

Avon Pension Fund

Investment Strategy Statement

1. Introduction

- 1.1 The Avon Pension Fund (the Fund) is administered by Bath & North East Somerset Council, which is legally responsible for the Fund. The Council delegates its responsibility for administering the Fund to the **Avon Pension Fund Committee** (the Committee), which is its formal decision making body. Members of the Committee represent a cross section of the Fund's stakeholders and therefore a range of views are taken into account when agreeing policy and strategy.
- 1.2 The Committee is supported by a sub-committee, the **Investment Panel** (the Panel), which considers matters relating to the management and investment of the assets of the Fund in greater detail. Although the Panel has delegated powers to take decisions on specific issues (including the selection, monitoring and termination of mandates) and makes recommendations to the Committee, setting the strategic asset allocation is the responsibility of the Committee. Operational implementation of strategy is delegated to officers.
- 1.3 In addition, the **Local Pension Board** has an oversight and scrutiny role to ensure good governance through monitoring of the Fund's performance, activity of the Committee and compliance with regulations and statutory duties. The Board's role is to assist the administering authority to ensure the management of the pension fund is effective and efficient.
- 1.4 This statement sets out the principles that will guide the Committee when making decisions about the investment of the Fund's assets. It also sets out the framework for investing the Fund's assets which is consistent with the funding strategy, as set out in the Funding Strategy Statement.
- 1.5 The Investment Strategy Statement (ISS) is an important governance tool for the Fund, as well as providing transparency in relation to how the Fund's investments are managed. This statement will be reviewed by the Committee at least triennially or more frequently should any significant change occur. There is ongoing quarterly and annual monitoring of the strategy which enables the Committee to take advice as to whether a review is needed at any time.
- 1.6 The Avon Pension Fund is a participant in **Brunel Pension Partnership** which is fundamentally changing the way in which the Fund's strategic asset allocation is implemented. This is a long term strategic partnership of ten LGPS funds. How pooling impacts the Fund's investment arrangements and the authority delegated to the new company is explained in detail in this statement.

2. Investment Beliefs

- 2.1 The Fund is a long-term investor whose aim is to deliver financially sustainable returns to meet the future pension benefits of its members. The Committee has a fiduciary duty to act in the best interest of the Fund's members. This includes managing Environmental, Social and Corporate Governance ('ESG') issues that may be financially material to the Fund.
- 2.2 The Fund has the following investment beliefs which underpin the investment strategy and guide decision making around investment of the Fund's assets.
 - **The Funding Strategy and the Investment Strategy, and thus the employer contribution rates, are inherently linked.** A material change to one cannot be effected without due regard for the others.

- **Strategic asset allocation** is the key factor in determining the risk and return profile of the Fund's investments.
- **Investment governance is key to effective decision making.** The Fund has a governance framework in place that ensures effective decision making regarding the investment of its assets.
- **Long term approach to investing.** The strength of the employer covenant¹ and funding strategy, which allows for any deficit to be recovered over time, enables the Fund to take a long term view of investment strategy.
- **Diversification of assets is an important element of the risk management framework.**
- **Environmental, Social and Governance factors** are important drivers of the sustainability of investment returns over the long term and they can have a material financial impact if not managed appropriately.
- **Active management can add value to returns, albeit with higher short term volatility.**
- **Value for money from investments** is important, in terms of net returns. Asset pooling is expected to help reduce costs over the long term, whilst providing more choice of investments, and therefore have the potential to enhance Fund returns.

3. Approach to Asset Pooling

- 3.1 The Fund participates with nine other administering authorities to pool its investment assets through the Brunel Pension Partnership. At the centre of the partnership is Brunel Pension Partnership Limited (Brunel), a company established specifically to manage the assets within the pool.
- 3.2 The Avon Pension Fund, through its Committee, retains responsibility for setting the detailed strategic asset allocation for the Fund and allocating assets to the portfolios provided by Brunel. Brunel, established in July 2017, is wholly owned by the ten administering authorities (in equal shares) that participate in the pool. The company is authorised by the Financial Conduct Authority (FCA). It is responsible for implementing the detailed strategic asset allocations of the participating funds (the 'clients') by investing the clients' assets within defined outcome focused investment portfolios. In particular, it researches, procures and selects the external managers or pooled funds required to meet the investment objective of each portfolio. Brunel will create collective investment vehicles for quoted assets such as equities and bonds; for private market investments it will create and manage an investment programme with a defined investment cycle for each asset class.
- 3.3 As a client of Brunel, the Fund has the right to expect certain standards and quality of service. The Service Agreement between Brunel and its clients sets out in detail the duties and responsibilities of Brunel and the rights of the Avon Pension Fund as a client. It includes a duty of care of Brunel to act in its clients' interests.
- 3.4 The governance arrangements for the pool have been established. The Brunel Oversight Board is comprised of representatives from each of the administering authorities and two member observers with agreed constitution and terms of reference. Acting for the administering authorities, it has ultimate responsibility for ensuring that Brunel delivers the services required to achieve investment pooling and deliver each Fund's investment strategy. Therefore, it has a monitoring and oversight function. Subject to its terms of reference it will consider relevant matters on behalf of the administering authorities, but does not have delegated powers to

¹ The Employer covenant is the employer's financial ability to support its legal obligations arising from its defined benefit pension scheme now and in the future

take decisions requiring shareholder approval. These are remitted back to each administering authority individually. As shareholders of Brunel, the administering authorities' shareholder rights are set out in the Shareholders Agreement and other constitutional documents.

