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London Pensions Fund Authority
Investment Strategy Statement

May 2019

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1. Introduction

The Board ("the Board") of the London Pensions Fund Authority ("the Fund") has prepared this Investment Strategy Statement ("the Statement") in accordance with the Guidance on Preparing and Maintaining an Investment Strategy Statement and after taking appropriate advice.

As set out in the Regulations, the Board will review this Statement from time to time, but at least every three years, and revise it as necessary. Also, in the event of a significant change in relation to any matter contained in this Statement, changes will be reflected within six months of the change occurring.

The Regulations require all Administering Authorities to take "proper advice" when formulating an investment strategy. In preparing this document and the overall investment strategy the Board has taken advice from Local Pension Partnership Investment Limited which is an FCA regulated investment manager with specific expertise and regulatory permissions to provide advice on investments.

2. Investment objectives

The Fund's primary investment objective is to ensure that over the long term the Fund will have sufficient assets to meet all pension liabilities as they fall due.

In order to meet this overriding objective the Board maintains an investment policy so as to:

- Optimise the net returns from investments whilst keeping risk within acceptable levels and ensuring liquidity requirements are at all times met;
- Contribute towards achieving and maintaining a sustainable future funding level;
- Enable employer contribution rates to be kept as stable as possible.

The Fund will use its influence as a large institutional investor to encourage responsible long-term behaviour.

Note that all returns quoted below are net of fees and expenses.

3. Asset allocation framework

To pay benefits over time the Fund needs to generate a rate of return that is at least equal to the actuarial discount rate. The starting point for considering asset allocation is a simple portfolio of bonds and equities. However, this basic portfolio does not optimise diversification and therefore expected risk adjusted return.

In order to prudently diversify sources of risk and return, the Fund allocates capital across a wide variety of different asset classes. To be added to the portfolio, asset classes are first judged for **suitability**; they have to be well understood by the Board, consistent with the Fund's risk and return objectives; and they have to make a significant contribution to the portfolio by improving overall net return and risk characteristics. In addition, the new asset classes have to be less than perfectly correlated with equities and bonds, so that the portfolio benefits from increased **diversification**. The scheme has identified a total of seven asset classes plus cash (viewed a store of liquidity) that combined form the **Policy portfolio**.

The seven asset classes shown below have different exposures to economic factors (GDP growth and inflation), and combine different geographies, and currencies. In assessing suitability the Board has considered the respective return drivers, exposure to economic growth and sensitivity to inflation – each an important consideration, relative to the sensitivities of the Fund's liabilities and managing risk.

Asset class	Long-term return drivers	Economic Growth sensitivity*	Inflation sensitivity*	Geography	Currency
Credit	- Yield (minus credit losses) - Roll down - Change in yield - Liquidity premium	Low	Medium	Diversified	Diversified
Diversifying strategies	Diversified	Low	Low	Diversified	Diversified
Fixed income	– Yield (minus credit losses) – Roll down – Change in yield	Low	High	Diversified	Diversified
Infrastructure	– Dividend income – Dividend growth – Capital growth	Medium	Medium	Predomanantly OECD	Diversified
Private equity	– Dividend income – EPS growth – Change in PE	Medium	Medium	Diversified	Diversified
Public equity	– Dividend Income – EPS growth – Change in PE	High	Low	Diversified	Diversified
Real estate	– Rental yield minus Capex – Rental growth – Capital growth	Medium	Medium	Predominantly UK	Predominantly GBP

*Sensitivities shown are to positive shocks, i.e., if growth and inflation surprise on the upside

These are the eight building blocks (seven asset classes plus cash) used to create the Policy Portfolio. The Board have determined benchmark weights each asset class which it believe to be best suited to meeting the long term objectives of the Fund. It has also identified tolerance ranges within which shorter term variations would be tolerated and/or actively pursued due to a combination of relative returns and investment opportunity. The benchmark weight and tolerances are shown in the table below.

