Leicestershire County Council Pension Fund – transition exercise note

Introduction

This paper is addressed to the Investment Sub-Committee ("ISC") of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to provide recommendations on the implementation of planned changes to the strategic allocation to the Fund's listed equity portfolio.

This paper should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing. We provide comment from an investment but not a legal or tax perspective.

Please note that Hymans Robertson LLP and our group companies have a wide range of clients some of which are fund managers who may be included in and/or recommended to you as part of this exercise. We have a research team that advises on shortlisting fund managers in manager selection exercises, which is separate from our client and other relationships with fund managers and therefore we do not believe there will be a conflict that would influence the advice given. We would be happy to discuss this and provide further information if required.

Background

The Committee has agreed to implement the strategic changes summarised in table 1.

Table 1 Summary of planned strategy changes

	Current allocation	Target allocation	Change AUM £m)
Current LGIM - UK and regionals	15.9%	0%	-908
L&G UK Equity Fund		2%	114
L&G All World Equity Fund		8%	457
L&G Low Carbon Transition Fund		3.50%	200
		13.5%	**-137**
Central Global Equity	9.1%	12%	164
Central EM	3.2%	0%	-182
Central Climate MFF	15.7%	12%	-211
			-228
Total cash released £m			**-366**

Source, LCCPF 31 March 2023

The primary focus for Hymans as transition advisor is to advise on the implementation of the equity changes. It is important, and helpful, to be aware of the destination investments and context for the changes, along with contingent decisions (e.g. suitability of the MAC fund) but this will sit more in the domain of your Investment Consultant as your strategy advisor. We will work collaboratively on your behalf where practical to do so, noting this is a benefit of working with Hymans on both aspects.

Based on the data above, the overall equity transition reduces the equity allocation by £366m

The destination funds are MAC and private markets, noting a reduction in EMD is also planned.

We note that it may make sense to fund MAC in a small number of tranches, but also that it would be suitable from a strategic perspective to hold cash for a short period while this is being implemented.

When it comes to exposure management, the main focus in the implementation of the changes to the equity allocation is on achieving the overall strategic changes to the equity portfolio and maintaining exposures throughout.

In the following sections we summarise key points from discussions with key parties involved in the planned activity.

Points to note from calls/emails with LGIM

- Carried out analysis of in-specie v transition approach to implementation of planned changes based on info shared with them earlier in the year.

In-specie

- the in-specie option involves the LGIM pooled fund team managing the strategic changes via a combination of unit switches at mid (where no trading is required) and bid/offer (where units are being created/cancelled and trading spread applies);
- the LGIM analysis carried out in May indicates spread costs plus asset transfer costs (custody costs to move stocks between accounts) of c£265k with market exposures managed throughout. This analysis facilitated the strategic reduction of c£138m in the LGIM allocation;
- this approach avoids stamp duty costs as no change of beneficial owner;
- note that LGIM would need to draft IMA, instruction letter etc to implement this change which would require legal review.

Transition

- the transition option would involve utilising a transition manager and…
    - transitioning the current stock holdings into a transition account with a custodian;
    - the transition manager trading the assets to the target portfolio and transferring these into the target pooled funds;
    - the cost estimate provided by LGIM for this approach was £600k;
    - this cost is an implementation shortfall estimate and therefore includes explicit and implicit costs (ie not directly comparable to option 1)
    - there are no assumed fees to LGIM for providing the transition services. Were a transition manager to be used, there would be project management costs/commissions for the services - this would therefore likely require a call off from lot 1/2 of the transition framework (indicative fees >75k plus costs to select TM, also LGIM noted no capacity until December/January);
    - there would also be stamp duty potentially.

Conclusion

- we would support the in-specie approach on the basis that market risks are manages and projected costs are lower by c£400k after allowing for potential transition manager fees.
- Noting the likely date for completion of required due diligence for the LGPS Central Global Active fund is a few months away, we asked LGIM for a cost estimate to hold cash in a World equity passive mandate and fund this as part of the in specie. The cost estimate reduces to £228k under this approach.

Points to note from calls with LGPS Central

- We covered a number of transition related considerations in the calls with the LGPS Central teams, primarily focusing on the three equity mandates involved in the transition.

LGPS Central Global Equity

- Currently expect due diligence on the fourth manager in the Central Global Equity to be available in Nov/Dec and for manager changes to be made around then, with Russell appointed to implement the transition changes.
- We understand that a core strategic requirement prior to investment is due diligence on the new manager therefore this change is likely to take place next year.

LGPS Central Climate MMF

- We spoke with the operations team at Central along with the fund's Transfer Agent, Northern Trust. They confirmed that in order to facilitate a unit cross with Staffordshire on 20 September 2023, the two key actions for LCCPF are to
  - Confirm by early in the week commencing 10 September the planned trade amount;
  - Secondly to provide a signed instruction letter for this amount in line with a normal disinvestment instruction, for the date agreed with Staffordshire.
- Crossing units will save an estimated £184,000 in fund transaction costs (source, LGPS Central)

LGPS Central Emerging Markets Equity

- In relation to the planned Emerging Markets transition, we spoke with Mark Davies and Colin Pratt and understand the following:
  - the EM fund has a planned manager change with CTI to be terminated as a manager and another manager to be appointed imminently, with Russell managing the transition exercise;
  - a call is planned with all investors in late September to discussed planned changes to the investment managers within the sub fund. This may present a liquidity opportunity for investors wishing to redeem units and also those wishing to invest;
  - In addition, whilst the Central team indicated that whilst a single redemption for c£180m would was not expected to incur non-standard ADL costs, a phased redemption of say 2-3 instructions would be preferable to avoid that potential scenario.

