Leicestershire County Council

LOCAL PENSION COMMITTEE – 21 JANUARY 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

OVERVIEW OF THE ASSET STRATEGY AND STRUCTURE

Purpose of the Report

1. The purpose of this report is to inform the Committee of the annual review of the Leicestershire Pension Fund's (the Fund) strategic investment allocation and structure.

Background

2. The nature of the Fund's liabilities is long-term. The strategic investment benchmark is structured to reflect the nature of liabilities by focusing on the need for long-term returns and a degree of inflation-linked returns. Market fluctuations will cause the Fund's actual asset allocation to vary from the agreed strategic asset allocation and investment within asset classes in which funding is 'drawn down' over a period of time will create further variation. The strategic benchmark should, therefore, be considered an 'anchor' around which the actual asset allocation is managed.

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

4. Central's product offer continues to develop and the strategy review has been undertaken with this in mind like previous years. Dialogue continues with Central and other partner funds on a regular basis to ensure that Central's offer meets the goals of the Fund. Pooling of Fund assets continues, with a number of investments made over the last year, the Fund has made good progress regarding an orderly transition to Central products to date. Existing Fund assets that are unlisted and illiquid will take longer to transition where an appropriate product exists at Central.

5. As at September 30th 2021, the value of pooled funds directly managed by Central and low cost index trackers from Legal and General totals £3.0 billion or 54% of the Fund's total value. The Fund has made additional commitments to a number of Central products including private equity, private debt and infrastructure funds totalling c£0.25 billion that have not yet been called and are not included in the £3.0 billion figure above.

6. Any decision on the appropriate investment allocation is inherently difficult and will inevitably come down to a 'trade-off' between expected risk and return. Whilst historic measures for risk and return can be instructive about how different asset classes are correlated to each other, they clearly give no guarantee that these historic links will persist, as a result an 'optimal' asset mix does not exist. This does

not detract from the desirability to agree a strategic asset allocation benchmark that makes intuitive sense in terms of the risks being taken to achieve a required return.

Summary of last years (Jan 2021) proposals and progress

Proposal	Actions
Growth assets	
Private Equity – increase target by 1% to 5.75%. Increase in strategic target reflecting existing allocations. Consider opportunistic investment in Adam St Secondaries	The Fund is overweight to this asset class as a result of good performance. Taking into account the future expected distributions as a result of having a mature portfolio officers recommended an investment into an Adam Street Secondaries Fund in 2021.
Targeted Return 7.5% target – to consider the Central pooled offering when available.	The Central offer is not available for investment. It is expected to be available for investment in early 2022. The Fund was overweight to target (7.5%) to this asset class and during the year the two holdings were divested from to partially Fund an investment into a Central product.
Income assets	
Infrastructure – 9.75% target weight. Review the use of a Central offer.	Central launched a core/core plus offer which the Fund committed to invest into in 2021. The value add/opportunistic offer will be considered once the manager line up in completed per the advice from Hymans.
Property – 10% target weight. Consider introducing a residential property allocation and LGPS Central direct property product.	The Fund added to residential property during the year via the mandate with LaSalle who manage the indirect holdings. In addition, to address the underweight LaSalle were instructed to increase investments that would suit the portfolio. Central's direct property offer will be available in 2022.
Global credit - liquid sub investment grade – 4.0% target weight. Exit the JP Morgan Credit holding, reduce target return allocation to fund.	The Fund invested into the Central MAC (multi asset credit) fund in 2021 to satisfy this proposal. At the same time, the JP Morgan credit holding was divested, and two targeted return managers were trimmed to raise cash for this investment. The Fund also utilised existing cash.
Global credit – private debt 10.5% target weight. Distressed debt opportunity with existing managers new offering if appropriate.	The Fund was underweight this asset class. The existing distressed debt manager had key personnel depart. Central launched a new product

	incorporating a low return product and higher returning product. With the funds being returned by an existing private debt manager the Fund committed funds into three products, two from Central and one from an existing manager.
Protection assets	
Investment grade credit – 3.0% target weight. Including c0.5% in a short dated investment bond Fund to generate extra yield relative to cash.	This proposal was completed in 2021 with a 0.5% allocation to short dated bond fund.
Currency hedge – adjust the benchmark hedge of foreign currency assets from 50% to 30%	This proposal was enacted by Aegon, the Fund's currency hedge manager in April 2021.

