Agenda Item 8

Leicestershire County Council

LOCAL PENSION COMMITTEE – 8 MARCH 2024

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.

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. An update on progress was provided to the meeting of the Investment Sub Committee in October 2023.

Markets Performance and Outlook

3. A summary of global asset class performance over various time frames as at quarter end 31 December 2023 is shown below. Gold has crept back over 10% pa over the last 20 years having dipped below (9.8% pa) last quarter. Performance of gold going forward on the 20-year timeframe will become more difficult given its increase in price during the period from 2004 and 2008 when it doubled in price from around $400 / ounce to over $900 by March 2008.

	3 months*	One year	Three years	Five years	Ten years	Twenty years
GLOBAL EQUITIES	11.0%	22.7%	6.4%	12.3%	8.6%	8.0%
PRIVATE EQUITY	12.7%	31.6%	14.5%	16.4%	12.4%	NA
PROPERTY	17.9%	11.3%	6.0%	7.6%	7.9%	8.3%
INFRASTRUCTURE	10.9%	6.8%	6.0%	7.3%	5.7%	7.4%
HIGH YIELD	6.8%	15.8%	2.3%	4.9%	5.2%	9.7%
PRIVATE DEBT	0.7%	4.1%	0.0%	0.5%	-0.2%	0.0%
UK GILTS	8.6%	3.7%	-9.6%	-3.0%	1.2%	3.2%
UK INDEX-LINKED	9.5%	0.7%	-11.6%	-4.1%	2.0%	4.4%
GOLD	6.9%	7.5%	5.2%	10.0%	8.4%	10.2%

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

Source: Bloomberg Note: listed proxies have been used for Infrastructure, Property, Private Debt and Private Equity

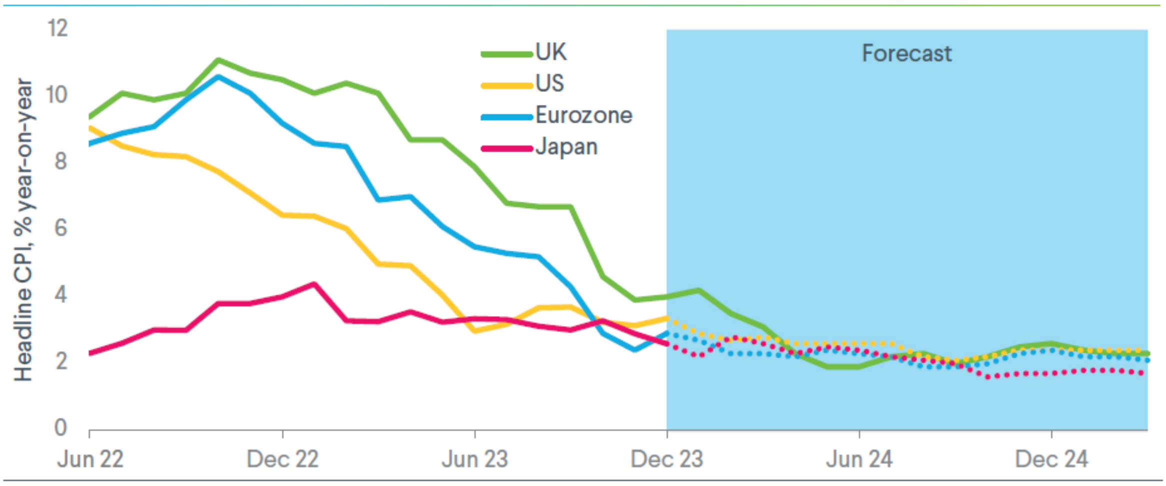
Market backdrop

4. 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. However global growth defied all but the most optimistic forecasts in 2023, despite the rate hiking cycles seen over the past two years. A fuller capital markets update, provided by Hymans Robertson is appended to this report.

5. Global growth confounded expectations in 2023. Full-year real global GDP growth was around 2.6% in 2023, despite forecasts of a slowdown to 1.5% as higher interest rates, energy prices and a cost-of-living squeeze weighed on consumers and business. The Fund is a diversified global investor and will have benefited during 2023. The valuation of the Fund is now over £6bn for the first time.

