**INVESTMENT SUB-COMMITTEE – 26 JULY 2023**

**REPORT OF THE DIRECTOR OF CORPORATE RESOURCES**

**RECOMMENDED CHANGES TO THE PROCTECTION ASSETS GROUP OF INVESTMENTS FOR THE LEICESTERSHIRE LGPS**

## Purpose of report

1. The purpose of this report is to provide information to the Investment Sub-Committee (ISC) in respect of the protection assets group portfolio review and proposed changes to investments.

2. This paper will be supported by a presentation from Hymans Robertson (Hymans), the Fund's investment advisor.

## Policy Framework and Previous Decisions

3. There have been a number of changes to the protection assets group of investments over the past years. A summary of previous decisions is provided below.

4. At the meeting of the Local Pension Committee 20 January 2023 the following changes were proposed and approved:

    a. Increase in the strategic asset allocation to the currency hedge from 0.5% to 0.75% of total fund assets.

    b. Decrease in the strategic asset allocation to investment grade credit from 3.00% to 2.75% of total fund assets.

5. There were no changes proposed for protection assets at the meeting of the Local Pension Committee 21 January 2022 when the strategic asset allocation was reviewed.

6. At the meeting of the Local Pension Committee 21 January 2021 where the strategic asset allocation was discussed the following changes were proposed and approved:

    a. Moving the benchmark hedge of foreign currency exposure from 50% to 30%.

    b. Decrease in the strategic asset allocation to index linked bonds from 5.0% to 4.5% of total of fund assets.

    c. Introduction of 0.5% of total fund assets to be invested into a short dated corporate bond fund pending satisfactory due diligence. Due diligence was completed, and a 0.5% allocation was initiated in 2021.

**Background**

7. This review is being undertaken following the approval of the Local Pension Committee at its meeting on 20 January 2023 to conduct three asset class reviews post the changes in the Strategic Asset Allocation (SAA) review. A full summary of the 2022 to 2023 SAA is shown below. Reviews for Listed equity, targeted return and protection assets were proposed.

| Asset Group | Asset Class | 2022 SAA | 2023 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 investment grade markets | 4.00% | 9.00% | + 5% |
| Income | Global credit - private debt (incl. 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% | |

8. The listed equity review, targeted return review and protection assets review have been undertaken by the Fund’s investment advisor Hymans Robertson. Hymans presented the outcome of the first two of the three planned reviews to the Investment Sub Committee (ISC) on 26 April 2023.This paper now sets out the outcome of the last of the three planned reviews.

9. Although the whole portfolio’s SAA gets reviewed each year, officers and Hymans have been reviewing asset classes within the portfolio in more detail over the last couple of years. As such, protection assets, which has not had a formally distinct review before, is now being so reviewed.

10. The current protection assets groups portfolio as of 31 March 2023 is compromised of the following holdings:

| Asset group | Manager: Investment | 2022 SAA target | 2023 SAA target | £m 31.03.23 | Actual weight 31.03.23 |
|---|---|---|---|---|---|
| Protection | Aegon: Inflation-linked bonds (ILB) | 4.50% | 4.50% | 248 | 4.3% |
| Protection | Aegon: short dated climate transition fund | 0.5% | 0.5% | 57 | 1.0% |
| Protection | Central: Investment grade credit (IGC) | 2.5% | 2.25% | 147 | 2.6% |
| Protection | Aegon: Currency hedge | 0.5% | 0.75% | 34 | 0.6% |
| **TOTAL** | | **8.00%** | **8.00%** | **486** | **8.5%** |

**Scope of the review**

11. The scope of the protection assets group review includes the following:

    1. Define the investment objective
    2. Review the current portfolio of protection assets including performance
    3. Review of the structure of the protection portfolio
    4. Implementation

12. Hymans make reference to changes to the target allocation being out of scope given this is investigated annually as part of the portfolio SAA review. They go on to state increases in interest rates and government bond yields have changed the attractiveness of protection assets relative to other asset classes.

13. They have also deferred consideration of alternative protection assets such as asset backed securities, private debt secured against real assets and gold until the annual SAA review.

**Key Findings**

14. Hymans confirm that the Fund invests in protection assets in order to protect its funding position by reducing investment risk and mitigating the impact of fluctuations in the value of the liabilities. They do also note that protection against a range of key risks is also provided by other asset classes in the Fund's diversified portfolio.

15. Hymans summarise that the Fund's protection assets are generally appropriate, benefitting from very competitive fee arrangements and deliver performance (where track records are long enough) in line with expectations and see no pressing requirement to materially change the mandates or divest from them.

