Leicestershire County Council

LOCAL PENSION COMMITTEE – 27th NOVEMBER 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 30th September 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		Growth Stabilising		Income ▲	
GROWTH ASSET CLASS	US Equities	GEM Equities EU Equities Private Equity	UK Equities ▲ Asia Pac Equities ▼	Commodities Japan Equities ▲	
INCOME ASSETS	Property		Credit ▼		EM Debt Infrastructure ▲
STABILISING ASSETS	JP Bonds	Index-Linked EU Bonds ▼ UK Bonds US Bonds ▼		Gold IG Bonds ▲	
INVESTMENT STYLES	Size	Growth ▼	Momentum	Value ▲	Quality/ESG Low Volatility
CURRENCIES		US Dollar		GBP, Yen, Euro	

3. Central's summary is noted below:

   a. increase the allocation to income assets to overweight mainly due to Infrastructure and EM Debt.

   b. Growth Assets we keep at underweight mainly due to their high valuation and market risk scores.

   c. Stabilising Assets we keep at underweight mainly due to their high valuations.

4. It is worth noting that significant underweight and significant overweight positions have remained largely similar since last quarter with the only significant move being the Value investment style moving from significant underweight to overweight.

5. A summary of the asset class performance over various time frames covering the 3 months from July to September 2020 and longer time frames is shown below. Three asset classes show double digit returns over a 20 year time frame, property, high yield and gold. Equities show the lowest 20 year return at 5% but this includes the peak from the 2000 dot com boom.

	3 months*	One year	Three years	Five years	Ten years	Twenty years
GLOBAL EQUITIES	8%	11%	8%	11%	9%	5%
PRIVATE EQUITY	-1%	-10%	4%	13%	11%	N/A
PROPERTY	1%	-12%	4%	6%	9%	10%
INFRASTRUCTURE	2%	-14%	-1%	4%	5%	N/A
HIGH YIELD	3%	1%	3%	6%	7%	10%
UK GILTS	-1%	4%	6%	5%	5%	6%
UK INDEX-LINKED	-2%	0%	7%	7%	8%	7%
GOLD	2%	21%	15%	14%	6%	11%

Source: Bloomberg (NB: assumes dividends were reinvested), Note: Listed proxies have been used for Infrastructure, Property and Private Equity.

Overall Investment Performance

6. A comprehensive performance analysis over the quarter, year and three-year period to 30th September 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. Officers and Portfolio and Evaluation have met in the quarter to discuss improvements to the performance tables which should allow for three and five year performance metrics to be included from March 2021.

7. 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.

8. For the period ending 30th September 2020 the Fund delivered an investment return of +1.8% for the quarter, -1.1% over the last 12 months and +3.9% pa annualised over the three year period.

9. The Fund's total value as at 30 September 2020 is £4.6 billion. At 31st March 2019, the triennial valuation date the Fund had assets valued at £4.3 billion. 18 months into the three year cycle, assuming linear asset growth of 3.8% (which Hymans Robertson concluded has a 80% likelihood over the next 20 years and is used in the 2019 valuation for reporting the funding level of the scheme) would equate to a fund valuation of c£4.6 billion.

Valuation versus benchmark target

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

	Current Weighting	2019 benchmark	2019 difference	2020 new Benchmark	2020 New Difference
Equities	**49.8%**	48.0%	+1.8%	46.75%	+3.05%
Real Income	**22.0%**	26.5%	-4.5%	24.75%	-2.75%
Alternatives	**24.2%**	25.5%	-1.3%	27.5%	-3.30%
Cash and hedge collateral	**4.0%**	0%	+4.0%	1.0%	+3.00%
	100.0%	100%		100%	

11. 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 quarter end not all of the proposed changes to the Fund to re balance to the new benchmark have been enacted with the exception of the termination of the Funds currency overlay with Millennium and the new £100m investment into Central's Corporate Bond fund. Two changes are in the progress and should be complete by 2020 end.

