meeting	**PENSIONS INVESTMENT SUB-COMMITTEE**	
date	**30 MARCH 2007**	agenda item number

REPORT OF THE STRATEGIC DIRECTOR OF RESOURCES

NAPF CONFERENCE – MAKING CHANGE MAKE SENSE – MARCH 2007

Purpose of the Report

1. To inform Members of the main areas covered at the Annual NAPF Conference.

Information and Advice

2. The NAPF Conference was held in Edinburgh on 14 -16 March 2007 and was attended by two Members and two officers. Its theme was Making Change Make Sense and examined many of the changes occurring from a trustee and manager perspective. The Conference heard from a number of expert speakers from the pensions industry and also from two high profile politicians namely Al Gore, the ex Vice President of the United States and Ed Balls, the current Economic Secretary in the Treasury.

3. Al Gore's focus was climate change and the role that Pension Funds could take to help reduce the potentially catastrophic implications of the current and emerging climate crisis. He highlighted outdated concepts of what it means to be a prudent trustee and felt there was a lack of consideration of environmental and social issues when planning for wealth creation. The principles of responsible investment provided a framework for progress and he urged Pension Fund Managers to think long term and not to ignore sustainable investments in favour of short term return. Good investors should seek additional information on environmental records, attitude to communities, ethics and value in researching investment opportunities. Pension Funds now had such huge sums at their disposal that they could influence and shape the ways that companies operate and could provide environmentally sound and sustainable practice across all parts of the global economy.

4. Ed Balls outlined the trends of the last 10 years and reflected on a number of these including growing pensioner inequalities, the reduced number of defined benefit schemes, the decline in contributions to

provide pensions and a fall in confidence in some investment vehicles e.g. endowments, designed to finance pensions. He identified measures taken by the Government to address the many challenges and specifically highlighted the steps taken in establishing the Pensions Protection Fund, the Pensions Regulator and the Pensions Bill. He stressed the importance of the UK's financial services, particularly asset management where over £3 trillion of assets are managed making the UK, in terms of international business, probably the world's largest asset management centre. Industrial investors exercise indirect control and significant influence over much of British corporate activity and the Government has investigated how this process could work more effectively. The Myners Principles were one result of this investigation and other examples were given including the Marathon Club of Institutional Investors, who are working on guidance for long term only investing. Shareholder engagement was seen as an important part of improving corporate governance throughout the UK corporate sector.

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

a) <u>Liability Driven Investments</u>

All pension funds face several risks from a number of different sources e.g. longevity, investment and earnings risk. Liability driven investment strategies have been developed to counter these over the long term. The approach often centres on using liabilities as the key benchmarks (rather than utilising market related benchmarks) on the basis that pension funds exist to pay pensions and not to exceed market benchmarks. The liability driven investment can take many different forms but the speakers advocated a broad exposure to alternative investments and a global emphasis. The alternatives to equities were listed as property, private equity, emerging markets, hedge funds and commodities. The end result of a liability driven strategy was not so much higher returns but rather reduced risks and less accounting (balance sheet) volatility. However, it was accepted that such a strategy was not a cure all but provided a holistic approach to meeting a Fund's liabilities.

b) <u>Securities Class Actions</u>

Securities Class Actions are a means by which shareholders of a company seek to recoup losses incurred as a result of an act of fraud by that company. Class actions primarily relate to America with the key benefits being both to gain compensation for real financial loss incurred and to encourage better corporate governance practices at a company. Shareholders have different rights in the UK and Class Actions do not tend to apply in Britain but Funds now routinely hold American stocks and UK investors have become more active in joining Class Actions. The Nottinghamshire Fund is currently engaged in a number of actions in the US. The session concluded that if a Fund holds US shares then it probably has a fiduciary duty to seek to recover sums in appropriate Class Actions.

c) Pensions Black Hole

Many schemes are now in deficit and strategies to address these deficits were discussed. A key starting point was to ensure that the Pension Fund's needs are clear and to then develop a process for exploiting opportunities over a long term horizon ensuring the Fund's risk appetite is also addressed. Diversification was seen as a key requirement but it was accepted that not all diversification was good. Funds should analyse past returns but should be creative in looking to the future considering new asset classes, new markets, strategies and investments. Overall, though, Funds should be aggressive in their risk taking where it was sensible to do so but should be confident that their strategy would produce net returns which should exceed their liabilities and thus reach full funding over the long term.

d) Investment Consultants – Measuring Performance

Assessing the quality of a pension consultant's advice is always a difficult task because of the timeframe of the task and the impossibility of anyone always being able to predict the optimum asset allocation. Attempts to assess the effectiveness of consultants' decisions often identify a range of performances. According to data from a former research company, no consultant has been able to select managers that beat the benchmark over a three year period more effectively than doing it at random. In many ways, consultants' performance is similar to fund managers' performance. In both disciplines the best results are achieved by talented individuals working in firms with good resources and processes. But the area will be difficult particularly because it will be hard to put a value on being advised not to do something. However whatever the relationship with consultants, it will be the trustees who will ultimately bear the responsibility for investment decisions taken.

e) Infrastructure

Infrastructure used to be the preserve of government but the private sector has become increasingly involved in this market recently either working with government in the form of public-private partnerships or buying assets outright and securing them as private enterprises. The assets tend to share a number of features. They are relatively immune to economic conditions, often regulated and their pricing structures tend to be inflation linked. They are sometimes run as a useful addition to a pension fund's portfolio. There are currently a number of infrastructure funds available which buy assets say to improve their operational and financial efficiency and generally sell them or float them after a number of years, not dissimilar to private equity. However, some commentators have expressed concern that, due to high demand, that the infrastructure sector is being over-valued and suffering from excessive leverage. Pension Funds are advised to tread carefully and bear in mind that infrastructure is an illiquid asset class involving a long term commitment.

f) Active Investing

The Chief Executive of Hermes emphasised the importance of constructive and collaborative shareholder work with companies to improve corporate governance. This in turn should lead to improved performance and return. Highlighting examples of bad corporate governance in the United States, particularly in relation to back dated stock options and excessive pay to departing executives, the speaker outlined the position in the UK where shareholders had the power to dismiss Directors, something which was not possible in the US. Hermes' record in encouraging better corporate governance has been successful and several examples of consistent out performance of the benchmark from companies engaged in corporate governance discussions by Hermes were given. The speaker urged trustees to think longer term in making investments and break away from short term bargains.

6. Overall, the Conference was very useful providing the opportunity to hear from some key players in the pensions scene and to receive updates on current thinking and developments.

Statutory and Policy Implications

7. 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

8. That the Conference report is noted.

ARTHUR DEAKIN
STRATEGIC DIRECTOR OF RESOURCES

Background Papers Available for Inspection

Nil