| Bath & North East Somerset Council | |
|---|---|
| MEETING: | **AVON PENSION FUND COMMITTEE** |
| MEETING DATE: | **10 DECEMBER 2021** |
| TITLE: | **INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 September 2021)** |
| WARD: | **ALL** |
| **AN OPEN PUBLIC ITEM** | |
| **List of attachments to this report:**<br>Appendix 1 – Fund Valuation<br>Appendix 2 – Mercer Investment Performance Report<br>Appendix 3 – LAPFF Quarterly Engagement Monitoring Report<br>Appendix 4 – Revised Investment Strategy Statement<br>Exempt Appendix 5 – Mercer Paper: Impact Investing<br>Appendix 6 – Draft Public and Exempt Minutes from Investment Panel meeting held 19 November 2021 | |

## 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 2021.

1.3 The Investment Strategy Statement at Appendix 4 has been updated to account for the most recent changes to the strategy following the equity allocation review, creation of FRMG and the change to the EPS structure.

1.4 On the request of the Committee Mercer have provided a paper on Impact Investing which can be found at Appendix 5. Mercer will present their paper at the meeting.

## 2 RECOMMENDATION

**The Avon Pension Fund Committee is asked to note:**

2.1 **Approve the revised Investment Strategy Statement**

2.2 **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 improved slightly over the period to just over 101%. The surplus was estimated to have increased slightly over the quarter from £43m to £66m.

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 INVESTMENT PERFORMANCE

### A – Fund Performance

5.1 The Fund's assets increased by £139m (2.9%) over the quarter ending 30 September 2021 giving a value for the Fund of £5,710m. 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 detracted 0.5% over the quarter as Sterling weakened.

**Table 1: Fund Investment Returns** (Periods to 30 September 2021)

| | 3 Months | 12 Months | 3 Years (p.a) |
|---|---|---|---|
| Avon Pension Fund (incl. currency hedging) | 2.9% | 13.8% | 6.0% |
| Avon Pension Fund (excl. currency hedging) | 3.4% | 12.8% | 5.9% |
| Strategic benchmark (no currency hedging) | 3.3% | 16.2% | 7.8% |
| Currency hedge impact | -0.5% | 1.0% | 0.1% |

5.2 **Fund Investment Return:** There was significant volatility in markets towards the end of the quarter, caused by supply chain disruptions and fears of default from Chinese property developer Evergrande. Gains made in July and August were wiped out in September. A lack of reliable alternative energy sources compounded supply chain disruption which drove gas prices higher. Global developed equites returned 2.6% over the quarter while emerging markets fell 5.7% in the same period. Increasing inflationary pressures led to talks of possible interest rate rises in the UK, with the Fed and ECB confirming plans to begin tapering their respective asset purchase programs. The 10-year US treasury yield rose above 1.5% following the September Fed meeting. In the UK, 5- and 10-year gilt yields increased 31bps and 30bps to 0.64% and 1.02%, respectively. In UK LDI markets, Q3 brought the inaugural green gilt, with the

2033 bond bringing record demand and a final issue size of £10bn. While demand for defensive Infrastructure assets, such as water and electric utilities, grew following rising Delta variant numbers, this proved a negative influence on the rest of the sector, which was also hit by supply chain disruptions, gas price volatility and questions around the status of the US infrastructure bill. Issuance of high yield bonds was strong and remain on course for a record-breaking year, with Private Debt markets also holding up despite a seasonal slowdown in August. Rent collection improved in the retail Property sector, with fears of falling valuations in the office sector mitigated by increased overseas demand and lack of high-quality supply. Sterling depreciated against the US Dollar by 2.4%, by 0.1% against the Euro and by 1.9% against the Japanese Yen. Further information on 3Q asset class performance can be found in the Mercer report at 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 detracted 0.5% over the quarter.

5.4 **Risk Management Strategies:** The liability hedging component of the risk management framework delivered a return of 4.1% over the quarter due to changes in inflation expectations. No interest rate or inflation triggers were breached over the quarter. The EPS added marginal gains to produce a net return of -0.6% over the quarter. The collateral position at the end of the quarter was within agreed constraints. FRMG are currently reviewing the inflation hedging position following a refresh of the liability benchmark portfolio and are also in the process of implementing the changes required to the EPS following the Committee's decision to exit the dedicated emerging market equity allocation.

**B – Investment Manager Performance**

5.5 The Global Sustainable Equity portfolio posted a strong absolute return of 3.6% over the quarter, outperforming the index by over 2%. Stock selection was the main driver of returns. The High Alpha portfolio returned 1.7% in absolute terms, underperforming the index by nearly 1%. Underperformance in this portfolio was driven by stock selection and an overweight to China as fears of default following the Evergrande headlines spread to other sectors in the region. The Emerging Market equity portfolio posted an absolute return of -6.5% and a relative return of -0.8% over the quarter. Rising energy prices resulted in the portfolio underweight to the Energy and Materials sectors detracting from relative performance. The DRF portfolio posted an absolute return of 0.5%. Core Infrastructure, Renewable Infrastructure and Secured Income all saw strong positive absolute returns despite a slowdown in the pandemic recovery and supply bottlenecks. The Fund's LDI portfolio provided a tailwind to total fund returns as the hedging positions added value as inflation expectations rose. Of those mandates with a 1-year track record the majority earnt positive absolute returns with notable outperformance across the Infrastructure mandates and Sustainable Equity. The currency hedge detracted over the quarter but was additive to returns over 1- and 3-year timeframes as Sterling strengthened over these periods.

