Agenda Item 7

Leicestershire County Council

LOCAL PENSION COMMITTEE – 17TH MARCH 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CLOSURE OF TACTICAL UNDERWEIGHT POSITION IN INDEX-LINKED BONDS

Purpose of the Report

1. The purpose of this report is to inform the Committee of the action taken in February 2017, which brought the Fund's exposure to global index-linked bonds back up to its 7.5% strategic asset allocation weighting.

Background

2. The Fund's strategic benchmark weight in index-linked bonds has been 7.5% of total fund assets since early in 2013. These holdings have performed well and the asset class performed particularly strongly in the aftermath of the Brexit vote. Whilst there were a number of reasons as to why the asset class might continue to produce good returns, there was also a strong case for suggesting that prices had risen "too far, too fast" and that the balance of probability was that prices might fall or simply stagnate.

3. Given how far prices had risen in such a short period of time, it was considered sensible to consider reducing the index-linked weighting on a tactical basis. At the end of August 2016, and following consolation with the Chairman of the Committee, delegated powers were used to instruct the sale of sufficient quantity of index-linked bonds as to bring the actual weighting down to 5%. The Committee were informed of this action in an urgent report presented to the meeting held on 2nd September 2016.

4. As there were a number of potential scenarios in which the price of index-linked gilts might continue to rise in the short term, it was not considered appropriate to reduce the weighting of index-linked bonds below 5%. The strategic benchmark remained at 7.5% and the underweight was purely tactical, with the intention to bring the actual weighting back up to the strategic benchmark level when market conditions suggested that this was sensible.

5. As part of the January 2017 Annual Strategy Meeting the continuation of the strategic benchmark weighting of 7.5% to index-linked gilts was reaffirmed, although the benchmark against which the portfolio (managed by Kames Capital) would be measured was changed to one that reflected all UK Government Index-Linked Bonds in issue – the previous benchmark encouraged a higher level of investment in long-dated bonds where market prices are more volatile. The Committee also approved that Officers and Investment Consultants effect the return to the strategic benchmark investment level, as-and-when the time was deemed appropriate.

Closure of tactical underweight

6. In late February 2017 conditions within index-linked markets were such that it was considered advisable to bring the weighting back up to its target. Attached to this report as appendix an appendix is a note produced by Scott Jamieson, the Fund's independent investment advisor that summarises why this action was proposed. Once agreed, the action was implemented quickly.

7. If the same holdings had been repurchased in late February 2017 as those that had been sold in August 2016, then the cost of the repurchase would have been £4.2m less than the proceeds of the sales. This £4.2m should be considered the 'profit' from the action taken – in effect the sales that occurred meant that the Fund avoided a fall in the value of its assets of this amount.

8. Whilst the 'profit' from the action is actually quite modest relative to the size of the Fund's assets, the nature of the LGPS means that this is £4.2m (plus future investment growth on this sum) that the employing bodies will not have to pay into the Fund. As such, the action should be considered a success.

Recommendation

9. The Committee is asked to note the report.

Equality and Human Rights Implications

None specific

Appendix

Note on restoring target exposure to UK Index-linked bonds

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APPENDIX

Note: On restoring target exposure to UK Index-linked bonds

Summary

In August 2016 the weighting to index-linked bonds was tactically reduced in an attempt to monetise some of the spectacular gains seen in UK government bonds that followed the UK vote to leave the European Union. Subsequently Officers, supported by the Independent Advisor, together with Kames Capital were granted discretion to reinstate the strategic weighting at a time and level of their choosing – mindful of the desire to maximise the profit generated and the need to maintain the desired weighting in a defensive asset. The position was restored at the end of February; the move resulted in a profit of just over £4m.

Detail

Members will be well aware of the sustained climb in UK Government bond prices in recent years (it is this that has driven the relentless ascent in the Scheme's liability values). This move acquired feverish proportions following the *Brexit* vote as investors feared that the UK economy (and that of the EU) would enter a sharp recession. The clamour for defensive exposure resulted in the real yield on 50-year UK Government bonds falling below minus 1.8% - at this level, investors would be guaranteed to lose more than half their capital in real terms. Recognising the extreme conditions, the Director of Corporate Resources' Delegated Powers were utilised (following due consultation with the Chair) to allow the liquidation of one third of the index-linked bonds held in an attempt to avoid the value erosion that would result from the move higher in real yields that might follow a sober market re-assessment of the long term outlook. The move was implemented in the last week of August 2016.

At the 2017 Strategy Review Members further resolved to alter the benchmark for the index-linked portfolio from a long duration index to one that captured the movements in the broader market[1]. This change is a structural move intended to 'lock in' the exceptional rise in long-dated IL bond prices. The interaction between the tactical move last summer and the change in strategic benchmark meant that the bonds sold would not necessarily be those repurchased. [In practice, the IL bond manager (Kames Capital) has discretion over which particular bonds they wish to own at any particular point in time.] This strategic change means then that an exact measurement of the profit from the tactical sale would not be available.

In February 2017 it was the view of those delegated to manage the weighting restoration, that the gilt market had entered a period of consolidation where the tactical merit of being underweight in a strategic asset (UK IL) was much less clear cut than was the case last summer. The Government had auctioned material quantities of fresh stock and met solid demand (the auctions were twice covered). The US bond market (this market sets the tone for world bond markets) had itself also stabilised after a period of an unprecedented selling generating the potential of a material recovery if a supportive catalyst emerged. In this context, the upcoming elections in Holland and France are judged have the potential to initiate such a move. As a result, the strategic weighting (against the new benchmark) was restored ahead of month end. Allowing for the absence of like-for-like purchases, the profit gained (or capital preserved) from the tactical reduction was just over £4m.

Members are asked to note that the target weighting in index-linked bonds has been restored for a profit of over £4m.

[1] In practice the UK Index-linked All Stocks index as compiled by FTSE has been adopted.

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