HERTFORDSHIRE PENSION FUND

Appendix A: Investment Strategy Statement

1. Introduction

This is the Investment Strategy Statement (“ISS”) of the Hertfordshire Pension Fund (“the Fund”), which is administered by Hertfordshire County Council, (“the Administering Authority”). The ISS is made in accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (“the Regulations”). This document replaces the Fund’s Statement of Investment Principles.

The ISS has been prepared by the Pension Committee (“the Committee”) having taken advice from the Fund’s investment adviser, Mercer. The Committee acts on the delegated authority of the Administering Authority.

The ISS, which was approved by the Committee on 31 March 2017, is subject to periodic review at a maximum every three years or following any significant change in investment policy. The Committee has provided the Pension Board with an opportunity to review and comment on the contents of the Fund’s investment strategy and will continue to work with the Pension Board to review its operation.
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This ISS has been designed to be a living document and is an important governance tool for the Fund. This document sets out the investment strategy of the Fund, provides transparency in relation to how the Fund investments are managed, and acts as a risk register.

The Committee seeks to invest, in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund’s Funding Strategy Statement (dated 1 April 2017).

Investment Beliefs

The Committee has, as part of the process of creating this Investment Strategy Statement agreed a set of ‘Investment Beliefs’ which are summarised briefly below:

- All investment decisions should be made on an objective basis supported by the most appropriate evidence available.
- The Hertfordshire Pension Fund has very long term liabilities and it is therefore believed that a long-term approach to investment matters is both appropriate and desirable.
- Risk and return are related. Riskier assets are expected to be held only when there is a reasonable expectation of higher returns being generated. There are some risks for which no additional return is expected; these should be avoided or mitigated.
- Diversification is an effective way of reducing the volatility of an asset portfolio and therefore reducing the volatility of the Pension Fund’s funding level.
- Investment risk is multi-dimensional and complex. The Fund is subject to a range of investment risks which are addressed in the investment strategy-setting process. There are other risks such as regulatory risk, employer risk and longevity risk which are addressed elsewhere.
- Excess returns are not certain. The Committee aims to manage the Fund on a cost-effective basis and seeks correspondingly favourable terms from the Fund’s asset managers. It is also recognised that ‘value for money’ is best considered in terms of ‘net of fees’ returns which the Committee monitors regularly.
- The real world, of economies and markets, is complex. Simple explanations are unlikely to be robust. To reflect this complexity the Committee takes material time and effort to understand the issues with which it is faced and also, from time to time, undertakes training on specific topics from specialist providers.

- Innovation and evolution can be of benefit to the long term investor. A willingness to consider new investment ideas is likely to bring value to the Fund in the longer term, especially if balanced with a consistency of thought and governance processes.
- Environmental, Social and Governance factors cannot be ignored by those responsible for a large and diversified portfolio of assets. In particular, the risks of being exposed to poor ESG practice is likely to be material for the Fund, and the Committee therefore includes, as part of its monitoring processes, reviews of managers' ESG policies and practices.

2. Investment strategy and the process for ensuring suitability of investments

The Fund's objective is to pay benefits as they fall due and this requires the build-up of sufficient reserves in advance. The Fund is currently assessed to have a deficit, in respect of historic benefits accrued, and so the asset strategy is focused on achieving returns in excess of gilts, without taking undue risk in order to reduce this deficit. Having a thorough understanding of the risks facing the Fund is crucial and these are covered later in this statement.

The target asset allocation as at March 2016 for the fund is set out in the table below and has an allocation of 75% to growth assets and 25% to defensive assets:

Asset class	Allocation %	Role (s) within the strategy
Equity: UK Global **Total**	 16.0 34.2 **50.2**	Long term growth in excess of gilt returns and expected inflation. Includes diversification of UK and Global equities for market growth and currency exposure
Bonds	25.0	Dampens the volatility of funding level Income generating Liability matching properties Diversification of return source
Property	8.0	Diversification. Generates investment income; Returns expected to be inflation-sensitive Exposure to Illiquidity premium
Alternatives	15.8	Diversified source of returns Some inflation protection Source of income Exposure to illiquidity premium
Cash	1.0	Cash flow to meet statutory liabilities, including monthly pension payroll payments.

