Leicestershire County Council

LOCAL PENSION COMMITTEE – 29 NOVEMBER 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS

Purpose of Report

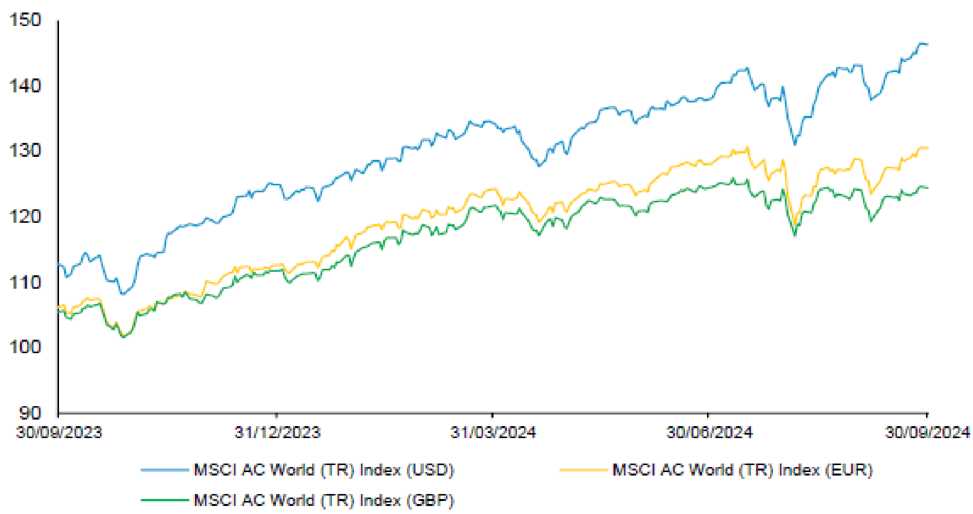
1. The purpose of this report is to provide the Local Pension Committee (LPC) with an update on the investment markets and how individual asset classes are performing.

2. The report also provides an update on action taken by the Investment Sub-Committee (ISC) at its meeting on 2 October 2024 with respect to an investment recommendation in sub investment grade debt and seeks approval for a proposal to commit £25m to a timberland investment.

Markets Performance and Outlook

3. Ongoing disinflation lined the way for interest rate cuts from the major central banks in the quarter ending 30 September 2024. These buoyed hopes of a soft economic landing, against a backdrop of slowing, but still solid, global growth. Bonds and equities alike managed to produce positive returns in this environment as news of interest rate cuts eased any concerns of recession.

4. Global equity markets rose over the quarter, rallying to all-time highs by the end of September (see below the MSCI all country world index over 1 year). The key drivers were easing inflation figures in the US, a 0.5% interest rate cut by the US Federal Reserve (Fed) and continued optimism over advancements in artificial intelligence (AI).

