

**DERBYSHIRE COUNTY COUNCIL
PENSIONS AND INVESTMENTS COMMITTEE**

31 October 2018

Report of the Director of Finance & ICT

INVESTMENT STRATEGY STATEMENT CONSULTATION RESULT

1 Purpose of the Report

To advise the Pensions and Investments Committee (the Committee) of the outcome of consultation in respect of Derbyshire Pension Fund's revised Investment Strategy Statement (the ISS) and to seek final approval for the ISS.

2 Information and Analysis

The ISS was approved by the Committee on 11 September 2018, subject to the outcome of consultation with the Fund's stakeholders. The consultation process opened on 12 September 2018 and ran until 28 September 2018.

Stakeholders in Derbyshire Pension Fund (the Fund) were asked for their comments on the ISS. Members of the Pension Board were asked at the Pension Board meeting on 11 September 2018 to feedback any comments on the ISS to officers. The consultation was advertised on the County Council's website and there was a link to the consultation from the Derbyshire Pension Fund section of the website. Details of the consultation were also included in the September Employer Newsletter which was sent to all the Fund's employers.

Stakeholders were asked to submit comments either by an email link from the consultation page on the County Council's website or by post. The Fund received three email responses to the consultation, two from individuals and one from a local fossil fuel divestment coalition.

All of the respondents would like the pension fund to exclude from its portfolio investments in fossil fuel companies. One of the respondents would also like the pension fund to exclude: companies involved in the production or marketing of arms, tobacco, or alcohol; and "companies with a reputation for tax avoidance and poor treatment of workers whether in the UK or abroad". Another respondent would like the pension fund to invest in renewable energy

businesses, whilst excluding investments in: “Israeli owned/run businesses in the West Bank Occupied Territories”; and “military arms businesses which sell arms to regimes which are in breach of international law”. The fossil fuel divestment coalition has requested the addition of extra wording to the ISS regarding the exclusion of stocks from the portfolio where there is evidence of long term financial risk, as well as Environmental, Social and Governance (ESG) concerns, in line with fiduciary duties.

No changes to the ISS are recommended following the consultation. The Fund has a strategy of engagement to influence behaviour and enhance value rather than exclusion and the ISS makes it clear that ESG factors will be taken into consideration alongside conventional financial considerations within the investment process.

The Strategic Asset Allocation Benchmark contained within the ISS will be adopted from 1st January 2019 and the asset allocation recommendations taken to the December Pensions and Investments Committee will be based on the revised benchmark.

The recent launch of Derbyshire Pension Fund’s website and the continued development of employer engagement are expected to increase the level of stakeholder participation in any future consultations.

3 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

Files held by the Director of Finance.

5 Officer’s Recommendations

That the Committee:

- 5.1 confirms that no changes to the revised Investment Strategy Statement are required based on the outcome of the consultation and approves the revised Investment Strategy Statement set out in Appendix 1 to the report.

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Appendix 1

Investment Strategy Statement

October 2018

Introduction

This is the Investment Strategy Statement (the ISS) of Derbyshire Pension Fund (the Fund), which is administered by Derbyshire County Council. The ISS is drawn up in compliance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Regulations) and has been prepared following consultation with such persons as Derbyshire County Council considered appropriate.

The ISS will be reviewed following any material change in the factors which are judged to have a bearing on the stated investment policy and at least every three years as required by the Regulations.

The primary objective of the Fund is to ensure that over the long term the Fund will be able to meet all benefit payments as and when they fall due. These payments will be met by contributions resulting from the funding strategy or asset returns and income resulting from the investment strategy. The funding and investment strategies are, therefore, inextricably linked; the Funding Strategy Statement can be found on Derbyshire County Council's website: <https://www.derbyshire.gov.uk/site-elements/documents/pdf/working-for-us/pensions/investments/funding-strategy/funding-strategy-statement.pdf>

Fund Governance

Derbyshire County Council is an administering authority for the Local Government Pension Scheme in accordance with Local Government Pension Scheme Regulations 2013. The Pensions and Investments Committee (the Committee) is responsible for discharging Derbyshire County Council's statutory function as the administering authority for the Fund.

The Committee is responsible for determining the Fund's investment policy, monitoring performance and overall stewardship of the Fund. Members of the Committee act in a similar manner to trustees and take advice from Anthony Fletcher, the Fund's Independent Adviser and from the Director of Finance & ICT and the Fund's in-house investment managers.

A proportion of the Fund's investments are managed on an active basis by the Fund's in-house Investment Team, and by LGPS Central Limited, a company established to manage investments on behalf of nine LGPS pension funds across the Midlands. Where the appropriate skills are not available internally, or through LGPS Central Limited, external managers are used.