- 3.5 Brunel Oversight Board is supported by the Client Group, comprised primarily of investment officers drawn from each of the administering authorities but will also draw on Administering Authorities finance and legal officers as required. It has a primary role in reviewing the implementation of pooling by Brunel, including the plan for transitioning assets to the portfolios, and provides a forum for discussing technical and practical matters, confirming priorities, and resolving differences. It is responsible for providing practical support to enable the Brunel Oversight Board to fulfil its monitoring and oversight function. Once the assets are managed within the Brunel portfolios, the Client Group will monitor Brunel's performance and service delivery. The Committee and Investment Panel will receive regular reports covering portfolio and Fund performance and Brunel's service delivery.
- 3.6 The proposed arrangements for asset pooling were formulated to meet the requirements of the Regulations and Government guidance. Regular reports have been made to Government on progress, and the Minister for Local Government has confirmed on a number of occasions that the pool could proceed as set out in the proposals made.
- 3.7 Bath & North East Somerset Council approved the full business case for the Brunel Pension Partnership in 2017. The process of transitioning the Fund's assets to the portfolios managed by Brunel started in April 2018 (the passive equity assets transitioned in July 2018) and is expected to be completed (except for legacy private market assets) during 2021. A transition timetable agreed between the clients and Brunel is regularly monitored by the Client Group. Until such time as transitions take place, the Avon Pension Fund will continue to maintain the relationship with its current investment managers and oversee their investment performance, working in partnership with Brunel where appropriate.
- 3.8 Following the completion of the transition plan, it is intended that all of the Avon Pension Fund's assets will be invested through Brunel portfolios. However, the Fund has certain commitments to long term illiquid private market and fund of fund investments which will take longer to transition across to the Brunel portfolios. These assets will be managed in partnership with Brunel until such time as they are liquidated, and capital is returned. It is also recognised that the implementation of the Fund's Liability Risk Management Framework and Equity Protection Strategy, via Brunel, will need to be carefully considered, when appropriate.

4. Investment Objective

- 4.1 The Fund's investment objective is to achieve a return on the assets, consistent with an acceptable level of risk that will enable the Fund to meet its pension liabilities over time, that is, to achieve 100% funding in line with the funding strategy. The investment strategy must therefore generate returns that will help stabilise and minimise employer contribution rates in the long-term, as well as reflect the balance between generating return consistent with an appropriate level of risk, protecting asset values from market falls and matching liabilities.
- 4.2 The investment strategy is reviewed at least every three years to reflect the changing liability profile of the Fund. At the date of the 2016 actuarial valuation, the Actuary's assessment of future investment returns for the investment strategy generated a best estimate average expected return of CPI +3.5% per annum. In setting the funding strategy a margin for prudence is taken on these expectations. As a result, to achieve 100% funding for the 2016 valuation, a minimum return of

CPI +2.2% per annum (the discount rate) over 16 years was assumed in the Funding Strategy.

- 4.3 The Investment Strategy was last reviewed in 2017. Following changes made to the asset allocation and given the fall in bond yields since the 2016 valuation, the minimum return target to achieve 100% funding reduced to CPI +2.1% per annum.²
- 4.4 The Fund adopts a more prudent investment strategy for those liabilities where the employer has ceased to participate in the Fund or for certain admission bodies where there is no guarantee underpinning the liabilities. The assets are invested in corporate bonds and the liabilities are valued using the yield on the corporate bonds as the discount rate. As this portfolio of assets grows in size, a bespoke investment strategy will be explored to match cash flows and hedge inflation and interest rates more efficiently. The objective will be to reduce the volatility in employer contributions.

5. Investment strategy and the process for ensuring suitability of investments

- 5.1 The long term nature of the liabilities means the Fund can allocate a larger weighting to assets expected to generate a higher return (or growth assets) which may introduce volatility in the short term but are ultimately expected to generate higher returns than the other assets in the long term. The investment strategy takes into account the expected risk-reward profile of each asset class and is flexible enough to take advantage of short term opportunities to achieve its strategic returns and fulfilling its fiduciary duty to members.
- 5.2 The Fund invests across a diversified portfolio of investments to reduce investment risk. The majority of the investment portfolio is invested in a diversified range of return seeking assets which aim to generate capital growth and income, constructed in a way to achieve the required investment return.
- 5.3 However, as the liability profile of the Fund matures, the Fund has begun to increase its exposure to assets that better match the cash flow profile of its pension liabilities. This includes the allocations to Secured Income and Infrastructure where inflation linked income is a significant driver of return on these assets.
- 5.4 The Fund has also implemented a Liability Risk Management Framework (LRMF), which uses the Fund's allocation to Index Linked Gilts more efficiently to increase the certainty of achieving its return objective. It does this by structuring the Index Linked Gilts and derivatives in a way that better matches the pension benefit cash flows that the Fund will pay out in the future. This strategy is explained in more detail in the Risk Management section.
- 5.5 As the Fund nears full funding, the asset allocation reflects a lower risk appetite, particularly a reduction in equity risk; however, there remains a need for sufficient equity exposure to sustain the investment return within the funding strategy. As there was a significant improvement in the Funding Level at the time of the 2017 Investment Review, an Equity Protection Strategy (EPS) is in place to protect the improvement in the funding level from future falls in the equity markets. This strategy uses synthetic equity instruments, specifically options on global equity indices. The objective is to materially reduce the risk that contributions will need to rise at the next valuation in order to restore a funding deficit caused by a fall in equity markets.

