



**MNOPF Trustees Ltd**

**TKU Investment Training**

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14 July 2011

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# 1. Basic principles relating to investment of assets

# The Investment Cycle



*Represents description of a complete investment process and a checklist for good practice*

# IC Beliefs – guiding principles

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## *Mission and Goals*

**Meet** defined benefit **obligations**

New Section mission dependent upon investment results and employer support

Time horizon for **New Section** is c15 years

**Risk management** is the Fund's principle priority

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## *Strategic Goals*

Achieve self-sufficiency from both **asset allocation** decisions and **manager selection**

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## *Journey Plan*

Achieve 105% over 15 years on a gilts basis for the New Section.

Increase the chances of meeting the **self-sufficiency target(s)** by switching into **matching assets** as the funding position improves

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## *Risk and Return*

Financial success is measured against the liabilities (liabilities +2%)

Risk assessed **qualitatively and quantitatively (tracking error c10%)**

Peer group risk does not shape Fund strategy

Higher return and risk expectations for the New Section than for Old Section

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# IC Beliefs - guiding principles

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## *Investment strategy*

Asset allocation is a **greater driver of returns** than manager selection

**Exploit extreme valuations** by changing asset allocation

**Improve efficiency** by a lower reliance on equities than institutional norms

Significant illiquidity is unattractive particular to the Old Section

The asset class characteristics are to be understood by the IC

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## *Insurance and hedging*

Important to distinguish between risks that may be rewarded and those that are unlikely to be

Important to **manage risks** as necessary

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## *Governance*

Likelihood of meeting the target returns is related to the **governance** employed

Ultimate responsibility for the investment of assets rests with the Board

The development and implementation of asset allocation and development of the risk budget is delegated to the IC

In turn, the IC delegated the role of CIO to Towers Watson which allows direct application of principles and decision-taking as well as advice to the IC

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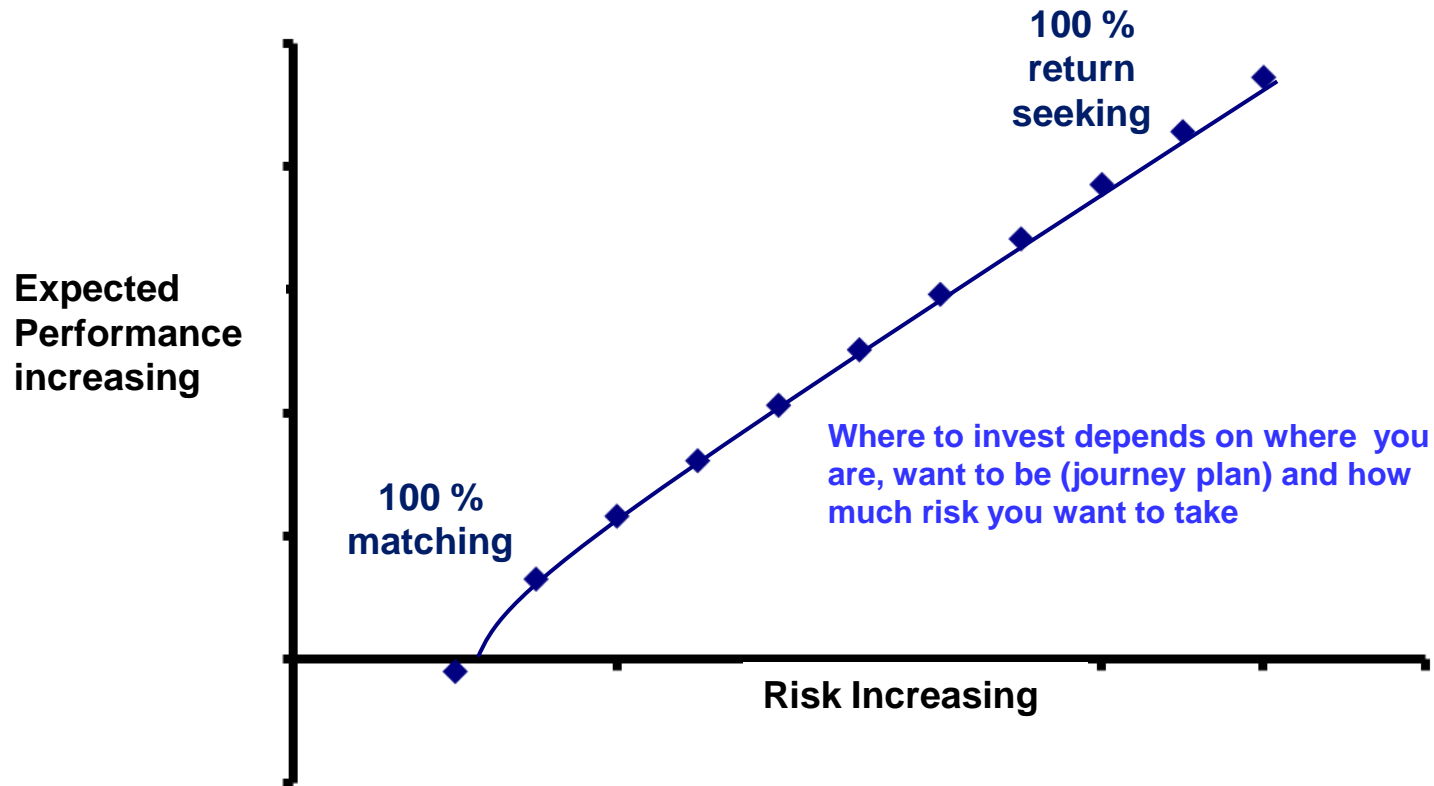
# Risk vs. Return

