Leicestershire County Council

INVESTMENT SUB-COMMITTEE – 2 OCTOBER 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CASH POSITION 30 JUNE 2024, DEPLOYMENT AGAINST THE STRATEGIC ASSET ALLOCATION, BANK RISK SHARE INVESTMENT

Purpose of the Report

1. The purpose of this report is to update the Investment Sub-Committee (ISC) on the cash holding of the Leicestershire County Council Pension Fund (Fund) and plans for its deployment against the Strategic Asset Allocation (SAA).

2. The report also provides background information regarding a proposed commitment to bank risk share investments in order to maintain alignment to the SAA and a proposed sale of a non-core asset.

Background

3. Hymans Robertson, the Fund's investment advisor, completed the 2024 Strategic Asset Allocation (SAA) as part of the Fund's annual investment review. The Strategy was reviewed by officers and was approved by the Local Pension Committee (LPC) at its meeting on 26 January 2024.

4. Cash balances are reported to the LPC alongside Fund investment values by investment managers each quarter. At the last update presented to the LPC meeting on 6 September 2024, the cash balances as at 30 June 2024 totalled £417million (£386million 31 March 2024) with an additional £59million (£51million 31 March 2024) with the Fund's currency hedging manager, Aegon Asset Management (Aegon) which acts as collateral for the Fund's currency hedge. Taken together this represents 7.3% (6.9% last quarter) of total Fund assets.

5. The Fund does not have a specific cash allocation as part of the SAA other than to set a limit of 0.75% of total Fund assets to reflect the cash held at Aegon to act as collateral for the currency hedge. Cash is held across a number of money market funds (MMF) and fixed deposits in line with the Fund's cash management strategy (CMS).

6. As a result of making changes to reduce exposure to listed equity holdings, reducing these towards the target of 37.5% of total Fund assets, as approved by LPC in January 2023, the Fund has held higher levels of cash. As such a Cash Management Strategy (CMS) for the Fund was approved by the ISC on 11 October 2023.

Cash holdings as at 30 June 2024

7. The Fund, as of 30 June 2024 held a total of £476million in cash across multiple money market funds (MMFs), fixed deposits and Aegon in relation to the currency hedge. Cash is forecast to reduce slowly over to the end of the financial year to circa £330million but is largely dependent on resumption of investments to the LGPS Central multi asset credit (MAC) fund where the Fund has approximately £170million left to invest in order to reach the target weight of 9% of total Fund assets.

8. Owing to the positive cashflow nature of the Fund, due to payments to pensioners or dependants being lower than pension contributions and funds returning money, the Fund's cash balance grows without regular reinvestment to realign to the SAA.

9. With interest rates elevated in comparison to the period from 2009 to 2022 the Fund has been receiving interest payments on average in excess of 5% during the 2023/24 and so far into the 2024/25 financial year. At the time of writing (24 September 2024) the weighted average interest rate on fixed term deposits is 5.09% on a weighted average maturity of just under 3 months. Rates on the four money market funds range between 4.9% and 5.0%.

10. The Fund has held a higher amount of cash during the past two years whilst awaiting to deploy funds into underweight areas of the asset allocation. These underweight areas have been within the income portion of the portfolio and within the illiquid investments, property, infrastructure and private credit where managers call on cash as they make investments. This paper recommends adding to existing commitments in order to facilitate closing the underweight positions in a controlled manner.

SAA 2024

11. A recap of the current SAA is included below. The LPC agreed that the SAA approved in January 2023 remained fit for purpose in 2024 and this was approved at the meeting of the Local Pension Committee on 26 January 2024. The 2024 SAA is shown below with changes from the 2022 SAA shown in the final column of the table below. It was noted that there were a number of changes in progress from the 2022 to 2023 SAA and it would take the remainder of 2024 to complete these changes.