16. They do, however, make a case for improving investment outcomes by changing the allocation between ILB and IGC and this will be covered in more detail during the presentation by Hymans.

17. Hymans are also comfortable with the policy and structure of the foreign exchange (FX) hedging arrangements which includes both the Aegon FX programme, and any hedging performed by the managers of individual mandates. They do note, however, that there is scope to improve the application of the hedging policy which again will picked up in more detail by Hymans in their presentation and is covered in more detail in the report below.

## Investment Objective

18. Hymans note the rationale for investing in protection assets. They note the poor returns experienced by both ILB and IGC over the past 18 months and explain the rationale for both asset classes with respect to meeting liabilities.

19. In summary, higher long-term inflation increases the future cost of benefits, but the effect of increased costs is offset by the increase in interest rates and government bond yields (which increases the investment returns assumption). This increase, when applied to the Fund's liabilities via a higher discount rate drives down the present value of the Fund's liabilities. As a result, the Fund's funding position can improve, if going forward investment returns are realised.

20. Hymans point out that since the global financial crisis (GFC) interest rates have remained low which increased the value of the Fund's liabilities (lower discount rate applied to the Fund's liabilities). However, this also improved the value of the assets within the protection assets portfolio.

21. They also reduce the overall level of investment risk, although they are impacted by short term market volatility (see the last 12-18 months). They are lower risk given the very high likelihood that investors will receive all the interest and principal repayments. This is especially so for government bonds.

22. Hymans will cover in their presentation the other areas the portfolio invests in and their effect on protecting the portfolio from macroeconomic and financial risks, which would eventually be reflected on the value of liabilities and assets.

## Review of the current mandates

23. The protection assets mandates are described below including benchmarks and targets.

| Manager | LGPSC | Aegon | Aegon | Cash Funds |
|---|---|---|---|---|
| Fund | Investment Grade Credit | Index-linked Fund | Short Dated Climate Transition Fund | Pooled cash funds Aegon collateral account |
| Active/Passive | Active | Active | Active | Active |
| Benchmark | LGPSC Corp Index + 0.8% | FTSE All Stocks Index Linked Index | SONIA 3 Month +1.25% (GBP) | SONIA 3 Month |
| Target outperformance | 0.80% (rolling 3 year period, net of fees) | 0.30% (rolling 3 year period, gross of fees) | 1.25% (rolling 3 year period, gross of fees) | 0.00% |
| Target allocation | 2.25% | 4.5% | 0.5% | 0.75% |
| Inception date | Apr 20 | Dec 13 | Mar 21 | Mar 16 |

24. Hymans have reviewed each of the mandates and will be covering this in more detail during their presentation. Of note, on review of the IGC mandate managed by Central they point out the consideration of a third manager (the Central IGC mandate has two underlying managers) but point out they do not believe this is necessary for a fund which focuses on corporate bonds. The Central product is diversified with both managers holding in excess of 350 securities each covering multiple sectors, location of issue and of varying credit ratings.

25. Hymans in reviewing the performance of the three investment mandates note the poorer performance of the Central IGC mandate relative to the benchmark, but also note that within nearly three years of operation, the last 18 months has seen an extraordinary level of volatility in bond markets especially given the speed of interest rate increases which has an inverse effect on bond prices in general. Central note that it is too early to take action on the basis of performance alone.

26. Of the two Aegon products, the index linked bond fund has performed in line with expectations and the short dated climate transition fund has had a tough comparison versus its cash plus benchmark but has performed in line with its peer group. It is worth noting that again this fund has just two years of history and so it is too early to draw performance related conclusions.

27. The FX programme has performed well since inception (January 2014). The comparison to the benchmark position shows a 0.9% pa return. Hymans state that this is a good result for an active FX programme with fairly tight exposure and low turnover of position, (i.e., the programme does not trade heavily.)

**Alternative protection assets**

28. Hymans summarise a number of alternative protection assets that may provide further diversification. They explain the rationale and potential applicability within their paper. In summary the six alternative assets listed will be further explored as part of the 2024 SAA review. There may be other assets that are considered as part of the 2024 SAA review but at present Hymans note the following which will be explained as part of the presentation given by Hymans:

    a. Green bonds
    b. Real asset backed investment grade senior debt
    c. Senior tranches of asset backed securities
    d. Gold
    e. Absolute return bond strategies
    f. Equity protection strategies

29. The applicability of any of these alongside the investment requirements and drive to simplify the operation of the Fund will be analysed later in the year. Adding any would undoubtedly increase portfolio complexity but may improve risk adjusted returns which will need to be considered further.

