

**LPFA**

**STATEMENT OF INVESTMENT PRINCIPLES**

**SEPTEMBER 2008**

## **STATEMENT OF INVESTMENT PRINCIPLES**

This statement covers the LPFA's policy with regard to the Investment Principles laid out in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998.

The relevant Principles are:

- LPFA Overview
- LPFA Governance
- Investment objectives
- Investment Strategy
- Types of investment
- The mix of different types of investment
- Risk
- Expected return on investments
- Realisation of investments
- Extent to which responsible investment considerations are taken into account
- The exercise of voting rights
- Statement of compliance with the Myners principles
- Appendix – Regulatory Context

## **LPFA OVERVIEW**

The LPFA Fund is broadly similar to other LGPS funds of comparable size, except in one material aspect. As a result of the abolition of the Greater London Council (GLC) and Inner London Education Authority (ILEA), the maturity of the Fund is heavily weighted towards current or deferred payment of pensions to former employees of these two bodies. This will lead to a substantial outflow of monies over the medium term.

As a consequence, actuarial advice led to the notional division of the LPFA Fund into two sub-funds to match the liability profile with the appropriate duration and class of asset.

### **Pensioner Sub-Fund**

This comprises mainly pensioners and deferred beneficiaries of organisations no longer in existence (e.g GLC, ILEA) and contributors from organisations who no longer give access to the LPFA fund.

A significant proportion of the sub-fund by value is invested in cash-flow matching bond mandates, targeted to meet liabilities in the form of annual cash flows plus 1.5% outperformance p.a. A small component of passive global equities is retained as diversification and in anticipation of a superior long term return.

### **Active Sub-Fund**

This comprises all scheduled and admitted bodies who remain open to the LPFA Fund for all their employees.

The sub-fund's investments are held substantially in equities. This investment allocation is intended to maximise growth in the value of the assets, subject to an acceptable level of risk, and reflects the active scheme members age profile. Alternative assets (private equity, global property, infrastructure and commodities) together with multi-asset target return mandates and an active currency mandate complete the portfolio composition and are both targeted at RPI + 5% in line with liabilities.

## **LPFA FUND GOVERNANCE (further details in Appendix 1)**

### **Board**

Board members of the LPFA are appointed by the Mayor of London. The Board decides on the investment policies most suitable to meet the liabilities of the Fund and has ultimate responsibility for investment strategy.

## Investment Committee

The general principle is that the Board set the overall asset allocation strategy between global equities (including private equity), target return and alternatives with tolerance ranges. Details are shown in the following table.

Asset Class	%	
	Minimum	Maximum
Global Equities (including private equity)	50	70
Target Return	15	25
Alternative Assets	15	25

The Investment Committee is a subset of the Board and is delegated to determine tolerance ranges for sub-asset classes and implement the asset allocation strategy within those ranges. The Investment Director, in consultation with the Chairman and Chief Executive, is delegated to carry out the tactical implementation of the strategy, including the appointment of managers or purchase of units in funds for mandates up to £50 million (broadly 2% of the active sub fund). Appointments for mandates in excess of £50 million require the approval of the Investment Committee

## Advice

The Board obtains and considers advice from LPFA executive officers, and as necessary from the Fund's actuary, investment managers and two independent advisors who advise on investment matters.

## Management

The Board has delegated the management of the fund's investments to professional external investment managers appointed in accordance with the LGPS Regulations, and whose activities are specified in detailed investment management agreements (IMA's) and regularly monitored. A portfolio of alternative assets (encompassing private equity, global property, infrastructure and commodities) are managed "in-house" in accordance with parameters determined by the Board and in consultation with the Chairman.

## **Investment objectives**

The investment objectives are to achieve a return on assets which:

- (i) is sufficient to meet funding strategy statement objectives arising from triennial actuarial valuations of the fund (latest 2007)
- (ii) contribute towards achieving and maintaining a future funding level of 100%
- (iii) is set at a level which does not force the managers to take unnecessary risks

In addition, the LPFA seeks to use its influence as a large institutional investor to support and develop best practice in corporate governance generally and sustainable environmentally responsible investment in particular.