In 2015, Derbyshire Pension Board was established to assist the administering authority to ensure the effective and efficient governance and administration of the Local Government Pension Scheme.

Full details of the Fund's governance arrangements, including the governance arrangements for the LGPS Central Pool, are contained in the Governance Policy and Compliance Statement which is published on the County Council's website:

<https://www.derbyshire.gov.uk/site-elements/documents/pdf/working-for-us/pensions/governance/policy-statements/pensions-governance-policy-and-compliance-statement.pdf>

Investment Objectives

The Committee has agreed a long term investment strategy that aims to maximise the returns from investments within acceptable levels of risk, contributes to the Fund having sufficient assets to cover the accrued benefits, and enables employer contributions to be kept as stable as possible.

The investment strategy takes into account the following beliefs:

- A long term approach to investment will deliver better returns
- The long term nature of LGPS liabilities allows for a long term investment horizon
- Asset allocation is the most important factor in driving long term investment returns
- Liabilities influence the asset structure; funds exist to meet their obligations
- Risk premiums exist for certain investments; taking advantage of these can help to improve investment returns
- Markets can be inefficient, and mispriced for long periods of time; therefore there is a place for active and passive investment management
- Diversification across investments with low correlation improves the risk/return profile
- Secure and growing income streams underpin the ability to meet future liabilities
- Responsible investment can enhance long term investment performance
- Investment management costs should be minimized where possible but net investment returns after costs are the most important factor

Strategic Asset Allocation Benchmark

The Committee aims to balance risk and reward by apportioning the Fund's assets over a range of asset classes to achieve the Fund's goals, to manage risk and to match the investment horizons. The objective is to generate a return that is at least equal to the

discount rate used in the actuarial valuation in order to meet the Fund's liabilities. The actuarial valuation at 31 March 2016 was prepared on the basis of a discount rate of 4.0% compared with a discount rate of 4.6% for the actuarial valuation at 31 March 2013. The lower discount rate reflects lower expected investment returns going forward.

The Strategic Asset Allocation Benchmark (the Benchmark) for the Fund has been formulated in consultation with Anthony Fletcher, following an Asset Liability Modelling Review carried out by Hymans Robertson, the Fund's Actuary. The Benchmark takes into account the required level of return and an appropriate balance between generating long term investment returns and exposure to investment risk. The Benchmark includes a wide variety of asset classes, in order to diversify sources of risk and return, and equity allocations spread by geographic regions. It takes into account the future expected returns from the different asset classes, the historic levels of volatility of each asset class and the level of correlation between the asset classes.

The Fund's asset classes are allocated into three categories:

- Growth Assets: largely equities, plus other volatile higher return assets such as private equity
- Income Assets: assets which are designed to deliver an excess return, but with more stable return patterns than Growth Assets because income represents a large proportion of the total return of these assets
- Protection Assets: lower risk government or investment grade bonds, together with cash

The asset allocation of the Fund is reviewed on a quarterly basis, and tactical positions around the Benchmark are agreed by the Committee following advice from the Fund's in-house investment managers and the Fund's Independent Adviser.

The Benchmark and the permitted ranges for tactical allocations are set out in the following table:

Asset Category	Asset Allocation	Permitted Range	
Growth Assets	57.0%	+/- 8%	
Total Equities	53.0%	+/- 8%	
UK Equities	16.0%	+/- 4%	FTSE All Share
-Overseas Equities	38.0%	+/- 6%	
-North America	12.0%	+/- 4%	FTSE World N America
-Europe	8.0%	+/- 3%	FTSE AW Developed Europe Ex-UK Net
-Japan	5.0%	+/- 2%	FTSE World Japan
-Pacific ex-Japan	4.0%	+/- 2%	FTSE All World Asia-Pacific ex Japan
-Emerging Markets	5.0%	+/- 2%	FTSE Emerging Markets
-Global Sustainable	3.0%	+/- 2%	FTSE All World
Private Equity	4.0%	+/- 2%	FTSE All Share + 1%
Income Assets	23.0%	+/- 6%	
Property	9.0%	+/- 3%	IPD UK Quarterly Property Index
Infrastructure	8.0%	+/- 3%	LIBOR 3m + 2%
Multi-Asset Credit	6.0%	+/- 2%	LIBOR 3m + 3%
Protection Assets	20.0%	+/- 5%	
Fixed Income	6.0%	+/- 2%	FTSE UK Gov Fixed All Stocks
Index Linked Bonds	6.0%	+/- 2%	FTSE UK I-L All Stocks
Non-Government Bonds	6.0%	+/- 2%	BAML £ Corp Bonds
Cash	2.0%	0 - 8%	Sterling 7 Day LIBID
Total	100.0%		

