

**HERTFORDSHIRE COUNTY COUNCIL**

**INVESTMENT COMMITTEE**

**THURSDAY 20 JUNE 2002 AT 10.00 AM**

**Agenda Item No:**

**2**

**STATEMENT OF INVESTMENT PRINCIPLES**

**Report of the Finance Director**

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**1. Purpose of the Report**

To seek approval for the fund's Statement of Investment Principles.

**2. Summary**

2.1 The Policy Committee originally approved a Statement of Investment Principles (SIP) for the Hertfordshire Fund on 1 July 1999. A revised version, taking into account requirements to cover ethical investment and risk, was approved on 13 August 2000.

2.2 The attached SIP has been updated to take account of:-

- benchmark and asset allocation changes from 1 July 2002;
- recommendations in the Myners' report on "Institutional Investment in the UK".

2.3 The SIP includes at Appendix A an evaluation of compliance with the 10 "Myners Principles".

**3. Conclusion**

A revised SIP is attached for approval by the Committee.

#### **4. Background**

The Local Government Pension Scheme (Management & Investment of Funds) (Amendment) Regulations 1999 (Statutory Instrument 1999 No. 3259) introduced the statutory requirement for administering authorities to publish a “Statement of Investment Principles” (SIP) by 3 July 2000.

The Policy Committee of the County Council, as the administering authority for the Hertfordshire Fund, approved the SIP on 13 April 2000.

##### **4.1 Myners Principles**

4.1.1 In March 2001, Paul Myners published his “Review of Institutional Investment in the United Kingdom. This set out a number of principles of best practice and recommended that Pension Funds should set out in the SIPs the extent to which they are following these principles.

4.1.2 In response to these proposals the Government issued a revised set of ten principles in October 2001 and indicated that it would be reviewing the voluntary compliance of pension funds with these.

4.1.3 Appendix A in the attached SIP sets out the principles, the current level of compliance with these principles and areas for development in the future for the Hertfordshire Fund.

##### **4.2 Benchmark Changes**

4.2.1 At their meeting on 6 March 2002, members of this Committee approved the implementation of a scheme specific benchmark.

4.2.2 Following discussions with the Fund Managers concerned, the new benchmark has been agreed and will be implemented from 1 July 2002.

4.2.3 The SIP has been amended to reflect this change.

#### **5. Conclusion**

The SIP for the Hertfordshire Fund, revised to take account of benchmark changes and Myners’ Principles, is attached for approval by the Committee.

## **HERTFORDSHIRE COUNTY COUNCIL**

### **LOCAL GOVERNMENT PENSION SCHEME**

#### **STATEMENT OF INVESTMENT PRINCIPLES**

##### **Introduction**

The County Council ('the Council') is responsible for the administration of the Hertfordshire Local Government Pension Scheme (LGPS). The Council has a statutory duty to ensure that any Local Government Pension Scheme funds, not immediately required to pay pension benefits, are suitably invested.

As required by statute the Council has approved a statement of investment principles which are applied to the management of the LGPS investments ('the Fund').

In accordance with Government guidelines, the extent to which the Hertfordshire scheme complies with the 10 Principles set out in the Myners' review of Institutional Investment in the U.K. is set out at Appendix A to this statement.

##### **Who makes the investment decisions?**

The Investment Committee of the County Council ("the Committee"), advised by the Finance Director, is responsible for setting the overall investment strategy, monitoring investment performance and the implementing relevant policies. The Committee consists of 8 County Council members; 3 (non-voting) district council members elected by the Hertfordshire Local Government Association and a non-voting Unison representative.

Day to day operational decisions are delegated to the County Council's Finance Director.

All investments, with the exception of property unit trusts ("PUTs"), are managed by external investment management organisations ('the managers').

From 1<sup>st</sup> July 2002, in-house staff in Corporate Finance, reporting to the Finance Director, will be responsible for the management of PUTs.

##### **What are the investment objectives of the Fund?**

- a) To comply with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, specifically to ensure that all:-
  - funds are suitably invested,
  - investments are diversified,
  - relevant investment limits are not exceeded,
  - investments and investment arrangements are regularly monitored and reviewed.

- b) To ensure that the Fund has sufficient assets to pay scheme benefits.
- c) To achieve a long term rate of return on the invested funds (both capital gains and income) which assists in controlling the level of employer's contributions to the Fund and also the cost of the pensions to the local tax payers where appropriate by;
  - i) as a minimum matching the actuary's rate of return assumptions made when assessing the Fund's level of funding, and
  - ii) exceeding the fund benchmark by 1% measured over three year rolling periods.

### **Achieving the investment objectives**

The Council, having taken appropriate professional advice, has made the arrangements set out below to reduce the risk that one or more of the investment objectives for the Fund are not achieved over the long term.

