Leicestershire County Council

LOCAL PENSION COMMITTEE – 26 JANUARY 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

OVERVIEW OF THE CURRENT ASSET STRATEGY AND PROPOSED 2024 ASSET STRATEGY

Purpose of the Report

1. The purpose of this report is to inform the Local Pension Committee of the outcome of the annual review of the Leicestershire Pension Fund's (the Fund) strategic investment allocation and structure. A paper written by the Fund's investment advisor Hymans Robertson supports this section and is appended to this paper.

2. The report also provides advice regarding the Fund's current investment strategy relating to fossil fuel exposure and provides advice, as requested by the Committee at its last meeting in December 2023, on the proposal to 'require LGPS Central to establish a fossil fuel free fund'.

Background

3. The nature of the Fund's liabilities is long-term. The strategic investment benchmark is structured to reflect the nature of liabilities by focusing on the need for long-term returns and a degree of inflation-linked returns. Market fluctuations will cause the Fund's actual asset allocation to vary from the agreed strategic asset allocation (SAA) and investment within asset classes in which funding is 'drawn down' over a period of time will create further variation. The strategic benchmark, which is set each year, should therefore be considered an 'anchor' around which the actual asset allocation is managed.

4. The Fund is invested in funds administered by LGPS Central (Central), a private company jointly owned by the Fund and seven other pension fund administering authorities. By pooling investment, Central aims to reduce costs, provide additional manager monitoring and improve responsible investment outcomes and investment returns to the ultimate benefit of Fund employers and members.

5. Central's product offer continues to develop, and the strategy review has been undertaken with this in mind like previous years. Dialogue continues with Central and other partner funds on a regular basis to ensure that Central's offer meets the goals of the Fund. Pooling of Fund assets has resulted in Central becoming the single largest investment manager the Fund invests with. The Fund has made good progress regarding an orderly transition to Central products to date. Some investments in niche areas or where current investments are illiquid will take time to transition or may be kept outside of the pool on the advice of the Fund's investment advisor. The advisor will take into account all relevant legislation and government guidance.

6. As of 30 September 2023, the value of pooled funds directly managed by Central and low-cost index trackers collectively procured from Legal and General (L&G) totals £3.0 billion or 52% of the Fund's total value. The Fund has significant uncalled commitments made to Central illiquid products that, all things being equal, once called will increase the proportion of pooled funds invested with Central.

7. Any decision on the appropriate investment allocation is inherently difficult and will inevitably come down to a 'trade-off' between expected risk and return. Whilst historic measures for risk and return can be informative about how different asset classes are correlated to each other, they give no guarantee that these historic links will persist, and as a result an 'optimal' asset mix does not exist.

8. 2022 was a reminder of this as previously held beliefs were proven not to be the case as both bonds and equities sold off sharply. This does not detract from the desirability to agree a strategic asset allocation benchmark that makes intuitive sense in terms of the risks being taken to achieve a required return in line with the Fund's required rate of return as calculated by the Fund's actuary Hymans Robertson.

9. At the 1 December 2023 Local Pension Committee meeting, officers were asked to consider whether LGPS Central should be requested to set up a fossil fuel free fund. Officers were asked to investigate and present to the Local Pension Committee its findings and advice on the matter.

Summary of Last Years (Jan 2023) Asset Strategy Proposals and Progress Made to Date

10. No changes to asset allocations were proposed by the Fund's investment advisor at the January 2023 Local Pension Committee. However, a number of asset class reviews were recommended, the outcomes of which are summarised below:

    a. Listed equity review – this was completed and considered in April 2023 by the Investment Sub-Committee (ISC) which agreed the implementation of the move from 42% of total assets being held in listed equity assets to 37.5%. The review was split into three stages and the recommendations of an independent transition advisor appointed as part of the review are summarised below:

    - Stage 1: Collapse the regional passive Legal and General Investment Management (LGIM) portfolio including the single stock funds into the following three Funds with LGIM:

        - L&G UK Equity Fund – 2% of total Fund assets
        - L&G All World Equity Fund – 8% of total Fund assets
        - L&G Low Carbon Transition Fund – 3.5% of total Fund assets

    - Stage 2: Decrease the allocation to the Central Climate Factor fund – 12% of total Fund assets.

