Agenda Item 7

Leicestershire County Council

LOCAL PENSION COMMITTEE – 3 MARCH 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS

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 focusing on private debt, a summary valuation of the Fund's investments as of 31 December 2022 (Appendix A).

   b. Information on the levelling up government white paper and Information on local investments, in particular Leicester, Leicestershire, and Rutland

Markets Performance and Outlook

2. A summary of asset class performance over various time frames as at quarter end 31 December 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 earlier in 2022. Private Equity has no 20-year source information available.

	3 MONTHS*	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	TWENTY YEARS
GLOBAL EQUITIES	10.04	-17.60	4.56	5.76	8.66	8.32
PRIVATE EQUITY	2.06	-19.93	5.19	8.10	12.52	N/A
PROPERTY	4.22	-25.01	0.27	4.47	7.25	9.41
INFRASTRUCTURE	11.04	-0.18	1.67	3.83	6.55	8.60
HIGH YIELD	6.49	-11.03	-1.14	1.50	4.81	10.73
PRIVATE DEBT	0.57	-6.29	-1.50	-1.17	-0.45	0.18
UK GILTS	1.70	-25.06	-8.24	-3.58	0.36	3.15
UK INDEX-LINKED	-5.99	-34.42	-8.82	-4.25	1.95	4.65
GOLD	1.37	11.52	9.61	9.27	3.93	10.19

Note: Private Market asset classes will typically display lower volatility compared to their listed index proxies.
Source: Bloomberg Note: listed proxies have been used for Infrastructure, Property, Private Debt and Private Equity.

Portfolio changes in the quarter ended

3. It was busy end to 2022 as many commitments made in 2021 and 2022 were called in the final quarter. As a result, there were several planned and orderly divestments made from overweight positions to provide the funds to satisfy these calls which varied by manager and covered infrastructure and private debt in the main.

a. In December 2022, £27m divested from Aegon's short-dated investment grade bond fund. The Fund held an overweight position here awaiting calls from managers.

b. In December 2022, instructions were placed with Aspect Capital and Ruffer to divest £30m and £20million, respectively. This reduced the Fund's overweight position to targeted return and helped rebalance the three individual managers to a more equal one third each.

c. In December 2022, Legal and General Investment Managers (LGIM), who manage over £850m in passive global equities for the Fund, were instructed to divest £70m to bring their overweight position closer to the target, this was the final divestment instruction in 2022.

4. Two rebalancing investments were made in line with the Fund's SAA, these were to index linked bonds and investment grade corporate bonds. These two asset classes had fallen in value throughout 2022, with index linked bonds (ILB) having fallen 32% and investment grade corporate bonds having fallen 19% in 2022. The Fund added £67m to ILB in early December 2022 and £34m to investment grade corporate bonds.

5. During the quarter, the Fund also recovered £25m of excess collateral held at Aegon to support the foreign exchange hedge. The collateral was recovered given the improved performance of sterling versus the US dollar which had sold off in the previous quarter when additional collateral was provided to Aegon by the Fund. Officers are in regular contact with Aegon in order to understand the market and level of hedges in place.

Cash at quarter end

6. At quarter end the cash held by the Fund totalled £96m, with an additional £20m cash held as collateral with Aegon for the currency hedge.

7. 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 had during the quarter ending September 2022 (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.

8. 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.

9. 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.

10. Officers are also mindful of considerable commitments approved by the Committee over 2021 and 2022 that have started 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 to avoid frequent redemptions.

Overall Investment Performance

11. A comprehensive performance analysis over the quarter, year, and three-year period to 31 December 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.

12. Of note is the news that Portfolio Evaluation’s directors have decided to close the business during 2023 and have advised all clients of their intention. There are several LGPS funds affected. Officers from the funds affected within our pool have started to look at a number of options and will report back on any updates.

13. 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.

