CHESHIRE PENSION FUND

Investment Strategy Statement

2018

Published by: Cheshire Pension Fund,
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1. Introduction

This is the Investment Strategy Statement (the "Statement") of Cheshire Pension Fund (the "Fund") as required by regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the "Regulations").

The regulations require administering authorities to formulate and to publish a statement of its investment strategy, in accordance with guidance issued from time to time by the Secretary of State.

The ISS is an important governance tool for the Fund. The document sets out the current investment strategy of the Fund, provides transparency in relation to how the Fund's investments are managed, acts as a high level risk register, and has been designed to be informative for all stakeholders. This document replaces the Fund's Statement of Investment Principles.

In preparing this Statement, the Fund has consulted with such persons as it considers appropriate and the document will be updated based on any factors that the Fund considers material to its liabilities, finances or attitude to risk.

This statement will be reviewed at least triennially or more frequently if appropriate.

Any feedback or comments on this document should be addressed to the Pension Fund Manager and emailed to pensions@cheshirewestandchester.gov.uk.

2. Investment Objectives and Beliefs

The primary objective of the Fund is to provide pension and lump sum benefits for members on their retirement and/or benefits on death before or after retirement for their dependants, in accordance with LGPS Regulations.

The Funding Strategy and Investment Strategy are intrinsically linked and together aim to deliver stable contribution rates for employers and a reduced reliance on employer contributions over time.

The investment objective is therefore to maximise returns subject to an acceptable level of risk whilst increasing certainty of cost for employers, and minimising the long term cost of the scheme. Having a thorough understanding of the risks facing the Fund is crucial and these are covered later in this statement.

The Fund's investment beliefs which help to inform the investment strategy are as follows:

- Funding, investment strategy and contribution rates are linked
- The strategic asset allocation is the key factor in determining the risk and return profile of the Fund's investments
- Investing over the long term provides opportunities to improve returns
- Diversification across asset classes can help to mitigate against adverse market conditions and assist the Fund to produce a smoother return profile due to returns coming from a range of different sources.

- Managing risk is a multi-dimensional and complex task but the overriding principle is to avoid taking more risk than is necessary to achieve the Fund's objectives
- Environmental, Social and Governance are important factors for the selection and sustainability of investment returns over the long term
- Value for money from investments is important, not just absolute costs. Asset pooling will help reduce costs whilst providing more choice of investments and will therefore improve Fund returns.
- High conviction active management adds value to returns over the long term.

3. Investment Strategy and the Process for Ensuring Suitability of Investments.

Translating the Fund's investment and funding objectives into a single suitable investment strategy is challenging. The key objectives often conflict. For example, minimising the long term cost of the scheme is best achieved by investing in higher returning assets e.g. equities. However, equities are also very volatile (i.e. go up and down fairly frequently in fairly large moves), which conflicts with the objective to have stable contribution rates.

Additionally, the number of employers in the Fund has increased significantly in recent years meaning that there are groups of employers with different underlying characteristics and with different long term funding objectives.

In order that the Fund delivers on its key objectives (ensuring that each employer takes the appropriate level of investment risk, giving each the best opportunity possible to achieve its long term funding objective whilst increasing certainty of cost), the Fund operates four distinct investment strategies.

Each investment strategy has its own strategic asset allocation benchmark. The strategic benchmark is consistent with the Fund's views on the appropriate balance between generating required long-term returns, whilst taking account of market volatility, risk and the nature of the Fund's liabilities.

The Fund is required to monitor its investment strategy relative to the agreed asset allocation benchmark in order to ensure that it remains consistent with the overall objective. The Fund undertakes a fundamental review of the strategic asset allocation every three years following actuarial valuations. The Fund also monitors compliance with this statement at least quarterly and monitors progress towards the long term funding objective for relevant groups of employers at least monthly.

The strategic asset allocation at 1 April 2018 for each of the four investment strategies is shown in table 1.

