Leicestershire County Council

LOCAL PENSION COMMITTEE – 18 NOVEMBER 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS, 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 is managing the recent rise.

Markets Performance and Outlook

2. A summary of asset class performance over various time frames as at quarter ended 30th September 2022 is shown below. Two asset classes now show double digit returns over a 20-year time frame, high yield and gold with property dropping below 10% per annum returns over 20 years the quarter before last. Private Equity has no 20-year source information available.

	3 MONTHS*	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	TWENTY YEARS
GLOBAL EQUITIES	-6.75	-20.15	4.27	4.96	7.89	8.20
PRIVATE EQUITY	-0.95	-15.66	5.07	8.01	12.82	N/A
PROPERTY	-10.83	-16.43	-1.05	4.11	7.01	9.20
INFRASTRUCTURE	-9.63	-5.98	-0.17	2.06	5.66	8.25
HIGH YIELD	-4.86	-16.92	-2.18	0.40	5.03	10.67
PRIVATE DEBT	-0.26	-6.79	-1.55	-1.27	-0.46	0.19
UK GILTS	-13.57	-24.46	-10.04	-3.52	0.15	3.10
UK INDEX-LINKED	-9.70	-26.99	-9.75	-2.37	3.11	5.04
GOLD	0.25	14.08	7.47	9.25	3.10	10.37

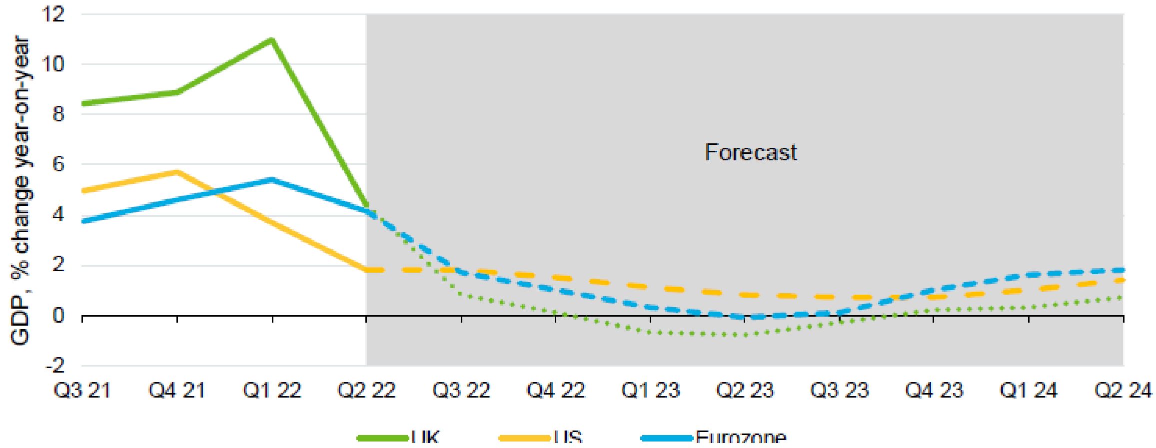
Capital Markets Update – Hymans September 2022

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.