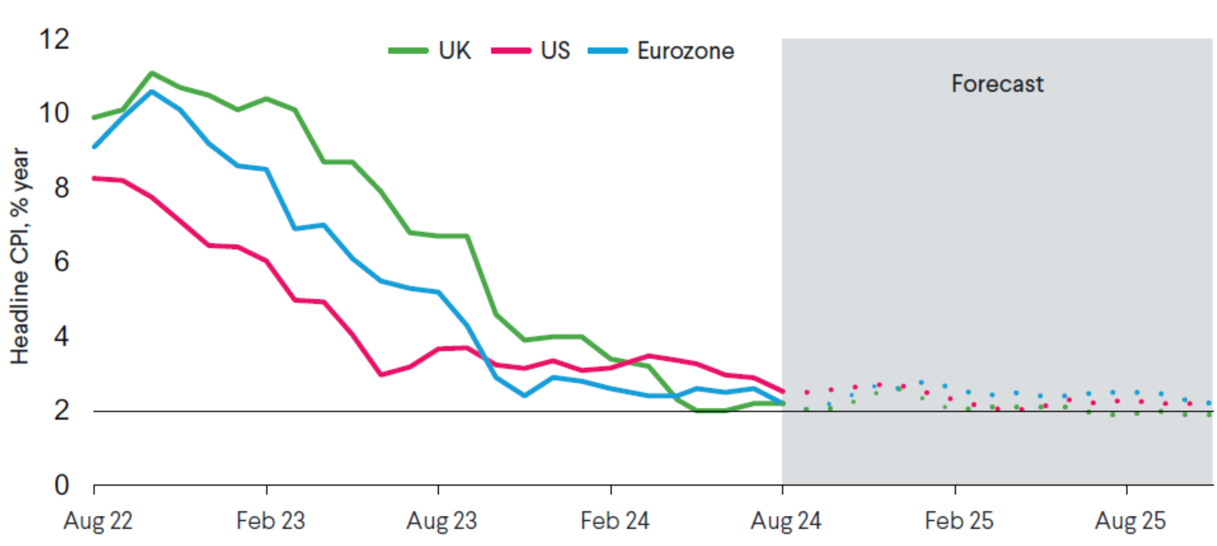


5. In quarter three, US equities rose, with the S&P 500 trading at new highs. US inflation eased over the quarter to 2.5% in August, down from 3.0% in June which allowed for the somewhat higher than expected 0.5% interest rate cut. European

shares also rose over the quarter, influenced largely by the outlook for the US's economy and interest rates. Euro area inflation fell to 2.2% in August and the European Central Bank cut its deposit rate by 0.25% in September which was its second cut. UK equities were marginally higher but underperformed global equities. Inflation was flat at 2.2% in August, as expected.

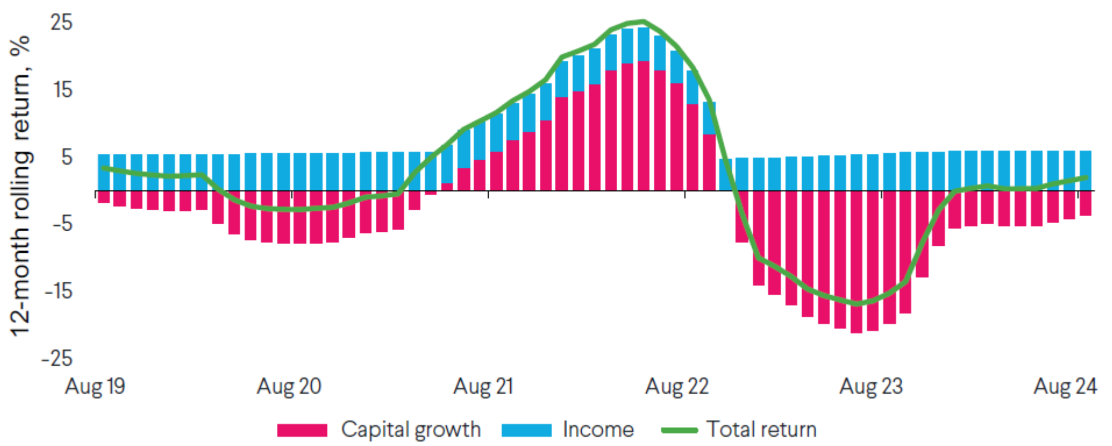
6. Asia Pacific, excluding Japan, was the best-performing region; China's stock markets soared on the government announcement of a raft of stimulus measures intended to boost the economy. Japan was the worst performer. Tokyo's stock market was hit hard by an unexpected interest rate rise by the Bank of Japan in July.

7. Prospects for future rate cuts seem to be data dependant and whilst recent inflation developments (see below) leave scope for Central banks to lower interest rates, some factors such as forecasted inflation and suggest the pace of cuts could be drawn out. Core inflation remains higher than 2% in the UK, euro region and US and is forecast to stay around that level into 2025. Risks exist to higher inflation from wage growth which is still elevated across major advanced economies and business surveys point to acceleration in input cost inflation in the service sector.



