Item 2

3rd March 2021

Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

Contact: Richard McIndoe, Director

Review of Investment Strategy and Structure

Purpose of Report:
To conclude a review of Strathclyde Pension Fund's Investment Strategy and Structure.

Recommendations:
The committee is asked to note the various strands of work carried out as part of the review of investment strategy and structure and to approve:

- Baillie Gifford's portfolio being moved to that manager's Global Alpha strategy benchmarked against the MSCI All Country World Index (MSCI ACWI);
- the revised benchmark for the L&G passive portfolio set out at 6.4.2;
- a re-allocation of **1%** from DIP to the JP Morgan International Infrastructure Fund;
- a re-allocation of **1%** from PIMCO to Ruffer;
- that the small (**1.5%** of Total Fund) index linked gilts allocation in Hedging & Insurance be sold and held as cash; and
- that the Statement of Investment Principles be update to reflect these changes.

Ward No(s):	Citywide: ✓
Local member(s) advised: Yes ☐ No ☐	consulted: Yes ☐ No ☐

1 Background

A review of investment strategy in conjunction with the actuarial valuation of the Fund as at 31st March 2020 is one of the major items in the SPF 2020/21 business plan.

2 Previous Reviews

In March 2015, the SPF Committee agreed to adopt a new risk-return framework as the basis for modelling and developing investment strategy. The committee also agreed that implementation of Alternative strategy 1, "Alt 1" illustrated below, should be progressed as quickly as opportunities, market conditions and other practicalities would allow.

Asset	Start	Alt 1	Alt 2	*Alt 3*	*Alt 4*
	%	**%**	**%**	***%***	***%***
Equity	72.5	62.5	**52.5**	*42.5*	*32.5*
Hedging/Insurance	4.5	2.5	**2.5**	*2.5*	*2.5*
Credit	3.0	5.0	**5.0**	*5.0*	*5.0*
S/T Enhanced Yield	7.5	15.0	**20.0**	*25.0*	*30.0*
L/T Enhanced Yield	12.5	15.0	**20.0**	*25.0*	*30.0*
	100	**100**	**100**	***100***	***100***

In 2018, with Alt 1 largely complete, the Committee agreed to begin implementation of Alt 2. This was completed during 2019/20.

3 Priorities for 2020 Review

Given the lengthy transition period experienced by the Fund in implementing Alt 1 and Alt 2, the Panel agreed at the outset of the review that a period of minimal strategic change would be welcome to allow time to fully assess the attributes and performance of the revised structure.

Within this context, the Investment Advisory Panel agreed the following priorities at its meeting in February 2020:

- asset liability modelling to better understand and if necessary re-state the long-term objectives and return target for the Fund;
- explicit consideration of the risk which inflation poses to the long term objectives;
- climate risk scenario modelling;
- review of credit spread triggers; and
- review of the current equity structure.

The structure of the non- equity asset categories was also reviewed.
Results of the actuarial valuation and conclusions of the reviews of strategy and asset category structures are summarised below.

4 2020 Actuarial Valuation

The actuarial valuation of the Fund as at 31st March 2020 produced the following headline result.

	31 Mar 2017 (£m)	31 Mar 2020 (£m)
Past Service Liabilities	***18,761***	**19,744**
Market Value of Assets	***19,699***	**20,941**
Surplus	*939*	1,197
Funding Level	**105%**	**106%**

Review of Investment Strategy

5 Asset Liability Modelling

The actuarial valuation process produces detailed cash flow data relating to the Fund's expected long term contributions income and pensions payments. Using this cash flow data together with projected investment returns under multiple economic scenarios, the Fund's actuaries and investment consultants, Hymans Robertson, have carried out extensive asset liability modelling. This tests the ability of the current and alternative investment strategies to achieve or maintain the funding target. Conclusions of the modelling are as follows:

- the current strategy is expected to achieve the Fund's objectives with a 70% likelihood of success although there is still a significant downside risk exposure;
- any further de-risking (reduction of equity allocation) at current funding levels would lead to a worsening of success measures with minimal impact on downside risk; and
- the current strategy should therefore be maintained subject to some minor amendments which are described below together with details of some proposed changes to the structure of individual investment categories.

