Leicestershire County Council

LOCAL PENSION COMMITTEE – 19th JUNE 2020

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS AND INVESTMENT PERFORMANCE OF INDIVIDUAL MANAGERS

Purpose of Report

1. The purpose of this report is to present to the Committee, an update on the investment markets and how individual asset classes are performing, a summary valuation of the Fund's investments at 31st March 2020 (Appendix A), together with figures showing the performance of individual managers.

Market Outlook and Performance

2. An update on asset classes and market performance is provided by LGPS Central's (Central) Tactical Asset Allocation (TAA) report (Appendix B) whose 6 -18 month view is summarised below, arrows indicate movement in weighting since the last quarter.

Table1: Weightings ▲ Upgraded, ▼ Downgraded compared to previous quarter

	Significant Underweight	Underweight	Neutral	Overweight	Significant Overweight
Estimated Probability	80-70%	70-65%	55-45%	70-65%	70-80%
BROAD ASSET CLASS	Stabilising ▼			Income	Growth ▲
GROWTH ASSET CLASS	US Equities			UK Equities, Commodities, Asia Pac Equities, GEM Equities ▲ Private Equity ▲	Japan Equities, EU Equities ▲
INCOME ASSETS	Property ▼	Infrastructure ▼			Credit, ▲ EM Debt ▲
STABILISING ASSETS	JP Bonds, Index-Linked, ▼ EU Bonds ▼	UK Bonds ▼		Gold, US Bonds ▼	IG Bonds ▲
INVESTMENT STYLES	Low Volatility	Momentum, ▼ Quality/ESG ▼	Size ▲	Growth ▲	Value ▲
CURRENCIES		US Dollar	Euro, Yen	GBP	

3. Central's summary is noted below:

   a. LGPSC changes Growth Assets to significant 0verweight from Neutral, remains overweight Income Assets and increased underweight to Stabilising Assets.

   b. Growth Assets have very attractive valuations after recent market falls and are supported by positive sentiment.

   c. Stabilising Assets have done well. LGPSC's outlook remains cautious on those but notes that they can provide downside protection in times of recession.

   d. LGPSC prefers exposure to Income Assets as an alternative to Stabilising Assets where yields and expected returns, combined with a low correlation to those riskier Growth Assets, will provide better diversification.

4. A summary of the asset class performance over various time frames covering the 3 months from January to March 2020 and longer time frames is shown below. The rapid move downwards in most asset classes during the first quarter of 2020 is illustrated below.

Table 3: Historical Annualised Returns in local currency (* except for the 3 months, where total return is used)

	3 months*	One year	Three years	Five years	Ten years	Twenty years
GLOBAL EQUITIES	-21.3%	-12.3%	1.4%	3.1%	6.2%	3.3%
PRIVATE EQUITY	-29.1%	-11.7%	-0.9%	5.7%	8.1%	NA
PROPERTY	-23.3%	-15.6%	0.2%	2.1%	8.5%	10.1%
INFRASTRUCTURE	-29.2%	-20.9%	-3.2%	-0.4%	4.2%	NA
HIGH YIELD	-13.6%	-6.6%	0.1%	3.1%	7.2%	9.1%
UK GILTS	6.8%	11.7%	5.3%	5.1%	6.3%	5.8%
UK INDEX-LINKED	1.7%	6.5%	4.2%	6.6%	8.2%	6.9%
GOLD	11.0%	32.4%	9.7%	10.1%	5.9%	10.5%

Overall Investment Performance

5. A comprehensive performance analysis over the quarter, year and three-year period to 31st March 2020 is provided in Appendix A. Portfolio Evaluation collate information directly from managers and calculate performance, which will provide an independent check of valuations and allow greater reporting flexibility. Introduction of this reporting enhances the control and assurance for the Fund. Current performance reporting is limited to three years, however work is ongoing to provide longer history.

6. It is important to note that the valuations produced can be different to those provided by managers or included in the Statement of Accounts. For example, timing differences of use of different accounting methodologies. The differences are not expected to be material in the context of the messages being conveyed by the report.

