

Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND INVESTMENT PANEL	
MEETING DATE:	11 NOVEMBER 2010	AGENDA ITEM NUMBER
TITLE:	PASSIVE INVESTMENT	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of Attachments:		
Appendix 1 - Concentration within UK and Global Equity Indices		

1 THE ISSUE

1.1 At the Committee meeting on 24 September 2010, it was agreed that the Investment Panel would consider a further switch between the UK and overseas equity assets that are managed on a passive basis. This report provides the background to the issue and sets out the impact of altering the allocation on the Fund's risk level. The Panel are asked to consider whether any recommendations should be made to the Committee or whether any further work is required.

2 RECOMMENDATION

That the Investment Panel agrees:

2.1 Whether to recommend to the Committee that the allocation to passively managed UK equities should be reduced and the proceeds invested in a passively managed global equity portfolio

2.2 The percentage of assets to be switched under 2.1

3 FINANCIAL IMPLICATIONS

3.1 There is no impact on the investment management fees as the switch would be implemented within the passive equity portfolio managed by BlackRock.

4 BACKGROUND

4.1 The issue of concentration within the UK equity market has been discussed at previous Investment Panel and Committee meetings. The UK equity index is concentrated at both the stock and sector level. At the sector level the UK market is heavily weighted in financial stocks and oil & gas and at the stock level the top ten holdings account for 38% of the capitalisation of the index. In comparison, the top ten holdings in a Global index is 9% (see Appendix 1).

4.2 At the sector level there are significant differences to the allocations between the UK indices and global indices (see Appendix 1), in particular the technology, industrials, energy and materials sectors.

4.3 Concentration is an issue for the Fund due to its high allocation to passively managed UK equities. Within the UK equity allocation, 67% is managed passively (17% of total assets) and 33% is managed actively (8.5% of total Fund assets).

5 IMPACT ON FUND RISK & RETURN PROFILE OF SWITCH FROM UK EQUITIES TO OVERSEAS EQUITIES

5.1 In their paper of February 2010, JLT provided the following risk and return analysis if the UK equity exposure is reduced in favour of overseas/global equities managed on a passive basis:

UK:Overseas allocation	Expected Market Return	Absolute Volatility
45:55 (i.e. current allocation)	8.5%	16.0%
30:70	8.5%	16.2%

5.2 The expected long term return to the Fund does not alter if the allocation changes. However, a global universe would expose the Fund to increased stock and sector diversification.

5.3 The marginal increase in volatility is due to the currency risk introduced by the non-sterling equities. As the table demonstrates, an increase in the allocation by 15% to global equities generates a marginal increase in volatility, therefore a smaller increase of say 5% will result in a very small change in volatility. However, the Panel should note that the Fund will be actively hedging its currency exposure of its overseas equity portfolios in the future, thus the increase in volatility should be reduced.

5.4 The Fund currently invests 45% of its equity assets in UK equities and 55% in overseas equities. This is very similar to the allocation of the average WM LA Fund which allocated 44% to UK equities and 56% overseas equities (as at 31 March 2010).

5.5 The table below shows the effect of switching between passively managed UK and overseas equities from 45:55 to 30:70 on the equity allocation at the total fund level and on the allocation to passively managed UK and overseas equities at the total fund level:

		Current allocation (%)	Potential Allocations (%)		
			A	B	C
	% UK /Overseas equity within equity allocation	45 / 55	40 / 60	35 / 65	30 / 70
(1)	% of UK / overseas equities at total fund level	27 / 33	24 /36	21 / 39	18 / 42
(2)	% of UK / overseas equities managed passively at total fund level	17 / 12	14 / 15	11 / 18	8 / 21
(3)	% of UK / overseas equities managed actively at total fund level	10 / 21	10 / 21	10 / 21	10 / 21

5.9 The table shows that, for example, a 10% switch within the equity portfolio from UK to overseas equities (to 35% UK / 65% overseas – Column B) would result the following:

- (1) At the total fund level UK equities would fall to 21% from 27%, and overseas equities would rise from 33% to 39% of assets.
- (2) At the total fund level the UK equities managed passively would fall from 17% to 11%, and overseas equities managed passively would rise from 12% to 18% of assets
- (3) At the total fund level allocations to actively managed equities are unchanged.

5.10 Any switch between UK and overseas equities could be implemented within the passive portfolio managed by BlackRock in a cost effective way, without altering the level of assets managed by BlackRock. As discussed previously, given the passive nature of this portfolio the size of assets managed by BlackRock is not an issue.

5.11 The Panel needs to consider whether any recommendation needs to be made to the Committee or not. Officers are in favour of reducing the passively managed UK equity assets (by switching into passively managed global equities) to reduce stock/sector concentration risk that is significantly more prevalent in the UK equity index.

6 RISK MANAGEMENT

6.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management

processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

7 EQUALITIES

7.1 An equalities impact assessment is not necessary.

8 CONSULTATION

8.1 N/a

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 No decisions are being made. The issues being considered to make a recommendation to the committee are contained in the report and comments are sought in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Feinstein, Investments Manager 01225 395306
Background papers	
Please contact the report author if you need to access this report in an alternative format	