

BATH AND NORTH EAST SOMERSET

AVON PENSION FUND COMMITTEE INVESTMENT PANEL

EXEMPT MINUTES OF THE MEETING OF WEDNESDAY, 8TH MARCH, 2023 AVON PENSION FUND COMMITTEE INVESTMENT PANEL

Minutes of the Meeting held

Wednesday, 8th March, 2023, 1.00 pm

Bath and North East Somerset Councillors: Shaun Stephenson-McGall (Chair) and Paul Crossley

Co-opted Voting Independent Members: John Finch and Pauline Gordon

Advisors: Steve Turner (Mercer) and Nick Page (Mercer)

Also in attendance: Nick Dixon (Head of Pensions), Liz Woodyard (Group Manager for Funding, Investment & Risk), Nathan Rollinson (Investments Manager) and Jeff Wring (Service Director - Commercial and Governance)

38 EMERGENCY EVACUATION PROCEDURE

- Due to the weather conditions (snow) on the day of the meeting the Panel reverted to meeting informally via Teams to discuss the reports within the agenda.
- Therefore, no evacuation procedure was required to be announced.

39 DECLARATIONS OF INTEREST

There were none.

40 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

Apologies had been received from Councillor Chris Dando and Jackie Peel.

41 TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

The Chair announced that two additional reports would be discussed by the Panel in addition to those reports already included in the agenda pack.

- Risk Management Review – Investment Panel Brief
- Investment Strategy Review: Equity Portfolio – Active vs. Passive

Risk Management Review – Investment Panel Brief

Steve Turner, Mercer addressed the Panel and introduced the report. He explained that they had put together a draft scope and a number of exam questions that they

were proposing the Panel to investigate. He said that they would work with the Panel on the review and then ultimately the Panel would make a recommendation to the Committee.

Nick Page, Mercer added that the timings of that recommendation were still to be decided, potentially it could be made in June, but maybe it would be part of the Q3 meetings. He added that the brief was looking at should the Fund continue with the risk management framework and all the various components.

He said that they would be looking at the risk management framework as a whole at first, what risk exposures there are within the fund and how we are trying to manage those. He added that they will also look at what risk reductions are coming through at the moment from each component and link in with Paul Middleman as the Scheme Actuary to get more from the funding side.

He explained that there would be two questions and that these two questions would apply for each component.

Liability Driven Investment (LDI) – (1) Should the Fund continue with leveraged LDI? We can examine the benefits, drawbacks, the costs and the gain. He said he also thought it would be quite helpful to see what the whole fund could look like without leveraged LDI, where could some of the collateral be freed up and where could that be put to use - is there an alternative way to almost deliver the risk return profile that we have got now?

(2) If the decision is to continue, what should the hedge ratio be?

Equity Protection Strategy – (1) Should the Fund continue with equity protection?

(2) If the decision is to continue, what should the hedge ratio be?

Currency Hedging Strategy – (1) Should the Fund continue with currency hedging?

(2) If the decision is to continue, what should the hedge ratio be?

The Head of Pensions commented that if the Panel were to look back at LDI since its inception, clearly the purpose was to deliver a tighter alignment between assets and liabilities. He asked if it was possible for the Panel's benefit to show the movement of assets and liabilities observed since inception and then to show those movements if we hadn't had LDI.

Nick Page replied that he felt it would be possible to produce figures over the last five years on a quarterly basis regarding this. He added that if this was likely to stay and continue, then it might be a good stat to include within the more regular monitoring reports as well.

Pauline Gordon commented that it would also be useful to see just how the prudence tracks and how different it would be. She added that she believed they were talking about around 0.25 versus 0 for the whole framework and it would be useful to see if we could tie in something around that as there would be a slight

difference in liabilities if we didn't have it.

Nick Page replied that he would need to think how they could do that, but agreed that it would be really useful. He added that they would try to work in both the asset side impact as well as the funding side impact.

The Group Manager for Funding, Investment & Risk commented that for a very significant period of that five years the interest rate hedging had only gone on in the last year and therefore wondered how that data could be shown.