12. The Fund currently has a larger than two percentage point variance to the three main benchmark targets, equites, real income and alternatives. At present, officers are not overly concerned given the swings in valuation and the fact some investment managers valuations are delayed, for example private equity where managers don't value each investment every quarter and property where lack of transactions doesn't allow for accurate valuations. The cash and hedge collateral will reduce over time following the Fund's recent commitments to Private Equity £20m and Infrastructure £25m although these will not be called immediately.

13. The cash component is made up of £133m cash and £50m collateral held with Aegon for the currency hedge. Given this years' volatility in markets it makes sense to hold some additional cash in the event currency markets move unexpectedly which may require additional collateral.

14. The 2020 asset allocation has a cash target of 1% to reflect the fact the Fund will always have cash and collateral with the Funds active currency manager Aegon. We have instructions with our existing property managers to allow the fund to purchase property that fits the current fund profile, since last quarter one new property for the direct Colliers portfolio has been sourced which has completed in November. Finding suitable property during the covid related shutdown has proven difficult with suitable stock not on the market.

15. The alternatives part of the Fund's portfolio includes the increase in allocation of +2% from a combination of changes which will be enacted when Central launch the Multi asset credit product, due diligence been completed, and committee have approved.

16. The real income part of the portfolio includes the property, infrastructure and index linked bonds. The benchmark includes the changes to reduce the index linked weighting by 2.5% to 5% as part of the annual strategic asset allocation review and reinvest the proceeds in a new investment grade bond fund. The Fund enacted this change in Q1 of 2020. The index linked bonds are marginally overweight at present with a slight underweight to investment grade corporate bonds.

17. The process to move a portion of the Fund’s passive portfolio to the LGPS Central Climate balanced fund is underway with the selection process of a transition advisor complete. The transition manager has been selected and a transition is planned in December 2020. This will not move the variances between asset categories but will address part of the strategic asset allocation change from January 2020.

18. The Fund is mindful of the current annual asset allocation work being undertaken by Hymans which will be available in January 2021 for approval by the Committee. At this stage, after accounting for changes pending with LGPS Central, underweight areas of the portfolio can be addressed.

19. 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
Equity exc hedge	2.0	3.1	-1.3	2.8	4.1	6.3
Private Equity	10.8	3.4	11.2	5.7	15.1	8.9
Real Income	-1.1	0.2	-2.8	0.4	4.1	4.6
Alternative	-0.2	1.0	-1.7	3.6	2.4	4.5
TOTAL FUND inc hedge	**1.8**	**2.1**	**-1.1**	**3.2**	**3.9**	**5.4**

20. The equity underperformance in the quarter is largely due to the target allocation the fund has to the climate multi factor fund which is included in the benchmark but as yet the Fund has not allocated to. The effect of this under allocation on the whole portfolio is -0.4% in the quarter. As previously mentioned, the Fund intends to transition these funds from LGIM to Central in December as long as no market related volatility delays this.

21. The Private Equity relative outperformance to benchmark contrasts with underperformance last quarter of 21% and is related to timing issues regarding valuations, once volatility has settled variations will become less pronounced. It is worth noting that these investments are long term in nature with each vintage taking at least 10 years to deploy all commitments and realise distributions. The benchmark is against global equity markets, which have regular valuations.

22. Real income underperformed the benchmark in the quarter mainly due to the infrastructure element which was -2.6% to the benchmark, the other two elements were largely in line. The benchmark for the major infrastructure holdings is LIBOR + 4% which at current rates is close to 4% per annum or 1% per quarter, however underlying assets will be valued based on their merits. In the quarter to date our major infrastructure funds will include holdings that are GDP sensitive and therefore would be revalued accordingly and whilst the benchmark is expected to always be positive.

23. The Fund has three investments with KKR within infrastructure, with only the last still investing, the earlier two investments are growing and harvesting assets with net IRRs (internal rate or return) of 15.6% and 16.4%. Fund 3 is 55% invested. The independent report contains an anomaly on the performance metrics which officers are talking to the independent valuation provider about.

