Common Good and Trusts Investment Sub-Committee

Due to Scottish Government Guidance relating to Covid-19, the meeting will be held remotely

Thursday, 29th April, 2021 - 2.00 p.m.

AGENDA

Members are reminded that should they have queries on the detail of a report they should, where possible, contact the report authors in advance of the meeting to seek clarification.

Morag Ferguson
Head of Legal and Democratic Services
Finance and Corporate Services

Fife House
North Street
Glenrothes
Fife, KY7 5LT

22nd April, 2021

Please contact:
Wendy MacGregor, Committee Officer, Fife House
Email: Wendy.MacGregor@fife.gov.uk

Agendas and papers for all Committee meetings can be accessed on www.fife.gov.uk/committees

THE FIFE COUNCIL - COMMON GOOD AND TRUSTS INVESTMENT SUB-COMMITTEE – REMOTE MEETING

26th November, 2020 **3.30 p.m. – 4.05 p.m. -**

PRESENT:	Councillors Dave Dempsey (Convener), David Barratt, Bobby Clelland, Mino Manekshaw and Jonny Tepp.
ATTENDING:	Elaine Muir, Head of Finance, Laura Robertson, Finance Operations Manager, Lesley Kenworthy, Business Partner, Eleanor Hodgson, Accountant and Anne Bence Accountant, Finance; Helena Couperwhite, Manager - Committee Services and Wendy MacGregor, Committee Officer, Legal & Democratic Services.
APOLOGIES FOR ABSENCE:	Councillors Altany Craik and Fiona Grant.

5. DECLARATIONS OF INTEREST

Councillor Bobby Clelland declared an interest in the business on the agenda being a trustee of the Mine Workers Pension Scheme.

6. MINUTE

The Committee considered the minute of the Common Good and Trust Investment Sub-Committee of 27th November, 2019.

Decision

The Committee agreed to approve the minute.

7. COMMON GOOD AND TRUST FUNDS

The Committee considered a report by the Executive Director, Finance and Corporate Services providing an update on the market value of investments of the Common Good and Trust Funds. The report was provided on an accrual basis to inform the Committee of the investment performance over the last financial year.

Decision

The Committee noted the update on the market value of investments of the Common Good and Trust Funds and the investment performance over the financial year 2019-20.

8./

8. REVIEW OF INVESTMENT ARRANGEMENTS - COMMON GOOD AND TRUST FUNDS

The Committee considered a report by the Executive Director, Finance and Corporate Services providing details of the outcome of a review of the current investment strategy for Common Good and Trust Funds. The review was undertaken by Hymans Robertson and provided some recommendations which were included in the report.

Decision

The Committee:-

(1) approved the recommendation made by Hymans Robertson to review the Investment Strategy;

(2) agreed to remit the Head of Finance to work with Hymans Robertson to investigate an alternative global equities mandate;

(3) agreed to remit the Head of Finance, with support from investment advisers, to appoint a fund manager to facilitate the move from investment in UK Equities to Global Equities; and

(4) agreed that an additional meeting of the Common Good Investment Sub-Committee would be held on 9th March, 2021 to provide members with an update on the performance of investments and the review of the Investment Strategy.

29th April, 2021

Agenda Item No. 4

Common Good and Trust Funds

Report by: Eileen Rowand, Executive Director of Finance and Corporate Services

Wards Affected: All

Purpose

The purpose of this report is to provide an update on the market value of investments of the Common Good and Trust Funds. This report is provided on an accrual basis and is to inform members of the investment performance as at December 2020.

Recommendation

Members are asked to note this report.

Resource Implications

None.

Legal & Risk Implications

None.

Policy & Impact Assessment

An EqIA is not required because the report does not propose a change or revision to existing policies or practices.

Consultation

N/A.

1.0 Background

1.1. Janus Henderson took over the management of the Common Good and Trust Funds investment portfolio in March 2001. As a result, £2.777m of Common Good and Trust funds were invested in the Preference & Bond Fund and the UK Equity Income Fund, with £1.725m in relation to the Fife Educational Trust Fund being invested in a separate portfolio on 8 June 2007.

1.2. The investment strategy for the Fife Educational Trust Fund and Common Good and Trust Funds is the same; to generate income whilst preserving and growing capital.

