Agenda Item 11

Leicestershire County Council

LOCAL PENSION COMMITTEE – 19 JUNE 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 (LPC) with an update on the investment markets and how individual asset classes are performing.

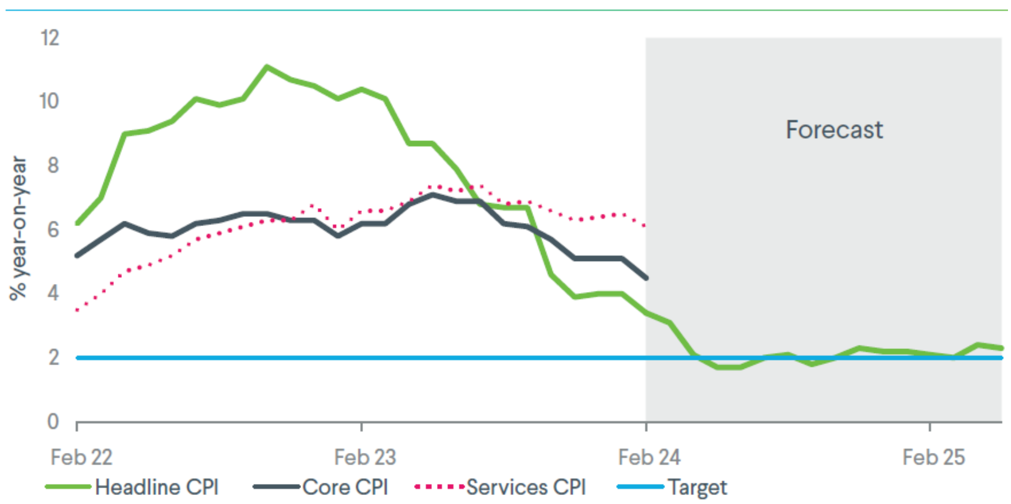
2. The report also provides an update on progress with respect to the listed equity changes, as approved by the Investment Sub-Committee (ISC) on 19 April 2023. An update on progress was provided to the meeting of the ISC on 11 October 2023 and to the LPC on 8 March 2024.

Markets Performance and Outlook

3. The first quarter of 2024 was the strongest for global equity since 2019 (+8.2%). LGPS Central (along with most other commentators) note that the future trajectory of global interest rates remain of paramount importance for investors. Given many portfolios, including the Fund's own, contain a material weight to listed equity, all other things being equal (which they rarely are) prospects of lowering rates would be a tailwind to equities as was demonstrated by the 2024 quarter one rally.

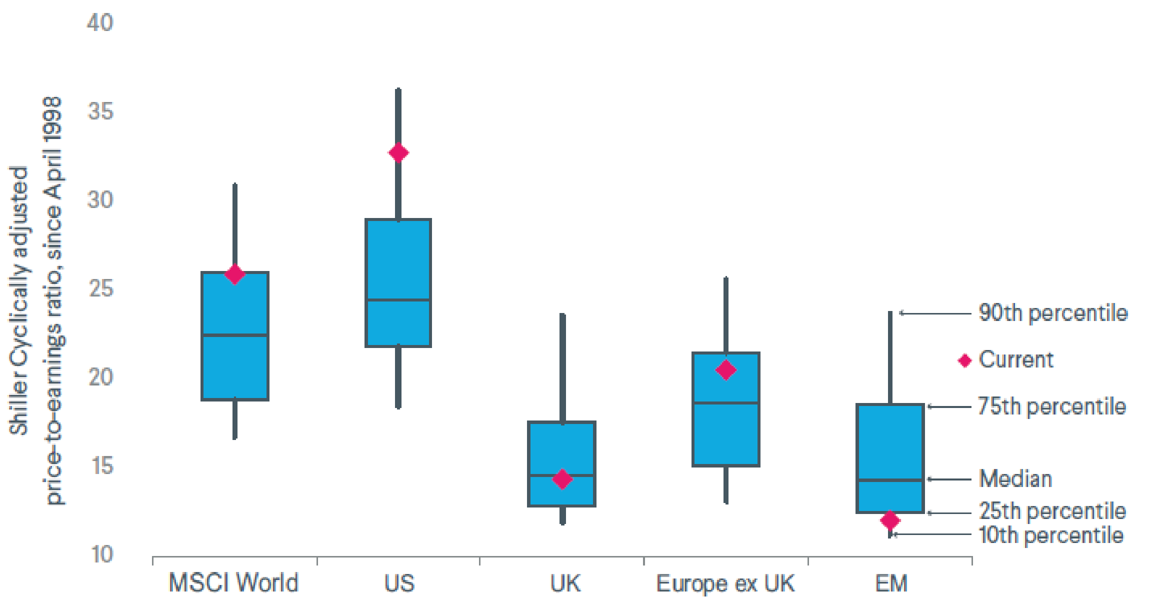
4. Inflation, however, has proved to be stickier than expected and as such the number of interest rate cuts in 2024 has decreased significantly during the first quarter of 2024. With that backdrop it is somewhat surprising that listed equity has performed so well. Hymans believe whilst UK headline CPI is falling, underlying price pressures may give central bankers the opportunity to pause before cutting rates. A similar experience with US inflation was witnessed where inflation was above expectations early in the year through January and February.

