Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**18 JULY 2013**	**AGENDA ITEM NUMBER** **9**
TITLE:	**INVESTMENT STRATEGY IMPLEMENTATION WITHIN EQUITY AND BOND PORTFOLIOS**	
WARD:	**ALL**	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Global Equity Portfolio, JLT Appendix 2 – Bond Portfolio, JLT		

1 THE ISSUE

1.1 The Committee agreed the new investment strategy at the Special Committee Meeting on 6 March 2013. The implementation of the new strategy was delegated to the Panel and a workplan was agreed.

1.2 This report makes the following proposals for the implementation of the new strategic asset allocation:

(1) **Equity Portfolio** – Following agreement to fund the allocations to diversified growth and emerging market equities from the passive BlackRock equity portfolio, this paper proposes the appropriate regional allocation within the overseas equity portfolio and the timing for changes to be made.

(2) **Bond Portfolio** – Proposes changes within the bond portfolio to move towards the new target allocations and the timeframe for the changes.

(3) **Investments income** – Sets out how income will be taken from the passive equity portfolio and the UK corporate bond fund when it becomes necessary.

2 RECOMMENDATION

That the Investment Panel:

2.1 Agree the overseas regional equity allocation and arrangements for annual rebalancing set out in paragraph 4.9

2.2 Agree the changes to the allocation within the bond portfolio and timescale for the changes set out in paragraph 5.5

2.3 Note the intention to take income from the investments portfolio in line with the Cash Management Policy, as set out in paragraph 6.7

3 FINANCIAL IMPLICATIONS

3.1 Changes to the investments structure will impact investment management costs. The level of management fees reflects the nature of the mandate and approach taken by the manager. For example, appointing an active mandate which is funded from passively managed assets will have a corresponding increase in fees reflecting the more resource intensive (and therefore expensive) management approach of an active mandate. There will also be costs incurred in implementing changes to the investment management structure which include consultant's advice (for strategy and manager selection) and transition management costs.

3.2 Provision for advice and the cost of new mandates have been included in the budget. For budgeting purposes transition management costs and changes in management fees have been estimated prior to any mandates being agreed.

4 EQUITY PORTFOLIO – Overseas Regional Equity Allocation

4.1 At the Panel meeting on 4 June 2013, the Panel agreed to fund the new DGF and Emerging markets mandates from the BlackRock passive equity portfolio in two stages and use the opportunity to restructure the BlackRock passive portfolio to deliver appropriate regional allocations and options to take income.

4.2 The appropriate regional split within the overseas developed market equity portfolio was reviewed by JLT and their analysis is set out in Appendix 1. JLT advise a fixed regional allocation for developed market equities in order to address certain biases present in the market cap weighted global indices used as benchmarks by the Fund's equity portfolios. The proposed fixed split of 50% North America, 25% Europe, 12.5% Pacific Rim and 12.5% Japan mitigates against the market cap indices' heavy weighting towards the US markets in particular, and broadly maintains the current allocation. The regional allocation will be reviewed annually by JLT and any rebalancing activity driven by cash flows will take these target regional allocations into account. JLT's report at Appendix 1 provides further rationale for the regional split and rebalancing arrangements.

4.3 Table 1 reprises the changes to the strategic allocation agreed by Committee in March 2013:

Table 1 – Liquid Growth Portfolio (% of Fund Assets)

	Old Strategy	**New Strategy** (Target Allocation)	**Change**
Equities	**60%**	**50%**	**-10%**
UK	18%	15%	-3%
Overseas	42%	35%	-7%
(of which Developed markets)	*37%*	*25%*	*-12%*
(of which Emerging markets)	*5%*	*10%*	*+5%*
Diversified Growth	**0%**	**10%**	**+10%**
Total Liquid Growth	**60%**	**60%**	**=**

4.4 Focussing on the reduction in Overseas equities (including emerging markets) from 42% to 35%, Table 2 summarises the changes required from the current overseas equity allocation to achieve the proposed regional allocations after the

DGF and emerging markets allocations have been made (note that the Fund is currently overweight equities):

Table 2 - Overseas Equity Allocations (% of Fund Assets)

Equity Region	Current look through allocation (March 2013)	JLT proposed regional allocation (after allocations to DGF and EM Equity)	Change required
North America	18.49%	12.50%	-5.99%
Europe (xUK)	9.77%	6.25%	-3.52%
Japan	4.56%	3.13%	-1.43%
Pacific	4.20%	3.12%	-1.08%
Emerging Markets	5.80%	10.00%	4.20%*
Total Overseas Equities	**42.83%**	**35.00%**	

*Note that the Fund is currently tendering for an EM equity mandate to manage 5% of fund assets the result of which theoretically results in a small overweight to EM but this analysis includes the small allocation to EM within the Schroder active global equity portfolio which may or may not be maintained as it is at the discretion of the manager.

4.5 As agreed the allocations to DGF and emerging market equities are to be funded from the BlackRock passive equity portfolio. The Fund's active overseas equity mandates (managed by Genesis, Invesco, SSgA and Schroder) will remain unchanged. At the same time as implementing the new mandates, the passive equity portfolio managed by BlackRock will be adjusted to:

(1) reflect the revised regional allocations, and

(2) incorporate income units where available (this is discussed further in section 6).

4.6 The resulting changes within the BlackRock passive overseas equity portfolio are included in Appendix 1, at Table 3.1.

