

INVESTMENT COMMITTEE 17 FEBRUARY 2015

ROYAL BOROUGH OF KENSINGTON AND CHELSEA

REPORT OF THE TOWN CLERK AND EXECUTIVE DIRECTOR OF FINANCE

PENSION FUND STATEMENT OF INVESTMENT PRINCIPLES

This document constitutes the Statement of Investment Principles (SIP) of The Royal Borough of Kensington and Chelsea Pension Fund (the Fund). The SIP describes the investment policy that is being pursued by the Fund.

The Committee is asked to note the revised SIP which has been updated as required by regulations to reflect the changes made during the last six months.

FOR APPROVAL

1. THE SCHEME

1.1 The Local Government Pension Scheme (LGPS) was set up under statute to provide retirement, death and other benefits for all eligible employees. The LGPS benefits were amended from 1 April 2008. For service prior to this, the ongoing pension is 1/80th of a member's final salary for every year of service plus a lump-sum of 3/80^{ths} for every year of service, on their retirement. The scheme continued as a final salary defined benefit scheme which pays 1/60th of the final salary for service from 1 April 2008 until 31 March 2014. There is no automatic lump sum, but members have the option to exchange some pension for a lump-sum payment.

From 1 April 2014, the LGPS changed again, based on career-average earnings from that point forward. It is funded by variable employee contributions dependent on salary and ranging from 5.5 per cent to 12.5 per cent of pensionable pay and by employer contributions, which are set following an actuarial valuation review of the assets and liabilities of the Scheme every three years. The benefits of the Scheme are defined by statute and increased for inflation in line with changes in the Consumer Prices Index as at September.

1.3 The LGPS is managed by several designated administering authorities, of which the Royal Borough of Kensington and Chelsea (The Royal Borough) is one such authority. Each administering authority maintains a pension fund and invests monies not required immediately to meet benefits. As at 31 March 2014, the assets of the fund were valued at around £696 million. There are about 10,000 members of the Fund: 31 per cent

active, 26 per cent pensioners and 43 per cent deferred pensioners. Further details of the Fund's investments and performance are published annually in the Pension Fund Report and Accounts which is available on the Council's web site www.rbkc.gov.uk.

Legal Requirements

- 1.4 The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 1999 introduced a requirement that authorities administering pension funds prepare, maintain and publish a statement of the principles governing their decisions on the investment of the pension fund assets.
- 1.5 The Royal Borough published its first Statement of Investment Principles in July 2003. The requirements were last modified in The Local Government Pension Scheme (Management and Investment of Funds) Regulations were last amended in 2013 and require authorities to state the extent to which they comply with the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel Principles for Investment Decision Making in the Local Government Pension Scheme in the United Kingdom.
- 1.6 The SIP should be revised within six months of any significant changes being agreed by the Investment Committee, to ensure it remains a true reflection of the investment policy of the Fund.
- 1.7 In preparation of the SIP, appropriate advice has been received from the Fund's appointed advisers.

2. FUND GOVERNANCE

- 2.1 The following governance structure has been adopted for the administration of the Fund. This structure allows the important decisions on investment policy to remain the responsibility of the Investment Committee, while delegating the day-to-day aspects to the Managers, the Royal Borough Officers or the Advisers as appropriate. The responsibilities of each of the parties involved in the Fund's governance are set out below.

The Investment Committee

- 2.2 The Investment Committee includes elected representatives of The Royal Borough: each has voting rights. The Investment Committee reports to Full Council and has full, delegated authority to make investment decisions. The Investment Committee decides on the investment policies most suitable to meet the liabilities of the Royal Borough Fund and has ultimate responsibility for the governance of the Fund including investment strategy. It will not invest in assets which cannot be explained in a straightforward manner.

Advice

- 2.3 Four independent advisers supplement the Investment Committee. It also receives and considers advice from officers of The Royal Borough and investment advice from its appointed external Investment Consultant (Hymans Robertson), the Actuary to the scheme (Barnett Waddingham) and its Investment Managers.

