By:	Director of Finance
To:	Superannuation Fund Committee – 6 June 2008
Subject:	**INVESTMENT STRATEGY**
Classification:	Unrestricted

Summary: To propose changes to the Fund's investment strategy

FOR DECISION

INTRODUCTION

1. The Committee regularly keeps its investment strategy under review and following the 2007 actuarial valuation it is timely to undertake a more fundamental review.

ACTUARIAL VALUATION

2. In the 2007 actuarial valuation the overall funding level improved by 10% to 73%. This primarily reflected strong investment returns in the period 2004 to 2007 of 14.1% per annum compared with the investment return assumed by the actuary of 6.3%. So the Fund's above average allocations to Equities and Property were positive contributors and the main detractors were the poor performance of the Global Tactical Asset Allocation fund and variable investment manager performance.

3. There are four firms of actuaries undertaking the valuations of local authority funds. From the Society of County Treasurers figures which are available the average increase in funding level was 9%, so our increase was slightly above average level. However, there was a significant variation between actuaries with the two largest actuaries funds increasing on average by 8.6% and 5.5% respectively. The two smaller firms results saw average increases of 13% and 18%. This does suggest a significant difference in the approaches being taken by actuaries. I believe that the approach taken by Hymans Robertson was both prudent and realistic for the long term future of the Fund.

4. For the period 2001-04 compared to the average investment performance of a Local Authority fund the Kent Fund return was at the average level and for 2004-07 the Kent Fund was slightly above average.

5. For the 2007-10 period Hymans Robertson have once again assumed an investment return of 6.3%. For the period 1 April 2007 to 31 March 2008 the Fund return was –5.8%.

6. The table below is based on Goldman Sachs Asset Management Global Investment Strategies figures.

Asset Class	Expected Total Return %	Expected Total Volatility %
UK Gilts	5.0	4.5
UK Corporate Fixed Income	5.1	4.1
UK Inflation Fixed Income	5.0	5.0
Overseas Government FI	5.0	3.7
UK Equity	8.2	14.5
US Equity	8.5	14.6
Japan Equity	7.9	18.5
Europe Equity	8.7	15.7
Pacific Equity	7.6	14.0
Emerging Equity	13.3	25.5
Global Equity	8.5	13.7
UK Property	4.6	3.6
Global Property	9.5	17.6
Commodities	6.1	20.2
Hedge Funds	6.6	3.5
Global High Yield	7.0	8.1
Emerging Debt	9.1	14.5
Global Infrastructure	8.0	17.8
Private Equity	12.0	20.9

These figures are indicative and show a wide dispersion of investment returns and an even wider range of volatility between asset classes.

ASSET ALLOCATION

7. As at 31 March 2008 the Kent Fund asset allocation compared to the WM LA average was:

Asset Class	Kent		WM LA
	Actual %	Benchmark %	
UK Equity	33.1	34.5	34.1
Overseas Equity	34.8	34.5	31.2
Fixed Income	15.6	15.0	18.6
Property	10.1	11.0	7.3
Alternatives	0.8	0	3.9
Cash	5.6	5.0	4.8

8. From this we can highlight:

(1) The Kent Fund allocations are only marginally different from the WM average. We are above average on Overseas Equities and Property and below average on Fixed Income and Alternatives.

(2) The 5% allocation to GTAA would have been classified as Alternative – the 5% in Cash is a short term investment decision.

9. Hymans Robertson have undertaken a large scale modelling exercise to look at the impact of different scenarios and compared the results against criteria of Prudence, Affordability, Stewardship and Stability. Their summary report is attached in the Appendix and they will explain the outcomes at the meeting. A further Structure Modelling exercise is currently underway to examine the shorter term impact of different strategies.

10. The main recommendation is that the there is no strong case for radical change to the Fund's strategy. However, in comparison to the current strategy, the Fund could achieve similar levels of return and reduce overall volatility and by investing a larger proportion of the Fund in Alternative asset classes. The main benefits of this are:

(1) Equity risk dominates the overall risk of the assets relative to liabilities.

(2) We would achieve improved diversification by investing more in assets which have a low correlation with equalities.

(3) Some of these Alternatives ie. Private Equity offer potentially higher returns.

(4) Opportunities exist due to the rapid innovation in products in recent years.

11. In increasing the overall allocation to Alternatives we need to focus on:

(1) The target level of the allocation. Hymans Robertson view is that for it to have a meaningful impact on the overall Fund – a total allocation of 20% including the current 10% UK Property and 1% European Property is proposed.

(2) It will take time to build up to the allocation. So we do not have to find all the funding immediately.