Conclusions

- Proceed with crossing opportunity with Staffordshire on 20 September
- Await the information shared on the investor call in late September in relation to the Emerging Markets redemption. From a strategic perspective we understand there is a preference to remain invested in equities rather than have too much cash.
- Progress with Global Active due diligence when available before funding.

Points to note from call with Stafordshire

- Staffs are investing c£300m into the Climate multi factor global equity, implementing with Macquarie in late Sept;
- They hope to cross the portion that LCCPF will disinvest and instruct Macquarie to trade the remainder;
- In addition, they plan to sell c.£250m of the Global active fund, potentially more. Do not have committee sign off, expected Q1 2023.

Implementation stages

Following the initial discussions summarised above and engagement with your investment consulting team at Hymans, we recommend the following implementation stages to achieve you agreed strategic changes:

		Description	When	Considerations	Market exposure	costs	Next steps
1.	Central Climate MFF	Full disinvestment of c£211m	Opportunity to cross with Staffs on 20 September dealing date	Achieves a little over half of the planned equity reduction noting there would be a small increase to the EM weighting within equities. Achieves strategic change in timely and cost-effective manner.	Reducing equities overall so no requirement to maintain exposure and cash acceptable for a short period. Invest proceeds in MAC, subject to suitability and other private markets drawdowns.	Zero as crossing with staffs	Proceed with investment instruction
2.	LGIM	Move to regional/ESG mandates	Q4 2023	LGIM analysis of in-specie v transition provides clear evidence that this in-specie approach is optimal both from a cost and exposure management perspective. Invest surplus cash in passive developed world equity fund, pending completion of LGPS Central Global active DD.	Maintained throughout, need to consider exposure management when moving out of LGIM into Central.	c.£228k-£265k	Progress legal paperwork with LGIM, firm up on asset values and plan implementation for Q4
3.	Central EM	Full divestment of c180m	Q4 2023/Q1 2024	Sell gradually to manage costs and avoid excess cash. Investor call planned for late Sept which may inform potential redemption strategy. Strategic reduction to equities, this combined with the Climate MMF redemption is expected to result in the overall equity allocation being broadly in line with agreed strategic target.	Invest proceeds in MAC, subject to suitability and other private markets drawdowns.	tbc	Await outcome of September investor call and consider available options
4.	Central Global Equity	Invest additional £164m	Q1 2024 (due to likely timeframe for suitability of 4th manager being added)	Fund from LGIM equities, using a passive developed world equity fund to maintain market exposure pending completion of the LGPS central due diligence.	Tbc	tbc	LGPS Central due diligence and update on new manager and timings.

Recommendation and next steps

Based on the analysis carried out and the discussions with the LCCPF team, your investment consulting team and the key stakeholders involved in the planned transition activity, we recommend that LCCPF proceed with stage 1 - the Climate MMF crossing opportunity with Staffordshire on the 20 September dealing date - noting that this will achieve part of the planned equity reduction. Proceeds can be held in a cash investment pending investment in MAC/private market drawdowns, noting that confirmation of suitability of the MAC sub fund is expected in Q1 2024.

We will continue to progress stage 2 planning with LGIM and stages 3 and 4 with LGPS Central and your consulting team over the coming weeks and provide updates on next steps.

Please do not hesitate to contact us should you have any queries on this paper.

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General Risk Warning and Transition risk warning

The approach adopted in effecting a transition will differ depending on the nature of the underlying assets and the managers employed. Where possible, in undertaking transitions we seek to affect an “in-specie” transfer of stocks from the old manager(s) to the new manager(s). In practice, it is likely that a proportion of existing assets (either stock or units) will need to be sold and cash arising from such sales being passed to the new manager(s).

In effecting the transition, we will seek to minimise dealing costs and maintain market and currency exposure as far as practicable during the transition.

Cash from the sale of existing assets may remain un-invested for a period of time. If markets were to rise during the period such cash is being held, the scheme may experience an “opportunity loss”. To reduce the potential size of opportunity loss we may advise on one or more of the following:

- phasing, over a period of time, the sale of existing assets that are not to be retained;
- requesting the new manager(s) to purchase stock/units at or around the date of sale of existing assets and using any available cash held to settle the transactions;
- requesting the new manager(s) to purchase stock/units at or around the date of sale of existing assets in advance of cash being available for settlement;
- utilising the use of derivatives such as financial futures to achieve exposure to the relevant markets at or around the date of sale of existing assets.

Practical considerations (such as the size of the scheme or the scope of the manager(s)’ agreement(s)) may preclude one or more of these approaches from being pursued. In particular, Trustees should note that these measures are intended to reduce the extent to which the scheme may be over-exposed to cash during the transition period, and for practical purposes it may not be possible to eliminate the associated risk.

Trustees should be aware that the purchase of units/securities in advance of cash being available for settlement may result in an interest charge being applied to the scheme.

Financial futures purchased to gain an exposure to markets will result in a payment to/from the scheme should there be an increase in the price of the future and vice versa. Trustees should note that the performance of the financial futures purchased could deviate from the performance of the underlying indices (“basis risk”) and of the target portfolio.

Whatever course of action is pursued, we cannot guarantee that the scheme will not be adversely affected by market movements over the transition period.

The cost of dealing in securities can fluctuate from day to day and thus we cannot guarantee that any estimate of the cost of transition provided in advance will not be exceeded.

Whilst we will undertake a number of checks to provide comfort that assets are being transferred in accordance with trustees’ directions, such checks should not be considered as constituting a full audit and reconciliation between the relevant parties.

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.