

BATH AND NORTH EAST SOMERSET

AVON PENSION FUND COMMITTEE INVESTMENT PANEL

Friday, 19th November, 2021

Present:- Councillor Shaun Stephenson-McGall (Chair), Councillor Paul Crossley, Councillor Chris Dando, John Finch, Pauline Gordon and Shirley Marsh-Hughes

Advisors: Steve Turner (Mercer) and Josh Caughey (Mercer)

Also in attendance: Tony Bartlett (Service Director - Financial Control and Pensions), Liz Woodyard (Group Manager for Funding, Investment & Risk) and Nathan Rollinson (Investments Manager)

25 WELCOME & INTRODUCTIONS

The Chairman welcomed everyone to the meeting. He made a statement to the Panel regarding the recent COP 26 meeting. A copy of the statement can be found as an online appendix to these minutes, a summary is set out below.

I am encouraged by the commitments made across constituencies, sectors and national jurisdictions as part of COP including action on coal, vehicles, finance and nature. I see a lot of these pledges as a direct reflection of the work undertaken by the Fund.

As a Fund we have recently made a significant decision to realign our equities portfolio – moving over half a billion of equities to a Paris aligned fund which is designed to divert capital away from carbon intensive sectors and companies and reward those that are well positioned for the transition. This includes the complete exclusion of coal and tar sands companies as well as companies whose primary business function relates to the exploration, extraction or distribution of fossil fuels and will ultimately see us reduce carbon emissions by 7% each year in line with a 2050 net zero trajectory.

COP saw The Glasgow Financial Alliance for Net Zero (GFANZ) announce that capital committed to net zero by 2050 now stands at over \$130tn. Included within this staggering statistic are the IIGCC Paris Aligned Asset Owners group, to which the Fund belongs. This framework commits us not only to achieving net zero emissions by 2050, but also to delivering significant reductions in emissions in the interim. To that end, we have recently adopted two new decarbonisation objectives, which will see the Fund reduce absolute emissions by 43% by 2025 and 69% by 2030 (vs. a 2020 baseline).

Recognising the importance that commitments are backed up by tangible action we have agreed to divest over £280m from emerging market companies, which will produce an immediate reduction of Fund emissions by 28%; exiting regions where wholesale policy shifts are more difficult to achieve. The proceeds will instead be invested in a broad range of climate and environmental solution providers as well as companies that contribute to social sustainability.

Over the last 6 months we have increased our communications with members by utilising social media and connecting with our membership directly. This month saw the launch of our first ESG member survey; the results of which will be used to inform future strategy on climate.

The role for the Fund and its strategic partners remains as critical as ever. We will continue to collaborate, engage with companies to accelerate progress towards net zero, and continue to advocate for a supportive policy environment that will facilitate change ultimately for the benefit of our members.

26 DECLARATIONS OF INTEREST

There were none.

27 APOLOGIES FOR ABSENCE AND SUBSTITUTIONS

There were none.

28 TO ANNOUNCE ANY URGENT BUSINESS AGREED BY THE CHAIR

There was none.

29 ITEMS FROM THE PUBLIC - TO RECEIVE DEPUTATIONS, STATEMENTS, PETITIONS OR QUESTIONS

There were none.

30 ITEMS FROM COUNCILLORS AND CO-OPTED AND ADDED MEMBERS

There were none.

31 MINUTES: 17TH SEPTEMBER 2021 AND 17TH SEPTEMBER 2021 EXEMPT

The Panel were minded to approve the minutes.

32 INFRASTRUCTURE PORTFOLIOS

The Group Manager for Funding, Investment & Risk introduced this item to the Panel and highlighted the following areas from the report.

The legacy portfolio is 'generalist' in that it invests across a range of infrastructure assets whereas to date the Fund has invested in Brunel's renewables portfolio, noting that Brunel have also offered a 'generalist' infrastructure portfolio in each investment cycle. Therefore, the legacy portfolio provides diversification within infrastructure for the Fund.

Brunel is in process of finalising the private market portfolio specifications for the next cycle of private market investments. The portfolio specification has not been agreed as yet and Mercer advice is subject to the final portfolio offered.

This paper is for the Panel to explore the potential options and implications (operationally, timing) for the legacy portfolio. Allocations to the next cycle of private market portfolios offered by Brunel will be agreed at the Panel meeting in 1Q22, once portfolio specifications are available.