Summary of 2022 proposals

7. The summary of proposals made by Hymans have been assessed by officers. Officers have shared the proposals with LGPS Central in order to gain further insight with respect to future pooling. Due to the short timeframe between receiving a final SAA proposal from Hymans and the publication of papers for the Committee meeting Officers held a call with LGPS Central to talk through the proposals and discuss any inconsistencies with the direction of travel of Central product development and performance of their products. In addition, sharing with Central the Fund's future plans helps with their understanding and development of products and is complimentary with the spirit of pooling.

8. For 2022, Hymans do not propose the Fund make changes to the Fund's target asset allocations, as was previously agreed by the Committee in January 2021, but have included proposals relating to reviews which may lead to changes within asset classes. These are covered within the Hymans report which is included as part of the private session on the agenda.

	Proposed target weight (%)
Growth (55.25%)	
Listed equity	42.0 (40.0-44.0)
Private equity (inc secondaries)	5.75
Targeted return	7.5
Income (36.75%)	
Infrastructure (inc timberland and infracap)	9.75
Property	10.0
Emerging market debt	2.5
Global credit – liquid sub inv grade markets	4.0
Global credit - private debt (inc M&G/CRC)	10.5
Protection (8%)	
Inflation-linked bonds	4.5
Investment grade credit	3.0
Currency hedge	0.5
Total	**100.0**

Growth

Listed Equity

9. No target weight changes are recommended having transitioned a sizeable proportion of passive equity (c£750m) into the LGPS Central Climate balanced multi factor fund during that last quarter of 2020.

10. Hymans note the development of the Fund's Climate / Net Zero Strategy and as such recognise there could be change once complete. It is proposed that the Fund carries out a review of its listed equity portfolio, taking into account geographic mix, active/passive split, style exposure as well as climate risks and opportunities. This would incorporate the simplification of the LGIM passive mandates as recommended in the 2021 strategy review. Hymans further recommend this includes a review of the LGPS Central's active equity holdings to ensure that they are meeting the Fund's requirements and performing in line with expectations.

11. In advance of the formal review it is worth noting the individual performances of the main listed equity positions the Fund holds.

12. The Fund holds a number of regional passive funds with Legal and General (LGIM). Part of the holding was divested in Q4 2020 when the Fund made an investment into the Central climate factor fund. At 30th September 2021 the holding totalled £954m, circa 17% of total fund assets. The table below compares the return of this investment versus the Vanguard passive FTSE all world product which holds investments in nearly 50 countries and covers circa 95% of the global investable market capitalisation.

	1 yr	3 yr pa	5 yr pa
Total passive equity LCCPF LGIM (at 30.09.21)	24.8%	8.4%	10.1%
All world passive (at 31.12.21)	18.3%	20.2%	14.2%

It is worth noting that although the Fund's performance is lower over longer timeframes there will be a number of reasons of differing performance not all of which may be suitable for the Funds strategy. There are too many variables to consider without a fuller review as proposed by Hymans.

13. Per the above the Fund also has a significant holding in Central's climate factor fund. This Fund is passive and its holdings are titled towards favourable climate characteristics. The Fund was launched in October 2019 with Leicestershire Pension Fund investing in December 2020. Comparing the climate fund to a passive FTSE All world product would seem reasonable, whilst bearing in mind the short timescales. The table below shows since inception performance versus the benchmark for the fund and the FTSE all world index.

Performance (%)	3 Months	6 Months	1 Year	Since Fund Launch
Climate Fund Return	2.23%	9.85%	19.41%	14.86%
Benchmark	2.16%	9.74%	19.08%	14.64%
Difference	0.07%	+0.11%	0.33%	0.22%
FTSE AW (Net of Tax)	1.43%	8.79%	22.20%	15.53%

14. It can be seen that the Climate factor fund has performed in line with its benchmark as can be expected for a passive product but has fallen short of the FTSE all world passive. Again, this is can be for a number of reasons which will be considered within a wider review. However, the timeframes considered are short and the climate fund provides the Fund with other benefits that at the time of the decision included balancing the factor exposures the Fund was exposed to from a higher value factor exposure to a more balanced factor exposure.

