AGENDA MANAGEMENT SHEET

Name of Committee	**Pension Fund Investment Board**
Date of Committee	**4 August 2008**
Report Title	**A Way Forward**
Summary	Report setting out options on future asset allocation and fund manager arrangements.
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	None

CONSULTATION ALREADY UNDERTAKEN:- Details to be specified

Other Committees	☐	....
Local Member(s)	☐	
Other Elected Members	☒	Cllr Davis - Chairman of the Investment Board
Cabinet Member	☐	
Chief Executive	☐	....
Legal	☒	John Galbraith
Finance	☒	David Clarke, Strategic Director, 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	☐	....

Pension Fund Investment Board – 4 August 2008

A Way Forward

Report of the Strategic Director, Resources

Recommendation

That the Director's report be noted with the Board discussing options on future asset allocation.

1 Introduction

1.1 In 2004, the decision was made by the Investment Board to move away from the two balanced investment portfolios that we had been running with for nearly two decades. It was considered right to break away from the traditional approach that had served us well and to adopt a portfolio of specialist managers, underpinned by a balanced index-tracker.

1.2 As we have run with this approach for almost four years, it is considered timely to review the success, or otherwise, of this approach and consider the investment model that we should use in the medium term future.

1.3 At the Investment Board meeting on 19 May 2008, the consultant from Mercer presented proposals that included further diversification of the Fund's investments into alternative asset classes such as private equity and infrastructure. Since that meeting, officers have asked Keith Neale, the former County Treasurer of Essex County Council, to cast an independent eye over our asset allocation and investment manager arrangements.

1.4 This paper is an officer discussion document drawing on the views of Mercer Investment Consulting, Keith Neale and in-house officer experience. Whilst In reality, investment models come about as a result of personal preference, appetite for risk and investment objectives, also very much involved is a healthy dose of blind faith and good luck.

2 Specialist Investment Performance

2.1 Overall, the health of the Warwickshire Fund is sound. The results of the triennial valuation show that our employer target contribution rate at the 100% funding level is second lowest only to Somerset when compared with all the other county councils nationally. We are, therefore, in a relatively strong

position, which means that our need to out-perform is not as demanding as other Pension Funds.

2.2 The table below shows the performance of our fund managers since inception. What is revealed is that:

- Barclays is delivering just about on the benchmark, which is what we would expect from a index-tracker, passive manager;
- MFS is just ahead of the benchmark;
- Threadneedle is comfortably ahead of the benchmark;
- State Street and UBS (both global equities and fixed income) are behind the benchmark.

2.3 The overall investment performance of the Fund from 1 October 2004 to 30 June 2008 is 40.0% against the fund benchmark of 40.1%.

2.4 The performance target for the managers (excluding Barclays as a passive manager) is to beat the benchmark on a rolling three-year basis. In reality, only Threadneedle has achieved its performance target.

2.5 Based upon our own investment objective, the specialist manager model has failed to deliver. Not only that, we have paid very significant active management fees for this under-performance.

3 Reasons for failure

3.1 Theoretically, the move to specialist management should provide enhanced performance over passive or balanced management. Passive management means owning shares in companies just because they are in the relevant index, even if fundamental research suggests that they are not worth holding.

3.2 Balanced management means an investment house investing across all asset types, including ones where their track record is not so good. Picking managers who are specialist in their niche areas should result in the achievement of out-performance.

3.3 However, there are problems with the specialist model:

Cost of fees

3.4 A significant sum in fees is paid to specialist managers compared with passive managers. For example, 0.05% for a passive manager compared with up to 1% for a specialist manager. This can be justified if the specialist manager consistently out-performs. However, based upon the Warwickshire experience, we have paid high specialist fees for under-performance. In fact, little evidence has been found to support the view that specialist managers are able to consistently outperform.

Compounding difficult decisions

3.5 In order to out-perform via an optimal specialist manager model, a number of difficult linked decisions need to be called correctly. For example, we would need to:

1) appoint the correct investment advisor;

2) receive the correct investment advice;

3) make the correct asset allocations;

4) appoint the correct specialist managers;

5) select the correct timing to change any of the investment components;

6) In addition to this, managers need to make the correct investment decisions.

3.6 A failure to get these decisions right creates a compounding effect, leading to a less than optimal solution. The surprise is not that funds end up with less than optimal solutions, but they believe that it is achievable.

