Agenda Item 10

Leicestershire County Council

LOCAL PENSION COMMITTEE – 9 SEPTEMBER 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 provide the Local Pension Committee with:

   a. An update on the investment markets and how individual asset classes are performing, a summary valuation of the Fund's investments as at 30th June 2022 (Appendix A), together with figures showing the performance of individual managers.

   b. Information into the effect of inflation on pensions and how the Fund deals with it.

Markets Performance and Outlook

2. A summary of asset class performance over various time frames as at quarter end is shown below. Three asset classes now show double digit returns over a 20-year time frame, high yield and gold with property dropping just below 10% per annum returns over 20 years this quarter. Private Equity has no 20-year source information available.

	3 MONTHS*	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	TWENTY YEARS
GLOBAL EQUITIES	-15.4%	-15.2%	6.8%	7.5%	9.4%	7.5%
PRIVATE EQUITY	-15.5%	-8.7%	8.1%	8.6%	13.5%	N/A
PROPERTY	-14.8%	-6.0%	5.4%	6.8%	8.3%	9.3%
INFRASTRUCTURE	-7.4%	5.5%	3.4%	4.8%	7.2%	8.2%
HIGH YIELD	-9.1%	-11.8%	0.1%	1.7%	6.6%	10.4%
UK GILTS	-7.8%	-14.3%	-3.5%	-0.7%	1.7%	4.1%
UK INDEX-LINKED	-18.1%	-17.3%	-4.2%	-0.5%	3.9%	5.7%
GOLD	0.7%	16.0%	10.1%	9.3%	3.8%	10.4%

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

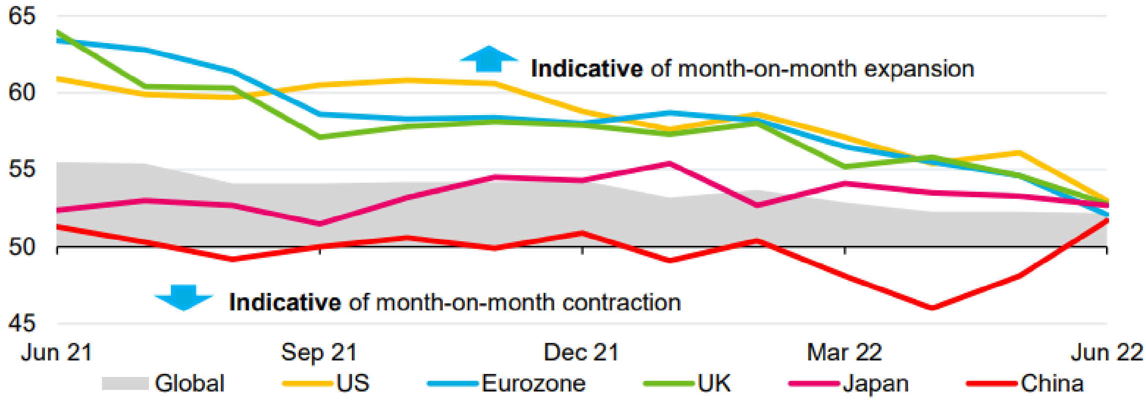
Capital Markets Update – Hymans June 2022

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

4. Hymans note that inflation continued to surprise to the upside, sending inflation forecasts higher. Subsequent increases in interest-rate projections, as well as an ongoing squeeze on consumers from higher prices and borrowing costs, have weighed on growth forecasts. Recently in August the Bank of England warned that UK inflation is likely to stay elevated and warned of inflation rising further to around 13%

(CPI) later in the year when energy prices are expected to rise to the new price cap driven by the surge in gas prices.

5. Since the last update (spring 2022) Hymans note, further to above, that consumer confidence as measured by the Manufacturing Purchasing Managers' Index has plunged in the major advanced economies as inflationary pressures and higher borrowing costs squeeze consumers' real incomes (readings below 50 indicate manufacturing contraction). Consumer confidence surveys in the US, UK and Eurozone have all fallen to levels typically consistent with recession.



6. Hymans note that against this backdrop, global growth forecasts are falling, and inflation forecasts are rising. Central banks are increasingly focussing on inflation, concerned the risks that it becomes entrenched are growing. In response, the Bank of England raised rates for the sixth time since December in August, to 1.75% p.a., and the US Federal Reserve delivered another bumper 0.75% p.a increase, bringing the Fed Funds rate to 2.25% p.a.

7. Hymans state as central banks concentrate on their primary task, an even faster increase in interest rates than markets expect cannot be ruled out, which would increase the chances of recession.

8. Concluding, Hymans note that although an even faster increase in interest rates than anticipated cannot be ruled out, core sovereign bond yields have risen substantially and are at a level that could provide ballast if increased recession risks materialise, assuming inflation moderates. Investment-grade credit looks attractive relative to gilts, while speculative-grade credit spreads are at levels that provide compensation against a material rise in defaults.

