

Pension Fund Investment Board 12 November 2012

Pension Fund Cash Flow

Recommendation

That the Board approves the proposal set out in paragraph 4.1 of the report.

1. Introduction

- 1.1 The Fund's assets are invested across a range of different pooled and segregated mandates. With segregated mandates, any income which arises can, in principle, be paid over to the Fund rather than being available to the manager for re-investment. With pooled funds, units tend to be either 'distribution' or 'accumulation' units. There is no income paid out from accumulation units.
- 1.2 The advantage of drawing down the income from investments is that the manager is not forced to sell assets to meet the regular cash outgoings of the Fund. Where a manager is invested in a long term asset class such as equities which may exhibit significant volatility over shorter time periods, it is important to avoid having to sell assets at what might be a low point in markets as the portfolio is then smaller when the positive returns come through in the future.
- 1.3 The current mandates with managers require that any positive cash flows from investment activities are used by the managers to acquire further investment. These positive cash flows arise from two main activities, investment income and realised profit/loss. In addition we also recognise a third class of investment return in the form of unrealised profit/loss on investments.

Investment income

- 1.4 For 2011/12 the fund received investment income of some £13.6 million (2010/11 £10.2 million). This is in effect all of the dividends / interest received on the funds various investments. Attached at **Appendix B** is a copy of Note 18 in the funds 2011/12 annual accounts showing the analysis by investment type.

Realised profit/loss

- 1.5 For 2011/12 the realised profit on disposal of investments totalled £16.2 million. **Appendix B** includes a copy of note 5 of the 2011/12 pension fund accounts. This represents the difference between the cost and the disposal price achieved. This can also be described as “gains”. At present the mandates in place with managers requires them, within certain parameters, to re invest the sale proceeds (along with the profit /loss) in to appropriate new investments.

Unrealised profit /loss

- 1.6 For 2011/12 the unrealised profit on investments totalled £14.9 million. This reflects the uplift in the market price of investments compare to the opening valuation at the beginning of the financial year rather than a positive cash flow.
- 1.7 In summary the total income / profit for the fund in 2011/12, amounted to £44.7 million, of which £29.8 million relates to positive cash flows. As reported to the July 2012 meeting of the investment board, the fund is likely to go cash flow negative at some point in the next few years. This is dependant on decisions by the employers within the scheme, but in the current climate it is prudent to assume that the majority of the major employers will not be looking to increase employee numbers.
- 1.8 The proposal is to look to amend the mandates of managers to allow the fund to request that investment income could be paid to the fund rather than being re invested.

2. Fund Managers

Passive Managers

- 2.1 The funds passive managers are, Legal and General (“L&G”), BlackRock, and State Street. Distribution units are not available for these funds, though L&G do make available a facility whereby units can be sold at a mid-price (i.e. at no cost) up to a maximum value equivalent to the notional income received on the investments. This facility is available for the both the equity and bond funds.

Active Managers

- 2.2 The fund has two active segregated equity managers, a UK equity mandate managed by Threadneedle and a global equity mandate, managed by MFS. The Fund has the option of drawing this income, rather than it being re-invested by the managers.

- 2.3 The Fund has two property mandates managed by Threadneedle and Schroders. The investment with Threadneedle is in a pooled fund where only accumulation units are available. However, the Schroders fund-of-funds mandate is a segregated portfolio of underlying fund holdings, some of which produce income which is available for withdrawal.
- 2.4 The Fund also holds shares in a Fund of Hedge Fund mandate, managed by Blackstone Alternative Asset Management. There is no option for drawing down income from the shares.
- 2.5 **Appendix A** summarises the funds mandates and highlights where income is available.

New Managers

- 2.5 JP Morgan has created an income (distributing) share class for the JPM Strategic Bond Fund, although it is not yet launched (i.e. the share class is available to invest in but as yet this facility has not been utilised). Therefore, the estimated annual income quoted below is based on a similar share class, as a proxy. Barings do not offer income units in the Dynamic Asset Allocation Fund.

3. Estimated Annual Income

- 3.1 Table 1 summarises the estimated amount of income available from each fund manager, based on forecast data from the respective fund managers.