Review of Individual Asset Categories

6 Equity

As explained above, no change is proposed to the overall equity target exposure. This will remain at **52.5%** of total assets. However, the geographic diversification and the mandate structure have also been reviewed and some changes are suggested. The review and its conclusions are summarised below.

6.1 Review

Hymans Robertson produced a series of reports reviewing the equity structure. These included detailed style analysis and modelling of a range of geographic benchmark options. The Investment Advisory Panel considered these at its meetings in August and November 2020.

6.2 Mandate Structure

The mandate structure combines passive, active and specialist portfolio benchmarks in order to implement the equity allocation in a diversified, efficient and cost effective way.

The structure was reviewed in 2015 prior to the implementation of Alt 1. The additional equity reduction in implementing Alt 2 was effected broadly pro rata across mandates, though some opportunity was taken to adjust weightings. The structure is summarised as follows.

Portfolio	Alt 2 Target (Fund %)	Alt 2 Target (Equity %)
L&G Market Cap	18.0	34.25
L&G RAFI	6.0	11.4
Baillie Gifford	7.5	14.3
Lazard	2.5	4.75
Oldfield	2.5	4.75
Veritas	2.5	4.75
Henderson	1.0	1.9
JP Morgan	3.0	5.7
Genesis	1.5	2.9
Pantheon (PE)	5.0	9.5
Partners (PE)	2.5	4.75
DIP	0.5	0.95
Total Equity	**52.5**	**100**
Other Assets	*47.5*	-
Total Fund	**100.0**	**100**

No change is proposed to the overall mandate structure.

6.3 Regional Structure

The current regional structure was agreed in 2015 before Alt 1 was implemented. It was based on the market capitalisation of the principal regions at the time adjusted, to some extent, to reflect existing overweights to the UK and Emerging Markets. This structure was broadly maintained with Alt 2 implementation.

Since 2015, there have been some changes to the regional balance of the global equity market – North America has grown significantly relative to other markets; the UK has declined. To reflect this the following revised benchmark allocation is proposed.

Region		Market Cap 30 Sep 20 %	Current Benchmark Allocation %		Proposed Benchmark Allocation %	
Europe	**UK**	3.5	20	35	**10**	**25**
	Europe ex UK	13	15		**15**	
N America	**N America**	61	40	40	**48**	**48**
Asia and Emerging Markets	**Asia Pacific ex Japan**	3	6	25	**5**	**27**
	Japan	7	8		**8**	
	Emerging Markets	12.5	11		**14**	
Total		**100**	**100**		**100**	**100**

The revised benchmark maintains the existing rationale of pursuing a global investment strategy to maximise the opportunity set, whilst adjusting the benchmark allocation (in comparison to global market cap) to provide broader diversification across the 3 main market regions.

Some bias to the UK and Emerging Markets has been retained to reflect the Fund's base currency and the future growth expected from developing economies.

In practice, the regional allocation only applies to certain mandates. The Fund sets a regional benchmark for the passive portfolio based on this allocation adjusted to take account of the specialist mandates. For active portfolios the Fund sets global benchmarks where possible, and the regional allocation is a product of the manager's investment decisions. It is now proposed that this approach should be extended with the mandate changes described below.

6.4 Mandate Changes

6.4.1 Baillie Gifford

Baillie Gifford were originally appointed by SPF in 1995. They have consistently been one of the Fund's best performing managers ever since then. Originally a UK equity portfolio, the mandate has grown significantly and changed several times. After a period as a global equity mandate, the benchmark was changed to exclude the US in 2008 in order to accommodate the Fund's strategy and regional allocation as it was then. Excluding the largest equity market from the Fund's largest active mandate now seems anomalous and potentially counter-productive, particularly in light of the proposed increase in the Fund's overall exposure to North America. It is therefore proposed that the mandate should now be expanded to global equity. The portfolio would adopt Baillie Gifford's Global Alpha strategy and would be benchmarked against the MSCI All Country World Index (MSCI ACWI) which is used for the Fund's other global equity portfolios. A summary of the Global Alpha strategy in included at Appendix A.

