Appendix 1

WEST MIDLANDS PENSION FUND

SIAB ANNUAL REVIEW

September 2014

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For and on behalf of Hymans Robertson LLP

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Annual Review of SIAB PAGE

Addressee

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1 Executive summary

Introduction

The Fund’s Strategic Investment Allocation Benchmark (“SIAB”) is reviewed on an annual basis, with a more detailed review of the suitability of the investment strategy in the context of the Fund’s long-term funding objectives taking place on a triennial basis following the Fund’s valuation. That investment strategy review was carried out earlier this year and the results were presented to the Committee in June. In broad terms, the investment strategy review concentrated on the appropriate level of split between two types of assets, which we categorise as “stabilising” and “return-seeking”. This annual review is concerned with the structure of the stabilising and return-seeking portfolios in terms of the asset classes selected and the way in which they are managed.

Summary

The investment strategy review indicated that the Fund’s high-level strategy was appropriate to meet the Fund’s funding objectives in current circumstances. The SIAB sets out the structure chosen to implement that strategy and is well diversified across a range of asset classes. Equity risk still dominates and the Fund should continue to seek out suitable opportunities to reduce equity exposure and diversify into other areas that currently contribute relatively small amounts of risk. However, following a period of strong performance from most asset classes, we think there are few cheap opportunities currently available.

The Fund remains over-diversified in terms of the number of mandates. Our last review suggested that consolidation was likely to take a period of years. We recognise that progress has already been made in streamlining the portfolio and in putting in controls to make the management and oversight of portfolios more efficient. However, we believe that this should remain a key priority for the Fund.

We believe that control of the investment management of any fund benefits from clarity about the aims of investment in each asset type and in the selection of individual mandates. For the Fund, much of this is the responsibility of the in-house management team. We suggest that this should be supplemented by the Committee’s formally setting out its investment beliefs. This will provide a high-level framework for the Committee’s oversight of the Fund and act as a guide for the in-house team in its management of existing assets and analysis of new opportunities.

We set out some detailed recommendations about the structure of individual asset class portfolios. Whether these or others are agreed, we believe it is important that actions are prioritised and timetabled in a business plan. This should not be set in stone; priorities can change and any business plan should reflect this. It should be driven by a sensible assessment of available resources rather than attempt to achieve all identified actions by a random target date. However, a flexibly managed and realistic business plan, set up and maintained by the in-house team, would provide the Committee with a valuable summary of the work done and planned on its behalf.

2 Background

SIAB Review

The Fund's Strategic Investment Allocation Benchmark is reviewed on an annual basis, with a more detailed review of its suitability in the context of the Fund's long-term funding objectives taking place on a triennial basis following the Fund's valuation. That latter review was carried out earlier this year and the results were summarised in a paper, ***Main Fund: 2014 investment strategy review***, which was presented to the Committee on 25 June 2014. The investment strategy review confirmed that the high-level investment strategy was currently appropriate for the Fund's funding objective in current circumstances, but noted that the strategic framework could be developed both to allow for changes in funding position and to introduce alternative strategies to accommodate the requirements of different employers. **We recommend that this strategic areas is explored further prior to the Fund's 2016 valuation.**

Aims of the annual review

The main aims of this annual review are

- to analyse the sources of risk in the portfolio; and
- to suggest potential opportunities to improve the SIAB or its implementation.

Current SIAB

The SIAB as at 30 June 2014 is set out in table 1 below. More detail on the mandates underlying these exposures is included as an Appendix.

