

Pensions Committee

2.30 p.m., Wednesday, 24 June 2015

Annual Investment Update – Lothian Buses Pension Fund

Item number	5.10
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an update on the investments and funding position of the Lothian Buses Pension Fund.

Over the twelve months to 31 March 2015, investment markets returns were very strong (global equities, index-linked gilts and property all grew at a double digit rate).

The Fund produced a return of 15.1% over the year. The benchmark return was 14.9%. Over five years, the fund produced a return of 11.0% per annum compared with a benchmark return of 9.2% per annum.

Despite very strong investment markets over the 2014/15 year, the decline in market yields has led to a deterioration of the funding level. The funding levels on an ongoing and gilts basis at 31 March 2015 were estimated to be 106% and 81% respectively.

The Fund's Investment Strategy 2012-17 is being implemented gradually. The Fund's risk reduced further over the year with a modest reduction in the equity weighting accompanied by an increased allocation to index-linked gilts and alternative investments.

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Annual Investment Update – Lothian Buses Pension Fund

Recommendations

- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 That the Pensions Committee notes the performance, funding update and asset allocation of the Lothian Buses Pension Fund.

Background

- 2.1 The purpose of the report is to provide an update on the investment and funding position of the Lothian Buses Pension Fund to 31 March 2015.
- 2.2 The investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required by the employer, Lothian Buses plc.

Main report

Investment Strategy

- 3.1 Asset markets continued to respond positively to low interest rates and unconventional monetary policies over 2014/15. Global equities generated returns of 18% in sterling terms benefiting from the US dollar strength because of the large exposure to US stocks. These returns were matched by UK property, which returned 18% as the commercial property recovery took hold. Yet, these returns were outshone by a greater than 20% return from index-linked gilts, for which demand appears to be insatiable in the face of pension fund de-risking, quantitative easing and general inflation uncertainty.
- 3.2 The Fund adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. The investment strategy is set at the broad asset class level of Equities, Index-Linked Gilts and Alternatives, which are the key determinants of investment risk and return. Investment strategy includes Equities and Alternatives on the assumption that these assets will deliver better performance than Index-Linked Gilts in the long-term.
- 3.3 The Pensions Committee approved the Investment Strategy 2012-17 for Lothian Buses Pension Fund in October 2012.

	Long term Strategy Allocation 2012-17 %	Permitted Range %
Equities	55	45 - 65
Index-Linked Assets	15	10 - 30
Alternatives	30	10 - 35
Cash	0	0 - 10
TOTAL	100	

- 3.4 The strategy reduces the allocation to equities (including private equity) from 63.5% at the end of 2012 to 55% by the end of 2017 and increases the allocation to index-linked gilts and alternatives. It recognises a gradually changing risk profile for the Fund, but retains significant exposure to real investments, such as Index-Linked Gilts and Equities, which have a history of protecting or enhancing purchasing power, after the effects of inflation have been taken into account.
- 3.5 The Fund's investment objectives are:
- Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
 - Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.
- 3.6 The implementation of the Investment Strategy 2012-17 has continued to proceed at a measured pace as investment opportunities became available and as research on opportunities was completed. Progress towards the long term strategy allocation involves the interim strategy allocation and the actual asset allocation changing gradually over time. The pace of change can be accelerated or slowed depending on asset prices, the availability of alternative investments and research conclusions on new strategies.
- 3.7 This is reflected in the interim strategy allocation and actual allocation over the financial year 2014/15 which are shown in the table below.

	Manager	Actual Allocation 31 March 2014 %	Actual Allocation 31 March 2015 %	Interim Strategy Allocation 31 March 2014 %	Interim Strategy Allocation 31 March 2015 %
EQUITIES					
Global Alpha	Baillie Gifford	32	31		
Global High Dividend Yield	Internal	32	30		
Private Equity	Internal	1	1		
Subtotal		65	62	62.5	60.5
INDEX-LINKED ASSETS					
Index-linked bonds	Baillie Gifford	7	7		
Index-linked gilts	Internal	4	4		
Subtotal		11	11	10	12
ALTERNATIVES					
Property	Standard Life	9	10		
Other Real Assets [1]	Various	5	6		
Other Bonds [2]	Baillie Gifford	8	7		
Subtotal		22	23	27.5	27.5
Cash	Internal	2	4	0	0
TOTAL		100	100	100	100

