Croydon Council

REPORT TO:	**PENSION COMMITTEE** **10 March 2015**
AGENDA ITEM:	**8**
SUBJECT:	**Emerging Market Equities**
LEAD OFFICER:	**Richard Simpson, Assistant Chief Executive (Corporate Resources and s.151 Officer)**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**

CORPORATE PRIORITY/POLICY CONTEXT:

Sound Financial Management: To paper recommends the Committee invest in emerging markets thereby ensuring the fund is diversified across geographical regions.

FINANCIAL SUMMARY:

There are no direct financial consequences for this report, although the choice of fund manager and their performance against target returns will impact on the performance of the Fund.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

1. RECOMMENDATIONS

1.1 The Committee agree to invest 5% of Fund’s value (circa £40 million) in an active emerging market equity fund and that allocation be funded from the fund’s current overweight equity position.

1.2 The Committee agree to delegate the selection of the particular active emerging market equity fund manager to the Assistant Chief Executive (Corporate Resources and s.151 Officer) in consultation with the Chairman and Vice Chairman of the Pension Committee.

2. EXECUTIVE SUMMARY

2.1 The case for a 5% investment in emerging market equities is outlined in Appendix A of this report.

3. DETAIL

3.1 The fund's equities are invested in a LGIM passive fund tracking the FTSE4Good index which holds no exposure to emerging markets. Previously the fund had exposure to emerging market equities principally through the Fidelity Institutional Select Emerging Markets fund and a smaller exposure in the GTP portfolio.

3.2 An allocation of 5% to emerging market equities is recommended to ensure the fund has diversity across all geographical regions.

3.3 Aon Hewitt, the fund's independent investment advisor, are of the view that emerging market equities are attractively priced in the current market and hence it is an opportune time to invest.

4. FINANCIAL CONSIDERATIONS

4.1 Appointment of an active emerging market equity manager will incur ongoing investment management fee which will be a charge against the Pensions Fund. However the benefits of diversifying the portfolio across geographic regions should outweigh this cost.

5. OTHER CONSIDERATIONS

5.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

6. COMMENTS OF THE SOLICITOR TO THE COUNCIL

6.1 The Council Solicitor comments that there are no direct legal implications arising from this report.

Approved by Gabriel MacGregor, Head of Corporate Law on behalf of the Council Solicitor & Director of Democratic & Legal Services

CONTACT OFFICER:

Nigel Cook, Head of Pensions and Treasury,
Chief Executives Department, ext. 62552.

BACKGROUND DOCUMENTS: none

Appendix A: Aon Hewitt: Emerging Market Equities

Aon Hewitt
Consulting | Investment Consulting Practice

London Borough of Croydon Pension Fund

Date: 17 February 2015
Prepared for: The Pension Committee
Prepared by: Daniel Carpenter
Dave Lyons

Emerging Markets Equities

Introduction

Aon Hewitt is in the process of carrying out a detailed investment strategy review for the London Borough of Croydon Pension Fund (“the Fund”). The objectives of the investment strategy review are summarised in the separate paper *'Investment Strategy Review – Next Steps'*.

At the investment strategy training workshop on 20 January 2015, discussion took place on the Fund's limited exposure to emerging market equities in light of the switch from the active equity managers to Legal & General Investment Management Limited ("L&G"). Given Aon Hewitt's current medium and long term investment market views, we recommend that the Pension Committee instigate a direct allocation to Emerging Market equities.

This paper provides the background to the Fund's approach to investing in Emerging Markets equities, an overview of the expected benefits of an allocation, Aon Hewitt's current medium and long term market views of the opportunity and our recommendation to the Pension Committee.

Background and high level recommendation

Previously the Fund had an allocation to Emerging Markets equities at the discretion of the Fund's active managers (principally Fidelity). As at 30 September 2014, this allocation was approximately 5% and was actively managed, meaning that the fund manager selected the underlying companies to invest in based on an expectation of future relative outperformance (as opposed to replicating an index).