6.4.2 Legal & General (L&G) Market Cap

L&G were appointed by SPF in 1998 when the Fund decided to introduce a passive approach for some of its portfolio management. L&G have consistently delivered this efficiently and effectively since then. Like Baillie Gifford's, the mandate has grown significantly. It has also changed frequently, having been used as the main channel through which SPF has implemented strategic and structural changes. As a consequence of the changes to the regional allocation and the Baillie Gifford portfolio proposed above, it is necessary for the L&G mandate to change again. The following revised benchmark allocation is proposed.

Region	Benchmark Allocation	
	Current %	Proposed %
UK	27.8	**11.5**
Europe ex UK	8.8	**14.5**
N America	57.5	**49.5**
Asia Pacific ex Japan	2.9	**5.0**
Japan	3.0	**7.5**
Emerging Markets	0.0	**12.0**
	100	**100**

6.4.3 Currency Hedging

In September 2017, the Committee agreed that the Fund should hedge 33% of currency exposure arising from overseas listed equity by switching a proportion of investments in Legal and General passive index funds to currency hedged versions.

Hymans Robertson produced a paper for the November meeting of the Investment Advisory Panel which considered whether the current hedging strategy remains appropriate. It concluded that, while currency risk will always be second order compared to other risks associated with the Fund's assets, the current strategy maintains the aim of some reduction in equity return volatility particularly in times of market stress. It is therefore proposed that the hedging strategy should be maintained around its target weight of 33% of overseas listed equity. To achieve this, the L&G allocation proposed above would be implemented as follows.

Region	L&G Benchmark Allocation		Hedging Ratio Achieved %
	Hedged %	Unhedged %	
UK			
Europe ex UK	82	18	43
N America	87	13	43
Asia Pacific ex Japan	86	14	43
Japan	88	12	43
Emerging Markets	0	100	0
Total			**33**

6.4.4 Legal & General (L&G) RAFI

RAFI is an alternative approach to passive investment where allocation to stocks is based on value factors as opposed to market capitalisation, The Fund first invested in a RAFI strategy in 2013 and increased its exposure to the current level in 2015.

Since the RAFI strategy was adopted the market has evolved significantly, and a number of other factor based investment strategies are now available. Given the increased interest in climate change and responsible investment, some strategies now also target Environmental, Social and Governance (ESG) and sustainability factors.

A paper produced by Hymans Robertson outlined ways that the Fund could integrate responsible investment or climate factors into an index-based solution with L&G.

The value tilt of the RAFI allocation plays a key role in balancing overall style exposures across the Fund's equity mandates. Some further work is required:

- to ensure that any alternative strategy would meet the Fund's long term investment objectives alongside its wider approach to responsible investment and equity investing, and
- to consider which specific climate related factors or objectives such a strategy would seek to achieve.

No immediate change is proposed, but alternative indices, including lower carbon versions of RAFI will continue to be actively reviewed, and a proposal may be brought forward in early course.

6.4.5 Private Equity

SPF started its global private equity programme in 1990. The programme has been very successful, consistently delivering returns (net of costs) which are significantly higher than public market indices. In 1990, SPF was predominantly a UK equity investor. To reflect this, the FTSE All Share index was agreed as the benchmark for the private equity programme. This now seems an anachronism given that SPF is a global investor. The private equity benchmark will therefore be changed to MSCI AC World with a portfolio return target of +5%.

7 LTEY

The LTEY mandate structure is summarised as follows.

Portfolio	Alt 2 Target (%)
UK Property - DTZ	**10.0**
Global Property – Partners Group	**2.5**
DIP	**5.0**
Global Infrastructure – JP Morgan	**2.5**
Total LTEY	**20.0**

The **5%** allocation to DIP is equivalent to DIP's entire target allocation. Actual DIP LTEY figures as at 31st December 2020 were as follows.

	(£m)	(% of Total Fund)
Committed	1,282	5.0
NAV	**741**	**2.9**

The **2.5%** allocation to the JP Morgan International Infrastructure Fund (IIF) was agreed in 2018 as part of Alt 2 implementation. The allocation is now fully funded. JP Morgan presented to the February 2021 meeting of the Investment Advisory Panel. The Panel agreed that the IIF has performed well to date and its structure and management suggest it should continue to do so in the longer term.

