

HAMPSHIRE COUNTY COUNCIL**Decision Report**

Decision Maker:	Pension Fund Panel
Date:	16 December 2011
Title:	Tactical asset allocation
Reference:	3511
Report From:	County Treasurer

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1. Executive Summary

- 1.1. The purpose of this paper is to provide further information on how tactical asset allocation could be applied to the Pension Fund's investments.
- 1.2. It follows the Panel's discussion at the meeting on 14 September 2011 of the progress on implementing the changes to the Pension Fund's investment management arrangements. The Panel requested a more detailed paper from the County Treasurer on tactical asset allocation.
- 1.3. The report outlines the options available to the Panel.
- 1.4. The Independent Adviser, Harvey Cole, has provided a paper on de-risking, liability driven investment (LDI) and other issues which is attached as Appendix 1.

2. Background

- 2.1. With the assistance of the Fund actuary Aon Hewitt, the Panel agreed earlier this year a 'strategic asset allocation' for the Pension Fund, across the asset classes of equities, bonds, property and alternative investments. 'Strategic' in this context refers to an asset allocation which should be in place for perhaps three to five years.
- 2.2. After reviewing the Pension Fund's liabilities and assets following the actuarial valuation at 31 March 2010, Aon Hewitt had reported that there was an opportunity to reduce the level of risk within the strategic asset allocation. In particular, the allocation to equities could be reduced and the allocation to UK index linked bonds increased.
- 2.3. The Panel accepted Aon Hewitt's advice and adopted the strategic asset allocation summarised in Table 1.

Table 1 – Strategic asset allocation

	New strategic asset allocation - short term %		New strategic asset allocation - long term %
Equities			
Global	26.0%		26.0%
UK – active	14.0%		14.0%
UK – passive	14.0%	==>	0.0%
	-----		-----
Equities total	54.0%		40.0%
Bonds			
Global	5.0%		5.0%
UK index linked	21.0%	==>	35.0%
	-----		-----
Bonds total	26.0%		41.0%
Property			
UK	6.6%		6.6%
European	1.8%		1.8%
to be allocated	1.6%		1.6%
	-----		-----
Property total	10.0%		10.0%
Alternative investments	10.0%		10.0%
Cash	0.0%		0.0%
	-----		-----
Total	100.0%		100.0%
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- 2.4. Aon Hewitt acknowledged that market conditions may not be optimal currently for increasing the allocation to UK index linked bonds to 35% of the Pension Fund. In the short term, the Panel agreed to hold the 14% intended for UK index linked bonds in passively managed UK equities, as shown in Table 1. In practice, 7% is currently held in new passive portfolios with the remaining 7% retained in Aberdeen's lower risk, actively managed UK equities portfolio.
- 2.5. This approach reflected Aon Hewitt's advice to reduce the level of risk in the Pension Fund's investment arrangements, by terminating two actively managed equities portfolios with high performance targets. In the short term, the changes have reduced the exposure to active management but they have not reduced the exposure to equities themselves.

- 2.6. In the meantime, it has been suggested that the 14% held temporarily in equities could be used to introduce tactical asset allocation to the Pension Fund's investment arrangements. It should be noted, however, that a tactical approach is likely to be a longer term change and, if the Panel decide to go ahead with tactical asset management, it would probably be necessary to fine-tune the strategic asset allocation to make the necessary funds available on a long term basis. The levels of funds required will vary depending on how tactical asset allocation is implemented, as outlined later in this report.

3. Specialist investment management and tactical asset allocation

- 3.1. The use of 'specialist' portfolios, with fund managers each focussing on one asset class only, was introduced as part of the changes to the Pension Fund's investment management arrangements in 2007. Prior to that, the Pension Fund employed 'multi-asset' managers with mandates to invest in equities and bonds from across the world. The property portfolio has always been separate and, prior to 2007, no alternative investments were held by the Pension Fund.
- 3.2. The multi-asset portfolios enabled the fund managers to undertake some degree of tactical asset allocation, such as switching between equities, bonds and cash, and between regions of the world, within parameters set by the Pension Fund.
- 3.3. That opportunity was no longer available when the specialist, or 'best of breed', fund managers were appointed in 2007.
- 3.4. The Panel considered whether to employ a tactical asset allocation manager in May 2007 but concluded that no action should be taken. The main areas of concern were that:
- changes made by a tactical asset allocation manager could conflict with the global approach to investing in equities and bonds that the Panel had adopted
 - the Pension Fund's strategic allocation to UK index linked bonds reflected its liabilities and should not be reduced for tactical reasons
 - there would be additional fee costs as a result of employing a tactical asset allocation manager.