Source: Datastream and Consensus Economics

8. For UK property, some glimmers of hope have returned as annual returns have risen with income offsetting capital declines. Over the last 12 months (to August 2024) the total return of the MSCI UK property total return index was +1.9%, whilst capital values still fell by around 3.8%. A Royal Institute of Chartered Surveyors (RICS) survey suggests rents will continue to rise alongside improved occupier demand and increasing capital values. Inevitably, however, the market has been at the mercy of the UK interest rates and future expectations and any news of higher for longer interest rates will have negative consequences for capital values.



Source: MSCI IPD UK Monthly Property Index

9. A summary of global asset class performance over various time frames as at quarter end 30 September 2024 is shown below. Gold having had a good run through the quarter is showing returns over 10% per annum over the last five, ten and twenty years. 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 per ounce to over $900 by March 2008. Global equity and private equity have had a good quarter which has improved performance over all time frames versus the last quarter.

	3 months*	One year	Three years	Five years	Ten years	Twenty years
GLOBAL EQUITIES	6.9%	32.2%	8.7%	13.0%	10.0%	8.8%
PRIVATE EQUITY	5.2%	28.3%	8.8%	12.3%	14.1%	NA
PROPERTY	16.8%	34.7%	3.5%	5.3%	8.1%	8.3%
INFRASTRUCTURE	13.4%	30.8%	9.5%	6.9%	6.3%	7.7%
HIGH YIELD	4.1%	16.2%	3.7%	4.6%	5.6%	9.5%
PRIVATE CREDIT	0.1%	1.2%	-0.6%	0.1%	-0.1%	-0.2%
UK GILTS	2.5%	8.1%	-7.5%	-5.3%	0.4%	3.0%
UK INDEX-LINKED	1.5%	6.2%	-12.5%	-7.6%	0.8%	4.0%
GOLD	7.1%	30.0%	14.7%	10.4%	10.2%	11.3%

Source: Bloomberg, note: listed proxies have been used for infrastructure, property, private debt and private equity

10. A fuller Hymans capital markets Autumn overview is included as an appendix to this report.

Portfolio changes in the quarter ended September 2024

11. The main changes during the July to September 2024 quarter are shown below. All changes listed were in cash.

Central global active equity fund	July 2024	Added £70 million
Central emerging market equity (EME) fund	July 2024	Divestment in total over 2 transactions totalling c190 million
Ruffer	August 2024	Added £20 million

Central direct property	September 2024	Added c£18 million

12. The net effect on cash, quarter on quarter, has been an increase from £417million to £456million.

Cash holdings and outstanding commitments

13. The level of cash held by the Fund is higher than the Strategic Asset Allocation (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 £456m (£417m last quarter) in cash and an additional £90m (£59m last quarter) with Aegon as collateral in order to support the currency hedge. Taken together this represents 8.4% (7.3% last quarter) of total Fund assets.

14. 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 37.5% to listed equity is planned to be completed towards the end of 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. If calls for commitments the Fund has made are received slower than anticipated then officers, whilst taking advice from the Fund's investment advisor, may chose to remain overweight listed equities longer rather than hold higher levels of cash.

15. 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 over £940million awaiting to be called with over £750m of that amount being allocated to LGPS Central products. In addition, the Fund has approval to commit a further £260million to Central products in 2025 and 2026 across infrastructure asset classes. £280million was committed to two LGPS Central private debt vintages during the quarter.

16. 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; MMFs, term deposits and certificates of deposit. The final two having maximum terms of one year.

17. At the time of the Committee meeting the Fund is expected to have cash holdings of around £475million split between MMFs and fixed term deposits. The Fund, at the time of writing has £325million invested in fixed deposits with a weighted average interest rate of 4.95% (was 5.18% at the last update) with an average term to maturity of 2.7 months.

18. Within the quarter the treasury team invested £20million with a counterparty that breached the treasury advisors limit. The investment also breached the limit for the country limit by £10million. The breach was reported to the Director of Corporate Resources and taking into account various factors, including the nearing maturity of

£20million on the 9 December 2024 which would bring both counterparty and country limits back within limits, it was felt appropriate to keep the additional deposit in place until maturity.

