

**PENSIONS COMMITTEE**  
**19 MARCH 2019****PENSION INVESTMENT UPDATE**

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**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 Property and Infrastructure commitments be noted;**
  - d) **He be authorised to revisit the specific US Property Debt Walton Street Fund II investment and consider currency hedging options at each capital drawdown of the investment, in consultation with the Chairman of the Pensions Committee and Chairman of the Pensions Investment Advisory Panel (Exempt Appendix 4);**
  - e) **The outcome of the due diligence report for Venn Fund II be noted (Exempt Appendix 5);**
  - f) **The transition of the existing active Emerging Market investments into the LGPS Central Global Emerging Markets Fund subject to appropriate due diligence being undertaken be agreed (Exempt Appendix 6);**
  - g) **The potential transition of the existing Active Corporate Bond fund into the LGPS active be noted;**
  - h) **The funding position compared to the investment performance be noted;**
  - i) **The update on Responsible Investment activities and Stewardship investment pooling be noted; and**
  - j) **The LGPS - Statutory guidance on asset pooling informal consultation and the proposed response from Worcestershire County Council Pension Fund be noted (Appendix 8).**

**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 Advisory Panel (Appendix 1).

#### JP Morgan Emerging Markets

4. JP Morgan (Emerging Markets) portfolio underperformed against their benchmark over the quarter with an underperformance recorded of -1.6% against their benchmark (-5.4% v. -3.9%) over the quarter. The cumulative effect of three poor quarters has badly hit their performance against their benchmark over one year, now behind by -4.1% (-11.7% v. -7.6%).

5. This scale of underperformance has regrettably had a clear negative impact on their three year performance against target, now -2.0% annualised. Since inception they have slipped further behind target, at -1.5% against their performance requirement. Both country allocation and stock selection had a negative impact on performance in Q4.

#### JP Morgan Corporate Bond

6. JP Morgan reported an underperformance of -0.6% (-1.0% v -0.4%) in Q4 2018 against their benchmark. Their performance against benchmark over the last 12 months has deteriorated further, putting them into negative territory at -0.6% (-3.3% v -2.7%), which is obviously well behind their performance target. Relative to their performance target, they are behind by -0.8% over three years, and -0.7% over ten years, which has deteriorated.

7. It is recommended that JP Morgan Bonds and Emerging Markets remain on watch until their three year performance is tracking further towards target. However, it is likely that these funds will transition to mandates provided by LGPS Central which are explained further in this report.

### **Property and Infrastructure Commitments**

8. At the last meeting of the Committee the performance update provided details of the Property and Infrastructure commitments detailing some key issues for consideration, one of them being the maturity to real estate debt funds (Venn and Walton Street).

9. The Committee agreed to allocate £30m to Venn Fund II and a suitable commitment to Walton Street Fund II in the region of the current allocation of £27m subject to due diligence taking place.

#### Walton Street Fund II

10. The due diligence report for Walton Street undertaken by the LGPS Central Alternatives Investment Director was received on the 14 November 2018 and considered by the Chairman of the Committee, Chairman of the Pensions Investment Advisory Panel, the funds independent investment consultant and the Chief Financial Officer on the 28 November 2018. The recommendation within the report stated '*Taking all the areas discussed into account LGPS Central would recommend an investment into Walton Street Real Estate Debt Fund II.*'

11. The salient factors and risks were discussed in detail and an investment of \$40m (equivalent to around £30m in sterling) was agreed subject to currency hedging options being explored to guard against the impact of the currency being the US dollar and the potential impact on returns.

#### Currency Hedging

12. The fund has traditionally not undertaken specific currency hedging facilities as they tend to be costly and over time have been fairly cost neutral. The Fund has benefitted from the weakness in GBP over the last couple of years as equity markets have risen. There was always going to be some element of “give back” at some stage which was one of the reasons for having the equity protection strategy in place. Currency issues have been and will continue to be carefully considered, even if we ultimately take no actual action.

13. LGPS Central were asked to explore potential Currency hedging options in relation to this particular investment (Executive summary at Appendix 4).

14. Given that USD/GBP is near historical lows, a volatile environment and the ongoing Brexit uncertainty, USD/GBP moves are possible in either direction, but in LGPSC’s view it is more likely for GBP to appreciate than depreciate.

15. The report concluded that the:-

- a) Biggest currency risk of the Investment in our assessment is GBP appreciating against USD;
- b) Due to remaining Brexit uncertainty GBP is expected to remain volatile; and
- c) The Fund can choose to “insure” (hedge) the risk, thereby stabilising the Investment return

16. This was debated at the Pensions Investment Advisory Panel (PIAP) on the 28 February 2019. It was agreed that although in general terms our basic principle is not to hedge our current investment exposure, it was felt that for this specific investment we will look to revisit and consider currency hedging options at each capital drawdown of the investment in liaison with the Chair of the Pensions Committee and Chair of the Pensions Investment Advisory Panel.