A re-allocation of **1%** from DIP to the JP Morgan global infrastructure fund is proposed to achieve a better overall balance for the LTEY structure.

8 STEY

The STEY mandate structure is summarised as follows.

Portfolio	Alt 2 Target (%)
Absolute Return	**6.0**
PIMCO	**5.0**
Ruffer	**1.0**
Multi Asset Credit	**4.5**
Barings	**2.75**
Oak Hill	**1.75**
Private Corporate Debt	**3.5**
Barings	**1.25**
Alcentra	**1.25**
Partners Group	**1.0**
Private Real Estate Debt	**1.0**
ICG Longbow	**1.0**
EM Debt	**2.5**
Ashmore	**2.5**
DIP	**1.5**
Cash	**1.0**
Total STEY	**20.0**

The Ruffer allocation was approved in 2018 as part of the Alt 2 implementation. The Committee report proposed a **1%** initial allocation and clearly indicated that the balance between PIMCO and the new allocation might be adjusted at a later date.

Ruffer presented to the February 2021 meeting of the Investment Advisory Panel. The Panel agreed that Ruffer have performed well to date (and previously for the No.3 Fund) and that their investment process remains attractive.

A re-allocation of **1%** from PIMCO to Ruffer is proposed to achieve a better overall balance for the STEY structure.

Alternative cash arrangements were reviewed as part of the Global Custody tender process, but no compelling new cash strategy was identified.

9 Hedging & Insurance

The Hedging & Insurance mandate structure is summarised as follows.

Portfolio	Alt 2 Target (%)
L&G Index Linked Gilts	**1.5**
Total Hedging & Insurance	**1.5**

One of the priorities for the review was explicit consideration of the risk which inflation poses to the Fund's long term objectives given that all of the Fund's liabilities are inflation-linked. This formed part of Hymans Robertson's asset liability modelling. The modelling confirmed that inflation is a key risk factor for the Fund, but is expected to have a lower impact than other asset risks in a range of different environments. Hymans did not recommend that the Fund considers any immediate actions to manage interest rate and inflation risk which they believe are managed through the existing diversified investment strategy.

At an early stage in the review the Investment Advisory Panel had questioned whether the relatively small allocation to Index Linked Gilts made any significant contribution to the overall investment strategy or whether it could be better deployed elsewhere, most likely in corporate bonds which currently represent better value. Hymans' modelling supported disposal of the Index Linked Gilts, albeit the impact is likely to be minimal.

There may be an opportunity, though, to add some value by switching between these asset categories, together with nominal gilts and cash, over time. It is therefore proposed that the small index linked allocation is moved into cash and that further work is carried out on a relative value framework which would achieve this.

10 Credit

The Credit mandate structure is summarised as follows.

Portfolio	Alt 2 Target (%)
L&G Corporate Bonds	**6.0**
Total Credit	**6.0**

No immediate change is proposed to this allocation.
It may be increased to **7.5%** in due course, using the proceeds from the sale of the index linked bonds currently held in the Hedging & Insurance category. This would be subject to conclusion of work on the relative value framework described above.

11 Climate Risk Scenario Modelling

Hymans Robertson's asset liability modelling included a scenario-based review of climate risk. Conclusions were that:

- the Fund is exposed to climate risk through both its assets and liabilities
- the modelling illustrates a wide range of potential future funding outcomes as a direct result of government business action or inaction on climate change
- some, though, by no means all, of these are very negative.

SPF already recognises the risk posed by climate change and is responding to it via its climate change strategy. The modelling will be useful in informing future development of that strategy, but no immediate change is proposed.

12 Policy and Resource Implications

Resource Implications:	
Financial:	The management fee for Baillie Gifford's Global Alpha strategy is higher than that for the current mandate, but competitive relative to the market norm for this type of investment strategy. The cost of transition is estimated to be 0.006% of assets being transferred or c. £13m. There may be some transition costs in respect of other proposed changes but these are expected to be minimal.
Legal:	None
Personnel:	None
Procurement:	None
Council Strategic Plan:	Strathclyde Pension Fund aligns with the theme of a well governed city.
Equality and Socio Economic Impacts:	
Does the proposal support the Council's Equality Outcomes 2017-22	Equalities issues are addressed in the Fund's Responsible Investment strategy, in the scheme rules which are the responsibility of Scottish Government and in the Fund's Communications Policy which has been the subject of an Equalities Impact Assessment.
What are the potential equality impacts as a result of this report?	No specific equalities impacts.
Please highlight if the policy/proposal will help address socio economic disadvantage.	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.

