

**DERBYSHIRE COUNTY COUNCIL**  
**PENSIONS AND INVESTMENT COMMITTEE**

**28 October 2015**

**Report of the Director of Finance**

**PROPOSED STATEMENT OF INVESTMENT PRINCIPLES**

**1 Purpose of the Report**

To receive the Fund's Statement of Investment Principles.

**2 Information and Analysis**

**Requirements for a Statement of Investment Principles and Content**

Derbyshire County Council is an administering authority for the Local Government Pension Scheme in accordance with Local Government Pension Scheme Regulations 2013. The Derbyshire Pension Fund (the Fund) is maintained for the benefit of Derbyshire County Council's own employees, the employees of the scheme employers, and the employees of admission bodies.

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "Investment Regulations"), made under powers contained in Section 7 of the Superannuation Act 1972, govern the management and investment of pension fund monies. Section 12 (1) of the Investment Regulations require an administering authority to prepare and maintain, after consultation with such persons as it considers appropriate, a written statement of the principles governing its decisions about the investment of fund money (a Statement of Investment Principles or SIP).

Section 12 (2) of the Investment Regulations sets out eight items which the Statement must cover and these are set out below.

- (a) The types of investment to be held;
- (b) The balance between different types of investment;
- (c) Risk, including the ways in which risk are to be measured and managed;
- (d) The expected return on investments;
- (e) The realisation of investments;

- (f) The extent (if at all) to which social, environmental or ethical considerations are to be taken into account in the selection, retention and realisation of investments;
- (g) The exercise of the rights (including voting rights) attaching to investments, if the authority has any such policy; and
- (h) Stock lending.

In line with Regulations set out above, the Fund has prepared a proposed Statement of Investment Principles and a copy is set out in Appendix 1.

### **Fund Specific Asset Allocation & Performance Benchmark**

The Fund specific asset allocation was approved by the Committee on 29 July 2015. The performance benchmark represents an appropriate standard against which the Fund's performance is measured by GS Performance Services, a specialist performance measurement organisation. Generally, broad market and stock and bond indices are used as performance benchmarks.

### **Socially Responsible Investment**

In accordance with the Local Government Pension Fund (Management and Investment of Funds) Regulations 2009, Derbyshire Pension Fund is required to cover within its Statement of Investment Principles its policy on:

“the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments”; and

“the exercise of the rights (including voting rights) attaching to investments, if the authority has any such policy”.

A voting policy for Derbyshire Pension Fund was approved at the Pensions and Investments Committee on 29 July 2015. The Fund's position on social, environmental, governance and ethical considerations is contained within its Statement of Investment Principles. The reasoning behind the Fund's position is set out below:

#### **i) Fiduciary Duty**

Although LGPS funds are established under statute rather than trust, Derbyshire County Council, as the administering authority for Derbyshire Pension Fund, owes fiduciary duties both to scheme employers and scheme members. This was confirmed by Nigel Giffen QC in “Duties of Administering Authorities Under The Local Government Pension Scheme” commissioned by the LGPS Advisory Board in March 2014.

The QC's opinion was that the "administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way). However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environment considerations, so long as that does not risk material financial detriment to the fund. In taking account of such considerations, the administering authority may not prefer its own particular interest to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority)."

## ii) **Environmental, Social and Governance (ESG)**

**ESG** is a generic term used in capital markets, it covers analysis that captures the effects of environmental, social and corporate governance considerations on portfolio returns. ESG and ethical are not clearly defined in law.

When investing in equities for the longer term, risks to the long term sustainability of a company's earnings are assessed. ESG factors can provide a "fuller picture of the company in which you are investing" (AXA Investment Managers – Piloting ESG Integration October 2012). Taking account of ESG factors in the investment decision-making process can initially be seen as a way of reducing exposure to potential company crises, such as environmental disasters and health and safety failures. However, there is also a large body of evidence that adherence to good practice in certain areas covered by the ESG label (e.g. board structure, good disclosure of information, reputation) results in better long term performance.

