

Local Members Interest	
Nil	

## **PENSIONS PANEL – 4 MARCH 2014**

### **Report of the Director of Finance and Resources**

#### **Annual Investment Strategy for Pension Fund Cash 2014/15**

##### **Recommendation of the Chairman**

1. That the Pensions Panel approves the proposed Annual Investment Strategy (AIS) for the investment of internally managed Pension Fund cash.

##### **Reasons for Recommendations**

2. The Local Government Pension Scheme (Management and Investment of Funds) Regulations in 2009 require the administering authority to formulate a policy for the management of Pension Fund cash. The Government also provides specific guidance to local authorities under the Local Government Act 2003 in completing an AIS; the relevant principles of which have been used to structure this AIS for the Staffordshire Pension Fund.

##### **Background**

3. The Pension Fund has a small strategic asset allocation to cash of 1%, recognising that cash balances are needed for the day to day management of the Fund. This cash is managed by Officers in the County Council's Treasury and Pension Fund Team; mainly in the short-term to provide liquidity to pay bills as they arise. It is not invested solely to seek a return and is not, therefore, usually considered as a major asset allocation decision.
4. The cash does increase from time to time, pending investment in other major asset classes e.g. property. The proposed AIS will therefore need to allow for such situations occurring. Also, the Panel will need to agree these temporary increases as part of its quarterly review of the strategic asset allocation benchmark, together with any associated ranges.
5. The proposed AIS will not deal with the segregated, relatively small working cash balances held by the custodian (Northern Trust) under the control of the investment managers or with cash arising from occasional transitional activity. Overnight, Northern Trust sweep funds into their "AAA" rated Money Market Funds (MMF).

##### **AIS for Pension Fund Cash 2014/15**

## Objectives of investment

6. The proposed main objectives for the AIS are to:
  - a) provide security of capital (i.e. ensure the return of the money);
  - b) provide liquidity (i.e. pay the bills as they fall due and ensure funds are available for reinvestment when needed); and
  - c) earn interest (i.e. obtain a reasonable return within the constraints outlined at a) and b)).
7. The 1% allocation to cash will by its nature need to be kept short-term; the AIS that follows sets out a system for selecting counterparties and investment instruments to manage these cash balances.
8. Where balances exceed this allocation, say pending investment in other asset classes, then investments will be needed that recognise their longer-term nature.
9. This AIS proposes an approach that will cope with both sets of circumstances.
10. The County Council has appointed Arlingclose as its treasury advisor, and in part their role is to provide a creditworthiness service to the Council of suitable investment counterparties. This information is also available to the Pension Fund and will be used accordingly in this AIS.

## Credit Rating Criteria and the Approved Lending List (the List)

11. Government regulations state that local authorities have to decide how they define a "high credit rated" counterparty (i.e. a bank or a building society) and this is a useful starting point for this AIS.
12. Arlingclose provide information about suitable investments in the context of the current economic risk environment and incorporate the views of credit rating agencies (for example, Fitch, Standard and Poors, Moodys). What follows is an overview of how this operates. However, it is important to understand that the Pensions Panel is responsible for the decisions taken with all cash investments.
13. Credit ratings provided by the three main credit rating agencies form an important, but not the only aspect of how creditworthiness is assessed by Arlingclose. For 2014/15 minimum credit-rating thresholds are set at a long-term rating of "A-" where available. Counterparties that are rated below this level are excluded from the List.
14. In addition the following are also considered:
  - Statements of potential government support.
  - Credit Default Swaps (CDS) (i.e. the cost of insuring against counterparty default).
  - Share prices.

- Gross Domestic Product (GDP) in the country of incorporation.
  - Macro-economic factors.
  - Information in the press.
  - A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.
15. In practical terms all of this information is considered by Arlingclose when they determine their recommendations. Any change in these criteria can result in a counterparty being removed from the lending list, not solely a change in credit rating.
  16. In the recent past, the economic environment has been very volatile, so the advice provided by Arlingclose results in counterparties with high quality credit characteristics that are intended to insulate against further volatility. Of course, the future cannot be foreseen and in some situations changes may need to be made quickly to the List, but this is considered a cautious approach that fits with the need to ensure the security of the cash investments. Taking the above, and Arlingclose's recommendations, into account, the Banks and Building Societies listed at Appendix 2 are recommended appropriate for use by the Pension Fund.
  17. The Treasury Management Panel, chaired by the Director of Finance and Resources, meets monthly and a review of the Pension Fund List and any changes made by Arlingclose will take place at these meetings. In between meetings the Treasury and Pension Fund team will implement any recommendations made by Arlingclose. On the rare occasion that Arlingclose do not make a firm recommendation then this will be referred to the Treasury Management Panel for their review. Any decisions arising from such exceptions will be reported to the Pensions Panel together with periodic reports on the investments made and their resultant performance.

