

Leicestershire County Council Pension Fund

Annual review of asset strategy and structure

January 2021



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1 Introduction and purpose

Addressee

This paper is addressed to the Local Pension Committee (“LPC”) of Leicestershire County Council Pension Fund (“the Fund”). The purpose of this paper is to provide the 2021 annual assessment of the Fund’s investment strategy.

The note has not been prepared for use for any other purpose. This report complies with Technical Actuarial Standard 100: Principles for Technical Actuarial Work.

Executive Summary

Our paper considers both the strategic asset allocation and its implementation, taking into account the range of funds offered or to be offered by LGPS Central.

As per previous strategy reviews, our recommendations continue the direction of travel towards an investment strategy with greater focus on predictable and sustainable income-based returns.

Equity

Listed equity

With the transition to incorporate a factor-based benchmark (including managing climate exposure) carried out in December, we remain comfortable with the strategic allocation and split between active and passive management of the listed equity portfolio.

We propose that LPC delegate to the Officers and ISC a review of the implementation of the LGIM passive equity holdings in the second half of 2021, with a view to simplifying the number of regional funds used.

The Fund remains overweight to listed equity. This, combined with the overweight to private equity, offset the underweight allocation to property and infrastructure. Funding of future net increases to the property and infrastructure portfolios should be funded from listed equities.

Private equity

The allocation to private equity is currently above the 4.75% strategic allocation. Given the attraction of this asset class to long-term returns, the long-term nature of the investment and the decision to maintain this allocation, we have **increased the strategic target allocation by 1% to 5.75%**, and correspondingly reduced the listed equity target by 1% to 42%. This reduces the extent of the private equity overweight to less than 0.5% and brings the listed equity strategic allocation to the mid-point of the target range, although we note that we do not expect any listed equities to be disinvested in order to implement this strategic change.

LGPS Central have recently appointed Ian Brown as Omar Ghafur’s replacement and it is expected that LGPS Central will launch a 2021 vintage of the private equity sub-fund. Although the Fund is currently overweight relative to target, ongoing investment into private equity will be required to maintain the allocation over time. **We propose that the LPC delegates to the Officers and the ISC a review of suitability of this sub-fund once further detail becomes available.**

Secondary private equity involves acquiring interests in existing established primary private equity funds. The pandemic has forced some investors and fund managers to restructure their portfolios, which has provided an opportunity to acquire assets in the secondary market at discounts. The Fund already has a small exposure to the Secondaries market via the Aberdeen Standard Investments SOF funds (with a value of c.£25m as at end September 2020).

Adam Street are currently raising for their Global Secondaries Fund VII (GSF7). As noted, the current allocation to private equity is already above target. However, the Fund is currently underweight other private assets

(property and private lending). At the margin, the higher expected return from private equity will retain a higher overall portfolio expected return.

Therefore, **we propose the LPC delegates to the ISC and Officers to consider making an allocation to this fund, subject to consideration of the coverage of private equity secondaries in the LGPS Central offering and due diligence.**

Currency hedging

The Fund has direct currency exposure through its non-UK equity investments. Currency movements provide additional variation in the returns earned on non-sterling denominated assets.

The Fund currently manages this volatility by strategically hedging 50% of the non-sterling exposure through a standalone programme is managed by Aegon Asset Management. Following a review of wider factors affected by currency, covered in Section 7, **we recommend reducing the benchmark level of hedging from 50% to 30%.**

Non-UK currency exposure associated with the Fund's bond exposure is largely hedged within the associated mandates. We continue to consider full hedging of currency exposure here to be appropriate.

Targeted return

The launch of the LGPS Central Targeted Return sub-fund is expected in the near future. In the absence of more detail around what the sub-fund composition will look like, **we suggest the LPC retain the three mandates until such time that the LGPS Central sub-fund is available, trimming each of the mandates to fund the multi-credit allocation.**

Index-linked gilts

While we consider hedging inflation sensitivity to be a real benefit in managing funding risk, the current level of index-linked gilts only provides limited protection against inflation, and we do not see current pricing as attractive. **Hence, we propose a small drop in the strategic allocation to index-linked gilts of 0.5% to 4.5%, recognising the introduction of a 0.5% strategic allocation to cash held by Aegon within their currency hedging programme.**

Infrastructure

We understand that LGPS Central are due to launch their infrastructure sub-fund before March 2021. As yet no managers have been selected. **We propose that the LPC delegate to the Officers and ISC that a review of the suitability of the sub-fund be carried out once there is further clarity on this. The expectation is that if the LGPS Central sub-fund is deemed suitable then the Fund's underweight to this asset class would be addressed by committing to the Pool offering over 2021. We propose this is also delegated to the Officers, subject to satisfactory completion of the suitability review.**

Property

We remain comfortable with the current strategic target allocation of 10%. However, given our continued cautionary view of UK property, we do not see any short-term pressing need to increase the Fund's allocation towards target. As noted, the Fund is currently overweight listed equity and private equity, and maintaining these relative allocations will, at the margin, add to the expected return.

We propose the LPC delegate to the ISC to review the property allocation during 2021 and to consider scope to incorporate residential property into the strategy as a diversification from pure commercial exposure, and whether this is via LGPS Central or via the Fund's existing property managers.

Furthermore, we propose the Officers and ISC review the LGPS Central funds when further details are available, to consider their suitability for ongoing use by the Fund for its property exposure, and for the Officers to report back to the LPC before any further action is taken.

Credit markets

Investment grade credit

As part of the 2020 strategy review, the allocation to index-linked gilts was reduced and the proceeds invested into the LGPS Central investment grade credit sub-fund. This allocation is 2.5%.

We propose the Officers and ISC are delegated to review the Aegon Short Dated Investment Grade Bond Fund and subject to satisfactory due diligence, permit Aegon to allocate up to £25m (or c.0.5% of Fund assets) of the cash that they hold to manage the currency hedging programme into this Fund. This will generate a marginal extra yield relative to cash, whilst retaining liquidity and limited drawdown.

The Fund also holds additional cash at times, either due to commitments made but not yet funded, or due to net cashflow generated from investments and contributions relative to outgo. We note the allocation to cash is currently 2.9%. **Subject to due diligence and advice on relative yields available, we propose the Officers are delegated discretion to use the Aegon fund, or any alternative fund reviewed and considered appropriate by the ISC, as a short-term alternative to holding cash.**

Liquid multi-asset credit

As part of the 2020 strategy review, it was agreed to increase the liquid multi-asset credit ('MAC') allocation to 4.0%. The intention was that this allocation would be achieved using the LGPS Central MAC sub-fund (subject to due diligence). The expected launch date for this fund is March 2021.

Subject to completion of the due diligence, **we recommend that the LPC delegate to the Officers and ISC implementation of the target allocation to liquid multi-asset credit.** The expectation is that the existing small allocation to JP Morgan MAC would be transferred into the LGPS Central sub-fund, with the remaining allocation funded from a pro-rata disinvestment from the Fund's three Targeted Return managers.

Emerging market debt

LGPS Central launched their EMD sub-fund in during 2020. The Fund transitioned the existing EMD holdings with Ashmore to the LGPS Central sub-fund in December. **We remain comfortable with the 2.5% target allocation and do not propose any changes.**

Private debt and distressed debt

There remain some dislocations in a number of markets in the wake of the pandemic. Distressed debt focuses on investments where a borrower's debt burdens have become unsustainable. It typically involves restructuring 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.

The economic disruption caused by the pandemic is clearly going to lead to more restructuring and the provision of financing for distressed debt, though it may be 6-12 months before the opportunities emerge.

The Fund already has exposure to distressed debt via the M&G Distressed Opportunities Fund ('DOF') range. In Q3 2020, it was announced that Paul Taylor, Head of Restructuring and the leading fund manager for the DOF strategies, would be leaving the team. Given the significance of Paul's departure we would not recommend that the Fund commit to the most recent vintage of the DOF funds ('DOF V') at this time. However, the Fund is currently underweight to private debt, and we consider this a relatively attractive area for investment. Therefore, **we propose that the Officers and ISC revisit the M&G DOF team and distressed debt opportunity during the course of the year, once the new team structure has had time to bed in.**

Summary of proposals

We set out below a summary of the investment strategy.

	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 manage 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	

We look forward to discussing this report with the LPC.

Prepared by:-

Andy Green, Partner
Emma McCallum, Investment Consultant

For and on behalf of Hymans Robertson LLP, January 2021.

Reliances and limitations

The actuarial profession introduced Technical Actuarial Standard (TAS) 100 with effect from 1 July 2017. As part of our internal compliance regime, Hymans Robertson has chosen to apply the principles of TAS100 in the delivery of investment advice. TAS100 applies to work where actuarial principles and/or techniques are central to the work and which involves the exercise of judgement.

In this report we have provided our estimate of expected asset class returns and used this to estimate the return on the Fund as a whole based upon the current and proposed strategic asset allocation. The Fund's asset allocation at 30 September 2020 has been sourced from Portfolio Evaluation reporting provided on 10 November 2020.

The expected returns are based upon 20-year median returns derived from our proprietary economic scenario generator (ESS) asset model. As with all modelling, the results are dependent on the model itself, the calibration of the model and the various approximations and estimations used. These processes involve an element of subjectivity. This model uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated to reflect metrics that can be measured in markets, such as yields, while other more subjective parameters do not change with different calibrations of the model. The expected returns we have shown are relative to expected CPI. We have assumed a 1% difference between expected RPI and CPI, consistent with the assumption made in the actuarial valuation basis.

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 investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

2 Fund asset allocation, including LGPS Central Pool sub-fund status

Current strategic asset allocation

The current strategic target allocation is shown in the table below:

Equities (44.75-48.75%)			Real Income Assets (24.75%)			Alternatives/Credit (27.5%)		
	Manager	Target %	Inflation Linked (14.75%)				Manager	Target %
Listed				Manager	Target %	Target return	Aspect	7.5
Regional inc UK and EM	LGIM	15.0	Index-linked	Kames	5.0		Pictet	
Global multi-factor (passive)	LGPS Central	15.0	Infrastructure	IFM	9.75		Ruffer	
Global (active)	LGPS Central	8.0		KKR		IG credit	Central	3.0
Emerging Markets	LGPS Central	4.0		JPMorgan		EM Debt	Central	2.5
			Timberland	Stafford		Liquid MAC	Central/JPM	4.0
			Infracapital	M&G		Global credit private debt	Partners	10.5
							M&G DOF	
							CRC	
Private			Property (10%)					
				Manager	Target %			
	Adams Street	4.75	Fund of Funds	La Salle	10.0			
	ASI PE 2ndaries		Smaller lots, active value	Kames		Direct	Colliers	

The actual allocation as at 30 September 2020 is compared with the current target allocation below.

	Current Target	Actual	Above or below target
Equities incl. private equity	44.75 – 48.75%	51.0%	++
Target return	7.5%	10.5%	++
Property	10.0%	8.2%	-
Infrastructure (incl. timber)	9.75%	8.4%	-
EMD	2.5%	2.3%	-
Liquid multi-asset credit	4.0%	0.6%	--
Global credit private debt	10.5%	8.5%	-
IG credit	3.0%	2.3%	-
Inflation-linked gilts	5.0%	5.4%	+
Cash	-	2.9%	++
Total	100%	100%	

At the end of September 2020, the Fund was notably overweight to equities and target return, and underweight to credit, especially multi-asset credit. The Fund also holds a higher cash balance than in previous years.

We note that market movements over Q4 2020 will have altered the actual allocation, but the key differences are as a result of some elements of the 2020 review still due to be implemented, pending LGPS Central Pool establishing funds.

Recap of recommendations from the 2020 strategy review

We summarise the key recommendations from the 2020 strategy review below:

- 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.
- Introduction of a new 3.0% allocation to Investment grade credit.
- Increasing the Fund's allocation to liquid multi-asset credit to 4.0%.
- Removal of the Millennium active currency mandate.
- 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%).
- 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.

We provide an update on the implementation of these recommendations below given the reliance on the availability of the respective LGPS sub-funds. The only strategic change not linked to LGPS Central was the removal of the Millennium active currency mandate which was terminated in Q1 2020.

LGPS Central sub-fund update

As discussed in previous reviews, our understanding is that the LPC and the Fund's Officers have an appetite to use the Pool as much as possible, albeit subject to the funds being offered being suitable for meeting the Fund's strategy and fund structures being credible. As such we continue to focus our advice and recommendations primarily on transitioning to products offered by LGPS Central (subject to the necessary suitability due diligence) and where such products are not yet available from LGPS Central we have focused on products offered by the Fund's existing managers.

Progress over 2020

- 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.
- The LGPS Central Emerging market debt sub-fund launched in Q4 2020. The Fund's existing EMD holdings with Ashmore were transitioned into the LGPS Central sub-fund in December 2020.
- LGPS Central have selected two managers, BMO and Western Asset Management, for the multi-asset credit sub-fund. As referenced above, LGPS Central are in advanced stages of finalising the multi-asset credit (MAC) sub-fund, which is expected to launch in March 2021.
- The LGPS Central All-World Equity Climate Multi-Factor sub-fund was launched in the summer of 2020. The Fund transitioned assets into the sub-fund in December. 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.
- The Fund continued to top-up private market allocations over 2020, namely, private equity and infrastructure, with commitments to Adam Street 2020 Global fund and JPM infrastructure.

Expected timeline for other sub-fund launches over 2021

- The Infrastructure sub-fund is due to launch by March 2021. As yet no managers have been selected.
- LGPS Central are aiming to launch their direct property sub-fund in June 2021. No date has been set for the launch of an indirect property sub-fund.
- The Targeted Return sub-fund is not due to launch now until summer 2021.
- Following LGPS Central's appointment of Ian Brown as Head of Private Markets, it is expected that a 2021 vintage of the private equity sub-fund will be available in early 2021. Similarly, further developments are expected in the private debt space.

3 Investment objectives and required return

The strategic funding objectives of the Fund can be described as follows:

- To ensure members' benefits are met as they fall due.
- To support a long-term funding approach that is consistent with a stable and affordable contribution approach from the employers.
- To remove any funding shortfall over 17 years, with a target to reduce this recovery period.

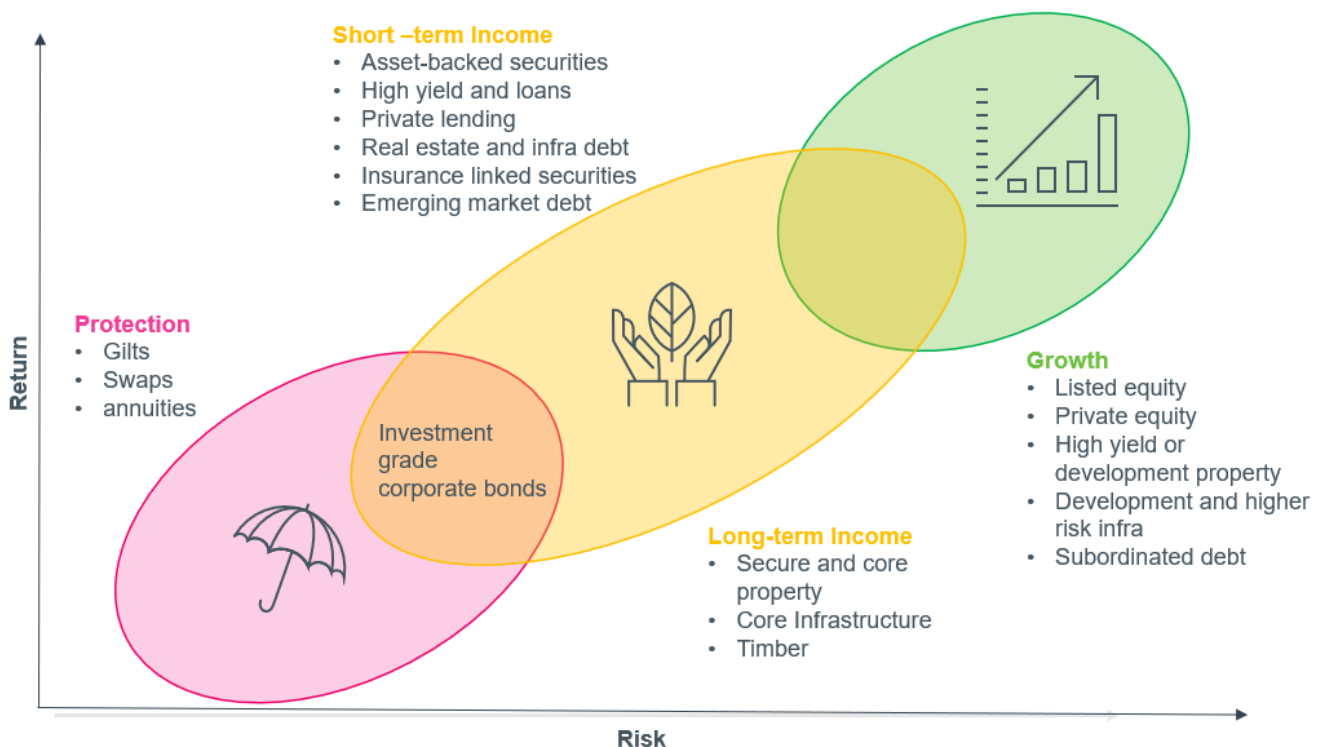
The investment strategy should be set to achieve these funding objectives. In practice, to the extent that the discount rate used reflects the expected return on the Fund's assets, this is an integrated process.