    - Stage 3: Increase the allocation to the Central Global Equity fund – 12% of total Fund assets.

    - Stage 4: Divest from the Central Emerging Market multi manager fund.

At the time of writing, Stages 1 and 2 have been completed. This has reduced the actual weight of listed equity assets towards the 37.5% target, simplified the Legal and General passive holdings and introduced a low carbon transition passive fund. Stage 2 was completed in September 2023 with c£220m returned to the Fund from a decrease in the allocation to the Climate multi factor fund.

Stages 3 and 4 of the changes which increases the holdings in the LGPC Central Global active equity fund and reduces the holdings in the LGPS Central Emerging Equity fund is planned to be completed in the first half of 2024. These changes are currently being planned with Central pending the outcome of a three-year review of the LGPS Central Global Equity fund which could result in a change in the mandate, such as a change of underlying investment manager for the fund.

b. Targeted Return – this review was also completed and presented to the ISC meeting held in April 2023. The proposal allowed the Fund to simplify its holdings from three mandates to two mandates, by removing two mandates and adding one new one. The target weight (i.e. amount to be invested) will be reduced from 7.5% to 5.0% of total Fund assets. At the time of writing the Fund has placed final instructions to reduce holdings in the two mandates which were approved to be divested. The new mandate is being built up to its target weight of 2% with the final investment planned during February 2024.

c. Protection assets – this review was presented to the July 2023 meeting of the ISC. Hymans Robertson presented the case to reduce the allocation to index linked bonds from 3.75% of total Fund assets to 3.25% and adding the reduction to the investment grade credit asset class pending their instruction on the relative pricing of the two classes.

At the time of writing, Hymans Robertson believe the timing is not favourable to make the switch and will advise once the outlook becomes favourable.

Executive Summary of Recommendations for the 2024 Strategic Asset Allocation Strategy

11. Hymans Robertson (Hymans) believe the current (2023) SAA target weights are still appropriate and therefore do not recommend a change. The Fund has made changes over the last three years towards adding predictable and sustainable income-based returns which should continue to support a stable and affordable level of contributions. The summaries against each major asset class are listed below. Further details of all recommendations are included within the appendix and will be presented by a representative from Hymans at the meeting.

Equities

Hymans recommend the Fund should maintain the allocation to listed equity at 37.5% and private equity at 7.5%, and progress the changes agreed at the April 2023 ISC meeting.

Targeted Return

Hymans recommend the Fund should maintain the allocation to targeted return at 5.0%, and progress the changes agreed during the April 2023 ISC review of the asset class.

Infrastructure
Hymans recommend the Fund should maintain the target allocation to Infrastructure at 12.50%, and that consideration is given as to what additional commitments are needed over the next 3 years in order to reach the target allocation, whilst maintaining the desired risk and geography profile per the framework agreed by the ISC in July 2022. Hymans will be asked to complete a strategy on how to maintain the Fund's timberland exposure given the current exposure via closed ended funds will start to return, increasing capital over the next 3 to 5 years.

Property
Hymans recommend that the Fund should maintain the target allocation to Property at 10% and remain comfortable with the structure agreed by the ISC in April 2022. Hymans recommend using part of the expected Active Value funds return of capital to commit to La Salle in 2024 in order to implement the decision of the ISC in April 2022.

Multi Asset Credit (MAC)
Hymans recommend that the Fund should proceed with the 5% increase in the allocation to MAC agreed as part of the January 2023 SAA review. They also recommend the increase be implemented by additional commitments to the LGPS Central MAC fund, which is to be funded from cash reserves and from LGPS Central's standalone Emerging Market Debt fund. They recommend that the increase to MAC takes place over 2024 period given the size of the commitment, to increase confidence in the Central product and for the tactical outlook for higher yielding credit to improve.