The new investment strategy will target an asset allocation of 65% to growth assets, and 35% to defensive assets, of which 10% will be invested in real assets. The Fund will look to deliver this new strategy and asset allocation over the medium term and will work with the Fund's investment consultant to implement this new strategy. The table below provides an overview of the role each asset plays in achieving the Fund's objectives is set out in the table below:

Asset class	Allocation %	Role (s) within the strategy
Equity: UK Global **Total**	 10 30 40.0	Long term growth in excess of gilt returns and expected inflation. Includes diversification of UK and Global equities for market growth and currency exposure
Bonds	25.0	Dampens the volatility of funding level Income generating Liability matching properties Diversification of return source
Property	8.0	Diversification. Generates investment income; Returns expected to be inflation-sensitive Exposure to Illiquidity premium
Alternatives	16.0	Diversified source of returns Some inflation protection Source of income Exposure to illiquidity premium
Real Assets*	10.0	Diversification Generates investment income and some inflation protection Exposure to illiquidity premium
Cash	1.0	Cash flow to meet statutory liabilities, including monthly pension payroll payments.

*The Fund will look to allocate to a range of Real Assets, this is expected to include, although not limited to, High Lease to Value Property (HLV), Infrastructure Debt and Private Residential Property (PRS).

The Committee is responsible for the Fund's asset allocation which is determined via a triennial strategy review as part of the actuarial valuation process, but is kept under constant review; noting that strategic changes are an evolutionary process.

The triennial review looks at both qualitative and quantitative analysis, covering:

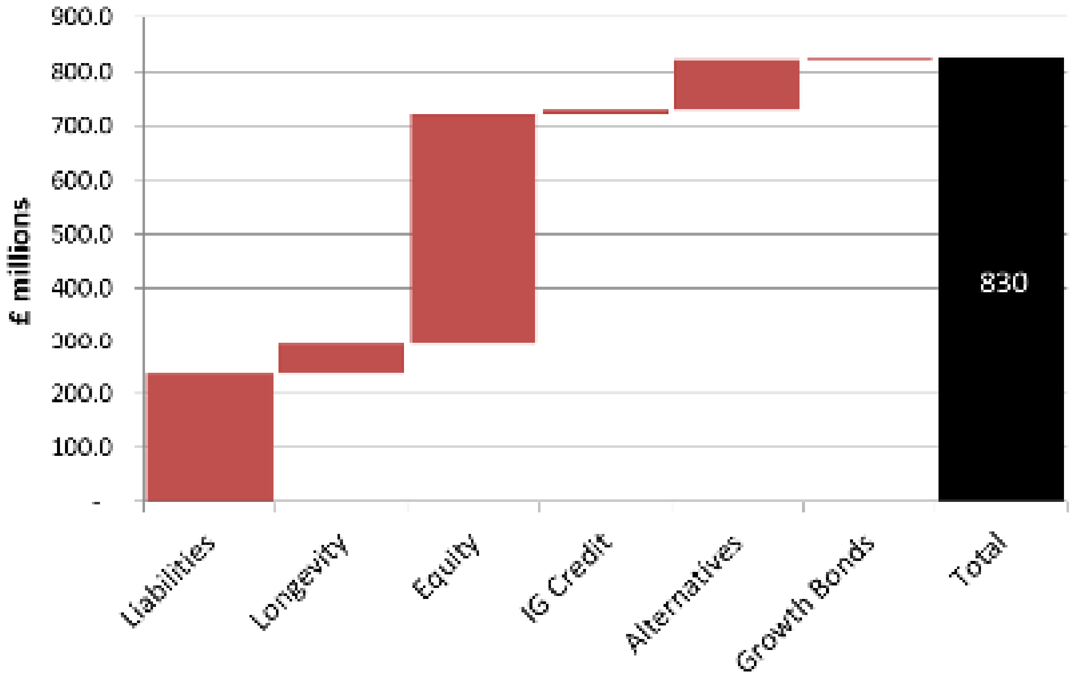
- The required level of return that will mean the Fund can meet its future benefit obligations as they fall due
- The level of risk that the Fund can tolerate in absolute terms, and in relation to its funding level and deficit
- An analysis of the order of magnitude of the various risks facing the Fund 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.