Asset Group	Asset Class	2022 SAA	2023 & 2024 SAA	Change from 2022 SAA
Growth	Listed equities	42.00% (40% - 44%)	37.50%	- 4.5%
Growth	Private equity	5.75%	7.50%	+ 1.75%
Growth	Targeted return	7.50%	5.00%	- 2.5%
Income	Infrastructure (incl. timber)	9.75%	12.50%	+ 2.75%
Income	Property	10.00%	10.00%	
Income	Emerging market debt	2.50%	0.00%	- 2.5%
Income	Global credit – liquid sub investment grade markets	4.00%	9.00%	+ 5%
Income	Global credit - private debt (inc M&G/CRC)	10.50%	10.50%	
Protection	Inflation-linked bonds	4.50%	4.50%	
Protection	Investment grade credit	3.00%	2.75%	-0.25%
Protection	Currency hedge	0.50%	0.75%	+0.25%
Protection	Cash / cash equivalent	0.00%	0.00%	

<u>Current allocation (30 June 2024) versus 2024 SAA</u>

12. The main changes as approved by the Local Pension Committee in January 2023 and carried forward to 2024 were:

    a. a reduction to listed equity to 37.5% of total fund assets;
    b. and an increase to liquid global credit to 9% of total Fund assets.

<u>Listed equity update</u>

13. 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 reorganise 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.

14. 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.

15. Phase two, which was the reorganisation of the Legal & 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, a UK passive index fund, an all-world passive fund and a low carbon transition (LCT) fund.

16. Phase three concluded at the end of July 2024 as the Fund added £120million to the LGPS Central global equity fund (target weight of 12% of total Fund assets) and

divested in full (around £185million) from the LGPS Central global emerging markets fund.

17. The final phase is a controlled reduction over time from the LGIM all world equity fund which would then bring the Fund's listed equity weighting to 37.5% of total assets. At present, given the cash holdings it has been agreed with the Fund's investment advisor to hold the overweight position in the LGIM all world passive equity fund. The overweight as at 30 June 2024 is circa £200million.

18. There is also a smaller overweight position within the LGPS Central Climate multi factor fund of circa £60million which is also being held given cash position.

19. The overweight positions are likely to be held whilst cash is awaiting calls from commitments made to private market investments. The topic is to be addressed within the work for the 2025 SAA which is scheduled to be presented to the LPC at its meeting in January 2025.

Liquid global credit update

20. The increase to this asset class refers to the decision to add to an existing LGPS Central product, multi asset credit (MAC) and take the Fund to the target weight of 9% of total Fund assets.

21. The plan to add to this investment during 2024 with a number of similar sized investments was paused in August after three investments totalling £175million were made. A similar amount was planned to be added during the remainder of 2024.

22. On the 22 August 2024 LGPS Central informed partner funds of news at one of the two managers who manage the MAC fund. The news related to the Co-Chief Investment Officer (CoCIO) at Western Asset Management (WAM) taking an indefinite leave of absence to defend allegations made in a "Wells Notice" (a preliminary warning issued by the United States (US) Securities and Exchange Commission (SEC) to individuals or entities that are being investigated for potential violations of securities laws) from the SEC. The investigation centres on the allocation of US Treasury Futures trades in a limited number of accounts.

23. LGPS Central have informed investors in the MAC fund that this fund is in no way connected to the trades in question. In addition, LGPS Central have held a call with WAM on 22 August 2024 to further understand the internal investigations WAM are undertaking. WAM confirmed the Co-CIO in question never directly traded on the MAC fund and his input was limited to high level strategic asset allocation and markets.

24. The Fund is a long-term investor and as such does not make short term tactical decisions but given the potentially serious nature of the allegations feel it is prudent to halt the planned investments which would have taken place during August, October and December 2024. The LPC will be updated further at the next meeting scheduled on the 29 November 2024.

Overall allocations versus target

25. The table below illustrates a similar story to the previous updates during 2024. The Fund is currently overweight growth assets and cash and underweight income assets. Considerable commitments have been made to address the underweight position within the income asset group which will take many quarters to be called. In the meantime, the Fund will be underweight income assets and overweight cash and growth assets.

	30/6/24 £m	2024 SAA	30/6/24 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
Growth	3,474	50.0%	54.0%	4.0%	257	214	-392	79
Income	2,034	42.0%	31.6%	-10.4%	-668	715	-119	-73
Protection *	509	8.0%	7.9%	-0.1%	-6	0	16	10
Cash	417	0.0%	6.5%	6.5%	417			
	6,434	**100.0%**	**100.0%**					

Growth	30/6/24 £m	2024 SAA	30/6/24 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
Listed Equity	2,765	37.50%	43.0%	5.5%	352		-352	0
Targeted Return Funds	303	5.00%	4.7%	-0.3%	-19		20	1
Private Equity	407	7.50%	6.3%	-1.2%	-76	214	-60	78

