Leicestershire County Council

LOCAL PENSION COMMITTEE – 01 DECEMBER 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.

2. The report also provides an update on progress with respect to the listed equity changes, as approved by the Investment Sub-Committee on 19 April 2023, and to the scope for the Fund's investment advisor's strategic asset allocation (SAA) review which will be presented to the Committee for approval in January 2024.

Markets Performance and Outlook

3. A summary of global asset class performance over various time frames as at quarter end 30 September 2023 is shown below. No assets are now showing double digit returns over 20 years with gold dropping to 9.8% per annum (annualised this quarter), sterling high yield debt dropping out the quarter ending 30 June 2023, and property the quarter ending 31 March 2023.

	3 months*	One year	Three years	Five years	Ten years	Twenty years
GLOBAL EQUITIES	-3.1%	21.6%	7.7%	7.0%	8.1%	8.1%
PRIVATE EQUITY	9.5%	19.2%	15.6%	9.9%	11.4%	NA
PROPERTY	-8.4%	-1.6%	2.8%	2.8%	6.1%	7.9%
INFRASTRUCTURE	-7.3%	6.9%	7.3%	4.0%	5.1%	7.4%
HIGH YIELD	3.7%	15.4%	2.1%	2.8%	4.9%	9.7%
PRIVATE DEBT	1.4%	4.0%	0.8%	-0.6%	-0.2%	0.0%
UK GILTS	-0.8%	-3.0%	-12.2%	-4.2%	0.2%	2.8%
UK INDEX-LINKED	-5.3%	-13.5%	-14.3%	-5.4%	1.0%	4.0%
GOLD	0.2%	1.9%	0.9%	10.6%	6.2%	9.8%

Note: Private Market asset classes will typically display lower volatility compared to their listed index proxies.

Portfolio changes in the quarter ended

4. The year 2022 was a busy year for calls and reallocations to the SAA based on commitments made in 2021 and 2022. However, 2023 has been far quieter so far with respect to the volume of reallocations and calls. During the quarter up to 30 September the following changes were completed:

   a. The first phase of the listed equity changes agreed by the Investment Sub Committee (ISC) on 19 April 2023 was completed resulting in the reduction to the LGPS Central climate multi factor fund holdings for circa £220million. This reduction was scheduled to align with another partner fund who was adding to the same fund, and as such a very low-cost switch of units enabled both Funds to avoid trading costs. The resulting cash was added to the Fund's cash balances.

   b. The first reductions to the Fund's targeted return holdings commenced. Holdings at two managers were reduced to equal monetary amounts and will be divested in total over the coming months. The initial reduction totalled £48.5million which was added to the Fund's cash balances.

Outstanding commitments

5. Capital calls from other commitments were concluded as and when they were received. At the time of writing the value of outstanding commitments is significant at nearly £0.6billion and illustrates the approvals made by the Committee 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.

6. There are significant commitments waiting to be signed once the relevant product subscription documents are available. At present these total circa £350million with £280million approved for Central 2023 private credit vintages.

Market backdrop

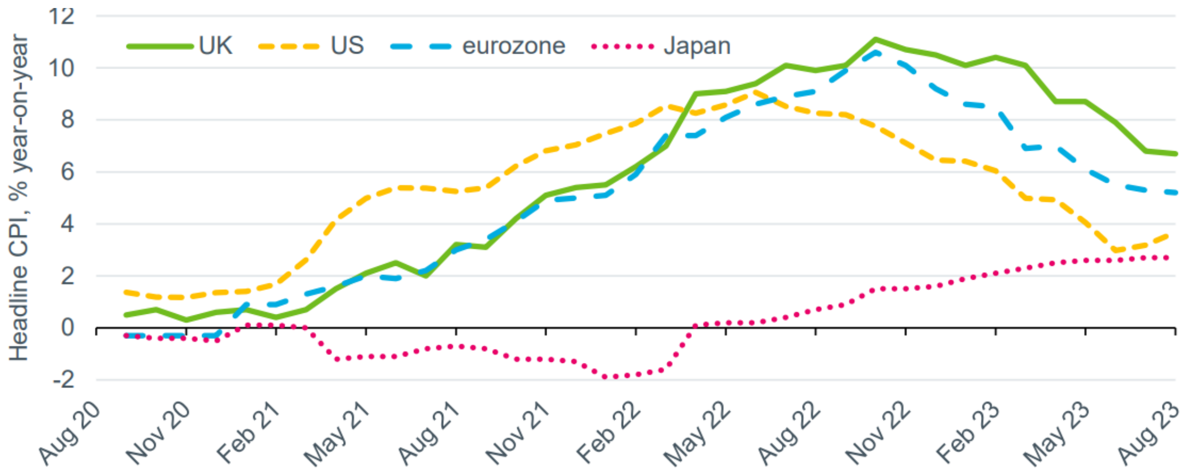
7. Equity markets have endured a difficult 18 months including the slowing down of global trade, the war in Ukraine, energy shortages, inflation increases in developed nations and a rapid increase of interest rates in many countries. Global growth continues to defy downbeat expectations, where headline inflation seems to be finally falling in developed markets but core inflation (usually removing food and fuel) remains above most central bank targets. A fuller capital markets update, provided by Hymans Robertson is appended to this report.

