AGENDA MANAGEMENT SHEET

Name of Committee	**Pension Fund Investment Board**
Date of Committee	**19 February 2007**
Report Title	**Asset Allocation**
Summary	The report considers options on asset allocation.
For further information please contact:	Phil Triggs Group Manager (Treasury and Pensions) Tel: 01926 412227 philtriggs@warwickshire.gov.uk
Would the recommended decision be contrary to the Budget and Policy Framework?	No.
Background papers	Reports from fund managers

CONSULTATION ALREADY UNDERTAKEN:- Details to be specified

Other Committees	☐	....
Local Member(s)	☐	....
Other Elected Members	☒	Cllr Davis, Chair of Pension Fund Board
Cabinet Member	☐	....
Chief Executive	☐	....
Legal	☒	Tony Maione
Finance	☒	David Clarke, Strategic Director of Resources (reporting officer)
Other Chief Officers	☐	....
District Councils	☐	....
Health Authority	☐	....
Police	☐	....
Other Bodies/Individuals	☐	....

FINAL DECISION YES

SUGGESTED NEXT STEPS: Details to be specified

Further consideration by this Committee	☐	....
To Council	☐	....
To Cabinet	☐	....
To an O & S Committee	☐	....
To an Area Committee	☐	....
Further Consultation	☐	....

Agenda No 3

Pension Fund Investment Board 19 February 2007

Asset Allocation

Report of the Strategic Director of Resources

Recommendation

1) That the Fund's venture into alternative asset classes (5% fund of hedge funds and 5% property), making a 10% allocation to alternatives in total be taken from the Equity proportion of the Fund as set out in Appendix A.

2) That the Board agree to the seeking of quotes from Black Rock and other transition managers and the subsequent appointment of a manager to administer the transition process.

1. Introduction

1.1 Asset allocation is the distribution of investments across different asset classes such as equities, bonds, property, etc. The asset allocation decision is key in relation to the level of risk that the Fund adopts in respect of its investment objective, namely to achieve a long term return of 1.5% above world markets (or other appropriate) benchmark return in order to be at or above a 100% funding level.

1.2 The rationale of moving away from the traditional equity and bond asset classes into alternative asset classes is to create diversification and reduce the impact of individual asset class volatility. Ideally, investors would like to see a smooth appreciation of assets over time to help meet their funding objectives.

1.3 Throughout this process, the Council has been advised by Mercer Investment Consulting.

2. Current Asset Allocation at 31 December 2006

2.1 **Appendix A** shows the Fund's current investment strategy and the proposed investment strategy following the 10% allocation to alternatives

2.2 In 2006, the Pension Fund Investment Board ("the Board") agreed to allocate 10% of the portfolio to alternative asset classes. In addition, the Board decided that the most suitable asset classes for the Fund would be Property and Fund of Hedge Funds. This report addresses where Mercer Investment Consulting recommends the 10% allocation to the Property and Fund of Hedge Funds mandates is sourced from.

3 Source of the Allocations to the Property and Fund of Hedge Funds Mandates

3.1 The Board will recall that when it decided to invest in alternatives, it was agreed that the allocation should form part of the 'return seeking' asset class. It is therefore appropriate for the allocation to the Property and Fund of Hedge Funds mandates to be sourced from the Fund's existing return-seeking assets, namely equities.

3.2 Historically, pension funds have invested in bonds to reduce risk relative to liabilities whilst investing in equities as a source of excess return. Mercer's asset liability modelling (ALM) process assumes an expected return of around 8% per annum from equities over the long term. However, as seen over recent years, equities have the potential for large variations in returns from year to year. This is known as volatility and is the basis on which portfolio risk is measured.

3.3 To put this into context, Mercer estimates absolute equity market volatility to be around 17% per annum. By this, we mean that we expect equity returns in two years out of three to be between expected equity returns (currently around 8% per annum) + 17% and - 17%, i.e., between - 9% and + 25%. This of course means that for one year in three, the returns could be outside of this range and, in particular, worse than - 9% every one year in six.

3.4 Bonds, on the other hand, have a much lower absolute volatility of around 5% to 9% per annum but with a commensurately lower expected return (currently around 4% to 5% per annum). It can be seen that in order to gain more, we need to subject the portfolio to increased risk.

3.5 Mercer's central assumptions are currently that both property and fund of hedge funds are generally expected to achieve a return of around 2% per annum over fixed interest gilts whereas equities are estimated to achieve out-performance over gilts of around 4% per annum. In addition, the absolute volatility of achieving this performance is around 14% for property and around 10% for fund of hedge funds. We note that specific vehicles will have their own return targets and expected volatilities, so these figures just look at the asset classes in general.

