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Leicestershire County Council Pension Fund ("LPCF") Strategic Asset Allocation third party advice review:

Scope of work: Hymans Robertson report reviewed – 21st December 2020 – 6th January 2021

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Executive Summary

The broad Strategic Asset Allocation proposed by the investment consultant is unchanged from last year. In our review of last year's recommendations LGPS Central commented that we were comfortable that the estimated long-term asset class returns used by the consultant were reasonable, and that the resultant assumption for long-term investment returns at a total Pension Fund level provided sufficient 'headroom' to give a strong possibility of achieving a return that is at least as high as that assumed within the 2019 actuarial valuation of the Fund.

While the intervening period has been unique from both a social perspective and within investment markets, overall returns have been surprisingly good – although very volatile. The speed and extent of the market sell-off in February and March 2020 was unusual, but not as unusual as the speed and extent of the recovery within asset classes such as equities and corporate bonds.

The consultant's long-term (20-year) investment return expectations are lower across all asset classes than they were at the time of the 2019 actuarial valuation. For certain asset classes (specifically within bond and credit markets) this reflects the reality of lower yields, while in others it reflects a combination of the higher-than-anticipated short-term returns that have been achieved and the game-changing impact of COVID-19 onto the global economy and individual companies/asset classes. LGPS Central believes that these lower forecast returns remain reasonable and still suggest that the required investment return can be achieved by the proposed Strategic Asset Allocation.

Overall, the proposed Strategic Asset Allocation appears to give a good balance of risk and return that is appropriate for a Pension Fund of Leicestershire's level of maturity.

There are a number of comments that we would like to make in respect of specific proposals included in the investment consultant's report.

Private Equity

It is noted that the Leicestershire Pension Fund is currently above its target weighting to Private Equity (PE). The lack of certainty about cashflows within PE makes maintenance of any target difficult when it is expressed as a percentage of assets, given the number of moving parts within a Pension Fund.

It is often tempting to 'manage' the weighting down by not committing further capital, in the expectation that distributions being ahead of drawdowns going forward will create a natural rebalancing. This, however, risks having gaps within vintage years and this is not optimal, given that it is impossible to know in advance when the best vintage years will be. It seems sensible to continue to commit capital to new vintage years, despite the already overweight position and the consultant's proposals recognise this.

Figures provided by Adams Street Partners (ASP) suggest that net cash distributions from Leicestershire Pension Fund's investments with them will turn significantly positive in 2021 and accelerate thereafter, meaning that new commitments (which will be drawn over multiple years) should be able to be made without further increasing the overweighting of the asset class.

Historically, falls in quoted equity markets have encouraged LPs to sell some of their PE investments within the secondary market as the 'denominator effect' has pushed their PE weighting up. Given the remarkable turnaround in quoted markets since the middle of March 2020 – in respect of both the speed and level of market rises – there may be less motivated sellers than would have been expected six months ago as this denominator effect has reversed itself very quickly. There are also signs of 'dry powder' within dedicated secondary funds and this may lead to overpayment (i.e. narrower discounts) by managers. While these two factors may point to a less attractive secondary market opportunity than has been brought about by previous quoted equity market falls, there are still sufficient reasons to suggest that the secondary market will still offer attractive returns for investors. The secondary market has matured considerably over the last decade and many sales are now inspired by portfolio management techniques rather than simply to manage the overall weighting of the asset class.

ASP's secondary fund offerings are, however, different to many secondary fund strategies in that they are looking to purchase only select funds that they know and understand. They often buy single funds where the GP is leading the sale on behalf of investors, and where the GP will only allow sale to a select group of investors. Many of the GP funds purchased in the secondary market by ASP are held already held within their Primary Funds (c. 80% by value).

An unwillingness to buy anything that they do not fundamentally believe to be exceptionally attractive tends to lead to smaller discounts than the average achieved within the secondary market and as an illustration their current secondary fund has achieved an average discount of 7%, against a market average of roughly double this over the investment period so far. ASP's historic performance in the secondary market has been strong, despite not benefitting hugely from simply buying at big discounts to NAV, and well over 80% of the performance achieved has come from improved company valuations rather than the discount achieved on purchase. Their secondary product offering is differentiated to much of the market, and not in direct competition with it.

