worcestershire
countycouncil

AGENDA ITEM 10

PENSIONS COMMITTEE
13 DECEMBER 2019

PENSION INVESTMENT UPDATE

Recommendation

1. **The Chief Financial Officer recommends that:**

   a) **The Independent Financial Adviser's fund performance summary and market background be noted (Appendices 1 to 3);**

   b) **The update on the Investment Managers placed 'on watch' by the Pension Investment Advisory Panel be noted;**

   c) **The update on the transition of the Active Corporate Bonds mandate into the LGPS 'Global active Investment Grade Corporate Bond Fund be noted;**

   d) **The funding position compared to the investment performance be noted;**

   e) **The update on the Equity Protection current static strategy extension be noted;**

   f) **The update on Responsible Investment activities (Appendix 4) and Stewardship investment pooling and the Stewardship code be noted;**

   g) **The update on the LGPS Central report on the voting undertaken on the Funds behalf be noted (Appendices 5 to 7); and**

   h) **The update on the development of a Climate Risk Monitoring Platform be noted.**

Background

2. The Committee will receive regular updates on Fund performance. The Fund's Independent Financial Adviser has provided a Fund performance summary and a brief market background update at Appendix 1 together with the following supporting information.

- Bar Chart of active investment managers' performance (Appendix 2)
- Portfolio Evaluation overall Fund Performance Report (Appendix 3)

The market background update is provided to add context to the relative performance and returns achieved by the Fund's investment managers.

3. The Committee will also receive regular updates regarding 'on watch' managers and will receive recommendations in relation to manager termination in the event of a loss of confidence in managers by the Pension Investment Sub Committee (Appendix 1).

JP Morgan Corporate Bond
4. As we head towards the transition of this mandate to LGPS Central's appointed managers (Fidelity and Neuberger Berman), JP Morgan have shown an outperformance of 0.1% (2.4% v 2.3%) in Q3 2019 against their benchmark. Their performance against benchmark over the last 12 months has deteriorated slightly at 0.4% (10.1% v 9.7%), however that is still behind their performance target by 0.5% over three years and 0.3% over the 10 years. Transition of this mandate is planned for January 2020, and an update is provided later in this report.

Property and Infrastructure Commitments
5. The table below highlights the total commitments to the end of October 2019 being £602million and the amount that has been drawn, i.e. the capital invested being £442million (73%). These types of investments can take several years to be fully committed.

Property & Infrastructure Commitments		Commitment £'m	Amount Drawn Sept 19	%
Total Commitment Property Investments		253	184	73%
Total Commitment Infrastructure Investments		349	258	73%
Total		**602**	**442**	**73%**

Transition of Corporate Bonds to LGPS Central

Corporate Bonds

Transition of assets to LGPS Central
6. LGPS Central have again appointed Inalytics to provide transition oversight to look to provide as smooth a transition as possible within the target implementation shortfall. LGPS Central then asked Inalytics to procure a transition manager and on 22 August appointed Blackrock as Transition Manager. A transition kick off meeting was undertaken again on the 18 November 2019 and funds are likely to transfer early 2020. The Investment Sub Committee and Pension Committee will be kept informed as to progress.

Overall Management Fees
7. The Management fees are in the region of 8.3bps compared to the 17bps we pay now, so an estimated saving based on the existing Assets under management of approximately £0.1m per annum. However, the transitions costs will need to be considered before any real ongoing savings are achieved.

Estimated Funding Levels
8. Table 2 shows the overall Funding level of the Fund. It should be noted that this is a weighted average across all the employers that are part of the Fund The range of funding levels across the employers was circa 20% to 120% (based on 2016 valuation)

9. The last actuarial valuation undertaken as at the 31 March 2016 showed that the fund was 75% funded with a £654m deficit at this point. The Actuary provided a preliminary valuation in September 2019 and further detail is provided in the 2019 Actuarial Valuation Funding Strategy Statement report on this agenda. This has been updated for discount rate assumptions, life expectancy trends, covenant, data quality etc. The estimated funding levels in March 2019 were to 91% with a deficit of £265m. The Asset valuation as at the end of October 2019 was £2.865m.

Table 2: Estimated Pension Fund Funding levels based on a like for like comparison to the 2016 actuarial valuation.

