Subject	**Investment Strategy Review**	**Status**	For Publication
Report to	Authority	**Date**	19th March 2020
Report of	Fund Director and Head of Investment Strategy		
Equality Impact Assessment	Not Required	Attached	No
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1 Purpose of the Report

1.1 To approve the revised strategy arising from the review of the Investment Strategy and the revised Investment Strategy Statement reflecting the revised strategy.

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2 Recommendations

2.1 Members are recommended to:

a. **Endorse the changes to the investment strategy set out in this report, including the changes in relation to Equity Protection set out in Appendix B on the confidential part of the Agenda.**

b. **Approve the revised Investment Strategy Statement at Appendix A.**

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3 Link to Corporate Objectives

3.1 This report links to the delivery of the following corporate objectives:

Investment Returns

To maintain an investment strategy which delivers the best financial return, commensurate with appropriate levels of risk, to ensure that the Fund can meet both its immediate and long term liabilities.

Responsible Investment

To develop our investment options within the context of a sustainable and responsible investment strategy.

The Investment Strategy is the operational expression of the Authority's Investment Beliefs and is central to achieving both the returns required to meet the actuary's assumptions and the way in which they are achieved.

4 Implications for the Corporate Risk Register

4.1 The actions outlined in this report relate to the identified risks arising from market volatility, changes in the Fund's cash flow dynamic and the systemic risk arising from climate change. In all cases the strategy proposed aims to mitigate these risks.

4.2 No investment strategy is without risk and the intention of the review process is to identify a strategic asset allocation that has in excess of a 60% probability of achieving the actuarially required return. This has to be done in a way that is consistent with the Authority's appetite for investment risk which is best described as moderate. The proposals contained in this report achieve that balance, and while the option of a small allocation to a higher risk equity portfolio is introduced into the potential asset mix (although with no current proposal to introduce such an allocation) this increase in risk is mitigated by the overall move of assets into less volatile asset classes.

5 Background and Options

Background

5.1 It is usual to review the investment strategy of a pension Fund following an actuarial valuation, in the case of LGPS Funds every three years. This is because the changed Funding level and cash flows which are identified at the valuation may require the Fund's investment strategy to achieve different objectives and possibly a different return target. Such reviews require a significant amount of financial modelling and therefore it is usual to use a consultancy to support the work given that the Authority does not possess the technical capability to undertake this type of modelling. In this case the Authority's Investment Advisory Panel has been supported in undertaking the review of the Investment Strategy by Hymans Robertson and members have previously been briefed both on the nature of the review and the results of the work.

5.2 As Hymans Robertson's detailed report contains certain proprietary information it is not being published on grounds of commercial confidentiality. This report sets out the broad conclusions arising from the work, and the views of the Investment Advisory Panel on how those conclusions impact on the Investment Strategy, in particular the Strategic Asset Allocation which is the single largest contributor to the returns delivered by the Fund in the longer term. All of these are then translated into the statutorily required Investment Strategy Statement which is set out in Appendix A.

Stakeholder Views

5.3 In constructing their Investment Strategies and Investment Strategy Statements LGPS Administering Authorities are required to have regard to the views of relevant stakeholders. It is extremely difficult to sensibly consult on the minutiae of an investment strategy. Therefore in consulting with stakeholders during the valuation process and on the Funding Strategy Statement officers have identified specific outcomes which stakeholders wish to see delivered by the Investment Strategy. In addition the views of individual scheme members expressed in routine correspondence with the Authority have been considered in arriving at the recommended course of action.

5.4 The principal concerns coming out of this work are:

- The need to maintain stable employer contributions once deficits have been eliminated. All other things being equal (which is not always the case as the McCloud impact proves) employers would wish for contributions to only vary within a relatively narrow range. Ideally many employers would like to see contributions reduce but they are generally realistic in accepting that stability within a narrow band is likely to be the best that can be achieved.
- The need for investment returns to contribute to bringing remaining deficits down more quickly. The low Funding levels of some more recently admitted smaller employers mean that they are looking to the investment strategy to outperform the base assumptions in order to reduce their deficits more quickly.
- Individual scheme members consistently raise issues around responsible investment and how the Fund is responding to climate change in contact with the Authority. While this is a concern for some employers their responses tend to be more motivated by purely financial considerations.

