Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**26 JUNE 2020**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 March 2020)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Annual Investment Review Appendix 3 – LAPFF Quarterly Engagement Monitoring Report Appendix 4 – Brunel update Exempt Appendix 5 – Pooling transition costs & savings update	

1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic aspects of the Fund's investments and funding level; and policy and operational aspects of the Fund.

1.2 This report contains performance statistics for periods ending 31 March 2020.

1.3 The report summarises the changes to the investment strategy approved in April 2020 (see section 7).

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to note:

2.1 **The information set out in the report and appendices**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund from 1 April 2020 will affect the 2022 triennial valuation. Section 4 of this report discusses the trends in the Fund's liabilities and the funding level.

4 FUNDING LEVEL

4.1 Using information provided by the Actuary, Mercer has analysed the funding position as part of the report at Appendix 2 (section 2). This analysis shows the impact of both the assets and liabilities on the (estimated) funding level. **It should be noted that this is just a snapshot of the funding level at a particular point in time.**

4.2 Key points from the analysis are:

a) The funding level fell from c.96% to c.84% over the year to 31 March 2020. The deficit was estimated to have increased sharply over the year, from £283m to £863m.

b) The decline in the funding level was driven by the sharp contraction in market prices experienced at the end of 1Q 2020; steady improvements in the deficit and funding level had been seen up to this point.

5 ANNUAL INVESTMENT REVIEW

5.1 This quarter Mercer has provided an annual investment review of the year to 31 March 2020 (see Appendix 2) rather than the normal quarterly performance report. The report discusses the impact of COVID-19 on investment returns and the short- and long-term outlook for various asset classes.

5.2 The purpose of this report is to inform the Committee as to how the strategy has performed over the last year, and to provide a summary of the outcomes of the 2019/20 investment strategy review.

6 INVESTMENT PERFORMANCE

A – Fund Performance

6.1 The Fund's assets decreased by £352m (c.6.4%) over the year ending 31 March 2020 giving a value for the Fund of £4,467m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and manager. Manager performance is monitored in detail by the Investment Panel. The Fund's investment return and performance relative to the benchmark is summarised below. The Fund's currency hedge detracted -1.1% over the year.

Table 1: Fund Investment Returns (Periods to 31 March 2020)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	-9.9%	-6.4%	1.0%
Avon Pension Fund (excl. currency hedging)	-8.6%	-5.3%	1.3%
Strategic benchmark (no currency hedging)	-11.1%	-6.3%	1.6%
Currency hedge impact	-1.3%	-1.1%	-0.3%

6.2 **Fund Investment Return:** Returns over the year were dominated by an exceptional level of volatility in the first quarter of 2020 arising from the COVID-19 pandemic. Developed market equities were down by 20% while emerging markets depreciated by 19% over the quarter. US and UK equities were down by 19.6% and 23.9% respectively. The yield on the US 10-year Treasury ended March at 0.7%, 1.21% below the previous quarter. In the UK, 10-year Gilts moved from a peak of 0.8% to end the quarter at 0.36%. Central banks around the world delivered a swathe of emergency measures and strove to maintain lending liquidity to avert a credit crunch. Fears over the impact of the virus pushed oil prices into freefall. The collapse was exacerbated by the start of a price war between Saudi Arabia and Russia. Over the 12-month period to 31 March 2020, Sterling depreciated by 2.6% against the US Dollar from $1.30 to $1.24. Sterling depreciated by 7.2% against the Yen and by 4.8% against the Euro, from €1.16 to €1.13.

6.3 **Fund Performance, exclusive of currency hedging, was -5.3% over the year versus a benchmark return of -6.3%. The relative +1.0% over the year is attributed to;**

a) **Asset Allocation:** Asset allocation contributed **0.8%** over the year, driven by an overweight to infrastructure and an underweight to UK equities versus the strategic benchmark.

Despite a large devaluation in LDI assets through the year, an underweight versus the benchmark allocation meant this was a lead contributor to the positive asset allocation.

b) **Manager Performance:** Active manager impact over the year was **0.2%.** Lead contributors included the Fund's overseas equities allocation and hedge funds. Conversely, the lead detractor was the multi-asset credit mandate.

Separately, the equity protection strategy contributed +0.6% as markets fell during the final quarter of the year and the strategy became more valuable.

6.4 **Currency Hedging:** The hedging programme is in place to manage the volatility arising from overseas currency exposure, in particular to protect the Fund as sterling strengthens and returns from foreign denominated assets reduce in sterling terms. The hedging programme detracted 1.3% over the quarter and detracted 1.1% over the year.

