Leicestershire County Council

INVESTMENT SUB-COMMITTEE – 1 MAY 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

REVIEW OF THE LEICESTERSHIRE LGPS PROTECTION ASSET PORTFOLIO

Purpose of report

1. The purpose of this report is to update the Investment Sub-Committee (ISC) in respect of a planned review of the Fund's protection assets as agreed at the January 2024 meeting of the Local Pension Committee.

2. Appended to the report is a Powerpoint presentation which will be delivered at the meeting by representatives from Hymans Robertson.

Policy Framework and Previous Decisions

3. The annual strategic asset allocation (SAA) review is presented for approval each year and recommends high level asset allocation changes for the Fund. The latest SAA was approved by Local Pension Committee in January 2024, where a recommendation to review the Fund's protection asset holdings was also agreed.

4. The SAA for protection assets was held at 8% of total Fund assets whilst awaiting the outcome of the review. The scope of the review was to be agreed by Fund officers in consultation with Hymans Robertson and is included within this paper.

Background

5. The Fund's protection assets are comprised of three investments and an active foreign currency exposure hedge. Values and the target allocation are shown in the table below.

Protection asset	Manager	Value at 31.12.2023	2024 Target allocation	31.12.2023 actual allocation
Index linked bonds (ILB)	Aegon	£240m	3.5%	3.9%
Short dated corporate bonds	Aegon	£60m	0.5%	1.0%
Investment grade bond fund	LGPS Central	£158m	3.25%	2.6%
Active currency hedge	Aegon	£48m*	0.75%	0.8%

*represents the value of the cash collateral that supports the foreign currency hedges

6. The Fund’s protection assets allocation has remained at 8% for a number of years now with the main changes being adjustments between the four mandates listed in the table above as previously agreed by the Investment Sub-Committee in July 2023. These were to :

    a. Decrease ILB from 4.5% to 3.5% of total Fund assets
    b. Increase investment grade credit (IGC) and short dated corporate bonds from 2.75% to 3.75% of total fund assets, with Hymans Robertson advising on the timing for the change to reduce ILB and increase IGC.

7. The decision on when this change takes place is to be agreed and will be addressed later in this report.

Scope of the review

8. Following the 26 January 2024 Local Pension Committee meeting, where a protection assets review was approved, officers and Hymans Robertson agreed on the following scope:

    a. Why invest in protection assets?
    b. Should the allocation to protection assets be increased?
    c. What level of protection assets best supports the aim of maintaining stable, lower contribution rates over time?
    d. Is there a case for introducing alternative protection assets?
    e. What is the optimal combination of new / existing protection assets?
    f. How should any increase in protection assets be funded?
    g. How would an increase in protection assets impact on the Fund’s aims of achieving Net Zero (“NZ”) and/or other Environmental, Social and Governance (“ESG”) considerations?

9. In order to answer the questions, Hymans Robertson carried out asset liability modelling (ALM) to assess the impact of changes in protection assets on funding outcomes. The aim of the review is to understand if increasing the allocation to protection assets could increase the likelihood of remaining fully funded over the long term whilst reducing the downside risk over the shorter term.

10. This paper will cover some of the main conclusions relevant to the proposal from the scope as described at point 8. The presentation delivered on the day will cover more detail on all areas of the scope.

Why invest in protection assets

11. Quite simply the Fund invests in protection assets in order to reduce overall investment risk and to mitigate the impact of fluctuations in the value of the Fund’s liabilities over longer time periods. Over shorter time periods these assets have known to be volatile and therefore may not reduce the volatility of total returns.

12. They are considered to be low risk because there is a very high likelihood of receiving the principal and interest payments due, especially with respect to sovereign debt.

13. Importantly, however, they protect the Fund’s funding position. They achieve this by matching the fluctuations in the value of the Fund’s liabilities as interest rates and (in the

case of index-linked investments) inflation expectations change. In 2022/23, as interest rates rose, the value of protection assets fell sharply, but the value of the Fund's liabilities fell further, leading to a material improvement in the funding position. This can work in reverse also if interest rates were to reverse sharply.