Sustainability Impacts:	
Environmental:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.
Social, including opportunities under Article 20 of the European Public Procurement Directive:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.
Economic:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.
Privacy and Data Protection impacts:	None.

13 Recommendations

The committee is asked to note the various strands of work carried out as part of the review of investment strategy and structure and to approve:

- Baillie Gifford's portfolio being moved to that manager's Global Alpha strategy benchmarked against the MSCI All Country World Index (MSCI ACWI);
- the revised benchmark for the L&G passive portfolio set out at 6.4.2;
- a re-allocation of **1%** from DIP to the JP Morgan International Infrastructure Fund;
- a re-allocation of **1%** from PIMCO to Ruffer;
- that the small (**1.5%** of Total Fund) index linked gilts allocation in Hedging & Insurance be sold and held as cash; and
- that the Statement of Investment Principles be update to reflect these changes.

APPENDIX A

Baillie Gifford Global Alpha

Global Alpha is a long-term diversified global equity strategy selecting growth stocks on a bottom up basis with a focus on fundamental analysis. The strategy combines the specialised knowledge of Baillie Gifford's investment teams with the experience of some of its most senior investors.

The Global Alpha strategy will invest in shares of companies anywhere in the world and in any sector, selecting strong companies that the team believes will grow significantly over the coming years. Its aim is to outperform its benchmark, the MSCI All Countries world index, by **2% - 3% p.a.** (net) over rolling 5-year periods. Performance of the strategy to end September 2020 was in excess of this target.

The strategy typically holds equity in **70-120** companies at any point in time. It has an active share of 85% and a turnover of <20%, demonstrating the manager's commitment to active investment management on a long term basis. Current assets stand at c. £27 billion. While the strategy had been closed to new investors for many years, recent outflows from pension fund de-risking released capacity and in Q3 2019, Baillie Gifford announced that the strategy was re-opening for both segregated investment and pooled fund clients.

The Fund's current mandate and the Global Alpha strategy have 16 stocks in common with c.23% direct overlap. On a sector basis, the main impact of a switch would be an increase in the Fund's Baillie Gifford portfolio exposure to healthcare, and a decrease in exposure to industrials, with exposure to other sectors remaining broadly similar. Style analysis shows that the Global Alpha strategy has a broadly similar growth bias to the Fund's current mandate.

The management fee for Global Alpha is higher than that for the current mandate, but competitive relative to the market norm for this type of investment strategy. The cost of transition is estimated to be 0.006% of assets being transferred or c. £13m.

Baillie Gifford Global Alpha Paris Aligned Fund

In May 2020, Baillie Gifford announced the launch of a Paris-Aligned variant of the core Global Alpha strategy, available only for existing clients. Given that it is unrated and largely untested, this version of the strategy is not currently proposed for SPF, but could be an option in future.

The team and the investment approach for Global Alpha Paris-Aligned is the same as the core Global Alpha fund. The difference between the two funds is in the Paris-Aligned variant's additional objective, which is to invest in companies that collectively have a lower weighted average carbon intensity ("WACI") than the MSCI ACWI Paris-Aligned benchmark.

The Global Alpha Paris-Aligned variant therefore follows the same investment philosophy and process as the core Global Alpha strategy, except for an additional screening to assess the extent to which companies are compliant with the Paris Agreement. This two-tiered screen potentially results in a stock being excluded from the core Global Alpha portfolio, with assets being redistributed across the portfolio. There are no stocks included in the Paris-Aligned variant that are not already in the core Global Alpha portfolio. The Paris-Aligned portfolio that is produced after the additional screening process is very similar to the core Global Alpha portfolio with c.94-95% overlap, and only 7 holdings excluded (as at September 2020).