Agenda Item 6

INVESTMENT SUB COMMITTEE – 31 MARCH 2021

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

STRATEGIC ASSET ALLOCATION UPDATE AND LGPS CENTRAL CLIMATE FUND TRANSITION

Purpose of the Report

1. The purpose of this report is to update the Investment Sub Committee (ISC) on the plans to enact the 2021 strategic asset allocation (SAA) and update on the outcome of the transition from Legal and General passive equities to the LGPS Central Climate Balanced fund.

Background

2. Hymans Robertson, the Fund's Actuary, completed the 2021 SAA as part of the Funds annual investment review. The Strategy was reviewed by officers and was approved by the Local Pension Committee at the January 2021 meeting.

3. The Fund, as a part owner of LGPS Central (Central), has an aim to transition investments to cost effective and relevant products at Central as and when they are made available.

4. Local management of investments will continue in the medium term for closed-ended funds, whereby an investment manager is appointed to fulfil a specific purpose via funds that are set up to run for a specified period of time. These investments will be managed locally until the capital is repaid, due to the lack of a natural ability to exit the investment in the event of issues arising.

5. As at 31st December 2020 the Fund is an investor in five Central funds and the 2018 private equity vintage, the total value managed by Central is c£1.6bn or about a third of total Fund assets. In addition the Fund has advisory mandates with Central covering another £900m in assets or 18% of the Fund. Together this is about 50% of the Fund. The Fund's LGIM passive equity holdings which are classed as pooled add another 17%, so in total 67%.

6. During 2020, the Fund invested into the following Central products:

   a. Central Investment Grade Corporate Bond fund
   b. Central Climate Balanced Multi Factor Fund
   c. Central Emerging Market Debt Fund

SAA 2021 Recap

7. The Fund's 2021 SAA was approved at the January 2021 Pension Committee. The quarterly independent valuation reports will reflect the new SAA targets from next quarter when the Fund reports on the quarter from January 2021 to March 2021.

8. A reminder of the 2021 SAA is shown in the table below.

	Proposed target weight (%)	Comments
Growth (55.25%)	55.25	
Listed equity	42.0 (40.0-44.0)	Broad factor based passive allocation implemented December 2020, using LGPS Climate multi-factor sub-fund
Private equity (inc secondaries)	5.75	Increase in strategic target reflecting existing allocations Consider opportunistic investment in Adam Street Secondaries
Targeted return	7.5	Currently higher allocation. Use 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 JP Morgan 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 cash	0.5	Recognition of cash held by Aegon for this mandate. Adjust benchmark hedge ratios used by Aegon from 50% to 30%
Total	100.0	

Current investment allocation vs 2021 SAA

9. The table below shows the three main asset groups as at 31st December 2020 versus the 2021 SAA to highlight the changes that need to be made. The column on the far right shows the change in millions of pounds required to balance the asset group to the SAA target.

	Actuals 31/12/2020 £k	2021 SAA	31/12/20 Actual weight %	Difference, actual to 2021 SAA	£m to SAA weight
Growth	3,052	55.25%	61.7%	6.5%	-321
Income	1,311	36.75%	26.5%	-10.2%	506
Protection	452	8.00%	9.1%	1.1%	-57
Cash	129	0.00%	2.6%	2.6%	-129
	4,944	100.00%	100.0%		

10. The bigger changes are within the growth and income asset groups. The 2021 strategy to balance to the SAA weights for the underlying holdings is described further below.

11. The Fund's position entering 2021 versus the SAA is overweight growth and underweight income. A simple summary would say, sell growth assets and buy income assets whilst utilising the cash position.

12. The strategy for growth assets is described below.

Growth	31/12/2020 £k	2021 SAA	31/12/20 Actual weight %	Difference, actual to 2021 SAA	£m to target weight
Listed Equity	2,245	42.00%	45.4%	3.4%	-169
Targeted Return	513	7.50%	10.4%	2.9%	-142
Private Equity	294	5.75%	6.0%	0.2%	-10

13. Targeted Return: The Fund is overweight by 2.9% or c£140m. This is largely as a result of the target allocation being changed downwards and the unavailability of a suitable Central product to transfer to. When the Multi Asset Credit fund is available and approved by committee the Fund will sell holdings within the targeted return class to release cash to fund the LGPS Central MAC fund. The Fund may utilise a portion of the cash on hand in addition if officers deem the growth class hasn't materially moved further away from the SAA target.

14. The LGPS Central Targeted Return product is currently scheduled for launch in Q4 of 2020. When it is available and subject to due diligence, the remaining holdings from the three mangers will be divested with the proceeds being used to buy units in the Central Fund at the weight prescribed within the SAA, 7.5%.