Table 1: SIAB and Fund allocation as at 30 June 2014

	SIAB %	*Fund %*		SIAB %	*Fund %*		SIAB %	*Fund %*
Equities	**58.0**	***57.1***	**Fixed Interest**	**19.0**	***22.5***	**Alternatives**	**23.0**	***20.4***
			Stabilising					
UK	10.0	*9.7*	Index Linked Gilts		*6.2*	Direct Property	6.0	*6.1*
Continental Europe	6.0	*6.4*	Conventional Gilts	10.0	*1.8*	Indirect Property	3.0	*2.7*
North America	9.0	*9.5*	Liquid Assets		*4.1*	Commodities	0.0	*1.9*
			Return Seeking					
Japan/Pacific Basin	6.5	*6.1*	Corporate Bonds		*4.7*	Infrastructure	4.0	*3.1*
Emerging Markets	8.5	*8.4*	Emerging Market Debt	9.0	*2.6*	***Absolute Return***	**10.0**	***6.0***
Global	8.0	*4.8*	Other Fixed Interest		*3.1*	Hedge Funds	3.0	*2.1*
Private Equity	10.0	*12.2*				Insurance Linked	3.0	*1.6*
						Special Opportunities	4.0	*2.9*

Link to investment strategy review

In broad terms, the investment strategy review concentrated on the appropriate level of split between two types of assets, which we categorise as stabilising and return-seeking. The annual review is concerned with the structure of the stabilising and return-seeking portfolios in terms of the asset classes selected and the way in which they are managed.

3 General recommendations

Stabilising assets

These include conventional gilts, index-linked gilts and cash. They are assets that typically respond in a different way to changing economic circumstances from the rest of the Fund's portfolio. They provide the Fund with liquidity and some protection against adverse economic circumstances. In our review of the Fund's bond portfolio in October 2012, we recommended that this portion of the Fund be managed passively and we still advocate this approach.

We recommended a SIAB allocation of 5.5% in index-linked gilts (the existing SIAB allocation at the time), with the remainder in conventional gilts, but suggested that the overweight position in index-linked could be tolerated in the short term. That overweight position persists. The Committee should perhaps decide if and when the position should be brought in line with benchmark; alternatively, <u>it may wish instead to adjust the SIAB to bring it in line with the actual allocation at 30 June 2014 i.e.6.2%</u> (we would be comfortable with such a decision). There is no single right answer to the split: the Fund's desire to hedge inflation or secure liquidity would be relevant factors. The appropriate split may vary over time and the Committee may wish to consider the split as part of any more general consideration of how the SIAB might develop in the future.

Return-seeking assets

These include equities, alternative assets and non-stabilising bonds. The primary objective of this part of the portfolio is to generate returns in excess of the growth in the Fund's liabilities. It is ways in which this objective might be achieved more efficiently that is the focus of the rest of the paper. Listed equities are the subject of a more detailed analysis to be presented to the Investment Advisory Sub-Committee and only a brief summary of the recommendations is included in the current paper.

In our initial report of October 2012, we arranged our recommendations into three categories. We follow that approach in the discussion that follows.

Governance

The aim here is to ensure that management resource is allocated efficiently. Earlier recommendations generally related to the observation that the Fund is over-diversified in terms of the number of mandates. If these are largely reiterated, it is because, as was acknowledged at the time, unwinding positions in illiquid asset classes can take several years.

- The private equity, overseas property and infrastructure portfolios are spread widely across a large number of relatively small holdings. The aim here should be to reduce the work involved in monitoring managers and assessing new opportunities. In these cases we believe the appropriate plan of action includes:
    - Identifying a list of managers that will be considered
    - Determining the approximate annual net contribution level required to keep or move the portfolio in line with target over time. The nature of these investments means that it would be unrealistic to expect exposure to remain precisely in line with target; we think that aiming for stability in contributions is a more useful discipline.
    - Maintaining and monitoring approximate cash flow projections to ensure that plans remain broadly on course.
- Similar comments could be made in respect of the illiquid holdings in the Fixed Interest portfolio, although the approach here may be best considered as part of the development of the return-seeking bond portfolio more generally. This is addressed later.

Articulation

The discipline of accounting for the reasons why asset types and individual mandates are included in the Fund is a good way of bringing consistency to the management of the Fund. Over the last couple of years this has resulted in, for example

- splitting the bond portfolio between stabilising and return-seeking components; and
- focusing the Absolute Return portfolio on a narrower range of opportunities.

