AGENDA ITEM 6
REPORT NO. PC/03/18

HIGHLAND COUNCIL

Committee:	Pensions Committee and Board
Date:	8 February 2018
Report Title:	Statement of Investment Principles
Report By:	Director of Corporate Resources

1. Purpose/Executive Summary

1.1 The purpose of this report is to seek approval from Members on the proposed Statement of Investment Principles for the Highland Council Pension Fund (HCPF).

The Statement of Investment Principles is prepared as required by the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 (No. 233).

2. Recommendations

2.1 The Committee is asked to approve the Statement of Investment Principles.

2.2 The Committee is asked to approve the following changes to the strategic benchmark in order to increase the expected return and reduce volatility in the portfolio:
- reduce equities from 61% to 56%;
- reduce bonds from 20% to 12%; and
- reinvest the proceeds in illiquid and liquid alternative assets.

3. Introduction

3.1 The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 (No. 233)[1] require administering authorities to prepare, maintain and publish a written statement of principles (SIP) that govern their decisions about investments. The SIP must be reviewed regularly and should be updated when there are material changes in policy.

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[1] http://www.legislation.gov.uk/ssi/2010/233/crossheading/investment-and-use-of-pension-fund-money/made

4. Governance

4.1 The Highland Council is the Administering Authority for the Highland Council Pension Fund ("the Fund").

4.2 The Highland Pensions Committee and Board has delegated responsibility for the supervision of the Funds.

4.3 The appointment of Investment Consultants, Actuaries and Performance Measurement Consultants to give advice and assist in the discharge of the Authority's responsibilities is conducted by Officials of the Authority under competitive tendering procedures. Details of the current Investment Consultants, Actuaries and Performance Measurement Consultants are at Appendix 3.

4.4 The SIP forms part of a framework that includes:

- The Statutory Regulations
- The Pensions Board
- The Pensions Committee
- The Investment Sub Committee
- The Funding Strategy Statement
- Administration Strategy
- Governance Policy

4.5 As set out in the 2010 Regulations, the SIP should set out policy on the following:

- the types of investment to be held (Appendix 2)
- the balance between different types of investment (Appendix 2)
- risk, including the ways in which risks are to be measured and managed (section 9)
- the expected return on investments (section 12)
- the realisation of investments (section 14)
- the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments (section 16)
- the exercise of the rights (including voting rights) attached to investments (section 18)
- stock lending (section 19)

4.6 In addition, the statement must also cover the extent to which the authority complies with guidance provided by the Scottish Ministers and, to the extent it does not comply, the reasons for not complying.

5. Pension Fund Ownership and Responsibilities

5.1 The administration of the Fund is a statutory duty on the Council required by Regulations made under the Superannuation Act 1972. It is neither a joint function with other Councils nor a lead authority arrangement. The Fund's status is that of a Fund of the Council, which is regulated by statutory instruments. The Fund has no separate legal identity from the Council.

5.2 Elected Members of the Council, therefore, who serve on the Pensions Committee and Board, and Investment Sub-Committee, serve not as Trustees but in the same capacity that they serve on other Committees of the Council. It is, however, widely held that in administering LGPS Funds, Councillors are in the same position as a body of Trustees and, in recent years, the term "Quasi Trustee", has come into use to describe Councillors acting in this capacity.

5.3 The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 includes instructions on the appointment of Investment Managers. The Regulations also require Quasi Trustees to consider the suitability of particular investments, ensure diversification of the investments and requires them to obtain and consider proper advice, at reasonable intervals, about their investments.

6. Description of Fund's liabilities

6.1 The LGPS is a defined benefit pension scheme which provides benefits related to final salary for Members. Each Member's pension is specified in terms of a formula based on salary and service and is unaffected by the investment return achieved on the Fund's assets.

6.2 The employing bodies are responsible for meeting the balance of costs necessary to finance the benefits under the Scheme and their contribution rates are determined from time to time based on the advice of the Fund's Actuary.

