

# **Statement of Investment Principles**

**Approved by Pensions Committee on 2<sup>nd</sup> June 2009**

## **Introduction**

1. The Local Government Pension Scheme Regulations (the Regulations) require an administering authority to prepare, maintain and publish a written statement of the principles that govern their decisions about investment. This document forms that statement.
2. In the course of preparing this statement, the Pensions Committee (the Committee) has sought advice from the Fund's Investment Advisor.
3. The Committee reviews the Statement annually, or more frequently if required.
4. The Statement is provided to the Fund's investment managers, who are required to follow the principles that it sets out and to report showing how they have done so.

## **Governance**

5. South Tyneside Council (the Council) is the administering authority of the local government pension fund set up for the Tyne and Wear County area.
6. The Council has set up the Committee and has required it to control and resolve all matters relating to the administration and investment of the Fund. The Committee has eighteen members. The Council nominates eight members and the other four district councils within the County area nominate one member each. The trades unions and the employers (excluding the district councils) each nominate three members, who sit in an advisory capacity.
7. The local authority members are remunerated in accordance with each council's scheme of allowances.
8. The Council's Jobs and Enterprise, Regeneration and Resources and Culture and Well-being Select Committee may reviews the decisions and actions of the Committee.
9. A training programme is available for members of both committees.
10. Hewitt has been appointed as Actuary.
11. Hymans Robertson has been appointed as Investment Advisor.
12. The Committee meets quarterly to consider investment matters. It sets the investment objectives and policy, whilst responsibility for tactical asset allocation and for the selection, retention and realisation of specific investments has been delegated to external investment managers.
13. The performance of the managers is measured by independent external agencies.

14. The detailed formal monitoring of the investment of the Fund is undertaken by an Investment Panel, which is comprised of three Committee members, two of the Fund's officers and the Investment Advisor. The Panel meets quarterly to consider the investment objectives and policy and each manager's performance and process. It reports to the Committee on its findings and makes recommendations on any action that is required.
15. If the Committee accepts a Panel recommendation to review and change the investment objectives or policy, or the management structure, or a manager's appointment, the Committee will require the Panel to implement that change. If a formal review of a manager's appointment is required, this may result in a tendering process, where required by law.
16. The Fund's officers undertake the day to day monitoring of the investment of the Fund.
17. The Fund has a service plan that sets out in detail the development of the structure and processes that govern the investment of the Fund.

### **Investment Objectives and Policy**

18. The investment objectives of the Fund are:
  - To maintain securely a portfolio of assets of appropriate liquidity which will generate income and capital growth which, together with employer and employee contributions, will meet the cost of current and future benefits which the Fund provides, as set out in the statutory documentation.
  - To minimise the long term costs of the Fund by maximising the return on the assets, whilst having regard to the objective stated above.
  - To comply with the regulations relating to the investment of local government pension funds.
19. In order to assist in setting the Fund's strategic investment policy, an asset liability modelling study is carried out. This study examines the Fund's financial position, the profile of its membership, the nature of its liabilities and includes an analysis of the expected ranges of outcomes from differing investment policies.
20. The current strategic asset allocation is based largely upon a study carried out as at 30<sup>th</sup> November 2004 by Hymans Robertson, based upon the liabilities shown by the 2004 valuation. The projected investment returns that were used in this study are shown in an appendix. Having considered the outcome of this initial study, the Committee concluded that a diversified portfolio, of which about 67.5% is invested in UK and overseas equities, 22.5% in bonds and 10% in property, represented a suitable strategic asset allocation benchmark for the Fund. The degree and nature of risks attaching to such a portfolio, when taken in conjunction with the expected returns, were considered by the Committee to be appropriate for the Fund.
21. The Committee monitors the suitability of its investment policy on an ongoing basis in the light of the Fund's developing liabilities and finances. A further study was carried out by Hymans Robertson in 2007/08 and the findings were approved by the Committee on 26<sup>th</sup> February 2008. Some revisions were made to the

investment strategy during 2008/09 but the majority of the recommendations will not be implemented until market conditions are more stable.

22. An appendix is attached that sets out the detail of the strategic benchmark.

### **The Investment Management Structure**

23. The Committee considers that the Fund must have an investment management structure that provides exposure to a suitably diversified, but complementary, range of investment styles and processes.

24. It is the view of the Committee that the strategic benchmark is best implemented by investing the entire Fund on a specialist basis, using passive asset allocation and a combination of active and passive stock selection.

25. The structure includes discretionary mandates for the active management of UK equities, pan european equities, global equities, pacific equities, emerging market equities, global bonds, corporate bonds and currencies.