4. Action since the last report

- 4.1. Since the Panel considered the issue in September 2011, the County Treasurer has undertaken further research on how tactical asset allocation could be introduced. This has included meetings with a number of firms and advisers, with the Chairman and the Independent Adviser in some cases.
- 4.2. The track record for the successful use of tactical asset allocation is limited. Many Local Government Pension Scheme (LGPS) funds have adopted a specialist arrangement for fund management, like Hampshire, but there is very little evidence for successful tactical asset allocation. Discussions have

been held with one LGPS fund that has recently introduced a more innovative approach to asset allocation but that does not yet have a significant track record.

5. What is tactical asset allocation?

- 5.1. In simple terms, the aim of tactical asset allocation is to add value by moving assets away from the central allocation set in the strategic asset allocation for shorter term periods to take advantage of valuation anomalies in the different asset classes.
- 5.2. The duration of “shorter periods of time” can vary. Some tactical asset allocation specialists look to make changes at very short intervals, even from day to day. The frequency of trades to reflect short term or tactical views would be higher.
- 5.3. Others argue that whilst this might cover the really short term and the strategic asset allocation covers the longer term, there should be yet another layer of focus, for medium term asset allocation. If a strategic asset allocation is intended to be in place for three to five years, a ‘dynamic’ or medium term asset allocation could be reconsidered every 6 to 12 months and be expected to last for perhaps 18 months.

Adding value

- 5.4. There are also questions about the purpose of tactical asset allocation. The definition above refers to “adding value”. But an alternative might be to use tactical asset allocation techniques simply to mitigate risks, with no explicit attempt to add value to the Pension Fund. This would attempt to make changes to the asset allocation in advance of major events in investment markets, such as the collapse in 2007 and 2008 or the recovery in 2009, purely on a defensive basis.

Downside protection

- 5.5. It would be possible to introduce a form of downside protection so that the Pension Fund does not suffer in full from market falls. That form of insurance can be expensive to implement however, particularly in times of market uncertainty. The cost can be offset by giving up part of the upside when markets rise, but it would be necessary to consider whether a LGPS fund needs to take that approach if, because of its strong covenant, it is able to take a longer term view of investment performance.

Performance measurement

- 5.6. It also raises the question of how to assess whether the tactical asset allocation manager is being successful. It could be considered essential to set the manager a target to achieve. The alternative would be to ask them simply to avoid the downside, somehow. A specific target could be related to cash, as that can be considered the ‘safest’ asset class (eg, a target of LIBOR +x%) or the Pension Fund’s overall performance target. Performance could be assessed over rolling three-year periods.

- 5.7. One firm's tactical asset allocation fund has a performance target of cash plus 10% per annum and a volatility target of 10% to 15% per annum.

Taking account of liabilities

- 5.8. A further point to consider is whether the tactical asset allocation manager should be simply required to focus on the Pension Fund's assets and make whatever moves are necessary to mitigate risks to those assets, without any thought to the impact of those risks on the Pension Fund's liabilities. That approach might lead to the manager selling all the Pension Fund's UK index linked bonds, if the manager thought they were likely to underperform.
- 5.9. Alternatively, the tactical asset allocation manager could also be required to take into account the Pension Fund's liabilities and the impact of market movements on the value of those liabilities. That might lead to a different decision on whether it was prudent to sell UK index linked bonds.
- 5.10. It would seem to be important that the tactical asset allocation manager should be aware of the Panel's longer term intention to increase its holdings of UK index linked bonds.
- 5.11. This could begin to link into techniques such as liability driven investment and decisions on adopting tactical asset allocation might need to take that into account if the Panel had plans to apply liability driven investment techniques in the future.
- 5.12. One approach to tactical asset allocation could focus on a relatively simple set of asset classes, such as equities, bonds and cash. But it would also be possible to use derivatives to take positions in just about every asset class, from regional equity markets to different categories of bonds to commodities, currencies and alternative investments. The use of different types of investments in tactical asset allocation is considered in more detail later in this report.