#### a) Suitable Investments

The Investment Committee considers that the following types of investments, within specific limits, are suitable for the purposes of a pension scheme:

- cash, bank deposits and other short term money market investments;
- quoted fixed interest securities; individual securities and pooled investment vehicles;
- quoted equity investments; individual securities and pooled investment vehicles;
- property unit trusts;
- derivative instruments, but not to be used for speculative purposes;
- unquoted equity investments and venture capital pooled vehicles.

#### b) Fund benchmark and asset allocation

From 1<sup>st</sup> July 2002 the Fund will adopt a specific benchmark which has been approved by the Committee, following appropriate professional advice from the investment consultant, fund managers and the performance measurement consultant. The composition of the Fund benchmark is set out at Appendix B to this Statement.

The weightings of the various asset classes within the benchmark form the basis for asset allocation within the Fund.

The asset allocation set out in the benchmark is designed to spread the risk and minimise the impact of poor performance in a particular asset class. It seeks to achieve a spread of investments across both the main asset classes (quoted equities, bonds, private equity and property) and geographic regions within each class.

c) Management of Investments

The main choices when selecting a fund management style are:

- ◆ Active or passive – making independent decisions when buying or selling investments (active) or buying stocks to replicate a specific index (passive);
- ◆ Balanced or specialist – investing across a broad range of asset classes (balanced) or in a narrow, specific asset class (specialist).

The Fund uses a mixture of “active, balanced” and “active, specialist” managers.

The number of managers and the share of the Fund by type as at 31<sup>st</sup> March 2002 is shown in table 1 below, along with the target allocation for 31<sup>st</sup> March 2003:

**Table 1**

	<u>No. of managers</u>	<u>Share of total Fund at</u>	
		<u>31<sup>st</sup> March 2002</u>	<u>31<sup>st</sup> March 2003</u>
External, active, balanced	3	82.3%	76%
External, active, specialist	3	17.1%	15.5%
Private equity	2	0.6%	1.5%
In-house, active, specialist (property unit trusts)		0%	7%

Full details of the managers, their mandates and fee basis are shown at Appendix C.

All the managers need the approval of the Chief Financial Officer to acquire shares in any securities that are not listed on a recognised stock exchange.

d) Social, environmental and ethical considerations

The County Council retains external investment management organisations to select, monitor and realise the Fund’s investments. The investment managers are expected to apply their professional expertise to maintain suitably diversified portfolios for a Local Government Pension Scheme. When making investment decisions the managers are expected to take account of what they reasonably believe are all relevant considerations.

e) Investment Restrictions

The following investment restrictions apply to the funds under management:

- i) all limits determined under the LGPS (Investment and Management of Funds) Regulations 1998;

ii) additional limits which have been determined by the Council:

Venture Capital	-	total investments are not to exceed 5 per cent of the value of the Fund.
Options, futures & contracts for differences		Maximum 25% of UK equity portfolio. Only to be used to protect against possible adverse fluctuations in the values of other investments or cash in the portfolio.
Individual equity holdings	-	the total holding in a single company is not to exceed 5% of the issued share capital.

There are no other restrictions placed on the managers' investment decision making.

e) Investment Performance Measurement

The investment performance of the Fund's managers is measured by an independent organisation, the WM Company, which reports quarterly to the Finance Director and at least annually to the Investment Committee.

f) Monitoring of Investment Managers

The Committee meets quarterly to consider reports from each investment manager. Each manager makes a presentation in person to the Panel on at least an annual basis and to the Finance Director (or his representative) on a more regular basis.

h) Actuarial Valuation

The LGPS is subject to triennial valuations by an independent actuary. Employers' contributions are determined by the actuary to ensure that in the long term the fund's assets will match its liabilities.

i) Voting of Shares

The Fund routinely votes on all matters raised by the largest 350 listed UK companies where it owns shares. The Fund's voting policy is to vote in accordance with the current principles of corporate governance best practice, as advised by the Pensions Investment Research Consultancy, except when the advice of the Fund's managers indicates such action would not be in the best financial interests of the Fund.

j) Custody Arrangements

The Fund's assets are held in custody by an independent custodian, where reasonable controls have been certified by an appropriate auditor.

This Statement of Investment Principles was approved by the Investment Committee of Hertfordshire County Council on . Copies are available on request for participating scheme employers, scheme members, pensioners and deferred beneficiaries. The statement will be reviewed on an annual basis by the Council's Investment Committee.

