WIRRAL COUNCIL

PENSIONS COMMITTEE

16 JULY 2019

SUBJECT:	**SYSTEMATIC INVESTMENT**
WARD/S AFFECTED:	**NONE**
REPORT OF:	**DIRECTOR OF PENSIONS**
KEY DECISION?	**NO**

1.0 EXECUTIVE SUMMARY

1.1 This report provides Members with a further update on the progress made in the development of internally managed factor-based investment strategies.

2.0 BACKGROUND AND KEY ISSUES

2.1 In January 2018, Committee gave approval for the Director of Pensions to continue the development and implementation of an internally managed factor portfolio consistent with the philosophy outlined in the report to Committee.

2.2 I am pleased to inform Committee that a global multifactor portfolio was funded in March this year with an initial investment of around £200m. This followed extensive back-testing and verification by the investment team in conjunction with FTSE Russell who provided assurance around the multifactor process we have adopted. Considerable modification to internal operational processes and procedures was also required and these have been reviewed by internal audit and a satisfactory audit opinion received. The Fund's Compliance Manual is being updated with these changes and will be brought to a future meeting of this Committee.

2.3 Assets were transitioned from the UK Optimised Interim Portfolio to fund the factor portfolio. MJ Hudson provided an independent assessment of the transition arrangements.

A pre-trade analysis estimated the cost of implementing these changes to be 0.47% of the fund value. The annualised hedged tracking error between the legacy and target portfolios of 2.95% gave rise to a range of +/- 0.27% around this central cost estimate. The final transition shortfall result of 0.12% is below the central cost estimate and below the one standard deviation opportunity cost range. This was mainly driven by the effectiveness of the hedging strategy and the transition manager's ability to trade the more illiquid names.

2.4 The appendix attached provides an overview of the factor portfolio’s philosophy and process which is intended to be complementary to the existing mix of internal and external portfolios.

2.5 In view of the successful initiation of this portfolio, we are continuing to work on further opportunities to deploy systematic strategies and increase the proportion of internally managed assets, consistent with our pooling objectives.

3.0 RELEVANT RISKS

3.1 The Fund diversifies its equity mandates with regard to mandate size and style. The first explicitly factor driven portfolio was implemented through an external investment mandate in 2009. It is important that any changes to mandate style and structure have due regard to both investment and operational risks.

4.0 OTHER OPTIONS CONSIDERED

4.1 The option of engaging external investment managers has been considered.

5.0 CONSULTATION

5.1 N/A.

6.0 OUTSTANDING PREVIOUSLY APPROVED ACTIONS

6.1 There are no previously approved actions outstanding.

7.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

7.1 There are none arising from this report.

8.0 RESOURCE IMPLICATIONS: FINANCIAL; IT; STAFFING; AND ASSETS

8.1 The portfolio has been implemented within the projected cost structure and is on track to deliver the cost savings anticipated.

9.0 LEGAL IMPLICATIONS

9.1 There are none arising from this report.

10.0 EQUALITIES IMPLICATIONS

10.1 Has the potential impact of your proposal(s) been reviewed with regard to equality?

(b) No because there is no relevance to equality.

11.0 CARBON REDUCTION AND ENVIRONMENTAL IMPLICATIONS

11.1 There are no carbon usage implications, nor any other relevant environmental issues arising from this report.

12.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

12.1 There are none arising from this report.

13.0 RECOMMENDATION/S

13.1 That Members note the report and the progress made in increasing the proportion of internally managed assets.

14.0 REASON/S FOR RECOMMENDATION/S

14.1 This portfolio change is consistent with the government's pooling criteria to reduce costs whilst maintaining investment performance.

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APPENDICES

Report on systematic investing.

BACKGROUND PAPERS/REFERENCE MATERIAL

BRIEFING NOTES HISTORY

Briefing Note	Date

SUBJECT HISTORY (last 3 years)

Council Meeting	Date
Pensions Committee **Pensions Committee**	**January 2018** **September 2017**

APPENDIX

Factors are sources of systematic risk which empirical evidence suggests generate a return premium for those market participants willing to assume such risk.

It is the objective of Merseyside Pension Fund to deliver superior long-term risk-adjusted returns relative to the appropriate market capitalisation-weighted index through the design and implementation of a global developed market equity multifactor portfolio.

Merseyside Pension Fund is employing a proprietary, rules-based methodology to construct a portfolio whose exposure to five factors is equally-sized; whilst simultaneously satisfying constraints pertaining to capacity and diversification. Adhering to capacity constraints means one can effectively implement/trade the strategy in the global equity markets; whilst diversification constraints limit our exposure to idiosyncratic risk (i.e. a source of risk whose exposure to we are not necessarily rewarded).

Each factor to which the portfolio is exposed is supported by a body of academic research; with strong theoretical explanations as to why exposure has historically provided excess return to those willing to assume such risks. These factors, together with their associated observations and means of capture, are as follows:

Factor	Observation	Implementation
Low volatility	Low volatility stocks outperform high volatility stocks	Taking market capitalisation index weights as the starting point, tilt towards low volatility stocks and away from high volatility stocks
Value	Cheap stocks outperform expensive stocks	Taking market capitalisation index weights as the starting point, tilt towards cheap stocks and away from expensive stocks
Momentum	High momentum stocks outperform low momentum stocks	Taking market capitalisation index weights as the starting point, tilt towards high momentum stocks and away from low momentum stocks
Quality	High quality stocks outperform low quality stocks	Taking market capitalisation index weights as the starting point, tilt towards high quality stocks and away from low quality stocks
Size	Small company stocks outperform large company stocks	Taking market capitalisation index weights as the starting point, tilt towards small company stocks and away from large company stocks

Merseyside Pension Fund's decision to target several factors in parallel (thus, adopting the so-called 'multifactor approach') as opposed to any one factor in isolation (i.e. 'single factor approach') is shaped by a significant body of empirical evidence which suggests that a portfolio whose exposure is to any single factor; whilst statistically-likely to outperform its associated cap-weighted benchmark over the long-term; is prone to performance cyclicality; outperforming in either pro or countercyclical economic environments. Thus, the act of combining exposure to multiple factors whose long-term return series are lowly-correlated should, mathematically, serve to improve the level of risk-adjusted return the portfolio delivers.

Merseyside Pension Fund’s chosen methodology for combining exposure to multiple factors within a single portfolio is, again, shaped by the empirical evidence, which suggests that an integrated (‘bottom-up’) approach is superior is a composite (‘top-down’) one; the reason being that, independent of the starting universe, the former constructs a portfolio whose factor exposure per unit of diversification is superior.

To manage the issue of factor drift, whereby the level of factor exposure the portfolio has decays as a function of time, Merseyside Pension Fund will rebalance on a semi-annual basis. Again, this decision is supported by empirical evidence which suggests that a semi-annual rebalance periodicity strikes the right balance between revenue (i.e. factor return) and cost (i.e. trading cost, amongst other things).

Merseyside Pension Fund has committed c. £200mn to this portfolio; the source of these funds being the UK Optimised Interim Portfolio.