Shropshire County Pension Fund

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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

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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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