6.3 The Regulations require the level of employers' contributions to be as stable as possible.

6.4 Beneficiaries have an interest in the extent to which the Fund's assets are sufficient to meet accrued benefits albeit their benefits are guaranteed by the Regulations. The employers however, have a direct financial interest in the investment return achieved on the Fund's assets since they have a direct bearing on their own costs.

7. Liability Profile

7.1 The funding level shown by the last full Actuarial Valuation at 31/03/17 compared to the valuation at 31/03/14 is shown below.

31/03/14	**Past Services Liabilities**	**31/03/17**
%		**%**
47	Active Members	43
14	Deferred Pensions	16
39	Pensioners	41
£m		**£m**
1,331	Total Liabilities	1,740
1,279	Assets	1,753
(52)	Surplus (Deficit)	13
96.2%	Funding Level	101%

7.2 Active membership liabilities, therefore, are slowly decreasing as a proportion of total membership while the deferred numbers show a slight increase. The Fund's overall liability profile is not untypical of the general position of Funds in the LGPS and many LGPS Funds are much more mature (number of pensioners is equal or greater than number of active members).

7.3 The main actuarial assumptions contained in the last Valuation are set out in Appendix 1.

8. Funding Strategy

8.1 A Funding Strategy Statement for the Pension Fund has been prepared in accordance with Regulation 75A (1) of the Local Government Pension Scheme (Scotland) Regulations 1998 as amended by the Local Government Pension Scheme (Scotland) Amendment Regulations 2005. The Statement describes the strategy of the Highland Council in acting in its capacity as Administering Authority for the funding of the Highland Council Pension Fund.

The Statement is included as an item on this meeting's Agenda and will be published on the Fund's website.

9. Investment Policy

9.1 The Fund's Investment Policy will be directed to ensuring that in normal market conditions, all accrued benefits are fully covered by the actuarial value of the Fund's assets and that an appropriate level of contributions is agreed by the administering authority to meet the cost of future employees' benefits accruing.

9.2 The existence of surpluses or deficits from previous valuation periods can reduce or increase the contributions made by employers. Volatility in the employers' contribution rate is undesirable and policy will be directed towards ensuring as stable a contribution rate as possible.

9.3 While stability of cost has the higher priority, absolute cost to the employer is also important. This implies:

- that the cost of administering the Fund will be constrained by the adoption of best management practice and benchmarked against leading public and private sector funds;
- that employers will adopt appropriate and economic policies in those areas where they have discretion and where the costs of their actions fall on the Fund;
- that the Fund will recover "strain on the Fund" costs to minimise cross subsidisation between employers;
- that the Fund's overall investment policy will be geared to the production of superior investment returns relative to the growth of liabilities. This implies that the Fund will continue to take an active risk relative to its liability profile.

9.4 The investment policy of the Fund is intended to strike an appropriate balance between the policy most suitable for the long term, consistent with the objectives outlined above.

9.5 The long term investment objective of the Fund is to achieve a real rate return of 3-4%

per annum on average. The Fund has a strategic benchmark for each Manager. In broadly defining the assets to be held and setting the asset allocation this benchmark provides an efficient balance between risk and return in light of the liability profile, and funding level of the Fund. There are changes proposed to the current asset allocation in order to reduce the overall risk in the Fund. The current assets as at 30 November 2017 and proposed asset allocation, is at Appendix 2.

9.6 The strategic benchmark is expected to produce a return over the long term in excess of the investment return assumed in the Actuarial Valuation. The Fund's assets are currently managed approximately 79% on an active basis and these are expected to outperform their respective benchmarks over the long term. The remainder is managed on an index tracking ("passive") basis. The plan to reduce equities and bonds will eventually result in the Fund's assets being managed approximately 89% on an active basis and 11% on a passive basis.

9.7 The Fund's strategic asset allocation is intended to achieve a satisfactory long term return commensurate with an acceptable level of risk (defined as volatility of returns).