14. Hymans illustrate that the specific protection assets talked about (IGC and ILB) are not the only forms of protection within the Fund. The Fund has numerous investments that provide index linked cashflows such as certain property and infrastructure investments. In addition, many listed companies exhibit pricing power, where they are able to increase prices in line with inflation. The Fund also has investments within private debt where investments made by the underlying managers are based on variable interest rates which increases returns (all other things being) to investors when benchmarks such as SONIA (sterling overnight index average) increase.

Asset liability modelling (ALM) outcomes

15. Hymans ran 5,000 simulations for the next 17 years which is the Fund's funding horizon. Each simulation considers a different path for asset returns and liabilities, and key economic variables such as inflation and interest rates. Detailed assumption regarding calculation of liabilities and asset performance is included in detail within the appendix and will be presented on during the meeting by Hymans.

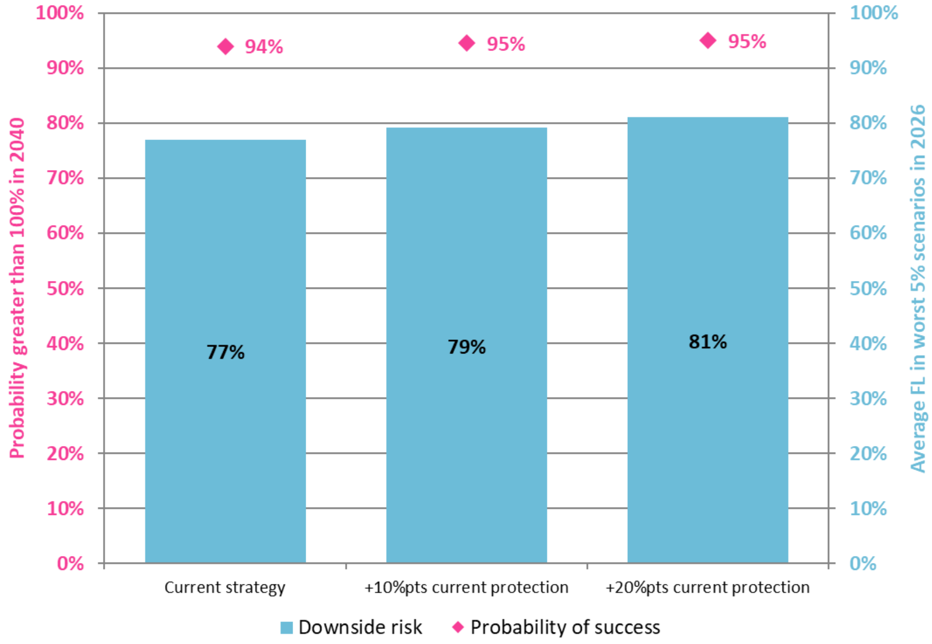
16. The resulting 5,000 simulation outcomes are then ranked by probabilities of 'good' and 'bad' funding levels with the median funding level considered to be where there is a 50% chance of meeting that funding level from the 5,000 ranked simulations.

17. Hymans conclude that in 75% of simulations the Fund would have a funding level in excess of 100% in 17 years. The outcomes from the modelling are contained in more detail within the appendix and a representative from Hymans will present these at the meeting.

