
Worcestershire County Council Pension Fund – Benchmark Discussion

As the Fund has evolved and given its current manager structure and associated benchmarks it has been noticed that a small number of them should be reviewed. This review considers three of them:

The three benchmark items for discussion are as Follows:

1. The weighting to the UK equity benchmark allocation is the sum of 17% minus the property and infrastructure weight in excess of 20%. This can result in the equity benchmarks being under the expected strategic weight with resulting in an impact of the Total Fund benchmark return.
2. The inflation plus absolute return benchmarks (there are two used in the Fund) sum to more than 15% as of June 2023. It should be noted that as of March 31 the benchmark return for RPI was 13% for the year and that the asset class underperformed it. Please note that only the Infrastructure benchmark is part of the Total Fund benchmark. As this was unexpected it is appropriate to review it and consider other options.
3. The property benchmark (due to a large fee being charged by MSCI) needs to be reviewed. It only accounts for 60% of the Total Property Asset class benchmark and less than 5% of the Total Fund benchmark. Two options are considered, using an Absolute Return Target only (as used on the underlying Property Funds, or substituting the MSCI UK Monthly Property Index with the FTSE EPRA Nareit Developed Europe Index.

If any of the changes are implemented it should be noted that the Fund strategy and investment management structure and future investment funding is expected to remain unchanged.

Additionally, the benchmark options, if implemented would be expected to have a limited impact on the overall Fund benchmark return. Please note that the purpose of the Fund benchmark and the constituent manager benchmarks is to provide:

- An objective comparison for each of the portfolios and as such should reflect the objectives and long-term investment goals of the various portfolios and asset classes.
- At the asset class and Total Fund level to also provide a comparative risk and return assessment of the Fund strategy and investment return targets of the Fund.
- It should be the drivers to Fund allocation, results and objectives of the Fund that should be key to the Fund and the benchmark structure should be a support measure for those functions.

UK Equity Weighting in The Total Equity and Total Fund Benchmarks

Within the Total Fund benchmark the UK Equity benchmark weighting is determined by a calculation including the current benchmark weights of Property and Infrastructure as follows:

- The strategic asset allocation to UK equities in the Total Fund benchmark is 17%; this is a component of the 70% strategic weight to equities.
- The combined strategic weight to Property and Infrastructure is 20%.
- The strategic benchmark weight to Property and Infrastructure is the sum of the underlying actual portfolio weights i.e. there is no overweight / underweight position due to the holdings in the Fund from these two asset classes.
- Any excess over / under the 20% allocation in the allocation to property and infrastructure (8% and 12% respectively – although this must be confirmed) is deducted / added to the UK equity strategic benchmark weight.

- A minor point is that the benchmark return of the Fund cannot be determined until the results of the Fund's investments have been calculated for each month. This is quite unusual and may slow down the production of performance reporting.

This policy was decided a number of years ago when the property and infrastructure asset classes were subject to large contributions.

The result of this has been:

- That the allocation to UK equities in the benchmark has been significantly less than 17% since mid-2022 (prior to that it was overweight); as of the end of June 2023 the weight to UK equities in the Total fund benchmark was 13.4% and the overall weight to equities was 66.4%, more than 3% underweight the Total Equity strategic benchmark weight.
- There are no asset allocation attribution contributions from property or infrastructure because the overweight position is neutralised by using the invested weights in the Fund as the benchmark weights. This results in the overweight position to these asset classes is not reviewed.
- The asset allocation attribution contributions from UK equities will have been under / overstated.

The return of the Total Fund benchmark and Total equity benchmark will have been impacted to some degree (in effect the benchmark has been underweight UK equities and overweight property and infrastructure. An approximate calculation if the 17% weight for UK equities and 20% weight for Property and Infrastructure) would have increased the Total Fund benchmark return by 5 – 15 bps.

It should be noted that this approach to Fund benchmark construction is rare.

Whilst this position could be reversed by market movements it is unlikely given the Funding being invested in Alternative assets by the Fund. Therefore, the Fund may wish to consider fixing the weights to accurately reflect the strategic benchmark and rebalance when appropriate. The options are numerous:

- A review of Fund results coupled with a review of expected drawdowns could be implemented annually (or half yearly or quarterly) and the Total Fund benchmark amended accordingly.
- Establish automatic rebalancing points that are mechanistic and triggered when allocation limits are exceeded.

The key to both these approaches is to include the impact of market movements in the process. If market movements are the cause to rebalancing this will generate more benchmark volatility and more administration. Therefore, the expected value of drawdowns and distributions should be monitored in respect of the benchmark structure.

The timeline for review is not urgent but it should probably be completed by the end of the financial year (it would also be possible to back date it until April 2023).

Impact of RPI on Benchmark Returns

For the year ending March 2023 CPI and RPI were 10% and 13% respectively. For portfolios and asset classes that had these measures as part of their benchmark structure the impact would have been significant. Within the Fund this impacts only two benchmarks:

- AEW Property Fund whose benchmark is UK RPI +4%. This portfolio has significantly underperformed to a level that implies that it is not just because of the benchmark. Please note that its weight within the Fund was only 0.5% as of June 2023, it is not part of the Total Fund benchmark. Within the benchmark RPI was 13% for the year ended March 2023.

