Agenda Item 9

Leicestershire County Council

LOCAL PENSION COMMITTEE – 16 JUNE 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 an update on the investment markets and how individual asset classes are performing focusing on property and a summary valuation of the Fund's investments as of 31 March 2023 (Appendix A).

Markets Performance and Outlook

2. A summary of global asset class performance over various time frames as at quarter end 31 March 2023 is shown below. Two asset classes still 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	7.3%	-6.8%	15.7%	7.4%	8.7%	9.0%
PRIVATE EQUITY	2.2%	-12.7%	19.0%	10.3%	10.6%	N/A
PROPERTY	1.8%	-19.3%	9.4%	6.3%	6.5%	9.5%
INFRASTRUCTURE	3.9%	-3.5%	15.2%	5.8%	6.4%	8.9%
HIGH YIELD	3.8%	-4.4%	5.2%	2.3%	4.8%	10.6%
PRIVATE DEBT	1.0%	-4.3%	4.8%	-1.0%	-0.5%	0.1%
UK GILTS	2.2%	-17.2%	-9.9%	-3.2%	0.5%	3.2%
UK INDEX-LINKED	4.2%	-27.5%	-9.2%	-3.5%	1.6%	4.7%
GOLD	5.9%	8.3%	6.9%	11.0%	4.3%	10.6%

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. After a busy end to 2022, when many commitments made in 2021 and 2022 were called during the final quarter, and two rebalancing investments (index linked bonds and investment grade corporate bonds) were completed, the start of 2023 was calmer with regular smaller capital calls from existing commitments. There were no divestments required in the quarter.

Cash at quarter end

4. At quarter end the cash held by the Fund totalled £69m, with an additional £34m cash held as collateral with Aegon for the currency hedge. Taken together this is around 1.8% of total fund assets.

5. 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.

6. 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.

7. 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 following the change made by the Committee in January 2021 which was actioned in April 2021.

8. Officers are also mindful of considerable commitments approved by the Committee over 2021, 2022 and 2023 that have started to be called by underlying investment managers.

9. Although the Fund doesn’t have a specific cash allocation as part of the strategic asset allocation, officers are mindful of not running cash too low and having to make frequent requests to fulfil calls by managers which can be lumpy.

<u>Overall Investment Performance</u>

10. A comprehensive performance analysis over the quarter, year, and three-year period to 31 March 2023 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.

11. Last quarter we noted 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.

12. 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.

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

	Quarter	1 yr.	3 yr. pa	5yr pa
Total Fund	+1.7%	-1.3%	+10.4%	+6.3%
vs benchmark	-1.0%	0.0%	+1.6%	+0.4%

14. The Fund has experienced positive returns versus the benchmark across longer time frames. However, 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 over longer periods of time as is evident this quarter. 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.’

15. The in-quarter underperformance versus the benchmark of -1.0% is mainly driven by the growth asset class which underperformed the benchmark. Given the majority of the growth asset class are passive investments the underperformance has been generated by the active portion of the growth class, and in this case has been the private equity holdings which experienced a -6.6% decline during the quarter. The valuations for the underlying private equity investments lag those of public listed markets and as such are often seen to increase or decrease after the repricing seen in listed markets.

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 and 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 Robertson in 2023.

17. The -1.3% return for the financial year ending 31 March 2023, which is the same as the Fund’s benchmark over one year 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.

18. The last actuarial valuation for the Fund assumed a long-term return of 4.4%pa. On that basis (and all other things being equal) a lower return over the next 2 years to the next actuarial valuation date (31 March 2024) would result in a worse funding position than reported as of 31 March 2021 when the Fund reported a 105% funding level, up from 89% at the previous valuation. The majority of the increase in funding level was due to investment returns in excess of the expected return. A 3.8% pa return was expected versus an actual 10.3% pa. It is important to note that 3 years is a short period of time and as such large variations are to be expected between expected and actual returns.

19. The variation in returns is taken into account when proposing the strategic asset allocation and employer funding rates in order to protect the pension fund members from unfavourable outcomes.

2023 Investment Plans and actual weighting versus 2023 SAA

20. 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 alongside the actual position as of 31 March 2023 bearing in mind that changes to move towards the 2023 SAA are in progress.