UK CPI Feb 2022 to Feb 2025



5. Whilst inflation data has proved to be less optimistic through the first quarter of 2024, 2024 growth data as defined by GDP (gross domestic product) has been revised upwards, for example US GDP was revised from 1.4% in January to 2.2% in March. At the same time global growth forecasts for 2024 have been revised upwards to 2.4%.

6. Hymans believe that global equity valuations look elevated in some regions. However, opportunities do remain notably within emerging markets, where the adjusted price earnings ratio (a measure of how expensive or cheap the price of an equity share is when compared to the ‘earnings’ for that one share) is favourable. The UK also shows ‘fair ‘valuations below for companies and is slightly below the median valuation when comparing to data since 1998. Note that much of the MSCI (Morgan Stanley Capital International) world apparent high adjusted price earnings owes a lot to US valuations. The US market is over 65% of the MSCI world index. It must be understood that price earnings valuations is just one of many metrics that can be used to value a company and long periods of out performance or underperformance is common.



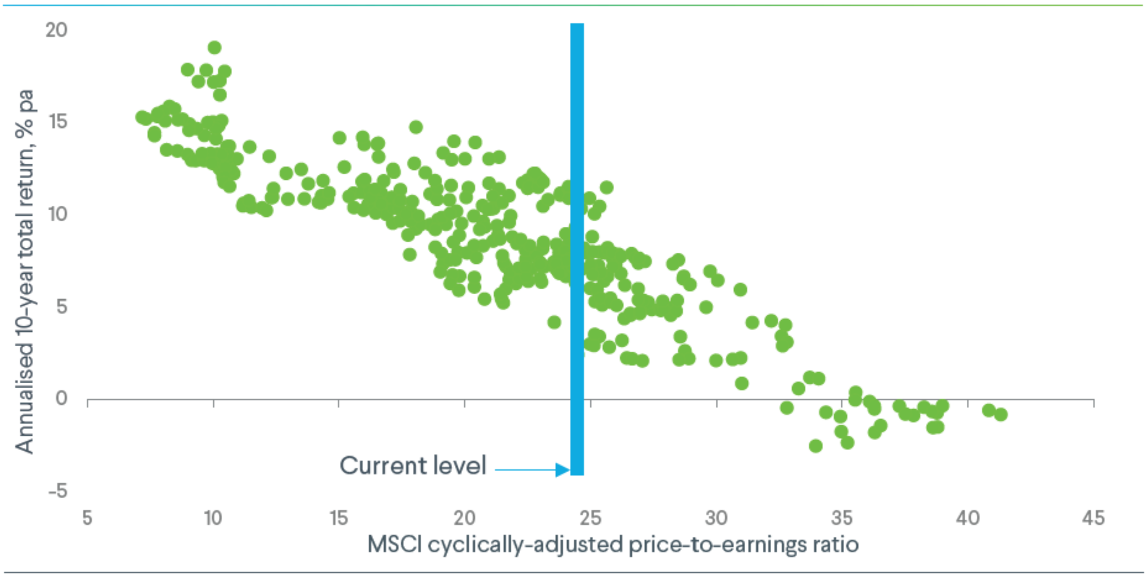
7. Hymans include a property section within their report (appended to this report) and state a range of indicators hinting at signs of improvement for the UK commercial property sector. The Fund has a target 10% allocation to property in total but together the underperformance in comparison to other assets and an approved strategy to transition to a more global property exposure the Fund is underweight whilst monies are being invested to realign the exposure. The graph below shows the UK commercial property net initial yield (NIY) and revisionary yields (based on estimated rental values when leases are renegotiated) and show NIY at the highest they have been for nearly 10 years.