15. A side benefit of the Climate factor fund investment is that it has a lower carbon footprint than the equivalent FTSE all world product. The difference at 30th September amounts to a 60% reduction in tonnes of CO_2 equivalent per million dollars of revenue from the benchmark index.

<u>Private Equity</u>

16. Hymans propose maintaining the existing weighting at 5.75%. The Fund has made a number of commitments to private equity over the last two years and currently has an overweight position at 7.2% of total Fund assets, helped by favourable near term performance versus other asset classes. The recent commitments will be drawn over a number of years and as such will continue to gradually be drawn into the market, whilst the mature nature of the private equity portfolio will mean cash is returned to the Fund over time to reduce the weighting towards the target.

<u>Targeted Return</u>

17. The target weight for this asset class is 7.5% and is currently marginally overweight at 8.2% having been trimmed in 2021 to fund the LGPS Central MAC commitment.

18. The three current strategies combined have delivered in excess over the longer term benchmark with returns of 4.5% pa (+0.1% to benchmark) and 5.3% since inception (+0.9% to benchmark).

19. Targeted return performance versus whole Fund performance is shown below:

	1 yr	**3 yr pa**	**5 yr pa**

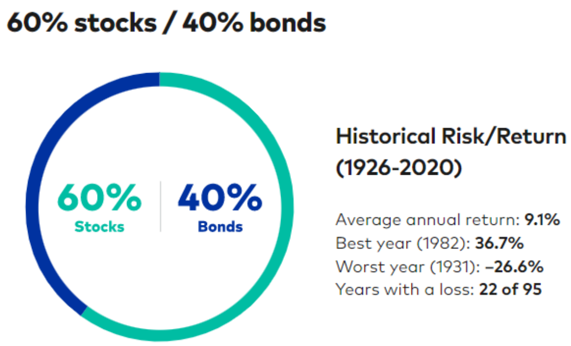
Targeted Return (3 managers)	15.7%	6.2%	4.5%
Targeted Return Benchmark (cash + 4%)	3.9%	4.3%	4.4%
Whole Fund	18.4%	7.8%	8.3%
Whole Fund Benchmark	13.8%	7.5%	7.6%

It is worth discussing the relative merits of an allocation to this mandate where investment risk is assumed to be lower which is represented by a lower target. Hymans are supportive of an allocation to this asset class to provide diversification from equities and capture market opportunities within the growth element of the Fund's portfolio.

20. For note the proposed SAA has roughly a 70% equity to 30% bond split when excluding property, infrastructure and cash and at present given the overweight to equity the actual position is roughly 75% equity and 25% bonds.

21. Historically a 60/40 portfolio (equity and bonds) has been seen as the guidepost for a moderate risk investor. This split has displayed growth through the inclusion of equities whilst bonds smooth the volatility, offer income and generally lower the risk of the portfolio through the contrasting returns pattern versus equities.

22. Taken from Vanguard, (a large US based investment company) the returns on a historical 60/40 portfolio is shown below. Losses are incurred in just under a quarter of all years in the sample with an average return well in excess of the required return of the Leicestershire Pension Fund.



