YCS UK LIMITED
YOUNG CONSULTANCY SERVICES

ANNUAL REPORT 2013/14

Independent Adviser/Consultant
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1. The purpose of this commentary is to provide an independent annual appraisal of the administration, governance and performance of the Clwyd Pension Fund. As my appointment to the Independent/Adviser role commenced on 1 July 2008, this report covers my fifth and last full year in this dual capacity role. Overall, the year 2013/14 was one of review, reflection and reassessment both in terms of world markets and the Local Government Pension Scheme (LGPS) itself.

2. Over recent years, the LGPS environment has been characterised by an increasing flow of regulatory documents on funding, risk, policy and governance. More recently, there have been various initiatives under the broad banner of "working together", ranging from potential fund amalgamations to simple increased collaboration between LGPS funds, which are all largely concerned with reducing costs, particularly the level of fees paid to investment managers. At the same time, there had been an ongoing review of the scheme to make it fair and affordable, which ultimately resulted in the new LGPS 2014.

3. As part of this environment of change and initiatives, the first half of 2013/14 saw LGPS funds inundated with documentation – a consultation paper on the detail of LGPS 2014, a discussion paper on new LGPS governance arrangements in England and Wales and a "Call for Evidence" on the future structure of the LGPS. Whilst the consultation paper on LGPS14 sought responses on a number of the detailed regulations proposed for implementing the new scheme and, in this sense, was a technical consultation with LGPS pension administration officers, the other two papers were more fundamental, with potentially far-reaching consequences for LGPS funds. However, all required detailed and careful responses, putting the in-house teams on both investments and pensions administration under particular pressure.

4. On governance it was an accepted fact that practices amongst LGPS funds varied considerably and that the Public Service Pensions Act 2013 had provided a broad framework for a common approach. The discussion paper raised various questions and sought views around the implementation and operation of this framework within the LGPS. The Fund responded accordingly but broadly accepted the move to a formal Committee structure and this is currently being implemented.

5. However, many of the details around national oversight and additional scrutiny at a local level are still being fine-tuned. The results of these deliberations should become clear in later 2014, although it is already known that each LGPS authority will be required to establish a formal set of internal controls for administering and managing its scheme, in addition to all the information on risk currently being provided in each fund's Statement of Investment Principles and its reporting requirements in the Annual Accounts under IFRS 7.

6. The key paper, however, was clearly the "Call for Evidence" on the future structure of the LGPS, which followed on from some peripheral comments in the Hutton report about the quality and consistency of LGPS data. These were picked up in early 2013 by the Local Government Minister Brandon Lewis, who talked about the need for "robust data" and not shying away from "a smaller number of funds" if this could be shown to improve efficiency and cost-effectiveness. This national initiative effectively put on hold the already long-running project aimed at examining possibilities for "Collaborative Working in Wales", which itself had been the subject of various data collection exercises and consultations.

7. The "Call for Evidence" paper itself was based around a set of objectives and a series of questions that respondents were asked to address. Whilst these objectives were designed primarily to generate discussion and debate, they did seem a slightly odd collection, ranging from the very general (dealing with deficits) to the very specific (providing greater investment in infrastructure). At the same time, it was not always clear how the questions set related to these objectives, although there was clearly some overlap. In addition, there was no reference to key funding and investment considerations such as liabilities and their control, and no mention whatsoever of risk.

8. Pension funds are extremely complex vehicles, where all the moving parts are inter-linked. Funding level, strategy, risk and return targets, performance and fees etc. are all inter-dependent and cannot be looked at in isolation. In fact, some of the objectives identified were potentially contradictory. In summary, there was concern that the context set by the objectives and questions failed to appreciate the complexity of pension funds, with little apparent consideration given to the wider fund picture, the relationships between various investment objectives and the impact of some of these objectives on others. The Fund response made these points whilst attempting to cover all the objectives and questions comprehensively and constructively.

