P-Solve

London Borough of Hammersmith & Fulham Pension Fund

Investment Strategy Review next steps: Alternatives implementation or DAA

This note is addressed to the Audit & Pensions Committee (the "Committee") of the London Borough of Hammersmith & Fulham Pension Fund (the "Fund"). As part of the recent Strategy Review we proposed the Committee seek to reduce the equity holding, diversify the assets by sources of return and diversify by regional allocation (specifically the bias towards UK). In particular, we discussed introducing an allocation to Alternatives.

The purpose of this note is to describe the implementation options available for reducing the equity holding and the governance implications for each.

As a reminder for the Committee, we begin with what we mean by Alternatives and why we propose the Committee consider the introduction of an Alternatives mandate.

What we mean by Alternatives

There is a very wide range of investments that can be considered as "alternative". However, more simplistically they can be thought of as covering three different types of investment, as shown in the table below.

Broad type	Description	Examples
Traditional illiquid	Assets that pension schemes or institutions have held traditionally but that are illiquid in nature	Private equity Private debt (e.g. loans) Property
Non-Traditional "liquid"	Assets that pension schemes have typically not used significantly but that are relatively easy to trade	Commodities Non-traditional active management strategies (e.g. Hedge Funds) Carbon-credits Shipping
Non-traditional or emerging illiquid	Assets that pension schemes have typically not used significantly and that are also illiquid. These include opportunities that are more recent to emerge	Wine/art etc Insurance linked securities Intellectual capital

Why Alternatives and factors affecting returns

One of the main reasons for investing in alternatives is a belief that there are higher and/or more diverse risk-adjusted returns available.

The return arguments are relatively straightforward:

- More muted economic growth in developed markets makes seeking alternative sources of return more important
- Early stage growth opportunities have for some years tended to be illiquid anyway and investors are rewarded for providing liquidity
- Diversification by return driver (see table below) is becoming more important in the current economic climate – many are hard to access directly other than through Alternatives

- The greater availability of capital in private markets is leading to a need for institutions to think about competing for return. This results partly from the progressive de-listing of capital markets, and partly because of the rise of private financing deals going forward. In addition, shortage of capital (eg in bank lending) is generating opportunities for private capital.

In terms of factors affecting returns, we can summarise what drives long term return investments into ten underlying broad factors. These are shown in the table below.

Driver	How this drives returns
Scarcity	Some resources are finite (oil, precious metals), others are unique (artwork). Both offer the potential for return as scarcity drives up prices.
Population Growth	Availability of more people to provide services/goods
GDP per Capita	People working harder/more efficiently increases productivity
Dependency Ratio	Changes in the ratio of workers to dependents can contribute to growth
Savings Ratio	The balance between spending on consumption now and investment to generate future growth (and consumption)
Attractors	Unnecessary spending. Branded items, luxury goods, trophy assets
Risk Transfer	A return premium exists as some are willing to pay extra to insure against unexpected/large losses.
Subsidy	Governments offer targeted return incentives to encourage desired market activity or behaviour, giving exposure to public sector policy stability.
Innovation	Changing behaviours through thought/product development
Alpha/Arbitrage	Return can be generated through the application of skill (intellectual capital) and the exploitation of information.

Of these factors, four are components of economic growth, to which the majority of listed assets are exposed. These are Population Growth, GDP per Capita, Dependency Ratio and Savings Ratio.

The other factors, however, tend to be significantly less pronounced, if represented at all, in traditional portfolios of listed assets. An Alternatives portfolio can be used to gain access to these other return drivers.

Drivers of return for the Fund

The table below shows the exposure the Fund has to the different drivers of return across the investment mandates.

Driver	Gilts		UK Equity	Overseas Equity	DAA	Private Equity	Hedge Funds
	LGIM (12.5%)	*GSAM (12.5%)*	*Majedie (25%)*	*MFS (25%)*	*Barings/ Ruffer (25%)*	*Invesco/ Unigestion*	*Majedie Tortoise*
Scarcity							
Economic Growth	✓	✓	✓	✓	✓	✓	
Attractors							
Risk Transfer							
Subsidy							
Innovation						Maybe	
Alpha/Arbitrage					Some	Some	✓

We see that the main driver of return is economic growth. Though there is some exposure to other drivers of return, through the private equity and hedge fund mandates, these only represent 3% of the Fund's assets. In addition, the investment strategy is heavily weighted toward equity exposure, and in particular UK equity exposure.