Increasing the allocation to protection assets

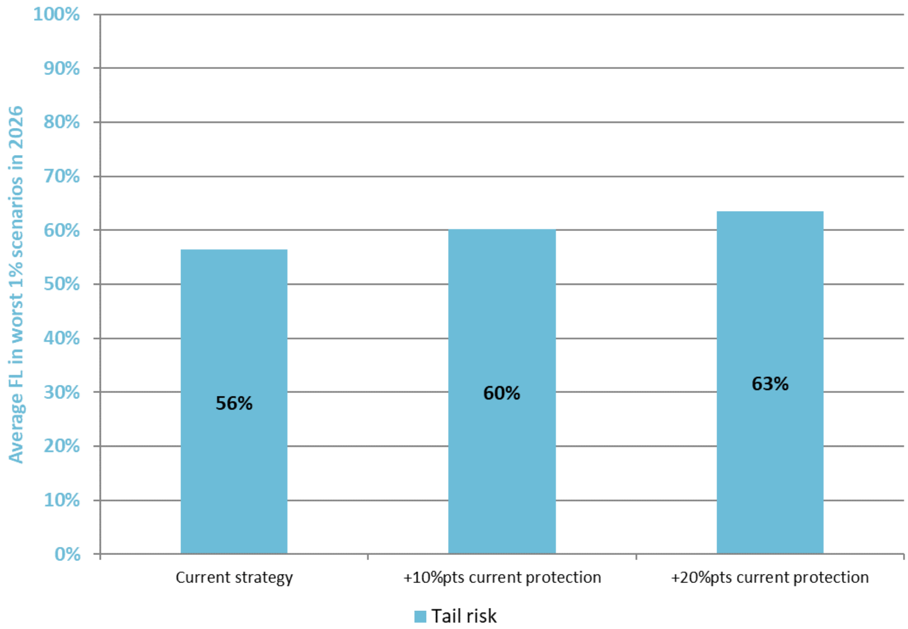
18. With a relatively low target protection assets weighting of 8% Hymans assessed the impact of increasing protection assets investments on funding levels by 2026 and 2040.

19. Hymans conclude that even a material increase in protection assets (18% and 28% of total fund assets allocated to 'protection') has a marginal change in the probability of being 100% funded in 2040. This is best illustrated in the graphic below and the rationale for why this is the case will be explained further at the meeting during the presentation from Hymans and is included within the appendix.



20. Officers and Hymans have considered protection against 'tail risks'. Tail risks can be described as events that are very unlikely to happen but would have a material negative impact on the Fund's assets and ultimately on funding levels. Hymans define tail risk as the worst 1% of outcomes from the ALM over three years.

21. The effect on funding levels under the current strategy and increasing protection assets to 18% or 28% in three years' time is illustrated in the graphic below where under the worst simulations a material deficit is possible. In these cases, an increase in protection assets does have an impact on the forecasted funding levels.



22. Hymans have considered circumstances when increased protection assets would improve funding levels in the worst 10% of outcomes for a single factor. The factors they selected were:

   a. Overseas equity returns 1.5% or below

b. 17 real yields below 0.7%
c. Actual inflation (RPI) above 4.7% and
d. Scheme assets below £13.9bn in 2040

23. In these circumstances the probability of being fully funded is shown in the table below and compared to the all 5,000 scenarios on the last row of the table. Hymans do not recommend tailoring investment strategies to specific scenarios, largely due to not being able to accurately forecast macro economic conditions over the long term.

Market factor	Long-term average value	Probability of success (under "worst" 10% of scenarios for each factor)		
		Current Strategy	+10%pts current protection	+20%pts current protection
Overseas equity returns	Below 1.5%	62%	67%	70%
17 year real yields	Below -0.7%	80%	82%	82%
Actual inflation (RPI)	Above 4.7%	92%	92%	93%
Scheme assets	Below c£13.9bn in 2040 (varies per strategy)	59%	66%	71%
All scenarios (for reference)		94%	95%	95%

Conclusions

24. Hymans conclude that the results of the ALM do not provide a compelling case for increasing the weighting to protection assets at the current time, however:

- they note an increased allocation might improve probability of success and downside risk, but only marginally so;
- they believe an increased allocation to protection assets would help in tail risk scenarios, but they would not eliminate the risk of material deficits re-opening;
- they believe maintaining a reasonable level of contributions and investment risk/return in order to maintain a healthy funding surplus is we believe a better approach to mitigating tail risk;
- an increased allocation to protection assets would also be more helpful in the event of sustained equity underperformance, but we do not recommend tailoring investment strategies to specific scenarios for the reason stated in point 22.

25. In summary, at present the current SAA for protection assets as described earlier in the paper applies until the next annual review.

Climate risk implications

26. Further to the ALM analysis, Hymans considered the implications of any increase in protection assets on the Fund's management of both climate risks (physical and transition risks) and climate opportunities.

27. Hymans assessed each asset class on a qualitative basis using a red, amber, green rating system as set out in their presentation. From this rating system generally gilts and investment grade corporate bonds are assessed to have lower exposure to climate risks than equities, and most (but not all) real assets.