9. The "Call for Evidence" was followed in later 2013 by the Government appointment of a consultant to evaluate various options for change, resulting in a current Government consultation exercise on the future of the LGPS. Whilst the outcomes from this have not been delivered yet, forced fund mergers no longer appear to be on the agenda, with the Government focus now more on the creation of Common Investment Vehicles and the use of more passive management. The Fund continues to participate in this ongoing debate and is monitoring potential outcomes very carefully.

10. Clearly the above events consumed a lot of resource in 2013/14 but, despite these distractions, the business of running the Fund on a day to day basis had to be maintained by the fund finance and administration teams. Agreed staffing structures are now in place but, as noted in last year's report, recruiting staff with the appropriate LGPS expertise continues to be a challenge. Consequently, there remained during the year a number of staff within the pension administration team covering permanent posts on temporary contracts, whilst they received in-depth training to ensure competency in these roles. It is pleasing to note that these positions were reviewed towards the end of 2013 and some permanent appointments were made. However, as a result of staffing and recruitment issues in prior years, backlog problems persist. A specific team to tackle this was established in May 2013 but again recruiting experienced staff proved a problem and progress in reducing the backlog has suffered.

11. It is important, however, to put all this into the context of the additional pressures faced by the pension administration team during the year and to acknowledge its achievements. In addition to the detailed consultation exercise noted earlier and, later in the year, preparations for implementing effectively the new LGPS 2014, 2013/14 was also a Fund valuation year. This involved the preparation and successful delivery of all the valuation data to the actuary during the summer. At the same time, a revised website was launched and the communications programme maintained, continuing to receive critical acclaim from both scheme employers and scheme members.

12. For the fund finance team, the year was one of real progress despite the pressures. In mid-year the key part of the revised staff structure was completed, with the appointment to the vacant Pension Finance Manager post, whose additional initial training was supplemented by an intense period of meetings with many of the Fund's alternative asset managers. Clearly this team, and the Clwyd Pension Fund Manager in particular, was also heavily involved in the various Government responses required, in conjunction with the Fund's external advisers.

13. In addition, the team successfully completed the first questionnaire exercise aimed at testing investment managers' compliance with the Fund's Sustainability Policy. This policy, a key element of the Fund's investment philosophy, recognises the relationship between good environmental, social and governance practices and long-term business profitability. The questionnaire exercise, probably the first of its kind amongst LGPS funds, was very well received by managers and proved generally positive. The responses received, particularly the weaker ones, will be pursued as part of the normal pattern of officer meetings with managers during the coming year. This questionnaire exercise is likely to be a recurring one and the aim of the initial piece of work was to set a benchmark for each manager in order to measure improvement going forward.

14. However, the team's major project during the year was implementation of the Fund's flightpath project. Last year’s report noted that in recent years overall funding levels had been affected as much by fluctuations in liability levels as by asset performance, leading to a growing focus on liability-drivers such as inflation, interest rates and mortality. The Fund had already introduced broad diversification and risk diversity within the asset structure to minimise volatility. Flightpath's applies similar principles to liabilities, through a specialist provider on the long-term management of funding risk. After considerable in-house research into the concept, the exercise to appoint a specialist provider commenced in late 2012. This proved a lengthy, complex and challenging exercise, carried out in close association with the Fund's actuary and Independent Adviser/Consultant. However, after several separate stages and reviews, an appointment was made in late Autumn 2013.

15. The implementation through Insight, the chosen provider, raised further complexities that required resolution, but the first phase was completed successfully by 1 April 2014, as planned. As noted previously, the flightpath project proved to be extremely challenging and the fund finance team was absolutely correct in taking it slowly and adopting a cautious, professional and thoroughly-researched approach, especially as the Fund was one of the first LGPS funds to implement this strategy in full.

