Appendix 1

AVON PENSION FUND COMMITTEE
ANNUAL REPORT TO COUNCIL
(April 2012 - March 2013)

1 BACKGROUND TO THE AVON PENSION FUND

The Avon Pension Fund is a statutory scheme regulated by the Local Government Pension Scheme Regulations 2008 (as amended) and the Local Government Pension Scheme Regulations (Management and Investment of Funds) Regulations 2009 (as amended). Bath & North East Somerset Council ("the Council") administers the Fund on behalf of more than 170 employing bodies including the four unitary authorities. The Fund has c. 89,000 members and the value of the Fund as at 31 March 2013 was £3.1 billion.

(a) AVON PENSION FUND COMMITTEE TERMS OF REFERENCE

The Council has delegated responsibility for the Fund to the Avon Pension Fund Committee whose terms of reference, as agreed by the Council in May 2013, are set out below:

"To discharge the responsibilities of Bath and North East Somerset Council in its role as lead authority for the administration of the Avon Pension Fund. These include determination of all Fund specific policies concerning the administration of the Fund, investing of Fund monies and the management of the Fund's solvency level. In addition, the Committee is responsible for all financial and regulatory aspects of the Fund. At all times, the Committee must discharge its responsibility in the best interest of the Avon Pension Fund.

The key duties in discharging this role are:

1. Determining the investment strategy and strategic asset allocation.
2. Determining the pensions administration strategy.
3. Making arrangements for management of the Fund's investments in line with the strategic policy.
4. Monitoring the performance of investments, investment managers, scheme administration, and external advisors.
5. Approving and monitoring compliance of statutory statements and policies required under the Local Government Pension Scheme Regulations.
6. Approving the Pension Fund's Statement of Accounts and annual report.
7. Commissioning actuarial valuations in accordance with the provisions of the Local Government Pension Scheme Regulations.
8. Considering requests from organisations wishing to join the Fund as admitted bodies.
9. Making representations to government as appropriate concerning any proposed changes to the Local Government Pension Scheme."

In discharging its role the Committee can delegate any of the above or implementation thereof to the Sub-Committee ("the Investment Panel") or Officers.

Committee Membership

The Committee structure is as follows:

Voting members (12)	5 elected members from B&NES (subject to the rules of political proportionality of the Council) 2 independent trustees 3 elected members nominated from the other West of England unitary councils 1 nominated from the education bodies 1 nominated by the trades unions
Non-voting members (4)	1 nominated from the Parish Councils Up to 3 nominated from different Trades Unions

Committee meetings and workshops:

The Committee meets quarterly. In addition, a Special Committee Meeting was held to discuss the Investment Strategy. Attendance at these meetings was 80% for the voting members and 69% for the non-voting members.

Ad hoc workshops are arranged as necessary reflecting the Committee's meeting agendas. These workshops are designed to explore specific policy issues in detail. During the last twelve months, three workshops were arranged to finalise the Fund's policy for Socially Responsible Investing and two workshops were held to review the investment strategy.

Investment Panel

The role of the Avon Pension Fund Committee Investment Panel is to consider, in detail matters relating to the investment of the assets within the strategic investment framework and performance of investment managers in achieving the Fund's investment objectives.

The Investment Panel will:

1. Review strategic and emerging opportunities outside the strategic asset allocation and make recommendations to the Committee.
2. Review the Statement of Investment Principles and submit to Committee for approval.
3. Report regularly to Committee on the performance of investments and matters of strategic importance

and have delegated authority to:

4. Approve and monitor tactical positions within strategic allocation ranges.
5. Approve investments in emerging opportunities within strategic allocations.
6. Implement investment management arrangements in line with strategic policy, including the setting of mandate parameters and the appointment of managers.
7. Approve amendments to investment mandates within existing return and risk parameters.
8. Monitor investment managers' investment performance and make decision to terminate mandates on performance grounds.
9. Delegate specific decisions to Officers as appropriate.

