

Pension Fund Committee

Meeting to be held on 15 April 2011

Electoral Division affected: None

The Operation of the Investment Panel – Investment Decision Making

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Executive Summary

This report sets out proposals for the operation of the Investment Panel as a key element of delivering the new investment strategy, agreed by the Committee at its meeting on 10 December 2010.

It is vital to the successful implementation of the new investment strategy that the Investment Panel is rigorous, transparent and accountable to the Committee. The Investment Panel will in effect, be acting as the Fund's "internal investment managers" and as such, all decisions (whether it be a decision to proceed with or to withdraw from an investment opportunity) and supporting reasons must be transparent, and the Panel held to account by the Committee for performance.

The report also sets out the process that will be adopted by the Investment Panel in order to achieve clear transparency and accountability. This includes:

- the importance of due diligence
- the role of the independent advisors (specifically that agreement from both advisors is necessary for an investment proposal to proceed)
- the role of the Assistant Director of Finance as a check within the system
- the role of the Fund Treasurer
- accountability and reporting arrangements to the Pension Fund Committee
- the constitution, and
- the role of the Chair/Deputy Chair.

Recommendation

The Committee is asked to consider the proposed arrangements for the operation of the Investment Panel and in particular the role of the Chair and Deputy Chair.

Background and Advice

The Investment Strategy

At its meeting on 10 December 2010, the committee agreed a new investment strategy. The overall objectives of the strategy are:

- To ensure that resources are available to meet the Pension Fund's liabilities through achieving investment performance at least in line with actuarial assumption, and
- To achieve full funding (i.e. no funding deficit) over a period no longer than the current recovery period.

In order to achieve this, some significant changes to the investment strategy were agreed which are designed specifically to achieve the actuarial assumption of an annual return of gilts plus 2½%, taking into account the Fund's risk appetite.

The drivers for the change in investment strategy are:

- Deficit reduction leading to reduced and stable contribution rates
- Separate treatment and management of investment and liability risks, but with an overall reduction in the Fund's risk exposure
- Appropriate rewards for the risks the Fund is prepared to take
- Stability and improvement of performance, to reduce volatility and avoid large draw downs of the Fund's capital.

In order to deliver this, the Committee agreed a change in asset allocation designed to deliver long-term income streams to the fund, or to provide a counter balance against movements in equities.

As part of this change, the Committee agreed the revised role of the Investment Panel. The Panel will fulfil the role of internal "fund manager", controlling the distribution of cash (contributions, dividends, coupons etc) to asset classes as well as strategic and tactical allocation changes as driven by market circumstances and opportunity.

Whilst there will continue to be a number of traditional mandates managed by fund managers, over time, the Fund will move towards making one-off investments, for example, in unitised funds or specific projects.

It is important that with this change, the governance and accountability arrangements for the Investment Panel are clear. The Investment Panel is directly accountable to the Committee in terms of investment performance, and this is codified in the proposed constitution, set out elsewhere on the agenda. The Investment Panel will operate within the investment strategy agreed by the Committee, with the decisions taken (both in terms of investments approved and those not approved), and performance, reported to each meeting of the Committee.

As an important part of the accountability framework, the decision making process by the Investment Panel must be clear and transparent. In particular, it must be clear how differences in opinion between the independent advisors regarding a specific investment are resolved.

At the last meeting the Committee considered new governance arrangements for the Investment Panel, and raised specific concerns regarding accountability of the Investment Panel, and the process for resolving differences of opinion of Panel members. The Committee agreed that in order to provide greater accountability to

the Committee that the Chair, or Deputy Chair, be a member of the Investment Panel.

This report sets out for the Committee:

- the process which the Investment Panel will follow
- the accountability and reporting arrangements to the Committee
- the position of the Chair/Deputy Chair.

The Investment Process

As set out above, the changes to the operation of the Investment Panel are part of the approval by the Committee of the Fund's new Investment Strategy in December 2010. This differs significantly from the previous strategy in a number of ways, specifically:

- The Fund will become more global in its investments;
- The Fund will be more actively managed than in the past;
- Asset allocations will be within broad ranges;
- There will be less manager concentration;
- Investments, subject to return criteria and risk analysis, will be in a wider range of asset types;
- The strategy will aim to have an impact on the Fund's liability exposure;
- The Strategy will include investments generating strong long term cash flows which will tend to be investments in funds rather than through managers.

A key component within the adoption of the strategy is that the Fund needs to have the capacity to, for want of a better phrase, "be its own investment manager". To achieve this effectively there needs to be an appropriate body to make, or recommend, investment decisions within the context of the strategy agreed by the Committee and for the decision making process to be much swifter than is traditionally the case in Funds which are wholly externally managed.