16. In summary, 2013/14 certainly produced a challenging environment for both pension administration and fund finance staff as the preparations for LGPS 2014 and the wider changes gathered pace. All performed heroically in ensuring that day to day duties were maintained as far as possible within the staffing constraints and the additional pressures being faced. This bodes well for 2014/15 and implementation of the changes required in terms of governance and the scheme itself.

17. After the personnel changes post the 2012 elections, which produced a new Chairman and Vice-Chairman, the Pension Fund Panel continued to gel and develop during the year, with attendance and participation strong. It is pleasing to report that the Chairman, who had suffered an enforced period of absence through illness returned to lead the Panel in mid-year. Training remained a key focus. Most Panel meetings continued to include training elements and members also attended more formal seminars and conferences. The clear aim here is to ensure that members are kept up to date in an investment environment that is forever evolving both in terms of approaches and products. On approaches, the obvious example is flightpath, whilst on products, the Fund again maintained its ground-breaking reputation through new investments in social impact-based venture capital and sub-Saharan private equity.

18. As noted in the opening paragraph, 2013/14 was also a year of reflection and reassessment for world markets. The March quarter of 2013 and the year 2012/13 generally were typified by unusual exuberance, with all equity markets posting solid positive returns, the majority in double figures, but largely on the back of a liquidity-driven environment. In response, the new financial year saw markets pausing for thought and contemplating whether such enthusiasm was justified for all markets.

19. Whilst certainly there appeared to be gradually improving economic news, particularly from the US, and a return to GDP growth, albeit modest initially for most countries, this period of reflection brought back to the fore many of the concerns that had troubled markets for the majority of 2012. Whilst these remained centred on US debt, the slowdown in China, the sustainability of the restructuring ambitions in Japan and especially the resolution of issues in Europe, later developments in the Middle East, the Ukraine and Thailand added to these worries. In short, these competing factors made for another volatile year in world markets, with fears persisting about the strength of this recovery and whether this could be sustained, as well as the wider political issues

20. As a result, markets overall produced only modest progress, with global equities delivering around 6%. However, this overall position conceals a much more complex picture, with the more considered environment in 2013/14 leading to greater discrimination between markets and, in simple terms, producing a dichotomy in performance between developed and developing world equities. The US and UK posted returns of 9-10% whilst Europe led the field with a positive 18% gain. The exception to this in developed markets was Japan, where confidence in the ability of politicians to deliver the structural reforms promised appeared to stall and Japanese equities largely stood still in the year. In contrast, emerging market equities faltered after the significant gains made in prior years, losing around 10% in the year as liquidity was withdrawn. The exception here was frontier markets, the new emerging markets, which produced strong positive returns.

21. Away from equity markets, private equity and real assets such as property and infrastructure produced solid returns in the year, slightly above those for global equities. However, commodities returns were negative and bonds overall were about flat, with the negative returns from Government stock only partly offset by credit. In absolute terms, therefore, the overall Fund return in 2013/14 is likely to be disappointing, with performance positive but only marginally so.

22. In comparative terms too, 2013/14 is likely to be a weak year for the Fund within its peer group of local authorities. As noted in previous reports, the Fund is structured to provide protection when markets fall through broad diversification and a lower weighting to more volatile assets such as equities. This was exacerbated in 2013/14 by the Fund's long-term focus on developing markets and its deliberately low weighting to Europe in particular.

23. At manager level within equities, most met their targets and a number made up ground in terms of since-inception performance, with the weaker performance overall largely down to asset mix. Other asset categories performed largely as expected, although the hedge fund managers, whilst offering downside protection, do continue to disappoint in terms of the returns achieved.

24. The key disappointment elsewhere in the portfolio was the continuing weak performance of its tactical asset allocation managers, particularly Blackrock. These three managers comprise 12% of the Fund's assets and, within this, Blackrock is double-weighted at 6%. The aim of these managers is to move assets between asset categories tactically to take advantage of differing market environments and to produce a positive return from this. Whilst the two smaller-weighted managers were flat or marginally positive and producing returns not too far below expectations, Blackrock delivered a negative 10% in 2013/14, with the 3-year number showing a negative 4% per annum, despite stronger performance in some earlier years. Clearly this area of tactical asset allocation and the managers employed is one that will require reassessment as part of the forthcoming Fund Structure review.