Investment Management

- 2.4 The Investment Committee has delegated the investment management of the Fund's investments to professional investment managers, whose activities are specified in detailed investment management agreements or contracts relating to specific pooled investments. Compliance is regularly monitored by the appointed investment consultant, the officers and through reports and presentations to the Investment Committee. No investments, except surplus cash pending transmission to the investment managers or required to meet the Fund's liabilities as they fall due, are managed by The Administering Authority.
- 2.5 The Investment Committee is responsible for:
- Overall investment strategy and strategic asset allocation with regard to the suitability and diversification of investments;
 - Monitoring compliance with this Statement of Investment Principles and reviewing its contents;
 - Appointing investment managers, an independent custodian, the Fund actuary, external independent advisers and investment consultants;
 - Setting performance benchmarks and reviewing investment manager performance against these benchmarks on a regular basis;
 - Reviewing the managers' expertise and the quality and sustainability of their investment process, procedures, risk management, internal controls and key personnel;
 - Reviewing policy on social environmental and ethical matters and on the exercise of rights, including voting rights; and
 - Reviewing the investments over which they retain control and obtaining advice about them regularly from the Investment Consultant. The Investment Committee will also obtain written advice from the Investment Consultant when deciding whether or not to make any new investments.
- 2.6 The Investment Committee is advised by The Royal Borough Officers, who are responsible for:
- Ensuring compliance with statutory requirements and the investment principles set out in this document and reporting any breaches to the Investment Committee;
 - Management of surplus cash, in accordance with The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 and the Royal Borough's Annual Treasury

Management Strategy. Performance is measured against the 7-day London Interbank Bid (LIBID) rate;

- Investment accounting and preparing the annual report and accounts of the fund; and
- Ensuring proper resources are available for the Royal Borough's responsibilities to be met.

2.7 The Investment Managers are responsible for:

- The investment of pension fund assets in compliance with the legislation and the detailed investment management agreements or contracts;
- Tactical asset allocation around the strategic benchmarks set by the Investment Committee;
- Stock selection within asset classes;
- Voting shares in accordance with agreed policy;
- Preparation of quarterly reporting including a review of past investment performance, transaction costs and future investment strategy in the short and long term; and
- Attending meetings of the Investment Committee as required.

2.8 The Independent Custodian (Northern Trust) is responsible for:

- Provision of monthly accounting data summarising details of all investment transactions during the period;
- Providing details of investment transactions in a timely manner to the independent measurers of performance;
- Safe custody and settlement of all investment transactions, collection of income, withholding tax reclaims and the administration of corporate actions;
- The separation of investment management from custody which is paramount for the security of the assets of the Fund; and
- Providing comparative information on the Fund's performance relative to the benchmark and targets, and the relative performance of different asset classes.

2.9 The Actuary (Barnett Waddingham) is responsible for:

- Undertaking a triennial valuation of the Fund's assets and liabilities and interim valuations as required, including those to enable compliance with the International Accounting Standard IAS19 (formerly FRS17);
- Advising on the rate of employer contributions required to maintain appropriate funding levels; and
- Providing advice on the admission and withdrawal of employers to the scheme, including external employers following externalisation of services.

2.10 The Co-opted External Independent Advisers are responsible for providing advice to support the Investment Committee in its decisions.

- 2.11 The Investment Consultant (Hymans Robertson) is responsible for:
- Advising on the investment strategy of the fund and its implementation;
 - Advising on the selection of investment managers, and the custodian;
 - Providing investment information, investment advice¹ and continuing education to the Investment Committee and the executive officers; and
 - Independent monitoring of the investment managers and their activities;

3. PENSION FUND LIABILITIES

Overview

- 3.1 The Royal Borough Pension Fund is similar to other funds run by Local Authorities in terms of its maturity. The Actuary determined that the funding level was 95 per cent at the 31 March 2013 valuation, an increase of 6 per cent over the 2010 valuation level. Since 2005, the Investment Committee has pursued a policy of diversifying its investment allocations with the objective of reducing the volatility of investment returns.
- 3.2 Following disappointing overall returns for the Fund as a whole, a major review was undertaken, commencing in February 2010, with the aim of securing improvements to the long-term investment performance.
- 3.3 At its July 2010 meeting, the Committee agreed to a change in the strategy of the Fund to target allocations of 60 per cent equities, 30 per cent absolute return funds, five per cent property and five per cent private equity. Re-balancing may be undertaken from time to time to bring allocations closer to these targets, but only if the allocations to asset classes have moved significantly from the targeted amounts.
- 3.4 There is no specific allocation to bonds or to cash, although a small amount of cash is required to maintain liquidity and the absolute return fund managers invest varying proportions of their funds in bonds. This strategy is intended to grow the value of the assets at a managed level of risk in the medium to long term.

Scheme Benefits

- 3.5 The LGPS is a defined benefit scheme, which provides benefits related to final salary for its members to 31 March 2014 and on a career average basis thereafter. Each member's pension is specified according to a formula based on salary and service and is unaffected by the investment return achieved by the fund. Full details of the benefits are set out in the LGPS regulations.

¹The Investment Consultant is authorised by and registered with the Financial Conduct Authority for the provision of investment advice.