² Each time the Fund estimates the funding level in-between valuations, the financial market assumptions are updated to reflect actual market prices; all other assumptions remain unchanged. The financial assumptions are updated so that the valuation basis of the liabilities is the same as for the assets. If the Fund was invested 100% in bonds, then a 0.5% reduction in bond yields would cause a 0.5% reduction in the Discount Rate. As the Fund has a diverse mix of assets, the impact of the fall in bond yields is reduced.

- 5.6 Strategies that utilise synthetic instruments, derivatives and currency forward contracts require the positions to be 'collateralised'. This is because the positions are marked-to-market daily and the Fund has to be able to fund that position. As a result, the Fund holds collateral to support the EPS, LRMF and its currency hedging policy.
- 5.7 The strategic framework includes a target allocation against which strategic performance will be monitored. In addition, there are ranges for each asset category that allow limited deviation within the framework. The ranges enable the Fund to reflect changes in the market outlook and provide greater flexibility to manage cash flows and rebalancing. Over the long term, the ability to periodically rebalance asset holdings to release cash will enable the Fund to effectively implement de-risking strategies such as the LRMF and EPS.
- 5.8 The Fund's long term asset allocation, along with an overview of the role each asset plays is set out in the following table. The upper bound of the permitted range represents the maximum percentage that can be invested in that asset class. The allocation to Secured Income (mainly Long Lease Property and operational infrastructure assets that generate income) and the increase in Infrastructure will be implemented over the next few years. Until these investments are made, the allocations to Multi Asset Credit and Property will be higher than the long term target allocations. Other asset classes included in the Investment Review but not considered a strategic priority included Private Equities and Debt. It is, however, envisaged that the merits of these asset classes, as well as others deemed suitable to meet the Fund's investment objective will be reviewed in the future.

Asset Class	% of Fund	Permitted Range	Role within Strategy
Equities	37.5%	27-47%	Highest risk asset class, builds exposure to domestic and overseas companies, returns expected to outstrip fixed income, limited impact of inflation, comprises both passive and active approaches, with the latter designed to outperform the market.
Developed Market Equities	32.0%	27-37%	Possess characteristics e.g., highly developed capital markets, high liquidity, bond 'proxies'/income seeking, large and small market cap. Includes a UK SRI specific mandate. Given the globalisation of sectors and companies, the strategic policy is to allocate to global markets. As a result there is not a specific allocation to UK equities or other regional markets. The long term aim is allocate to UK Equities in line with its global market cap. The allocation UK equity is currently c.10.6%.
Emerging Market Equities	5.5%	0-10%	Possess characteristics such as rapid growth, illiquidity premium, potential for large capital growth.
Diversified Growth Funds (DGF)	15%	10-20%	To provide an equity like return over the long term but with a lower level of volatility. Can include allocations to equities, bonds, cash and other assets (including through derivative exposure), which are dynamically managed. Expected to provide some downside protection in periods of equity market stress.
Illiquid Growth	27.5%	10-37.5%	Benefits from the 'illiquidity premium' where the Fund is compensated for locking assets up for a predetermined period.

Hedge Funds	5%	0 - 7.5%	Operates in a range of niche markets, looking to generate returns from unconstrained active management, reduces the volatility of the Growth portfolio and increases diversification of returns.
Property	7.5%	5 - 10%	Provides further diversification to Growth portfolio. Includes private markets exposure where returns are less correlated with listed markets, and where the Fund is expected to receive a higher return. Property is expected to provide a hedge against inflation in the medium to longer term.
Secured Income	7.5%	0-10%	Backed by long maturity assets, Secured Income assets include long lease property, operational infrastructure assets and residential housing. These assets generate contractually secure income streams that provide a greater stability of returns, explicit inflation linkage and generate cash flows over time
Infrastructure	7.5%	5-10%	Investments in UK and global infrastructure assets seek to invest in assets with strong market positions, predictable regulatory environments and high barriers to entry. Infrastructure is expected to provide a hedge against inflation in the medium to longer term. Some development risk will be considered.
Other Opportunities	0%	0 - 5%	Leaves capacity for investment in other illiquid growth assets which seek to increase diversification across the portfolio.
Credit	8%	3-14%	
Multi Asset Credit	6%	3-9%	In the portfolio to generate returns from a broad range of credit based assets in a diversified way.
Corporate Bonds	2%	0-5%	Corporate bond prices have credit risk of the issuer embedded within the price and are therefore considered higher risk than government issued securities and are expected to generate returns commensurate with this higher credit risk. Held to broadly match a specific proportion of the liabilities
Liability Matching (Collateral Assets)	12%		
	0%	0 - 10%	Low risk of default, and can provide protection against the impact of changes in interest rates on the Fund's liabilities. Not currently held.
	12%	<i>range determined by collateral requirement</i>	Index linked bonds provide a direct hedge against inflation risk. Low risk of default. Bonds can be structured by varying the maturity of the bonds held to match the pension payment cash flows.
Cash*	0%	0 - 5%	Cash is also exposed to credit risk and is generally a very low yielding asset. For this reason the Fund aims to be as fully invested as possible given requirements for working capital and the management of cash flows for private market assets.