Asset Classes

All financial instruments are open to consideration by the Committee. The Fund currently invests in quoted and unquoted securities of UK and overseas markets, including equities, government and non-government bonds, multi-asset credit, property, infrastructure and cash, either directly or via pooled vehicles. Derivatives are used to hedge the currency exposure of the overseas government bond holdings. The use of derivatives may be extended further in the future for the purpose of efficient portfolio management or to hedge other specific risks. The introduction of any new financial instrument/asset class or any extended use of derivatives will only be considered by the Committee following the receipt of appropriate training and advice from suitably qualified persons.

Equities

Equities are classed as growth assets with the potential to provide returns in excess of inflation from growth in both capital values and income. Reinvested income accounts for a large proportion of long term equity returns. As equity returns are linked to company revenues and profits, investing in equities increases exposure to volatility. Investors expect to be compensated for that volatility by higher returns.

Over the last 50 years, in the UK, equities have provided a real return (after inflation) of 5.6% pa, compared with a real return of 3.1% pa from long dated government bonds and 1.2% pa from cash. Over the last 20 years, the respective real returns were 3.2% pa, 3.6% pa and 0.3% pa. In the US, the real returns over the last 50 years were 5.6% pa from equities, 3.6% pa from 20yr government bonds and 0.7% pa from cash. US respective real over 20 years were 5.0% pa, 4.5% pa and -0.26% pa.¹ Despite the increasing correlation between the majority of developed equity markets, investing in different geographic regions still provides portfolio diversification and investing in emerging markets generally provides access to higher economic growth rates and exposure to different economic drivers of return.

Bonds

Bonds offer predictable streams of income and predictable returns if held to maturity. They are held as stabilising assets to reduce volatility and to provide diversification. As pension funds mature they can be used to provide liquidity and to match liabilities as they fall due.

The Fund holds conventional fixed income, index-linked and corporate bonds and within multi-asset credit it holds private debt, high yield debt and asset-backed securities. Index linked bonds are regarded as a particularly good match for pension fund liabilities. The majority of the Fund's government bond holdings are issued by the government of the United Kingdom; the currency exposure of any overseas sovereign bonds holdings is hedged to sterling.

Property

Property investments have traditionally been split between three different sectors: office; retail and industrial. Increasingly within the asset management industry, exposure to niche sectors such as student accommodation and exposure to debt secured against property assets is also included within the property asset class. Returns from this asset class come from rental income and the change in market values. Rental income has accounted for a

¹ Source: Barclays Equity Gilt Study 2017

large proportion of total returns over the long term. Given the relative stability of rental income, which gives property bond like characteristics, the returns from property are generally expected to fall between the returns from equities and those from bonds.

Property investment can be carried out directly via the purchase of physical properties or indirectly via the purchase of pooled vehicles or property company shares. The majority of the Fund's property exposure is gained via direct investment; pooled vehicles are used to gain exposure to niche sectors and overseas assets. The Fund's exposure to property debt is currently contained within the allocation to corporate bonds.

Alternatives

Alternatives include infrastructure, private equity, hedge funds, commodities and pooled multi-asset funds (also known as diversified growth funds). The Fund has exposure to infrastructure and private equity.

Infrastructure offers access to long term predictable cash flows, which are often linked to inflation. A low correlation to the business cycle and the other major asset classes provides diversification benefits and long investment horizons. The majority of the Fund's infrastructure investments are in developed European core assets (long term assets with regulated returns) and social PFI concessions (typically schools, hospitals and military accommodation).

Private equity investment refers to investment in unquoted, privately owned companies. Investors expect to receive an illiquidity premium for investing in this asset class and target returns above those expected from publicly quoted equities. Returns from private equity primarily come from capital growth, rather than income when investments are exited (realised) following a period of business growth/transformation. Private equity offers access to a broader universe of companies than the publicly quoted space.

Risk

The overall risk for the Fund is that its assets will be insufficient to meet its liabilities. The Funding Strategy Statement, which is drawn up following the triennial actuarial valuation of the Fund, sets out how any deficit in assets compared with liabilities is to be addressed.

Underlying the overall risk, the Fund is exposed to demographic risks, regulatory risks, governance risks and financial risks (including investment risk). The measures taken by the Fund to control these risks are included in the Funding Strategy Statement and are reviewed periodically by the Committee via the Fund's risk register. The primary investment risk is that the Fund fails to deliver the returns anticipated in the actuarial

valuation over the long term. The Committee anticipates expected market returns on a prudent basis to reduce the risk of underperforming expectations.

