management fees.

  Stability of relative returns.

  Low transaction costs relative to active management.

  Diversity of investments.

  New approaches to passive management (such as "fundamental indexation") are available, which counter some of the disadvantages below and are gaining traction in the marketplace. They are potentially worth further investigation for this mandate.

- Disadvantages
  Potential opportunity costs – no scope for added value relative to the index and potential risk of moving out of active portfolios at "inopportune" times.

  If tracking a market capitalisation based index, there is the inherent issue of needing to buy more of stocks that become more expensive, and sell stocks that become cheaper.

  Potential concentration of investment in individual companies because of structural issues in markets (e.g. the UK equity market). Newer approaches such as "fundamental indexation", where the portfolio is constructed according to rules based on the valuation of stocks within the universe, can mitigate this risk.

  Tracking "momentum driven" markets may create volatility, e.g. dotcom bubble.

  The additional risk, at total Fund level, from active management is low and can act as a diversifier from the strategic risks being run.

5.2 Analysis indicates that active managers in aggregate deliver average performance (before fees). Consequently, the issue is the ability to select the best performing managers and to change them before performance declines. Manager performance is however cyclical and the costs of transition between managers is high. Consequently there are considerable risks associated with an active approach to management.

5.3 Members considered that the Fund's experience of active management indicated that the passive approach provides an opportunity to achieve average returns without the volatility and uncertainty associated with active management.

5.4 Members concluded that having a significant proportion of Fund assets managed passively was consistent with their investment beliefs. The Committee's expectation is that the Fund's principal holdings in equities and bonds could be passively managed. The Committee remains prepared to consider active management for those elements of the Fund either where passive management is not a viable option (e.g. property), or where the Committee believes the targeted use of active management may be more beneficial.

5.5 Members did however recognise that the costs of any transition would be significant and that timing would be critical. Consequently the change should be phased and determined by market conditions.

6. IMPLEMENTATION

6.1 The broad principles which Members have established for the future direction of the Fund may be summarised as :

- Core assets to be passively managed.
- Number of managers to be minimised where possible.
- Transition to new structure to be phased to maximise value from existing managers' holdings.

6.2 A preliminary review suggests that the core index fund representing 76% of the total fund assets will potentially comprise the equity and fixed interest mandates which are currently managed by UBS, Alliance Bernstein and RCM. There are, however, issues to consider on which index to track and the basis on which individual stocks are to be weighted. This requires further detailed investigation.

6.3 The residual element of the fund has a diverse range of asset classes for which there are a number of options for the structure going forward. This again requires detailed investigation and advice.

6.4 It is recommended that Hymans Robertson be instructed to prepare a report to the next meeting of this Committee detailing the options for the restructuring of the fund on the broad principles outlined by Members in section 6.1, and a detailed timetable for implementation.

7. FINANCIAL IMPLICATIONS

7.1 Restructuring of the Fund will inevitably involve considerable costs and such costs will need to be factored into any proposals.

8. LEGAL IMPLICATIONS

8.1 The investment of pension funds is a statutory function and is undertaken by the administering authority in accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The aim of the investment is, acting prudently with regard to risk, to obtain the best return on the fund investments.

8.2 An administering authority must formulate a policy for the investment of its fund money with a view to the advisability of investing fund money in a wide variety of investments and to the suitability of particular investments and types of investments. The authority must consider the advice of its independent expert in taking any steps in relation to its investments.