We also understand that there is an intention to introduce a new classification “Real assets and infrastructure” into the SIAB (it will sit as part of the Fund’s alternatives investments). We understand that this new classification will have a long-term target allocation of 6% of Fund assets and initially be made up of the Fund’s existing infrastructure (4% strategic allocation) and agricultural investments. We are comfortable with this new classification being introduced into the SIAB as it should help with the articulation process and provide greater clarity as to why certain asset classes are held by the Fund.

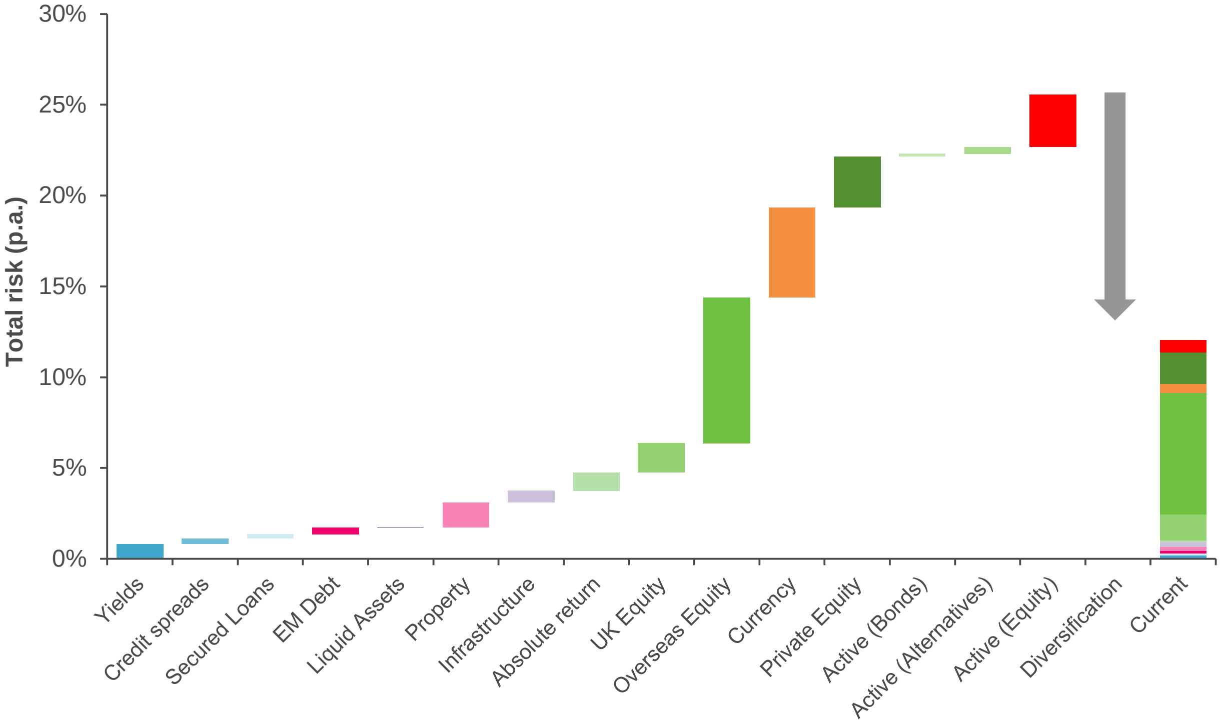
Much of the detail in this respect will be the responsibility of the in-house management team. Examples would be the recommendation to set out more clearly the strategic aims of the private equity, overseas property and infrastructure portfolios in terms of factors such as geographical allocation, focus on income or growth and sector biases. However, we believe that there is also value in the Committee’s undertaking a high-level exercise that sets out its investment beliefs. This will provide a framework for the Committee’s oversight of the Fund and a guide for the in-house team in its management of existing assets and analysis of new opportunities. We would be delighted to help in this belief setting process, perhaps by facilitating a session at your October training days.

Management of risk and return

The aim here is to look for ways to diversify the sources of return in the Fund’s portfolio, to reduce risk while not compromising the Fund’s return objectives.