Risks of tactical asset allocation

- 5.13. Various forms of tactical asset allocation have been used for a number of years but there is no readily available evidence of whether they are successful. It may be easier for the manager of an actively managed equity portfolio to pick a company whose shares will be successful because there is plenty of information readily available about the company. But it may be more difficult to pick the overall direction of markets and it is probably even more difficult to predict successfully the timing of changes in market direction.
- 5.14. As an example, Phillips & Drew were certain that the dot.com bubble would burst in the late 1990s. They proved correct eventually but lost their clients substantial amounts before the collapse happened. There can be periods when it seems that everyone agrees that markets are over or under valued but markets do not move as forecast.
- 5.15. Tactical asset allocation might be expected to attract a premium level of management fee given the breadth of knowledge and skills required.

- 5.16. As mentioned earlier, it might be necessary to consider whether LGPS funds can simply take the long view of their investments and not use shorter term tactical asset allocation. This approach would rely on LGPS funds' strong covenant, compared with private sector pension funds. Unlike LGPS funds, pension funds in the private sector can have additional pressure from their parent companies' balance sheets. However, LGPS funds are subject to pressures on their employers' contribution rates and there is increasingly limited scope nowadays to accept increases in contribution rates at one actuarial valuation in the hope or expectation that markets will improve at the next valuation.
- 5.17. It should be borne in mind, however, that tactical asset allocation will not always pay off. There is a significant risk that the tactical asset allocation manager will be wrong and will worsen, not improve, the Pension Fund's position.
- 5.18. A further risk could be that the 'short-term' tactical asset allocation becomes longer term by default because markets stabilise in a particular position. The apparently short-term decisions taken by the tactical asset allocation manager then become more important to the funding position of the Pension Fund than the so-called strategic asset allocation put in place with the assistance of the Fund actuary.
- 5.19. It may also be necessary to be wary of introducing additional risk to the Pension Fund's investment arrangements as a reaction to the events of the financial crisis of 2007 and 2008. Those events have been described as the worst since the Depression of the 1930s. Whilst it is possible that there have been structural changes in the way that markets operate that will make them more volatile in future, there may be a risk of overreacting to a once in 70 years event.

6. How can tactical asset allocation be applied?

- 6.1. Tactical asset allocation can be implemented for a Pension Fund by moving real or 'physical' assets between asset classes. A move from equities to bonds, for example, would involve selling equities held in an existing manager's portfolio and buying bonds. That would be disruptive to the Pension Fund's active managers, such as Aberdeen, Newton and Schroders, and expensive in terms of brokers' commission and taxes.
- 6.2. An alternative, still moving physical assets, would be to use passively managed pooled funds, such as the Pension Fund's portfolios of UK index linked bonds and UK equities with Legal & General and State Street. There are still costs involved, however, in terms of the bid/offer spreads.

Exchange traded funds

- 6.3. A further option would be to use exchange traded funds (ETFs). These are still 'physical' assets but the costs of trading are said to be lower than for passively managed pooled funds. They can be traded much more frequently than passive pooled funds, as they can be bought and sold whenever exchanges are open. Access to that higher level of liquidity could be important for short-term tactical asset allocation.

- 6.4. The ETFs used for this purpose could be asset-backed, unleveraged ETFs with much less risk than the synthetic ETFs which have been the subject of recent adverse publicity. Leveraged EFTs could be used, if the Pension Fund was comfortable with the risks, to obtain greater impact.
- 6.5. Some ETFs can also be subject to stock lending, which should help to reduce the costs. There is also a much wider range of asset classes available as ETFs than as passively managed pooled funds, which would increase the scope for the tactical asset allocation manager to take different positions.

