The energy to succeed

Adam Cadle speaks to Centrica Pension Fund CIO Chetan Ghosh about the fund's recent progress and ongoing investment strategies

What is the combined value of the Centrica Combined Common Investment Fund?

Total assets are circa £5.8 billion at the end of May 2014. Using a gilt based discount rate, which is probably the easiest way to compare one scheme to another, the funding level would be circa 70 per cent currently.

How did the Centrica pension fund fare in 2013 in terms of returns, funding levels and coverage ratio?

The year was characterised by the strong returns for developed equity markets, and the negative impact of the taper tantrum on fixed income and emerging market assets. Our returns for 2013 were circa 8.5 per cent, which given the high level of assets we have to hold in fixed income for risk management purposes, was a very pleasing result. Using a gilt based discount rate, the funding level improved from about to 65 per cent to circa 70 per cent over 2013.

Since your appointment as chief investment officer how has the investment strategy of the funds changed? How is the investment fund's portfolio structured in terms of allocations to specific asset classes?

We made the key philosophical change early on in my tenure when we moved to an approach of having liability related investment objectives, rather than a long term static asset allocation. This forces you to have a much greater focus on opportunity cost and question the relevance of every asset class in your portfolio much harder.

The last 18 months has seen a good example of the flexibility that this approach allows us. In 2009/10, we heavily increased our allocation to investment grade credit on the back of outsized yields that had arisen from the financial crisis. During 2013, as credit spreads contracted significantly, we thought that a lot of outright cheapness of the investment grade credit market had gone and we aggressively rotated into other areas of the fixed income universe like senior loans and private debt.

Currently, we have 45 per cent in assets expected to deliver equity type returns, 25 per cent in corporate bonds and senior loans, 5 per cent in property, and 25 per cent in liability matching assets, which include investments in social housing, infrastructure, ground rents and commercial leases.

Has infrastructure come into the fund's thinking under the Pensions Infrastructure Platform (PIP)?

No. We had already made our allocations to infrastructure before the PIP came to peoples' attention. We allocated to infrastructure for very specific liability matching reasons. We wanted to have access to the entire infrastructure asset (not just debt or equity), and its inflation linked revenue stream, which is a good match to benefit outgo. We are very pleased with how these investments have gone; there is no leverage in our investments, which is unusual in this asset class, and we receive UK inflation linked payments with a healthy additional return above gilts.

Smart beta is a term commonly used within the industry at the moment. Have you considered incorporating this investment strategy?

We have looked at smart beta extensively in the equity space. We do believe that smart beta offers a welcome low cost way to access certain features of the equity universe, such as low volatility, size, value etc. However, we decided that most smart beta strategies were not for us as we focus on risk adjusted returns, which screened out value based strategies for example. In addition, we require a robust economic rationale as to why return patterns should be as they are. While we do not dispute the observed phenomenon that low volatility stocks have delivered similar returns as more volatile stocks, we were deterred by the 'back-fitted' rationale that was then being produced to rationalise why this should occur. We do not believe that it will necessarily occur going forward.

We are likely to include some strategies that improve the overall diversification of an equity portfolio. We recognise the deficiencies of the market cap approach, where one needs the winners to keep winning. Sensible construction approaches that improve diversification make sense to us.

What are the advantages of having an in-house investment team for the defined benefit funds? What are the workings behind this?

We feel very fortunate to have a strong sponsor that has backed the development of an in-house investment team, and we have recently taken the team up to five in size.

The advantages have been huge. From a simple cost perspective, we pay for ourselves many times over. In the first few months of joining, I noticed that the passive fees that we were paying were significantly above market level and got those fees reduced. This cost saving alone would finance the salaries if my team had double the number of people.

The benefits are much more far reaching than this cost example however. We have a team dedicated to sourcing relevant investment opportunities that fit with the dynamics and the investment philosophy of the CCCIF. It would have been difficult to source many of the investments that we have in the portfolio today without this resource.

Were any de-risking processes undertaken in 2013 and are any being conducted in 2014?

We have an excellent funding level de-risking program in place, where we sell out of equities into gilts if our funding level has gone well in excess of the level that we were expecting. We did quite a few trades in 2013 on this basis.

Our general trajectory is to take risk out of the assets over a circa 15 year time frame and therefore, we are continuously looking for ways to add genuine diversification to the assets and manage the mark to market funding level volatility risks. Last year saw some significant changes to the portfolio from a diversification perspective; we made the fixed income changes outlined earlier, and allocated to insurance linked securities, mining revenues, frontier and small cap equities, and a risk parity strategy.

Awareness, understanding and overall usage of exchange traded funds amongst institutional investors is increasing all the time. Do ETFs come into Centrica's investment thinking?

We have used ETFs in the past within our currency hedging programme. Our equity collateral pool was invested in an ETF to ensure a high level of liquidity.

We tend to find that ETFs are best suited to investors who perhaps trade much more frequently than pension schemes with long term investment horizons, and value the liquidity that an ETF can bring. Typically, ETFs come at a higher price and we can find cheaper ways to access asset classes. It would be very rare that we would require the short term liquidity an ETF would bring.

Sin stocks, SRI and ESG investing are investment terms which cause wide debate among many investment fund managers. How is Centrica positioned on these investment policies?

We are similar to many other schemes in that we delegate the decision making on such matters to our fund managers. There is a clear expectation that they take such considerations into account when investing but we do not apply any filters to the investment universe.

What is your outlook for the rest of 2014 and the CCCIF?

We are very happy with the portfolio as it is structured given the many changes we made in 2013. This year is likely to see less portfolio change as we think it is sensible to bed down after the changes of last year. Key focus points for us this year will be our second round of commitments to matching assets that can deliver strong long dated cash flows but with better yields than gilts and how we structure our property portfolio. In addition, we will continue to evolve our framework for making valuation assessments of asset classes.

In terms of the wider macro environment, we hope that the return to modest growth continues although we still worry about the overall level of government debt and continued need for real wage devaluation in the developed markets. We won't typically change the portfolio based on macro views, as we tend to find that macro events can be quite binary in their outcomes and we have very little 'edge' in making macro assessments relative to other investors with much shorter term time horizons. We focus on strategic and valuation considerations for the assets in our portfolio.

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