The Panel consists of up to six voting members from the Committee and meets at least quarterly ahead of Committee meetings.

The Panel met formally four times during the year with attendance at 87.5%. In addition each meeting was followed by a workshop where the investment managers present on their performance and outlook for their portfolio.

Committee members also attended the Fund's Annual Employers' Conference which was held in February 2013. This well attended conference provides an opportunity for employers to meet with the Fund officers and committee members to discuss the overall service provided and explore topical issues that affect the employers.

2 TRAINING

The administering authority recognises the importance of training of Committee members given their fiduciary duties. The Fund provides training to committee members to ensure they possess an appropriate level of knowledge, skill and understanding to discharge these duties.

The Fund's approach to training is based on the Myners principles for best practice in decision making in pension funds which highlights the need for administering authorities to ensure:

- that decisions are taken by persons or organisations with the skills, knowledge advice and resources necessary to make them effectively and monitor implementation; and
- those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

The Fund has in place a training framework which is based on CIPFA's (Chartered Institute of Public Finance and Accounting) Knowledge and Skills Framework for LGPS funds, which identifies six areas of knowledge as follows:

i. Legal and governance context
ii. Pensions Auditing and Accounting Standards
iii. Procurement and Relationship Management
iv. Investment Performance and Risk Management
v. Financial Markets and Product Knowledge
vi. Actuarial Methods, Standards and Practices

Committee training is delivered in a variety of formats, reflecting the strategic importance of the subject matter to the Committee's agenda and the differing level of knowledge and understanding across the Committee. Many of the areas identified by the framework are covered through detailed committee reports and workshops where the topic is explored greater in detail.

In addition, Committee members are encouraged to attend seminars and conferences which broaden their understanding of investments and topics of relevance to the LGPS.

3 REVIEW OF THE YEAR

a) INVESTMENT PERFORMANCE

The Fund generated an investment return of 13.8% during the year which was in line with the average local authority fund return. Over the last three years the Fund's return was 8.4% p.a. which is 0.3% ahead of the average local authority fund return.

The 2012/13 investment return was driven primarily by the strong returns from the equity portfolios which comprise 60% of the Fund's assets. Global markets rose c. 16% during the year. The value of the bond portfolio also rose during the year as the 'flight to safety' within bond markets continued as investors sought the relative safety of UK government bonds.

b) FUNDING LEVEL

As at 31 March 2013 the Actuary has estimated that the funding level has marginally fallen to 69% from 70% a year earlier. This contrasts with the 82% funding level at the 2010 valuation. The fall in the funding level since 2010 is due to the increase in liabilities; the investment return is ahead of expected returns over the period since the 2010 valuation. The value of the future pension liabilities is calculated using a discount rate based on UK gilt yields and the benefits are indexed to inflation. Thus increases in inflation and falls in gilt yields since 2010 have both caused the value of the liabilities to rise. Gilt yields in the UK are still near historic lows. These low yields are a result of investors seeking relative safety in non-euro denominated bonds, such as UK gilts whilst the Eurozone debt crisis remains unresolved. In addition, the Bank of England's policy to support the economy through its "quantitative easing" programme, in which the Bank purchases gilts from banks, has also kept yields low.

The next triennial valuation as at March 2013 is now in progress. This will set the employer contribution rates for the three years from April 2014 to March 2017.

c) POTENTIAL CHANGES TO THE LGPS

During the year the government began the consultation about the changes to the new scheme which will see the current "final salary" scheme being replaced by a "career average revalued earnings" scheme. The new scheme will come into effect from 1 April 2014 and the changes to the benefits structure will be reflected in the 2013 triennial valuation.

Recognising the significant impact on operations of the new scheme, the Committee agreed to invest in additional resources in terms of staff and IT systems in order that the new scheme is efficiently managed by both the Fund and scheme employers. The resources are required to ensure there is effective communication to members and employers and to increase the use of electronic data transmission between the Fund and scheme employers.