Asset Group	**Asset Class**	**2022 SAA**	**2023 SAA**	**Change from 2022 SAA**	**31.3.23 Actual weighting**	**Vs 2023 SAA**

Growth	Listed equities	42.00% (40% - 44%)	37.50%	- 4.5%	43.9%	+6.4%
Growth	Private equity	5.75%	7.50%	+ 1.75%	7.6%	+0.1%
Growth	Targeted return	7.50%	5.00%	- 2.5%	7.5%	+2.5%
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%	9.9%	-2.6%
Income	Property	10.00%	10.00%		7.3%	-2.7%
Income	Emerging market debt & Global credit – liquid sub inv grade markets	6.50%	9.00%	+ 2.5%	5.6%	-3.4%
Income	Global credit – private debt (inc M&G/CRC)	10.50%	10.50%		8.4%	-2.1%
Protection	Inflation-linked bonds	4.50%	4.50%		4.3%	-0.2%
Protection	Investment grade credit	3.00%	2.75%	-0.25%	3.6%	+0.85%
Protection	Currency hedge	0.50%	0.75%	+0.25%	0.6%	-0.15%
Protection	Cash / cash equivalent	0.00%	0.00%		1.2%	+1.2%

21. In summary the net effect of the 2022 to 2023 SAA changes approved is an increase to the allocation to the income asset group (+5.25%) whilst equally reducing the allocation to the growth asset group.

22. The current position at asset group level shows that the Fund is overweight to growth assets and underweight to income assets and largely in line with protection assets versus the new 2023 SAA. The underweight to income assets which on face value looks large is in the process of being resolved with commitments made over the last 18 months or so to various managers which are in the process of being called. As these commitments are called officers will first use cash and then divest from overweight positions.

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

    a. A listed equity asset group review – taken to April 2023 ISC
    b. A targeted return review – taken to April 2023 ISC
    c. A protection assets review – planned for July 2023 ISC

Property asset class review

24. Following on from last quarter where private credit was in focus, the Fund's property managers are being reviewed this quarter. A summary of the Fund's property holdings are shown below:

Fund name	Geographic	Sector	£m 31 March 2023	% of total Fund
Colliers direct portfolio	UK	Retail, warehouses, office, industrial, alternatives	£99.0	1.7%

Colliers indirect portfolio	UK	Leisure, offices	£16.5	0.3%
LaSalle indirect portfolio	UK, Europe, RoW	Industrial, offices, retail, retail warehouses, residential, alternatives	£245.8	4.3%
DTZ Active Value 1 (AV1)	UK	Retail, industrial, office and leisure	£16.5	0.3%
DTZ Active Value 2 (AV2)	UK	Retail, industrial, office and leisure	£38.3	0.7%
Total			£416.1	7.3%

25. The Fund's total holdings equate to 7.3% of total Fund assets which is 2.7% lower than the SAA target of 10%. The Committee has however approved commitments of £120m to the LGPS Central direct property fund at the April 2022 ISC. Earlier this year the Fund committed the first £60m to the DTZ fund. The remaining £60m will be committed once progress is made by DTZ in deploying Funds. Deployment of the full £120m would equate to 9.4% property weighting, about a 2% increase in overall property weighting all other things being equal.

26. The Fund uses three managers at present to manage property, Colliers, LaSalle and DTZ. DTZ have recently taken over the management of the active value funds (AV1 and AV2) given Aegon (the previous manager) decided to exit the UK direct property market in 2022. A process managed by the trustee of the AV1 and AV2 funds ran a procurement process where DTZ emerged as the preferred bidder.

27. The appointment of DTZ is fortunate for the Fund, and it's aim is to simplify the Fund's manager roster given the decision at the April 2022 ISC to award management of the Colliers mandate to DTZ once the LGPS Central direct property fund, also managed by DTZ is up and running.

28. Over the coming year the fund will have transitioned to two managers, DTZ and LaSalle, with all funds managed by DTZ classed as pooled investments. There are various benefits of moving to these two managers which include simplification of the Funds manager roster and improved governance by leveraging Central's expertise.

29. The go forward plan for the Fund's property holdings is described below taken from the April 2022 ISC where it was stated the transition would be undertaken gradually over the next five years (to 2027).