Table 1 – Strategic Asset Allocation

		Investment Strategy (%)			
Asset Class	Investment Objective	Growth A	Growth B	Medium Growth	Gilts
Growth		**60**	**50**	**50**	**-**
Equity	- Exposure to global equity markets. - Outperform global equity markets - Contains high conviction active strategy with meaningful outperformance target.	30	20	20	-
Absolute Return	-Provide significant real returns (currently CPI + 5%) -Lower volatility than equities. -Low correlation to equities (beta). -Preserve capital at times of stress	15	15	15	-
Illiquid Alternatives	- Long term returns in excess of public equity markets - Access to assets that provide link to inflation	15	15	15	-
Diversifying & Matching		**40**	**50**	**50**	**-**
Diversifying Fixed Income	- Unconstrained exposure to fixed income - Focus on return generation - Flexible duration	20	20	20	-
Liability Aware	- Access to assets which provide liability matching characteristics such as movements in interest rates and inflation	20	30	30	100

The Fund allows asset allocations to fluctuate around the target allocations subject to the tolerances set out in table 2 overleaf.

In addition to the fundamental review of the strategic asset allocation undertaken every three years, the Fund monitors progress of employers within Growth Strategies A and B on a monthly basis. This gives the Fund the opportunity to adjust the strategic asset allocation in the event that a group of employers are ahead or behind their funding plan. This is an important mechanism used by the Fund to ensure that each employer continues to take the appropriate level of investment risk, giving each the best opportunity possible to achieve its long term funding objective whilst increasing certainty of cost. The progress of employers in Medium Growth Strategy and Gilts Strategy is monitored every three years as these employers are already invested in their “target funding plan”.

A full explanation of the process undertaken to assess employer funding progress is provided in the Fund’s Investment Risk Management document which is published on the website.

Table 2 – Tolerance Ranges

Asset Class	Growth Strategies A and B	Medium Growth
Equities	+/-5%	+/-2.5%
Absolute Return	+/-2.5% (rebalancing dependent on magnitude, cost and liquidity)	+/-2.5% (rebalancing dependent on magnitude, cost and liquidity)
Illiquid Alternatives	+/-2.5% (rebalancing dependent on magnitude, cost and liquidity)	+/-2.5% (rebalancing dependent on magnitude, cost and liquidity)
Diversifying Fixed Income	+/-2.5%	+/-2.5%
Liability Aware Assets	+/-2.5%	+/-2.5%

The maximum percentage of assets to be held in each asset class is set out in table 3.

Table 3 – Maximum Allocations

Asset Class	Growth Strategies A and B[1]	Medium Growth
Equities	25.0%	25%
Absolute Return	17.5%	17.5%
Illiquid Alternatives	17.5%	17.5%
Diversifying Fixed Income	22.5%	22.5%
Liability Aware Assets	32.5%	32.5%

Infrastructure

The Fund is committed to increasing its exposure to infrastructure assets where this aligns with the overarching investment and funding objectives. Infrastructure investing comes in many forms and the Fund's investment strategy enables the potential for infrastructure to be included within both the Illiquid Alternatives and Diversifying Fixed Income portfolios. The Fund's long term aspiration is to target an infrastructure allocation of up to 10% of Fund assets and this will be explored further by the Fund through its partnership with LGPS Central.

[1] Maximum allocations for Growth Strategy A and B reflect the maximum allocation that would apply where the investment strategy is on the last step as part of the risk management framework i.e. has moved through the 97% funding level trigger (see the Risk Management/De-risking Strategy on the Fund's website for further details).

A fundamental review of the strategic asset allocation is undertaken every three years following the actuarial valuation that provides assurance that the investment strategy is aligned to the long term funding plan. This review utilises both qualitative and quantitative analysis, and covers;

- The required level of return that will mean the Fund can meet its future benefit obligations as they fall due.
- The level of risk that the Fund can tolerate in absolute terms, and in relation to its funding level and deficit.
- A reassessment of the pace of de-risking in line with the risk management process described above.
- An analysis of the order of magnitude of the various risks facing the Fund is established in order that a priority order for mitigation can be determined.
- The desire for diversification across asset class, region, sector, and type of security.