An investment in the new ASP Secondaries Fund is justified by their historic strong performance and by market dynamics which suggest they will be able to usefully deploy any capital raised. Their current Secondary Fund (Fund VI) offering is, however, currently only about 75% committed and the use of a subscription line for Fund VII means that it may be at least 18 months before any capital is

drawn from investors. If the Leicestershire Pension Fund has a strong desire to increase its exposure to secondary PE funds more quickly than this, LGPS Central would be happy to help them to consider the options available.

Currency Hedging

It would be difficult to argue that Sterling's position as one of the world's 'safe haven' currencies still exists, or that it will be regained in the foreseeable future. As a result, it is not unreasonable to suggest that, in general, Sterling will weaken against other major global currencies (USD, JPY, EUR and increasingly the Chinese Renminbi) in times of market stress.

If Sterling is expected to generally weaken in times of market stress, having a hedge in place will offset some of the gains that would otherwise be achieved due to the strengthening of overseas currencies against Sterling. Further, the hedging produces an outcome in this situation whereby cash is required to meet any daily mark-to-market losses incurred by the hedges. While the need to sell assets to meet this cost can be managed to a certain extent by the retention of a 'float', it is sub-optimal for this float to be too large as it means that cash is always retained and cannot be invested productively (i.e. into assets that are expected to produce positive performance in the long-term). A reduction of the Sterling hedge makes the physical management of the cashflows relating to it more straightforward and reduces the risk of having to make forced sales at inopportune times. But this is not in itself a good reason to reduce the hedge; were Sterling to strengthen the opportunity cost of a lower hedge would by far outweigh any practical benefits achieved by easier management of the hedge.

Currency hedging reduces overall volatility of returns, although there is only a relatively modest difference in this volatility at any level between 30% and 70%. Amending the level of currency hedge will impact onto future investment returns and it makes sense to take into account the current perceived 'fair value' of Sterling against its actual level when making a change. Given that the proposal is to reduce the level of the hedge, it is clearly optimal to do this when Sterling is strong.

Assessing fair value for any asset is somewhat subjective, and currencies are generally judged on a relative basis rather than in absolute terms so are even more difficult to value definitively. The broad principle of a reduction in the hedging amount is based on sound logic of protecting value when it is most needed (i.e. when asset values are falling). The timing of the change is more difficult, and it would be worthwhile seeking the views of a number of different investment managers with specific currency expertise to try to ascertain the appropriate way forward. LGPS Central would be happy to use its contacts to assist in this. The Leicestershire Pension Fund's major currency exposure is to the US Dollar and market positioning by investors currently suggests an expectation for weakness within this currency. The market is, of course, not always correct.

LGPS Central's current view is that Sterling does not have an obvious material mis-valuation against overseas currencies in general, although the very recent announcement of a new national lockdown is likely to slow the speed of economic recovery and limit any immediate sterling strength. We do, however, believe that the USD may well suffer in the period ahead and it is our least favoured currency. Given that the USD is the largest exposure within the hedge, we are of the opinion that reducing the default hedge at this point should only be undertaken after it has been given very careful consideration.

It is considered sensible to continue to allow Kames Capital flexibility on the percentage of each currency to actually hedge (i.e. they can deviate from the default if they feel this to be appropriate).

This will allow them to take account of factors that may be relevant to a single currency (e.g. they may consider it likely that the JPY will strengthen while the USD simultaneously weakens).

The Leicestershire Pension Fund also has exposure to currencies through assets other than equities and bonds, and it would be appropriate to review the position of this at the same time as considering the potential implementation of a lower equity-related currency hedge. It is likely that the only meaningful exposures to currencies outside of the equity-related positions would be for the US Dollar and Euro.

Indirect Residential Property

The current underweight position of property investment relative to benchmark is noted, and the consultant's view that there is no obvious urgency to correct this position is broadly supported by LGPS Central. This does not mean to say that there are not opportunities within the market, but there has certainly not been any significant fall in asset prices (except where justified by specific events such as tenants going into administration) that make the market appear extremely cheap. Sector and individual property selection are likely to be key to strong performance in the near-term. We believe that there will always be opportunities within the property market and that it is best to keep an open mind to investing in opportunistic value-add opportunities that are usually best accessed via specialist managers that are able to use their expertise, network and dynamism to harness them.