9.8 The Council understand that active management may add to or subtract from the returns which could be achieved by managing the asset mix in a wholly passive manner but they believe that over the long term, active management should add value. This additional return is felt to be worth the increase in investment risk which results from the appointment of active managers.

10. Investment Responsibilities

10.1 The Fund pursues a policy of lowering risk through diversification of both investments and Investment Managers. It has delegated day to day investment decisions to Investment Managers.

10.2 The complete list of investment managers, their mandates and the target split of the Fund is attached as Appendix 3. Management agreements are in place for each Investment Manager, which set out the relevant benchmark performance target, asset allocation ranges, and any investment restrictions.

10.3 The adoption of a strategic benchmark and the explicit monitoring of performance relative to performance targets constrain the Investment Managers from deviating significantly from the intended approach, while permitting flexibility to manage the Fund in such a way as to enhance returns. The division of investment responsibilities is set out below.

10.4 The Council is responsible for:-

- Preparing the Statement of Investment Principles;
- Monitoring compliance with the Statement and reviewing its contents, at least annually;
- The establishment and review of strategic asset allocation benchmarks and targets;
- Appointing the Investment Manager(s) and any external Consultant(s) felt to be necessary;
- Appointing the Custodian(s);
- Reviewing on a regular basis, the Investment Managers' performance against

established benchmarks, and satisfying themselves as to the Managers' expertise and the quality of their internal systems and controls; and

- Compliance with relevant legislation including the Markets in Financial Instruments Directive II (MiFID II).

10.5 The Investment Managers are responsible for:-

- The investment of the Fund's assets in compliance with prevailing legislation and the constraints imposed by each Managers' detailed Investment Management Agreement or limited Partnership Agreement with a view to giving effect to the principles contained in this document so far as reasonably practicable;
- Tactical asset allocation around the benchmarks set out in the Investment Management Agreements;
- Selection of individual securities within asset classes;
- Preparation of a quarterly review of investment performance;
- Attending review meetings at the Council's request;
- Preparation of an annual certificate of compliance with this document;
- Notifying the Council promptly of any breach of their investment management responsibilities as set out in the Investment Management Agreements, this Guide and in the Statement of Investment Principles;
- Providing details in a timely manner to the organisation responsible for the Fund's Performance Measurement (currently the Northern Trust Company), to enable them to calculate the rate of return achieved on the Fund's investments.

10.6 The Custodians are responsible for:-

- The safekeeping of assets and the execution of transactions in accordance with the Custody and Securities Lending Agreements;
- Their own compliance with prevailing legislation;
- Providing the Council with quarterly holding lists of the Fund's assets and details of all transactions during the quarter.

10.7 The Actuary is responsible for:-

- Providing the Council with advice as to the maturity of the Fund and its funding level to aid the 'Trustees' in balancing the investment objectives of the Fund through the Actuarial Valuation.

10.8 The Investment Consultants are responsible for:-

- Assisting the Council in the preparation and review of this document if required.
- Providing the Council with advice relating to the establishment of strategic asset allocation benchmarks and any associated ad-hoc investment considerations.

11. Control of Risk

11.1 The Fund pursues a policy of lowering risk through diversification of both investments and investment managers (Appendix 2). A management agreement is in place for each investment manager, which sets out the relevant benchmark performance target, asset allocation ranges, and any restrictions, as determined for the Fund.

12. Expected Return on Investments

12.1 The long term investment objective of the Fund is to achieve a real rate of return of 3-4% per annum on average.

12.2 The Fund's Investment Advisors, Aon Hewitt reviewed the asset allocation alongside the Actuarial Valuation as at 31 March 2017 and recommended some changes to the asset allocation.

12.3 The Investment Sub Committee reviewed these proposed changes to the asset allocation benchmark in December 2017 and Pensions Committee is asked to approve these. The proposed changes to the strategic benchmark are as follows:

- allocation to equities be reduced from 61% to 56%
- allocation to bonds be reduced from 20% to 12%
- increase the allocation to illiquid alternative assets from 9% to 17% using a mix of income focussed and growth focussed illiquid strategies.
- allocation of 5% to absolute return strategies

12.4 The reason for the change is to reduce the reliance on equities and target increased prospective returns from other sources and also to better position the Fund for a rising interest rate (and bond yield) market environment.

