INVESTMENT SUB-COMMITTEE – 26 JULY 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CASH UPDATE AND AMENDNMENT OF PREVIOUS RECOMMENDATION TO PRIVATE CREDIT INVESTMENTS

Purpose of the Report

1. The purpose of this report is to update the Investment Sub-Committee (ISC) on the cash holding of the Leicestershire County Council Pension Fund (Fund) and the plans for its deployment against the Strategic Asset Allocation (SAA).

2. The paper also seeks approval to remove the limits previously approved by this Sub-Committee in October 2022 regarding commitments to LGPS Central in 2023/24.

Background

3. Hymans Robertson, the Fund's investment advisor, completed the 2023 Strategic Asset Allocation (SAA) as part of the Fund's annual investment review. The Strategy was reviewed by officers and was approved by the Local Pension Committee at its meeting on 20 January 2023.

4. Cash balances are reported to the Local Pension Committee alongside Fund investment values by investment managers each quarter. At the last update the cash balances totalled £69m with an additional £34m with the Fund's currency hedging manager, Aegon asset management (Aegon).

5. The Fund does not have a specific cash allocation as part of the SAA other than a 0.75% of total Fund assets to reflect the cash held at Aegon to act as collateral for the currency hedge.

6. The Fund, as a part owner of LGPS Central (Central), has an aim to transition investments to cost effective and relevant products at Central as and when they are made available.

7. At its meeting on 12 October 2022, the Investment Sub-Committee approved 2023/2024 commitments to LGPS Central's private credit fund subject to the Fund being no more than 20% of the total raised for each of the two funds.

    a. LGPS Central Low Return Sleeve. A £180m commitment subject to a minimum fund raise by Central of £900m. (equates to a maximum 20% of the total fund)

    b. LGPS Central Real Assets Sleeve. A £100m commitment subject to the Fund being a maximum of 20% of the total raised.

8. In some cases, owing to the complex nature of building products suitable for a variety of partner funds, delays have been experienced. As a result, the Fund has been conscious of making investments outside of Central in order to not stray further from the strategic allocation agreed by the Pension Committee whilst maintaining an interest in any potential Central product when it becomes available.

Cash holdings on 31 March 2023

9. The Fund, as of 31 March 2023 held £69million in cash, or 1.2% of total Fund assets (based on the £5.7billion valuation as of 30 March 2023). In addition, the Fund held £34million as collateral with Aegon for the active currency hedge mandate.

10. Owing to the positive cashflow nature of the Fund, due to payments to pensioners or dependants being lower than pension contributions and funds returning money, the cash balance grows without regular reinvestment to realign to the SAA.

11. The Fund has held a higher amount of cash during the past two years whilst awaiting to deploy funds into underweight areas of the asset allocation. These underweight areas have been within the income portion of the portfolio and mainly within the more illiquid investments, property, infrastructure and private credit. During 2022 the underweight positions were addressed with approvals at the April, July and October ISC meetings. Many of these commitments are yet to be called.

SAA 2023

12. An updated 2023 SAA was approved at the January Local Pension Committee meeting. The 2023 SAA is shown below with changes from the 2022 SAA shown in the final column.

Asset Group	Asset Class	2023 SAA	2022 SAA	Change
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	2.50%	0.00%	- 2.5%
Income	Global credit – liquid sub inv grade markets	4.00%	9.00%	+ 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%	

Current allocation versus SAA

13. The actual allocations to asset classes versus both the 2022 and 2023 SAA is shown in the table below. The main changes as approved by the Local Pension Committee in January 2023 were a reduction to listed equity, an increase to infrastructure and an increase to liquid global credit. These are highlighted in yellow. Large differences to the SAA target are as a result of the recent change in the SAA which will take time to enact given the slower nature of making investments into private markets.

	Benchmark SAA 2023	Actual Mar-23	Difference to SAA
Growth assets			
Listed Equity	37.5%	43.90%	6.40%
Private Equity	7.50%	7.56%	0.06%
Targeted Return	5.00%	7.51%	2.51%
Income assets			
Infrastructure	12.50%	9.90%	-2.60%
Global credit - private debt / CRC	10.50%	8.43%	-2.07%
Property	10.00%	7.29%	-2.71%
Global Credit - liquid MAC	9.00%	3.74%	-5.26%
Emerging market debt	0.00%	1.94%	1.94%
Protection			
Inflation linked bonds	4.50%	4.35%	-0.15%
Investment grade (IG) credit	2.50%	2.57%	0.07%
Short dated IG credit	0.25%	0.99%	0.74%
Active currency hedge collateral	0.75%	0.60%	-0.15%
Cash	0.00%	1.22%	1.22%

14. The direction of travel over the last couple of years has been to reduce allocation to the growth asset group and allocate to the income asset group. The most recent SAA review upheld this view.