7. For the period ending 31st March 2020 the Fund delivered an investment return of -11.2% for the quarter, -4.3% over the last 12 months and 1.8% annualised over the three year period.

8. The Fund's total value as at 31 March 2020 is £4.1 billion.

9. The Fund's asset allocation compared to the investment strategy at 31st March is shown in the table below together with the last years benchmark and the new benchmark per the revised target asset allocation.

	Actual Weighting	Old benchmark	Old difference	New Benchmark	New Difference
Equities	46.5%	48.0%	-1.5%	46.75%	-0.3%
Real Income	26.9%	26.5%	+0.4%	24.75%	+2.2%
Alternatives	24.2%	25.5%	-1.3%	27.5%	-3.3%
Cash and hedge collateral	2.4%	0%	+2.4%	1.0%	+1.4%
	100.0%	100.0%	0.0%	100.0%	0.0%

10. The Fund's actual allocation varies over time due to different market movements across the various asset types. This quarter in particular has seen markets move more rapidly. The benchmark allocations have been amended based on the approved

strategic asset allocation from the January 2020 meeting. As at 31st March 2020 the proposed changes to the Fund to re balance to the new benchmark have not been enacted with the exception of the termination of the Funds currency overlay with Millemnium.

11. The alternatives part of the Fund's portfolio includes the increase in allocation of +2% from a combination of changes which will be enacted later in the year when Central have launched relevant products, due diligence been completed, and committee have approved. Comments versus the previous benchmark weights will continue until changes are enacted through the year to move towards the new benchmarks weights.

12. The real income part of the portfolio includes the property, infrastructure and index linked parts of the portfolio. The benchmark includes the changes to reduce the index linked weighting by 2.5% as part of the annual strategic asset allocation review. As at 31st March the Fund had not divested a part of the index linked holding and as such was roughly in line with the previous target.

13. The new allocation to Investment Grade Corporate Bonds was addressed in April 2020 this year with an initial £100 million investment to address the 3% target weight to this asset class. A separate paper is included within this meetings agenda.

14. The following table provides the performance of the Fund and the asset classes over short and longer-term periods, compared to their respective benchmarks.

	3 Months %		1 Year %		3 Years %	
	Fund	Benchmark	Fund	Benchmark	Fund	Benchmark
Equities	-19.6	-17.3	-11.5	-8.8	-0.9	0.5
Private Equity	-0.3	-15.9	11.1	-6.2	11.3	2.2
Real Income	0.6	0.3	2.7	2.6	5.0	4.6
Alternative	-4.4	0.5	0.7	4.2	1.4	4.2
TOTAL FUND inc hedge	**-11.2**	**-8.4**	**-4.3**	**-2.3**	**1.8**	**2.5**

15. The Private Equity relative outperformance to benchmark is due to the individual investments being valued less often given the illiquid nature of the assets.

16. The investment performance of the individual managers for the year to 31st March 2020 is set out in appendix A.

17. The remainder of this report covers the following asset classes in more detail, equities, emerging market debt and targeted return.

Equities

18. The Fund ended the quarter with a 46.5% allocation to equities. This includes the allocation to LGPS Central sub funds which total 11.1% of the total fund value. The bulk of the Fund's equity holdings are with Legal and General (LGIM) totalling £1.22 billion.

LGIM

19. The LGIM portfolio contains a number of passive funds covering the UK, all world

and geographic specific funds. The total value of these funds is £1.22 billion with a loss of 19.8% over the quarter and loss of 11.3% over the last 12 months. The LGIM portfolio performed in line with benchmark returns as expected of a passive fund.

20. Re balancing occurred in the period across the various funds to maintain benchmark targets. There was a net £18m movement to the UK portfolio from the global (exc UK) portfolio. This is due to the UK market underperforming relative to other global markets. The best performing LGIM regional investments the Fund holds are Japan equities at -11% and North American equities at -14% in the quarter.

LGPS Central Active Global Equity

21. This fund had a valuation of £307 million at quarter end having initially invested in March 2019. The performance since inception has lagged the benchmark by 3.8% having returned -7.35%. The target for the fund is to outperform the benchmark by 1.5% per annum net of costs over rolling 5 year periods. Performance in the quarter ended was -18.9% vs a benchmark return of -16%.

