Agenda Item 10

Leicestershire County Council

LOCAL PENSION COMMITTEE – 08 SEPTEMBER 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 listed equity and a summary valuation of the Fund's investments as of 30 June 2023 (Appendix A).

2. The report further provides an update on progress with respect to the listed equity changes as approved at the 19 April 2023 meeting of the Investment Sub-Committee.

Markets Performance and Outlook

3. A summary of global asset class performance over various time frames as at quarter end 30 June 2023 is shown below. Only one asset class now shows double digit returns over a 20-year time frame: gold, with sterling high yield debt dropping out this quarter (10.6% over 20 years at 31 March 2023) and property dropping below 10% per annum returns over 20 years in 2022.

	3 MONTHS*	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	TWENTY YEARS
GLOBAL EQUITIES	6.3%	17.1%	11.9%	8.6%	9.4%	8.5%
PRIVATE EQUITY	4.3%	7.8%	11.8%	9.3%	11.1%	NA
PROPERTY	1.2%	-4.3%	6.6%	4.8%	6.9%	8.9%
INFRASTRUCTURE	-0.1%	4.2%	10.9%	5.3%	6.7%	8.0%
HIGH YIELD	0.7%	5.9%	1.8%	2.3%	5.0%	9.8%
PRIVATE DEBT	0.9%	2.3%	1.6%	-0.8%	-0.3%	0.0%
UK GILTS	-6.0%	-15.5%	-12.2%	-4.4%	0.3%	2.8%
UK INDEX-LINKED	-6.9%	-17.6%	-13.3%	-4.6%	1.6%	4.2%
GOLD	-5.3%	1.9%	1.6%	9.8%	6.4%	10.4%

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

4. After a busy end to 2022, when many commitments made in 2021 and 2022 were called during the final quarter, the second quarter for 2023 was far quieter. There were no major divestments or commitments during the quarter other than for calls from managers to which the Fund has made commitments.

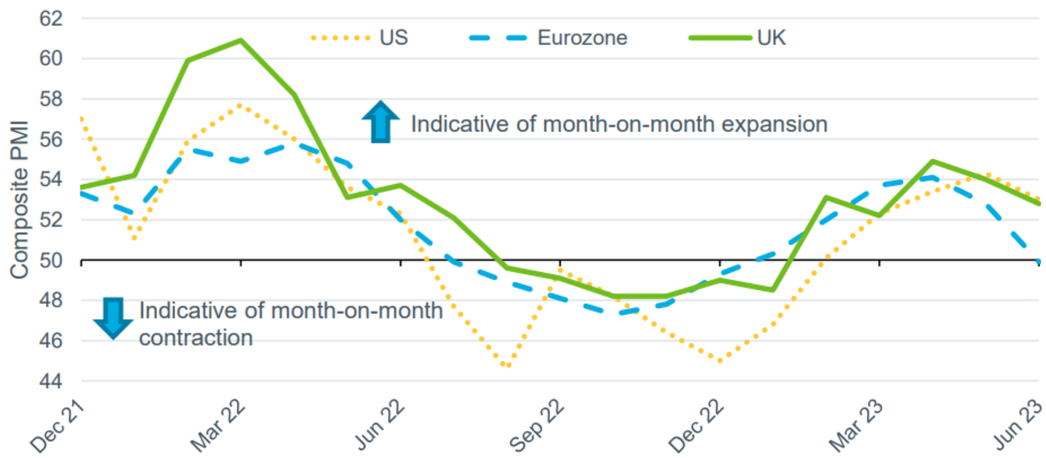
5. As at the time of writing the value of outstanding commitments is significant at over £0.5bn and illustrates the approvals made by the committees to align the Fund with the strategic asset allocation (SAA). The majority of the outstanding commitments is to a variety of LGPS Central (Central) investment products which include private debt, infrastructure, private equity and UK property.

Market backdrop

6. Equity markets have endured a difficult 18 months including the slowing down of global trade, the war in Ukraine, energy shortages, inflation increases in developed nations and a rapid increase of interest rates in many countries. A fuller capital markets update, provided by Hymans Robertson is appended to this report.

7. In spite of the headwinds, returns have proved to be resilient, with strong labour markets and robust consumer spending with the Fund's combined holdings returning +4.2% over the last year. Although this return is dwarfed by previous years returns when the Fund, riding on the back of a post pandemic bounce, has enjoyed returns of 7.7% pa over the last three years.