Perfect Knowledge

3.7 For managers to consistently out-perform the market, they need access to knowledge that gives them an edge. In the web-based environment, we are in a position where considerable knowledge and research is freely available to all managers. There is clearly still scope for interpreting knowledge and research differently. However, there is little evidence that individual managers have significantly out-performed, thereby justifying the notion that a manager has a true market edge.

4 Searching for the Holy Grail

4.1 The rather defeatist conclusion to be drawn from the above analysis is that while pension funds continue to search for the Holy Grail of out-performance, the truth is that it does not exist. We are spending a lot in active fees to try and achieve out-performance. Collectively, pension funds fail to deliver this.

4.2 While some pension funds may be able to point to either a manager or basket of managers who have out-performed, this tends to be for a limited time period. The saying that “even a broken watch is right twice a day” is possibly a good analogy of some fund managers occasionally getting things right.

4.3 On the basis that the Warwickshire Fund is relatively healthy, there is a question mark over whether we need to pay active fees trying to find the Holy Grail of out-performance

5. Possible Alternatives

5.1 The move to greater diversification does seem to be correct as it has the benefit of reducing risk. However, there should be a question mark about the timing of movements into further diversification. We need to achieve the 'right move at the right time' rather than the 'right move at the wrong time'.

5.2 Whilst the theory behind a specialist manager model is accepted as sound. it is argued that it is not generally deliverable in practice. An alternative model, therefore, needs to be found that:

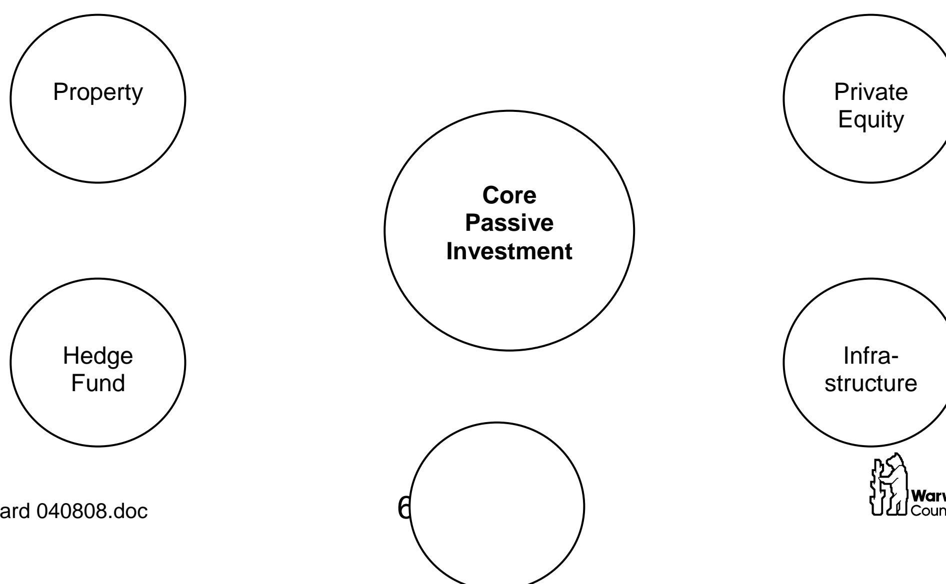
- delivers performance within acceptable levels of risk;
- delivers returns that are beneficial to the actuarial position;
- includes an appropriate degree of diversification;
- pays fees that are commensurate to the investment performance that is delivered.

5.3 In considering alternative models, it is hard to get away from the thought that passive investment return is relatively easily achieved at a very modest level of fees. The question is, therefore, whether there is any compelling argument for risking under-performing this benchmark in the hope of out performing it.

5.4 The evidence from Warwickshire's experience is that we are as likely to under-perform passive benchmarking as we are to out-perform with the existing model. In doing this we will have incurred significant levels of fees.

5.5 The alternative proposal being suggested in this paper is a move away from specialist management to a portfolio that is highly passive. However, acknowledging the benefits of diversification, it is also proposed that a core passive model is supplemented by a number of satellite specialist diversity portfolios. The model would look something like the following:

A Core Passive Model



5.6 The advantages of this model are:

- Performance linked to the markets. On the basis of a significant amount of the core passive investment being in equities, this should be beneficial over the longer term.
- Lower costs. With specialist fees being very significant, this would hugely benefit the fund.
- The satellite investments will still provide scope for out performance in the more ‘alternative’ asset classes.

6. Implementation

6.1 At this stage an implementation plan for a core passive model has not been worked up as the views of members to a radical change in direction are sought first.

DAVID CLARKE
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July 2008