Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**11 DECEMBER 2020**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 September 2020)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Fund Valuation Appendix 2 – Mercer Investment Performance Report Appendix 3 – LAPFF Quarterly Engagement Monitoring Report	

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 30 September 2020.

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 increased from 92% to 93% over the quarter to 30 September 2020. Based on investment returns and net cashflows into the Fund, the deficit was estimated to have reduced over 3Q20, from £420m to £376m.

b) The increase in the funding level occurred as the value of the assets rose by more than the present value of the liabilities over the period.

5 INVESTMENT PERFORMANCE

A – Fund Performance

5.1 The Fund's assets increased by £77m (1.9% net investment return) over the quarter ending 30 September 2020 giving a value for the Fund of £5,032m. 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 inclusive and exclusive of currency hedging and performance of the strategic benchmark are presented below, in absolute terms. The Fund's currency hedge contributed 0.8% over the quarter.

Table 1: Fund Investment Returns (Periods to 30 September 2020)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	1.9%	-0.2%	3.4%
Avon Pension Fund (excl. currency hedging)	1.1%	-0.9%	3.8%
Strategic benchmark (no currency hedging)	-0.2%%	-0.8%	4.4%
Currency hedge impact	0.8%	0.7%	-0.4%

5.2 **Fund Investment Return:** Global equity markets ended the quarter in positive territory. Developed markets were up 6.6% in local currency terms while emerging markets appreciated by 8.8%. US equities were the strongest performer driven mostly by growth technology stocks. The depressed energy sector weighed heavily on UK equities which depreciated over 3% per the FTSE All Share index. 10-year benchmark US and UK yields ended the quarter higher reflective of "risk-on" sentiment and credit spreads narrowed. Sterling appreciated against the US Dollar by 4.6% and by 2.3% against the Japanese Yen and was flat versus the Euro over the quarter. Further information on asset class performance can be at Appendix 2. Post period-end the US election result and a COVID-19 vaccine breakthrough sparked an equity market rally, pushing prices to all-time highs.

5.3 **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 added 0.8% over the quarter.

5.4 **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). Over the quarter, and in line with expectation, the value of the Fund's LDI portfolio increased slightly, mainly due to a small rise in implied inflation. The Fund's inflation hedge ratio was increased to 35% of assets in line with the recommendation agreed by Committee at its September meeting. Post period-end a response to the consultation on RPI methodology was published. The announcement on RPI reform clarified that the Retail Price Index (RPI) will align to the UK Consumer Price Index from 2030 and that there will be no provision for compensation to existing index-linked gilt holders. Following the announcement short-term inflation expectations rose due to sustained Brexit risk. A perceived lack of upcoming inflation linked bond issuance, which would create a supply and demand imbalance, pushed inflation expectations at longer maturities higher. With inflation risks to the upside persisting, Officers and Mercer will work with the manager to further increase the inflation hedge ratio of the LDI programme to the maximum allowable under mandate guidelines, under delegated authority.

5.5 **Equity Protection Strategy Performance (EPS):** The Fund's equity protection strategy declined in value over the quarter, as markets rose further from the protection levels in place. All regions of the equity protection strategy posted a positive market value at the end of the period, except for the US as underlying equity markets in this region moved significantly higher. An adjustment to the underlying regional make-up of the options was made during the quarter to ensure minimal mismatch between the protection strategy and the underlying physical equity exposure, where UK equities were exited to facilitate the transition to the Brunel Global Sustainable Equity portfolio.

5.6 **Collateral Management:** At the end of the period the manager sold down £290m of passive equity holdings held for collateral purposes in order to maintain a comfortable collateral position following the inflation hedge increase. This was viewed as a rebalancing exercise to reduce the Fund's overweight equity allocation; hence a decision was taken not to replicate the lost equity exposure synthetically.

