

# Pensions Committee

2.00 p.m., Tuesday, 15 March 2016

## Investment Strategy Review – Lothian Buses Pension Fund

Item number	5.5
Report number	
Executive/routine	
Wards	All

### Executive summary

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The Lothian Buses Pension Fund's Investment Strategy 2012-17 is being implemented gradually, with a reduction in the equity weighting accompanied by an increased allocation to index-linked gilts and alternative investments.

The Investment Strategy Panel's review of strategy post the 2014 Actuarial Valuation has concluded and Committee is asked to approve a revised investment strategy which aims to reduce risk further, over the next 5 years.

### Links

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Coalition pledges

Council outcomes

[CO26](#)

Single Outcome Agreement

## Investment Strategy Review – Lothian Buses Pension Fund

### Recommendations

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- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 That Committee notes the outcome of the review of investment strategy for the Lothian Buses Pension Fund undertaken by the Investment Strategy Panel;
- 1.3 That Committee approve the revised investment strategy for the Lothian Buses Pension Fund;
- 1.4 That Committee agrees that the option for Lothian Buses Pension Fund to be merged into Lothian Pension Fund, and the most appropriate timing, is explored further in consultation with stakeholders.

### Background

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- 2.1 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. Alternative investments include property, non-government debt, infrastructure and timber.
- 2.2 The Investment Strategy Panel undertakes a strategy review at least every three years, typically following a triennial actuarial valuation. The Pensions Committee approved the Investment Strategy 2012-17 for Lothian Buses Pension Fund in October 2012.

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

- 2.3 The current strategy reduces the allocation to equities (including private equity) from 65% at the end of 2012 and increases the allocation to index-linked gilts and alternatives.
- 2.4 An update on the implementation of the investment strategy was reported to Pensions Committee in December 2015 and the table below provides the Fund's current investments. The increase in the allocation to alternative investments has proceeded at a measured pace as suitable investment opportunities have become available. The equity weighting has also reduced.

	<b>Manager</b>	<b>Interim Strategy Allocation 31 March 2012 %</b>	<b>Interim Strategy Allocation 31 January 2016 %</b>	<b>Actual Allocation 31 January 2016 %</b>
<b>EQUITIES</b>				
Global Alpha	Baillie Gifford			29
Global High Dividend Yield	Internal			29
Private Equity	Internal			1
<b>Subtotal</b>		<b>65</b>	<b>58.5</b>	<b>59</b>
<b>INDEX-LINKED ASSETS</b>				
Index-linked bonds	Baillie Gifford			8
Index-linked gilts	Internal			5
<b>Subtotal</b>		<b>10</b>	<b>14.0</b>	<b>13</b>
<b>ALTERNATIVES</b>				
Property	Standard Life	10		11
Other Real Assets [1]	Various	15		8
Other Bonds [2]	Baillie Gifford			8
<b>Subtotal</b>		<b>25</b>	<b>27.5</b>	<b>27</b>
<b>Cash</b>	<b>Internal</b>	<b>0</b>	<b>0</b>	<b>1</b>
<b>TOTAL</b>		<b>100</b>	<b>100</b>	<b>100</b>

[1] Includes infrastructure and timber; [2] Includes corporate bonds and loans

## Main report

- 3.1 Following the 2014 Actuarial Valuation, the Investment Strategy Panel has reviewed the Fund's investment strategy in light of developments in pension fund membership, expected cash flow, funding level, fund maturity, historic and prospective investment risk and returns.
- 3.2 Net cash flow (excluding investment income) has been marginally negative. Investment income will become an increasingly important source of stability as the Fund is closed to new members.

3.3 The funding level declined between the 2011 and 2014 valuations, due to liabilities growing at a faster pace than assets, largely the effect of falling gilt yields. This trend has continued since the 2014 actuarial valuation.

### **Employer Covenant**

3.4 The ability and willingness of the employer to pay contributions to the pension fund (i.e. its covenant) is an important consideration in setting investment strategy for any pension fund.

3.5 In the context of a standalone transport company, the current investment strategy contains meaningful funding level volatility which could affect affordability. While the company is currently in a healthy financial position, the review has afforded the opportunity to clarify the funding approach if the position worsened and also when the last active member leaves the Fund.

3.6 As Lothian Buses Pension Fund closed to new members in 2008, the number of active members is reducing and in due course the Fund will consist entirely of deferred and pensioner members. In normal circumstances, on the departure of an admitted body's last active member the admission agreement is terminated, a cessation valuation is undertaken on a prudent basis and any debt is crystallised with no recourse to further employer contributions.

3.7 After discussion with shareholder and the company, the investment strategy review has assumed that Lothian Buses will continue to pay deficit contributions (if required) after the last active member has left the Fund. The funding position and required employer contributions would be reviewed at triennial actuarial valuation in the normal way. The Admission Agreement is currently being updated accordingly.