The nature of the objectives suggests a strategy focused on long-term sustainable return. The current strategy already reflects a focus on long-term investing, with allocations to private assets where the return is earned over-time and where the Fund takes advantage of an illiquidity premium in return.

The objective of generating a return that helps deliver a stable contribution lends itself to predictable and sustainable returns. This can be achieved through investments where there is a focus on predictable income rather than capital gains, which may be more variable.

This ties in well with the short and long term income assets, as set out in our Growth, Income and Protection asset framework below.

Chart 1: GRIP asset framework



We note that the attribution of asset types into three buckets is subjective, and there are overlaps between Growth, Income and Protection. For example, investment grade corporate bonds provide protection against interest rates but also provide a level of income above government bonds. Equally, targeted return could be considered under Income or Growth, and in the case of Ruffer, includes a persistent allocation to Protection assets too.

The Fund asset allocation can be aligned to these categories, as we have done in the table below. We note that long-term income assets also typically incorporate an element of inflation linkage to the expected return, i.e. they are real income assets.

	Target weight (%)
Growth (55.25%)	55.25
Listed equity	43.0 (40.0-44.0)
Private equity (inc secondaries)	4.75
Targeted return*	7.5
Income (36.75%)	36.75
Infrastructure (inc timberland)	9.75
Property	10.0
Emerging market debt	2.5
Global credit – liquid sub inv grade markets	4.0
Global credit - private debt	10.5
Protection (8%)	8.0
Inflation-linked bonds	5.0
Investment grade credit	3.0
Total	100.0

We note that Targeted Return assets could be considered a combination of growth, income and even protection assets given the objective of positive absolute returns. However, to the extent that they typically include a proportion in equities, we classify these mandates as growth.

Finally, we note that implementation within some asset classes can lend itself more easily to achieving more sustainable returns through alignment to ESG and lower climate risk or low carbon features. We return to this in Section 5.

Required rate of return on assets

The discount rate used in the 2019 actuarial valuation of the Fund is 3.8%. This rate was set such that there is an 80% likelihood of the return on Fund assets being at least equal to the discount rate over the next 20 years based on our asset return model as at 31 March 2019.

The corresponding central average return of the strategy was expected to be higher than 3.8% p.a.; i.e. there was a 50% likelihood that the return on the current strategy will be 5.9% p.a. or higher.

The table below illustrates asset returns and the return on the Fund since April 2019 to September 2020:

	12 months to 31/3/2020	6 months to 30/9/2020	18 months to 30/9/2020	18 months to 30/9/2020 p.a.
UK equities	-18.5%	7.0%	-12.8%	-8.7%
Global equities	-5.3%	23.9%	17.3%	11.4%
Emerging market eq	-13.2%	24.3%	8.0%	5.3%
IG corporate bonds	0.0%	10.7%	10.7%	7.0%
Inflation-linked gilts	2.2%	7.9%	10.2%	6.7%
Fund	-4.3%	9.7%	5.0%	3.3%

Reflecting the material fall in equities and widening of credit spreads over the first quarter of 2020, the Fund return over the 12 months to 31 March 2020 was negative. However, the bounce back in markets since means that returns over 18 months are only a little short of the funding discount rate. Moreover, since September, equity and credit markets have continued to perform strongly.

Looking forward, our absolute level of expected returns on assets have fallen reflecting the change in market conditions, in particular interest rates and credit spreads.

The table below compares our assumptions at the 31 March 2019 and 31 October 2020 for the Fund's core assets. We expand upon the changing market conditions in Section 4.

20 year expected return p.a.	From 31 March 2019	From 31 October 2020
Global equities	5.8%	5.5%
Private equity	7.8%	6.4%
Infrastructure	6.0%	5.5%
Property	4.3%	3.9%
Sub-Inv grade bonds	5.1%	4.3%
IG corporate bonds (A rated)	1.5%	0.9%
Inflation-linked gilts	0.3%	-0.1%
Fund (50th percentile return)	5.9%	5.5%

As a result, at end October 2020, the median expected return on the Fund was 5.5% p.a., i.e. 0.4% p.a. lower. We note that the median (or 50th percentile) Fund return is higher than the sum of the parts with respect to the expected returns on underlying asset-classes, as it allows for correlations between the assets and the benefit of diversification between assets.

The implied discount rate at 31 October 2020, looking at the equivalent return with an 80% likelihood, is also lower, at 3.4% p.a., i.e. the relative return is maintained.

Offsetting this to some extent, implied inflation has also fallen from 3.65% to 3.3% (20-year implied gilt inflation). However, we 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.

In isolation, the slightly lower funding level and a lower future expected return imply a lower likelihood of success, i.e. less than an 80% chance of achieving funding over 20 years. However, the expected return is still comfortably above 3.8% p.a.

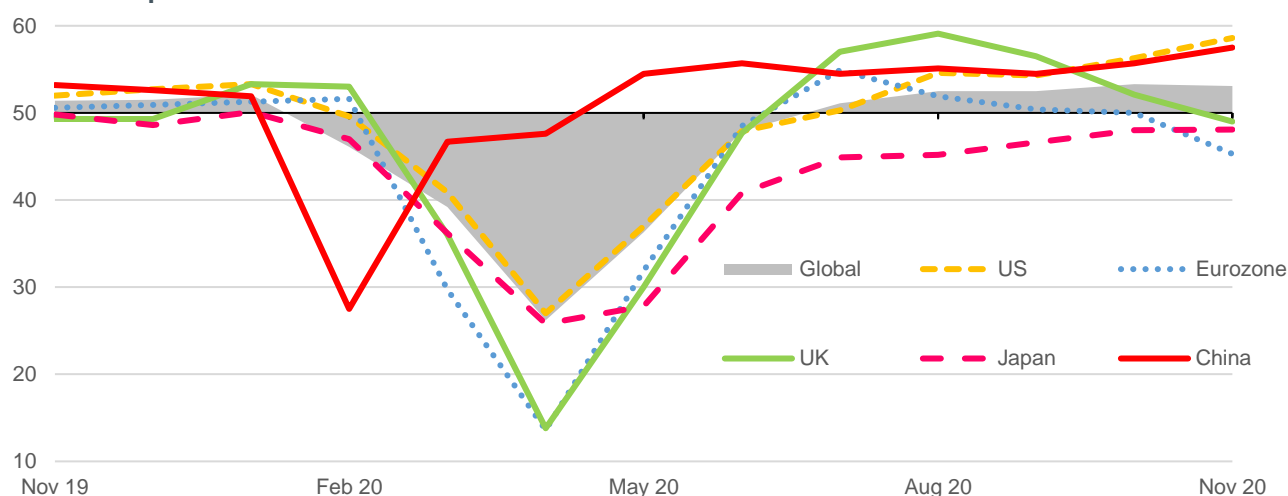
4 Market commentary

Overview

Announcements of effective vaccines allowed companies and markets to put near-term economic weakness in the context of a potential end to the pandemic in 2021. Global equity markets, oil and industrial metals prices rose in concert with US treasury yields in the fourth quarter.

Despite Q3 GDP releases showing a sharp initial rebound in economic activity, output remains well below end-2019 levels in most economies. Furthermore, the global economy is set to end 2020 on a weak note after many countries, particularly in Europe and the US, re-imposed restrictions to reduce COVID-19 infections. However, PMI surveys provide little evidence of a slowdown at a global level (Chart 1).

Chart 1: Composite PMIs

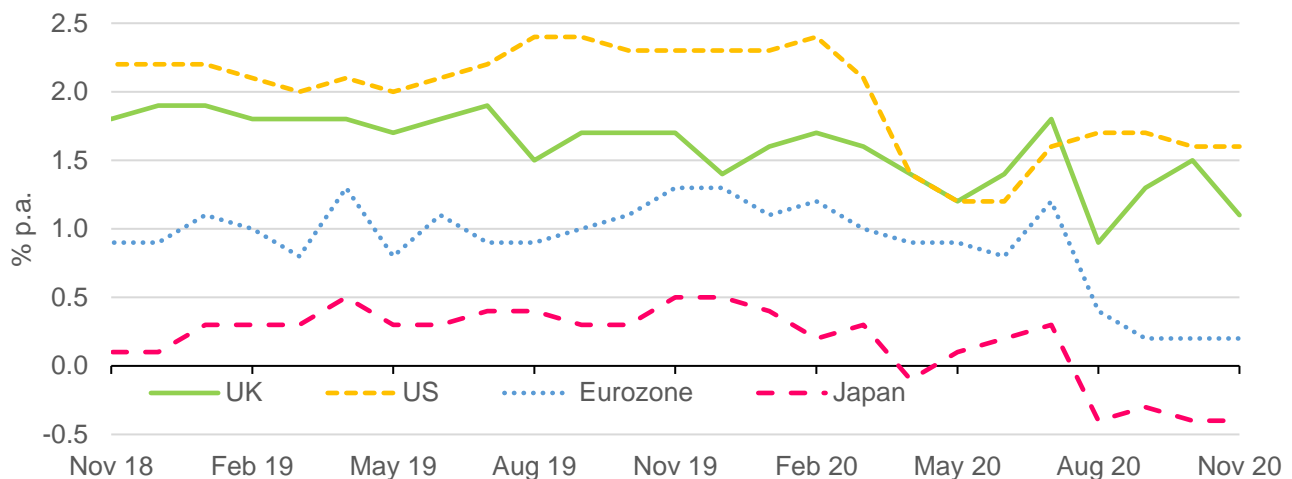


Eurozone and UK composite PMIs have fallen, but the global equivalent remains at a level signalling expansion, supported by solid readings in the US, China and elsewhere. Even in the Eurozone and UK, both manufacturing and services have held up far better than during initial lockdowns in spring. Once again, subject to looser restrictions and facing a stronger external environment, manufacturing has been far more resilient than services, remaining at a level typically consistent with strong expansion.

Consensus forecasts a 4.2% fall in 2020 global GDP followed by a 4.8% expansion in 2021, though output in the major advanced economies is not expected to reach pre-pandemic levels until at least 2022. While vaccine developments have not altered the average projection (most forecasts already assumed social distancing would continue in to 2021 but fade over time as vaccine coverage expanded and therapies improved), we believe the risks to the outlook are now more balanced. Though cases continue to rise at a global level, it appears increasingly likely that many advanced economies could vaccinate a large proportion of their most vulnerable citizens early this year, potentially paving the way for a more permanent relaxation of restrictions.

Sterling was volatile in the fourth quarter as Brexit talks approached their conclusion. It ended the period 1.5% higher in trade-weighted terms as the EU and UK reached a trade deal enabling tariff- and quota-free movement of goods. In trade-weighted terms, the US dollar and Japanese Yen, both typically considered safe-haven currencies, fell 4.3% and 1.2%, respectively, below end-September levels as economic sentiment improved.

Chart 2: Core CPI inflation

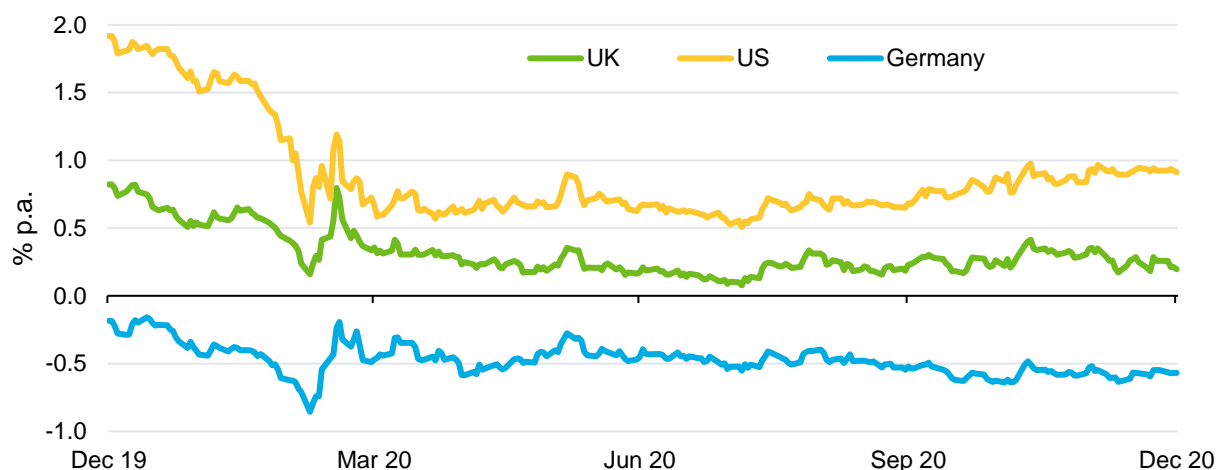


Some commentators fear the release of pent-up demand when the pandemic subsides could lead to a surge in inflation. However, most are more sanguine when GDP remains well below trend and unemployment is expected to rise. The consensus estimate is for a fall in inflation in 2020 to be followed by a modest increase in 2021. While a sustained rise in inflation, and the subsequent need to raise interest rates, would represent a risk to economic recovery and asset prices, the resilience of supply during the pandemic and a return to normality that will probably be gradual suggest any inflation pressure will be limited and interest rates are likely to remain low for an extended period.

Government bonds

10-year US Treasury yields rose as the economy continued to recover in Q4, but equivalent UK and German were little changed as near-term economic weakness prompted their central banks to increase asset purchases. In the UK, Brexit disruption may moderate the economic rebound expected in 2021 and the Bank of England has been looking at the implications of further easing through negative interest rates. Against that backdrop, very low yields are vulnerable to a less favourable fundamental background as growth and inflation recover and less technical support as monetary easing is replaced by short-term stability and longer-term tightening.

Chart 3: 10-year government bond yields

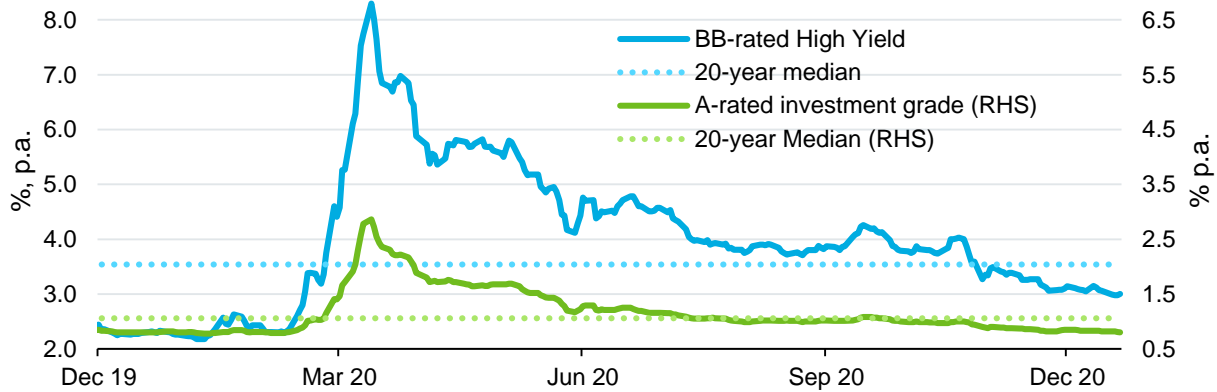


Despite the government's announcement that RPI will be aligned with CPIH (c.1% p.a. lower) in 2030, with no compensation for index-linked gilt holders, implied inflation actually rose at longer terms. This may suggest markets have not fully discounted the changes.

Credit

Unusually for a period of financial stress, companies have been able to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields. Although default rates have risen – to 8.4% in the last 12 months to November¹ in the US high yield market – the accommodative funding conditions have helped keep them well below the peaks of previous crises. However, it is likely defaults could remain elevated as companies lose government support.