Funding the use of physical assets

- 6.6. Using 'physical' assets such as pooled funds or ETFs involves having assets available on a £ for £ basis for the full value of each tactical asset allocation decision. If the tactical asset allocation manager wished to reduce the Pension Fund's exposure to equities by 20%, eg, from 40% of the Pension Fund to 20%, it would be necessary to have 20% of the Pension Fund (ie, £700m) available in a pooled fund or ETFs for that purpose.
- 6.7. The tactical asset allocation manager may have other short term allocations in play at the same time, so the proportion of the Pension Fund that would need to be available for the tactical asset allocation manager would be considerable. The 14% of the Pension Fund currently held in UK equities on a short term basis is unlikely to be sufficient.
- 6.8. It would also be disruptive for the Pension Fund's existing actively managed portfolios if money had to be taken away from them for the tactical asset manager to use.
- 6.9. One firm has estimated that a minimum of 25% of the Pension Fund's assets (ie, £875m) would need to be allocated to tactical asset allocation if full coverage of the Pension Fund was to be achieved using physical assets.
- 6.10. On the other hand, it would be possible to run a trial run of tactical asset allocation with physical assets (and/or derivatives) by using a small portfolio within the Pension Fund. But that trial approach would not put in place risk mitigation or tactical asset allocation for the whole Pension Fund.
- 6.11. An alternative would be to restrict the tactical asset allocation manager for the Pension Fund as a whole to relatively small movements, such as +/-2% from the strategic asset allocation. Some tactical asset allocation firms offer that service.

Derivatives

- 6.12. A further alternative would be to use derivatives instead of 'physical' assets. Some managers offering this service would primarily use futures, with some use of options. Other managers would also use swaps.
- 6.13. Only a small part of the positions taken by the tactical asset allocation manager would need to be cash-backed, as collateral. One manager who uses derivatives for tactical asset allocation has estimated that 2% of the Pension Fund (£70m) would need to be set aside to provide full coverage of

the Fund. The remainder of the 14% currently held on a temporary basis in UK equities could be allocated to longer term portfolios.

- 6.14. As alternative, another tactical asset allocation manager has suggested that all the Pension Fund's existing portfolios could be liquidated and then futures and index tracking funds including ETFs would be used to get a 'diversified beta' approach (ie, market return) using tactical asset allocation.
- 6.15. The range of derivatives available covers most of the markets a tactical asset allocation manager is likely to want to access.
- 6.16. If the Panel wished to adopt tactical asset allocation using derivatives, it would be sensible to apply it across the whole Pension Fund. The manager would probably expect to be set an outperformance target to achieve.
- 6.17. It would be necessary to make sure that the use of derivatives comply with the LGPS regulations. These regulations are not explicit in relation to the use of derivatives but are usually interpreted as allowing their use for risk mitigation and the prudent management of financial affairs. Following the Hammersmith and Fulham BC case in the late 1980s, the use of swaps by local authorities and LGPS funds has ceased.

7. Governance issues

- 7.1. Decisions on tactical asset allocation matters are likely to require detailed technical knowledge similar to that required for actively managed investment portfolios. In addition, the decisions may need to be taken at relatively short notice and at unpredictable times. That would not fit easily with the Panel's schedule of meetings or with arrangements that could be established for a sub-group of Panel members.
- 7.2. For these reasons, it would seem to be sensible for decisions on tactical asset allocation matters to be taken by the appointed manager on a fully discretionary basis, not by the Panel. The manager could be set clear parameters by the Panel for the extent of shorter term changes that could be made to the central strategic asset allocation. The manager would then report at regular intervals, including attendance at Panel meetings at six monthly or annual intervals.
- 7.3. By the nature of tactical asset allocation, it would seem to be impractical to have more than one tactical asset allocation manager or adviser. To employ two or more would require some means of deciding which advice to adopt. Alternatively the Pension Fund would need to be divided in some way, so that one tactical asset allocation manager would deal with part of the Pension Fund and the second manager would deal with the remainder. Although the idea of allowing more than tactical asset allocation managers to 'compete' might seem attractive, it would not appear to be practical, as well as expensive in terms of fees.

8. Procurement issues

- 8.1. It is likely that the value of a longer term contract for tactical asset allocation would exceed the EU threshold (currently £156,000) and a full procurement

process would be required to select and appoint a tactical asset allocation manager.

