Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**26 MARCH 2021**
TITLE:	**INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 December 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 31 December 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 93% to 95% over the quarter to 31 December 2020. Based on investment returns and net cashflows into the Fund, the deficit was estimated to have reduced over 4Q20, from £376m to £272m.

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 £138m (3.2% net investment return) over the quarter ending 31 December 2020 giving a value for the Fund of £5,169m. 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 1.0% over the quarter.

Table 1: Fund Investment Returns (Periods to 31 December 2021)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	3.2%	2.9%	3.7%
Avon Pension Fund (excl. currency hedging)	2.2%	2.8%	3.8%
Strategic benchmark (no currency hedging)	4.5%	3.0%	5.0%
Currency hedge impact	1.0%	0.1%	-0.1%

5.2 **Fund Investment Return:** The prospect of vaccine rollouts and supportive geopolitical events drove growth assets higher across the board. Global equities returned 8.5% in sterling terms. The US lagged other developed regions returning just over 6%, while UK equities rallied over 12%. Over the year US equities generated the strongest returns into the high double digits benefitting from rapid growth in technology stocks, while the UK lagged due to its oil & gas and financials sectoral bias. Yields remained suppressed due to COVID-related central bank stimulus and credit spreads narrowed, indicative of the risk-on sentiment. Sterling appreciated against the US Dollar by 5.7%, by 1.3% against the Euro and 3.4% against the Japanese Yen. Further information on 4Q asset class performance can be found on page 8 of Appendix 2.

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 1.0% 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 the Fund's LDI portfolio provided a marginally positive return due to changes in inflation expectations. Post period-end the Fund's inflation hedge ratio was increased to c.45% of assets, following the outcome of the RPI reform consultation. This means that no further inflation hedging will be implemented even if inflation triggers are hit as the hedge ratio is now at the maximum allowable under mandate guidelines. The suitability of the current mandate guidelines will be factored into the annual review of the risk management framework, which is reported to Panel and Committee in September.

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. This detracted from the overall fund return over the quarter. Officers, acting on advice from Mercer, considered a tactical opportunity to restrike the protection levels given the significant increase in the underlying equity markets, which would allow further upside participation. Due to unattractive pricing and the potential losses incurred under a downside scenario, Officers agreed to take no action but to keep the prospect of closing out the structure ahead of time - and moving to a dynamic approach sooner - under review.

5.6 Post period-end Officers and Mercer reviewed counterparty banks shortlisted for the implementation of the dynamic equity protection strategy. Having assessed the banks across a broad set of criteria including cost, operational capability and client servicing, Officers and Mercer, under delegated authority, agreed to appoint three banks to minimise concentration risk. The final appointment of each bank will be subject to an independent legal review of key trade terms and documentation.

5.7 **Collateral Management:** At the end of the period the collateral position was within prescribed parameters. No breaches were reported during the quarter. The collateral tolerance increased following the sell down of £290m of passive equity holdings to coincide with the inflation hedge increase.

B – Investment Manager Performance

5.8 Brunel reports on the performance of the assets they manage on behalf of the Fund. Mercer continue to provide quarterly commentary and analysis of all the Fund's mandates and at the strategic total fund level. We are reviewing the quarterly reporting given that most of the assets are now managed by Brunel; Mercer's will continue to provide assurance, but the focus will be more strategic.

5.9 Manager total returns over the quarter were positive for all assets except for the overseas property mandate, noting that performance for this mandate is lagged by one quarter. The Fund's active equity portfolios marginally outperformed their respective benchmarks. The Hedge Fund mandate performed well in local currency terms as did the Multi-Asset Credit and Diversified Return strategies. Over the year, the Global High Alpha portfolio delivered significant outperformance, largely as a result of one underlying manager with a significant growth stock bias. The Emerging Market portfolio fared less well, underperforming the benchmark by 1%. There have been significant downward revisions to the values of some underlying overseas property assets over the year, however it is worth noting that the manger has delivered significant value on a since inception basis. Both the core infrastructure and overseas property mandates are affected by static benchmarks, which can magnify underperformance. Over a 3-year period core infrastructure and hedge funds delivered significant value, outperforming their respective benchmarks. The MAC manager underperformed its cash benchmark but posted over 4% in absolute terms. Detailed analysis of investment manager performance can be found at Appendix 2.

