Leicestershire County Council

LOCAL PENSION COMMITTEE – 2ND SEPTEMBER 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ACTION TAKEN USING DELEGATED POWERS OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of the Report

1. To inform the Board of the action taken by the Fund since the last meeting, using the delegated powers available to the Director of Corporate Resources.

Background/Action taken under delegated power

2. The Fund's global index-linked portfolio is managed by Kames Capital and has a target weighting of 7.5% of total Fund assets. It is intended to be a portfolio that is relatively glacial in its evolution but takes account of market prices and market movements.

3. In recent months the value of index-linked bonds has increased significantly, to the point that investors were willing to accept a real loss of 1.7% p.a. for the next 30 years by holding a UK index-linked bond. There has been a significant appreciation in the capital value of UK index-linked bonds since the EU Referendum vote.

4. Given the fact that there was no obvious justifiable reason why prices had risen so far, and so fast, the Fund's independent investment advisor produced a paper (attached as an appendix to this report) that suggested taking some profits would be a sensible option. Although the next meeting of the Local Pension Committee (i.e. this meeting) was in the not-too-distant future at the point of receiving guidance to reduce the Fund's exposure to index-linked bonds, it was considered more sensible to take action swiftly than to wait and risk markets being materially different by the time the Local Pension Committee had considered the matter.

5. As a result, the Director of Finance consulted with both the Chairman and the Vice Chairman with a recommendation that the sales were carried out as soon as possible by using powers delegated to the Director of Corporate Resources. Both were supportive of this course of action and the sales of c.£65m occurred on 25th August 2016, which reduced the Fund's weighting in the asset class to 5%.

6. These sales should be considered tactical in nature, and the expectation is that the Fund will reinvest monies back into index-linked bonds (and return to its strategic benchmark weighting of 7.5%) when prices have returned to levels that are more justified by the economic outlook. In the interim period the monies will be held as cash.

7. The sale proceeds were over 25% above what would have been received if the sales had occurred at the end of May. They also occurred at a time that UK index-

linked prices were at an all-time high. This obviously does not mean that prices cannot go higher still, but it does provide some context to how far prices for a low-risk asset have risen in recent months.

Recommendation

8. It is recommended that the Committee notes the report.

Appendix

9. Note of the Independent Investment Advisor - Reducing the Exposure to UK Index-linked Bonds.

Equal Opportunities Implications

None specific

Background Papers

None

Officers to Contact

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Note: On reducing the exposure to UK Index-linked bonds

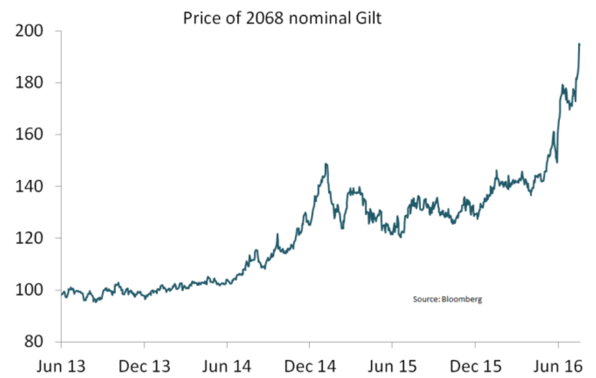
Summary

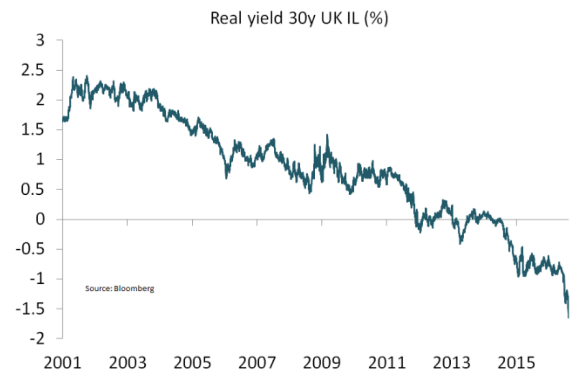
Conditions in the UK government bond market currently are verging on the chaotic with prices rising almost exponentially (and yields hurtling lower). Although these instruments are the Fund's natural asset they offer no value to the Fund (in terms of delivering the long term real return required) and are not held in sufficient quantity to deliver a material level of risk reduction (relative to liabilities). The Fund is guided to exploit the recent surge in prices by reducing its weighting to UK bonds and so monetise recent gains. This is suggested in anticipation of much more attractive levels to rebuild the exposure.