For this reason, we propose that the Committee considers ways in which diversification by return driver can be improved within the current investment strategy. The most obvious way to achieve better diversification is to introduce an allocation to Alternatives. However, the Committee needs to consider the implementation options and governance implications of such an action. An alternative means of reducing reliance on UK equity returns would be to increase the allocation to DAA.

Implementation and governance considerations

The Committee recently met with Ruffer who described some of the allocations to alternative investments in the DAA mandate. These are predominantly illiquid strategies which are designed to benefit from market distress and an ability to provide liquidity to the market. Though Ruffer do not offer a stand alone alternative investment fund, the Committee could nevertheless allocate funds to this manager to diversify the assets further, and slightly increase the exposure to Alternatives. If the Committee invests further funds with Ruffer, they will also benefit from the increased allocation to rotational mandates, whereby the manager actively rotates between asset classes according to his long-term views.

The table below describes three possible methods of gaining direct exposure to Alternatives, and compares them with the other option discussed above: increasing the allocation to Ruffer.

	Alternatives mandates			**DAA**
	(1)	(2)	(3)	(4)
	Fund of Funds/ Stand-alone	Basic Advisory	Delegated	Ruffer
Description	Trustee appoints a single manager who is responsible for choice of asset classes and/or underlying managers	Trustee is responsible for choice of asset classes and underlying managers	Delegated manager is responsible for choice of asset classes and underlying managers, within risk constraints set by the Trustees	Ruffer allocates funds across broad spectrum of asset classes and actively rotates between different classes Philosophy is to preserve capital
Expected composition of allocation	Single mandate	Likely only 2 to 3 mandates, in relatively familiar asset classes e.g. Global Property, Fund of hedge funds	Expect 10-15 underlying mandates in a wide range of asset classes e.g. Global Property, Fund of hedge funds, commodities, catastrophe risk, shipping, carbon credits	A diverse split between equity from different regions, credit and some alternatives Manager has flexibility to switch between classes according to outlook
Governance requirement	Time cost associated with selecting a manager (Low to Medium)	Time cost associated with receiving training on asset classes and underlying managers (Medium)	Delegated to a third party manager with specific risk controls Governance shifts to monitoring the Delegated manager (Low to Medium)	No additional governance requirements (Low)
Diversification by return driver	Medium	Low - Medium	High	Low
Indicative fees	1-2% p.a.*	1-2% p.a.*	0.5% p.a. AUM c1% p.a. for underlying managers*	0.85% p.a.

** Managers may also charge a performance fee*

The Committee should be aware that for the first two options, each mandate appointed with a new manager may require the Committee to perform a procurement exercise and will incur advisory fees each time.

Though new mandates will be appointed with different managers in the delegated approach too, the Fund may only have to perform the procurement exercise for the delegated manager and incur the advisory fees for this one manager.

Target Strategy

As discussed in our Strategy Review, we would propose the Committee reduce the exposure to UK Equity, through the Majedie mandate, by 10% in favour of an alternatives allocation. The table below describes how the strategic allocations would change. The Committee should note that the total Fund investment target would not change as a consequence of implementing these options.

Asset Class	Manager	Current Strategic Allocation (%)	Proposed Allocation Options 1-3 (%)	Proposed Allocation Option 4 (%)
UK Equity	Majedie	25.0	**15.0**	**15.0**
Overseas Equity	MFS	25.0	25.0	25.0
DAA	Barings	18.8	18.8	18.8
	Ruffer	6.2	6.2	**16.2**
Alternatives		0.0	**10.0**	0.0
Matching Fund	Goldman Sachs/LGIM	25.0	25.0	25.0
Private Equity	Invesco/Unicredit			
Total		**100.0**	**100.0**	**100.0**
Allocation to alternatives	**(assumes DAA managers have 5-10% allocation)**	**1.25 – 2.5**	**11.25 – 12.5**	**1.75 – 3.5**

Next Steps

We will discuss with the Committee the relative merits of each implementation option for Alternatives on 23 February 2012. In particular, we would like the Committee to consider which of the options, if any, it would be able to implement or explore further. Depending on this decision, P-Solve would be able to provide the Committee with further training on the alternative asset classes which fit with the implementation method(s) chosen.

Should the Committee conclude, at this time, it does not want to proceed with a direct allocation to Alternatives or more time is required to consider the options, one immediate step the Committee could take to reduce the bias towards UK equity is to increase the allocation to the DAA funds, managed by Ruffer. Though this does not necessarily achieve the same level of diversification by driver of return, it does achieve a better diversification by asset class and region, as the allocation to direct equities and the UK respectively would be reduced.

P-Solve

February 2012