Private Credit
Hymans recommend the Fund should maintain the target allocation to private debt at 10.5%, with corporate and asset-backed senior lending strategies forming the core of the portfolio.

They recommend that the current allocation to distressed debt (via three M&G distressed opportunities funds) is allowed to wind down. Hymans believe distressed debt remains an attractive opportunity at certain points in the credit cycle but recommend that the Fund gains exposure via a broad-based, opportunistic credit strategy with the manager taking responsibility for timing capital commitments.

Bank Capital Relief
Hymans recommend that the Fund makes further commitments to regulatory capital relief strategies in 2024 as its existing commitments are realised.

Protection Assets
Hymans recommend a fuller review of this asset class is undertaken to ascertain if a material increase from the 7.5% current target weight may result in better risk adjusted returns. Hymans also recommend further investigation into the case for gold and investment grade real asset backed senior debt as a protection asset as part of this work. A paper would be presented to the ISC incorporating asset liability

modelling and more up to date assumptions. Officers will assemble a scope for this proposal in the coming weeks.

Hymans recommend the reallocation between index linked bonds (ILB) and investment grade credit (IGC) is deferred given their shorter-term outlook on both asset classes. They propose reconsidering timing of this reallocation alongside the protection asset review which is to be bought to the ISC.

Benchmarks
Hymans recommend the Fund undertakes a review of the benchmarks being used to monitor manager performance with a list of proposed changes included within the appendix for this paper noting changes where benchmarks should be reviewed and changed ahead of others.

<u>Summary of Investment Sub Committee reviews pending</u>

12. The proposals include a number of reviews that will be planned by officers with Hymans Robertson and will be presented to meetings of the ISC during the year. A review covering the protection assets as described at point 11 of this report will include among other things, consideration to increasing the SAA weight from 7.5%, when to commence the reallocation between inflation linked bonds and investment grade credit and consideration of alternative protection assets. A second review will cover how the Fund maintains an allocation to bank risk share and timberland asset classes as the current investments return capital to the Fund.

<u>2024 SAA vs actual weights and required returns</u>

13. Underpinning the changes proposed above is the investment objectives and required return for the Fund. The Fund's recent valuation (as of March 2022) was presented to the Local Pension Committee in November 2022. The Fund's actuary, Hymans shared with the investment advisor (also Hymans Robertson) the outcomes of the actuarial valuation and assumptions contained within. The proposed changes in target allocation are proposed such that attainment of the overall investment performance is consistent with that assumed by the actuary.

14. The strategic asset allocation is designed around the required future investment return and an acceptable level of risk. Without this clarity it would be possible to have a strategy that targets a return that is high but takes excessively large risks and as a result has a higher possibility of failing to achieve its target, thereby putting unnecessary upward pressure onto employers' contribution rates. Likewise, a target that is too low may be easily achieved but has a lower probability of producing the returns needed to reduce future employers' contribution levels.

15. Hymans have taken into account the Fund's Net Zero Climate Strategy (NZCS) and always consider changes to the SAA and the impact on delivery of the proposed 2030 medium term targets included within the NZCS. The next full Fund valuation is due in March 2025 (with results available later in 2025) and will align investment return expectations which will again be matched with liability forecasts.

16. Hymans have concluded that the current investment strategy remains appropriate taking into account the Fund's objectives and funding position. They have also considered asset class expected returns alongside the Fund's objectives and

funding position. The expected median return for the 2024 SAA is now 8.7%pa which is ahead of the required rate to maintain a fully funded scheme.

17. At the last full actuarial valuation point (31 March 2022) the actuary calculated a 75% likelihood of achieving 4.4% investment return per annum (pa) and reported a 105% funding level as of 31 March 2022. The median return projection (50% likelihood of achievement) associated with the 2022 valuation was 6.5% pa, this is comparable with the 8.7%pa. At the same point last year (2023) when the SAA was presented to the Local Pension Committee the median return (50% likelihood) was calculated to be 8.2%pa.