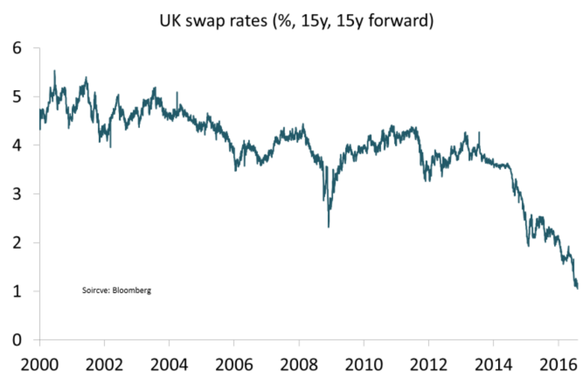
Market Backdrop

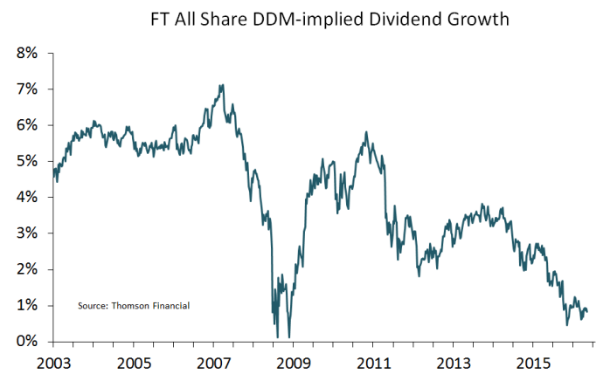
Yields across the major world bond markets have, for some time, been falling steadily and to levels that, hitherto, would have been unimaginable. Low inflation, anaemic economic growth, quantitative easing and near zero policy interest rates have all been strong factors behind the downshift. This process has accelerated this year in response to the building belief that the US Federal Reserve will not be able to deliver the policy rate increases it had previously projected.

The result of the recent UK EU Referendum and the return of QE to the UK and the halving of the base rate have further fuelled an unprecedented surge in gilt prices. To illustrate, the price of the longest nominal gilt, redeeming in 2068, has doubled over the past two years; medium term (15-year) interest rates projected to apply 15 years hence are 0.9% and 30-year index-linked bonds offer investors a guaranteed annual real loss of 1.7%. Meanwhile although the UK equity market is less than 2% off its all-time high (as measured by the FT All Share index), the valuation of equities, relative to prevailing UK interest rates and as captured in the implied breakeven dividend growth rate) has rarely been this cheap. The All Share dividend yield is currently three times that of the 30-year gilt.









Current gilt valuations imply that the UK economy will not, for at least a generation, return to a normal balance of growth and inflation. Put differently, ratings suggest that investors expect a severe economic development beyond that seen in 2008/09 (gilt yields today are triple the lows seen over that winter). While such an event could occur it will have to happen despite the strenuous efforts of the world's monetary and fiscal policymakers.

Discussion

The Fund currently holds some £250m of government index-linked bonds representing a weighting of around 7.2%; the strategic weighting has been set at 7.5%[1]. That the IL weighting hasn't risen further reflects the rise in the £ value of all the overseas investments – international equity markets have risen by 19% in £ terms since the date of the Referendum. In context then there is no immediate need to reduce exposure to UK IL bonds. In absolute terms however and as the previous section highlights, there is significant price risk to the existing stock of bonds unless the UK economy encounters a severe economic shock and/or and monetary instability.

When examining any particular asset it is generally instructive to assess its valuation – even though valuation metrics can be often have dubious origins (generally reflecting biases of the investor). In the case of index-linked bonds, valuation support faded when real yields became negative. Why would an investor accept a guaranteed negative real return of capital? Perhaps because they judged that they would be able to sell the bonds on a lower real yield later (the 'greater fool approach') or because they sense that a period of high inflation is in prospect and that all other investments will deliver even worse returns in real terms. The current allocation has motivations closer to the first explanation than the second – the world economy retains a deflationary bias and global policymakers seem far from endorsing the array of measures that explicitly seeks to debase debt levels through high and sustained inflation. Put differently, the Fund owns index-linked bonds as protection against difficulties in risk markets and the concomitant fall in bond yields; we have had the latter 'insurance' gain without necessarily suffering the former.

With prices detached from any reasoned valuation support it is impossible to argue with great confidence that today's values are unlikely to be surpassed. Real yields of -1.7% on long dated IL are, in a sense, not more or less challenging than yields of -0.7% or -2.7%. The recent erumpent price behaviour is however indicative of a market caught in severe imbalance; imbalances such as these are always passing phases and when stability returns prices could easily fall.

Summary

The Fund owns a defensive asset which is exhibiting chaotic price behaviour in a manner which, currently, is adding value to the Fund; asset risk would be reduced by locking in some of the performance seen recently. A reduction in weighting to 5% would leave a reasonable weighting to the sector, should current trends continue, but would also crystallise a material profit – in an asset which no long term investor with the growth target of the LCCPF would hold to maturity.

[1] The benchmark for the IL sub-portfolio is the Over 15-year UK IL index. At outset the intention was to mandate exposure to those bonds with the greatest price gearing into yield declines in the event that real yields would decline in the manner experienced in recent weeks.