The Fund can allocate to the next Brunel infrastructure portfolio to maintain the current strategic allocation independently of any decision concerning the legacy portfolio.

The Panel, having been satisfied that the public interest would be better served by not disclosing relevant information, **RESOLVED**, in accordance with the provisions of the Section 100(A)(4) of the Local Government Act 1972 that the public should be excluded from the meeting for this item of business, because of the likely disclosure of exempt information as defined in paragraph 3 of Part I of Schedule 12A of the Act as amended.

The Panel were minded to note the report and next steps outlined.

33 PERFORMANCE MONITORING

The Investments Manager introduced this report to the Panel and highlighted the following points.

- The Fund's assets increased by £139m in the quarter (2.9% net investment return) ending 30 September 2021 giving a value for the Fund of £5,710m. Sustainable Equities did well despite the surge in Gas prices. No major concerns to raise at this stage.
- Responsible Investment – COP 26: Onus to drive change on the private sector. Climate disclosures becoming more mandatory.
- Draft TCFD report and Responsible Investment Annual Report due for discussion at Committee meeting in December.

Josh Caughey, Mercer addressed the Panel and highlighted points from within Appendix 2 - Mercer Performance Monitoring Report.

Executive summary

- Funding level and risk: The funding level is estimated to have improved slightly over Q3 to just over 101%, as asset growth outweighed the rise in the value of the liabilities. It is estimated to have increased by 8% over the year to 30 September 2021.
- The Value-at-Risk rose over the quarter to £1,206m, or 21.4% of liabilities, mainly due to the increase in the absolute value of the assets. Risk as a proportion of liabilities has reduced over the year, largely due to the decision to move towards a dynamic equity option strategy.

Market Outlook

- Global equity returns were flat over the quarter in US dollar terms on the back of heightened fears over recent increases in the price of energy and related supply chain disruptions. However, central banks and in particular the US Federal Reserve continued to assert that the rise in inflation was transitory and would dissipate over time. A weaker sterling led to positive global equity returns in the low single digits for unhedged UK investors.
- Economic activity remained strong although the rise of the delta variant and shortages of people and goods in some sectors slowed activity through the quarter. While governments mostly avoided imposing new lockdowns, activities in certain face-to-face sectors, most notably travel, softened. In addition, ongoing supply disruptions in a range of sectors (most notably the auto sector) led to both less activity and higher prices.
- We expect economic growth to remain strong, although supply disruptions and near term weakness in China, could lead to near term growth being weaker than we had thought. However, any growth shortfall this year may be offset by better growth next year, especially in China and supply constrained sectors. It seems likely that the impact of COVID on economies and markets will fade, especially in those economies that have vaccinated the most.

Performance vs. expected strategic returns

Returns have been above expectations for all equity mandates, given the strength of equity markets since 2019.

BlackRock Passive Global Equity - Returns are above strategic expectations and the mandate has tracked the underlying market.

Brunel Global Sustainable - Strong returns from equity markets and the mandate has now outperformed thanks to a strong third quarter.

Brunel Emerging Markets - Returns are above strategic expectations though the mandate has underperformed benchmark since inception.

Brunel Diversified Returns - Returns above expectation so far thanks to exposure to rising equity markets and some of the asset class positioning of the four underlying managers.

Brunel UK Property - Mandate incepted in January 2021; too early to draw conclusions although property market has fared well so far in 2021.

Brunel Renewable Infra - Returns above expectations (despite contracting over one year period), but mandate is still in the drawdown phase.

Shirley Marsh-Hughes asked if the Value at Risk takes into account the risk strategies put in place.

Josh Caughey replied that it does in terms of reduction in assumed volatility in equities and allows for the ongoing dynamic protection that is in place.

Shirley Marsh-Hughes suggested that within a future report a comparison is shown for VaR without the risk strategies.

Steve Turner replied that that would be possible. He added that they could also attempt to show a comparison with other LGPS funds.

The Service Director for Financial Control and Pensions commented that there is always likely to be an element of risk within the portfolio and asked if the Fund was taking on more risk than normal due to the growth of the portfolio.

Steve Turner replied that the level of risk within the investment strategy would always take into account wider funding elements. He added that work is being carried out on this and was a topic that could be discussed more widely in the future.

He then highlighted some main points within Appendix 5 – Mercer Paper: Managing Inflation Risk to the Panel.