5.5 The first two points above are to some extent contradictory as the first implies lower volatility and potentially less risky investments while the second implies a higher risk and therefore potentially higher return strategy. This is not necessarily the case as illustrated below. The final point is in essence one about implementation rather than strategy and is referred to below.

Valuation Changes which can impact asset allocation

5.6 The modelling undertaken by Hymans Robertson shows a number of factors arising from the changes which have taken place since the 2016 valuation process which impact the sort of changes which we need to consider making to the asset allocation. Principally these are:

- An improved Funding level at virtually full Funding which in most defined benefit schemes would lead to a substantial de-risking exercise. However, because LGPS remains open to members building up further benefits a substantial allocation to growth assets needs to remain in order to reduce the risk of a deficit recurring.
- A change in the cash flow dynamic of the Fund. The balance of membership within the Fund is over time shifting away from active members towards deferred members and pensioners. As a result income from contributions is now less than payments of pensions. This means that it is necessary for the Authority to use a portion of its investment income to pay pensions. This is sometimes termed “being cash flow negative”. This situation will continue and over time the gap between contributions and pensions will increase and it will be necessary to harvest a greater proportion of investment income leading to a need to identify more potentially income generating assets.

5.7 Taken together these factors point towards some movement of assets away from growth assets towards income generating assets although nowhere near the scale of movement that might be seen in a private sector scheme which has achieved an equivalent Funding level. In effect this continues the movement seen in the previous review following the 2016 valuation.

Revised Strategic Asset Allocation

5.8 The Hymans Robertson's work identified two potential alternative asset allocations which would give an improved likelihood of successfully delivering the required returns over the next ten years. The first, which has a slightly better chance of success, involved a reduction in exposure to growth assets (essentially equities) from 57% to 37%, while the second involved a reductions to 52%, with only a slightly reduced chance of success when compared to the first. The first option would require a very major shift of assets into alternatives which would be extremely difficult to achieve in any reasonable timescale. Therefore the second option is preferred by both Hymans and the Investment Advisory Panel as it can be implemented in a reasonable timescale. The table below shows the current and proposed strategic asset allocations and the current actual allocation together with the change required in order to achieve the proposed allocation. In examining this it is worth bearing in mind that based on the 31st December 2019 Fund value a 1% movement represents about £88m

Asset Class	Current Benchmark %	Actual at 31.12.19 %	Proposed Benchmark %	Change v Current Benchmark %	Change v Actual %
UK Equities	15.0%	15.5%	10.0%	-5.0%	-5.5%
International Equities	35.0%	37.8%	35.0%	0.0%	-2.8%
Private Equity	7.0%	6.8%	7.0%	0.0%	0.2%
Total Growth^	**57.0%**	**60.1%**	**52.0%**	**-5.0%**	**-8.1%**
Multi-asset credit*	6.0%	4.9%	6.0%	0.0%	1.1%
Infrastructure	5.0%	4.3%	10.0%	5.0%	5.7%
Private Debt	3.5%	4.1%	5.5%	2.0%	1.4%
Property	10.0%	9.1%	10.0%	0.0%	0.9%
Total Income^	**24.5%**	**22.4%**	**31.5%**	**7.0%**	**9.1%**
UK Index Linked Gilts	12.0%	11.6%	10.0%	-2.0%	-1.6%
Corporate bonds	5.0%	4.8%	5.0%	0.0%	0.2%
Cash	1.5%	2.8%	1.5%	0.0%	-1.3%
Impact of Equity Protection		-1.7%			1.7%
Total Protection^	**18.5%**	**17.5%**	**16.5%**	**-2.0%**	**-1.0%**
Total	**100.0%**	**100.0%**	**100.0%**	**0.0%**	**0.0%**

*Note – The current High Yield and Emerging Market Bond portfolios are included here as the intention is that they should transition to the Border to Coast Multi-Asset Credit product.

