Oxfordshire Council Pension Fund

Transfer of Assets to

Brunel Partnership

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OXFORDSHIRE PENSION FUND COMMITTEE – 9 MARCH 2018

TRANSFER OF ASSETS TO BRUNEL PARTNERSHIP

Report by the Independent Financial Adviser

1. This report sets out an indicative plan for the transfer of the assets of the Oxfordshire Pension Fund ("OPF") into the portfolios envisaged by the Brunel Partnership ("Brunel"), which are set out in Appendix 1 to this report. As seven of the portfolios are still in draft form (BMA, DHF, PPY, PIN, PSI, PPD, and PPE), I have excluded them from this report but see para. 14 regarding BMA) My recommendations at this stage will therefore cover the 80% of the OPF allocated to Equities, Bonds and Diversified Growth Funds. Recommended allocations are expressed as %-ages of the OPF (currently 1% of OPF is approximately £24m).

2. When planning the investment policy for a Pension Fund, there are three levels of decision-making which need to be undertaken. These are:

   - **Overall Strategy** including asset allocation across suitable asset classes, rebalancing process and mechanism for change

   - **Investment Structure** covering the mandates under which the fund's investment managers should operate: balanced/specialist; active/passive; investment styles etc

   - **Manager Selection** - reviews of how the existing managers have carried out the mandates entrusted to them

3. For the OPF, the normal procedure has been for the Independent Financial Adviser to present a report to the Pension Fund Committee a year after the triennial Actuarial Valuation. This report deals with the overall strategy of the Fund in the light of the actuarial valuation,and the structure of the Fund, and analyses the performance of each of the external investment managers' in carrying out their mandate. The latest of these reports - 'Fundamental Review of Asset Allocation' – was discussed, and its recommendations accepted, at the March 2017 Committee.

4. When advising on the transfer of assets to Brunel, however, there are constraints on what can be recommended. While endeavouring to maintain the existing **strategy** of the Oxfordshire Fund after transition, we have to work within the Table of Portfolios available within Brunel (see **Appendix 1**). While this list is broad enough to encompass the main asset classes (UK and Overseas Equities, Fixed Income, Multi-Asset), the choice of **Investment Structure** is limited; this is exemplified by the restricted range of Fixed Interest funds on offer (see paras. 10-14). Finally, **Manager Selection** will be decided by Brunel, and not by Oxfordshire, so that this element falls outside the remit of this report.

5. OPF's current asset allocation strategy, as agreed at the March 2017 committee meeting, is shown in Table 1 below.

Asset Class	**Target Allocation (%)**	**Range (%)**
UK Equities Overseas Equities	26 28	24 - 28 26 - 30
Total Equities	**54**	**50 - 58**
UK Gilts (18.75%) Corporate Bonds (37.5%) Index-Linked Bonds (31.25%) Overseas Bonds (12.5%)		
Total Bonds	**21**	**19 - 23**
Property Private Equity Multi-Asset Infrastructure Cash	8 9 5 3 0	6 – 10 6 – 11 4 - 6 2 – 4 0 - 5
Total Other Assets	**25**	**18 - 31**

Table 1 - OPF asset allocation policy

6. In order to maintain this policy after transition to Brunel, the allocation to the categories listed in Appendix 1 would be:

Equities (Active + Passive) 54%
Fixed Interest 21%
Diversified Growth 5%

7. In addition to the 54% listed equity allocation, OPF also has equity exposure through its Private Equity. As a general rule, Private Equity is expected to deliver returns 2-3% p.a. higher than those on listed equity, while having the disadvantage that the investment is illiquid until realisations are made by the managers. For this reason, the higher expected return is known as the 'illiquidity premium'. (There is a secondary market in Private Equity interests, but the seller is likely to receive less than Net Asset Value on sales in normal times, and significantly less in times of equity market weakness. The same is true of OPF's listed Private Equity because of the size of its holdings). OPF's 9% allocation to Private Equity is one of the highest in any of the LGPS Funds.