2012 also saw the introduction of "auto-enrolment". Although not directly affecting the pension fund, there was a significant amount of work communicating to employers about auto-enrolment and how it affected their pension arrangements.

d) PENSIONS ADMINISTRATION

(i) Budget

During the Year to 31 March 2013, total costs were £656,000 (5%) under the budget of £12.8 million. However, excluding Investment Management, custody fees and governance costs, administration costs were £152,000 under the budget of £2.1million, a saving of 7%.

Spending on Investment Management and custody fees was £282,000 under budget due to reductions in the rates charged by some managers. The investment management and custody fees of £10.1 million equate to 0.32% of the Fund's assets.

(ii) CIPFA Benchmarking (Benefits Administration)

The Fund participates in the annual Pensions Administration CIPFA Benchmarking exercise where its performance and running costs are compared against its peers and against the "average fund".

In 2011/12 the Fund's overall costs at £17.71 p.a. per member were less than the average of £20.45. Staffing costs (excluding payroll) were significantly less at £6.52 per member against £8.82. Payroll costs per pensioner member of £1.07 compares favourably against the average of £3.15.

The Fund invests heavily in communications with communication costs at £2.55 per member compared to the average of £1.12. Although significantly higher, the Committee has prioritised resources to this area as it strongly believes in the importance of providing members with timely, accurate information. This is delivered by specific newsletters to active and pensioner members, a high quality website, provision of member access to their "account" via the website and the facility for scheme employers to send information via the website's secure portal. Savings are being realised through the increase use of electronic delivery to members and employers alike.

The results of the Benchmarking exercise are discussed by the Committee.

(iii) Pensions Administration Strategy

The Pensions Administration Strategy came into effect in April 2011 with the aim of encouraging employers and the Fund work more closely together to provide an ever improving level of service to Fund members.

Performance of both the Fund and employers is now being closely monitored and during 2012/13 was reported via Quarterly Performance Reports to larger employers and through review meetings with some employers. The Strategy provides a transparent and robust operating and performance framework which improves accountability and has successfully focussed attention on the need for both parties to invest in and make use of electronic data provision to improve efficiency.

The Strategy is due for review after April 2013.

4 COMMITTEE BUSINESS TO MARCH 2013

a) Investment Strategy

During the year a number of strategic decisions were implemented as follows:

- New investment strategy was agreed in March 2013. The overall investment objectives (risk and return targets) remain unchanged but the new strategy allows greater flexibility for the Fund to achieve its objectives, primarily through the introduction of investment strategies that enable dynamic allocation between assets over shorter timeframes. In addition, the asset allocation allows for greater use of tactical positions within agreed limits.
- The Committee concluded its review of the Fund's Responsible Investing Policy ensuring that the Fund's policy reflects best practice across the whole Fund, subject to the constraints imposed by the investment structure. The policy was published in June 2012.

b) Funding Strategy (Interim Valuation)

During the year an interim valuation was commissioned to up-date the Committee on the funding position in order to prepare scheme employers for the potential outcome of the 2013 actuarial valuation. The interim valuation at 30 September 2012 showed a rise in the funding level to 73% but by 31 March 2013 the estimated funding level had fallen again to 69%.

c) Approval of the 3-year Service Plan and Budget 2013/16

The Service Plan details the service developments are planned to be undertaken during the next three financial years (2013/2016). The plan is designed to respond to known and anticipated legislative changes and Committee initiatives, as well as to take the Pensions Service forward by improving performance and the overall quality of service to members and employers.

Given that the "new Scheme" will be introduced in 2013/14 with an implementation date of April 2014, much of the plan's focus is on the roll out of the new scheme, especially the Fund's communications with members and employers, IT requirements and training of both internal staff and staff at scheme employers.

