

<b>Bath &amp; North East Somerset Council</b>	
MEETING:	<b>AVON PENSION FUND COMMITTEE</b>
MEETING DATE:	<b>28 JUNE 2021</b>
TITLE:	<b>INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 31 March 2021)</b>
WARD:	<b>ALL</b>
<b>AN OPEN PUBLIC ITEM</b>	
<p><b>List of attachments to this report:</b></p> <p>Appendix 1 – Fund Valuation</p> <p>Appendix 2 – Mercer Annual Investment Review</p> <p>Appendix 3 – LAPFF Quarterly Engagement Monitoring Report</p> <p>Appendix 4 – Mercer Paper: Investing in Chinese Equities</p>	

## **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 2021.
- 1.3 Mercer have produced a briefing note on Chinese equities which can be found at Appendix 4. The paper discusses the evolving structure of the Chinese equity market and key risks and opportunities associated with investing in the region. The paper should be considered against the backdrop of the Fund's ongoing equity allocation review.

## **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 3). 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 rose from c.84% to c.97% over the year to 31 March 2021. The deficit was estimated to have decreased over the year, from £863m to £171m.
  - b) The increase in the funding level was driven by an increase in the value of the assets, which outstripped the growth in the present value of the liabilities.

### 5 ANNUAL INVESTMENT REVIEW

- 5.1 This quarter Mercer has provided an annual investment review of the year to 31 March 2021 (see Appendix 2), presented in a new format. The report discusses recent investment market performance, risk metrics and funding level projections.
- 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 forward looking views on investment returns.

### 6 INVESTMENT PERFORMANCE

#### A – Fund Performance

- 6.1 The Fund's assets increased by £834m (17.3%) over the year ending 31 March 2021 giving a value for the Fund of £5,301m. 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 currency hedge added 2.4% over the year. The main detractor was the Equity Protection Strategy given equity markets rallied during the year.

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

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	2.7%	17.3%	4.9%
Avon Pension Fund (excl. currency hedging)	2.2%	14.9%	5.0%
Strategic benchmark (no currency hedging)	4.1%	20.5%	6.8%
Currency hedge impact	0.5%	2.4%	-0.1%

**6.2 Fund Investment Return:** In the year to 31 March 2021 governments unveiled unprecedented monetary and fiscal support packages to combat the economic contraction caused by the pandemic. Markets soon began to recover from the lows experienced at the outset of the crisis. Infection rates, vaccine efficacy and virus variants dominated news flows over the period but there were several notable non-Covid developments. An acrimonious election saw Democrat Joe Biden win the US presidential election, which was received positively by markets in anticipation of an exceptional monetary stimulus package designed to accelerate the post-pandemic economic recovery. The UK and EU signed a deal on goods, averting the spectre of a no-deal Brexit. Brexit news saw Sterling appreciate against the US dollar and helped to alleviate some of the uncertainty for markets.

Equity market performance was characterised as falling into a year of two halves. By Autumn 2020, equity markets had recovered pre-Covid losses, driven largely by high-growth sectors such as technology. Sectors that struggled to survive as the pandemic escalated included the Consumer Discretionary sector, which includes the travel and hospitality industries. Positive test results for the vaccine in November signalled the beginning of a period of stronger relative performance for slower growth, more mature sectors such as energy and financials. The MSCI All-Country World Index returned 3.7% in GBP terms over 1Q21 and 39.6% for the twelve months ending 31 March 2021. Although regional stock level performance varied significantly over the year both developed and emerging market equities posted similar returns at aggregate level. The US and China outperformed the wider market, posting gains of 43.3% and 50.9% respectively. The sectorial composition of the UK market meant that it underperformed over the year, posting a return of 27.1%.

Fixed income assets were impacted by global monetary and fiscal stimulus packages too, where the prospect of higher inflation eroded the value of sovereign bonds, particularly in the final quarter of the year.