Chart 4: Global investment-grade and speculative-grade corporate credit spreads

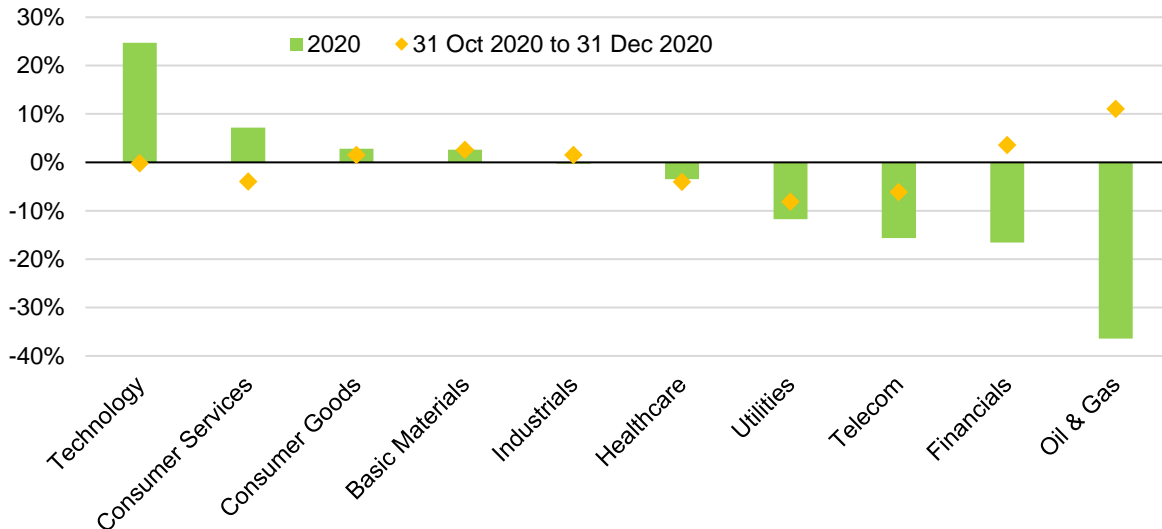


Nonetheless, global credit spreads have retraced much of the widening seen in Q1 and are now well below longer-term medians (Chart 4). Credit assets which have seen less direct policy support, such as asset-backed securities and leveraged loans, look to offer better value than similarly rated fixed-interest corporate bonds.

Equities

The pandemic-induced recession has been notable by its creation of winner and losers: “social distancing” stocks, mainly in the technology sector, have benefitted not only from their ability to grow earnings while most other stocks saw huge pressure on profits, but also from the decline in the discount rates used to ascribe a present value to their future earnings. Progress towards a vaccine has, to an extent, reversed this narrative since the start of November as cyclical sectors benefitted from improving economic sentiment (Chart 5).

Chart 5: FTSE ALL World Relative Total Return



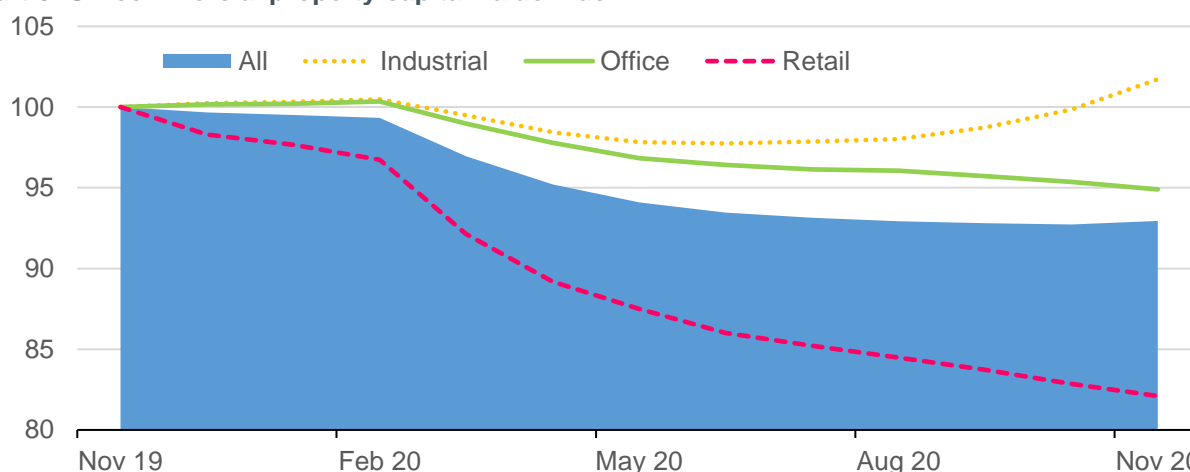
¹ Moody’s Weekly Market Outlook issuer-weighted default rate

Global equity valuations at, or near, record-high levels continue to mask stark divergences across sectors and regions. Cheaper valuations in regions such as Europe and the UK, with their higher-than-average cyclical exposures, may suggest there is further room for the value rotation to run. However, while rises in government bond yields are limited and gradual, longer-duration growth sectors, such as technology, may well remain in favour in spite of high valuations. Vaccine rollouts should see significant pressure on COVID-19 laggards ease, but the disruption caused by the pandemic may accelerate longer-term trends. A rapid increase in technological adoption and efforts to de-carbonise the global economy would lend further fundamental support to the “winners” while weighing on old-economy cyclical sectors, such as oil & gas. Partly as a result of this tension between current valuations and longer-term prospects, we would not advocate taking any strong regional, sectoral or stylistic positions.

Property

The 12-month total return on the MSCI UK Property index was -1.9% to end-November, though monthly returns have been positive since July. Capital values, in aggregate, have fallen 7.1% in the year to November, predominantly due to an 17.9% fall in the retail sector (Chart 6). Retail capital values continue to fall month by month, and the decline in office values has accelerated in the last 3 months. A recovery in industrial capital values, up 5.6% since July, highlights the continuing divergence between property sectors: the pandemic has accelerated the longer-term trend from in-store to online spending, increasing demand for logistics and warehousing facilities.

Chart 6: UK commercial property capital value index



Aggregate rents have fallen 2.4% over the last year, although the month-on-month falls that have occurred since February have levelled off. Retail rents and, at a slower pace, office rents continue to fall, but annual rental growth in the industrial sector not only remains positive but rose in November. Rent collection remains a challenge for landlords; the issue was probably at its height in the initial lockdown earlier in the year, but the recent re-imposition of restrictions may limit the immediate improvement.

The creation of winners and losers extends to property: the mix of what constitutes an optimal property portfolio will continue to change. However, property in aggregate is likely to remain an important source of diversification and yield.

5 Responsible investing

Responsible Investing and ESG

The Fund's policy on Responsible Investing and approach to incorporating environmental, social and governance ('ESG') factors into investment decisions is set out in the Fund's Investment Strategy Statement ('ISS'), which was last reviewed by the Committee in January 2020. To date, the Fund's approach has largely been to delegate investment decision-making and voting to underlying investment managers.

As stated in the Fund's ISS (dated January 2020), the Fund has access to the Responsible Investment ('RI') resource and expertise provided by LGPS Central, which the Fund will use to help guide its approach. LGPS Central will manage sub-funds in accordance with their Responsible Investment and Engagement Framework. Details of the framework are summarised in the ISS. In brief, LGPS Central's investment and RI beliefs focus on factors that enhance risk-adjusted returns through long-term sustainable investing.

As highlighted in previous reviews, LGPS Central is a signatory of the Principles of Responsible Investment ('PRI') (a leading global standard for responsible investing) and ESG assessment is a key component of LGPS Central manager assessment for future sub-fund appointment. As such, while the assets currently held outwith LGPS Central will be transitioned over a period of years, all new investments via LGPS Central sub-funds will comply with the PRI.

Climate change

One area noted in the ISS is the consideration of the financial impact of climate change on investments. In October 2020, the Fund received its first climate risk report from LGPS Central. The view is to refresh this reporting on at least an annual basis, with the aim to continue to see incremental improvements in the Fund's RI position.

At a high level, the LGPS Central climate risk report found that the Fund's equity portfolio had a carbon footprint that was c.17% lower than the benchmark. Our recommendation in the 2020 strategy review for the Fund's passive equities to include an allocation to LGPS Central's climate balanced multi-factor fund, which we consider to act as a sustainability factor, will go some way towards improving this metric in the 2021 reporting.

More widely, the GrIP asset framework introduced in Section 3 lends itself to a focus on income and sustainability. In particular, income assets classes can lend themselves more easily to achieving more sustainable returns through alignment to ESG and lower climate risk or low carbon features.

We have considered the scope to consider the impact of climate change within other asset classes, such as infrastructure and debt, although we expect this to be in conjunction with LGPS Central as they develop new sub-funds going forwards.

Managers, including LGPS Central, can demonstrate their commitment to responsible investment through their adherence to industry standards. There are two standards directly relevant to the Fund's investment managers; the Principles for Responsible Investment and the Financial Reporting Council's UK Stewardship Code.

We propose the Officers and ISC continue to monitor and review the adherence of LGPS Central and directly appointed managers to these standards. We note that the UK Stewardship Code has been overhauled with a new Code having come into force at the start of 2020. Existing signatories to the old Code will cease to be signatories in 2021 unless they meet the revised requirements which are substantially higher.

6 Equities

The Fund's target benchmark equity allocation is largely in listed equity markets 43% (but within a 40-44% range) with a further 4.75% in private equity, including the Aberdeen Standard secondaries fund. As at 30 September 2020 the actual allocation to equity remained above the target range.

	Manager	Target %	Actual %
Listed equity		42.0	44.9
Regional (passive)	LGIM passive market cap	15.0	31.3
Global (active)	LGPS Central	8.0	8.4
Emerging markets (active)	LGPS Central	4.0	4.1
Global multi-factor	LGPS Central	15.0	0.0
Private equity		4.75	6.1
	Adams Street	4.0	5.8
	Aberdeen Standard secondaries	0.75	0.5

Listed equity

The listed equity allocation comprises a mix of regional and global allocations implemented through passive and active mandates. The global equity exposure and part of the emerging market exposure are actively managed within LGPS Central funds, while the regional equity was passively managed by Legal & General (LGIM).

The listed equity allocation was reviewed as part of the 2020 strategy review. The main changes were to replace the Fundamental indexation and part of the regional passive market cap allocation with a multi-factor benchmark.

Manager	Strategy	Old Weight	New Weight	Change
LGIM regional (market cap passive)	UK Equity	15.5%	7.5%	-8%
	European ex UK Equity	6%	6%	
	North American Equity	14%	14%	
	Japanese Equity	6%	3%	-3%
	Pacific ex Japan Equity	6%	3%	-3%
	Emerging Market Equity	4.5%	2.5%	-2%
LGIM (fundamental indexation)	RAFI AW 3000 Europe ex. UK	6%	0.0%	-6%
	RAFI AW 3000 North America	14%	0.0%	-14%
Total LGIM Passive		72%	36%	-36%
LGPS Central (passive)	Climate Balanced Multi-Factor	0.0%	36%	+36%
Total Multi-Factor Passive		0.0%	36%	+36%
LGPS Central (active)	Global Equity	19.0%	19.0%	
LGPS Central (active)	Emerging Market Equity	9.5%	9.5%	
Total Active Equity		27.5%	27.5%	-
Total Listed Equity		100.0%	100.0%	

The LGPS Central All-World Equity Climate Multi-Factor sub-fund was launched in the second half of 2019. The LGPS Climate Multi-Factor sub-fund benchmark incorporates a climate overlay to its factor-based index. Along with the reduction in UK equity market exposure (which has a higher exposure to carbon intensive industries), the Fund should expect to see improved metrics in the next annual climate risk report prepared by LGPS Central. The required asset transitions took place in December to bring the Fund in line with the weights shown above.

We remain comfortable with the listed equity portfolio and do not propose any further changes to the strategic allocation or the split between active and passive management. However, **we propose that LPC delegate to the**

Officers and ISC a review of the LGIM passive equity holdings in the second half of 2021, with a view to simplifying the number of regional funds used.

Private equity

The Fund has a 4.75% strategic allocation to private equity, including the investment in Aberdeen Standard's secondary fund. The Fund's existing private equity exposure is through closed-ended funds and therefore will continue to be held separately from LGPS Central until capital is returned over time.

Given the closed-ended nature of these funds, it is necessary to continue to make further commitments to this asset class in order to maintain the target. The Fund committed a further \$25m to the Adam Street 2020 Global Fund in Q4 2020 in order to maintain the allocation. We expect ongoing investments required to maintain the allocation to private equity are made to Adams Street until such time as LGPS Central have a new suitable offering which may not be until later in 2021.

The Fund previously invested £10m in the 2018 vintage of the LGPS Central private equity sub-fund. Following the departure of Omar Ghafur, Head of Private Markets at LGPS Central, the launch of 2019 vintage was delayed and subsequently cancelled. LGPS Central have recently appointed Ian Brown as Omar Ghafur's replacement and as such it is expected that LGPS Central will launch a 2021 vintage of the private equity sub-fund.

We propose that the LPC delegates to the Officers and the ISC a review of suitability of this sub-fund once further detail becomes available.

Secondaries market opportunity

Investing in Secondary private equity involves acquiring interests in existing established primary private equity funds. They can provide the opportunity to gain immediate exposure to well-seasoned portfolios from a range of primary managers, thus accelerating capital deployment and increasing diversification.

The pandemic has forced some investors and fund managers to restructure their portfolios, which has provided an opportunity to acquire assets in the secondary market at discounts. Investing in Secondaries, particularly in the aftermath of the current pandemic, can be advantageous for the following reasons:

- Investors gain immediate access to mature portfolios which accelerates the deployment of capital and the subsequent realisation of returns;
- The risk of primary managers investing in assets that are not consistent with the investors expectations, also referred to as 'blind pool' risk, is eliminated;
- Greater diversification is achieved through exposure to a wider range of underlying portfolio companies;
- It is possible to gain exposure to underlying funds from the best primary managers that would normally be difficult to access; and
- As alluded to above, there is an opportunity to acquire interests at a discount to the net asset value (NAV) of the underlying primary funds. This is essentially a premium for providing liquidity to the market.

Secondaries are usually acquired at a discount to NAV, with the average discount around 12% in 2019. These discounts have widening since the beginning of the pandemic and associated global lockdowns. We believe that the next 12-18 months could be a particularly good time to invest because of the strong deal-flow and higher discounts available.

The number of managers specialising in this area is small. The Fund already has a small exposure to the Secondaries market via the Aberdeen Standard Investments SOF funds (with a holding valued at c.£25m at end September 2020).

Adam Street are currently raising for their Global Secondaries Fund VII (GSF7). We view Adam Street's capabilities in this area positively and believe that they would be well-placed to take advantage of the secondary opportunities expected to come to the market over the next few years. For reference, the first close for this fund is expected to be March 2021.

The current allocation to private equity is already above target. However, as noted in section 9 and 10, the Fund is currently underweight other private assets (property and private lending). Therefore, we propose that the strategic allocation to private equity is increased by 1% to 5.75% with the Fund seeking to increase exposure to Secondaries.

We propose that the LPC delegates to the ISC and Officers to consider implementation options, subject to the necessary due diligence. Firstly looking to the LGPS Central 2021 private equity offering once further details become available and taking into account the sub-fund's positioning on secondaries. Should there be limited exposure to secondaries via the LGPS Central offering then consideration could also be given to Adam Street's offering in this space.

7 Currency hedging

Introduction and summary recommendation

The Fund has direct currency exposure through its non-UK investments. Currency movements provide additional variation in the returns earned on non-sterling denominated assets. The Fund currently manages this volatility by strategically hedging a proportion of the non-sterling exposure as follows:

- A standalone programme is managed by Aegon Asset Management with a strategic target to hedge 50% of the non UK listed equity exposure, currently hedging around £850m.
- Non UK currency exposure associated with the Fund's bond exposure is largely hedged within the associated mandates. This ensures currency movements do not affect the value of the income or redemption proceeds of the bonds held.

In this section we review relevant factors that may be considered when setting strategic target currency hedging levels in global equity portfolios. We do not include any further review of currency hedging within the bond mandates, where we consider full hedging of currency exposure to be appropriate.

In brief, we recommend continuing to hedge a proportion of the currency exposure associated with the Fund's listed equities. However, for the reasons outlined in this section, and discussed in more detail in Appendix 1, we suggest reducing the benchmark from 50% to 30%.

Relative to the current strategy this has the following advantages:

- **It maintains the aim of some reduction in equity return volatility, but places a greater focus on reducing volatility in times of market stress;**
- **It considers currency hedging at the overall Fund level rather than just at the equity level;**
- **It reduces the level of potential calls on capital to settle losses on currency contracts*, which may require the sale of other assets at a time this may not be attractive to do so.**

*Relative to strategic benchmark. Aegon may use their discretion to implement higher levels of hedging, and management of any additional associated capital should form part of their decision-making.

We consider that this strikes a good balance between managing risk at a portfolio level and managing costs.

We support the ongoing focus on risk management and associated volatility reduction, as provided by Aegon, in managing the currency hedging, rather than an outright actively managed currency mandate.

Strategic objectives

Investors may have different potential strategic objectives when they choose to manage the currency risk associated with equity exposure. The most common is to reduce the risk as measured through volatility of returns.

We believe the additional objectives of managing funding volatility and downside volatility in times of market stress to be a worthwhile extension of the core objective to reduce return volatility, if these objectives can be harnessed.