## Matching assets

The assets that most closely match the Fund's liabilities  
Buy-ins, bonds and bond like derivatives

## Return-seeking assets

Held to outperform liabilities  
Equities, property, hedge funds, infrastructure



*Choice between the two presents the classic investment trade off*

## Asset class risks

- Risk should be treated as completely inter-connected to return:  
*Drivers of excess return are sources of risk, and vice versa*
- The IC has beliefs around five economically justifiable return 'drivers'  
*Investment exposures that create value above gilt returns after adjusting for risks and costs*

**Equity risk premium**

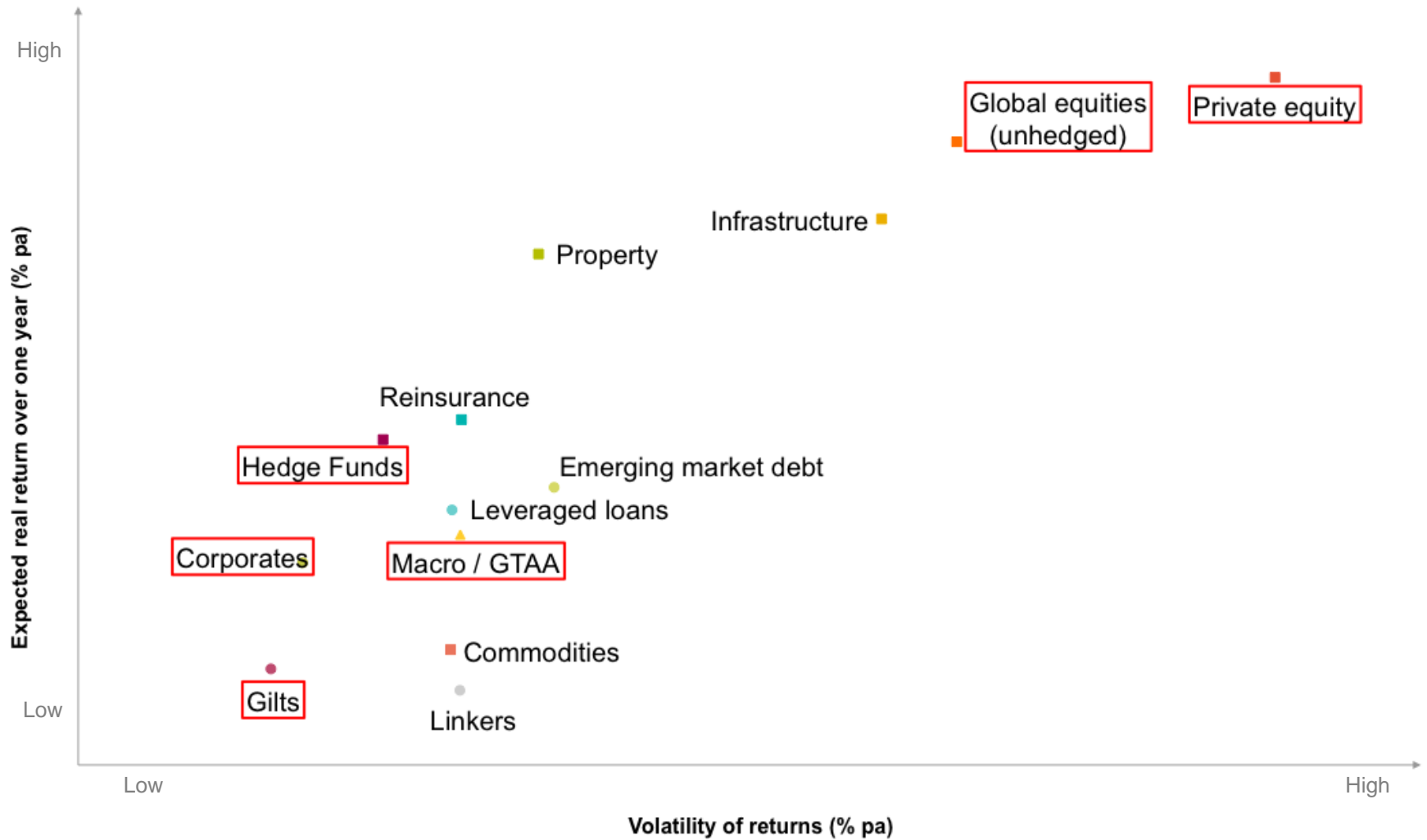
**Illiquidity premium**

**Skill premium**

**Credit risk premium**

**Insurance premium**

# Risk / return profile of major classes



*Risk management by asset class diversity*

## 2. Asset allocation

# Asset class overview

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## *Equities*

- **Return-seeking** asset class – higher returns at higher risk
  - Investing mostly in ordinary equity shares listed on **recognised exchanges worldwide**
  - **Diversification** opportunities through global markets
  - Implemented through **passive** or **active** management
  - Volatility and currency risk can be hedged through derivatives
  - Risk of capital destruction or capital loss if company goes bankrupt
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## *Private equity & Infrastructure*

- Long-term investment in **unquoted** and / or **unlisted companies**
  - **High returns** but also **high failure** rate
  - Diversification effect is limited due to correlation with public equity markets
  - Volatility, illiquidity, manager selection risk
  - **Expensive** asset class
  - Requires monitoring and regular commitments
  - **Infrastructure** - large fixed assets providing essential services (bridges, toll roads, pipelines and water treatment facilities)
  - Typically grouped into social (eg.hospitals) and economic (egtoll roads) categories
  - Acts as a diversifier to other asset classes.
  - Monopolistic stream of income
  - Inflation-linked cash flows
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# Asset class overview

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## *Property*

- **Return-seeking** asset class
- Institutional investment in **real estate** primarily attained via commercial buildings
- Shorter-term bond-like characteristics and longer-term equity-like characteristics create an **attractive risk-return trade off**
- Can be effective **inflation hedge**
- **Low correlation** with other asset classes
- Illiquidity and manager selection risk

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## *Hedge funds*

- **Not an asset class** - rather a combination of different strategies to achieve higher returns
- Hedge funds invest in **instruments** across equities, fixed income, currencies and commodities
- **Exploit inefficiencies** in the market
- **Low short-term correlation** between hedge funds and traditional asset classes
- Likely lower volatility than equities
- Manager selection, strategy allocation and transparency risk