2.0 2020-21 Performance

2.1 The current valuations for these funds are shown below: -

	Common Good & Trust Funds	Fife Educational Trust Fund	Total
	£	£	£
Valuation as at 31 March 2020	4,525,791	1,305.095	5,830,886
Increase / (decrease) in year	826,984	312,111	1,139,095
Valuation as at December 2020	5,352,775	1,617,206	6,969,981

Janus Henderson have provided some additional commentary on the performance of the fund, which is attached as Appendix 1

2.2 Income earned by Janus Henderson Investors up to December 2020 is also shown, as is the investment Income as a percentage of the market value at the end of the financial year (i.e. the return)

	Common Good & Trust Funds	Fife Educational Trust Fund	Total
	£	£	£
Income earned to December 2020	199,283	53,790	253,073
% of Valuation as at 31 Dec 2020	3.72%	3.33%	3.63%

2.3 This income is credited to the Common Good and Trust Fund revenue accounts and used to support expenditure in year

2.4 During the year to end December 2020 the Common Good and Trust Funds have made disbursements of £221,843.69. The Fife Educational Trust held no meetings up to the end of December 2020 as a result of COVID restrictions but at their meeting held in January 2021, £81,447 was allocated for disbursement and will be paid out prior to the end of the financial year on 31 March 2021.

3.0 Conclusions

3.1 The market value of the Common Good and Trust Funds have improved during the year and have an increased value at 31 December 2020.

Appendix 1 – Janus Henderson Preference & Bond Fund Commentary

Report Contact
Laura Robertson
Finance Operations Manager
Fife House

Telephone: 03451 55 55 55 extension 450552
Email: Laurac.robertson@fife.gov.uk

Appendix 1

Janus Henderson Commentary

UK and Equity and Growth Fund

During the 9 months from 1st April 2020 to 31st December 2020, the Janus Henderson UK Equity Income & Growth Fund rose 28.9% (I Inc share class), outperforming the FTSE All-Share which rose 20.5% and the IA UK Equity Income peer group which rose 24.2% (all figures are total return, £). This outperformance was concentrated in the fourth quarter of 2020, following the positive phase III Covid-19 vaccine trial read-out from Pfizer (and subsequently Moderna and AstraZeneca). On a 12 month historic basis the Fund's yield (I Inc share class) as at the end of December was 3.0%.

At the sector level, the two largest drivers of the relative outperformance were the overweight positions in Industrials and Financials (these sectors are also the two largest sector overweight positions of the Fund relative to the FTSE All-Share benchmark).

In the case of the Industrials, end markets were (broadly, although with some exceptions) very difficult in 2020, leading companies to focus on cutting costs and in many cases closing manufacturing facilities. What this means (in our view) is that as industrial end markets recover we will see substantial operating leverage as growing sales drop through to earnings at a faster pace than consensus anticipates. We have begun to see this potential earnings recovery being reflected in valuations as the sector has recovered in recent months, however in the largest industrial positions within the portfolio (such as Morgan Advanced Materials and TT Electronics), we think the scale of cost cutting remains underappreciated. In some cases the strong performance of shares in the fourth quarter of 2020 reflected relief that end markets could potentially recover in the future – this was particularly true for companies exposed to civil aerospace end markets such as Meggitt and Senior.

In the case of Financials, the source of relative outperformance during the nine month period came from a combination of the life insurers held such as Phoenix, which acted defensively (particularly as they maintained their dividends at a time of steep dividend cuts elsewhere), as well as diversified financials such as Numis (which benefited from a large number of equity raises to shore up balance sheets in the initial stages of the pandemic). More recently, the banks held such as Natwest have also performed well on the expectation of a domestic economy recovery into 2021, at a time of comparatively strong capital positions and (in our view) conservative provisioning. We have in recent months been adding to the banks weighting for these reasons, bringing it approximately in line with the benchmark weighting in banks.

29th April 2021

Agenda Item No. 5

Review of Investment Arrangements - Common Good and Trust Funds – Global Equity Considerations

Report by: Elaine Muir, Head of Finance

Wards Affected: All

Purpose

The purpose of this report is to provide further details of the outcome of a review of the current investment strategy for Common Good and Trust Funds. A review was undertaken by Hymans Robertson and presented to this Committee. The committee requested further information in respect of investing in Global Equities as opposed to UK equities only.

Recommendation

Members are asked to:

1) Approve the recommendation made by Hymans Robertson to implement a single investment mandate which is consistent with the current approach adopted.
2) Approve the recommended approach for the funds to achieve global equity exposure through a passive market-cap index, preferably with climate or ESG tilt if practicable.
3) Remit the Head of Finance, with support from investment advisers, to appoint a fund manager to facilitate the move from investment in UK Equities to Global Equities.

Resource Implications

Commissioning further work on this area from investment adviser will incur a cost which will be charged to the funds on a proportionate basis.

Legal & Risk Implications

There are risks associated with all investments and the likely return that the Common Good and Trust Funds will receive depends on the investment mandate and market volatility.

Policy & Impact Assessment

An EqIA is not required because the report does not propose a change or revision to existing policies or practices.

Consultation

Consultation with Investment Advisers Hymans Robertson has been carried out in preparation of this report.

