

NORTH YORKSHIRE COUNTY COUNCIL

PENSION BOARD

20 APRIL 2017

INVESTMENT STRATEGY STATEMENT

1.0 PURPOSE OF THE REPORT

- 1.1 To provide Pension Board members with the opportunity to formally confirm that the ISS has been prepared in accordance with the Regulations.
- 1.2 To allow the Pension Board to raise anything that they would like to see in future versions of the document.

2.0 BACKGROUND

- 2.1 To remind Pension Board members, the LGPS (Investment and Management of Funds) Regulations 2016 came into force on 1 November 2016, replacing the 2009 Regulations. A new requirement of these Regulations was that administering authorities are required to have an Investment Strategy Statement (ISS) and that it be first published no later than 1 April 2017. This requirement replaces the previous requirement to maintain a Statement of Investment Principles (SIP).
- 2.2 The purposes of the SIP and the ISS are very similar, being the provision of evidence that administering authorities have considered the suitability of their Fund's investment strategy and the approach to implementing that strategy.
- 2.3 The ISS, attached as **Appendix 1**, has been prepared in accordance with DCLG's "Guidance on Preparing and Maintaining an Investment Strategy Statement" document, attached as **Appendix 2**. This guidance supports the Regulations and goes into some detail about what the ISS should cover. Part 2 of the guidance describes the component parts to be included in the ISS, which are:
 1. Investment of money in a wide variety of investments
 2. The suitability of particular investments and types of investments
 3. The approach to risk, including the ways in which risks are to be measured and managed
 4. The approach to pooling investments, including the use of collective investment vehicles and shared services
 5. How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments
 6. The exercise of rights (including voting rights) attaching to investments
- 2.4 The guidance for each section includes a summary of requirements identifying the key points the ISS is expected to address. Each section of the ISS, with the exception of the approach to pooling investments, is based on the Fund's SIP, updated to meet these requirements. The section on pooling is necessarily brief, as the detailed arrangements including the range and characteristics of sub-funds as well as the

reporting arrangements to each Pension Fund Committee are still to be worked through. Future iterations of the ISS will include more details as pooling develops.

2.5 The Independent Professional Observer was asked to comment on the ISS. He made a number of observations, particularly in relation to pooling investments and policies which may change through coordinating the approach with partner Funds within Border to Coast Pensions Partnership.

2.6 Specifically, points were made on:

- Setting out the proportion of assets that will be invested through pooling
- Summarising assets that would not be suitable for pooling
- Considering the views of interested parties when making investments decisions based on non-financial factors
- Explaining the approach to social investments
- Reporting on voting activity in the Annual Report
- Statement on investments in entities connected to the Administering Authority
- Statement on persons consulted in relation to the ISS

2.7 The Fund's approach to these issues will become clearer either as pooling arrangements develop or as examples of best practice emerge. Recognising that the ISS is a fluid document, it is anticipated that amendments will be required in due course.

3.0 **RECENT EVENTS**

3.1 The regulations stated that the new ISS should be published on the website by 1 April 2017. The draft document was therefore taken to the February PFC meeting where it was approved. It was then sent to employers for consultation, there were no changes required from this. It was also circulated to the Pension Board for comments which were reflected in the final document to be published. The document was published on the website prior to the deadline.

3.2 As mentioned in paragraph 2.7, the ISS is a fluid document. It is therefore intended to take an updated ISS to the Pension Fund Committee for approval at the 6 July 2017 meeting. Any future versions will also be consulted on with the Pension Board and the Fund's employers.

3.3 Due to the short timescales the ISS could not be formally brought to a Pension Board meeting before the publication date required by the Regulations, instead it was circulated to all Board Members for comments. We would therefore like to provide the Pension Board with the opportunity to formally confirm that the ISS has been prepared in accordance with Regulations, any raise any issues that they would like to be reflected in the future version of the ISS before the updated document goes to the PFC in July.