8. Global growth in 2023 has been subdued, even by post-Global Financial Crisis (GFC) standards, but more resilient than expected. Consumer spending exceeded expectations, particularly in the US; fiscal support dulled the impact of higher energy prices on European consumers; and China emerged from its zero-Covid restrictions earlier than hoped.

9. Inflation has generally stayed on a downward trend, but the recent sharp rise in oil prices led to an uptick in year-on-year US CPI inflation in August (see chart below). Declines in energy prices have been a key contributor to the reduction in headline inflation over the last year, and so any reversal could slow the downtrend. Central banks might choose to 'look through' the immediate impact of a temporary, supply

driven increase in energy prices. However, the risk of second-round effects, alongside sticky core inflation and tight labour markets, are reasons why central banks may proceed cautiously with rate cuts.

Inflation remains elevated whilst trending lower through 2023



10. Hymans believe the tone of central bank comments at recent meetings, where rates have been held and market pricing suggest that policy rates are at or close to peaking, that subsequent cuts will be gradual. This will limit the potential boost to growth from looser monetary policy in 2024 and 2025.

11. Hymans do not believe growth will collapse but expect it to fall to a very lacklustre pace in 2024, followed by a modest recovery in 2025. While consensus forecasts for global GDP growth in 2023 have risen to 2.4% from 1.6% at the start of the year, 2024 global GDP forecasts have fallen to 2.1% from 2.5%, and Hymans believe a poorer outcome is very possible.

12. Hymans view on gilts has improved given the weak real growth outlook and expected declines in inflation. In the presence of an independent central bank, and in the absence of catalysts that augur higher long-term real growth, Hymans think longer-term nominal, and, to a slightly lesser extent real, yields are reasonably attractive relative to fair value.

13. From a credit perspective Hymans believe that, with weaker corporate earnings and higher borrowing costs starting to make their mark on debt affordability measures (debt as a proportion of earnings is generally rising, while earnings as a multiple of interest payments is falling), the fundamental outlook for credit is challenging. They conclude, on balance retaining a preference for higher quality credit over speculative-grade.

14. Hymans believe 2023 has outperformed the downbeat forecasts made at the start of the year, but its pace has been subdued and they think it's likely to slow further. With weak growth and rising borrowing costs providing a tough outlook for corporate earnings, the fundamental outlook for equity and credit markets is challenging. They therefore maintain defensive positioning, preferring 'safe' assets (sovereign bonds, cash and high-quality credit) over 'risk' assets such as equity, speculative-grade credit and property over the nearer term.

15. 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 the Fund, which 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.

16. It is well known that a major source of investment returns is asset allocation. The rebalancing of the Fund to the target SAA 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.

17. It is one of the reasons that the January Local Pension Committee meeting has been used primarily for presenting the revised SAA for the coming year. The usual process has commenced with the Fund's investment advisor and officers for the Fund. The scope agreed for the 2024 review is included later within this paper.

Cash at quarter end

18. At quarter end the cash held by the Fund totalled £328million, with an additional £38million cash held as collateral with Aegon for the currency hedge. The increase in cash is due to the cash released from the reduction in listed equity per the 2023 SAA and explained earlier. Taken together the £366m is 6.3% of total fund assets.

19. Given the significant uncalled commitments the Fund has, 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. Given the rates of return on cash have increased significantly over 2023 holding cash isn't the drag on returns it once was. At present the cash held by the Fund earns in excess of 5%. A cash holdings forecast was presented to the ISC on 11 October 2023.

20. 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.

21. 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. The investments made will be to align to the approved SAA.

22. The cash level is higher than it has been for a number of years. A forecast was taken to the last ISC meeting which shows a reduction in cash to the end of March 2024. This forecast is reliant on a number of factors including conclusion of the 2023 SAA which included a number of proposed changes that the investment advisor is finalising their thoughts on given the change in the mandate for the LGPS Central MAC product. The final decision on this investment will be incorporated into the SAA 2024 refresh.

Overall Investment Performance

23. A comprehensive performance analysis over the quarter, year, and three-year period to 30 September 2023 is now conducted by Hymans Robertson who collate information directly from managers and calculate performance, which provides an independent check of valuations and allows greater reporting flexibility. The valuation summary is included with the managers reports within the exempt part of today's agenda. This service was previously provided for by Portfolio Evaluation who have since decided to close the business. Hymans have taken over the service having acquired the historical records.