## Compliance with 10 Myners' Principles

<p><b>Principle 1 Effective Decision Making</b></p>	<p>Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.</p> <p><i>Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary.</i></p> <p><i>It is good practice for trustee boards to have an investment subcommittee to provide the appropriate focus.</i></p> <p><i>Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structure and processes to carry out their role effectively. They should draw up a forward-looking business plan.</i></p>	<p><u>Current position</u></p> <p>Day to day operational decisions are delegated to the County Council's Finance Director who, with relevant members of his staff, regularly attends seminars and briefing sessions to maintain a high level of skill and knowledge in investment matters.</p> <p>Members of the Investment Committee act in the role of trustees for the Fund. They attend training sessions organised by the County Council. They receive standard attendance allowances for this work.</p> <p>Both members and officers involved with making investment decisions take advice from appropriately qualified professionals where appropriate.</p> <p><u>Development area</u></p> <p>During 2002/03 the Investment Committee will draw up a business plan setting out the future investment strategy for the Fund.</p>
<p><b>Principle 2 Clear objectives</b></p>	<p>Trustees should set out an overall objective for the Fund that:</p> <p><i>Represents their best judgement of what is necessary to meet the Fund's liabilities given their understanding of the contributions likely to be received from employers and employees; and</i></p>	<p><u>Current position</u></p> <p>The Fund's main investment objective as set out in this SIP is to have sufficient assets to meet the liabilities by achieving a long term rate of return on the investments at least equal to the rate used by the actuary when setting the contribution rate every three years.</p>

	<ul style="list-style-type: none"> <li>▪ <i>Takes account of their attitude to risk, especially their willingness to accept underperformance due to market conditions.</i></li> </ul> <p><i>Objectives for the overall Fund should not be expressed in terms which have no relationship to the Fund's liabilities, such as performance relative to other pension funds, or to market index.</i></p>	<p><u>Development area</u></p> <p>To define acceptable risk levels for the Fund as a whole and for individual managers.</p>
<p><b>Principle 3</b> <b>Focus on asset allocation</b></p>	<p><i>Strategic asset allocation decisions should receive a level of attention (and where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity. Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.</i></p>	<p><u>Current position</u></p> <p>The use of a scheme specific benchmark from 1<sup>st</sup> July 2002 requires Committee members, with professional advice, to make high-level, asset allocation decisions.</p> <p>The Fund will no longer use a peer-group benchmark, which resulted in asset allocation based on the average for a group of other funds.</p> <p>The new benchmark gives more substantial weighting to alternative investment opportunities in private equity and property, alongside the other major asset classes of equities and bonds.</p> <p><u>Development area</u></p> <p>A newly-appointed investment consultant will be asked to review the broad asset allocation strategy, as reflected in the benchmark, every year and recommend amendments where appropriate for the Fund.</p>

<p><b>Principle 4 Expert advice</b></p>	<p><i>Contracts for actuarial services and investment advice should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.</i></p>	<p><u>Current position</u></p> <p>To date the Fund has used the investment consultancy service provided by the actuary on an ad hoc basis.</p> <p>The Fund has now tendered separately for an Investment Consultant and an appointment should be made by 30<sup>th</sup> June 2002.</p>
<p><b>Principle 5 Explicit mandates</b></p>	<p><i>Trustees should agree with both internal and external, investment managers an explicit written mandate covering agreement between trustees and managers on:</i></p> <ul style="list-style-type: none"> <li>▪ <i>an objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances;</i></li> <li>▪ <i>the manager's approach in attempting to achieve the objective; and</i></li> <li>▪ <i>clear timescale(s) of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.</i></li> </ul> <p><i>The mandate and trust deed and rules should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.</i></p>	<p><u>Current position</u></p> <p>Formal, written agreements are in place with each manager which set out the investment objective, the benchmark, any limits on investments and the period over which performance is to be measured.</p> <p>An annual report is presented to the Committee detailing all the costs involved in managing the Fund's investments, including direct and indirect costs.</p> <p>Only 1 of the Fund's external managers still uses soft commissions.</p>

<p><b>Principle 5 contd.</b></p>	<p><i>Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur; including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund’s other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund’s transactions.</i></p>	<p><u>Development Areas</u></p> <p>New management agreements will be drawn up in 2002/03 to reflect the new benchmark, where appropriate, and to specify the risk tolerances to be applied by the managers.</p> <p>Further discussions will take place on soft commissions with the manager concerned with the objective of having no soft commissions by 31<sup>st</sup> March 2003.</p>
<p><b>Principle 6 Activism</b></p>	<p><i>The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.</i></p>	<p><u>Current position</u></p> <p>At present there is no specific reference to activism in the management agreements.</p> <p><u>Development area</u></p> <p>The issue will be reviewed by the Committee, following discussions with managers and the investment consultant, before a decision is made on how this should be reflected in the management agreements.</p>