	Mar-16	Mar-18	Oct-18	Dec-18	Mar-19
Assets £'M	1,952	2,701	2,708	2,650	2,795
Liabilities £'M	2,606	2,794	2,861	2,871	3,065*
Surplus (-) / Deficit	**654**	**93**	**153**	**221**	**265**
Estimated Funding Level	**75%**	**97%**	**95%**	**92%**	**91%**

** Note this is based on the Actuary preliminary valuation that the next triennial review is based on. The other Liability figures before this were based on a like for like comparison to the assumptions used in the 2016 valuation.*

10. Note the valuation takes on board the extension of the Equity protection.

Equity Protection update

11. Members will recall that a number of Equity Protection options / considerations were discussed and provided at the last Committee. A caveat to the discussions was that the Actuary believed that the Fund could benefit from using an equity protection strategy in terms of providing increased certainty and affordability of contributions if markets were to deteriorate. Note this only covers our passive portfolio of approximately £1.1bn (including the Equity Protection valuation).

12. A recap of the aspects considered were:

a) **The Governance angle** to protect from the risk of increased employer contributions. This would mean extending the current static strategy to around mid-2020 slightly past the formal sign off date for the 2019 actuarial valuation (31 March 2020). As part of this consideration it would be investigated as to whether more upside participation can be implemented over this period without giving up too much downside protection. This would also provide the Actuary certainty that the Equity Protection is in place when the actuary's rates and adjustments certificate have to be signed off;

b) **The Risk profile** as technically the Equity Protection strategy does help provide diversification in the portfolio and reduces the risk profile as part of the valuation (admittedly at a cost like paying an insurance premium); and

c) **A longer term dynamic strategy.** This needs to be considered as part of the Asset Allocation review that will be conducted from June through to around November 2019 to ascertain whether the Equity Protection Strategy should become an integral part of the Funds future investment strategy.

13. It was agreed that:

   a) The Equity Protection current static strategy be extended to mid-2020 to protect employer contributions and provide certainty to the Actuary that the Equity Protection is in place when the actuary certificate must be signed off.

   Progress – This has been completed and included in the 2019 valuation

   b) Those options be explored as to whether more upside participation can be implemented over this period without giving up too much downside protection be delegated to the Chief Financial Officer in consultation with the Chair of Pensions Committee; and.

   Progress – This has been actioned and a summary is provided in the table below

   Revised Equity Protection levels implemented

Mandate & Market	Initial Market Level	87% when protection kicks in	70% when protection ends	Level at which cap is achieved	% Level at which cap is achieved	Dividend yield	Total Return including Dividend yield
EDOS 5 - S&P	2,895.90	2,519.40	2,027.10	3,162.60	9.21%	1.54%	10.75%
EDOS 6 - ESTOXX	3,282.80	2,856.00	2,297.90	3,453.50	5.20%	3.24%	8.44%
EDOS 7 - FTSE	7,270.90	6,325.70	5,089.60	7,612.50	4.70%	4.07%	8.77%
EDOS 8 - FTSE	7,157.30	6,226.90	5,010.10	7,530.60	5.21%	4.13%	9.34%

   Notes an example: Should the S&P go above the 3,162.6-market value cap then WPF will not benefit from total returns above this level being 10.75%. Likewise, the S&P market value is protected from market falls between the market value of 2519.4 (87%) and 2,027.13 (70%)

   c) The Equity Protection Strategy be considered as part of the Asset Allocation review that will be conducted from June through to around November 2019 to ascertain as to whether this should become an integral part of the Funds future investment strategy

   Progress – The outcome is included in the Strategic Asset Allocation Report on this agenda.

Strategic Asset Allocation

14. Table 3 below shows the existing asset allocations against the Strategic Asset Allocation targets. This highlights that our overall investment in equities is still high being over 80.0% (81.2% as at June 2019) (including the equity protection) compared to the target of 75%. This is mainly due to the committed Property and Infrastructure investments not being fully drawn down at this stage. As the drawdowns occur then this will bring in the actual asset allocations within the target parameters set as part of the investment strategy.

