Report

meeting	PENSIONS INVESTMENT SUB COMMITTEE	
date	8 October 2009	agenda item number

REPORT OF THE SERVICE DIRECTOR (FINANCE)

LGC Investment Summit 2009

1. Purpose

1.1 To report on the LGC Investment Summit held at the Celtic Manor Resort, Newport, on 11-12 September 2009.

2. Information and Advice

2.1 The LGC Investment Summit is described as the flagship local authority investment event and is one of the foremost investment conferences in the calendar. In accordance with the Pension Fund's training policy and the need to maintain levels of investment knowledge, the 2009 conference was attended by Councillors Mike Cox, Sheila Place and Carol Pepper and the Council's Investments Officer, Simon Cunnington.

2.2 The conference attempted to plot a course through the economic crisis to the next triennial valuation in 2010, asking whether funds should continue to be "equity junkies" or increase the use of alternative assets within their asset allocation strategies.

2.3 The first session was given by Andrew Milligan from Standard Life Investments. He presented the economic backdrop to the crisis, discussing the key lessons learned and asking whether the remedial measures were working. The crisis has shown that excessive debt levels do matter and that the financial system is more complicated and interlinked than previously thought. The extreme events encountered over the last year have required an extreme response that has been co-ordinated across the world. He believes that the response so far has worked, with many positive signs appearing but was cautious of the near-term future.

2.4 In order to fully recover, economies will need to rebalance and start to repay the “debt mountain”. Debate is ongoing as to the best approach to take:

- the Irish approach of taxation and cuts
- the Latin American route of inflation
- continued low interest rates and quantitative easing as in Japan

2.5 The uncertainty surrounding the recovery and particularly the future path of inflation will make investment decisions difficult. Low interest rates make cash yields unattractive, corporate bonds and absolute return strategies are appealing in the short term but equities and property continue to offer long term value.

2.6 The next session considered the issue of diversification. The first speaker, Ewen Cameron Watt from Blackrock, suggested alternative assets (property, private equity, hedge funds, infrastructure and commodities) as a good source of diversification. However, the range of returns within each of these asset classes is generally wider than with equities and bonds and with a greater risk of very bad outcomes (so called “fat tail” risk). It is vital therefore to ensure that due diligence and manager selection is carried out effectively and that risk and returns are monitored on an ongoing basis.

2.7 The second speaker in the session was Quentin Fitzsimmons, head of government bonds and currency at Threadneedle. He asked the basic question of ‘what is diversification’ and stated that it was more than just investing in different asset classes. Instead, diversification means comparing a fund’s risk appetite to that of the market and carefully considering the time horizon and implementation of investment strategy - higher returns require a longer time horizon; certainty of returns places greater reliance on bonds and cash. The Threadneedle approach was to utilise a flexible, absolute return strategy, combining a range of investment instruments (including derivatives) that are expected to deliver returns at differing speeds.

2.8 The third session looked at risk. Nick Vickers, Head of Financial Services at Kent County Council, introduced delegates to investment risk through their experience of investing cash with Icelandic banks. Kent has exposure of £33 million to Iceland but is expecting to eventually recover £30 million. He then moved on to the pension fund, comparing an average local authority fund to the more adventurous Fund X.

2.9 The average fund is easy to understand, has low manager fees and should do well if equities perform strongly. However this reliance on equities means little diversification and the average allocation to alternative assets is too small to impact on overall performance. Fund X has a lower exposure to equities and a much greater allocation to alternatives. This gives a more diversified fund with more emphasis on manager skill and with the potential to reduce volatility of returns. However, extensive due diligence is required, governance needs are

greater and the ongoing monitoring is complex. In addition, manager fees will be higher and, if equities do perform strongly, the fund will heavily underperform its peers.

2.10 Following an asset allocation review, Kent has decided to move partly towards this approach by increasing its allocation to alternatives to 20% of the fund. It favours private equity, infrastructure and sustainable investments but has so far avoided hedge funds.

2.11 The hedge fund perspective was given by the next speaker, Simon Savage from GLG Partners. He stated that hedge funds should provide both capital growth and capital protection by balancing consideration of investment opportunity and risk management. Taking advantage of the investment opportunities requires manager skill and as the "hit rate" for this is generally low, it is important to pick a manager with a good win/loss ratio. This means that, although all managers make as many bad investment decisions as good ones, the successful managers make high returns from a high proportion of their good decisions.