1.0 Background

1.1. It has been some considerable time since a review of the current investment arrangements for Fife Educational Trust, Common Good and Trust Funds was undertaken. In order to establish if the current arrangements continue to be fit for purpose a review was commissioned to be undertaken by Hymans Robertson, one of the Investment Advisers used by the Council for Fife Pension Fund.

1.2. The results of this review were presented to Common Good and Trust Fund Investment Sub-Committee at its meeting on 26 November 2020.

1.3 The review recommended a review of equity allocations and the move to a global equity mandate. The Sub-Committee requested that further information on global equities be presented to the committee and consideration be given to ESG.

2.0 Issues

2.1 Hymans Robertson have undertaken further work and have provided an overview of the various styles of equity investing to aid informed decision making.

2.2 Three styles of equity investment are examined – passive, active and factor-based. All three have their own merits and important roles to play in a balanced equity portfolio.

2.3 The approach recommended by Hymans Robertson to achieve global equity exposure is through a passive market-cap index, preferably with climate or ESG tilting if practicable. The simplicity of implementation, low fees, governance requirements and market exposure make traditional passive approaches an attractive option given the Fund's objectives and size.

2.4 The attached report by Hymans Robertson provides further information on the styles of equity investment along with ESG considerations, recommendations and outline of next steps.

2.5 The next steps involve gaining Committee's view on ESG considerations, Emerging markets and expected fall in income from revised allocation.

3.0 Conclusions

3.1 It has been some considerable time since the investment strategy for Common Good and Trust funds was reviewed. A report was considered in November 2020 which recommended considering a move to global equities.

3.2 Hymans Robertson have prepared a further report outlining Global Equity considerations.

3.3 It is recommended that a single investment mandate is implemented with exposure to global equities through a passive market-cap index.

Background Reports

- Review of Investment Arrangements – Common Good and Trust Funds – November 2020

List of Appendices

- Appendix 1 – Global Equity Considerations – Hymans Robertson LLP

Report Contact

Laura Robertson
Finance Operations Manager
Fife House

Telephone: 03451 55 55 55 extension 450552
Email: Laurac.robertson@fife.gov.uk

Global equity considerations

1 Introduction and executive summary

1.1 Addressee

This paper is addressed to the Committee of the Common Good and Trust Funds ("the Funds").

The purpose of this paper is to explore the range of global equity fund management styles available to the Funds, outline the relative merits of each approach and provide the Committee with a recommendation as to which management style we suggest the Funds proceed with. Further to these discussions, we will look to provide a short-list of our preferred managers and strategies that meet the criteria agreed by the Committee.

This paper has not been prepared for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the paper is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the paper may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

1.2 Background

The Funds overarching objective is to generate income whilst preserving and growing capital. Below are what we consider to be the key requirements of the equity portfolio to help deliver this objective:

- Ability to deliver long-term real returns;
- Ability to deliver a predictable level of income;
- Diversification by sector, asset class and geography; and,
- An integrated approach to responsible investment.

Following a review of the Funds' investment strategy in March 2020, it was agreed that the Funds would look to transition their equity portfolio (valued at c.£4.1m as at 31 December 2020) from UK to global equities. The rationale for this decision is to gain greater diversification and reduce concentration risk from both a regional and sectoral perspective by solely allocating to the UK. We still consider this to be a sensible approach.

1.3 Executive summary

The purpose of this paper is to provide an overview of the various styles of equity investing to allow the Committee to make an informed decision. All three styles of equity investing (passive, active, factor-based) have their own merits and an important role to play in a balanced equity portfolio.

However, given the size of the mandate being considered we recommend the Committee implements a single investment mandate, consistent with the current approach adopted by the Committee.

On balance, our recommended approach for the Funds to achieve global equity exposure through a passive market-cap index, preferably with climate or ESG tilting if practicable. We believe the simplicity of implementation, low fees, low governance requirements and broad equity market exposure make traditional passive approaches an attractive option given the Fund's objectives and size.

We look forward to discussing this paper with you.

Prepared by:-

Jordan Irvine, Investment Consultant
Sean Lintott-White, Investment Analyst

For and on behalf of Hymans Robertson LLP

General Risk Warnings

Please note the value of investments, and income from them, may fall as well as rise. This includes but is not limited equities, government or corporate bonds, derivatives and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of investments. As a result, an investor may not get back the full amount of the original investment. Past performance is not necessarily a guide to future performance.

Hymans Robertson LLP has relied upon or used third parties and may use internally generated estimates for the provision of data quoted, or used, in the preparation of this report. Whilst reasonable efforts have been made to ensure the accuracy of such estimates or data, we cannot be held liable for any loss arising from its use.

