report

meeting	**PENSIONS INVESTMENT SUB COMMITTEE**	
date	**30 SEPTEMBER 2005**	agenda item number

REPORT OF THE DIRECTOR OF RESOURCES

LGC PUBLIC SECTOR PENSION FUND INVESTMENT SEMINAR

1. Purpose of the Report

1.1 To report on the contents of this seminar.

2. Attendance

2.1 The Pension Fund have regularly been represented at this seminar since its inception in the early 1990s. This year's seminar was held once again in Southampton on 8 – 9 September, and attended by Mike Cox, John Dunstan, Peter Hurford and Simon Cunnington.

3. Economic Scheme and Investment Prospects

3.1 The economic overview was provided by a Speaker from Scottish Widows, who are one of the providers of our AVC's. He predicted declining rates of economic growth in the period up to 2007, with UK growth rates around 2% whereas US rates would decline to around 3% per annum. He saw this as a "soft landing" for the major economies, with little risk of recession. He felt that inflationary pressures would gradually fade, with inflation rates in the UK of about 1.7%, and he did not think that the current high levels of oil prices would be maintained because production had been increased in the last 12 months in response to a surge in demand. He though that there would be further rises in the US interest rates to about 4.5%, whereas his prediction for UK interest rates in 12 months time was 4%. One factor in determining US interest rates might be the need to rein back on house speculation currently taking place in the US.

3.2 His predictions for returns in various asset classes over the next 12 months were that UK property would achieve 9%, which was much higher than his prediction for UK equities and gilts. Nevertheless, he was predicting much higher returns on overseas bonds and equities, primarily from currency gains as sterling weakened. The Fund has not previously taken positions on currency, and so would not benefit significantly in the short term if sterling were indeed to weaken. This might be something to raise with Schroders, who are able to make some geographical judgements within their global equities portfolio.

4. The Future of the Local Government Pension Scheme

4.1 A Speaker from the LGA repeated the regular concerns about increasing longevity and higher costs to employers. He pointed out that LGPS pensioners live between two to four years longer than the UK average, and this obviously added to overall costs. Nevertheless the LGA supported a funded final salary scheme, provided this was affordable for employers, and there was a view that a revised LGPS might have to be designed around an affordable employer rate of contributions, coupled with increased employee contributions. The cost of revoking the 2005 Regulations changes had been put at up to £400 million for each year of delay, although this figure was currently being re-assessed by Actuaries. The LGA's position seemed to be that none of this additional cost could be met by the employing organisations, and furthermore, his view was that the 85 Year Rule itself was likely to be challengeable on age discrimination grounds, and so would have to be removed anyway.

4.2 The Speaker from UNISON said that concentration on averages masked a position where some people would need access to pensions earlier than might be possible in the future, and he pointed out that the current average age of retirement is around the age of 58. He felt that staff would not be able to work longer until there were changes to work patterns and career structures, rather than just imposing a new higher normal retirement date of 65. He was also concerned that the current 6% employee contribution led to low take up and high drop out amongst manual and part time workers and so an increase in employee contributions would exacerbate this problem. He felt strongly that all existing pension promises should be maintained by the employers and indicated that the ballot last Spring had shown how strongly their Members felt about this.

4.3 A Speaker from the United States described how US pension protection funds were now in deficit and overall savings rates were zero. If nothing were done about pensions liability, then the credit rating on countries would plunge in the next 20 years. Action is needed to slow down the rate of growth in benefits including raising the normal retirement age and potentially giving smaller pensions increases to those receiving larger amounts.

5. Alternative Investments

5.1 A Speaker on hedge funds described how these had been around for over 50 years, but had expanded rapidly in the last 5 years, and he expected this growth to continue. Their main attraction was the potential to produce a positive return in a time of declining stock markets, but they can under-perform equities in a rising market. They are seen as a potential diversifier, rather than a whole fund strategy. They are not necessarily a high risk investment strategy, particularly if a fund of funds approach is taken, using a manager who can monitor the activities of individual hedge fund managers.

5.2 The Head of Pensions at Strathclyde Pension Fund described how his fund had allocated 5% to alternative investments, but placed this entirely in private equity, rather than hedge funds. His fund had been concerned about lack of transparency in hedge fund activities the impact of relatively large amounts of money being invested very quickly, and the potential impact on the rest of the fund invested in equities if hedge funds were indulging in selling equities they did not own and hoping to buy them later when the price had fallen. His fund's independent adviser and consultant were opposed to investment in hedge funds, but he accepted that some Local Authority funds had decided to make these investments for a small part of their portfolio.

5.3 A Speaker made the case for commodities as an asset class, which had produced a similar return to UK equities over the past 35 years with a lower level of risk. These returns seem to have a low correlation with returns on other asset classes, and so might perform well when others were not doing well. It was suggested that if investment in commodities was attractive, this should be done through a pooled fund approach, rather than by individual speculative purchases.

6. <u>Approaches to Solving Pension Fund Deficits</u>

6.1 It was suggested that pension funds facing significant deficits needed to think of different approaches if they were to make inroads into their deficits. Unfortunately, this might mean more complex approaches, using derivatives within "tactical asset allocation" funds and currency overlays. There is much talk about "liability driven investment", but this inevitably takes funds into a higher proportion of bonds within their fund, and there has recently been a big increase in demand for bonds, particularly from private sector funds. This has driven up the price and we now see that the yields on bonds are the lowest level since 1700. Furthermore, if the fund is in a deficit position, then it is unlikely to ever get out of this by having a large proportion of its assets invested in low-yielding bonds. Local Authority funds, with their continuing positive cashflows seem to be maintaining their preference for equity investment.

7. <u>Developments in Equity Investing</u>

7.1 A Speaker from Schroders described the benefits of active management of equities, using managers who are prepared to back their judgement and not stick close to benchmarks. A Speaker from Hendersons talked about "enhanced indexation", which is passive investment plus a bit. The extra bit is gained by exploiting anomalies and inefficiencies in the market and can produce some extra returns at relatively low risk. Both Speakers claim to have achieved good returns from their products; it is perhaps unfortunate that both of these investment houses have not always produced excellent returns when they have been managing our funds.

8. Investment Strategies

8.1 The final session of the conference was devoted to a discussion about whether a fund should have one overall investment strategy or try to design different strategies for employing organisations within the fund who might be at different stages of their existence. Both Speakers agreed that anything other than an overall strategy was impracticable, but there needed to be regular dialogue with employers to explain the investment strategy that the fund was undertaking. The Actuary helps us with this process by providing a position statement and separate employer contribution rates for each of the major employers within the fund.

9. Statutory and Policy Implications

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.

10. Recommendation

10.1 The report be noted.

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DIRECTOR OF RESOURCES

Background Papers Available for Inspection

Conference papers.