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## *Commodities*

- **Return seeking** asset class
  - **Low correlation** with equities
  - Some hedge against inflation and against sharp commodity spikes that tend to be negative for equities
  - 'Roll' risk/Implementation issues
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# Asset class overview

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## *Portfolio notes - Collateralised Debt Obligation (CDO)*

- **Return-seeking** asset class
- Over the long-term returns are likely similar to equities
- CDOs (securities backed by a pool of various other securities) gain underlying credit exposure through credit default swaps
- Provide diversification away from equities
- Credit loss, counterparty, credit spread and credit quality risk

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## *Reinsurance*

- **Return seeking** asset class
  - Natural disasters can result in extreme loss, which may be too concentrated a risk for insurance companies writing protection. Many such insurance companies are willing to pay above the economic rate in-order to remove at least part of this risk from their balance sheet, consequently a premium to investors is available
  - **Insurance Linked Securities (ILS)** provide access to this premium
  - **Exploit inefficiencies** in the reinsurance market
  - **Low correlation** (near zero) between reinsurance products and traditional asset classes
  - Likely lower volatility than equities
  - Manager selection, legal / regulatory and timing risk
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# Asset class overview

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## High yield

- Fixed income asset class investing in non-investment grade securities (BBB- and below)
- High yield debt provides diversification in the investment portfolio through alternative asset classes and has a low correlation with some other more traditional asset classes
- Additional risks associated with high yield debt, such as downgrade/default risk
- Timing issues

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## Asset backed securities

- Fixed income type asset class investing in securitised products of a pool of assets (eg credit card loans, mortgages)
- Diversifies credit exposure with income stream
- Additional risks such as illiquidity, pre-payment, complexity of structure
- Timing issues/manager issues

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## Secured loans

- **Return-seeking** asset class
  - Investment in **syndicated loans** to European sub-investment grade borrowers 'near par'
  - Asset class has historically offered stable, attractive returns
  - **Low correlation** to other asset classes – diversification benefit
  - Liquidity and manager selection risk
  - **Active management** required to enable generation of alpha
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# Asset class overview

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## *Emerging market debt*

- **Return-seeking** asset class
- **Sovereign / corporate debt issues** in emerging economies to local or hard (USD) currency
- Conceptually similar to traditional bonds
- **Low correlation** to other asset classes – diversification benefit
- Credit / default, currency, political and manager selection risk
- **Active management** to screen for unwanted risk
- Long term improving fundamentals of emerging economies

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## *Emerging market currencies (EMC)*

- **Return-seeking** asset class
  - EMC refers to an **investment in 'cash' investments** denominated in emerging market currencies on an unhedged basis
  - Returns driven from currency appreciation / depreciation and carry (interest rate differential between countries)
  - Expected higher return from higher yielding currencies from risk premium of investing in these currencies
  - **Downside risks** include departure from current globalisation trends, reduction in global growth, China risks
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# Asset class overview

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## *Investment grade credit*

- **Return-seeking and matching** characteristics
- Fixed-income asset class – investing mainly in the **UK investment grade (IG) corporate bonds** (i.e. better than BBB-)
- Bonds are intrinsically similar to pension fund liabilities - series of cash flows sensitive to interest rate risk but also to credit risk / perception thereof
- Lower expected returns than equity – but at **comparatively lower risk**
- **Diversification** benefit in an overall portfolio of equities and alternatives
- Default risk
- Credit quality deterioration risk
- Credit and downgrade risks can be **diversified away** through active management

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## *UK gilts*

- Fixed-income asset class - investing in **government debt** of varying maturity
  - Diversification benefit – but low return
  - Gilts are said to **match** pension fund liabilities - series of cash flows sensitive to inflation and interest rate risk
  - Index-linked bonds are linked to the local inflation rate – **reduce inflation risk**
  - Sovereign **default risk low**
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# Asset class overview