We note that the programme managed by Aegon Asset Management for the Fund includes a focus on "*managing risk to protect the fund in absolute terms in times of market stress*".

In addition, active currency management can be seen as a source of additional returns. The Fund has employed managers for standalone active currency mandates in the past, but no longer holds any mandates with the sole aim of adding value through active currency decisions.

Currency hedging to reduce equity return volatility

Whilst the vast majority of a global equity portfolio's volatility comes from the volatility of the stocks that comprise the equity market, currency movements add to that volatility of returns.

We note that the main benefit in terms of risk reduction is gained through the first 50% of hedging. Hedging more than 50% has a much more marginal effect, and hedging levels above 70% may actually result in volatility beginning to increase again.

When considering equity volatility reduction on a standalone basis, analysis suggests that the optimal level of currency hedging is between 50% and 70%.

A strategic hedging target of 50% is also consistent with the simple principle of avoiding the maximum impact of currency movements, in the absence of any certainty over the direction of currencies, i.e. half right.

Scope to reduce funding volatility

Consideration should also be given as to how currency risk interacts with other investment risks that affect the Fund's funding, particularly interest rate and inflation risk.

For example, if real gilt yields fall, we might expect sterling to depreciate relative to other currencies as, all else equal, the factors which tend to reduce real yields (i.e. lower growth expectations and/or higher inflation) also tend to weigh on a countries' exchange rate. In such a scenario, having some currency exposure may act to offset the impact on the funding level associated with lower real yields or higher inflation, and would therefore help to manage risk at an overall Fund level. **Hence, retaining some unhedged currency exposure appears helpful in managing funding risk.**

We note however that the results will be somewhat dependent upon the time period considered.

Reducing volatility in market stress: sterling performance in periods of economic weakness

Whilst historically sterling may have been seen as a safe-haven currency, there is little evidence in the more recent past of the last three decades to suggest sterling benefits from so-called "safe-haven" status.

The 2015-17 global earnings recession, of course, coincided with the surprise outcome of the vote to leave the EU. Anticipation of a supply-side, and hence inflationary, shock from disruption to trade and labour markets, alongside the UK's persistent twin deficits, and hence ongoing dependence on capital inflows, resulted in a sharp depreciation in sterling.

Most recently, in the first quarter of 2020 on the back of the Covid pandemic and recognition that it would affect the global economy and trade, sterling depreciated sharply. Sterling potentially suffered from being an economy dependent on global trade and the relative size of central borrowing packages announced.

The relative weakness of sterling in times of market and economic stress is something that we consider a likely feature going forward. In isolation, this suggests retaining a lower level of currency hedging than the neutral 50-70% range identified earlier.

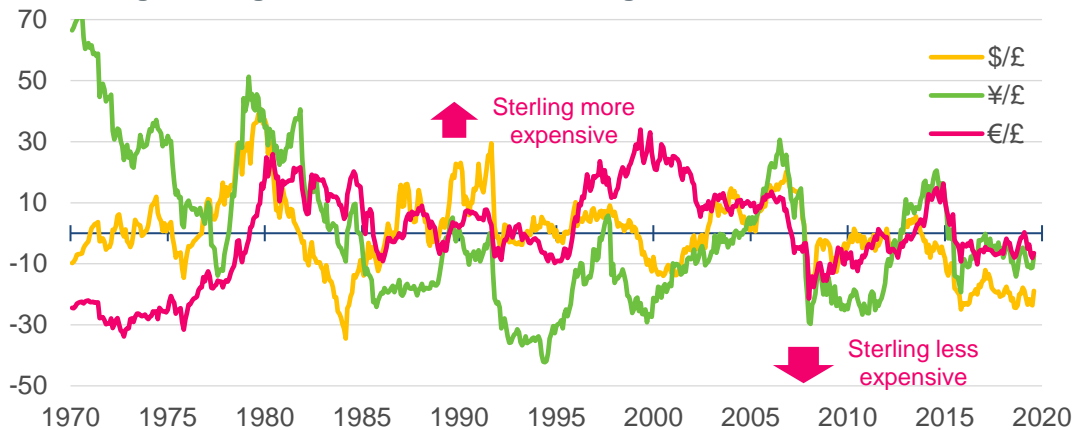
Current valuations

Given the longer-term depreciation of sterling since mid 2015, unhedged global equity returns to a sterling-based investor have been higher than the hedged returns.

Purchasing power parity (PPP) theory asserts that changes in inflation differentials between regions will be offset in the long-term by an equal and opposite change in the exchange rate, i.e. an exchange rate should adjust to allow for relative inflation between two countries over the long-term, so that prices for products and services are the same in each.

The chart below shows the deviation in inflation-adjusted exchange rates from long-term average.

Real sterling exchange rates deviation from average since 1970



The chart would suggest Sterling is currently less expensive, and might suggest a higher level of currency hedging would be appropriate. However, exchange rates can, and do, diverge considerably from PPP benchmarks and longer-term inflation adjusted averages for several reasons:

- Economic – relative GDP and/or productivity growth, inflation and interest rate differentials
- Financial – current and fiscal account balance and asset flows
- Political uncertainty

Looking forward, a premium for holding sterling might not seem unreasonable given the potential headwinds and ongoing uncertainty around the implications for the UK exit from the EU.

On balance, we do not think there is any reason to adjust the strategy currency target on valuation grounds, at least in the short to medium term.

Capital requirements and costs of running a hedging programme

When a currency contract expires, one party has to make good its position to the other reflecting the movement in exchange rates since the contract was implemented.

Reflecting one of these extreme events, we note that during the latter part of February and first three weeks of March 2020, sterling collapsed vs the Yen, Euro and US dollar by around 12%. On a programme of c.£850m, that meant a potential settlement of £100m. Given the hedging position was only covering 50% of the Fund's equity exposure, it should be noted that the Fund's equities rose in value by £200m due to the same currency movements. However, the equities had also fallen in value due to wider concerns surrounding the pandemic, and hence selling equities to settle the currency hedging would mean locking in the capital losses. Rather than selling equities, Aegon hold a cash reserve (c.£50m as at 30 September 2020), and they also have access to index-linked gilts which they can sell.

In the normal course of events the flow of profits due to sterling strengthening or capital calls due to sterling weakening will be modest. However, the Fund needs to have access to capital in order to meet any settlement on currency losses. **At the margin this tends towards a lower hedging target.**

8 Targeted return

The strategic allocation to Targeted Return was reduced from 9.0% to 7.5% as part of last year's review, with the proposed reduction used fund the increase in the allocation to multi-asset credit and a small element to investment grade credit. In practice, the current allocation is still close to the pre-2020 target (10.5% as at September 2020) as LGPS have not yet launched their multi-asset credit fund (see below in this section).

The current Targeted Return allocation is broadly split between Aspect, Pictet and Ruffer. As a reminder, Aspect operates a systematic managed futures hedge fund, while Pictet and Ruffer manage long-only asset allocation funds, with Pictet's fund being the more tactical.

The aim of the Targeted return portfolio is to provide a return of cash + 3-4% net of fees, equivalent to a return in excess of CPI+3% long-term, while providing diversification from equities, which is the single largest asset allocation for the Fund.

The Fund's actual allocation at 30 September 2020 is summarised below:

	Aspect Capital	Pictet	Ruffer	Combined
Actual allocation	£132.1m	£166.8m	£183.6m	£482.7m
	2.9%	3.6%	4.0%	10.5%

Performance is summarised below.

	Aspect Capital	Pictet	Ruffer
9 months to 30 Sept 2020	-9.9%	9.9%	9.4%
3 years to 30 Sept 2020, p.a.	0.5%	1.2%	5.4%
Since inception, p.a.	3.7% (Dec 13)	3.6% (Sep 15)	6.0% (Dec 13)

Over the nine months to end September 2020, Pictet and Ruffer have delivered positive returns, with Aspect producing a negative return of similar margin, experiencing a reversal of the strong returns delivered in 2019.

We still consider the objective of tilting the Fund's strategy to capture market risks and opportunities as worthwhile objective. We understand that LGPS Central expect to launch a Targeted Return sub-fund in the summer of 2021. The sub-fund will aim to target a cash+4% return with limited correlation to equities. The initial investment case provided by LGPS Central in respect of the Targeted Return sub-fund suggests that there may be between 6 and 12 different strategies within the portfolio.

Subject to confirmation that the objectives of that sub-fund are consistent with the Fund's current objectives, we would expect the Fund's Targeted Return exposure to be replaced with the LGPS Central sub-fund over the course of 2021.

The launch of the LGPS Central Targeted Return sub-fund is expected in the near future. In the absence of more detail around what the sub-fund composition will look like, the LPC could retain the three mandates until such time that the LGPS Central sub-fund is available, trimming each of them to fund the multi-credit allocation. It may be necessary for the Officers and ISC to review possible alternatives through the course of the year if the LGPS Central sub-fund progress is slow and/or the final proposal is not seemed to be suitable for the Fund.

9 Real assets and inflation

Real assets

The Fund currently has a 5% allocation to index-linked gilts ('ILG'), which provide a direct link to inflation expectations. In addition, the Fund targets c.19.75% in long-term income assets through its investment in infrastructure (including Timberland) and property, which are expected to provide a real return.

Index-linked gilts and inflation

The ILGs are held in a segregated mandate managed by Kames against an FTSE All-Stock Index-linked index. At the end of September 2020, the ILG portfolio at Kames totalled c.£248m.

A key development has been the expectation that RPI inflation would be replaced or changed to CPI inflation at some point in the future. This is important as the Fund pays CPI benefit increases, but index-linked gilts are revalued with RPI increases. Hence, although index-linked gilts provide real return protection, there is a basis mis-match that may lead to deviation in the level of this protection until there is greater clarity and re-pricing of index linked gilts.

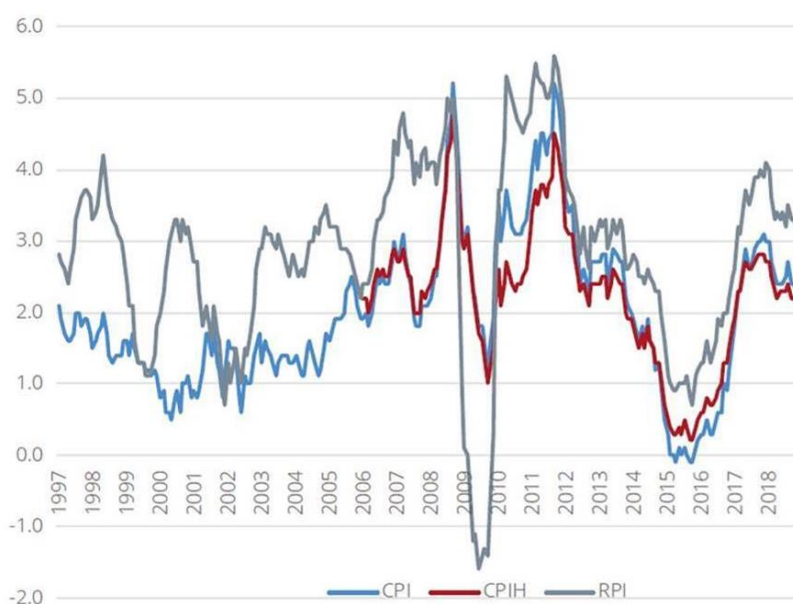
As noted in our 2020 strategy paper, in September 2019, the Government responded to the House of Lords Economic Affairs Committee's January 2019 report, Measuring Inflation, which recommended that problems with the RPI be 'fixed', and to proposals from the UK Statistical Authority ('UKSA') that the publication of RPI should cease.

Following a consultation period, the Government announced on 25 November 2020 that RPI will be aligned with CPIH as proposed, but not before 2030 and no compensation is being offered to index-linked gilt holders.

Implications for the Fund

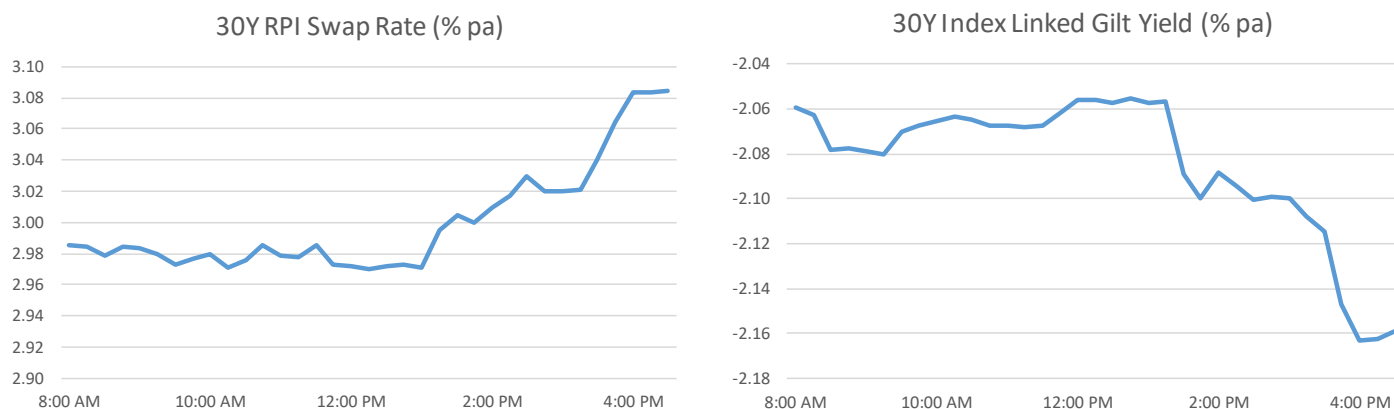
Aligning RPI to CPIH is expected to reduce the rate of inflation linked to assets such as index-linked gilts that reference RPI. As illustrated below, the difference between RPI and CPI/CPIH historically has been in the region of 1% p.a. This has a material impact on long dated RPI-linked assets and liabilities.

Annual percentage change in CPI, CPIH and RPI



Source: Office for National Statistics, 'Inflation and price indices'

In anticipation of this outcome, implied RPI inflation in index-linked gilts had already been re-pricing downwards, such that the gap between expected RPI and CPI beyond 2030 was much less than 1% p.a.



However, on the day of the announcement RPI pricing actually rose. This may appear counterintuitive, but we expect there was an element of indiscriminate buying of inflation on the back of clarity about future measurement. The rise in inflation did also apply to CPI pricing beyond 2030 (albeit a much smaller market, so tradeable CPI pricing is not that transparent), and the implied gap between the two post 2030 narrowed further towards zero. We note that other factors will affect real yields. For example, expectations around a no deal Brexit.

While there is an implied loss to RPI linked assets, and the value of RPI linked benefits where relevant, the announcement brings clarity to the problem. Furthermore, pushing the implementation date back to 2030 at least reduces the impact when there was a possibility that the implementation date could have been set as early as 2025.

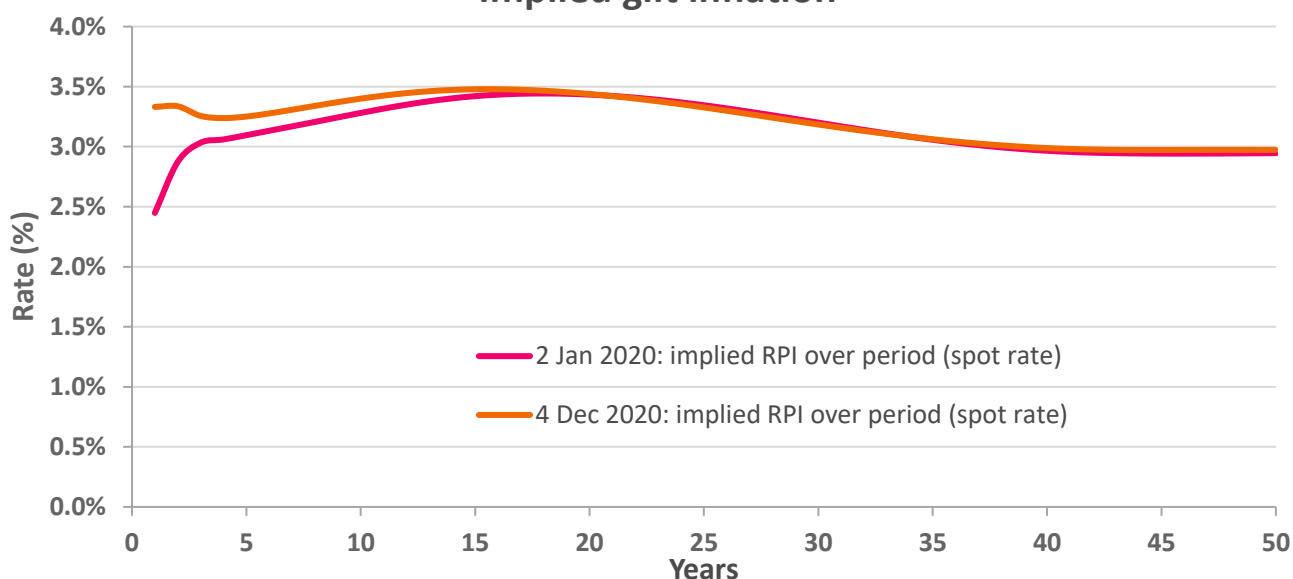
On the liability side, the value of the Fund's benefits linked to CPI will change at the next valuation as a result of this announcement. The actuarial assumption for valuing CPI-linked liabilities is unlikely to be RPI less 1%. As the basis for setting the CPI assumption for future actuarial valuation is as yet unknown, we have assumed that 2.3% remains broadly reflective of CPI given market moves.

