Leicestershire County Council

LOCAL PENSION COMMITTEE – 25 JANUARY 2019

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ANNUAL REVIEW OF THE ASSET STRATEGY AND STRUCTURE

Purpose of the Report

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

Background

2. The nature of the Fund's liabilities is long-term. The strategic investment benchmark is structured to reflect the nature of liabilities by focusing on the need for long-term returns and a degree of inflation-linked returns. Market fluctuations will cause the Fund's actual asset allocation to vary from the agreed strategic asset allocation and investment within asset classes in which funding is 'drawn down' over a period of time will create further variation. 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 is inherently difficult and will inevitably come down to a 'trade-off' between expected risk and return. Whilst historic measures for risk and return 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 an 'optimal' asset mix does not exist. This does not 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.

4. LGPS Central's product offer continues to develop and the strategy review has been undertaken with this in mind. The report attached as Appendix B to this report provides a summary of the current view of the mapping between the Fund's assets and Central's offer. Dialogue continues with Central and other partner funds to ensure that Central's offer meets the goals of the Fund.

Required Investment Return

5. The strategic investment benchmark has to be designed around the required future investment return and an acceptable level of risk. 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.

6. At September 2018 the funding level had improved by 6% to 82% since the March 2016 valuation, leaving a net shortfall of £933 million. The estimated liabilities of the Fund have increased, but this has been more than compensated for by investment

returns. The recent fall in equity markets will have had a detrimental effect, but this is within the bounds of normal market volatility, for a long-term investor.

7. Since March 2016 the discount rate used to value liabilities has fallen, implying the investment return required for a fully funded pension fund has reduced to CPI + 1.2%. To improve the Fund's funding level, in the long-term, a higher level of investment return from the asset investments is targeted. Hymans' view is that the future expected investment returns have reduced to CPI + 3.4%, this is not unusual after a period of overperformance. The relative difference in the two sets of returns has not materially changed since March 2016

8. Overall this means that there is no requirement to significantly amend the benchmark as part of this review. The next tri-annual valuation of the Fund will take place in 2019. When further factors, particularly the employer contribution rates, will be taken into account.

9. The key proposal is to increase the strategic allocation to credit (emerging market debt plus global credit) from 10% to 12.5%, funded from the Targeted Return allocation. A report from the Funds investment consultants, Hymans Robertson, attached as Appendix A provides the detail on the rationale behind the recommended change to the investment benchmark.

10. The Hymans' report also contains recommendations for some specific areas for review by the Investment Subcommittee that will be required to maintain the Fund's investment in line with the strategic benchmark.

Recommendations

11. It is recommended that;

   a) The revised strategic benchmark for the Fund as set out in the table below and detailed in page 25 of Appendix A of the report be approved;

	Proposed target weight (%)	Retain, Central or remove
Equities (44-48%)		
Listed equity	40.0-44.0	
LGIM passive/RAFI		Retain through LGPS Central negotiated fee
Emerging markets active		Central
Global active		Central
Currency hedging		Move to LGIM or Central
Private equity	4.0	Retain existing, new commitments to Central
Real (26.5%)		
Inflation-linked bonds	7.5	Move to Central or LGIM
Infrastructure	6.0	Retain existing, new commitments to Central
Timberland	3.0	Retain existing, but review long-term hold
Property	10.0	Retain, but review Central offering
Alternatives/Diversifiers (25.5%)		
Targeted return	9.0 (9.5-11.5)	Move to Central
Currency overlay (notional)	0.0	Remove when move Targeted return to Central
Emerging market debt	2.5	Retain until solution included in Pool
Global credit (inc private debt)	10.0 (7.5)	Central for liquid market multi-credit; Retain Partners for existing private lending, but look to Pool to provide solution for new investments
Opportunity pool	c.4.0% (4.0-8.0)	Retain existing holdings; look to Pool for distressed debt solution to replace M&G DOF over time
Total	**100.0**	**Removes 9 external mandates initially, excluding closed ended funds that wind down over time.**

b) The Investment Subcommittee be asked to consider over the course of 2019 the product launches by LGPS Central and the appropriate commitments to be made by the Fund, including the investments to divest;

c) The Investment Subcommittee be asked to review the structure of the Fund's currency hedging programme and how best to implement the hedge post pooling;

d) The Investment Subcommittee be asked to review any distressed debt opportunities that may arise;

e) The current notional exposure to the Millennium currency overlay be maintained at £340 million.

Equality and Human Rights Implications

12. None.

Appendix

Appendix A - Annual review of asset strategy and structure, Hymans Robertson

Appendix B - Investment Mapping to LGPS Central Pool, Independent Consultant

Background Papers

Report to the Local Pension Committee – 19 January 2018 – Appendix A, Portfolio Structure of the Fund
http://cexmodgov1/documents/s134829/Appendix%20A.pdf

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