Leicestershire County Council

INVESTMENT SUB-COMMITTEE – 11 OCTOBER 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CASH FORECAST TO YEAR END 23/24 AND CASH MANAGEMENT STRATEGY

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 of the cash management strategy (CMS) for the Fund.

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 (30 June 2023) the cash balances totalled £54m with an additional £50m 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 to set a limit of 0.75% of total Fund assets to reflect the cash held at Aegon to act as collateral for the currency hedge.

6. The Fund has previously attempted to keep cash balances as low as possible owing to not having cash as a strategic allocation.

7. As a result of making changes to the equity holdings from the approved 2023 SAA, the Fund is likely to hold higher levels of cash and as such it is appropriate to consider a CMS for the fund.

Cash holdings on 30 June 2023

8. The Fund, as of 30 June 2023 held £54m in cash, or 0.9% of total Fund assets (based on the £5.75billion valuation as of 30 June 2023). In addition, the Fund held £50million as collateral with Aegon for the active currency hedge mandate.

9. 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.

10. 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

11. An updated 2023 SAA was approved by the Local Pension Committee at its meeting in January. 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

12. 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. a reduction to listed equity,
    b. an increase to infrastructure
    c. and an increase to liquid global credit.

13. 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. The listed equity changes are described in more detail in a separate report elsewhere on today's agenda. The table below shows the current June 30 2023 actual allocation versus the SAA, and the current commitments and expected 2023/24 cashflow from divestments into the asset class. The main changes to the SAA detailed above and as approved by the LPC at its meeting in January 2023 are highlighted in yellow.

	Benchmark SAA 2023	Actual Jun-23	Difference to SAA	Current Commitments and 23/24 cashflow	Updated SAA difference
Growth assets					
Listed Equity	37.5%	44.38%	6.88%	-6.9%	0.0%
Private Equity	7.50%	7.39%	-0.11%	0.4%	0.3%
Targeted Return	5.00%	7.63%	2.63%	-2.6%	0.0%
Income assets					
Infrastructure	12.50%	10.19%	-2.31%	2.4%	0.1%
Global credit - private debt / CRC	10.50%	8.09%	-2.41%	8.3%	5.9%
Property	10.00%	7.32%	-2.68%	1.9%	-0.8%
Global Credit - liquid MAC	9.00%	3.72%	-5.28%	5.3%	0.0%
Emerging market debt	0.00%	1.97%	1.97%	-2.0%	0.0%
Protection					
Inflation linked bonds	4.50%	4.01%	-0.49%	0.0%	-0.5%
Investment grade (IG) credit	2.50%	2.51%	0.01%	0.0%	0.0%
Short dated IG credit	0.25%	0.98%	0.73%	-0.7%	0.0%
Active currency hedge collateral	0.75%	0.87%	0.12%	0.0%	0.1%
Cash	0.00%	0.95%	0.95%		

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 inroads 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 there is no requirement for the cash, the overweight positions will remain.

16. At the time of writing there are close to £0.6billion in outstanding calls to managers which will need to be satisfied over the coming years. Much of the uncalled amount is to products managed by Central with c£250m awaiting to be called by the Central private debt vintages.

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. The listed equity changes are being managed via a transition plan created by a transition advisor (Hymans Robertson were appointed via a framework procurement exercise with details included elsewhere on today's agenda) in conjunction with the Fund's advisor Hymans Robertson. Details of this transition are covered in more detail in a separate report elsewhere on today's agenda. The targeted return reduction from 7.63% to 5.00% has commenced post 30 June 2023 with redemptions from two managers. Planned reductions over a number of months from the same two managers will continue alongside subscriptions to an existing targeted return manager and a new manager. Officers expect to have concluded the changes to the targeted return managers by the end of the current financial year.

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 ISC at its meeting in April 2023 where three commitments totalling around £100m were approved. The actual weight to the infrastructure class will increase as commitments are called.

c. An increase to the global credit, liquid credit and EMD (Emerging Market Debt) asset class from 6.5% to 9%. Officers were 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. The upcoming review of the Fund's SAA will allow for closer review of the changes made by Central and appropriateness of allocation to the product. Any actions taken will be reported to the next Local Pensions Committee meeting.

17. The existing underweight to private debt of circa 2.5% will continue to close during 2023 all else being equal due to calls from significant commitments already made. The Fund is awaiting Central's 2023 private debt vintages to be launched, there is an existing approval of a combined £280m that can be committed to the LGPS Central private debt 2023 vintages.

18. A £60m commitment was made to the LGPS Central Direct Property Fund. This is yet to be called at the time of writing. 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. Officers are watching the valuation of property assets given the difficult 12 months with respect to decreasing property valuations whilst UK and developed global interest rates have risen.

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 effect of 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. In the case of global credit there are significant commitments approved which will take more than a year to be called by the underlying managers, by which time more capital will have been repaid to the Fund.