18. The excess returns expected over the actuarial required return is largely due to the increase in interest rates and government bond yields experienced through 2022 and 2023 which has impacted the returns expectation as used for the SAA.

19. The Fund has a number of changes that need to be completed as illustrated in the table below in order to align to the 2024 SAA target. Some of these changes will have taken place since the latest snapshot as of 30 September 2023 and as such the gap to the 2023 (and 2024) SAA will have closed.

Asset Group	Asset Class	2022 SAA	2023 &2024 SAA	Change from 2022 SAA	30.9.23 Actual weighting	Vs 2024 SAA	Changes / commitments to be called £m (GBP) time of writing
Growth	Listed equities	42.00% (40%-44%)	37.50%	- 4.5%	40.7%	+3.2%	Reduction commenced. Agreed changes
Growth	Private equity	5.75%	7.5%	+ 1.75%	7.1%	-0.4%	£80m 23/24 + £80m 24/25 commitments approved
Growth	Targeted return	7.50%	5.00%	- 2.5%	6.8%	+1.6%	Reduction commenced July 2023, complete H1 2024
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%	10.7%	-1.8%	£180m committed outstanding
Income	Property	10.00%	10.00%		7.2%	-2.8%	£90m commitment outstanding
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
Prot	Inflation-linked bonds	4.50%	*3.5% changed from 4.50%		3.8%	-0.7%	Awaiting timing confirmation from Hymans
Prot	Investment grade credit	3.00%	*3.75% changed from 2.75%	-0.25%	3.5%	+0.75%	Awaiting timing confirmation from Hymans
Prot	Currency hedge	0.50%	0.75%	+0.25%	0.7%	-0.05%	
Prot	Cash / cash equivalent	0.00%	0.00%		5.7%	+5.7%	Awaiting to be called from outstanding commitments

*At the July 2023 meeting of the ISC a change was recommended and approved for inflation linked bonds and investment grade credit from the January 2023 SAA approval. The weights shown for these 2 asset classes represent the most up to target weights from the July 2023 ISC meeting approval.

<u>Proposal to establish a Fossil Fuel Free Fund</u>

20. At the last meeting of the Committee held on 1 December 2023 a member proposed requesting LGPS Central to set up a fossil fuel free fund. Fund officers have instructed Hymans to provide guidance on such a proposal, in particular advising on:

- the Fund’s current position regarding fossil fuel exposure;
- the pros and cons of establishing a fossil fuel free fund;
- whether the current approach supports the investment and responsible investment strategy.

21. Fund officers have also, via their scheduled interactions with other Central partner funds, investigated the appetite for such a product.

22. A summary of the findings is set out below. The Hymans paper includes additional background and is included within the appendix to this paper. A representative from Hymans Robertson will be available to take questions on this matter at the meeting.

Current position

The Fund’s Net Zero Climate Strategy (NZCS)

23. The current strategy for managing climate risk is detailed within the NZCS which was approved by this Committee in March 2023. This Strategy was written using the International Investors Group for Climate Change (IIGCC) net zero framework and based on considerable work and engagement with employers, scheme members, investment managers and other stakeholders which shaped the current approach adopted to managing the path to net zero (including reducing fossil fuels and more generally carbon emissions). The list below highlights some of the steps taken as part of the development of the Strategy:

    - 21 January 2022 Committee workshop on development of the Net Zero Strategy.
    - 25 March 2022 Workshop session on targets and metrics that were proposed and a summary of other LGPS fund climate strategies.
    - Advice from Hymans presented to the Committee in June 2022 which reviewed proposed targets and set out further detail on the approach to engagement and divestment following comments at the March 2022 meeting.
    - 13 October 2022 briefing following the engagement conclusion on targets and measures.
    - The Climate Risk Report and Climate Scenario Analysis presented to the Committee in November 2022, alongside the draft NZCS.
    - Presentation of the final NZCS in March 2023 to the Local Pension Committee taking into account an extensive consultation exercise.
    - Officers ongoing dialogue with Pension Committee members when requested.