24. The remainder of this report covers the following asset classes in more detail, equities, property and targeted return.

Equities

25. The Fund ended the quarter with a 49.9% allocation to equities. This includes the allocation to LGPS Central sub funds which total 12.5% of the total fund value. The bulk of the Fund's equity holdings are with Legal and General (LGIM) totalling £1.45 billion or 31% of the total fund.

LGIM

26. The LGIM portfolio contains a number of passive funds containing a range of geography specific funds. The total value of these funds is £1.45 billion with a gain of 1.1% over the quarter and loss of 3.5% over the last 12 months. The LGIM portfolio performed in line with benchmark returns as expected of a passive fund. The LGIM funds include two passive value tilted investments, RAFI developed Europe and RAFI North America which have performed poorly in comparison to the other global regional passive investments held with LGIM, due to the inclusion of strongly performing 'growth' stocks.

27. However, the worst performing geography was the UK, with 2.4% loss in the quarter and 14.4% loss over the last 12 months. The returns are not too surprising given the make up of the UK FTSE100 which has a higher GDP sensitive focus and as such suffered during a time when technology stocks performed well. The best performing LGIM passive was the North American Fund which posted a 4.5% return in the quarter following the previous quarter when in recorded a 21.9% return.

LGPS Central Active Global Equity

28. This fund had a valuation of £387 million at quarter end (£372 million at last quarter) having initially invested in March 2019. The performance since inception has lagged the benchmark by 1.55% at September 2020 end and was 2.5% behind at June 2020 end. The target for the fund is to outperform the benchmark by 1.5% per annum net of costs over rolling five year periods. Performance in the quarter ended was +4.2% which is 0.8% above benchmark and 0.4% ahead of target.

29. The fund uses three managers independently. Since inception, both Schroders and Union have outperformed the benchmark by 5.2% and 1.4% respectively. Performance has been impacted by Harris which has underperformed by 10.6%, Harris' underperformance to benchmark was similar last quarter. Harris have a value bias and as such have been impacted by the relative underperformance versus other styles, notably growth. Central have assessed that the three managers continue to follow their stated investment process and portfolio constructions are in-line with expectations. Within a multi manager fund the Fund would expect to see times where not all managers are performing in line with benchmarks over a long period of time, this lack of correlation demonstrates an element of diversification.

30. During the previous quarter (April to June) Central's investment committee approved a recommendation to reduce Harris' target weight within the portfolio to 28.3% and allocate the resulting capital to Schroders bringing their target weight

to 37.2%. Union’s target position remained unchanged. This action reduced the fund’s over exposure to ‘value’ stocks and will go towards reducing the underweight in growth and quality factors.

31. The style tilt graph shows that the overall fund still has a value tilt but which has been reduced since the change was made.

