Date: Friday, 20 March 2015

Time: 10.30 am

Venue: Shrewsbury Room, Shirehall, Abbey Foregate, Shrewsbury, Shropshire, SY2 6ND

Contact: Sarah Townsend, Committee Officer
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PENSIONS COMMITTEE

TO FOLLOW REPORT (S)

8 LDI and Unconstrained Bonds (Pages 1 - 8)

A presentation from Mr John Belgrove of Aon Hewitt will be received and the report of the Head of Finance, Governance & Assurance (Section 151 Officer) is attached, marked 8.

Contact: James Walton (01743 255011)

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Committee and Date	Item
Pensions Committee 20 March 2015 10.30am	8 Public

LDI & UNCONSTRAINED BONDS

Responsible Officer James Walton
e-mail: james.walton@shrophire.gov.uk Tel: (01743) 255011 Fax (01743) 252184

1. Summary

1.1 The Committee, together with the Officers and Aon Hewitt has been reviewing the Fund's investment strategy. This included building a greater understanding of the Fund's investment risk relative to its liabilities. A number of potential improvements to the investment strategy have been discussed with the Committee during training sessions prior to Committee meetings and at the annual training day in July. Following, and subject to, a further training session undertaken directly prior to Pension Committee, the report outlines two recommendations for implementation.

2. Recommendations

2.1 Committee approve the recommendation in Appendix A to begin the process to put in place a Liability Driven Investment (LDI) manager which will replace the current index linked gilt holding. Committee therefore authorise officers to undertake a manager selection process to identify an appropriate LDI Manager.

2.2 Committee approve the recommendation in Appendix A to replace all or part of the investment grade corporate bond allocation with a more unconstrained bond mandate, for example multi asset credit or PIMCO's diversified income Fund. Committee therefore authorise officers to undertake a manager selection process to identify an appropriate Unconstrained Bond Manager.

REPORT

3. Risk Assessment and Opportunities Appraisal

3.1 Risk management is considered by Committee in making decisions under the governance arrangements.

3.2 The recommendations contained in this report are compatible with the provisions of the Human Rights Act 1998.

3.3 There are no direct environmental, equalities or climate change consequences of this proposal.

4. Financial Implications

4.1 The potential costs are detailed in Appendix A to this report but will depend on the managers which are appointed during the selection process. It is anticipated that the costs of the selection process as identified within the recommendations will not exceed £50,000.

5. Background

5.1 The Committee, together with Officers and Aon Hewitt has been reviewing the Fund's investment strategy. This included building a greater understanding of the Fund's investment risk relative to its liabilities.

5.2 A number of potential improvements to the investment strategy have been discussed during training sessions prior to Committee meetings and at the annual training day in July.

6. Liability Driven Investment (LDI)

6.1 The present value of the Fund's liabilities, as measured by the Fund's Actuary (Mercer), will increase if long-term gilt yields (interest rates) fall and if long term inflation rises. If this is not matched by a corresponding rise in the Fund's asset value then the funding level will fall.

6.2 The current investment strategy has a 10% allocation to index-linked gilts which will move in a similar way to the liabilities as interest rates and inflation changes. LDI, which uses derivatives, would enable the Fund to more efficiently match its assets to the interest rates and inflation movements of its liabilities.

6.3 Members received training on LDI at the annual training day in July and a further training session will be provided to Committee by Aon Hewitt prior to the start of the meeting and continued training will be provided during implementation.

6.4 Members are asked to approve the recommendation in Appendix A to begin the process to put in place a Liability Driven Investment (LDI) manager which will replace the current index linked gilt holding following a selection process.

7. Investment Grade Bond Allocation

7.1 PIMCO currently manage 7.5% of the Fund in their investment grade corporate bond fund. The Fund has benefited from strong returns from this asset class since 2009. However, the future outlook now appears limited by low yields, low credit spreads and declining liquidity.

7.2 By moving to an unconstrained bond mandate, for example multi-asset credit, the aim is to improve the Fund's risk adjusted returns going forward.

7.3 A further training session will be provided to Members on this prior the start of the meeting outlining the reasons why we should replace all or part of the investment grade corporate bond allocation with a more unconstrained bond mandate.

7.4 Members are asked to approve the recommendation in Appendix A to replace all or part of the investment grade corporate bond allocation with a more unconstrained bond manager, for example multi asset credit or PIMCO's diversified income fund and decide on the allocation.