3. Risk measurement and management

The Committee assesses risks both qualitatively and quantitatively, with the starting point being the triennial strategy review. Risks are considered, understood and then prioritised accordingly.

Investment Risks

The Fund is exposed to a number of different types of risk of which the most significant are related to investment and market risk. The chart below shows the VaR[1] (Value at Risk, essentially the minimum losses that would occur in a 1-in-20 downside event) facing the Fund, split into major risk categories.



As the above graphic illustrates, equities and liabilities are the greatest sources of risk, although equities are expected to outperform liabilities over the long term, they are the fund's largest single source of risk. The other significant source of risk is from changes in the present value of its liabilities, which is sensitive to changes in gilt yields and inflation expectations. Further detail on the risks and any mitigation actions that the Fund takes to address them are detailed below.

Equities

The largest risk that the Fund is running is in relation to its equity holdings. Should equity market conditions deteriorate significantly this will have a negative impact on the funding level. The Fund holds equities in order to provide the necessary returns to ensure that the Fund remains affordable. The Committee believes that the extra returns that are expected to be generated by equities compensate for the level of risk equities bring to the Fund, but mitigates this risk by investing significant amounts in diversifying assets; bonds, property and alternatives.

The Fund is a long term investor but does require income over and above contributions received in order to pay pensions. A strategy is therefore being developed that would seek additional income from alternative assets and bonds, rather than from equities, in order to avoid being a forced seller at a low point in the market.

Liabilities

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[1] VaR calculation based on the valuation results of 31 March 2016.

The Fund's liabilities are affected by both interest rates (gilt yield) and inflation; the pensions that the Fund will ultimately pay to members are linked to inflation and so as inflation expectations rise so do the expected cashflows that the Fund will have to pay in future. The Fund's liabilities are also sensitive to interest rates because of the method that the actuary uses to place a present value on all the future pension payments. The Fund will seek to invest in a range of assets that:

- provide returns in excess of inflation;
- in some cases provide an inflation-linked income, subject to a tolerable level of volatility;
- are sensitive to interest rates to reduce the impact that changes to the present value of the liabilities have on the funding level.

Alternatives

The Fund has a significant amount of assets allocated to a range of alternatives, with specific allocations to property and private equity in addition to an alternatives mandate which invests in a range of asset classes. The risks that these investments bring at an individual level are not insignificant but the Committee believe that over the long term alternatives will provide returns that compensate for the risks being run. Additionally the level of diversification the assets provide helps to reduce the Funds reliance on returns from equities. Illiquid assets such as property are also a valuable source of income.

Active Manager Risk

Investment Managers are appointed to manage the Fund's investments on its behalf. This risk is small relative to other risks; nevertheless the Fund still addresses this risk though diversification of its exposure to active managers and careful monitoring of their progress. The Fund maintains a balance between passive and active management; determining the most appropriate approach in relation to the asset class. The Fund has an active risk management programme in place that aims to help it identify the risks being taken and put in place processes to manage, measure, monitor and (where possible) mitigate the risks being taken. Key risks and mitigating controls are incorporated in the Fund's risk register which is monitored on an ongoing basis and reported to the Pensions Committee and LGPS Board quarterly.

The Fund's portfolio is well diversified across asset classes, geography and asset managers. As different asset classes have varying correlations with other asset classes, by investing in a range of different investments, the fund can reduce the total level of risk run to a material extent.