4.0 **RECOMMENDATION**

4.1 Pension Board members confirm that the ISS has been prepared in accordance with the Regulations.

4.2 Pension Board members raise anything that they would like to see in future versions of the document.

BARRY KHAN
Assistant Chief Executive (Legal and Democratic Services)
County Hall
Northallerton

Background Documents: None

NORTH YORKSHIRE PENSION FUND**INVESTMENT STRATEGY STATEMENT****TABLE OF CONTENTS**

Section		Page
1	INTRODUCTION	2
2	OBJECTIVES OF THE FUND	2
2	INVESTMENT OF MONEY IN A WIDE VARIETY OF INVESTMENTS	2
3	THE SUITABILITY OF INVESTMENTS	4
4	THE APPROACH TO RISK	5
5	THE APPROACH TO POOLING	6
6	SOCIAL, ENVIRONMENTAL AND GOVERNANCE ISSUES	7
7	RIGHTS ATTACHED TO INVESTMENTS	8

1.0 INTRODUCTION

- 1.1 Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Regulations) requires administering authorities to formulate, publish and maintain an Investment Strategy Statement (ISS). This document is the ISS of the North Yorkshire Pension Fund (NYPF, or the Fund) for which North Yorkshire County Council (the Council) is the administering authority.
- 1.2 The Council has delegated all its functions as the administering authority of NYPF to the Pension Fund Committee (PFC, or the Committee). The Corporate Director - Strategic Resources, who reports to the Chief Executive, has day to day control of the management of all aspects of the Fund's activities.
- 1.3 The Committee determines the investment policy of the Fund and has ultimate responsibility for the investment strategy. The Committee undertakes its responsibilities after taking appropriate advice from external advisers.
- 1.4 The Committee seeks to invest in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund's Funding Strategy Statement.

2.0 OBJECTIVES OF THE FUND

- 2.1 The primary objective of the Fund is to provide pension benefits for members upon retirement and/or benefits on death for their dependents, on a defined benefits basis. Investments will therefore be selected with the aim of fully funding these benefit requirements over an extended number of years. The funding position will be reviewed at each Triennial Valuation with adjustments to the investment strategy, asset allocation and to investments with investment managers as required.
- 2.2 The investment objective of the Fund is to provide for sufficient capital growth of the Fund's assets in a range of market conditions, supplemented by employee and employer contribution income, to meet the cost of benefits as they fall due. It is translated into a suitable strategic asset allocation benchmark designed to address the nature of the Fund's liabilities, and deliver returns over the long term including through periods of volatility in financial markets.

3.0 INVESTMENT OF MONEY IN A WIDE VARIETY OF INVESTMENTS

- 3.1 The Committee reviews the investments of the Fund on a regular basis. The last review of the investment strategy took place in 2013 and there is an ongoing review of the strategy, alongside the 2016 Triennial Valuation, due to be completed in 2017. Additional reviews of individual asset classes have also taken place, with particular regard to diversification and suitability. The Committee receives advice from its Investment Consultant when undertaking such reviews.
- 3.2 These reviews provide a framework designed to produce the returns the Fund requires over the long term to meet its future liabilities. Each asset class invested in is allocated a range, and rebalancing takes place when values stray beyond them due to market conditions. Further rebalancing may take place based on tactical views of the Fund's advisers.
- 3.3 The Fund's current strategic asset allocation is set out below. The table also includes the ranges within which the asset allocation may vary without specific reference to the Committee, however in practice the allocation is considered by the Committee each quarter and adjustments made as necessary.

	Minimum %	Benchmark %	Maximum %
Equities	50	62	75
Alternatives	10	20	20
Fixed Income	15	18	30

- 3.4 The largest proportion of the Fund's investments are in equities which is aimed at growing the value of assets over the long term. Other return seeking asset classes complement this goal, with the allocation to liability matching assets providing a measure of protection against rising liability valuations.
- 3.5 Each asset class is sub-divided into two or more mandates with different investment managers and operating to different benchmarks, further increasing the diversification of the Fund's investments.
- 3.6 The most recent changes to the strategy have been the addition of Alternatives, being Property (2012), Diversified Growth Funds (2013) and Private Debt (2016). These asset classes have served to further diversify the Fund's investments, spreading risk and reducing short term volatility.
- 3.7 Each investment manager operates to a specific benchmark and to specific mandate restrictions appropriate to their process and style, so that in aggregate, their activities are aligned to the overall performance requirements and risk appetite of the Fund. Each manager holds a range of underlying investments which reflects their views relative to their respective benchmarks, as permitted by their mandates.
- 3.8 The investment management arrangements of the Fund are as follows.