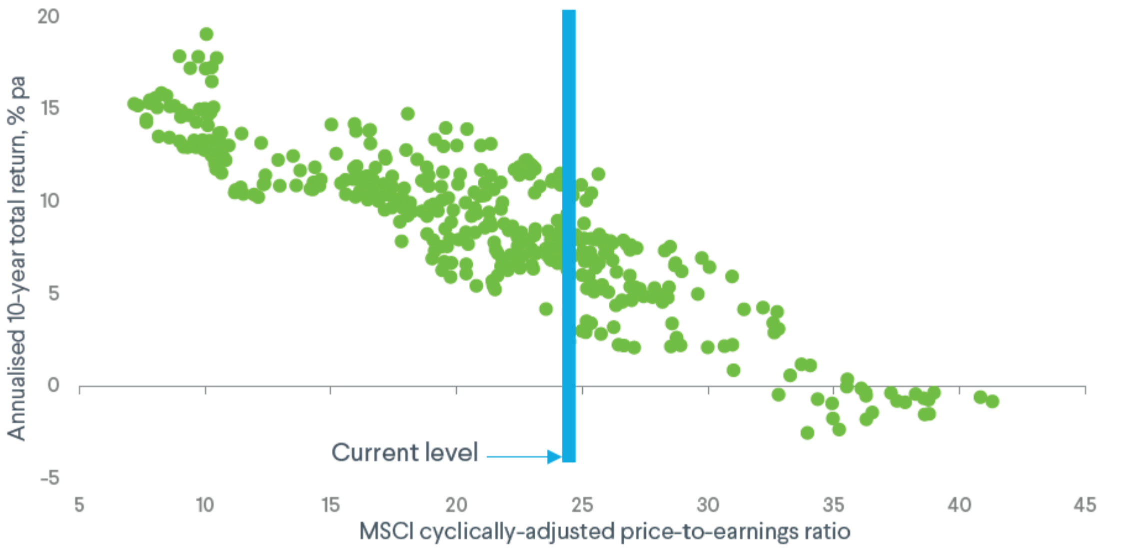
6. Hymans summarise that forecasters underestimated the resilience of consumer spending and the extent to which consumers would use savings built up during the pandemic, particularly in the US. The US economy was expected to stagnate in 2023; instead, real GDP looks to have risen 2.5%, making the US economy the engine of growth among the major advanced economies.

7. Forecasts for inflation into 2024 are illustrated below and should enable the major central banks to start reducing interest rates in the second half of 2024. But tight labour markets and strong wage and services inflation mean the pace of decline is likely to slow. Easy wins from falling energy and moderating food and goods prices are largely in the rear-view mirror.



Source: Datastream

8. The Hymans report also includes data on past equity returns based on price earnings ratios similar to today. The table below shows that when equities have had a similar ratio to now (around 24) then the future 10-year return per annum has been between 5% and 12% per annum. The Fund and its advisor take into account information such as this when developing the strategy, whilst noting the Fund is a very long-term investor which is cashflow positive and is able to 'ride out' long drawdowns in equity markets without having to divest assets to pay pensions and lump sum benefits.



Source: Datastream

9. The Fund, which is open to new members and with liabilities extending far into the future, taking an always invested (not timing the market) position is important. The Fund is, from a listed equity perspective, highly diversified. It is exposed to many geographies and every major sector via the three Legal General passive funds and the three funds invested via Central, which in total are now valued at nearly £2.5bn.

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

Portfolio changes in the quarter ended

11. The main changes during the October to December 2023 quarter related to the Fund's growth asset group. The changes are described in the table below.

Aspect (targeted return)	October and November 2023	£40m & £40m redeemed over the two months in line with gradually divesting from this mandate.
Pictet (targeted return)	October and November 2023	£20m & £40m redeemed over the two months in line with gradually divesting from this mandate
Ruffer (targeted return)	November 2023	£25m investment made to bring the mandate towards 3% of total Fund assets
Fulcrum (targeted return)	October and November 2023	The first two of four planned subscriptions at £30m each in order to reach a target of 2% of total fund assets

Reorganisation of the Legal and General (LGIM) passive equity portfolio	November 2023	Moved from 7 regional passive investment funds and 7 UK single stock funds into 3 passive funds, more information below.

12. The final redemptions for both the Pictet and Aspect mandates occurred during January 2024 after the quarter end. This closes out the position from these two mandates in line with the decision taken by the Investment Sub-Committee (ISC) at its meeting in July 2023.