## **Investment strategy**

The LPFA Board is responsible for setting the strategic asset allocation of the fund. Usually, it is set after considering the results of an asset and liability study. In setting the strategic asset allocation the LPFA Board seeks medium term rates of return sufficient to meet the expected growth in the fund's liabilities at an acceptable level of risk.

The investment strategy of the fund was reviewed in 2008 following the 2007 valuation. It was decided that no major changes were necessary to the existing strategy which was implemented as a result of the 2004 valuation. The LPFA had moved to a specialist manager structure for the management of the fund's assets at the end of 2005.

A notable change in 2008 in the Active Fund was the adoption of target ranges for the major asset classes and the introduction of two new sub funds, one for quoted securities called the Satellite fund and the other for non-quoted securities called the Opportunistic fund. Both of these have target ranges from 0% to 5%. This will enable investments in a specialism where the LPFA would not want to award a major mandate, or where it can take advantage of a medium term opportunity. In quoted securities, an example would be emerging markets and for the Opportunistic fund an example would be a credit exposure.

Another minor strategic change in 2008 within the Active Fund was to increase the exposure to diversifying assets by 5%, at the expense of global equities.

## The LPFA holdings as at 31 October 2008

### Active Sub Fund

Investment Manager	Valuation (£ million)	Actual Asset Allocation (%)	Target Allocation Range (%)	Benchmark	Excess Return
LGIM	441.8	22.0	10-30	FTSE AW TR	-
Newton	294.7	15.0	15-20	MSCI ACW	2.0%
MFS	371.9	19.0	15-20	MSCI ACW	2.0%
Satellite Fund	0.0	0.0	0-7.5	MSCI ACW	2.0%
Private Equity	167.7	8.6	0-7.5	RPI+5%	2.0%
<b>Global Equities Managers</b>	<b>1,276.1</b>	<b>64.6</b>	<b>50-70</b>		
BlackRock	197.9	10.0	7.5-12.5	RPI+5%	2.0%
<b>Target Return Funds **</b>	<b>197.9</b>	<b>10.0</b>	<b>5-15</b>		
Record Active	(8.7)	0.0	0.0	*	1.5%
<b>Currency Management</b>	<b>(8.7)</b>	<b>0.0</b>			
Diversifying Assets	314.8	16.0	5-22.5	RPI+5%	2.0%
Opportunistic Fund	18.6	1.0	0-7.5	RPI+5%	-
<b>Diversifying Assets Cash**</b>	<b>333.4</b>	<b>17.0</b>	<b>15-25</b>		
<b>Total</b>	<b>1,962.8</b>	<b>100.0</b>	<b>0-15</b>	-	-

### Pensioner Sub Fund

Investment Manager	Valuation (£ million)	Actual Asset Allocation (%)	Target Allocation (%)	Benchmark	Excess Return
BGI	393.9	35.0	32.5	Liability CF	1.0%
ECM	220.8	20.0	22.5	Liability CF	1.75%
Insight	416.9	37.0	32.5	Liability CF	1.25%
<b>Cash Flow Matching</b>	<b>1,031.6</b>	<b>92.0</b>	<b>87.5</b>		
LGIM	92.2	9.0	12.5	FTSE AW TR	-
<b>Global Equities</b>	<b>92.2</b>	<b>9.0</b>	<b>12.5</b>		
<b>Cash</b>	<b>(10.8)</b>	<b>(1.0)</b>	<b>0.0</b>		
<b>Total</b>	<b>1,113.0</b>	<b>100.0</b>	<b>100.0</b>		

\* 50% Hedge – overseas equities.

\*\*UBS Target Return Mandate was terminated in September 2008 and the proceeds are currently being held in cash.

## **Types of investment to be held**

The fund may invest in any category of investment permitted by the LGPS (Management and Investment of Funds) Regulations 1998, as amended. In so doing, it will (i) have due regard to diversification, the return potential, liquidity, risk, management costs and environmental impact arising.