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

	Quarter	1 yr	3 yr pa	5yr pa
Total Fund	+2.1%	-3.5%	+5.5%	+5.7%
vs benchmark	+0.9%	+1.7%	+1.0%	+0.6%

15. The Fund has experienced strong returns versus the benchmarks with positive returns across all time frames from an absolute perspective. It is important to note that investment returns can be negative and for a protracted period, and chances of negative returns over shorter periods of time are considerably higher than longer periods 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 and as such the portfolio has a diverse mix of assets including assets classed as ‘protection.’

16. 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. However, given the dual sell offs in both equity and bonds in 2022, the Fund’s protection assets suffered negative returns which were marginally ahead of their respective benchmark returns. As a result, there is a protection assets review to be conducted by Hymans in 2023.

17. The -3.5% return for the calendar year 2022, which is +1.7% versus the Fund’s benchmark can be seen as positive for the year which included many negatives including, sustained equity sell offs, a deteriorating bond market, falling global GDP alongside rapid global central bank interest rate increases.

2023 Investment Plans

18. The Fund’s 2023 Strategic Asset Allocation (SAA) was approved at the January 2023 Pension Committee. There were a number of changes approved which are summarised in the table below.

Asset	Asset Class	2022 SAA	2023 SAA	Change from

Group				2022 SAA
Growth	Listed equities	42.00% (40% - 44%)	37.50%	- 4.5%
Growth	Private equity	5.75%	7.50%	+ 1.75%
Growth	Targeted return	7.50%	5.00%	- 2.5%
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%
Income	Property	10.00%	10.00%	
Income	Emerging market debt & Global credit – liquid sub inv grade markets	6.50%	9.00%	+ 2.5%
Income	Global credit - private debt (inc M&G/CRC)	10.50%	10.50%	
Protection	Inflation-linked bonds	4.50%	4.50%	
Protection	Investment grade credit	3.00%	2.75%	-0.25%
Protection	Currency hedge	0.50%	0.75%	+0.25%
Protection	Cash / cash equivalent	0.00%	0.00%	

19. In summary the net effect of changes approved is to increase the allocation to the income asset group (+5.25%) whilst equally reducing the allocation to the growth asset group.

20. A schedule of work has been agreed with Hymans to facilitate the changes similar to 2022. Proposals will be considered with officers in advance of presenting to the Investment Sub-Committee meetings (ISC) in 2023. The following are to be reviewed by Hymans:

    a. A listed equity asset group review
    b. A targeted return review
    c. A protection assets review

<u>Levelling up summary and investing locally</u>

21. It has been a year since the Government published it policy paper, ‘Levelling Up the United Kingdom.’ The Paper also provides details of twelve new missions across four broad areas:

    a. boosting productivity and living standards by growing the private sector, especially in those places where they are lagging;
    b. spreading opportunities and improving public services, especially in those areas where they are weakest;
    c. restoring a sense of community, local pride and belonging, especially in those places where they have been lost; and,
    d. empowering local leaders and communities, especially in those places lacking local agency.

22. Of note to Funds such as the LGPS, the paper suggests unlocking institutional investment in infrastructure, by asking local government pension schemes to publish plans for increasing local investment amongst other initiatives. Although the term local investment is not defined in the paper, it was subsequently clarified by England and Wales LGPS' Scheme Advisory Board that "investments anywhere in the UK could be included in a levelling up plan"

23. The Fund does invest in Funds that do have investments in the United Kingdom. In particular, the LGPS Central infrastructure Fund has forecast a 25% allocation to UK investments. Considering that the UK makes up around 10% of the global economy infrastructure deals (data provided by Prequin) over the last decade this over weights the UK which was a stipulation by partner funds when the fund was being designed.

24. The Fund has infrastructure holdings with seven infrastructure managers. Estimating the impact of current commitments would indicate the Fund will have c£100m (or around 14% of all the Fund's infrastructure) invested in UK assets by middle of 2024. Again, this is well in excess of the United Kingdom's share of global infrastructure.