<table>
<tr><th>Current holding</th><th>Transition to</th><th>Target proportion of all property</th><th>Current proportion</th></tr>
<tr><td>Colliers direct portfolio</td><td>DTZ legacy direct portfolio</td><td>UK 40%</td><td>UK 24%</td></tr>
<tr><td>Colliers indirect portfolio</td><td>LaSalle indirect portfolio</td><td rowspan="4">UK 20%
Global 40%</td><td rowspan="4">UK 69%
Global 5%
Cash 2%</td></tr>
<tr><td>LaSalle indirect portfolio</td><td>Keep, expand to include global allocation</td></tr>
<tr><td>DTZ Active Value 1 (AV1)</td><td rowspan="2">Recycle capital returns into LaSalle to reach maintain the UK and global allocation</td></tr>
<tr><td>DTZ Active Value 2 (AV2)</td></tr>
</table>

30. Differences to target proportion to be addressed as follow:

    a. UK direct – the 16% shortfall will be addressed largely by the commitment of £120m to the Central UK direct property fund. £60m has recently been committed. If all £120m was committed and called at present the UK direct property proportion would equate to about the target level of 40%, all other things being equal.

    b. UK indirect – the 49% overweight position to UK 35% underweight to global are linked. LaSalle have a programme to start moving from UK indirect toward global indirect. The first part of the change is a $30m commitment made to the LaSalle global navigator fund. The transition will involve other global funds and will take place over a number of years.

The property market outlook

31. Property fund performance continued to be weak in the first quarter of 2023. The UK property market saw a large decrease in total returns over Q4 2022 as previously noted, although early 2023 data has shown a material improvement. Three month All Property returns to March 2023 were +0.2%. Residential was the best performing sector (2.9%), followed by Retail (1.5%) and Industrials (0.4%). Offices posted the lowest returns at -1.8%. The data is showing tentative signs of stability, although there remains the risk of further volatility in pricing, until financial conditions stabilise.

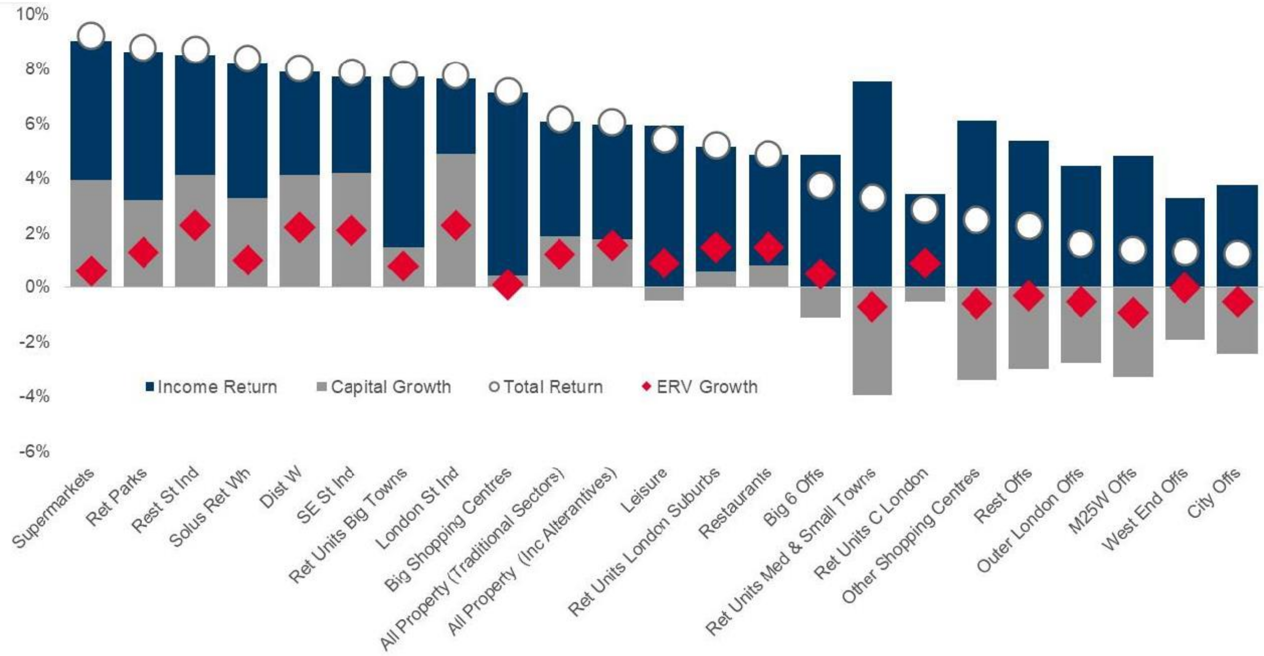
32. Market commentators seem to think the next 12-18 months will see borrowers absorb higher costs and have an eye on income returns whilst minimising capital depreciation:

    - Offices at the top end of energy efficiency will be in demand in prime locations whilst secondary locations and those will lower EPC (energy performance certificate) scores will continue to face headwinds given vacancy rates remain high.

