AVON PENSION FUND COMMITTEE - INVESTMENT PANEL

Minutes of the Meeting held

Wednesday, 18th November, 2015, 9.30 am

Members: Councillor Christopher Pearce (Chair), Councillor David Veale, Councillor Cherry Beath, Ann Berresford, Councillor Mary Blatchford and Shirley Marsh
Advisors: Tony Earnshaw (Independent Advisor), Steve Turner (Mercer) and James Giles (Mercer)
Also in attendance: Tony Bartlett (Head of Business, Finance and Pensions), Liz Woodyard (Investments Manager), Matt Betts (Assistant Investments Manager) and Matthew Clapton (Investments Officer)

12 EMERGENCY EVACUATION PROCEDURE

The Democratic Services Officer read out the procedure.

13 DECLARATIONS OF INTEREST

There were none.

14 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

There were none.

15 TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

There was none.

16 ITEMS FROM THE PUBLIC - TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

There were none.

17 ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

There were none.

18 MINUTES: 11 SEPTEMBER 2015

The public and exempt minutes of the meeting of 11 September 2015 were approved as a correct record and signed by the Chair.

19 MANAGING LIABILITIES - ADDITIONAL ANALYSIS

The Investments Manager introduced this item. She reminded members that at the previous meeting they had examined the concept of better matching the Fund's asset base to its liabilities and thereby reducing volatility in the funding position. They had considered the use of index-linked gilts to help with the management of inflation risks throughout the portfolio. At the end of the discussion the Panel had asked for further work to be done, in particular on how the framework would impact on the Fund's portfolios in terms of cash flow. Mercer's had accordingly prepared another presentation, which had been circulated with the agenda. She said that if the decision was taken to adopt the proposal in principle, the implementation would be spread over a period of years and would be taken into account in the next valuation.

Mr Turner and Mr Giles commented on the Mercer document *Risk management framework – further training and scenario analysis*, which had been circulated with the agenda.

Mr Turner said the aim was to address the volatility in and growth of the deficit with a long-term plan to manage risk in an effective way. He reminded Members that since the last valuation the funding level had been as high as 87%, but had now come down to about 75%. Liabilities had increased. At the previous meeting the Panel had decided to implement the first step, which was to switch the Fund's current holdings in fixed interest and overseas and overseas government bonds into index-linked gilts (to hedge 12% of the Fund). Mercer was in addition proposing that leveraging should be used to allow the Fund to match 36% of funded liabilities. The presentation gave details of the hedging instruments that could be employed. These were divided into physical instruments (fixed-interest gilts, corporate bonds, and index-linked gilts) and synthetic/derivative instruments (interest rate swaps, inflation swaps and gilt repos).

The report by Mercer was debated with significant discussion around the concept of leverage, the risks arising from leverage and how they would be managed including credit and counterparty risk and how the cash flows would be effectively hedged.

Responding to comments from the Independent Investment Adviser and from Members about the timing of investments, Mr Turner said timing was important, but there would never be a magic bullet to cope with short-term market changes; what was important was having a long-term plan to increase the level of protection. He did not think that interest rates would rise significantly in the near future. However, the deficit had risen, which would affect the valuation this year, and as the scheme is still open the liabilities will continue to grow.

The Chair asked Mr Turner about the supply of instruments to hedge the liabilities as supply might dry up as an increasing number of pension schemes invested in them, with the implication that the Fund should invest in them as soon as possible. Mr Turner thought that an increase in demand of a magnitude that would exhaust the supply was unrealistic, but a large volume of transactions would keep yields down. The Investments Manager said this needed to put in context, by, for example, comparison with how gilt yields had behaved over the past 10-20 years. Gilt yields are lower than they would be, because of pressure from pension funds to hedge their liabilities. But there were other factors, such as expectations for interest rates and inflation and the Government's stated intention to have a budget surplus rather than a deficit, which made it difficult to predict the trend in gilt yields. Mr Turner said that there was reason not to delay hedging, and the Fund should be considering a three-year programme to increase its investment in hedging instruments.

Representatives from Insight Asset Management gave a presentation on how an investment manager would implement such a strategy and how they would manage the risks and cashflows.

Responding to a question from a Member, the Investments Manager said that hedging of liabilities could be done within a pooling arrangement of LGPS funds, or could be kept independent of the pooling arrangements.