Asset class	Benchmark weight	Range
Cash	1.0%	0%-10%
Credit	9.0%	0%-12.5%
Diversifying strategies	15.0%	0%-20%
Fixed Income	2.5%	0%-15%
Infrastructure	10.0%	0%-15%
Private equity	7.5%	0%-15%
Public equities	45.0%	35%-55%
Real estate	10.0%	5%-15%
Total	100%	0

The weights are to be maintained within the ranges as long as the scheme can find attractive opportunities that meet its return, risk, and cash flow requirements. In the absence of opportunities investments will not be "forced" and under/over allocations may be made to any asset class. This includes allocations falling outside of the tolerance range. Should any allocations fall outside of the range the Board shall seek to bring the allocation back within the range as soon as suitable opportunities are identified.

Each asset class has its own specific investment objective and within each asset class there are further diversification controls. The mandates are managed by Local Pensions Partnership Ltd (LPP)'s subsidiary, Local Pensions Partnership Investments Ltd (LPPI), to whom the Fund has delegated investment management and implementation duties in line with the principle of asset pooling within LGPS. LPPI has discretion to act on behalf of the Board in order to implement the allocations set out in the Policy Portfolio. This includes determining any over/under allocation within the tolerance ranges. Should allocations fall out of the ranges LPPI is responsible for informing the LPFA and agreeing appropriate action. Note that all returns referred to below are net of fees and expenses.

Cash

The objective is to maintain a store of liquidity in a cost effective manner by allocating capital to securities or funds in appropriate markets. It is intended that the bulk of cash liquidity is stored in GBP sterling.

Credit

The objective is to deliver 1-month GBP LIBOR + 3% to 5% over a 7-year cycle. The aim is to gain cost effective exposure to (mostly illiquid) diverse sources of return linked to global credit markets and credit instruments, while minimising risk of permanent loss. The pool will pursue this aim primarily by allocating capital to investment vehicles, mandates or pooled funds managed by external third parties.

Diversifying strategies

The pool seeks to gain cost effective exposure to diversifying sources of return distinct from global equity beta and bond duration. The pool will pursue this aim primarily by allocating capital to investment strategies managed by external third parties. The objective is to deliver 1-month GBP LIBOR + 4% - 6%.

Fixed income

The objective is to outperform Barclays Global Aggregate Bond Index + 0.5% over a 7-year cycle. The pool will pursue this aim by investing in underlying funds actively managed by external third parties which are diversified across geographies, instrument types and maturities, with an emphasis on capital preservation.

Infrastructure

The objective is to deliver UK CPI + 4% - 6% over a 7-year cycle. The investments seek to generate a satisfactory risk adjusted return through improved diversification predominantly in OECD nations and predictable cash flows that indirectly hedge against inflation. .

Private equity

The objective is to outperform the MSCI World, net dividends reinvested, in GBP unhedged Index by 2% to 4% over a 7-year cycle with minimal J-curve effect. Investments include, but not be limited to: Buyout, Venture Capital, Growth Equity, Special Situations/Distressed and Upstream Energy.

Public equity

The objective is to outperform the MSCI All Country World, net dividends reinvested, in GBP unhedged Index by 2% over a seven year period. Equity investments are made via LPPI, by investing in underlying funds managed by LPPI and by external third parties. LPFA also gains exposure to equities via equity index futures which are designed to replicate the performance of the MSCI All Country World Index.

Real estate

The aim is to gain cost effective, diversified exposure to property assets that earn predictable cash flows and provide a partial hedge against inflation, as well as meet the investment objectives of UK CPI + 4% - 6%. The largest exposure of the portfolio will be to traditional sectors of the UK commercial real estate market. A smaller allocation will be made to value-added and opportunistic investments.

4. Investment governance

The Board is responsible for setting the objectives and risk tolerances of the scheme. The Board sets in conjunction with the scheme's actuary the required rate of return needed to achieve its objectives and the risks it is willing to take. Once these parameters are established, the Board will determine the strategic asset allocation or Policy Portfolio that it believes has the highest probability of succeeding. The implementation of the asset allocation is delegated to an expert investment manager, in this case, LPPI. LPFA is a shareholder of LPP and maintains ongoing corporate governance controls but plays no direct role in Investment Management activities. The Board will monitor the performance of LPPI and the portfolio.

5. Investment implimentation

The implementation of all investments is delegated to LPPI, an FCA authorised company. The partnership was set up by the LPFA and Lancashire County Council for the purpose of achieving economies of scale, greater internal resource and superior investment opportunities. The partnership brings the benefit of scale and expert resources beyond that which would be available to the Fund alone. This facilitates lower costs and a broader opportunity set which together facilitate improved net returns.

