Leicestershire County Council

LOCAL PENSION COMMITTEE – 19 JANUARY 2018

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

STRATEGIC INVESTMENT BENCHMARK AND PORTFOLIO STRUCTURE OF THE FUND

Purpose of the Report

1. The purpose of this report is to recommend changes to the Fund's strategic investment benchmark, as outlined in Appendix A and Appendix B of the report.

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 inherently difficult, and will inevitably come down to a 'trade-off' between expected 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. As a result it is somewhat fanciful 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 benchmark 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 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 the increase in the funding level (i.e. ratio of assets to liabilities) that has occurred since the 2016 actuarial valuation has had the impact of

marginally reducing the future required return. The very strong performance of risk assets since the actuarial valuation has, however, reduced expected future investment returns by broadly the same level as the reduction in the required return. Overall, this means that there is neither a requirement to seek to significantly enhance future investment returns, nor is there any scope to meaningfully reduce the level of investment risk that is required. Given this fact it is perhaps no surprise that the Annual Strategy Review proposes a further evolution of the strategic benchmark, rather than wholesale changes.

Recommended Changes

6. 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 by the Committee in January 2017 is still considered broadly capable of achieving the required return.

7. 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 can be made that would improve the risk/reward trade-off then these should be seriously considered. Part of the consideration that goes into proposing changes is an assessment of valuations within markets at a point-in-time; put simplistically it is far more likely that a reduction in equities will be proposed if they are felt to be highly valued, than if they are considered to be cheap.

8. The attached appendices to the report 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. Whilst appendices A and B specifically refer to recommended actions, appendices C and D should be considered background information about general investment themes that are likely to add additional ‘context’ to today’s discussions.

9. The Fund’s dominant asset class remains equities, and there is no proposal that this changes. It is, however proposed that the strategic benchmark weighting of equities be reduced by 2% in order to invest an extra 1% into each of infrastructure and timberland. These asset classes are considered to offer broadly similar long-term returns to equities, but with the probability of a more consistent return. The additional investment in timberland will be via the Stafford International Timberland VIII (into which a $30m commitment has already been made). It is recommended that the Director of Finance, following discussions with the Fund’s Investment Advisors be given discretion about the most appropriate split of the additional monies into infrastructure, albeit that the monies will only be invested via the Fund’s existing infrastructure managers (IFM, JPMorgan and KKR), in order that due account can be taken of how efficiently the new monies can access the market. The suggested revised strategic benchmark for the Fund can be found at page 20 of Appendix A.

10. In October 2017, the Investment Subcommittee agreed the latest investment into a number of ‘opportunity pool’ investments which, when fully drawn, will bring the weighting of this asset class to around 5%, it is recommended that the target range

is increased from 4%- 6% to 4% - 8%. This will provide scope to make further investments in the event that suitable ones are found, and it is proposed than any additional monies required to fund new opportunity pool investments will be drawn from either equities or targeted return. The exact source of the monies for further opportunity pool investments will be considered on a case-by-case basis at the point of approval of any investment, and will depend on valuation levels at the appropriate time.

11. Given the strengthening of sterling over the last year and taking into account the expected underperformance of the UK economy on a global basis in the years ahead, it is recommended that the default hedging position for currency exposure caused by the Fund's exposure to overseas equities is reduced to 50% from the current 70%. It should be noted that the default hedge acts only as a neutral point around which the hedge implementation manager (Kames Capital) will base their actual positions; if they have strong views on the valuation of any currency relative to sterling, they are free to position their hedges accordingly.

12. There is no proposal to amend the strategic weighting of property from its current level of 10%, but it is recommended that a further £25m investment is made into the Kames Active Value Property Unit Trust II (KAVPUT II) to close some of the current underweight position. The Fund already has a £25m investment in KAVPUT II and the managers' pipeline of deals suggests that the additional investment can be made in a speedy manner and on attractive terms.

13. It is recommended that the target portfolio sizes of Ruffer and Pictet - who both form part of the targeted return weighting - are amended slightly; Ruffer from 6.5% to 6.0% and Pictet from 1.5% to 2.0%. This will reflect a more optimal balance of the various portfolio styles within targeted return, but is unlikely to lead to any immediate additions or withdrawals of cash from within the portfolios. The portfolios will be adjusted towards their revised weightings as-and-when cash flows are required for other purposes.

14. It is recommended that the Investment Subcommittee be asked to consider the issues of the regional equity split, the indices against which the Fund's passive equity assets are managed and the potential impact of climate change onto future benchmark returns. The latter two of these issues are likely to be considered by a number of other Funds that are part of LGPS Central, and some element of joint working is likely to be sensible. It is anticipated that these issues will be considered during 2018, with any recommendations brought back to the Local Pension Committee in due course.

<u>Summary</u>

15. The strategic asset allocation benchmark agreed as part of the January 2017 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

16. It is recommended:

a) That the revised strategic benchmark for the Fund as shown on page 20 of Appendix A of the report be approved

b) That subject to recommendation a), the Director of Finance ,following consultation with the Fund's investment consultants, be authorised to split the increase in the Fund's strategic asset allocation to infrastructure between the Fund's existing infrastructure managers;

c) That the revised portfolio split within the Fund's targeted return portfolios as set out below, be approved::

Ruffer	6.0% of total Fund assets
Aspect Capital	3.5% of total Fund assets
Pictet	2.0% of total fund assets

d) That a change in the neutral hedging position in respect of the Fund's currency exposure created by its overseas equity benchmark position to 50% be approved;

e) That an additional £25m investment into the Kames Active Value Property Unit Trust II in order to close some of the Fund's current underweight position in property, be approved;

f) That the Investment Subcommittee be asked to consider over the course of 2018 the issues of the regional equity split, the appropriate benchmarks against which the Fund's passive equities should be managed and the potential impact of climate change onto benchmark returns.

Background Papers

None.

Appendices

Appendix A – Annual review of asset strategy and structure addressee

Appendix B - Reviewing the neutral currency hedge ratio

Appendix C - Searching for mitigants

Appendix D - Adjusting the regional equity mix

Equality and Human Rights Implications

None specific.

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