12.5 Future recommendations will be taken to the Investment Sub Committee regarding the specific actions required to move to the proposed asset allocation and detail of the asset classes to be used.

12.6 The expected returns for the various asset classes are shown in Appendix 5. Applying these returns to the strategic benchmark leads to a best estimate expected annual return for the Fund of 6.3%, (as at 31 March 2017) net of fees, before Manager's out performance targets are taken into account.

13. Diversification of Investment

13.1 The Council appointed The Northern Trust Company as the Fund's Global Custodian. As at 31 December 2017, the Fund has seven appointed investment managers.

13.2 The Investment Managers were appointed to outperform prescribed benchmarks while remaining within asset mix constraints. Each Manager, with the exception of the index tracking Manager, has full discretion in asset mix and stock selection, subject to the investment principles contained in this document and, more importantly, to the detailed Investment Management Agreement relative to each appointment, to add value to the benchmark set. In choosing investments, the Managers must have regard to:-

- Their benchmark;
- Their performance objective;
- Diversification; and
- The suitability of those assets.

13.3 If the Manager wishes to invest in investment vehicles which do not form part of the benchmark or in individual securities which are not authorised by the Investment Management Agreement, they must obtain the written authorisation of the Council in advance of any such investment.

13.4 The Council will consider the performance of the Investment Manager at least annually in comparison to agreed strategic benchmarks.

13.5 The Council will review the overall investment strategy of the Fund at least annually and carry out a full strategy review every three years, taking account of changes in the funding position of the Fund. Other non-investment factors, such as salary inflation, price inflation, mortality, early retirement, new entrants etc. may also impact materially on the funding position and strategy.

13.6 As noted in para 12.2 and 12.3, a revised asset allocation is proposed which was reviewed at Investment Sub Committee in December 2017.

13.7 The Committee has taken proper advice in respect of all the above decisions from the Fund's Investment Advisor, Aon Hewitt.

14. Realisation of Investments

14.1 Approximately 80% of the investments held by the Fund at 31 December 2017 are quoted on major stock markets and may be realised quickly if required. Property investment is via pooled funds which are relatively illiquid. These currently make up approximately 10% of the total Fund. There are also private equity (target asset allocation 5%) and property debt investments (target asset allocation 4%) which are very illiquid.

14.2 If the active membership of the Fund was to remain stable at 2017 levels then the Fund is projected to be in a cash negative position for the foreseeable future.

14.3 This position has changed since the 2014 valuation (cash flow positive until 2026) due to the total payroll, and therefore contributions paid, at 31 March 2017 being around 9% lower than assumed in the 2014 projections; and the total benefit payment at 31 March 2017 being around 6% lower than assumed in the 2014 projections.

14.4 However, assuming the current investment income yield is maintained (2016/17 investment income was £31.1m), then this would generate sufficient income to meet benefit payments for the immediate future. Provided the investment income yield remains at current levels then the time when assets need to be sold to meet benefit payments still looks sometime in the future. The Investment Sub Committee will consider which managers to take income from as part of setting a 'Cash flow meeting policy'.

14.5 It should be noted though that the negative cash flow position could be increased by a combination of public sector cuts, member opt-outs or outsourcing which reduces the pensionable payroll.

15. Underwriting

15.1 The Fund's Investment Managers are permitted to underwrite and sub underwrite stock issues only on the basis that the subject stock is already held in the portfolio or that the

Manager wishes to acquire a long term holding.

16. Social, Environmental and Ethical Considerations

16.1 The Fund recognises that social, environmental and ethical considerations are among the factors which Investment Managers will take into account, where relevant, when selecting investments for purchase, retention or sale. However, the over-riding consideration for Pension Committee members is their fiduciary duty to the scheme employers and scheme members.