Funding the Benefits

- 3.6 Active members are required to make pension contributions at variable rates, depending on the level of their salaries. The Royal Borough and other employers participating in the Fund are responsible for meeting the remainder of the costs necessary to finance the benefits payable from the Fund by applying employer contribution rates, determined following the actuarial review and consultation with the Fund Actuary. The employers therefore have a direct financial interest in the investment return achieved on the Fund's assets to the extent that any funding shortfall is met from employers' contributions.
- 3.7 The Royal Borough published a revised Funding Strategy Statement in November 2012, as required by the LGPS regulations.

Actuarial Valuation

- 3.8 The Fund is valued every three years in accordance with the LGPS regulations and monitored each year by the officers and the Actuary. The last valuation was as at 31 March 2013.

4. INVESTMENT POLICY

Investment Objectives

- 4.1 The Investment Committee's main objective for the Fund is to ensure that the Fund's assets and the future contributions are invested in such a manner that the benefits due to members and their beneficiaries can be paid from the Fund as they arise.
- 4.2 The investment objective of the Fund is to maintain an appropriate funding level and to ensure growth above inflation in the value of the assets to control and minimise the level of costs passed on to Council Taxpayers by facilitating low and stable employer contribution rates in the long term. The Council remains the ultimate guarantor of the scheme members' benefits.
- 4.3 To this end, the assets of the fund are not structured in a way that closely matches the liabilities of the fund, but they are weighted towards diversified equity and other growth investments, which historically have provided a greater return than most fixed interest assets. **The target is for all of the Fund to be invested in growth assets to meet the objective outlined in paragraph 4.1.**

Investment Strategy

- 4.4 The Investment Committee's general principle is to exercise its powers to invest, as would a prudent and knowledgeable businessperson in making provision for persons for whom he had a moral duty to provide and taking into consideration the LGPS regulations and the liabilities of the Fund.

- 4.5 The Investment Committee has accordingly agreed the following general policies with regard to certain matters, having considered advice from the Adviser and also having due consideration for the objectives and attitude to risk of the Investment Committee members. These policies can only be changed by a formal decision of the Investment Committee.

Investment Management Strategy

- 4.6 The investment management strategy is to appoint professional fund managers to manage investments actively with the exception of a twenty per cent allocation to passively managed equities which provides market returns at minimal cost. The other managers take active sector and stock positions in order to outperform the indices against which they are benchmarked. The Fund will continue to hold an investment in a property fund of funds and invest in private equity funds of funds.

Strategic Benchmark.

- 4.7 The strategic benchmark for the Fund is set with reference to the long term nature of the Fund's liabilities, and is reviewed regularly. The current benchmark is set out in the table below:

Asset	Benchmark Allocation (%)	Expected real long-term return
Global equities	60	3.8%
Absolute return fund	30	3.8%
Private Equity	5	3.8%
Property	5	2.1%
Total	100	3.7%

Cash is not included in the benchmark as there is no set allocation to it as an asset class.

Performance Targets

- 4.8 Performance targets are set on a rolling three-year basis in relation to a variety of benchmarks and weighted indices which are specific to each manager. These are set out in Section 5. The investment managers' performance against the benchmark targets is reviewed at quarterly and annual intervals by the Fund's performance measurement company (Northern Trust) who provide independent performance statistics and by the Investment Consultant who interprets those statistics and comments on the level of risk taken by the managers to achieve the performance.

Reporting

- 4.9 The investment managers' current investment decisions and actions are reported quarterly to the Investment Committee. The Investment Committee publishes this Statement of Investment Principles and the minutes of their meetings, which include the results of their monitoring of the advisers and the investment managers.

Review

- 4.10 The investment strategy is reviewed periodically with a major review taking place every three years following the actuarial valuation of the Fund.

5. INVESTMENTS

- 5.1 The powers and duties of the Authority to invest Fund monies are set out in the LGPS (Management and Investment of Funds) Regulations 2009. These state that from 1 April 2010 the Council, as Administering Authority must not invest any monies not immediately required for the payment of benefits and pensions with its own cash balances. The Fund's cash is invested separately and since 1 April 2011, the Fund has been required to have a separate bank account. However, the Fund has acquired the ability to borrow money on a short-term basis (for the payment of transactions such as pensions and transfers) from the Administering Authority in order to meet its obligations.
- 5.2 For all investments, the Administering Authority is required to take account of the need for diversification, and of advice from persons properly qualified by their ability and practical experience of financial matters to provide that advice.