15. The Fund made good in roads to closing the gaps to the previous year's (2022) SAA by the end of 2022, with commitments to products within the income asset group. The overweight positions mainly reside within the equity portion of the Fund. Whilst the Fund is awaiting capital calls from managers and no requirement for the cash the overweight positions will remain.

16. There are at present over £0.5billion in outstanding calls which will need to be satisfied over the coming years. Around half is due to uncalled commitments to private credit vintages with the remainder combined mainly of infrastructure and private equity commitments.

17. The Fund now has three primary areas to address during 2023 versus the 2023 SAA:

    a. Reducing the growth assets weighting, particularly within listed equity and targeted return. An exempt report considered by the ISC on 19 April 2023 addressed this change. It is important to note that this is a significant change and as such will be carefully considered by officers. It is likely this work may not have been fully completed by the end of the current financial year. There are no significant issues to note in completing this work at this stage and the Local Pension Committee will be informed of progress at each quarterly meeting.

    b. The infrastructure increase to 12.5% of total Fund assets was highlighted in advance by Hymans when they were proposing the previous years (2022) SAA. As such, the move to 12.5% has been planned by officers and a recommendation was included as part of the report presented to the April 2023 ISC meeting where three commitments totalling around £100m were approved.

    c. An increase to the global credit, liquid credit and EMD (Emerging Market Debt) asset class from 6.5% to 9%. Officers are in discussions with LGPS Central (Central) and other partner funds regarding making changes to an existing Central mandate before the Fund will consider making additional allocations. This is progressing and outcomes will be discussed with the Fund's investment advisor before any decisions are made. Any actions taken will be reported to the next Local Pensions Committee meeting.

17. The existing underweight to private debt of circa 2% will continue to close during 2023 all else being equal due to calls from significant commitments already made. This paper includes a recommendation to commit a further £280m. Once the target allocation is reached a steady state of commitments will be needed, as such smaller commitments can be expected going forward.

18. A £60m commitment was made to the LGPS Central Direct Property Fund. This is yet to be called. DTZ, the investment manager for the fund, is assessing the market for opportunities. The total approved amount to the Central Direct Property Fund is £120 million which would almost close the underweight to this class.

20. Overall, the underweight to the income class is reducing in a controlled manner. The Fund does not want to overcommit in any given year in order to rapidly close the underweight position which could lead to poor returns in the event of economic conditions or investment manager selection proving to be unfavourable in hindsight. As such the increase to the income asset group has been a multiyear process.

<u>Plans for 2023/24</u>

24. The table below shows the expected changes the Fund is considering at this point in time in order to align to the SAA. Given the market value changes of asset classes throughout the year will affect the actual weightings considerably, these forecasts will change as the year progresses.

25. There are a couple of investments marked on the table below relating to global credit and private equity. It is still too early to note if additional commitments will be

required in these areas, in particular private equity, but if needed proposals will be presented to the ISC at its October 2023 meeting for consideration. The areas marked in yellow show current commitments approved and estimates at the time of writing for the in year (2023/2024) cashflow expected and potential future ISC approvals.

Growth	31/03/23 £m	2023 SAA	31/03/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Commitments approved	2023/24: other cashflow / divests	Future ISC changes	Diff to target weight post changes £m	% diff to SAA
Listed Equity - Active and Passive	2,507	37.50%	43.9%	6.4%	366		-366		0	0.0%
Targeted Return Funds	429	5.00%	7.5%	2.5%	143	110	-253		0	0.0%
Private Equity	432	7.50%	7.6%	0.1%	4	60	-35	25	54	0.9%

Income	31/03/23 £m	2023 SAA	31/03/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Commitments approved	2023/24: other cashflow / divests	Future ISC changes	Diff to target weight post changes £m	% diff to SAA
Infrastructure	565	12.50%	9.9%	-2.6%	-148	160	-20		-8	-0.1%
Global credit - private debt / CRC	482	10.50%	8.4%	-2.1%	-118	250	-50	280	362	6.3%
Property	416	10.00%	7.3%	-2.7%	-155	120	-15		-50	-0.9%
Global Credit - liquid MAC	213	9.00%	3.7%	-5.3%	-300	300			0	0.0%
Emerging market debt	111	0.00%	1.9%	1.9%	111		-111		0	0.0%