The 2013/14 administration budget increased by £290,000 reflecting the additional resources required to deliver the new scheme and auto-enrolment. This includes extra staff resources and the cost of new "middleware" to enable electronic transfer of data from payroll systems into the pensions system. This should generate savings in the future. In addition, there were one-off advisory costs of implementing the new investment structure. Recurring savings of £85,000 were identified mainly through embedding the use of electronic systems to deliver the service.

d) Treasury Management Policy and Cash Management Policy

The Fund's Treasury Management Policy sets out how the Fund's cash is invested to meet its day-to-day requirements. The cash managed under this policy at any time is c. £25 million, which represents less than 1% of the Fund's value.

The management of this cash is delegated to the Council's Treasury Management Team. However, the Fund's cash is invested separately (via separate bank account) to the Council's and the Fund has a bespoke Treasury Management Policy.

Following the continuing downgrading of the credit ratings of the UK banks, the Treasury Management Policy was revised in line with the Council's policy, to ensure there is adequate flexibility for the efficient management and investment of the short term cash.

In addition, as the Fund's cashflow profile is "maturing" more rapidly than previously anticipated (the monthly payment of pension payments is now exceeding the monthly receipt of pension contributions). As a result the Committee agreed changes to the Cash Management Policy which set a framework for utilising investment income and asset sales to meet pension payments (currently investment income covers the cash requirement and asset sales are not required). The review of the investment strategy took account of the cash flow requirements and as a result, the passively managed investments will be switched into pooled investment funds that distribute income to investors (rather than reinvest within the pooled fund).

e) Monitoring of Voting at Company Meetings

Voting at shareholder meetings is one tool with which the Fund can influence corporate behaviour. As the Fund's investments are managed by external managers, the voting decision is delegated to the manager, with the intention that the voting decision will be aligned with the investment decision. In 2011 the Fund appointed an agent to monitor the voting undertaken on behalf of the Fund and to report to Committee annually about the voting behaviour and the wider trends and issues around corporate governance. The first annual report was presented to Committee in 2012. From this report the Committee identified two areas they wanted managers to focus on that could have a significant impact on corporate performance:

(i) Remuneration policy and how it relates to corporate performance and objectives

(ii) Whether Board structures provide adequate independence to the decision making process and draws on experience and knowledge from a diverse selection of individuals

f) Administration

Following the introduction of the Pensions Administration Strategy, the Committee reviews Quarterly Performance Monitoring Reports showing the Fund's and employers' performance. Where the performance is below expectations, the Committee has used its influence where appropriate to discuss the issue internally with those responsible for service delivery. As the Fund rolls out the electronic data interface to more of the large employers during 2013 and other employers use the alternative electronic facility to inform the Fund of membership changes, it is expected that improvements in employer performance will be sustainable.

g) Workplans

Separate workplans are prepared for the Committee and Investment Panel detailing the forthcoming areas of work relating to investments strategy and policy and Benefits administration to give the Committee and officers the opportunity to review the and accommodate issues that may arise.

5 FUTURE BUSINESS

The Committee's (and Investment Panel's) focus over the next twelve months will be as follows:

a) Investments

- Investment Strategy – implement changes to the investment structure in line with the agreed strategy.
- Explore options for investing in infrastructure.
- Investigate how liability driven investing could assist in hedging the interest rate and inflation impact on the liabilities.

b) 2013 Triennial Valuation

- Agree the Funding Strategy Statement that sets the parameters for the funding plan and contribution rates.

c) Benefits Administration

- Respond to the on-going consultation exercises on the new LGPS Scheme and monitor the project to implement the new scheme including the communications plan to explain the changes and their significance to members and employers.
- Review the AVC Strategy on the number and types of funds to be offered to members to assist them in saving towards retirement.
- Approve any changes as a result of the Review of the Pensions Administration Strategy due after April 2013.

d) Governance

- Engage with and respond to government consultations expected during the year on the governance structure of funds at the local level and possible proposals to change the arrangements for administering the LGPS funds nationally.

Avon Pension Fund

June 2013