Agenda Item 11

Leicestershire County Council

LOCAL PENSION COMMITTEE – 10 JUNE 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS AND INVESTMENT PERFORMANCE OF INDIVIDUAL MANAGERS

Purpose of Report

1. The purpose of this report is to present to the Committee, an update on the investment markets and how individual asset classes are performing, a summary valuation of the Fund's investments as at 31st March 2022 (Appendix A), together with figures showing the performance of individual managers.

Markets Performance and Outlook

2. A summary of the asset class performance over various time frames as at the quarter ending is shown below. Three asset classes now show double digit returns over a 20 year time frame, property and high yield with gold added this quarter having dropped slightly below the 10% during 2021. Private Equity has no 20 year source information available.

	3 MONTHS*	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	TWENTY YEARS
GLOBAL EQUITIES	6.6%	18.9%	20.8%	14.9%	12.5%	8.1%
PRIVATE EQUITY	7.5%	43.6%	26.5%	16.0%	17.4%	N/A
PROPERTY	16.1%	41.2%	20.0%	12.5%	12.2%	11.2%
INFRASTRUCTURE	4.6%	11.8%	10.1%	7.7%	7.7%	8.3%
HIGH YIELD	-0.6%	3.8%	7.2%	5.5%	9.4%	10.7%
UK GILTS	2.5%	-5.3%	3.4%	2.5%	3.6%	5.1%
UK INDEX-LINKED	4.7%	3.9%	7.2%	4.7%	6.4%	7.3%
GOLD	3.7%	-2.7%	10.4%	7.8%	3.0%	10.3%

Source: Bloomberg (NB: assumes dividends were reinvested), note: Listed proxies have been used for Infrastructure, Property and Private Equity.

Capital Markets Update – Hymans Spring 2022

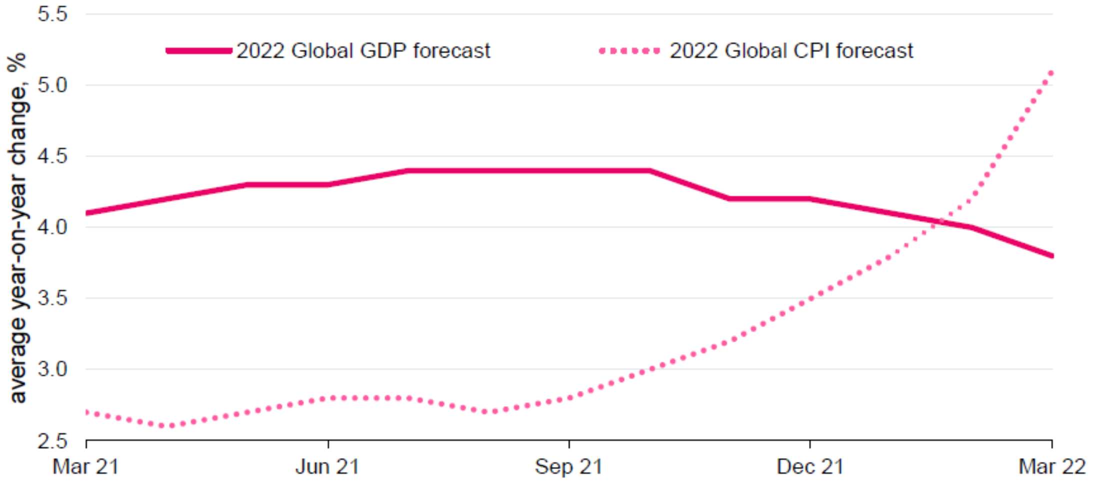
3. A markets update is included from Hymans Robertson, the Funds Investment Advisor and is included as Appendix B. Some highlights are included below.

4. Hymans note the Russia-Ukraine conflict, and its impact on commodity prices, has exacerbated existing inflationary pressures, weighing on the growth outlook as input and living costs rise, and central banks turn less accommodative with sovereign bond yields rosing significantly as interest-rate rise expectations increased, equity prices fell, and credit spreads widened as the outlook dimmed.

5. Hymans note consensus forecasts for global growth have been revised downwards whilst global CPI forecasts have reached new highs as the Russia-Ukraine conflict has reinforced and intensified existing trends (see chart below). Russia and Ukraine

represent a small share of global GDP and trade but produce a disproportionate share of key global commodity exports. Physical disruptions and sanctions have triggered broad commodity price rises which, alongside existing inflationary pressures, are increasing input costs and weighing on real consumer incomes.