26. There is a paper elsewhere on today's agenda regarding a recommended private equity commitment totalling £85million. This will take a number of years to be called whilst for distributions from the Adam's Street Partners (ASP) private equity portfolio is forecast to increase in the coming years.

Growth	30/06/23 £m	2023 SAA	30/06/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Diff to target weight post changes £m	% diff to SAA
Listed Equity - Active and Passive	2,552	37.50%	44.4%	6.9%	395	0	0.0%
Targeted Return Funds	439	5.00%	7.6%	2.6%	151	0	0.0%
Private Equity	425	7.50%	7.4%	-0.1%	-6	104	1.8%

Income	30/06/23 £m	2023 SAA	30/06/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Diff to target weight post changes £m	% diff to SAA
Infrastructure	586	12.50%	10.2%	-2.3%	-133	7	0.1%
Global credit - private debt / CRC	465	10.50%	8.1%	-2.4%	-139	338	5.9%
Property	421	10.00%	7.3%	-2.7%	-154	-47	-0.8%
Global Credit - liquid MAC	214	9.00%	3.7%	-5.3%	-304	0	0.0%
Emerging market debt	114	0.00%	2.0%	2.0%	114	0	0.0%

Protection	30/06/23 £m	2023 SAA	30/06/23 Actual weight %	Difference, actual to 2023 SAA	£m to target weight	Diff to target weight post changes £m	% diff to SAA
Inflation linked bonds	231	4.50%	4.0%	-0.5%	-28	-28	-0.5%
Investment grade (IG) credit	145	2.50%	2.5%	0.0%	1	1	0.0%
Short dated IG credit	57	0.25%	1.0%	0.7%	42	0	0.0%
Active currency hedge collateral	50	0.75%	0.9%	0.1%	7	7	0.1%

Cash	55	0.00%	0.9%	0.9%	55		

Higher than previous levels of cash

27. The effect of reducing listed equity to the SAA target of 37.5% weighting will mean the Fund will be holding higher levels of cash whilst awaiting calls from managers in order to reinvest. As a result of the first phase of the realignment around £220m in cash was added. Future phases of the realignment as described elsewhere on today's agenda will give the Fund options to stay invested in equity or decrease equity exposure and take cash. These decisions will be taken with advice from the equity transition advisor and the Fund's investments advisor.

28. In the current environment where cash yields are around 5% per annum, this is less of a problem than it would have been around a year ago when interest rates were considerably lower.

29. The current forecasts based around the current version of the listed equity transition plans shows cash to peak around £350m or about 6% of the Fund before falling

back as cash is reinvested into other underweight areas. The higher levels of cash are as a result of reducing the listed equity and targeted return weight to the SAA target.

30. Other changes that are forecasted to take place include calls from private market commitments (private debt, infrastructure and property), as well as the use of cash to invest into the underweight liquid MAC space which the Fund's advisor will remark on as part of the annual SAA refresh.

31. The table below illustrates net cash holdings by month. The forecast is subjective and listed equity changes currently planned in February 2024 might be earlier or later which may impact on other changes.

	Net contributions	Listed Equity changes	Targeted Return changes	Private Equity changes	Infra changes	Private debt changes	Property changes	Global credit Liquid MAC changes	in month cashflow	End of month cash forecast	% Cash of Fund
Sep-23	5	220	0	0	-5	-16	0	0	205	315	5.5%
Oct-23	5	0	30	0	-8	-16	0	0	12	326	5.7%
Nov-23	5	0	11	0	-8	-18	-20	0	-29	297	5.2%
Dec-23	5	0	69	0	-8	-18	0	0	48	346	6.0%
Jan-24	5	0	0	4	-13	-18	-45	0	-67	279	4.9%
Feb-24	5	172	0	4	-13	-18	-20	-95	36	315	5.5%
Mar-24	5	0	0	4	-13	-26	0	-95	-125	190	3.3%

Pension Fund cash management strategy (CMS)

32. The Fund does not have a CMS. It does however utilise highly liquid and secure money market funds (MMF) to park cash overnight. These are deemed to be more secure than holding large cash balances at a single bank. MMF invest in instruments such as cash and government bonds which have a high credit rating. Consequently, the MMF is usually triple A (AAA) rated by a rating agency. AAA being the highest rating an investment product can have. In order to diversify risks from holding cash in a single type of investment product (a money market fund) other forms of investment products are proposed to be utilised.

33. As a result of having a larger than usual cash holding it is deemed appropriate to formalise the CMS for the Fund. It will be reviewed annually in line with other policies the Fund has such as the investment strategy statement (ISS) and funding strategy statement (FSS).

