worcestershire countycouncil

AGENDA ITEM 7

PENSIONS COMMITTEE
21 JUNE 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 that River & Mercantile will provide on the currency hedging options required for the specific US Property Debt Walton Street Fund II investment within the Management fee for the existing Equity Protection Mandate be noted;**

   d) **The outcome of the due diligence meetings relating to the active Emerging Market investments (Exempt Appendix 4) and that steps will now be taken to transition these funds to the LGPS Central Global Emerging Markets Fund be noted;**

   e) **The outcome of the due diligence conducted relating to the Active Corporate Bonds mandate (Exempt Appendix 5) be noted and that the transition into the LGPS 'Global active Investment Grade Corporate Bond Fund be agreed;**

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

   g) **The Equity Protection current static strategy be extended to mid 2020 in order to protect employer contributions and provide certainty to the Actuary that the Equity Protection is in place when the actuary certificate has to be signed off;**

   h) **The Chief Financial Officer be granted delegated authority in consultation with the Chairman of the Pensions Committee to explore static strategy options as to whether more upside participation can be implemented over this period without giving up too much downside protection;**

   i) **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;**

j) **The update on Responsible Investment activities and Stewardship investment pooling be noted (Appendix 7);**

k) **LGPSC compile and vote on invested shares on the Funds behalf in line with the LGPSC Voting principals *(*Appendix 8, 9 and 10*);* and**

l) **The development of a Climate Risk Monitoring Platform (Appendix 11) 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 Advisory Panel (Appendix 1).

JP Morgan Emerging Markets

4. JP Morgan reported an underperformance of -0.5% (7.4% v. 7.9%) over the quarter. The cumulative effect of four poor quarters has hit their performance badly against their benchmark over one year, now behind by -6.5% (-4.7% v. 1.9%).

5. This scale of underperformance has continued to have a clear negative impact on their three year performance against target, now -1.9% annualised. Since inception they have slipped further behind target, at -1.6% against their performance requirement.

6. Stock selection had a negative impact on performance in Q4, country allocation was positive.

7. Given the imminent transition to the new management arrangements with LGPS Central, some reflection on the history of this mandate is to some degree inevitable. Since inception in December 2011 the deliberate value bias of this portfolio has been out of favour and has therefore struggled in performance terms versus managers with more of a growth style. The decision to appoint two managers with contrasting styles was sensible at the time, and to some degree the fact that LGPS Central have chosen to appoint three Emerging Market managers vindicates that, beyond the desire to avoid manager concentration risk. We have always struggled to compare JP Morgan's performance against managers with similar style characteristics, due to the lack of them. Pooling provides a new opportunity.

JP Morgan Corporate Bond

8. JP Morgan reported an outperformance of 0.6% (4.7% v 4.1%) in Q1 2019 against their benchmark. Their performance against benchmark over the last 12 months has

sneaked back into positive territory at 0.1% (3.3% v 3.2%), however that is still well behind their performance target.

9. Relative to their performance target, they are behind by -0.5% over three years, and -0.4% over ten years, which is an improvement. It is likely that this fund will transition to mandates provided by LGPS Central which are explained further in this report.

Property and Infrastructure Commitments

10. The Committee have previously agreed to allocate £27m to Walton Street Fund II a US Property Debt Fund and at the last meeting agreed to 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.

11. Discussions have been held with River and Mercantile who currently provide our Equity Protection strategy who have the facility to implement this type of currency hedging option. We are pleased to announce that River & Mercantile have agreed to provide this facility at no extra cost to the management fee currently being charged for the Equity Protection Strategy. Changes are currently being made to the Investment agreement to implement this facility.

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

Active Emerging Markets

12. 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 £356.1m as at the end of March 2019.

13. The Pensions Committee in March agreed to the transition the existing active emerging market equities to the LGPS Central AGEM subject to this due diligence taking place. If there were 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.

Due Diligence undertaken

14. There was an initial interview with LGPS Central on the 5 April 2019 to understand the investment objectives and processes that had taken place and further individual meetings with the 3 appointed managers on the 25 April 2019 and the 8 May 2019. An invite from WPF was made to all partner funds. Derbyshire had conducted their own due diligence via conference call and West Midlands Pension Fund joined us for this process.

15. A detailed update from these due diligence meetings was provided to the Pensions Investment Sub Committee on the 11 June attached as Exempt Appendix 4.

Overall Management Fees

16. The Management fees are in the region of 37bps compared to the 65 to 69bps we pay at the moment so an estimated saving based on the existing Assets under management of approximately £1.1m per annum. However the transitions costs will need to be taken into account before any real ongoing savings are achieved.

Overall Conclusion

17. Based on the 3 interviews with the fund managers and the interviews with LGPS Investment Directors on the 5 April it was concluded that the existing Active Emerging Market funds with JP Morgan and Schroder's be transitioned into the LGPS Global Emerging Markets fund. This was discussed and agreed with the Chair of the Pensions Investment Advisory Panel.