Pooled vehicles are used wherever appropriate. Where assets are not physically pooled the management is typically pooled.

The partnership has created seven asset class categories to allow access to the asset classes listed in the Asset Allocation Framework section. The asset class categories are a combination of internally managed and externally managed strategies that offer an effective and efficient way of achieving asset class exposures.

The Fund also expects to benefit from scale via pooling arrangements with other funds in order to better access direct investments in areas such as infrastructure. Some of the asset class categories are expected to use derivatives as part of their strategies. Derivatives can reduce implementation costs, or change economic exposures. They may be used for both active and passive management strategies. The broad use of derivatives is explicitly approved by the Board for both investment purposes and efficient portfolio management. Both exchange traded and over the counter derivatives may be used.

6. Pooling of assets

The Board has delegated the management of its investments to LPPI who are responsible for managing 100% of the assets of the Fund. A significant majority of the Fund's assets have already, or are expected to be, transitioned into investment pooling vehicles managed by LPPI. A small minority of assets will remain on the balance sheet of the Fund as "legacy assets". Assets will be held as legacy assets if the costs of transitioning outweigh any potential gains, the assets have reached "harvesting period", or transitioning would have a negative impact on the scheme's investment strategy. Proceeds from assets in "harvesting period" will be reinvested through LPPI pooled funds.

Asset class	SAA target	% Pooled*	Legal structure
Cash	9.0%	98%	Limited partnership
Diversifying strategies	15.0%	87%	Limited partnership
Fixed income	2.5%	100%	Authorised contractual scheme
Infrastructure	10.0%	98%	Limited partnership
Private equity	7.5%	100%	Limited partnership
Public equities	45.0%	98%	Authorised contractual scheme
Real estate	10.0%	0.0%	Authorised contractual scheme (pooling vehicle to be launched H2 2019)

*Data as at 31st December 2018.

7. Risk management

The gradual reduction and elimination of funding deficit is a core goal for the Board. Funding deficit is influenced by both assets and liabilities and for this reason the Board adopt an Asset and Liability Management approach which includes the use of liability hedging strategies. The Board review the hedging policy on an ongoing basis and may seek to hedge inflation and/or interest rate exposure using a combination of physical and derivative instruments.

Diversification is a very important risk management tool. As described in the section on Asset Allocation, the scheme will seek to maintain a diversified exposure to several different asset classes, geographies, and currencies. The Board expect this to provide (at least) two levels of protection: first, in periods of market turmoil some assets will preserve capital better than others, allowing the portfolio to better withstand a shock. Second, in periods of rising markets, some assets will do better than others, and since the Board do not know with certainty which ones will do best, it is better to diversify.

Another line of defence at the scheme level is to examine how the portfolio would perform under different scenarios including stress scenarios. The objective is to minimise the impact that losses to the portfolio have on future contribution rates. When setting Asset Allocation the Board have considered different stress scenarios and possible outcomes.

The asset class categories described in the implementation section are also subject to a number of constraints to allow for intra-asset class diversification, including sector, country, manager, and maximum exposure to a single asset.

8. Performance measurement

Fund performance is measured at a number of different levels. The objective of the Fund is to outperform the actuarial discount rate. The Policy Portfolio is selected by the Board with advice from LPPI, the delegated investment manager, and is expected to generate returns above the discount rate over the long run.

The performance of the pooling arrangements is monitored via regular reporting and through periodic meetings. Performance for LPPI is measured against the Policy Portfolio. LPPI seeks to outperform the Policy Portfolio on a risk adjusted basis by tilting asset weights in an opportunistic manner, via active sub-asset class selection, selecting the best stocks/managers for each of the pooled funds, and by implementing investments in a low cost manner. Investment performance is measured against widely used and transparent benchmarks.

Where performance falls short of expectations the Board will identify the cause of this underperformance and will respond appropriately either to alter its Policy Portfolio (where asset allocation is the underlying cause). The Board can request changes to the management of the pooled funds (where management skill within LPPI is the underlying cause) or withdraw approval of any of the LPPI pooled funds from the list of approved funds for use within the Policy Portfolio. In practice LPFA would expect to work collaboratively with LPPI to identify and remedy the cause of any underperformance.