To put some of the above risks into perspective the table below shows how a range of events could impact the Fund:

Event	Event movement in isolation	Impact on Deficit
Fall in equity markets	20% fall in equities	£430m
Rise in expected inflation	1% increase in inflation	£585m
Fall in interest rates	1% fall in interest rates	£585m
Active Manager underperformance	3% underperformance from all active managers	£80m

The other principal risks that the Fund is exposed to can be identified as:

- The Fund's investment strategy and asset allocation does not deliver the long term asset returns and growth required to meet the Fund's liabilities;
- The Funding level of the Pension Fund deteriorates;
- Scheme employers default on meeting their obligations to the Pension Fund and LGPS; and

- Third party risk – failure of Fund providers and regulatory non-compliance.

Details of these risks and a summary of control mechanisms can be found in appendix E of the Fund's funding strategy statement http://www.yourpension.org.uk/Hertfordshire/Fund-information/Policy-statements.aspx.

Cashflow Risk

The Fund's cash flow position is currently positive but the Fund is gradually becoming more mature and this position is monitored by the Fund's officers and Fund Actuary at each triennial valuation This will become an important consideration in setting and monitoring the Fund's investment strategy and asset allocation to illiquid and liquid assets. This issue is currently addressed at total Fund level. As part of the lead up to the next triennial valuation the Fund will look to develop sub-strategies to address the differing funding levels of the employers within the scheme. The Fund also receives investment income which could be used to pay benefits rather than be re-invested if and when the Fund becomes cash flow negative.

Demographic Risk

The Committee reviews the demographic assumptions of the Fund every three years as part of its triennial valuation to mitigate the risk that any changes to longevity and other factors would have on the Fund. Measures to mitigate this risk include review of employer contributions, asset allocation and bond or other insurance. Further details on the assumptions used in the valuation can be found in appendix C of the Fund's funding strategy statement http://www.yourpension.org.uk/Hertfordshire/Fund-information/Policy-statements.aspx.

Fund Governance Risk

The Fund believes that there is a benefit to the Fund to be gained from good governance of its Committee in the form of either an increased return and/or decreased risk. Poor governance can lead to opportunities and risks being missed, and have a detrimental effect on the funding level and deficit.

Details of the Fund's governance structure can be found in the Governance Compliance Statement, details of which can be found in the Annual Report and Accounts http://www.yourpension.org.uk/Hertfordshire/Fund-information/Annual-reports.aspx .

Environmental, Social and Governance ('ESG') Risks

The Committee believes that ESG risks should be taken into account on an ongoing basis and are an integral part of the Fund's strategy and objective of being a long term investor.

The Committee believes that engagement with the underlying companies through our investment managers is key in relation to strong corporate governance and managing ESG risks, which in turn will enhance returns. Details of the Fund's policies can be found later in this statement.

Asset Pooling Risk

The Fund is a member of the ACCESS pool and may be exposed to additional risk during the transition of assets to the pool and may incur unexpected costs in relation to the transition of assets among managers. The pool will seek suitable professional advice during this transition period to budget and manage cost.

4. Approach to asset pooling

Hertfordshire is a member of the ACCESS pool along with the following 10 other pension funds:

East Sussex
Essex
Hampshire
Cambridgeshire
Isle of Wight
Kent
Norfolk
Northamptonshire
Suffolk
West Sussex

All eleven funds are committed to working together collaboratively to meet the criteria for pooling and have signed a Memorandum of Understanding to underpin their partnership (will be updated for IAA). ACCESS is working to a project plan in order to create the appropriate means to pool investments. The first investments planned to be pooled in 2018 will be passively-managed investments.

The ACCESS Funds have set out how they meet the pooling criteria, the pool's structure, governance arrangements and services to be shared in the submission made to the Government in July 2016, which is available on ACCESS's website http://www.accesspool.org/

All eleven ACCESS funds expect that all investments will be pooled apart from a minority of investments where there is a no value for money benefit to pooling These have been / will be set out as part of the pooling criteria

Assets to be invested in the Pool

The Fund's intention is to invest its assets through the ACCESS Pool as and when suitable Pool investment solutions become available. An indicative timetable for investing through the Pool was set out in the July 2016 submission to Government. They key criteria for assessment of Pool solutions will be as follows:

1. That the Pool enables access to an appropriate solution that meets the objectives and benchmark criteria set by the Fund
2. That there is a clear financial benefit to the Fund in investing in the solution offered by the Pool, should a change of provider be necessary.