2 Approaches to equity investment

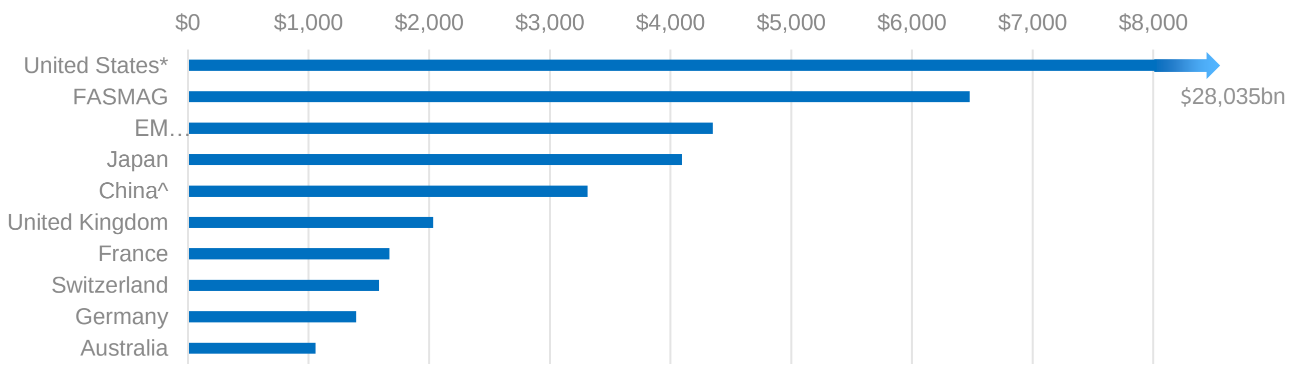
Equity approaches range across a spectrum from ‘active’ management to ‘passive’ or index-tracking strategies. Traditionally, passive equity investment centred on ‘market-cap’ based indices. However, over recent years there has been an increasing focus on factor based investing and we explore these three approaches below.

2.1 Passive (‘Market-cap’) investment

Market cap indexation follows an approach where equity indices are constructed using a company’s size to determine its weight in an index. The size of a company is calculated using the market capitalisation of that company (i.e. the number of outstanding shares of that company multiplied by its share price, although often adjusted to only allow for the shares that are available to be traded, known as the “free float”). Indices are then constructed to give larger weights to larger companies. The market cap passive products deliver a very broad-based equity exposure and there are a wide range of index providers that offer vehicles that track the performance of such market cap-weighted indices. The strategies aim solely to replicate their given benchmark in a low-cost and transparent way.

The greater focus on fees, coupled with a difficult period for actively managed strategies (which we detail in the active management section below) has led to a huge growth of investments into passive equity funds over recent years. However, whilst market capitalisation indices offer many benefits (including simplicity, lower governance requirements, low costs and ease of execution), market cap indices have a degree of “momentum” built into them. This is caused by the linkage between a company’s stock price and its weight in the index - that is, a company whose stock price is appreciating (and is possibly overvalued) will have a higher weight in the index. Conversely, a depreciating stock (which might, on average be undervalued) will have a diminishing weight in the index.

One of the main criticisms of market cap passive approaches is that larger weights are allocated to the largest companies and although some may merit such large weights, many end up overvalued relative to their fundamentals. Therefore, it can be argued that market cap-based indices systematically overweight over-priced securities and underweight under-priced securities, leading to a less efficient allocation of capital and risk concentrations within the index product. This leads to the second main criticism of market cap passive investment - whilst the products are designed to deliver low levels of relative risk compared to the index they track, some indices can end up with significant levels of stock, sector or regional concentration and as a result can have high levels of *absolute* risk. For example, the chart below shows that the market capitalisation (in USD) of six technology stocks FASMAG (Facebook, Amazon, Samsung, Microsoft, Apple and Google (Alphabet)), which combined are greater than the entire size of the equity markets of Japan, the UK, and individual European countries.



Source: MSCI, Hymans, October 2020

*$28trn US market capitalisation excludes Facebook, Amazon, Microsoft, Apple and Google (Alphabet) ^Based on MSCI China. MSCI China captures large and medium cap representation but excludes significant proportion of China A Shares. EM (excluding China) excludes Samsung.

The below table summarises the advantages and disadvantages of taking a passive approach to equity investing:

Advantages	Disadvantages
Low cost (cheaper than active management)	Can be more volatile, especially in less efficient markets (e.g. emerging markets)
Easy to understand and requires low governance	Lacks flexibility as there is an inability to protect capital or underweight securities
Readily replicated by liquid derivatives market	Index choice is subject to absolute levels of risk
Greater liquidity and capacity	

In summary, market cap investing does have the advantages of being simple, transparent and easy to understand. Tracking a market cap index also means investing the most money in the largest and most liquid stocks, and the costs of implementation are relatively low. The main challenge is that market cap indices represent past performance (those stocks that have historically done well) rather than the prospects for future performance.