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## *Liability Driven Investment (LDI) - pooled*

- **Not an asset class** – it is a process of investing into a wide range of cash and derivatives to increase the degree of matching between assets and liabilities
- Investments in inflation linked bonds, fixed interest bonds and the use of swaps
- Used for **hedging purposes**

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## *Swaps*

- Agreements between two parties to exchange two payment streams
- Can provide interest rate and inflation sensibility
- Counterparty credit risk managed through collateralisation

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## *Repos*

- **Gilt sale and repurchase** agreement
  - **Liability matching** asset class
  - Allows exposure to gilts / index-linked gilts without upfront capital commitment. Therefore **raise cash** from existing gilt holdings to finance further purchases
  - **Retain interest / inflation rate exposure** of the repoed gilts
  - Attractive alternative to swaps in current economic climate
  - Leverage, credit / default, roll risk
  - **Higher governance mandate** - hedge strategy design and implementation, appointment of execution agent, legal and operational requirements, regular monitoring and review
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## 3. Fund Management

# Fund management with Delegated CIO

- Delegated CIO appointed in a Fiduciary Management and Investment Advisory Services Agreement (FMA)
- Delegated CIO appoints investment managers as agent for the Fund
- Subject to restrictions set in FMA
- Board and IC responsibilities
- Independent Investment Adviser responsibilities

**Investment review**

**Legal review**

**Ongoing monitoring**

**Executes agreements**

**Investment manager fee budget**

# Active versus Passive

	<i>Passive</i>	<i>Active</i>
✓	Cheap and reliable Easy to monitor	Can be used across a wide range of markets with different objectives Can add substantial value at fund level
?	Will, by design, give the average market return	
✗	Is only available where there is a defined market index and so can limit exposures	Is expensive and many active managers detract value after fees  Is complex to set up and maintain  Need sufficient number of managers to ensure diversification

*New Section employs predominantly active management*

## Other portfolio considerations

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### *Pooled vs. Segregated*

- Smaller size mandates – pooled option preferred
- Segregated mandates allow for customisation
- Relative risk considerations

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### *Rebalancing*

- The DCIO conducts rebalancing where required
- Cash buffer maintained to ensure pension payments are met in a timely and orderly manner

