Agenda Item 9

Leicestershire County Council

LOCAL PENSION COMMITTEE – 20 JANUARY 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

OVERVIEW OF THE CURRENT ASSET STRATEGY AND PROPOSED 2023 ASSET STRATEGY

Purpose of the Report

1. The purpose of this report is to inform the Local Pension 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, which is set each year, 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, provide additional manager monitoring and improve responsible investment credentials and 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 has resulted in Central becoming the single largest investment manager the Fund invests with. The Fund has made good progress regarding an orderly transition to Central products to date. Some investments in niche areas or where the investments are illiquid will take time to transition or may be kept outside of the pool on the advice of the Fund's investment advisor.

5. As at September 30th 2022, the value of pooled funds directly managed by Central and low cost index trackers collectively procured from Legal and General totals £2.7 billion or 48% of the Fund's total value. The Fund has significant uncalled commitments made to Central illiquid products that, all things being equal, once called will increase the proportion of pooled funds. During 2022 commitments were made to property, infrastructure and private credit products.

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, and as a result an 'optimal' asset mix does not exist. 2022 was a reminder of this as previously held beliefs were proven not to be the case as both bonds and equities sold off. 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 in line with the Fund's required rate of return as calculated by the Fund's actuary Hymans Robertson.

Summary of last years (Jan 2022) proposals and progress

7. No changes to asset allocations were proposed at the January 2022 Local Pension Committee, however, a number of asset class reviews were recommended, the outcomes of which are summarised in the table below.

Proposal	Actions
Listed equity review	This review has not commenced and has been communicated to the committee that approving a net zero climate strategy and incorporating the required targets into the scope of the listed equity review would take place once the net zero climate strategy (NZCS) is approved. This strategy is currently under consultation and the listed equity review will take place in 2023. The upcoming review will take into account geographic mix, active/passive split, style exposure as well as climate risks and opportunities.
Property review to restructure the current portfolio	A strategy review conducted by Hymans was approved by the Investment Sub-Committee (ISC) at the April 2022 meeting. This review included setting geographical targets, the desired mix of direct and indirect investments as well as a route to transition to the target mix.
Infrastructure review	An infrastructure review was conducted by Hymans and presented to the ISC in July 2022. Three investment proposals we approved (with one requiring completion of due diligence) that would bring the Fund closer to its target infrastructure allocation of 9.75%. The review also outlined the target geographical and risk profile for the overall infrastructure portfolio. As at September 2022 the actual weight was 9.2% with a commitment made but uncalled by the manager to bring the actual weight closer to target.
Targeted Return review	The Central offer for this product became available in late 2022 and due diligence by Hymans was commenced. Given the complexity of the offer and timing of the 2023 SAA it was agreed by officers to delay bringing a proposal to committee until after the SAA proposal was completed. At present, officers and Hymans are in discussion with Central. Further due diligence may take place and an update will be provided to the relevant committee in 2023.

Review of distressed debt	This review was concluded by Hymans with the scope expanded to include all private debt. The proposal was bought to the October ISC with multi-year commitments approved to manage the allocation to this asset class approved. Hymans advised against allocating to distressed debt as part of their advice.

Summary of 2023 proposals

8. The summary of proposals made by Hymans have been assessed by officers, who have since shared the proposals with LGPS Central in order to gain further insight with respect to future pooling. Officers have also discussed the proposals with LGPS Central which helps their understanding and development of products and is in line with the spirit of pooling.

9. For 2023, Hymans propose the Fund make a number of changes to the Fund's target asset allocations. The changes are presented in the table below showing the 30th September actual weighting, current target SAA alongside the 2023 proposed target SAA.

10. Due to their sensitive nature, the specific investments which are affected by the proposed changes, timing and mechanics of investing and divesting are detailed in a separate paper which will be considered during the exempt part of the agenda.

Proposed changes

Asset Group	Asset Class	Sep 2022 Actual	Current SAA	Proposed SAA	Change
Growth	Listed equities	43.4%	42.00% (40% - 44%)	37.50%	- 4.5%
Growth	Private equity	8.0%	5.75%	7.50%	+ 1.75%
Growth	Targeted return	8.9%	7.50%	5.00%	- 2.5%
Income	Infrastructure (incl. timber)	9.2%	9.75%	12.50%	+ 2.75%
Income	Property	8.9%	10.00%	10.00%	
Income	Emerging market debt	1.8%	2.50%	0.00%	- 2.5%
Income	Global credit – liquid sub inv grade markets	3.6%	4.00%	9.00%	+ 5%
Income	Global credit - private debt (inc M&G/CRC)	7.4%	10.50%	10.50%	
Protection	Inflation-linked bonds	3.3%	4.50%	4.50%	
Protection	Investment grade credit	3.4%	3.00%	2.75%	-0.25%
Protection	Currency hedge	1.0%	0.50%	0.75%	+0.25%
Protection	Cash / cash equivalent	1.1%	0.00%	0.00%	

Investment objectives and required return

11. Underpinning the changes proposed is the investment objectives and required return for the Fund. The Fund's recent valuation (as at March 2022) was presented at the November Local Pension Committee. The Fund's actuary, Hymans Robertson shared with the investment advisor (also Hymans Robertson) the outcomes of the actuarial valuation and assumptions contained within. The proposed changes in target allocation are proposed such that attainment of the overall investment performance is consistent with that assumed by the actuary.

12. The Fund most recent valuation calculates a 75% likelihood of achieving 4.4% investment return per annum and reports a 105% funding level as at 31st March 2022. The median return projection (50% likelihood of achievement) associated with the most recent valuation is 6.5% pa. These returns were calculated by the actuary based on long term asset assumptions as at 31st March 2021.