In the Law Commission's Fiduciary Duties of Investment Intermediaries, which was presented to Parliament in June 2014, a wide scale review of literature found that, over three to ten year time scales, companies that scored well for ESG factors outperformed or yielded comparative returns to others, and were a lower risk as measured by the cost of capital and debt capital. Some factors were more significant than others, the main benefits were from environmental and governance ratings. The use of socially responsible factors to exclude investments in particular companies or sectors, known as negative screening, generally had neutral or mixed results.

## iii) **Ethical**

Taking into account purely ethical concerns when choosing investments in order to show moral disapproval of activities is controversial. The

Law Commission said that: “trustees of general pension funds should only divest for purely ethical reasons (unrelated to financial risk) if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share their outlook. Secondly, they should anticipate that the decision will not result in financial detriment to the scheme.”

Negative screening to exclude stocks/sectors on ethical grounds limits the investable universe and can adversely affect the risk and return characteristics of the portfolio. Given the large number of stakeholders in the Derbyshire Pension Fund, there would be little left to invest in if every company that individual or small groups of stakeholders viewed as doing something unsavoury was excluded.

#### **iv) The Fund’s Position**

The Derbyshire Pension Fund’s in-house investment team seek to understand relevant ESG factors alongside conventional financial considerations within the investment process, and the Fund’s external investment managers are expected to do the same. Membership of the Local Authority Pension Fund Forum (LAPFF) helps Derbyshire Pension Fund to engage with companies to understand the issues and to promote best practice. LAPFF was set up in 1991 and is a voluntary association of 64 Local Authority pension funds based in the UK with combined assets of approximately £165bn. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. A strategy of engagement with companies, rather than negative screening to exclude stocks from the portfolio on ESG/ethical grounds, is more compatible with the Administering Authority’s fiduciary duties and supports responsible investment. Collective pressure from investors via organisations such as the LAPFF has helped to encourage listed companies to enhance their corporate governance and to improve their environmental and social impacts.

#### **v) Consultation**

It is intended to consult with scheme employers and other stakeholders on the proposed Statement of Investment Principles via the Derbyshire County Council website.

### **3 Other Considerations**

In preparing this report the relevance of the following factors has been considered: financial, legal and human rights, human resources, equality and diversity, health, environmental, transport, property and prevention of crime and disorder.

## **4 Background Papers**

The Local Government Pension Scheme (Administration) Regulations 2009.  
Working papers held within the Investment Section.

## **5 Officer's Recommendation**

That the Committee approve the Statement of Investment Principles set out in this report subject to the outcome of consultation with the Fund's stakeholders.

PETER HANDFORD

Director of Finance

19 October 2015

**Appendix 1****DRAFT****Proposed Statement of Investment Principles****DERBYSHIRE PENSION FUND****Statement of Investment Principles****Introduction**

Derbyshire Pension Fund's Statement of Investment Principles ("the SIP") is drawn up in compliance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, following consultation with such persons as the Derbyshire Pension Fund considers appropriate. Derbyshire County Council, as the administering authority for the Derbyshire Pension Fund, as specified under the Local Government Pension Scheme Regulations 2013, is required to review the Statement from time to time and to update it for any material change in the policies referred to in the Statement.

**The LGPS Scheme**

The Local Government Pension Scheme (LGPS) is one of the largest public sector pension schemes in the UK with around 4.6 million members. The LGPS is administered locally for participating employers through 89 regional pension funds in England and Wales, of which the Derbyshire Pension Fund (the "Fund") is one.

There are approximately 170 employers in the Fund, including Derbyshire County Council, Derby City Council, all the district and borough councils in Derbyshire, Peak District National Park Authority, Derbyshire Police Authority, Derbyshire Fire Authority, Derby College, Chesterfield College, University of Derby, a host of town and parish councils and a large group of smaller employers via admission arrangements. At 31 March 2015, the Fund had 90,000 members, comprising 38,000 active members, 26,000 deferred beneficiaries and 26,000 members in receipt of a pension.

**Scheme Governance**

The Fund's Governance Policy Statement was approved by the Pensions and Investment Committee ("the Committee") in September 2015.

