Matching Fund Considerations

London Borough of Hammersmith & Fulham Pension Fund

Introduction

This paper is addressed to the Audit & Pensions Committee (the "Committee") of the London Borough of Hammersmith & Fulham Pension Fund (the "Fund") and considers the continued suitability of the existing Matching Fund structure. We firstly provide a recap of the Fund's investment strategy and overall objectives before discussing how the Matching Fund fits within these objectives. We have also provided an overview of the performance of the Goldman Sachs Asset Management ("GSAM") portfolio since inception before going on to discuss the continued suitability of the Matching Fund structure.

In conclusion, we believe the existing Matching Fund continues to be appropriate for the Fund and do not recommend making any changes at this time. The rest of this paper discusses the reasoning for this recommendation.

Current Investment Strategy

The table below outlines the Fund's broad investment strategy:

Asset Class	Manager	Asset Allocation	Objective (p.a.)
Investment Fund	-	**75%**	**LB + 3%**
UK Equities	Majedie	22.5%	FTSE All Share + 2%
Global Equities	MFS	22.5%	FTSE World ex UK + 2%
DAA	Barings	18.8%	3 Month £ LIBOR + 4%
DAA	Ruffer	11.2%	3 Month £ LIBOR + 4%
Matching Fund	-	**25%**	**LB + 1%**
Bonds Portfolio	GSAM	12.5%	3 Month £ LIBOR + 2%
Gilt Portfolio	LGIM	12.5%	2 x LB - LIBOR
Total Fund	-	**100%**	**LB + 2.5%**

** LB refers to the Liability Benchmark, a portfolio of Gilts designed to perform broadly in line with the Fund's liabilities, according to their respective sensitivity to changes to interest rate and inflation expectations.*

Overall, the Fund's investment strategy targets a return of LB + 2.5% p.a. (with the Investment Fund and Matching Fund targeting 3% and 1% respectively of outperformance).This is in line with the return required for the Fund to be fully funded by the end of the Recovery Plan in 2026.

Matching Fund overview

The purpose of the Matching Fund is predominantly to provide the Fund with protection against changes in interest rates and inflation (which will affect the value of the Fund's liabilities). The Matching Fund also aims to outperform the Fund's liabilities by 1% p.a. in order to help meet the Fund's overall target of LB + 2.5%.

50% of the Matching Fund assets are invested in a bond portfolio managed by GSAM. The current GSAM portfolio has been in place since February 2009, when assets were transferred from a conventional bond mandate, benchmarked against gilts and corporate bonds, into a more flexible bond fund targeting an absolute return of 3 Month £ LIBOR + 2% p.a.

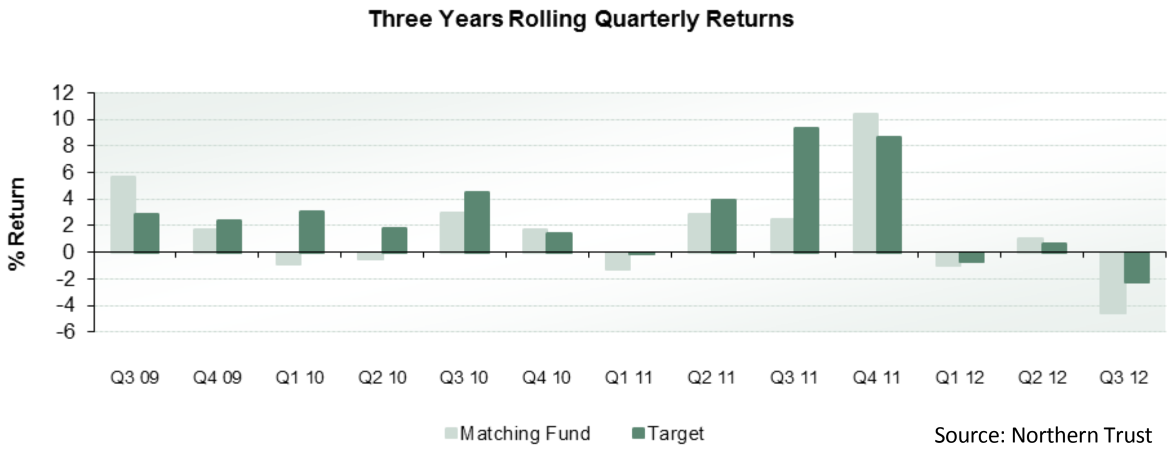
The remaining 50% of the Matching Fund assets are invested with LGIM in a portfolio aiming to control risk by investing in a portfolio of gilts and derivatives that broadly matches the Fund's liabilities. The current LGIM solution was implemented over Q1 2012. As the Fund only allocates 12.5% of overall assets to LGIM, it is not possible to hedge the total level of the Fund's liabilities. Therefore, LGIM targets two to three times leverage, meaning that the Fund gets two to three times the interest rate and inflation exposure implied by the assets invested. Considering these restrictions, the hedge was designed to be as efficient as possible, which translates into LGIM hedging 40% of the Fund's liability cashflows falling between 2027 and 2056. This design was chosen to have a similar duration to the Fund's liabilities and excludes the Fund's short term liabilities (which are relatively less sensitive to changes in interest rates and inflation) and very long term liabilities (which make up a very small proportion of overall liabilities). For performance monitoring purposes, LGIM are measured against a leveraged version of the Fund's LB. However, in reality LGIM are only hedging a subset of the Fund's liabilities and therefore comparing their performance relative to this objective should be done with care.