8. A summary of global asset class performance over various time frames as at quarter end 31 March 2024 is shown below. Gold is the only asset class with returns over 10% pa over the last 20 years having dipped below 10% (9.8%) for the quarter ending 30 September 2023. 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	8.2%	23.7%	7.5%	11.2%	9.3%	8.2%
PRIVATE EQUITY	7.3%	38.2%	13.7%	15.0%	13.2%	NA
PROPERTY	-1.3%	7.9%	2.4%	4.0%	7.0%	7.6%
INFRASTRUCTURE	1.4%	4.1%	5.4%	4.8%	5.1%	7.2%
HIGH YIELD	2.8%	14.7%	2.7%	4.5%	5.1%	9.6%
PRIVATE DEBT	0.5%	3.6%	-0.3%	0.0%	-0.2%	-0.1%
UK GILTS	-1.8%	-0.5%	-7.9%	-4.0%	0.7%	3.1%
UK INDEX-LINKED	-2.2%	-5.6%	-10.5%	-5.6%	1.5%	4.1%
GOLD	9.0%	10.6%	12.5%	12.4%	8.6%	10.7%

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

9. The figure below is taken from the previous Hymans capital markets summary but is useful to include again to remind us of the range of equity investment outcomes when the markets have a similar price earnings ratio. The figure shows that when equities have had a similar ratio (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 long-term investor, 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. The Fund currently has a target allocation to listed equity of 37.5% with an additional 7.5% to private equity. The allocation to listed equity has been lowered over the years as the strategy has evolved and added exposure to private markets such as infrastructure.



Source: Datastream

10. 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 and General passive funds and the three funds invested via Central, which in total are now valued at nearly £2.7bn or 43% of total Fund assets.

11. 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.

12. It should be noted that the Fund's assets have grown considerably over the past few years as a combination of being cashflow positive and positive investment returns in line with expectations. The markets over the past three and five year periods have been supportive. However poorer periods of performance can occur and can last for many years.

Portfolio changes in the quarter ended March 2024

13. The main changes during the January to March 2024 are shown below. All changes listed below were in cash.

Aspect (targeted return)	January 2024	Final redemption of units, c£51m in cash
Pictet (targeted return)	January 2024	Final redemption of units, c£55m in cash
Fulcrum (targeted return)	March 2024	£30m investment
Central Direct Property fund	February 2024	c£21m called
Central infrastructure core/core plus fund	February 2024	c£17m called
Central multi asset credit (MAC) fund	February and March 2024	Added £120m combined over 2 months

14. The final redemptions for both the Pictet and Aspect mandates occurred during January 2024. 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. The result is a net reduction of one manager from the total portfolio as Fulcrum was added as a new mandate in 2023.

15. The net effect on cash quarter on quarter has been a small reduction from £421m to £386m.

<u>Listed equity reorganisation update</u>

16. 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.

17. 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.

18. Phase two, which was the reorganisation of the LGIM passive holdings, was completed in mid-November 2023 which collapsed the LGIM geographic holdings and single stock holdings into three funds.

19. 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 appointment of a fourth manager to the Central Global Equity fund which has now been concluded and Central are in the process of planning the reorganisation of holdings with the four managers. The transition advisor is in talks with officers, the Fund's investment advisor and LGPS Central regarding the final changes.

20. 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. The table below shows the progression of the listed equity transition to date and the adjustments left to complete.

21. The final part of the reorganisation of the listed equity portfolio will come from reducing the listed equity weight down to 37.5% of total fund assets (currently 42.7%) which will be completed in stages, taking into account the cash the Fund already holds, future timing of calls, advice from the Fund's investment advisor and the Fund's rebalancing policy.