4. Risk measurement and management

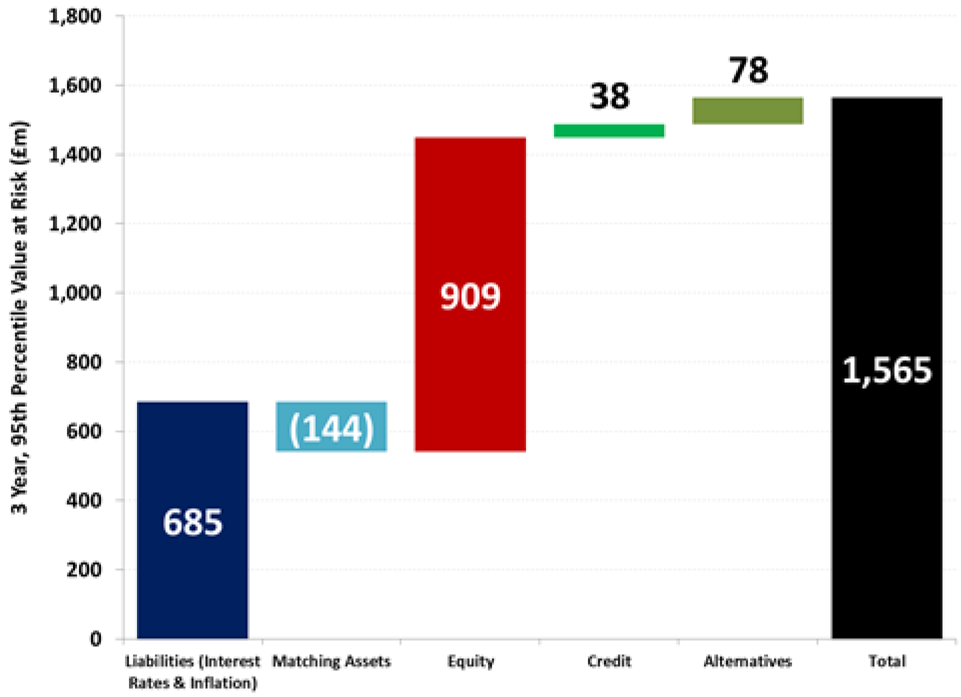
The Fund assesses risks both qualitatively and quantitatively, with the starting point being the investment strategy review which is undertaken every three years. The Fund's approach to risk is informed by the Pension Fund Committee, its professional advisors and officers of the Fund.

The key risks that the Fund is exposed to can be grouped under the following headings: investment, funding, operational and governance. These risks are identified, measured, monitored and managed on an active basis with the Pension Fund Manager being responsible for the oversight of this process.

These risks are summarised as follows:

A. <u>INVESTMENT RISK</u>

The Fund uses Risk Attribution Analysis to better understand the order of magnitude of the main investment risks the Fund is facing and to inform decision making and resource planning. The chart below shows the VaR (Value at Risk, essentially the increase in the deficit that would occur in a 1-in-20 downside event) facing the Fund, split into major risk categories.



This is purely an illustration of the potential downside risk at a point in time (in this case 31 March 2018) and helps the Fund to prioritise its resources towards the areas of greatest risk.

As an additional illustration of risk, table 4 below shows how a range of events could impact the Fund:

Table 4 – Sensitivity Analysis

Event	Event movement	Impact on Deficit
Fall in equity markets	20% fall in equities	c.£484m
Rise in Inflation	1% increase in inflation	c.£650m
Fall in interest rates	1% fall in interest rates	c.£746m[2]
Active Manager underperformance	3% underperformance from all active managers	c.£71m

As shown in both the Value-at-Risk attribution chart and the sensitivity analysis, the highest allocation of investment risk currently relates to interest rate and inflation.

[2] Based on 2016 valuation report

Interest Rate and Inflation – The investment strategy recognises risk and looks to increase the allocation to assets that provide protection against falling rates and rising inflation expectations when affordable to do so, which is considered appropriate in the context of the Fund's position as a long term investor.