The UK property market continued to be polarised. The most liquid parts of the market were industrials, prime offices (where Grade A office space remains in short supply), supermarkets and residential (where private rental growth grew by 1.4% over the year). Conversely most shopping centres and leisure schemes remained illiquid with performance characterised by low levels of rent collection.

Sterling appreciated 11% against the US Dollar and 4% against the Euro over the year, marking a reversal of Sterling weakness in previous periods. At 31 March 2021, a pound bought \$1.38 and €1.17.

**6.3 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 0.5% over the quarter and 2.4% over the year.

**6.4 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 year the Liability Benchmark Portfolio (LBP), which is used by BlackRock to hedge against movements in the value of the Fund's liabilities arising from changes in interest rates and inflation, was updated based on the assumptions and member data underlying the 2019 actuarial valuation.

Further, due to the significant uncertainty around the future path of inflation caused by the RPI reform consultation and the co-ordinated central bank response to the pandemic, the Committee elected to opportunistically increase the level of inflation hedging in two stages over the course of the year. As a result, 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.

Over the year implied inflation expectations increased which drove positive absolute returns from the LDI mandate; 5.2% over the quarter and 3.5% since inception.

- 6.5 Equity Protection Strategy Performance (EPS):** Following the renewal of the static equity protection strategy which allowed Panel time to consider the two main implementation options for a dynamic strategy, the decision was made to implement a 'bank-led' approach, where a counterparty bank would provide a custom index to replicate the Fund's defined options strategy, which the Fund would then gain exposure to via a total return swap. Officers and Mercer assessed a selection of banks across a broad set of criteria including cost, operational capability and client servicing, and under delegated authority agreed to appoint three banks to minimise concentration risk. An independent legal review of key trade terms and documentation concluded post period-end and the onboarding of the appointed banks commenced. Following completion of all trading activity (which took place in May 2021), Officers and Mercer will present a post-trade report to Panel in 3Q21.

In terms of performance over the year the existing static EPS performed as expected, detracting value as equity markets rallied. Since inception (November 2017) the overall return of the proxy equity portfolio, net of the protection, was 5.9% for developed market equities. If the protection had not been in place the return would have been 10.0%. The net return since inception (January 2020) for the emerging market portion was 5.4%. If the protection had not been in place the return would have been 8.7%. The funding position detailed in Section 3 of Appendix 2 includes the impact of the equity protection strategy at 31 March 2021. The VaR numbers on p11 of Appendix 2 have been updated to reflect the modelled impact of the dynamic equity protection strategy.

- 6.6 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.

£290m of passive equities were switched into gilts within the BlackRock QIF to maintain a comfortable collateral position following the inflation hedge increase. As a result, the Fund's overweight equity allocation reduced.

## **B – Investment Manager Performance**

6.7 Manager total returns over the quarter were mixed with equity mandates posting positive absolute returns and fixed income assets adversely impacted by the government bond sell off. On a relative basis the equity mandates underperformed their respective benchmarks due to the inherent quality and growth factor bias. The market rewarded value stocks over the quarter; particularly the financials and energy sectors. The MAC portfolio and Corporate Bond portfolio (held in the QIF for cashflow matching purposes) both posted negative absolute returns largely as a result of yield curve steepening. On a relative basis, the MAC portfolio underperformed its custom benchmark largely as a result of US Dollar strength which negatively impacted its Emerging Market positions. The Brunel DRF also posted a negative absolute return which is attributable to the portfolios underlying growth and quality equity biases and long exposures to sovereign bonds and the Japanese Yen. Elsewhere, the Hedge Fund mandate performed well in local currency terms noting that the Fund no longer has a strategic allocation to this asset class and the allocation is expected to wind down over time. The core infrastructure mandate posted positive absolute returns as revised valuations began to reflect a post-pandemic recovery. The Fund's LDI portfolio provided a tailwind to total fund returns over the quarter as inflation expectations rose and the Fund's inflation positions added value.