Corporate Bonds

18. Pensions Committee in March were informed that the next potential transition is likely to be the existing active corporate bonds mandate currently with JP Morgan with an existing value as at March 2019 of £145.8m. The mandate being proposed by LGPS Central is a 'Global active Investment Grade Corporate Bond Fund. A rigorous process similar to that of the AGEMS above was detailed in a report (Exempt Appendix 5) to the Pensions Investment Sub Committee on the 11 June 2019 to appoint 2 fund managers being Fidelity IL Pension Management and Neuberger Berman (Europe) Limited.

Due Diligence

19. As part of the necessary due diligence all partner funds had the opportunity to meet and interview the 2 fund managers at a Partner Fund Investment Working Group on the 16 May 2019. Our Independent Investment Advisor also attended.

20. Based on the evidence provided in the presentation Exempt Appendix 5 and the meetings with the 2 fund managers with all partner funds and their advisor, the Pensions Investment Sub Committee agreed to the transition the existing Active Bonds mandate with JP Morgan to LGPSC Active Bond mandate and that this be forwarded to Pensions Committee on the 21 June for final consideration and agreement

Overall Management Fees

21. The Management fees are in the region of 8.3bps compared to the 17bps we pay at the moment 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 taken into account before any real ongoing savings are achieved.

22. 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.

Estimated Funding Levels

23. 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)

24. 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 March Committee showed that the fund was estimated to be 94% funded (on a like for like basis) with a deficit of £182m as at the end of January 2019.

25. The Actuary provided a very initial 2019 valuation updated for discount rate assumptions, life expectancy trends, data quality etc, which have still to be finalised. The estimated funding levels March 2019 were to 92% with a deficit of £245m. Further work is ongoing and a report on the updated position will be provided in October.

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

	Mar-16	Mar-18	Aug-18	Oct-18	Dec-18	Jan-19	Mar-19
Assets £'M	1,952	2,701	2,823	2,708	2,650	2,699	2,795
Liabilities £'M	2,606	2,794	2,842	2,861	2,871	2,881	3,040*
Surplus (-) / Deficit	**654**	**93**	**19**	**153**	**221**	**182**	**245**
Estimated Funding Level	**75%**	**97%**	**99%**	**95%**	**92%**	**94%**	**92%**

** Note this is based on the initial estimated liabilities by the actuary on what the next triennial review will be based and will be subject to change*

Triennial Valuation 2020/21 to 2022/23 and Equity Protection considerations

26. 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.

27. As part of a strategy meeting with the Actuary on the 15 May 2019 discussions were held concerning the Equity Protection Strategy

28. The actuary provided a specific paper on the 'impact of Equity Protection on contributions'. River & Mercantile were in attendance along with the Funds Independent Investment advisor.

29. This emphasised that the Fund had implemented an equity protection strategy as at the 31 March 2018 for a specific reason; to protect from the risk of falls in the investment markets leading to deterioration in the Pension Fund's funding position with consequent increased contributions at the next valuation.

30. Given the expiry date, it was felt a good time to review whether the current structure should continue or whether an alternative long term approach should be adopted. A number of potential strategies were considered:

a) We no longer require the protection strategy, and the options are left to expire and not renewed;
b) The same static strategy is renewed;
c) A different static strategy which offers different downside protection and upside potential is adopted; and
d) A longer-term dynamic strategy is better suited to the Fund's objectives.

31. The paper provided by the Actuary considered these options for a number of different market scenarios to illustrate the impact competing structure have on contributions. It also provided a more in depth analysis of the static approach (protection for a certain fixed length of time) and dynamic approach (a longer term tool to control equity downside risk).

32. The caveat to all this was that the Actuary believes 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.

33. In discussions it was felt that there were a number of aspects to consider being:

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 has 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 similar to 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.

34. This was discussed and agreed with the Pensions Investment Sub Committee on the 12 June 2019 and were asked to recommend to Pensions Committee that:

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

Strategic Asset Allocation

35. 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 83.1% (83.2% in December 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