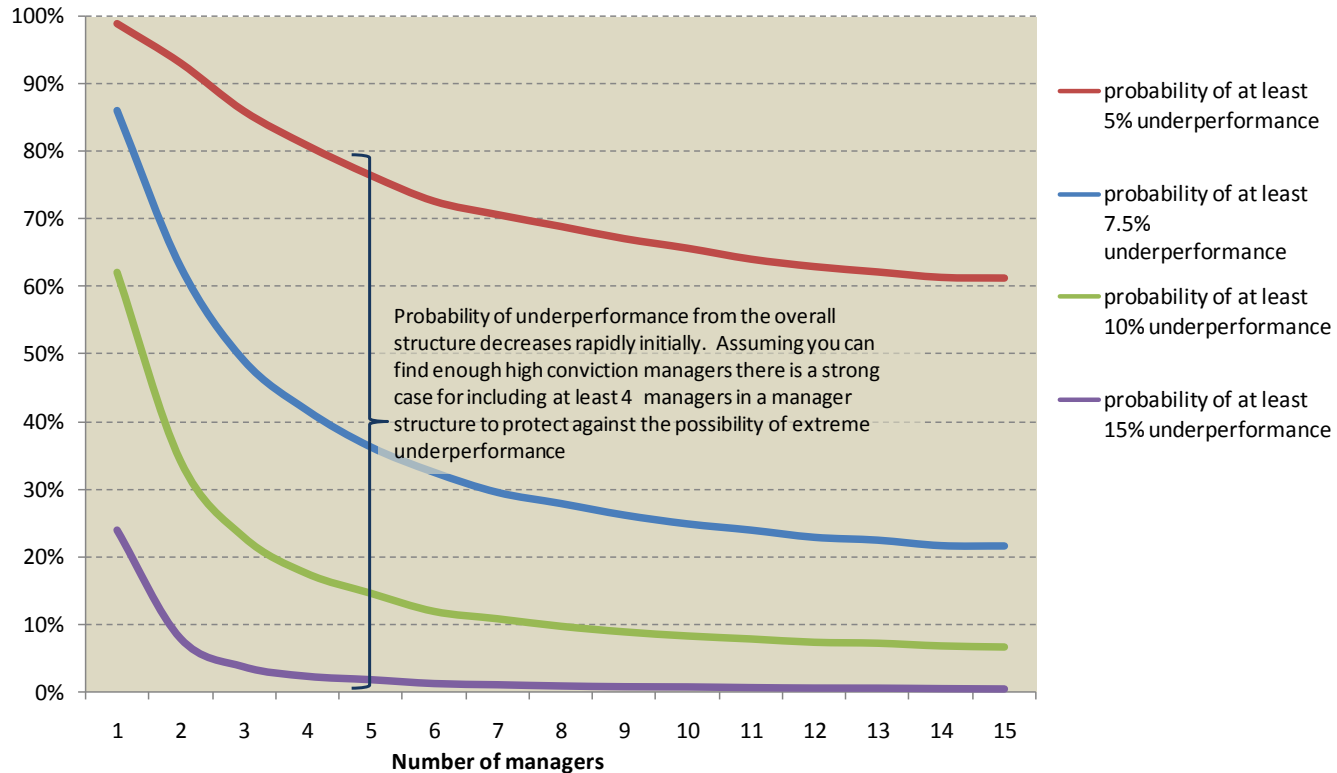
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### *Investment manager styles*

- Manager vary by investment style – value, growth, momentum etc
  - Managers focus on different things – market-cap, themes etc
  - Aim to have an appropriate mix across the portfolio