3.6 Allocating the investment to property and fund of hedge funds from the Fund's equity allocation will provide the Fund with a diversification from the current focus on equities, which should therefore enhance the risk/return trade-off within the Fund's overall asset allocation.

3.7 Property has historically performed well at different times of the economic cycle relative to equities. Property tends to perform well during periods of falling interest rates, when equity markets may be performing less well as a result of the general economic downturns that tend to accompany those falling interest rates.

3.8 The return on property has therefore had a low correlation to that of equities and to reflect this Mercer's ALM assumes a correlation of 0.2 between equities and property, demonstrating the anticipated diversification benefits.

3.9 Investment in fund of hedge funds will be targeting an absolute return and offers the expectation of positive returns regardless of how the equity and bond markets perform, given that exposure to market movements is to a large extent hedged. However, the hedge is not perfect and fund of hedge funds in general can have directional market exposure which impacts on returns. For example, hedge fund returns were hit in May/June 2006 when equity markets fell back sharply. For this reason, Mercer's ALM assumes a correlation of around 0.7 between equities and hedge funds. The proposed mandate is, however, seeking a vehicle with lower correlation than this, i.e., closer to 0.3.

3.10 Fund of hedge funds as a group have the flexibility to invest in a wide range of asset classes and employ investment techniques not available to traditional investment funds.

4 Conclusion

4.1 The Board has agreed to allocate 10% of the Fund's assets to property and fund of hedge funds in order to diversify the "return seeking" assets and enhance the risk/return trade off currently employed within the asset allocation.

4.2 This report has highlighted that Mercer believes that both property and fund of hedge funds will over the long term outperform bonds and that they have a higher associated volatility than bonds (albeit lower than the volatility of equities). There are a number of characteristics to highlight the diversification benefits that property and fund of hedge funds brings versus equities, which further supports why both asset classes should be funded from the Fund's current equity allocation.

5 Transition Process

5.1 The Board will recall that during the previous major restructuring and transition process undertaken in September 2004, Warwickshire employed the services of Merrill Lynch Investment Managers (MLIM) to run the transition process.

5.2 MLIM ran a very efficient service, enabling the Fund to achieve its restructuring at minimal cost. Moreover, the accounting and reconciliation processes were effectively achieved, enabling the officers to show the external auditors exactly how the transition process had been managed all the way through the process.

5.3 It should be noted that MLIM are now incorporated with Black Rock and it is recommended that quotes from Black Rock and other transition managers be sought in order to run the transition process for the conversion of equities to cash to distribute to the newly appointed hedge fund and property managers.

6 Recommendation

6.1 That the Fund's venture into alternative asset classes (5% fund of hedge funds and 5% property), making a 10% allocation to alternatives in total, be taken from the Equity proportion of the Fund as set out in Appendix A.

6.2 That the Board agree to the seeking of quotes from Black Rock and other transition managers and the subsequent appointment of a manager to administer the transition process.

DAVID CLARKE
Strategic Director of Resources

Shire Hall
Warwick
February 2007

Appendix A

Warwickshire Pension Fund – Proposed Asset Allocation

Asset Class	Index-Tracker (BGI) %	UK Equity (Threadneedle and SSGA) %	Global Equity MFS and UBS) %	Alternatives (To be confirmed) %	Fixed Income (UBS) %	Total %
UK Equities	**2.00**	**27.00**	**3.50**			**32.50**
Overseas Equities	**10.00**		**22.50**			**32.50**
European	7.50		5.50			13.00
North American	1.25		8.50			9.75
Far East/Emerging	1.25		8.50			9.75
Property				**5.00**		**5.00**
Hedge Funds				**5.00**		**5.00**
UK Corporate Bonds	**2.00**				**8.00**	**10.00**
UK Fixed Interest	**2.00**				**8.00**	**10.00**
UK Index-Linked	**5.00**					**5.00**
Total	**21.00**	**27.00**	**26.00**	**10.00**	**16.00**	**100.00**

Warwickshire Pension Fund – Existing Asset Allocation

Asset Class	Index-Tracker %	UK Equity %	Global Equity %	Fixed Income %	Total %
UK Equities	**2.00**	**32.00**	**3.50**		**37.50**
Overseas Equities	**11.00**		**26.50**		**37.50**
European	8.50		6.50		15.00
North American	1.25		10.00		11.25
Far East/Emerging	1.25		10.00		11.25
UK Corporate Bonds	**2.00**			**8.00**	**10.00**
UK Fixed Interest	**2.00**			**8.00**	**10.00**
UK Index-Linked	**5.00**				**5.00**
Total	**22.00**	**32.00**	**30.00**	**16.00**	**100.00**