Manager	Mandate	Objective
Standard Life	UK Equities	To outperform the FTSE 350 (excluding Investment Trusts) Equally Weighted Index by 3% pa over the long term
Baillie Gifford	Global Equities (Global Alpha)	To outperform the FTSE All World Index by 2% over the long term
Baillie Gifford	Global Equities (Long Term Global Growth)	To outperform the FTSE All World Index by 3% over the long term
Dodge & Cox	Global Equities	To outperform the MSCI All Country World Index over a market cycle
Veritas	Global Equities	To outperform CPI + 6% to 10% over the medium term
Fidelity	Overseas Equities	To outperform an MSCI geographically weighted index by 2% pa over the medium term
Newton	Diversified Growth Fund	To outperform LIBOR by 4% over the medium term
Standard Life	Diversified Growth Fund	To outperform LIBOR by 5% over the medium term
Hermes	UK Property	To outperform the IPD Other Balanced Property Funds Index by 0.5% over the medium term
Legal & General	UK Property	To outperform the IPD All Balanced

		Property Funds Index over the medium term
Threadneedle	UK Property	To outperform the IPD All Balanced Property Funds Index by 1% to 1.5% over the medium term
M&G	UK Government Bonds	To outperform liabilities by 0.5%
ECM	European Corporate Bonds	To outperform LIBOR by 3%
BlueBay	Private Debt	IRR of 9% gross (7% net) including 4.5% cash yield
Permira	Private Debt	IRR of 9% gross (8% net) including 5% cash yield

4.0 THE SUITABILITY OF PARTICULAR INVESTMENTS AND TYPES OF INVESTMENTS

4.1 The following categories of investment have been approved as suitable for the NYPF.

UK Equities provide a share in the assets and profitability of public companies floated on UK stock exchanges. Capital gains and losses arise as share prices change to reflect investor expectations at the market, sector and stock levels. Income is derived from dividends.

Overseas Equities are similar to UK Equities but allow greater diversification amongst markets, sectors and stocks. Valuations are affected by exposure to movements in the relative value of the foreign currencies in which investments are made against sterling. Exchange rates are likely to reflect differentials in inflation so should not affect returns materially over the long term, but over the short term currency movements may significantly add to or subtract from returns. Equities are expected to provide high returns compared to other asset classes (the "equity-risk premium"); to address the NYPF deficit position a high proportion of assets will be held in equities.

UK Bonds are debt instruments issued by the UK Government and other borrowers. Bonds provide a fixed rate of interest and are usually redeemed at a fixed price on a known future date. Valuations primarily reflect the fixed level of interest, the period to redemption and the overall return demanded by investors. They are vulnerable to rising inflation and correspondingly benefit from falling inflation.

Overseas Bonds are similar to UK Bonds but have exposure to currency exchange rate fluctuations. As with UK bonds they are influenced by local inflation rates.

Index Linked Bonds are bonds that provide interest and a redemption value directly linked to a measure of inflation, usually the Retail Price Index or a similar index. The returns from this asset class act as a useful proxy for movements in liability values.

Diversified Growth Funds	are an alternative way of investing in shares, bonds, property and other asset classes. These funds are managed by specialist multi-asset managers and target returns slightly below that of equities but with significantly reduced volatility due to the diversification of their constituent parts.
UK Property	is an investment in buildings, indirectly through pooled vehicles. Capital gains and losses occur as prices fluctuate in line with rental levels and investor demand. Income is generated from rents collected from tenants. The nature of rental agreements gives property some of the characteristics of bonds, whilst growth and inflation provide some of the characteristics of equities. It is, therefore, a useful diversifying asset class.
Private Debt	is loan arrangements provided directly to companies over the medium term for an index linked return, significantly above rates charged by commercial banks. Typically they are provided through pooled fund arrangements and require that investors commit funds for a period of 5 to 7 years, with income and capital being returned throughout that time.
Derivative Instruments	such as options and futures are mechanisms through which the Fund can be protected from sudden changes in share prices or exchange rates. Although not income producing they can result in capital gains and losses. They may be used to hedge the Fund's exposure to particular markets.
Cash	is invested in authorised institutions in accordance with the treasury management policy of the Council under the terms of a Service Level Agreement and attracts interest at market rates.

