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# AUDIT, PENSIONS AND STANDARDS COMMITTEE

**28th June 2012**

| **CONTRIBUTORS** | **STATEMENT OF INVESTMENT PRINCIPLES** | **WARDS** |
|---|---|---|
| | | **All** |
| DF | This report updates and amends the Statement of Investment Principles of the Pension Fund. | |

**RECOMMENDATION:**

1. To agree the Statement of Investment Principles.

**LOCAL GOVERNMENT ACT 2000**
**LIST OF BACKGROUND PAPERS**

| No. | Description of Background Papers | Name/Ext. of Holder of File/Copy | Department/ Location |
|---|---|---|---|
| 1. | Statement of Investments File | B Pearce, Extn 1808 | **16th Floor, Westminster City Hall,** |

## 1. INTRODUCTION

1.1 Regulation 12(1) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which came into force on 1st January 2010 requires administering authorities to prepare, maintain and publish a written statement of the principles governing their decisions about the investment of fund money. This is known as the "Statement of Investment Principles".

1.2 The regulations require the Statement to be updated within six months of any material changes in the pension funds investment policy. Consequently the Statement has been updated for the recent change to the fund's Liability Benchmark, for the recent change in the percentage of the fund managed by Majedie, MFS and Ruffer and has added paragraphs on risk in accordance with IFRS accounting practices.

1.3 The Statement includes the funds compliance with the principles of investment practice set out in the publication by CIPFA called "Investment Decision Making and Disclosure in the Local Government Pension Scheme: A guide to the application of the Myners Principles" which was published on 11th December 2009.

1.4 The statement was last updated in March 2010 and the opportunity has been taken to make some minor amendments to update the Statement. It is proposed to publish the revised statement on the Council's website and intranet.

## 2. RECOMMENDATION

2.1 That the Committee agree the Statement of Investments Principles.

**LONDON BOROUGH OF HAMMERSMITH & FULHAM PENSION FUND**
**STATEMENT OF INVESTMENT PRINCIPLES – JUNE 2012**

## 1. BACKGROUND

### 1.1. Legal

Regulation 12(1) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 requires administering authorities, after consultation with such persons as they consider appropriate, to prepare, maintain and publish a written statement of the principles governing their decisions about the investment of fund money. The purpose of this document is to satisfy the requirements of the regulations.

### 1.2. Scheme

The Local Government Pension Scheme ("the Scheme") was established in accordance with statute to provide death and retirement benefits for all eligible employees. The Scheme is a contributory, defined benefit occupational pension scheme. It is funded by employee contributions and by variable employer contributions, which are set every three years, following an actuarial valuation of the assets and liabilities of the scheme.

The benefits of the Scheme are defined by statute and they are inflation proofed in line with annual increases in the Consumer Price Index for September. The Scheme is operated by designated administering authorities, of which the London Borough of Hammersmith and Fulham is one such authority. Each administering authority maintains a Pension Fund ("the Fund") and invests monies not required immediately to meet benefits.

### 1.3. Audit and Pensions Committee

The Council has delegated the investment arrangements of the scheme to the Audit and Pensions Committee ("The Committee") who decide on the investment policy most suitable to meet the liabilities of the Scheme. The Committee meets on a quarterly basis.

The Committee is made up of elected members of the Council who each have voting rights and invites representatives from the admitted and scheduled bodies within the Fund and from the trade unions, as observers. The Committee reports to the full Council.

### 1.4. Advice

The Committee obtains and considers advice from the Executive Director of Finance and Corporate Governance, and as necessary from the Fund's appointed actuary, investment managers, co-opted members and advisors.

### 1.5. Investment Management

The Committee has delegated the management of the Fund's investments to professional investment managers, appointed in accordance with the Scheme's regulations, whose activities are specified in detailed investment management agreements and regularly monitored.