**Proposed change to IGC and ILB**

30. Hymans propose a change to the allocation between these two asset classes following this review but deferred to later in the year. The change will effectively reduce the ILB allocation by 1% and add that to the IGC allocation. The lack of overlap between holdings means Hymans recommend a sale of ILB and subscription to IGC with Aegon coordinating sales with ongoing portfolio management to minimis transaction costs.

31. The rationale is underpinned by deciding upon the balance between proving protection against higher-than-expected long term inflation provided by ILB, and the higher yield achieved by IGC. Hymans believe an increased IGC allocation will lead to improved longer term funding outcomes.

32. In arriving at their conclusion Hymans have considered the following which they will presented during the meeting:

    a. Geographic allocation – is allocation spread optimally and looks at both country of issue and currency of issue.

    b. Portfolio efficiency – does investment performance improve as the percentage of bonds allocated to non-sterling bonds increases using January 1997 to June 2023 as the historical dataset.

    c. Will increasing allocation to overseas bonds improve portfolio efficiency (i.e., improve returns per unit of risk taken)

    d. Is the split between active management and passive management optimal – Hymans review the pros and cons of each for both IGC and ILB including the buy and hold strategy.

    e. Climate change implications of the protection portfolio with respect to achievement of the Fund's net zero objectives.

33. When analysing the Fund's corporate bonds (Central's IGC and Aegon's short dated climate transition fund) the result shows an overall allocation of 56% to overseas bonds which is well diversified by issuer. LGPSC allocates 50% to sterling bonds, 50% to overseas bonds but the underlying managers have the flexibility to vary geographic allocations within their respective mandates. Aegon has the flexibility to allocate globally without restriction, but currently allocates 70% to overseas bonds.

34. When analysing the ILB market, Hymans note that it is large, liquid, and efficient which lends itself to passive management overactive given the lack of opportunities. The Fund's ILB mandate is however an active mandate however the Fund's returns have been similar to the benchmark and the level of risk taken is low. The Fund also benefits from a favourable fee deal. As such Hymans recommend the Fund retains the current approach.

**<u>Climate change implications</u>**

35. This is an area that is under review post the approval of the net zero climate strategy (NZCS). Carbon foot printing calculations for credit have lagged equity markets but inclusion into the Fund's annual climate risk reporting is invariably easier where the bond in question has equity that is also measured. As such the Fund's expects to be able to measure both the IGC and short dated climate transition fund climate metrics in the near future. At present the short dated climate fund provides weighted average carbon intensity numbers and the IGC fund should soon follow.

36. Hymans make a number of recommendations to improve the carbon reporting of the protection portfolio which officers will work through and include:

    a. Work with LGPSC to include corporate bonds in its 2023 climate risk report and the index-linked sovereign bonds in the 2024 report, taking into account the new guidance from the Assessing Sovereign Climate-Related Opportunities and Risks initiative (ASCOR) on accounting for sovereign greenhouse gas (GHG) emissions;

b. Determine an appropriate approach for carbon accounting for the Fund's cash investments and FX hedging programme;

c. Further engage with investment managers to ensure they are taking appropriate action on capital reallocation to reduce portfolio emissions, and are engaging with underlying issuers to achieve real-world emissions reductions, drawing where appropriate on new guidance on stewardship provided by the Institutional Investors Group on Climate Change;

d. Consider what further changes (if any) should be made to the protection portfolio in order to deliver the agreed targets.

**FX hedging programme**

37. As set out above, the benchmark FX hedge position for the Fund moved from 50% of foreign currency exposure to 30% in 2021 when the Local Pension Committee approved the change at its January 2021 meeting. Aegon who manage the Fund's FX programme enacted the change from 50% to 30% in the first half of 2021. The change was based on analysis illustrating a 30% hedge providing improved overall investment outcomes.

38. It is important to note that the programme is intended to protect the Fund's position from FX movements of foreign currency investments when converted to the Fund's base currency of GBP. It is also important to note that Aegon operate an active hedge, with managers at Aegon applying their skill and knowledge to outperform the benchmark hedge position of 30% where possible.

39. Officers for the Fund speak to the mangers operating the hedge regularly (at least once a month) to understand the market dynamics, changes in hedging positions and collateral requirements.