Table 3 Strategic Asset Allocation targets

Fund as at the 30th September 2019			Strategic Asset Allocation targets	
Asset Class	Portfolio Weight		Asset Class	Portfolio Weight
Actively Managed Equities	**25.9%**		**Actively Managed Equities**	**20.0%**
Far East Developed	14.4%		Far East Developed	10.0%
Emerging Markets	11.5%		Emerging Markets	10.0%
Passively Managed Equities – Market Capitalisation Indices	**30.7%**		**Passively Managed Equities – Market Capitalisation Indices**	**40.0%**
United Kingdom	12.7%		United Kingdom	23.5%
North America	11.5%		North America	9.0%
Europe ex UK	6.5%		Europe ex UK	7.5%
Passively Managed Equities – Alternative Indices	**15.5%**		**Passively Managed Equities – Alternative Indices**	**15.0%**
Global	15.5%		Global	15.0%
Equity Protection	**7.8%**			
Fixed Interest	**5.8%**		**Fixed Interest**	**10.0%**
Actively Managed Bonds & Corporate Private Debt	5.8%		Actively Managed Bonds & Corporate Private Debt	10.0%
Actively managed Alternative Assets	**14.3%**		**Actively managed Alternative Assets**	**15.0%**
Property	6.0%		Property & Infrastructure	15.0%
Infrastructure	8.3%			
TOTAL	**100.0%**		**TOTAL**	**100%**

Responsible Investment (RI) Activities

15. The term' responsible investment' refers to the integration of financially material environmental, social and corporate governance ("ESG") factors into investment processes. It has relevance before and after the investment decision and it is a core part of our fiduciary duty. It is distinct from 'ethical investment' which is an approach in which moral persuasions of an organisation take primacy over its investment considerations

16. The Fund adopts a policy of risk monitoring and engagement with companies with sub-optimal governance of financially material Responsible Investment (RI) issues, in order to positively influence company behaviour and enhance shareholder value; influence that would be lost through a divestment approach. The Fund extends this principle of “engagement for positive change” to the due diligence, appointment and monitoring of external fund managers.

Local Authority Pension Fund Forum (LAPFF)

17. LAPFF exists to promote the long-term investment interests of member funds and beneficiaries, and to maximise their influence as shareholders whilst promoting the highest standards of corporate governance and corporate responsibility at investee companies. Formed in 1990, LAPFF brings together a diverse range of 79 public sector pension funds and five pools in the UK with combined assets of over £230 billion.

18. Some key highlights from their quarterly engagement report (July to September 19) were:

- Over the summer, LAPFF has been engaging with several defence companies cited for their role in supplying weapons to the Saudi coalition for the war in Yemen. The LAPFF Executive approved this engagement because LAPFF funds have been targeted by protestors concerned about the role of local authorities in funding this war.

- Along with Sarasin, Church Commissioners and Royal London Asset Management, LAPFF has been engaging with Glencore over concerns about corruption in the Democratic Republic of Congo. The issues raised during this engagement prompted the Forum to send engagement requests to four other companies embroiled in corruption probes – Shell, ENI, Petrobras and Total.

- LAPFF issued two voting alerts during the period under review. The first alert related to Sports Direct, a company that has recently faced the ire of investors after its latest results highlighted underwhelming performance as well as substantial unpaid taxes. These issues led to the company’s primary auditor, Grant Thornton, announcing the intention to resign ahead of the company AGM.

- The second alert relates to Ryanair. LAPFF has requested that the company improve its governance practices for several years. Despite signing recognition agreements with several unions, Ryanair management still appears to struggle to work constructively with unions and staff to negotiate mutually beneficial terms and conditions of employment

- As part of a wider investor discourse, LAPFF joined a call with Southern Company to discuss the implementation of compensation mechanism which links executive remuneration with climate factors. Southern Company is the second largest gas and electric utility company in the US and has recently set GHG reduction targets of 50% by 2030 (compared 2007 output) and ‘low-to-no carbon emissions’ by 2050. In support of this target, the company has also announced a new compensation metric that is tied to the carbon reduction goal.

19. Through LAPFF, the Fund engaged with 108 companies during the quarter on issues ranging from human rights climate change, environmental issues, governance and board composition. Most engagements concerned climate change. Two engagements led to a substantial improvement and five engagements led to a change in process /small improvement. Most engagements were conducted by meetings with specialist staff or the company Chair. The issues are set out in the Quarterly Engagement Report which is attached at Appendix 4 and is also available on LAPFF’s website together with the previous quarterly engagement reports. : LAPFF quarterly-engagement-reports

Stewardship Code
20. In the October report to Committee it was noted that the Financial Reporting Council (FRC) were due to publish a revision to the Stewardship Code. This was published on the 24 October announcing a substantial and ambitious revision to the **UK Stewardship Code**.