Protection	31/03/23 £m	2023 SAA	31/03/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Commitments approved	2023/24: other cashflow / divests	Future ISC changes	Diff to target weight post changes £m	% diff to SAA
Inflation linked bonds	248	4.50%	4.3%	-0.2%	-9				-9	-0.2%
Investment grade (IG) credit	147	2.50%	2.6%	0.1%	4				4	0.1%
Short dated IG credit	57	0.25%	1.0%	0.7%	42		-42		0	0.0%
Active currency hedge collateral	34	0.75%	0.6%	-0.2%	-9				-9	-0.2%

Cash	69	0.00%	1.2%	1.2%	69					

26. It is also worth noting for global credit that the commitments approved and future ISC changes will take a number of years to be fully called whilst in the meantime existing investments will continue to return capital. At present the £482m is invested via four managers with Partners group consisting of £243m, or roughly half of the amount invested, the majority of which will return to the Fund as the underlying vintages return capital. The oldest 2014 and 2016 vintages of the Partners funds total £33m and have been returning capital. The four more recent vintages will start to return more in the coming years.

Effect on cash to March 2024

27. When including the effect of commitments already made and any that may be called during 2023/24, the Fund will expect to have a relatively low cash holding at the end of March 2024. If cash is needed in advance of the changes being implemented to the growth assets part of the portfolio, officers will assess the areas that are most overweight to the approved SAA. Any changes will be reported at the next Local Pension Committee meeting.

28. With the size of the uncalled commitment rising (about £500m currently) and the unknown timing of calls from underlying managers (normally 5 workings days' notice is provided) officers are minded to keep a closer watch on cash levels. Divestments can in some cases take more than five working days to receive so there maybe times over the next year when cash balances might be higher than in recent times.

29. Unused pension fund cash is invested in secure money market funds when not invested and with higher interest rates now than over the recent past the drag on returns is not as pronounced.

30. The prudent estimate regarding private debt commitment capital calls has been made. Officers have assumed £150m of private debt commitments will be called prior to April 2024. The Fund has existing uncalled commitments totalling c£270m at July 2023 with Central and Partners group private debt products.

31. The table below illustrates the major changes through to the end of March 2024.

	£m	Description
6th April 2023 cash position	**74**	Excludes cash held as collateral for currency hedge and cash held by managers for reinvestment
Management expenses	-5	These are investment management expenses paid directly by the Fund. Majority of fees are paid from the investments held with the managers.
Investment income	30	Income distribution paid to the Fund, primarily from property and infrastructure investments
Currency Hedge	0	No cashflow forecast estimated given the inherent difficulty in doing so. The Fund currently has c£35m in collateral. This is deemed adequate and would provide enough collateral for a 10% adverse movement in the Fund's 3 major foreign currency exposures, US Dollar, Euro and Yen. No forecast cashflow effect given no strong view on whether the Pound will strengthen or weaken from current position
Non investment cashflow	55	Employer and employee contributions exceed the benefit payments made. Only moves gradually compared to the previous year.
Reduction to listed equity & short dated IG bonds	60	Listed equity is overweight to SAA (37.5% target) by c370m, some of this may be divested as needed by capital calls that have been made.
Targeted return reduction to 5% of all assets	140	Reducing the overweight in line with SAA when targeted return review is complete
Commitments drawn	-407	Represents existing commitments made forecast to be drawn to next March year end
Expected capital distribution	117	Forecast distributions expected from holdings
Forecast closing cash position 31st March 2024	**64**	Aim is to keep cash as low as possible and keep fully invested in line with the SAA approved at the start of each year.

Change in cash to year end	-10	

32. Overall, Officers expect closing cash to be of a similar level to the opening position at the start of the next financial year. Any large movements in the cash generated or lost by the hedge managed by Aegon will have an impact on the overall ending position. The two largest elements are timings of calls and distributions which could substantially change. However, the Fund has enough liquid overweight positions which could be divested if cash were to run low. Conversely if more distributions were received and fewer calls were made then Officers would in most circumstances leave overweight positions in place until the requirement for cash arose given there is a 0% target for cash.

Private Debt recommendations change

33. At its meeting on 12 October 2022, the Investment Sub-Committee approved 2023/2024 commitments to LGPS Central's private credit fund subject to the Fund being no more than 20% of the total raised for each of the two funds.

    a. LGPS Central Low Return Sleeve. A £180m commitment subject to a minimum fund raise by Central of £900m. (equates to a maximum 20% of the total fund)

    b. LGPS Central Real Assets sleeve. A £100m commitment subject to the Fund being a maximum of 20% of the total raised.