^Note- The categorisation of assets between Growth (those held for capital appreciation), Income (those held principally to provide an income stream), and Protection (those held to match liabilities and capital protection) are a best estimate for ease of analysis. For example some asset classes such as property can have growth characteristics as well as income characteristics.

5.9 The logic of making the movement out of equities by reducing the allocation to the UK is that the Fund is over-exposed to the UK relative to the scale of its economy within the world economy. This will remain the case even after the change, although to a lesser extent. It is usual for pension Funds to be over exposed to their home economy but this does present something of a risk in terms of concentration. This is somewhat exacerbated in the UK given the predominance in the index of a small number of very large companies (including a high proportion of carbon intensive stocks). Thus as well as increasing the opportunity set by moving to a more global focus a reduction in exposure to the UK index will have some benefit in reducing exposure to carbon intensive industries. Within the equity allocations the Investment Advisory Panel would recommend maintaining the option of moving a small portion of the international equities into a higher target global mandate at some point subject to the relevant Border to Coast product(s) establishing a performance track record and a formal due diligence process.

5.10 The other strategic movement is out of UK index linked gilts. This reflects the fact that the dynamics of the gilt market are currently (and seem likely to remain) skewed resulting in assets which are extremely expensive while the Fund needs to increase its access to income the level of which is greater elsewhere in the asset mix.

5.11 The proposed increases in allocation are to infrastructure which should generate strong (largely) index linked cash flows and private debt which also throws off income. Both these are less volatile asset classes contributing to a reduced risk exposure for the Fund overall.

Harvesting Income

5.12 As stated above the Fund needs to increase the degree to which it harvests income from its investments in order to ensure that cash is available. As part of the investment strategy to achieve this it is important to agree a hierarchy within the strategic asset allocation for the harvesting of income. This is sometimes called an income waterfall. The proposed hierarchy is as follows:

1. Property (net rental income)
2. Index linked gilts and corporate bonds (interest receipts)
3. Multi-asset credit (interest receipts)
4. Private debt (interest receipts)
5. Infrastructure (dividend flows)
6. Listed equity (dividend flows)
7. Private equity (proceeds from sale of underlying investments)

5.13 Officers are undertaking further detailed work in order to generate a better picture of day to day cash flow requirements and Border to Coast are providing means whereby income can be received from their products as necessary. This will be reflected in future monitoring activity.

The Future of Equity Protection

5.14 The current Equity Protection Strategy is due to mature between March and June 2020, the Investment Advisory Panel have considered the position based on advice from Hymans Robertson and have made specific recommendations with regard to this. Some of the details underlying this are market sensitive and are therefore dealt with in a confidential Appendix B which will be considered under Part II of the agenda.

Implementation

5.15 Any strategy needs to be capable of being implemented and in considering with Hymans Robertson the various potential strategic options the Investment Advisory Panel have involved Border to Coast in the discussions in order to ensure that they are aware of what the Authority will be asking of them in terms of type and scale of product.

5.16 The implementation of the new strategic asset allocation will need to be phased as the asset classes into which assets will be moving are largely in the alternatives space where commitments take some time to draw down. Officers will discuss with Border to Coast opportunities to minimise the disruption caused by transitioning assets by attempting to match SYPA’s movement of assets out of particular products with other partner Funds moving assets into them. While this cannot be done in all cases where it can happen it will reduce costs for all concerned and can avoid potentially unnecessary churn in the underlying stocks within a portfolio. Similarly the Authority has taken advantage of the provision of favourable terms to move Funds out of cash and into the product that will provide the core of the Border to Coast Multi-Asset Credit Fund when launched.