* Cash is separately accounted for and is invested in line with the Fund's Treasury Management Policy.

5.9 The Fund currently implements its strategy through mandates managed by a number of external investment managers. Implementation and choice of investment approach and manager is dependent on the asset class, how the investment objective of the asset class drives overall risk and return and investment costs.

- 5.10 The current management arrangements include passive mandates that deliver the market return by replicating the index in a cost and implementation efficient manner as well as active mandates where managers are using their skill to enhance the market return and manage risk, to a greater or lesser extent. This includes the mandates in place across equities, multi asset credit, DGFs, hedge funds, property, secured income and infrastructure mandates.
- 5.11 Consideration of each asset class or investment approach includes modelling of risk adjusted return expectations and an assessment of the extent to which the investment manager's approach is consistent with the Fund's Responsible Investment (RI) Policy including an assessment of the Environmental, Social and Governance (ESG) risks and opportunities identified for each asset class. Product structure and management costs will also be a factor.
- 5.12 However, from 1 April 2018 implementation of the Fund's investment strategy is delegated to Brunel with all assets transitioning into portfolios set up by Brunel over the next few years. Brunel is responsible for constructing each portfolio, deciding the number of underlying mandates, allocation to style and approach to investing, selecting and monitoring the managers within each portfolio, controlling investment risk within each portfolio and reporting back to its clients as the "Investment Manager". Currently Brunel is only managing passive equity assets having appointed LGIM as the manager. The Fund's passively managed Low Carbon portfolio transition into Brunel in July 2018. As the ISS is updated in the future more of the assets will be invested in Brunel portfolios.

Details of the investment management structure can be found in Appendix 1.

6. Risk Measurement and Management

Investment Risk

- 6.1 The risk and return profile of the assets is measured against the strategic objective and considered in the context of the Fund's capacity as a long term investor. The main risk to the Fund is that the Fund's assets do not produce the returns needed to meet the liabilities, as determined by the Funding Strategy Statement. The main risk to the employers is the volatility of the contribution rates, and affordability.
- 6.2 The Committee recognises that, whilst investing in higher risk assets increases potential returns over the long-term, it also increases the risk of a shortfall in returns relative to that required to cover the Fund's liabilities, as well as producing more short-term volatility in the funding position. The Fund's diverse range of asset classes and approaches to investing is designed to achieve returns in a variety of market environments. By holding a range of assets that are not perfectly correlated, the Fund expects to reduce the level of risk it is exposed to, whilst increasing the potential to generate attractive risk-adjusted returns.
- 6.3 In addition, specific strategic risks are managed via the Liability Risk Management Framework and the Equity Protection Strategy which are explained below.
- (i) The overarching objective the LRMF is to reduce funding level volatility by increasing the Fund's exposure to lower risk assets that better match the value of the liabilities. The Fund cannot reduce its exposure to growth assets (e.g. equities) and use the proceeds to purchase 'liability matching' assets (e.g. Index Linked Gilts³), as return expectations would then fall short of the assumptions built in to the funding plan. The LRMF allows the Fund to retain its allocation to growth assets and simultaneously increase its exposure to 'matching' assets through the use of

³ Index Linked Gilts are considered the best match for being able to pay out income equivalent to the Fund's liabilities as their cash flows are adjusted for inflation, as are the pension liabilities

repurchase agreements, (a form of borrowing in capital markets) and interest and inflation swaps⁴.