25. The Fund's infrastructure investments also invest in renewable energy generation with commitments made to LGPS Central's core/core+ sleeve investing in a UK focussed solar and battery storage assets developer, a fund focussed on investing in core UK infrastructure specifically targeting social, renewables, transport, and utilities assets and a global fund focussing on core renewable and energy transition assets with a view to accelerating the world's transition to net zero greenhouse gas emissions.

26. In addition to infrastructure holdings, the Fund also holds significant UK property assets. As at the 31 December 2022, the Fund held approximately £397m in UK property assets from the total property holdings of £418million. Again, this allocation is higher than the United Kingdom's benchmark share of global property. Of note, the ISC approved a strategy in April 2022 that will modify the property portfolio to one with a more balanced global exposure.

27. The Fund has for many years preferred diversified global investment options rather than UK or regional only specific Funds for a number of reasons:

    a. Adding new managers with smaller commitments adds to the overall local governance burden with respect to manager monitoring and reporting.

    b. Investment pooling means the Fund should first engage with LGPS Central in order to invest, thereby benefiting from lower fees, manager oversight and shared governance costs which should provide better value for money and risk adjusted investment returns. Of note, at present there has not been enough partner fund interest for LGPS Central to create a UK only infrastructure fund.

    c. Were the Fund to find a manager outside of LGPS Central that invested within a geography, for example the Midlands, there is no guarantee that Funds would be invested wholly within Leicester, Leicestershire, and Rutland (LLR). In all likelihood, investments would spread outside of LLR and into surrounding counties.

    d. As the Fund has grown, the value of investment commitments has also grown to ensure that any new holding can have a meaningful investment returns impact on the Fund. Given the additional governance and monitoring impact of each new manager appointment, the Fund would want to invest at least 1% of the total

Fund value and ideally 2%. At present, that 1% would represent c£55m and £110m for a 2% allocation. Even at £55m, a regional investment manager would find it difficult to find enough good opportunities to deploy money into LLR in a timely manner. It is worth noting that LLR is c1.5% of UK GDP.

e. Investing locally may mean settling for opportunities that offer lower returns than those available from managers who specialise in a wider geography. This could mean decisions are made that are not in the best interests of the participating employers.

f. Managers are incentivised to earn at least the returns their mandates stipulate and where performance fees exist, exceed the required (hurdle) rate to earn these performance fees. As a result, investments would be made within LLR that earn the Fund a fully commercial return.

g. Investments may not be popular with public in the locality. Although the Fund could limit the mandate this would make it even harder for manager to deploy profitably. Conversely if the Fund were to not limit the mandate, then it cannot influence the managers running the scheme commercially.

h. The Fund would be subject to reputational risk if problems were to arise with local schemes but would have minimal ability to intervene.

i. Hymans have during the July 2022 review of the Fund’s infrastructure investments stated their preference is, ‘to favour global developed markets strategies rather than regional strategies’. They state, ‘by taking a regional approach, investors risk investing in markets that do not offer the best current investment opportunities and risk suffering disappointing returns.’

j. The Fund risks compounding a local economic issue which could reduce the ability of a local body to pay contracted sums to the investment which in turn reduces investment return.

k. The Fund needs to be mindful of conflicts of interest. Delegating investment decisions to managers able to investment across a wider geography than LLR reduces potential conflicts.

l. There are no restrictions on the mangers investing in LLR if they find the right opportunity. The Funds approach is to allow managers investment decision flexibility in order to find the better opportunities.

28. The Fund by earning a commercial return supports local authorities (and other employers) by earning commercial returns in order to keep employer contributions lower than they otherwise could be. Local Authorities are able to access funding at lower rates than the pension fund who are then able to chose where to invest locally.

29. With the contacts available at the various infrastructure investment managers, were investible schemes available in LLR these could be passed to relevant manager to make them aware of the opportunity.