It is important to note that the Fund is exposed to external, market driven, fluctuations in asset prices which affect the liabilities (liabilities are estimated with reference to government bond yields) as well as the valuation of the Fund's assets. Holding a proportion of the assets in government bonds helps to mitigate the effect of falling bond yields on the liabilities to a certain extent. Further measures taken to control/mitigate investment risks are set out in more detail below:

Concentration

The Committee manages the risk of exposure to a single asset class by holding different categories of investments (e.g. equities, bonds, property, alternatives and cash) and by holding a diversified equity portfolio, spread by both geography and market sectors. Each asset class is managed within an agreed permitted range to ensure that the Fund does not deviate too far away from the Benchmark, which has been designed to meet the required level of return with an appropriate level of exposure to risk, taking into consideration the level of correlation between the asset classes.

Volatility

The Benchmark contains a high proportion of equities with a commensurate high degree of volatility. The strong covenant of the major employing bodies enables the Committee to take a long term perspective and to access the forecast inflation plus returns from equities.

Performance

Investment managers are expected to outperform the individual asset class benchmarks detailed in the overall Strategic Asset Allocation Benchmark. The Fund's performance is measured by an independent provider and reported to the Committee on a quarterly basis. The Committee takes a long term approach to the evaluation of investment performance, but will take steps to address persistent underperformance.

Illiquidity

Close attention is paid to the Fund's projected cash flows; the Fund is currently cash flow 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 flow positive for the short to medium term. Despite the growing proportion of illiquid investments in the Fund, a large proportion of the assets are held in liquid assets and can

be realised quickly, in normal circumstances, in order for the Fund to pay its immediate liabilities.

Currency

The Fund's liabilities are denominated in sterling which means that investing in overseas assets exposes the Fund to a degree of currency risk. The Committee regards the currency exposure associated with investing in overseas equities as part of the return on the overseas equities; the currency exposure on overseas bonds is hedged back to sterling.

Stock Lending

The Fund does not currently participate in any stock-lending arrangements, but is likely to in the future as part of the LGPS Central pool. The Committee will ensure that robust controls are in place to protect the security of the Fund's assets before entering into any stock lending arrangements.

Custody

The risk of losing economic rights to the Fund's assets is managed by the use of a global custodian for custody of the assets, regular scrutiny of the Fund's providers, and the maintenance of independent investment accounting records.

LGPS Central Pool

Derbyshire Pension Fund is part of the LGPS Central Pool (the Pool) with the LGPS funds of Cheshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands, the West Midlands Integrated Transport Authority and Worcestershire. The Pool has been established in accordance with Government requirements for the pooling of LGPS investment assets. Collective investment management offers the potential for substantial savings in investment management fees, increased opportunities for investor engagement and access to a shared pool of knowledge and expertise.

The eight administering authorities of the pension funds within the LGPS Central Pool are equal shareholders in LGPS Central Limited. LGPS Central Limited (the Company) has been established to manage investments on behalf of the Pool, and received authorization from the Financial Conduct Authority in January 2018. The Company launched its first sub-funds within an Authorised Contractual Scheme collective investment vehicle in April 2018. The Fund entered into a discretionary management agreement with the Company in respect of the investment management of the Fund's UK Equity portfolio in April 2018. The

transition of the Fund's remaining assets into products offered by the Company is likely to take several years. Responsibility for determining the Strategic Asset Allocation Benchmark and the tactical quarterly asset allocation positions remains with the Fund.

Robust governance arrangements have been established both within the Company and within the wider Pool to ensure that the Company operates effectively and meets the objectives of the pension funds within the LGPS Central Pool.

A Joint Committee, set up in accordance with provisions of the Local Government Act 1972, provides oversight of the delivery of the objectives of the Pool, the delivery of client service, the delivery against the LGPS Central Pool business case and deals with common investor issues.

A Shareholders' Forum, comprising one elected Member from each of the participating administering authorities, oversees the operation and performance of LGPS Central Limited and represents the ownership rights and interests of the shareholding councils within the LGPS Central Pool.

To support the Joint Committee and the Shareholders' Forum, a Practitioners' Advisory Forum has been created, consisting of Officers from each of the shareholding councils within the Pool. This forum provides day-to-day oversight of the Operator, scrutinizing the delivery of products, investment performance and investment costs, monitoring customer service and the delivery of wider investor services, such as voting and responsible investment.

