Agenda Item 9

Leicestershire County Council

LOCAL PENSION COMMITTEE – 17 JANUARY 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

STRATEGIC INVESTMENT BENCHMARK AND PORTFOLIO STRUCTURE OF THE FUND

Purpose of the Report

1. To recommend changes to the Fund's strategic investment benchmark, as outlined in the attached appendices to this report. The appendices have been written by Hymans Robertson (Appendix A) and by Scott Jamieson, the Fund's Independent Investment Advisor (Appendix B).

Background

2. The Pension Fund has long-term liabilities. The agreement of a strategic investment benchmark can, therefore, be based on the long-term expectation of returns within certain asset classes. Market fluctuations mean that the Fund's actual asset allocation will never exactly match the agreed strategic asset allocation and investment within asset classes in which funding is 'drawn down' over a period of time further confuses the position. The strategic benchmark should, therefore, be considered an 'anchor' around which the actual asset allocation is fixed.

3. Any decision on the appropriate investment benchmark split is fraught with difficulties, and will ultimately be a 'trade-off' between risk and return. Whilst historic measures for risk and return have some use and can be instructive about how different asset classes are correlated to each other, they clearly give no guarantee that these historic links will persist into the future. As a result it is futile to suggest that it is possible to design an 'optimal' asset mix; this should not, however, detract from the desirability to agree a strategic asset allocation benchmark that makes intuitive sense in terms of the risks being taken to achieve a required return.

Required Investment Return

4. Before a strategic investment return can be designed, it is important to be clear about the required future investment return. Without this clarity it would be possible to have a strategy that targets a return that is very high, but takes overly large risks and as a result has too high a possibility of failing to achieve its target – thereby putting unnecessary upward pressure onto employers' contribution rates. Likewise a target that is too low may be easily achieved, but has the disadvantage of having very little probability of producing the returns needed to lessen future employers' contribution increases.

5. The Leicestershire Fund has, for many years, set a required investment return that is sufficient to assist in controlling future employers' contribution rate increases, but not so risky that the actual outcome might have the opposite effect. This required return has generally been for an annual return of about 4% above Consumer Price

Inflation (CPI), and from this it is possible to arrive at a strategic asset allocation benchmark that gives sufficient diversification to mitigate some of the inherent risks to future investment returns. The required investment return is set in the full knowledge of the level of future investment returns that are allowed for within the Fund's actuarial valuation. By way of a comparator, the very long real return from equity markets is generally estimated at between 5% and 6%.

Recommended Changes

6. The outcome of the 2016 actuarial valuation saw a slight improvement in the funding level (i.e. the ratio of assets to liabilities), but the improvement was insufficiently large to suggest that an amendment to the Fund's overall appetite for risk was required. An annualised return of c.4% above CPI is still an appropriate target for returns.

7. Any assessment of whether a strategic investment benchmark is capable of achieving the target return requires assumptions to be made about expected future investment returns on an individual asset class basis. These asset class assumptions take into account current market levels so will not remain stable over time, but the strategic asset allocation benchmark agreed in January 2016 is still considered capable of achieving the target return.

8. Unlike many Pension Funds, Leicestershire formally considers its strategic asset allocation on an annual basis so changes are always likely to be 'evolution, not revolution'. There is no presumption that annual changes will be required, however if changes could be made that would improve the risk/reward trade-off then these should be seriously considered.

9. The attached appendices contain more detailed explanations about the reasons behind the recommended changes, but the remainder of this report will focus on the recommendations and the rationale behind them.

10. The most significant recommended change is that 2.5% of the Fund's strategic asset allocation benchmark be switched from equities into direct lending. This recommendation recognises that there are a number of factors that could potentially put pressure onto equity market values (in particular the fact that corporate profitability needs to improve to justify current valuations), and that direct lending is a less risky way of achieving similar returns. The switch exchanges valuation risk with liquidity risk, given that direct lending is an illiquid asset class. Equities will remain the Fund's largest asset class by some distance, and this recommendation could easily be construed as marginal. It is, however, one that is thought to be worthwhile.

11. The Fund is currently below its 5% benchmark weighting in credit (an asset class that includes direct lending), and this underweight is a function of other asset classes having outperformed over the last six months together with one of the existing credit investments returning capital in advance of expectations. Partners Group, with whom the Fund already has investments in direct lending, will present their available funds at today's meeting and if the Committee are comfortable with their credentials it is recommended that both the 2.5% proposed increase in direct lending (if agreed) and the current underweight credit position be invested into a mixture of their 2016 and 2017 funds.

12. In late August 2016 the Fund took action to reduce, on a tactical basis, its 7.5% benchmark weighting in index-linked gilts down to a 5% actual weighting. This reduction followed significant increases in prices that did not appear to be fully justified by fundamentals, and prices have since fallen to the point that increasing the weighting back to the full 7.5% weighting is considered appropriate. The exact timing of this increase is subject to agreement between Officers, investment consultants and Kames Capital; the repurchase of index-linked gilts (at a lower price than when the sales occurred) is not subject to any change in the Fund's strategic benchmark.