34. After the annual SAA if all partner funds were collated and shared with Central there would not be enough new capital flowing into the two sleeves the Fund is interested in. This would mean that the Fund could not invest a significant amount with LGPS Central and meet the conditions of the approved recommendations. An alternative approach would be needed.

35. This approach could be the use of legacy managers or employing new managers. Officers have discussed the risks associated including, actions needed taking into account, time and cost to run external due diligence, the additional governance burden and the desire to pool, to name a few.

36. Officers approached Hymans Robertson to review the 20% limit in light of the recommendation made in 2022 for multiyear commitments to the Central low return and real assets sleeves. Their paper is included as an appendix to this report.

37. Hymans paper notes the setting of limits for investment ownership limits to be common practice when investing in pooled funds. It is designed to protect from investing in sub scale products, in addition, the 20% limit proposed was for:

    a. Ensuring funds were large enough to invest efficiently, and enable Central to achieve portfolio and manager diversification

    b. Increasing the likelihood of securing fee savings, something first vintages have achieved at a level more than the Fund could have achieved alone.

    c. Ensuring the Fund would not be the largest investor in either sub fund (low return of real assets) and therefore be at risk of having to take responsibility for managing them if Central were unable to meet its obligations.

38. Central reviewed the private debt plans from Central based on the expected level of soft commitments from partner funds 2023 SAA plans. Based on those soft

commitments the Fund would become around 65-70% of each of the two sleeves, breaching the current 20% limits.

39. In order to satisfy the Fund's concerns, Central have proposed the following which Hymans have reviewed:

a. Keep both sub funds open for new investment until September 2024 thereby allowing partner funds to invest into both products based on revised SAA's that would be approved in the first half of 2024, as well as allowing for commitments from partner funds recycling distributions from existing investments.

b. Manage (loan) concentration risk by guiding the number of managers/strategies and number of underlying investments each strategy would employ (based on strategy guidance / previous vintages) based on the current level of soft commitments, as shown in the tables below.

Low return sleeve: loan concentration, 0.67% based on 150 underlying loans.

Total Commitments, £m		#Managers	#Underlying Loans	Ave. Loan Concentration, %
Lower	Upper			
>200	<400	3	150	0.67%
>400	<600	4	200	0.50%
>600	-	5	250	0.40%

Real assets sleeve: loan concentration, 5% based on 20 underlying loans

Total Commitments, £m		#Managers	#Underlying Loans	Ave. Loan Concentration, %
Lower	Upper			
>100	<200	2	20	5.00%
>200	<400	3	30	3.33%
>400	-	4	40	2.50%

Hymans comment that they are comfortable that these provisions will ensure adequate diversification for both sleeves and are comfortable with the higher concentration within real assets where loans are typically larger but lower risk due to interest in a tangible asset.

c. If more than the current level of soft commitments are received by Central then Central to improve diversification further per the tables above.

d. Where a key person event occurs (for example, the investment director leaves), Central will convene a meeting with the Advisory Committee to discuss.

40. Hymans have stated they are comfortable that these provisions will provide adequate diversification and as a partner fund and shareholder (of LGPS Central) the Fund would have significantly more influence over ongoing management arrangements than it would with a third-party manager.

41. Hymans also cite a further reason for proceeding in support of pooling. Hymans believe Central's ability to launch regular vintages is, in the long term, in the best interests of the Fund

Recommendation

42. That the Fund proceed to commit in 2023/24:

i. £180m to the new LGPS Central Low Return Sleeve; and
ii. £100m to the LGPS Central Real Assets Sleeve

as approved by the ISC on 12 October 2022, but that the 20% limit on these commitments also previously agreed by the ISC no longer be applied for the reasons now outlined within the report.

Supplementary Information

43. None

Equality and Human Rights Implications

44. The cash update and infrastructure top up is a high-level document and there are no direct Equality and Human Rights implications. The Fund considers issues around Equality and Human Rights as part of responsible investment which incorporates 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, and its approach to engagement in support of a fair and just transition to net zero.

Appendix

45. Appendix 1: Private Debt commitments 2023 Hymans Robertson

Background Papers

None

Officers to Contact

Mr D Keegan, Director of Corporate Resources
Tel: 0116 305 7668 Email: Declan.Keegan@leics.gov.uk

Mr B Kachra, Senior Finance Analyst - Investments
Tel: 0116 305 1449 Email: Bhulesh.Kachra@leics.gov.uk