13. At the time of writing the final investments to the Fulcrum and Ruffer mandates have been planned based on the 31 December 2023 valuation point. Once these investments are completed, the targeted return changes will have been completed. The final investments will bring both to their target weights of 3% Ruffer and 2% Fulcrum of total Fund assets.

14. The reorganisation of the LGIM passive portfolio resulted in lowering the listed equity weight towards the target 37.5% of total fund assets.

15. Two changes remain to be completed from the 2023 listed equity recommendations which where were approved at the April 2023 meeting of the ISC, a redemption from the LGPS Central Emerging Active equity fund and an investment into the LGPS Central Global Active equity fund. The net effect of this final change will be a small return of cash to the Fund. Officers are in contact with another partner fund who is looking to make a divestment as part of their SAA realignment which would allow for a swap of units which would save on transaction costs.

16. The Central global equity fund is currently in the process of appointing a fourth manager to the three-manager setup and once this is completed the Fund's transition advisor will update the plan to finalise the last 2 changes.

<u>Cash holdings and outstanding commitments</u>

17. The level of cash held by the Fund is higher than the SAA limit of 0.75% of total Fund assets. This, alongside a cash flow is presented to the ISC each quarter. At the quarter end the Fund held £421m in cash and an additional £48m with Aegon as collateral in order to support the currency hedge. Taken together this represents 7.7% of total Fund assets.

18. The excess has resulted from the SAA recommendations in 2022 and 2023 which prompted a switch from liquid assets, mainly listed equity and targeted return into illiquid assets within the income asset group. These illiquid assets take time for money to be invested (called) by the underlying managers. The managed reduction in liquid assets has continue, however the Fund is still overweight to these asset classes. The final alignment to the 2024 SAA target weight of 42.5% to listed equity and targeted return assets won't be complete by year end. Completing this alignment would add further cash whilst commitments are awaiting to be called and at present the Fund has ample cash to meet commitments.

19. The Fund has made relevant commitments to the underlying mangers which are in the process of being called and at the time writing there are commitments totalling c£650m awaiting to be called. In addition, the Fund has approval to commit a further c£360m in 2024 across private equity and private debt asset classes. Officers are in regular

contact with LGPS Central to ascertain a likely launch date for the private credit vintage and a contingency plan will be developed in the event of delays so that the Fund can make the relevant commitments so as to maintain a steady allocation to this asset class.

20. Over the financial year 2023/24 the cash has been held in a mixture of money market funds (MMFs) and fixed deposits. Given the higher cash holdings a cash management strategy was presented to the October 2023 meeting of the ISC which formalised the limits and types of institutions the Fund can use. The majority of the cash is currently held in three of the available types, money market funds (MMFs), term deposits and certificates of deposit. The final two having maximum terms of one year. At present the Fund has not utilised terms greater than six months owing to the smaller pool of available institutions offering one-year terms and the pricing of one-to-six-month terms.

21. At the time of the Committee meeting the Fund is expected to have cash holdings of around £400m, which is marginally lower than the value as at the 31 December 2023. The Fund currently has £250m invested in fixed term deposits with a weighted average interest rate of 5.35%. As such holding excess cash is providing a substantial return

22. A cashflow forecast for the Fund estimates that cash should reduce gradually over the calendar year towards £200m. Much of the reduction in cash will result from a planned c£300m investment to take place over the calendar year to the LGPS Central multi asset credit fund. The first investment of £50m investment has taken place during February 2024.

23. Other changes to align to the 2024 SAA are shown in the table below. The commitments / investments approved will be called over a number of years whilst the 2024/25 cashflow column shows expected movements over 2024/25. In summary the Fund is overweight cash and growth assets and underweight income assets. Although commitments of a substantial amount have been made to income asset classes, they will take time to be fully called.