Following the move of the assets from the three active managers to L&G there is no longer an opportunity for the Fund to potentially benefit from a discretionary allocation to Emerging Market equities. Emerging Market equities potentially offer the opportunity for greater rates of economic growth, and therefore investment return, than developed equity markets and therefore the Fund could benefit from an allocation. Furthermore, Aon Hewitt believes that there is currently an opportunity to invest into Emerging Market equities over the long term at relatively attractive valuations.

The ongoing investment strategy review will certainly result in a recommendation to allocate a proportion of the Fund to Emerging Market equities. Therefore we recommend that the Pension Committee agree to invest the current overweight equity balance into Emerging Market equities concurrent to the ongoing investment strategy review, with the agreed results of that review likely determining the extent to which that allocation is added to.

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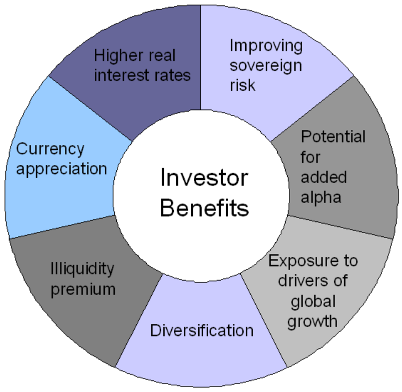
Investor benefits

There are various benefits that institutional investors expect to receive from Emerging Market equities exposure.

Emerging Markets do not suffer from such high debt levels and generally have strong and promising fundamentals. As the proportion of global growth from Emerging Markets grows and their capital markets develop, the proportion of global market capitalisation from Emerging Markets will also increase. Exposure to Emerging Markets now captures the growing importance and success of the emerging world, together with a range of other benefits summarised in the diagram below:



We do note, though, that the growth in Emerging Markets that we have experienced in the past will not necessarily be replicated going forwards in such a persistent fashion, despite all the structural positives for Emerging Markets. The global economic outlook is less bright than a decade ago and key markets (China, India) are encountering structural growing pains that could restrict investment and economic growth going forward. Growth rates will be uneven across regions.

Also, there is a lot of specific country risk across Emerging Markets countries with a wide range of stages of development. While this report groups Emerging Markets together, the heterogeneity of the group should not be ignored.

Historic performance

The table below shows the performance over various time periods for the main developed and Emerging Market equity indices. This shows that whilst performance has been variable over the shorter term, over the longer term Emerging Market equities have outperformed their developed market counterparts.

Emerging Markets: Strong Growth Relative to Developed Markets

Index Performance to 31 Dec 2014	1 Year (%)	5 Year (% p.a.)	10 Year (% p.a.)
Developed Equities	12.07%	11.59%	8.85%
Emerging Equities	3.97%	2.81%	11.06%

Source: Datastream

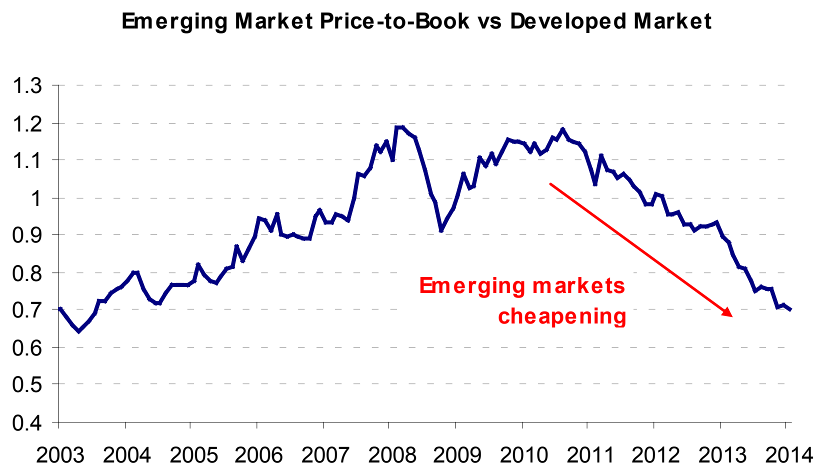
Whilst past performance is not necessarily a guide to future performance, as we have noted there are a number of underlying structural positives for making an allocation to Emerging Market equities.