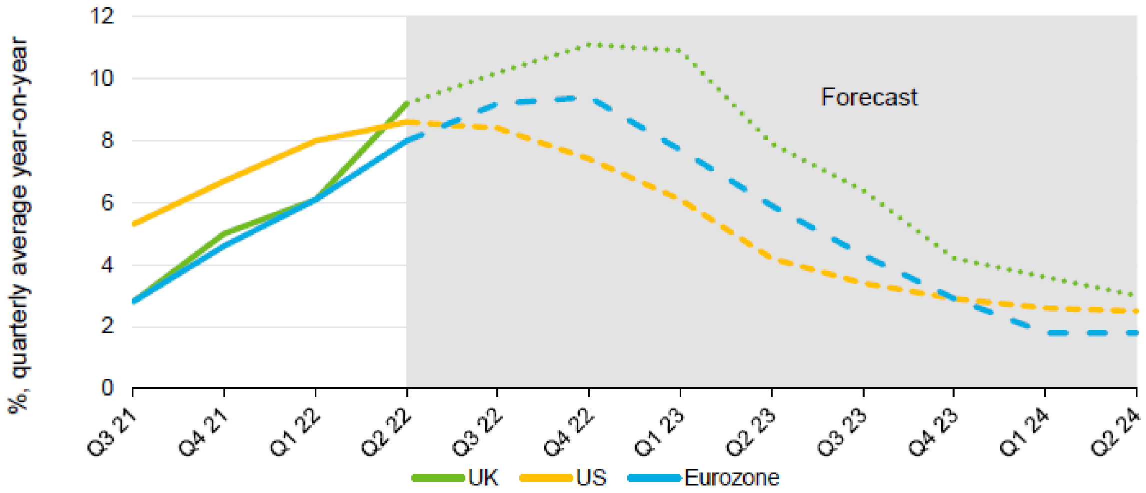
4. Hymans note that as high inflation and rising interest rates weigh heavily on consumers and businesses, consensus forecasts suggest growth in the major advanced economies will slow considerably in 2023 (see chart below). The consensus forecasts

at the time of writing suggest a recession in the UK and eurozone and a near miss for the US. More recently the Bank of England (BoE) reported that the UK may suffer a two year long recession lasting into 2023 after it raised UK interest rates by 0.75%.

Chart 1: Consensus forecasts suggest a recession in the UK and eurozone and a near miss for the US



5. Hymans also reported that year on year consumer price index (CPI) inflation remains very high in the major advanced economies, but is expected to moderate in 2023 and fall back towards its target in 2024 (see chart below), as commodity prices fall and supply chain pressures ease.



6. Hymans note that while the energy price interventions by the UK and European governments will limit the near-term peak in headline inflation, they may also support aggregate demand, by preserving consumers' disposable incomes. This potentially increases the risk of ingraining core inflation (currently running at 6.5%, 6.6%, and 4.8% in the UK, US, and eurozone, respectively), which is a much bigger concern to central bankers than the height of a headline spike.

7. Hymans commented on UK government bonds after the volatile market endured during September when UK government bonds significantly underperformed global comparators as the government proposed a significant loosening of fiscal policy in September. Selling threatened to get out of control as cash calls on pension funds' leveraged interest rate and inflation hedging programmes saw them sell collateral, often gilts, or reduce hedging, equivalent to selling gilt exposure into the market.

8. Yields fell back once the Bank of England (BoE) intervened with temporary purchases of long-dated bonds amid material risks to financial stability. The market recovered further when the replacement Chancellor unwound most of the proposed fiscal loosening. Even so, real and nominal yields remain well above the levels seen immediately prior to the 'mini' budget and look reasonably attractive relative to our assessment of longer-term fair value.

9. Hymans commented that global equities rallied in July but fell sharply in the second half of Q3 as inflation and higher interest-rate expectations weighed on both valuations and the fundamental outlook. The Fund's own equity positions in comparison to global equity benchmarks have performed well and are covered later in the paper.

10. Commenting on property Hymans highlighted transaction volumes have declined and redemptions from property funds have increased dramatically with several UK commercial property funds now limiting withdrawals. Existing selling pressure from institutions rebalancing portfolios, given the scale of property's outperformance year to date, has latterly been exacerbated by pension funds' attempts to sell assets to meet collateral demands. Capital values have been dropping since June and the industrial sector has been the hardest hit and had benefited the most from capital appreciation over the last year with yields reaching record lows.

11. In Conclusion, Hymans note major central banks have increasingly shifted to the view that the recent rise in inflation is persistent and are setting policy to achieve a sustained return to target. While market forecasts suggest this will be achieved over the next year or so, they also suggest this will require higher interest rates than previously expected. The rebalancing of global economic supply and demand is likely to require a period of sub-trend economic growth.