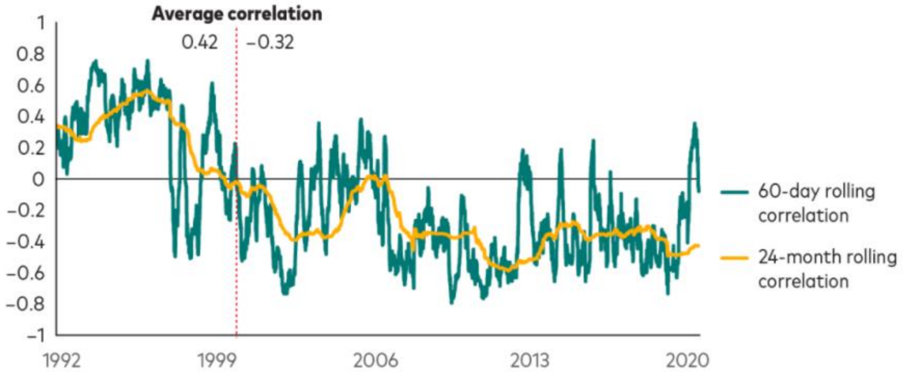
23. The table below compares the Fund's current 75/25 equity bond allocation and performance to a passive 60/40 and 80/20 portfolio. The Leicestershire Pension Fund returns are lower over an annualised three year period to both the passive portfolios whilst being in line over the longer five year period. Reference portfolio performance is taken from Vanguard.

	1 yr	3 yr pa	5 yr pa
60/40 portfolio (31.12.21)	9.9%	11.0%	7.5%
LCCPF 75/25 portfolio (30.09.21)	18.4%	7.8%	8.3%
80/20 portfolio (31.12.21)	14.4%	13.3%	9.1%

24. For a long term investor, like the Fund, the reduced volatility is important as it should help avoid sharp drawdowns which would impact on employers contribution rates if actuarial valuation were to be conducted during a drawdown. The table below shows the average correlation of stocks and bonds from 1992 to 2020 on a rolling 60 day and 24 month time frames. The conclusion is that there is a negative correlation between stocks and bonds over the longer term time frame from around

2000. Nb a -1 reading shows a perfect negative (opposite) correlation, or totally uncorrelated.

Short-term trends can vary; long-term positive or negative correlations can last decades



Sources: Vanguard, based on data from Refinitiv from January 1, 1990, through July 26, 2021. Data appear on chart only at the start of 1992 to reflect the end of the first 24-month rolling correlation.

25. The Fund's two active equity funds managed by Central have had mixed performance as illustrated in the table below. Active equity funds should outperform their benchmarks over longer time frames and as such fees are generally higher when compared to passive equity funds. Both funds are nearly 3 years old and will be included in the wider listed equity review to take place later in 2022.

	1 yr	3 yr pa	Since inception pa	Start
Central Emerging Markets Equity - ACTIVE	-4.23%	n/a	6.37%	19/07/2019
FTSE emerging market - BENCHMARK	-4.33%	n/a	6.73%	
Central Global Equity - ACTIVE	28.70%	n/a	17.07%	12/03/2019
FTSE all world - BENCHMARK	22.67%	n/a	15.88%	

Income

Infrastructure

26. Hymans recommendation is to maintain the 9.75% weighting. The Fund is currently underweight with a 7.3% weighting. There are a number of commitments that are yet to be called that will close the gap to the target which include two commitments made recently, LGPS Central core infrastructure at £70m and JP Morgan infrastructure income fund at $32m. Officers estimate that once called the difference to target weight will be closer to 1%. This will mean that further commitment will need to be made as distributions will continue to return from closed ended investments.

27. Hymans see infrastructure as an attractive asset class and cite the original rationale for investing as:

    a. A wide opportunity set – the asset class offers exposure to an increasingly diverse set of assets. Overall transaction volumes fluctuate from year to year, but the trend is broadly stable. Decarbonisation and Build Back Better policies should increase the supply of opportunities, but many long-standing obstacles to originating new deals persist.

b. Attractive risk-adjusted returns – headline returns have fallen (see chart below for core infrastructure), but the premium paid to investors for taking infrastructure risk has remained remarkably stable.

c. Long-dated income streams, often index-linked - remain a key characteristic of core, operational infrastructure assets.

d. Diversification – returns are driven by a wide range of factors and, in many cases, are less sensitive to the economic cycle than equities generally.

e. Strong downside protection – core infrastructure assets typically have a role in delivering essential public services and may benefit from contracted revenue, so downside risk is typically limited.

f. Positive environmental and social impacts – infrastructure assets will play a key role in decarbonisation and there is strong evidence that well targeted investment in infrastructure boost local prosperity.