    - Industrials corrected massively during 2022 after the amazing run in the years preceding. Demand remains strong and supply is constrained in some areas which supports landlords pricing of rents.

    - Retail footfall improved post lockdowns ending in 2022 however the sector now faces headwinds from the cost of living crises. Supermarkets, a sub sector of retail, endured a double digit decline in capital values during the quarter. The overall sector has repriced accordingly and may offer more stable conditions.

33. DTZ investors believe the UK property market should see the largest total returns within supermarkets, retail parks and industrials over the next five years (2023-2037). The graphic below breaks out income and capital growth for each type of property type. The lowest five-year total return being expected from offices in general.



The Fund's property performance

34. The Fund alongside the wider property market has suffered capital falls over the last year. The capital falls have been steep, especially for those countries where interest rate increases were sharp like the UK. Given the large weighting to the UK, the Fund's property repriced lower during 2022.

35. The last quarter in 2022 (October to December) had the highest UK quarterly downward correction since MSCI started recording prices in the UK. A 14.6% reduction was recorded for the MSCI UK monthly property index (GBP).

36. The Fund is however underweight to property versus the target 10% SAA and has been so during 2022 which has provided some comfort from the falling prices. The lower comparative prices has provided a better entry point to add money to this asset class and as such the Fund committed £60m of the £120m authorised commitment to UK direct property in April 2023. The remaining £60m will be committed once the speed of property purchases by DTZ becomes apparent and direction of the UK property market becomes clearer.

37. The one, three and five year performance numbers for the Fund's property investments are shown below.

Fund	£m 31.3.2023	One year %	Three yrs. pa %	Five years pa %	Since inception (SI) pa %
Colliers direct portfolio	99.0	-12.3	+2.4	+3.7	+5.9
Colliers indirect portfolio	16.5	-6.5	-4.1	-1.8	-0.4
LaSalle indirect portfolio	245.8	-13.7	+3.6	+3.2	+7.8

DTZ Active Value 1 (AV1)	16.5	-7.9	+1.3	+1.8	+4.3
DTZ Active Value 2 (AV2)	38.3	-17.4	-1.1	+0.6	+2.4
Total property	416.2	-13.2%	+2.0%	+2.5%	+4.7%
Total benchmark*		-14.9%	+2.6%	+2.7%	+4.1%
Difference		+1.7%	-0.7%	-0.2%	+0.6%

*MSCI UK monthly property index

The Colliers UK portfolio

38. The portfolio comprises a small amount of indirect holdings (£16.5m) from two pooled funds, a central London office fund and a leisure focused fund and 21 directly owned properties covering retail, retail warehouses, offices, industrial and alternative asset classes which are valued at £99m.

39. This direct UK portfolio is in the early stages of transfer to DTZ. It will be managed alongside the new pooled UK direct fund which the Fund has committed £60m into. The portfolio compromises freeholds, long and short leasehold interests that the manager will manage along the same fee structure as the direct pooled fund. Officers and DTZ are working on a plan to eventually transition management, no formal notice to transfer management has been served to Colliers whilst the project plan is being completed.

40. The performance of the Colliers managed portfolio outperformed the benchmark by 2.6% over the last 12 months. The income yield was 6.2% which could have been improved had the vacancy rate been lower. The vacancy rate of 12.5% is higher than the MSCI average vacancy rate of 10.3% The bulk of the vacancy is at an office property in Richmond which is undergoing improvement with a view to making it more marketable in a difficult letting environment.

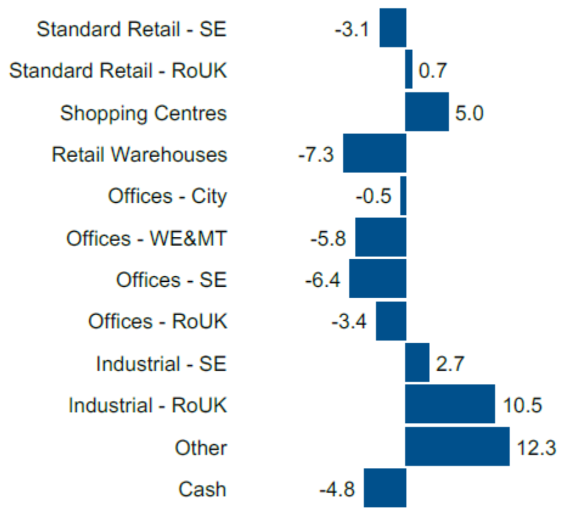
LaSalle indirect portfolio

41. The majority of the Fund's property holdings reside with LaSalle and is comprised of holdings in 20 pooled funds. At March end the holdings were valued at £246m (includes £9.5m in cash). There is a combination of open and closed ended funds with a preference for open ended funds and lower risk core property holdings.