<u>Effect of inflation on the Fund</u>

12. Current inflation is significantly above the Bank of England target (2% pa) and the assumption proposed for the Fund's 2022 valuation of 2.9% pa. However, prevailing expectations are that inflation pressures will be relatively short-term and move back towards the Bank's target in the longer-term (3 years+).

13. 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. 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.

14. Further analysis will be undertaken to understand Fund cashflow taking into account high pension increases.

15. 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, for example, growth assets such as equities are generally expected to perform better in an inflationary environment to provide similar levels of 'real' returns.

16. 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.

17. 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.

18. 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.

<u>Portfolio changes in the quarter ended</u>

19. In August 2022 £30m was 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.

20. 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.

21. During the quarter the Fund also provided additional collateral to Aegon to support the foreign exchange hedge, primarily due to the strengthening US Dollar. This additional collateral provided can be recalled given the improved performance of sterling versus the US dollar. Collateral at Aegon is maintained bearing in mind the level of hedge and volatility of the major foreign exchange positions. Officers are in regular contact with Aegon in order to understand the market and level of hedges.

<u>Cash at quarter end</u>

22. At quarter end the cash held by the Fund totalled £60m, with an additional £58m cash held as collateral with Aegon for the currency hedge.

23. 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 1.05 to the US Dollar the amount of collateral reduces, and the Fund may be asked to provide additional cash collateral to maintain the hedges.

24. 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.

25. 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.

26. Officers are also mindful of considerable commitments approved by the Committee over 2021 and 2022 that will be begin to be called by underlying investment managers. Many of the commitments have been made to illiquid investments. The profile of calls by managers can be lumpy and as such having cash available will be helpful in order to avoid frequent redemptions.

2022 Investment Plans

27. 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**	

28. 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 position in progress.

b. Infrastructure – this has completed with actions agreed by the Investment Sub-Committee 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 now be undertaken following receipt of the Climate Risk Report 2022 and preparation of the draft 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.

29. 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.

30. A private debt review was undertaken and presented to the October Investment Sub-Committee where a number of proposals were approved in order to close the underweight to this asset class over the period 2022 – 2024.

a. That a commitment of £140m to the LGPS Central Low Return Sleeve be approved.

b. That a commitment of £80m to the LGPS Central Real Assets Sleeve be approved subject to officer discussion regarding the target return and investment strategy changes for the fund reflecting current market conditions.

c. That a commitment of up to £60m to Partners MAC 7 Vintage be approved, subject to the Leicestershire Fund being no more than 20% of total MAC 7 commitments, with any unused commitments up to the maximum £60m to be taken into account for the 2024 private debt.

d. That the following commitments be made in 2023/2024:

i. Subject to a minimum fund raise by Central of £900m an additional £180m to be committed to the new LGPS Central Low Return Sleeve. If the current Sleeve's end date is extended, then this minimum fund raise of £900m will not apply given the size of the existing commitments.

ii. Up to a total of £100m commitment to the LGPS Central Real Assets sleeve subject to the Leicestershire Fund being a maximum of 20% of the total sleeve. Any unused commitment up to the maximum £100m to be taken into account for the 2024 private debt proposal.

e. That the commitments set out above be funded from existing cash resources where possible and that the Director of Corporate Resources, following consultation with the Chairman of the Local Pension Committee, be authorised to divest overweight positions back to the Strategic Asset Allocation target to fund any remaining commitments.

<u>Overall Investment Performance</u>

31. A comprehensive performance analysis over the quarter, year, and three-year period to 30th September 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.

32. 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.

33. 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.

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

	Quarter	1 yr	3 yr	5yr
Total Fund	-0.6%	-1.1%	+5.3%	+5.8%
vs benchmark	+0.1%	+1.2%	+0.8%	+0.5%

35. The Fund has experienced strong returns versus the benchmarks with positive returns across all but the 1-year time frame from an absolute perspective. 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 assets classed as ‘protection’.

36. 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.

37. 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

38. All three asset groups (growth, income and protection) performed fairly well versus their respective benchmarks during the quarter. Protection assets performed well comparative to the benchmark (+1.1%) but suffered from an absolute return perspective with a -7.4% return over the quarter.