8. However, there is a divergence building between strong services demand and weaker manufacturing with higher inventories weighing on manufacturing output. The strong consumer spend has been helped by pandemic savings and wage growth which some commentators state has been diverted towards services. The most recent data does, however, show services growth beginning to slow with June's purchasing managers index (PMI) data suggesting the recent 2023 upturn is easing. (A PMI reading over 50 suggests expansion and under 50 a contraction as shown in the graph below.)



9. Some managers quarterly commentary is more bearish than others. For example one manager notes the Federal Reserve has been caught out by the onset of inflation which has been exacerbated by continuing strength in the US economy and cannot afford to allow more liquidity into the system (in fact it is removing liquidity via quantitative tightening) while also maintaining its credibility. The implication is that being able to tame inflation is likely to take precedent even if it could mean ushering

in unwanted economic headwinds. The view of the manager is that with this type of outcome (interest rates higher for longer) investors will have lower appetite for risk. However, many investors portfolios are still shaped for a low interest rate world and therefore there could be downward pressures on equity valuations.

10. Indeed, there are a host of competing factors that influence equity pricing, with local (for example, UK RPI, or employment number statistics) and macro factors (relative central bank interest rates, global growth actuals and forecasts, quantitative easing or tightening by central banks) playing a part. The fact that corporate earnings are down on last year does not seem to be very good news. But the numbers reported for the second quarter (to 30 June 2023), on average, have been comfortably above consensus expectations which will have helped support equity pricing.

11. The focus on a global recession, either a ‘soft landing’ or a ‘hard landing’ makes constant news with participants making a case for either, backed by which ever evidence supports that claim. For a Fund like ours, that is open to new members and liabilities extending far into the future taking an always invested (not timing the market) position is important. The Fund, from a listed equity perspective is highly diversified. It is exposed to many geographies and every major sector.

12. It is well known that a major source of investment returns is asset allocation. The rebalancing of the Fund to the target strategic asset allocation is therefore of importance and where appropriate and in line with the rebalancing policy, efforts are made to rebalance. The current Legal and General Investment Management (LGIM) regional investments rebalance automatically via instructions in place with the investment manager. The investments managed by LGPS Central require dealing instructions to be placed in order to realign with the SAA.

13. It is one of the reasons that the January Local Pension Committee meeting has been used primarily for presenting the revised strategic asset allocation for the coming year. The usual process commences months in advance of the proposals with the Fund’s investment advisor and officers for the Fund.

Cash at quarter end

14. At quarter end the cash held by the Fund totalled £50m, with an additional £55m cash held as collateral with Aegon for the currency hedge. Taken together this is around 1.8% of total fund assets.

15. Given the large amounts of uncalled commitments as stated earlier holding some cash is preferable over having to divest at short notice (most managers give the Fund five working days to satisfy calls made on commitments) especially given the rates of return on cash which have increased significantly over 2023. At present the cash held by the Fund earns in excess of 5%.

16. 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.

17. 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.

18. 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.

19. The Fund doesn't have a specific cash allocation as part of the SAA and as such officers are mindful of not running cash too high or too low and having to make frequent redemption requests to fulfil calls by managers.

Overall Investment Performance

20. A comprehensive performance analysis over the quarter, year, and three-year period to 30 June 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.

21. Early in 2022, officers were informed 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.

22. 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 this report.

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

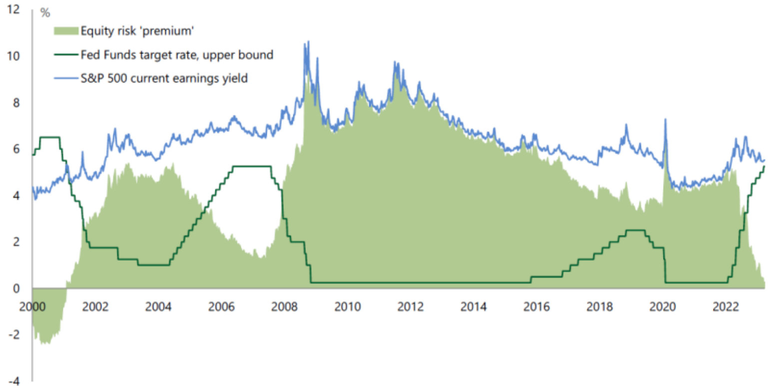
	Quarter	1 yr	3 yr pa	5yr pa
Total Fund	+1.0%	4.2%	+7.7%	+5.9%
vs benchmark	-0.4%	-0.5%	+1.5%	+0.3%

24. The Fund has experienced positive returns over the quarter at +1.0%. 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 such the Fund takes a longer term view of returns which is supported by the objectives of the annual SAA exercise. The exercise seeks to understand the risks and opportunities to the Fund over a longer period and as such the portfolio has a diverse mix of assets grouped into one of three buckets named, growth, income and protection.