8. A key decision when setting the structure of a Fund is the extent to which the Equities are managed actively or passively. A summary of the arguments for and against passive management is given in **Appendix 2**. At present 30% of OPF's UK and Overseas Equities are held through passive (tracker) funds. While there is no ideal ratio for the active/passive split, 30% passive was felt to be high enough to damp down the risk of under-performance by the active managers, while affording them sufficient scope to deliver out-performance. As the overall strategic allocation is 26% UK and 28% Overseas, the passive element of OPF is 7.8% UK and 8.4% Overseas. Table 2 below sets out the five passive equity funds being offered by Brunel, and the geographic split of their benchmark indices. (OPF policy has been not to hedge its overseas equity exposure, so EPD.H has been disregarded)

9. I believe that Emerging Markets are best managed on an active basis, so that certain countries or regions can be excluded entirely (e.g. in case of political risk), and stocks can be selected and weighted on their perceived merits rather than on an index-determined basis. As a result OPF's exposure will be obtained via the Active Equity fund EEM (see paragraphs 11 &12).

10. As a general principle, it is preferable in the early stage of Brunel to limit the number of different funds held by OPF, and I have therefore not recommended an allocation to EPL (the Passive Low Carbon Fund) or EPS (Passive Smart Beta). In the case of EPS, I am not convinced by the rationale of using 'a number of equity factors or styles' in a passive fund.

Fund code	Benchmark	UK %	O/S Dev'd %	Emerging %	Allocation
EPU	FTSE All-Share	100	0	0	7.2
EPD	MSCI World	7	93	0	9.0
EPE	MSCI Emerging	0	0	100	0
EPL	MSCI World	7	93	0	0
EPS	MSCI World	7	93	0	0
	Combined	7.8	8.4	0.0	

Table 2 – Allocation to Passive Equity Portfolios

(The figures in the 'Allocation' column are the weights of OPF which need to be invested in each of the Brunel portfolios in order to achieve the geographic split shown across the bottom line).

11. In constructing an allocation to **Active Equities** via the available Brunel portfolios, two requirements are :
    - Approximately 18% in UK Equities
    - 4% in Emerging Market Equities (approx. 13% of the overseas equity allocation of 28%, in line with the MSCI ACWI Index).

12. The UK Equity allocation must come primarily from EUK, as this is the only active UK Equity portfolio on offer; likewise the active Emerging Market allocation will be primarily achieved through the allocation to EEM. In order to limit the number of different portfolios, but to maintain exposure to medium-alpha and high-alpha Global Equity mandates similar to those currently held in OPF, I am recommending almost equally-weighted allocations to EGC and EDH. The resulting split is shown in Table 3 below.

Fund code	Target return	UK	O/S Dev'd (%)	Emerging	Allocation (%)
EUK	FTSE All-Share +2%	100	0	0	17
EGC	MSCI ACWI +1-2%	6	82	12	8.8
EDH	MSCI World +2-3%	7	93	0	9.0
ELV	MSCI ACWI +	6	82	12	0
ESG	MSCI ACWI +2%	6	82	12	0
ESC	MSCI Sm Cos +2%				
EEM	MSCI Emerging +2-3%	0	0	100	3

	Combined	**18.0**	**15.8**	**4.0**	

Table 3 – Allocation to Active Equity Portfolios

13. While the Active and Passive Equity portfolios offered by Brunel give OPF the ability to transition into similar structures, the **Fixed Interest** options do not permit such a straightforward switch. The existing OPF Fixed Interest allocation is managed by one manager (Legal & General) according to the guidelines shown in Table 4 below, with a target of out-performing the composite benchmark by 0.60% per annum gross of fees.

	Benchmark	**Target %**	**Range**
UK Government	**FTSE-A All Government**	**18.75**	**0 – 32**
UK Index-Linked	**FTSE-A I-Linked (Over 5 years)**	**31.25**	**24.5 – 73.5**
UK Corporate Bonds	**iBoxx £ non-Gilts (All)**	**37.50**	**17.5 – 22.5**
Overseas Bonds	**JPM Global Gov (ex-UK) (£)**	**12.50**	**0 - 23**

Table 4 – Existing Fixed Income mandate (Legal & General)

14. The wide ranges allow the manager to take positions around the target weights to express his views on such issues as the pricing of credit or the outlook for inflation, while also being free to vary the average duration of each portfolio depending on his view of the overall direction of interest rates and yields.

15. Under the structure proposed by Brunel, there is currently no overall Fixed Interest manager, but instead OPF will be required to commit to several separate funds from the list shown in Table 5.