The Committee is responsible for discharging Derbyshire County Council's statutory function as the administering authority for the Fund. LGPS funds are not separate legal entities from administering authorities and are not covered by trust law. However, members of the Pensions and Investments Committee act in a very similar manner to trustees.

The Pensions and Investments Committee is responsible for determining investment policy, assessing the suitability of a particular investment or types of investments, appointing managers and advisers, asset allocation decisions, monitoring performance and general stewardship of the Fund. Further details in respect of the Committee's terms of reference, frequency of meetings, composition, roles and functions and operational procedures are set out in the Governance Policy Statement, a copy of which can be found on the Fund's website.

## Day to Day Management

The Pensions and Investments Committee sets a long-term investment strategy with regard to the Fund's investment objectives and liabilities. The investment strategy is implemented through the development of investment portfolios within each asset class set out in the benchmark. The portfolios are constructed from investments which are accepted by the Committee and satisfy the relevant investment management regulations and in-house due diligence requirements. A significant proportion of the Fund's investments are managed on an active basis by the Fund's in-house investment managers. Where the appropriate skills are not available internally, external managers are used.

The split between active versus passive management and internally versus externally managed funds at 31 March 2015 is set out below:

Active Management	90.8%
Passive Management	9.2%
<b>Total</b>	<b>100.0%</b>

Internally Managed	85.2%
Externally Managed	14.8%
<b>Total</b>	<b>100.0%</b>

## Objectives

The Fund's objective is "To invest the pension fund with the aim of maximising its returns subject to an agreed level of risk and having taken into account the Fund's liabilities and its projected cash-flows."

## Types of Investments

The Pensions and Investments Committee has approved the following Asset Allocation for the Fund, together with the Fund's Specific Benchmarks:

Asset Category	Asset Allocation	Permitted Range	Specific Performance Benchmark
<b>Equities</b>	<b>60.0%</b>	<b>+/- 8%</b>	
UK Equities	28.0%	+/- 6%	FTSE All Share
Overseas Equities	32.0%	+/- 6%	
N. America	11.0%	+/- 4%	FTSE World N America
Europe	9.0%	+/- 4%	FTSE World Europe Ex-UK
Japan	5.0%	+/- 2%	FTSE World Japan
Pacific ex-Japan	4.0%	+/- 2%	FTSE All World Asia-Pacific ex Japan
Emerging Markets	3.0%	+/- 2%	FTSE Emerging Markets
<b>Bonds</b>	<b>22.0%</b>	<b>+/- 5%</b>	
Fixed Income	6.5%	+/- 3%	FTSE UK Gov Fixed All Stocks
Real Return	6.5%	+/- 3%	FTSE UK I-L All Stocks
Non-government	6.0%	+/- 3%	BAML £ Corp Bonds
Multi-Asset Credit	3.0%	+/- 2%	LIBOR + 3%
<b>Property</b>	<b>9.0%</b>	<b>+/- 3%</b>	
Direct	5.0%	+/- 2%	IPD UK Quarterly Property Index
Indirect	4.0%	+/- 2%	AREF/IPD UK Quarterly Property Fund Index
<b>Alternatives</b>	<b>7.0%</b>	<b>+/- 3%</b>	
Infrastructure	3.0%	+/- 2%	LIBOR + 2%
Private Equity	4.0%	+/- 2%	FTSE All Share +1%
<b>Cash</b>	<b>2.0%</b>	<b>0 – 8%</b>	Sterling 7 Day LIBID

No financial instruments are excluded from consideration, but the use of derivatives is restricted to hedging activity which (other than in the case of currency hedging) must be authorised in advance by the Pensions and Investment Committee (or by the Director of Finance in consultation with the Committee Chair if an urgent decision is required) in each case. Hedge Fund investment is not included in the Fund's Investment Benchmark.