6.5 **Liability Risk Management Strategy Performance:** The liability risk management strategy seeks to 'lock in' to attractive levels of real interest rates to achieve increased long-term certainty of real returns. Any increase in the present value of the Fund's liabilities should be met with a subsequent increase in the value of the liability hedging component of the BlackRock Qualifying Investor Fund (QIF). Towards the end of the year a series of measures were taken to address the potential implications of the ongoing Government consultation on RPI reform. In order to pre-empt any devaluation in RPI linked assets the Fund revised its trigger framework. The Investment Panel will continue implementation work around the trigger framework when the new liability benchmark has been generated by the Fund's actuary. Over the year inflation expectations fell which drove negative absolute returns from the LDI mandate; -34.5% over the year.

6.6 **Equity Protection Strategy Performance (EPS):** The EPS expired in three tranches throughout Q120, protecting the asset value during the 2019 triennial valuation. Part of the strategy protected the Fund from the large downward move experienced in March, however this was not sufficient to offset the losses crystallised in the January and February expiries, where equity markets were above the level at which the Fund could participate in upside gains. Before the end of the period the EPS was renewed and extended to cover developed market and emerging market equity exposure for an intervening period while the Panel considers alternative equity protection strategies. The Fund has seen a material benefit having renewed the protection strategy in January and February when markets were at close to all time highs. This effectively reset the protection level at a considerably higher level than the previous protection strategy, meaning that following the fall in markets in March the protection was highly valuable at the end of the period.

6.7 **Collateral Management:** Collateral held in the QIF that is used to capitalise the risk management strategies remained within its prescribed parameters throughout the year to March and was sufficient to absorb the stress tests that are routinely carried out to ensure operational efficiency. To allow additional collateral to be raised when required, and in order to keep leverage within the QIF guidelines, the investment manager has discretion to sell down a passive equity fund and replace any lost equity exposure synthetically.

B – Investment Manager Performance

6.8 Under the Red Amber Green (RAG) framework for monitoring manager performance, the Panel consider updates on all managers not currently achieving Green status including progress on action points. Any change in the RAG status of any manager is reported to Committee with an explanation of the change. **There were no changes to manager ratings this quarter.**

6.9 Absolute returns over the year to March were adversely impacted by COVID-19 related market volatility. The Fund's equity mandates were most severely impacted, with UK active equity mandates incurring double-digit losses. The Fund's low carbon passive equity mandate saw a modest benefit versus the broad market-cap weighted index due to its relatively low exposure to oil & gas companies. The price of Brent Crude Oil fell 67% over the year. The only equity mandate to post a positive absolute return over the period was the Fund's dedicated global sustainable mandate, which benefitted from its holdings in preventative healthcare and technology companies. The DGFs benefitted from their low correlation with the equity market. Ruffer's equity and credit protection strategies insulated them from the two hardest hit asset classes in the final quarter of the year. The Fund's alternative investments in hedge funds, property and infrastructure also performed well in absolute terms over the year, although the impact of COVID-19 on some alternative investments including property and infrastructure is yet to be fully accounted for, leading a number of managers to attach 'material uncertainty clauses' to valuations. The only mandates to exceed their benchmarks over the year were the UK SRI and global sustainable equity mandates. On a longer-term basis, most investment mandates with a three-year track record delivered positive absolute returns, with the exception of the UK equity mandate and the LDI assets. Positive relative returns were generated by the Fund's core infrastructure manager. Detailed analysis of investment manager performance can be found at Appendix 2.

7 INVESTMENT STRATEGY

Summary of 2019/20 Investment Strategy Review:

7.1 The Fund undertook a review of its investment strategy in 2019/20 which considered, amongst other things, the impact of climate change on potential investment returns and the Fund's maturing cash flow profile. The outcomes of the review involved a number of asset allocation changes and the setting of specific climate change objectives resulting from evidence-based climate change modelling that was carried out as part of the review.

7.2 The overarching objectives relating to the climate emergency are:

a) Implement a $<2^{0}$C aligned portfolio by committing to net zero emissions by 2050 or earlier. This will be achieved by working with Brunel using the results of the industry wide project being undertaken to assess what each 2^{0}C asset portfolio will look like. Expect to review the findings in line with the global stocktake timeline in 2022/23.

b) Reducing the carbon intensity of the portfolio over time with the aim of being 30% less carbon intensive by 2022.

c) Invest sustainably so that we support a 'just transition' to the low carbon economy with the aim of investing at least 30% of the assets in sustainable and low carbon investments by 2025.

d) Use the Fund's power as a shareholder to encourage change. Financial markets and companies urgently need to adapt their activities to support the transition to a low carbon economy. Collaboration as part of Brunel Pension Partnership makes our influence more powerful as they manage a £30bn pool of assets. In addition, the Fund will independently support investor led initiatives such as ClimateAction100+ and Institutional Investors Group on Climate Change to increase pressure on companies and governments to align with the Paris goals. If engagement does not work ahead of the Paris Stocktake in 2023, we will consider selective divestment from laggard companies.