4.2 Each asset class has different return expectations and volatility characteristics. They are blended to produce the optimal investment return while taking an appropriate level of risk. Periodic investment reviews assess whether this blend requires adjustment, including through the addition of new asset classes, to take account of changing market conditions and the evolving asset and liability profile of the Fund. Tactical rebalancing also takes place, as required. All monitoring, reviews and rebalancing is undertaken after taking advice from the Fund's Investment Consultant.

4.3 The 2016 Triennial Valuation was prepared on the basis of an expected return on assets of 5.9% over the long term. This return is 1.5% above the discount rate used to calculate the Fund's liabilities and reflects a "probability of funding success" as described in the Funding Strategy Statement of 75%. This is based on the Fund's current asset mix and assumes no outperformance from active management.

5.0 THE APPROACH TO RISK, INCLUDING THE WAYS IN WHICH RISKS ARE TO BE MEASURED AND MANAGED

5.1 The Fund to aims to achieve its funding objective by taking an appropriate level of risk, through investing a proportion of funds in growth assets. Ongoing monitoring of the risk profile takes place including reassessing its appropriateness through investment strategy reviews and at the quarterly meetings of the PFC when appropriate. Close regard is paid to the ongoing risks which may arise through a developing mismatch, over time, between the assets of the Fund and its liabilities, together with the risks which may arise from any lack of balance/ diversification of the investment of those assets.

- 5.2 The risk of financial mismatch is that the Fund's assets fail to grow in line with the liabilities. It is managed by the Committee through a review of the assumptions used to calculate the Fund's liabilities at each Triennial Valuation, and an assessment by the Actuary of the Fund's asset allocation strategy of the probability of achieving funding success. This assessment forms the basis for subsequent asset allocation reviews aimed at controlling risk and further improving the funding position.
- 5.3 Longevity risk and other demographic factors are assessed at each Triennial Valuation. The Committee reviews national and Fund specific trends as part of this process.
- 5.4 Systemic risk, being the possibility that an event akin to the financial crisis occurs, is mitigated through the diversified nature of the Fund's asset allocation strategy. The Committee has taken steps since 2008 to spread investments across a larger number of asset classes which behave differently in different market conditions. The risks associated with individual asset classes, the combined nature of risks at Fund level are reassessed at each strategy review and changes made as appropriate.
- 5.5 This diversification across asset classes and across investment managers within each asset class significantly mitigates concentration risk, so that the effect of underperformance of any one asset class or investment manager is minimised. Rebalancing activity prevents departure from the strategic asset allocation benchmark.
- 5.6 The significant majority of the Fund's assets are invested in liquid investments, so that the risk of illiquidity, being an inability to meet liabilities as a result of a lack of liquid assets, is minimal. The risk is further managed by cashflow forecasting.
- 5.7 Currency risk is that the Fund's assets, the majority of which are overseas, underperform relative to Sterling. This risk is managed through a periodic assessment of currency exchange rates including receiving advice on the suitability of hedging the major currencies the Fund's assets are denominated in.
- 5.8 Agreements with the Fund's custodian and investment managers provide protection against fraudulent losses. In addition regular checks are undertaken by independent auditors of the custodian's and investment managers' systems. These organisations have internal compliance teams which also monitor and report on risk.
- 5.9 The Fund maintains a Risk Register which identifies the key risks, an assessment of the potential impact of each risk should it occur, and the controls and contingency plans in place to mitigate the likelihood and severity of each risk. The Risk Register is reviewed by the PFC annually and by the Pension Board semi-annually.