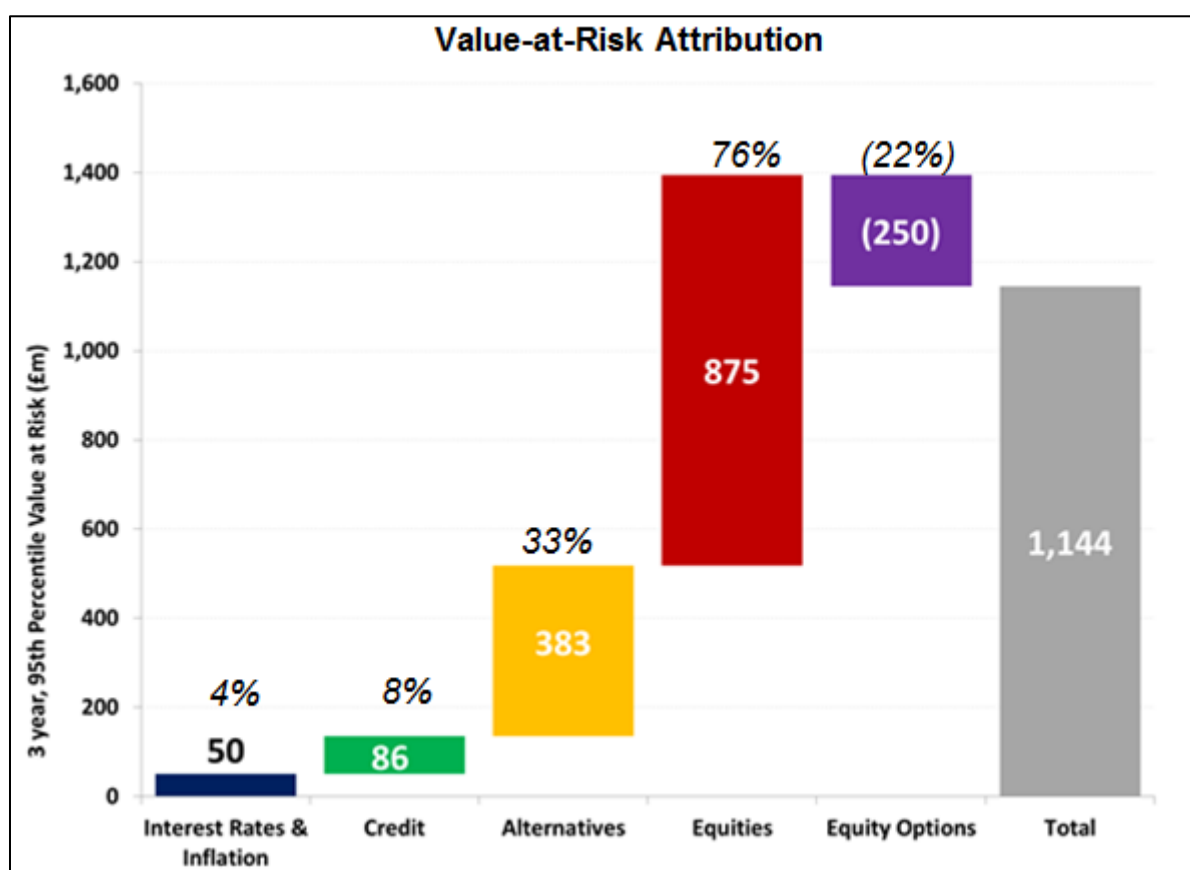
In order to meet the assumed investment return in the Funding Strategy of CPI+2.2%, the LRMF includes a number of predetermined 'real yield' triggers, where exposure to Index Linked Gilts is only increased when they pay a sufficiently high real yield to meet the Fund's requirements. 'Real yields' are the combination of nominal interest rates, that is the risk free interest rate attached to conventional Government bonds (gilts), plus the market expectation for future inflation rates. The trigger framework allows each component to be locked in separately to ensure the Fund does not forego an opportunity to lock in a favourable inflation rate or nominal interest rate and thereby increase the probability of capturing the required investment return.

Locking in either element of the 'real yield' according to the Fund's predetermined trigger framework brings with it a potential opportunity cost where inflation and/or nominal interest rates could be accessed at more attractive levels given a shift in market prices. However, the trigger framework is considered prudent enough that should this happen the Fund will ultimately still achieve its objective of being able to meet pension payments when they fall due. The trigger levels are reviewed for appropriateness every six months by the Fund's investment advisor.

- (ii) The EPS is underpinned by the funding level and protects the Fund's developed market equity assets against a significant draw down in equity market prices. However, equity gains are capped at c. 108% funding level (plus dividend income over the period the protection is in place). Capping the upside enabled the Fund to structure the downside protection efficiently in terms of protection levels and costs. The maturity of the EPS is structured to provide protection over the 2019 triennial valuation, meaning the Fund will have certainty of equity returns throughout this period.
- 6.4 Both risk management strategies are held in a Qualified Investor Fund (QIF), bespoke to the Fund, enabling all collateral management to be delegated to the investment manager. The LRMF and EPS both contain derivative instruments that require collateral (often in the form of cash) to be posted on a daily basis, to protect all parties to the transaction against the risk that one defaults and is unable to fulfil the terms of the financial contract.
- 6.5 To reduce the risk of the Fund having to sell assets at short notice to meet its obligations under the collateral agreements, there is an allocation to a passively managed pooled equity fund in the QIF. The investment manager will sell units in the equity fund in the QIF and purchase eligible collateral (gilts or cash) to meet collateral obligations when they arise. However, derivatives are then used to replicate the equity assets sold in order that the strategic allocation to equities is maintained.
- 6.6 The Value at Risk Attribution graph provides an indication of the main sources of investment risk that contribute to the volatility of the Fund's funding position, as measured by a three year "value at risk". This shows that in a downside scenario, which has a 1 in 20 (5%) chance of occurring, the impact on the deficit relative to the "best estimate" of what the deficit would be in three years' time. Equities remain the largest source of risk even after implementing the equity protection strategy.

⁴ An inflation swap is a contract used to transfer inflation risk from one party to another through an exchange of cash flows. An Interest rate swap is a contract to exchange a fixed interest rate for a floating rate, or vice versa, to reduce or increase exposure to fluctuations in interest rate.

- 6.7 The chart shows that if a 1-in-20 downside event occurred, in three years' time the deficit would be expected to increase by at least an additional £1,144m on top of the expected deficit at that time. This compares to an equivalent figure of £1,404m as at 31 March 2017, showing the significant downside risk reduction achieved as a result of the reduction in physical equity holdings and the implementation of the EPS.
- 6.8 The Investment Strategy is designed to be a long term strategy and withstand volatility and various risk scenarios. Scenario analysis is carried out as part of the strategic investment review. In the light of such events occurring, the long term strategy would be reviewed as appropriate. The strategic allocation has ranges around each allocation which enables tactical positions to be implemented to reflect the shorter term market outlook.



Source: Mercer

Note: approximate analysis as at 31 March 2018, based on the Fund's strategic asset allocation at that time.