Income	30/6/24 £m	2024 SAA	30/6/24 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
Infrastructure	667	12.50%	10.4%	-2.1%	-138	250	-30	82
Global private credit	507	10.50%	7.9%	-2.6%	-168	199	-85	-55
Property	455	10.00%	7.1%	-2.9%	-189	86	-4	-107
Global Credit - liquid	405	9.00%	6.3%	-2.7%	-174	180		6

Protection	30/6/24 £m	2024 SAA	30/6/24 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
Inflation linked bonds	230	3.50%	3.57%	0.1%	5		-5	0
Investment grade credit	160	3.25%	2.48%	-0.8%	-50		50	0
Short dated IG credit	61	0.50%	0.95%	0.4%	29		-29	0
Active currency hedge	59	0.75%	0.91%	0.2%	10			10

Cash	417	0.00%	6.5%	6.5%	417			

Outstanding commitments

26. The Fund has made commitments to a number of mangers which are in the process of being called, at the time writing commitments totalling over £700million awaiting to be called. Over the last couple of months £100million in commitments was added to the LGPS Central Infrastructure core / core plus fund, £30million to the LGPS Central Infrastructure value add / opportunistic fund, £40m to the LGPS

Central private equity 2023 vintage and $50million USD to the Adams Street 2024 private equity global funds programme.

27. In addition, the Fund has approval to commit a further £540million in 2024, 2025 and 2026 across, private credit and infrastructure asset classes from prior approvals. Officers are in regular contact with LGPS Central to ascertain a likely launch date for the private credit vintages and we anticipate a launch later in 2024 which if fund particulars are as expected will allow £280million to be committed from approvals made in 2023.

28. Infrastructure: the Fund is underweight by around £140million but now has circa £250million in uncalled commitments. The seeming over-commitment is explained by closed ended funds which will be returning capital over the coming years. Any commitments made can take a significant amount of time to be called depending on the strategy and investment climate and as such assessing future cashflows in from existing investments is important when making commitments. The Fund has flexibility in that it has investments in open ended funds which can provide liquidity if positions within infrastructure need to be reduced in the future.

29. Global credit private debt: the Fund is underweight by circa £170million but like infrastructure has around £200million in uncalled commitments. In addition, the Fund has approval to commit a further £280million over two separate LGPS Central products once the relevant products are launched. These two products were delayed whilst a key post was filled by LGPS Central. The £280million is not included as yet on the table above given no formal commitment has been made by the Fund. Again, the seeming over-commitment is explained by the existing investments returning capital whilst new commitments are made.

30. Property: the Fund is underweight by around £190million. This is due to the poorer performance of the property market in general when compared to other asset classes and the existing underweight the Fund had whilst awaiting the LGPS direct property fund to be setup. It would seem conceivable that if interest rates were to fall then property may exhibit a larger rebound than other asset classes. The Fund has circa £100million of uncalled commitments split across the direct UK property and indirect global property mandates with DTZ and LaSalle. Whilst this still leaves the class underweight any increases in value of property assets ahead of other asset classes would close this gap.

Bank risk share investments

31. The Fund has an investment to this niche asset class via one manager, Christofferson Robb and Company (CRC). The investments were made in 2017 and 2021, with commitments totalling £40million and £52million. The Fund invested in credit relief fund 3 (CRF3) and credit relief fund 5 (CRF5). Both investments are closed ended meaning liquidity is restricted and return of capital is dictated by the terms of the investment at the outset.

32. At the latest available valuation point the current valuation of the two holdings is £65.3m, noting the fact that the 2017 investment has been returning capital for a number of years and will have fully returned capital by the end of 2025. The 2021 investment is expected to start to return capital in 2025 with final capital being returned during 2030.

33. This type of investment falls into the global private credit framework which was approved at the October 2022 meeting of the ISC for which the Fund has a target allocation of 10.5% of total Fund assets. Within the framework there is a specific allocation of 10% (or 1% of total Fund assets) that is to be allocated to special situations debt. The range for this segment of private credit is 0 to 2% with a target of 1% of total assets.

34. At present the Fund has £65.3million invested with CRC. This is c1% of total Funds assets but is forecasted to reduce as capital is returned.

