Leicestershire County Council

# LOCAL PENSION COMMITTEE – 22 JANUARY 2021

# 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 allocation, 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 managed.

3. The Fund is part invested in funds administered by LGPS Central (Central), a private company jointly owned by the fund and seven other administering authorities. By pooling investment Central aims to reduce costs and improve investment returns to the ultimate benefit of Fund employers.

4. Central's product offer continues to develop and the strategy review has been undertaken with this in mind. Dialogue continues with Central and other partner funds to ensure that Central's offer meets the goals of the Fund. It is likely to be many years before the majority of the Fund is transferred to Central, although the Fund has made good progress to date. This is partly due to the Fund's unlisted and illiquid investments as well as the time taken by Central to develop investment options.

5. As at September 30th 2020, the value of pooled funds directly managed by Central and life funds managed by Legal and General totals 2.0billion or 44% of the Fund's total. In December 2020 the Fund transitioned an additional 2% from an external manager to LGPS Central bringing the total to c46%.

6. Any decision on the appropriate investment allocation 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.

**Summary of last years proposals and progress**

| Proposal January 2020 | Actions in 2020 |
|---|---|
| Reducing the Fund's allocation to index-linked gilts from 7.5% to 5.0%, with the proceeds to be invested in LGPS Central's Investment Grade bond sub-fund upon launch with a 3% weighting. | The Fund disinvested £55m from the Aegon (formerly Kames) index-linked gilt holding in April 2020 to bring the allocation broadly in line with the new 5.0% strategic target. The proceeds were invested in the newly launched LGPS Central Investment Grade Corporate Bond sub-fund. |
| Removal of the Millennium active currency mandate. | Completed in February 2020 |
| Switching the Fund's RAFI and part of the passive regional equity holding to the LGPS Central All-World Equity Climate Multi-Factor sub-fund. | The LGPS Central All-World Equity Climate Multi-Factor sub-fund was launched in Autumn 2019. The Fund transitioned assets into the sub-fund in December 2020. The new mandate was funded from the passive equity holding with LGIM, specifically, the entirety of the RAFI holdings were sold alongside a proportion of the regional equity holdings. |
| Reducing the strategic Targeted Return allocation from 11.5% to 7.5%, with the reduction largely allocated to multi-asset credit (+3.5%) and a small allocation to investment grade credit (+0.5%). | Awaiting the LGPS Central offering and as such the current Targeted return managers remain. |
| Increasing the Fund's allocation to liquid multi-asset credit (MAC) to 4.0%. | Awaiting the LGPS Central offering, two managers have been selected and an allocation is expected to take place during the first half of 2021 pending due diligence. |

**Summary of 2021 proposals**

7. The summary of proposals made by Hymans have been assessed by our independent consultant and officers. Officers have shared the proposals with LGPS Central in order to gain further insight with respect to future pooling. Their report is included as Appendix B.

8. For 2021, Hymans do not propose the Fund make changes to the Fund's target asset allocations but have included proposals relating to changes within asset classes. A summary table is shown below and is taken from the full Hymans report which is included as Appendix A. Changes within each asset class are covered within the Hymans report in detail and summarised below.

| | Proposed target weight (%) | Comments |
|---|---|---|
| **Growth (55.25%)** | **55.25** | |
| Listed equity | 42.0 (40.0-44.0) | Broad factor based passive allocation implemented December 2020, using LGPS Climate multi-factor sub-fund |
| Private equity (inc secondaries) | 5.75 | Increase in strategic target reflecting existing allocations Consider opportunistic investment in Adam St Secondaries |
| Targeted return | 7.5 | Currently hold higher allocation. Use this to fund sub-inv grade credit allocation; Review LGPS sub-fund when details available |
| **Income (36.75%)** | **36.75** | |
| Infrastructure (inc timberland) | 9.75 | Review and use LGPS sub-fund |
| Property | 10.0 | Consider introducing residential property; Consider LGPS Central proposals |
| Emerging market debt | 2.5 | - |
| Global credit – liquid sub inv grade markets | 4.0 | Existing JPM fund holding and reduction in Target Return used to fund allocation, subject to due diligence |
| Global credit - private debt | 10.5 | Review M&F DOF team mid-year to decide whether to make further allocation to distressed debt |
| **Protection (8%)** | **8.0** | |
| Inflation-linked bonds | 4.5 | 0.5% reduction in strategic allocation, reflecting recognition of cash held to mange currency hedge |
| Investment grade credit | 3.0 | Including up to c.0.5% retained by Aegon to support currency hedge programme |
| Currency hedge | 0.5 | Recognition of cash held by by Aegon for this mandate. Adjust benchmark hedge ratios used by Aegon from 50% to 30% |
| **Total** | **100.0** | |

9. In line with other local authority funds Hymans have decided to reclassify asset classes into ‘growth’, ‘income’ and ‘protection’. The Fund previously had classified asset classes into growth, real income and alternatives. The revised classification provides greater clarity regarding how asset class underlying investments are expected to perform under various general market conditions.