#### Money Market Funds (MMF's)

18. MMF's are pooled investment vehicles consisting of money market deposits and similar instruments. Arlingclose recommend the use of MMF's by their local government clients, and these have been used for some time by the Pension Fund and by Northern Trust as stated earlier.
19. It is MMF's that meet the criteria listed below which will be considered to have high credit quality and will be included on the list:
  - Recommended - to clients by treasury advisers, Arlingclose.
  - Diversified – MMF's are diversified across many different investments, far more than the Pension Fund could hope to achieve on its own account.
  - Same day liquidity – this means that funds can be accessed on a daily basis.
  - Stable fund value – the Pension Fund invests a pound and redeems a pound.
  - Ring-fenced assets – the investments are owned by the investors and not the fund management company.

- Custodian – the investments are also managed by an independent custodian, who operates at arms-length from the fund management company.

### Co-operative Bank

20. For many years the Co-operative Bank (“the Co-op”) has acted as banker for the County Council and Pension Fund; significant funds flow through the Pension Fund accounts over the course of a typical year. Recently a fall in the credit rating of the Co-op have led to overnight investments with the bank being avoided. As a result, the intention is to manage the balances held with the Co-op at the end of the day as close to nil as possible.

### Investment Diversification

21. In order to ensure diversification across cash investments, it is proposed that the maximum limit for exposure for each bank or building society is no more than 25% of total cash or £10m, whichever is the lower. The proposed maximum limit for AAA rated diversified MMF’s which are, by default, already invested across a larger number of counterparties is the lower of 50% of total cash or £20m. This approach is considered reasonable for the Pension Fund’s risk profile; taking into account that cash is only one asset class and the Fund already has diversification across other asset classes.
22. To allow the practical management of the treasury transactions each day, it is proposed that the choice over the investments made is delegated to the Director of Finance and Resources.

### Investment duration

23. Part of the service Arlingclose provide includes a recommended maximum investment duration. As cash balances are either held to pay day to day bills or awaiting investment elsewhere then it is judged reasonable to limit fixed term deposits with banks or building societies to a maximum duration of 12 months, regardless of the advice provided by Arlingclose.
24. This limit also provides enough flexibility to deal with cash balances that are awaiting reinvestment in another asset class where longer-term investments are more appropriate.
25. Arlingclose recommend a number of “cash plus and short bond funds”; these funds are higher risk than the MMF’s authorised for use earlier, but it is anticipated they will provide a higher return. An investment period of at least six months is recommended, so they provide a useful longer-term option to the investments with banks, building societies and MMF’s.
26. It is proposed to delegate the decision on the use of any cash plus and short bond funds, as recommended by Arlingclose, to the Director of Finance and Resources, should their use be considered appropriate for the placement of

longer term cash. An investment in these funds would be by definition diversified away from the other short-term investments.

27. A copy of the proposed List for the Pension Fund, excluding cash plus and short bond funds, is attached at **Appendix 2**.

### Risk

28. Cash is only a small part of the overall investments of the Pension Fund and the wider aspects of risk are taken into account in the strategic asset allocation where cash forms part of a diversified portfolio.
29. Looking at cash in isolation, then treasury management usually recognises that the two prime risk areas are security and liquidity. It is considered that focussing primarily on these two risks is appropriate for the Fund's relatively low 1% allocation to cash, for day to day cash management purposes, although the AIS has the flexibility to consider yield in the use of higher risk funds for example.
30. However, should the Panel decide at some point in the future to make a higher strategic allocation to cash, where seeking a higher return would become more important, then the balance of risk and reward would need to be revisited.

### Review of Strategy

31. The main circumstances where a revised strategy would be prepared include a change in:
- the Fund's strategic asset allocation;
  - the economic environment;
  - the financial risk environment; and
  - the regulatory environment.
32. Whilst the Panel will be responsible for approving any revised strategy, it may be necessary for action to be taken quickly. It is proposed, therefore, that the responsibility for assessing the circumstances above will rest with the Director of Finance and Resources.

**Andrew Burns**  
**Director of Finance and Resources**

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## Appendix 1

**Equalities implications:** There are no equalities implications arising directly from this report.

**Legal implications:** There are no direct legal implications arising from this report.

**Resource and Value for money implications:** All resource and value for money implications are covered in the body of this report.

**Risk implications:** Risk is inherent in a Treasury Management AIS and is dealt with throughout the report.

**Climate Change implications:** There are no direct climate change implications arising from this report.

**Health Impact Assessment Screening:** There are no direct implications arising from this report

## PENSIONS PANEL – 4 MARCH 2014

Staffordshire Pension Fund  
Approved Lending List

	<b>Time Limit</b>
<b><i>Banks and Building Societies (lower of 25% of total cash or £10m)</i></b>	
Barclays	12 months
HSBC	12 months
Lloyds / Bank of Scotland	6 months
Nationwide	12 months
RBS / NatWest	same day
Santander	6 months
<b><i>Money Market Funds (MMF) (lower of 50% of total cash or £20m)</i></b>	
Goldman Sachs	same day
J P Morgan	same day
Deutsche Bank	same day
Federated	same day