42. The strategy has worked well for the Fund which was commented on by Hymans at the April 2022 ISC when the property strategy review was presented. This performance has continued through 2022 beating its benchmark albeit still producing a negative return of -13.7%.

43. The portfolio is invested across many sectors but at present is UK focused. The graphic below shows the percentage holding in each sector versus the benchmark. The portfolio is overweight (versus the benchmark) the sectors which are tipped to perform well such as industrials and shopping centres and underweight offices.

Segment	Mandate	BM
Standard Retail - SE	1.6	4.7
Standard Retail - RoUK	2.2	1.4
Shopping Centres	5.8	0.9
Retail Warehouses	4.6	11.8
Offices - City	3.1	3.6
Offices - WE&MT	2.2	8.0
Offices - SE	1.0	7.4
Offices - RoUK	1.6	5.0
Industrial - SE	27.1	24.3
Industrial - RoUK	24.1	13.5
Other	24.4	12.1
Cash	2.4	7.2



44. Underlying metrics look good with a low vacancy rate of under 6% and a 4.7% yield which is recycled into the developing strategy to move towards the areas the manager feels are ‘healthy’ from an investor and occupational perspective such as student accommodation. LaSalle have been building the real estate debt element of the portfolio feeling it offers higher yield and capital value protection. The manager has also been increasing the exposure to those sectors of the market that have leases that have some indexation to RPI, such as the private rented sector.

DTZ active value 1 and 2 (AV1 and AV2)

45. These are the two closed ended funds which were originally managed by Aegon before they announced the closure of their UK direct property business. The trustee ran a procurement for a new manager with DTZ investors announced as the new manager.

46. The active value funds strategy invests in the value add risk spectrum buying secondary properties at attractive prices. In total across both funds 48 properties are being managed, our share of both funds (AV1 and AV2) has a combined valuation of £55m at the quarter end.

47. These two funds were earmarked to commence returning money but have had their capital returns delayed, mainly owing to the pandemic and soft market conditions. The return of capital would have been used to rebalance the portfolio between direct and indirect funds and between UK and global property.

DTZ active value 1 and 2 term extensions

48. During May officers were presented by DTZ with proposals to extend the life of the two closed ended funds (AV1 and AV2) in order to generate the best overall outcomes for investors. It is not surprising that the manager has come to this conclusion as having to divest 28 assets from AV1 and 20 assets from AV2 in a UK market at this stage is likely to result in worse returns than conducting a more orderly sell down with some improvements being made to properties prior to sale.

AV1 extension

49. The fund life for AV1 expires is due to expire on 10 October 2023, an extension to this will require approval from all unit holders. The manager has been speaking to all

investors and is recommending a two-year extension to 10 October 2025 allowing for an orderly sell down into a hopefully improving market from 2024 onwards.

AV2 extension

50. The fund life for AV2 expires on the 11 June 2023, upon which a 12-month wind down starts. The fund is structured so that a two-year extension is possible by passing an ordinary resolution, where 50% of unit holders approve the resolution. An approved resolution would take fund life to 11 June 2025 plus a 12-month wind down period.

51. Without the need for liquidity and given the Fund's underweight position in property officers are minded to support the fund manager and managing trustees' recommendation to approve fund extensions. In the meantime, both funds will continue to generate income returns in excess of 5% pa as estimated by DTZ.

52. There could however be some sales from both funds if offers are received that are in line with the managers expectations, those capital receipts for the Fund would be recycled with additional commitments to the LaSalle mandate which would continue to reshape the portfolio towards the target UK and global split as described earlier.

Leicestershire Pension Fund Conflict of Interest Policy

53. Whilst not a conflict of interest, it is worth noting that the County Council also invests funds with four managers with whom the Leicestershire County Council Pension Fund invests, namely Partners Group, JP Morgan, DTZ investors and Christofferson Robb and Company (CRC). Decisions on the County Council's investments were made after the Fund had made its own commitments.

Recommendation

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

Environmental Implications

55. 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 Implications

56. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance ("ESG") factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund's fiduciary duty. 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.

Human Rights Implications

57. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance ("ESG") factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund's fiduciary duty. 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

58. Local Pension Committee January 2021 - currency hedge

59. SAA approval at the LPC January 2023

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