2.2 Active management

Actively managed equity strategies employ a manager to select a portfolio of stocks, typically with the intention of outperforming the relevant market cap-based index over time. The two most common approaches to active management is value and growth investing. A value orientated fund manager makes active selections to different stocks, allocating to stocks that the manager believes are undervalued by the wider market (those managers that are benchmark aware would ensure their allocation was above the benchmark weight) and avoiding those that they believe are overvalued. Whereas a growth orientated fund manager focusses on stocks which have good growth prospects, typically cyclical companies in new areas of the market.

The price for this management is typically higher fund fees and the requirement for the investor to more closely monitor performance. Therefore, the allocation to active strategies should be based on a fundamental belief that active managers can outperform the benchmark and in turn that it is possible to identify those active strategies that can outperform the benchmark. Other specific considerations for adopting active management are the overall return and risk objectives, investment time horizons, liquidity requirements, any fee constraints and the willingness and ability to tolerate a material deviation in returns from a benchmark potentially for an extended period. The extent to which an investor desires to carry out active stewardship may also be a factor in the choice of active management. Whilst passive managers act as stewards of capital, they have to exercise that responsibility over many stocks. In contrast, active managers that have a significant allocation to a smaller number of specific stocks are more likely to have meaningful engagements with the companies owned.

If an active management approach is followed, in terms of implementation, a number of areas would need to be considered, including:

- Are there specific areas of equity markets where active strategies are more likely to succeed? If prospects for active managers are seen as limited in some regions or market segments, it may be better to adopt a core passive approach in these and utilise active strategies in areas where active management is considered as more likely to succeed.
- Active funds usually exhibit different investment style exposures (e.g. 'growth' or 'value'), which for most funds that follow a consistent investment philosophy and process will tend to persist across a cycle. In this case, active strategies can be used to target these desired factor exposures. In terms of the overall equity strategy,

it is important to consider both the individual style exposure in a fund, as well as the combined style exposure if a number of different funds are held in their portfolio. Unless there is a strong preference for a particular style, we would suggest the overall equity style exposure is kept fairly balanced and investors should not seek to manage this too actively, given the difficulty of timing shifts between these styles and the costs of doing so.

- In recent years there has been an increased focus on both the costs and value add of active management. Investors are increasing seeking 'true' active management - where fund managers take high conviction positions in individual stocks and meaningful positions versus the benchmark – and shunning "closet trackers", where a fund's active management offers barely anything distinctive from the benchmark. This is often linked to "unconstrained" investing, interpreted as constructing portfolios with limited or even no reference to standard benchmark weightings. There has been a greater focus on portfolio metrics such as "active share", which measures the level of differentiation to the benchmark index. Both the level of active management and its costs are important when considering active managers.

In aggregate, the active management industry has not managed to deliver the performance to overcome management costs, particularly over the past decade. Partly this reflects the prevalence of closet trackers and high product fees. However, it is also important to note that the last decade has been the longest-running equity bull market ever experienced. In this time, monetary stimulus from central banks following the onset of the global financial crisis in 2008 has helped fuel the strong returns delivered by equities. At times during this bull market, attention has focused more on macroeconomic factors and monetary policy rather than the company fundamentals that many actively managed strategies focus on. This has meant that company fundamentals have at times been rewarded less and, at the same time, levels of volatility in equity markets have, up until relatively recently, been compressed. All this has created a difficult backdrop for actively managed strategies.

2.3 Factor based investing

Over recent years, following the introduction of RAFI indices, a range of alternative indexation approaches have been developed, often described as 'factor-based investing' or 'smart beta'.

Equity factor investing, in its broadest definition, is a systematic, rules-based approach where securities are selected based on factors associated with higher returns. These factors have been identified by academic research as being significant drivers of market returns over the long-term. Factor investing can be implemented actively or passively.

A further benefit to most factor-based approaches is that they implicitly include a helpful rebalancing discipline. Since the weight of a stock in the portfolio is not based (solely) on its price, stocks which rise in price tend to get trimmed back periodically in favour of stocks which have fallen in price – a form of sell high, buy low, which should also add value over time.

Over 300 factors have been identified in various academic research, but many of these lack sufficient evidence to support their use in portfolio construction. The following factors are the most cited by academics and investors as being able to deliver sustained outperformance (relative to market cap) over the longer term:

1 **Value** – the value factor targets companies whose share price is deemed to be cheap relative to the company's fundamentals, therefore potentially offering good value. The theory is that cheaper stocks outperform expensive stocks over the long-term. The argument for the existence of a value premium is that investors on average overestimate how long stocks can sustain share price growth and overpay for them leading to value stocks being under-priced. The flipside of the argument is that some 'value' stocks are simply bad companies.