9. Equity valuations have fallen significantly and, for the first time since the market recovery took hold, no longer look stretched versus longer-term averages. However, earnings forecasts look increasingly vulnerable to downwards revisions and valuations may not yet fully reflect growing downside risks. UK commercial property fundamentals and performance have held up well, but the asset class is looking increasingly expensive in absolute terms, and also relative to bonds and equity.

Effect of inflation on the Fund

10. Current inflation is significantly above the Bank of England target (2% pa) and the assumption proposed for the Fund's 2022 valuation of 2.7% pa. However, prevailing expectations are that inflation pressures will be relatively short-term (1-2 years) and move back towards the Bank's target in the longer-term (3 years+).

11. Inflation is important as it pushes up the value of the Fund’s liabilities. The Local Government Pension Scheme (LGPS) has a link to September Consumer Price Index (CPI) inflation rate which is applied to pension payments from April the following year. It is expected that September CPI inflation will be around 10%. This will add pressure to the cashflow for the Fund which at present is positive i.e., the Fund pays out less in pension benefits than it receives in contributions from employers and employees.

12. Further analysis will be undertaken to understand Fund cashflow taking into account high pension increases. This analysis will be bought to the November Committee meeting.

13. The Fund is currently invested in many asset classes that would be expected to provide a good level of protection against sustained periods of higher inflation, e.g., growth assets such as equities are generally expected to perform better in an inflationary environment to provide similar levels of ‘real’ returns.

14. In addition, the Fund has invested in a portfolio of investments that diversifies risks. The majority of the portfolio is invested in non-UK assets, broadly in line with global benchmarks. Additionally, parts of the portfolio are relatively well suited to inflationary environments from a historical perspective, such as:

- Infrastructure where incomes are linked to inflation to some extent.
- Timberland funds where much of the value created comes from biological growth that is not correlated to economic cycles.
- Private debt where underlying loans are linked to a floating interest rate.

15. However, although some assets are more suited to coping with inflation (and benefit from higher incomes) this link becomes more strained as inflation increases and is sustained beyond what would have been deemed moderate inflation levels a few years ago.

16. It is worth noting that in the recent past the developed world in general has not witnessed high sustained inflation and that is a risk that officers will explore with the Fund’s Investment Advisor for the next Strategic Asset Allocation review which is to be presented at the January 2023 Committee meeting.

Portfolio changes since the quarter ended

17. In August 2022 £30m was partially divested from Aspect Capital in order to provide cash liquidity for future commitment calls. This decision was taken by the Director of Corporate Resources following consultation with the Chairman of the Local Pension Committee.

18. Aspect Capital is one of the Fund’s three ‘targeted return’ managers who have performed very well in 2022 and as such the targeted return asset class was ahead of the target allocation of 7.5% (of total fund assets). Divesting from Aspect Capital lowered the allocation closer to 7.5% and bought the three managers closer to equal weight within the targeted return asset class.

Cash at quarter end

19. At quarter end the cash held by the Fund totalled £68m, with an additional £29m cash held as collateral with Aegon for the currency hedge.

20. 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.

21. 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.

22. 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.

<u>2022 Investment Plans</u>

23. 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**	

24. The main areas of focus in 2022 will be to address the underweight positions in illiquid assets, namely property and infrastructure. There were three asset class reviews to complete in 2022:

    a. Property review – this has completed with actions to address the underweight in progress.

    b. Infrastructure – this has completed with actions agreed to address the underweight.

    c. Listed equity review - it was planned to compete this review later in 2022 as agreed at the 2022 SAA meeting in January. This will be undertaken following receipt of the Climate Risk Report 2022 and approval of the Net Zero Climate Strategy (NZCS). Taking into account both the CRR and NZCS will allow Hymans to review listed equity while taking all relevant information into account. It is therefore currently planned to undertake this review in the first half of 2023.

25. 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. 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. Private Debt – the Fund is underweight to this asset class and will require a further commitment to be made later in the year. Hymans have been instructed to commence work on proposing options and it is forecast to be bring a proposal to the October 2022 Investment Subcommittee.

<u>Overall Investment Performance</u>

26. A comprehensive performance analysis over the quarter, year, and three-year period to 30st June 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.

27. 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.

28. 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.

29. Summarised returns for the whole Fund versus benchmark are shown below:

	Quarter	1 yr	3 yr	5yr
Total Fund	-4.3%	+1.9%	+6.6%	+6.4%
vs benchmark	+0.1%	+2.1%	+1.1%	+0.6%

30. The Fund's total value as at the quarter end is £5.5 billion. (£5.8bn at 31st March 2022) At 31st March 2019, the last triennial valuation date, the Fund had assets valued at £4.3 billion.