We will continue to review the Fund's matching strategy as appropriate and advise the Committee when the level of hedging could be amended to achieve further objectives.

Holding GSAM and LGIM together provides the LB + 1% objective the Matching Fund targets.

Performance

The chart below shows the historical performance of the Matching Fund relative to its target (LB + 1%) over the last three years:



Source: Northern Trust

The current Matching Fund solution was only put in place with LGIM over Q1 2012 and therefore this history shows mainly the previous, less precise Matching Fund strategy. Taking this into consideration, the Matching Fund is 0.9% behind its target over the last 12 months and 5.6% p.a. behind its target over the last 3 years. However, this is largely a result of the LGIM portfolio underperforming the Fund's LB, for the reasons discussed above (i.e. only managing a limited spectrum of the Fund's liabilities). The GSAM portfolio has generally outperformed its target over this period, which we discuss further in the following section.

GSAM

History

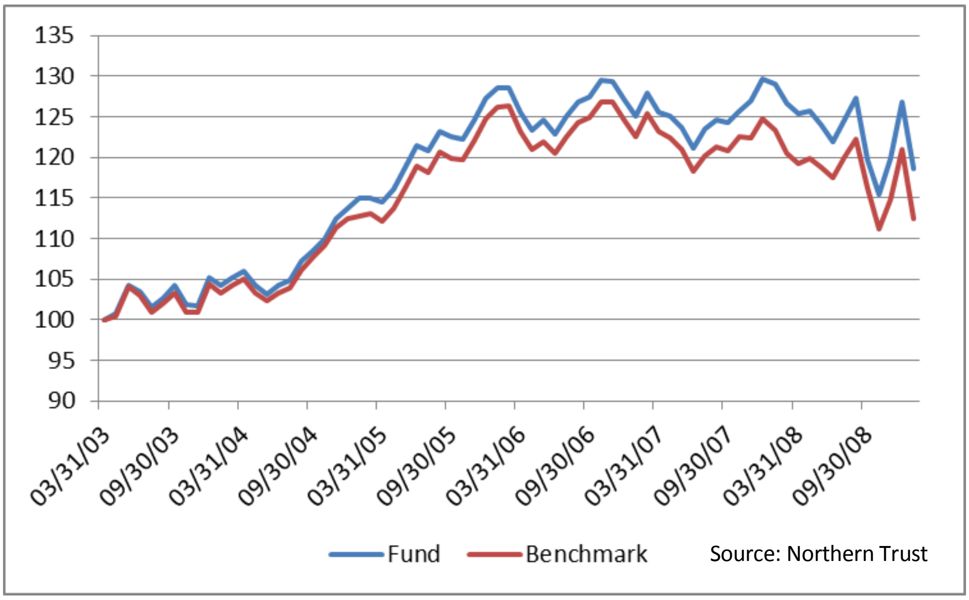
The Fund has had an active mandate in place with GSAM since April 2003. Originally GSAM were appointed to manage a balanced mandate on behalf of the Fund investing in both equities and bonds; in 2005 this mandate was amended to only include bonds. More detailed information on the mandates that GSAM have managed are shown in the table below:

		01/04/2003 – 30/06/2003	30/06/2003 – 01/11/2003	01/11/2003 – 12/05/2005	12/05/2005 – 06/02/2009
Benchmark	**Asset Class**	**Weighting**			
FTSE All Share	UK Equity	49%	44%	35%	-
MSCI World ex-UK (unhedged)	Global Equity	26%	29%	35%	-
FTSE UK Gilts Over 15 Years	UK Gilts	5%	5%	5%	16.67%
ML Over 10 Year Sterling Non-Govt	Sterling Corporate Bonds	20%	22%	25%	83.33%
Target		+ 1.15% (net)	+ 1.15% (net)	+ 1.15% (net)	+ 1.00% (gross)

On 6 February 2009, assets were transferred to the Global LIBOR Plus I Portfolio (later renamed the Strategic Absolute Return Bond I Portfolio) targeting 3 Month GBP LIBOR + 2% p.a. (gross of fees).

Performance

The chart below shows the performance of GSAM from April 2003 through to transferring the Fund's assets into the Strategic Absolute Return Bond I Portfolio in February 2009 (more below):



The Benchmark in the graph is as described in the table on the previous page, and does not include the additional outperformance in the target. Over this period GSAM were ahead of their benchmark by 0.9% p.a., placing them slightly behind their outperformance target – which varied between c.1% – 1.15% over this period.

