

# Item 6

CT/13/27  
Investment and Pension Fund Committee  
7 June 2013

## REBALANCING POLICY

### Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

**Recommendation: That the Committee approves the suggested rebalancing policy for the Pension Fund.**

#### 1. Introduction

- 1.1. The Committee sets the Fund's strategic asset allocation to support the Fund's long-term funding requirements. Since 1 July 2012 the asset allocation has been reflected in a strategic benchmark, with a target percentage being set for each asset class (e.g. the current target allocation for equities is 55%).
- 1.2. As market values move over time, and as managers over and underperform, the proportions actually held in different asset classes will move away from the target allocations. Although these differences between actual and target allocations are reviewed by the Committee periodically, a formal process for rebalancing the portfolio in between reviews has not been agreed previously by the Committee.
- 1.3. Rebalancing is considered a good discipline and has been shown to add value over time by taking profit from markets that have become overvalued, and buying assets that have recently gone down and have become undervalued. Rebalancing is also closely related to cash management, as 'surplus' cash is usually allocated to those asset classes that are below their target.

#### 2. Potential approaches to rebalancing

- 2.1 There are several approaches to rebalancing:
  - No rebalancing (i.e. do nothing). Asset values are allowed to track market movements, potentially leading to large variances between target and actual allocations. The weakness of this approach is that the strategic allocation is not being followed over time. Furthermore a Fund can become too exposed to the extremes of market momentum.
  - Mechanical rebalancing. Assets are automatically bought whenever they move away from the target allocation by more than a certain amount.
  - An overlay approach. An external manager is employed to monitor the Pension Fund's asset position and to use derivatives and other methods to ensure that the Fund's exposure to each asset class is brought back to the target allocations. This may also incorporate tactical positions to add value.

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- Pragmatic rebalancing policy. Tolerance limits are set for each asset class beyond which a decision is made on whether to rebalance. However, the policy remains flexible to ensure that a range of factors are considered before making a judgement on whether rebalancing should occur.
- 2.2 Any trading in assets clearly involves transition costs e.g. stamp duty, commissions, market impact. These must be considered when deciding how to rebalance. Mechanical rebalancing can lead to frequent trading and incur excessive costs which will erode the Fund's capital. It is therefore recommended that strict mechanical rebalancing is not adopted. Significant rebalancing should not be required more than 1 or 2 times per year.
- 2.3 To reduce trading costs it is possible to adopt an overlay approach. An external manager would use derivatives or cheaper investment vehicles (e.g. Exchange Traded Funds) to ensure the effective exposure to each asset class remains close to target. For example, if equities are underweight (i.e. below target) the manager could buy cheap exposure to equities to return the Fund's exposure to target. This approach may involve fund manager fees as well as the risks associated with dealing in derivatives. However, the fund manager may also be able to add value through tactical positions.

## 3 Suggested rebalancing policy

- 3.1 The recommended approach is that the Fund has a clear rebalancing policy which also retains flexibility to ensure that overtrading does not occur. A suggested flexible rebalancing policy is shown below.
- 3.2 The Fund's asset position should be reviewed by officers shortly after each month-end. As a guideline, each asset class will have a tolerance limit of +/- 2.5% from target. An asset class which is outside these limits will prompt a decision by officers, in discussion with the Fund's adviser, as to whether any action is required. Potential actions could then include selling overweight positions to fund purchases in underweight positions, allocating surplus cash to underweight positions, or leaving allocations as they are. There will be a balance between the need to maintain the strategic target weightings and the need to consider other factors. Examples of other factors are:
- potential trading costs
  - the relative value of different asset classes (e.g. by comparing current equity dividend yields versus bond yields)
  - future strategic plans; e.g. funding of new mandates or planned changes to strategy
  - expected future cashflows
- 3.3 Any rebalancing should also consider the individual mandates and fund managers. For example, concerns about a manager's stability or performance need to be considered before rebalancing. There may also be a preference for rebalancing between passive mandates as the transition costs are often cheaper. Additionally, for asset types with two or more managers, such as global equity and fixed income, there may be a need to rebalance between the managers to ensure that the different manager styles are equally weighted.

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- 3.4 The weightings of illiquid asset classes such as property and infrastructure need to be monitored, however it will take longer to rebalance these assets. It is therefore reasonable to review these asset classes once every quarter. For infrastructure a suitable response would be to delay future commitments rather than to sell holdings which may have no market.
- 3.5 Any rebalancing activity will be reported at the following quarterly Committee meeting. The Committee can also then indicate their preferences for rebalancing in particular market environments.

## 4. Conclusion

- 4.1 The proposed rebalancing policy is a pragmatic solution which requires a disciplined approach and timely decision making. However, it also requires the consideration of other factors when making a judgement as to whether rebalancing should occur.

Mary Davis

Electoral Divisions: All

Local Government Act 1972

List of Background Papers – Nil

Contact for Enquiries: Richard Bettley

Tel No: (01392) 383621 Room G97