Equities – The Fund holds equities in order to provide the necessary returns to ensure that the Fund remains viable. The Fund believes that the extra returns that are expected to be generated by equities over the long term compensates for the risk involved in equity investing. The investment strategy is diversified which helps to mitigate equity risk by investing significantly in bonds and alternatives.

Alternatives – The risks associated with investing in alternative asset classes including absolute return, property and private equity are relevant considerations when assessing the overall level of risk within the investment strategy. The Fund believes that over the long term, alternative asset classes will provide a level of return that compensates for the inherent risk. The additional level of diversification provided by these assets helps to reduce the Fund's reliance on equity returns. At the aggregate Fund level, investing in alternative asset classes reduces the overall level of risk.

Active Manager Risk – The Fund undertakes extensive due diligence on its appointed investment managers and formally monitors performance on a quarterly basis. This process is overseen by the Investment Sub Committee and is advised by Officers and the Fund's advisors.

Liquidity risk: The Fund invests in both liquid and illiquid assets meaning that not all assets can be realised at short notice. Given the long term investment horizon, the Fund accepts some liquidity risk given the potential for higher returns. The Fund monitors its liquidity position carefully to ensure that it is not a forced seller of long term assets in order to make day to day payments of benefits. Around 80% of fund assets are highly liquid.

Exchange rate risk: The Fund as a long term investor can tolerate some short term currency fluctuations, however this is managed carefully by its investment managers who are monitored against Sterling benchmarks and therefore use hedging techniques to contain this risk.

B. FUNDING RISK

The Fund's investment strategy is a fundamental part of ensuring that the risk of deterioration in funding level is managed effectively. Employer contribution strategies are aligned with the investment strategy; There are, however, a number of factors that could lead to a disconnect between the investment and contribution strategies. These risks are set out below:

Demographic risks - The Fund is subject to a range of demographic risks, but with particular reference to investment strategy, the Fund monitors the maturity of the membership base closely. A more mature membership base would mean that there were a greater number of pensioner members receiving benefits than active members paying contributions. The projected maturity of the membership base is factored into the investment strategy in order to ensure that as the membership base matures, the fund is invested in the appropriate level of income generating investments or investments that are realisable at short notice and at low cost.

C. OPERATIONAL RISK

Operational risks arise through the implementation of the Fund's investment strategy. These risks are set out below:

Transition risk – The Fund may incur unexpected costs in relation to the transition of assets between managers and/or asset classes. When carrying out significant transitions, the Fund takes professional advice and considers the appointment of specialist transition managers in order to mitigate this risk when it is cost effective to do so.

Custody risk – The Fund must ensure that it retains the economic rights to all Fund assets, when held in custody or when being traded. It does this through the use of a global custodian for custody of assets, the use of formal contractual arrangements for all investments and maintaining independent investment accounting records.

Credit default risk – A counterparty related to a Fund investment could fail to meet its contractual obligations. The Fund monitors this through robust internal compliance arrangements where applicable, contractual requirement for investment managers to manage counterparty risk on the Fund's behalf and robust due diligence prior to making any investment.

D. GOVERNANCE RISK

Good governance is an essential part of the Fund's investment strategy and the Fund therefore identifies **poor governance** as a potential risk that can have a detrimental effect on the funding level and the deficit. The Fund ensures that its decision making process is robust and transparent and this is documented in the Governance Compliance Statement which is published on the Fund's website.

Environmental, Social and Governance risks – The Fund's investment strategy contains its own policy on Responsible Investment. Non-compliance with this policy would expose the Fund to financial and reputational risk. The Fund believes that effective management of financially material Responsible Investment risks should support the Fund's requirement to protect returns over the long term. The Fund will seek to further integrate Responsible Investment factors into the investment process across all relevant asset classes. Further information on the Fund's approach to managing this risk is provided within the Responsible Investment Policy which is published on the Fund's website and as an appendix to this document.