Whatever the assumption for CPI used in the funding assessment, the level of pensions are sensitive to changes in the actual level of CPI. Looking forward, index-linked gilts and/or inflation derivatives now provide better direct protection against movements in CPI inflation, and it is useful to consider whether they have a role to play in the asset allocation.

In our 2020 review, we proposed introducing an allocation to investment grade (i.e. high quality) credit, either sterling credit or global credit hedged to sterling, and funding this by reducing the allocation to index-linked gilts by 2.5% (c£115m). This retained an element of nominal interest rate exposure but reduced the inflation pricing uncertainty around RPI. By allocating to investment grade credit rather than fixed interest gilts, there is a small yield pick-up, net of fees.

LGPS Central established the active Global investment grade bond sub-fund launch in early 2020, and the transfer from index-linked gilts took place in the second quarter. Since, April 2020 investment grade bonds have out-performed index-linked gilts by c.5%.

Implied gilt inflation



Real yields on index-linked gilts are negative and have fallen further over 2020, reflecting the fall in nominal gilt yields, ending November 2020 at -2.3% compared to -1.9% at the year start.

As illustrated in the graph, implied RPI inflation up to 2030 is between 3.0 and 3.5%, and implied inflation for periods of 10 year or more remains at 3.0% or higher. Despite the change to RPI from 2030, implied inflation is broadly unchanged. Even if considering implied inflation for periods from 2030 (i.e. when RPI becomes CPI), implied inflation does not fall below 2.9%. Against a central policy to keep CPI inflation at c2.0%, this suggests a significant premium baked into inflation pricing, particularly over the next 20 years.

Therefore, while we consider hedging inflation sensitivity to be a real benefit in managing funding risk, the current level of index-linked gilts only provides limited protection against inflation, and we do not see current pricing as attractive. **Hence, we do propose a small drop in the strategic allocation to index-linked gilts of 0.5% to 4.5%, recognising the introduction of a 0.5% strategic allocation to cash held by Aegon within their currency hedging programme.**

Real assets other than index-linked gilts

The Fund's allocation to property and infrastructure are currently below the strategic target.

	Current Target	Actual
Infrastructure (incl. timber)	9.75%	8.4%
Property	10.0%	8.2%
Total	19.75%	16.6%

Infrastructure

The current strategic allocation to infrastructure is 9.75%. This includes allocations to Infracapital and Timberland. The core infrastructure allocation is between three managers, namely, KKR (3 closed-ended funds), IFM and JP Morgan.

The actual allocation at end September 2020 was 8.4%. In October 2020, this underweight was partially addressed by committing an additional £25m to the JP Morgan Infrastructure Investments Fund. As is the case with most private investments, this capital will take some time to draw down so the underweight will gradually reduce over time (not allowing for distributions from the closed-ended funds which will also move the allocation).

We understand that LGPS Central are due to launch their infrastructure sub-fund before March 2021. As yet no managers have been selected. **We propose that the LPC delegate to the Officers and ISC that a review of the suitability of the sub-fund be carried out once there is further clarity on this. The expectation is that if the LGPS Central sub-fund is deemed suitable then the underweight to the asset class would be addressed by committing to the Pool offering over 2021. We propose this is also delegated to the Officers, subject to satisfactory completion of the suitability review.**

Property

The allocation to property is further from target. However, we also note that the shape of UK commercial property is in a period of potential significant change. As such we believe it is useful to take a broader, and potentially longer-term, look at how the property market might be expected to evolve, in order to consider how best to shape the portfolio.

The current holdings and strategic allocation to property is 10% as set out below (30 September 2020):

	Holding (£m)	Holding (%)	Strategic weight (%)
Aegon (Kames) Active Value I and II	67.2	1.5%	
La Salle	185.1	4.0%	
Colliers	126.2	2.7%	
Total	378.4	8.2%	10.0%

We note that LGPS Central provide a monitoring role for the Fund in respect of the current holdings.

Evolving property market

The UK commercial property market was already changing pre-pandemic, but 2020 has accelerated many of the trends that were underway, and are unlikely to fully reverse post-pandemic. Brexit potentially brings additional short-term uncertainty.

So, an important question for strategic investors is what a property allocation will look like over the longer-term.

We expect UK balanced property funds to transition to a more defensive allocation with even more focus on properties with longer leases and high-quality tenants. This will mean moving away from retail to focus more on industrials and resilient alternatives, including residential.

In order to keep ahead of this transition, investors may choose to make specific capital allocations to newer parts of the UK property market, such as residential, in order to diversify exposure and help mitigate the risk of lower returns over the short and medium-term facing some sectors of the UK commercial property market. Alternatively, investors may see portfolios evolve through existing mandates. Investors may also look to diversify into the broader global property market to complement current allocations to UK commercial property.

There is a growing availability for specialist funds, and the La Salle mandate allocates across a range of these. The Aegon funds focus on delivering higher returns than the broad market through investment in smaller higher yielding properties. Alternative strategies will be sector specific or include elements of development or re-purposing of properties.

We note that of the two Aegon funds, performance of Fund I has lagged the property market over the 12 months to September due to capital losses, reflecting above average voids, pre-pack administrations and some tenant non-payment of rents (such as Sportsdirect). Fund II has fared better, with rent recoveries above the manager's expectation, smaller capital losses and returns remaining above the broader market.

Further analysis of our outlook for longer-term commercial property is included in Appendix 2.

We understand LGPS Central have plans to launch a direct property sub-fund in June/July 2021 and an indirect property sub-fund at some point in the future. We expect these could provide an opportunity to address some of the changes affecting the property market.

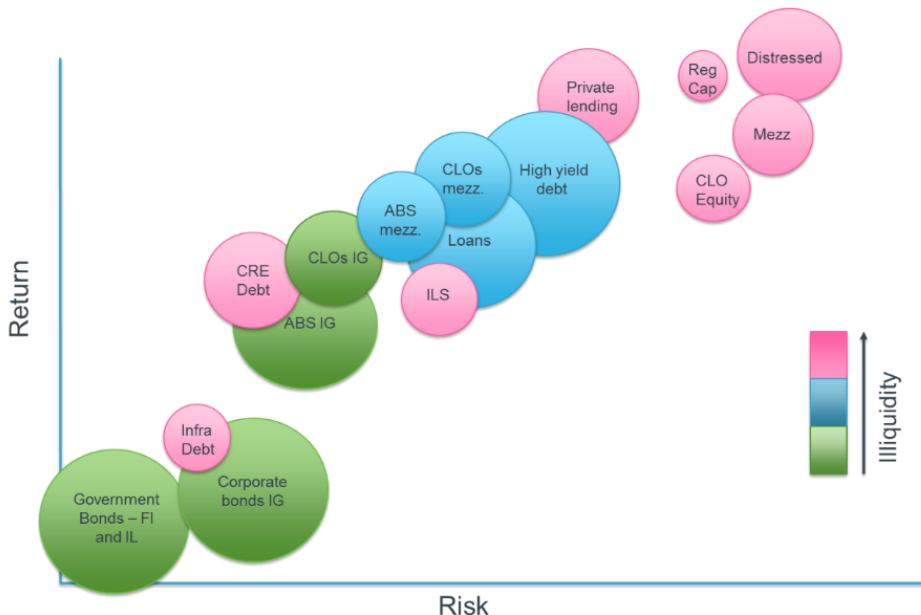
We remain comfortable with the current strategic target allocation of 10%. Given our continued cautionary view of UK property, we do not see any short-term pressing need to increase the Fund's allocation towards target.

However, we suggest the LPC delegate to the ISC to review the property allocation during 2021 and to consider scope to incorporate residential property into the strategy as a diversification from pure commercial exposure. We would expect this to be considered alongside discussions with LGPS Central on what property offering they expect to provide, and for consideration to be given as to whether the Fund's existing managers could provide additional exposure to residential property.

Furthermore, we propose the Officers and ISC review the LGPS Central funds when further details are available, to consider their suitability for ongoing use by the Fund for its property exposure, and for the Officers to report back to the LPC before any further action is taken.

10 Credit assets

As set out in previous reviews, we believe it makes sense for the Fund to continue to hold a meaningful strategic allocation to the predictability of returns provided by diversified higher yielding credit. These assets offer attractive strategic yield, with predictability in returns over time.



The Fund currently has exposure to both of liquid and private debt markets.

Investment grade credit

As part of the 2020 strategy review, the allocation to index-linked gilts was reduced and the proceeds invested into the LGPS Central investment grade credit sub-fund. This allocation is 2.5%.

The Aegon currency hedging programme holds cash to provide a margin for managing current settlements. Typically this is around £50m or 1.0% of Fund assets. Recognising that cash yields are low, and even negative net of fees, we propose the Officers and ISC are delegated to review the Aegon Short Dated Investment Grade Bond Fund and subject to satisfactory due diligence, to give Aegon the discretion to allocate up to £25m (or c.0.5% of Fund assets) of the cash currently held by Aegon to manage the currency hedging programme into the Short-Dated Investment Grade Bond Fund. This will generate a marginal extra yield relative to cash, whilst retaining liquidity and limiting drawdown.

The Fund also holds additional cash at times, either due to commitments made but not yet funded, or due to net cashflow generated from investments and contributions relative to outgo. We note the allocation to cash is currently 2.9%. Subject to due diligence and advice on relative yields available, we propose the Officers are delegated discretion to use the Aegon fund, or any alternative fund reviewed and considered appropriate by the ISC, as a short-term alternative to holding cash.

Liquid multi-asset credit

The Fund currently holds a small allocation to the JP Morgan multi-asset credit fund (c.£29m, 0.6%) for historic reasons. As part of the 2020 strategy review, it was agreed to increase the liquid multi-asset credit ('MAC') allocation to 4.0%. The intention was that this allocation would be achieved using the LGPS Central MAC sub-fund (subject to due diligence). LGPS Central did not launch their MAC sub-fund over 2020. The expected launch date is now March 2021.

In December, LGPS Central announced that the sub-fund would be comprised of a 50/50 split between BMO Global Asset Management and Western Asset Management. Due diligence on the sub-fund is due to be carried out in the coming weeks.

Subject to completion of the due diligence, **we recommend that the LPC delegate to the Officers and ISC implementation of the target allocation to liquid multi-asset credit.** The expectation is that the existing small allocation to JP Morgan MAC would be transferred into the LGPS Central sub-fund, with the remaining allocation funded from a pro-rata disinvestment from the Fund's three Targeted Return managers and cash.

We understand that the liquid MAC sub-fund may include up to a 10% allocation to Emerging Market debt (EMD). Unless there is a material overlap with the LGPS Central Emerging Market Debt sub-fund, **we would not propose adjusting the standalone allocation to EMD.** However, this should be considered as part of the due diligence.

Emerging market debt

The 2.5% strategic allocation to EMD provides diversification from other higher yielding debt markets. The actual allocation at end September 2020 was marginally underweight relative to target at 2.3%.

LGPS Central launched their EMD sub-fund in during 2020. The Fund transitioned the existing EMD holdings with Ashmore to the LGPS Central sub-fund in December.

We remain comfortable with this allocation and do not propose any changes.

Private lending

The Fund currently has investments in three private debt strategies. The strategic allocation, allowing for the M&G distressed debt and CRC capital release programmes, is 10.5% of Fund assets.

30 September 2020	Holding (£m)	Weight (%)	Strategic Allocation
Partners Multi Credit Funds (private lending)	280.4	6.1%	10.5%
M&G DOF strategies	63.3	1.4%	
Christofferson Robb	46.9	1.0%	
Total	390.5	8.5%	10.5%

The Partners allocation is across 4 vintage funds. The final capital call for the Partners MAC V fund was called in October 2020, so the actual weights will be slightly closer to target than the end September figures above suggest. However, we also note that the earlier vintages of the Partners MAC funds are continuing to return capital and as such it will be necessary to continue to top-up this allocation over 2021.

We continue to consider private lending a useful opportunity for institutional investors to access attractive yields with an illiquidity premium.

LGPS Central have no plans to deliver a private lending solution for Central Funds, and it will not be included in a multi-asset credit solution. Hence, the Officers and ISC would need to continue to review and allocate directly to private lending managers in order to maintain its target strategic weight to private lending.

Credit market opportunities

There remain some dislocations in a number of markets in the wake of the pandemic. There may also be more opportunities arise, depending upon how the global economy and markets develop from here. Below we highlight two such opportunities in the credit market and consider whether it would be appropriate and possible for the Fund to access these opportunities.

Special Situations Financing

Special Situations Financing is an extension of Core Direct Lending rather than a distinct asset class. It aims to deliver an enhanced yield by providing bespoke solutions to fundamentally strong businesses facing specific challenges or strategic opportunities relating to the pandemic. The terms available are more attractive than mainstream direct lending, partly because of the challenging circumstances borrowers face, partly because levels of competition in this segment of the market are lower.

The focus on strong borrowers and conservative loan structures means that this opportunity has a lower risk profile than distressed debt. Market participants expect the opportunity to remain attractive for the next 12-18 months as new financing opportunities emerge and for the strategy to deliver an unlevered, net return in the range 10-12% p.a.

The supply of opportunities is expected to be strongest in sectors that have been directly impacted by the pandemic, e.g. traditional retail (discretionary purchases), leisure, hospitality, consumer services and public transportation, and sectors that were facing transformational change before crisis began.

The Fund's existing direct lending manager, Partners Group, focus on more 'vanilla' corporate lending with a lower margin and do not have a product which specifically focuses on special situations. Any allocation would therefore require a new manager. **For these reasons and recognising the desire not to add new manager relationships at this time, we propose that no further action is taken with regard to this potential opportunity.**

Distressed debt

Distressed debt focuses on investments where a borrower's debt burdens have become unsustainable. It typically involves restructuring 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.

The supply of distressed debt opportunities fluctuates widely over the cycle. The economic disruption caused by the pandemic is clearly going to lead to more restructuring and the provision of financing for distressed debt, though it may be 6-12 months before the opportunities emerge.

It is expected that the opportunity will persist for several years particularly given the severity and likely prolonged duration of the current economic contraction. Unlike other opportunistic investments, it may well be preferable to commit capital in 12 months or so after the crisis has subsided and it becomes clear where the best opportunities lie and at what price they can be purchased.

The Fund already has exposure to distressed debt via the M&G Distressed Opportunities Fund ('DOF') range. In Q3 2020, it was announced that Paul Taylor, Head of Restructuring and the leading fund manager for the DOF strategies, would be leaving the team with his responsibilities passing to the deputy fund managers, Andrew Amos and Rafael Cerezo. Given the significance of Paul's departure we would not recommend that the Fund commit to the most recent vintage of the DOF funds ('DOF V') at this time.

Rather **we propose that the Officers and ISC revisit the M&G DOF team and distressed debt opportunity during the course of the year, once the new team structure has had time to bed in.** Given the expectation that the opportunity will persist and may be preferable in 6-12 months time this feels like the appropriate course of action until comfort is gained around the new team.

11 Summary of recommendations

Recommendations

We propose only modest changes to the Fund's investment strategy, reflecting market views and opportunities and the Fund's actual asset allocation:

- 1% increase in the strategic allocation to private equity;
- Adjustment of the benchmark currency hedge ratios used in the Aegon currency hedging mandate from 50% to 30%; and
- Subject to due diligence, introduction of a 0.5% allocation to short-date corporate bonds as an alternative to cash held by Aegon to support the currency hedging programme.

We set out below a summary of our proposed strategy. We have presented the strategic allocation using the GRIP asset framework.

	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 manage 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	

Given the proposed changes are marginal, the strategy broadly retains the same broad level of expected return and volatility as the current strategy.

Implementation of the strategic changes will be subject to due diligence of the respective underlying funds. The expectation is that over 2021 further progress will be made transitioning the Fund's assets into the LGPS Central Pool as new sub-funds become available. This will be a significant area of focus for the Officers and Committee as it will be necessary to assess suitability of the offerings prior to any transition.

Appendix 1 – Currency hedging

Strategic objectives

Investors may have different potential strategic objectives when they choose to manage the currency risk associated with equity exposure. The most common is to reduce the risk as measured through volatility of returns.

