

PENSION FUND COMMITTEE – 6 MARCH 2020

INVESTMENT STRATEGY

Report by the Director of Finance

RECOMMENDATION

1. **The Committee is RECOMMENDED to**
 - (a) **approve the draft Investment Strategy Statement including the Climate Change Policy as the basis for formal consultation and**
 - (b) **approve the interim changes to the Strategic Asset Allocation as recommended by the Independent Financial Advisor and summarised in paragraphs 39 – 45 of this report.**

Introduction

2. This Committee reviews its Investment Strategy Statement on an annual basis, and carries out a fundamental review of its asset allocation every three years following on from the tri-ennial Fund Valuation.
3. This report brings together the latest review of the Investment Strategy Statement including a new annex covering our Policy regarding Climate Change, and the formal advice of our Independent Financial Adviser in respect of our fundamental asset allocation.
4. Due to the restrictions on the investment cycles in respect of the allocations to the private market allocations within Brunel, the Committee are asked to approve a number of immediate proposals on asset allocations effective from 1 April 2020, as well as approving the draft Investment Strategy Statement and Climate Policy for formal consultation.

Investment Strategy Statement and Climate Change Policy

5. The key change to the Investment Strategy Statement is the addition of a separate annex in respect of our Climate Change Policy (see Annex 1). This Policy has been informed by the Climate Change Workshop held in November, plus 2 meetings of the Climate Change Working Group established at the December meeting of this Committee.
6. The draft Climate Change Policy should be seen as an initial position statement which will be subject to regular review reflecting the rapidly changing environment in which this initial policy has been established. In particular, the Policy itself recognises a number of shortfalls in the current availability of international accepted metrics used to assess the suitability of investments against the requirements of the Paris Agreement, and therefore

includes commitments to work with Brunel and others in the investment industry to establish such metrics. This will in turn allow more specific targets to be set within the Policy in future years.

7. The draft Policy was agreed for publication by the Working Group, although differences of opinion remain between the working group members. In particular, there was considerable discussion about the inclusion of clauses requiring the divestment of all investments in fossil fuel companies. The overall consensus was that such clauses were unnecessary and potential unhelpful.
8. The Policy as drafted makes it clear that the Fund should be looking to ensure all investments are consistent with the Paris Agreement. To the extent that any fossil fuel company does not have a clear action plan to ensure it is aligned with the Paris Agreement, it will fall foul of the principles within the draft Policy. As such we would be looking to Brunel to challenge any Fund Manager retaining an investment in that company and seeking changes to address the issue (whether that be via divestment by the Fund Manager or the potential removal of the Fund Manager).
9. A blanket policy on immediate divestment from fossil fuel companies runs the risk of ignoring the other key sectors which are contributing to the current climate emergency, including the transportation, energy and food sectors, as well as penalising any of the fossil fuel companies which are seeking to take the actions required to ensure compliance with the Paris Agreement and support the development of a renewable and sustainable future.
10. In addition to the changes to the Investment Strategy Statement to reflect the new Climate Change Policy, the Statement has been updated to reflect the changes in responsibilities as more of our assets transition to Brunel.
11. At the present time, the draft Investment Strategy Statement has not been amended for the proposed changes to the Strategic Asset Allocation. Subject to the decisions by this Committee in respect of the Strategic Asset Allocation, the draft Investment Strategy Statement will be updated before being issued for formal consultation.

Strategic Asset Allocation

12. As previously stated, the determination of the Strategic Asset Allocation is arguably the most important decision this Committee makes in terms of delivering its responsibilities. To support the Committee in making this decision, Officers procured advice from the Fund's Independent Financial Adviser, as well as further modelling of options and the implications of the current cashflow projections from MJ Hudson. The report of the Independent Financial Adviser is included as Annex 2 to this report, with the Executive Summary of the report from MJ Hudson included as an appendix.
13. The key objectives of the fundamental review of the asset allocation are to ensure that the Fund has sufficient liquid resources to meet the pension

liabilities as they fall due, and that all surplus assets are invested to ensure the appropriate level of return for any given level of risk. The asset allocation agreed should also be fully consistent with the Investment Strategy Statement, including the new Climate Change Policy.