7.3 In light of the COVID-19 pandemic, Committee took advice from Mercer on the suitability of the proposed changes and, having agreed that the long-term assumptions and rationale for making the changes were still valid, approved the changes in April 2020. To account for potential short-term cash flow implications, it was agreed that the increased allocations to private market assets (detailed below) should be phased over the next two-year Brunel investment cycle. The main changes to the investment strategy include: -

a) Allocate 10% of total assets to Global Sustainable Equities, to be funded from the existing allocation to UK and Global Equities.

b) Increase the target allocation to Renewable Infrastructure from 2.5% to 5.0% of total assets and to commit only an extra 1.25% in 2020, to be funded from the existing allocation to Diversified Growth Funds.

c) Increase the target allocation to Secured Income from 7.5% to 10% of total assets and to commit only an extra 1.25% in 2020, to be funded from the existing allocation to Diversified Growth Funds.

d) Allocate 5% of total assets to Private Debt and to commit only 1% in 2020, to be funded from the existing allocation to Hedge Funds.

7.4 The revised asset allocations were approved by B&NES Chief Executive under urgent powers in April 2020.

Overview of Strategic Performance:

7.5 **Asset Class Returns:** Developed market equity returns over the last 3 years fell to 2.6% p.a., materially below the assumed strategic return of 8.1% p.a. on the same basis. At the end of March the three-year return from emerging market equities had fallen to -1.2% p.a.; against an assumed return of 8.7% p.a. Over the three-year period index-linked gilts returned 2.9% p.a. versus an assumed return of 2.2% p.a. The three-year UK property return of 5.6% p.a. fell just short of the assumed return of 5.75%. Hedge fund returns were positive over the three-year period at 3.7% p.a. but remain below the strategic return of 5.1%.

7.6 **Transition of Assets to Brunel Portfolios:** At 31 March 2020 Brunel directly managed 30% of the Fund's assets across its Low Carbon passive equity portfolio, its actively managed UK, Emerging Market and High Alpha equity portfolios and private markets portfolios. A further 20% of assets relating to the Fund's risk management strategies are governed by Brunel legal agreements.

7.7 **Private Markets Commitments to Brunel Portfolios:** At 31 March 2020 25.3% of the Fund's cycle 1 £115m commitment to Brunel's renewable infrastructure portfolio had been deployed and 20.1% of the Fund's £345m commitment to the secure income portfolio had been deployed. The pace of capital deployment in the infrastructure portfolio remains on track. Deployment in the secure income portfolio, specifically the long-lease property component, has been slow partly as a result of a protracted negotiation around a large UK-based asset, where terms have now been agreed in principle. Further delays to deployment are expected in long-lease property as underlying fund managers defer acquisitions as a result of the COVID-19 pandemic. The current best estimate suggests further capital will not be called until late 2020 for the long-lease property funds. The operational infrastructure element of the secure income portfolio continues to invest in line with expectation, where capital deployment has not been affected to the same extent as long-lease property.

8 BRUNEL UPDATE

8.1 Appendix 5 is the quarterly Brunel update. Following the transitions in 4Q19, the transition costs incurred and investment fee savings achieved have been estimated and are set out in Exempt Appendix 6.

9 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

9.1 As at 31 March 2020 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark. The Fund redeemed £25m from Loomis Sayles in January and a further £30m post period end to bring the Multi Asset Credit allocation further in line with its long-term 6% target.

Cash Management

9.2 Cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.

9.3 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies.