Fund as at the 31 March 2019			Strategic Asset Allocation targets	
Asset Class	Portfolio Weight		Asset Class	Portfolio Weight
Actively Managed Equities	**27.3%**		**Actively Managed Equities**	**20.0%**
Far East Developed	14.3%		Far East Developed	10.0%
Emerging Markets	13.0%		Emerging Markets	10.0%
Passively Managed Equities – Market Capitalisation Indices	**31.5%**		**Passively Managed Equities – Market Capitalisation Indices**	**40.0%**
United Kingdom	13.8%		United Kingdom	23.5%
North America	11.3%		North America	9.0%
Europe ex UK	6.4%		Europe ex UK	7.5%
Passively Managed Equities – Alternative Indices	**15.3%**		**Passively Managed Equities – Alternative Indices**	**15.0%**
Global			Global	15.0%
Equity Protection	**8.9%**			
Fixed Interest	**5.9%**		**Fixed Interest**	**10.0%**
Actively Managed Bonds & Corporate Private Debt	5.9%		Actively Managed Bonds & Corporate Private Debt	10.0%
Actively managed Alternative Assets	**11.1%**		**Actively managed Alternative Assets**	**15.0%**
Property	5.1%		Property & Infrastructure	15.0%
Infrastructure	6.0%			
TOTAL	**100.0%**		**TOTAL**	**100%**

Responsible Investment (RI) Activities

36. 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

37. 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)

38. 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.

39. Some key highlights from their quarterly engagement report (Jan to Mar 19) were:-

- Ryanair Chair commits to standing down in 2020 after prospect of shareholder resolution by LAPFF
- Auditing, Reporting and Governance Authority(ARGA) to replace FRC after LAPFF consultation contribution acknowledged
- LAPFF part of investor group leading to Shell's proposal to include carbon reduction metrics in executive remuneration
- LAPFF joins investors calling on Facebook, Google and Twitter to strengthen controls on streaming of objectionable content following the Christchurch shooting
- LAPFF calls for tech company IPOs to adopt the principle of one share, one vote.
- The Forum joins investors in calling for the 20 largest carbon emitting utilities companies based in the US to commit to achieving net-zero carbon emissions by 2050
- LAPFF takes role of liaising with affected communities in investor tailings dam initiative.

40. Through LAPFF, the Fund engaged with 104 companies during the quarter on issues ranging from human rights climate change, environmental issues, reporting and sustainability. Most engagements concerned human rights. One engagement 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 6 and is also available on LAPFF's website together with the previous quarterly engagement reports. : lapff qrtly-engagement-reports.

Stewardship Code

41. Our Stewardship code has received approval from the Financial Report Council and is currently on their website.

Stewardship in Investment Pooling

42. 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 31 December 2018 is currently available.

Stewardship Themes

43. 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 are detailed in Appendix 7. The RIWG aim is to formulate objectives and plans for each of the four themes by the end of June 2019.

Voting Decisions
44. Currently LGPS Central compiles and votes the shares for West Midlands Pension Funds voting records (via LGPS Central contract with Hermes EOS). This is also used to the LGPS Central reports.

45. It is felt that this would be beneficial for Worcestershire Pension Fund, but would mean taking the voting decisions away from our active fund managers and having the votes executed in line with LGPS Central's Voting Principles (See Appendix 8). Given we are looking to transition our Emerging Markets mandates to LGPS Central who would then deal with our voting records, this would only leave our Mandate with Nomura.

46. Discussions have been held with Michael Marshall the LGPSC *Director of Responsible Investment & Engagement and there would be no extra cost to the Fund. If agreed then the first report on our voting records would be available for the October Committee. The report provides a*

- Donut charts for how votes have been cast in different markets (example attached Exempt Appendix 9), covering all portfolios in scope
- Table of vote-by-vote disclosure for full transparency (example Exempt Appendix 10 attached).

47. *It is recommended that the Pensions Committee agree that LGPSC compile and vote on the Funds behalf in line with the LGPSC Voting principals*

<u>Development of a Climate Risk Monitoring Platform</u>
48. The partner fund Responsible Investment Working Group and LGPS Central are proposing to develop a Climate Risk Monitoring Platform. 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

49. Appendix 11 provides a presentation that was provided detailing the steps to develop this platform. Pensions Committee will be updated as this develops.

Responsible Investment Conference
50. LGPS Central are providing a Responsible Investment Conference on the 9 July 2019 in Birmingham and all members of the Committee, Investment Sub Committee and Board have been invited

51. **Please note that Appendices 4, 5, 7,9 and 10 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
County Council: 01905 763763
Worcestershire Hub: 01905 765765

Specific Contact Points for this report
Rob Wilson
Pensions Investment, Treasury Management & Capital strategy manager
Tel: 01905 846908
Email: RWilson2@worcestershire.gov.uk

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)
- Active Global Equities Mandate presentation (Appendix 4) **(Exempt Information – Salmon pages)**
- Active Corporate Bonds presentation (Appendix 5) **(Exempt Information – Salmon pages)**
- LAPFF Quarterly Engagement Report October to December 2018 (Appendix 6)
- Stewardship Themes (Appendix 7) **(Exempt Information – Salmon pages)**
- LGPSC Voting principals (Appendix 8)
- LGPSC Voting report examples (Appendix 9 and 10) **(Exempt Information – Salmon pages)**
- Climate Risk Monitoring Platform (Appendix 11)

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 19 March 2019