LGPS Central Emerging Markets Active Equity

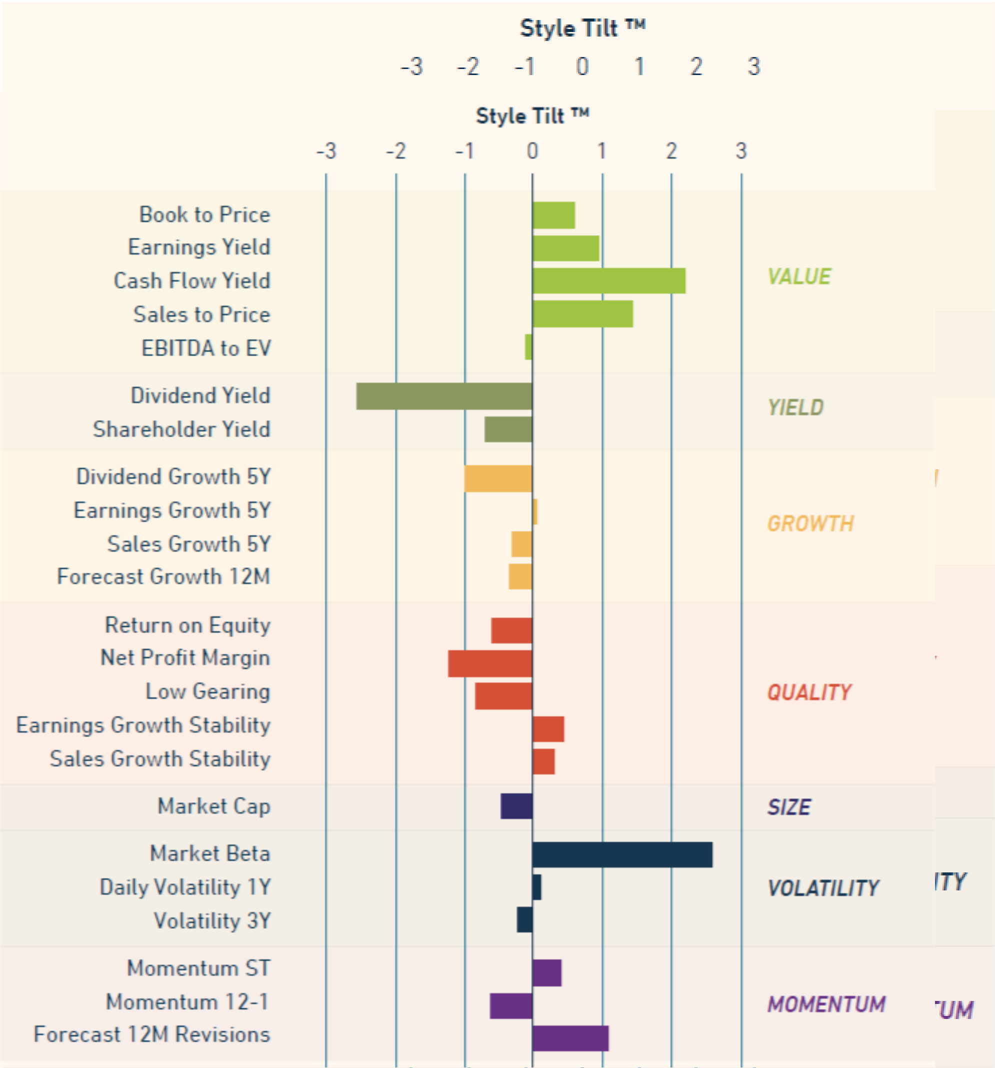
32. This fund had a valuation of £188million at quarter end (£180 million last quarter) having initially invested in July 2019. The performance since inception is in line with the benchmark having returned 1.06% pa since inception, whilst positive this is below the performance target of benchmark +2%. The performance in the quarter was +4.3% which was -0.15% vs benchmark.

33. Central employ three managers, BMO, UBS and Vontobel. Like the Global active equity fund, rebalancing may be carried out if any manager strays by +-2.5% from their target weight. At the last quarter end date all were within +-2.0%.

34. The UBS portfolio, again, showed the strongest performance in the quarter with BMO and Vontobel both marginally behind although positive. The overall fund remains tilted away from value and toward quality, a stance it has held for most of the year. It has a small tilt toward growth. See style analysis below.

35. The Central team held meetings every month during the quarter with each fund manager to ensure actions being taken are in line with the expectations of LGPS Central had when the managers were appointed.

Emerging Market Debt (EMD)



36. Ashmore are the Funds current EMD manager. The Fund has held this mandate since 2011. The Ashmore fund invests in mainly sovereign, quasi-sovereign and corporate bonds denominated in both local currency and US dollar and has a target of 1% above a blended benchmark.

37. The Fund has served notice to the managers at Ashmore as it prepares to transfer funds to the LGPS Central offering which is currently scheduled to be running before the end of 2020. The Leicestershire fund is one of three local authorities who are transferring their EMD investment.