## Balance Between Different Types of Investment

The overall strategy of the Fund, together with the setting of the Fund's benchmark asset allocation, was approved by the Pensions and Investment Committee in July 2015, following an Asset Liability Study in 2014. The Asset Liability Study addressed the long term strategy for the Fund, taking into consideration the risk tolerance of the Committee, the liability profile of the Fund and the current deficit level.

The Pensions and Investment Committee reviews the tactical allocation of the Fund on a quarterly basis, following advice from the Fund's in-house investment managers and an external advisor.



## Risk

The overall risk for the Fund is that its assets will be insufficient to meet its liabilities. The Fund is assessed on an actuarial basis every three years and is required to draw up a Funding Strategy Statement to show how any deficit is to be addressed. A copy of the Fund's Funding Strategy Statement can be found on the Fund's website.

It is the Pensions and Investments Committee's policy to manage investment risk by holding different categories of investments (e.g. the asset allocation between equities, bonds, property, alternatives and cash) and by holding a diversified equity portfolio spread by both geography and market sectors. The Fund's benchmark asset allocation was last reviewed in 2015 by the Fund's external advisor and in-house investment management team in conjunction with the Fund's actuary. The asset allocation is designed to meet the Fund's performance requirements for the level of risk agreed by the Pensions and Investments Committee.

Each asset class is managed within an agreed permitted range to ensure that the Fund does not deviate too far away from the benchmark asset allocation, whilst allowing for a degree of flexibility. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "Investment Management Regulations") also set a number of investment limits.

Contracts with external investment management providers specify the level of risk to be taken by the managers.

Custodian risk is managed through continuous monitoring and periodic reviews of the custodial arrangements.

The Fund's risk register identifies the key identified risks, including an assessment of the potential impact and probability of each identified risk, together with current and proposed risk mitigation procedures. The risk register is reviewed by the Pensions and Investments Committee on an annual basis.

## Expected Return on Investments

The Fund is subject to actuarial review every three years. The last actuarial valuation, at 31 March 2013, was prepared on the basis of a longer term investment return of 4.6% p.a. Over the shorter term investment returns can be extremely volatile.

The strategic asset allocation is expected to produce a return, over the long term, in excess of the investment return assumed in the Actuarial Valuation. The return achieved within each actively managed asset class is expected to be greater than the relevant asset class benchmark on an annualised basis over a rolling three year period. The Pensions and Investments Committee

acknowledges that there is a relationship between risk and reward, with higher returns often associated with higher levels of risk.

Fund performance is calculated independently each quarter, the results are compared with the Fund's own specific benchmarks and Local Authority averages. The results are then reported to the Pensions and Investment Committee.

Long term investment returns are reported to Fund members through the Pension Fund's Annual Report.

### **Realisation of Investments**

The Fund is currently cash positive, in that annually there is an excess of cash paid into the Fund from contributions and investment income after pension benefits are paid out. The Fund expects to be cash positive for the short to medium term.

The majority of the Fund's investments are quoted on major stock markets and can be realised quickly, in normal circumstances, if required. More illiquid investments, such as Property, Multi-Asset Credit and Alternatives make up a small, but growing, proportion of the Fund. The Investment Management Regulations limit holdings of unquoted companies to 15% of the Fund, investments in partnerships to 30% and investments in single holdings to 10%. Pensions and Investments Committee guidelines limit investment in Property, Multi-Asset Credit and Alternatives to 12%, 5% and 10%, respectively.

### **Socially Responsible Investment**

The Pensions and Investments Committee believes that environmental, social and governance (ESG) issues are among the factors that can impact financial returns and the long term sustainability of investments. Consideration of ESG matters is an integral part of the Fund's investment process, for both in-house and external managers, whilst recognising the overriding fiduciary duty to maximise investment returns for the benefit of Scheme members, within acceptable risk parameters.

The Fund is a member of the Local Authority Pension Fund Forum (LAPFF) which promotes high standards of corporate governance and corporate responsibility amongst the companies in which Local Authority pension funds invest. A strategy of engagement with companies, rather than negative screening to exclude stocks from the portfolio on ESG/ethical grounds, is more compatible with the Administering Authority's fiduciary duties and supports actively engaged and responsible investment.