2 **Low volatility** – academic research has found that lower risk stocks (e.g. based on the stability of the company's share price or revenue) earn higher risk-adjusted returns than more volatile companies over the

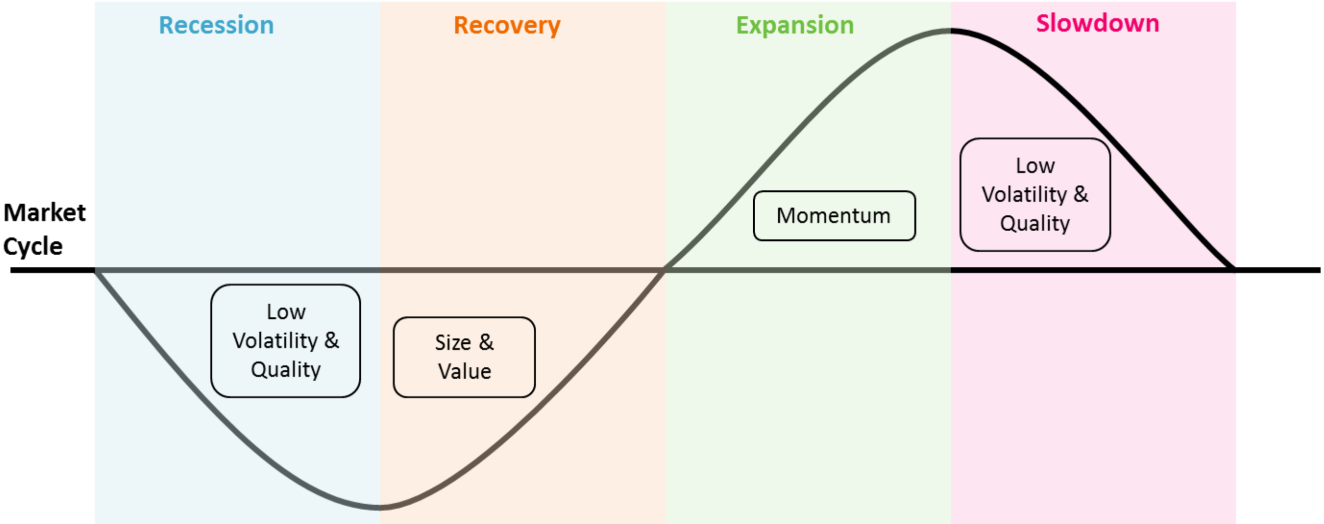
long-term. The behavioural argument is that investors' desire to share in the possibility of higher returns from high-risk stocks leads them to being overpriced on average.

3 **Size (small cap)** – the theory is that smaller companies outperform larger companies over the long-term. This could be because smaller companies are less liquid and under-researched compared to larger companies, which creates a premium for smaller stocks. It could also be argued that smaller, in some cases newer companies, have more potential for future growth.

4 **Quality** – what constitutes 'quality' is less well defined than other factors, but broadly speaking, high-quality companies are typically defined as either having relatively strong and stable profit streams and/or other desirable financial metrics (e.g. low debt, high margins and returns on capital). Some studies have found that high quality companies tend to outperform lower quality companies over the long-term. The general argument for the existence of a quality premium is that investors tend to underestimate the value of stable and consistent performance over the long term.

5 **Momentum** – the momentum factor is based on findings that price trends persist (i.e. recent well-performing stocks tend to continue to do well for a period). This is because investors tend to prefer to invest in recent winners, leading to further increases in share price. In addition, momentum stocks tend to have higher business cycle risk which, in theory, requires additional return to compensate investors.

Factors in market cycle



These factors have been found to be cyclical but operate differently at different stages of the market cycle. Therefore, a multi-factor approach will target multiple factors at the same time so smooth out the cyclicality. The benefit of doing this is that it should limit potential drawdowns of investing in one particular factor and deliver more stable returns.

Arguably an element of systematic return enhancement or lower volatility for the majority of factor tilts is due to "smart" rebalancing, i.e. the principle of disciplined buying low, selling high. There are plenty of academic studies supporting the existence of this "rebalancing premium". The key is ensuring you have the right balance between enhancing return from rebalancing and low enough turnover for transaction costs not to erode this value.

While factor-based investing can be implemented in both an active and passive approach, the active approach involves trying to time the cyclicality of individual factors which we believe is very difficult. Instead we prefer a passive approach to factor-based investing where you try to match the performance of an equity index constructed using a factor-based approach. This could be by weighting according to one or more of the factors listed above.

The historical data shows that factors offer better risk-adjusted returns over the very-long term, which supports their use as an alternative to a market cap indexation approach. However, factor investing is not without risk and individual factors can suffer extended periods where they perform poorly, both in absolute terms and relative to a market cap-weighted index.