16.2 The Scheme Advisory Board (SAB), set up by the Scottish Government to regulate Scottish LGPS under the 2015 Local Government Pension Scheme (Governance)(Scotland) Regulations 2015, obtained advice from legal counsel on the fiduciary duty of Pensions Committees.

16.3 This advice is published on the SAB website and concludes that:

"Pensions Committees in Scotland owe a fiduciary duty to the scheme employers and the scheme members in general and specifically in relation to investment matters. Those duties should be exercised in the best interests of the beneficiaries and in relation to investment decisions, should aim to achieve the best financial position for the fund, balancing risk and return in the usual way."

http://lgpsab.scot/wp-content/uploads/2016/06/Report-National-Scheme-Advisory-Board-v4-updated-23_2_16.pdf

16.4 Whilst recognising its over-riding fiduciary duties the Fund will continue to encourage its managers to engage on issues with companies in which it holds investments as the Fund believes that environmental, social and corporate governance (ESG) issues will have a significant effect on the performance of investment portfolios through time.

16.5 Engagement in this context is to involve the Investment Managers in:

- Meeting and corresponding with Companies on relevant issues;
- Working with the representatives of other shareholders, where appropriate;
- Voting against adverse proposals at Company AGM/EGMs;
- Reporting regularly on actions taken in this regard.

16.6 The managers will be instructed to summarise this engagement activity in their quarterly Investment Reports.

16.7 Where it is consistent with its fiduciary duty, the Fund would follow the principles below:

- Incorporate ESG issues into investment analysis and decision-making processes – this would require to be done by the investment managers and monitored by the Fund.
- Be an active owner and incorporate ESG issues into ownership policies and practices - this will be mainly achieved by exercising voting rights and the engagement activity of managers.
- Seek appropriate disclosure of ESG issues by entities in which the Fund is invested - this will be achieved through investment manager engagement.

17. Corporate Governance

17.1 The Fund ensures that the votes attached to its holdings in all UK quoted companies are exercised whenever practical. The Fund's votes are exercised by its Investment Managers in accordance with their own policies and practices and taking account of the Combined Code on Corporate Governance.

18. Exercise of Voting Rights

Voting rights are exercised at the discretion of each investment manager, in line with the manager's own voting policies and procedures, and subject to any specific instructions from the Pension Fund. The Council's Custodian provides regular reports on voting undertaken.

19. Stock Lending

19.1 During 2015, after evaluation of the risks and assurance that there would be adequate collateral to support stock lending arrangements, it was decided that The Fund will undertake stock lending. The Fund now has a stock-lending agreement with Northern Trust.

19.2 The amount of lendable securities is limited to a maximum of 25% of the value of the Fund; and this arrangement will be regularly reviewed to take account of changing market circumstances.

20. Compliance

20.1 Investment Managers will provide an annual statement to the Council confirming that they have given effect to the investment principles contained in this document so far as reasonably practicable (highlighting exceptions).

20.2 The Custodian will certify on an annual basis that they have complied with this document.

20.3 The Council will be responsible for assessing the risks assumed by the Fund at global level, i.e. assuming that the portfolios of the individual Investment Managers were amalgamated.

20.4 The Council is responsible for monitoring the Fund's performance both at the global level and at Investment Manager level.

20.5 The Council is responsible for ensuring compliance with legislation including the Markets in Financial Instruments Directive (MiFID II) and having processes in place so that the Highland Council Pension Fund maintains its status as a "professional investor".

20.6 The Council is responsible for monitoring the qualitative performance of the Investment Managers and Custodians employed to ensure that they remain suitable for the Fund. These qualitative aspects include, inter alia, changes in ownership, changes in personnel, poor administration, compliance with regulatory bodies/codes/guidelines etc.

20.7 Adhering to guidance given by Scottish Ministers, The Fund is compliant with the six revised principles on investment decision making for occupational pension schemes, as set out in 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’ (see Appendix 4).