26. Following consideration of the efficiency, liquidity and level of transaction costs likely to prevail within each market, the Committee determined that up to about 25% of the Fund should be managed on a passive basis. As a result of the termination of the active equity mandate in December 2008, the assets from that mandate are being managed on a passive basis, leading to a temporary increase in the allocation to passive management. The passive mandate includes a proportion of the total allocation to UK equities, US equities, European ex UK equities and UK government bonds.

27. About 7.5% of the Fund is to be invested in private equity. This position is being built up over a period of years, largely by investment in funds of funds. The allocation is being top-sliced from the allocation to quoted equities.

28. An allocation of about 3% of the Fund is invested in active currency funds.

29. Allocations, each of up to 1% of the Fund, are being made into infrastructure funds. These are top-sliced from the allocation to gilts.

30. The Fund's officers monitor the overall allocation of the Fund's assets, relative to the strategic benchmark, with assistance from the passive manager. In the light of this monitoring, the actual asset allocation is maintained within agreed margins around the strategic benchmark by the direction of cash flow or by the reallocation of assets between portfolios, as appropriate.

31. Independent custodians have been appointed to take responsibility for the safe keeping of the assets within each of the Fund's stock market portfolios. The Fund's officers monitor the operation of the custodians.

32. The property portfolio is managed on an advisory basis.

33. The Committee's expectations in respect of returns from the Fund's investments are expressed through achievable and prudent objectives and restrictions that have been set for each mandate. The objectives and restrictions have been discussed

and agreed with each manager with the aims of ensuring a prudent approach to investment and of allowing each manager to implement their natural investment style and process. The use of any financial instruments is not prohibited, except where such prohibition is required by legislation or where it has been agreed with a manager that its use is inappropriate.

34. An appendix is attached that sets out details of the individual mandates.
35. The majority of the managers are remunerated by way of ad valorem fees. Performance fees receive consideration but have only been adopted where there is no ad valorem alternative.
36. The Investment Advisor is remunerated by reference to the time and resources expended in that role.
37. The managers are permitted to use soft commission arrangements where the Committee believes this practice to be a satisfactory approach for the manager to access resources in the most cost efficient way to the Fund.

### **Diversification**

38. The strategic asset allocation benchmark and the investment objectives and restrictions placed upon the managers are designed to ensure that the Fund's investments are adequately diversified.
39. Within each asset category in each portfolio, the manager concerned is responsible for appropriate diversification.
40. The restrictions ensure that, at a stock selection level, the Fund avoids undue concentration.

### **Suitability**

41. The Committee has taken advice from the Investment Advisor to ensure that the strategic asset allocation benchmark is suitable for the Fund, given its financial position, statutory status and liability profile.
42. Within each of the Fund's portfolios, the manager concerned is responsible for the suitability of individual investments.

### **Realisation of Assets**

43. The Fund maintains sufficient investment in liquid or readily realisable assets to meet the payment of benefits, together with a margin for unexpected cashflow requirements so that, whenever possible, the realisation of assets will not disrupt the overall investment policy. When the Committee requires assets to be realised out of a portfolio in order to meet cashflow requirements or to reinvest the proceeds elsewhere, the realisation of individual holdings is at the discretion of the manager of the portfolio.

## **Risk**

44. The Committee recognises that there are a number of risks involved in the investment of the assets. The policy is to minimise these risks as far as possible, consistent with earning a satisfactory return on investments. In particular:

- Solvency risk and mismatching risk is controlled through the asset allocation strategy and through ongoing triennial actuarial valuations.
- Liquidity risk is controlled by estimating the annual net benefit outgo or inflow and liaising with the managers to ensure that sufficient cash balances are available.
- Manager risk is controlled through the investment objectives and restrictions in each manager's agreement and through the ongoing monitoring of the managers.
- Custodian risk is controlled through the restrictions set out in each custodian's agreement and through the ongoing monitoring of the custodial arrangements.
- Position, currency and political risks are controlled through the approach to diversification.
- Counterparty risk is controlled through the restrictions followed by the managers with respect to the trading of securities and cash management.

## **Socially Responsible Investment**

45. Responsibility for the selection, retention and realisation of investments is delegated to the managers.

46. The Committee has reviewed and will continue to review from time to time the policies operated by each of the Fund's managers in respect of social, environmental or ethical considerations. Having done so, the policy of the Committee is that the extent to which such considerations are taken into account in investment decisions is at the discretion of each manager. However, active managers must take such considerations into account where they may have a financial impact on the portfolio. The passive manager is not required to take account of such considerations in the selection, retention and realisation of investments.

47. Each manager is urged to pursue a policy of engagement with companies and to take account of such considerations in its corporate governance and voting policy.