2.4 ESG considerations

It is becoming increasingly clear, that being cognisant of Environmental, Social and Governance (ESG) risk (of which climate risk is a particularly notable example), should have a positive impact on long-term returns. Our view is that the all investors should look to understand how their investment managers or prospective managers incorporate ESG thinking within their strategy.

For active managers, it will be important to understand how they build ESG factors into their investment process, for instance whether this is separate element supported by specialist team or considered to be embedded in the overall stock analysis.

For index-tracking approaches (both conventional passive market-cap and under alternative indexation), the decision on if and how to incorporate ESG risk management into the portfolio will lie within how the given strategy is constructed. An index is set of rules for managing a portfolio, and so rules can be set to screen or tilt away from certain stocks which exhibit high levels of ESG risk, or, toward stocks that are deemed likely to benefit from having ‘positive’ ESG characteristics.

Whether index-tracking or active, the manager should also be able to clearly articulate their policy on engagement with the companies held in the portfolio, and in particular their attitude to exercising voting rights. We believe proactive stewardship (principally through voting and engagement activity) to be the central means of enhancing long term value-creation and would favour managers who demonstrate a robust approach in the space.

We would also suggest the Committee discuss whether there are particular ESG issues they might want to integrate into the new mandate. This might be aligned to their own responsible investment beliefs or with the mission of the Funds to provide a social good. There now exist solutions across **all** equity management approaches that consider a wide range of ESG issues, which the Committee can explore at the manager selection stage. We note that these solutions can include a focus on issues including UN Global Compact (10 principles for sustainability derived from other UN initiatives), the UN Sustainable Development Goals (“SDGs”) or themes such as climate change and diversity.

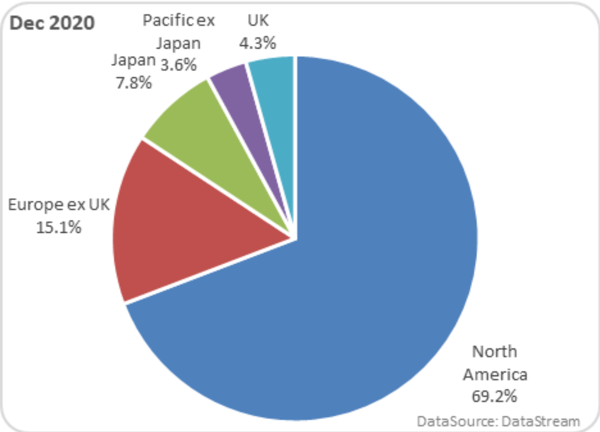
2.5 An allocation to Emerging Market equities

The Committee will be aware of our general preference for a global equity approach as opposed to a regional approach, however even at a global level, there remains the decision whether to allocate to developed market equities only or include Emerging Market (EM) equities within the allocation.

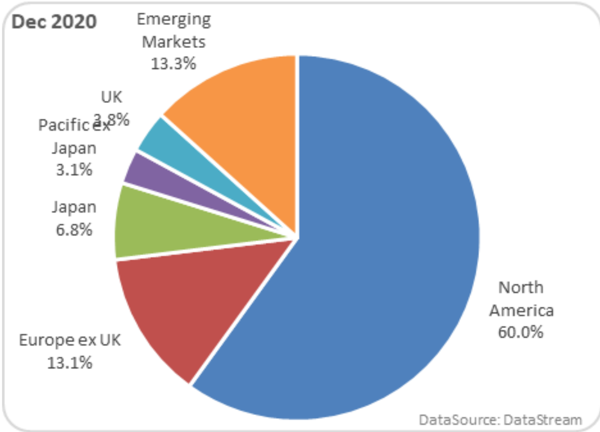
In line with the rationale for transitioning to a global equity portfolio from the UK, we also view inclusion of EM as broadening the opportunity set and providing further diversification benefit. This principle applies to each of the three explored management approaches, though we note that are fewer factor-based solutions that include EM, with a majority still focussed on developed markets.

The chart below shows the differences in regional equity exposure under a market cap approach for MSCI World Index (excluding EM) and MSCI ACWI Index (including EM).

MSCI World Index (excluding EM)



MSCI ACWI Index (including EM)



We note the outperformance of emerging market equities relative to developed market equities could more than offset any additional returns expected through active management.

3 Recommendation and next steps

3.1 Recommendation

The Funds currently invest in an active UK equity fund through Janus Henderson's UK Equity Income & Growth. The underperformance of the current equity allocation highlights the difficulties of getting active management right. The table below is a reminder of the performance of the current Janus Henderson mandate relative to benchmark since 2015.