Of those mandates with a 1-year track record all posted positive absolute returns (except for the overseas property mandate). Notable outperformance came from the MAC, hedge fund and infrastructure portfolios. The global high alpha portfolio was the standout performer amongst the Fund's equity mandates, outperforming its benchmark by nearly 8%. 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 manager has delivered significant value on a since inception basis.

### **Overview of Strategic Performance:**

6.8 **Asset Class Returns:** Returns since the last valuation date (March 2019) for all equity mandates, the MAC portfolio and core infrastructure are ahead of the assumed strategic returns used during the 2019/20 investment review. The overseas property portfolio lags its assumed return due to the impact of COVID on the property market and the other mandates are either still in build-up phase or do not have a sufficient track record (e.g. Brunel DRF) to properly compare against strategic return assumptions.

6.9 **Transition of Assets to Brunel Portfolios:** At 31 March 2021 Brunel directly managed over 70% of the Fund's assets across equities, diversified returns and private markets allocations. Assets relating to the Fund's risk management strategies are also governed by Brunel legal agreements.

6.10 **Private Markets Commitments to Brunel Portfolios:** At 31 March 2021 39% of the Fund's Cycle 1 (2018-2020) £115m commitment to Brunel's Infrastructure portfolio had been deployed. Pace of deployment remained steady, which is reflective of the fact the Brunel portfolio focuses on high-quality, essential services assets which have been impacted by COVID to a lesser extent than discretionary infrastructure assets.

At 31 March 2021 69% of the Fund's £345m commitment to the Secured Income portfolio had been deployed. A notable pickup in pace of deployment in the final quarter of the year was largely the result of one underlying manager

completing on 4 separate asset purchases. Post period-end a further £58m was drawn down, leaving £48m of undrawn capital for the cycle 1 Secured Income portfolio.

- 6.11 Over the quarter Cycle 2 (2020-2022) commitments continued drawing down capital. 6% of the £120m renewable infrastructure and 33% of the £120m secured income commitments have been deployed. The Brunel private debt portfolio launched during the period and is expected to start drawing down in May on the Fund's £245m commitment.

The re-registration of the Fund's UK property assets (to be managed by Brunel) commenced in January. As part of the transition the Fund committed £10m to an affordable housing fund, which works with regional house builders to develop new-build housing for the underserved affordable rental sector. Redemptions in non-transferable funds held by the legacy UK property manager continued to progress as the Fund seeks to rebalance its allocation to the 3.75% strategic allocation. As at 30 April 2021 the legacy property manager had sold £65m of the funds retained. The remaining balance (c.£45m) is expected to be sold by the end 2Q 2021.

## **7 PORTFOLIO REBALANCING AND CASH MANAGEMENT**

### **Portfolio Rebalancing**

- 7.1 As at 31 March 2021 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark. The Fund redeemed £30m from Loomis Sayles in April to bring the Multi Asset Credit allocation in line with its long-term 6% strategic allocation. The residual £150m sum held by the Fund's legacy DGF manager Ruffer was sold in anticipation of private markets capital calls. Proceeds of this sale were transferred to the BlackRock liquid beta strategy that is designed to replicate the returns of the Fund's strategic benchmark.

### **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 – ANNUAL REVIEW**

### **8.1 Brunel Responsible Investment Highlights:**

- i. **Stewardship Outcomes Report.** The second edition of Brunel's 'Responsible Investment and Stewardship Outcomes Report' covering the year to December 2020 along with their inaugural 'Climate Action Plan Report' profiled successes across several key RI themes including social inequality, modern human slavery, cyber security and fossil fuel financing which culminated in industry wide recognition when Environmental Finance named the partnership Pension Fund of the Year. The report seeks to meet the requirements of the new Financial Reporting Standards – Stewardship Code 2020 as well as the EU Shareholder Rights Directive.