Assets held outside the pool

At the time of preparing this statement the Fund has elected not to invest the following assets via the ACCESS Pool:

Asset class	Manager	% of Fund assets	Benchmark	Reason for not investing via the ACCESS pool
Private Equity	HarbourVest, Standard Life Capital, Pantheon	3.3%	FTSE All-Share index	Existing illiquid asset programmes will run off at normal lifecycle to avoid crystallising exit costs and loss of illiquidity premium earned.
Alternatives	LGT Capital	9.6%	3 month sterling LIBOR	This mandate is made up of illiquid and liquid asset classes which because of the

				nature of both the fee structure and legal structure of the entities invested in is likely to make pooling both extremely difficult to implement and significantly more costly for the Fund..
Operational Cash	Hertfordshire County Council	1%	7 day LIBID	The Hertfordshire Pension Fund needs to manage its cash flow to meet statutory liabilities, including monthly pension payroll payments, therefore a reasonable level of operational cash will be held outside the pool.

5. Environmental, Social and Corporate governance and the exercise of rights (including voting rights) policies

With regard to responsible investment, the Committee is mindful of the following legal principles, which are based on recent decisions in the courts and which apply to all pension schemes:

a. Administering authorities are free to adopt a policy of socially responsible investment, provided that they treat the financial interests of all classes of scheme members as paramount and their investment policies are consistent with the standards of care and prudence required by law.

b. Administering authorities are free to avoid certain kinds of prudent investment, which they consider scheme members would regard as objectionable as long as they make equally financial advantageous and prudent investments elsewhere. They may also make “ethical” investments provided these are otherwise justifiable on investment grounds.

c. Administering authorities are not entitled to subordinate the interests of members to ethical or social concerns. The financial performance of the Fund consistent with proper diversification and prudence is paramount.

The Committee has a fiduciary duty to invest Fund assets in members’ best interests and so must ensure that assets are invested in an appropriate manner; as a result any ESG considerations must be taken in light of expected return implications.

ESG issues can have a material impact on long-term risk and return outcomes and considering these issues is consistent with the fiduciary duty of the Committee. The Fund is a long-term investor and is committed to being an active owner. It wishes to promote a policy of dialogue on responsible investment issues, through its investment managers, with company management.

The Committee has identified the following ESG issues as a focus for engagement with its managers:

- Environmental issues: including conserving energy, promoting alternative energy sources, recycling, avoiding pollution and using environmentally friendly and sustainable resources
- Human rights: including child labour issues in foreign subsidiaries of UK companies or operations in countries with oppressive regimes
- Employment standards: including equal opportunities, health and safety, trade union recognition and employee participation

The Fund invests via pooled funds and therefore expects its underlying investment managers to exercise voting and engagement rights on its behalf. The Fund is therefore subject to the ESG and voting policies of the individual investment managers. The Committee considers these policies when appointing a new manager and when monitoring investment managers, the Officers consider whether each manager's actions and engagement activities have been appropriate and in keeping with the Fund's policy.

The Fund complies with the UK Stewardship Code ('the Code') and is preparing a formal statement of compliance with the Code for assessment. The Fund encourages its underlying investment managers to comply with the Code.

It is proposed to monitor action by investment managers on a quarterly basis and further develop this policy on an annual basis on the basis of experience. The Committee will also receive an annual report from its Investment Consultant on the ESG credentials of its investment managers.

Myners Principles

Although no longer referenced in the Regulations, the Committee considers that assessment of compliance with the Myners Principles is a valuable governance tool. A copy of the Fund's Myners Compliance Statement can be found in the Annual Report and Accounts. http://www.yourpension.org.uk/Hertfordshire/Fund-information/Annual-reports.aspx .