4.7 Implementation of the changes has been delegated to Officers. The changes will take place in two stages in line with when the two new mandates are invested. It is anticipated that the DGF mandate will be funded in October/November 2013 and the emerging markets mandate in January 2014. It should be noted that the proceeds from the redemption of the Man portfolio will initially be used to fund the DGF mandates (due to timing), so the Fund will remain overweight equities until the planned infrastructure investments are made, or until JLT advises differently on tactical grounds. In addition, Officers may seek to sell down the overweight UK passive fund before selling down the passive global fund to stay nearer the 30:70 UK:Overseas target through the period of change.

4.8 BlackRock will facilitate any switches within the passive portfolio via in specie transfers from existing funds thereby minimising transaction costs and the number of trades required to achieve required outcome. Officers will investigate the benefits of using an independent transition manager versus the services of BlackRock to achieve fund movements.

4.9 PROPOSAL: That the Fund's overseas developed market equity regional allocation is a fixed split of 50% North America, 25% Europe, 12.5% Pacific Rim and 12.5% Japan, rebalanced annually following review by JLT and Panel.

5 BOND PORTFOLIO

5.1 The new strategic allocation reduced the allocation to conventional gilts and increased the allocation to UK corporate bonds. Table 3 summarises these changes and provides the current allocation.

Table 3 - Bond Portfolio (% of Fund Assets)

	Old Strategy	New Strategy (Target Allocation)	Change in Strategic allocation	Current Allocation (31 March)	Change required in actual allocation
UK Gilts	**6%**	**3%**	**-3%**	**3.5%**	**-0.5%**
Index Linked UK Gilts	**6%**	**6%**	**=**	**6.7%**	**-0.7%**
UK Corporate Bonds	**5%**	**8%**	**+3%**	**6.2%**	**+1.8%**
Overseas bonds/ Other	**3%**	**3%**	**=**	**2.6%**	**+0.4%**

5.2 As the Fund was underweight gilts and overweight corporate bonds compared to the old strategy, the movement required to achieve the new strategic allocations is relatively small. Given the amount of changes being made to the investments portfolio at this time, it is proposed to make a significant move towards the target allocations within gilts, index linked gilts and corporate bonds and then 'fine tune' the allocations when the Fund is rebalanced once all the changes within the investments portfolio have bedded in. The proposed moves can be incorporated within the current investment structure. It is therefore proposed to allocate c.1.2% (actual amount is dependent on changes to market values in the interim) from the BlackRock Gilts and Index Linked Gilts funds to the RLAM UK Corporate Bond Fund.

5.3 JLT's brief at Appendix 2 discusses the timing for the switch and recommends an immediate allocation based on their outlook for yields and the relative value between gilts, index linked gilts and corporate bonds. JLT do not advise any tactical allocations within the bond portfolio at this time and so the proposed moves are towards the central target allocations. The rationale for these recommendations is further explained in Appendix 2.

5.4 Please note, the intention is to incorporate Signet's fund into the bond portfolio when make future changes to the portfolio to invest in infrastructure.

5.5 PROPOSAL: That the Fund switches assets from the BlackRock Gilt and Index Linked Gilt funds to RLAM UK Corporate Bond Fund to move towards the target allocations, as soon as is practically possible.

6 INVESTMENT INCOME

6.1 The Cash Management Policy allows for income to be taken to meet any shortfall in cash at the discretion of the Investments Manager taking into account the Fund's cash flow requirements. The income from the passively managed gilt and index linked gilt portfolios are no longer automatically reinvested, and the passively managed pooled equity funds will be invested in distributing units.

6.2 In 2012/13 c.£10m was taken from the investments portfolio to fund cash flow requirements, £6m of this was income from the gilt portfolios. Current cash flow forecasts show the requirement to take income from the investments portfolio rising to c.£17m in 2013/14 and c.£25m in 2014/15.

6.3 BlackRock intend to create income distributing units for the regional equity funds in their life fund range. The World fund that the Fund currently invests in will not have distributing units (it invests via the regional funds). Therefore the passive portfolio will be structured around the regional life income distributing funds as summarised in Appendix 1 at Table 3.1.

6.4 The estimated size of the passive equity funds managed by BlackRock under the proposed changes will fall from c22% of Fund assets to c10% of Fund assets (a fall of c.£380m at March 2013 market values). This reduces the opportunity to take income, however the reduction is offset by moving the assets held in the World fund (c10% of Fund assets at March 2013) which can't distribute income, to the regional funds which can. This results in the estimated income available from the passive equity portfolio to be of a similar scale despite the changes reducing the overall size of the passive equity portfolio – estimated at c. £20m for 2013/14.

6.5 Given the proposed reduction in gilt holdings it may also be necessary to invest a proportion of the enlarged UK corporate bond portfolio in the income distributing corporate bond fund managed by RLAM. This fund follows exactly the same investment strategy as the accumulating fund that the Fund currently invests in. Officers will decide the extent to which this portfolio needs to be invested in the income distributing fund based on the estimated cash flow requirements of the Fund.

6.6 It should be noted that where income is distributed from an investments portfolio, investment returns will be diminished and the cumulative effect of reinvestment is lost, which over a period of years can be significant. The decision not to re-invest income also impacts the performance monitoring of the mandates.

6.7 FOR NOTING: Income to be taken from the BlackRock passive equity portfolio and from the RLAM UK Corporate Bond Fund when it becomes necessary, in line with the Fund's Cash Management Policy

7 RISK MANAGEMENT

7.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund. The Committee has delegated implementation of the new target strategic asset allocation and return profile to the Investment Panel.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary.

9 CONSULTATION

9.1 N/a.

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 The issues to consider are contained in the report.

11 ADVICE SOUGHT

11.1 The Council's Monitoring Officer (Divisional Director – Legal & Democratic Services) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	
Please contact the report author if you need to access this report in an alternative format	