#### Venn Fund II

17. The due diligence report for Venn (attached as Appendix 5) undertaken by the LGPS Central Alternatives Investment Director was circulated to the Chair of the Pension Committee and Chair of PIAP on the 1 March for consideration. The recommendation within the report stated '*Taking all the areas discussed into account LGPS Central would recommend an investment into Venn Capital Debt Fund II.*'

18. This was agreed and the Finance Manager for Pensions was asked to negotiate the suggested changes to the Investment Rate of Return, Fees and staggered investment with Venn.

## **Transition of Active Emerging Market Equities and Corporate Bonds to LGPS Central**

### Active Emerging Markets

19. Pensions Committee have been kept up to date with the process being conducted for the transition across of our active Emerging Markets equities to the LGPS Central Active Global Emerging markets mandate (AGEM). Worcestershire currently has active emerging market mandate with JP Morgan and Schroder's totalling £331.2m as at the end of December 2018. The attached presentation (Appendix 6) details the rigorous process that was conducted to appoint 3 fund managers being the Bank of Montreal (BMO), Vontobel and UBS.

20. LGPS Central felt that the appointment of three managers was the most appropriate structure as it provided a good mix of cost savings. diversification of risk and investment returns.

21. At the Stakeholders day presided over by LGPS Central on the 27 February 2019 some members of the Pensions Committee were taken through the attached presentation and given the opportunity to question the 3 appointed fund managers. The investment performance provided at the meeting showed that 2 out of the 3 appointed fund managers had performed better over 5 years in comparison to our best performing fund, whilst the other was on a par. The savings on fees is likely to be in the region of 15 to 30bps.

22. This was discussed in detail at the Pensions Investment Advisory Panel on the 28 February and it was agreed to transition the existing active emerging markets equities fund to the LGPS Central AGEM subject to appropriate due diligence being undertaken by the Pensions investment manager and the Funds Investment consultant.

23. Pensions Committee are asked to agree to the transition of the existing active emerging market equities to the LGPS Central AGEM subject to this due diligence taking place. If there are no issues from the due diligence, then we will work closely with LGPS Central to ensure a smooth a transition as possible and regular updates will be provided to Committee.

### Corporate Bonds

24. The potential next transition is likely to be the existing active corporate bonds mandate currently with JP Morgan with an existing value as at December 2018 of £139.1m. The mandate being proposed by LGPS Central is a 'Global active Investment Grade Corporate Bond Fund. A rigorous process similar to that of the AGEM above has been conducted to appoint 2 fund managers being Fidelity IL Pension Management and Neuberger Berman (Europe) Limited.

25. LGPS Central are to arrange a product information day in order that Committee members can understand more about the proposed investment and ask questions directly to the appointed fund managers.

26. This will be discussed at the next Pensions Investment Advisory panel on the 11 June and further recommendations together with the details of the proposed fund investment will be brought to the Pensions Committee on the 21 June 2019.

### **Estimated Funding Levels**

27. 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. Mercers have provided an estimated update on a 'like for like' basis (Table 2 below) using the same assumptions as at the last valuation. The report to the November Committee showed that the fund was estimated to be 99% funded with a deficit of £19m as at the end of August 2018.

28. However Committee were informed to be cautious, particularly around the asset valuations being subject to market fluctuations as we had already seen some market volatility in October which would decrease the funding level and increase the level of deficit. This continued through to December 2018 and reduced estimated funding levels to 92% with a deficit of £221m, with a recovery in January to 94% funded with a deficit of £182m.

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

	<b>Mar-16</b>	<b>Mar-18</b>	<b>Aug-18</b>	<b>Oct-18</b>	<b>Dec-18</b>	<b>Jan-19</b>
Assets £'M	1,952	2,701	2,823	2,708	2,650	2,699
Liabilities £'M	2,606	2,794	2,842	2,861	2,871	2,881
<b>Surplus (-) / Deficit</b>	<b>654</b>	<b>93</b>	<b>19</b>	<b>153</b>	<b>221</b>	<b>182</b>
<b>Estimated Funding Level</b>	<b>75%</b>	<b>97%</b>	<b>99%</b>	<b>95%</b>	<b>92%</b>	<b>94%</b>

### **Triennial Valuation 2020/21 to 2022/23**

29. Initial discussions have commenced with the actuary on the next triennial valuation and very draft initial contributions have been discussed with the County and District councils. There is still a lot of areas to finalise, such as risk management, investment returns, data quality, covenant, public sector pay estimates, etc., before final contribution rates will be finalised. A further strategy meeting is taking place on the 5 March which will take on board the Equity Protection strategy.

### **Equity Protection**

30. Further discussions were held with River and Mercantile (R&M) on Equity Protection options on the 28 February 2019 and at the moment no further action is required. R&M will bring future detailed option proposals to the next Investment Advisory Panel on the 11 June and recommendations brought to Pensions Committee on the 21 June 2019. The current strategy expires between the 15 August 2019 and October 2019.