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# Diversification – by manager style

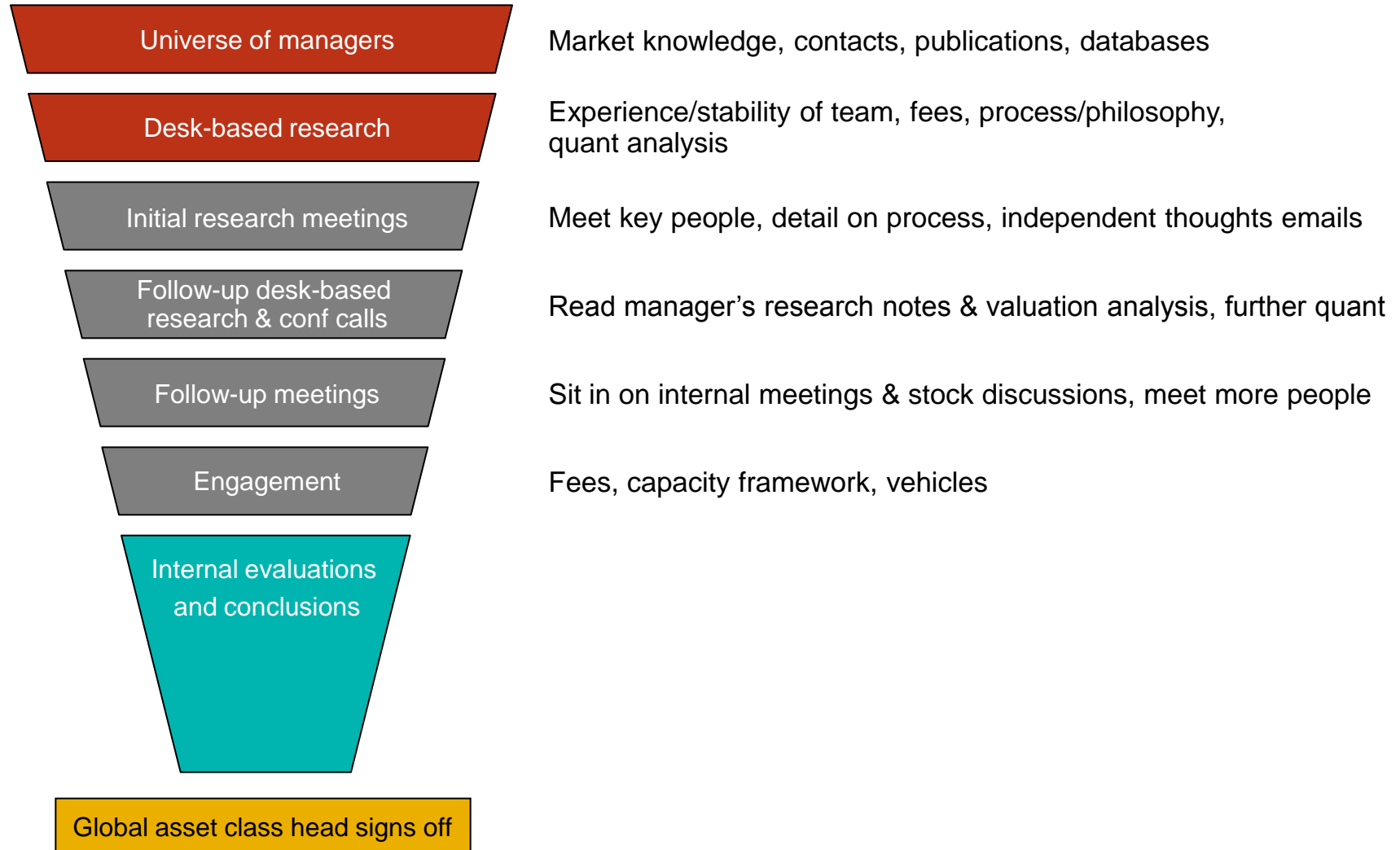
Benefits of diversification in a manager structure assuming 1 rated managers: Expected probability of meaningful underperformance from the overall structure at some point over a 10 year period