Ashmore Total Return Fund (Net Returns) GBP Unhedged				
Performance as at 30/09/2020	3 Months	I Year	3 Years	Since Inception
Fund Absolute Performance (GBP Unhedged)*	-1.38%	-9.46%	0.29%	6.08%
*Manager Blended Benchmark (GBP Unhedged) * 50% JPM EMBI GD, 25% JPM GBI-EM GD, 25% JPM ELMI*	-2.83%	-4.38%	3.10%	6.13%
Relative Performance to Benchmark	1.45%	-5.09%	-2.80%	-0.05%
Alpha target (Benchmark +1%)	-2.58%	-3.38%	4.10%	7.13%
Relative Performance to Alpha Target	1.20%	-6.09%	-3.80%	-1.05%

38. The performance of the holding over the four timeframes is shown below. The since inception numbers cover just over nine years of performance and show an annualised 6.08% return per annum which is just shy of the benchmark returns of c6.13% pa and 1.05% pa behind the target. Over the more recent timeframes the fund suffered a larger fall during the first three months of 2020 than the benchmark and as such the one year and three year figures show poor performance versus the benchmark. The last six months have recovered some of the damage from the first three months of the year with the most recent quarter outperforming the benchmark by 1.45%.

Real Income - Property

39. The Fund employs three property managers, Colliers, LaSalle and Kames who hold a combination of direct and indirect property holdings. The total value at the quarter end date is £378m and 8.2% of total fund assets against a target weight of 10%.

40. This is currently 1.8% below the target allocation. Officers are mindful of the illiquid nature of property investment and the need to stay close to the benchmark. The nature of markets where pricing isn't transparent due to low volumes means officers are keeping in contact with managers to understand if and where opportunities are available. The Fund has instructed Colliers earlier in the year to bring to the Fund's attention property that would fit the direct portfolio. At present one property for c£10m has been completed upon in November 2020, an industrial unit near Northampton. The instruction to search out good value remains property remains whilst the Fund is also interested in the direct property offering from Central due in 2021 to close the gap to target allocation.

41. The Kames active value funds which the Fund has £67m invested within have produced flat returns over the quarter, small capital losses offset by rental income. Both Kames funds rely on active management and have underperformed the benchmark, the AREF all balanced property index which returned +0.2% during the quarter. Over one year time frames active value I was behind the benchmark by -2.6% and active value II is ahead by +1.5%. Both funds have exposure to office and retail sectors which have been hard by the rental slowdown and subsequent asset value capital reductions.

42. The Colliers property investment marker report included within the Committee pack highlights the individual sectors and how capital values have been affected over the year. High street retail coming in with the highest capital value losses of c22% in the year to September 30th with rental income at c6% representing a total return of -16%.

43. The industrial sector has remained the bright spot with total returns in the year of +4.0% helped by strong tenant demand with growth in online sales meaning an increasing need for warehousing space. The downside being that there is more money chasing the low stock that is available on the market which is pushing down yields.

Alternative - Targeted Return

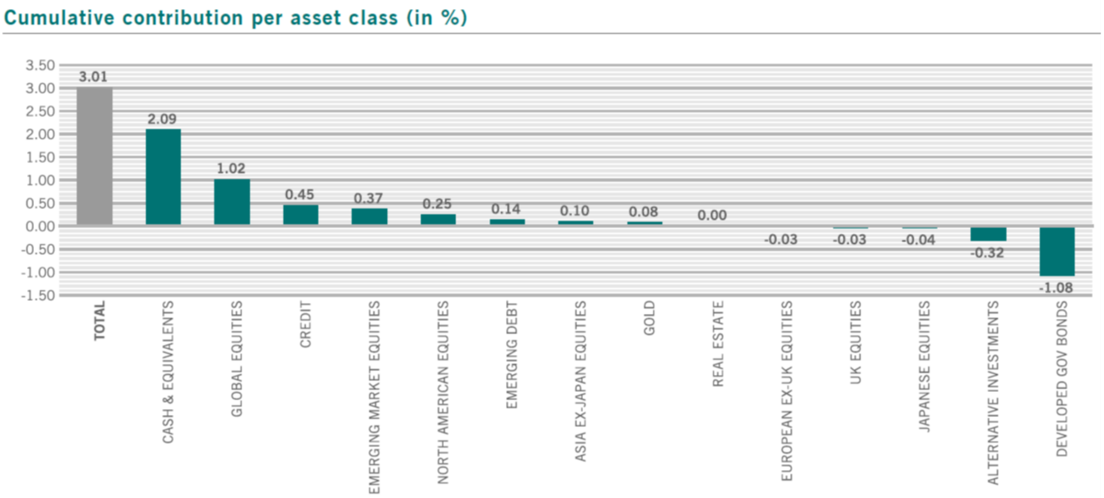
44. The Fund employs three managers to with an overall target to return one month (London inter bank offered rate) LIBOR + 4%. All three have different strategies and show varying success. Over the nine months in 2020 the portfolio has produced a flat return of +0.1%, however the return has shown considerably less volatility than equity markets owing to the investment styles. Nonetheless it is short of the target return.