The appropriate body to formulate investment recommendations in the context of the Lancashire County Pension Fund is the Investment Panel. The Panel includes a minimum of two independent investment advisors appointed by the Committee, an internal investment professional, together with the County Treasurer and the Assistant Director of Finance. The Assistant Director of Finance has a specific role to act as a check within the system in terms of ensuring that risks to the fund are rigorously assessed and the Committee's strategy is strictly adhered to.

Given the constitutional framework within which local authorities operate the decision maker in these areas is the County Treasurer, as Treasurer to the Fund. In the discussion at the last meeting of the Committee members indicated a preference for greater member involvement in and direct oversight of the process.

The first principle is that all investment decisions must be made within the Investment Strategy agreed by the Committee. This strategy sets out both broad asset allocations and the expected returns from those allocations. This sets the basic

framework within which the Investment Panel must operate. No investment proposal which falls outside the bounds of these criteria will be considered by the Panel. If the investment professionals on the Panel feel that there is reason to change elements of the strategy then they must make the case for this both to the Treasurer and to the Committee.

The first stage of the investment decision process is to identify an investment opportunity which merits further investigation. It is anticipated that this will be largely undertaken by officers within the Treasurer's Treasury Management and Pension Fund team, and in order to achieve this, the Leader of the Council approved the restructure of the team at his decision making session on 5 April 2011.

At this stage, an early indication is sought from the Independent Advisors, the Head of Treasury Management and Pension Fund and Assistant Director of Finance as to whether the further investigation should be undertaken at this stage. This stage indicates only that this is an opportunity worth looking at in the context of delivering the Investment Strategy.

The next stage of the process is best described as "due diligence" and involves officers compiling a detailed report on each opportunity covering:

- Fit within the specific asset class
- Compliance with the Investment Strategy criteria
- Risk and return characteristics of the investment
- Legal structure of the investment and constraints
- Price/duration and optionality characteristics.

As part of the internal compliance process, the reports will be signed off by the Assistant Director of Finance that appropriate due diligence has been undertaken. No opportunity will be considered by the Investment Panel without a completed, signed off, due diligence report.

This report will be considered by the three investment professionals on the Panel and unless there is unanimity among them then the opportunity will not be presented to a meeting of the full Panel chaired by the Treasurer for consideration.

Opportunities which do not achieve unanimous support at this stage will be reported to the full Panel for information together with the reasons for their rejection. If there are specific concerns that further investigation or modification may deal with the Panel may agree that further work be undertaken. This information will also be included in the Panel report to the Pension Fund Committee.

Opportunities that satisfactorily pass the "unanimity" test and the Panel debate are then laid before the Fund Treasurer for approval and implementation.

Reporting and Accountability to the Pension Committee

As the Investment Panel is acting as the Committee's "internal fund manager", it is vital that the Panel are held to account by the Committee, and that all decisions taken are clear and transparent.

After each Investment Panel meeting, a report will be presented to the Committee by the Treasurer which sets out:-

- The investment proposals presented for consideration
- The investment proposals rejected for consideration, and the reasons why
- The "business case" for each investment presented for consideration. This will include the anticipated return and the specific performance measures to be adopted for each individual investment which will monitor the effectiveness of the decision and the efficiency of the implementation
- The investment proposals accepted or rejected and the reasons for the decision.

This enables the Committee to hold the Treasurer accountable for the investment decisions taken, as the accountable officer charged under the scheme of delegation with delivering the Committee's investment strategy. It must be stressed that the Treasurer cannot allocate any funds for approval without the prior agreement of the two independent advisors and the internal investment professional. This is codified within the proposed constitution of the Pension Fund Committee, set out elsewhere on the agenda.

At the last Committee meeting, members agreed that either the Chair or Deputy Chair would sit as a member of the Investment Panel. This proposal has been carefully considered by officers and the Committee is advised that membership of the Panel would place the Chair and Deputy Chair in a difficult position as having been seen to be party to the original decisions they would not then be able to participate in the Committee's consideration of the Investment Panel report. It is therefore recommended that the Committee re-consider its original view.

Consultations

The two independent advisors have been fully consulted on the development of new methods of operation of the Investment Panel, and support the proposals within the report.

Implications:

This item has the following implications, as indicated:

Risk management

The Investment Panel is charged with monitoring the performance and risk management of the Fund at an overall level, whilst monitoring the activities of the individual external fund managers and internal investments on a regular basis.