9. The way forward

- 9.1. The first issue for decision by the Panel will be whether or not to introduce tactical asset allocation arrangements.
- 9.2. The Panel needs to consider what it is they are trying to achieve through a tactical asset allocation route. The initial requirement was related to the view that the Panel had no approach in place to react quickly with regard to the circumstances of the financial crisis in 2007 and 2008 highlighted in paragraph 5.19. That might suggest a much simpler approach than some of the alternatives outlined in this report. The Panel also needs to consider again the reasons highlighted in paragraph 3.4 for not proceeding with such an approach in May 2007:
 - changes made by a tactical asset allocation manager could conflict with the global approach to investing in equities and bonds that the Panel had adopted
 - the Pension Fund's strategic allocation to UK index linked bonds reflected its liabilities and should not be reduced for tactical reasons
 - there would be additional fee costs as a result of employing a tactical asset allocation manager.
- 9.3. If the Panel does wish to proceed, it will need to decide what sort of tactical asset allocation process it wishes to put in place:
 - simple risk mitigation to reduce the volatility of the Pension Fund's returns, with no performance target and taking no account of the Pension Fund's liabilities, or
 - a small trial portfolio, to act as a test run for tactical asset allocation, or
 - a full approach covering the whole Pension Fund, using either physical assets (pooled funds or ETFs) or derivatives, or
 - a whole Fund approach, but taking into account the impact on the Pension Fund's liabilities, or
 - a tactical asset allocation mechanism that is consistent with liability driven investment (LDI) techniques if the Panel wishes to adopt LDI in the future.
- 9.4. These are important and difficult issues to decide and the Panel may wish to consider whether it would be sensible to seek the views of the Independent Adviser who is likely to be appointed following this meeting of the Panel.
- 9.5. If there is to be a change of Independent Adviser, it would be sensible for the new appointee to be comfortable with the tactical asset allocation arrangements for the Pension Fund. They may also have some useful insights for the Panel to consider once they have had the opportunity to review the Pension Fund's investment management arrangements. The

downside would be a short delay in the procurement of a tactical asset allocation manager.

- 9.6. Aon Hewitt may also have some useful comments to make, particularly if the Panel wishes to adopt an approach to tactical asset allocation that takes account of the Pension Fund's liabilities.
- 9.7. In deciding the action to take, it will be important not to lose sight of Aon Hewitt's earlier advice that there was scope to reduce the level of risk in the Pension Fund's investment arrangements.

10. Recommendation

- 10.1. That the Panel decide whether to appoint a tactical asset allocation manager, taking account of the issues set out in section 9 of the report.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	yes/no
Corporate Business plan link number (if appropriate):	
Maximising well-being:	yes/no
Corporate Business plan link number (if appropriate):	
Enhancing our quality of place:	yes/no
Corporate Business plan link number (if appropriate):	
OR	
This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because actions are required to decide whether to appoint a tactical asset allocation manager.	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

De-risking, Liability Driven Investment (LDI) and Other Issues

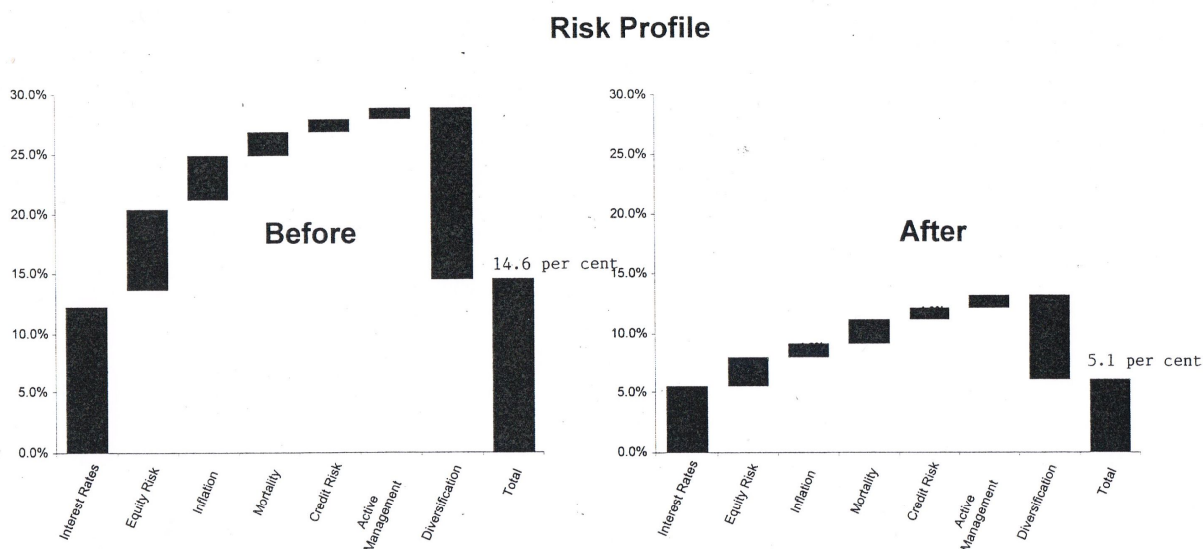
Paper by Harvey Cole, Independent Adviser