## 2. INVESTMENT RESPONSIBILITIES

### 2.1. The Audit and Pensions Committee is responsible for:

- Determining overall investment strategy and ensuring that investments are sufficiently diversified, are not over concentrated in any one type of investment, and that the Fund is invested in suitable types of investments, as required by relevant regulations,

- Appointing the investment manager(s), custodian, actuary and any independent external advisors felt to be necessary for the good stewardship of the Fund,

- Monitoring the performance of the investment managers, custodians, actuary and external advisors to ensure that they remain suitable.

- Preparing, publishing and maintaining the Statement of Investment Principles, and reviewing its contents,

- Preparing, publishing and reviewing the Funding Strategy Statement, the Governance Compliance Statement and the Communications Policy and Practice Statement,

- Receiving actuarial valuations of the Fund regarding the level of employers' contributions necessary to balance the Fund.

- Reviewing policy on corporate and social responsibility and on the exercise of rights, including voting rights,

- Approving the final accounts and balance sheet of the Fund.

- Approving the Business Plan of the Fund.

### 2.2. The Investment Managers are responsible for:

- The investment of the Pension Fund assets in compliance with prevailing legislation and the detailed Investment Management Agreements,

- Tactical asset allocation and security selection around the strategic benchmark set by the Committee,

- Preparation of quarterly reports including a review of investment performance,

- Attending meetings of the Committee as required,

- Voting shares in accordance with the Council's policy except where the Council has made other arrangements.

### 2.3. The Custodian *(Northern Trust.)* is responsible for:

- Its own compliance with prevailing legislation,

- Providing valuations and accounting data summarizing details of all investment transactions within the fund,

- Safe custody and settlement of all investment transactions, collection of income, tax reclaims, and the administration of corporate actions.

- Providing a performance measurement service of the investment managers against their specific benchmarks

- Voting the Fund's shares in accordance with the investment manager's instructions.

**2.4. The External Advisor** *(P-Solve Asset Solutions.)* **is responsible for:**

- Advising and assisting the Executive Director of Finance and Corporate Governance and the Committee on the investment objective and investment strategy of the Fund and its implementation,

- Assisting the Executive Director of Finance and Corporate Governance and the Committee in their regular monitoring of the investment managers' performance,

- Assisting the Executive Director of Finance and Corporate Governance and the Committee in the selection and appointment of investment managers and custodians,

- Advising and assisting the Executive Director of Finance and Corporate Governance and the Committee on other investment related issues, which may arise from time to time,

- Providing continuing education and training to the Committee and Officers.

**2.5. The Actuary** *(Barnett Waddingham)* **is responsible for:**

- Undertaking a triennial valuation of the Fund's assets and liabilities and interim valuations as required, including those to enable compliance with the International Accounting Standard IAS19

- Providing advice as to the maturity of the Fund and its funding level in order to aid the Committee in balancing the short term and long term objectives of the Fund,

- Providing advice on the admission to and withdrawal of admitted bodies in the Fund.

**2.6. The Executive Director of Finance and Corporate Governance is responsible for:**

- Day to day administration of the Fund

- Investment accounting and preparing the annual report and statement of accounts of the fund

- Monitoring compliance with statutory requirements and the investment principles set out in this document.

- Ensuring that this document is regularly reviewed and updated in accordance with the Regulations.

- Ensuring proper resources are available to meet the Council's responsibilities.

## 3. PENSION FUND LIABILITIES

### 3.1 Overview

The Hammersmith and Fulham Pension Fund is broadly similar to other funds of comparable size in terms of its maturity. The actuary determined that the funding level was 74% at the 31st March 2010 valuation. The Committee has agreed with the actuary for the Council to make additional employer contributions over a period of 25 years to bring the funding level back to 100%.

The Fund's primary long-term risk is that the Fund's assets will fall short of its liabilities. The Fund's liabilities are sensitive to inflation via pension and pay increases, to interest rates and to mortality rates. The assets that would most closely match the liabilities are a combination of index-linked gilts as the liabilities move in accordance with changes in the relevant gilt yields.