	Passive or active	AUM 30.09.23 £m	% of total portfolio %	AUM 31.3.24 £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%		
LGIM Asia Pacific (ex Japan) 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%	129	2.0%	2.0%		
LGIM All World Equity Fund	Passive	0	0.0%	702	11.1%	8.0%	505	197
LGIM Low Carbon Transition Fund	Semi active	0	0.0%	232	3.7%	3.5%		
LGPS Central Active Global Equity Multi Manager Fund	Active	542	9.4%	636	10.1%	12.0%	758	-122
Emerging Markets Multi Manager Fund	Active	177	3.1%	185	2.9%	0.0%	0	185
LGPS Central Climate Balanced Multi Factor Fund	Semi active	698	12.1%	812	12.8%	12.0%	758	54
Total		**2348**	**40.7%**	**2695**	**42.7%**	**37.5%**		**313**
Total LGIM products		**931**	**16.1%**	**1063**	**16.8%**	**13.5%**		**197**
Total Central products		**1417**	**24.6%**	**1632**	**25.8%**	**24.0%**		**116**

Cash holdings and outstanding commitments

22. 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 £386m (£421m last quarter) in cash and an additional £51m (£48m last quarter) with Aegon as collateral in order to support the currency hedge. Taken together this represents 6.9% (7.7% last quarter) of total Fund assets.

23. The additional cash is a result 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 continued, 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 is planned to complete during 2024/25. Completing this alignment would add further cash whilst commitments are awaiting to be called and at present the Fund has ample cash to meet those existing commitments.

24. 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£600m 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 vintages. Since the last update a key hire has been added to the Central team and work is progressing on finalising the private credit 2024 mandates for senior secured credit and real asset sleeves where the Fund already has existing approvals from 2023.

25. 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.

26. At the time of the Committee meeting the Fund is expected to have cash holdings of around £420m. The Fund, at the time of writing has £325m invested in fixed term deposits with a weighted average interest rate of 5.24% (was 5.35% at the last update) with an average term to maturity of 3.8 months.

27. 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 investment to take place over the calendar year to the LGPS Central multi asset credit (MAC) fund where an additional £180m is planned to be invested on top of the £120m added so far in 2024. The target weight for this asset class is 9% of total Fund assets and the amount to invest will be adjusted through the year as new valuations are received.

28. 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 significant commitments have been made to income asset classes, they will take time to be fully called.

Growth	31/3/24 £m	2024 SAA	31/3/24 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	2,697	37.50%	42.7%	5.2%	328		-347	-19	-0.3%
Targeted Return Funds	299	5.00%	4.7%	-0.3%	-17			-17	-0.3%
Private Equity	414	7.50%	6.6%	-0.9%	-60	173	-80	33	0.5%

Income	31/3/24 £m	2024 SAA	31/3/24 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	628	12.50%	9.9%	-2.6%	-162	140	-20	-42	-0.7%
Global credit - private debt / CRC	525	10.50%	8.3%	-2.2%	-138	194	-85	-29	-0.5%
Property	452	10.00%	7.2%	-2.8%	-180	133	-4	-51	-0.8%
Global Credit - liquid MAC	348	9.00%	5.5%	-3.5%	-221	180		-41	-0.6%
Emerging market debt	63	0.00%	1.0%	1.0%	63		-63	0	0.0%

Protection	31/3/24 £m	2024 SAA	31/3/24 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	235	3.50%	3.72%	0.2%	14		-16	-2	0.0%
Investment grade (IG) credit	159	3.50%	2.52%	-1.0%	-62		60	-2	0.0%
Short dated IG credit	60	0.25%	0.95%	0.7%	45		-45	0	0.0%
Active currency hedge collateral	51	0.75%	0.81%	0.1%	4			4	0.1%
Cash	386	0.00%	6.1%	6.1%	386				

Overall Investment Performance

29. Investment performance analysis over various time frames to the period quarter ending 31 March 2024 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.

30. 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.

31. A number of benchmarks to compare actual performance by mandate will be amended through the year by Hymans per the recommendations approved at the January meeting of the Local Pensions Committee. This is in order to better compare the investment risk versus the expected return. Officers have planned to complete the remaining changes over the next three reports. For this quarter the following changes were completed:

Fund	Previous benchmark	New benchmark
LGPS Central Climate Multi factor fund	FTSE AW Climate Bal Com Factor	FTSE All World
All private equity funds (Central, Adams Street, Abrdn)	FTSE AW index	FTSE AW + 3% pa
JP Morgan Infrastructure, IFM infrastructure and Stafford Timberland	SONIA (sterling overnight index average) 3 month +4%	8% pa

32. 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.

