EXTRACTS FROM REPORT TO PENSIONS WORKING PARTY
30 OCTOBER 2012

BENCHMARKS

Purpose of the Report

1. To outline the purposes of benchmarks and initiate discussion on current benchmarks used by the Fund and suggestions for change.

Information and Advice

2. A benchmark is defined as a standard by which something can be measured or judged. Benchmarks perform two main functions for a pension fund – firstly to define and evaluate the overall performance of the Fund; secondly to set targets for individual fund managers against which their performance will be measured.

3. The Fund is currently split into five main portfolios:
    - In-house global equities
    - Schroders global equities
    - Kames bonds
    - Aberdeen direct UK property
    - Various pooled equity, property and alternative investments

4. Each main manager has a specific benchmark made up of relevant market indices with a specified target for outperformance. The current benchmark arrangements are shown in Appendix A. The investments within the last portfolio mostly compare performance with a particular market index but, as these are largely pooled investments, the Fund has little control over these benchmarks. The overall performance of the Fund is currently compared to a composite benchmark created by combining the various benchmarks used within each portfolio.

5. Appendix B shows extracts from the Fund's Funding Strategy Statement (FSS) and Statement of Investment Principles (SIP). According to the FSS the long term objective of the Fund is to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities in order to ensure that liabilities can be met and employers' contribution rates can be kept as nearly constant as possible. It is recognised that investment returns have a valuable role in achieving these aims.

6. The results of the 2010 valuation show the liabilities to be 84% covered by current assets. Future deficit contributions are set to recover the deficit over a period of up to 20 years. However, positive investment returns can help to reduce the deficit and mitigate the impact on employers. For this reason the current strategic asset allocation favours growth assets (equities and property) over defensive assets (bonds and cash).

7. In carrying out the triennial valuation, the actuaries make allowance for the expected long term returns from the Fund's investments. At the 2010 valuation the long term expected returns from the main asset classes were:

Equities/absolute return funds	7.5%
Gilts	4.5%
Bonds & Property	5.6%

   Actual investment returns are incorporated into the next valuation as either a positive or negative inter-valuation factor.

8. The current composite Fund benchmark does not link directly to the Fund's long term objectives. The strategic benchmark should have an explicit link to the liabilities and make clear the long term nature of the objective. It is suggested therefore that a strategic benchmark be set for the Fund that incorporates the expected long term returns from the various asset classes. This would be reviewed and amended as appropriate after each triennial valuation. The strategic asset allocation is then determined with this benchmark in mind.

9. The benchmarks set for each manager have a dual role. They enable comparison of performance to market indices but they also influence the investment approach of the manager by effectively setting limits over the assets in which they can invest. The performance target also gives an indication of the level of risk that is acceptable. The benchmarks set for each manager should reflect the risk and return expectations arising from the strategic asset allocation.

10. The current benchmarks for the In-House portfolio and for Schroders include reference to the CAPS (Mellon) consensus. These use the average asset allocations from the BNY Mellon universe of funds (the average allocations as at 31 March 2012 are shown in Appendix B). The Fund used to use BNY Mellon for performance measurement but has recently switched to WM as this more closely reflects LGPS funds. If it is considered appropriate to continue using average allocations as a means of setting benchmarks, it is recommended that these be based on WM Local Authority average allocations.

11. There are question marks, however, over using consensus or average allocations to drive performance. Although it can be useful to compare to other funds, performance benchmarks should link to the Fund's particular circumstances rather than those of an average fund. An alternative would be to set a benchmark based on the proportion of each region in the global stock market. These weightings could be adjusted according to Members' views on particular markets.

12. The overall objective of the Fund is very long term in nature but regulations require that performance is monitored on a quarterly basis. However, the guidance on compliance with the revised Myners Principles suggests that 'although returns will be measured quarterly, a longer timeframe (typically 3 – 7 years) should be used to assess the effectiveness of Fund management arrangements'. The Fund has always believed in looking at a manager's long term track record when concerns arise over performance but it is suggested that focusing quarterly reporting more on longer term performance (for example 1 and

3 years) would highlight this belief and also link more clearly to the long term objective of the Fund.