## **Mix**

The Fund will at all times hold a widely diversified portfolio of investments. As intimated earlier approx. 30% of the portfolio is invested in cash flow matching bonds and 70% invested in a combination of global equities, target return funds and alternative assets. This allocation mix is based on actuarial advice that matches the current liability profile and funding position of the Fund.

## **Risk**

The returns achieved from investment will to a considerable degree reflect the risks taken. The LPFA seeks to control risk, not eliminate it. The Fund deals only with reputable service providers to minimise counterparty risk.

Risk can be looked at in numerous ways:

(i) the absolute risk of a reduction in the value of assets through negative returns. Whilst this cannot be entirely avoided (e.g. if all major investment markets decline in unison) it can be minimised by positioning the assets of the Fund across a number of different types of asset and markets.

(ii) the risk of underperforming the benchmarks, or relative risk.

Our investment managers can, to a large extent, control relative risk by using statistical techniques to forecast how volatile their performance is likely to be relative to their benchmarks or targets. Each manager has a mandate specific benchmark and agreed maximum level of risk.

(iii) different classes of asset have different risk and return characteristics. The returns from equities have, historically, been higher than from bonds but they are more volatile and risky. In setting the investment strategy the LPFA pays regard to the expected risks and returns of the various classes and the correlation between those returns to target or expected return within an acceptable level of risk.

(iv) other financially material risks (and opportunities) such as corporate governance and environmental issues are required to be considered and controlled by our fund managers in relation to all asset classes.

(v) the Fund's assets produce worse returns than those assumed by the actuary, who values the assets and liabilities every 3 years, and that the solvency of the Fund deteriorates.

The adoption of a strategic asset allocation strategy and the detailed monitoring of performance and risks relative to the targets constrains the investment managers from deviating considerably from the intended outcome, whilst at the same time allowing adequate flexibility to manage the portfolios in such a way as to enhance returns. The appointment (actual and proposed) of at least two investment managers for each major asset class, with different investment styles, helps provide an adequate level of diversification of manager risk.

### **Realisation of investments**

In normal market conditions a sufficient percentage of assets of the Fund is held in securities that can be realised quickly, if required. The cashflow mandates include swap programmes across different maturity profiles which does affords opportunities for the sale in the event of a liquidity crisis, but neither as quickly or cheaply as for quoted equities. Whilst Limited Partnerships and similar vehicles used in private equity and infrastructure and property funds have historically suffered from a perception of limited liquidity, the secondary market continues to expand. Overall, the LPFA is satisfied that it holds a sufficient proportion of the Fund in liquid assets to meet any expected or unexpected demands for cash. Regular income arising from investments will normally be re-invested in existing mandates.

### **Expected return on investments**

It is not possible to control the absolute return on investments but over the long-term the Fund seeks to achieve the returns required to achieve the objectives of its funding strategy statement. Further details on the expected returns from investments and how they interact with the formal triennial valuation of the Fund's assets and liabilities by the Actuary are included in the Funding Statement.

## **Responsible investment**

The LPFA recognises the importance of the principles relating to responsible investment and the need for robust corporate governance in seeking to achieve its investment objectives. The Fund has regular meetings with investment managers to discuss and evidence their attitude to ESG issues. We are recruiting another person within the LPFA investment team to focus and drive our efforts in the ESG arena.

The LPFA was a pioneering signatory to the UN Principles of Responsible Investment. Whilst reserving the right to act independently if it chooses, the Fund will most likely operate through partnerships and alliances with other pension funds or organisations. For example, the LPFA is currently involved with the Local Authority Pension Fund Forum, the Institutional Investors Group on Climate Change and the UK Social Investment Forum.

This focus extends across the Fund and to the internally managed alternative assets portfolio where in addition to holding relatively significant investments in “cleantech” venture capital within the private equity portfolio, there is also a designated (30%) focus on environmental infrastructure within the overall infrastructure allocation. This covers both environmental technology and renewable energy opportunities.

## **Exercise of voting rights**

Our external fund managers vote the shares that they manage on our behalf following ISS guidelines, although the LPFA retains the right to act itself should the occasion arise. Contentious resolutions resulting in a vote against the resolution, complete with rationale are documented and included in the regular reporting papers presented at each Investment Committee meeting.