For this reason, the benchmark used to measure the estimated movement in liabilities, The "Liability Benchmark" is calculated based on the movement of a selection of index-Linked gilts, which most match the fund's liabilities as measured at the actuarial valuation, in the following proportions: 45% Index-Linked Treasury Gilt 1 1/4%, 20% Index-Linked Treasury Gilt 1 1/4% 2027, 10% Index-Linked Treasury Gilt1 1/8% 2037, 5% Index-Linked Treasury Gilt 0 3/4% 2047 and 20% Index-Linked Treasury Gilt 1 1/4% 2055.

### 3.2 Scheme Benefits.

The Scheme is a defined benefit scheme. Each member's pension is specified in terms of a formula based on salary and service and is unaffected by the investment return achieved on the Fund's assets.

Full details of Scheme benefits are set out in the regulations. The Council has also published a guide for members of staff who are eligible to join the Scheme.

### 3.3 Funding the Benefits

As defined in the Scheme regulations, all active members of the Scheme are required to contribute a percentage of their pensionable pay to the Fund on a sliding scale based upon their level of earnings.

The Council and other employers in the Fund are responsible for meeting the balance of costs necessary to finance the benefits payable from the Fund. Employer's contribution rates are determined triennially based on the advice of the Fund's actuary and are subject to inter-valuation monitoring.

### 3.4 Actuarial Valuation

The Fund is valued by the actuary every three years in accordance with the Local Government Pension Scheme Regulations and monitored each year by the Executive Director of Finance and Corporate Governance.

The next valuation will be based on the value and position of the Fund as at 31st March 2013 and any changes in the contribution rate payable by the Council due to that valuation will take place from 1st April 2014.

## 4. INVESTMENT STRATEGY

### 4.1 Aims and Purpose of the Fund

The aims of the Fund are to:

- Enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers and admitted bodies,
- Manage employers' liabilities effectively,
- Ensure that sufficient resources are available to meet all liabilities as they fall due,
- Maximise the returns from investments within reasonable risk parameters.

The purpose of the Fund is to:

- Receive monies in respect of contributions, transfer values and investment income, and
- Pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses, as defined in the Local Government Pension Scheme Regulations

### 4.2 Investment Management Strategy

The Committee, after advice from P-Solve, the Fund's advisor, has agreed an investment strategy consisting of having four portfolios, UK Equity, Global (ex UK) Equity, Dynamic Asset Allocation and a Matching Fund (to match some of the Fund's liabilities). The investment strategy is designed to give diversification and specialisation and achieve optimum return against acceptable risk. Within the four portfolios the Committee has appointed external investment managers with clear strategic benchmarks which place maximum accountability for performance against that benchmark on the investment manager.

The UK Equity portfolio is managed by Majedie Asset Management, the Global (ex UK) portfolio by MFS International (UK) Ltd, the Dynamic Asset Allocation portfolio is split between Baring Asset Management Ltd and Ruffer LLP and the Matching Fund is split between Goldman Sachs Asset Management and Legal and General Investment Management.

Additionally, the Panel has agreed to invest up to £15 million in four private equity fund of funds. Two are managed by Invesco, which has approximately 75% invested in the United States and 25% in Europe, and the other two are managed by Unigestion which are invested almost entirely in Europe.

### 4.3 Strategic Benchmarks and Performance Targets

Each investment manager has been set a strategic benchmark in order to achieve the overall investment objective for the Fund. The current percentage managed, benchmarks and performance targets for each investment manager are set out below:

- UK Equity (22.5%) - Majedie Asset Management to produce a return of 2% after fees above the FTSE All Share index returns over rolling three-year periods.
- Global (ex UK) Equity (22.5%) - MFS International (UK) Ltd to produce a return of 2% after fees above the FTSE World (ex UK) index returns over rolling three-year periods.
- Dynamic Asset Allocation (30.0%) – Baring Asset Management Ltd (18.75%) and Ruffer LLP (11.25%) to produce an absolute return of 4% in excess of cash based on the 3 month sterling LIBOR over rolling three-year periods.
- Matching Fund (25%) - Goldman Sachs Asset Management (12.5%) to produce an absolute return of 2% in excess of cash based on the 3 month sterling LIBOR over rolling three-year periods and Legal and General Investment Management (12.5%) to produce a return of two times the Liability Benchmark Portfolio minus 3 month Libor over rolling three year periods, where the Liability Benchmark Portfolio is the combination of gilts chosen for the Fund to measure the movement in liabilities.