39. The protection assets consist of three holdings which all include bonds which as previously mentioned in the paper have endured a very difficult quarter. The Aegon index linked bond fund suffered another poor quarter (but slightly better than their benchmark) with a return of -8.9%.

40. Growth and income asset groups both had small positive absolute gains during

the quarter and were roughly in line with benchmark returns. It is worth noting that both growth and income asset groups include investments that are not valued daily and as such there will be an element of probable downward revisions for investments in private equity (growth group), infrastructure and property in the coming quarter or two as they catch up to the daily valued equivalents.

41. Over a longer one-year timeframe the total Fund outperformed the market benchmark by +1.2% with an absolute return of -1.1%. Whilst this is a negative return over one year it is worth noting the context this return has been achieved withing in terms of economic and geo-political news over the last 12 months.

Asset sectors / managers performing well this quarter

42. 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.

43. Underlying performance varied across the managers within the growth class. An area which performed well within this class was targeted return, again having posted a +1.8% versus the benchmark to the quarter to June 2022 and now a +1.9% for the quarter to September 2022.

44. 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 performance return of +3.6% led by Aspect who followed last quarter's stellar performance with another solid quarter with a +8.2% return. Their strategy of momentum or trend following (can invest or markets going up or down) had worked into the third quarter of 2022 and gives them a 1-year return of +40.9%. 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.

45. 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.

46. The main positive contributions for Aspect came from a large 'short' in bonds (which added almost 4.1%), currency positioning (+3.8%, with USD strength a major contributor) and interest rates (+1.8%). The latter position was positive due to a realisation by markets that policy rates were likely to rise faster, and higher, than had previously been thought probable. A 'short' in stock indices added 1%.

47. Stafford (Timberland) with whom the Fund have invested in three vintages have had another good quarter of performance, +7.3% and a 1-year performance of +29.7%. (Note quarter performance is to 30th June as the most recent manager report). All three vintages benefited from positive foreign exchange movements. The investment into timber should be a diversifier for the Fund given biological growth of the asset will occur over time. All three vintages are distributing and as such the Fund has made plans to maintain an allocation to timber via the commitment (pending satisfactory due diligence) made at the July Investment Sub-Committee to the Stafford Carbon Opportunities Offset Fund.

48. The performance across all three vintages has had positive tailwinds from a combination of positive foreign exchange movements, improved timber pricing and positive reappraisal results for underlying timber assets however it is worth noting that inflationary pressures cannot be passed on entirely and as such returns may be adversely impacted.

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

49. 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 with both quarter performances shown to illustrate the level of decline since 30th March 2022.

Fund	Actual % of Fund at quarter end 30.09.22 (target weight)	Quarter performance to 30.09.22	Quarter performance to 30.06.22
LGPSC emerging market debt fund	1.8% (2.5%)	-4.4%	-11.7%
LGPSC investment grade credit fund	1.9% (2.5%)	-8.7%	-9.1%
Aegon index linked bond fund	3.3% (4.5%)	-8.9%	-17.7%

50. 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 global bonds.

51. The UK index linked bond investment lost another 8.9% following a -17.7% decline the previous quarter. The quarter to 30th September had unprecedented events unfold including, central bank intervention, political and monetary policy changes. As a result, some of the longest dated index linked holdings experienced huge changes in price over the quarter with some falling by over 50% and then gaining over 100% by the end of the quarter.

52. In the backdrop of tightening monetary policy due to elevated inflationary pressure, fixed interest holdings within mandates will be under pressure although some managers are beginning to wonder if the central banks will be able to raise rates as far as they have signalled. Any change from the current tone to raising could spark a rally in prices and reduce yields.

53. As a result of the current conditions and recent performance all three managers are below their target weights as of 30th September 2022. Officers have commenced work to rebalance the underweights alongside the Fund's investment advisor. Any changes made will be reported at the next Committee meeting.

<u>Recommendation</u>

54. The Local Pension Committee is asked to note the valuation of the Fund

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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