Probabilities are approximated assuming individual manager tracking error of 5% pa, Net Information Ratio of 0.33, average manager active correlation of 0.3 and normal distribution of manager returns. Underperformance defined as peak to trough cumulative, not annualised.

*Diversification is important to help protection against underperformance of one manager*

# Manager monitoring



# Ownership and stewardship

## **Adoption of the UK Stewardship code**

UK Stewardship Code ('the Code') supersedes the Institutional Investors Committee Statement of Investment Principles.

The Code encourages all institutional investors, including pension funds, to outline their position on this and to 'comply or explain' their adherence to the Code.

Institutional investors following the UK Stewardship Code undertake to

1. Publicly disclose their policy on how they will discharge their stewardship (ownership) responsibilities
2. Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be disclosed
3. Monitor their investee companies
4. Establish clear guidelines on when and how they will escalate their activities (i.e. vote or engage) as a method of protecting or enhancing shareholder value
5. Be willing to act collectively with other investors where appropriate
6. Have a clear policy on voting and disclosure
7. Report periodically on their stewardship voting activities

MNOPF makes reference to the Code within the Statement of Investment Principles.

The Fund has delegated voting rights to its investment managers and it expects that each of its investment managers will state whether they adhere to the Code or not this year.

## 4. Statement of Investment Principles

# Statement of Investment Principles (SIP)

- The MNOF takes a '**compliance approach**' which ensures the SIP meets its legal requirements
- The SIP is designed so that certain amendments can be implemented through the appendices, rather than the main body of the document.
- What information must a SIP include?
  1. Kinds of investments held, and balance between them
  2. Expected return on investments
  3. Defining, measuring and managing risks
  4. Selling investments
  5. Exercising (or not) any rights attached to investments
  6. Considering (or not) social, environmental, ethical factors
  7. Gaining advice on suitability of the Fund's investments
- Need to review and, if necessary, revise a SIP:
  - at least every three years or
  - without delay after any significant change in investment policy