B – Investment Manager Performance

5.7 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.**

5.8 Manager total returns over the quarter were positive for all assets, except for the UK equity mandates. Global and Emerging Market Equities performed strongly. The Fund's Hedge Fund mandate performed well, both in local currency and Sterling terms. Multi-Asset Credit strategies also performed well and the Fund's residual holding in its legacy DGF manager posted modest gains over the quarter. Property returns over the quarter were positive, noting that the Overseas Property mandate is lagged by one quarter. Valuation uncertainty persists in this asset class. Over the year, returns displayed a similar pattern with most asset classes posting positive absolute and relative returns, with the exception of property and core infrastructure. The 1-year relative underperformance in the core infrastructure mandate is partly a result of Sterling appreciating against the US dollar in the final quarter of 2019, before the Fund switched into a GBP share class. The relative underperformance is exacerbated by the managers 'cash+' benchmark. Over a 3-year period core infrastructure delivered significant value. Of the other mandates with a 3-year track record returns were mixed. The legacy DGF manager and MAC manager underperformed their cash benchmarks but posted c.3% and c.2% absolute returns, respectively. Detailed analysis of investment manager performance can be found at Appendix 2.

5.9 With Brunel now managing most of the liquid assets, officers and Mercer will revise the quarterly monitoring reports to reflect the new arrangements.

6 INVESTMENT STRATEGY

6.1 **Asset Class Returns versus Strategic Assumptions:** Developed market equity returns over the last 3 years were 9.4% p.a., ahead of the assumed strategic return of 6.8% p.a. used during the 2019/20 investment strategy review. The 3-year return from emerging market equities was 4.6%; below the assumed 3-year return of 8.3%. Over the 3-year period index-linked gilts returned 7.0% p.a. versus an assumed return of 1.6%. The 3-year UK property return of 3.2% p.a. lags its assumed return of 5.2%, due to continued recent uncertainty.

6.2 **Private Markets Commitments to Brunel Portfolios:** At 30 September 2020 34% of the Fund's cycle 1 £115m commitment to Brunel's renewable infrastructure portfolio had been deployed and 32% of the Fund's £345m commitment to the secured income portfolio had been deployed. The pace of capital deployment across both asset classes remains slow due to managers deferring acquisitions as a result of the pandemic. The current best estimate suggests further capital will not be called until late 2020 into March 2021 for the long-lease property funds. Capital calls are expected to resume sooner for the infrastructure portfolio as tactical opportunities are explored. The operational infrastructure element of the secured income portfolio has not been affected to the same extent as the long-lease property assets and the Fund's entire commitment of £94m to the underlying manager has been called. Post period-end capital calls were issued for the Fund's Cycle 2 commitments to the renewable infrastructure and secured income portfolios. The Fund will seek to increase Cycle 2 commitments at the next available opportunity in March 2021; increasing them in line with strategic allocations.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

7.1 £290m of passive equities were switched into gilts within the BlackRock QIF in order to reduce the Fund's overweight equity allocation and top up the collateral pool for the risk management strategies.

Cash Management

7.2 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.

7.3 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.

8 RESPONSIBLE INVESTMENT ACTIVITY

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

i. Brunel joined the Workforce Disclosure Initiative. The initiative calls for greater transparency on workforce policies and practices in companies' direct operations and supply chains. Brunel also joined the Good Work Coalition, which engages with companies on the importance of a real living wage and living hours.

ii. The Fund pledged its support, both via Brunel and in its own right, for an engagement initiative targeting marine microplastic pollution; a priority theme as outlined in the Fund's recently published Responsible Investing Annual Report.

iii. Policy Advocacy – Brunel supported calls for the UK Government to expedite the issuance of 'green gilts'. The first green sovereign bond will be issued in 2021 and the money raised by the bonds will be used to help fund projects to tackle climate change, build infrastructure investment and create jobs in the sector.

8.2 **Brunel Voting & Engagement Summary**: Federated Hermes engaged with 211 companies held by Avon in the Brunel segregated portfolios on a range of 606 ESG issues. Environmental topics featured in 28.9% of engagements, 78.9% of which related directly to climate change. Social topics featured in 21.0% of engagements, where human capital, human rights and diversity featured prominently. Of the 29.7% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 124 meetings (1,397 resolutions). At 57 meetings they recommended opposing one or more resolutions. Over 70% of the issues Hermes voted against management on comprised board structure and remuneration.

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

Companies Meetings Voted:	392
Resolutions voted:	4711
Votes For:	4107
Votes Against:	552
Abstained:	11
Withheld* vote:	41

** 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.*

8.4 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.

9 RISK MANAGEMENT

9.1 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.

10 EQUALITIES

10.1 A proportionate equalities impact assessment has been carried out using corporate guidelines and no significant issues have been identified.

11 CLIMATE CHANGE

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

12 OTHER OPTIONS CONSIDERED

12.1 None.

13 CONSULTATION

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

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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	