Statement of the Fund’s investment beliefs

Belief 1: The Committee accepts that some investment risk must be taken to generate the returns required to keep the Fund affordable over the long-term. The level of risk taken will depend upon a number of factors including its funding position and market conditions.

The implication is that, although you recognise that investment risk (i.e. exposure to non-matching assets) is needed in the portfolio to generate the required returns, this needs to be considered on ongoing basis to ensure it is appropriate (i.e. not too high or, indeed too low) given the Fund’s objectives.

Proof statement

The Fund’s investment strategy currently has a notable level of investment risk, with 50% allocated to equities, 30% to diversifying/yielding assets and only 20% protection assets (bonds). The investment strategy is reviewed as part of each valuation cycle. The most recent review, carried out in late 2016, showed that based on the current contribution strategy, the level of risk in the portfolio was broadly consistent with the long term aims of the Fund, namely to have a good probability of reaching full funding in 2037.

We also discussed the potential investment strategy at full funding, accepting that investment risk will still have to be taken at full funding to keep the Fund affordable, albeit this risk is likely to be lower than the current level.

Over the next few years, we anticipate increasing the focus on the Fund’s strategic risk, including investment monitoring, identifying funding level triggers (to manage the level of investment risk) and potential employer specific investment strategies.

Belief 2: Markets are dynamic and asset valuations fluctuate for a number of reasons, creating opportunities for investors.

The implication is that it is possible, where there is sufficient due diligence and skill, to add value by investment in (and potentially switching between) asset classes. It is expected that the majority of any tactical switches are implemented by active investment managers; but the Fund may make strategic allocations (with a medium-term horizon) to certain asset classes that are mispriced due to structural change or regulatory change. The Committee seek to gain confidence in their manager appointments by carrying out due diligence (including the manager’s people, process, philosophy and business) and their competition in advance of any appointment.

Proof statement

The Fund’s investment strategy includes allocations to active managers. In particular, the absolute return managers have flexibility to adapt their asset allocations as they see fit within the parameters of their respective mandates, with a view to generating positive absolute returns irrespective of prevailing market conditions.

The Committee also pay close attention to the valuations of asset classes and markets, taking advice from its investment consultant regarding opportunities within markets. Notable examples are the training sessions that the Panel have received on alternative credit assets, with a view to potentially evolving the Fund’s bond allocation, and the decision to invest in Standard Life’s SOFIII fund.

Any appropriate opportunities are then considered in the context of the Fund’s overall investment strategy. The Fund’s “opportunistic” allocation gives it considerable flexibility to capture any attractive opportunities.

The Fund also engages in rebalancing from time to time to capture a “rebalancing dividend”. Through this process, the risk of the actual allocation deviating too far from the target investment strategy is managed by having rebalancing ranges in place and by, when it is deemed appropriate to do so, trimming back overweight allocations and topping up underweight allocations.
Belief 3: Diversification, to an extent, reduces risk and improves stability of returns
The implication here is that both within asset classes and across asset classes, diversification is expected to result in reduced volatility of returns over the long term. The Fund’s investments should be diversified by combining assets with different risk characteristics where possible, whilst maintaining realistic expectations about the potential for sources of return to become correlated under market stress. The more volatile the portfolio, asset class or manager performance is, the more diversification can benefit the Fund. However, there are also diminishing marginal benefits of diversification and the impact on return needs to be understood.

Proof statement
The Committee understands the importance of diversification within an investment strategy, but is conscious of the risks associated with over-diversification. Diversification is considered between asset classes and within asset classes.

The Fund invests in a range of asset classes to diversify the sources of return and risk factors that it is exposed to e.g. the property allocation and the diversified growth allocations (which themselves have considerable diversification built in). Within asset classes, the Fund’s equity allocation has exposure to different regions, sectors, benchmarks and managers.

Belief 4: An illiquidity premium enhances returns and can be of strategic benefit given the Fund’s long term investment horizon.
The implication here is that by “locking away” funds for longer periods of time, the Fund should expect to be compensated for the lack of liquidity in the form of higher expected returns.

Proof statement
The Committee have previously expressed a willingness to invest in illiquid assets, provided there is sufficient liquidity within the Fund to pay the expected benefit outgo over the short term. In setting the Fund’s investment strategy, the Committee took into account the Fund’s expected cashflows.

Given the Fund’s relatively long term investment horizon, there are opportunities in global markets for the Fund to take advantage of the illiquidity premium, for example, the Fund’s property and SOFIII allocations. The Panel is also currently receiving training on alternative credit assets that offer an illiquidity premium with a view to potentially evolving the Fund’s bond allocation.

Belief 5: The use of derivatives offers the ability to mitigate certain investment risks and may have a place in the risk management of the Fund. However, derivatives also introduce other types of risk which themselves must be understood and managed.
The implication is that derivatives may be a useful tool to manage and alter the risk exposure of the Fund, for example a transition manager may use derivatives to ensure the Fund is neither out of market or doubly exposed to market movements when a switch of assets is taking place. However, the use of derivatives in itself is not without risk, with inherent risks such as the lack of transparency to the underlying exposures. The risks of derivatives must be fully understood before they can be used in the Fund’s investment strategy.

Proof statement
A number of the Fund’s managers, particularly Invesco and Insight, use derivatives to enhance diversification and manage the underlying risk exposures within their portfolio. Their use of derivatives to manage downside risk is important to the mandates’ ability to preserve capital in falling markets. The Committee receive training on a regular basis from each of its managers, including on the underlying investments and their approach to managing operational risk aspects.
Belief 6: Management fees can have a material impact on Fund performance.
While the Committee expect a return premium from investing in different assets (and different approaches to managing assets), the cost of accessing these must be understood.

Proof statement
Costs of investment are considered whenever a new allocation is being considered. Details of the investment management fees are included in the Fund’s quarterly investment monitoring. The Fund encourages its managers to sign up to the Cost Transparency Code. The Fund has also participated in fee benchmarking projects which assess the fees being paid relative to other pension schemes.

Belief 7: The Fund’s governance budget is not limitless and should be focussed on the areas that have the greatest impact on outcomes.
The implication of this is that simplicity of investment structure is preferred to allow the Committee’s time to be spent looking at more strategic areas rather than spending too much time on monitoring or managing relationships. Additional complexity in the investment structure should only be introduced if the potential for adding value is clear.

Proof statement
The Fund’s investment strategy is built around a core of passively managed assets – both equities and bonds – which are not governance intensive. A large proportion of the strategic diversification is achieved by investing in mandates that themselves hold a range of different funds or investments.

Belief 8: Environmental, social and governance (“ESG”) factors can influence the Fund’s future outcomes
As asset owners, the Committee has responsibility for ensuring it understands the ESG factors the Fund is exposed to, for putting in place appropriate arrangements to fulfil their roles, and to manage any risks/exploit any opportunities that may exist.

Proof statement
The Fund is signed up to the FRC’s Stewardship Code and was awarded tier 1 status. The Fund’s voting arrangements are reported on a quarterly basis and the Fund’s managers are asked to report on their engagement activity on a regular basis.

Approved 26 September 2017