Adding an exposure to residential property (over-and-above the modest investment within the La Salle portfolio) will enhance diversification within a property portfolio.

Investors have been gaining exposure to residential property for a number of years now, having found it very difficult to access the area previously due to the need to purchase multiple properties (for both diversification and lot size reasons) and the logistical management issues that this brings. While there are now many more structured ways of accessing the residential opportunity, it is our fundamental view that it remains an area from which achieving good investment returns is quite difficult. There is limited evidence of managers who have been successful within this niche area and some of the track records are not long enough to cover a genuine residential property market cycle, so it is an area on which we remain wary. Getting access to the right manager with the right strategy is key.

There are certain areas of the property market to which it makes sense for individual investors, no matter how large, to gain access through pooled funds run by specialist managers. LGPS Central continues to work with Partner Funds to try to agree a suitable product that will allow them access to these areas indirectly. At present there is insufficient clarity about the structure of this product (e.g. will it be a 'sleeved' approach with individual Partner Funds able to allocate to those areas in which they have an interest) and the timing of its launch to know whether a future product will be suitable for Leicestershire Pension Fund's requirements. Residential does, however, seem to be an area of strong interest from Partner Funds and it seems highly likely that this will form part of the offering. If this is the case we will be looking to invest only with 'best in asset class' managers and only in the areas of residential property where the risk/return relationship appear strongest, as we do not believe that a blanket approach to residential property will necessarily enhance returns relative to broader commercial property opportunities.

Summary

LGPS Central is of the opinion that the overall Strategic Asset Allocation proposed by the investment consultant is a sensible balance of risk and return that is suited to the maturity of the Leicestershire Pension Fund, and is one that has a high probability of producing the long-term returns that are required to meet the discount rate used in the latest actuarial valuation.

Within Private Equity we support continued commitment to the asset class, despite the currently overweight position. Net distributions from ASP are likely to be strong in 2021 and beyond and provide plenty of scope to 'recycle' them without increasing the actual weighting. Secondary PE Funds can potentially enhance returns and reduce risk within the asset class, particularly when they have a differentiated approach and do not rely exclusively on large discounts to Net Asset Value to produce returns. The ASP Secondaries Fund VII is one such opportunity, although LGPS Central is happy to assist the Leicestershire Pension Fund if it wants to gain secondary market exposure more quickly than is likely to be achieved through a commitment to this Fund. It is also considered optimal for Leicestershire Pension Fund to continue to commit to Primary Funds in order to ensure that no vintage year 'gaps' appear within its PE portfolio.

There is no obvious reason from an investment perspective to suggest that there is a pressing need to close the gap between the actual and target weighting within the property asset class, although attractive opportunities should be taken when they become available. Indirect residential property investment would assist in diversifying the current almost exclusive weighting to commercial property, although LGPS Central believes that only experienced property investment managers operating within the most attractive sub-sectors of residential property are likely to add value relative to a continued focus on commercial property.

Within the Leicestershire Pension Fund's currency hedging program, LGPS Central agrees that Sterling is not currently (and is unlikely to return to) a 'safe haven' currency and will in general tend to weaken in times of market stress. This will lead to currency losses that occur at the same time as losses within the Leicestershire Pension Fund's other assets. The volatility reduction achieved at any level of hedge of equity currency exposure between 30% and 70% is relatively insignificant, so there is no clear case that there is an 'optimal' level of hedge. Changing a currency hedge position does, however, alter future investment outcomes quite significantly and should only be undertaken following detailed consideration about whether the timing is appropriate. LGPS Central's view is that the USD (the main currency exposure achieved through equities) is more likely to weaken against sterling than it is to strengthen in the period ahead, and if this is correct the proposed reduction in the hedge ratio does not seem to be currently appropriate. While LGPS Central supports the principle of a lower hedge, we would strongly recommend that the timing of its implementation is considered very carefully and that the views of a number of currency experts are sought. We would be very happy to assist the Leicestershire Pension Fund in obtaining these views.

LGPS Central is happy to answer any questions relating to this report.

Colin Pratt, Investment Director – Targeted Return and Manager of Managers

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