Nick Page replied that the inflation hedge had just been quite high since inception, around 20 or 30% higher than the interest rate hedge. He said even though the interest rate had been pretty low, he expected the inflation to have had a benefit.

John Finch stated that setting the new triggers was important because having got to an ongoing funding position of currently 97% the one thing we do not want to do is lose that position, because that has a big impact on future employer contributions. He said that the view forward of where markets are going was really important to the Fund and how we put that into practice.

Nick Page replied that this could be built into the review.

The Panel concluded to ask the Committee to approve the brief at its meeting later in the month.

Investment Strategy Review: Equity Portfolio – Active vs. Passive

Steve Turner introduced the report and highlighted some key points from within it. He said that its purpose was to give members a flavour of the actual actively managed funds and the passive fund, that is referenced, that they have got currently. He added that they were also looking to provide a bit more evidence about the level of diversification that the Fund is getting from the current active portfolio.

He explained that on the actively managed portfolios with Brunel there are two.

- 1) Global High Alpha - A standard, high conviction unconstrained global equity portfolio. Looking to outperform developed market equities. So, there's no emerging market equities in the benchmark, but the managers can invest in emerging markets tactically.

He said that it has shown different patterns of performance over different market cycles and that they had found and this to be pretty consistent with Brunel funds. He added that this was primarily because of their emphasis on reducing risk from a climate change perspective, but they will have positive tilts to growth stocks.

- 2) Sustainable - Very similar expected styles to that of Global High Alpha. It is consistent with Brunel's climate change philosophy and we see that as being aligned to your climate goals as well. Both funds are looking to decarbonize over time with a 2050 net zero objective in mind.

He added that where the Sustainable does differ is that it has a completely different set of managers and the benchmark for the fund is slightly different in that it includes emerging markets. So, the opportunity set of the stocks that

the managers can invest in is slightly expanded.

He stated that looking forward, the passive fund that you would be investing in more was the Paris-aligned benchmark. He explained that it is managed by BlackRock and was index tracking, looking to invest in a portfolio of stocks that will systematically reduce their carbon exposure by 7% per annum in order to get to net zero by 2050.

He added that the number of stocks that you will invest in is considerably larger than the actively managed funds, so there will be a lot more diversification and a broader range of stocks across a more a greater variety of sectors.

He said that for the Sustainable Brunel Fund other managers named Jupiter and Mirova need to be added to the chart, but the main point is that there is no overlap in terms of the underlying managers used. So, in theory, there is a lot of diversity in thought and research going into the stocks that are being selected across these two funds.

He outlined the sector exposures and the broad pattern of being overweight on information technology and healthcare for example. He added that on other sector tilts they were pretty well aligned, with the overall growth and quality-based philosophy of the two strategies - they do overlap, but it was expected.

He spoke of some climate metrics within the report, specifically the WACI (Weighted Average Carbon Intensity) and informed the Panel this is a carbon metric that they have been subtracting for some years now for Fund. He said that for Global High Alpha it is actually pretty low around 50% greater reduction compared to the index and slightly surprising in that it's quite a bit lower than the Sustainable fund.

He said that the one distinction was that from an ESG perspective, Global High Alpha is more singularly focused on its carbon footprint, whereas the Sustainable fund is looking to invest in companies with a wider ESG and sustainability perspective.

He added that you get a sense of how High Alpha and Sustainable have done relative to the normal kind of market cap benchmark and you can see it's some way off and so that helps support one of the main arguments for moving to passive management and to get more consistency in performance relative to benchmark. He said that results of active management can be quite episodic and dependent on what's happening in the market, so we are just trying to get a bit more of a balance in terms of consistency.

John Finch said it was difficult to compare data over a relatively short time period and thanked the Investments Manager for sharing a further graph. He added that he supported the recommendation to reduce the active exposure.

Steve Turner commented that it was hoped that this would see less exposure to the inconsistency of active management and more reliability in the relative performance - a slightly more diversified approach, a more of a systematic way of decarbonization. He added that whilst this was the driving factor, a consideration was given to the potential reduction in fees of £1.1 million.