25. The one-year underperformance versus the benchmark of -0.5% is mainly driven by the growth asset group and in particular the active elements of this asset group which

underperformed their respective benchmarks. In particular these include targeted return and the LGPS Central active emerging market equity (EME) fund. A summary of one year performance alongside commentary is provided below.

Mandate	Comments
Targeted return 1 yr +3.5%, vs benchmark -4.2%	After a stellar 2022 where the combined three mandates delivered a combined +14.1% versus a benchmark return of +5.9% there was always a chance of a return to more average returns. The benchmark for this asset group is a linked to cash plus 4% pa. The outperformance in 2022 was especially pleasing given the difficultly markets endured during 2022 when both equities and bonds suffered heavy falls. The year to June 2023 has a much higher benchmark requirement (+7.7%) given cash rates have increased over 2022 and 2023 and as such the returns expected from the 3 underlying mandates would need to be higher. Of the 3 mandates, one has outperformed the benchmark, Aspect Capital at +10.8%. Pictet and Ruffer have both underperformed the benchmark with +1.6% and -3.8% returns respectively. The Ruffer mandates one year performance has been weakest, especially over the first two quarters in 2023. It is not surprising given their investment philosophy however it would be unfair to judge their performance too harshly on just 2 quarters given their long term record. The Fund has been invested in the strategy since June 2009 with returns since inception at +5.9% pa. The markets for 2023 performed quite well, with both equities and bonds posting positive returns, however Ruffer were positioned poorly and have reduced their equity exposure expecting the increasing interest environment to provide headwinds for equities leading to cash moving towards cash products where returns are higher than in recent memory and offer little risk. The equity rally in 2023 led by the large tech names and in particular anything with an artificial intelligence (AI) slant caught Ruffer under allocated to this area whilst their investments that would benefit from a weak investment outlook underperformed as expected in this environment. Ruffer point to there being very little premium in investing in equity versus the return available on risk free assets. In fact, pointing out that it is as low as it has been in over 20 years.

	Equity risk but no risk premium US EQUITIES OFFERING THE SMALLEST PREMIUM OVER THE RISK-FREE RATE IN TWO DECADES  The Fund's investment advisor, Hymans Robertson has recently reviewed the Ruffer mandate as part of the targeted return review. Ruffer's views on markets don't correlate with many managers and as such they have made returns in years where many have not, eg during 2022 and the global financial crisis whilst maintaining a return roughly in line with their benchmark. Their method generating returns is a good diversifier for the Fund which includes many passive equity products which must track their benchmarks through good times and bad.
LGPS Central Emerging market equity 1yr -4.7%, vs benchmark -3.2%	This product underperformed the benchmark by 1.5% over a year. Although not a huge margin it has been a constant underperformer since inception in July 2019. This is a multi manager product with three managers appointed by Central to outperform a wide FTSE emerging market benchmark by 2% pa net of costs over rolling year 5 periods. The outperformance target recognises the level of additional management fees paid for active management. The 3 managers one year performance is impacted by its allocation to China (33% of the Fund) whose markets fell by 12% in quarter two alone with one manager significantly underperforming over 1 year at -7.4%. Their more recent positioning in two of the largest EM markets (China and India) has delivered poor returns versus the benchmark. The Indian market gained more than 10% in Q2 but the manager was underweight this country. Of note, is that multi manager products are always likely to have some managers that underperform benchmarks as a result of the selection process that aims to perform across a variety of market conditions and as such it is not a surprise that underlying managers underperformance is seen. Of more concern is the underperformance over multiple time frames stretching back to July 2019, nearly 4 years now.

	The manager of this mandate (Central) notes the improved performance towards the end of the June quarter as both emerging and developed markets rallied towards the end of the quarter as economic data painted a largely positive picture and raised the prospect of a soft landing for the global economy. It remains to be seen if a soft landing can be achieved and if the positioning of the 3 managers would lead to an outperformance versus the benchmark. Of the major style factors, this fund has a positive tilt towards companies that fit in the growth, quality and size factors.

26. Given the majority of the growth asset group, investments are passive investments any underperformance will have been generated by the active portion of the growth class. Over a one-year period, the largest underperformance versus the benchmark has arisen from the private equity (PE) holdings, -13.5%. Given the benchmark PE is measured against is a listed broad world index the lag which PE valuations suffer from is only now being fully experienced whereas the listed markets will have suffered these repricing's during the second half of 2022. Over a longer timeframe of three and five years the annualised return is 24.1% pa and 17.8% pa respectively, both of which are comfortably ahead of the benchmark.