48. Each manager must continue to develop its policy and provide a quarterly report that sets out how it has been implemented.

## **Rights Attaching to Investments**

49. Responsibility for the exercising of rights, including voting rights, attaching to investments is delegated to the managers.

## **Corporate Governance and Voting**

50. Each manager is required to prepare and implement a policy on corporate governance and voting. The policy towards UK quoted companies should take

account of the principles contained in the Combined Code and of the guidance offered by relevant organisations, including that contained in “The Responsibilities of Institutional Shareholders and Agents - Statement of Principles” prepared by the Institutional Shareholders Committee. The policy towards companies outside the UK should take account of the practices of the home nation.

51. Voting rights must be exercised in a manner that establishes a consistent approach to both routine and exceptional issues in order that company directors fully understand the manager’s views and intentions.

52. Whilst it has not been made compulsory for the managers to vote, they are strongly urged to do so.

53. Each manager must continue to develop its policy and provide a quarterly report that sets out how it has been implemented.

### **Additional Voluntary Contributions**

54. The Fund provides a facility for members to pay additional voluntary contributions (AVCs) to enhance their benefits. Members have a choice between buying added years of service or accumulating their AVCs to purchase benefits on a money purchase basis.

55. Investment of money purchase AVCs is undertaken through the Prudential Assurance Company. The Committee’s intention is to offer a range of funds that are intended to provide a suitable long-term return for members, consistent with the degree of risk accepted. A socially responsible fund is included within the range on offer.

56. The Committee reviews the suitability of the AVC arrangements annually, or more frequently if required, based upon advice provided by Hewitt Bacon and Woodrow.

57. The Fund also has an AVC facility with Equitable Life. Due to Equitable’s well publicised difficulties, this facility is no longer promoted by the Fund and does not receive new investment contributions.

### **Compliance with Principles of Investment Practice**

58. The Fund complies with all of the Principles of Investment Practice, as set out in the “CIPFA Pensions Panel Principles for Investment Decision Making in the Local Government Pension Scheme”.

### **Limits on Investment in Partnerships**

59. The Regulations contain the following limits on the percentage of a pension fund that may be invested into a partnership:

- 2% in respect of all contributions into any single partnership;
- 5% in respect of all contributions into partnerships.

60. The limits apply at the time that an investment is made.

61.The regulations provide for the limits to be raised as follows, subject to certain requirements being met:

- 5% in respect of all contributions into any single partnership;
- 15% in respect of all contributions into partnerships.

62.About 7.5% of the Fund is to be invested in private equity. This position is being built up over a period of years and the allocation is being top-sliced from that to quoted equities.

63.At its meeting on 27<sup>th</sup> February 2006, the Committee resolved that the limits applicable to the Fund be raised in order to accommodate the commitments that would be made into partnerships, as follows:

- The limit in respect of all contributions into any single partnership be raised from 2% to 3%.
- The limit in respect of all contributions into partnerships be raised from 5% to 15%.

64.The Committee has taken proper advice in respect of this decision from the Investment Advisor, Hymans Robertson, and from the Fund's officers.

65.This decision will apply for the period for which the Fund's strategic investment benchmark includes allocations to private equity, unless investment considerations require an earlier review.

66.No date has been set for an earlier review.

67.This decision is compliant with the Regulations.

68.Investment is being made in other alternative investments, such as infrastructure funds, through partnerships. These investments will be taken into account against the increased limits referred to above

### **Limits on Stock Lending**

69.The Regulations contain a limit of 25% on the value of the securities of a pension fund that may be transferred (or agreed to be transferred) under stock lending arrangements.

70.The Regulations provide for the limit to be raised to 35%, subject to certain requirements being met.

71.At its meeting on 28<sup>th</sup> November 2005, the Committee resolved that the limit be raised to 35%.

72.The Committee has taken proper advice in respect of this decision from the Investment Advisor, Hymans Robertson, and from the Fund's officers.

73.This decision has been taken to allow greater flexibility within the stock lending arrangement and to provide the potential for additional income.

74.This decision will apply for as long as the stock lending arrangement operates, unless an earlier review is required.

75.No date has been set for an earlier review.

76.This decision is compliant with the Regulations.

## **Asset Liability Study Projected Investment Returns**

The asset liability modelling study involves ten year projections of the Fund's liabilities and of returns from the various asset classes, over a large number of scenarios. Implicit within that process is a distribution of expected returns for each asset class over the ten year period. The table below shows the median real returns (i.e. returns in excess of price inflation) from the distributions in respect of the main asset classes, as used in the update of the study carried out as at 30<sup>th</sup> November 2004.