19. A cashflow forecast for the Fund estimates that cash should reduce gradually over the financial year towards £375million. The reduction in cash is dependent on a number of factors:

    a. The speed at which the significant commitments already made by the Fund are called.
    b. The pace at which to reduce listed equity overweight towards the target 37.5% of total assets.
    c. The pace at which investments into the LGPS Central MAC fund are made.

LGPS Central Multi Asset Credit (MAC) Fund update

20. The Fund has a target weight to this investment of 9%. At the 30 September 2024 snapshot the actual weight was 6.5%, implying a 2.5% (or £160million) underweight. The underweight position has been gradually closing during 2024, with the Fund having made three investments totalling £175million during the year to date. Three more investments were planned during 2024 to bring the Fund towards the target weight.

21. 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 U.S. 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.

22. 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.

23. There is a likelihood of investors removing cash from WAM which could depress, in the short-term, values of less liquid securities WAM are forced to sell. The MAC fund is a segregated mandate and so is less directly impacted from sales but will have common positions. The MAC fund has however had a strong quarter having outperformed the benchmark of cash plus 4% pa (+4.2% vs +2.3%).

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. LGPS Central are investigating options for this product and an update will be provided at the January 2025 Local Pension Committee meeting.

25. Other changes to align to the 2024 SAA are shown in the tables 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.

	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	% diff to SAA
Growth	3,438	50.0%	52.9%	2.9%	189	180	-313	56	-0.9%
Income	2,051	42.0%	31.6%	-10.4%	-677	984	-94	213	-3.3%
Protection *	552	8.0%	8.5%	0.5%	32	0	9	41	-0.6%
Cash	456	0.0%	7.0%	7.0%	456				
	6,497	**100.0%**	**100.0%**						

** includes hedge collateral at 0.75% of total fund assets*

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	% diff to SAA
Listed Equity	2,710	37.50%	41.7%	4.2%	273		-273	0	0.0%
Targeted Return Funds	327	5.00%	5.0%	0.0%	2			2	0.0%
Private Equity	401	7.50%	6.2%	-1.3%	-86	180	-40	54	0.8%

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	% diff to SAA
Infrastructure	683	12.50%	10.5%	-2.0%	-129	250	-30	91	1.4%
Global private credit	487	10.50%	7.5%	-3.0%	-195	465	-60	210	3.2%
Property	458	10.00%	7.1%	-2.9%	-191	104	-4	-91	-1.4%
Global Credit - liquid	423	9.00%	6.5%	-2.5%	-162	165		3	0.0%

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	% diff to SAA
Inflation linked bonds	233	3.50%	3.58%	0.1%	6		-6	0	0.0%
Investment grade credit	166	3.25%	2.56%	-0.7%	-45		45	0	0.0%
Short dated IG credit	63	0.50%	0.97%	0.5%	30		-30	0	0.0%
Active currency hedge	90	0.75%	1.39%	0.6%	41			41	0.6%
Cash	456	0.00%	7.0%	7.0%	456				

Overall Investment Performance

26. Investment performance analysis over various time frames to the period quarter ending 30 September 2024 is conducted by Hymans Robertson (Hymans), the Fund's Investment Advisor. Hymans 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.

27. 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.

28. 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 2024 meeting of the Local Pensions Committee. This is in order to better compare the investment risk versus the expected return.

Fund	Previous benchmark	New benchmark
CRC CRF 3	Absolute return +7.5%	Absolute return +9.0%
CRC CRF 5	Absolute return +8.5%	Absolute return +9.0%
LGPS Central real assets	Absolute return +5.0%	Cash 3 month + 3%

29. 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.

	Quarter	1yr	3yr pa	5yr pa
Total Fund	+1.0%	+10.8%	+5.0%	+6.3%
vs benchmark	-0.6%	-1.9%	-0.7%	-0.2%

30. 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.