27. Valuations for the underlying private equity investments lag those of public listed markets given they are not priced daily like the listed markets. Some underlying holdings will be valued twice a year and are based on a variety of factors such other comparable company sales and performance metrics rather than the price the market attributes to a company.

<u>Overview of the Fund's listed equity investments</u>

28. Following on from last quarter where property was in focus, the Fund's listed equity managers are being reviewed this quarter. A summary of the Fund's listed equity holdings and performance over one and three years is shown below.

	Passive or active	AUM 30.06.23 £m	% of total portfolio %	% of listed equity %	1 yr return %	1 yr return benchmark %	3 yr return %	3 yr return benchmark %
LGIM UK equity index Fund and UK core equity index fund	Passive	164	2.9%	6.4%	7.8%	7.9%	10.0%	10.0%
LGIM 7 FTSE 100 single stocks	Passive	24	0.4%	0.9%				
LGIM North America Equity index fund	Passive	349	6.1%	13.7%	13.7%	13.7%	11.0%	10.9%
LGIM Europe (ex UK) equity index fund	Passive	153	2.7%	6.0%	18.7%	19.2%	9.6%	9.6%
LGIM Japan Equity index Fund	Passive	73	1.3%	2.9%	12.5%	12.6%	4.8%	4.9%
LGIM Asia Pacific (ex Japan) developed equity index fund	Passive	66	1.1%	2.6%	2.9%	2.5%	5.9%	5.6%
LGIM World Emerging markets equity index fund	Passive	93	1.6%	3.7%	-3.4%	-3.4%	2.4%	2.4%
LGPS Central Active Global Equity Multi Manager Fund	Active	538	9.4%	21.1%	14.0%	11.7%	13.1%	10.4%
LGPS Central Active Emerging Markets Multi Manager Fund	Active	177	3.1%	6.9%	-4.7%	-3.2%	-0.6%	2.6%
LGPS Central Climate Balanced Multi Factor Fund	Semi active	913	15.9%	35.8%	10.0%	9.6%	10.2%	10.0%

29. The Fund’s total listed equity holdings are quite straightforward, the Fund uses just two managers: Central and Legal and General investment management (LGIM). All the actively managed products are managed via Central. The largest mandate with is with Central, the Climate balanced multi factor fund is a mandate which is passive in nature therefore not actively managed in the traditional sense. Although there is climate tilt applied the core characteristics is derived from the FTSE All World index and therefore holds many of the largest and resilient companies in the world including Apple and Microsoft as the biggest allocations. The benchmark has a number of ‘rules’ applied each quarter to rebalance the portfolio in order to meet the mandates ‘climate’ credentials.

30. The LGIM holdings are very low-cost passive investments which were collectively procured and represent very good value for money. These are investments which track a benchmark and as such are expected to generate performance very close to the benchmark.

31. It is worth noting that the total line up for listed equity will be revised in line with the recommendations approved at the 19 April 2023 ISC. These changes can be summarised as simplifying the passive holdings at LGIM into three holdings, a UK passive, a global passive and a global low carbon transition fund. In addition, a decision was taken to divest from the Central Emerging market active fund and equalise the weight to the climate multi factor fund and the global equity fund.

32. The net effect of the changes will allow the Fund to align to the lower listed equity weight of 37.5% which was agreed by the Local Pension Committee at it’s meeting on the 20 January 2023.

33. The Fund has an active global equity mandate, a three-manager product with Central. This product has performed well across multiple time frames. The other truly active product is the Central emerging equity mandate, another three-manager product which as part of the listed equity review taken to the ISC on 19 April 2023 was recommended to be divested from. Removal of the active allocation to emerging markets will reduce the Fund’s overweight (versus a global benchmark) emerging markets (EM) exposure to neutral, the Fund will retain EM exposure via a number of other listed equity mandates that are able to invest in those regions which include, the Central global equity fund and the Central climate multi factor fund. In addition, once the listed equity changes are concluded emerging market exposure will also be present within both the LGIM low carbon transition global fund and the LGIM all world equity fund.

34. The Fund has the ability to match market performance in a very cost-effective manner via the LGIM passive products where the management fee charged is very low, having been the subject of a collective (7 Local authority) procurement exercise.

35. The Fund may outperform listed market indexes via the three products at Central. The Climate multi factor fund tracks an index (the derivation of the FTSE all world benchmark) which has a significant reduction in exposure to fossil fuel reserves and carbon intensity when compared to the FTSE all world index. It also has a much higher exposure to firms which engage in the transition to a green economy. It is a very broad index with over 900 holdings with the top 10 holdings representing about 10% of the total value of the fund. The differences in ‘climate’ related exposure are highlighted below. The since inception performance of this fund versus it’s benchmark is marginally positive 9.6%pa vs 9.4%pa.