The Head of Pensions said that if the Fund does adopt this approach we should achieve similar growth rates and similar climate targets with a materially lower risk in the investment outcomes. He added that he thought that it was a very sensible proposal.

The Chair asked if we are now proposing to move from a 2/3 – 1/3 split to 50 / 50 when would it be appropriate to consider going to a 1/3 – 2/3 split in terms of 1/3 active and 2/3 passive. He said that he recalls someone at the full Committee also asking this if we think passive is better for so many other reasons.

Steve Turner replied that potentially this could be discussed at the next strategic review in three years' time. He added that he thought this would be good timeframe to see if Brunel can perform on a consistent basis.

John Finch said that presumably when we introduced the 2/3 - 1/3 split we didn't have the Paris aligned benchmark available, so therefore actually going more index weighting would not have helped the journey to decarbonization.

The Group Manager for Funding, Investment & Risk said that she thought the allocation we have is purely historical from changes that we've made over time, removing active UK equity and removing emerging markets and then deciding where to put it. She added that it's never been a case of we want to have a certain allocation to both.

John Finch asked where the Fund would take the money from to go into the passive fund, will we take it equally from High Alpha and Sustainable.

The Group Manager for Funding, Investment & Risk replied that it will depend on how much we have in the QIF as to what the actual allocation will be to the Paris-aligned managed by Brunel.

Pauline Gordon asked if it was known what this proposal does to our climate metrics.

Steve Turner replied that they were looking to do a refresh of those figures at some point and model it based on current position. He added they would also look at what does the future trajectory look like.

The Panel concluded to ask the Committee to endorse the proposal of a move to a 50/50 active/passive split as this was seen as appropriate. They noted that this would be expected to reduce costs by c. 0.05% or c. £1.1m p.a.

42 ITEMS FROM THE PUBLIC - TO RECEIVE STATEMENTS, PETITIONS OR QUESTIONS

There were none.

43 ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

There were none.

44 MINUTES: 25TH NOVEMBER 2022

These minutes will need to be approved at the next public meeting of the Panel.

45 REVIEW OF INVESTMENT PERFORMANCE FOR PERIODS ENDING 31 DECEMBER 2022

The Investments Manager introduced this report to the Panel. He informed them that Brunel performance on the listed equity side was positive over Q4, both in absolute and relative terms. He said that what really came through was the strong stock selection which offset the sector and style tilts that we've been discussing earlier today.

He said that with regard to the real assets and particularly on the property and the long lease component of the secure income portfolios, the pricing mechanisms of those funds used of have really started to reflect this kind of general rise in yields.

Referring to Appendix 1 he said that for the items that are rated amber the direction of travel is broadly positive, with the exception of the longer term overarching fund performance. He added that members will recall from the last meeting that they delegated to officers the switch from market cap equities in the QIF to Paris-aligned equities in the QIF and that they expect to be in a position to make this switch following the provision of the relevant tax advice which is due to be finalised by the end of March.

Steve Turner, Mercer stated that in terms of market background and our views, the key issue continues to be inflation and interest rates and in particular actions from the Federal Reserve (Fed). He said that he thought that where we are currently is that the global economy has almost been too resilient and it hasn't slowed down enough. He added that the Fed is clearly still concerned about inflation being higher than where it wants. He said that if needed to, based on the data, they would be prepared to start rising rates again by 50 basis points and ultimately holding them for longer.

He added that we think that the higher rates go, the more chance there is of a deeper slowdown. He said that if at the end of this year going into next year, the closer the interest rate gets to 6%, in the US in particular, that's where the trigger for us is in terms of the risks of slowdown. He said the market is actually projecting at 5.5% actually.

He said that hopefully inflation does come down on a structural basis everywhere and we see the Fed stop raising rates because that's the number one factor that's been influencing asset moves.

He stated that the funding level is estimated to have decreased marginally over the quarter to c.97%, as the assets contracted in value, outweighing the fall in the estimated value of the liabilities. It is estimated to be c.5% lower over the year to 31 December 2022.