Statutory Investment Limits

- 5.3 Statutory maximum limits were increased, subject to administering authorities taking proper advice and compliance with a variety of criteria in the LGPS (Management and Investment of Funds) Regulations 2009.
- 5.4 The normal maximum limits, as a percentage of the total Fund are restated as shown below. The potential higher limits which can be agreed by the Committee are shown in parentheses:
- Any single sub-underwriting contract is limited to one per cent (five per cent);
 - All contributions to any single partnership are limited to two per cent (five per cent);
 - All contributions to partnerships are limited to five per cent (30 per cent);
 - All loans and any deposits with local authorities or their preceptors are limited to ten per cent;
 - All investments in unlisted securities of companies are limited to ten per cent (15 per cent);
 - Any single holding is limited to ten per cent unless guaranteed by Her Majesty's Government;
 - All deposits with any single bank, institution or person, (other than the National Savings Bank) are limited to ten per cent;
 - All sub-underwriting contracts are limited to 15 per cent;

- All investments in units or other shares of the investments subject to the trusts of unit trust schemes managed by any one body are limited to 25 per cent (35 per cent);
- All investments in open ended investment companies where the collective investment schemes constituted by the companies are managed by any one body are limited to 25 per cent (35 per cent);
- All investments in units or other shares of the investments subject to the trusts of unit trust schemes and all investments in open-ended investment companies where the unit trust schemes and the collective investment schemes constituted by those companies are managed by any one body are limited to 25 per cent (35 per cent);
- Any single insurance contract is limited to 25 per cent (35 per cent); and
- All securities transferred (or agreed to be transferred) by the authority under stock lending arrangements are limited to 25 per cent (35 per cent).

Restrictions set by the Investment Committee

- 5.5 The Investment Committee permits managers to make investments in accordance with the mandates agreed at the time of their appointment. For pooled funds, the Committee agrees to the restrictions in place at the time of appointment and expects to be informed of any material change in the fund's investment strategy or the assets to which allocations can be made. The restrictions for each manager are included under their individual entries from paragraph 5.9.

Risks

- 5.6 The Investment Committee recognises a number of risks involved in the investment of the assets of the Fund, including:
- **The risk of failing to meet the objectives** – the Investment Committee will regularly take advice and monitor the investments to mitigate this risk. In all cases the Investment Committee measures risk by reference to the liabilities of the Fund. Prior to setting the strategy after each actuarial valuation they consider the risk of the funding level worsening based on different strategies.
 - **Funding and Asset/Liability mismatch risk** – this is addressed through the asset allocation strategy and through regular actuarial and investment reviews and the funding target. The majority of the Fund's liabilities are linked to inflation.
 - **Underperformance risk** – this is addressed through monitoring closely the performance of the Managers and taking necessary action when this is not satisfactory.
 - **Country risk** – the risk of an adverse influence on investment values from political intervention is reduced by diversification of the assets across several countries.
 - **Risk of inadequate diversification or inappropriate investment** – this is addressed by investing in a diversified portfolio of assets thereby avoiding concentration of assets in one particular

stock, sector or geographical area. The Investment Committee's agreements with the Investment Managers contain restrictions to limit the risks from each individual investment and prevent unsuitable investment activity.

- **Default risk** – this is addressed through the restrictions for the Investment Managers.
- **Organisational risk** – this is addressed through regular monitoring of the Investment Managers and Investment Advisers.
- **Liquidity risk** – the Fund generally invests in assets that are realisable at short notice.
- **Sponsor risk** – there is a risk of the Employer ceasing to exist but an Act of central Government would be required to abolish it..

- 5.7 The investment Committee will keep these risks under regular review. Risk advice and measurement is provided by the Adviser on an ad-hoc basis.

Rates of Return

- 5.8 Based on the expected rates of return for each asset class, the Investment Committee expects to achieve a real rate of return for the total Fund of approximately 3.7 per cent per annum over the long term.

Suitability

- 5.9 The Investment Committee has taken advice from the Investment Advisers to ensure that the asset allocation strategy is suitable for the Fund, given its liability profile.

Diversification

- 5.10 The choice of asset allocation strategy is designed to ensure that the Fund's investments are adequately diversified and liquid. The Investment Committee monitors the strategy regularly to ensure that the levels of diversification and liquidity are satisfactory.

- 5.11 The Investment Committee has decided that, due to the size of the Fund and the high costs of direct investment in property, the most appropriate form of investment in this asset class is through a property fund of funds with a portfolio of investments in the United Kingdom. For similar reasons, the Investment Committee made a commitment to invest up to five per cent of the Fund with a private equity fund of funds. By their nature, private equity investments are long term, so performance and valuation of these assets is determined in association with the Performance Measurer and the Fund's Actuary.

Realisation of Assets

- 5.12 All assets are held in segregated portfolios and pooled arrangements which can be realised easily if the Investment Committee so requires. The Fund has a strong funding level and is expected to have a fairly neutral or slightly negative cash flow for around 10 years. It is

anticipated that this will largely be offset by cash returns from the Fund's private equity investments. There is therefore unlikely to be a requirement to realise investments prematurely to meet pensions and other benefits. The Investment Committee monitors the cash flow requirements of the Fund to control the timing of any disinvestment of assets. When issuing instructions to realise assets, the Investment Committee requires them to be acted upon immediately, unless a specified date or time-period is set for the assets to be realised, or is set out in the investment management agreement.

