report

meeting	**PENSIONS INVESTMENT SUB COMMITTEE**	
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REPORT OF THE STRATEGIC DIRECTOR OF RESOURCES

NAPF CONFERENCE – INVESTING TODAY, SECURING TOMORROW – MARCH 2008

Purpose of the Report

1. To inform Members of the main areas covered at the annual National Association of Pension Funds (NAPF) Conference.

Information and Advice

2. The NAPF Conference was held in Edinburgh on 5-7 March 2008 and was attended by three Members and one Officer. Its theme was investing today, securing tomorrow and the Conference raised a number of key issues including investment risk, private equity, investing for a sustainable future, property and longevity implications for Pension Funds. The Conference heard from expert speakers from the Pensions industry and also from Lord Eddie George, the former Governor of the Bank of England. He provided the keynote address to the Conference.

3. In his session, Lord Eddie George reviewed the causes of the current credit crunch highlighting the role played by the sub prime mortgage sector in America. He commented upon the demise of Northern Rock saying that no one had seen it coming and that it was unrealistic to expect the Financial Services Authority to have anticipated it happening. He called for greater transparency on banks' liabilities and felt that the current problems would lead banks to question their existing business models, re-consider their risk profiles and to inevitably improve their controls. Looking ahead, he foresaw further credit losses and a slowdown in growth, particularly in America. He felt that the British economy would continue to grow but at a lower rate than originally forecast. Equity markets would be volatile but could recover and overall he was optimistic that the stability necessary for economic growth would return to the UK economy.

4. Other speakers covered a wide range of pension investment issues and the most relevant points from these are summarised as follows:-

a) Investment Strategy Risk

All Pension Funds face risks from a number of different sources with the asset allocation strategy acknowledged as a key determinant of the amount of risk each Fund faces. Investments in equities are often seen as high risk particularly in comparison to fixed interest investment and cash, the latter seen as risk free. Equity risk is often analysed over market risk (beta) and manager risk (alpha). Generally, the more risk, the higher the potential return but each Fund needs to spread risk and generally does this by means of diversification. Elaborate models exist to optimise portfolio structuring incorporating analytical tools and using alternatives such as derivatives to spread the risk in the search for optimising returns.

b) Private Equity

In total, UK Pension Funds hold approximately £14bn in private equity investments, about 1.7% of the value of British Pension Fund investments. In practice, most Pension Funds have little exposure to private equity, and of those that do, it is rare to find any Fund with more than 2.5% of funds committed. Fees can be high but returns can also be high though the average return tends to be in the region of 8% per annum. However, Funds can lose money and private equity involves committing cash for longish terms. Nevertheless increased Pension Fund investment in private equity should be considered because of the potential returns.

c) Investing for a Sustainable Future

The publication of the United Nations Intergovernmental Panel on Climate Change report in November 2007 reaffirmed the previous findings of the Stern report that climate change was occurring as evidenced by increasing air and ocean temperatures and rising sea levels. While such reports have raised awareness of the issue, Pension Fund trustees continue to be mainly concerned about addressing their Fund's liabilities and reducing deficits though, a view is emerging that trustees should take account of climate change in devising their investment strategies. Some Pension Funds are adjusting their strategies in this way to both manage the risk and to benefit from the opportunities that climate change offers. However, one of the primary responsibilities of Pension Funds is to ensure that they have sufficient funding to pay pensions in the long term. Although Pension Funds have started to reflect climate change issues, implementation is predicted to be slow. The likelihood is that, in the longer term, investment strategies will change to take account of climate change and more initiatives in this area are anticipated.

d) Outlook for Property

Pension Funds continue to hold varying levels of investment in property. The 2006 NAPF Survey showed that only slightly more than half (54%) of schemes invest in property. While 18% claimed to have increased their allocation in the previous 12 months, the average holding was 7%. Property investment has been mainly UK based but interest is increasing in overseas property. While Funds tend not to invest directly in individual properties, exposure can be increased through diversified funds and funds of funds. Overall, continued steady growth should remain achievable but growth rates will decline with future returns in single figures.

e) Longevity Risk

Increasing life expectancy has been commented upon frequently with mortality rates reducing by around 4.5% per annum at some ages compared to a long term average of 1.2% a year over the last 70 years. Rising longevity increases Pension Funds' exposure on pensions paid out adding to liabilities. It has been estimated that every extra year of life expectancy at age 65 adds 3% to the value of pension liabilities. In response to this, a number of financial products have emerged to try and counter this risk including longevity bonds, swaps and hedging instruments. However, attempts to develop such products have been problematical e.g. a type of longevity bond issued in 2004 was unsuccessful partly due to a lack of understanding by trustees. Further developments to produce products using derivatives and swaps are being marketed but it is still uncertain whether longevity risk can be managed cost effectively via financial products.

f) Other Sessions

The Conference received updates on a number of other areas including:-

a) Pension Protection Fund – by the end of 2007/8 the Fund's value had grown to £2bn and is expected to reach £5bn by the end of 2009.

b) Pension Fund Advisers – a NAPF survey of Pension Funds' views on professional advisers was generally positive. Pension Fund trustees are required to take advice from suitably qualified professionals but to make up their own minds on decisions.

c) Fiduciary Management Services – more common abroad than in the UK, some Pension Funds are delegating certain functions e.g. the choice of fund managers or making investment decisions to external service providers. This is primarily because of the increasing complexity of Pension Fund investment and more fiduciary management arrangements are likely in future years though trustees will still retain overall control of the Funds' investment strategy.

5. Overall, the Conference provided a very useful opportunity to receive updates on current issues and to identify emerging developments that could have an impact on the Pension Fund.

Statutory and Policy Implications

6. This report has been compiled after consideration of implications in respect of finance, equal opportunities, personnel, crime and disorder, human rights and those using the relevant service. Where such implications are material, they have been described in the text of the report.

Recommendation

7. That the Conference report is noted.

ARTHUR DEAKIN
STRATEGIC DIRECTOR OF RESOURCES

Background Papers Available for Inspection

Nil