[1] Includes infrastructure and timber

[2] Includes corporate bonds and loans

- 3.8 The Investment Strategy Panel reviews asset allocation and the progress to the new investment strategy on a quarterly basis and the internal team reviews it monthly.
- 3.9 At 31 March 2015, the Fund has an overweight position in equities and cash compared to the interim strategy allocation. The Fund is modestly underweight index-linked assets and more significantly underweight Alternative investments. Many of these investments are unlisted and increasing exposure is dependent on finding attractive opportunities.
- 3.10 Changes to the underlying structure of the Fund were more modest in 2014/15 following the significant changes implemented in the prior year (notably the move to have approximately half of the Fund's equity exposure managed by the internal team in a low cost, low turnover strategy).
- 3.11 The changes made in 2014/15 are described below:
- As part of the move to reduce equity exposure towards the interim strategy allocation, £7.5m was withdrawn from Baillie Gifford's equity

portfolio in February 2015 after a period of strong equity market performance over the year. The sale proceeds are being held in cash pending investment in Alternative assets.

- Dividend income is being withdrawn regularly from the internally managed global equity portfolio to further aid the targeted reduction in equities.
- There was little change to the allocation to index-linked gilts as the pace of investment has been gradual due to the high valuations/low real yields available in the market.
- Further investments were made in the Other Real Assets portfolio during the year in line with the long term strategy to increase the exposure to Alternatives. However, despite a strong double-digit return from Alternative investments, there was only a small increase in the percentage allocation in the Fund. Four UK and European infrastructure investments and four global timber investments amounting to £3.7m were made, but distributions from existing investments were high at £2.4m, meaning that net investment was fairly modest at £1.3m.

- 3.12 The Fund makes commitments to unlisted investments and the timing of these is uncertain as they depend on the manager being able to purchase assets. Details of outstanding commitments as at 31 March 2015 were as follows:

	Unfunded Commitments in Local Currency			TOTAL
	US\$ m	Euros m	£ m	£ m
Infrastructure	-	2.1	-	1.5

- 3.13 Following the completion of the 2014 actuarial valuation, the Fund will work with Lothian Buses plc and its investment advisers to revisit the investment strategy to ensure it remains appropriate.

Investment Performance to 31 March 2015

- 3.14 The Fund has achieved returns in excess of the strategic allocation over the last year and over the longer term timeframes shown in the table.

% per annum	1 Year	5 Years	10 Years
Lothian Buses Pension Fund	+15.1	+11.0	+10.3
Benchmark	+14.9	+9.2	+8.8
Relative	+0.2	+1.8	+1.5

- 3.15 The benchmark shown in the table comprises equity, index-linked gilt and cash indices as well as an inflation-linked index for the alternatives allocation. Returns relative to the benchmark over a one year period need to be placed in the context that there are no ideal benchmarks for many of the assets held in the Fund, especially the Alternatives. The Fund's benchmark for Alternatives is

inflation plus 3.5% per annum, which makes sense over the long term as the Fund's liabilities are linked to inflation. However, over shorter periods, there is less information content in the relative returns of the Fund because the development of asset prices is much more volatile than that of UK retail or consumer prices. The Investment Strategy Panel assesses the underlying risks of the portfolios that make up the asset allocation to ensure that these are consistent with the long term objectives of the Fund.

- 3.16 Over 2014/15, the Fund (+15.1%) modestly outperformed the benchmark (+14.9%). Asset allocation within the Fund proved beneficial over the year driven by the underweight exposure to the relatively lower returning Alternatives.
- 3.17 Within Alternatives, the Fund's relative performance was strong due to the high returns from the Standard Life Property Fund (+16.5%), Baillie Gifford Investment Grade Bonds (+13.3%) and Timber & Agriculture (+28.8%). Collectively, the Fund's Alternatives investments returned +14.8% over the year, comparing favourably to the Alternatives benchmark gain of 4.4% (inflation plus 3.5% per annum).
- 3.18 The Fund's Index Linked assets gained 16.2% over the year, lagging their benchmark return of 23.8%. The internal index linked gilts portfolio lagged notably over the year as a result of the decision to invest cash gradually. Despite valuations being historically high and real yields very low, the price of index-linked gilts continued to rise, so uninvested cash acted as a drag on performance.
- 3.19 The Fund's equity investments delivered good gains over the year, advancing 15.3%, though lagged the equity index return of +18.4%. Outperformance from Baillie Gifford's Global Alpha portfolio (+19.2%) was not sufficient to offset the relative underperformance from the internal Global High Yield Equity portfolio (+10.9%), which invests in lower risk equities and is expected to perform relatively well in weaker markets in line with the Fund's overall strategy. While equities tend to be a more volatile asset class, the Global High Dividend Yield portfolio specifically invests in financially stable equities with risk of less than 90% of the equity benchmark index, which helps to reduce the overall expected volatility of the Fund's returns.