13. The benchmark index against which the index-linked portfolio has been managed by Kames Capital has, until now, been the over 15 year index. This was a deliberate choice by the Fund as it encouraged exposure to longer-dated index-linked bonds which are more sensitive to changes in the market's appetite for inflation protection. In recent months it has become clear that investors are currently willing to pay a very high price for very long-term inflation protection and, despite their price falls, long-dated index-linked gilts still appear to be expensive – if investors cease to be willing to pay such a high price, long-dated index linked capital values could fall substantially. As a result it is recommended that the benchmark against which Kames Capital are measured is amended to the Index-Linked All-Stocks index. This change will, from a strategic perspective, lower the price sensitivity and also give the manager the ability to run a much more balanced portfolio within the asset class.

14. Within the Fund's targeted return approach, Pictet currently has a very low target weighting. Their actual weighting is higher than target as a result of the Fund being below the lower end of its Opportunity Pool investments, so their portfolio is actually a meaningful size (c.£94m, or 2.6%). At its target weighting of ½% (when Opportunity Pool investments reach 4%), it does not have a sufficiently large impact to justify its retention. It is believed, however, that the portfolio has a useful role in diversifying the other targeted return managers (Ruffer and Aspect). Pictet's performance has been good and is expected to remain acceptable. As a result it is recommended that the intended weightings of all three portfolios are adjusted so that Pictet's portfolio does not become an irrelevance. Reducing the target weighting of Ruffer and Aspect's portfolio by ½% each, and adding the 1% total to Pictet will achieve this recommendation and will not require any actual transactions as both Ruffer and Aspect are c. ½% below their target weights.

15. The Fund maintains a distinct currency hedging programme over its overseas equity assets, the neutral position of which is to hedge 50% of the currency exposure caused by the benchmark equity weighting back to sterling. Kames Capital carry out hedging on behalf of the Fund but do not simply hedge back to the neutral position, as they take account of a number of things (for example 'fair value' of a currency relative to sterling, how currencies are correlated to the Fund's other risks – most notably how they are linked to equity market strength and volatility) when deciding the actual hedged position. As an example the Fund has historically had simultaneous positions of a 100% hedge against the Euro and no hedge against the US Dollar.

16. From an academic perspective hedging out all exposure to overseas currency actually increases risk to a sterling investor, as it nullifies one area of diversification.

Remaining unhedged is less ‘risky’ than a full hedge, but a partial hedge of somewhere around 50% gives the best outcome in terms of risk reduction.

17. The Leicestershire Fund’s decision to avoid a ‘blanket hedge’ that ALWAYS hedges a fixed amount of non-sterling exposure is based on the belief that there will be periods, and sometimes extended periods, when it is possible to form a reasonable judgment that a particular currency is mispriced. The ability to potentially take advantage of this perceived mispricing can add significant value; not hedging the US Dollar over a prolonged period in which it strengthened against sterling and have a 100% hedge on certain occasions against a weakening Euro are examples of this.

18. The neutral position given to Kames Capital (currently 50%) will influence their positioning; for example if they do not have a strong view about a particular currency’s ‘value’ against sterling it is reasonable to expect them to be 50% hedged as this is the neutral position. If they were given a 25% neutral position, it would be expected that they would be hedged at this level if they had no strong view.

19. The well documented fall in sterling following the Brexit vote has made it a ‘cheaper’ currency than it was. This fall may ultimately be prove to be justified by weaker future economic performance, but it might equally be a (predictable) knee-jerk market reaction to the UK entering a period for which there is no historic precedence. Above all things, markets dislike uncertainty.

20. Given sterling’s fall it is recommended that the Fund’s neutral hedging position be increased to 2/3rd of the currency exposure caused by its overseas equity benchmark position. The impact of this change will be that at a neutral position the Fund will retain a higher exposure to sterling, which is now ‘cheaper’ than it has been at any time since the Global Financial Crisis. Importantly this change will not remove the ability for Kames Capital to express an investment view on the value of other currencies relative to sterling – for example they can remain fully hedged against currencies that they feel will weaken, and unhedged against currencies that they think will strengthen.

Summary

21. The strategic asset allocation benchmark agreed as part of the January 2016 Local Pension Committee meeting is still considered to be generally ‘fit for purpose’. The changes that are being recommended are not particularly significant but should improve the overall structure of the benchmark.

Recommendations

22. The Committee is recommended to:

a) Approve a revised strategic benchmark for the Fund as detailed within paragraphs 10 and 11 of the report and Appendix A;

b) Approve a revised portfolio split within the Fund's targeted return portfolios of:

Ruffer	6.5% of total Fund assets
Aspect Capital	3.5% of total Fund assets
Pictet	1.5% of total fund assets

c) Approve a change in the benchmark, against which the Fund's index-linked gilt exposure will be managed, to the All Stocks Index-Linked Gilt Index;

d) Approve a change in the neutral hedging position in respect of the Fund's currency exposure created by its overseas equity benchmark position to 2/3rd.

Equal Opportunities Implications

None specific.

Appendices

Appendix A – Annual Review of Strategy, Assets and Structure – Report of Hymans Robertson

Appendix B - Reviewing the neutral currency hedge ratio – Report of the Independent Investment Advisor

Background Papers

Report to the Local Pension Committee – 22 January 2016 – Strategic Investment Benchmark and Portfolio Structure of the Fund

http://cexmodgov1/ieListDocuments.aspx?CId=740&MId=4490&Ver=4

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