15. The Fund currently also maintains an overweight to listed equity. Officers are less concerned given the volatility and the fact that this class has a range of 40% to 44%. Compared to the top end the class, equity is 1.4% overweight. Officers will keep this under review and may act to reduce holdings within this class if the weight drifts further ahead of target. Overall, the overweight allocation would be resolved by investing in illiquid investments, but these take time to be called once committed and we are awaiting launches of products from Central for property and infrastructure.

16. The Fund also has three listed equity investments with Central, the two active multi manager funds, global emerging equity and global equity and the Climate Balanced multi factor fund which the Fund has recently invested in. Officers would look to annual SAA reviews to inform the Fund of any changes to the weights assigned to these funds.

17. Private Equity (PE) is covered elsewhere on today's agenda. The small overweight is deceptive given the mature nature of the Fund's PE investments, which results in money is being returned to the Fund as older vintages mature. It is worth mentioning that the Fund expects Central to launch a PE vintage later in 2021 which the Fund has expressed an interest in.

18. The strategy for income assets is described below:

Income	31/12/2020 £k	2021 SAA	31/12/20 Actual weight %	Difference, actual to 2021 SAA	£m to target weight
Infrastructure	387	9.75%	7.8%	-1.9%	-96
Global credit - private debt	354	10.50%	7.2%	-3.3%	-165
Property	386	10.00%	7.8%	-2.2%	-109
Global Credit - liquid sub inv grade markets	72	4.00%	1.5%	-2.5%	-126
Emerging market debt	113	2.50%	2.3%	-0.2%	-11

19. The Fund is underweight 'income' assets across all sub classes. The liquid sub investment grade credit allocation, which is waiting for the launch of Central' MAC product, has been addressed earlier in the paper.

20. The private debt allocation is one of the larger planned commitments in 2021. The Fund maintains the majority of its current holding with Partners Group over a number of vintages with the last commitment being approved in Q4 of 2019. The Fund has a smaller allocation to distressed debt via M&G. Central are planning to launch a private debt product and officers hope to update the Committee in the Summer. If the product is delayed or doesn't meet the Fund's requirements officers may look into an offering from the existing manager so that the Fund does not drift further from the target weight.

21. It is worth noting that investments in private debt require time to be fully called by the manager and so officers are aware that potential delays in product launches, together with the return on capital from existing private debt vintages may require oversized commitments into single vintages which the Fund would like to avoid from a risk perspective. Given the Fund is informed of distributions at short notice the Fund may be in a position where it receives a sizeable return of cash that, if there are delays launching the Central product may precipitate an investment outside of Central.

22. The Property allocation is currently underweight by 2.2% or c£100m. Officers are looking to address this gap using a number of options:

    a. Continued investment with the Fund's direct property manager Colliers who officers maintain regular contact with, in order to update them regarding the Fund's allocation to property. Colliers are aware that if they see a suitable asset on the market that fits the current portfolio then they will bring it to officers' attention. For example, the Fund added an 80,000 sq ft industrial warehouse for c£9m in Q4 2020.

    b. Recycling and continued investment as we receive distributions from LaSalle (the Fund's largest indirect property fund manager) so that the Fund at least maintains allocation. The LaSalle portfolio is a collection of closed and open ended funds which provide income and capital back to the Fund. LaSalle have informed officers, that in line with the mandate they are looking to invest into M&G's UK residential fund which will satisfy the SAA requirement regarding building an allocation to residential property. With a forecast total holding of c£19m the holding would equate to around 10% of the LaSalle total valuation. Officers estimate that the net commitment with LaSalle will be relatively minor unless new opportunities are sourced. Like Colliers, officers keep in contact with the manager so that opportunities can be taken advantage of whilst we are awaiting news of the Central product. If the Central offering is delayed then the Fund has the ability to invest further with LaSalle albeit this will lock up the funds for a number of years.

    c. An investment to the LGPS Central direct property fund which has slipped to the second half of 2021 with Infrastructure being prioritised by Central given the higher overall interest from partner funds. The Fund has expressed interest in the property fund. Whilst the Fund is awaiting this product to

allocate once due diligence is passed, officers are mindful of straying further from target weight and as such are keeping in contact with current managers. Under ideal circumstances the Fund will pick up the difference to property target weight using the Central product and use the two other managers mentioned above to avoid slipping further behind target weight.

23. The Fund's infrastructure allocation is currently 1.9% behind target or c£100m. The Fund has a number of options to close this gap.

    a. The Fund has a current commitment that has not been called for £25m to the JP Morgan infrastructure investments fund (IIF). At the October 2020 ISC when this investment was approved this fund had a queue for new money of nine months. The Fund currently expects this money to be called in the coming three to six months. The Fund also has outstanding commitments to M&G Infracapital of £12m.

    b. Central will be launching an Infrastructure product and are awaiting legal and tax queries to be formally completed. Hymans have been instructed to commence due diligence on behalf of the Fund. Officers currently expect to bring a proposal to the July Investment Subcommittee. The commitment will be informed by due diligence which will include a view on the amount to invest whilst considering existing managers fund's. The Fund currently has a number of investments with open and closed ended vehicles including a niche manager which invests in sustainable forestry which given the specialist nature may not be an area that Central will cover in the future vintages. The current estimated investment if the Fund does not invest further with existing managers could be significant, this is an area that will be picked up during due diligence. Depending on estimated timing the Fund should be able to fund this investment from existing cash balances.