30. It is worth noting the Fund must follow the law and statutory guidance for preparing and maintaining its Investment Strategy Statement and must take proper advice and act prudently when making investment decisions. The Fund’s investment advisor, Hymans Robertson prepares the annual strategic asset allocation (SAA), which outlines the

direction of Fund investments in the near term. The most recent SAA was approved at the 20 January 2023 Local Pension Committee meeting.

31. The appetite of the Fund for taking risk when making investment decisions is ultimately for local consideration and determination by the Local Pensions Committee subject to the aim and purpose of the Fund, to maximise investment returns within reasonable risk parameters. It is not the role of the Fund to put non-financial beliefs, such as political, ethical, moral, social, and local preference factors above those of the employers funding the pension scheme.

32. At the 18 November 2022 Local Pension Committee meeting, the Director of Law and Governance presented a paper regarding fiduciary duty and the LGPS, which covered the definition of fiduciary duty, the law on investment decisions and consideration of Environmental, Social and Governance (ESG) factors when making decisions. The covering paper is included as background paper.

33. The Director of Law and Governance has been consulted regarding the section on levelling up and investing locally.

Private Debt asset class review

34. Following on from the Partners Group presentation, the following section will expand on the Fund's total private debt holdings which are valued at £407m or 7.4% of total fund assets at the end of December 2022.

35. The Fund has had a 10.5% weighting approved to the private debt asset class. Given the manner in which money is called and returned to the Fund when investing in illiquid investments (such as private debt), there is a significant value of uncalled commitments that have been made over the last year that will close the gap to the 10.5% target. Commitments have been made to LGPS Central and Partners Group products following the October ISC where a multi-year plan was approved.

36. The multi-year plan covered commitments in financial years 2022/23 and 2023/24. The splitting of commitments reflects the need to manage cashflows within the Fund, so as not to be a forced seller of assets when managers call for funds and spread investments by year to reduce risks associated with investing substantial amounts during a smaller timeframe.

37. The Fund has investments in several risk categories ranging from lowest risk to highest risk and potential return. The allocation to these areas is broadly described in the following paragraphs.

38. Senior secured corporate – the fund invests to this class via Partners Group and LGPS Central's low return sleeve in the main. The senior debt sits high in the priority ranking order in the issuing company's balance sheet and is generally backed (secured) by corporate assets. The key return driver is the spread over the reference rate (the base rate). This spread varies depending on how deep in the capital structure the manager is willing to lend, and range from senior (such as, first call on assets in the event of default), and therefore safest to equity although there are limits to how much can be allocated to equity by each manager and the strategy they employ.

39. Real estate debt or real assets – the Fund invests to this class primarily via LGPS Central and the real assets sleeve. An £80million, commitment was made in 2022. Commercial real estate debt assets are loans backed by real estate. Returns vary

depending on where the loan is in the capital structure (senior to junior), the loan-to-value ("LTV") and if the asset is stabilised (such as, operational) or not. Real estate debt provides a consistent income with less risk than real estate equity.

40. There are several investment risks to consider, with the key being the credit risk of the borrower. The credit risk of the borrower can be assessed as the ability to pay but can also depend on the tenants' credit quality if debt service is dependent on income from tenants if the property is operational.

41. Special situations debt – the Fund investments in this asset class are via CRC (Christofferson Robb and Company) (and their two bank risk share vintages, CRF3 and CRF5) and LGPS Central's high return sleeve. This type of debt aims to deliver an enhanced yield by providing bespoke solutions to mid-market corporate borrowers which are fundamentally strong businesses facing specific challenges, such as short-term liquidity issues, facing near-term refinancing challenges or those looking for additional financing to pursue strategic opportunities. The underlying businesses are not distressed to the point of struggling to make payments on debt commitments but do entail more risk than other strategies mentioned above, as such the returns are higher. The typical returns range upwards from the high single digits to mid-teens.

