

## Leicestershire County Council Pension Fund

### 2021 Investment strategy review outline

#### General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

#### 1. Addressee

This paper is addressed to the officers of Leicestershire County Council Pension Fund (“the Fund” or “LCCPF”). The report provides an outline scope of the work we propose carrying out for the 2021 Investment Strategy review.

The note has not been prepared for use for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent.

#### 2. Background to objectives

##### Funding and investment objective

The strategic funding objectives combine supporting a long-term funding approach that is consistent with a stable and affordable contribution approach from the employers, while removing any funding shortfall over 17 years, with a target to reduce this recovery period. The investment strategy should be set to achieve these funding objectives. In practice, to the extent that the discount rate used reflects the expected return on the Fund’s assets, this is an integrated process.

##### Required rate of return on assets – 2019 valuation

The discount rate used for the 2019 actuarial valuation is 3.8%. This rate has been set such that there is a 80% likelihood of it being achieved over the next 20 years based upon the current investment strategy, i.e. 80% of projected returns over the next 20 years are 3.8% p.a. or higher based on our asset return model as at 31 March 2019. The corresponding central average return is expected to be higher than 3.8%; there is a 50% likelihood that the return on the current strategy will be 5.9% p.a. or higher.

The analysis carried out as part of the 2019 actuarial valuation suggested a c.75% likelihood of achieving 100% funding in the next 17 years including allowance for contributions. For non-stabilised sections, the secondary contribution rate is set to deliver a 75% likelihood.

##### Investment objectives

In our last review we described the Fund’s investment objectives as targeting a strategy with the following attributes:

- a minimum expected annual return of 5.9%;
- an 80% likelihood of achieving 3.8% p.a. over 20 years; and
- expected funding downside of less than 9% over a three-year period (aligned to the actuarial valuation cycle) in 75% of outcomes.

### 3. Scope of review

The Covid-19 pandemic means investment returns have been far from normal in the year to date 2020 and will affect future returns. This will have had an impact on the funding level of the Fund and the associated required return.

One of the consequences of the pandemic is that, as with many aspects of life, future returns are less certain at least in the medium term. Economic growth paths have changed, interest rate and inflation expectations have changed and so too have public and corporate finances.

While these factors all affect the asset side of the balance sheet, they also affect the value placed upon the Fund's liabilities. There are additional factors affected by Covid-19 that influence the Fund liabilities, such as longevity and other demographic changes, and affect employer strength and finances. Some of these are likely to be closely correlated with market factors.

These bigger picture challenges all form part of integrated risk and will be reflected in the 2022 actuarial valuation process. The focus of the interim annual investment strategy review is to consider how the Fund's investments are best deployed, and whether there are any changes to the current strategy required that result from the fallout of Covid-19 or potential risks and opportunities that arise.

With this in mind our review will consider the following:

#### A. Market background, required return, existing strategy expected return and associated risk

As referred to above, the 2020 pandemic will affect future economic growth rates and market returns. As context to the review, we will provide a summary of impact to date, and thoughts on future implications for capital markets, and in particular government bonds, equity and credit markets.

While this review is an interim exercise, and not based around a formal actuarial valuation, it is still appropriate to look at the impact that markets are likely to have had on funding, consider experienced returns relative to expected returns and whether these were within the range of expected outcomes. This will provide some guidance on likely future required returns.

Given the changes in interest rates, credit spreads and equity expectations, we will compare the expected return and associated expected volatility in returns of the Fund's strategy with expectations at the start of 2020. We will then compare the likelihood of achieving the required returns.

[Note – in the absence of a full actuarial valuation this analysis will be carried out using simplified but proportionate deterministic modelling, rather than stochastic modelling].

#### Stress testing

One of the consequences of an event such as a pandemic is that the range of outcomes becomes less certain. Measuring volatility around expected returns is useful but becomes more limited the greater the uncertainty there is around what the central expected return is.

Back in March there was complete uncertainty around the extent of the health risk and the human cost; the second 'phase' of uncertainty is the length of lockdown (or regional lockdowns), and the extent and pace of easing, with the final uncertainty being the ongoing longer-lasting impact including employment, household spending, public and corporate finances, and the risks of future waves of infection.

All three phases of the pandemic have a material impact on markets. In February, at the outset of the pandemic, we set out 3 scenarios to illustrate to some extent the range of base case, best and worst. While we may now be part way through easing phase there are plenty of uncertainties remaining; we have updated our 3 scenarios to provide an illustration of outcomes, again under base, poor and better than expected outcomes.

Unrelated to Covid-19, but potentially influential on interest rates, inflation expectations, currency and domestic market returns to UK investors, will be the ability for the UK to negotiate a successful transition out of the EU. We will comment on the potential for this to exacerbate funding movements.

## **B. Specific markets or strategy**

### **Property**

There is undoubtedly material change taking place in commercial property, which may take some years to play through. We will provide comment on the potential impact of Covid-19 associated with broader changes in consumer and working patterns on the UK commercial property market, including retail and office sectors, and how this may affect property strategy.

### **Currency hedging**

The Fund currently has a strategic target to broadly hedge 50% of non-UK equity exposure and 100% of non-sterling debt. Kames manage a risk adjusted active mandate around the non-UK equity exposure hedge, while the non-sterling debt is largely captured within manager mandates. The economic impact of Covid-19 will affect countries to varying degrees. For sterling there is the additional impact of the outcome of Brexit. This therefore provides a timely opportunity to revisit the level of currency hedging, and how it is implemented.

### **Opportunities**

Whenever there is market uncertainty, it creates potential opportunity for those with capital. The Fund is a long term investor and has persistently used its liquidity to invest in long-term assets and gain from an illiquidity premium. While many markets have bounced back quickly from the lows of March, and therefore have been much more robust than after the financial crisis of 2008/9, opportunities will still exist, either to generate higher returns on like-for-like investments or strategies that are specific to times of market stress. Examples will include distressed lending and special situations lending.

### **Responsible Investing and climate change**

While LGPS Central will consider the application of ESG within implementation, there are some strategic aspects of Responsible Investing that should be woven into the overall strategy and consideration of individual asset classes. In particular, we have raised previously the use of climate tilted equity benchmarks and the use of more sustainable and predictable returns from some assets. These will be integrated into our considerations and advice, where appropriate.

## **C. LGPS Central funds**

As discussed in previous reviews, the Local Pensions Committee have an appetite to use the LGPS Central Pool as much as possible, subject to the sub-funds offered being suitable for meeting the Fund's strategy and sub-fund structures being credible. We will provide an update on progress to use sub-funds where the decision has been made to use LGPS Central offering, and anticipated further use as new investment funds are launched. This will provide updates on:

- Passive equity investing;
- Multi-asset credit;
- Emerging market debt;
- Infrastructure;
- Absolute return investing.

The implications of this may be influenced by elements of the strategy review, such as how best to gain timely access to new opportunities.

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