The Fund regards the exercise of voting rights attached to its investments as having great importance. The Fund currently casts votes in respect of both its directly held equity investments in the United Kingdom and North America.

The Committee has appointed Institutional Shareholder Services (ISS), a third party voting agency to provide voting services for its directly held UK equity investments. Voting is carried out in line with recommendations from ISS, whose voting policy reflects the National Association of Pension Fund's Corporate Governance Policy and Voting Guidelines. The Fund is also a member of the LAPFF and periodically receives voting alerts on certain resolutions. If the voting alert from the LAPFF conflicts with the ISS recommendation, due consideration is given to all the arguments before the vote is cast.

The Fund has appointed Wellington Management in a discretionary capacity to manage its directly held North American investments, including voting in line with local practice. Wellington Management have policies and procedures to ensure that they collect and analyse all relevant information for each meeting, applying their proxy voting guidelines accurately and executing votes in a timely manner.

### **Stock Lending**

The Pensions and Investment Committee granted approval for the Fund to undertake stock-lending in 2012. At present, the Fund has yet to participate in any stock-lending arrangements and continues to evaluate its merits. Pensions and Investments Committee guidelines limit any stock-lending arrangements to 3% of the Fund. The Investment Management Regulations limit stock-lending to 25% of the Fund.

### **Principles of Investment Practice**

The Investment Management Regulations require that a fund's administering authority reports in its SIP on the extent to which it complies with six principles on investment decision making as set out in guidance published by the Chartered Institute of Public Finance and Accountancy (CIPFA) in November 2012, entitled "Principles for Investment Decision Making and Disclosure in the Local Government Pension Scheme in the United Kingdom 2015". Where this guide makes comments on examples of good practice in the light of the principles, its intention is to help funds to apply the principles, they are not expected to implement every element. The Fund's compliance with the six principles is set out in Appendix 1.

**[Date SIP approved by P&IC]**

## Appendix 1 – Compliance with six principles of investment practice

Principle	Evidence of compliance
<b>Effective Decision Making</b> <ul style="list-style-type: none"> <li>Decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make them effectively and monitor their implications.</li> <li>Those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.</li> </ul>	<ul style="list-style-type: none"> <li>The Fund has established a Pensions Board in accordance with the Public Service Pensions Act 2013.</li> <li>The role of the Pensions and Investments Committee is defined in the Governance Policy Statement.</li> <li>The Pensions and Investment Committee meets on a quarterly basis to discuss current issues, future policy and tactical asset allocation.</li> <li>The Committee have appointed suitably qualified internal investment managers to manage the investments of the Fund.</li> <li>The Fund takes advice from its independent adviser and its internal Investment Officer, both of whom attend the quarterly Pensions and Investments Committee.</li> <li>Members' declaration of interests is made at the commencement of each meeting of the Pensions and Investments Committee.</li> <li>A training needs assessment is currently being carried out with Members and will subsequently be done on an annual basis in line with CIPFA guidance.</li> <li>Preparation of an annual Service Plan.</li> </ul>
<b>Clear Objectives</b> <ul style="list-style-type: none"> <li>An overall investment objective(s) should be set out for the fund that takes account of the scheme's liabilities, the potential impact on local tax payers, the strength of the covenant for non-local-authority employers and the attitude to risk of both the administering authority and scheme employers and these should be clearly communicated to advisers and investment managers.</li> </ul>	<ul style="list-style-type: none"> <li>The Fund's objectives is "To invest the pension fund with the aim of maximising its returns subject to an agreed level of risk and having taken into account the Fund's liabilities and its projected cash-flows"</li> <li>The Fund's asset allocation is specifically designed to achieve the Fund's objectives, with tactical asset allocation reviewed at the quarterly Pensions and Investments Committee. In determining the Fund's asset allocation, the Committee consider all asset classes in terms of their suitability and diversification benefits.</li> <li>The Fund's targets are: <ul style="list-style-type: none"> <li>To the actuary's long term return requirements of 4.6%; and</li> <li>To achieve a return within each actively managed asset class greater than the relevant asset class benchmark on an annualised basis over a rolling three year period.</li> </ul> </li> <li>Target performance and timescales have been set by the Pensions and Investments Committee. The managers are required to adopt an active style of management and a flexible approach whilst seeking to contain risks in accordance with agreed parameters.</li> <li>Contracts for external investment managers specify targets, timescales and approach.</li> <li>The Fund's Funding Strategy Statement can be found on the Fund's website.</li> </ul>