20.8 The Fund is compliant with the statutory restrictions set out in the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010.

20.9 The Council will regularly consider the Fund’s compliance with this Statement of Investment Principles. The Statement will be reviewed annually and a revised Statement prepared and published where there has been any material change in the Fund’s policies.

20.10 There are no Legal; Equalities; Climate Change/Carbon Clever; Risk; Gaelic or Rural implications relating to this report.

Designation:	Director of Corporate Resources
Date:	31 January 2018
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Appendix 1 – Actuarial Valuation

Main Actuarial Assumptions as at 31 March 2017

	Nominal	**Real**
Discount rate	3.7%	1.3%
Increases in pay (exc. Promotional increases)	3.4%	1.0%
Price inflation (pension increases)	2.4%	-

This funding method used is known as the Projected Unit Method. As well as the whole fund, it is appropriate for individual employers that continue to admit new entrants to the Fund.

However, some participating employers may have a policy of not admitting new entrants. In this case, the membership profile will inevitably begin to age. Under these circumstances, the Projected Unit Method is arguably no longer appropriate and will not promote sufficient stability in the future service rate. For these employers, a funding method known as the Attained Age Method is adopted. This effectively looks at the cost of benefits that members will earn over the entirety of their remaining working lifetime (rather than just the year following the valuation).

Based on the actuarial valuation as at 31 March 2017.

Appendix 2 – Asset Allocation

Asset Class	Fund Actual at 30/11/17 %	Target set Aug 2016 %	Proposed target Feb 2018 %
UK equities - active	18.9	18.2	18.2*
UK equities - passive	4.9	4.8	3.3*
Global equities - active	31.1	*26.8	26.8*
Global equities - passive	12.0	11.2	7.7*
Total equities	**66.9**	***61.0**	**56.0***
Fixed income - active	11.3	15.0	12.0*
Fixed income - passive	4.3	5.0	-*
Total fixed income	**15.6**	**20.0**	**12.0***
Property – active	**9.6**	***10.0**	**10.0***
Property debt – active	**3.0**	**4.0**	**4.0***
Private equity - active	**4.9**	**5.0**	**5.0***
Other illiquid alternatives	**-**	**-**	**8.0***
Absolute return strategies	**-**	**-**	**5.0***
Total Assets	**100.00**	***100.0**	**100.0***
Expected Return (p.a)**	6.4%	6.2%	6.4%
Expected Volatility (p.a.)**	14.1%	13.2%	12.9%

* The targets shown reflect expected targets following full draw-down of the private equity, and other illiquid assets. Full draw down is expected to take several years.

** Based on Aon Hewitt's best estimate Capital Market Assumptions for 10 year returns and volatilities as at 31 March 2017.

Investment Management structure as at 1 April 2017:

- Global equity portfolios - active (Baillie Gifford and Pyrford)
- UK equity portfolio - active (Baillie Gifford)
- UK and global equities, bonds – passive (Legal and General)
- Bonds – active (Fidelity)
- Property – active (Schroders)
- Commercial Real Estate Debt – active (Aberdeen Standard Investments)
- Private Equity – active (Partners Group)

The breakdown of assets by manager is provided in the Fund's Annual Report & Accounts which can be found at

http://www.highlandpensionfund.org/media/3010/2016_17-annual-report-and-accounts-full-audited-version.pdf

Appendix 3 – Custodian, External Advisers, & Auditor Details

	Name	**Address**
Custodian and Investment Analyst	The Northern Trust Company	50 Bank Street Canary Wharf LONDON , EC2Y 5EA
Actuary	Hymans Robertson Consultants and Actuaries	Central Exchange 20 Waterloo Street GLASGOW, G2 6DB
Investment Consultant	Aon Hewitt	Aon Hewitt Limited Atria One 144 Morrison Street Edinburgh EH3 8EX
External Auditor	Grant Thornton	7th Floor Civic Centre Carlisle CA3 8QG