Additional aspects to consider when reviewing strategic currency hedging objectives are:

- To reduce volatility associated with funding, i.e. considering overall volatility of assets and liabilities, not just that associated with equities;
- Scope to reduce the downside volatility in times of market stress;
- Current valuation and specific risks associated with sterling or other currencies; and
- Avoiding material calls on cash calls to settle currency losses on the hedging programme which might lead to having to sell other assets at times of market stress.

We believe the additional objectives of managing funding volatility and downside volatility in times of market stress to be a worthwhile extension of the core objective to reduce return volatility, if these objectives can be harnessed.

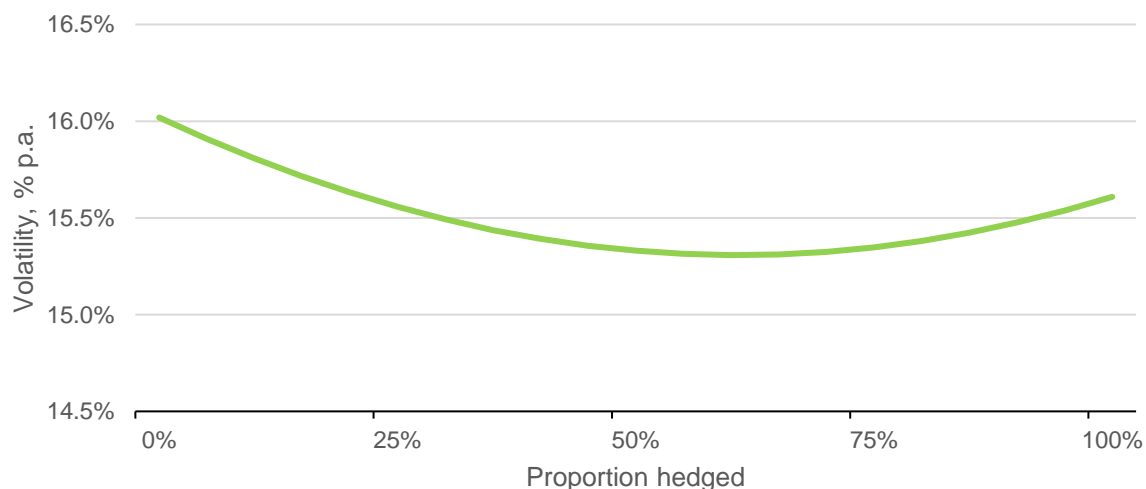
In addition, active currency management can be seen as a source of additional returns. The Fund has employed managers for standalone active currency mandates in the past, but no longer holds any mandates with the sole aim of adding value through active currency decisions.

Currency hedging to reduce equity return volatility

Whilst the vast majority of a global equity portfolio's volatility comes from the volatility of the stocks that comprise the equity market, currency movements add to that volatility of returns.

We show below how a degree of currency hedging is volatility reducing. Volatility of the unhedged global equity market returns over the period shown is 16.0% p.a. Volatility of the currency hedged return is 15.6% p.a.

Historic volatility of global equity portfolio versus proportion of currency hedged



We note that the main benefit in terms of risk reduction is gained through the first 50% of hedging. Hedging more than 50% either doesn't have any further effect or, with much hedging levels above 70%, may actually result in volatility beginning to increase again.

We also note that whilst the analysis uses data covering over 30 years (1988 to 2020), the shape of this chart is not constant for all time periods. However, if there are no material costs associated with currency hedging or persistent loss of return, it suggests some currency hedging of the equity portfolio will reduce volatility associated with returns.

When considering equity volatility reduction on a standalone basis, this suggests that the optimal level of currency hedging is between 50% and 70%.

A strategic hedging target of 50% is also consistent with the simple principle of avoiding the maximum impact of currency movements, in the absence of any certainty over the direction of currencies, i.e. half right.

Scope to reduce funding volatility

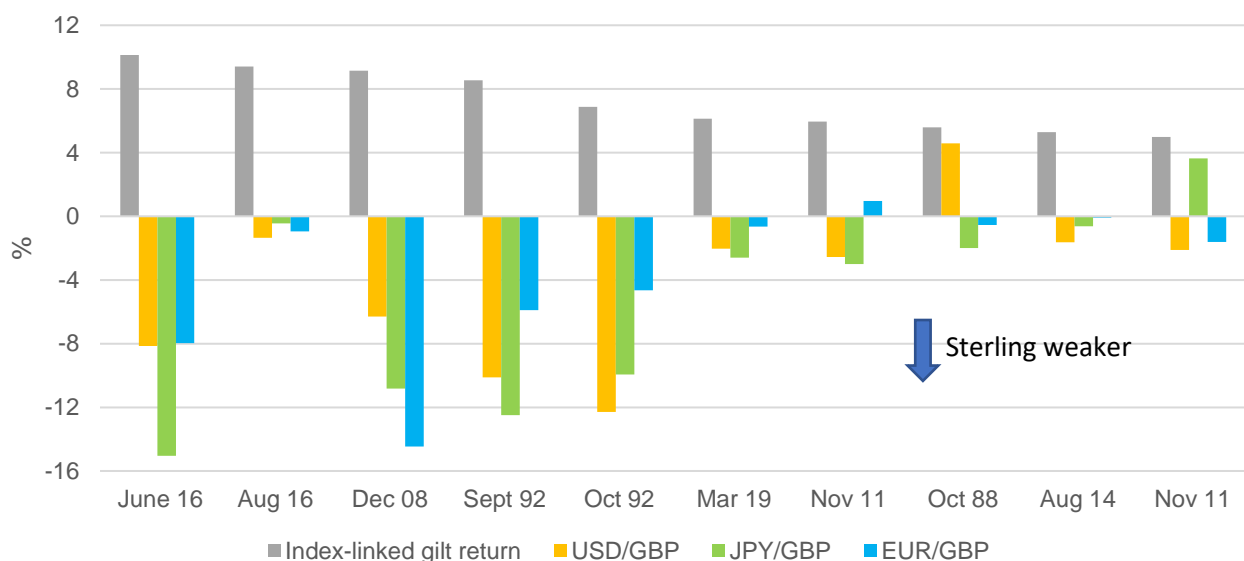
The analysis above looks at the equity holdings on a stand-alone basis. However, consideration should also be given as to how currency risk interacts with other investment risks that affect funding, particularly interest rate and inflation risk.

For example, if real gilt yields fall, we might expect sterling to depreciate relative to other currencies as, all else equal, the factors which tend to reduce real yields (i.e. lower growth expectations and/or higher inflation) also tend to weigh on a countries' exchange rate.

In such a scenario, having some currency exposure may act to offset the impact on the funding level associated with lower real yields or higher inflation, and would therefore help to manage risk at an overall Fund level.

The chart below illustrates how consistently a sharp fall in index-linked gilts (which increases the value of liabilities if based on a traditional gilts + inflation type discount rate) is correlated to a fall in sterling. Looking at more data points, the correlation is reasonably consistent, with a correlation of between 0.2 and 0.5. The picture is similar if considering the best months of fixed interest gilt returns.

Change in USD/GBP, JPY/GBP and EUR/GBP in best 10 months of index-linked gilt returns since 1987



Source: DataStream. Hymans Robertson calculations

For schemes that already hedge a material proportion of their inflation linked liability risk through holding index-linked gilts, this risk is already managed, supporting the use of currency hedging. However, **where there is little direct inflation asset exposure, retaining some unhedged currency exposure appears helpful in managing funding risk.**

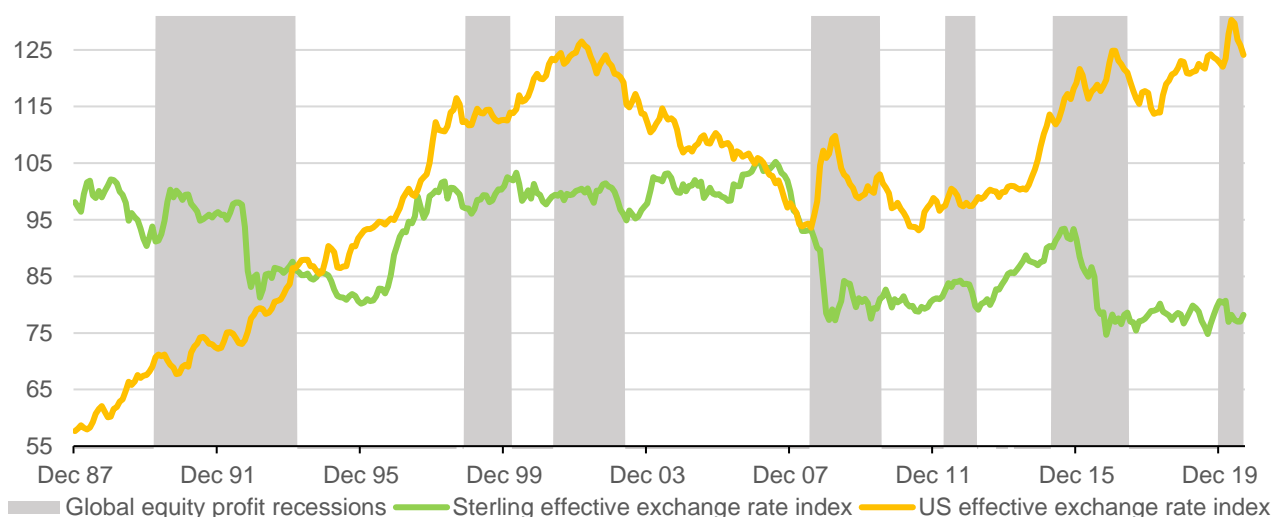
We note however that results will be somewhat dependent upon the time period considered.

Reducing volatility in market stress: sterling performance in periods of economic weakness

Whilst historically sterling may have been seen as a safe-haven currency, there is little evidence in the more recent past of the last three decades to suggest sterling benefits from so-called “safe-haven” status.

As illustrated in the next chart, the sterling effective exchange rate index has weakened in 6 of the past 7 global equity earnings recessions since 1987. Conversely, in line with its “safe-have” status, or perceived tendency to appreciate in times of market stress as the global reserve currency, the US dollar effective exchange rate index has risen over the course of 6 of the last 7 global equity earnings recessions.

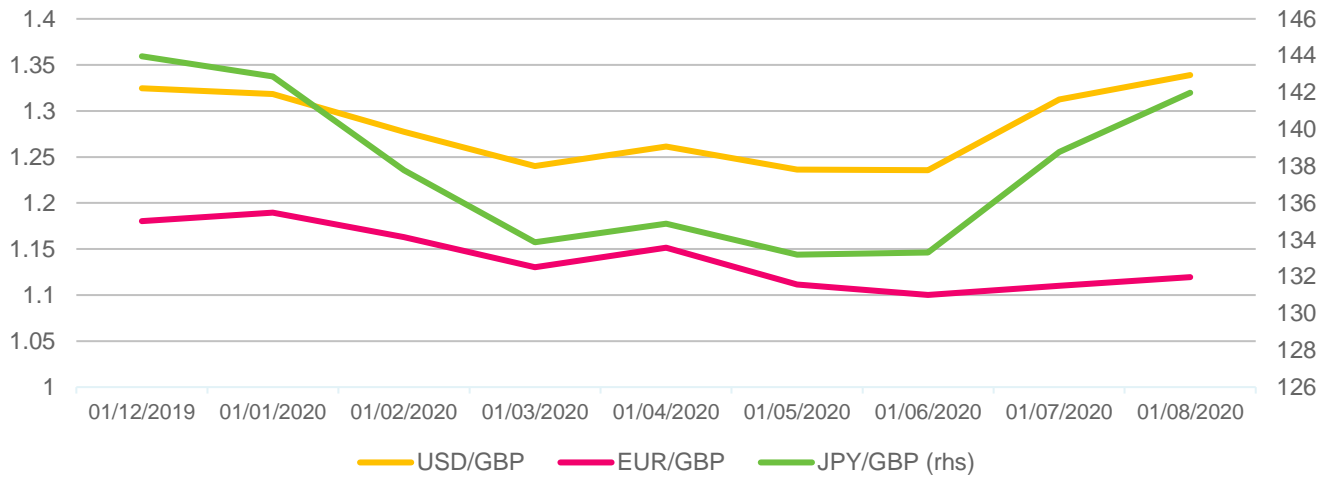
Sterling and US dollar effective exchange rates



Granted the 1990-94 global earnings recession coincided with the UK’s ejection from European Exchange Rate Mechanism, but the incident highlighted characteristics of the UK economy which made it susceptible to the rapid depreciation that followed – namely, twin current and fiscal account deficits and high relative inflation at the time. The 2015-17 global earnings recession, of course, coincided with the surprise outcome of the vote to leave the EU. Anticipation of a supply-side, and hence inflationary, shock from disruption to trade and labour markets, alongside the UK’s persistent twin deficits, and hence ongoing dependence on capital inflows, resulted in a sharp depreciation in sterling.

Most recently, in the first quarter of 2020 on the back of the Covid pandemic and recognition that it would affect the global economy and trade, sterling depreciated sharply. Sterling potentially suffered from being an economy dependent on global trade and the relative size of central borrowing packages announced.

Exchange rate movements 1 January 2020 to 31 August 2020



Since the pre-crisis levels in mid-March 2020, sterling has fallen 10% against the Euro and 5% against the Yen, but is now back to similar levels against the US dollar (perhaps more a reflection of a recent weakening dollar rather than strong pound).

The relative weakness of sterling in times of market and economic stress is something that we consider a likely feature going forward. In isolation, this suggests retaining a lower level of currency hedging than the neutral 50-70% range identified earlier.

We have also looked at whether there is a strong reason to apply a different level of hedging to one of the core currencies. The analysis shows a higher correlation between rises in inflation linked gilts and the fall in sterling relative to the yen, but given the relative size of the Japanese equity market within global equities, not so much so as to justify a different target level of hedging.

Current valuations

Given the longer-term depreciation of sterling since mid 2015, unhedged global equity returns to a sterling-based investor have been higher than the hedged returns.

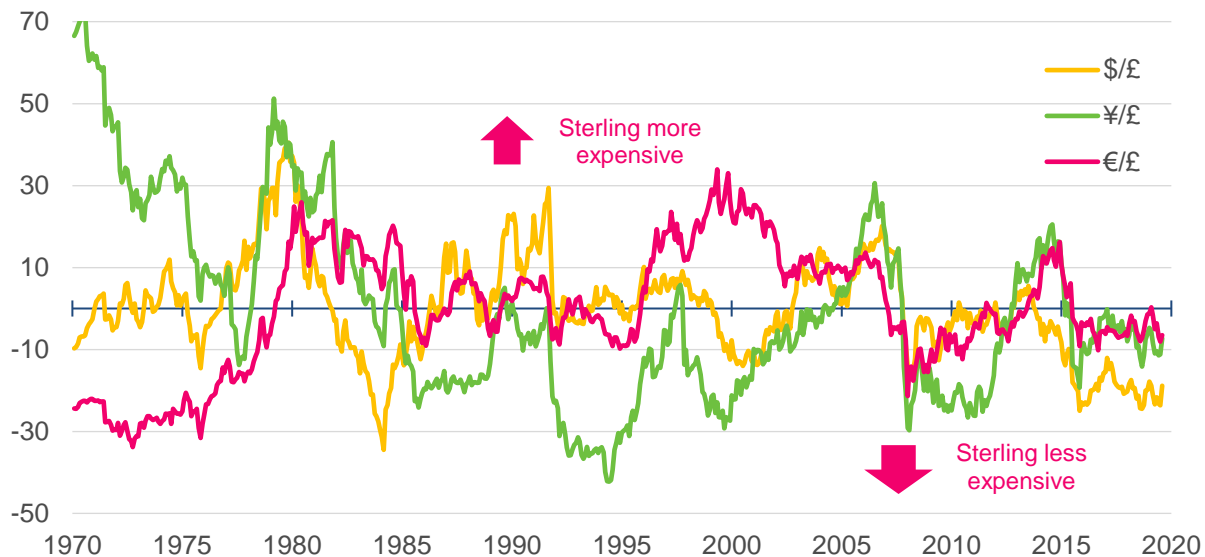
Hedged vs unhedged equity returns Dec 1987 – Aug 2020



Purchasing power parity (PPP) theory asserts that changes in inflation differentials between regions will be offset in the long-term by an equal and opposite change in the exchange rate, i.e. an exchange rate should adjust to allow for relative inflation between two countries over the long-term, so that prices for products and services are the same in each. However, history also tells us that exchange rates may diverge from “fair value” for several reasons and for considerable periods of time. As such, forecasting short-term exchange rates is notoriously difficult and is why many investors simply choose to hedge all or no exposure or select an arbitrary proportion.

The chart below shows the deviation in inflation-adjusted exchange rates from long-term average.