Table 1: Estimated Available Annual Income

Manager	Estimated Available Annual Income (£m)
L&G (Equities and Fixed Income)	5.9
Threadneedle (UK Equities)	6.0
MFS (Global Equities)	3.8
Schroders	1.8
JP Morgan	1.7
Total	19.2

- 3.2 Of the total amount in Table 1 it is assumed at this stage that around £10m will be required to meet the funds cash requirement in 2013/14.
- 3.3 The income will not be generated at an even rate throughout the year from the segregated mandates. Many UK companies, for example, have December year-ends and will pay their main final dividends between June and September 2013 and smaller dividends between December 2013 and March 2014. However, the indications from the managers are that the variations should not be substantial.

- 3.4 The Fund will be investing in income units for the new JP Morgan bond fund investment which will permit income withdrawal if necessary.

4. Proposal

- 4.1 Income will be drawn initially from L&G and Threadneedle (UK Equities) L&G are readily set up for this drawdown process through their notional income facility and this will be implemented by officers as will the process for drawing down the income from Threadneedle. Income would be available on a monthly basis from L&G, and on a quarterly basis from Threadneedle.
- 4.2 In the event of a large cash surplus building up in the funds current account, there is the option to instruct fund managers to suspend the distribution of income.

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Appendix A

Manager	Fund	Income Available?
L&G	Range of pooled bond and equity funds	Yes, 'notional dividend income facility' exists. This enables a regular income to be drawn at no cost (mid-market price) on a monthly basis. No income is available from the overseas equity funds.
BlackRock	Fund invests in Aquila Life range of funds.	No distributing share class for Defined Benefit schemes.
State Street	UK Equity Index Fund	No distribution facility available
MFS	Global Equity – segregated mandate	Yes
Threadneedle	UK Equity-segregated mandate	Yes, dividends would be swept into a separate income account and instruction given to custodian to pay income on a quarterly basis.
Threadneedle	UK Property Pension Fund – pooled fund	No distributing share class available
Schroders	UK Property Multi-Manager- segregated portfolio of pooled funds	Yes, 80% of income available for distribution
Blackstone	Fund of Hedge Fund	No distributing share class available

Appendix B

1. Realised and Unrealised Profit as published in Note 5 to the accounts 2011/12

	Value 1 April 2011 £ millions	Purchases at cost £ millions	Sales proceeds £ millions	Realised profit or loss (-) £ millions	Unrealised profit or loss (-) £ millions	Increase in debtors or (creditors) £ millions	Value 31 March 2012 £ millions
Fixed interest securities	5.3	0.0	0.0	0.0	0.9	0.0	6.2
Stocks and shares	328.2	130.2	-121.5	11.7	-4.9	0.0	343.7
Managed funds	837.0	25.2	-37.6	4.6	18.9	0.0	848.1
Cash and deposits	12.5	40.1	-42.2	0.0	0.0	-4.6	5.8
Other investments	1.7	0.2	-4.9	-0.1	0.0	4.6	1.5
Total	1,184.7	195.7	-206.2	16.2	14.9	0.0	1,205.3

Realised and unrealised profits added value of £31.1m (£16.2m+£14.9m) in the financial year 2011/12.

2. Investment Income analysis as published in Note 18 to the accounts 2011/12

2010/11 £000	Investment Income	2011/12 £000
5.9	Cash - UK - From administration of the Fund	5.2
23.3	Cash & Other Investments - UK - Fund Mgrs	-18.2
0.0	Cash & Other Investments - Overseas	1.3
4,667.9	Equities - UK	6,637.3
1,042.0	Equities - North America	1,264.6
1,391.3	Equities - Europe	1,576.6
317.2	Equities - Japan	288.4
114.6	Equities - Pacific (Ex Japan)	75.0
192.2	Equities - Emerging Markets	78.4
89.6	Stock Lending	47.8
2,311.4	Managed Funds - UK	2,263.7
122.4	Managed Funds - Overseas	1,316.9
10,277.8		13,537.2

Total investment income across all asset classes totalled £13.6m in the financial year 2011/12.