Appendix 4 Statement of Compliance with CIPFA Principles for Investment Decision Making

PRINCIPLE	COMPLIANCE	EVIDENCE
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* *Those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest*.	Fully compliant	Members are formally briefed on their fiduciary responsibility in the stewardship of the Pension Fund. Members take advice from the Council's officers, investment adviser, investment managers and global custodian. Members participate in a rolling training programme involving attendance at specific presentations, courses and seminars. Successive Councils have agreed to the formulation of an Investment Sub-Committee to consider pension fund issues and make recommendations to the Council's Pensions Committee and Board.
2. Clear Objectives *An overall investment objective(s) 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 advisors and investment managers.*	Fully compliant	Overall Fund objectives and attitude to risk are set out in the "Statement of Investment Principles" (SIP) which is regularly reviewed. The Fund's SIP, Funding Strategy Statements (FSS) and final accounts are available on the Council's website for all interested parties. Fund assets and liabilities are accounted for in triennial valuations prepared by the Fund's actuary. Periodic asset/liability exercises have been carried out by consultants and officers since 2003 leading to the development and ongoing review of bespoke benchmarks.
3. Risk and Liabilities *In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities.*	Fully compliant	The Fund takes advice from the actuary regarding the nature of its liabilities. Asset-liability modelling is undertaken periodically to aid the setting of investment strategy, and exercises specifically take account of covenant strength

These include the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk.		when assessing risk tolerance. Asset-liability modelling is undertaken by the investment advisor who obtains information from the actuary regarding liabilities to use in the model. All risk measurement in this context is performed with reference to the liabilities. The funding strategy for the Fund is expressed in relation to solvency of the Fund. Consideration is given to affordability of employer contributions at the actuarial valuation. The Pension Fund operates within the internal control arrangements administered by the Council which are subject to internal and external audit. All audit reports are scrutinised by the Council's Audit and Scrutiny Committee. The external auditors report annually to the Council's Audit and Scrutiny Committee. The Council maintains a risk register. The Council's risk management process would highlight any risks relating to the Pension Fund and these would be included in the risk register if appropriate. The risk register is reported to the Pension Committee. https://www.highland.gov.uk/meetings/meeting/3869/pensions_committee_and_board
4. Performance Assessment *Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisors.* *Administering authorities should also periodically*	Fully compliant	The Fund's performance and performance of the Fund Investment Managers is monitored quarterly by officers, the Global Custodian, the Investment Advisor and the Investment Sub-Committee. Investment Managers are given specific performance targets and these are assessed as part of the

make a formal assessment of their own effectiveness as a decision-making body and report on this to scheme members.		mandate monitoring process. The Investment Sub-Committee monitors performance against planned activities detailed in the Highland Council Pension Fund portfolio mandates, and reviews the appointment of advisers when appropriate. Investment managers attend the Investment Sub-Committee when requested, to explain performance. Training and attendance of members of the Investment Sub-Committee is monitored and recorded.
5. Responsible Ownership *Administering authorities should:* *Adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents* *Include a statement of their policy on responsible ownership in the statement of investment principles* *Report periodically to scheme members on the discharge of such responsibilities.*	Fully compliant	The Fund's Investment Managers have adopted the UK Stewardship Code 2010. The seven principles in the Code cover, and expand upon, the main issues highlighted in the Institutional Shareholders' Committee Statement of Principles (1991).The Highland Council Pension Fund delegates its voting responsibilities to relevant Investment Managers The Fund's policy on Social, Environmental and Ethical Considerations is included in the Statement of Investment Principles. The Fund's Annual Report and Accounts reproduces a summary of the Statement of Investment Principles. The Annual Report and Accounts and the Statement of Investment Principles is available on the Council's website.
6. Transparency and reporting *Administering authorities should:* *Act in a transparent manner, communicating with stakeholders on issues relating to their*	Fully compliant	Members are given information through the Council's web site, periodic seminars and newsletters. The Statement of Investment Principles (SIP), Funding Strategy Statement and Pension Fund Compliance