9. Environmental Social and Corporate Governance (ESG) Policy, and approach to social investments

The Fund is committed to being a long term responsible investor. The Fund complies with and follows the principles of both the UK Stewardship Code and to the UN-backed Principles of Responsible Investment.

Responsible Investment is an investment approach which recognises the significance of the long-term health and stability of the market as a whole and encompasses

- the integration of material ESG factors within investment analysis and decision-making
- the active use of ownership rights in order to protect and enhance shareholder value over the long term – primarily through voting and engagement.

The objective of responsible investment is to decrease investor risk and improve risk-adjusted returns. Responsible investment principles are at the foundation of the Fund's approach to stewardship and underpin the Fund's fulfilment of its fiduciary duty to scheme beneficiaries.

ESG integration and the active use of ownership influence are integral to the investment management services provided by LPPI, which are delivered in accordance with an LPPI Responsible Investment Policy. It is an LPPI RI belief that ESG factors are relevant at every stage in the investment cycle - within investment strategy, investment selection and within the stewardship of assets in ownership. As part of a prudent approach which applies care, skill and diligence, LPPI procedures ensure that ESG issues are routinely considered as part of the investment analysis,are incorporated into the due diligence leading to investment selection and continue to be monitored and reviewed as part of the active ownership of assets under management.

The approach to incorporating ESG factors is to establish the type and materiality of relevant issues on a case by case basis, whilst taking account of global norms, rather than to apply artificial exclusions through negative screening. ESG factors are considered over the time horizon within which specific investments are likely to be held, in order to clarify the context that risks and returns operate within and assist the evaluation of investment risks and opportunities.

The Fund shall invest on the basis of financial risk and return having considered a full range of factors contributing to financial risk including both those detailed above and relevant social factors to the extent these indirectly or directly impact on financial risk and return.

LPFA has identified climate change as a long-term material financial risk with the potential to impact all asset classes within the portfolio over time. The Fund has developed a Policy on Climate Change which sets out expectations of LPPI in relation to how the risks and opportunities arising from climate change will be identified, monitored and managed

10. Exercising the Rights of Ownership

The Fund recognises that encouraging the highest standards of corporate governance and promoting corporate responsibility by investee companies protects the financial interests of pension fund members over the long term. The Fund's commitment to actively exercising the ownership rights attached to its investments, reflects the Fund's conviction that responsible asset owners should maintain oversight of the way in which the enterprises they invest in are managed and how their activities impact upon customers, clients, employees, stakeholders and wider society.

The routes for exercising ownership influence vary across asset types and a range of activities are undertaken on the Fund's behalf by LPPI, including direct representation on company boards, presence on investor & advisory committees and participation in partnerships and collaborations with other investors. In the case of listed equites the most direct form of ownership influence comes through shareholder voting and engagement.

11. Voting

In most cases the Fund holds no direct ownership of shares of companies. However, through the investments managed by LPPI, the Fund has indirect ownership interests in listed companies across the globe. To ensure effective and consistent use of the voting rights attached to these assets LPPI works with an external provider of governance and proxy voting services. Voting is undertaken centrally rather than being delegated to individual managers and is in line with LPPI's Shareholder Voting Policy which promotes risk mitigation and long-term shareholder value creation by supporting responsible global corporate governance practices. The policy is reviewed and updated on an annual basis to reflect emerging issues and trends. A quarterly report on voting activity is available from the LPP website which is signposted via a link from the LPFA website.

12. Engagement

The Fund's approach to engagement recognises the importance of working in partnership to magnify the voice and maximise the influence of investors as owners. The Fund appreciates that to gain the attention of companies in addressing governance concerns, it needs to join with other investors sharing similar concerns. It does this primarily through:

- Membership of representative bodies including the Local Authority Pension Fund Forum (LAPFF) and the Pensions and Lifetime Savings Association (PLSA);
- Giving support to shareholder resolutions where these reflect concerns which are shared and represent the Fund interests;
- Joining wider lobbying activities when appropriate opportunities arise.

The Fund complies with the UK Stewardship Code and a statement of compliance which explains the arrangements which support its commitment to each of the seven principles is displayed on the Fund's website.

For more information, please contact:
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