

ASSET LIABILITY STUDY

SUMMARY

This report summarises the results of the asset liability study carried out following the results of the last actuarial valuation. The study recommends a revised asset allocation for the fund, including investment in two new asset classes.

RECOMMENDATIONS That

- (1) The results of the asset liability study be noted.
- (2) The asset allocation of the fund, and the control ranges around that allocation, be amended to:-

	Benchmark %	Control Range %
UK Equities	36	+/- 10
Overseas Equities	29	+/- 10
Total Equities	65	+/- 10
UK Fixed Interest Gilts	12	+/- 10
Overseas Bonds	0	Up to 10
Index-Linked Gilts	6	+/- 10
Corporate Bonds	12	+/- 10
Total Bonds	30	+/- 10
Property	0	Up to 5
Private Equity	2½	Up to 5
Hedge Funds	2½	Up to 5
Cash	0	Up to 10
Total	100	

to take effect from 1 January 2006 or as soon as practicable thereafter

OR

Such other asset allocation as the Committee agrees subject to the taking of proper advice.

- (3) The fund specific benchmark and indices against which performance will be monitored and the control ranges for each manager be updated accordingly.
- (4) A Manager Appointment Sub-Committee be set up as shown in Appendix 3 to select managers for the new asset classes from a short list drawn up by officers.

1. Introduction

At the February meeting of the Committee it was agreed that an asset liability study should be carried out by Mercer Investment Consulting .

This study has now been completed, and a copy of the executive summary is attached as Appendix 1 to this report. Copies of the full report have been circulated with this agenda.

In order to gain the best overall advice on asset allocation, a draft of the report was first discussed with Bexley's investment managers, UBS and Newton. In addition to practical knowledge of the market they were able to feed in their views on the prospects for future risks and returns on the various asset allocation classes.

The fund's main objective of maximising return within an acceptable level of risk and keeping costs under control in order to control volatility in the employers' contribution rate formed the basis for the study.

The study then considers the level of liabilities revealed by the recent actuarial valuation of the fund, and goes on to indicate how assets may best be allocated in order to meet these liabilities. The risk involved in investing in each type of asset is a key factor in the final decision.

2. Strategic Asset Allocation

In determining the most appropriate asset allocation, the study first considers the liabilities of the fund and how they will change over the foreseeable future. Bexley's fund is gradually becoming more mature – the proportion of pensioners and preserved pensions is increasing. Against this is set the risk in investing in each type of asset in order to reduce the fund's deficit. This indicates that there should be a slight increase in the use of equities at the expense of bonds in order to increase the potential to generate higher returns.

The Fund's adviser suggested that two new asset classes are introduced to diversify the risk of the fund. The two classes recommended are private equity and hedge funds, but the study does not rule out other "alternative investments" detailed in the report. Should the Committee not wish to support either or both of the proposed new asset classes then consideration could be given to alternatives such as property, or an increased allocation to equities.

Private equity

Private equity is capital available for investment in unlisted companies, and can be categorised into :-

- Buy-outs/buy-ins of established companies
- Development capital to enable companies to expand
- Venture capital to start or grow a company from an early stage

Investments are of a long term nature and losses are generally expected in the first few years of investment as there are risks that the companies do not succeed. However there is greater return potential in later years – Mercer assumes a long term return of 11% compared to 8.4% from normal equity investment. In order to reduce risk of losses occurring a "fund of funds" approach is recommended, whereby a share is taken in many funds. This has the advantage of:-

- Low minimum investments
- Diversification
- Access to top tier managers
- Experience and expertise in selecting funds

However, fees are higher in this specialised area. They range from 1.75% to 2.5% a year of capital invested, together with a performance bonus (typically 20% of returns above an agreed level – the “hurdle”). So fees on an investment of £9m would be at least £160,000 a year.

Further details from Mercer’s study are shown in Appendix 2.

Hedge funds

Hedge funds cover a broad spectrum, but are essentially funds invested with managers with the aim of achieving a return above cash, rather than relative to equity or bond markets. They aim to add value in all market conditions and may use the four main asset classes of equities, bonds, currencies and commodities to do this. As such they are regarded as a lower risk investment than equities, and an average annual return of 7% is expected.

Again fees are higher than equities, ranging from 2% to 3% a year of capital invested, again with a performance bonus (typically 20% of all returns ie. without a hurdle). So fees on an investment of £9m would be at least £180,000 a year.

Further details from Mercer’s study are shown in Appendix 2.

The change to strategy is summarised below:-

	Current %	Proposed %
UK Equities	36	36
Overseas Equities	24	29
Total Equities	60	65
UK Fixed Interest Gilts	16	12
Overseas Bonds	0	0
Index-Linked Gilts	8	6
Corporate Bonds	16	12
Total Bonds	40	30
Property	0	0
Private Equity	N/a	2.5
Hedge Funds	N/a	2.5
Cash	0	0
Total	100	100

In considering adopting two new asset classes, Members of the Committee will need to satisfy themselves that they have taken proper advice in this matter. Mercer Investment Consulting will provide further guidance at the meeting on these more specialist areas, building on the recent workshop held at the Marriott hotel.