Property

28. Hymans recommend maintaining the current allocation target of 10.0%, the Fund is currently underweight by 2.6% with a current weight of 7.4%. The Fund has committed additional money during 2021 with LaSalle, the indirect fund property manager.

29. Like infrastructure, Hymans reiterate the rationale for investment into property as:

a. Attractive risk-adjusted returns, with moderate linkage to inflation over the long-term. The headline returns of property have fallen, but the premium investors receive for taking property risk – estimated as the difference between the initial yield and government bond yields remains.

b. Downside protection. Stable income yields derived from rental income on multi-year leases have traditionally underpinned commercial property returns. Unfortunately, capital values have experienced periods of extreme volatility and the last few years have been no exception. Capital values in retail and office have come under pressure from long-term trends including online retail and remote working. The pandemic exacerbated these trends and adversely impacted other sectors such as hospitality and leisure which had previously flourished. By contrast, industrial/logistics and alternative sectors such as datacentre, laboratories, student accommodation have performed very strongly. In residential property, both rental income streams and capital values have historically been much more stable, at least in the UK.

c. Diversification. Returns on commercial property depend on the economic “health” of companies in the pool of prospective tenants, and on the availability of affordable finance, so are not immune to economic conditions. But commercial property is less sensitive to the economic cycle than equities generally and more influenced by idiosyncratic factors. Residential property is similarly influenced by the economic cycle, but demographics, government policy and local market factors also play a significant role

30. In summary, Hymans believe the investment rationale for Property remains valid. Furthermore, they note that there should be significant opportunities in the coming years to reposition surplus retail and office assets as the economic recovery continues and property requirements in the post-pandemic world become clearer.

Credit markets

31. The Fund has a target allocation of 17% of higher yielding credit markets, comprising 4% liquid multi-asset credit (MAC), 10.5% private debt and 2.5% Emerging Market Debt (EMD), these three classes sit within the income portion of the Fund's portfolio. The Fund also has a 3% allocation to investment grade credit which sits within the Protection portfolio of which 2.5% is invested within a LGPS Central product and 0.5% is within the Aegon short-dated credit fund.

32. Whilst the actual allocations to EMD and MAC are largely in line, the allocation to private lending is below target and currently at 6.3% which is 4.2% below target. The Fund has taken steps during the year to address this with commitments to a number of funds including two products with LGPS Central totalling £160m and two others with existing manager new vintages totalling £112m. Taken together officers expect the gap to target weight for private debt to close materially over the course of 2022, even whilst money is returned to the Fund from older investments which are in their distribution phase.

33. Hymans have reviewed the complete list of investments within credit and although they note some overlap in investment scope of the LGPSC MAC fund and the standalone Emerging Market Debt and private debt sub-funds they are generally satisfied with the structure.

34. Hymans highlighted the material allocation to subordinated debt and quasi-equity (via the CRC CRF and M&G DOF funds and to a less extent the Partners MAC and LGPS Central Private Debt High Return funds). But in the context of the overall credit portfolio they are comfortable with the allocations.

35. Overall, Hymans are happy with the allocation and allocating to a well diversified set of higher yielding credit strategies and are satisfied with the composition of the target portfolio in terms of risk profile, asset type, geography and seniority. They do propose further commitments to distressed debt as part of the broader allocation to higher yielding credit, but timing (of commitments and realisations) is critical. It is recommended that a review is undertaken in mid 2022, when the strength of the opportunity set during this cycle should be becoming clearer.

Cash management

36. As at end September 2021, the Fund had cash holdings totalling £203m, or 3.7% of assets. The strategic allocation to cash is 0%, although there is a recognition that it will be necessary to hold cash to manage day-to-day running of the Fund. It is expected that typically the cash balance would not persistently exceed 1% of assets, noting that the cash balance will fluctuate based on inflow and outflows which will be managed by the Officers.

37. Hymans note that the Fund may hold cash for a number of reasons:
    - Operational cash holdings – held to pay benefits and expenses

- Portfolio management – held to fund capital drawdowns for closed-ended mandates or to collateralise hedging programmes
- Strategic – a tactical decision to hold cash at a time when all asset classes are deemed expensive, i.e. reflecting investment views.