Self-Investment

- 5.13 The Fund has no assets invested in the business of the Royal Borough.

Investment Managers

- 5.14 The Investment Committee appointed two active global equity managers with effect from November 2010 and selected two absolute return managers in early 2011. A passive equity and bond manager, Legal and General Investment Management, was appointed in November 2009. Two managers were appointed in the summer of 2006 to provide the Fund with investments in property and private equity funds of funds.
- 5.15 More recently, in February 2014, the Committee received presentations from secondary property managers with a view to increasing the overall property holding to the target level of 5 per cent of the Fund. The first drawdowns for this investment of £15 million were made in November 2014. It is expected that the final payments will be made in early 2015.
- 5.16 Due to changes in the personnel responsible for investment management arrangements at Barings, it was decided to withdraw the funds from the manager. As an interim solution, to maintain a similar proportion of funds in appropriate asset classes, the funds were reinvested equally in a passive global equity fund and a sterling liquidity fund made up of bonds and cash.

Equity Managers

- 5.17 **Baillie Gifford**

Benchmark: MSCI All Countries World Index (including Emerging Markets).

Target: to outperform this by two per cent per annum net over rolling three-year periods.

- This manager was re-appointed in 2010 with a revised allocation to a pooled fund in its Global Alpha Strategy. The strategy is executed by the manager on the basis of a strong conviction that the stocks selected will outperform the market generally, regardless of their weight in the index. The Fund will invest typically in a portfolio of 70-120 global securities. The Fund may use Baillie Gifford Open Ended Investment Company (OEIC) sub-funds to gain diversified exposure to certain areas.

- All income is re-invested. The amount of cash held for any significant period will not normally exceed five per cent. The proportion of the portfolio invested in any one holding shall normally, on purchase, not exceed the index weighting by more than six per cent and generally not be less than 0.5 per cent of the Fund's value.
- The proportion of the portfolio invested in any one particular industry shall normally, on purchase, not exceed the index weighting by more than ten per cent. There is no minimum proportion. The proportion of the portfolio invested in any one particular region shall normally, on purchase, not exceed the index weighting by more than 20 per cent. There is no minimum proportion. There are no restrictions in respect of non index positions. For example, a significant position may be taken in Emerging Markets from time to time.
- The Fund does have the ability to make use of currency forwards and to invest in derivatives. It is only likely to do this in exceptional circumstances and will do so for defensive purposes only.

5.18 Longview Partners

Benchmark: MSCI World (local) (Total Return) Net.

Target: to outperform this by two per cent per annum net over three-year rolling periods.

- This manager aims to invest in a concentrated, but well-diversified global portfolio of superior quality, but predictable companies with improving business fundamentals and attractive cash valuations. It has a disciplined investment process and is agnostic to the index.
- The manager can invest in all listed stocks globally with a market capitalisation of or in excess of US\$ three billion. Industry and geographic allocation are purely derived by the bottom up stock selection process. In order to avoid systemic risk, Longview follow guidelines of a minimum allocation of 30 per cent to North America, a minimum allocation of 25 per cent to Europe, a maximum allocation of 20 per cent to Japan, and a maximum allocation of 12 per cent to emerging markets. Longview has a guideline limit of 12 per cent to any one industry (i.e. companies with common business drivers). The strategy is long only and no derivatives are used, other than currency forwards for currency hedging purposes. Short positions are not permitted.
- The choice of two global equity managers with differing investment styles provides diversification in manager risk for a major part of the Fund.

5.19 Legal and General Investment Management (LGIM)

Benchmark and target is MSCI World Index (Developed Markets only).

- This passive manager was appointed at the end of 2009 to enable the Fund to maintain its exposure to the Equity and Bond markets in the event that changes are made to other mandates in the portfolio.

During the re-tendering process, it was decided that 20 per cent of the Fund should be allocated to this manager to generate index returns at minimal cost.

- Legal and General invest in global listed equities in developed markets only in order to match the FTSE World Index (for which the MSCI is used as a proxy). In addition to this, limited use of derivatives is allowable for efficient portfolio management. Such derivatives include currency forwards and index futures.

5.20 **Absolute Return Managers**

Barings

Benchmark: Three-month London Interbank Offered Rate (LIBOR).

Target: To exceed the benchmark by four per cent per annum net over three-year rolling periods.