2.12 In terms of risk management, the speaker declared that modelling is always wrong because of the risk of unforeseen events. The key is to be systematic and realistic in considering risk. He also gave a useful insight into due diligence – ask whether you can understand the investment opportunity; if not, walk away.

2.13 The last session of day one covered currency and transition management. Blair Reid of Goldman Sachs Asset Management began by showing the marked move by local authority funds over the last 14 years from UK equities to overseas (from roughly 80:20 to about 50:50). This brings with it unintended currency risk for which funds are not being rewarded. Statistics showed that mitigating this risk through passive hedging has no impact on long term performance but can have major implications for short term performance and cash flow.

2.14 Active currency management was preferred as a genuine diversifier within a highly liquid and cost effective market. The fundamental approach considers the short, medium and long term drivers of exchange rates in order to formulate a view on the relative strength of pairs of currencies. These views are then implemented via forward foreign exchange contracts (derivative contracts whereby two parties agree to buy and sell specified currencies at a set rate on an agreed date in the future).

2.15 The day was rounded off by Lachlan French from Barclays Global Investors who outlined the benefits of transition management when moving from one investment manager or style to another. Transition incurs direct trading costs (taxes and commissions) but also implicit costs such as the bid/offer spread and the market impact of trades. Transition managers offer to manage all of these elements in order to reduce risk and minimise the impact on performance.

2.16 Day two opened with consideration of the continued value of equities. Ravi Mantha of Fidelity International reminded delegates that an equity is effectively a bet on a company's future earnings and he remained optimistic that this bet would be rewarded over the long term. Many of the problems in equity markets are caused by expectations exceeding reality and so it is important to maintain reasonable return expectations.

2.17 The speaker discussed the likely outcomes of both deflationary and inflationary environments and concluded that the authorities would do whatever was necessary to avoid deflation and the resulting economic depression. This is essentially good news for equities as companies are able to pass on higher costs and inflation will improve balance sheets.

2.18 The second speaker, Scott Berg from T.Rowe Price, also retained his faith in equities. He demonstrated that 2008 returns were among the three worst years since 1927 but that really poor years were generally followed by outstanding returns. However, for a sustained recovery to occur, four conditions must be satisfied:

- credit conditions must continue to improve
- pace of deleveraging must slow
- fiscal and monetary stimulus must bite
- deflationary mindset must be averted

The speaker believed that numerous opportunities will arise for active managers and that the case for emerging markets remains strong.

2.19 The conference was rounded off by Ronnie Bowie from Hymans Roberston who gave an actuarial view of the run up to the next valuation. He started by taking delegates back to 1979 when a typical fund's liabilities were matched by assets and both were only marginally greater than the pensionable payroll on which contributions were based. Moving forward to 2009 and the same fund's assets are 3 times greater than the payroll and the liabilities over 5 times greater. The implication is that it may now be unrealistic for deficits to be recovered by contributions.

2.20 In the intervening 30 years, assets grew in excess of liabilities for the first two decades but this was effectively "spent" on benefit improvements and early retirements, improving longevity and contribution holidays. Over the last decade, liabilities have outstripped the assets as the same "spending" continued.

2.21 Attempts to recover the deficits have 'four levers to pull'.

- contribution rates
- changes to benefits
- governance
- investment strategy

2.22 Any significant increases in contribution rates are unlikely to be accepted and radical changes to benefits may be needed to secure sustainability (eg a move to career average rather than final salary). Governance should be concerned with reducing risk and volatility in uncertain markets. However, over the long term, investments are still expected to deliver sufficient returns to assist in the deficit recovery process.

2.23 Delegates considered the content of the sessions to be highly relevant to their roles as members and officers of the administering authority of the Nottinghamshire funds. The conference also presented an opportunity for Members and Officers to speak to counterparts at other authorities and to establish or maintain contacts with others in the Pensions industry. This is vital to keep up to date with the latest issues affecting the funds.

3. Statutory and Policy Implications

3.1 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.

4. Recommendations

4.1 It is recommended that:

- it be noted that attendance at conferences is in line with the agreed trustee training programme and complies with best practice in maintaining up to date knowledge
- the report be noted.

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Background Papers Available for Inspection
None