25. As for next year, the economic environment is improving but many of the concerns remain. Globally, China needs careful management as its urbanisation programme and housing investment boom continue to moderate, reducing asset price and credit growth and thus producing a potentially deflationary outlook. Within Europe, the focus will probably be on Germany. European growth is certainly stronger and credit demand building, but on competiveness, Germany remains an outlier and the issue is whether it is willing to reflate wages to create some sort of economic convergence. On the UK, the economy is booming but spare labour capacity is reducing, potentially leading to rising wages and ultimately inflation. In summary, market volatility looks likely to continue, as many of the concerns, particularly the politic ones, persist and worsen, despite a generally improving economic environment.

26. On governance, there will also be changes in 2014/15, with the demise of the Pension Fund Panel and its replacement by a formal committee, probably with a larger membership, as well as some sort of scrutiny body. Whilst it is hoped that there will be a good degree of continuity through existing Panel members, clearly there are significant ongoing implications in terms of establishing revised governance arrangements and the training of committee members new to pension fund administration and investing.

27. Next year, therefore, is likely to be another challenging one for the in-house team and those elected members involved with the Fund. As well as implementation of the above governance changes and the introduction of the new LGPS 2014, towards the end of the year the Fund will be undertaking and implementing the results of its regular Fund Structure Review, a major and resource-intensive exercise impacting upon the Fund's advisers, officers and elected members alike.

28. As implied by the opening paragraph of this report, my planned retirement as the Fund's Independent Adviser/Consultant took place on 31 March 2014. This joint role has now been split and it is pleasing to note that appointments to these positions were made early in 2014/15. John Finch of JLT was made Fund Consultant and Karen McWilliam of Aon Hewitt appointed Independent Adviser, although this latter role has been modified slightly to place a far greater emphasis on governance, an understandable adjustment given the changes that are imminent. I wish them all well in their respective roles and have every confidence that the Fund is in good hands.

29. Despite such a challenging year on both administration and fund matters, it is pleasing to report further external recognition for the Fund. At the Europe-wide IP Real Estate Awards in May 2013, the Fund won the award for Best Real Estate Investor UK & Ireland and finished runner-up in the Best Medium-sized Real Estate Investor in Europe. Overall since 2007, the Fund has been honoured with 21 awards and has finished as runner-up in a further 18 categories. As noted previously, these awards are not given lightly and are highly prized throughout the UK and particularly wider Europe. Their award is a tremendous honour and a clear acknowledgement of the Clwyd Fund's pro-active and innovative approach. This in turn reflects the commitment of its Panel members and their willingness to move the Fund forward, as well as the continuity and strength of the in-house team.

30. As noted earlier, this report ends my formal connection with the Fund. This started in 1979, although my involvement on the investment side did not commence until 1982. At that time, the Fund was valued at just £100 million rather than its current £1.2 billion. The investment environment has certainly changed dramatically, growing more complex year by year and thereby increasing both the demands and workloads involved. However, from my own perspective the work has been both enjoyable and rewarding, and the last 30 years or so has been an amazing journey both for the Fund and for all those active in its management.

31. Finally, therefore, I would like to thank all the Chairs, Vice-Chairs and members that I have worked with over the years. They have always been willing to listen, learn and take a cutting-edge approach when necessary to further the Fund's progress. Politics has never been a factor. However, my greatest acknowledgement is reserved for those officers with whom I have worked over the years. My particular thanks go to Dave Bamber, with whom I shared more than 20 years on the Fund, and more recently Phil Latham and Debbie Fielder. The Fund has been very fortunate to have had such a dedicated, hard-working and professional team in place for so long and again I wish those remaining well for the future.

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