34. In order to utilise experience the administrating authority has within this field, the CMS is based upon the Leicestershire County Council's annual investment strategy as advised by the County Council's treasury advisor Link which incorporates:

a. The management of risk – the Council's investment priorities are security first, portfolio liquidity second and then yield (return).
b. A credit worthiness policy – Link's methodology includes the use of credit ratings from the three main credit rating agencies; Standard & Poor, Fitch and Moody's.
c. Country limits – the Link criteria includes a requirement for the country of domicile of any counterparty to be very highly rated. This is on the basis that it will probably be the national government which will offer financial support to a failing bank, but the country must itself be financially able to afford the support.

35. The combination of all the factors above produces an acceptable counterparty list, for the County Council, which comprises only very secure financial institutions, and a list that is managed pro-actively as new information is available. Officers propose to use a sub-set of the counterparty list as the basis of the Fund's CMS. The full set of allowable investments contains eleven different types.

36. Link has a methodology that includes the use of credit ratings. The credit ratings of counterparties are supplemented with the following overlays:

   a. "Watches" and "outlooks" from credit rating agencies;
   b. Credit Default Swap (CDS) spreads that may give early warning of changes in credit ratings; If a CDS price increases it may be signalling to the market an increase in risk of default.
   c. Sovereign ratings to select counterparties from only the most creditworthy countries.

37. This modelling approach combines credit ratings, and any assigned watches and outlooks, in a weighted scoring system which is then combined with an overlay of CDS spreads. The end-product of this is a series of bands which indicate the relative creditworthiness of counterparties. These are used by the Council to determine the suggested duration for investments. The Council further restricts the list of acceptable counterparties from the base list provided by Link.

38. It is the Council's restricted list that the CMS for the Fund is proposed to be based on. The CMS will, however, focus on a smaller list of allowable investments per the table below. Officers for the County Council and Pension Fund are familiar with the allowable list of investments and get regular updates from Link. Any updates that require amendments to investments made by the Fund will be actioned as soon as possible.

Investment	**Level of security**	**Maximum period**	**Maximum sum invested**
Money Market Funds: Low Volatility and constant NAV(2) Triple A rated fund	At least as high as acceptable credit rated banks.	Same day redemptions and subscriptions	£250m (max £50m in each MMF) Minimum use of two MMFs(1) with each MMF having a minimum size of £3bn GBP
Term deposits with credit-rated institutions with maturities up to 1 year (including both ring-fenced and non ring-fenced banks)	Varied acceptable credit ratings, but high security	1 year	£250m(2)
Term deposits with overseas banks domiciled within a single country	Varied acceptable credit ratings, but high security	1 year	£100m(3)
Certificates of Deposit with credit rated institutions with maturities of up to 1 year	Varied acceptable credit ratings, but high security	1 year	£250m

Term deposits with the Debt Management Office	UK Government backed	1 year	£500m
UK Government Treasury Bills	UK Government backed	1 year – held to maturity	£500m
Term Deposits with UK Local Authorities up to 1 year	LA's do not have credit ratings, but high security	1 year	£50m

[1] Limits can be extended higher temporarily by the Director of Corporate Resources and will need to be reported to the next meeting of the Local Pension Committee.

[2]Funds will be invested in constant or low volatility NAV MMFs. Constant NAV MMFs where the capital value of a unit will always be maintained at £1. These funds have to maintain at least 99.5% of their assets in government backed assets. Low volatility NAV MMFs are those where the MMFs are permitted to maintain the unit price at £1 as long as the net asset value does not deviate by more than 0.20% from this level.

[3]Limits per counterparty as advised by the treasury advisor will be used up to a total for all term deposits of £350m

39. Counterparty lists for term deposits (UK and overseas) and certificate of deposit have institution and country limits as advised by the Council's treasury advisor Link. The Link country limits includes a requirement for the country of domicile of any counterparty to be very highly rated. This is on the basis that it will probably be the Government that will offer financial support to a failing bank, but the country must itself be financially able to afford the support. The Council's list of acceptable counterparties will include a limit on the maximum amount that can be invested in all counterparties domiciled in a single country (except for the UK) in order to mitigate sovereign risk.

40. It is likely that only a small number of the allowable list above is used at any given time, but the flexibility afforded to the Fund from including government backed investments is useful in the event of a crisis when the Fund may want to consider placing cash with ultra-secure counterparties.

41. Cash held with Aegon asset management the Fund's currency hedging manager is held with banks. The banks must meet Aegon's rating criteria based on S&P and Moody's ratings. Officers will work with Aegon asset management to consistently apply the CMS..

42. For completeness, the management of excess cash is not an Investment Sub-Committee decision and as such pension fund cash will be managed by officers in line with the policy.

Recommendation

43. That the CMS for the Fund as set out in the table at paragraph 38 of this report be approved.

Supplementary Information

44. None

Equality and Human Rights Implications

45. 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.

Appendix

None

Background Papers

None

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