Improved Returns

Derisking is not aimed directly at improving investment returns, but to do so indirectly. There has been talk of raising returns by 1 per cent, but it is simply not possible to do this across a portfolio. The simple example that follows shows why this is.

If (say) 14 per cent of a portfolio is reinvested in a separate fund structured to provide a higher return, for the overall rate to improve from, say, 5 per cent to 6, the 'new' portfolio has to secure 12 per cent. It is impossible to achieve this without **increasing** the risk profile.

One successful fund has managed to maintain a slight overall gain against previous benchmarks by identifying seven separate components of risk and investing so as to minimise each of them. This is illustrated below.



A typical portfolio for this form of investing would consist of a (changing) mix of global equities, global bonds, commodities, currency, credit and a range of derivatives. However, equities normally make up no more than 15-20 per cent of the fund, so that the equity content of this portfolio is around 2 per cent of the total fund rather than 8-9 per cent before 'hiving off'.

Separate Fund or Overlay?

We are thinking of segregating around 14 per cent of the total fund into lower risk investment. This could be achieved either by putting the money into an absolute return fund managed on the lines described above, or a similar approach offered

by Fidelity which is based on minimising risk by controlling the volatility of different asset classes and the correlations between them through timing of purchases to avoid periods when correlations and volatility are high. Diversification in itself is clearly not an adequate response.

Overlays can screen out some risks and have the advantage of not necessarily involving substantial cash investment, although the degree of delegation to switch investments appears likely to prove high. Similarly, action to offset individual risks such as inflation, interest rates and longevity may well have a part to play – although counter-party risk must be a serious consideration in a world where the soundness of financial institutions can come unpredictably under suspicion.

Discount Factor

It seems that there has not yet been a final decision on the discount rate to be applied to LGPS funds in relating future liabilities to current assets. Hutton appeared inclined to support a rate related to RPI and this is surely preferable to a rate based on long-term interest levels, whether gilt-edged or corporate. Even with the proposed strong shift of emphasis in the fund's assets toward index-linked gilts, a high proportion of the investments will continue to consist of other asset classes.

A significant, but largely unremarked, event occurred last week when, for the first time ever, the return on index-linked turned negative across the whole yield curve from the shortest to the longest-dated stocks. While the conventional interpretation – that the market expects deflation over the whole of the next 50 years – is obviously not justified, this does emphasise the eventual impact of extremely low interest rates – and the potential volatility that is likely to accompany increases to more 'normal' levels in the medium-term.

Procurement

The growth of interest in LDI and Absolute Return investment is such that it may become in effect a new asset class in its own right. Some fears have been expressed at meetings I have recently attended that some funds may find themselves having to go through a formal procurement process when selecting a manager to operate a mandate in this sector.

There have been suggestions that schemes may be able to avoid this risk by ensuring that they specify the terms of any appointment in sufficient detail to make it a 'one-off', thus avoiding any requirement to open it up to competition.

For some time Croydon LB has been running a 'framework' scheme which opens up the possibility (under a 5-year agreement now three years into its operation) for participants to short-cut the procurement process where one or more existing members already have a contract in place. At a recent conference I discussed this with an officer from Croydon who has been involved in the scheme, and she would be happy to talk to us in more detail should it become relevant.