42. Distressed debt – the Fund's only investments in this area is via M&G's distressed opportunities funds two, three and four. This strategy focuses on debt issued by inherently viable businesses which has become unsustainable, usually after a period of significant operational and financial underperformance, but the businesses will still have a commercial rationale. It aims to generate a high return largely through capital growth, typically involves restructuring. The returns expected are upwards from mid-teens. The risk and return profile of the strategy is materially higher than other credit opportunities, such as special situations financing, because of the problems facing the underlying businesses.

43. The Fund's breakdown of private debt investments is shown in the table below. The LGPS Central investments are shown as at 31/12/22, whereas the independent external valuer has used a lagged valuation. The difference to the target allocation of 10.5% is lower at 1.8%. The outstanding commitments of £300million relate mainly to LGPS Central products and will be called by the underlying managers over their respective investment periods. These calls will be offset by capital distributions over the coming years mainly from the older investments in the asset group.

Investment	£m 31/12/22	£m outstanding commitment	% of total Fund	Market Segment
Partners Group – six vintages	245	22	4.4%	Senior corporate
CRC – two vintages	69	0	1.3%	Special situations
M&G – 3 vintages distressed opportunities	64	0	1.2%	Distressed debt
LGPSC – low return	52	188	0.9%	Senior corporate
LGPSC – high return	21	39	0.4%	Special situations
LGPSC – real assets	29	51	0.5%	Real asset debt
Total	**480**	**300**	**8.7%**	

44. At the October ISC a number of new commitments were approved which would take the Fund towards the target 10.5%. Alongside the approval was a framework which

described the target allocation to private debt market segments. The framework is included below alongside actual allocation.

Market Segment	Target %	Range %	Actual Dec 2022	Actual vs range
Senior corporate debt	65%	40% - 90%	62%	In line
Real asset debt	20%	10% - 30%	6%	Below
Special situations debt	10%	0% - 20%	19%	At top of range
Distressed debt	5%	0% - 10%	13%	Above

45. The commitments outstanding will bring the actual allocation closer to the targets which were approved at the October 2022 ISC. Of note is the over allocation to distressed debt. This allocation resides within three vintages of M&G's distressed opportunities fund all of which are closed ended and will return capital over the next two years. If there are no more commitments made to this area of the risk spectrum, officers forecast close to zero allocation to this area by the end of 2025.

46. Whilst special situations investments are currently at the top end its target range, we expect that over the next two years this allocation will fall slightly as investments made to CRC are returned whilst committed amounts are called by LGPS Central's high return sleeve.

47. The private debt framework developed as part of the review in October 2023 will be used to monitor actual and forecast allocations against on a regular basis. Indeed, all three reviews (property, infrastructure, and private debt) in 2022 followed a similar process where Hymans advised of a framework to work towards to diversify and allocate to the correct areas of the market and risk spectrum given the views of the investment advisor.

Leicestershire Pension Fund Conflict of Interest Policy

48. 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). Decisions on the County Council's investments were made after the Fund had made its own commitments.

Recommendation

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

Environmental Implications

50. The Leicestershire LGPS has developed a Net Zero Climate Strategy (NZCS) for the Fund. This outlines the high-level approach the Fund is taking to its view on Climate Risk. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment. The Fund is committed to supporting a fair and just transition to net-zero. There are no changes to this approach as a result of this paper.

Equality and Human Rights Implications

51. The Fund considers issues around Equality and Human Rights as part of its whole approach to responsible investment and environmental, social and governance factors in all investment decisions. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero. There are no changes to this approach as a result of this paper.

Appendices

Appendix - Portfolio Evaluation - Summary Valuation of Funds Performance

Background Papers

18 November 2022 – Local Pension Committee Appendix D - Outcome of Engagement on Net Zero Climate Strategy Targets and Draft Strategy and Responsible Investing Update

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