24. 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.

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

	Quarter	1 yr	3 yr pa	5yr pa
Total Fund	0.0%	+4.8%	+7.1%	+5.4%
vs benchmark	-0.4%	-1.1%	+1.5%	+0.2%

26. The Fund has experienced flat returns over the quarter which is lower than the benchmark return by 0.4%. The Fund tends not to focus on short timeframe returns which can be more volatile and instead looks towards the longer one, three and five-year returns as a measure of performance versus the benchmark.

27. 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.

28. The one-year underperformance versus the benchmark of -1.1% is mainly driven by the growth and income asset groups. The year to the end of September 2023 was marked by a sharp derating of risk assets as developed global central bank interest rates were raised. As a result, some risk assets which are included within both growth and income asset groups underperformed their benchmarks. As interest rate rise expectations reduce, market commentators expect downward pressure on risk assets to subside.

29. Over a one-year period, the largest underperformance versus the benchmark has arisen from the private equity (PE) holdings, -15.5%. Given the benchmark PE is measured against is a listed broad world index, the lag which PE valuations suffer from is now being fully experienced whereas the listed markets will have suffered these repricing's during the second half of 2022 and early 2023. Over a longer timeframe of three and five years the annualised return is 19.4% pa and 16.1% pa respectively, both of which are comfortably ahead of the benchmark.

30. 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.

Listed equity update

31. On 11 October the ISC received an update on the listed equity transition which it approved in April 2023 . This summarised:

    a. the decision taken to re organise the listed equity holdings and reduce the total Fund weight to 37.5%;
    b. the appointment of a transition advisor;
    c. and described a four-phase plan to reorganise and reduce the listed equity weight to 37.5% of total Fund assets.

32. As previously stated within this paper, phase one of this plan was completed in September and £220million was received by the Fund. At the time of writing phase two, which is the reorganisation of the Legal and General investment manager (LGIM) passive holdings, is planned to complete during mid-November once relevant advice from the investment advisor, new benchmarks and control ranges and contracts (including management fees) are agreed. A verbal update will be given during the meeting on the completion of this phase.

33. In line with the update given to the ISC on 11 October 2023 the final phases are forecasted to be completed by the end of the current financial year but are subject to a number of dependencies as highlighted within the paper.

34. A summary of the Fund's listed equity holdings at 30 September 2023 is shown below alongside the changes that have occurred, are planned to complete in November 2023 and those that are yet to be completed.

	Passive or active	AUM 30.09.23 £m	% of total portfolio %	% of listed equity %	Target % SAA 2023	Adjustments made to 30.09.23 £m	Adjustments planned since Qtr ended £m	Adjustments left to plan £m	Estimated final position £m
LGIM UK equity index Fund and UK core equity index fund	Passive	169	2.9%	7.2%	0%		Reorganise		
LGIM 7 FTSE 100 single stocks	Passive	25	0.4%	1.1%	0%		Reorganise		
LGIM North America Equity index fund	Passive	350	6.1%	14.9%	0%		Reorganise		
LGIM Europe (ex UK) equity index fund	Passive	150	2.6%	6.4%	0%		Reorganise		
LGIM Japan Equity index Fund	Passive	75	1.3%	3.2%	0%		Reorganise		
Japan) developed equity index fund	Passive	65	1.1%	2.8%	0%		Reorganise		
LGIM World Emerging markets equity index fund	Passive	96	1.7%	4.1%	0%		Reorganise		
LGIM UK Equity Fund	Passive	0	0.0%	0.0%	2.00%		115		115
LGIM All World Equity Fund	Passive	0	0.0%	0.0%	8.00%		617	-155	462
LGIM Low Carbon Transition Fund	Semi active	0	0.0%	0.0%	3.50%		202		202
LGPS Central Active Global Equity Multi Manager Fund	Active	542	9.4%	23.1%	12%			150	692
Emerging Markets Multi Manager Fund	Active	177	3.1%	7.6%	0%			-177	0
LGPS Central Climate Balanced Multi Factor Fund	Semi active	698	12.1%	29.7%	12%	-220			698
Total		**2348**	**40.7%**	**100.0%**					**2169**
Total LGIM products		**931**	**16.1%**	**39.6%**					**779**
Total Central products		**1417**	**24.6%**	**60.4%**					**1390**

35. Once the LGIM reorganisation is complete in November the Fund will still be overweight to listed equities, the final reduction in weight towards the target weight of 37.5% of total Fund assets will occur as part of the Central reorganisation.