Investment management performance is reviewed quarterly and annually upon receipt of independent data from Northern Trust, the Fund's custodian.

### 4.4 Reporting

The investment managers' performance is reported quarterly to the Committee. The Committee publishes this Statement of Investment Principles, a Funding Strategy Statement, a Governance Compliance Statement, a Communications Policy and Practice Statement and minutes of their meetings.

## 5. INVESTMENTS AND RISK

The powers and duties of the council to invest monies are set out in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The council is required to invest any monies which are not required immediately to pay pensions and any other benefits but must not invest any monies with its own cash balances. The Fund's cash is invested separately and since 1 April 2011, the Fund has been required to have a separate bank account. This bank account is with Northern Trust.

In making investments the regulations state that the Administering Authority must take account of the advisability of investing fund money in a wide variety of investments and the suitability of particular investments and types of investments. In doing so the council must obtain and consider the advice of persons properly qualified on investment matters.

### 5.1 Types of Investment

Investment can be made in accordance with the regulations in a broad spectrum of investments such as equities, fixed interest and other bonds, private equity fund of funds and property, both in the UK and overseas.

The regulations also specify other investment instruments that may be used such as bank deposits, stock lending, financial futures, hedge funds, traded options, insurance contracts, sub underwriting contracts and a contribution to a limited partnership in an unquoted securities investment partnership. The limits on the amount of monies that can be invested in each individual type of investment are specified in schedule 1 of the Regulations.

**5.2 Investment Management**

The Committee has appointed external investment managers under the terms of the Regulations whose roles are described in the Investment Strategy above. The managers are paid fees (one with a performance related element) based on percentage rates applied to the market value of the assets under management.

The Committee has appointed P-Solve Asset Solutions as the Fund's advisor. They are paid fees based on an agreed schedule of work. A fee is agreed with the advisor in advance for any additional work over and above the agreed schedule.

The Committee has appointed Northern Trust as global custodian. They are paid fees based on the market value of the funds under management and the number of transactions made by the investment managers.

**5.3 Investment Risk**

The investment strategy of the Fund has been set so as to meet a return equivalent to the Liability Benchmark (see paragraph 3.1 above) plus 2.2% p a. The investment strategy aims to exceed this and targets a return of 2.5% in excess of the Liability Benchmark. To achieve this the Fund's assets are invested in a broad range of asset classes in terms of geographical and industry sectors and individual securities which are expected to produce returns above the Liability Benchmark over the long term albeit with greater volatility. This diversification reduces exposure to *price risk, currency risk, interest rate risk, credit and liability risk* to an acceptable level.

The aim of the investment strategy is to minimise the risk of an overall reduction in the value of the Fund and to maximise the opportunity for gains across the whole fund portfolio. Responsibility for the Fund's investment strategy rests with the Audit and Pensions Committee and is reviewed on a regular basis.

*Price risk* represents the risk that the value of a financial instrument will fluctuate as a result of changes in market prices (other than those arising from interest rate risk or foreign exchange risk), whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all such instruments in the market.

The fund is exposed to *price risk*. This arises from investments held by the fund for which the future price is uncertain. All securities represent a risk of loss of capital. The maximum risk resulting from financial instruments is determined by the fair value of the financial instruments. The fund's investment managers aim to mitigate this price risk through diversification and the selection of securities and other financial instruments.

*Currency risk* represents the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The fund is exposed to currency risk on financial instruments that are denominated in any currency other than pounds sterling.

*Interest rate risk* represents the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The council recognises that interest rates can vary and can affect both income to the fund and the value of the net assets available to pay benefits.