3. Implementation

The proposed change in asset allocation does not represent a large change in the investments used as managers are currently overweight equities and underweight bonds. This should enable the increase to 65% equities to be achieved by 1 January 2006. The proposed new asset classes are specialist areas and a procurement process fully evaluating the market place using the OJEC procedure is advised should the Committee wish to proceed on this basis. It is proposed that officers, in consultation with Mercer Investment Consulting, should produce a short list of up to 4 managers for each asset class. The Committee could establish a working group of three Members to interview the short listed managers and appoint the successful applicant. Suggested terms of reference for this group are shown in Appendix 3. Any transfer of funds would be phased in to keep the cost of the change to a minimum, and some flexibility on the benchmark and control ranges will be needed to allow for the period prior to and during the initial investment in new assets.

Control ranges have been set within which the managers must operate. These have been set sufficiently wide to allow the managers flexibility in the timing of the change of asset allocations, and also to allow sufficient scope in the future for outperformance.

Both managers have been consulted over the changes in asset allocation and performance measurement, and have indicated their agreement to implement the changes.

4. Summary of Financial Implications

The cost of the transactions required in order to implement the changes to asset allocation has been estimated at 0.15% of the market value of the fund, although the explicit costs of investing in private equity and hedge funds are difficult to determine. This will be a non-recurring cost to the Pension Fund in this financial year, and should ensure that the fund will be able to meet its main objective more closely in the future. In particular it should reduce volatility in contribution rates.

The cost of the asset liability study was £25,000 and will be met from the Pension Fund.

Local Government Act 1972 – section 100d

List of background documents

Bexley London Borough Pension Fund – Investment Strategy Review –
Mercer Investment Consulting - November 2005.

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Executive Summary

1. Introduction

This report, which is addressed to the Authority, reviews the investment strategy of the Bexley London Borough Pension Fund, taking into account the results of the recent actuarial valuation and current market conditions. The main objective of the Fund is to maximise returns within an acceptable level of risk, in order to control volatility in the employer's contribution rate. The review aims to quantify the risk being taken by the Fund, in terms of how the investment strategy could affect the funding status at the next actuarial valuation.

2. Current Status of Fund

The funding level of the Fund as at 31 March 2004 was 83%. We have projected the funding level to take account of recent market conditions. At 31 March 2005 we estimate that the funding level had risen slightly to approximately 84%, if the actuarial assumptions adopted for the valuation are left unchanged.

The current benchmark asset allocation of the Fund is 60% equities and 40% bonds.

3. Recommendation on the Appropriate Risk Level

The analysis considers the expected development of the funding level and potential employer contributions from March 2007. This shows that increasing the level of risk to a level broadly commensurate with a 70% equity content helps to increase the chance of achieving a higher funding level in 2007, without significantly increasing the downside risk.

We therefore recommend a small increase in the risk level.

4. The Strategic Asset Allocation

We recommend an initial allocation to the alternative asset classes of hedge funds and private equity in order to provide diversification from traditional equity and bond asset classes. We suggest a target allocation of 5%, split equally between hedge funds and private equity. Our overall recommended strategic asset allocation is therefore to reduce bonds by 10% to give a benchmark of 65% equities, 30% bonds, 2½% private equity and 2½% hedge funds.

5. Bond Allocation

The overall allocation to bonds falls to 30% from 40%. Within bonds, we recommend retaining the existing 40:20:40 weighting between fixed interest gilts, index-linked gilts and corporate bonds.

6. The Allocation within Equities

Equities are currently split between UK and overseas equities in a 60:40 ratio. In view of the increasing concentration in the UK equity market, we recommended a move away from the UK in favour of overseas equities to a 55:45 split. Within equities, we recommend the current split is altered to achieve a broadly equal allocation amongst the three main trading blocks of Europe (ex UK), North America and the Far East. After consultation with the Fund's investment manager, this resulted in an allocation of 8% of the total fund to North America, 9% to Europe (excluding the UK), 5% Japan, 3% to the Pacific Basin (excluding Japan) and 4% to Emerging Markets.

7. Conclusion

The results of our strategic recommendations are set out below.

Asset Class	Current Allocation (%)	Recommended Allocation (%)	Change (%)	Ranges (%)
Equities	60	65	+5	55-75
UK	36	36	0	26-46
Overseas	24	29	+5	19-39
North America	7	8	+1	
Europe (ex UK)	10	9	-1	
Japan	4	5	+1	
Developed Pacific (ex Japan)	2	3	+1	
Emerging Markets	1	4	+3	
Bonds	40	30	-10	20-40
UK Fixed Interest Gilts	16	12	-4	2-22
UK Index-Linked Gilts	8	6	-2	0-16
UK Corporate Bonds	16	12	-4	2-22
Overseas Bonds	0	0	0	0-10
Private Equity	0	2.5	+2.5	} to Up
Hedge Funds	0	2.5	+2.5	
Property	0	0	0	0-5%
Cash	0	0	0	Up to 10%
Strategic Risk % p.a.	10.6	12.1		
Expected Strategic Return % p.a.	6.9	7.4		

Private Equity

What is it?