## Growth

10. Listed equity – no changes recommended having transitioned a sizeable proportion of passive equity (c£750m) into the LGPS Central Climate balanced multi factor fund during that last quarter of 2020.

11. Private Equity – Hymans propose maintaining the existing weighting and state that officers consider an allocation to a secondaries fund (global secondaries fund VII - GSF7) from Adams Street. The secondaries market can perform well post a market event which can precipitate institutions to become forced sellers which was the case post the Global Financial Crash (GFC). Given in some cases the holders are selling at distressed prices discounts can become available.

12. However, there has been a sharp rebound in valuations since the market lows of March 2020 and as such the expected discounts are probably not as attractive as they were post the GFC. There are other managers in the space and the Fund currently has a secondaries allocation via Standard Life, last valued at £25m or 0.5% of total portfolio as well as an investment in the Adams Street Global secondaries fund 6 made in 2017 which is currently valued at c£7m. In addition to the standalone secondaries fund with Adams Street, the Global Funds in which the Fund invests also allocate to secondaries, with a target of 20-25% of the total

commitment.  The Fund is currently overweight Private Equity but with distributions expected to ramp up in the coming years it is beneficial to run ahead of benchmark.

13. Targeted Return – this asset class resided within opportunities and has been moved into growth.  Given many of the strategies show more alignment to equity like risk and return it makes good sense on balance. Some holdings within the total portfolio however could sit in any of the three areas, for example Ruffer hold index linked bonds and gold which could feature within income and protection respectively.

14. The Fund's current allocation (c10.5%) is higher than the target allocation (7.5%) whilst the Fund awaits the Multi Asset Credit (MAC) product to be finalised by LGPS Central at which point all three managers holdings will be trimmed in order to fund an investment into the Central offering.  This is a change to the 2020 proposal where it was agreed that Ruffer would be divested in order to fulfil the funding of the MAC product.  Trimming all managers gives the Fund a more balanced targeted return portfolio whilst a new Targeted Return product is built by Central.  The Fund will trim managers in equal percentage terms and use excess cash holdings to fund any prospective MAC allocation.

15. When a suitable LGPS Central targeted return product is available the Fund will bring a proposal to Committee for approval.

**Income**

16. Infrastructure – Hymans recommendation here is to maintain the 9.75% weighting and consider the use the LGPS Central sub fund which is close to being finalised. The Fund is currently slightly underweight and a commitment was made to the open ended JP Morgan fund in 2020 which has yet to be called owing to a queue of commitments.  A proposal will be bought to committee once the Central sub fund is made available.  The Fund currently has a number of closed ended and income producing investments which will naturally provide capital and income to facilitate these future commitments.

17. Property – Hymans recommend maintaining the current allocation target of 10.0% and consider introducing residential property and LGPS Central property proposals. The Fund is slightly underweight currently but given the uncertainty in the property markets the c1.5% under allocation (at Sep 2020) seems reasonable.  Hymans have echoed the same within their proposal.

18. Hymans split out analysis of property into retail, industrials, offices and alternatives, with the later being a catch all and including the residential exposure they propose. Residential includes purpose built rental accommodation blocks rather than individual units. Hymans note that the residential sector within alternatives has proved the most resilient during the crisis given the population will continue paying housing costs whenever possible.

19. Factors in favour of investing in the private rented sector include, stable rental growth versus commercial property over the last 15 years, the structural supply shortage and growth proportion of people living in rented accommodation.  Hymans expect this trend to continue and the percentage of residential accommodation within the MSCI UK monthly property index to grow from the current 3%.

20. The introduction of residential property is covered in more detail within appendix 3 of the Hymans report but is underpinned by a diversification away from commercial property holdings. The Fund has a number of ways to possibly attain this exposure with Hymans recommending a proposal to be bought to Committee for approval.

21. Global Credit – Multi Asset Credit (MAC) – this is a 2020 proposal where the Fund is awaiting a finalised product to be launched by Central. The Fund will divest a portion of the targeted return holdings as described earlier in the paper.

22. Global credit – Private debt – Hymans propose the Fund evaluate an allocation to M&G's distressed opportunities fund (DOF) after a mid year review. The total allocation is 2.0% below the target of 10.5%. The Fund is invested in three private debt strategies with Partners group, M&G and Christofferson Robb. With investments returning money during 2021 there will be a requirement to top up the private debt allocation.