(3) We need to obtain value for money in how we invest as some of the options have very high fees.

(4) Alternative investments can be highly susceptible to fashion, the bull market is Commodities and high levels of investment in Infrastructure Funds are examples of this.

(5) We need to be open to opportunities – the Henderson PFI investment is an example where we have been in the past.

(6) There would be new governance challenges for the Fund. If we invest in a range of new asset classes there will be a number of procurement processes to be undertaken. It is not practical for all these to be undertaken by the full Committee – some will have to delegated to the Director of Finance, Chairman, Vice Chairman and Spokesman with advice from Hymans Robertson. We will need to be explicit about which decisions can be taken through this route.

(7) All our investment manager appointments are subject to full tendering arrangements. Our view is that when the Fund makes an investment decision to invest in a specific investment fund, as we did with GTAA, then there is not a need to undertake an EU process. We would of course need to undertake proper due diligence on any direct investment decisions.

ALTERNATIVE ASSET CLASSES

This section of the report relies heavily on Hymans Robertson presentation on 28 April and will focus on recommended asset classes for investment.

12. UK Property

(1) The current allocation to UK Property is 10%, slightly above the WM LA average of 7%. Up to the middle of 2007 UK Property had experienced a long period of strong positive returns (10.5% pa for 20 years, IPD Monthly). As well as the market performing well we have had outperformance by our property manager DTZ.

(2) Since mid 2007 the commercial property market has fallen by around 16% but DTZ believe that this understates the true extent of the decline. DTZ are presenting their strategy at this meeting – they seem to have become more pessimistic about the speed of recovery as they will explain.

(3) The first major decision on increasing our weighting to Alternatives is whether to allocate additional funds to UK Property. The rationale for this is:

- Strength of long term returns.
- A high quality manager already in place.
- Anticipated buying opportunities given the recent fall in the market.
- No change to our governance arrangements.
- No procurement process required.

(4) Members are asked to consider increasing the UK Property weighting to 12%, an increase of 2%, to be achieved by end 2010, subject to DTZ's views on the market and the availability of suitable stock.

13. **Global Property**

(1) The main characteristics of Global Property as an investment class are:

- It is seen as an asset class which will add value. For example, the Morgan Stanley Real Estate Fund VII Global which is currently seeking to raise capital of $10bn has a targeted rate of return of 20-25% gross IRR and has achieved a 33% IRR since inception in 1991.
- Good rental / capital growth prospects.
- Differs from the UK Market – different economic and market cycles.
- Has a wide spread by region / sector.
- Larger opportunity set (UK 10%, N America 39%, Europe ex UK 27%, Japan 11% and Asia ex Japan 13% of total market).

(2) Investment would need to be through a pooled fund, this could be specific funds which we select or a fund of funds. There are products available but there are significant negatives such as tax leakage and returns, volatility through currency, valuation issues and complicated structures.

(3) Members are asked to consider investing 1% of the Fund in Global Property and Officers with support from Hymans Robertson should be asked to investigate options for a report back to a future meeting of the Committee.

14. **Private Equity**

(1) After Property the most significant Alternative asset class which local authority funds are investing is in Private Equity. This is a very large and diverse asset class and the Kent Fund already has a small (£4m) allocation through YFM Private Equity. The main characteristics are:

- Equity or debt in unlisted companies.
- Global opportunities.
- Range of investable options including buyouts, venture capital and special situations.
- Poor liquidity with a limited secondary market.
- High manager fees.
- As an equity asset there is quite a high degree of correlation with quoted equities.

(2) There are a variety of ways of investing:

- Direct investment in individual companies. This is feasible but resource intensive and highly risky.

- Individual funds, such as our YFM investment. These are a long term, typically 10 year commitment that give an improved spread of risk.

- Fund of funds, Hymans Robertson preferred route, as they offer much improved diversification and better manager selection, but at the cost of an extra layer of costs.

(3) As a long term investor, which can deal with the illiquidity, and with the potential upside on performance there is a strong case for private equity within the Kent Fund. In the early years of the investment returns will be negative but as a small proportion of the total fund this is manageable.

(4) Members are asked to consider investing 2% of the Fund in Private Equity and Officers with support from Hymans Robertson should be asked to investigate options for report back to a future meeting of the Committee.

15. **Infrastructure**

(1) Initial Infrastructure investment was largely UK based in PFI and the Kent Fund has an investment of £10m in the Henderson Secondary PFI Fund targeting an absolute return in the mid-teens. Opportunities now exist worldwide.

(2) The case for investing is based on:

- Strong diversification characteristics

- Significant global need for infrastructure.