- ii. **Paris Aligned Portfolios.** Brunel were actively involved with the Institutional Investors Group on Climate Change (IIGCC) in the development of the Paris Aligned Investment Initiative and the Net Zero Investor Framework (NZIF), which aims to set a global standard for investors to demonstrate Paris alignment. The NZIF was published at the end of the year and Brunel participated in the pilot program to test the methodologies using data provided by the Fund.
- iii. **Fossil Fuel Financing.** Brunel co-filed shareholder resolutions relating to the phase-out of fossil fuel related financing at two of Europe's largest banks, enabling significant climate policy changes at HSBC and Barclays.
- iv. **The Brunel Carbon Metrics Report** revealed that Brunel listed equity portfolios in aggregate were 15.4% more efficient in terms of carbon intensity than the broader market.
- v. **Policy Advocacy.** Brunel were particularly active in terms of policy advocacy; joining forces with several other UK pension funds and making the case for the issuance of green gilts ahead of the government announcement to issue its first ever green bond in 2021 to help tackle climate change and build green jobs across the UK.

## 8.2 Avon Pension Fund Responsible Investment Highlights:

- i. **Marine Conservation.** The Fund, alongside 26 international investors, joined a collaborative engagement led by First Sentier Investment, with support from the Marine Conservation Society aimed at engaging 18 of the largest global manufacturers of washing machines to highlight the risk of micro plastic leakage and to champion technological advances to tackle the issue. Engagement on this topic is ongoing.
- ii. **Policy Advocacy.** The Fund participated in a number of engagements - through its membership to the IIGCC - calling on governments to increase their climate policy action and level of ambition, recognising the urgency required to achieve carbon neutrality by 2050.
- iii. **Carbon Metrics Report.** The Fund published its fifth annual carbon metrics report which showed, among other things, that the Fund's listed equity portfolio was 30% more carbon efficient than the benchmark (on a Weighted Average Carbon Intensity basis).
- iv. **Enhanced disclosures.** As an advocate for improved transparency in climate related disclosures the Fund committed to becoming an early adopter of the recommendations put forward by the Taskforce on Climate Related Financial Disclosures (TCFD). The Fund's first report will be published later in the year and will cover the 12 months to 31 March 2021.

**8.3 Voting and Engagement Summary:** Over the quarter Hermes (Brunel's appointed voting and engagement provider) engaged with 338 companies held by Avon in the Brunel segregated portfolios on a range of 1,175 ESG issues. Environmental topics featured in 24% of engagements, 78% of which related directly to climate change. Social topics featured in 22% of engagements, where human capital, human rights and diversity featured prominently. Of the 38% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 104 meetings (1,036 resolutions). At 36 meetings they recommended opposing one or more resolutions. 70% of the issues Hermes voted against management on comprised board structure and remuneration.

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

Companies Meetings Voted:	433
Resolutions voted:	5498
Votes For:	4808
Votes Against:	547
Abstained:	63
Withheld* vote:	80

*\* 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 ANNUAL ASSURANCE ON CONTROL ENVIRONMENT OF 3RD PARTY SUPPLIERS**

- 9.1 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.
- 9.2 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.
- 9.3 For the reports reviewed in 2020/21 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.
- 9.4 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.
- 9.5 Brunel do not produce an ISAE 3402 / SSAE 18 / SOC 1 report. Instead Brunel operate an industry standard 'three lines of defence' model that allows them to meet FCA regulations. The Brunel control environment is documented in line with AAF guidance. Controls are assessed by an independent compliance team. Furthermore, Brunel appoints an independent auditor to perform an internal audit. The objective of this review is to provide independent assurance over the design and operational effectiveness of the controls in place for oversight of Brunel's outsourced service providers.



## **10 RISK MANAGEMENT**

10.1 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.

## **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. 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.

## **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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<b>Background papers</b>	Data supplied by Mercer & SSBT Performance Services
<b>Please contact the report author if you need to access this report in an alternative format</b>	