List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information N/A
Cabinet Member N/A
Local Member N/A
Appendices A – Aon Hewitt Investment Recommendations

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Shropshire County Pension Fund
Date: 20 March 2015
Prepared for: The Officers
Prepared by: John Belgrove
Louis-Paul Hill

Investment Recommendations

Introduction

The Committee, together with the Officers and Aon Hewitt has been reviewing the Fund's investment strategy. This included building a greater understanding of the Fund's investment risk relative to its liabilities.

A number of potential improvements to the investment strategy have been discussed and we recommend two are implemented as soon as possible:

1. Replace the current index linked gilt holding with Liability Driven Investments (LDI).

2. Replace all or part of the existing investment grade corporate bond allocation with a more unconstrained bond mandate, for example multi-asset credit.

The first of these changes is a strategic change which should enable the Fund to reduce its risk relative to liabilities, by more efficient matching of interest rate risk and inflation risk, without reducing the Fund's expected return.

The second of the changes is more of a change of implementation than a strategic shift. This change is expected to improve risk adjusted performance given the current market environment.

Below we provide; the rationale, impact on cost and governance, together with next steps.

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1) Replace the current index linked gilt holding with LDI

Rationale

The present value of the Fund's liabilities, as measured by the Fund's Actuary (Mercer), will increase if long-term gilt yields (interest rates) fall and if long-term inflation rises. If this is not matched by a corresponding rise in the Fund's asset value then the funding level will fall.

The current investment strategy has a 10% allocation to index-linked gilts which will move in a similar way to the liabilities as interest rates and inflation changes.

LDI, which uses derivatives, would enable the Fund to more efficiently match its assets to the interest rate and inflation movements of its liabilities, i.e. either:

- Increase the level of liability matching while maintaining the allocation to growth assets;

Or;

- Achieve the same level of liability matching while increasing the allocation to growth assets.

Impact on cost and governance

The Fund currently pays a management fee of 0.0425% per annum (p.a.) for L&G's passive index-linked gilt mandate. LDI managers charge higher fees. For example, between 0.10% and 0.25% p.a..

In addition a one-off manager selection fee would be charged. Other additional advisory work could include helping to structure the LDI mandate, advising on liability hedging levels and market pricing, reviewing the manager's paperwork and assisting with any changes to reporting.

We would expect a potential increase in governance for the Officers and/or the Committee because this shift in investment strategy should bring a greater focus on asset performance relative to liabilities rather than each in isolation.

Next steps

1. Begin process to put in place an LDI manager, including selecting a manager.

2. Continue Committee training on LDI, including decision on initial level of liability matching.

3. Transition assets.

4. Decide on ongoing governance and long-term target for liability matching.

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2) Replace the investment grade corporate bond allocation with a more unconstrained bond mandate

Rationale

Investment grade corporate bonds account for 7.5% of the current investment strategy.

The Fund has benefited from strong returns from this asset class since 2009. However, the future outlook now appears limited by low yields, low credit spreads and declining liquidity (indicated by low bond inventory held by investment banks).

By moving to an unconstrained bond mandate, for example multi-asset credit, we are aiming to improve the Fund's risk adjusted returns going forward. We believe that skilful managers can add value by building a truly diversified portfolio. The defining feature of unconstrained strategies is the flexibility in their approach to asset allocation and security selection within the global bond universe, which can offer better returns and more downside protection.

Impact on cost and governance

The Fund currently pays around 0.47% p.a. management fee to PIMCO for their investment grade credit mandate. Managers with more unconstrained mandates tend to charge slightly higher fees. For example PIMCO's Diversified Income Fund charges fees of 0.69% p.a..

In addition a one-off manager selection fee would be charged. This fee will be reduced if the Fund selects the PIMCO Diversified Income Fund. Other advisory work could include reviewing the manager's paperwork.

No significant increase in the governance burden is expected.

Next steps

1. Select an unconstrained bond manager. PIMCO's Diversified Income Fund will be looked at as part of this process.

2. Decide on allocation between investment grade corporate bonds and unconstrained bonds.

3. Transition assets.

Decision

The Committee should make one of the following decisions on each of the recommendations detailed above:

- Proceed to implementation.
- Require further training or discussion before proceeding to implementation.
- Do not wish to proceed.

If the Committee approve the above recommendations, we will then arrange meetings with the appropriate managers with an aim to appoint an LDI and unconstrained bond manager.

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