*Credit risk* represents the risk that the counterparty to a transaction or a financial instrument will fail to discharge an obligation and cause the fund to incur a financial loss. The market values of investments generally reflect an assessment of credit in their pricing and consequently the risk of loss is implicitly provided for in the carrying value of the fund's financial assets and liabilities. In essence the fund's entire investment portfolio is exposed to some form of *credit risk*. However the selection of high quality fund managers, counterparties, brokers and financial institutions minimises *credit risk* that may occur through the failure to settle a transaction in a timely manner.

*Liquidity risk* represents the risk that the fund will not be able to meet its financial obligations as they fall due. The council therefore takes steps to ensure that the pension fund has adequate cash resources to meet its commitments. This will particularly be the case for cash to meet the pensioner payroll costs; and also cash to meet investment commitments. The council has immediate access to its pension fund cash holdings. The fund also has access to an overdraft facility with Northern Trust for short-term cash needs. This facility is only used to meet timing differences on pension payments.

### 5.4 Realisation of Investments

The vast majority of the Fund's investments are readily marketable and may be easily realised if required. Some investments, such as private equity and limited partnership schemes are less easy to realise in a timely manner but the total value of these types of investments is not considered to have any adverse consequences for the Fund.

### 5.5 Stock Lending

The council does not engage in the lending of stocks or other securities from its pension fund.

## 6. CORPORATE SOCIAL RESPONSIBILITY

This statement is an outline of the Fund's approach to shareholder engagement. It provides the basis for the broad policies which the Fund believes constitute best practice and provides the framework within which it will enter into engagement with companies in which it invests.

The Fund recognises that the neglect of corporate governance and corporate social responsibility (CSR) may lead to poor or reduced shareholder returns.

The Committee has considered how the Fund may best implement a corporate social responsibility policy, given the current resources available to the Fund. Accordingly, the Committee has delegated CSR (social, environmental and ethical) policy to the appointed investment managers. The council believes this is the most efficient approach whilst ensuring the implementation of policy by each manager is consistent with current best practice and there is appropriate disclosure and reporting of actions taken.

Authority has been delegated to the investment managers to exercise voting rights on behalf of the Fund. The investment managers are required to report how they have voted in their quarterly reports.

## 7. COMPLIANCE WITH THIS STATEMENT

The Committee will review the Fund's compliance with this Statement of Investment Principles and issue a revised version following any material change in the Council's policy.

## 8. COMPLIANCE WITH THE SIX MYNERS PRINCIPLES OF INVESTMENT DECISION MAKING

Regulation 12(3) of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 requires an administering authority to report on its compliance with the six Myners Principles, in accordance with guidance given by the Secretary of State. The guidance for the Local Government Pension Scheme is set out in the publication by CIPFA called "Investment Decision Making and Disclosure in the Local Government Pension Scheme: A guide to the application of the Myners Principles".

The principles, together with the council's position on compliance are set out below:

**Principle 1 - Effective decision-making,**

***Administrating authorities should ensure that:***

- ***Decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make them effectively and monitor their implementation; and***

- ***Those persons or organizations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.***

**Fully Compliant** - The council has delegated the management and administration of the pension fund to the Audit and Pensions Committee ("The Committee") which meets quarterly. The responsibilities of The Committee are described in paragraph 2.1 above.

The Committee is made up of elected members of the council who each have voting rights and has representatives from the admitted and scheduled bodies within the Fund and from trade unions, as observers. The Committee has specific terms of reference which are reviewed and agreed annually, standing orders and operational procedures and reports to the full council. Members are not paid specifically for these duties.

The Committee obtains and considers advice from the Executive Director of Finance and Corporate Governance, and as necessary from the Fund's appointed actuary, investment managers and advisors.

The Committee has delegated the management of the Fund's investments to professional investment managers, appointed in accordance with the scheme's regulations, whose activities are specified in detailed investment management agreements and regularly monitored.