- This manager was appointed in 2011 and funded in April with an allocation of 15 per cent of the Fund to the Baring Dynamic Asset Allocation Fund. The strategy was executed by the manager on the basis that value can be created by moving allocations between a variety of asset classes, depending on market conditions.
- At the end of August 2014 the Fund was advised that the investment manager responsible for the Dynamic Asset Allocation fund was leaving the company, along with his deputy. Having taken advice, it was agreed that this represented too much of a risk to the Fund, so the entire holding was sold.

As a temporary measure, and with a view providing similar exposure to the market, the proceeds were allocated equally to the LGIM passive global equity mandate and the same company's Sterling Liquidity Fund. The funds will remain in these funds until needed to meet objectives determined during revisions to the asset allocation strategy.

5.21 **Pyrford International**

Benchmark: Retail Price Index

Target: To exceed the benchmark by five per cent per annum net over three-year rolling periods.

- Pyrford were appointed at the same time as Barings and allocated the same proportion (15 per cent) of the Fund's assets. Their strategy is to allocate funds to highly regarded equities and bonds according to prevailing market conditions.
- Pyrford invest in investment grade sovereign debt securities and equities of companies that, at time of purchase, have a minimum stock market capitalisation of US\$500 million and that are listed, traded or dealt in on a Regulated Market. Particular emphasis is placed on Regulated Markets in North America, Europe (including the UK) and the Asia Pacific Region (including Japan).
- It is expected that the Fund will be weighted towards Pound Sterling denominated assets. The Fund may also hold up to 25 per cent of its Net Asset Value in cash. There is no restriction for investment in investment grade sovereign debt securities. The Fund may not

invest more than five per cent of its Net Asset Value in any investment grade non-sovereign debt securities.

- The Fund may invest up to 20 per cent of its Net Asset Value in Emerging Markets and a maximum of 10 per cent of the Fund's Net Asset Value may be invested in units or shares of other collective investment schemes (including certain exchange traded funds) within the meaning of Regulation 45(e) of the Regulations for the purposes of gaining exposure to the types of investments described herein or otherwise to pursue the investment objective and policies of the Pyrford Fund.
- Subject to the limitations set forth in the Prospectus and consistent with the Pyrford's investment policies, restricted use of derivatives is permitted. Forward foreign exchange transactions may be used to reduce the risk of adverse market changes in exchange rates or to increase exposure to foreign currencies or to shift exposure to foreign currency fluctuations from one country to another. Derivative instruments may be exchange-traded or over-the-counter. Derivative usage is not intended for the purposes of obtaining leverage or otherwise to alter the volatility of the Fund in pursuing its investment objectives.
- The choice of two managers with differing investment styles provides diversification in manager risk for a substantial part of the Fund.

5.22 **Property Fund of Funds Manager**

CBRE – OSIRIS Fund of Funds

Benchmark and target: IPD UK All Balanced Funds Index with a target to exceed this by 0.5 per cent over rolling three year periods.

- This is a specialist real estate manager and investment in the OSIRIS Fund of Funds gives the Royal Borough's Pension Fund exposure to a wide range of UK commercial property funds. Its key areas of investment are offices, industrial and warehousing units with long-term, secure cash flows, dominant retail property and alternatives, such as student accommodation and healthcare facilities.
- In addition to providing some diversification away from equity investments, this portfolio allows for risk to be spread through investment in a diversified range of property assets, rather than focusing on one sector of the market.

5.23 **Secondary Property Fund of Funds Manager**

KAMES

Benchmark and target: IPD UK All Balanced Funds Index with a target to exceed this by 0.5 per cent over rolling three year periods.

- This is a specialist secondary real estate manager and investment is into a closed-ended fund, expected to have a duration of approximately 10 years. Its key areas of investment are offices,

retail units, industrial and warehousing in secondary locations with long-term, secure cash flows.

- In addition to providing some diversification away from equity investments, this portfolio allows for risk to be spread through investment in a different range of property assets to those held in the CBRE investment.

5.24 **Private Equity Fund of Funds Manager**

Adams Street Partners 2007 and 2008 Global Funds

Benchmark: MSCI World Index

Target: MSCI World Index plus two per cent per annum net over rolling three-year periods.

- This is a specialist private equity manager and investment in their 2007 and 2008 Global Funds provides exposure to a variety of venture capital, buyout and other investments in a range of private equity funds and through Adams Street's direct investments. This is a long-term investment, intended to provide higher returns than equity markets over 5-10 years.
- At its meeting in May 2011, the Investment Committee agreed to make a further commitment to the Adams Street 2012 Global Fund in order to reinvest the proceeds from its earlier investment and maintain the five per cent allocation to this asset class.
- The Investment Committee has not selected more managers as the benefits of further manager diversification would be outweighed by higher fees, given the risk tolerance and the out-performance targets set.