13. The proposed 2023 SAA investment returns is based on the most recent asset returns expectations (as at 31st October 2022) for asset classes. The median (50% likelihood) return expectation is 8.2% in comparison to the actuarial returns expectation of 6.5%, also 50% likelihood.

14. The excess returns expected over the actuarial required return is largely due to the increase in interest rates and government bond yields experienced through 2022 which has impacted the returns expectation as used for the SAA.

15. For comparison the existing SAA has a median return expectation of 8.1% based on the same latest return expectations of asset classes and demonstrates a similar level of return is expected for the proposed change in SAA.

16. The strategic asset allocation 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 high but takes excessively large risks and as a result has a higher 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 a lower probability of producing the returns needed to reduce future employers' contribution levels.

17. Hymans have taken into account the Fund's draft net zero climate strategy (NZCS) and are mindful of changes to the SAA and the impact on delivery of the proposed 2030 medium term targets included within the draft NZCS.

18. The next full Fund valuation is due in March 2025 (with results available later in 2025),and will align investment return expectations which will again be matched with liability forecasts. In the period between now and 2025 annual reviews of the SAA will take place where the proposed SAA may be changed in line with the views of the Fund's investment advisor working with officers.

19. Proposed changes in SAA targets are briefly described below with more detailed contained within the exempt report.

Listed Equity

20. A reduction is proposed from the current weighting down to 37.5%. The actual weight is currently within the bounds of the existing target. This is the largest absolute change in value within this year’s proposed strategy. The exact nature of the change will be dependent on a separate listed equity review which was postponed from 2022 partly due to the completion of the net zero climate strategy which will feed into the medium-term requirements for a listed equity portfolio.

Private Equity

21. An increase to the weighting has been proposed to 7.5%. The current weight is 8.0% and so on the face of it no immediate changes are required. Noting that private equity valuations usually lag listed equity equivalents which are priced far more frequently, there may be a catch up of downward valuations if markets remain in their current mood.

Targeted Return

22. A reduction to the weighting has been proposed to 5.0%. Targeted return currently comprises of three of managers (each weighted equally). The actual weight as at end of September 2022 of 8.9% will have decreased due to two divestments in December 2022 to fund calls made on various commitments during the year.

Infrastructure

23. Hymans noted as part of the 2022 SAA proposal a potential future increase to the infrastructure weight. As part of the 2023 SAA proposal an increase to 12.5% is proposed. The July ISC approvals which included an infrastructure strategy and a number of manager commitments means the Fund is closer to the existing 9.75% target with a number of calls made in recent months bringing the Fund even closer.

Liquid Global Credit – sub investment grade and emerging market debt (EMD)

24. An increase to the weighting has been proposed to 9.0% from the current 4.0%. The current holding is made up a single multi manager product which is near the target weight of 4.0%. 2.5% of the 5% increase is dependent on changes that need to be agreed with the relevant manager of the single multi manager product. More information is provided within the exempt paper.

25. A review of the EMD weight is to take place at the same time alongside reviewing the single multi manager product. There are dependencies associated with this change that are described in the exempt paper.

Investment grade credit and currency hedge

26. A reduction to the investment grade weighting of 0.25% has been proposed alongside an increase of 0.25% to the collateral held for the Funds currency hedge. The increase of the allocation to the currency hedge to 0.75% recognises the value of the collateral held under normal circumstances over the last 12 months with Aegon, the Funds currency hedge manager. A weight of 0.75% equates to c£40m which, given the Fund’s benchmark hedge of 30% of foreign currency exposure, feels appropriate given the level of volatility experienced in recent times.

27. The reduction of 0.25% in investment grade bonds will be taken at the appropriate time during 2023 as part of the cash management and or based on tactical information received from the Fund's advisor.

Reviews pending

28. The proposals include a number of reviews that will be planned to take place during the year which include a listed equity review, targeted return review and protection assets review. Officers will plan with Hymans the relevant investment subcommittee that these reviews will be presented to.

Rebalancing principles

29. The Fund's rebalancing principles were drafted and presented to the Local Pension Committee at the November 2022 meeting. The rebalancing principles are included within the Investment Strategy Statement which is currently under consultation. The rebalance range (where no rebalancing is required) and the target for each asset class will be updated in the Investment Strategy Statement with the 2023 SAA if approved. The ISS will be presented to the Local Pension Committee for approval in March 2023.

30. The Hymans scope for the SAA reviewed the rebalancing principles. The investment advisor concluded that they consider the ranges and principles included as appropriate.

Leicestershire Pension Fund Conflict of Interest Policy

31. Whilst not a conflict of interest, it is worth noting that the County Council also invests funds with three managers which the Leicestershire County Council Pension Fund invests with, namely Partners Group, JP Morgan and Christofferson Robb and Company (CRC). The County Council's investments were made following due diligence Hymans Robertson had provided the Fund.

Supplementary Information

32. An exempt report providing further detail of the proposals for the Fund's asset strategy and structure, which is of a sensitive nature, is included within the exempt part of the agenda.

Recommendation

33. It is recommended that the Local Pension Committee notes the report.

Equality and Human Rights Implications

34. None.

Background Papers

Local Pension Committee – 18 November 2022 – Summary Valuation of Pension Fund Investments, Investment Performance of Individual Managers and Investment Advisor Objectives

Local Pension Committee - 21 January 2022 – Annual Review of the Asset Strategy and Structure

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