Calendar year performance

	2015	2016	2017	2018	2019	2020
Janus Henderson UK Equity Income & Growth	3.0	9.5	8.8	-12.8	12.1	-12.8
FTSE ALL-Share	1.0	16.8	13.1	-9.5	19.2	-9.8
Relative	**+2.0**	**-7.3**	**-4.3**	**-3.3**	**-7.1**	**-3.0**

Source: Janus Henderson, returns for the I Inc share class (net of management fees) to 31st December 2020 in GBP

This issue is not unique to this strategy. We note that in the US and Europe, only 22% and 27% of active managers respectively outperform their benchmarks[1].

Fundamentally, this is why we believe active management is best served through a blended approach of passive and active management, with contrasting styles of active equity management (i.e. a value and growth manager to complement each other).

Given the size of allocation being considered we do not believe a blended approach of styles to be suitable. Our preference is to retain one manager/mandate and try and achieve access to institutional investment funds (rather than retail) where the fees are more favourable, and the funds less likely to experience volatility in capital flows which can have material impacts on liquidity.

As highlighted above, selecting one active manager who consistently outperforms its benchmark is notoriously difficult, and we would be hesitant to suggest that the Committee allocates to an active equity manager.

In general, we are supportive of factor-based investing. The obvious appeal of investing in any of the individual factors outlined in section 2.3 is that according to the academic findings, each factor should deliver a better outcome (i.e. risk-adjusted return) than a traditional market cap-weighted index over a sufficiently long time horizon. However, this approach can also lead to periods of underperformance relative traditional passive funds. Should the Committee wish to consider this approach further, our preference is to take a multi-factor approach to benefit from multiple risk-adjusted return sources and to mitigate timing risk across the market cycle. This approach does add an extra layer of complexity into the strategy relative to market cap approach, but is something we'd be happy to explore further with the Committee.

Overall, our recommended approach is to achieve global equity exposure through a passive market-cap index, preferably with climate or ESG tilting if practicable. We believe the simplicity of implementation, low fees, low

[1] Source: S&P Indices Versus Active ("SPIVA"); relative performance of active managers is over a 5-year period up to 30 June 2020. https://www.spglobal.com/spdji/en/spiva/#/reports

governance requirements and broad equity market exposure make traditional passive approaches an attractive option given the Funds' objectives.

The Committee should note that under a passive global equity approach, the Funds will likely have to accept a lower level of income relative to both the existing mandate or an active global equity mandate (further details are shown in the appendix). This is because UK companies pay a higher level of dividend compared to the overseas companies. The current strategy delivers an income of around 3.4% p.a., equivalent to £235k per annum to the Funds, whilst the proposed strategy would deliver an income of around 2.6% p.a. equivalent to around £185k per annum, gross of fees. We do, however, note that this reduction in income is partially offset by a reduction in fees.

We also suggest the issues of rebalancing are considered separately as part of developing a strategy document on behalf of the Funds.

Next steps

The Committee should formally decide whether they are comfortable with our recommended approach for transitioning the Funds' equity portfolio to a passive market-cap strategy.

Further to these discussions, we will look to provide a short-list of strategies that meet the criteria agreed by the Committee and ultimately aid in the implementation of a new mandate with the selected manager. This would then be followed by the drafting of formal governance documents detailing the investment strategy of the Funds.

To help in preparing a short-list of investment managers, we are keen to understand the Committee's views on the:

- Inclusion of ESG tilts away from certain stocks which exhibit high levels of ESG and climate risk;
- Inclusion of Emerging Market equities in the global equity approach; and
- Whether the Committee has any concerns over the expected fall in income from moving to the new proposed allocation.

We look forward to discussing this paper with you.

Appendix 1 – Comparison of equity fund management approaches

	Description of approach	Typical portfolio size	Fees	Gross yield	Estimated annual income**	Factor bias	Concentration risk	ESG or climate integrated solutions?
Active management	Discretionary selection of stocks based on managers' investment strategy and philosophy	30-120 stocks	70-90bps	3-3.5%*	c.£132k	Typically, 'Growth' or 'Value' oriented though strategies don't necessarily have a bias	High	Yes
Passive (market-cap) management	Construction of portfolio by tracking index of global stocks weighted by market capitalisation	1000+ stocks	10-25bps	1.5-2%	c.£71k	Yes, due to 'momentum' of growth stocks in the index	Medium/High	Yes
Factor based	Construction of portfolio by weighting stocks using alternative metrics to market-capitalisation	1000+ stocks	20-35bps	1.5-2%	c.£71k	Exposure to selected factors; multi-factor has 'balanced' factor exposure	Low	Yes

*Global active equity funds specifically targeting income generation typically achieve 3-3.5%, gross of fees. 'Growth' style active equity managers will typically have distribution yields of <2%.

**Estimate of gross income assuming mid-range fees and gross yields based on 31 December 2020 valuation. Based on the trailing yield and the end of December valuation, the current UK equity mandate is expected to achieve c.£122k in income.