Chart 1: War in Ukraine upends global growth and inflation forecasts[1]



6. Hymans also expect that the Bank of England and the Federal Reserve will feel that high current inflation and tight labour markets justify further interest-rate increases. However, the picture has become more complicated for central bankers: interest rates can do little to combat supply disruptions, while high energy prices can eventually help to suppress inflation pressure by weighing on demand. As a result, policymakers could slow down the pace of hikes if energy prices lead to further deterioration in the consumer outlook.

7. Hymans conclude their Spring update with, “we still expect above-trend growth and though inflation is still not expected to be a long-term problem, even if exacerbated by the Russia-Ukraine conflict, it will be higher for longer. Nevertheless, central banks are likely to continue raising rates. The potential impact of inflation and energy prices on real consumer incomes increases the downside risks for growth”.

8. Continuing, Hymans believe a neutral position between income and growth assets is warranted given the combination of improved valuations and the view that markets have already moved to price in a lot of near-term inflation risk but caution with equity and property valuations still look extremely stretched versus history and the prospect of inflation-linkage in earnings and rental growth, set against the high inflation backdrop, prevents us from taking an underweight position in growth assets, despite high valuations and increased downside risks.

<u>Portfolio changes in the quarter (January to March 2022)</u>

9. No new investment decisions were made in the quarter however there was a strategic asset allocation (SAA) review in January where although no changes to the allocation were proposed a number of asset class reviews were agreed. The first of which was bought to the Investment Subcommittee in April, the detail of which is included elsewhere on today’s agenda.

10. Two top ups to existing products were approved by the Director of Corporate Resources following consultation with the Chair of the Pension Committee; these were:
    a. A £29m top to LGPS Central global multi asset credit fund which was underweight to the target weight of 2.5% of total fund assets.

    b. A £60m investment to the Aegon short dated bond investment grade bond fund. This investment was in line with the January 2022 SAA review, where it was noted that excess cash could be invested in this product awaiting investment into underweight assets that take time for commitments to be called.

11. Both investments were made in late March 2022 using cash.

Portfolio changes since the quarter ended

12. No new commitments have been made other than the decisions surrounding the Property asset class which were made at the April Investment Subcommittee.

Cash at quarter end

13. At quarter end the cash held by the Fund totalled £116m, with an additional £52m cash held as collateral with Aegon for the currency hedge.

14. It is worth noting that the collateral held for the currency hedge moves in accordance with the level of hedging and performance by Aegon. When the Pound strengthens versus hedged currencies the amount of collateral will increase and conversely when the pound weakens as it has during the quarter when it reached 1.22 to the US Dollar the amount of collateral reduces, and the Fund may be asked to provide additional cash collateral to maintain the hedges. The level of change in hedge collateral is impacted by the currencies hedged and level of hedge, either partial or full. Officers are in regular contact with Aegon to understand the current level of hedge and their rationale for the stated positions.

15. The Fund is cash flow positive as a consequence of paying less in pension benefits than it receives from member and employer contributions. This provides the Fund with flexibility in making investment changes without always having to divest and incur costs but also means regular investments are required to avoid cash building up.

16. Given the volatility in markets over the last 24 months it makes sense to hold some additional cash for the currency hedge in the event currency markets move unexpectedly which may require additional collateral. However, the requirement to hold as much cash as the Fund did has now reduced given the benchmark hedge position is 30% (was 50%) of foreign currency assets from the change made at the January 2021 Local Pension Committee meeting which was actioned in April 2021.

2022 Investment Plans

17. The Fund's 2022 Strategic Asset Allocation (SAA) was approved at the January 2022 Pension Committee. There were no changes to the 2022 SAA from the previous 2021 SAA. A reminder of the approved 2022 SAA is shown in the table below.

	Proposed target weight (%)	Comments
Growth (55.25%)		
Listed equity	42.0 (40.0-44.0)	Review to be carried out Q4 2022/Q1 2023
Private equity (inc secondaries)	5.75	Officers to manage ongoing commitments as required
Targeted return	7.5	Review LGPS sub-fund when final details confirmed with expectation to transition holdings in H1 2022 (subject to due diligence)
Income (36.75%)		
Infrastructure (inc timberland and infracap)	9.75	Enhanced monitoring of Infracapital; Review allocation to LGPSC Infrastructure Fund (Value-Add/Opportunistic) sleeve; Explore potential allocation to social infrastructure and infrastructure secondaries; Potential to increase target allocation to 12.5% (funded from listed equity) subject to review once current target has been achieved
Property	10.0	Review of property allocation to be carried out in H1 2022
Emerging market debt	2.5	-
Global credit – liquid sub inv grade markets	4.0	-
Global credit - private debt (inc M&G/CRC)	10.5	Review allocation to distressed debt in mid-2022
Protection (8%)		
Inflation-linked bonds	4.5	-
Investment grade credit	3.0	-
Currency hedge	0.5	-
Total	**100.0**	

18. The main areas of focus in 2022 will be to address the underweight positions in illiquid assets, namely property and infrastructure. Part of the infrastructure underweight was addressed with a commitment to LGPS Central's core and core plus product in 2021. There are three asset class reviews pending in the year also:

    a. Property review – this has completed with actions to address the underweight in progress.
    b. Infrastructure and listed equity reviews to be bought to the two Investment Subcommittee's later in 2022. The infrastructure review is currently being worked on by Hymans Robertson.