5. **Approach to asset pooling**

LGPS Central Ltd has been set up as an arms-length company, accredited by the Financial Conduct Authority, to manage the pooled investment assets of eight LGPS funds across the centre of England. The Cheshire Pension Fund is one of the eight partner funds, all of whom hold equal shares in the company. LGPS Central started trading on 3rd April 2018 and all partner funds will gradually start to migrate assets to the company over the next few years. The Fund is participating in the LGPS Central pool with the belief that the Fund will benefit from lower investments costs achieved through the aggregation of assets. In addition, the Fund will have greater access to a broader range of investable asset classes, including new and innovative products and services. LGPS Central and the partner funds have put in place a robust governance framework to ensure the company operates effectively and delivers timely and transparent reporting to shareholders and client funds.

The Fund will retain full responsibility and control over its strategic investment allocation policy with LGPS Central being responsible for implementing the strategy via the engagement and dismissal of managers and the day to day monitoring of manager investment performance. Subject to satisfactory due diligence and value for money considerations being satisfied, the Fund intends to invest all its assets with LGPS Central but will maintain some cash balances locally.

6. Responsible Investment

The Cheshire Pension Fund is a long term investor aiming to deliver a sustainable Pension Fund for all stakeholders.

Cheshire West and Chester Council, as the administering authority of the Fund, has a fiduciary duty to act in the best, long-term, interests of the Fund's employers and members. The Fund believes that in order to fulfil this duty, it must have a clear policy on how it invests in a responsible manner.

Responsible Investment is a fundamental part of the Fund's overarching investment strategy as set out in this Investment Strategy Statement – that is to maximise returns subject to an acceptable level of risk whilst increasing certainty of cost for employers, and minimising the long term cost of the scheme. The Fund believes that consideration of Environmental, Social and Corporate Governance ("ESG") factors are fundamental to this, particularly where they are likely to impact on the overarching investment objective.

The Fund's approach aims to ensure that consideration of ESG factors is embedded in the investment process, utilising the various tools available to manage ESG risks and to harness opportunities presented by ESG factors.

The Fund's core principles of responsible investment are:

1. We will apply **long-term thinking** to deliver **long-term sustainable returns**.
2. We will seek **sustainable returns** from **well-governed assets**.
3. We will use an **evidence-based** long term investment appraisal to inform **decision-making** in the implementation of RI principles and consider the costs of RI decisions consistent with our fiduciary duties.

The way in which the Fund ensures that these core principles are met, and how it monitors its own performance is provided within the Responsible Investment Policy.

7. Myners Principles

Although not specifically referenced in the Regulations, the Fund continues to assess its own compliance with the Myners Principles of Good Investment Governance. A statement that sets out an assessment of compliance is presented in appendix A.

8. Advice taken

In creating this statement, the Fund has taken advice from its Officers and its Investment Consultant. Also, in relation to each of the constituent parts, such as the asset allocation and risk mitigation, the Fund has taken advice from its Investment Consultant, Mercer, and the Scheme Actuary, Hymans Robertson. In providing investment advice, Mercer is regulated by the Financial Conduct Authority.

APPENDIX A – COMPLIANCE WITH MYNERS PRINCIPLES OF GOOD INVESTMENT GOVERNANCE

Principle	Evidence of Compliance
Principle 1 Effective Decision Making: Administering authorities should ensure: • That decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make them effectively and monitor their implementation; and • That those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.	**Compliant** Decisions are taken by the Section 151 Officer of the Administering Authority, advised by the Pension Fund Committee. The Section 151 Officer and the Committee has support from Council officers with sufficient experience to assist them. The Fund is also advised by professional actuarial and investment advisers. The Committee makes robust challenges to advice and is aware of where potential conflicts of interest may reside within the Committee and in relation to service providers.
Principle 2 Clear objectives: An overall investment objective should be set out for the fund that takes account of the scheme's liabilities, the potential impact on local tax payers, the strength of the covenant for non-local authority employers, and the attitude to risk of both the administering authority and scheme employers, and these should be clearly communicated to advisers and investment managers.	**Compliant** The Fund has established investment objectives which take account of the nature of Fund liabilities and the contribution strategy. The objectives are set based on advice from the Fund Actuary and Strategic Investment Advisor which informs the overall risk budget for the Fund. The overarching objective is reflected in the investment mandates awarded to the asset managers. There is dialogue with admitted bodies within the Fund in relation to the contributions they pay, their capacity to pay these contributions and the level of guarantees they can provide.
Principle 3 Risk and liabilities: • In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities. • These include the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk.	**Compliant** The investment strategy is considered in the light of the nature of the Fund liabilities, the timescale over which benefits will be paid, and financial and demographic factors affecting the liabilities, such as inflation and improving longevity. The Pension Fund Committee and Council officers challenged the contribution strategy with the Actuary, in order that it takes into account of risk factors for the Fund including strength of covenant. Discussions have also taken place with admitted bodies in relation to the affordability of contributions and the strengths of their covenants.