**Principle 2 - Clear objectives**

***An overall investment objective(s) should be set for the fund that takes account of the scheme's liabilities, the potential impact on local tax payers, the strength of the covenant for non-local authority employers, and the attitude to risk of both the administering authority and scheme employers, and these should be clearly communicated to advisors and investment managers.***

**Fully Compliant** - The Committee has agreed in conjunction with its advisor an investment objective that is directly related to the Fund's liabilities (See paragraph 3.1 above). The investment objective aims to enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers and admitted bodies,

The investment strategy has been set with the objective of controlling the risk that the assets will not be sufficient to meet the liabilities of the Fund while achieving a good return on investment (see paragraphs 4 and 5 above).

The approach taken reflects the Fund's liabilities and was decided upon without reference to any other funds. The Fund's performance is measured against the investment objective on a quarterly basis.

**Principle 3 – Risk and liabilities**

***In setting and reviewing their investment strategy, administrating authorities should take account of the form and structure of liabilities.***

***These include the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk.***

**Fully Compliant** - The Committee has agreed in conjunction with its advisor an investment Strategy that is directly related to the Fund's liabilities. The investment strategy is described in paragraphs 4 and 5 above.

The investment strategy is designed to give diversification and specialisation and achieve optimum return against acceptable risk (see paragraph 5.3 above).

**Principle 4 – Performance Assessment**

***Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisors***

***Administering authorities should also periodically make a formal assessment of their own effectiveness as a decision-making body and report on this to scheme members***

**Partially compliant** - The Committee has appointed investment managers with clear index strategic benchmarks (see paragraph 4.3 above) within an overall Investment objective which place maximum accountability for performance against that benchmark on the manager.

The managers are monitored at quarterly intervals against their agreed benchmarks, and independent detailed monitoring of the Fund's performance is carried out by P-Solve Asset Solutions, the Fund's advisor and by Northern Trust, the Fund's custodian who provide the performance figures.

The advisor is assessed on the appropriateness of asset allocation recommendations and the quality of advice given (see paragraph 2.4 above). The actuary is assessed on the quality and consistency of the actuarial advice received (see paragraph 2.5 above). Both the advisor and the actuary have fixed term contracts which when expired are tendered for under the OJEU procedures.

The Committee does not periodically make a formal assessment of its own effectiveness as a decision-making body but does receive quarterly reports as to how the Fund has performed against the investment objective set by the Committee. The performance figures are included in the extract from the accounts which is sent to stakeholders annually.

**Principle 5 – Responsible Ownership**

***Administering authorities should:***

- ***Adopt, or ensure their investment managers adopt, the Institutional Shareholders Committee Statement of Principles on the responsibilities of shareholders and agents***
- ***Include a statement of their policy on responsible ownership in the statement of investment principles***
- ***Report periodically to scheme members on the discharge of such responsibilities***

**Partially compliant –**

Majedie our UK Equity investment manager has adopted the Institutional Shareholders Committee Statement of Principles and MFS our overseas equity investment manager are signatories of the United Nations Principles of Responsible Investment (UNPRI).

Barings and Ruffer who manage our Dynamic Asset Allocation portfolios which have some equity exposure have not adopted the principles but have corporate governance and socially responsible investment policies which are broadly in line with the principles.

The Fund believes in using its influence as a shareholder to promote corporate social responsibility and high standards of corporate governance in the companies in which it invests (see paragraph 6 above). Authority has been delegated to the investment managers to exercise voting rights on behalf of the Fund. The investment managers are required to report how they have voted in their quarterly reports.

This Statement of Investment principles is included in the Pension Fund Annual Report which is available to all scheme members.

**Principle 6 – Transparency and reporting**

***Administering authorities should:***

- ***Act in a transparent manner, communicating with stakeholders on issues relating to their management of investments, its governance and risks, including performance against stated objectives***
- ***Provide regular communications to scheme members in the form they consider most appropriate.***

**Fully compliant** - The Governance Compliance Statement, the Statement of Investment Principles, the Funding Strategy Statement and the Communications Statement are all included in the Pensions Fund Annual Report which is published and is accessible to stakeholders of the Fund on the Council's web site and internal intranet. Monitoring results of the fund's performance are also included. An extract from the accounts is sent to stakeholders annually.