Current opportunity

Over the long term, Aon Hewitt forecasts that Emerging Market equities will provide a 0.8% to 1.7% return premium over developed market equities. Whilst this is expected to be at up to 50% greater volatility, it is also with typically lower correlation to developed market equity regions than those regions have with each other (i.e. with some anticipated diversification benefits). Therefore, as we have stated, we believe that there is a long term case for investment in Emerging Market equities.

However, we also believe that there is a current opportunity to invest in Emerging Market equities at relatively attractive valuations i.e. Emerging Market equities currently represent relatively good value compared to other equity regions. This is implied by the one and five year relative performance of Emerging Market equities versus their developed market counterparts in the table in the previous section.

In fact, Emerging Market equities have underperformed developed markets by over 40% in return terms over past three years and the valuation case is the best for years, as illustrated in the chart below.



Source: BarCap, Datastream

The chart shows that Emerging Market equities are almost at their lowest valuation levels compared to their developed market counterparts since 2003.

Therefore, we believe that currently there is a particular opportunity to invest in Emerging Market equities at relatively attractive valuations.

Active versus passive management

It is possible to invest in Emerging Market equities on either an active or a passive basis.

Active management involves the investment manager considering the relative prospects for different companies within an index and then investing predominantly in those that are expected to do relatively better.

Passive management involves the investment manager investing in all of the companies in the index benchmark at their index weightings i.e. replicating that index as precisely as possible within their fund.

The Fund's global equities were previously managed on an active basis, but more recently have been moved to be managed on a specialist passive basis.

There are a number of arguments for and against both active and passive management:

Active Management

Advantages

- Ability to add value over passive alternative
- Larger opportunity set
- Possibility of more attractive risk adjusted returns versus liabilities

Disadvantages

- High management fees (0.7% - 1% for a small mandate sizes)
- Costs associated with selection, transition, monitoring and governance
- May underperform the benchmark

Passive Management

Advantages

- Low cost
- Little monitoring required
- Aim to track benchmark - unlikely to underperform

Disadvantages

- No possibility to outperform
- Manager will not take views on holdings/countries/sectors that could be considered overvalued
- Investment opportunity set limited to constituents of particular index and universe of indices

Whilst our primary concern is for our clients to gain exposure to Emerging Market equities and we are of the view that passive exposure is preferable to no exposure, Aon Hewitt's strong preference is for active management within Emerging Market equities. This is because there are pockets of emerging markets which are typically less well researched or covered than some traditional markets and because flows and investor sentiment can cause market distortions, and therefore an active approach should outperform in this area. Additionally, there can be social, economic and political risks associated with particular Emerging Market equities regions and countries at specific periods in time, for example in some of Emerging Europe and Russia at present which pure index investors are unable to avoid, but active managers might.

However, we recognise that many of the strategic benefits of investment in emerging markets can also be achieved from a passive approach and investment manager selection is key for actively managed mandates.

Recommendation and next steps

We recommend that the Pension Committee resolve to invest the current overweight equity balance (taken from the overweight position in developed market equity) into a specialist Emerging Markets equity fund.

The Pension Committee should agree whether they would prefer to appoint an active or a passive specialist Emerging Market equities investment manager.

This initial investment in Emerging Market equities should be undertaken whilst the current investment strategy review is ongoing, with a view to potentially adding to the allocation in light of discussion of the results of that review.

In order to achieve this, the Pension Committee should delegate the appointment of an appropriate specialist Emerging Markets equity fund manager to the Officers and their investment adviser.

We look forward to discussing this paper with the Pension Committee at the upcoming meeting on 10 March 2015.

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