- 6.9 Each investment mandate is assessed quantitatively and qualitatively within a monitoring framework designed to address any underperformance, highlight any inappropriate risk taking behaviour and address factors that may impact the manager's ability to achieve long term outperformance goals. The performance of each manager is monitored against three year performance targets, consistent with a longer term investment approach. A number of risk metrics are monitored at the portfolio level including tracking error (the difference between the portfolio's return and the benchmark return it is measured against) and active risk positions (actual weighting of holdings versus the benchmark). At the Fund level, Value at Risk and the correlation between asset returns are monitored.
- 6.10 The following risks are also considered by the Committee:

(i) Governance Risk

This is the risk that Committee members do not have sufficient expertise to evaluate and challenge the advice they receive.

The Fund recognises the importance of maintaining an appropriate level of knowledge across the Committee and periodically the committee self-assesses its level of knowledge. It has taken steps to ensure that Committee members possess an appropriate level of knowledge, skill and understanding to discharge their fiduciary duties by having a training framework in place which is based on CPIFA's (Chartered Institute of Public Finance and Accounting) Knowledge and Skills Framework for LGPS funds. Officers commission expert advice to support strategic and implementation decisions. In addition, the Fund maintains a Risk Register that is regularly updated and monitored by the Committee.

(ii) Exchange Rate Risk

Foreign currency exposure is expected to be an unrewarded risk over the longer term.

The Fund has a hedging programme to protect the sterling value of its hedged overseas investments and to reduce the volatility that arises from movements in exchange rates. The programme consists of a 50% passive hedge of the US Dollar, Yen and Euro currency exposure for the Fund's developed market equity holdings, and a 100% hedge of currency risk for the infrastructure, global property and hedge fund investments. This passive approach seeks to achieve this reduction in volatility in an efficient and cost effective way. As a result of hedging these assets, in periods of sterling weakness the investment return will be lower than if the assets were unhedged.

(iii) Liquidity Risk

The inherent risk of holding illiquid/less liquid assets that cannot be easily converted into cash.

Given the long-term investment horizon of the Fund it is appropriate to accept liquidity risk where the Fund expects to benefit from an 'illiquidity premium'. However, the majority of the Fund's assets are held in liquid instruments and realisable at short-notice. The appropriate level of liquidity in the Fund is considered at each strategic review.

(iv) Cash Flow Risk

The Fund is becoming more mature and is slightly cash flow negative as payments to pensioner members exceed contributions.

The investment strategy is structured to generate investment income to help manage these negative cash flows. Monitoring cash flow is critical to the internal monitoring and rebalancing process and is an important consideration when setting investment strategy.

(v) Valuation Risk

The actuarial valuation assumes that the Fund generates an expected return equal to, or in excess of, the Fund's discount rate.

An important risk to which the Fund is exposed is that the actual return is not adequate, either due to higher than expected increases in CPI increasing liabilities more than expected, or if the assets do not deliver as expected. This risk is reduced by implementing a diversified investment strategy, through the alignment of the investment strategy with funding requirements through regular reviews, and through regular monitoring. The LRMF and EPS are solutions designed to mitigate aspects of this risk.

(vi) Longevity Risk

This is the risk that the members of the Fund live longer than assumed in the actuarial valuation model.

This risk is captured within the funding strategy which is monitored by the Committee on at least a three yearly cycle. Any improvement or deterioration in longevity will only be realised over the long term.

(vii) Regulatory and Political Risk

Across all of the Fund's investments, there is the potential for adverse regulatory or political change.

Regulatory risk arises from investing in a market environment where the regulatory regime may change. This may be compounded by political risk in those markets subject to political uncertainty. These risks are managed by diversifying across markets and are monitored by reviewing the investment strategy and specific investment mandates.

(viii) Employer Covenant Risk

There is a risk that employers within the Fund lack the financial capacity to make good their outstanding liabilities.

This risk is addressed through a covenant assessment monitoring process, which annually assesses the financial standing of all Employers in the Fund and the analysis is considered when setting the Funding Strategy. In addition a more prudent investment strategy is adopted for certain admission bodies and orphan liabilities where there is no guarantee underpinning the liabilities.

(ix) Environmental, Social and Governance (ESG)

ESG issues may be financially material to the Fund.

The Responsible Investing Policy sets out how the Fund will integrate ESG issues into its investment strategy, processes and ownership practices in the belief this can effectively mitigate the risks and positively impact investment performance. The materiality of ESG on each asset group is considered as part of the Strategic Reviews. In addition, relevant ESG criteria are considered for each mandate and are evaluated when selecting and monitoring managers.

The Fund's Responsible Investing Policy which provides greater detail on how ESG issues are managed within the investment strategy can be found on the Fund's website.

(x) Collateral Management Risk

The Fund recognises the importance of collateral to support specific components of the overall investment strategy. The Fund has implemented a robust and pro-active collateral monitoring process to ensure that the LRMF, EPS and currency hedging strategies are appropriately supported with adequate assets available for use as collateral at any point in time. This is important as in the event of a large adverse movement in market prices there is a risk that these unfunded investment strategies will require additional collateral, often in the form of cash, to be posted in order to maintain the strategies. The posting of collateral is a bilateral agreement designed to protect all parties to a transaction from the risk of default.

7. Environmental, Social and Corporate Governance (ESG) Policy

7.1 The Committee has a fiduciary duty to act in the best interest of the Fund's members and aims to deliver financially sustainable returns to meet the future pension benefits of our members. This includes managing Environmental, Social and Corporate Governance issues that may be financially material to the Fund.