Climate Metrics	FTSE AW Climate Balanced Comprehensive	FTSE All World	Change
Fosil Fuel Reserves (Metric Tons Per m$ Equity)	543	1761	-69%
Carbon Emissions Intensity (Metric Tons Per m$ Equity)	67	222	-70%
Weighted Average Emission Intensity (Metric Tons/m$ Revenue)	66	161	-59%
Green Revenues (Proportion of total revenue %)	5.94	3.83	55%

FTSE Russell as at 30th June 2023

2023 Investment plans and actual weighting versus 2023 SAA

36. 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. The last column in the table shows approximate commitments outstanding at the time of writing.

37. The listed equity changes were agreed by the meeting of the ISC meeting on 19 April. Progress is detailed later in this paper. The targeted return changes to a 5% target were also agreed at the same meeting of the ISC. Changes are in progress with the first divestments from mandates in July 2023.

38. The private equity commitments comprise of the commitments outstanding for the two LGPS Central vintages and the most recent Adam Street Partners (ASP) vintages. The older ASP vintages are returning capital and as such the current outstanding commitments are in place in order to maintain the 7.5% target weight.

39. The emerging market debt and global credit allocation was agreed at the 20 January 2023 meeting of the Local Pension Committee. Officers are working with LGPS Central on the development of the global credit product (multi asset credit or MAC) which is undergoing changes to the mandate. Once these are finalised and if Hymans Roberston are supportive, changes can be made to align to the target.

Asset Group	Asset Class	2022 SAA	2023 SAA	Change from 2022 SAA	30.6.23 Actual weighting	Vs 2023 SAA	Commitments to be called £m (GBP)
Growth	Listed equities	42.00% (40%-44%)	37.50%	- 4.5%	44.4%	+6.9%	Agreed changes, transition advisor appointed
Growth	Private equity	5.75%	7.50%	+ 1.75%	7.4%	-0.1%	60
Growth	Targeted return	7.50%	5.00%	- 2.5%	7.6%	+2.6%	Agreed changes
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%	10.2%	-2.3%	160
Income	Property	10.00%	10.00%		7.3%	-2.7%	120
Income	Emerging market debt & Global credit – liquid sub inv grade markets	6.50%	9.00%	+ 2.5%	5.7%	-3.3%	Agreed changes
Income	Global credit – private debt	10.50%	10.50%		8.1%	-2.4%	

	(inc M&G/CRC)						
Protection	Inflation-linked bonds	4.50%	4.50%		4.0%	-0.5%	
Protection	Investment grade credit	3.00%	2.75%	-0.25%	3.5%	+0.75%	
Protection	Currency hedge	0.50%	0.75%	+0.25%	0.9%	+0.15%	
Protection	Cash / cash equivalent	0.00%	0.00%		0.9%	+0.9%	

40. 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.

41. 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 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.

42. A schedule of work was agreed with Hymans at the start of the year to facilitate the changes in a similar way to 2022. Proposals were considered with officers in advance of presenting these to the Investment Sub-Committee meetings (ISC) in 2023. The following have been reviewed by Hymans and presented to the ISC.

    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 – taken to July 2023 ISC

<u>Transition advisor update</u>

43. As part of the changes being proposed to the listed equity mandates officers have commenced a process to procure specialist transition advisor services in line with the recommendations agreed at the meeting of the ISC on the 19 April 2023. A procurement exercise was commenced and there were seven suppliers who were able to bid for the work. The Fund has appointed Hymans Robertson who were ranked the best value for money quote and able to satisfy the scope provided.

44. The advisor will prepare the strategy and timing of the agreed listed equity changes. Updates will be provided to the Local Pension Committee as the transition progresses.

<u>Leicestershire Pension Fund Conflict of Interest Policy</u>

45. 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

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

Environmental Implications

47. 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

48. 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

49. 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 A - Portfolio Evaluation - Summary Valuation of Funds Performance
Appendix B – Hymans Robertson – Capital Markets update Summer 2023

Background Papers

50. Local Pension Committee January 2021, Annual Review of the Asset Strategy and Structure (Agenda Item 8) - http://cexmodgov01/ieListDocuments.aspx?CId=740&MId=6522&Ver=4

51. Local Pension Committee 20 January 2023, Overview of the Current Asset Strategy and Proposed 2023 Asset Strategy (Minute Item 98) http://cexmodgov01/ieListDocuments.aspx?CId=740&MId=7201&Ver=4

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