Funding Level

- 3.20 The funding level is the ratio of the pension scheme's assets to liabilities. Last year, the actuary estimated the funding level to be 116.7% at 31 March 2014 on an ongoing basis, which shows that the Fund met its objective of holding sufficient assets to meet the estimated current cost of past service liabilities at that date.
- 3.21 The actuary also calculated the funding level on the more prudent gilts basis to be 88.2% at 31 March 2014. The gilts basis is a more conservative approach reflecting the ultimate funding objective – the assets the Fund should hold at the point when the last active member leaves the Fund. The Fund is closed to new

members and the liabilities are expected to mature further over time. As the Fund is in deficit on a 'gilts' basis, the assets do not cover the liabilities, so the Fund continues to invest in growth assets, such as equities, to achieve full funding in the future.

- 3.22 Over the year 2014/15, despite very strong investment markets, a further decline in market yields points has led to a deterioration of the funding level. The funding levels on an ongoing and gilts basis at 31 March 2015 were estimated to be 106% and 81% respectively.

Conclusion

- 3.23 Implementation of the investment strategy has continued to progress over the last twelve months with a modest increase in the actual allocation to alternatives and an increase in cash combined with a reduction in equity exposure. Following the completion of the 2014 actuarial valuation, the Fund will work with Lothian Buses plc and its investment advisers to revisit the investment strategy to ensure it remains appropriate.
- 3.24 Based on the performance of the Fund's assets and the movement of real gilt yields, which affect the value of liabilities, the funding level has deteriorated over the last twelve months. As the Fund is in deficit on a 'gilts' basis at 31 March 2015, the assets do not cover the liabilities, so the Fund continues to invest in growth assets, such as equities, to achieve full funding in the future.
- 3.25 The absolute performance of Lothian Buses Pension Fund over the twelve month period was +15.1%. Five year performance was +11.0% per annum. Over ten years, the Fund returned +10.3% per annum.

Measures of success

- 4.1 The investment performance of the fund is crucial to the achievement of the required investment return which impacts on the funding level and employer contributions. The objectives for the investment are:
- Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
 - Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.

Financial impact

- 5.1 This report details the investment performance of the Lothian Buses Pension Fund. The investment performance has a significant impact on the funding levels and potentially on the contributions required from the employer, Lothian Buses plc.

Risk, policy, compliance and governance impact

- 6.1 Investment Strategy is the main determinant of funding level and volatility of employer contribution rates. The Investment Strategy is aimed at reducing the risk without sacrificing returns. There is no governance impact as a result of this report. Committee delegates the implementation of investment strategy to the Director of Corporate Governance, who takes advice from the Investment Strategy Panel. The Investment Strategy Panel is an important element of the governance of the pension fund investments.

Equalities impact

- 7.1 There are no equalities implications as a result of this report.

Sustainability impact

- 8.1 The Statement of Investment Principles (covered elsewhere on the agenda) sets out the Fund's approach as responsible asset owners, and details how voting, engagement and other Environmental, Social and Governance activity will be undertaken. Compliance with it is expected to contribute to the sustainability of the Fund's investments.

Consultation and engagement

- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund. The Pension Board includes a union representative from Lothian Buses.
- 9.2 Regular meetings are held with Lothian Buses plc to update them on the Fund and to consult on strategic issues.

Background reading/external references

None

Alastair D Maclean

Director of Corporate Governance

Contact: Bruce Miller, Investment Manager

E-mail: bruce.miller@edinburgh.gov.uk | Tel: 0131 469 3866

Links

Coalition pledges

Council outcomes CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed

Single Outcome Agreement

Appendices None