<p><b>Risk and Liabilities</b></p> <ul style="list-style-type: none"> <li>• In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities.</li> <li>• These include the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk.</li> </ul>	<ul style="list-style-type: none"> <li>• A description of the risk assessment framework used for potential and existing investments is included in the Statement of Investment Principles.</li> <li>• The Fund maintains a risk register and this is reviewed by the Pensions and Investments Committee on an annual basis. The risk register identifies the Fund's risk, including an assessment of the potential impact and probability, together with current and proposed mitigation controls and procedures.</li> <li>• An Asset Liability study was undertaken in 2014 to ensure that the Fund's asset allocation mix was appropriate in relation to its liability profile and the level of risk that the Pensions and Investment Committee was prepared to take. This led to the introduction of a new asset allocation in 2015.</li> </ul>
<p><b>Performance Assessment</b></p> <ul style="list-style-type: none"> <li>• Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisers.</li> <li>• Administering authorities should also periodically make a formal assessment of their own effectiveness as a decision-making body and report on this to scheme members.</li> </ul>	<ul style="list-style-type: none"> <li>• The Fund's performance is assessed on a quarterly basis, using data provided by GS Performance Services, a specialist performance measurement organisation.</li> <li>• The Fund's performance is reviewed by the Pensions and Investments Committee on a quarterly basis, including an independent review by the Fund's external advisor.</li> <li>• The asset class specific benchmarks are reviewed for appropriateness and approved by the Pensions and Investments Committee. Peer group benchmarks are used for comparison purposes only.</li> <li>• The recently created Local Pensions Board will also assist the administering authority to ensure the effective and efficient governance and administration of the Scheme.</li> </ul>

<p><b>Responsible Owner</b></p> <ul style="list-style-type: none"> <li>• Recognise, and ensure that their partners in the investment chain adopt, the FRC's UK Stewardship Code.</li> <li>• Include a statement of their policy on responsible ownership in the Statement of Investment Principles.</li> <li>• Report periodically to scheme members on the discharge of such responsibilities.</li> </ul>	<ul style="list-style-type: none"> <li>• The Fund's Statement of Investments Principles contains details on Socially Responsible Investment.</li> <li>• The Fund has appointed a third party voting agency to provide voting services in the UK. Consideration is given to voting alerts from the Local Authority Pension Fund Forum (LAPFF). Voting activity is undertaken in a number of overseas markets where votes are cast by the Fund's external investment manager in accordance with local practice.</li> <li>• Voting activity in the UK is reported on a quarterly basis to the Pensions &amp; Investments Committee. Further details on the Fund's voting policy together with the quarterly voting reports are available on the Fund's website.</li> <li>• The Fund is a participating member of the LAPFF and receives information on environmental, social and governance issues.</li> <li>• The Fund is currently assessing itself against the FRC's Stewardship Code.</li> </ul>
<p><b>Transparency &amp; Reporting</b></p> <ul style="list-style-type: none"> <li>• Act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.</li> <li>• Provide regular communication to scheme members in the form they consider most appropriate.</li> </ul>	<ul style="list-style-type: none"> <li>• The following are published on the Fund's website: <ul style="list-style-type: none"> <li>○ Non-exempt Pensions and Investments Committee reports and minutes, including fund performance reports.</li> <li>○ Statement of Investment Principles.</li> <li>○ Annual Report.</li> <li>○ Governance Policy Statement.</li> <li>○ Communication Policy.</li> <li>○ Funding Strategy Statement.</li> <li>○ Actuarial Valuation Report.</li> </ul> </li> </ul>