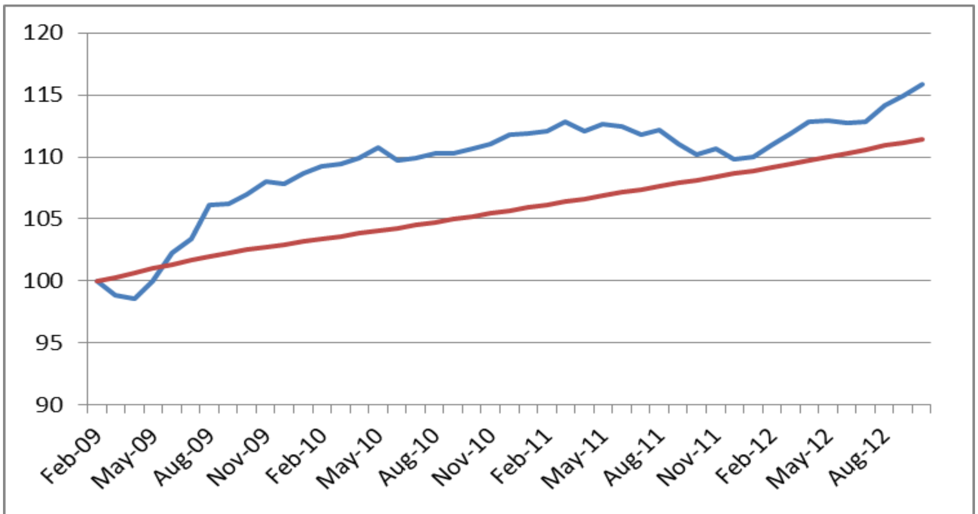
Strategic Absolute Return Bond I Portfolio

In 2008, we recommended the Committee adjusted GSAM's benchmark to be cash-plus rather than bonds-based, whilst maintaining the existing mandate. This solution had the following advantages:

- It was straightforward to implement
- The removal of the gilts-based benchmark freed up capital invested in these assets to be deployed more efficiently
- The risk budget was maintained

GSAM then proposed the alternative solution of investing in their pooled LIBOR Plus funds. These funds invest on a global basis across a range of bond assets, including government and corporate debt as well securitised assets. Following a discussion at their meeting, the Committee agreed to invest in the Strategic Absolute Return Bond I Portfolio and this mandate was funded in February 2009.

The chart below shows the performance of GSAM since the Fund's inception in this portfolio:



Source: GSAM

The portfolio performed strongly over 2009 and 2010 and was ahead of its target over this period (i.e. LIBOR + 2%). However, the portfolio struggled in 2011 and finished the year 4.5% behind its target. Contributors to this included the portfolio's pro-growth positioning in the corporate credit sector (at a time when credit spreads widened further) and a high allocation to securitised assets, which suffered in the face of rising risk-aversion and bank deleveraging.

So far in 2012, GSAM's portfolio positioning has seen it outperform its target by 3.0% (to 30 September). Therefore, coupled with strong performance over 2009 and 2010, the Strategic Absolute Return Bond I Portfolio has outperformed its target by 1.1% p.a. since inception.

Conclusion

Over the last few years, the Committee has made a number of changes to the Matching Fund to enhance its ability to meet the Fund's investment objectives. Namely, to protect the Fund from changes in interest rates and inflation and to generate the necessary outperformance to support the Fund's overall investment objective of LB + 2.5% p.a.

By implementing a new bespoke liability hedging solution with LGIM in Q1 2012, the Fund has significantly enhanced its ability to manage interest rate and inflation risk. However, this is not to say that this solution could not be extended in future to better meet the Fund's objectives. In addition, the decision made to transfer assets into GSAM's LIBOR benchmarked fund, a decision made to increase returns, has proven successful thus far and GSAM are ahead of their target by 1.1% p.a. since inception.

Gilt and corporate bond yields are currently at historic lows, which have led to strong performance in the LGIM and GSAM portfolios. Disinvesting from these assets now would crystallise the profits made to date. However, Gilts (invested through LGIM) are included in the investment strategy not to generate outperformance but to provide the Fund with protection against falling interest rates and rising inflation. Selling these assets now would compromise the liability hedge the Committee has implemented over the last few years and increase the Fund's exposure to interest rate and inflation risk. If (and when) yields do rise from their current levels, the Fund will experience a loss on its bond assets. However, by continuing to follow a matched investment strategy, this fall in asset value should be compensated for by a fall in the Fund's liabilities, resulting in an broadly neutral impact on the Fund's funding level (as the liability hedge is designed to do).

With regards to the risk of losing the gains made from the fall in corporate bonds yields (invested through GSAM), the management of this risk is delegated to the manager: it is expected that GSAM would rotate between different bond assets and cash to preserve the gains made. By delegating this decision, the manager is able to react to market conditions in a more dynamic manner to the benefit of the Fund.

Recommendation

For the reasons outlined above, it is not appropriate to alter the Matching Fund at this time. The LGIM solution is designed to provide the Fund with interest rate and inflation protection not to generate outperformance – even if the value of this portfolio falls, this should happen at times when the Fund's liability value is also falling. In addition, GSAM are on track to meet their outperformance target of 3 Month £ LIBOR + 2% p.a.

What is more pertinent is that we should address the objective for the overall Matching Fund and its consistency with the objectives at a mandate level for the LGIM and GSAM portfolios.

We look forward to discussing this further with the Committee.

P-Solve

November 2012