<p><b>Principle 7 Appropriate benchmarks</b></p>	<p><b><u>Trustees should:</u></b></p> <ul style="list-style-type: none"> <li>▪ <i>explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;</i></li> <li>▪ <i>if setting limits on divergence from an index; ensure that they reflect the approximations involved in index construction and selection;</i></li> <li>▪ <i>consider explicitly for each asst class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and</i></li> <li>▪ <i>where they believe active management has the potential to achieve higher returns, set both targets and risk controls they reflect this, giving the managers the freedom to pursue genuinely active strategies.</i></li> </ul>	<p><u>Current position</u></p> <p>The index to be used from 1<sup>st</sup> July 2002 was selected following consultation with an external investment advisor, as being appropriate for the Fund's investment objectives.</p> <p>The index will be reviewed annually from 1<sup>st</sup> April 2003 onwards.</p> <p>All the current managers have an active investment mandate, and are given the freedom to operate active strategies within the broad asset allocation set by the benchmark.</p> <p><u>Development area</u></p> <p>Further consideration will be given to the risk controls to be applied by each manager.</p> <p>The issue of active vs passive management will be included in the annual investment consultant's review from 1<sup>st</sup> April 2003.</p>
<p><b>Principle 8 Performance Measurement</b></p>	<p><i>Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment for performance and decision-making delegated to advisers and managers.</i></p>	<p><u>Current position</u></p> <p>Fund performance is measured quarterly by an independent company, both for the fund as a whole and for individual managers.</p> <p><u>Development area</u></p> <p>To formally document procedures for decision making, both for Committee members and managers.</p>

<p><b>Principle 9 Transparency</b></p>	<p><i>A strengthened Statement of Investment Principles should set out:</i></p> <ul style="list-style-type: none"> <li>▪ <i>who is taking which decisions and why this structure has been selected;</i></li> <li>▪ <i>the Fund's investment objective;</i></li> <li>▪ <i>the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at;</i></li> <li>▪ <i>the mandates given to all advisers and managers; and</i></li> <li>▪ <i>the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.</i></li> </ul>	<p><u>Current position</u></p> <p>The SIP covers all the areas set out in this principle with the exception of the projected investment returns on each asset class.</p> <p><u>Development area</u></p> <p>To determine, with the assistance of the newly appointed investment consultant, projected investment returns on each asset class.</p>
<p><b>Principle 10 Regular reporting</b></p>	<p><i>Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers. They should send key information from these annually to members of these funds, including an explanation of why the fund has chosen to depart from any of these Principles.</i></p>	<p><u>Current position</u></p> <p>The SIP is included in the Pension Fund Annual Report and Accounts, a copy of which is sent to all employers within the Fund. Copies are provided to members of the Fund on request.</p> <p><u>Development area</u></p> <p>Place the SIP on a pensions' website. Issue a newsletter with the 2002 annual benefits' statement which includes details of how members can get access to the SIP.</p>

**Composition of Total Fund Benchmark**

45%	UK	FTSE All Share (including Private Equity)
9%	North America	FTSE North America
9%	Europe ex UK	<b>FTSE ex UK</b>
5%	Japan	FTSE Japan
5%	Pacific ex Japan	FTSE AW Developed Asia-Pacific ex Japan
2%	Emerging Markets	MSCI Emerging Markets Free Index
4%	UK Gilts	FT- A Conventional Gilts All Stocks
4%	Corporate Bonds	Merrill Lynch Sterling non-gilts, all stocks index
4%	UK Index Linked	FT – A Over 5 Year Index Linked Gilt
4%	Overseas	Lehman Global Aggregates ex UK
1%	Cash	GBP 7 Day LIBID
8%	UK Property	IPD All Properties Index

**Hertfordshire's Fund Managers  
at 31<sup>st</sup> March 2002**

<b>Manager</b>	<b>Value of portfolio at 31<sup>st</sup> March 2002 £m</b>	<b>Type of mandate</b>	<b>Performance Target</b>	<b>Fee type*</b>
<b>Schroders Investment Management</b>	368.6	Active, balanced	1% above benchmark	Performance related
<b>Jupiter Asset Management</b>	418.7	Active, balanced	1% above benchmark	Ad valorem
	75.9	Active, specialist UK equities	2% above benchmark	Performance related
<b>Baillie Gifford</b>	257.4	Active, balanced	2% above benchmark	Ad valorem
<b>Capital International</b>	92.9	Active, specialist, Global Equities	1% above benchmark	Ad valorem
<b>Merrill Lynch</b>	48.1	Active, specialist, Bonds	0.5% above benchmark	Ad valorem
<b>Permira (formerly Schroder Ventures)</b>	6.3	Active, specialist, Private Equity	Not applicable	Performance related
<b>TTP Ventures</b>	0.9	Active, specialist Private Equity	Not applicable	Performance related

**\* *Fee types:***

*Ad valorem*

*Performance-related*

*based only on the value of the portfolio  
additional fees payable where performance exceeds the  
target*