Fund code	**Portfolio**	**Benchmark**	**Alpha**	**Allocation**
BPI	**Passive I-L Gilts**	**FTSE-A I-L (Over 15 years)**	**0**	**0**
BPI (L?)	**Passive I-L Gilts 3x leveraged**	**As above**	**0**	**0**
BSC	**Sterling Corp Bonds**	**iBoxx £ non-Gilts (All)**	**+1%**	**6**
BGB	**Global Bonds**	**Barclays Global Agg Bond (£)**	**+0.5 – 1.0%**	**2**
BMA (Draft)	**Multi-Asset Credit**			**[5]**

Table 5 – Brunel Fixed Interest Portfolios

16. While BSC and BGB look to be suitable homes for OPF's allocation to UK Corporate Bonds and Global Bonds (hedged to £) respectively, the choice of funds for conventional and Index-Linked Gilts is problematic as neither of the benchmarks proposed looks appropriate for OPF's needs. BPI is intended to provide an approximate match for an LGPS Fund's pension liabilities, as bond receipts are index-linked (albeit RPI) and very long-dated, while Table 5 contains no fund specialising in conventional gilts.

17. At present, as shown in Table 4, OPF's Gilt allocation is benchmarked against the FTSE-A Government All Stocks Index, and the Index-Linked allocation against FTSE-A Index-Linked (Over 5 year) Index. If Brunel were to offer passive funds based on these indices I would recommend allocating to them in OPF's existing proportions (**3% to the All Stocks tracker** and **5% to the over 5-year Index-Linked tracker**).

18. After the March 2017 Fundamental Review, the OPF was de-risked by switching 5% from Equities to Fixed Income, bringing the Fixed Income allocation up to 21% (see Table 1). If Brunel's proposed Multi-Asset Credit Fund (**BMA**) is available and suitable, I would recommend allocating **5% of OPF** to it as a low-volatility fund with protection against rising interest rates, and holding **16% of OPF across the other four funds**.

19. The **Diversified Growth Fund** offered by Brunel (code: DGF) has a performance target of [3-month £ LIBOR + 4-5% p.a.] which is consistent with the target on OPF's existing DGF fund managed by Insight. I am therefore comfortable in recommending a **5% allocation** of OPF to Brunel's DGF.

20. I recognise that the specifications of the funds offered by Brunel may alter, and that the transfers recommended here are not binding commitments, but rather an indication of OPF's likely appetite for each of the Brunel funds currently on offer.

Peter Davies

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February 13th, 2018

APPENDIX 2
[Extract from Fundamental Review of Asset Allocation, 2017]

Active or Passive management?

27. The basic distinction here is that an active manager will attempt to run a portfolio to produce a return which *exceeds* the return on a relevant index of that asset class (e.g. the FTSE All Share Index for a UK Equity portfolio) whereas a passive manager will aim to produce a return *equal to* the index return. The active manager may use a number of different techniques to select stocks for his portfolio, while the passive manager will normally operate a system of index-replication which generates a portfolio as close as possible to the notional portfolio underlying the relevant index. The passive manager will utilise very little discretion in managing his 'tracker' fund, as computer programs will be used to ensure the holdings continue to match the index constituents closely. There are significant economies of scale for a passive manager, as a larger fund can replicate more of the smaller constituents in an index, while the overheads remain relatively constant. As a result of all these factors, the fee charged to the investor under a passive mandate is far smaller than for an active one. The difference in fee for example between our current UK passive and active managers is just under 20 bps or 0.2%.

28. One of the considerations for the Pension Fund is whether the active manager can generate sufficient performance (gross of fees) in excess of the index to compensate for the lower fee charged by the passive manager. There are also, however, other considerations. By its nature, a market index is always fully-invested, whereas an active manager has the freedom to hold a certain amount of cash if he expects a general fall in the market. If the active manager uses this freedom at the right time, he can cushion the impact of a general market decline. Similarly, the active manager can – and should – hold a lower weight than the index in sectors he expects to be relatively weak, whereas the passive manager is obliged to maintain the index weight in every sector at all times. At present some **29%** of the Fund's UK Equities, and **27%** of the Overseas Equities, are managed passively. This has reduced the management fees payable, and reduced the risk of manager under-performance.

29. For most developed markets there is a choice of indices which can be replicated. In the UK, for example, investors can choose the broadest index (the FTSE All Share) or select size bands (FTSE 100, FTSE 250 or FTSE Small-Caps). [The All-Share Index comprises approximately 80% FTSE 100; 16% FTSE 250; 4% FTSE Small-Cap]. It is in large, liquid, well-researched equity markets (such as the US or UK) that indexation is more often employed, on the grounds that few active managers will be able to outperform in such efficient markets. Secondly, it must be remembered that a passive mandate is not the same as a low-risk portfolio. It may minimise *relative* risk, but not *absolute* risk.