36. The listed equity changes have progressed in a controlled manner with the final listed equity changes yet to be planned with Central. The transition advisor is in talks with officers and LGPS Central regarding the final changes. It is currently planned to complete all changes before the end of the financial year. The changes will enable the Fund to meet its overall listed equity target of 37.5% of total Fund assets.

SAA 2024 investment advisor scope

37. In keeping with the usual timetable, the 2024 SAA will be presented to this Committee at its meeting in January.

38. Officers commence the process in the last calendar quarter commencing with identification and agreement of a scope. The 2024 SAA review will incorporate the following:

    a. Market developments during 2023
    b. Review of the 2023 SAA objectives
    c. Net zero considerations given the Fund's approved interim and longer-term targets
    d. Review of the high-level strategy to ensure it remains appropriate
    e. Reminder of the composition of each asset class including performance to ensure the investment structure of the Fund remains appropriate
    f. Overall allocation and composition of the protection assets portfolio with consideration of alternative assets
    g. High yield debt (including multi asset credit) appropriateness taking into account the market developments
    h. Review of investment mandate and asset group benchmarks

2023 Investment plans and actual weighting versus 2023 SAA

39. The Fund's 2023 Strategic Asset Allocation (SAA) was approved by the Committee in January 2023 which included a number of changes as summarised in the table below, alongside the actual position as of 30 September 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.

40. The listed equity changes were agreed by the ISC on 19 April 2023. Progress is detailed earlier 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 with further divestments having taken place during October 2023 and November 2023. The first investments to the new targeted return manager, Fulcrum was made in October 2023 with an aim to gradually build this position to the target weight of 2% of total Fund assets.

41. The private equity commitments are comprised 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. An additional circa £80million was approved at the meeting of the ISC on 11 October 2023 taking into account future cash inflows as older vintages return capital.

Subscription documents for the circa £80million have not yet been completed and monies would take a number of years to be fully called.

42. 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	30.9.23 Actual weighting	Vs 2023 SAA	Changes / commitments to be called £m (GBP)
Growth	Listed equities	42.00% (40%-44%)	37.50%	- 4.5%	40.7%	+3.2%	Reduction commenced. Agreed changes, transition advisor appointed
Growth	Private equity	5.75%	7.5%	+ 1.75%	7.1%	-0.4%	£60m + £80m commitments approved at Oct 2023 ISC
Growth	Targeted return	7.50%	5.00%	- 2.5%	6.8%	+1.6%	Reduction commenced July 2023
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%	10.7%	-1.8%	£160m
Income	Property	10.00%	10.00%		7.2%	-2.8%	£120m
Income	Emerging market debt & Global credit – liquid sub inv grade markets	6.50%	9.00%	+ 2.5%	5.6%	-3.4%	Agreed changes, awaiting investment advisor SAA 2024 to finalise
Income	Global credit – private debt (inc M&G/CRC)	10.50%	10.50%		8.2%	-2.4%	Awaiting outcome of asset class review in 2024 SAA, £250m commitments and £280m approved to commit
Protection	Inflation-linked bonds	4.50%	4.50%		3.8%	-0.7%	
Protection	Investment grade credit	3.00%	2.75%	-0.25%	3.5%	+0.75%	
Protection	Currency hedge	0.50%	0.75%	+0.25%	0.7%	-0.05%	
Protection	Cash / cash equivalent	0.00%	0.00%		5.7%	+5.7%	Awaiting to be called from outstanding commitments

43. 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.

44. The current position at asset group level shows that the Fund is overweight to growth assets however this overweight has been reducing and underweight to income assets and largely in line with protection assets versus the 2023 SAA.

45. 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.

46. 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 ISC in 2023. All reviews were concluded by Hymans and presented to the ISC.

   a. A listed equity asset group review – presented to April 2023 ISC
   b. A targeted return review – presented to April 2023 ISC
   c. A protection assets review – presented to July 2023 ISC

Leicestershire Pension Fund Conflict of Interest Policy

47. 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

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

Environmental Implications

49. 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

50. 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

51. 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

Hymans Robertson, Capital Markets update Autumn 2023

Background Papers

52. 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
53. Investment Sub Committee 11 October 2023, Listed Equity Transition Update (Agenda item 7) https://politics.leics.gov.uk/documents/s179001/Equity%20transition%20update.pdf

Officers to Contact

Declan Keegan, Director of Corporate Resources
Tel: 0116 305 7668 Email: Declan.Keegan@leics.gov.uk

Simone Hines, Assistant Director Finance, Strategic Property and Commissioning
Tel: 0116 305 7066 Email: Simone.Hines@leics.gov.uk

Bhulesh Kachra, Senior Finance Analyst - Investments
Tel: 0116 305 1449 Email: Bhulesh.Kachra@leics.gov.uk