45. At present the Fund has plans under the current strategic asset allocation to cut the target weight to 7.5% of Fund assets with the disposal planned to be used to fund a future multi asset credit fund being launched by LGPS Central pending advisor due diligence and Committee approval.

46. The one and three year returns for targeted return have been behind target by 4.6% and 2.1%, the underperformance being driven by both Pictet and Aspect. Ruffer have beaten the target in both one and three year timeframes having had a boost from their performance in 2020 to date and now show a +9.8% over one year and +5.4% pa over three years.

47. Of the three managers Aspect, once again, had the worst performance in the quarter with a return of -5.5% (-4.7% last quarter). Aspect are a momentum based manager who trade based on historic correlations between asset classes and they trade long and short in hundreds of liquid futures markets. Their return this quarter was hurt in particular by a short position in US natural gas when unexpectedly hot weather in August and September caused a surge in demand for gas at a time when gas supply was interrupted by shutdowns from a hurricane.

48. Pictet posted the best performance of the three managers with a +3.0% return following on from a 6.7% return in previous quarter. They are now virtually flat over one year having recovered from the January to March quarter loss. Unlike



the other two managers Pictet are not able to take 'short' positions to take advantage of market sell offs. They do however change their investment holdings regularly with a view to control risk and cut they equity exposure from a high of 57% in the quarter to 41% at the end of the quarter. Most of the positions in asset classes were positive contributors in the quarter with developed government bonds dragging returns by -1.1% in the quarter per the chart below.

49. The Ruffer portfolio produced +1.1% in the quarter and now +9.8% over one year. They aim to build an 'all weather' portfolio, one that will make money when risk assets go up but also deliver returns when markets are in crisis. In order to do so they inevitably give up some upside to protect the downside risks.

50. Over the quarter the positives for the fund were investments in gold and gold equities which increased in value while US real bond yields and the US dollar declined. The price of gold rose 6% with gold equites, essentially a geared play on gold increased even further. US TIPS (treasury inflation protected securities) benefited from an increase in inflation expectations. Ruffer also hold credit protection which was hurt by the rebuild of risk appetite, however much of the gains produced from the first quarter of 2020 are retained.

Alternative – Distressed opportunities fund (DOF)

51. The Fund has a c£60m investment with M&G within three distressed opportunities funds. The earlier two funds (DOF II and DOF III) are in the last phase, distribution with the latest fund, M&G DOF IV, is in the reinvest phase with distribution due from November 2022.

52. The three funds are have invested across equity and debt, with the current fund the most exposed given it has not distributed and locked in returns as yet. DOF IV returns are linked closely to the effect of this years stress on companies ability to ride out the market distress, the remaining two funds have a started to exit investments with DOF III having distributed 20% of the committed capital and DOF II having 3 investments remaining to divest which are due to be divested during 2021.

53. The net IRRs for the three investments DOF II, II and IV are currently, 6.7%, -0.9% and -13% respectively. DOF IV investments are marked down in the current climate, but IRRs since inception have marginally improved from last quarter. Those investments exposed to sectors most affected are marked down as are those that less protection given their ranking in the capital structure.

Recommendation

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

<u>Appendices</u>

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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