24. The resulting strategy based on the IIGCC framework contains four key sections which satisfy and align with the Fund’s primary purpose of paying pensions and lump sum benefits as they fall due. These four sections are described below:

    - **Climate Change Risks and Opportunities**: how the Fund will further embed climate risk and opportunities considerations. This will include working with Investment Managers to ensure they have taken into account climate risks and opportunities.

- **Targets and Measures**: Net Zero by 2050, with an ambition for sooner, supported by interim and secondary measures to decarbonise the Fund's portfolio and increase investment in a range of climate solutions. This also sets out current coverage, and limitations facing the Fund.

- **Decision Making**: How the Fund can integrate targets and measures alongside best practice within the Fund's annual Strategic Asset Allocation, the Investment Strategy Statement and any investment decisions taken. Recognising the Fund can consider a range of investment approaches to manage risk and opportunities related to climate change, where there is a credible financial basis.

- **Stewardship Engagement and Divestment**: In line with the IIGCC the Fund believes that engagement will drive the transition for a low carbon economy. This sets out a four-step plan of evaluation, engagement, voting and divestment.

25. As a result, the Fund has a strategy which recognises and quantifies the climate change risk using carbon as the key metric to reduce such risk. This is alongside increasing the Fund's exposure to climate solutions and decreasing exposure to fossil fuel reserves as set out below.

<u>Ongoing investment and Fund management approach towards decarbonisation and managing climate risk</u>

26. The Fund has been actively managing and improving the carbon metrics for a number of years prior to approving a formal NZCS with changes to the Fund's holdings taking into account responsible investing and carbon metrics. Some of these changes are listed below:

- Transitioned a significant portion of the Fund's passive holdings with LGIM into LGPS Central's All World Equity Climate Multi Factor fund (Climate MFF), as of 31 September 2023 this is valued at £0.7bn. This provided the Fund with improved listed equity sector balance whilst improving the carbon metrics for the Fund.

  The Climate MFF incorporates three key climate change considerations: carbon emissions, fossil fuel reserves and green revenues. As at September 2023 the Climate MFF fund has better carbon metrics compared to the benchmark FTSE all world index as illustrated below and has marginally outperformed the benchmark since inception with returns of 9.02% pa versus 8.95% for the benchmark.

Climate Metrics	FTSE AW Climate Balanced Comprehensive	FTSE All World	Change
Fosil Fuel Reserves (Metric Tons Per m$ Equity)	525	1773	-70%
Carbon Emissions Intensity (Metric Tons Per m$ Equity)	61	214	-72%
Weighted Average Emission Intensity (Metric Tons/m$ Revenue)	61	154	-60%
Green Revenues (Proportion of total revenue %)	6.17	3.65	69%

- $114m committed to the Quinbrook Net Zero Power Fund. A Fund that invests in solar power with battery systems, both as part of the decarbonisation of the energy system, and as part of demand from data centres.

- $67m committed to the Stafford Capital Carbon Offset Opportunity fund, in addition to its existing investment in timberland. This fund looks to invest in sustainably managed timberland globally, provide a source of sustainable low carbon timberland materials, generate verified carbon offsets. In addition to the £123million already invested in Stafford Capital timberland funds.

- £135m committed the LGPS Central Core/Core+ Infrastructure Partnership which invests in infrastructure funds across the core/core plus space. To date this partnership has made several such investments which include UK focussed solar and battery storage, as well as social, renewables, transport, and utilities assets.