Principle	Evidence of Compliance
Principle 4 Performance assessment: • Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisers. • Administering authorities should also periodically make a formal assessment of their own effectiveness as a decision-making body and report on this to scheme members.	**Partially compliant** The performance of the Fund and its individual managers are monitored on a regular basis. The quality of advisers is assessed on a qualitative basis and is subject to periodic retender in order to ensure value for money. The Pension Fund Committee does not yet have a formal process in place to measure its own effectiveness.
Principle 5 Responsible Ownership: Administering authorities should • adopt, or ensure their investment managers adopt, the Financial Reporting Council's (FRC) Stewardship Code on the responsibilities of shareholders and agents. • include a statement of their policy on responsible ownership in the Investment Strategy Statement. • report periodically to scheme members on the discharge of such responsibilities.	**Compliant** The Pension Fund Committee encourages its investment managers to adopt the Financial Reporting Council's (FRC) Stewardship Code on the responsibilities of shareholders and agents on the Fund's behalf and all relevant managers comply. This Investment Strategy Statement includes a statement on the Fund's policy on responsible ownership. The Fund will publish an annual summary of voting and engagement activity.
Principle 6 Transparency and Reporting: Administering authorities should • act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives. • should provide regular communication to scheme members in the form they consider most appropriate.	**Compliant** The Fund maintains minutes of all Pension Fund Committee meetings and documents all key decisions through the EDN and ODN process. Minutes are available on the Fund website. The Council holds a formal annual meeting for members and also meets periodically with sponsoring employer bodies. A member representative attends Committee meetings. The Investment Strategy Statement is published on the Fund's website and is available to members on request. Other information on the Scheme is available to members on the Fund's website.

Glossary of Terms

Term	Definition
Absolute return	A fund that aims to achieve a positive return irrespective of movements in the equity and bond markets.
Alternatives	Typically seen as an "unconventional" asset class – i.e. an asset class, other than traditional asset classes such as equities, bonds, property and cash.
Bonds	A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate. Seen as a good "matching" asset for a pension scheme.
De-risking	Moving from growth to matching assets to reduce risk.
Diversifying fixed income	A bond like investment that is return seeking and provides a different source of return other than equities.
Equities	A share in a company. Seen as a "risky" or "growth" asset from a pension scheme perspective.
Flight path	The expected change in the Fund's funding position over time, allowing for contributions and investment returns.
Funding basis	The assumptions used by the Scheme Actuary to place a value on the Fund's liabilities (the value of the benefits to be paid out of the Fund).
Funding level	The difference in the value of the Fund's assets and liabilities. Assesses the financial health of the Fund.
Illiquid alternatives	An asset which is not easily traded (i.e. cannot be converted into cash quickly or without an impact to the price received)
Liquid asset	An asset which is easily traded (i.e. can be converted into cash quickly and with minimal impact to the price received)
Stochastic modelling	Stochastic modelling is a form of financial modelling that includes one or more random variables. The purpose of such modelling is to estimate how probable outcomes are within a forecast to predict conditions for different situations.
Target funding plan	The "targeted" investment strategy assuming a favourable funding position has been reached. It should be noted that whilst a specific asset allocation may be targeted, in practice this may change over time depending upon market opportunities and Fund specific events (e.g. make-up of the liability profile – proportion of pensioners / non pensioners etc).
Trigger point	Instigates a change in the growth / defensive split of the Fund based on the Fund's funding position at a point in time.