Leicestershire County Council

LOCAL PENSION COMMITTEE – 8 SEPTEMBER 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ACTION AGREED BY INVESTMENT SUB COMMITTEE

Purpose of Report

1. The purpose of this report is to provide the Local Pension Committee with details on decisions agreed by the Investment Subcommittee (ISC) at its meeting held on 26 July 2023.

Policy Framework and Previous Decisions

2. The Leicestershire Pension Fund (the Fund) has a requirement to maintain investments in asset classes close to the Fund's Strategic Asset Allocation (SAA) as existing investments are returned.

3. At the January 2023 Local Pension Committee meeting, the 2023 SAA was approved. The new SAA and changes from the 2022 SAA are best described in the table below.

Asset Group	Asset Class	2022 SAA	2023 SAA	Change from 2022 SAA
Growth	Listed equities	42.00% (40% - 44%)	37.50%	- 4.5%
Growth	Private equity	5.75%	7.50%	+ 1.75%
Growth	Targeted return	7.50%	5.00%	- 2.5%
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%
Income	Property	10.00%	10.00%	
Income	Emerging market debt & Global credit – liquid sub inv grade markets	6.50%	9.00%	+ 2.5%
Income	Global credit – private debt (inc M&G/CRC)	10.50%	10.50%	
Protection	Inflation-linked bonds	4.50%	4.50%	

Asset Group	Asset Class	2022 SAA	2023 SAA	Change from 2022 SAA
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%	

4. A schedule of work was agreed with Hymans Robertson (the Fund's investment advisor) post the January 2023 Local Pension Committee (LPC) meeting to facilitate the changes to the SAA in a similar way to what was done in 2022 with proposals considered with officers in advance of presenting these to the Investment Sub-Committee at its meetings (ISC) in 2023. The following were agreed to be reviewed by Hymans:

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

5. The first two reviews were presented to the April ISC meeting and reported to the LPC in June. This paper sets out an outline of the outcome of the last planned review for 2023.

<u>Protection Assets Review</u>

6. The scope of the protection asset review covered investment objectives, a review of the current portfolio including performance, a review of the structure of the portfolio and implementation.

7. The 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%**

8. 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. Protection against a range of key risks is also provided by other asset classes in the Fund's diversified portfolio.

9. Hymans summarised 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.

10. Hymans made the case for improving investment outcomes by changing the allocation between inflation-linked bonds (ILB) and investment grade credit (IGC). This change would 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 minimise transaction costs. Hymans proposed to defer the reallocation until the short-term outlook improved, as well as consider alternative protection assets such as real asset backed investment grade debt, gold, asset backed security at the next strategy review.

11. Hymans were 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 with some Fund exposures unhedged, partially hedged or only USD exposure is hedged. It is recognised FX hedging can be complex and costly, so Hymans recommend a pragmatic approach to consider changes and associated implementation options in conjunction with the currency manager and investment advisor.

12. At its meeting the ISC approved the recommendations listed below.

> “That 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 3.5% 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 the Investment Subcommittee paper (summarised at point 11 above).
>
> 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.”

Private Credit Investments

13. 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

14. Following the annual SAA if all partner funds commitments 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.

15. Other options include the use of legacy managers or employing new managers. Officers 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.

16. Hymans Robertson reviewed the 20% limit in light of the recommendation made in 2022 for multiyear commitments to the Central low return and real assets sleeves. Following discussion with Hymans and Central, Central proposed a number of proposals to resolve the concerns. Including,

    i. Keeping both sub-funds open for new investment, allowing partner funds to invest into both based on reviewed SAA's and any distributions received from existing investments.
    ii. Managing (loan) concentration risk by guiding the number of managers/strategies and number of underlying investments based on the current level of soft commitments.
    iii. If more than the current level of soft commitments were to be received, then Central will improve diversification appropriately.
    iv. Where a key person event occurs Central will convene a meeting with the advisory committee to discuss.

17. Hymans stated they were 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.

18. Hymans also cited 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.

19. Following the Investment Subcommittee's discussion, it was agreed to disapply the 20% limit on the previous commitments to the:

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

Recommendation

20. The Local Pension Committee is asked to note the report.

Environmental Implications

21. The Fund has developed a Net Zero Climate Strategy (NZCS). 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 Investment Strategy Statement. 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.

22. Carbon foot printing calculations for credit have lagged equity markets but inclusion into the Fund's reporting is invariably easier where the bond in question has equity that is also measured. As such the Fund will look to measure both the investment grade credit (IGC) and short dated climate transition fund climate metrics as part of the Fund's 2023 Climate Risk Report. The Fund will look to work with LGPS Central to include index-linked sovereign bonds, taking into account new guidance from the Assessing Sovereign Climate-Related Opportunities and Risks initiative on accounting for sovereign greenhouse gas emissions. The Fund will separately need to determine an appropriate approach for carbon accounting for cash investments and the FX hedging programme.

23. The Fund will look to engage with investment managers to ensure they are taking appropriate action on capital allocation and engaging with underlying issuers to achieve real-world emissions reductions. It is recognised the Fund may also need to consider if further changes need to be made to the protection portfolio to support decarbonisation.

Equality Implications

24. 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

25. 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

None

Background Papers

Investment Subcommittee, 26 July 2023 – Cash Update and Amendment of Previous Recommendation to Private Credit Investments (Agenda Item 7)

http://cexmodgov01/ieListDocuments.aspx?CId=919&MId=7257&Ver=4

Recommended Changes to the Protection Assets Groups of Investments for the Leicestershire LGPS (Agenda Item 8)

http://cexmodgov01/ieListDocuments.aspx?CId=919&MId=7257&Ver=4

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