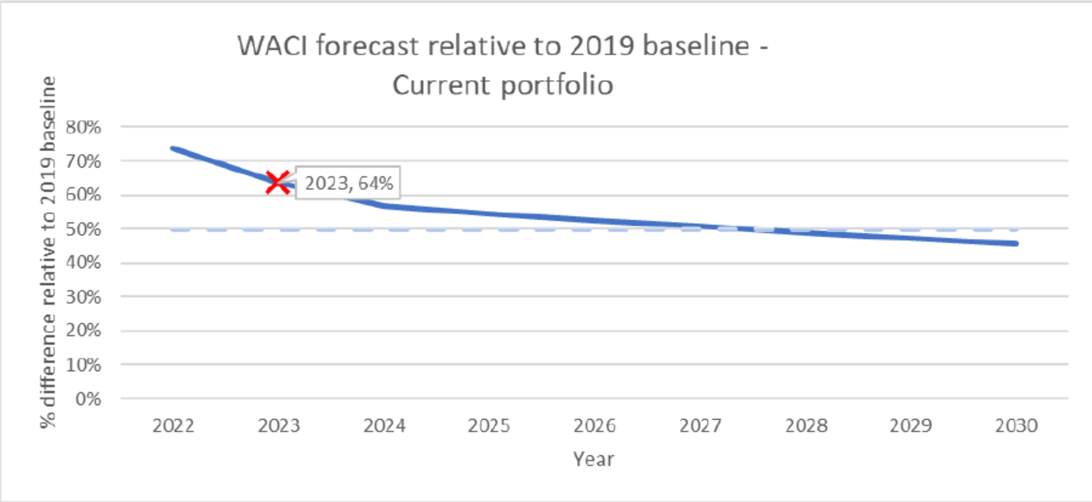
- £200million invested in LGIM's low carbon transition (LCT) fund in November 2023 which has an objective to reduce carbon emissions intensity and align with the net zero pathway. The LCT fund has an initial 70% reduction in carbon intensity versus the benchmark and aims for a 7% reduction per annum in line with a Paris aligned strategy. The LCT fund also incorporates LGIM's climate impact pledge which commits LGIM to helping invested companies reach net zero by 2050.

27. The use of funds that tilt towards companies with lower (sometimes significantly) carbon intensities is in line with both the NZCS and the IIGCC framework which believes in responsible stewardship and engagement before divestment action.

<u>Performance</u>

28. The result of the Fund's actions has been significant and has reduced the carbon intensity of the Fund from the 2019 baseline of 164 tonnes of CO_2 / $m revenue to 102 tonnes of CO_2 / $m revenue, a reduction of 38%. The Fund's current strategy has therefore ensured that good progress on this key measure has been made.

29. One of the interim targets approved within the NZCS is a 50% reduction from the 2019 baseline which would require the Fund to reach a carbon intensity of 82 tonnes of CO_2 / $m revenue by 2030. Hymans calculate that the Fund should meet this interim target earlier than 2030 but have considered reductions in carbon intensity may become harder as the low hanging fruit has likely been picked.



28. In addition to the current progress made with respect to reducing carbon emissions, the Fund has two equity transitions planned to complete during the first half of 2024. This transition will improve the funds carbon metrics, all other things being equal.

29. All equity transitions detailed above that have been planned as part of the 2023 SAA approvals have been made based on advice from Hymans who have balanced the requirement for producing the right level of investment returns whilst also seeking to ensure the 2030 interim NZCS targets and beyond are met. Hymans are mindful of the need to generate adequate investment returns which if missed for an extended period of time eventually results in increased employer pension contributions.

<u>Creating a new Fossil Fuel Free Fund</u>

30. It is important to note that requesting Central to build a new fund is an expensive exercise and one which all partner funds would need to pay for. The method used to develop investment products at Central requires known demand for an investment product before costs are incurred. Partner funds have been aligned on the approach undertaken by Central in provision of climate tilted funds to date.

31. Costs to develop products are shared under the cost sharing agreement signed by the eight Local Authority administering bodies. Central would be hesitant to develop a new product without enough investment funds being committed to warrant commencing feasibility work given the cost implications to other local authority administering bodies. The costs would not be insignificant in developing a new product and cost implications on other Local Authorities could place strain on the relationships between the Fund and its partners.