6. SOCIAL, ENVIRONMENTAL AND ETHICAL POLICY

6.1 The Investment Committee has considered socially responsible investment in the context of its legal and fiduciary duties and obligations. The Committee takes the view that non-financial factors should not drive the investment process at the cost of financial return on the Fund.

6.2 The Fund does not actively disinvest in companies for ethical, social or environmental reasons as this may impact on fund returns and would not accord with its principal objectives. The Committee does not have the relevant expertise to make frequent assessment of the financial impact of companies' activities. To that extent, the Committee maintains a policy of non-interference with the day-to-day decision making of the investment managers.

7. VOTING RIGHTS

7.1 The Investment Committee has delegated the Fund's voting rights to the investment managers, who are required, where practical, to make considered use of voting in the interests of the Fund. The Committee

expects the investment managers to vote in the best interests of the Fund.

- 7.2 The investment managers are required to report voting actions to the Investment Committee quarterly.

8. MONITORING AND GOVERNANCE

Background

- 8.1 The Investment Committee amended its asset allocation significantly as a result of the initial results of the 2010 valuation.

General Investment

- 8.2 The Investment Committee receives information and training on new developments in investment markets as appropriate. The Investment Committee will keep this Statement of Investment Principles under review and will review the scheme benchmark at least annually.

Investment Managers

- 8.3 Fund manager performance is monitored at regular, quarterly meetings of the Investment Committee to satisfy members that the Investment Managers continue to carry out their work competently and have the appropriate knowledge and experience to manage the assets of the Fund.
- 8.4 Reports are received showing how each manager has performed against their benchmark and the Investment Committee will assess each Manager's performance against their investment objective. Advice is received from the Investment Consultant and representatives from the Investment Managers are questioned regarding past performance and their intended investment strategies. Other matters affecting the fund are addressed as and when required at meetings of the Committee.
- 8.5 The Investment Committee (after consulting with the Investment Advisers) will consider at least once every 12 months whether they are satisfied that each Investment Manager has the appropriate knowledge and experience and is carrying out his work competently and complying with the benchmarks set by the Investment Committee. If the Investment Committee is not satisfied with the Investment Manager they will require that the Investment Manager takes such steps as will satisfy them in this respect, or will remove this Investment Manager.

Investment Advisers

- 8.6 The Investment Committee will monitor the advice given by the Investment Advisers on a regular basis. As part of this review, the Investment Committee will consider whether or not the Investment Advisers are carrying out their work competently.

Investment Committee

- 8.7 The Investment Committee monitors all the decisions it takes by maintaining a record of all decisions taken, together with a note of the rationale in each case.

9. FEES

Investment Managers

- 9.1 The Investment Managers are paid according to the terms of their respective contracts. The Investment Committee will consider the levels of fees paid, when assessing Managers' performance.

Investment Consultant

- 9.2 The Investment Consultant fees are based either on actual time spent and hourly rates for relevant individuals, or on fixed fees agreed in advance for specifically defined projects or services.

Investment Committee

- 9.3 The Chairman of the Investment Committee is entitled to receive a Special Responsibility Allowance. Other Council Members receive no additional allowance for being on the Committee, but the Independent Advisers receive an annual allowance for their services.

Custodian and Fund Performance Measurement

- 9.4 Custody fees are based on the value of the assets held by the Custodian on behalf of the Fund. Measurement fees are dependent on whether the assets are segregated or pooled.

10. COMPLIANCE

- 10.1 The LGPS (Management and Investment of Funds) Regulations 2009 require authorities to state the extent to which they comply with the six principles of investment practice set out in the CIPFA publication "Investment Decision Making and Disclosure in the Local Government Pension Scheme – A Guide to the Application of the Myners' Principles" and give reasons for not complying where they do not do so.
- 10.2 The Royal Borough of Kensington and Chelsea Fund complies as follows:

Revised Myners' Principles

<i>Compliance Requirement</i>	<i>Compliant Yes/No</i>	<i>Notes</i>
Principle 1: Effective Decision Making		
Administering Authorities should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make them effectively and monitor their implementation.	Yes	Decisions are made by the Investment Committee, with advice from co-opted members and the Fund's independent advisers. The Committee members receive quarterly reports on each fund manager's performance for monitoring purposes from the Custodian.
The persons and organisations involved responsible for decisions should have sufficient expertise to be able to evaluate and challenge the advice they receive and manage conflicts of interest.	Yes	The Investment Committee members have significant investment experience and of challenging Investment Manager performance and the advice they receive. Any conflicts of interest must be declared at the start of each meeting.
Principle 2: Clear Objectives		
Overall investment objectives should be set out for the Fund, taking into account the scheme's liabilities, the potential impact on local taxpayers, the strength of covenant for non-local authority employers and the attitude to risk of both the administering authority and scheme employers, and these should be clearly communicated to advisors and investment managers.	Yes	<p>The objectives are set out clearly and take into account the requirement to maintain a low cost over the long term in accordance with the Fund's degree of maturity. These are communicated to advisors and investment managers.</p> <p>There are only a small number of employers in the Fund, and they have been consulted on the funding strategy. However, it is impractical to operate tailored asset allocations for sub-funds with different risk profiles.</p>
Principle 3: Risk and Liabilities		
In setting and reviewing their investment strategy, administering authorities should take account of the form and structure of liabilities.	Yes	The structure of the liabilities has been considered in calculating the deficit recovery period based on the anticipated long-term positive cash-flow for the Fund. The risk associated with the target asset allocation takes into account the liability profile and in particular the long term nature of the LGPS.