Investment risk, measured in terms of the annualised volatility of the absolute return on the Fund’s portfolio is represented in the “waterfall” chart below. It shows, on the rightmost bar, the overall risk of the current strategy. This risk is around 12% p.a. In effect, this figure indicates that there is a 2 in 3 chance that the change in the value of assets in any year will be less than 12% above or below the average expected return. There is of course a 1 in 3 chance that the change in value could fall outside that range in either direction. To the left of the overall risk bar, the chart also shows the risk attributable to various elements of the portfolio viewed in isolation, as well as the benefits of diversification (i.e. the tendency of different risks to offset one another) in reducing overall risk (the black arrow).

Chart 1: Fund's risk breakdown



We make a few general observations. Again, these will in some cases confirm observations made in the past.

- The SIAB is already well diversified, spreading risk across a wide range of asset classes, and should obtain long-term benefits from the offsetting of these individual risks.
- Equity-related risks still dominate. This is not surprising, given the liquidity and potential returns that equities offer. Nevertheless, there is scope to diversify further to other areas that currently contribute only a small amount of risk.
- This means that we will, in general, be comfortable, with any moves to make modest increases to existing allocations at the expense of equities. Any changes should, of course, be subject to the effect on management resources and consistent with the agreed strategy for the asset class.
- Our view is that most risk premiums have been compressed by the strong performance of most asset classes in recent years. There are few, if any, genuinely cheap opportunities available. This may affect the implementation of changes to the SIAB – a decision that is strategically sound can be undone for many years by poor tactical implementation. The considerations to be borne in mind include:
    - Changes to the SIAB will involve some element of relative assessment. Buying an expensive asset need not be ruled out if it is funded by the sale of a more expensive one.
    - The strategic decision to invest in an asset class should be separated from the actual timing of the investment. Planning strategic changes should be viewed as preparing the Fund to do the right thing at the right time, not as requiring immediate action.
    - Where disinvestment is planned, a temporary increase in allocations to stabilising assets might be considered pending the opportunity to invest elsewhere.

- It may be difficult in practice to obtain exposure at a meaningful level to new opportunities that are of strategic interest. In these cases, the Fund's Special Opportunities allocation can be used as an incubator, helping to build familiarity with new asset classes until more substantial investment is practical.
- The Fund has a substantial exposure to illiquidity risk through its private equity, infrastructure, property and absolute return portfolios, which is not separately analysed above. The Fund has the capacity to accept illiquidity risk, but should be aware of the extent and consider whether there is a limit on illiquid assets in general that should be applied. Maintaining cash flow projections, as mentioned earlier, will be useful in monitoring that distributions from illiquid investments are in line with expectations.

More specific comments on individual asset classes are set out in the next section.

4 Asset classes

Listed equities

- The Fund's portfolio of actively managed global equity mandates should be streamlined along the lines already implemented for the emerging market portfolio.
- Other than emerging markets, regional portfolios should be managed passively.
- The size of the SIAB allocations to different geographical regions should be reviewed.
- Consideration could be given to further diversification in the form of a passive global mandate managed against a non-standard index.

Fixed Interest

- As outlined in Section 3, the Committee may wish to adjust the SIAB's strategic allocation to index-linked gilts to bring it in line with the actual allocation (as at 30 June 2014) of this asset class.
- Exposure to Emerging Market Debt is lower than the SIAB allocation. Although the market has rallied from its lows in January, valuations look less extended than they do in many other asset classes. This may be one area that could be considered for additional investment.
- As we suggested in our review of the bond portfolio in October 2012, we recommend that the rest of the return-seeking portfolio should focus on alternative credit markets, such as high yield bonds, secured loans and asset-backed securities. We believe that investigation should continue as to how exposure to alternative credit would be best achieved and managed for the Fund.
- This investigation should include consideration of whether exposure to illiquid, private debt can be incorporated within broad credit mandates or should be managed separately.
- This is one area where the strategic decision to invest may be separated from the implementation of the decision. Currently, exposure to credit is focused on higher quality, investment-grade issues. We do not think there is any urgency to raise the risk profile.