6.0 THE APPROACH TO POOLING INVESTMENTS, INCLUDING THE USE OF COLLECTIVE INVESTMENT VEHICLES AND SHARED SERVICES

- 6.1 The Fund is a provisional member of the Border to Coast Pensions Partnership ("BCPP", or "the Pool"). The proposed structure and basis on which the BCPP will operate was initially set out in the July 2016 submission to Government and is currently under review as part of the plans for formal creation of the Pool vehicle.
- 6.2 The key criteria for the assessment of the Pool are that it provides a suitable solution that meets the investment objectives and asset allocation strategy of the Fund and that there is significant financial benefit to joining the arrangements.
- 6.3 The change in arrangements is that the Pool will be responsible for manager selection and monitoring, which is currently a responsibility of the Committee. The responsibilities for determining the investment strategy and asset allocation strategy will remain with the Committee.

- 6.4 At the time of preparing this statement the details of the pooling arrangements are being finalised. However it is expected that NYPF's liquid assets will be transitioned into the Pool once suitable sub-funds are in place, and that illiquid investments will be retained by NYPF. New investments will be made through the Pool wherever possible.
- 6.5 The July 2016 submission to Government of BCPP, available on the Fund's website www.nypf.org.uk, provided a statement addressing an outline structure and governance of the Pool, the mechanisms by which the Fund can hold the Pool to account and the services that will be shared or jointly procured. Government approved this approach on 12 December 2016. The Fund has subsequently been working with the BCPP to progress final arrangements.
- 6.6 Arrangements include establishing a Financial Conduct Authority regulated company to manage the assets of BCPP partner funds. Based on legal advice describing the options on holding shares in this company (BCPP Limited), the Fund will hold all voting and non-voting shares rather than the Council. This is because the purpose of the company is to meet the needs of the constituent Funds in complying with the regulations on pooling, rather than for a Council specific purpose.
- 6.7 The Fund will hold the Pool to account through having a representative on the Joint Committee, which as an investor will monitor and oversee the investment operations of BCPP Limited. It will also have a representative on the Shareholder Board, which will as an owner provide oversight and control of the corporate operations of BCPP Limited.
- 6.8 As the Pool develops and the structure and governance of the Pool are established, the Fund will include this information in future iterations of the ISS.

7.0 HOW SOCIAL, ENVIRONMENTAL OR CORPORATE GOVERNANCE CONSIDERATIONS ARE TAKEN INTO ACCOUNT IN THE SELECTION, NON-SELECTION, RETENTION AND REALISATION OF INVESTMENTS

- 7.1 The PFC takes the view that its overriding obligation is to act in the best financial interests of the Scheme and its beneficiaries. It is recognised that environmental, social and governance ("ESG") factors can influence long term investment performance and the ability to achieve long term sustainable returns. Therefore, as a responsible investor, the Committee wishes to promote corporate social responsibility, good practice and improved performance amongst all companies in which it invests.
- 7.2 The Committee considers the financial impact of ESG factors on its investments through regular reporting by the Fund's investment managers. Engagement with company management and voting behaviour are integral to investment processes aimed at improving performance in companies in which they invest.
- 7.3 As well as delegating the Fund's approach to ESG issues to its investment managers, NYPF is also a member of the Local Authority Pension Fund Forum (LAPFF) which is the UK's leading collaborative shareholder engagement group. This organisation promotes ESG good practice on behalf of over 70 LGPS funds. Its activity acts as a complement to that undertaken by the Fund's investment managers. Any differences in approach are discussed with the Fund's investment managers so that the reasons are fully understood.
- 7.4 The Fund is compliant with the six principles on investment decision making for occupational pension schemes, as set out in the guidance published by the Chartered Institute of Public Finance and Accountancy in December 2009 called "Investment Decision Making and Disclosure in the Local Government Pension Scheme: A Guide to the Application of the Myners Principles".

8.0 THE EXERCISE OF RIGHTS (INCLUDING VOTING RIGHTS) ATTACHING TO INVESTMENTS

- 8.1 The Committee has delegated the exercise of voting rights to Pension Investment Research Consultants Limited (PIRC). Votes are executed by PIRC according to predetermined Shareholder Voting Guidelines agreed by the PFC, available on the Fund's website. These guidelines are aligned to the UK Stewardship Code and to best practice in other jurisdictions. Votes are cast for all UK equities held by the Fund, and for non-UK holdings where practicable. The Fund monitors voting decisions on a regular basis.
- 8.2 The Fund adheres to the Stewardship Code as published by the Financial Reporting Council. The Committee will expect both BCPP Ltd and any investment managers appointed by it to also comply with the Stewardship Code.
- 8.3 The Fund's collective engagement activity through the LAPFF supports the voting activity undertaken by PIRC.
- 8.4 The Fund aims to adopt the Principles of the Financial Reporting Council's UK Stewardship Code. A Statement of Compliance will be published on the Fund's website in 2017.