- Relatively stable, inflation linked, cashflows.

(3) The case against is:

- Strong investor demand has bid up prices.

- Possible impact from the credit crunch.

- Long term commitment with poor secondary liquidity.

(4) Long term this is an attractive asset class which the Kent Fund has already invested in.

(5) Members are asked to agree a 1% allocation (including the current PFI investment) and ask Officers to seek investment opportunities.

16. **Sustainable Investment**

(1) The liabilities of the Kent Pension Fund are very long term and the Fund needs to be aware of its ability to invest for the long term. As a major public pension fund we also need to be highly aware of our broader responsibilities in-terms of sustainability and the environment.

(2) We also need our investment managers to be tuned to developing sustainable environmental investment themes as these should be highly profitable in the future.

(3) In this context the Fund could set aside a proportion of it's total resources for sustainable / environmental projects. This would require much further investigation but in-terms of overall asset allocation Members are asked to consider a 1% allocation.

17. **Other Alternative Investments**

(1) **Currency Management**

- There are two main forms of currency management, passive and active. The success of each will depend on whether the currency positions taken on average result in net gains for the Fund. Passive management describes an approach in which the Manager eliminates some or all of the currency exposure which arises through holding non-UK assets. This approach is supported by a view that such exposure is largely unintended and adds a layer of unrewarded risk. Success depends on whether, over time, foreign currencies tend to depreciate relative to Sterling. Active currency management is more speculative in nature as the Manager takes positions in currencies based on views for short and medium term movements and with little or no direct regard for the exposures contained in the underlying assets. GTAA had a significant active currency element.

- Through its investment in Overseas Equities and to a limited extent Overseas Fixed Income and European Property the Fund has an exposure to currency fluctuations. The Fund has no overall hedging policy and individual managers do very little hedging. A passive currency hedge removes currency risk. In recent terms our lack of any hedge will have been advantageous for the euro against sterling and costly for the dollar against sterling. Officers have had extensive discussions with JP Morgan our custodian about passive hedging. Officers recommend that at the current time we remain unhedged but keep the position under review.

- Active currency management seeks to add value through an active approach. In theory this is a good way to add value but given the GTAA experience this may not be a suitable approach at this time.

(2) **Commodities**

- Again Commodity investment is a speculative activity. Investment assets include oil, gas, individual metals, timber, livestock and crops.

- Whilst Hymans Robertson see some benefits in Timber overall Commodities have had long periods of negative performance in the past and we could be buying at the absolute peak of the current cycle.

- Timber is worth some investigation but overall this is not a suitable asset class to invest in at the current time.

(3) **Hedge Funds**

- Hymans Robertson do not recommend this asset class at the current time. The Fund's very difficult experience with GTAA reinforces this.

(4) **Other**

- Other opportunities will come to the Fund and an example of this is the Alliance Bernstein proposition to invest in a Distressed Asset Fund. This is set out in the Fund Structure report and Members are asked whether they wish to invest.

18. **Summary**

(1) The proposed asset allocation to Alternative Investments is:

	Allocation %	Change %
UK Property	12	(+2)
European Property	1	(-)
Global Property	1	(+1)
Private Equity	2	(+2)
Infrastructure	1	(+1)
Sustainable	1	(+1)
Other	2	(+2)

(2) Overall asset allocation would be:

	Allocation %	Change %
UK Equities	34.5	(-)
Global Equities	34.5	(-)
Fixed Income	10	(-5)
Alternative	20	(+9)
Cash	1	(-4)

(3) The additional 9% allocation to Alternatives would be funded partly from Cash and the remainder by reducing the Fixed Income weighting from 15% to 10%.

(4) The UK / Global Equity split could be changed but at the moment there is no compelling case for doing so.

(5) Hymans Robertson have proposed appointing a passive manager for Equities largely to assist with any future transitions. It is proposed that a procurement process is undertaken and the Director of Finance in consultation with the Chairman, Vice Chairman and Spokesman makes an appointment.

RECOMMENDATIONS

19. Members are asked to agree the following:

(1) Increase the allocation to UK Property to 12% by June 2010.

(2) Allocate 1% to Global Property with an options report from Officers.

(3) Allocate 2% to Private Equity with an option report from Officers.

(4) Allocate 1% to Infrastructure and ask officers to identify investment opportunities.

(5) Allocate 1% to Sustainable Investment and ask Officers to commence research on options.

(6) Consider investing in the Alliance Bernstein Distressed Asset Fund.

(7) Agree the target asset allocation set out in paragraph 18(2).

(8) Authorise the Director of Finance to procure a passive manager for equities.

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