Property

- We are aware that the Officers are considering a modest increase to the property SIAB allocation to 10%. Both from the perspective of relative value and the strategic exposure, we are happy to support this.
- In practice, the actual exposure to property may be affected in the short term by market conditions and any restructuring that might take place following CBRE's recent re-appointment as the mandate's manager. Any short-term reduction in exposure should be tolerated even if the strategic decision is to raise the SIAB allocation.

Infrastructure

- The Fund's participation in the Pensions Infrastructure Platform may provide opportunities to raise exposure over time. Here, too, we are happy to support such an increase where the right opportunities are available.

Commodities

- We have always had reservations about the value of commodities as a strategic asset for pension funds. We therefore have no issues to raise in respect of the intended sale of existing exposure.
- Farmland and timberland could offer a more suitable means of gaining exposure to returns from natural resources. The Fund already has a small exposure through the Insight Farmland and the BlackRiver Agriculture funds. However, we think this is an area where the Fund will struggle to build a meaningful exposure at a sensible price.
- We are comfortable with the Fund's Agriculture holdings forming part of the new "Real assets and infrastructure" segment.

Absolute Return

- We continue to advocate, as we did in our review of the Absolute Return portfolio, that any hedge fund exposure should focus on strategies and funds that show a low correlation to equities and other traditional assets.
- However, we understand that the officers are considering removing hedge funds from the Fund's SIAB. Any hedge fund exposure implies a belief in the ability to select managers that can generate returns sufficient to cover the costs incurred and the governance demands associated with such mandates. If the officers and committee no longer have that belief, then we are comfortable with the Fund's hedge fund holdings being redeemed in an orderly fashion and the proceeds recycled into other growth assets.
- We remain comfortable with building exposure to Insurance-Linked Securities on a strategic basis. The recent performance of the market suggests that there is no urgency to reach target. Our preference remains that the Fund should aim to get exposure on a segregated basis that allows it to tailor the mandate to its own return requirements.

Other

- There are a range of other asset classes that could be viewed as potential investment opportunities for the Fund e.g. social housing. We will keep you informed of these potential investments; highlighting those that we think could be considered further by the Fund. At this time, beyond the points raised above (including the desire to rationalise and simplify the Fund's investment structure), we do not see any strong argument for introducing any new asset class into the Fund's investment structure at this time.

5 Summary

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We look forward to discussing this paper with you at your September meeting.

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For and on behalf of Hymans Robertson LLP
2 September 2014

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix 1 – Fund holdings as at 31 March 2014

Table 2: Listed equity portfolio

	£m		£m
Equities	**4,625.2**		
UK	**1,000.4**	**US**	**978.6**
Legal and General	29.2	Intech	146.5
In house	971.3	In House	832.1
Japan	**183.1**	**Europe**	**677.8**
Nomura	36.2	Blackrock	236.8
In House	146.8	In House	440.9
Pacific Basin (ex Japan)	**413.3**	**Global Equities**	**526.1**
Schroders	46.6	Baillie Gifford	38.3
In House	*366.7*	BlackRock	140.2
Emerging Markets	**845.9**	MFS	316.7
AGF	291.0	Old Mutual	30.9
F&C	297.9		
Mondrian	257.0		

Table 3: Fixed interest portfolio

	£m		£m
Fixed Interest	**2,174.7**		
Gilts	***192.5***	***Other***	***262.5***
Legal & General Passive	192.5	Highbridge Senior Loan	57.6
Index Linked	***639.1***	Advent	54.2
Legal & General Passive	639.1	Goldman Sachs	4.3
Sterling non-gilts	***480.8***	Newton Global Dynamic Bond	48.1
RLAM	171.3	Prudential M&G UK Companies	35.0
Schroder Corporate Bonds	246.9	Park Square Capital Partners II	12.1
Legal & General Passive	62.6	Indigo Capital	4.9
Overseas Government	***74.5***	Jupiter Convertibles	46.2
Legal & General Passive	***74.5***	***Cash***	***261.5***
Emerging Market Debt	***263.7***		
Ashmore	66.7		
Pioneer	70.4		
Capital International	69.0		
Bluebay	57.6		