31. 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.

32. 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.

33. 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

34. The +0.1% outperformance in the quarter versus the blended benchmark was largely as a result of the investments within the growth and protection portions of the Fund which outperformed the benchmark by +1.4% and +0.7% respectively. Income assets underperformed the benchmark by -0.8% in the quarter.

35. Over a longer one-year timeframe the total Fund outperformed the market benchmark by +2.1%. This was led by 'growth' assets which outperformed by +4.9% with smaller outperformance to benchmark from the income and protection assets versus their benchmark. Outperformance within growth assets is led by led by private equity where valuations are lagged and have softer comparisons to the year earlier. Officers expect this outperformance to normalise as valuations become more recent.

36. In comparison equity valuations in the quarter and over the year have declined for the Fund as evidenced by the passive equity holdings performance where over the 1-year period some geographical passive funds have experienced double digit declines from a year ago. European, Pacific (excluding Japan) and emerging markets passives are all down more than 10% (broadly in line with benchmarks) from a year ago.

Asset sectors / managers performing well this quarter

37. It is important to note that not all investment sectors will perform well in 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.

38. During this quarter which followed the immediate sell off from the start of the Russia Ukraine conflict the growth portfolio outperformed the benchmark by +1.4%. Underlying performance varied across the managers within the growth class. Two areas which performed well within this class were private equity (+9.8% versus the benchmark) and targeted return (+1.8% versus the

benchmark).

39. The three targeted return aim to achieve a return of cash +4% which as interest rates rise can become a harder ask. It therefore is welcome that the trio of managers (whose strategies complement each other) managed a quarter performance return of +3.0% led by Aspect who followed last quarters stellar performance with another solid quarter (+13.6% in the quarter). Their strategy of momentum or trend following had worked into the second quarter and gives them a 1-year return of +39.5%. It is important to note however that there will be times when Aspect won't perform as well when trends are not as strong for example.

40. 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.

41. Stafford with whom the Fund have invested into three vintages have had another good quarter of performance, +5.3% and a 1-year performance of +25.0%. (Note qtr. performance is to 31st March as the most recent manager report arrived after performance figures are calculated by the independent external company, portfolio evaluation).

42. The performance across all three vintages had positive tailwinds from a combination of positive foreign exchange movements, improved timber pricing and positive reappraisal results for underlying timber assets. In addition, Stafford note that they too are experiencing inflationary pressures, operating costs increasing as a consequence of labour and oil prices.

Asset sectors / managers not performing well this quarter

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

Fund	Actual % of Fund at quarter end (target weight)	Quarter performance
LGPSC emerging market debt fund	1.9% (2.5%)	-11.7%
LGPSC investment grade credit fund	2.1% (2.5%)	-9.1%
Aegon index linked bond fund	3.7% (4.5%)	-17.7%

44. All three investments invest in bonds whose prices move down as yields move up. Central Banks have continued to move interest rates higher and have signalled future increases. The result has been significant negative performance in the prices of bonds. The index linked bond investment lost 17.7% during the quarter (which is in line with the benchmark) and was driven by the continuation of the market pricing in evermore rate increases for the Bank of England which was supported by higher monthly inflation data and aggressive tighten signalled

by the US Federal Reserve. However, the increase in spot (monthly) inflation did not have the effect of pushing up future inflation expectations and as such inflation linked bonds performed poorly for a second quarter running.

45. Investment grade credit which is held via a multi manager fund with LGPS Central performed below benchmark in the quarter, -9.1% versus a benchmark return of -7.5%. Both underlying managers, Fidelity, and Neuberger Berman both underperformed the benchmark with specific instrument selection being the cause alongside Fidelity preferring European credits which underperformed US credit instruments.

46. In the backdrop of tightening monetary policy due to elevated inflationary pressure, fixed interest holdings within mandates will be under pressure. The Fund holds such holdings within a number of mandates in order to capture diversification and reduce risk from any single manager, geography, or sector within bonds in general.

47. As a result of the current conditions and recent performance all three managers are below their target weights as of 30th June. Officers will review with the Fund's investment advisor more recent valuations before making a proposal to use existing cash, or sale of overweight positions to rebalance these bonds positions.

Other news

48. As communicated last quarter Aegon Asset Management has decided to close its UK direct real estate business. Aegon manage two closed ended property funds valued at £74m (30th June 2022) which the Fund has invested in. The managing trustee, Saltgate has narrowed the search for a new manager with a shortlist of two being considered. A decision to appoint a new manager will hopefully have been made by the next Local Pension Committee meeting. Approval from current investors will be needed to appoint and as such Saltgate are keeping investors including officers at the Fund up to date.

Recommendation

49. 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 Summer 2022

Equality and Human Rights Implications

None.

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