Growth	31/12/23 £m	2024 SAA	31/12/23 Actual weight %	Difference, actual to 2024 SAA	£m to target weight	Commitments / investments approved	2024/25: other cashflow / divests	Diff to target weight post changes £m	% diff to SAA
Listed Equity - Active and Passive	2,480	37.50%	40.7%	3.2%	197		-197	0	0.0%
Targeted Return Funds	313	5.00%	5.1%	0.1%	9			9	0.1%
Private Equity	422	7.50%	6.9%	-0.6%	-35	80	-80	-35	-0.6%

Income	31/12/23 £m	2024 SAA	31/12/23 Actual weight %	Difference, actual to 2024 SAA	£m to target weight	Commitments / investments approved	2024/25: other cashflow / divests	Diff to target weight post changes £m	% diff to SAA
Infrastructure	654	12.50%	10.7%	-1.8%	-107	160	-20	33	0.5%
Global credit - private debt / CRC	513	10.50%	8.4%	-2.1%	-126	504	-85	293	4.8%
Property	431	10.00%	7.1%	-2.9%	-177	133	-13	-57	-0.9%
Global Credit - liquid MAC	226	9.00%	3.7%	-5.3%	-322	300		-22	-0.4%
Emerging market debt	121	0.00%	2.0%	2.0%	121		-121	0	0.0%

Protection	31/12/23 £m	2024 SAA	31/12/23 Actual weight %	Difference, actual to 2024 SAA	£m to target weight	Commitments / investments approved	2024/25: other cashflow / divests	Diff to target weight post changes £m	% diff to SAA
Inflation linked bonds	240	3.50%	3.9%	0.4%	27		-27	0	0.0%
Investment grade (IG) credit	158	3.50%	2.6%	-0.9%	-55		55	0	0.0%
Short dated IG credit	60	0.25%	1.0%	0.7%	45		-45	0	0.0%
Active currency hedge collateral	48	0.75%	0.8%	0.0%	3			3	0.0%
Cash	421	0.00%	6.9%	6.9%	421				

	31/12/23 £m	2024 SAA	31/12/23 Actual weight %	Difference, actual to 2024 SAA	£m to SAA weight	Commitments / investments approved	2024/25: other cashflow / divests	Diff to target weight post changes £m	% diff to SAA
Growth	3,214	50.0%	52.8%	2.8%	171	80	-277	-26	0.4%
Income	1,946	42.0%	32.0%	-10.0%	-611	1098	-239	248	-4.1%
Protection	506	8.0%	8.3%	0.3%	19	0	-17	2	0.0%
Cash	421	0.0%	6.9%	6.9%	421				
	6,087	**100.0%**	**100.0%**						

Overall Investment Performance

24. A comprehensive performance analysis over the quarter, year, and three-year period to 31 December 2023 is conducted by Hymans Robertson who collate information directly from managers and calculate performance, which provides an independent check of valuations. The valuation summary is included with the managers reports within the exempt part of today's agenda.

25. 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.

26. Summarised returns for the whole Fund versus benchmark are shown below excluding the effect of the hedging facility. This metric is being worked on by Hymans Robertson and will be available by the next quarter.

	Quarter	1 yr	3 yr pa	5yr pa
Total Fund	+3.8%	+6.3%	+6.3%	+7.2%
vs benchmark	-0.1%	-2.5%	+1.0%	+0.3%

27. The Fund experienced a positive return over the quarter of +3.8%, broadly in line with the overall benchmark. The Fund tends not to focus on short timeframe returns which can be more volatile and instead looks towards the longer three and five-year returns as a measure of performance versus the benchmark.

28. 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.

29. The one-year underperformance versus the benchmark of -2.5% is mainly driven by the growth and income asset groups. The year to the end of December 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.

30. Over a one-year period, the largest underperformance versus the benchmark has arisen from the private equity (PE) holdings, -11.5%. 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 early 2023. Over a longer timeframe of three and five years, private equity's annualised return is 18.5% pa and 16.1% pa respectively, both of which are ahead of the benchmark.

31. 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.

32. The targeted return holdings have also lagged the benchmark return over 1 year by 8.1%. This is largely due to returns at Aspect and Ruffer not matching the benchmark return which is cash plus 4%. The positive interest environment during 2023 has meant the benchmark for 2023 was a return of 8.8%. Over a longer timeframe targeted return has performed well, outperforming over both the three and five year periods.

Listed equity update

33. On 11 October 2023 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; and
    c. described a four-phase plan to reorganise and reduce the listed equity weight to 37.5% of total Fund assets.

34. Phase one of this plan was completed in September 2023 and £220million was received by the Fund when the LGPS Central climate multi-factor fund holding was reduced to the target weight of 12% of total Fund assets.

35. Phase two, which was the reorganisation of the Legal and General investment Manager (LGIM) passive holdings, was completed in mid-November 2023 which collapsed the LGIM geographic holdings and single stock holdings into three funds.