Table 4: Property portfolio

	£m		£m
Property	**927.8**		
UK (Direct)	***629.8***	***Asia (Indirect)***	***20.1***
CBRE/In-house	629.8	AEW Value Asia	0.6
UK (Indirect)	**58.4**	Phoenix Asia IV	17.7
Igloo Regeneration	12.8	Phoenix Asia V	1.8
Kames Property Unit Trust	33.1	***Emerging (Indirect)***	***34.3***
Bridges Sustainable Prop Fund	12.5	Goldman Sachs Dev Real Estate	2.0
US (Indirect)	***39.6***	Brazil REOF I	5.4
Beacon Capital Strategic Partners	9.9	Brazil REOF II	6.1
Blackrock Res. Opps Fund	21.8	PLA Residential Fund III	10.2
High Street Ref III	7.8	Bluehouse APIII	10.6
Europe (Indirect)	***67.1***	***Global (Indirect)***	***78.5***
AEW Episo	14.2	Blackrock Global	1.1
Rockspring Pan European PUT	6.5	Whitehall Street	3.9
RREEF European Value	3.6	UK Morgan Stanley AIP	31.8
Sveafastigheter Fund III	21.0	Morgan Stanley REFVE VII	16.4
Mansford Real Estate Opportunities Fund	21.8	Dune REF II	25.3

Table 5: Infrastructure portfolio

	£m		£m
Infrastructure	**293.4**		
UK PFI/PIP	***38.2***	***CleanTech***	***106.3***
Henderson PFI Secondaries	26.4	HG Renewable Power Partners	4.0
Innisfree PFI Secondaries	11.6	Aqua Resources Fund	10.6
Dalmore PIP	0.2	Riverstone/Carlyle Infrastructure	18.0
Global Diversified	***148.9***	Khosla Ventures III	15.7
ARCUS Euro Inf. I	13.4	Impax New Energy	3.4
Infracapital Partners	13.6	Waste Resources Fund	8.5
Eiser Infrastructure	12.5	Impax New Energy II	18.5
Steelriver	15.6	Blackstone Cleantech	10.7
J P Morgan AIRRO	32.1	First Reserve Energy Fund	17.0
AMP Capital AGIF	8.3		
Global Infrastructure Partners	9.7		
Goldman Sachs Int. Infrastructure	9.0		
EQT Infrastructure Fund	19.5		
Alterna Core Capital	15.2		

Table 6: Commodities portfolio

	£m		
Commodities	**189.6**		
Futures and equities funds	***171.5***	***Farmland***	***18.1***
Goldman Sachs Commodities	33.0	Insight Global Farmland Fund	17.6
Wellington Mgt Commodities	31.4	Blackriver Agriculture	0.5
Investec Global Com & Res	30.9		
Mesirow Fin Com Mgt	22.2		
Blackstone Resources Select	33.5		
Theam Quant Commodities	20.5		

Table7: Absolute return portfolio

	£m		
Absolute Returns	**642.6**		
Hedge Fund – macro, etc.	***191.2***	***Insurance-linked securities***	***112.6***
Bluetrend Fund Ltd	41.9	Coriolis Mistral Fund	
Blue Crest Ltd	52.2	Coriolis Horizon Fund	37.4
Aspect Fund Class I	58.0	Catco Diversified Fund	1.4
Capula GRVF	39.1	Catco Series B	46.3
Hedge Fund – credit	***10.4***	Catco Series C	27.5
Oakhill Strategic Credit Fund	8.4	***Diversified Growth***	***170.7***
Goldman Sachs Opp Partners	2.0	CF Ruffer Total Return	76.3
Hedge Fund – equity-related	***78.5***	Baillie Gifford LF Div. GW	49.5
Taconic Opportunity Fund	40.0	Baring Int IRE Dynamic	44.9
Davidson Kempner Int.	38.5	***Other***	***50.2***
Funds of Hedge Funds	**29.0**	Sciens Aviation Special Opps	9.9
Dorchester Capital Secondaries	3.7	Sciens Aviation Special Opps II	21.7
Dorchester Capital Secondaries I	14.1	Oaktree Fund V	18.7
Dorchester Capital Secondaries III	11.2		