Real sterling exchange rates deviation from average since 1970



The chart would suggest Sterling is currently less expensive, and might suggest a higher level of currency hedging would be appropriate. However, exchange rates can, and do, diverge considerably from PPP benchmarks and longer-term inflation adjusted averages for several reasons:

- Economic – relative GDP and/or productivity growth, inflation and interest rate differentials
- Financial – current and fiscal account balance and asset flows
- Political uncertainty

This can lead to periods of under- or over-valuation even if, over time, currencies do tend to oscillate around longer-term inflation-adjusted averages and market forces, not least the scope for arbitrage, tend to limit their deviation, returning them towards these levels.

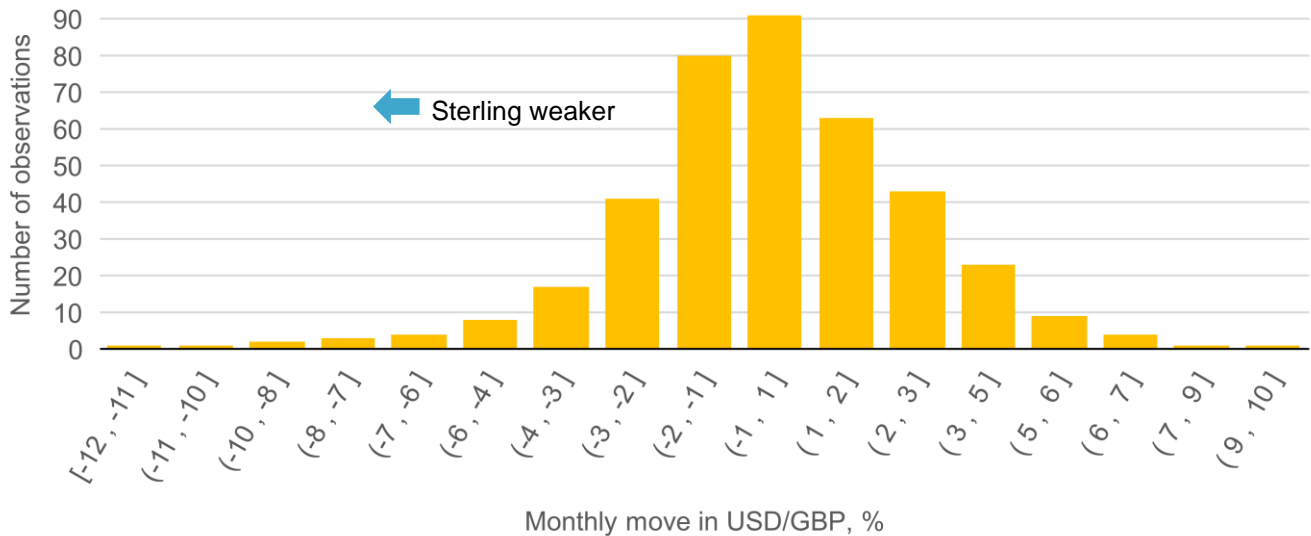
Looking forward, a premium for holding sterling might not seem unreasonable given the potential headwinds and ongoing uncertainty around the implications for the UK exit from the EU.

On balance, we do not think there is any reason to adjust the strategy currency target on valuation grounds, at least in the short to medium term.

Capital requirements and costs of running a hedging programme

When a currency contract expires, one party has to make good its position to the other reflecting the movement in exchange rates since the contract was implemented. The chart below illustrates the range of monthly movement between sterling and the US dollar (by far the Fund’s largest regional equity holding).

Monthly moves in USD/GBP, frequency of occurrence since 1987



The chart shows that most monthly moves in sterling versus the dollar are between +/-3%, with only 2 observations of a fall in sterling of 10% or more.

Reflecting one of these extreme events, we note that during the latter part of February and first three weeks of March this year, sterling collapsed vs the Yen, Euro and US dollar by around 12%.

On a programme of c.£850m, that meant a potential settlement of £100m. Given the hedging position was only covering 50% of the Fund's equity exposure, it should be noted that the Fund had made £200m due to the same currency movements on the equities held. However, equities had fallen in value, and hence selling equities to settle the currency hedging would mean locking in the capital losses.

Rather than selling equities, Aegon hold a cash reserve of c.£50m as at 30 September 2020, and they also have access to index-linked gilts which they can sell.

In the normal course of events the flow of profits due to sterling strengthening or capital calls due to sterling weakening will be modest. However, the Fund needs to have access to capital in order to meet any settlement on currency losses. **At the margin this tends towards a hedging target at the lower end of the acceptable range.**

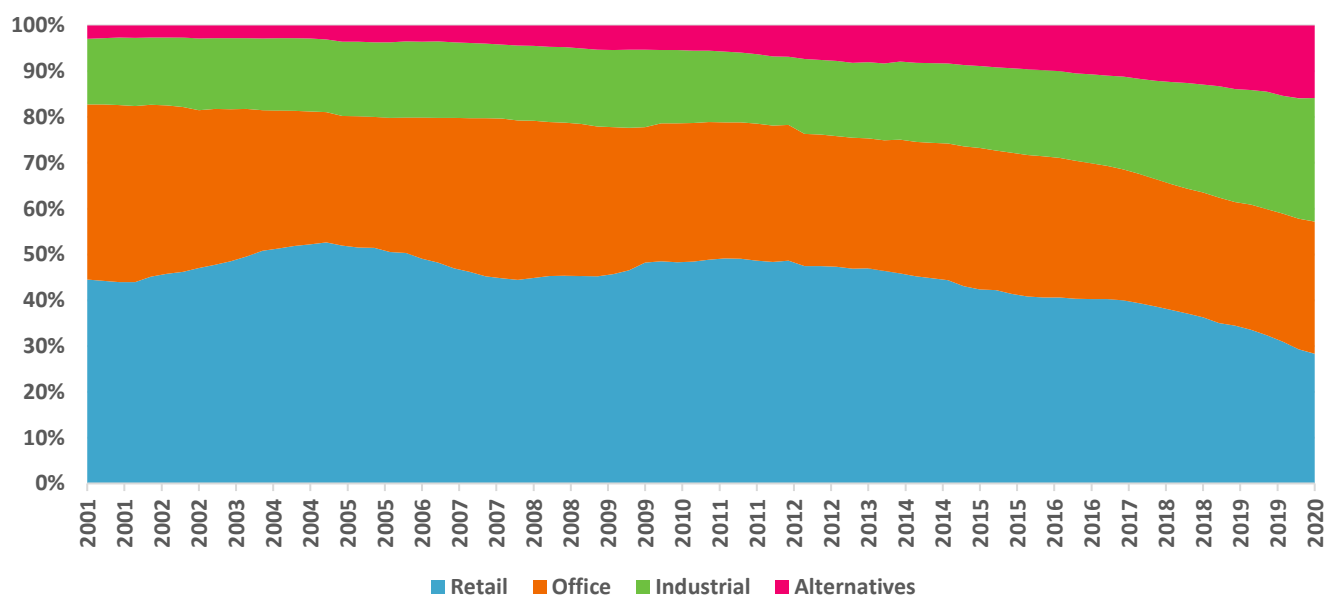
Finally, we note that implementation costs will be dependent on mandate size but are typically a few basis points and should not therefore overly influence the validity of a currency hedging strategy.

Appendix 2 – The future for property

Introduction

The UK property market has been undergoing structural change for a number of years, attributable to changes in urbanisation, demographics and investor sentiment. As Chart 1 shows below, the makeup of the broader market (represented here by the MSCI UK Quarterly Property Index) has been changing over the last two decades.

Chart 1 – Sector Composition of MSCI UK Quarterly Property Index



Source: MSCI.

As the chart shows, retail represented just under half of all property investments in 2000 but this exposure has seen a decline to around 30% today, a trend that is expected to continue. Conversely, the industrial sector, which includes warehouses, manufacturing premises and logistics & distribution facilities, has been increasing its share over time, largely due to the increased demand for large distribution and logistics units. This trend is expected to continue but the increased presence of larger distribution and logistics facilities could make the sector more cyclically exposed to any decline in the economy amid lower consumer spending, reflecting the switch in consumer buying behaviour from high street to online. More recently, the office sector has experienced a decline in market share, pointing to a more recent trend towards flexible and remote working. Finally, the proportion of the UK property market represented by alternatives has grown to 15% and is expected to increase further; CBRE projections suggest exposure to move from 15% today to 25% by 2030.

This paper examines recent UK property market performance before examining existing structural trends and the impact of the pandemic in either accelerating or stalling these trends, looking across each of these four sectors. We also explore how these changing market dynamics are likely to influence property returns going forward and discusses some of the ways that investors can reposition their portfolios over the coming years.

Recent UK property market performance

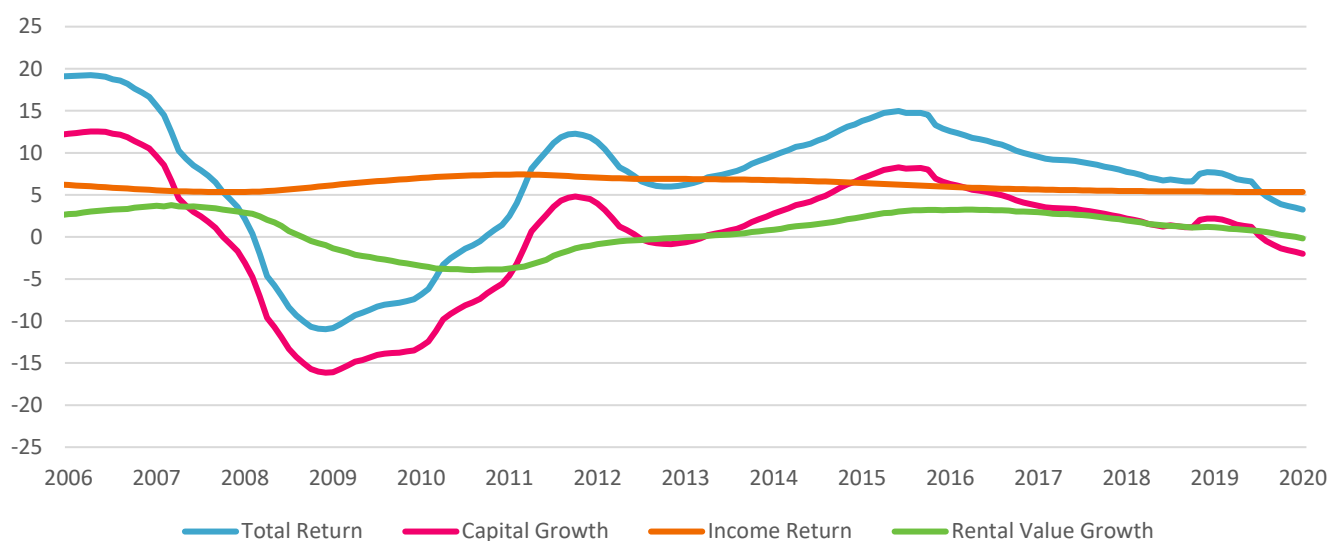
Before we describe the changing picture within sectors, it is important to understand how UK commercial property has performed over recent years, both before and during the onset of the pandemic.

There was a concern even pre-pandemic that elements of the commercial property market were in the downturn phase of a cycle. However, the timing of the pandemic means that a normal market cycle cannot be presupposed. In fact, the future of all sectors will be affected by the shape of the economic recovery, affecting recent and future performance.

The Bank of England indicated in August that it expects unemployment to reach 7.5% by the end of 2020, assuming a UK-EU trade agreement deal and assuming an extension of the furlough scheme. While there have been extensions to the furlough scheme, a trade agreement by 1 January 2021 remains uncertain at this stage.

Hence, relative to the Bank of England position, on the downside, there is therefore the potential for no EU trade agreement, a continuation of further national lockdowns to control pandemic waves, or if a vaccine is slow to be distributed.

Chart 2 – Rolling 3 Year Returns of the MSCI UK Monthly Property Index (All Property 2006-)



Source: MSCI.

The chart above shows that the returns for the UK property market have been falling since early 2016. This includes both the total return and capital return which were on an upward trend until Brexit-related uncertainty caused both measures to trend downwards. The chart shows that despite the Brexit-related uncertainty, the stability of income has remained, with the income return remaining just above 5% p.a. Rental growth has also been on a downward trend since 2016 reflecting the uncertainty that Brexit has had on the property market.

While this chart shows how the broad UK property market has performed, it masks significant sector divergence, with the industrial sector performing far stronger than the retail sector in particular which has been under significant structural change (we explore this later in this paper).

The UK property market saw an initial steepening of capital value falls in the early months of the pandemic, causing total returns to fall, although these have since moderated. Although all sectors have fallen, the retail sector has been the standout poorest performer so far this year.

Sector analysis

We now explore the changing dynamics in each of the four main property sectors:

- retail;
- industrials,
- offices; and
- alternatives.

Retail: All doom and gloom?

Coming into 2020, the wider UK property market performance was already being dragged down by the retail sector. In 2019 16,073 store units closed across the UK with over 143,000 total job losses. This trend has continued into 2020 with 13,868 stores closing and job losses numbering over 125,000 so far in 2020 (up to 1 September), with this number expected to increase to over 235,000.

The pandemic and lockdown have certainly exacerbated a crisis in retail, a sector already struggling with a combination of the shift of consumer behaviour to online shopping, a slowing of consumer spending since 2015 and fierce competition amongst retailers. The growing number of vacancies paired with the fact that investors are actively looking to reduce their retail exposure over the last few years has meant that capital values and overall performance of the sector has taken a significant hit.

Given the national lockdown when all non-essential shops were closed, it's no surprise that traditional retail is struggling. Rent collections in retail have been down markedly since March and estimates are that this will continue; although collection statistics vary across firms, Fitch reported three large property REITS collected between 16-36% of retail rents in June 2020, reflecting retailers having had essentially zero or drastically reduced revenues. With the recent extension of the moratorium on evictions until December, there is comment that some performing retailers deferring rents and landlords have little recourse in these situations.

Since shops have started reopening, some cities are seeing a rebound in fortunes. While in London there has been a decline of footfall with levels only reaching around 31% of pre-crisis as at September 2020, the pandemic has changed commuting patterns (and thus spending patterns), meaning that footfall in some smaller regional towns, such as Blackpool and Bournemouth, has actually increased to 141% and 133% of pre-pandemic levels respectively. The obvious uncertainty is whether this is a short-term catch up, and what will be the longer-term trend.

One change coming out of the pandemic is some renewed attention to turnover-based leases, which could help keep some retailers in business. Turnover-based leases see tenants pay rent based on their turnover and how sales perform. Certainly in this model, the landlord has a more active interest and becomes a participant in the store's outcome; while this might result in more volatile and cyclical income streams, we wouldn't expect the use of such leases to become commonplace and, as such, the overall impact to investors is likely to be muted.

On a broader note, uncertainty around retailer performance and rising vacancies across the country will likely add downward pressure to rents, a picture worsened by the macro elements: should unemployment increase considerably or there is prolonged uncertainty, consumer spending will be hit, which will mean further pain for the retail sector in general.

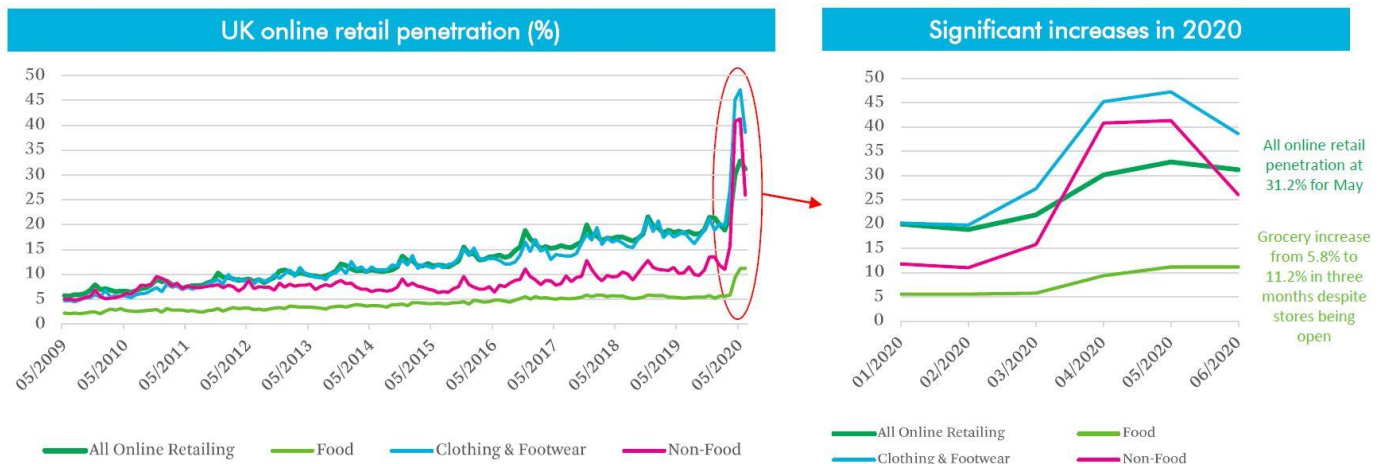
While the traditional retail picture is bleak, there are some potential brighter spots of retail that continue to attract investment. Essential retail, such as supermarkets, are well valued by investors for being typically long-term, inflation-linked leases. As supermarkets have stayed open throughout the pandemic, and even seen an uptick in revenue during lockdown as people couldn't eat out, this particular sub-sector has fared very well. Other asset managers are looking to the future shopping experience with large retail parks (referred to as retail warehouses) anchored by a supermarket or large, well-known retailer. These are expected to fare well as they are naturally better pre-dispositioned for social distancing with spacious, outdoor layouts and also potentially support greater integration of click-and-collect as there is floor space available for storage.