	Quarter	1yr	3yr pa	5yr pa
Total Fund	+3.9%	+8.9%	+6.6%	+7.0%
vs benchmark	-0.6%	-2.5%	+0.3%	+0.2%

33. 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.

34. The Fund experienced a positive return over the quarter of +3.9%, (+3.8% last quarter). The underperformance in the quarter is largely due to the underperformance of the private equity mandate (-10.2% for the quarter). Private equity valuations lag liquid public markets where prices are updated daily, whereas underlying companies within private equity portfolios may update pricing twice a year with other companies valued based on sales and comparable public market equivalents. Over three and five-year periods, however, private equity returns have been in line with the new benchmark FTSE AW+3% pa 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.

35. The one-year underperformance versus the benchmark of -2.5% is mainly driven by the growth and income asset groups. The change to the private equity benchmark (From FTSE AW to FTSE AW +3%) will make attainment of the benchmark more difficult but importantly will provide a better understanding of the required return. As interest rate rise expectations reduce, market commentators expect downward pressure on risk assets to subside.

36. The targeted return holdings have also lagged the benchmark return over one year by 3.4%. This is largely due to returns at Ruffer not matching the cash + 4% benchmark. The positive interest environment during 2023/24 has meant the benchmark for 2023/24 was a return of 9.1%. Over a longer timeframe targeted return has performed well, outperforming over both the three and five-year periods albeit with some volatility whilst the group of three mandates included Aspect which has now been fully divested.

37. The Fund has a long history of investing in private credit stretching back to 2014 when it invested in the 2014 vintage of the multi asset credit (MAC) series of funds from Partners group. The Fund has since invested in five further vintages from Partners group. Returns are expected to be in line with a cash plus 4% pa benchmark and all but the 2016 vintage has returned It has also invested in three private credit funds launched by LGPS Central more recently as the pool developed its product offering. A summary of the Partners Group and Central investments is shown below.

Partners Fund name	Amount committed / current NAV £m	Since inception net IRR % pa
MAC 2014 I	100 / 13	5.4%
MAC 2016 III	70 / 11	3.0%
MAC 2017 IV	120 / 28	4.8%
MAC V	100 / 78	6.3%
MAC VI	60 / 59	7.4%
MAC VII	19 / 11	n/a too early

LGPS Central Fund name	Amount Committed / current NAV £m	Since inception net IRR % pa*
Low return 2021	240 / 126	9.6%
High return 2021	60 / 32	7.3%
Real asset 2021	117 / 52	n/a, target 4.5%-6.0%

*at 31 Dec 2023 per investment manager reports

38. At present the Fund has £410m invested in private credit across these two managers, there is (at 31 March 2024) around £200m left to call from the three Central investments. The Fund is working with Central and other partner funds to launch new vintages of the low return and real asset products. If these were launched successfully the Fund has an existing approval to commit £180m to the low return product and £100m to the real asset (invests primarily in infrastructure and property debt) product.

39. The Funds protection asset investments span three products: investment grade credit, index linked bonds and short dated investment grade credit. Overall, this area of the portfolio is at the target weight. There is a rebalance due between index linked bonds and investment grade credit which is awaiting advice from Hymans with respect to timing. Officers will report back to the Local Pension Committee once this relatively small reduction to inflation linked bonds and addition to investment grade credit is complete.

40. In terms of performance over the three and five periods, this group of assets has marginally outperformed the benchmark by 1.1% and 0.5%pa respectively.

<u>Outcomes from the 2024 SAA</u>

41. 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.

42. 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.

43. 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 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. This review is now complete, Hymans concluded the current strategy should be retained with no clear need to make changes to the target weights of the existing protection assets and no clear rationale at this stage to add new asset classes to this group.

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. This review will be presented to the July 2024 meeting of the ISC.

44. 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. As described earlier the first changes to benchmarks has commenced.

Leicestershire Pension Fund Conflict of Interest Policy

45. 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

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

Environmental Implications

47. 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

48. 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

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.

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

Appendix

Hymans Robertson, Capital Markets update Spring 2024

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