28. UK sovereign bonds in particular can be considered to have lower climate risk exposure than corporate bonds generally because risks are diversified across the whole economy, the UK government has control over its own policies and regulations and the UK is advancing on climate adaption and mitigation. However, UK sovereign bonds offer less direct exposure to climate opportunities though there is an embryonic market in green sovereign bonds. Bondholders also have less scope to accelerate the decarbonisation process through effective engagement.

29. Hymans considered that the Fund's Net Zero Climate Strategy looks to strike a balance between reducing risk and maintaining exposure to climate opportunities and remaining invested and engaging with companies to support real-world emissions reduction. Given this at this point in time Hymans do not believe a material increase in protection assets could be justified solely based on climate risk alone.

30. Climate risk will continue to be reviewed as part of the Fund's SAA. It is recognised that increased climate risk may give reason to re-consider factors such as asset allocation decisions in the future.

<u>Alternative protection assets</u>

31. As part of the scope, and as a follow on from the January 2024 asset strategy, Hymans reviewed three alternative protection assets, gold, real asset backed senior debt and investment grade asset backed securities.

32. The ideal additional or alternative protection assets would reduce volatility and protect from tail risks whilst also protecting against a range of specific risk such as high inflation, or credit defaults for example. Hymans conclude that at present no such asset exists, with most protection assets offering some protection against some of these risks.

33. Hymans have, however, provided background on all three alternatives as well as performance metrics over a 20-year timeframe. They:

- describe each asset;
- what of protection is provided to the Fund;
- how the asset provides the protection;
- what additional risks does the asset introduce; and
- what are the governance and implementation implications.

34. In concluding for alternative protection assets, Hymans:

   a. Do not see a strong case for adding to real asset backed senior debt or asset backed securities (ABS), mainly due to the additional complexity and increased governance burden;

   b. See gold having strong returns but with high volatility and big drawdowns (higher than that of equities). They do note however that gold has the lowest correlation to equities (as well as having low correlation to index linked bonds) and therefore could provide good protection to material equity market falls;

i. Hymans understand that gold would be a new asset class and would provide an additional governance burden although LGPS Central may be able to provide a solution. They also note the Fund would require a large allocation to make a material effect on funding levels.

ii. They do, however, want to keep gold on watch and may revisit this asset class at the next SAA review in January 2025.

Rebalancing the IGC and ILB allocation

35. At the July 2023 ISC meeting, there was a recommendation to change the ILB allocation to 3.5% and for IGC 3.75% of total Fund assets. However, there was a decision to defer the reallocation of capital between ILB and IGC until Hymans have concluded their outlook on both asset classes.

36. Hymans have now guided that they still retain a preference to ILB over IGC and so the Fund should retain the overweight to ILB vs the 3.5% target whilst Hymans await the optimal time period to make the change and inform officers. Hymans complete a capital markets review once a quarter which will inform officers of the optimal time for making the changes.

Consultation

37. The Sub-Committee is asked to note the report.

Resource Implications

38. The Director of Corporate Resources has been consulted. There are no additional resource implications.

Recommendations

39. None

Background papers

40. 26 January 2024 Local Pension Committee, Overview of the current asset strategy and proposed 2024 asset strategy – https://democracy.leics.gov.uk/documents/s180890/SAA%20Jan%202024%20public%20copy.pdf

41. 26 July 2023 Investment Sub Committee, Recommended changes to the protection assets group of investments for the Leicestershire LGPS - https://democracy.leics.gov.uk/documents/s177887/Protection%20assets%20review.pdf

Circulation under the Local Issues Alert Procedure

42. None.

Equality Implications/Other Impact Assessments

43. The recommendation is a high-level strategic document and there are no direct Equality and Human Rights implications. The Fund takes into account issues around Equality and Human Rights as part of responsible investment which incorporates environmental, social and governance factors in all investment decisions. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero.

Environmental Implications

44. Climate risk implications have been taken into account as part of the review of the protection portfolio. The proposed approach aligns with the Net Zero Climate Strategy and the Fund's commitment to supporting a fair and just transition to net-zero.

Human Rights Implications

45. This paper outlines the approach the Fund is taking with protection assets. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment.

Appendices

46. Appendix – Hymans Robertson Protection assets review May 2024

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