22. Central have appointed three managers for the mandate, Harris, Schroders and Union. Harris, a deep value biased manager suffered during the first quarter with returns of -28.0% and underperformed its benchmark by 12.0%. This underperformance was as a result of value investments underperforming versus growth during the sell-off in the first quarter. Central are monitoring and evaluating the performance of the manager and the risk inherent within the multi manager strategy.

23. Harris' disappointing performance within the fund was somewhat balanced by the 2 other managers who both outperformed the benchmark. Schroders by +2.12% and Union by +2.43%. However, the outperformance was not enough, and the fund underperformed in the quarter by 2.9% vs the benchmark. It is worth noting that 'value investing' experienced the worst quarter in over a decade.

24. The weighting of each manager is liable to be rebalanced when +-2.5% from their target. As a result of the significant differences in performance in the quarter Harris were -3.7% vs their target allocation within the fund. Given the volatility in the markets, Central are evaluating on a weekly basis the performance of each manager and informing partner funds before enacting any changes.

LGPS Central Emerging Markets Active Equity

25. This fund had a valuation of £152 million at quarter end having initially invested in July 2019. The performance since inception is ahead of the benchmark by 0.57% having returned -17.9%. The performance in the quarter was -18.1% which was +0.9% vs benchmark. The target for this fund is to outperform the benchmark by 2.0% per annum net of costs over rolling 5 year periods.

26. Central employ three managers, BMO, UBS and Vontobel. Like the Global active equity fund, rebalancing maybe carried out if any manager strays by +-2.5% from their target weight.

27. BMO underperformed the benchmark return by 143 basis points (bps) with a

return of -20.4%.

28. The portfolio is built from a bottom-up, benchmark agnostic perspective in line with the investment manager's investment philosophy and process of investing in cash generative, high quality companies. On a country basis, the largest exposures are in China and India where combined they account for approximately 40% of the portfolio. Relative to index, the portfolio is underweight China and overweight India.

29. The regional allocation effect was a major drag on performance, with China driving the largest single negative country impact. The underweight position impacted relative performance with China being the most resilient market, only losing around 4% in the quarter. The relative overweight positions in India, Indonesia and South Africa also had a material negative impact on the portfolio. All of these markets have seen significant sell-offs during the period as each struggled with containment of the pandemic outbreak. Indonesia lost 36%, India was down 26% while South Africa was down 37%

30. UBS underperformed the benchmark return by 123 basis points (bps) with a return of -20.2%.

31. The UBS portfolio is built on the remit of exploiting pricing inefficiencies determined by estimating long-term intrinsic value from future cash flows. The selection process is primarily bottom up coupled with top-down macro and industry factor research. Consequently, the country and sector positioning is less important for the fund than the stock exposures.

32. The portfolio continues to be tilted toward financials and technology as well as consumer services. It is also overweight oil & gas. The overweight in financials and poor stock picking in the sector impeded returns with the sector suffering -40% to -50% downswings in returns as currency impacts affected the stocks. The Technology overweight drove good relative returns, but the stock selection detracted, as the industry benefitting from the switch from offline to online in the sector. The small oil & gas overweight was the second largest detractor to performance (-118bps), with both asset allocation and stock selection costing. The consumer services positioning added 149bps with asset allocation and stock selection both contributing positively.

33. Vontobel outperformed the benchmark return by 533 bps with a return of -13.7%.

34. The portfolio philosophy and process exploits the positive correlation between improvements in a company's return on invested capital (ROIC) and its share price performance. As a result, factor analysis shows that the portfolio tilts towards quality companies with good governance. Companies which generate a high ROIC and have strong industry position are more likely to generate high free cash flows and as a result have stronger balance sheets with better capabilities to invest in R&D or M&A and should therefore exit the crisis in a better position in the industry.

35. The country allocation returned a positive 280 bps in the period. The Vontobel portfolio is significantly overweight China (a market that held up well in the period) and significantly underweight India (a poorly performing region), this was a positive boost to returns in the period.