19. Other changes to bring the Fund in line with the SAA that officers are also considering:

    a. Targeted return – officers and Hymans are working with LGPS Central to deliver a product alongside one other partner fund. The product is now likely to be available in mid 2022. This product has been delayed owing to the due diligence work that is ongoing by Central and the two partner funds interested. Hymans have commenced due diligence work on this product.

    b. Infrastructure – Pending due diligence the Fund may invest in the LGPS Central infrastructure value add/opportunistic fund once manager selection has progressed. Owing to the specialist nature of this area, infrastructure manager selection is deemed to be a more important factor when deciding to invest. Whilst the Fund is awaiting the outcome of the infrastructure review by Hymans the use of the value add/opportunistic sleeve will be on hold.

    c. Private Debt – the Fund is underweight this asset class and with expected commitments and distributions will require a further commitment to be made later in the year. Hymans have been informed and it is forecast to be bring a proposal to the October 2022 Investment Subcommittee.

Overall Investment Performance

20. A comprehensive performance analysis over the quarter, year and three-year period to 31st March 2022 is provided in Appendix A. Portfolio Evaluation collate information directly from managers and calculate performance, which provides an independent check of valuations and allows greater reporting flexibility.

21. Officers have requested the movement of the currency hedge be applied to the total portfolio, previously this calculation only applied to the equity portion of the portfolio. This is a more accurate reflection, given that the hedge applies to all unhedged foreign currency positions throughout the portfolio. The Fund now reports the total portfolio including and excluding the effect of the hedge.

22. It is important to note that the valuations produced can be different to those provided by managers or included in the Statement of Accounts. For example, timing differences or use of different accounting methodologies. The differences are not expected to be material in the context of the messages being conveyed by the report.

23. Summarised returns for the whole Fund versus benchmark is shown below:

	Quarter	1 yr	3 yr	5yr
Total Fund	-0.7%	+11.4%	+9.2%	+7.5%
vs benchmark	+0.6%	+2.6%	+1.1%	+0.7%

24. The Fund’s total value as at the quarter end is £5.8 billion. (£5.8bn at 31st December 2021) At 31st March 2019, the last triennial valuation date, the Fund had assets valued at £4.3 billion. The Fund has grown by £1.5bn over the last three years.

25. The Fund has experienced strong returns in an absolute sense with positive returns across all time frames alongside favourable returns versus the benchmark. It is important to note that investment returns can be negative and for a protracted period of time. One of the objectives of the annual SAA exercise is to understand the risks and opportunities to the Fund over a longer period of time and as such the portfolio has a diverse mix of assets including a number of investments within the ‘protection’ category that should provide a cushion in the event of market shocks.

26. These ‘protection’ assets include index linked bonds and investment grade credit which have historically performed well under market stresses. In addition, there are other investments within the growth the income portions of the portfolio that display good defensive characteristics.

27. Examples include infrastructure investments which have a lower proportion of investments tied to GDP sensitive industries or managers who employ strategies that profit in the event of market volatility or decline such as Ruffer and Aspect who are two of the three managers within the total return portfolio.

Asset class performance covering growth, income and protection investments

28. The +0.6% outperformance in the quarter versus the blended benchmark was largely as a result of the investments within the growth portion of the Fund outperforming the benchmark by +1.4%.

29. Over a longer one-year timeframe the total Fund outperformed the market benchmark by +2.6%. This was led by ‘growth’ assets which outperformed by +4.1% with small underperformance to benchmark from the protection assets at -0.4% versus their benchmark. Outperformance within growth assets was led by private equity where valuations are lagged and have softer comparisons to the year earlier. Officers expect this outperformance to normalise over the coming quarters.

<u>Asset sectors / managers performing well this quarter</u>

30. It is important to note that not all investment sectors should perform well at any given period of time. The Fund is constructed such that there should be a level of natural counterbalance when markets are booming or crashing.

31. During this quarter which included a sell of which coincided with the Russia Ukraine conflict the overall equity portfolio performed well being down -0.9%, however this masks the underlying positions which varied across the managers within the growth class. Two areas which performed well within this class were private equity (+8.4% versus the benchmark) and targeted return (+6.1% versus the benchmark).