38. Hymans recognise that while the Fund continues to allocate to private assets which are typically closed-ended and draw down funds over a period of time, it is increasingly common for the Fund to be overweight to cash and underweight to the corresponding private asset class (e.g. infrastructure, property and private credit).

39. Another part of the reason the Fund has higher cash balance than normally expected is due to LGPS Central's product development process which has sometimes taken longer than expected to result in an investable product given the collective building of mandates between all partner funds. At present the size of commitments made, versus expected distributions, is likely to materially reduce the cash balance.

40. Given Central has created a number of funds over the last two or three years and is now moving into a 'business as usual' phase, the majority of development is largely complete and as such investing into Central funds should be smoother. For example, additional private debt investments could be considered into current open vintages or planned for a new vintage which are planned at 18 month intervals at present.

Rebalancing Principals

41. Over time the relative performance of different asset classes and managers will mean that asset allocations will deviate from the agreed targets. These deviations increase the risk of unforeseen and undesirable investment outcomes. For example, if the Fund were persistently underweight the strategic target allocation to equities then the strategy would be unlikely to meet the expected return requirements.

42. The current deviations by asset class is illustrated below and is largely described as follows:
    - Overweight equities – helped by strong performance in 2021
    - Overweight cash
    - Underweight illiquid assets, property and infrastructure

	Current Target	Actual	Above or below target
Equities incl. private equity	45.75 – 49.75%	52.6%	++
Target return	7.5%	8.2%	+
Infrastructure (incl. timber)	9.75%	7.3%	- -
Property	10.0%	7.4%	- -
EMD	2.5%	2.4%	-
Liquid multi-asset credit	4.0%	3.7%	-
Global credit private debt	10.5%	6.3%	- -
IG credit	3.0%	2.4%	-
Inflation-linked gilts	4.5%	4.5%	
Currency hedge (collateral)	0.5%	0.5%	
Cash	-	3.7%	++
Total	**100%**	**100%**	

The underweight to private debt as shown has commitments that will close the deficit to target weight over the coming years.

43. Hymans propose a 2% deviation from target weight at strategic asset class level would be a trigger for rebalancing, and is the point that the benefits of the switch are expected to outweigh the costs involved. Officers will need to be mindful if considering a divestment from a pooled fund that may trigger a levy. As part of the review of the Investment Statement Strategy it is proposed that the Fund formalise and documents its Rebalancing principals through the review of the Investment Strategy Statement.

Investment objectives and required return

44. The strategic investment benchmark is designed around the required future investment return and an acceptable level of risk. Without this clarity it would be possible to have a strategy that targets a return that is very high but takes overly large risks and as a result has too high a possibility of failing to achieve its target – thereby putting unnecessary upward pressure onto employers' contribution rates. Likewise, a target that is too low may be easily achieved but has very little probability of producing the returns needed to lessen future employers' contribution increases.

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

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

46. The Fund currently targets an investment return of 5.9% pa which is in line with Funding Strategy being adopted post the 2019 triennial review.

47. Hymans have reviewed the Funds current estimated investment return alongside required returns and have estimated (before the 2022 actuarial results) it is expected that the Fund will be running a higher level of investment risk than required. It is felt that this is not excessive and allows employer contribution levels to remain stable and more affordable. The balance between investment risk and contributions will be revisited in the 2023 Investment Strategy Statement review once the triennial valuation results are finalised.

48. The next full Fund valuation is due in March 2022 (with results available later in 2022) and will align investment return expectations with liability forecasts. The Fund can then reassess the investment return required alongside a full liability forecast.

Supplementary Information

49. An exempt paper providing further detail of the proposals for the Fund's asset strategy and structure, which is of a sensitive nature, is included elsewhere on the agenda.

Recommendation

50. It is recommended that the Local Pension Committee note the report.

Equality and Human Rights Implications

51. None.

Background Papers

22 January 2021 – Local Pension Committee - Annual Review of the Asset Strategy and Structure

https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6522&Ver=4

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