5.17 The proposed changes in general build on the products already being provided by Border to Coast, or which are in the later stages of development (such as Multi-Asset Credit). There is one area however where a new product would prove useful which is a “listed alternatives” Fund. This provides a somewhat less volatile “holding” place for money moved out of equities before it can be deployed into the pure alternatives portfolios. The Authority already holds some of these stocks in its legacy alternatives portfolios which were originally bought for this reason, and these could potentially transfer to such a Fund. A Fund of this sort is now on the Border to Coast development plan, although it is not practical to launch it until 2021 at the earliest.

5.18 The other implementation issue impacting Border to Coast is the pace at which the company can deploy cash into the alternatives portfolios. The initial subscriptions from partner Funds to these products were significantly greater than initial estimates and it seems likely that these will increase as a result of strategy reviews. The Company are aware of this issue and are looking to ensure that they have sufficient resources to both be able to deploy and provide ongoing management for this level of capital.

5.19 The Authority, along with other LGPS Administering Authorities conducting strategy reviews has been lobbied about the nature of the investment mandates which it uses to deliver its strategy. In particular this lobbying focuses on the exclusion of particular types of investment from equity portfolios (generally fossil fuel stocks), the use of some form of “green” or “ESG” index as the benchmark for equity investment, and the setting of some sort of carbon reduction target. These are perfectly valid considerations and members may wish to express a view on whether the Authority should move down this route. However, it must be recognised that to do so within the constraints of pooling would, at the very least, require the achievement of agreement with all the other investors in the products in which we are invested. Alternative means of achieving this would require a move to a passive investment style which the Authority has not previously supported and would if implemented have wide ranging implications beyond the Authority itself.

Outstanding Issues

5.20 There are a number of additional issues where Hymans Robertson provided some advice as part of their work and these will be addressed in the coming months, as shown below:

- Agricultural Property – Hymans Robertson provided a view on the investment rationale for this asset class. This will be reflected in the conclusion of ongoing discussions within the Investment Advisory Panel that will be reported to members in the next municipal year.
- Tobacco investment – Hymans Robertson provided an analysis which provides part of the evidence base for a discussion amongst members that will be facilitated at the seminar planned for July this year.
- Local Investment – Hymans Robertson provided some advice in terms of the definition of the mandate for this allocation which officers will incorporate in the ongoing management of these investments.
- Climate Scenarios – Hymans Robertson analysed the potential impact on the Fund's assets and liabilities in a range of climate scenarios. This information can be used to plan adjustments to either the investment strategy or the contribution plan in the light of actual progress to deliver the goals of the Paris agreement. This work will therefore influence the ongoing development of the Authority's investment policy framework.

Investment Strategy Statement

5.21 The Authority is required to produce an Investment Strategy Statement, which in effect sets out how it goes about managing the money which it invests. This statement should be updated within six months of any change in process or strategic asset allocation.

5.22 Appendix A provides an updated Investment Strategy Statement for approval reflecting the various changes in strategy and process outlined in this report.

6 Implications

6.1 The proposals outlined in this report have the following implications:

Financial	The proposed changes to the investment strategy continue the trend of recent reviews of reducing the exposure to less costly equity investments and moving assets into more costly alternatives. All other things being equal the improved returns generated from alternatives should outweigh any increase in fees. However, this can only be proven in retrospect. Investment strategy should be set with regards to the likelihood of achieving the required returns. While fees are clearly a relevant consideration they are a second order issue which should be dealt with once the asset allocation has been determined.
Human Resources	None
ICT	None
Legal	The updating of the Investment Strategy Statement is required by the LGPS Investment Regulations and therefore the Authority is demonstrating compliance with the regulations.

Procurement	The Authority will be placing new investments through Border to Coast which is a Teckal Company controlled by the Authority and the other 11 shareholders and there is therefore no need to tender the services to be provided.

George Graham **Sharon Smith**

Fund Director **Head of Investment Strategy**

Background Papers	
Document	**Place of Inspection**