<b>Asset class</b>	<b>10 year median real return % pa</b>
Global (ex UK) Equities (unhedged)	4.6
UK Equities	4.8
Property	2.9
AA Sterling long-dated Corporate Bonds	2.0
Long-dated UK Gilts	1.3
UK Index-Linked Gilts	0.8
Foreign Bonds (unhedged)	2.0

The returns shown above were those projected from 30<sup>th</sup> November 2004 and hence would not necessarily apply at any subsequent date.

The results of the asset liability modelling study reflect not only these median returns, but also more complex factors such as:

- The volatility of returns from each asset class.
- The degree to which returns from one asset class are linked to returns from other classes.
- The relationship between movements in assets and movements in liabilities.

Inflation has been assumed at 2.8%.

## Strategic Benchmark

<b>Asset Class</b>	<b>Allocation %</b>	<b>Index</b>
<b>UK Equities</b>	<b>27.50</b>	FTSE All Share
<b>Overseas Equities</b>	<b>40.00</b>	
- US	12.50	FTSE All World US
- Europe ex UK	13.50	FTSE World Europe ex UK
- Japan	7.00	FTSE All World Japan
- Other Far East	3.50	MSCI All Country Pacific Free ex Japan inc Malaysia
- Emerging Markets	3.50	MSCI Emerging Markets Free
<b>Fixed Interest</b>	<b>22.50</b>	
- UK Gilts	8.00	FTSE-A British Govt All Stocks
- UK Index-Linked	3.00	FTSE-A British Govt Over Five Year Index-Linked
- Sterling Non Government	11.50	ML Sterling Non Gilt All Stocks
<b>Property</b>	<b>10.00</b>	IPD Monthly Index

### Notes

About 7.5% of the Fund is to be invested in private equity. This position is being built up over a period of years and is top-sliced from the allocation to quoted equities.

About 3% of the Fund is invested in actively managed currency funds, which are contained within the allocation to passively managed US equities.

Allocations, each of up to 1% of the Fund, are being made into infrastructure funds. These are top-sliced from the allocation to gilts.

## Management Structure

Manager	Mandate	Objective
Mandate vacant	UK Equities	To aim to outperform the FTSE All Share Index by 2.0% p.a. over three year rolling periods. To aim not to underperform the FTSE All Share Index by more than 5.5% over any rolling 12 month period.
UBS	Pan European Equities	To outperform the FTSE Europe (including UK) Index – Developed Series by 2% p.a. over three year rolling periods with the return being no more than 5% below the Index in any one year.
Capital International	Global Equities	To outperform the FTSE All World Index by 2% pa over three year rolling periods with the return being no more than 5% below the Index in any one year.
Capital International	Emerging Market Equities	To outperform the MSCI Emerging Markets Investable Market Index.
Schroder	Japanese Equities	To outperform the FTSE All World Japan Index by 2% pa over three year rolling periods with the return being no more than 4% below the Index in any one year.
Schroder	Pacific ex Japan Equities	To outperform the MSCI All Countries Pacific Free ex Japan Index by 2% over three year rolling periods with the return being no more than 5% below the Index in any one year.
Legal and General	UK Equities	To match the return on the FTSE All Share Index.
Legal and General	US Equities	To track the total return of the FTSE World North America Index within expected tolerances of +/-0.5% in two years out of three.
Legal and General	UK ex Europe Equities	To track the total return of the FTSE Europe (ex UK) Index within expected tolerances of +/- 0.5% in two years out of every three.

<b>Manager</b>	<b>Mandate</b>	<b>Mandate</b>
Legal and General	UK Index-Linked	To match the return on the FTSE – A British Government Over Five Years Index Linked Index
Legal and General	AAA Fixed Interest	To match the return on the iBoxx Sterling AAA All Stocks Index.
Legal and General	UK Gilts	To match the return on the FTSE – A British Government All Stocks Index
Various	Private Equity	5% net of fees above the returns on quoted equity.
Prudential M&G	Corporate Bonds	To outperform a composite benchmark by 0.75% pa over three year rolling periods with the return being no more than 2% below the Index in any one year.  The benchmark is:  80% iBoxx Non Gilt All Stocks  10% FTSE - A British Government All Stocks  10% FTSE – A British Government Over Five Years Index-Linked
Henderson	Government Bonds	To outperform the performance benchmark return by 2% pa over three year rolling periods.  The benchmark is:  45% FTSE – A British Government All Stocks  55% iBoxx Sterling Non Gilt All Stocks
Aberdeen Property Investors	Property	To outperform the IPD All Funds Universe by 0.5% pa over three year rolling periods.
BGI and Record	Currency	Absolute return.