31. Over the one-year period the effect of cash plus benchmarks has made attainment of the overall benchmark harder as we now enter a second year of interest rates over 4%. Many of the Fund's benchmark's measured against cash plus a margin of three to four percent and as such mangers have had to reposition portfolios which had been subjected to downward capital valuations. Private equity for example overall is now measured as against a public market index plus 3% pa to reflect the additional returns expected from a less liquid and riskier asset class. Against this background of higher benchmarks the actual three year return of 13.7%pa falls short of the benchmark by 0.4%pa.

32. The Fund has experienced a positive return over the three and five-year timeframes. However, as comparatives have become harder, especially for the mandates where cash returns plus a margin is the benchmark, overall the Fund is now showing an adverse variance versus benchmark on the longer timeframes. These investments include the mandates with Partners group (2.3% of total Fund assets) and LGPS Central Multi asset credit (6.5% of total Fund assets) for example.

33. Credit based investments performed poorly as interest rates rose which negatively impacted the capital value of the holdings. This impacted the MAC fund where our investment was added during a period when interest rates were closer to zero. Credit investments where the underlying holdings benefit from higher interest rates have had returns improve but not to the same extent as the benchmark.

34. The change in benchmarks through the year has on balance increased the overall benchmark target although it is hard to accurately calculate the effect. The changes were proposed to more accurately reflect risk being taken and to align more closely to the manager targets.

35. The Fund's last strategy review noted the projected 20-year median return to be 8.7% pa based on the higher interest rate and inflation data. It also noted a one-year dispersion of c14% around this median return reflecting the variability in returns based on the Fund's strategic asset allocation. Whilst the Fund has enjoyed good returns over the medium term which has in part improved its funding ratio, future investment returns are not guaranteed and can be subject to multiple years of negative returns.

Pooling progress

36. In light of the recent Mansion House speech and subsequent consultation which is covered elsewhere on today's agenda the points below highlight the Fund's current position regarding pooling. The Fund's current pooled total is £2.6billion or 40.1% of total fund assets. When including the Legal and General (LGIM) passive equity investments as pooled the total rises to £3.7billion or 57% of total Fund assets. The LGIM investment product was a mandate that was procured collectively by seven administering authorities prior to the commencement of pooling. The management fees are very competitive as a result of LGIM's dominant market position.

37. In light of the previous Government's desire to get all listed equity assets pooled by 31 March 2024, the Fund and the Pool have been investigating cost effective methods to pool the LGIM assets in a manner that the Government are requesting.

38. The Fund, as mentioned earlier on this paper, has around £760million in uncalled commitments to LGPS Central products. This represents 12% of the current valuation of the Fund. In addition, the Fund also has £260million in approvals to Central infrastructure funds adding a further 4%.

	Pooled	Plan to pool <1 year	Liquid investments	Illiquid investments	Total
Growth assets					
Listed Equity Passive		1,103			1,103
Listed Equity Active	1,607				1,607
Listed Equity	1,607	1,103			2,710
Private Equity	17			384	401
Targeted Return			327		327
Income assets					
Infrastructure	104		324	255	683
Global credit - private debt / CRC	236			252	487
Property	49	93	267	49	458
Global Credit - liquid MAC	423				423
Protection					
Inflation linked bonds			233		233
Investment grade (IG) credit	166				166
Short dated IG credit			63		63
Active currency hedge collateral			90		90
Cash			456		456
Total	**2,602**	**1,196**	**1,759**	**940**	**6,497**
% of total fund	**40%**	**18%**	**27%**	**14%**	

39. The liquid investments represent investments that could be sold relatively easily given a relatively liquid market exists. In some cases, there is likely to be costs involved or a discount for example in the case the two open ended infrastructure funds. The level of discount (or premium in fewer cases) is dependent on market supply and demand in the main.

40. Iliquid investments include private equity, property, closed ended infrastructure funds and the private credit investments with M&G, Partners Group and CRC that are in the process of returning capital and a secondary market for selling positions is limited. Even if a secondary market existed the exposures to the existing asset class would be reduced, and given the underweight positions the Fund has versus its strategic asset allocation this underweight situation would worsen.