14. The work undertaken by MJ Hudson which itself was informed by cash flow projections produced by the Fund Actuary found that in the short term, whilst cash flow from dealings with members was expected to go negative (i.e. total payment of pensions would exceed the current level of pension contributions), the levels involved could be met from within current cash balances and did not require a major switch to income releasing assets.
15. The report from MJ Hudson then looked at modelling levels of return against levels of risk/volatility to establish the “efficient frontier”, where the level of return is maximised for any given level of risk.
16. MJ Hudson identified that our current asset allocation falls somewhat short of the efficient frontier, and indeed short of the current Strategic Asset Allocation. This reflects the underweights in the private markets whilst we wait for Brunel to identify suitable investment opportunities, and these Funds to call down the committed cash. Moving towards the strategic asset allocation would both improve the potential investment returns as well as reducing risk/volatility through the greater diversification of the portfolios.
17. MJ Hudson therefore produced a number of options which brought the asset allocation closer to the efficient frontier, either by increasing investment returns for the same level of risk/volatility or reducing risk/volatility whilst achieving the same levels of investment return.
18. The report and recommendations of the Independent Financial Adviser then build on the conclusions from MJ Hudson to produce a more detailed proposal for changes to the asset allocation. In bringing forward his proposals, the Independent Financial Adviser also look to ensure that any changes were consistent with the revised Investment Strategy Statement and Climate Change Policy.
19. Included in the proposals from MJ Hudson and endorsed by the Independent Financial Adviser was a proposal to implement a new investment in the Private Debt Portfolio offered by Brunel. Under the investment arrangements for all the private markets, commitments must be made by 31 March 2020 to be included in the next 2 year cycle, although further top-up commitments can be made in April 2021 where an allocation has been made in April 2020. Any new allocation to Private Debt must therefore be agreed at this time to be registered with Brunel by 31 March 2010.
20. The Independent Financial Adviser is recommending an immediate commitment of £80m or around 3% of the Fund. This can be topped up in April 2021 to the 5% recommended in the MJ Hudson report following further detailed review of the proposal.

21. The MJ Hudson report also recommended a 5% allocation to multi asset credit. At the present time, this portfolio is not available through Brunel, but should be developed during 2020/21. This enables further consideration of the proposal to be made before any final decision is made.
22. The MJ Hudson report also proposed further increases in the allocations to Infrastructure and Private Equity. The report from the Independent Financial Adviser indicates reservations on this proposal due to the increase in illiquidity that would result. In particular, further work needs to be undertaken to assess the ability of the Fund to meet its existing commitments to the private markets and pay pension liabilities as they fall due in the event of another financial crisis of the level experienced in 2008. As the existing asset allocation already requires significant allocations to the private market and infrastructure portfolios, any delay in agreeing an increase in these allocations is not seen to be critical and could be implemented in April 2021 if necessary.
23. In respect of ensuring consistency with the draft Climate Change Policy, the report from the Independent Financial Adviser is recommending an immediate switch of 5% of the Fund from the UK passive portfolio to the global low carbon passive portfolio. The proposal reflects the high weighting to the fossil fuel and mining sectors within the current UK passive index, and the lower levels of carbon intensity within the low carbon fund.
24. At this stage it is not recommended to make further allocations to the low carbon or sustainable equities portfolio, until further work can be completed on developing the metrics to assess the suitability of the products against the principles established in the draft Climate Change Policy. Once this work is completed, further transitions can be proposed, or further requests can be made to Brunel for the development of additional portfolios which more closely reflect the need to align all investments with the requirements of the Paris Agreement.
25. It should also be noted that the allocation to infrastructure to bring the actual investment in line with the current asset allocation will include a significant investment in renewable infrastructure.

LORNA BAXTER
Director of Finance

Contact Officer: Sean Collins
Tel: 07554 103465

February 2020