7.2 The Fund has a Responsible Investing (RI) Policy where it defines RI as the integration of ESG issues into its investment processes and ownership practices in the belief this can positively impact financial performance.

7.3 These ESG issues are central to the Fund's responsible investment beliefs, which are set out in the Fund's published Responsible Investment Policy (RI), which supports

the wider investment strategy. In developing its approach to RI, the Fund seeks to understand and manage ESG and reputational risks to which the Fund is exposed.

7.4 The Fund's approach to Responsible investing is based on its RI Principles as follows:

- As a long term investor it seeks to deliver long term sustainable returns
- Management of ESG risks is consistent with the Fund's fiduciary duty to members
- ESG issues are integrated at all stages of the investment decision-making process
- Strategies and policies must be evidence-based
- The Fund has a duty to exercise its stewardship responsibilities as an owner
- The Fund aims to be transparent and accountable
- Recognition that Climate Change is an ESG factor that poses a potential long-term financial risk to the Fund

7.5 The Fund's policy is to integrate RI across its investment decision-making process for the entire portfolio. ESG issues considered when setting the investment strategy and objectives include the impact of ESG issues on each asset class, the materiality of ESG risks within those asset classes and whether there are any strategic ESG-related opportunities that would generate value. The extent to which managers evaluate and manage ESG issues in their investment process is assessed in the selection, retention and realisation of investment managers.

7.6 The Fund does not have an exclusion policy to divest from specific assets, but manages such risks by analysing ESG factors identified as potentially financially material in its strategic reviews. The Fund expects its managers to engage with company management on ESG issues they have identified as being a risk to the investment case; it is the Fund's belief that engagement and responsible stewardship will influence corporate behaviour more effectively than divestment. Managers are required to report to the Fund on their engagement activities and other ESG initiatives regularly.

7.7 Having identified Climate Change as a potential long term risk to the Fund's assets, the Fund monitors its carbon exposure annually to inform strategic decisions relating to climate change. As a result of such analysis, the Fund's equity allocation that is managed passively is invested in a Global Low Carbon Equity Index Fund. This Low Carbon fund does not exclude investments in carbon intensive stocks but significantly reduces the carbon exposure (by around 2/3rds) in a risk adjusted way through stock selection so that over the long term the return from this portfolio should be similar to the mainstream index.

7.8 As well as setting out the longer term framework, the RI policy identifies shorter term strategic priorities which are reviewed annually.

7.9 The Fund expects its investment advisors to proactively consider and integrate ESG issues when providing investment advice to the Fund. In addition, the Fund will assess the extent to which investment managers integrate ESG risks into their investment approaches.

7.10 The Fund recognises the importance of collaboration with other investors in order to achieve wider and more effective outcomes. In this respect, the Fund is a member of the Local Authority Pension Fund Forum (LAPFF), a membership group of LGPS funds that focuses on corporate governance issues, and the promotion of high standards of corporate governance and responsibility.

7.11 Both the Committee and the Pensions Board have members and other stakeholder representatives who actively engage with stakeholders to ensure the Fund is aware and can respond effectively to stakeholder concerns.

- 7.12 For the assets invested in the Brunel portfolios, Brunel will be responsible for managing ESG aspects on behalf of the Fund; the Fund will still have responsibility when setting its investment strategy. It is expected that Brunel will meet all the Fund's requirements with regard to Responsible Investing and develop them further over time. As a Client of Brunel, the Fund feeds into the policies adopted by Brunel for the pool.
- 7.13 Brunel's Investment Principles articulates clearly its commitment and that of each underlying Fund in the pool, to be responsible investors and as such recognises that ESG considerations are part of the process in portfolio construction, the selection, non-selection, retention and realisation of assets. One of the principal benefits achieved through scale and resources arising from pooling, is the improved implementation of responsible investment and stewardship across all the portfolios.
- 7.14 Each Brunel portfolio specification explicitly includes responsible investment and an assessment of how ESG considerations may present financial risks to the delivery of the portfolio objectives. These considerations are taken into account when constructing the Brunel portfolios and in the selection, non-selection, retention and realisation of assets. The approach undertaken will vary in order to be the most effective in mitigating risks and enhancing investor value in relation to each portfolio and its objectives.
- 7.15 Brunel is a signatory to the UN backed Principles of Responsible Investment and has published a comprehensive Responsible Investment Policy. The policy has been developed in conjunction with the Brunel Oversight Board and Client Group. The policy provides a framework under which Brunel will publish supporting guidelines, position statements, annual implementation and engagement plans, proxy voting policy and voting records. For more information visit the Brunel Pension Partnership website.

Social Investments

- 7.16 Investments that deliver social impact as well as a financial return are often described as "social investments". Social investment includes a wide spectrum of investment opportunities. The Fund applies risk and return criteria consistently when evaluating all investment opportunities including those that address societal challenges as well as generate competitive financial returns with an acceptable risk / return profile in line with the investment strategy.
- 8. Policy of the exercise of rights (including voting rights) attaching to investments**
- 8.1 The FRC UK Stewardship Code (the Code) explains that "stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole." The Fund is a signatory to the Code and has outlined its approach to stewardship, including voting and engagement in its Statement of Commitment to the Code. The Fund has been evaluated by the FRC as Tier 1 compliant. A Tier 1 rating is defined as those providing a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.
- 8.2 The Fund believes that voting is an integral part of the RI and stewardship process. Under the current arrangements voting is delegated to its investment managers; however, the Fund regularly monitors how its investment managers undertake voting and engagement activities in comparison to relevant codes of practice. Where practicable, the Fund will exercise its voting rights in all markets and its investment managers are required to vote at all company meetings. The Fund retains the right to

recall stock that has been lent out under its securities lending programme to enable voting.