Investment sub committee (ISC) approval

41. The ISC met on the 2 October 2024 to consider a proposal to invest in a bank risk share investment. The investment advisor had considered a number of ways to maintain exposure to this asset class and recommended to the committee a £40million commitment to the existing managers' Capital Relief fund 6 pending satisfactory due diligence. Hymans, the Fund's investment advisor and CRC presented and took questions from the ISC.

Additional commitment to the Stafford infrastructure timberland continuation fund (SITCON)

42. The ISC at its meeting on 24 July 2024 approved Stafford Capital Partners proposal to create a continuation fund be formed from existing investments in Stafford infrastructure timberland (SIT) funds 6, 7 and 8. Officers had requested Hymans Robertson to conduct a review with the earliest fund, SIT 6 reaching the end of its term in June 2024. The main benefit of continuation funds such as

this is the assets are rolled into the continuation vehicle which avoids capital being returned to investors who may want to maintain an allocation.

43. To maintain a target weight to timberland within the overall infrastructure holdings (20% of the total 12.5% of fund assets within infrastructure; or 2.5% of total fund assets) it will be necessary for the Fund to commit further to this asset class. Given the relatively small allocation estimated to be needed and favourable fee terms offered for investors to the continuation vehicle.

44. Hymans Robertson following its review, has recommended that a £25million commitment is required to maintain the allocation to timberland. Hymans considered various options; to invest into the new vintage of the Stafford Timberland vintage (SIT10), invest into the Stafford carbon offset opportunities fund (COOF) which the Fund has an existing commitment to, or buy additional interests within the continuation vehicle (SITCON) from existing investors requiring liquidity.

45. Existing investors will have priority over purchasing additional interests and the pricing will be at the net asset value, no premium or discount. Hymans Robertson note that as SITCON is a fully invested portfolio, transaction costs would be far less than those associated with a Fund that is seeking to originate and execute new investments. For example, Stafford have indicated that the costs of acquiring additional interests in SITCON may be in the region £5,000. This is substantially lower than when new vintages are being setup.

46. Hymans Robertson do note that while the Fund would be investing into a known portfolio which is has a track record, Stafford's intention to divest from non-core assets will make for a more concentrated portfolio. However, given the modest additional investment and relatively large number of go forward assets (25-30) Hymans are comfortable with the exposure.

Leicestershire Pension Fund Conflict of Interest Policy

47. Whilst not a conflict of interest, it is worth noting that the County Council also invests funds with four managers with whom the Leicestershire County Council Pension Fund invests, namely Partners Group, JP Morgan, DTZ investors and Christofferson Robb and Company (CRC). Decisions on the County Council's investments were made after the Fund had made its own commitments.

Recommendation

48. The Local Pension Committee is asked to:

(a) Note the update provided regarding investment markets, how individual asset classes are performing and action taken by the Investment Sub-Committee (ISC) at its meeting on 2 October 2024;

(b) Approve the recommended £25million commitment to the Stafford infrastructure continuation fund (SITCON).

Environmental Implications

49. The Leicestershire LGPS has developed a Net Zero Climate Strategy (NZCS) for the Fund. This outlines the high-level approach the Fund is taking to its view on Climate Risk. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment. The Fund is committed to supporting a fair and just transition to net-zero. There are no changes to this approach as a result of this paper.

Equality Implications

50. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance ("ESG") factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund's fiduciary duty. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero. There are no changes to this approach as a result of this paper.

Human Rights Implications

51. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance ("ESG") factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund's fiduciary duty. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero. There are no changes to this approach as a result of this paper.

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 24 July 2024, Review of the Leicestershire LGPS infrastructure assets
https://democracy.leics.gov.uk/documents/s184320/Infra%20and%20Timberland%20assets%20update%20July%202024.pdf

Appendix

Hymans Robertson, Capital Markets update Autumn 2024

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