Illquid markets

36. Illiquid market asset classes include, private equity, private debt and some property and infrastructure funds. Given that the investments within these funds are not easily valued given that there is no public market quoting prices, there is little buying providing price visibility or the fund manager has suspended dealing to stem outflows whilst the volatility in the markets continues the Fund has some investments that at 30th March may not have been fully written down.

37. As a result, those asset classes currently appear to have performed well in the quarter. The true value of our Fund's holdings will become clearer in the coming months with some investments showing to be far better insulated against short term market fluctuations. It is worth noting that the Fund is a long term holder of investments, is cash flow positive and where prices are depressed the Fund can take advantage of pricing opportunities.

38. At the time of writing (early June 2020) many markets have experienced a sharp bounce back from the March 2020 lows with some regional markets (US, Europe exc UK and Japan) less than 5% down year to date.

Emerging Market Debt

39. Ashmore have underperformed the benchmark in the quarter by -10.3% with a -16.9% performance. This performance is quoted unhedged in GBP and net of fees. This follows a marginal underperformance to benchmark in the previous quarter ending 31st December 2019 of -0.16%. Since the inception of this mandate the fund has returned 7.77% pa (GBP unhedged) versus a benchmark return of 6.78%, an outperformance of 0.99% pa.

40. Given the fund has substantially underperformed the benchmark over the last quarter this has impacted the 1 and 3 year periods which also saw substantial underperformance of 13.1% and 4.4% respectively to benchmark when measured in GBP net of fees.

41. Ecuador, Lebanon and Argentina were the largest country detractors during the quarter. All three countries were higher conviction positions with each featuring significantly more within the fund than the weight within the benchmark.

42. Ecuador with one of the highest rates of infection from the COVID-19 pandemic and an economy significantly dependent on oil exports faced a major challenge in balancing domestic needs and maintaining its debt payment schedule.

43. Lebanon became the first sovereign issuer to declare a moratorium on its USD 31.3bn external debt during Q1. A restructuring proposal will likely be forthcoming during Q2, but the abruptness of the moratorium announcement implies that the restructuring process may be lengthy and potentially adversarial.

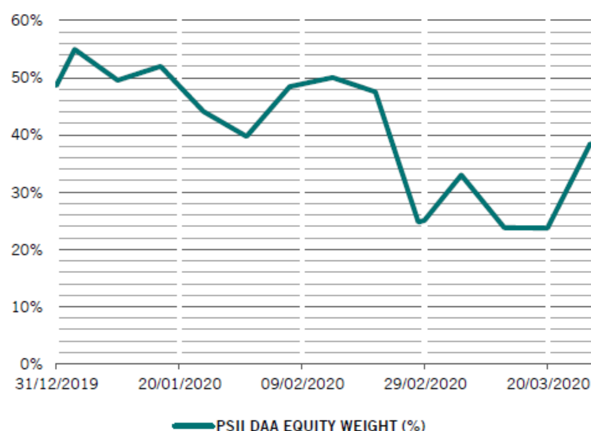
44. Argentina launched its debt restructuring process during the quarter, confirming that it wished to avoid a hard default but making clear that its current resources were insufficient.

Targeted Return

45. The three managers the Fund employs within this category have a target return

of LIBOR (London inter bank offered rate) plus 4% pa. With that in mind a combined return of -3.4% over the quarter versus a 1.1% target is tolerable given the market backdrop.

46. Of the three managers Pictet were the were the disappointment, with a return of -10.0%. Many of the 'calls' they made were very sensible (cutting equities, for example) but it could not shield the portfolio from the ravages of a market caught up in the fear of the impact of COVID-19 from both a health and economic perspective. The graph below shows the equity weighting being cut from c50% at 31st December 2019 to around 30% during March as Pictet felt markets were showing complacency to impacts of COVID 19. However, that 30% allocation still cost the fund 7% in negative performance.