Members had further questions about the complexity of the concept, the mechanics of implementation and the difficulty of assessing the risks involved. One said LGPS funds are reluctant to get involved in such investments, because their complexity is challenging. Mr Turner replied that LGPS funds now regularly invested in asset classes that had once seemed too complex.

A Member asked how many LGPS funds were currently using this kind of hedging strategy. Mr Turner said that there were about ten.

The Head of Business, Finance and Pensions referred to the court ruling some years ago that it was unlawful for local authorities to invest in interest rate swaps, which was made after some local authority treasury departments had been using them for about seven years. Local authorities were therefore still cautious about this type of instrument. A Member asked whether it was now lawful for LGPS funds to invest in them. The Investments Manager replied said the investment regulations were going to be reviewed, and when updated should allow funds to adopt an investment framework that would allow this. However, funds were currently able to invest via pooled funds. It would take a long time to develop a liability hedging framework, which was why work on it had begun now.

RESOLVED:

1. That, in principle, the Fund should put a framework in placed to more effectively use the investment assets to match the liabilities.

2. To prepare a framework to be considered by the Panel for recommendation to the Committee. The proposal will bring together the work done to date and the proposed framework, including a 3 year plan to increase the level of matching and a longer term plan to reach a target level of matching when affordable.

After the discussion was concluded, the Head of Business, Finance and Pensions said that it was likely that Members still had questions about these issues. He suggested that it would unproductive if at the next meeting there was a rerun of today's discussions, so he invited Members to email any questions or concerns to the Investments Manager. Officers would then prepare a response identifying the benefits that could be achieved from this proposal.

The Chair said that a great deal of information had been presented to Members, and that it was important not to let the details obscure the fundamental issues. He said that a future report should focus on the basic principles and on how and when the proposal might be implemented. The Investments Manager suggested that the framework and the timescale of implementation could not be discussed until the basis for the next valuation was known.

20 REBALANCING POLICY

The Assistant Investments Manager presented the report. He said that there were target allocations for the different asset classes in the Fund, which were permitted to drift within defined ranges. Rebalancing was important to ensure that the Fund's assets remain invested in line with the target investment strategy. It also forced the selling of relatively expensive assets and the purchase of relatively cheap assets, tending to add value over time.

The Fund's current rebalancing policy was given in Appendix 1. For liquid assets the present policy allowed rebalancing between growth and stabilising assets when the balance deviated by +/-2%, and automatic rebalancing took place when the deviation was +/- 5%. Mercer had reviewed the policy, and were proposing narrower ranges and a more robust decision-making framework to reflect their views on the market outlook for different asset classes. The table on agenda page 163 showed the proposed rebalancing ranges. Two rebalancing ranges were set for each asset class in addition to the neutral range, according to whether the assets were deemed unattractive or attractive. Mercer's dashboard on page 127 summarised their view of the attractiveness of different asset classes. .

The proposed delegations for the operation of the policy were set out in subparagraphs 4, 5 and 6 of paragraph 6.1 of the report.

The Investments Manager explained that rebalancing was used for cash management.

A Member commented that the 'attractive' range proposed for emerging markets of 9-15% appeared high and out of line with the +/-1% 'neutral' range. She suggested that it might be the right time to increase the benchmark allocation of 10% for emerging markets, where good growth was to be expected in the longer term. Mr Turner said that benchmark for equities overall was 50%, of which emerging markets accounts for about one fifth of this and was a significant allocation.

RESOLVED to recommend to the Committee:

1. the revised rebalancing policy set out in Appendix 3 Section 1.

2. the implementation of the policy to be delegated to officers in consultation with the investment consultants where appropriate, as set out in Appendix 3 Section 2.

21 REVIEW OF INVESTMENT PERFORMANCE

The Assistant Investments Manager introduced this item and summarised the key performance information. He reported that Schroders were still rated amber on the RAG monitoring report, but their relative one-year performance had improved significantly. The mandates with Signet and Gottex had been terminated, so they no longer appeared in the RAG report.

Mr Turner commented on the Mercer investment performance report.

A Member said that she would like to know the ESG ratings of the Fund's investment managers. Mr Turner said this information could be provided.

RESOLVED to note the report.

The meeting ended at 12.23 pm

Chair(person) ....

Date Confirmed and Signed ....

Prepared by Democratic Services

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