Responsible Investment

Responsible investment is an approach to investment that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long term returns.²

The Committee believes that responsible investment covers both incorporating ESG factors into the investment process and Fund stewardship and governance through considered voting and engagement with investee companies.

Effective management of financially material ESG risks should support the requirement to protect investment returns over the long term. The Fund's 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

² UN Principles for Responsible Investing
Investment Strategy Statement Approved
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same. Non-financial factors may be considered to the extent that they are not detrimental to the investment return.

The Committee recognizes its responsibility to act in the best interest of the Fund's employers and scheme members, whilst seeking to protect local tax payers and employers from unsustainable pension costs.

A strategy of engagement with companies to influence behaviour and enhance value, 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.

It is recognized that risks and opportunities related to climate change could be experienced across the whole of the Fund's investment portfolio and that the current understanding of the potential risks posed by climate change and the development of consistent climate related disclosures are still at an early stage. It also recognised that it will take time for companies to adapt to changing regulatory and market positions. The incorporation of ESG factors into the investment process and Fund stewardship and governance activities will seek to manage the risks associated with climate change.

Membership of the Local Authority Pension Fund Forum (LAPFF) helps Derbyshire Pension Fund to engage with companies to understand relevant issues and to promote best practice. LAPFF was set up in 1991 and is a voluntary association of 77 Local Authority pension funds based in the UK with combined assets of over £230bn. 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.

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

The Committee has appointed Institutional Shareholder Services, a third party voting agency to provide voting services for its directly held UK equity investments. Voting is carried out in line recommendations from Institutional Shareholder Services, whose voting principles cover four key tenets on accountability, stewardship, independence and transparency. The Fund also periodically receives voting alerts from the LAPFF on certain resolutions. If the voting alert from the LAPFF conflicts with the voting service recommendation, due consideration is given to all the arguments before the vote is cast. A report to review the Fund's voting activity is taken to the Committee on a quarterly basis.

The Fund has appointed Wellington Management (Wellington) in a discretionary capacity to manage its directly held North American investments, including voting in line with local practice. Wellington 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.

The Fund is a Tier 1 signatory to the Financial Reporting Council's UK Stewardship Code (the Fund's statement of compliance with the Code can be found on Derbyshire County Council's website: <https://www.derbyshire.gov.uk/site-elements/documents/pdf/working-for-us/pensions/investments/investment-strategy/financial-reporting-council-stewardship-code-statement-2017.pdf>). The Code aims to enhance the quality of engagement management between investors and companies to help improve long-term risk-adjusted returns to shareholders. The Fund expects its external investment managers to support the UK Stewardship Code.

Following the launch of the LGPS Central Pool, an increasing portion of the Fund's investments will be transitioned into products managed by LGPS Central Limited. The Company has developed a Responsible Investment & Engagement Framework (the Framework) incorporating the Responsible Investment beliefs of the Pension Funds within the LGPS Central Pool which will be applied to both internally and externally managed investment mandates. The Framework contains the following beliefs:

- Long-termism: A long-term approach to investment will deliver better returns and the long-term nature of LGPS liabilities allows for a long-term investment horizon.
- Responsible Investment: Responsible Investment is supportive of risk adjusted returns over the long-term, across all asset classes. Responsible investment should be integrated into the investment process of the Company and its investment managers.
- Diversification, risk management and stewardship: Diversification across investments with low correlation improves the risk return profile. A strategy of engagement, rather than exclusion, is more compatible with fiduciary duty and more supportive of responsible investment, because the opportunity to influence companies through stewardship is waived in a divestment approach. Even well-diversified portfolios face systematic risk. Systematic risk can be mitigated over the long-term through widespread stewardship and industry participation.
- Corporate governance and cognitive diversity: Investee companies and asset managers with robust governance structures should be better positioned to handle the effects of shocks and stresses of future events. There is clear evidence showing

that decision-making and performance are improved when company boards and investment teams are composed of cognitively diverse individuals.

- Fees and remuneration: The management fees of investment managers and the remuneration policies of investee companies are of significance for the Company's clients, particularly in a low-return environment. Fees and remuneration should be aligned with the long-term interests of our clients, and value for money is more important than the simple minimisation of costs.
- Risk and opportunity: Risk premia exist for certain investments; taking advantage of these can help to improve returns. There is risk, but also opportunity in holding companies that have weak governance of financially material ESG issues. Opportunities can be captured so long as they are aligned to the Company's objectives and strategy, and so long as there is a sufficient evidence base upon which to make an investment decision.
- Climate change: Financial markets could be materially impacted by climate change and by the response of climate policy-makers. Responsible investors should proactively manage this risk factor through stewardship activities, using partnerships of like-minded investors where feasible.