## **Compliance with Myners principles**

The Fund aims to comply fully with the Myners principles. A detailed report of that compliance can be found in our Annual Report and Accounts and is a public policy statement on the LPFA website.

## **Context**

To place this Statement of Investment Principles in context, the attached Appendix sets out an overview of the LPFA and the relevant regulatory and governance parameters.

**REGULATORY CONTEXT**

1. This statement has been made under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, that requires that the LPFA (and others) must prepare, maintain and publish a written statement of the principles governing their decisions about investments.
2. This statement has been prepared by the Board of the LPFA. It sets out the principles that govern our decisions about the investment of the assets that we administer under the Local Government Pension Scheme (LGPS).
3. The Local Government Pension Scheme was established in accordance with statute to provide death and retirement benefits for all eligible employees, mainly local government staff. The LGPS is a funded final salary scheme.

Scheme summary (for details please refer to member booklet.)

	<b>Pre 1/4/2008/ scheme</b>	<b>Post 1/4/2008 scheme</b>
<b>Accrual rate for benefits</b>	<p>Pension of 1/80<sup>th</sup> of salary for each year of membership.</p> <p>Lump sum of 3 x pension with the option of additional commutation at the rate of £1 annual pension for £12 lump sum, up to HMRC limit of 25% of capital value.</p>	<p>1/60<sup>th</sup> of salary for each year of membership from 1/4/2008. <b>Membership to 31/3/2008 to be calculated as before.</b></p> <p>Lump sum by commutation at the rate of £1 annual pension for £12 lump sum, up to HMRC limit of 25% of capital value.</p>
<b>Employee contribution rate</b>	<p>6% for the majority of members, although a small number currently retain a protected 5% rate.</p>	<p>Banded employee contributions determined on an annual basis ranging from 5.5% if earnings less than £12,000 to 7.5% if earnings in excess of £75,000. Bands increased by RPI.</p> <p>The introduction of a cost sharing mechanism of overall scheme costs increase.</p> <p>Protected 5% contribution rate to be phased out over 3 years.</p>

<p><b>Normal Retirement Age</b></p>	<p>Normal retirement age of 65 but voluntary retirement possible from age 60 onwards. Benefits subject to reduction where the 85 year rule (membership plus age) is not met.</p>	<p>65 for all members, although current protections under the rule of 85 will apply to all membership up to 31/3/2008. Some protection for older members who reach 60 prior to 31/3/2020 for future membership.</p> <p>Voluntary retirement from age 60 but subject to actuarial reduction in respect of membership which is not protected.</p>
<p><b>Early Retirement</b></p>	<p>Immediate payment of benefits on efficiency/redundancy grounds from age 50.</p> <p>Voluntary retirement with employer consent and flexible retirement from age 50.</p>	<p>Immediate payment of benefits on efficiency/redundancy grounds from age 55.</p> <p>Voluntary retirement with employer consent and flexible retirement from age 55.</p> <p>A protected age of 50 for the above for those who reach 50 by 31/3/2010 and were in the Scheme prior to 1/4/2008.</p>

Benefits are defined in law and inflation-protected in line with increase in the RPI (Retail Price Index). The scheme is administered by designated administering authorities such as the LPFA.

**Investment committee Terms of Reference**

The function of the Investment committee is to consider the appropriate investment policy of the Authority and what steps might be taken, subject to possibly amending Regulations, to implement a matched investment strategy, and to include all aspects of investment policy and management.

The specific duties of the Investment Committee are as follows:

- To implement, review and monitor the investment policy and strategy of the Fund.
- To monitor the performance of the Fund and investment managers against the targets set.
- To review the management agreements and fees charged.
- To consider the extent to which advice is required from the investment advisers, the actuary appointed for the Fund and investment managers.
- To monitor action taken on voting shares and review developing best practice.
- To monitor the operation of the securities lending programme.
- To consider any other matters where requested to do so by the Board.
- To report to the Board on the discharge of the above duties.