23 February 2017



Department for
Communities and
Local Government

Local Government Pension Scheme

Guidance on Preparing and Maintaining an Investment
Strategy Statement



© Crown copyright, 2016

Copyright in the typographical arrangement rests with the Crown.

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, <http://www.nationalarchives.gov.uk/doc/open-government-licence/version/3/> or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at <http://forms.communities.gov.uk/> or write to us at:

Department for Communities and Local Government
Fry Building
2 Marsham Street
London
SW1P 4DF
Telephone: 030 3444 0000

For all our latest news and updates follow us on Twitter: <https://twitter.com/CommunitiesUK>

September 2016

ISBN: 978-1-4098-4897-4

Foreword

This guidance has been prepared to assist administering authorities in the local government pension scheme in England and Wales with the formulation, publication and maintenance of their Investment Strategy Statement.

New investment regulations to be introduced later this year will include a requirement for administering authorities to publish new Investment Strategy Statements by 1st April 2017 in accordance with the guidance set out below.

Administering authorities will be required to act in accordance with the provisions in this guidance when Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 comes into force.

Part 1

Introduction and background

This guidance has been prepared to assist administering authorities in the formulation, publication and maintenance of their Investment Strategy Statement required by Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. Unless otherwise stated, references to regulations are to the 2016 Regulations.

An administering authority's duty to prepare, maintain and review their Funding Strategy Statement under Regulation 58 of the Local Government Pension Scheme Regulations 2013 ("the 2013 Regulations") is unaffected.

Statutory background

Regulation 7(1) requires an administering authority to formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State.

The Investment Strategy Statement required by Regulation 7 must include:-

- a) A requirement to invest money in a wide variety of investments;
- b) The authority's assessment of the suitability of particular investments and types of investments;
- c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
- d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
- e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

- f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The Investment Strategy Statement must also set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment. This, in effect, replaces Schedule 1 to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("the 2009 Regulations").

Under Regulation 7(6) and (7), the statements must be published by 1st April 2017 and then kept under review and revised from time to time and at least every three years. Under transitional arrangements, key elements of the 2009 Regulations relating to investment policies will continue in force until such time that the Investment Strategy Statement under Regulation 7 is published.

Directions by the Secretary of State

Regulation 8 enables the Secretary of State to issue a Direction if he is satisfied that an administering authority is failing to act in accordance with this guidance.

One of the main aims of the new investment regulations is to transfer investment decisions and their consideration more fully to administering authorities within a new prudential framework. Administering authorities will therefore be responsible for setting their policy on asset allocation, risk and diversity, amongst other things. In relaxing the regulatory framework for scheme investments, administering authorities will be expected to make their investment decisions within a prudential framework with less central prescription. It is important therefore that the regulations include a safeguard to ensure that this less prescriptive approach is used appropriately and in the best long term interests of scheme beneficiaries and taxpayers.

Where there is evidence to suggest that an authority is acting unreasonably, it may be appropriate for the Secretary of State to consider intervention, but only where this is justified and where the relevant parties have been consulted. Regulation 8 includes a number of safeguards, including full consultation with the relevant authority, to ensure that the proposed power is used appropriately, proportionately and only where justified by the evidence.

The Secretary of State's power of intervention does not interfere with the duty of elected members under general public law principles to make investment decisions in the best long-term interest of scheme beneficiaries and taxpayers.

The power of Direction can be used in all or any of the following ways:-

- a) To require an administering authority to make changes to its investment strategy in a given timescale;
- b) To require an administering authority to invest assets as specified in the Direction;
- c) To transfer the investment functions of an administering authority to the Secretary of State or a person nominated by the Secretary of State; and

- d) To require an administering authority to comply with any instructions from either the Secretary of State or the appointed person in circumstances when the investment function has been transferred.