<u>The Pros and Cons</u>

32. Hymans outline in the appendix attached to this report the pros and cons of strategies which adopt blanket exclusion policies covering all companies in specific sector(s), for example, those which own material fossil fuel reserves. Where appropriate officers have added additional context.

33. Hymans believe the arguments in favour of fossil fuel-free strategies include those listed below but it should be noted that the majority of these impacts would accrue to society as a whole. Officers also recognise that this is not necessarily what is

being asked for in the motion, so these factors will apply to varying extents at this point.

- Eliminates direct transition risks to the Fund associated with the stocks excluded;
- May be appropriate for specific types of company that lack opportunities to transition to a low carbon business model;
- Signals to stakeholders that the Fund has limited appetite for climate risk and expects action to be taken by prospective investments to reduce it;
- May lead companies excluded to take action to reduce emissions, for example, by decommissioning assets
- May increase the cost of capital for fossil fuel companies leading to fairer pricing of the true cost of climate change and a more appropriate allocation of capital.
- May increase pressure on policymakers to take further action on decarbonisation;

34. The cons associated with an approach to using a fossil fuel free fund can have a negative impact on both investment outcomes and the wider economy if used inappropriately. For example:

- Reducing portfolio diversification, thereby increasing prospective market risk and potentially reducing investment returns. Lower investment returns than planned may ultimately result in higher employer funding rates.
- Excluding fossil fuels from a listed equity fund may not result in a lower carbon intensity for the fund. Excluding fossil fuels companies from an investment product is a crude way of managing carbon emissions as there are other industries which have high carbon emissions which would replace the excluded companies. There are examples of fossil fuel free funds which have higher carbon intensities than the two funds (LGIM LCT and Central MFF) we currently invest in. This would not be supportive of the NZCS and achievement of its interim 2030 carbon intensity targets.
- Increasing portfolio complexity and costs, especially if the Fund needed to invest via segregated accounts in order to implement the wider exclusions it required which may not be practical in private markets today.
- Depriving the Fund’s managers of an opportunity to exert influence on excluded companies and/or transferring ownership to less responsible investors, potentially leading to them decarbonising more slowly.
- Missing out on a share of the added value created when companies do decarbonise, thereby reducing prospective returns.
- Withholding capital from companies that have a critical role to play in decarbonisation – for example oil and gas companies using their offshore operations expertise to become major renewable providers.
- A strong focus on eliminating fossil fuel exposures may adversely impact on other aspects of the Fund’s Net Zero Climate strategy.
- Once holdings are sold any future benefits from companies decarbonising would be lost to the Fund.

35. As agreed at the Conference of the Parities summit (COP28) in December 2023 there is a call for a managed and progressive transition away of fossil fuels from the global economy. The role of institutional investors and their asset managers is key in supporting this. This can be achieved through

    - working with portfolio companies to decarbonise their operations, and:
    - providing financing support for companies providing products and services that the wider economy needs to decarbonise successfully.

36. Both require investors to remain invested in and engage with companies. This is in line with the NZCS and as per the Fund's RI policy in which the Fund required all its investment managers to take ESG factors including climate change into account in investment decision making and to address them through active stewardship of its investments. Divestment would mean the Fund loses both these avenues that policy advisers are required for elimination of fossil fuels from the global economy.

37. An exclusionary fossil fuel free fund, as referenced earlier represents a crude way of filtering the investment universe, thus increasing the chance of the Fund's investment strategy conflicting with its fiduciary obligation to ensure that benefits get paid, whilst taking a prudent and appropriate level of risk to generate the necessary investment returns.

38. The Fund's NZCS recognises divestment will be appropriate if engagement is not successful but ultimately that is dependent on a number of factors such as companies starting point, the sector, not having resources to achieve decarbonisation or as part of the escalation of engagement. Further, where investment managers refuse to engage, do not provide credible evidence or reasoning why they are failing financially on environment, social or governance factors the Fund has the power to replace an investment manager.

39. Hymans remind the Fund that the primary purpose is to pay pensions and lump sum benefits, and it should aim to take a prudent and appropriate level of risk in order to generate the necessary investment returns.