<i>Compliance Requirement</i>	<i>Compliant Yes/No</i>	<i>Notes</i>
Have the implications for local tax payers, the strength of the covenant for participating employers, the risk of their default and longevity risk been considered?	Yes	The implications for local tax payers and longevity risks are considered when setting the contribution rates at the triennial valuation reports. The covenants of almost all employers are considered strong, since they are almost exclusively public bodies covering over 99 per cent of the membership.
Principle 4: Performance Assessment		
Arrangements should be in place for the formal measurement of performance of the investments, investment managers and advisers.	Yes	The Custodian independently measures the performance of the managers' investments and its reports are presented to the Investment Committee quarterly. This enables them to assess the performance of the managers and advisers.
Administering authorities should also periodically make a formal assessment of their own effectiveness as a decision-making body and report on this to the scheme members.	Yes	The published annual report and accounts includes information on the performance of the Fund over time and the decisions made by the Committee. They are available through the administering authority's website. The Administering Authority considers the improved funding level of 95 per cent at the 2013 valuation is indicative that decision making has been effective.
Principle 5: Responsible Ownership		
Administering authorities should: adopt, or ensure that their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents	Yes	All three of the Fund's global equity investment houses and both of the absolute return managers have signed up to this code and adhere to these principles.
Include a statement of their policy on responsible ownership in their statement of investment principles	Yes	The Investment Committee has considered socially responsible investment in the context of its legal and fiduciary duties and obligations. The Committee takes the view that non-financial factors should not drive the investment

<i>Compliance Requirement</i>	<i>Compliant Yes/No</i>	<i>Notes</i>
		process at the cost of financial return on the Fund. (Para.6.1)
Report periodically to scheme members on the discharge of these responsibilities?	Yes	As this Statement of Investment Principles forms part of the Annual Report and Accounts, the statements above comply with this requirement.
Principle 6: Transparency and Reporting		
Administering authorities should: act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.	Yes	The information is provided in the administering authority's report and accounts which is available through the website.
Provide regular communication to scheme members in the form they consider most appropriate.	Yes	The published annual report and accounts are considered sufficient, since the benefits of the scheme are defined and guaranteed by statute.

NICHOLAS HOLGATE

TOWN CLERK AND EXECUTIVE DIRECTOR OF FINANCE

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DEFINITION OF TERMS

Unregistered stock

Unregistered stock is the common practice of allowing professional investors to trade newly issued shares or bonds before they are registered with the Securities and Exchange Commission or other national regulatory body. The purpose of this is to speed the issuance of new bonds or shares to professional investors without burdening the issuer with rules designed to protect amateur investors. Registration is usually completed a few months after the stock is first issued.

Short sales of stock

Selling a share that the vendor has borrowed and is committed to buy at a future date on the expectation of a profit as the share price declines.

Stocklending

The practice of lending stock to other investors. Investors may wish to borrow stock in order to enter into a short sale (see above) or to avoid a settlement failure.

Forward currency trades

A currency forward contract is, in effect, an agreement to exchange currencies on terms agreed today but where settlement occurs some months later rather than the following day. Currency forwards can be used either to take a position on future changes in exchange rates or to reduce the exposure to particular currencies. The forward currency market is large and liquid but transactions are not made on an exchange.

Purchased currency options

Right (but no obligation) to buy or sell an amount of foreign currency at an agreed price before a specific date. The use of currency options may be motivated by the desire to increase or decrease the exposure to changes in particular currency exchange rates.

Derivatives

A financial instrument whose value is derived from an underlying security or benchmark. (Examples are the options referred to above).

Currency spot and forward contracts

A spot contract is a trade carried out for normal settlement, which is usually the next business day. For currency forward contracts see forward currency trades above.

Options, futures and options on futures.

Options on futures are exchange-traded and can be based on any futures contract. Most often used by investment banks to manage exposure arising from their normal trading activities and by specialist investors wishing to express views on narrow areas of the financial markets.