In-House
Benchmark:
CAPS (Mellon) consensus equities

Schroders
Benchmark:

UK equities	57%
CAPS (Mellon) consensus overseas equities	42.5%
Cash	0.5%

Relevant indices for both In-House and Schroders portfolios:

		Average at 31/3/12	
Equity Region	**Index**	**CAPS**	**WM LA**
UK	FTSE All-Share	47.3%	48.8%
US	FTSE AW US	18.6%	19.5%
European	FTSE WI Europe ex UK	15.9%	11.4%
Japanese	FTSE AW Japan	6.2%	5.0%
Pacific ex Japan	FTSE AW Developed Asia Pacific ex Japan	6.9%	7.4%
Emerging Markets	MSCI Emerging Market	4.6%	7.3%
Cash	LIBID 7 day	0.5%	0.5%

Kames
Benchmark:

FTSE-A Gilt All-Stock	40%
Merrill Lynch Sterling Non-Gilt All-Stock	30%
Citigroup WGBI ex-UK (unhedged)	20%
FTSE-A Index-linked Gilt over 5 years	10%

Allocation ranges:

UK Government Bonds	10-70%
UK Corporate Bonds	10-50%
International Government Bonds (including 20% International corporate bonds)	0-40%
UK Index-Linked Bonds	0-30%
Cash	0-15%

Aberdeen
Benchmark:
IPD Annual December Universe

Extracts from the Funding Strategy Statement

3.1 **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, scheduled, resolution 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

5.1 To meet the requirements of the Regulations the Administering Authority's long term funding objective is for the Funds to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities (the "funding target") assessed on an ongoing basis including allowance for projected final pay.

5.2 The principal method and assumptions to be used in the calculation of the funding target are set out in Appendix A. Underlying these assumptions are the following two tenets:

- that the Scheme and the major employers are expected to continue for the foreseeable future; and
- favourable investment performance can play a valuable role in achieving adequate funding over the longer term.

6.1 The investment policy of the funds is set out in the Statement of Investment Principles (SIP). In assessing the value of the Scheme's liabilities in the valuation, the funding basis sets the discount rate to value the liabilities as the expected investment return from the agreed investment strategy taking into account the investment strategy adopted by the Scheme, as set out in the SIP.

6.2 The results of the 2010 valuation in respect of the Nottinghamshire County Council Pension Fund show the liabilities to be 84% covered by the current assets, with the funding deficit of 16% being covered by future deficit contributions.

The current benchmark investment strategy, as set out in the SIP, is:

Equities	55% - 75%
Property	5% - 25%
Bonds	10% - 25%
Cash	0% - 10%

6.3 The Fund will be invested on a core/satellite approach, with approximately 40% of the fund managed in-house on an enhanced index-tracking basis, and the balance with specialist managers who are given targets for out-performance against benchmarks.

Extracts from the Statement of Investment Principles

5.1 Contribution income currently exceeds benefit payments and a recent investment strategy review, carried out by the Fund's actuaries, found that this is likely still to be the case in 20-30 years time. This makes it unlikely that assets will have to be realised in order to meet pension benefits and allows the Fund to implement a long term investment strategy.

5.2 The agreed asset allocation ranges are therefore:-

Equities	55% to 75%
Property	5% to 25%
Bonds	10% to 25%
Cash	0% to 10%

These ranges will be kept under regular review. If it appears likely that these limits might be breached because of market movements, reference will be made to a meeting of the Pensions Working Party for advice. The proportions are those aimed at achieving best returns whilst minimising overall variability in the future employers' contribution rates. These have been confirmed as appropriate by the investment strategy review.

5.3 In carrying out the triennial valuation, the actuaries make allowance for the expected long term additional returns from the Fund's investments relative to a portfolio of Government bonds. The assumed level of out-performance at the most recent valuation was 2.3% per annum. Actual returns will be incorporated into each actuarial valuation.

5.4 The policy of the Fund will be to treat the equity allocation as a block aimed at maximising the financial returns to the funds (and thus minimising the employers contribution) consonant with an acceptable level of risk. The block of Bonds, Property and Cash is aimed at lowering overall risk (at the cost of anticipated lower return). The Fund will vary between the asset classes according to market circumstances, relative performance and cash flow requirements.