So what will happen with the abundance of vacant or distressed retail stock? If city centres wish to revitalise their high streets, the local councils will likely have to look to alternative uses for properties, which could provide some regional office or residential supply to other sectors.

Industrials: Logistics and the rise of ecommerce

There has long been a rise in online shopping to the detriment of bricks and mortar retail. With the national lockdown affecting non-essential shops, this caused a massive spike in ecommerce activity as spending shifted online. Online ecommerce penetration jumped from 19% to 32% from February 2020 to May 2020 with a slight decrease since. Chart 3 below breaks this out by sector:

Chart 3 – The Growth of E-Commerce in the UK



Source: CBRE and the Office for National Statistics.

Logistics, a sub-sector of industrials, has been a popular allocation for investors for some time. The second quarter of 2020 saw a record take-up for UK logistics property, mainly driven by ecommerce-related functions. This is a spike in activity previously fuelled by tenants seeking to secure both larger warehouse spaces and smaller, “last-mile” facilities close to city centres.

According to Fitch, rent collection in the logistics sector for April-June was 95% with collection rates for “big-box” assets higher than urban warehouses with smaller tenants. This trend is augmented by investor demand for assets in such a resilient sector, which is pushing prices higher, particularly for large warehouses with prime tenants, such as Amazon, and investors need to be selective going forward. Although ecommerce could see a slight impact if consumer spending is reduced, this is not expected to dampen the enthusiasm or expectations for long-term logistics sector growth.

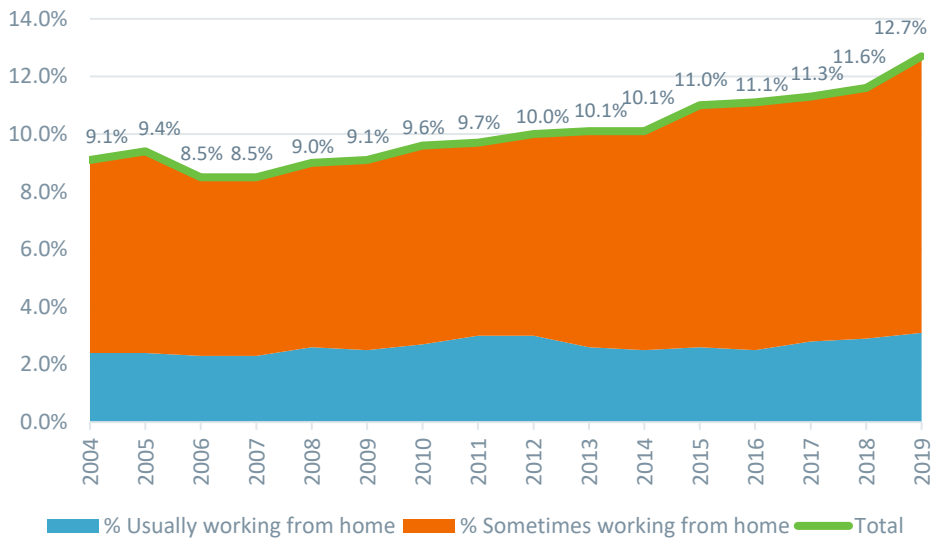
Offices: Working hard or hardly working?

The trend of flexible, or remote working, and for more flexible co-working spaces had begun to grow in favour, in part due to the rise of tech start-ups across the country and the growing popularity of collaborative working spaces made popular by the likes of WeWork.

With lockdown forcing the vast majority of office workers to work from home, this trend has become the “norm”, and there have been many articles about the death of the office. While these concerns may be overstated, there has certainly been a sentiment shift amongst workers and companies are taking heed and re-examining their office space requirements.

Pre-pandemic, employees who were working from home at least part of the time were a relatively small proportion of the workforce but had been growing as demonstrated in Chart 4.

Chart 4 – The Rise in Home Working



Source: Federated Hermes and Morgan Stanley Research.

A survey by Morgan Stanley has indicated a significant acceleration of this trend with all demographics and sectors indicating a preference to work from home more frequently in the future. There has been deterioration in sentiment for offices, with 93% of respondents to the RICS Q2 survey expect businesses to cut back on their office space requirements to some extent. A more recent survey by the Institute of Directors also reflects this trend with over 50% of executives planning to cut office space after the pandemic, with over 21% indicating this cut is likely to be significant. In addition, nearly three-quarters of the executive respondents indicated that they would encourage staff to increase working from home post-pandemic. This change of demand is set to change the dynamics of office sector, but we may not see the impact for a few years as companies are unlikely to break current leases and will make any changes at lease renewal stage.

However, we do not believe the pandemic spells the death of the office overall. The office remains important for both employers and employees. The office promotes cohesion, collaboration and brand recognition, and there is no question of the importance of the social aspect in this regard and the broader mental health wellbeing for most employees. However, office space originally marked for fixed desks may instead become more collaborative working spaces with increased hot-desking.

For investors, it is expected that location becomes even more important: well-located, best-in-class assets, with a strong ESG profile, will maintain the most robust valuations. However, as with all sectors, office demand could be affected by the economic recovery: a lack of economic recovery will likely lead to corporate insolvencies and increased layoffs and unemployment.

Alternatives: Mixed fortunes

Alternatives is a catch-all sector for assets outside of the main three sectors: retail, office and industrials. Within alternatives, hotels and residential (typically purpose-built rental accommodation rather than individual houses and flats) are the most established sectors, but there has been a more recent emergence of student accommodation and healthcare underpinned by similar fundamentals: changes in demographics, a rise in middle-class incomes and urbanisation.

Residential property has, by far, proven itself to be the most resilient sector during the crisis and this is no real surprise as it is expected that the population will continue paying for its housing costs whenever possible. The Private Rented Sector (PRS) is a nascent sector in the UK but is quickly gaining traction, although there is very limited supply. Given the resilience and supply and demand factors, this will continue to be a sector of interest for investors going forward.

Other sectors within alternatives have had a much more mixed picture. UK hospitality has seen a bifurcation in performance. On the one hand, business hotels in city centres have suffered dramatically and have uncertain futures given the lack of business travel and the uncertainty over whether (or even if) business travel will normalise back to pre-pandemic levels. On the other hand, hotels positioned to take advantage of the UK boom in domestic holidays are performing beyond expectations.

Investment in student accommodation has risen over the last few years and one would expect the pandemic to cause challenges in this sector. While we may have expected the pandemic to have discouraged foreign students (or at least encouraged deferral of places), for high quality assets linked to red brick universities, there has been no change in performance. In fact, initial data shows lower than expected vacancy rates as universities have taken on more domestic students. A key question is the extent to which this persists.

With the healthcare sector, it remains to be seen how it will fare through the pandemic. While an ageing population had meant a rise in care homes and investment as a sector, the sector has suffered general reputational damage due to its handling of the pandemic and the fact that care home residents suffered more than the general population.

Income based property

Long lease property funds invest in a subset of the UK property market, specifically targeting properties let to (typically higher quality) tenants on long, index-linked leases typically in excess of 15 years. Long lease funds have invested in a wide range of sub-sectors including supermarkets, leisure, offices, medical facilities, hotels and student accommodation, where the income stream is expected to be robust and sustainable. The resilience of these sectors throughout the pandemic has been mixed: given the long duration requirement of lease agreements, long lease property funds have avoided significant exposures to the troubled parts of the UK retail sector (high street retail and shopping centres), and have benefitted from exposure to supermarkets. However, exposures to hotels, leisure and student accommodation has seen the biggest immediate stress due to a fall in rent collections amid the lockdown enacted in March.

Commercial ground rents can be considered an extension of long-lease, with even greater value placed on the income rather than residual values. The main security for holdings, other than tenant quality, is the over-collateralisation provided through vacant possession values being greater than the value of the ground rents. While the pandemic has placed greater pressure on rent collection than long lease funds given exposure to leisure sector, this vacant possession value provides protection to valuations, so long as vacant possession values do not decline materially too.

We have explored many of these sectors above and to date rent collection on long lease funds has been stronger than the broader market, but it should be noted that the starting yield on long lease property is typically lower than for the broader property market (reflecting the expected security of income) and any tenant credit event can therefore impact the stability of future returns.

A reduction in broad market rents that leads to overrenting of long-lease properties would also affect residual values. Any reduction in rent collection and increasing concerns about the short-term prospects of some sectors that long lease funds target, predominantly leisure and student accommodation, means that the near-term outlook for these elements of some long lease funds is less predictable as this pandemic continues, but we have

greater conviction in the medium and long-term prospects of long lease funds compared to core balanced property funds.

Forward-looking return expectations

As is expected in times like these, any forecasts for economic growth are ever-changing in the face of changing expectations for economic recovery and potential lockdowns. The UK is now officially in a recession. In July 2020, UK GDP had recovered 18.5% above its low in April but still remained below Q4 2019 by some 11.5%. For Q3 as a whole, the expectation is that GDP will be around 7% less than Q4 2019. However, there are differing views, even within the Bank of England, as to how protracted the recovery will be amid assertions that some sectors may not fully recover.

For property specifically, capital values at an aggregate level fell through the first half of 2020. However, it is hard to base too much certainty about the outlook on these figures - the few transactions that have been completed have focused on prime, i.e. best in class assets, and there hasn't been much of a move in pricing for these assets. The temporary protections such as government support, moratorium on evictions, and lenders overlooking covenant breaches has removed motivation for any stressed or distressed sellers. While there is some stability coming through in the data, it could be seen as a potential "false dawn" if there are more insolvencies and unemployment to come and, in this scenario,, once transactions normalise, it's likely that values would fall further.

Many property managers we have spoken to expect capital value declines to continue into next year, with CBRE predicting a total fall peak-to-trough across all property of about 15% over 11 quarters with the expected trough in H1 2021. This compares favourably to corrections in the past with the Global Financial Crisis peak to trough decline being 40% over 8 quarters and the 1990s correction which took 14 quarters and a value drop of 25-30%. This smaller peak-to-trough is mainly attributable to the monetary policy backdrop with low yields across the board.

With this unprecedented low yield environment, property yield spreads are relatively wide versus fixed income yields from a historical perspective. It is expected that this will give some support to values, suggesting less decline than seen in other market shocks.

With capital values likely to continue to face downward pressure well into 2021, total return expectations among those property investors brave enough to make forecasts over the next 3-5 years have low single digit returns for UK commercial property. Income returns should mitigate the declining capital values but we do not believe we have yet reached the bottom of the current property cycle. While rental value growth had been broadly flat over the last few years, in mid-2019 this started trending downwards month-on-month. Void rates on the MSCI UK Monthly Property Index are also trending higher, driven by increased vacancies in the retail sector, and are now above historical averages.

So, what next? Looking further afield

The return expectations outlined above do not compare favourably to returns experienced over the last decade so investors will have to look to other areas in the property sector for attractive risk-adjusted return going forward.

We expect future property allocations among investors could look markedly different to current allocations, which are dominated by the UK core commercial property market sectors. There are potentially two areas of the property market investors may look to target to mitigate against the current risks to UK commercial property.

UK Residential Sector

There is a structural imbalance in the UK housing market with a chronic shortage of supply caused by under-development and an increase in the population. People are renting for longer as it takes a lot longer to save a deposit to buy a house. According to a Government report in 2018, the number of households in the Private Rental Sector (PRS) had doubled in 15 years, with 20% of households now residing in PRS. This is a demand trend we expect to continue, which will further support this nascent sector going forward.

The residential sector has experienced materially more stable rental growth relative to the commercial property market over the last 15 years, with year on year growth typically range bound between +1% and +3%, except in H2 2009/H1 2010 when it dropped to -1%. This compares with the commercial property market, which has varied between a low of -8% (in H2 2009) and +5% (source: Thomson Reuters, DataStream, ONS, MSCI and ASI).

We have also seen the resilience of the sector during the pandemic and expect that it will continue to be the most resilient sector as people typically prioritise paying rent over other expenses regardless of their economic situation. Investing in the residential sector provides diversification to a commercial property portfolio and we consider it to be a good complementary investment.

The residential property market currently only accounts for just over 3% of the MSCI UK Monthly Property Index, although we expect this share to grow over the coming years.

The sector is still relatively difficult for investors to access, reflecting the national lack of supply. As such most investment will require some development risk, and we are seeing focused strategies that sometimes blend an element of social housing as well.

Returns vary according to the sub-sector of the residential market, in particular with higher returns available for the private rented sector compared to social and affordable housing, which is subject to greater regulation. In any event, investors will be potentially need to invest at the construction stage in order to generate returns that are more comparable with historical UK commercial property returns as investing in purely operational assets will deliver returns many consider to be insufficient to make an allocation.

Global Property

On a relative value basis, UK property is currently considered undervalued compared to most of the continent, mostly due to underperformance following the Brexit referendum in 2016 and the ongoing risk premium arising from the uncertainty of a Brexit deal. Once there is more certainty on a Brexit deal (or even no deal and the dust has settled), we can expect international capital flows back into the asset class and yields will begin to compress.

According to LaSalle Investment Management, the UK real estate market in 2018 was only around 6% of global institutionally owned real estate with a regional breakdown as follows: Americas 36%, Europe 28%, Asia Pacific 31% and ROW 5%. While the UK has always been attractive for foreign capital as it is a relatively liquid market backed by a strong legal framework, the benefit of a global allocation to property is the diversification beyond the domestic market provided from an enhanced opportunity set. While there is no doubt that real estate markets outside of the UK are undergoing similar trends, particularly in retail, a focus on resilient sectors internationally would be of benefit to all investors with a property allocation.

It is important to look beyond Europe to include allocations to the United States, the largest and most liquid property market in the world, as well as potentially Asia-Pacific. According to Invesco, the investable universe in transparent and developed markets is estimated at \$19.3 trillion, equating to over 70% of the total global real estate universe.

Diversification through a global property approach brings the benefit of scope for risk reduction both within a portfolio and can reduce the risk profile of the overall property portfolio.

We acknowledge some will have retained scars from investing in overseas property from the global financial crisis when many were left with poor performing, illiquid overseas holdings that often took years from which to redeem. Implementation challenges remain to mitigate risks, minimise tax leakage and deliver attractive risk-adjusted returns. However, we believe lessons have been learnt from the mistakes made over a decade ago and there are a greater number of truly global strategies now available to investors for investors looking for long-term holdings and a focus on broader return rather than income focused return.

ESG and Impact Investing

ESG, climate change and sustainability in particular, are now firmly on the agenda in major real estate markets as investors look to manage climate change risks especially. The global transition away from fossil fuels and towards a low-carbon economy has significant impact on buildings, with Savills having estimated that real estate is responsible for almost 40% of energy and process-related emissions globally.

Asset managers predict that it will become almost impossible to sell buildings that aren't climate friendly, requiring further investment to bring them up to standard. Highly efficient buildings can mean higher levels of operational performance, lower emissions and lower cost of capital.

Investors are also increasingly taking into consideration the social side of ESG. There is no denying that real estate plays a significant role in our lives and society; from houses and flats where we live to our workplaces, where we shop and locations where the things we use or buy are made or stored. There is, therefore, a real social impact of building in and around communities, from creating jobs to providing housing.

Investors concerned with ESG can look to specific funds or strategies with either a focus on the environment or social impact, but it is worth noting that many asset managers are already integrating ESG within their core investment processes.

Important Considerations

One of the key considerations investors must consider when investing in property is transaction costs. Unlisted UK commercial property is an expensive asset class to invest in, typically incurring high spreads of c.7-8% from entry to exit, largely due to stamp duty. While fund structure may increase the tax efficiency and reduce costs, investors should generally make allocations for the long-term and only invest if they are prepared to lock capital away for at least a full market cycle.

Investors looking to transition some or all of their current UK core commercial property portfolios into newer areas of the market should be mindful that it can take a number of quarters for capital to be drawn in the solutions outlined in the previous section so should plan accordingly.

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