40. Hymans believe the current approach to investment and net zero enables the Fund's managers to consider a wide range of investments and build a well-diversified portfolio and state that the approach to dealing with fossil fuel exposure is consistent with achievement of both the investment strategy and NZCS.

41. The NZCS has been developed over a number of years and has demonstrated effectiveness in reducing overall carbon intensity, fossil fuel reserves and increased exposure to climate solutions as evidenced by the annual climate risk report and carbon metrics. This is in line with Fund's fiduciary duty.

42. A concentrated investment strategy such as one with material exclusion policies, which is designed to minimise current exposure to a single risk factor such as fossil fuels, would not be consistent with these objectives nor the Fund's investment beliefs.

43. Hymans acknowledge that the successful decarbonisation of fossil fuel companies will require concerted action by the Fund, its investment managers and portfolio companies. This in turn depends on good stewardship. Hymans have therefore made a number of recommendations which are listed below, and which can be implemented as part of the NZCS.

- Strengthening engagement with underlying managers appointed directly by the Fund, to ensure that stewardship is being undertaken to the same standard as those overseen by LGPS Central
- Encouraging managers to improve stewardship reporting to provide greater insights not just on engagement activity, but also the actions taken, and outcomes achieved by portfolio companies
- Better reporting which would facilitate a deeper dive on the effectiveness of stewardship around fossil fuel companies, and which may lead to further changes in the portfolio and potentially some further tightening of exclusion criteria.

44. As previously mentioned, Hymans believe exclusions of fossil fuel companies within a fossil free fund is unlikely to contribute much to addressing climate change in the wider economy but may well lead to worse financial outcomes for the Fund.

45. Hymans believe the Fund’s approach to managing exposure to fossil fuel companies therefore remains appropriate. They do not believe there is a case for applying a blanket exclusion policy covering such companies within a new fund, as this would benefit neither the Fund nor the wider economy.

46. Concluding, Hymans do not believe that development of a fossil fuel free fund would offer a “good” Net Zero strategy for the Fund or the economies in which it invests at this time. Hymans recognise enhanced reporting may provide a basis for setting a firm target around the removal of fossil fuel from the portfolio when the NZCS is next reviewed.

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 three managers which the Leicestershire County Council Pension Fund invests with, namely Partners Group, JP Morgan and Christofferson Robb and Company (CRC). The County Council’s investments were made following due diligence Hymans Robertson had provided the Fund.

Recommendations

48. It is recommended that the Local Pension Committee:

(a) approve the maintenance of the target SAA allocation as described at paragraph 19 of this report.

(b) that the Director of Corporate Resources be authorised to make benchmark changes as per the guidance given at paragraph 11 of this report and the appendix to this report, with such changes to be delivered quarterly through the year, commencing for the June Local Pension Committee meeting.

(c) agree that the following two reviews be undertaken and presented to the ISC for consideration:

- A protection assets review as described at paragraph 12 of this report, with the final detailed scope of the review to be agreed between officers and Hymans Robertson.

- A review to maintain exposure to two asset classes which will be returning capital over the coming years (bank risk share investments and Timberland). The final scope of the review to be agreed between officers and Hymans Robertson.

(d) Notes the advice now provided by the Fund's investment advisor, Hymans Robertson, regarding the proposal to require LGPS Central to establish a fossil fuel free fund and agrees with the recommendation not to proceed with this proposal at the current time.

(e) Agree the recommendations put forward by Hymans Robertson, as detailed in paragraph 43 above, to implement as part of the Fund's Net Zero Carbon Strategy.

Equality 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.

Human Rights 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.

Appendix

Appendix A: Hymans Robertson, Strategic Asset Allocation 2024 & listed equity exclusions

Background Papers

Local Pension Committee - 20 January 2023 – Annual Review of the Asset Strategy and Structure

Investment Sub-Committee – 26 July 2023 – Protection assets review

Local Pension Committee - 01 December 2023 – Climate risk management report

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