32. The Fund’s main private equity position is held with via numerous funds with Adam Street Partners (ASP). The Fund has investments with ASP stretching back to 2002 however recently the Fund has started to make commitments to LGPS Central products with the most recent commitment made in 2021 for £30m. Private equity valuations are different to listed equity in that there is not a recognised liquid market for pricing and as such private equity portfolios valued on a rolling basis. This can lead to valuations which can be out of date for portions of the underlying companies that have not been valued at this quarter end for example. It is with this in mind that private equity valuations have to be looked at over longer periods of time.

33. The Funds targeted return managers had a mixed quarter with two showing positive returns and one negative. The stand out performance came from Aspect Capital who returned an impressive +20.0% in the quarter with Ruffer returning +4.3%.

34. Aspect is a momentum-based manager whose positioning is based on historic correlations between asset classes and the fact that assets tend to ‘trend’ in a given direction for long periods. Their computer models drive the size and direction of positions in hundreds of different liquid futures markets, and they can go ‘short’ (sell assets that they do not own) as well as ‘long’ depending on the direction of the trend.

35. The 20.0% return in period was as a result of a long position in energies, generating 8.8% of the return and a short position in bonds, which added 6.7%. From a sizing perspective these positions were large but not extreme and both benefited from an accelerating price trend that had already been evident for some time, and hence positions had been gradually increasing.

36. Ruffer maintain a portfolio that they believe has the ability to make money when risk asset markets go up but has protection when they fall. They will always hold assets that fall into their categories of ‘greed/growth’ and ‘fear/protection’ but the exact mix (and the actual assets held) will depend on how they view economies

and markets at any point in time.

37. Ruffer's portfolio produced a return of 4.3% in the quarter, which was highly creditable against falling equity and bond markets. The portfolio did well whilst equity and bond markets were falling as can be seen throughout the Leicestershire portfolio where managers hold only one or the other type of asset. Exposure to interest rates (rising), credit default swaps (which benefit from worsening conditions for risk assets), gold and gold equities all provided tailwinds. Avoidance of growth equities, which Ruffer feel are overpriced, for cash generative companies also added to performance.

<u>Asset sectors / managers not performing well this quarter</u>

38. Emerging market debt, investment grade credit and index linked bonds were areas that suffered during the last quarter. The Fund has the following allocations summarised in the table below:

Fund	Actual % of Fund quarter end (target weight)	Quarter performance
LGPSC emerging market debt fund	2.1% (2.5%)	-8.5%
LGPSC investment grade credit fund	2.2% (2.5%)	-7.0%
Aegon index linked bond fund	4.3% (4.5%)	-5.5%

39. All three investments invest in bonds whose prices move down as yields move up. As will be addressed during the LGIM presentation, Central Banks have started to move interest rates up and have signalled future increases. The result has been significant negative performance in the prices of bonds.

40. Index linked bonds, although suffering a -5.5% loss in the quarter had shorter dated index linked bonds slightly positive whilst longer dated bonds performed far worse. The pressure on longer dated index-linked bonds and on fixed-income in general, started in December 2021 but carried on into January. Hawkish comments and activity from central banks, including from the Bank of England, was the main challenge for the bond market. Given the inflation worries in the near-term, short dated or front-end bonds outperformed.

41. Aa a result all three managers are below their target weights at 31st March and officers will review more recent valuations before making a proposal to use existing cash and rebalance to towards the target weight.

<u>Other news</u>

42. Aegon Asset Management has decided to close its UK direct real estate business following the communication in July 2021 to close the Aegon Property Income Fund, a commercial property fund for UK wholesale investors and are in the process of winding-up the Kames Target Healthcare Fund after the sale of the portfolio in December 2021. Aegon believe these closures have undermined the commercial viability of its UK direct real estate business.

43. Aegon manage two closed ended property funds valued at £73m (31st March 2022) which the Fund has invested in. Aegon has formally tendered their

resignation as investment manager. The managing trustee, Saltgate has contacted officers at the Fund, LGPS Central and officers at other Central funds who are also investors to communicate a course of action.

44. The investment management agreement allows for eventualities like this and Aegon will serve a six month notice where it is planned Saltgate will appoint a replacement manager which will be approved by investors to take over management of each property fund.

Recommendation

The Local Pension Committee is asked to note the report.

Appendices

Appendix A - Portfolio Evaluation - Summary Valuation of Funds Performance.

Appendix B – Hymans – Capital markets Spring 2022

Equality and Human Rights Implications

None.

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