40. Hymans have reviewed the hedging currently in place which covers around £1.9bn in FX exposure. There are 18 foreign currencies hedged with the three main currencies (USD, Euros, and the Japanese Yen the largest exposures). Given the programme is an active programme, Aegon have the ability to fully hedge (100% of FX exposure for a particular currency), apply a fully unhedged position and any anywhere in between, with 30% being the benchmark position. Only where there is a strong case do they position at either end of the spectrum bearing in mind this is a hedging programme and not a currency trading strategy.

41. Hymans make a number of recommendations which they will more fully present at the meeting. In summary they present a table by mandate where each mandate has a recommendation to either use a hedged share class or use the hedging facility from Aegon at either the target hedge ratio of 30% or 100% for specific asset classes.

42. Where it is deemed inexpensive and relatively easy to do, Hymans recommend the Fund use hedged share classes from the investment managers. There are two managers in particular that Hymans recommend officers enter into dialogue with and then consult with the investment advisor. Quinbrook, with whom the Fund has invested around $114m to see if there is a possibility to switch to a GBP share class, and Central with respect to the climate factor fund, infrastructure fund and private debt mandates to discuss how best to operationally hedge the underlying FX exposures and the level of the hedge to be implemented.

43. Other mandates are specifically noted within the appendix which have underlying FX exposure and Hymans advise that the main currency exposures should also be hedged at the benchmark level of 30%. Hymans are recommending that officers employ a GBP hedged share class, or where this is deemed inappropriate, for example, due to time and cost required to make this change, use the Aegon FX hedging programme to hedge the FX exposure.

44. Hymans have reviewed the requirement to hold collateral at Aegon to support the FX programme. They conclude that the cash held with Aegon, plus the investments in the short dated product and index linked bonds mandates provide sufficient capital if the FX programme is expanded and implemented.

**<u>Consultation</u>**

45. This paper refers to several documents that have been approved or consulted upon. A summary is shown below:

    a. Strategic Asset Allocation (SAA) 2023 – approved at the 20 January 2023 Local Pension Committee meeting.

    b. Strategic Asset Allocation (SAA) 2022 – approved at the 21 January 2022 Local Pension Committee meeting.

    c. Strategic Asset Allocation (SAA) 2021 – approved at the 22 January 2021 Local Pension Committee meeting.

    d. Climate Risk Report (CRR) 2022 – approved at the 18 November 2022 Local Pension Committee meeting.

    e. Net Zero Climate Strategy (NZCS) – approved at the 3 March 2023 Local Pension Committee meeting. This strategy had previously held a public engagement exercise in Summer 2022 which gathered over 1000 responses and a public consultation which received over 700 responses.

**<u>Resource Implications</u>**

46. The Director of Corporate Resources has been consulted. There are no additional resource implications.

**<u>Recommendations</u>**

47. It is recommended the Investment Sub-Committee approve the following changes to protection assets and other impacted mandates and that the Director of Corporate Resources be authorised to take the necessary action for the Fund to manage the changes as outlined below:

    a. Implement a change to the ILB allocation to 3.25% and for IGC 3.75% of total Fund assets. However, to defer the reallocation of capital between ILB and IGC until Hymans have concluded their outlook on both asset classes.

    b. Engage with Aegon regarding the ILB mandate and their ability to enhance and protect returns by investing in overseas bonds at the appropriate times.

c. Consider the changes to the FX hedging arrangements as described at points 37-44 of this paper.

d. At the next SAA review (planned for January 2024) the Fund reviews the target allocation to protection assets and explore further the inclusion of alternative protection assets.

**Background papers**

48. Local Pension Committee Meeting, 3 March 2023 – Net Zero Climate Strategy - https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7202&Ver=4

49. Local Pension Committee Meeting, 20 January 2023 – Strategic Asset Allocation – https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7201&Ver=4

50. Local Pension Committee Meeting, 21 January 2022 – Strategic Asset Allocation – http://cexmodgov01/ieListDocuments.aspx?CId=740&MId=6757&Ver=4

51. Local Pension Committee Meeting, 22 January 2021 – Strategic Asset Allocation – http://cexmodgov01/ieListDocuments.aspx?CId=740&MId=6522&Ver=4

52. Local Pension Committee Meeting, 18 November 2022 – Climate Risk Report - https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6761&Ver=4

**Circulation under the Local Issues Alert Procedure**

None.

**Equality Implications/Other Impact Assessments**

53. The listed equity review is a high-level strategic 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.

**Human Rights Implications**

54. This paper outlines the approach the Fund is taking with its listed equity. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment.

**Appendices**

Appendix – Hymans Robertson Protection Assets Review

**Officer(s) 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