24. The difference to Emerging Mrket Debt (EMD) is small, at present officers do not see a need to make an investment. If the difference were to increase officers will make a top up investment to the Central product the Fund transitioned to in December 2020.

25. The strategy for 'protection' assets is described below:

Protection	**31/12/2020 £k**	**2021 SAA**	**31/12/20 Actual weight %**	**Difference, actual to 2021 SAA**	**£m to target weight**
Inflation linked bonds	251	4.50%	5.1%	0.6%	-28
Investment grade credit	111	3.00%	2.2%	-0.8%	38
Currency hedge	91	0.50%	1.8%	1.3%	-66

26. Both inflation linked (IL) bonds and investment grade (IG) credit require smaller changes to align with the SAA targets. 0.5% of the 0.8% variance within IG credit is in the process of being utilised by a new allocation to a short-dated investment grade investment that was approved at the February 2021 Local Pension Committee meeting. This £25m allocation will be funded from cash reserves and or the cash held with Aegon that has been realised from the hedges that have been in

place as Sterling has appreciated. Taken together the Fund's cash holdings amount to £218m or 4.4% of total fund and will be utilised as calls are made to commitments in place and where new investments are to be made as described through this paper.

27. Given the relatively low variance on index linked bonds we propose to leave the holding slightly overweight, if the variance increases, officers will take appropriate action to rebalance the realised funds elsewhere.

Change to the Aegon Currency Hedge mandate

28. At the January 2021 meeting the Local Pension Committee approved that the Director of Corporate Resources, following consultation with Aegon and the Fund's investment consultants, be authorised to determine the appropriate time to reduce the Fund's foreign currency exposure within the Aegon Currency Hedge mandate from 50% to 30%.

29. Officers have engaged with Aegon to understand the options and considerations for moving to a 30% hedge in one move or transitioned over a period of time.

30. Aegon's thoughts revolve around using the USD exposure to analyse liquidity, collateral required to be held with Aegon and the number of transactions involved in a move to 30% hedged exposure.

31. They note that in their experience there is little benefit finessing the movement by changing in a number of steps. Ultimately it comes down to market timing and officers note that since the end of January 2020 the USD (the main currency exposure for the Fund) has stayed in a fairly tight range having depreciated from mid October to end the of January 2021. This depreciation of the USD is a headwind to the Fund's USD holdings which will have reduced in value when translated to GBP, however the USD hedge will have gained in value to partially offset the losses.

32. The change to a neutral hedge position of 30% of the Fund's foreign currency exposure will be undertaken in one tranche in the coming weeks.

Outcome of the transition to the Central Climate Balanced Fund

33. The Fund transitioned c£750m (inc £41m in cash) to the LGPS Central Climate Balanced "Climate" fund in December 2020. The target assets and cash were subscribed into units of the Climate fund on the 9th December. This is likely to be the largest transition the Fund has to a Central pooled investment.

34. The Fund appointed MJ Hudson as the transition advisor ("advisor") using the Norfolk framework and appointed LGIM as the transition manager ("TM") under advice from the advisor.

35. Appointment of LGIM as the TM allowed the Fund to benefit from lower transfer taxes that would otherwise have been payable had the Fund used a TM other than LGIM. In addition, the Fund also benefits in range of areas when using LGIM, including but not limited to, retained ownership and exposure during owned transition account, legacy asset knowledge of the TM with respect to trading and potential liquidity opportunities within LGIM's client base.

36. The pre trade calculation outlined the expected cost of the transition. This cost is defined to include, commissions and taxes, spread from transacting and LGIM fees. The estimate was defined as 18 basis points or 0.18%. To this mid point estimate a range is added to represent the risk in trading between legacy and the target portfolio, this range, termed an opportunity cost (or benefit if the target assets become cheaper) was estimated at 45bps.

37. MJ Hudson completed a post trade report which highlighted the actual cost of the transition at 13.3bps versus the 18bps estimate, but the Fund benefited from a net benefit from various futures trades which overall left the Fund with a net benefit of 1.7 bps rather than a cost.

38. The Fund was fortunate that this transition was completed with nil cost. The Fund could not expect all transitions to end with such a low cost.

Recommendation

39. It is recommended that the Investment Sub Committee notes the report.

Equality and Human Rights Implications

40. None.

Appendix

None

Background Papers

None

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