10 RESPONSIBLE INVESTMENT ACTIVITY

10.1 **Brunel Responsible Investment Activity:** Key RI achievements over the quarter included:

i. Brunel co-filed a shareholder resolution at Barclay's AGM. Following a series of engagements, which Brunel was actively involved in, Barclays announced an ambition to become a net-zero bank by 2050. In the absence of any short-term targets by Barclays, Brunel supported both the Barclays management resolution to become net-zero by 2050 and the shareholder resolution that called for Barclays to set and disclose targets to phase out its financing of fossil fuel companies where they are not aligned with the goals of the Paris Climate Agreement. The AGM took place post quarter end in May where the management resolution won near unanimous support from shareholders while the shareholder resolution won significant minority support, surpassing the 20% threshold where UK companies are required to consult with shareholders and explain the views received and actions taken publicly within six months.

ii. As a signatory to the United Nations Principles of Responsible Investment (UNPRI), Brunel are required to file an annual report disclosing how the organisation has performed against the PRI's industry-standard environmental, social and governance framework. Submission of this report will lead to an assessment and score that will enable stakeholders to evaluate Brunel's approach to RI and will provide useful insights on areas for improvement.

iii. Post period-end Brunel published their annual Responsible Investment and Stewardship Outcomes Report, acknowledging the significant contribution made by Avon alongside all Brunel client funds. The report gives an account of how Brunel have delivered against joint strategic responsible investment priorities through the year. The report is available on the Fund's website at the following address:

https://www.avonpensionfund.org.uk/brunel-pension-partnership-2020-responsible-investment-and-stewardship-outcomes-report

10.2 **Brunel Engagement Summary**: Over the quarter Hermes (Brunel's appointed voting and engagement provider) have engaged with 274 companies held by Avon in the Brunel portfolios on a range of 795 ESG issues. Environmental topics have featured in 25.5% of engagements, over 80% of which relate directly to climate change. Social topics featured in 19.7% of engagements, where diversity and human rights featured prominently. Of the 34.6% of Governance related engagements the majority of discussions revolved around executive remuneration. Strategy, risk and communication topics such as audit and accounting and cyber security featured in the remaining 20.1% of engagements over the quarter. Separately, Brunel joined several institutional investors, in sending letters to FTSE350 companies who have failed to comply with the UK modern day slavery act by publishing a modern day slavery statement, or who have not adequately disclosed. Human rights and modern human slavery will form a key part of Brunel's voting strategy in 2020.

10.3 **Stewardship Update:** During the quarter, the Fund's external managers undertook the following voting activity on behalf of the Fund:

Companies Meetings Voted:	361
Resolutions voted:	4627
Votes For:	4124
Votes Against:	418
Abstained:	46
Withheld* vote:	39

** A withheld vote is essentially the same as a vote to abstain, it reflects a view to vote neither for or against a resolution. Although the use of 'abstain' or 'withheld' reflects the different terms used in different jurisdictions, a 'withheld' vote can often be interpreted as a more explicit vote against management. Both votes may be counted as votes against management, where a minimum threshold of support is required.*

10.4 The Fund is a member of LAPFF, a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds. LAPFF's activity in the quarter is summarised in their quarterly engagement report at Appendix 3.

11 ANNUAL ASSURANCE ON CONTROL ENVIRONMENT OF 3RD PARTY SUPPLIERS

11.1 As part of the risk management process the Fund annually reviews the internal control reports (ICR) of the custodian and investment managers (and their administrators where relevant) and reports the findings to Committee. These reports are often designated SSAE16 or ISAE3402 reports, which states which set of standards are being reported against.

11.2 ICR reports describe the internal control environment of an organisation. The management of the organisation are responsible for identifying the control procedures which they consider appropriate to enable certain control objectives to be met. External auditors verify that the controls identified are in place and comment on whether the controls will achieve the stated objectives or not.

11.3 For the reports reviewed in 2019/20, with the exception of one legacy investment manager, in each case the external auditor's report stated that the controls were in place and achieved the control objective. As part of the process, officers discuss the significance of the internal control reports with investment managers and custodian on an on-going basis and follow-up any issues flagged in the reports. Two qualifications, noting a failure in the invoicing process and a lack of adequate review and suitability of non-standard client reporting were noted for one of the Fund's legacy managers. Following corrective action taken by the manager no further action was taken.

11.4 The ICRs of the pooled funds (and their administrators/custodian) and the Fund's custodian are also audited by the Fund's external auditor as part of the annual audit.

12 RISK MANAGEMENT

12.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset

Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. This report monitors (i) the strategic policy and funding level in terms of whether the strategy is on course to fund the pension liabilities as required by the funding plan and (ii) the performance of the investment managers. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

13 CLIMATE CHANGE

13.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and is addresses this through its strategic asset allocation to Low Carbon Equities, Sustainable Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

14 OTHER OPTIONS CONSIDERED

14.1 None.

15 CONSULTATION

15.1 The Council's Monitoring Officer and Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

Contact person	Nathan Rollinson, Assistant Investments Manager (Tel: 01225 395357)
Background papers	Data supplied by Mercer & SSBT Performance Services
Please contact the report author if you need to access this report in an alternative format	