35. Given the 1% target to this asset class it is prudent to make another commitment to a manager specialising in special situations debt.

Who are CRC?

36. CRC are a private credit manager who specialise in European bank capital release. The firm was founded in 2002 by Richard Robb CEO and Johan Christofferson the Managing Partner. The firm manages c$7bn in assets of which bank capital release transactions account for the vast majority of assets.

37. Pension schemes comprise 65% of the firm's assets under management and includes UK pension funds, with most investors domiciled in North America. They employ 70 staff split mainly across London, New York, Milan and Tokyo.

38. Since 2004 they have focused on capital release transactions to mainly European banks' loans to consumer and small medium enterprises (SMEs).

What is bank risk share?

39. Bank risk share or bank capital release is a strategy that allows investors (like pension funds to earn a return from banks who need to or want to target the level of capital they need to hold for the loans they have made. If a bank needs to raise capital in order to meet regulatory requirements (in essence to protect from losses from loans made) then it has a number of options. In some cases banks choose to transfer the risk associated with loan losses to managers such as CRC.

40. By arranging a mechanism for transferring the risk of loans made, banks can receive approval from the regulators to hold less regulatory capital against existing loans. This releases capital to support other activities. As capital is expensive for banks, they can afford to pay a healthy premium to the counterparty that the risk is being transferred to. The banks end up with lower risk weighted assets (loans weighted on the level of risk they present to the bank) and better capital ratios.

41. CRC for example, 'buys' portfolios of loans from banks and is paid an insurance premium by the bank to do this which is passed onto the investors such as pension funds. CRC is specialised in this area and has been carrying out bank risk transfer transactions since 2002 and has been able to produce good returns for investors through vintages launched since and through the major financial crises. Although the premium paid to the manager by the banks is significant, it is still financially advantageous for them to do this as it frees up capital for other uses that would be otherwise reserved for underlying loans defaulting.

42. Currently there are a number of managers and strategies available for this strategy as it has become more popular with both investors and banks who see this is a favourable method to control capital requirements.

43. On the exempt part of today's agenda a recommendation will be made to invest in a bank risk share strategy in order to maintain exposure to the special situations allocation of the private debt framework. The recommendation comes with reference to a review conducted by the Fund's investment advisor details of which are included in the report in the exempt part of the agenda.

Cotham Farms Estate – Nottinghamshire

44. The Fund has a single rural asset which is managed by Leicestershire County Council's internal strategic property services team.

45. The property is located at Cotham about 7 miles south of Newark, Nottinghamshire and extends to around 755 acres, consisting of mainly grade 3 arable land, with some grade 2. A plan highlighting the land holdings is appended to this report. There is a set of modern farm buildings (known as Booth's Buildings), a detached bungalow with outbuildings "Manor Farm Bungalow" (sublet by the Tenant to a retired farmworker on a nominal rent) and a semi-detached cottage, "No 1 The Poplars" (sublet by the Tenant to a retired farmworker on a nominal rent) and several parcels of woodland.

46. The whole property, with the exception of a block of woodland is let to a single tenant on an Agricultural Holdings Act tenancy. The tenancy is subject to succession rights and could be eligible for a further two succession lifetime tenants. The land is well farmed; the current tenant manages it on the basis of a contract arrangement with neighbours, and the property is well looked after. The current rent reflects the rental levels achievable on farms of this nature, given the tenancy terms and the rental formula under the Agricultural Holdings Act. Notice has been served for review of the rent effective from March 2025.

47. Under the terms of the tenancy, the Landlord insures and recharges the insurance premium, however, other than management and collection of the rent, there are very few outgoings associated with the property.

48. The Fund's investment advisor is of the opinion that this single rural asset of immaterial value is deemed non core and is not part of the strategy for the Fund. In this case, Hymans Robertson have advised that the Fund seek professional advice from an agent on how to best maximise value for the Fund from a sale of the asset.

49. Officers for the Fund will engage with the appropriate resource at Leicestershire County Council's property team to engage a relevant agent. Any updates will be reported to the Local Pension Committee.

Recommendation

50. It is recommended that the Investment Subcommittee note this report.

Supplementary Information

51. None

Equality Implications

52. There are no direct equalities 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

53. There are no human rights implications arising from this report.

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

Appendix

Appendix A: Cotham Farm land holdings

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