Before issuing any Direction, the Secretary of State must consult the administering authority concerned and before reaching a decision, must have regard to all relevant evidence including reports under section 13(4) of the Public Service Pensions Act 2013; reports from the scheme advisory board or from the relevant local pension board and any representations made in response to the consultation with the relevant administering authority. The Secretary of State also has the power to commission any other evidence or additional information that is considered necessary.

General

Part 2 below sets out the guidance for authorities under each of the component parts of Regulation 7. The specific requirements under each heading are shown at the end of each sub section in a text box and in bold type. It is important to note, however, that these lists are not exclusive and that administering authorities are also required to comply with general public law principles and act within a prudential framework.

Part 2

Regulation 7(2) (a) - Investment of money in a wide variety of investments

A properly diversified portfolio of assets should include a range of asset classes to help reduce overall portfolio risk. If a single investment class is not performing well, performance should be balanced by other investments which are doing better at that time. A diversified portfolio also helps to reduce volatility.

For example, the range of asset classes could include UK and overseas equities of different sectors; bonds with varying maturity; alternative investment assets such as private equity, infrastructure and cash instruments.

However, this guidance does not purport to prescribe the specific asset classes over which fund monies must be diversified. This remains a decision for individual administering authorities to make. Administering authorities are expected to be able to demonstrate that those responsible for making investment decisions have taken and acted on proper advice and that diversification decisions have been taken in the best long term interest of scheme beneficiaries.

An administering authority must also be able to demonstrate that they review their diversification policy from time to time to ensure that their overall target return is not put at risk.

Summary of requirements

In formulating and maintaining their policy on diversification, administering authorities:-

- **Must take proper advice**

- **Must set out clearly the balance between different types of investments**
- **Must identify the risks associated with their overall investment strategy**
- **Must periodically review their policy to mitigate against any such risks**

Regulation 7(2)(b) - The suitability of particular investments and types of investments

The concept of suitability is a critical test for whether or not a particular investment should be made. Although individual investment classes will have varying degrees of suitability in the context of an authority's funding and investment strategies, the overall aim of the fund must be to consider suitability against the need to meet pension obligations as they fall due.

Assessing the suitability of different investment classes involves a number of factors including, for example, performance benchmarks, appetite for risk, policy on non-financial factors and perhaps most importantly, funding strategy.

What constitutes suitability is clearly a matter for individual administering authorities to consider and decide in the light of their own funding and investment strategies, but there is a clear expectation that the assessment should be broadly consistent across all administering authorities. Administering authorities must therefore take and act on proper advice in assessing the suitability of their investment portfolio and give full details of that assessment in their Investment Strategy Statement.

Summary of requirements

In formulating their policy on the suitability of particular investments and types of investments, administering authorities:-

- **Must take proper advice**
- **Should ensure that their policy on asset allocation is compatible with achieving their locally determined solvency target**
- **Must periodically review the suitability of their investment portfolio to ensure that returns, risk and volatility are all appropriately managed and are consistent with their overall investment strategy**

Regulation 7(2)(c) - The approach to risk, including the ways in which risks are to be measured and managed

The appetite of individual administering authorities for taking risk when making investment decisions can only be a matter for local consideration and determination, subject to the aim and purpose of a pension fund to maximise the returns from investment returns within reasonable risk parameters.

Some of the key risks that an administering authority needs to be aware include financial, demographic or regulatory risks. A detailed summary of the identification of all risks and counter-measures to mitigate against them is beyond the scope of this guidance, but administering authorities will continue to have regard to the requirement under Regulation

58 of the 2013 Regulations to have regard to the “Guidance on Preparing and Maintaining a Funding Strategy Statement” published by CIPFA, which includes a section on risk and the ways in which it can be measured and managed.

Summary of requirements

In formulating their policy on their approach to risk, administering authorities:-

- **Must take proper advice**
- **Should clearly state their appetite for risk**
- **Should be aware of the risks that may impact on their overall funding and investment strategies**
- **Should take measures to counter those risks**
- **Should periodically review the assumptions on which their investment strategy is based**
- **Should formulate contingency plans to limit the impact of risks that might materialise**

Regulation 7(2)(d) - The approach to pooling investments, including the use of collective investment vehicles and shared services

All authorities must commit to a suitable pool to achieve benefits of scale. Administering authorities must confirm their chosen investment pool meets the investment reform and criteria published in November 2015, or to the extent that it does not, that Government is content for it to continue.