**Overview of Strategic Performance:**

5.6 **Asset Class Returns:** Returns since the last valuation date (March 2019) for all equity mandates and core infrastructure are ahead of the assumed strategic returns used during the 2019/20 investment review. The legacy property portfolio lags assumed returns due to the impact of COVID on the property market. Due to the way this portfolio invests (capital drawn down over time) the focus should be on longer-term performance. Other mandates are either still in build-up phase or do not have a sufficient track record (e.g., Brunel MAC) to properly compare against strategic return assumptions.

5.7 **Private Markets Commitments to Brunel Portfolios:** At 30 September 2021 49% 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 30 September 2021 93% of the Fund's £345m commitment to the Secured Income portfolio had been deployed. A notable pickup in pace of deployment in the past two quarters has largely been the result of increased acquisition activity. Post quarter end the remaining capital was drawdown in full.

5.8 Over the quarter Cycle 2 (2020-2022) commitments continued drawing down capital. 14% of the £120m renewable infrastructure and 37% of the £120m secured income commitments have been deployed. The Brunel private debt portfolio made its first capital call (£19m) on the Fund's £245m commitment. The next anticipated call will be in January 2022.

## 6 PORTFOLIO REBALANCING AND CASH MANAGEMENT

**Portfolio Rebalancing**

6.1 As at 30 September 2021 all asset allocations were within the control ranges for rebalancing based on the strategic benchmark, except for private markets allocations that are still drawing down capital. Further proceeds were received from the wind down of the Schroder UK Property portfolio, some of which has been invested in Brunel's UK Property portfolio.

**Cash Management**

6.2 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.

6.3 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.

## 7 INVESTMENT PANEL ACTIVITY

7.1 The Investment Panel is responsible for addressing investment issues including the investment management arrangements and the performance of the investment managers. The Panel has delegated responsibilities from the Committee and may also make recommendations to Committee. The Panel's last formal meeting was held on 19 November 2021 in virtual format. There are no decisions to note or recommendations to approve by Committee this

quarter. The draft minutes of this meeting provide a record of the Panel's discussion (see Appendix 6).

## 8 RESPONSIBLE INVESTMENT ACTIVITY

8.1 Responsible Investment highlights during the quarter included:

i. **FRC 2020 Stewardship Code Submission.** Post quarter end the Fund submitted its first report under the new 2020 FRC Stewardship Code. The Fund was a tier 1 signatory to the previous iteration of the Code. Successful applicants to the new Code will be notified in 1Q22**.**

ii. **Paris Aligned Benchmarks.** Following the successful launch of a new suite of Paris-aligned climate benchmarks developed by FTSE Russell and Brunel, LGIM (Brunel's passive equity provider) transitioned nearly £3bn into its new product which tracks the FTSE Russell indices. Avon transitioned its 10% (£575m) allocation to low carbon equities into the new product at the end of the quarter.

iii. **Asset Owner Diversity Charter.** The Fund pledged its support for a new charter developed by the Diversity Project which, on release, gained the support of asset owners representing over £1tn in AUM. The Charter seeks to formalise a set of actions designed to improve diversity, in all forms, across the asset management industry and calls for diversity to be incorporated into manager selection, ongoing manager monitoring and to lead and collaborate with others in the investment industry to identify diversity and inclusion best practice. Brunel have also pledged their support for the initiative.

8.2 This quarter the Fund will publish its inaugural TCFD report alongside its Annual RI Report which has been updated to include periods to September 2021 to capture the outcomes of the equity allocation review. See Agenda Item 10.

8.3 **Voting and Engagement Summary**: Over the quarter Hermes engaged with 149 companies held by Avon in the Brunel active portfolios on a range of 475 ESG issues. Environmental topics featured in 32% of engagements, 78.9% of which related directly to climate change. Social topics featured in 23.8% of engagements, where human capital, human rights and diversity featured prominently. Of the 26.5% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 116 meetings (1,228 resolutions). At 41 meetings they recommended opposing one or more resolutions. 64% 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: | 702 |
| Resolutions voted: | 3,941 |
| Votes For: | 3,419 |
| Votes Against: | 460 |
| Abstained: | 9 |
| Withheld* vote: | 53 |

** 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 INVESTMENT STRTAEGY STATEMENT (ISS)

9.1 Appendix 4 is the revised ISS. It has been updated for the following changes:

a) In the equity allocations following the recent review as follows (see Section 5 of ISS):

- switch from Low Carbon Passive to Paris Aligned passive
- reduction to Emerging markets
- investing proceeds into Global Equity and Sustainable portfolios.

It also includes the new carbon reduction targets for 2025 and 2030 (see paragraphs 8.6-8.8 of the ISS).

b) Creation of the Funding & Risk Management Group

c) Change to the Equity Protection Strategy from static to dynamic structure.

## 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 addresses this through its strategic asset allocation to Paris Aligned Global 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.

| | |
|---|---|
| **Contact person** | Nathan Rollinson, 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** | |