36. Phases three and four which are the divestment of the Central Emerging Market Fund and investment into the LGPS Central Global Equity fund are being planned to coincide with the suitable appointment of a fourth manager to the Central Global Equity fund.

37. The Fund currently aims to divest from the Central emerging equity fund at around the same time as investing into the LGPS Central global equity fund in order to minimise the cash being held by the Fund, followed by regular rebalancing of the equity positions in line with the targets for each of the holdings. The table below shows the progression of the listed equity transition to date and the adjustments left to complete.

	Passive or active	AUM 30.09.23 £m	% of total portfolio %	AUM 31.12.23 £m	% of total portfolio %	Target % SAA 2024	Target weight £m	Adjustments left to plan £m
LGIM UK equity index Fund and UK core equity index fund	Passive	169	2.9%	0	0.0%	0%		
LGIM 7 FTSE 100 single stocks	Passive	25	0.4%	0	0.0%	0%		
LGIM North America Equity index fund	Passive	350	6.1%	0	0.0%	0%		
LGIM Europe (ex UK) equity index fund	Passive	150	2.6%	0	0.0%	0%		
LGIM Japan Equity index Fund	Passive	75	1.3%	0	0.0%	0%		
developed equity index fund	Passive	65	1.1%	0	0.0%	0%		
LGIM World Emerging markets equity index fund	Passive	96	1.7%	0	0.0%	0%		
LGIM UK Equity Fund	Passive	0	0.0%	124	2.0%	2.0%		
LGIM All World Equity Fund	Passive	0	0.0%	643	10.6%	8.0%	487	-181
LGIM Low Carbon Transition Fund	Semi active	0	0.0%	213	3.5%	3.5%		
LGPS Central Active Global Equity Multi Manager Fund	Active	542	9.4%	575	9.4%	12.0%	730	117
Emerging Markets Multi Manager Fund	Active	177	3.1%	181	3.0%	0.0%	0	-181
LGPS Central Climate Balanced Multi Factor Fund	Semi active	698	12.1%	742	12.2%	12.0%		
Total		**2348**	**40.7%**	**2478**	**40.7%**			
Total LGIM products		**931**	**16.1%**	**980**	**16.1%**			
Total Central products		**1417**	**24.6%**	**1498**	**24.6%**			

38. 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 was previously forecast to complete the two LGPS Central changes by the end of financial year, however this is now likely to take place in 2024/25.

Outcomes from the 2024 SAA

39. The Fund's 2024 Strategic Asset Allocation (SAA) was approved by the Committee at the meeting held on 26 January 2024. Hymans Robertson presented at the meeting and summarised that since the last SAA (2023) there had been a material shift in the markets. Many asset classes having posted losses, nominal yields have risen across

all maturities and there has been a material shift in the inflation curve, with expected inflation falling in shorter durations, but staying higher for longer.

40. As part of the annual SAA review, Hymans reviewed the funds current holdings and against the economic backdrop concluded that the current (2023) investment strategy remains appropriate taking into account the Fund's objectives and funding position. A reminder of the of the 2024 SAA target weights is included on table at point 23 of this report.

41. The recommendations approved included a number of reviews to be carried out through the year which are planned to be presented to meetings of the Investment Sub Committee (ISC) during May and July 2024. The two reviews being planned are:

    a. A protection assets review, which will consider amongst other things an increase to the protection assets weighting if the change may result in better risk adjusted returns. Hymans will also investigate if alternative asset classes could be included within the protection assets group. The scope is being worked up by officers and Hymans at the time of writing.

    b. 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 in the coming weeks and will be presented to the ISC scheduled for May 2024.

42. In addition, the Committee approved that the Director of Corporate Resources be authorised to make benchmark changes, with such changes to be delivered quarterly through the year, commencing at the June (2024) Local Pension Committee meeting. These changes are designed to better compare the Fund's underlying investments actual performance versus an appropriate target (the benchmark) so that a better appreciation of relative performance can be ascertained.

Leicestershire Pension Fund Conflict of Interest Policy

43. 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

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

Environmental Implications

45. 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

46. 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

47. 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.

Background Papers

Local Pension Committee 26 January 2024, Overview of the Current Asset Strategy and Proposed 2024 Asset Strategy (Agenda item 6)
https://democracy.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7538&Ver=4

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

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Appendix

Hymans Robertson, Capital Markets update January 2024