Private equity (also known as venture or development capital) incorporates a range of non quoted equity type investment. These range from backing new company start-ups through to providing development capital for existing companies and to providing capital for buyouts. Private equity is often seen as an extension to a fund's small cap equity exposure.

Main Characteristics

- Long-term in nature and illiquid – there is often a lock-in period in most vehicles, typically of ten to twelve years, although we note that the secondary market has improved in recent years.
- The manager will seek to obtain exposure to a range of different investments and will call on the investors for money to back these investments over a period of years. In the early years investors are called on for money. In later years the money is paid back to investors as investments are realised.
- To compensate for the illiquidity and increased risk of company failure inherent in such investments, investors will expect a return in excess of that provided by conventional equity markets, perhaps of the order of 4-5% pa.
- May provide some diversification from quoted equities as its fortunes are less impacted by market sentiment, say. (Economic factors will still have a common effect).
- Typically a pension fund will achieve exposure to the asset class through a closed end limited partnership pooled vehicle in which a fund's assets are commingled with other investors.
- J-curve returns expected. That is, the investment will lose value in the early years as cash is invested and fees incurred (this will impact on fund values and funding levels). The true return will not be known until the end of the investment's lifetime.
- There is manager risk in identifying and appointing a successful private equity manager as there is a high degree of variability of returns between different managers in the universe.
- Less regulated than the quoted equity markets.
- Fees are typically high. They are based on committed capital and may include a performance-related element. The fund of funds approach introduces an additional layer of fees.

Suitability

Private equity investment is really only suitable for a fund which is prepared to accept the long term, potentially illiquid nature of the investment. Furthermore, it can be problematic for underfunded funds as the investment may be seen to drop in value in the early years.

Currently, the Fund's strategic benchmark has no allocation to private equity. We believe that an allocation to private equity would be an appropriate long term consideration for the Fund, allowing the pursuit of additional expected return and further diversification benefits. We therefore recommend that an initial 2.5% allocation to private equity should be considered by the Authority. This position would then be reviewed after the next actuarial valuation.

Absolute Return Strategies (“Hedge” Funds)

What are they?

These are investment strategies which target a positive return in absolute terms rather than relative to an index or benchmark. They therefore aim to add value across all market conditions, e.g. also in falling equity markets.

There is no single definition of an absolute return product or “hedge” fund. The terms cover a myriad of approaches and opportunities.

Main Characteristics

- Highly dependent upon manager skill.
- The manager is free to operate in a variety of markets and to utilise non-traditional strategies such as variable long/short exposures, leverage, arbitrage and derivative instruments.
- They are typically distinguished from traditional investments by their ability to short sell assets. Short-selling is done through a variety of methods, but essentially means taking a negative exposure to an asset i.e. the fund benefits from a fall in the price of the short asset.
- Can be used to reduce short-term volatility in returns, as often established to have limited correlation with equity and bond markets.
- The term ‘hedge’ can sometimes be a misnomer, as some hedge funds are fully hedged against market movements (called ‘market neutral’), some are partially hedged and some are not hedged at all.
- Often more illiquid than traditional asset classes.
- Fees are typically high, as for private equity.
- Less regulated than traditional asset classes.
- Lack of transparency of underlying investments.

Pension funds typically gain exposure to absolute return opportunities through a Fund of Hedge Funds.

As highlighted above there are a wide range of strategies available, ranging from “Global Macro” (exploiting major economic themes), “Arbitrage” (taking advantage of pricing anomalies), “Event-driven” (taking advantage of pending corporate activity), through to “Long/Short” and “Market Neutral” strategies. Investing via a fund of hedge funds, allows pension funds to gain access to a portfolio of investments:

- diversified by manager and strategy,
- with manager selection, due diligence and portfolio construction delegated to professionals,
- with access to the best hedge funds, many of which have capacity constraints, and
- with typically greater liquidity than individual single strategy hedge funds.

The price to pay for these potential advantages is an additional layer of fees to the fund of funds manager.

Suitability

Hedge funds may present the Fund with a means of adding additional return above traditional assets. In particular, they typically aim to add value across all market conditions and as such can also offer diversification benefits.

In addition, we have seen a migration of key individual fund managers from the mainstream equity marketplace to hedge funds (allowing them, for example, to express negative views in a long/short product, rather than being restricted by long-only views). Consideration of these products may be necessary if the Fund is keen to gain access to the “stars” of the industry.

We would be in favour of the Fund building up an exposure to absolute return vehicles. This should be achieved over time, and in a diversified fashion. We recommend an initial allocation of 2.5% which should be targeted at an absolute return investment vehicle.

Pensions Committee – Manager Appointment Sub-Committee

Orders of Reference

1. The appointment of Fund Managers

Delegated Powers

1. To appoint Fund Managers for fund of funds investments covering private equity and hedge funds.