47. The portfolio also suffered from hedging performance back to sterling and to exposure to aircraft leasing investments which fell by more than 50%. Pictet believe the holdings have been oversold and understand the market well and are unlikely to reduce their position at present. At the quarter end the fund held meaningful defensive positions to government bonds, cash and gold or gold miners. Given the fall in equities of c20% in the first quarter a -10% return is a good return in comparison.

48. Ruffer's minor negative return of -0.4% should be seen as a very good outcome, with their equity and credit protection proving its value. Ruffer have long believed that credit was incorrectly priced (i.e. was too expensive) and that it failed to take account the risks associated with highly leveraged companies with poor fundamentals and often weak loan covenants. In 2015 they set up a fund, managed by external credit specialists. Credit was hit badly in the market sell-off, with the fund almost doubling in value on the back of both market direction and the rise in value of various Credit Default Swaps (CDS) against individual names.

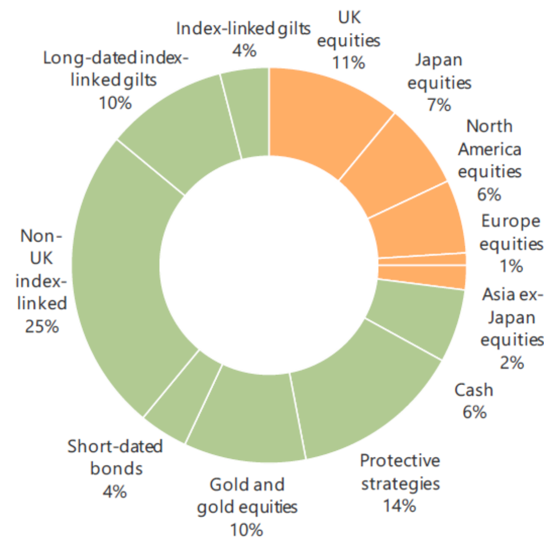
49. Option protection in equities was achieved with a combination of put options against a number of indices and some volatility (VIX) options; the exposure to VIX options was, however, much lower than it has been in the recent past. Both parts of the strategy paid off, with some of the VIX options paying 80-100 times cost, and the positioning has now been virtually neutralised following the sale of virtually all the positions. Although Ruffer fear that there is at least one more downward leg to the market, protecting against it is now too expensive.

50. While the performance of these two strategies was spectacular, judging against

the long-term value that they have added gives a less rosy picture. The credit protection commenced in 2015 and at the end of March 2020 the net gain was only £2.6m. As at the end of the quarter the equity protection had actually *lost* £18m since the inception of the strategy in what can be simplified as a continual bleed of cash from insurance policies that were never claimed upon.

51. The Ruffer portfolio holds assets that allow the fund to maintain their defensive outlook. They maintain their long held view that Inflation is an inevitable outcome of the fiscal and monetary largesse, and Central Banks will have an unwritten policy to encourage inflation that is above target (but relatively well controlled) so that the real value of the debt burden can be reduced. Index-linked bonds will be the major beneficiary of this.

52. The picture below illustrates their defensive view, risk assets shown in orange.



53. Aspect produced a net performance of +0.8% in the quarter and +12.1% in the year to 31st March 2020. They are a trend following manager whose positioning is based on historic correlations between asset classes and the fact that assets tend to 'trend' in a given direction for long periods. Their computer models drive the size and direction of positions in hundreds of different liquid futures markets, and they can go 'short' (i.e. sell assets that they do not own) as well as 'long' depending on the direction of the trend.

54. Their exposure to stock indicies was cut heavily in February and early March and so impacted them in February's sell off and less so in March. The portfolios heavy positioning in bonds, which was cut significantly in mid-March as equity/bond correlations increased substantially offset much of the loss from equities.

55. The biggest contributor to performance in the quarter was from energies at +4%, with the majority of the gain coming from a modest net short position as oil prices dropped during the coronavirus demand shock and opec failing to agree a production cut.

Recommendation

56. The Local Pension Committee is asked to note the report.

Appendices

Appendix A - Portfolio Evaluation - Summary Valuation of Funds Performance.

Appendix B - Report of LGPS Central Limited – Tactical Asset Allocation (Market outlook and Performance).

Equality and Human Rights Implications

None.

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