3.8 With this clarity, the Fund can continue to adopt a long-term investment approach.

### **Outcome of Investment Strategy Review**

3.9 The review was aided by asset liability modelling undertaken by the Fund's investment adviser which highlighted the potential impact of the future funding level volatility on the company's balance sheet and contributions.

3.10 The largest funding risks identified were those driven by the liability value, which is a function of changes in long term interest rates and inflation, and the equity risk, which is expected to diminish over the very long term.

3.11 The asset liability modelling explored options to reduce investment risk in the Fund including the use of derivatives to hedge inflation and interest rate risk. Investment Strategy Panel concluded that, whilst derivatives may be useful in some circumstances, the Lothian Buses Pension Fund should initially look to reduce risk by:

- Continuing to reduce equities allocation in favour of bonds;
- Further de-risking within equities;
- Lengthening the duration of the Fund's bonds to provide greater downside protection in the event of reductions in interest rates.

3.12 The Committee is asked to approve the investment strategy for the Lothian Buses Pension Fund for 2016 – 2021 as follows:

<b>Asset Category</b>	<b>CURRENT Long term Strategy Allocation 2012-17 %</b>	<b>REVISED Long term Strategy Allocation 2016-21 %</b>	<b>Change in Long Term Strategy %</b>	<b>Change from Current Allocation %</b>
Equities	55	40	-15	-19
Index-Linked Assets	15	20	+5	+7
Other 'Real' Assets	30	18	-	-1
Fixed Income Assets		22	+10	+14
Cash	0	0	-	-1
<b>TOTAL</b>	<b>100</b>	<b>100</b>	-	-

3.13 The strategy includes:

- further reduction in the Fund's equity exposure;
- a distinct asset class of 'Fixed Income Assets'. Currently the Fund holds approximately 10% of fixed income assets within 'Alternative' investments.

3.14 Given the financial strength of the company, and confirmation that the company is committed to continue to pay contributions after the last active member leaves, it is proposed to implement the strategy over the next five years. Implementation should depend on the progression of the funding level and the availability of suitable fixed income assets.

3.15 The Committee is also asked to agree that the revised strategy be implemented over the next 5 years and delegate its implementation to the Executive Director of Resources in consultation with the Investment Strategy Panel.

3.16 The objectives for the investment strategy are currently:

- 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.

3.17 Discussions on appropriate funding and investment objectives for all three pension funds have commenced with the Fund's Independent Professional Observer and will be reported to Committee in June 2016.

## **Review of Option to Merge Lothian Buses Pension Fund into Lothian Pension Fund**

- 3.18 Lothian Buses Pension Fund is defined in regulations as a sub-Fund of Lothian Pension Fund and there is an option within regulations for the Fund to be subsumed into Lothian Pension Fund. During the investment strategy review this has been highlighted and explored.
- 3.19 Currently, unlisted investments such as infrastructure, timber and private debt are made for the Lothian Buses Pension Fund (if appropriate) at the same time as the Lothian Pension Fund. In most cases, such investments would be impractical for Lothian Buses Pension Fund as a relatively small pension fund. The two funds share such investments in fixed proportions for ease of administration. With the change in the Lothian Buses Pension Fund investment strategy, the way in which such investments are allocated between the two funds will need to be reviewed.
- 3.20 Different employer investment strategies (unitisation) have recently been put in place for the Lothian Pension Fund. Currently two different investment strategies are in place for employers within Lothian Pension Fund; 100% index-linked gilts and that for the remaining employers. There is scope to increase the number of different strategies for employers within Lothian Pension Fund and Investment Strategy Panel is exploring these options.
- 3.21 The unitisation functionality could help with implementation of the new investment strategy for the Lothian Buses Pension Fund, as it allows more flexible allocation of investments. It would also bring other efficiencies such as accounting, actuarial valuations and investment manager arrangements.
- 3.22 It is recommended that the Committee agree that the option for Lothian Buses Pension Fund to be merged into Lothian Pension Fund, and the most appropriate timing, is explored in consultation with stakeholders.

### **Measures of success**

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- 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 investments 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**

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- 5.1 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

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- 6.1 Investment Strategy is the main determinant of funding level and volatility of employer contribution rates.
- 6.2 There is no governance impact as a result of this report. Committee delegates the implementation of investment strategy to the Executive Director of Resources, 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

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

## Sustainability impact

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- 8.1 The Statement of Investment Principles 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

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- 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, to consult on strategic issues and to ensure that the risks inherent in the strategy are understood and are acceptable.

## Background reading/external references

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None

### **Hugh Dunn**

Acting Executive Director of Resources

Contact: Bruce Miller, Investment Manager

E-mail: [bruce.miller@edinburgh.gov.uk](mailto:bruce.miller@edinburgh.gov.uk) | Tel: 0131 469 3866

# Links

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**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