- Total Infrastructure Asset Class whose benchmark is 70% UK CPI +5.5% plus 30% Absolute Return of 10%. For the period ended June 2023 the benchmark had a return of 12% and for March 2023 13%. The asset class has underperformed by -0.3% and -2.3% respectively. Please note that its weight within the Fund benchmark was 15.3% as of June 2023. Within the benchmark CPI was 10% for the year ended March 2023.

As would normally be expected it is appropriate to review benchmarks in times of unusual stresses. It should be noted that the average 12-month growth rate of the CPI between 1950 and 1988 was 6.4%, while the average between 1989 and April 2022 was 2.5%. CPI has now dropped to below 5%. For the year ending March 2023 the level of inflation was a considerable outlier.

Usually with unusual movements in markets (e.g. stock market crashes) the Fund will 'weather' the results, this is partly due to the both the portfolios and the benchmarks are impacted. In this instance only the benchmark is impacted as the correlation between the assets and the benchmarks is less than in other asset classes.

The options available to the Fund are numerous and include:

- Leaving the current structure as is with the expectation that the asset class returns, over the long term, will 'catch-up' as inflation returns to a more expected level i.e. treat the results as an anomaly and that the rationale underpinning them is still relevant.
- If it is considered that CPI / RPI may increase significantly or that recent events were outside of the expected parameters when the CPI / RPI benchmarks were selected it may be appropriate to cap them, for example at 7% per annum. This could be considered if these benchmarks are still considered relevant comparators to the portfolios being considered.
- Review CPI and RPI benchmarks to determine if they are still relevant as comparators.

As regards implementation the timeline for review is not urgent but it should probably be completed by the end of the financial year (it would also be possible to back date it until April 2023).

Total Property Benchmark

Currently the Property asset class benchmark consists of a blended benchmark of 60% MSCI UK Monthly Property Index and 40% of an Absolute Return Target of 7.5%. When reviewing the composition of the property investment funds of the Fund the following should be noted:

- Of the nine property portfolios eight are evaluated relative to an Absolute Return Target of between 5.5% and 9% per annum. The remaining portfolio is evaluated relative to a UK RPI plus an Absolute Return Target of 4% per annum.
- The Fund maintains a diversified property portfolio that consists of UK Property Funds, European and US Property Funds.
- The Fund also invests in some specialist property vehicles such as Forestry Funds, and Property Private Debt Funds.
- No property portfolios of the Fund are monitored versus the MSCI UK Monthly Property Index.
- The MSCI UK Monthly Property Index is just less than five percent of the Total Fund benchmark.
- The MSCI UK Monthly Property Index is a benchmark that has a market capitalisation of approximately £27,000 million and monitors assets of 34 portfolios and 1445 properties. It consists of predominantly UK assets. I have attached a recent factsheet for this benchmark. It is clear that the composition of it has little resemblance to the composition of the Fund, both in terms of geographical and asset group diversification.

It has been identified that the Fund will have to pay a significant fee to continue to use the MSCI Property Monthly Index, or any other MSCI Property benchmark such as the MSCI Property Quarterly Index (this also has a problem as it is not usually finalised by the time WCCPF receives its quarterly report).

This has led to a review of alternative property benchmarks available to the Fund. As a general observation there are no real direct UK property benchmarks other than MSCI available in the UK. There are two alternative options available to the Fund:

1. Have the Property Asset Class benchmark consist of, like the underlying property portfolios, and Absolute Return Target Only. This will be consistent with the underlying portfolios but have no allocation to a property asset benchmark.
2. An alternative to replace the MSCI Monthly Property Benchmark is the FTSE EPRA Nareit Developed Europe Index. This is available from the new investment performance monitoring provider. I have attached a recent factsheet from FTSE about this index. It consists of Real Estate Investment Trusts (REITs) and Real Estate Holding & Development companies. It is available at the end of the day in GBP sterling.

The Index consists of 107 portfolios incorporating assets from a broad range of European countries. The following should be noted:

- It appears to have underperformed the MSCI Property Index over the 1 year, 3 year and 5-year periods ended 31st December 2022 (this may need more analysis).
- It is more volatile than the MSCI Property Index largely due to the daily valuation of these assets on the stock market, the correlation to other equity assets and the lagged nature of the property valuations in the MSCI Property Index.

If the Fund decides to change the Property Benchmark of the Fund this should be completed before the production of the investment performance report for the 30th September 2023.

Conclusion

There is considerable scope for movement due to the options available on all three topics being considered; however, at this time further discussion is required.

Please note that all numbers, comments, and ideas contained in this document are for information purposes only and as such are not investment advice in any form. Please remember that past performance is not a guide to future performance. the property valuations in the MSCI Property Index.