23. Distressed debt focuses on investments where a borrower's debt burdens have become unsustainable. It typically involves restricting of either the business and/or its capital structure and often requires a highly active intervention by the debt holder. It involves higher levels of risk than typical debt provision, with the result that it aims to generate a high return largely through capital growth.

24. The Fund has exposure to three DOF funds presently and given senior departures in 2020 Hymans are proposing officers revisit the team and opportunities in 6 to 12 months until comfort is gained with the new team. The likely effects of the severe downturn is likely to persist for several years in Hymans opinion and as such it may be preferable to commit capital later when opportunities and prices become clearer.

**Protection**

25. Currency Hedge – Aegon (formally Kames) manage the Fund's active currency hedge around a benchmark position of hedging 50% of the Fund's foreign currency exposure. This 'investment' has been moved into the protection category having sat outside of the categories previously. Hymans are suggesting reducing the hedged position to 30%. The benefits Hymans argue are:

    a. Maintaining some reduction in return volatility and reducing volatility during market stress
    b. Reduced the level of potential calls on capital to settle losses if position move against the hedge

26. Officers have spoken to Aegon to discuss potential changes to the benchmark position. Aegon feel comfortable with the change and have started to think about the potential changes they would make to the programme and how they would position for various events, e.g. an equity risk off event.

27. Index linked bonds – Hymans propose a change here to the 2020 target position of 5.0% by reducing to 4.5%. This recognises the cash needed by Aegon as collateral for the currency hedge. The Fund currently is a little overweight and the position will be re assessed during the next quarterly valuation.

**Investment objectives and required return**

28. The strategic investment benchmark is 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.

29. The triennial review as at 31 March 2019 showed the Fund had an 89% funding level which had improved from 76% as at 31 March 2016. At 31 March 2019 the funding level had improved to 89%, a 13% increase since the March 2016 valuation, leaving a net shortfall of £537 million. The estimated liabilities of the Fund have increased, but this had been more than compensated for by improved investment returns.

30. The current objectives of the Fund are summarised below:

    a. Ensure members benefits are met as they become due
    b. Support a long term funding approach that is consistent with a stable and affordable approach from the employers
    c. Remove the funding shortfall over 17 years with a view to reduce this recovery period where possible

31. The Fund currently targets an investment return of 5.9% pa which is in line with Funding Strategy being adopted post the 2019 triennial review. However, Hymans' current view states that expected long term returns on major asset classes have fallen reflecting the change in market conditions, in particular interest rates and credit spreads. The Fund's investments are now expected to earn 5.5% p.a, a reduction of 0.4% p.a.

32. As at the 2019 valuation, the funding level and funding deficit calculation's had an investment return assumption of 80% likelihood, namely 3.8% p.a. The current 5.5% p.a forecast return is still comfortably ahead of this. The reduction in future estimated investment returns would reduce the 80% likelihood of attaining the Fund's investment return of 3.8%. Offsetting this, the implied inflation has also fallen from 3.65% to 3.3% (20 year implied gilt inflation). Hymans note that this measure of inflation is RPI, rather than CPI, and due to the changes in the calculation of RPI, implied CPI may not have fallen to the same extent over the period. Taking these points together, it is expected that the funding level will have fallen, but not materially. The situation gives the Fund a couple of options:

    a. Take on more investment risk to increase returns or
    b. accept the current asset allocation and associated forecast returns as Hymans advise

33. The next full Fund valuation is due in March 2022 and will align investment return expectations with liability forecasts. The Fund can then reassess the investment return required alongside a full liability forecast. More detail is provided within Section 3 of the appended Hymans report.

**Recommendation**

34. It is recommended that;

a) The revised strategic asset allocation for the Fund as set out in the table below be approved;

| | Proposed target weight (%) | Comments |
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| Currency hedge | 0.5 | Recognition of cash held by by Aegon for this mandate. Adjust benchmark hedge ratios used by Aegon from 50% to 30% |
| Total | 100.0 | |

b) That the Investment Subcommittee be asked to consider over the course of 2021 the changes necessary to align the Fund's investments with the revised strategic allocation and the relevant product launches by LGPS Central and other investment managers.

c) That the Director of Corporate Resources, following consultation with Aegon and the Fund's investment consultants, be authorised to determine the appropriate time to reduce the Fund's foreign currency exposure within the Aegon Currency Hedge mandate from 50% to 30%.

## Equality and Human Rights Implications

35. None.

## Appendix

Appendix A - Annual review of asset strategy and structure, Hymans Robertson
Appendix B – LGPS Central review of 2021 strategy proposal

## Background Papers

None

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