6 INVESTMENT STRATEGY

6.1 **Asset Class Returns versus Strategic Assumptions:** Developed market equity returns over the last 3 years were 10.5% 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 6.2%; below the assumed 3-year return of 8.3%. Over the 3-year period index-linked gilts returned 6.1% p.a. versus an assumed return of 1.6%. The 3-year UK property return of 2.8% p.a. lags its assumed return of 5.2%, due to continued uncertainty in the sector.

6.2 **Private Markets Commitments to Brunel Portfolios:** At 31 December 2020 37% of the Fund's Cycle 1 (2018-2020) £115m commitment to Brunel's renewable infrastructure portfolio had been deployed and 37% of the Fund's £345m commitment to the secured income portfolio had been deployed. The pace of capital deployment across both portfolios is expected to increase in the coming quarters as the pipeline for new build and operational renewable energy assets remains strong and acquisition activity is starting to pick-up in the long lease sector. Already in 1Q21, a further £109m has been invested in Secured Income resulting in 70% of the Cycle 1 commitment now invested. Over the quarter Cycle 2 (2020-2022) commitments also began drawing down capital. Of the scaled back commitments made to Cycle 2 in April 2020, 12% of the renewable infrastructure and 7% of the secured income commitments had been deployed. Post period end, Cycle 2 commitments were increased in line with strategic allocation weights. During 1Q21 the Secured Income portfolio made further drawdowns amounting to £36m on Cycle 2 commitments. The Brunel private debt portfolio for Cycle 2 is launching in 1Q 2021 and is expected to start drawing down on the Fund's commitment early in 2Q 2021.

7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

Portfolio Rebalancing

7.1 The residual holding in the Ruffer DGF (c. £160m) was sold in December in anticipation of private markets drawdowns and to align the portfolio with the 10% strategic allocation. Cash proceeds of the sale were subsequently invested in the Fund's liquidity strategy, managed by BlackRock.

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 **IIGCC - Paris Aligned Investment Initiative (PAII):** The Fund signed up to the PAII Asset Owner Commitment, which seeks to standardise investors' net-zero commitments and ensure alignment with the overarching goals of the Paris Agreement. The Fund volunteered portfolio data to enable Brunel to participate, alongside 4 other strategic investors, in the initial modelling, testing and development phase of the Framework that underpins the Commitment. When the Fund's portfolio was tested, as part of the pilot, it concluded that a significant degree of alignment had already been achieved in its existing investment strategy due to the low carbon intensity of the Brunel portfolios in which it invests and the significant strategic changes that were made following the 2019/20 review.

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

i. Brunel was one of 16 institutional investors, representing $2.4tn, that co-filed a climate change resolution at HSBC, co-ordinated by ShareAction. It called on HSBC to publish a strategy and targets in order to reduce its exposure to fossil fuel assets on a timeline consistent with Paris climate goals. In March intensive engagement with HSBC in the lead up to its AGM resulted in Brunel and all co-filers withdrawing the resolution on the understanding that HSBC would put forward their own resolution that includes commitments to set, disclose and implement a strategy with short- and medium-term targets to align its provision of finance across all sectors with the goals and timelines of the Paris Agreement, to phase out the financing of coal-fired power and thermal coal mining by 2030 in the European Union and by 2040 in other markets and to produce an annual report on the progress of the strategy.

ii. Through its membership to the Good Work Coalition, Brunel sent companies a second round of letters arguing for the importance of the living wage and was one of 64 investors to write to the boards of mining companies to seek assurances about how the sector maintains a social license for operations among First Nations and Indigenous communities.

iii. Policy Advocacy – Through IIGCC Brunel signed letters calling for UK and EU leaders to set ambitious 2030 Nationally Defined Contributions (NDC) aligned to their respective Net Zero 2050 targets.

8.3 **Brunel Voting & Engagement Summary**: Federated Hermes engaged with 297 companies held by Avon in the Brunel segregated portfolios on a range of 878 ESG issues. Environmental topics featured in 26% of engagements, 77% of which related directly to climate change. Social topics featured in 22% of engagements, where business conduct, human rights and diversity featured prominently. Of the 31% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 108 meetings (749 resolutions). At 43 meetings they recommended opposing one or more resolutions. 65% of the issues Hermes voted against management on comprised board structure and remuneration.

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

Companies Meetings Voted:	437
Resolutions voted:	3482
Votes For:	2973
Votes Against:	457
Abstained:	13
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.*

8.5 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	