management of investment, its governance and risks, including performance against stated objectives. *Provide regular communication to scheme members in the form they consider most appropriate.*		Statement along with the Pension Fund Annual Report are published on the Pension Fund web site. http://www.highlandpensionfund.org/highland-pension-fund/about-us/forms-and-publications/ The Fund's policy statements, including its Governance Policy Statement, SIP and FSS are maintained regularly. Documents are available on the Council's website for stakeholders and any other interested parties. The Fund produces an Annual Report and Accounts, referring to the availability of the key documents (listed above) on the Council's website. http://www.highlandpensionfund.org/highland-pension-fund/about-us/forms-and-publications/ The Fund produces periodic newsletters for pensioner members and for active members and briefings for employers. The website is updated regularly. The Investment Sub-Committee Minutes are submitted for approval to the Council's Pensions Committee and are published on the Council's website.

Appendix 5 – Expected Return on Investments

Aon Hewitt prepared best estimate expected returns at 31 March 2017 on the Fund's investments to input into the actuarial valuation.

Asset Class	Expected Return (% pa)
UK Equities	6.6%
Global Equities	7.1%
Private Equity	8.2%
UK Property	5.5%
Corporate Bonds	2.1%
Fixed Gilts	1.4%
Property Debt*	3.3%
Other illiquid investments**	10.0%
Absolute Return Strategies	4.5%

* Property Debt returns differ depending on strategy employed. Return assumption based on lower yielding senior debt strategy, consistent with the SLI CRED mandate.

** estimate based on "best ideas" illiquid portfolio that would consist of similar strategies currently (such as Private Equity and Property Debt), but include also current favourable market opportunities in direct lending and infrastructure.

The Aon Hewitt assumptions are produced for bonds, equities, real estate/property and a range of alternative asset classes and include asset class returns, volatility and correlation assumptions.

- The return assumptions are "best estimates" of annualised returns, by which Aon Hewitt mean annualised median returns. That is, there is a 50/50 chance that actual returns will be above or below the assumptions. The assumptions are long-term assumptions, based on least 10 year projection periods and are updated on a quarterly basis.
- Aon Hewitt assumptions are based on consensus or market based inputs unless we believe that the consensus view is clearly unrealistic. For example, analyst expectations for company earnings are often over-optimistic so caution is needed when interpreting them.
- Aon Hewitt use data from a wide range of sources when formulating the Capital Market Assumptions (CMAs) including, among others, Consensus Economics, the Institutional Brokers' Estimate System (I/B/E/S), the Bank of England, the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters, the European Central Bank and research produced by range of prominent investment banks and research institutes.
- The base asset class assumptions are for market returns, with the exception of private equity where Aon Hewitt have also made an additional allowance for managers outperforming the market.
- Investment management costs have also been excluded – in effect the assumption made is that value added from active management meets investment management fees, which in practice value added could reasonably be assumed to exceed investment management fees

For the purposes of their actuarial modelling for the actuarial valuation as at 31 March 2017, slightly lower expected returns on investments, as calculated by Hymans Robertson using the Hymans Robertson Economic Scenario Service and provided to the Council in November 2017 were used. These are shown below.

The expected returns shown in the table below are the 20 year (absolute) geometric averages and the volatilities quoted are the first year's standard deviations. All returns are shown net of fees. No allowance for active management has been made with the calculation of these returns.

Asset Class	**Expected Return (% pa)**	**Expected Volatility (% pa)**
UK Equities	5.9%	16.0%
Global Equities	5.5%	18.0%
Private Equity	6.8%	29.0%
Index Linked Gilts (medium dated)	0.5%	7.0%
Fixed Interest Gilts (long dated)	0.5%	12.0%
Corporate Bonds (medium dated)	2.1%	10.0%
Corporate Bonds (long dated)	1.4%	12.0%
Absolute Return Bonds (near zero duration)	4.1%	3.0%
Diversified Alternatives	4.3%	11.0%