He said that the Value-at-Risk decreased over the quarter to £1,184m due to the fall in absolute value of the Fund's assets and decreases in underlying volatility assumptions for the equity and credit assets.

Pauline Gordon asked if it could be explained why the risk decomposition looks very different in terms of rates and inflation between the end of the year and the end of September.

Nick Page replied that they have changed their inflation volatility assumptions to account for the fact that we think things are going to be a bit more volatile going forward, just as the central banks signal and the rate rises. He added that it's just an anticipation that inflation has probably not subsided as much as maybe we might have hoped. He said that it is probably looking bigger as well because of the quite small relative numbers, so even though it's 2.5 / 3 times bigger, the interest rates in absolute terms, it's not really moved that much, but the reason for the movement is around the inflation assumptions and inflation volatility assumptions.

Pauline Gordon asked why then the inflation risk had gone negative from being positive at the end of September.

Nick Page replied that they expected the inflation of real yields to be a little less volatile than fixed deals on their own. He added that the interest rate hedges would have been increased at the end of September already and then paused. He said that he would look into this point in more detail.

The Panel were minded to note the information as set out in the reports.

46 RISK MANAGEMENT FRAMEWORK REVIEW FOR PERIODS ENDING 31 DECEMBER 2022

The Investments Manager introduced the report to the Panel. He highlighted to them one point regarding the collateral adequacy requirements post volatility that were seen in September / October last year. He explained that guidance had been received from both the Central Bank of Ireland and the Pensions Regulator that they recommend a collateral buffer of anywhere between 300 and 400 basis points as being best practice for leverage risk management mandates such as the one that the Fund has in place. He said that at the end of December the Fund's collapsible buffer was just under 200 basis points, so BlackRock used their discretion to sell some of the passive equities that were held in the QIF and replaced that loss exposure synthetically. He stated that as a result of that the Fund's collateral buffer now is approximately 300 to 350 basis points.

He added he believed that the intention was to formalize the new collateral adequacy framework as part of this wider review of risk management over the coming weeks and months.

Nick Page addressed the Panel and set out the following points from the report.

- Funding level in December was around 97% - since year end we've seen growth markets perform better than maybe they did last year and yields up a little bit as well over the year.
- The trigger framework is currently paused as we discussed earlier and that will be reviewed as part of the LDI brief.
- Equity protection - over the year a positive performance.
- The volatility reduction from having the equity protection strategy was about 30%. We've seen considerable reduction in volatility, so it is all working as intended from our perspective on the equity protection.

He stated that Mercer are working on a new monitoring framework with BlackRock. He added that regulators are wanting Funds to target 3% to 4% within their risk management frameworks.

He said that at the last FRMG they discussed various proposals from BlackRock about how we can implement the collateral framework in light of the fact that BlackRock have improved how they calculate the headroom levels as well as trying to take into account all the different risks we now have within the risk management framework.

He added that based on the new collateral monitoring framework, the headroom level was about 2%, which is clearly under that 3 to 4% guidance range. Therefore, on 27th of February, BlackRock sold £210 million of the pooled equities and they put on synthetic exposure to an equivalent amount using the MSCI World Index - that action has improved the headroom level to around 3.4%, well within that range.

The Panel were minded to note:

- i) The performance of each of the underlying RMF strategies
- ii) That ongoing FRMG workstreams relating to the collateral adequacy and LDI trigger frameworks.

47 FORWARD AGENDA

The Group Manager for Funding, Investment & Risk introduced this report. She said that depending on the results of the local elections and whether there was a completely new Panel would to a degree dictate what reports are brought to the July meeting. She stated that the date was the 14th of July and if we have a pretty stable Panel, we will try and bring the review of the LDI Framework otherwise it would be September.

She added that other topic that the Panel will become much more involved with over the next 18 months will be the Local Impact Portfolio.

The Panel were minded to note the report.

The meeting ended at 2.10 pm

Chair(person)

Date Confirmed and Signed

Prepared by Democratic Services