Any change which results in failure to meet the criteria must be reported by the administering authority, and/or pool, to the Secretary of State and the Scheme Advisory Board.

Administering authorities should set out their approach to pooling and the proportion of assets that will be invested through the pool. This must include the structure and governance arrangements and the mechanisms by which the authority can hold the pool to account.

Where services are shared or jointly procured, the administering authority must set out the rationale underpinning this and the cost benefit of this, as opposed to pooling.

Administering authorities must provide a summary of assets to be held outside of the pool, and how this demonstrates value for money. The progress of asset transfers to the pool must be reported annually against implementation plans and submitted to the Scheme Advisory Board. Where it is possible that an asset could be pooled in the future, authorities must set a date for review and criteria that need to be met before the asset will be pooled.

Summary of requirements

In formulating and maintaining their approach to pooling investment, including the use of collective investment vehicles and shared services, an administering authority must:-

- **Confirm the pooling arrangements meet the criteria set out in the November 2015 investment reform and criteria guidance at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_investment_reform.pdf, or have been otherwise agreed by the Government**
- **Notify the Scheme Advisory Board and the Secretary of State of any changes which result in failure to meet the criteria**
- **Set out the proportion of assets that will be invested through pooling**
- **Set out the structure and governance arrangements of the pool and the mechanisms by which the authority can hold the pool to account**
- **Set out the services that will be shared or jointly procured**
- **Provide a summary of assets that the authority has determined are not suitable for investing through the pool along with its rationale for doing so, and how this demonstrates value for money;**
- **Regularly review any assets, and no less than every 3 years, that the authority has previously determined should be held outside of the pool, ensuring this continues to demonstrate value for money**
- **Submit an annual report on the progress of asset transfers to the Scheme Advisory Board**

Regulation 7(2)(e) - How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments

When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.

Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it.

The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and

corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.

However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

Investments that deliver social impact as well as a financial return are often described as “social investments”. In some cases, the social impact is simply in addition to the financial return; for these investments the positive social impact will always be compatible with the prudent approach. In other cases, some part of the financial return may be forgone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund.

Summary of requirements

In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority:-

- **Must take proper advice**
- **Should explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors**
- **Must explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments**
- **Should not pursue policies that are contrary to UK foreign policy or UK defence policy**
- **Should explain their approach to social investments**

Regulation 7(2)(f) - The exercise of rights (including voting rights) attaching to investments

The long-term investment interests of administering authorities are enhanced by the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest. Poor governance can negatively impact shareholder value.

Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure

and corporate governance, including culture and remuneration. Engagement by administering authorities is purposeful and can identify problems through continuing dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

Engagement enables administering authorities as long term shareholders to exert a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and corporate governance issues.

Administering authorities are encouraged to consider the best way to engage with companies to promote their long-term success, either directly, in partnership with other investors or through their investment managers, and explain their policy on stewardship with reference to the Stewardship Code. Administering authorities should become Signatories to the Code and state how they implement the seven principles and guidance of the Code, which apply on a “comply or explain” basis.

Concern has been expressed in the past about the scope of Regulation 12(2)(g) of the 2009 Regulations which, in effect, allowed each administering authority to decide whether or not to adopt a policy on the exercise of the rights attaching to investments, including voting rights. To increase awareness and promote engagement, Regulation 7(2)(f) now requires every administering authority to formulate a policy that reflects their stewardship responsibilities.

Summary of requirements

In formulating their policy on the exercise of rights, administering authorities:-

- **Must give reasons in their Investment Strategy Statement for not adopting a policy of exercising rights, including voting rights, attaching to investments**
- **Should, where appropriate, explain their policy on stewardship with reference to the Stewardship Code**
- **Should strongly encourage their fund managers, if any, to vote their company shares in line with their policy under Regulation 7(2)(f)**
- **May wish to appoint an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers, if any, and for reports on voting activity to be submitted annually to the administering authority**
- **Should publish a report of voting activity as part of their pension fund annual report under Regulation 57 of the 2013 Regulations**