8.3 The Fund publishes a Responsible Investment Report annually which includes analysis of the voting and engagement activity of its investment managers.

8.4 Avon Pension Fund will continue to operate under the current stewardship arrangements until its assets are transitioned into the Brunel portfolios, when Brunel will take over responsibility for each portfolio. Brunel is fully supportive of the UK Stewardship Code and the effective oversight of the companies in which we invest, including the exercise of our rights as a shareholder.

8.5 As part of owning publicly listed companies Brunel, on behalf of its clients, will have the opportunity to vote at company meetings (AGM/ EGMs). To provide guidance to its managers, Brunel has a single voting policy for all assets managed by Brunel in segregated accounts. Hermes EOS has been appointed to support Brunel as its engagement and voting service provider. Brunel will publish its voting policy and provide online voting records at least annually.

9. Monitoring

9.1 The investment strategy is monitored regularly by the Committee and Panel with an annual review to monitor whether the strategy has delivered as expected and whether any changes need to be considered between strategic reviews. The Panel periodically review aspects of the strategy due to changes in market environment, or concerns about asset class or manager performance.

9.2 A strategic review is undertaken at least every three years, after the triennial valuations, to ensure the investment strategy is consistent with the funding strategy and liability profile and takes into account forward looking return expectations for all assets classes.

10. Advice Taken

9.1 In preparing this statement, the Committee has taken advice from Fund Officers, the Fund's appointed investment consultant and the Client Officer Group at the Brunel Pension Partnership. The Fund's Pension Board reviews the Investment Strategy Statement before it is approved by Committee.

11. Publication

10.1 This is a public document and is published on the Fund's website www.avonpensionfund.org.uk/finance-and-investments. Documents referred to in this Statement are listed in Appendix 2 and are also published on the Fund's website.

Draft – Approved by Avon Pension Fund Committee on 7 December 2018

Appendix 1 – Investment Mandates at 30 June 2018

Manager	Mandate	Passive / active	Performance Objective	% of Fund	Inception date
BlackRock	Corporate Bonds	Passive	iBoxx £ non-gilts over 15 years	1.7%	01/04/2003
BlackRock	Low Carbon Global Equities	Passive	MSCI World Low Carbon Target	10.5%	05/12/2017
BlackRock	Liability Risk Management Framework	Bespoke	In line with customised benchmark	11.4%	11/07/2017
Blackrock	Equity Protection Strategy & Global equities	Passive	MSCI World (for Global Equity Fund)	8.8%	30/11/2017
Jupiter Asset Management	UK Equities (Socially Responsible Investing)	Active	FTSE All Share +2% p.a.	4.6%	01/04/2001
TT International	UK Equities	Active	FTSE All Share +3-4% p.a.	4.3%	11/07/2007
Schroders Investment Management	Global Equities	Active	MSCI All World Index +2-4% p.a.	8.1%	01/04/2011
Genesis Investment Management	Emerging Market Equities	Active	MSCI Emerging Markets Index	2.4%	13/12/2006
Unigestion	Emerging Market Equities	Active	MSCI Emerging Markets Index +2% p.a.	2.4%	21/01/2014
Standard Life	Diversified Growth Funds	Active	LIBOR +4% p.a.	5.1%	04/02/2015
Pyrford International	Diversified Growth Funds	Active	RPI +5% p.a.	3.0%	14/11/2013
Ruffer	Diversified Growth Funds	Active	3M LIBOR +5% p.a.	5.1%	27/09/2017
JP Morgan Asset Management	Fund of Hedge Funds	Active	Higher of LIBOR +3%, or 6% p.a.	4.9%	13/07/2015
Schroders Investment Management	UK Property	Active	IPD UK Pooled Property Fund Index +1% p.a.	5.0%	01/02/2009
Partners Group	Overseas Property	Active	IPD Global Property Index +2% p.a.	4.5%	18/09/2009
IFM	Infrastructure	Active	Gilts +2.5% p.a.	6.4%	30/09/2014
Loomis	Multi Asset Credit	Active	In line with customised benchmark	10.3%	29/09/2017
Record Currency Management	Currency hedge (equity exposure)	Passive	N / A	1.5%	26/07/2011
				100%	
Brunel Portfolios post 30 June 2018					
Brunel (switched from Blackrock Low Carbon Global)	Low Carbon Global Equities	Passive	MSCI World Low Carbon Target	10.5%	11/7/2018

Appendix 2- Related Documents

1. The latest Funding Strategy Statement can be found in the Funding Strategy Statement section

<https://www.avonpensionfund.org.uk/finance-and-investments>

2. The latest Responsible Investing Policy can be found in the Responsible Investment Policy section

<https://www.avonpensionfund.org.uk/finance-and-investments>

3. The latest FRC UK Stewardship Code - Statement of Commitment can be found in the Corporate Governance Policy section

<https://www.avonpensionfund.org.uk/finance-and-investments>