21. The new Code substantially raises expectations for how money is invested on behalf of UK savers and pensioners. The new Code establishes a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. Key changes include: -

- An extended focus that includes asset owners, such as pension funds and insurance companies, and service providers as well as asset managers. This will help align the approach of the whole investment community in the interest of end-investors and beneficiaries.
- A requirement to report annually on stewardship activity and its outcomes. Signatories' reports will show what has been done in the previous year, and what the outcome was, including their engagement with the assets they invest in, their voting records and how they have protected and enhanced the value of their investments. This greater transparency will allow clients to see how their interests are being served.
- Signatories will be expected to take environmental, social and governance factors, including climate change, into account and to ensure their investment decisions are aligned with the needs of their clients.
- Signatories are now expected to explain how they have exercised stewardship across asset classes beyond listed equity, such as fixed income, private equity and infrastructure, and in investments outside the UK.
- Signatories are required to explain their organisation's purpose, investment beliefs, strategy and culture and how these enable them to practice stewardship. They are also expected to show how they are demonstrating this commitment through appropriate governance, resourcing and staff incentives.

22. The new Code takes effect from the 1 January 2020 and it is understood as we are an existing signatory to the existing code we will have approximately 12 months to comply. We will be working alongside LGPS Central who are providing support to all the pooling partner funds to help them update their respective Stewardship Code statements.

23. We will report back on the implications as soon as this is known.

Stewardship in Investment Pooling
24. As part of LGPS Central we are actively exploring opportunities to enhance our stewardship activities. More information is on the LGPS website LGPSCentral – Responsible Investment. One of the principal benefits, achieved through scale and resources arising from pooling are the improved implementation of responsible investment and stewardship. Through its *Responsible Investment & Engagement Framework* and its Statement of Compliance with the UK Stewardship Code, LGPS Central is able to help implement the Fund's own *Responsible Investment Framework*. LGPS Central Issues Quarterly Stewardship Reports to demonstrate progress on

matters of investment stewardship and can be found on the above link for which the quarter ending the 30 September 2019 is currently available.

Stewardship Themes

25. Each of the partner funds were invited to take part in a short survey, to gauge interest in a list of potential stewardship themes. The outcome was an agreed shortlist of four (proposed at a recent Responsible Investment Working Group RIWG), which comprised of climate change, single-use plastic, technology & disruptive industries, and tax transparency. Further details of these 4 themes and the progress to date is provided in the quarterly stewardship report.

Voting Decisions

26. At the last meeting it was agreed that it would be beneficial for LGPS Central would compile and vote the shares for Worcestershire Pension Fund voting records (via LGPS Central contract with Hermes EOS and executed in line with LGPS Central's Voting Principles).

27. 'Donut' charts for how votes have been cast in different markets and regions (Appendices 5 and 6) and a Table of vote-by-vote disclosure for full transparency is available at Appendix 7.

Development of a Climate Risk Monitoring Platform

28. As highlighted in the June report, the partner fund Responsible Investment Working Group and LGPS Central are developing a Climate Risk Monitoring Service. This would provide four optional deliverables

- Assistance drawing up a climate change framework and strategy
- Per fund an annual climate change risk report tailored to individual funds requirements comprising
  - Climate scenario analysis, fund wide, all asset classes
  - Carbon metrics scorecard (carbon footprint, stranded asset analysis, etc.
  - Annual climate stewardship plan
- Per fund annual training of Pensions Committee
- Task Force for Climate-related Financial Disclosures (TCFD) report for public disclosure with our annual report

29. All partner funds have now agreed to take this forward. A procurement exercise has been completed for Climate Scenario Analysis and Carbon Risk Metrics and providers appointed. Work is now ongoing to look to provide initial reports for each individual partner fund before financial year end.

Contact Points

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Supporting Information

- Independent Financial Adviser summary report (Appendix 1)
- Bar Chart of active investment managers' performance (Appendix 2)
- Portfolio Evaluation overall Fund Performance Report (Appendix 3)
- LAPFF Quarterly Engagement Report April to June 2019 (Appendix 4)
- 'Donut' charts for how votes have been cast in different markets and regions Appendices 5 and 6 and a Table of vote-by-vote disclosure (Appendix 7)

Background Papers

In the opinion of the proper officer (in this case the Chief Financial Officer) the following are the background papers relating to the subject matter of this report:

- Agenda papers and Minute of the Pensions Committee meeting held on 16 October 2019