### **Strategic Asset Allocation**

31. 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 83.2% (85% in September 2018) (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**

<b>Fund as at the 31<sup>st</sup> December 2018</b>		<b>Strategic Asset Allocation targets</b>	
Asset Class	Portfolio Weight	Asset Class	Portfolio Weight
<b>Actively Managed Equities</b>	<b>26.6%</b>	<b>Actively Managed Equities</b>	<b>20.0%</b>
Far East Developed	14.0%	Far East Developed	10.0%
Emerging Markets	12.6%	Emerging Markets	10.0%
<b>Passively Managed Equities – Market Capitalisation Indices</b>	<b>30.8%</b>	<b>Passively Managed Equities – Market Capitalisation Indices</b>	<b>40.0%</b>
United Kingdom	13.5%	United Kingdom	23.5%
North America	10.9%	North America	9.0%
Europe ex UK	6.4%	Europe ex UK	7.5%
<b>Passively Managed Equities – Alternative Indices</b>	<b>15.0%</b>	<b>Passively Managed Equities – Alternative Indices</b>	<b>15.0%</b>
Global		Global	15.0%
<b>Equity Protection</b>	<b>10.8%</b>		
<b>Fixed Interest</b>	<b>5.5%</b>	<b>Fixed Interest</b>	<b>10.0%</b>
Actively Managed Bonds & Corporate Private Debt	5.5%	Actively Managed Bonds & Corporate Private Debt	10.0%
<b>Actively managed Alternative Assets</b>	<b>11.3%</b>	<b>Actively managed Alternative Assets</b>	<b>15.0%</b>
Property	5.2%	Property & Infrastructure	15.0%
Infrastructure	6.1%		
<b>TOTAL</b>	<b>100%</b>	<b>TOTAL</b>	<b>100%</b>

32. Earlier on this Committee's agenda was the initial Strategic Asset Allocation Review undertaken by Hymans Robertson LLP and the key findings will be considered alongside the detailed strategic allocation review to be conducted later in the year. This report provided a very good foundation for this review and highlights a number of key questions and considerations for Committee relating to areas such as the Structured equity and investment pooling

### **Responsible Investment (RI) Activities**

33. 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

34. 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.

35. A report was presented to Committee on the 28 November detailing the Pension funds approach to responsible investment and seeking approval to the Stewardship Compliance Statement. As part of this report it was agreed that the key areas of the Local Authority Pension Fund Forum (LAPFF) quarterly engagement report be included in the Committees future pensions investment updates

36. The Local Authority Pension Fund Forum (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.

37. Some key highlights from their quarterly engagement report (Oct to Dec 18) were:-

- LAPFF raises the stakes and calls for a shareholder resolution at Ryanair
- AGM attendance raises operational risk of joint ventures in relation to Samarco dam
- Affordability and climate risk strategy explored in meetings with construction firms and housebuilders
- Regulatory and other challenges of plastic waste and pollution addressed with consumer goods and packaging companies

38. Through LAPFF, the Fund engaged with 95 companies during the quarter on issues ranging from human capital management and Board composition to climate change reporting and sustainability. Most engagements concerned shareholders rights. Two engagements led to a change in process and eight engagements led to a moderate / 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 7 and is also available on LAPFF’s website together with the previous quarterly engagement reports. : [lapff qrtly-engagement-reports](#).

### **Stewardship in Investment Pooling**

39. 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.

### **LGPS - Statutory guidance on asset pooling informal consultation**

40. The Ministry of Housing, Communities and Local Government Minister (MHCLG) have issued new statutory guidance on LGPS asset pooling (Appendix 8). This will set out the requirements on administering authorities, replacing previous guidance, and builds on previous Ministerial communications and guidance on investment strategies.

41. Views have been invited on the attached draft guidance. This will be an informal consultation with interested parties only, including the Scheme Advisory Board (SAB), Pensions Committees, Local Pension Boards, the pool Joint Committees or equivalent, the Cross Pool Collaboration Group, the pool operating companies where owned by participating funds, CIPFA and ALATS. The consultation will remain open for 12 weeks and will close on 28 March.

42. LGPS Central Partner funds are sending in a combined response as well as individual partner fund responses. Our response is attached at Appendix 8 for comment by the Committee.

**43. Please note that Appendices 4, 5 and 6 contain exempt information (on salmon pages) and should members wish to discuss the information included in these Appendices they would need to consider passing the appropriate resolution and moving into exempt session.**

## Contact Points

### County Council Contact Points

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### Specific Contact Points for this report

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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)
- LGPS Currency Hedging Executive summary (Appendix 4) **(Exempt Information – Salmon pages)**
- Venn Due Diligence report (Appendix 5) **(Exempt Information – Salmon pages)**
- Active Global Equities Mandate presentation (Appendix 6) **(Exempt Information – Salmon pages)**
- LAPFF Quarterly Engagement Report October to December 2018 (Appendix 7)
- LGPS Statutory guidance on asset pooling informal consultation Worcestershire County Council Pension fund response (Appendix 8)

## 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 28 November 2018