- Given that the Fund's liabilities are linked to inflation, one of the Fund's key risks is that investment returns don't keep pace with the liabilities in an elevated and sustained inflationary scenario. If inflation rises by 1% and the assets don't keep pace, then this would be equivalent to a 30% fall in the value of the Fund's equity holdings (c. £700m funding strain).
- The investment portfolio is robust to a wide range of inflationary scenarios through the direct inflation hedging within the liability driven investment (LDI) strategy, as well as allocations to real assets such as infrastructure and property that provide some inflation sensitivity.
- Important to have lots of diversification within the portfolio because different asset classes will help us in different ways in different times.

Introduction

- Long term secular forces driving disinflation such as globalisation could be turning the other way now.
- Direct inflation risks have also increased as a result of changed central bank philosophies and more monetary/fiscal coordination.
- Governments may prefer to reduce public debt indirectly through higher inflation rather than outright taxation.
- We believe the risk of seeing a wider range of outcomes has increased, including among them:
 - more frequent inflation regime changes
 - higher inflation volatility
 - longer periods of higher inflation levels

Markets may be underestimating the risk of higher inflation

- Inflation levels are currently well above the Bank of England's 2% p.a. target, but most central banks' current view is that this is transitory.
- The risk is that current inflation becomes more entrenched and problematic, noting higher inflation is also associated with higher volatility of inflation.
- Across the developed world, short term inflation is highest in the UK, however, we view the weakening of secular disinflationary forces is a global phenomenon.

What's the fundamental issue with inflation?

- The Fund's liabilities are directly linked to (uncapped) CPI inflation. A rise of inflation by 1% p.a. would increase the size of the liabilities by 20% (all else equal).
- This means that the investment strategy has to deliver an additional 1% p.a. otherwise this would lead to a funding strain putting upwards pressure on contributions.
- The Fund's discount rate for past service is currently CPI + 1.75% p.a. meaning if (CPI) inflation is higher, the Fund's investments need to return more in order to satisfy the discount rate requirements.

Assessing inflation risk

- The likelihood of certain inflationary scenarios occurring has increased.
- Equity/bond dominated portfolios have performed well through the last two decades of disinflation...but a transition to a more inflationary regime could negatively impact both equities and bonds.
- Rising likelihood and adverse impact means inflation exposure for the average portfolio should be reviewed to avoid taking unrewarded risk. This inflation risk may require a re-alignment of portfolios.

Different scenarios are shaped by different inflation drivers...

We consider different forward-looking economic scenarios of how economies and markets could behave under different conditions resulting from different combinations of inflation drivers and other factors that interact.

- Demand-pull drivers: Economic Growth / Monetary & Fiscal Policy
- Cost-push drivers: Supply costs / Labour costs / Technological productivity gains

Pauline Gordon asked if further discussion was required with the Actuary regarding CPI+ and the basis.

Steve Turner replied that around two valuations ago it was common for LGPS to have discount rates that were Gilts based, but struggled to lock into them. He added that a broader discussion with the Actuary would be welcome. He said that Mercer were comfortable with CPI+ basis.

Building scenarios - Incorporating energy transition

- A major scenario that has not been discussed so far is that of energy transition. We believe this is a critical consideration and needs to be considered separately from broader economic scenario analysis.
- Rather than being an economic scenario on its own, we expect it to occur alongside many of the scenarios considered here.
- The risks and opportunities presented by energy transition are likely to be more dependent on specific strategy selection than higher level asset class allocation, which means it is harder to generalise in an asset class heat-map.

Asset classes to mitigate inflationary environments

Private Debt

- Vast majority of cases a floating-rate asset class that provides a 'hedge' against central bank rate response to inflation.
- Higher starting yields make them a more attractive option than listed floating rate instruments.
- Could become a useful part of the portfolio going forward.

Commodities, and commodity related strategies

- Commodities hedge against cost-push inflation as they tend to exhibit high 'inflation beta'. Economic transformation drives demand for commodities – urbanization and energy transition are structural forces that could support prices over the longer term.
- Volatile, with ESG implications.

Equity Protection to act as a shock absorber.

Summary

No single asset class gives universal inflation protection to all scenarios – we need to invest across a selection of strategies to help broaden the protection and the Fund has many of the building blocks already.

The Fund is well positioned for growth scenarios where inflation moderately exceeds central bank targets (balanced growth) or where central banks force nominal yields below inflation (financial repression) – equities and traditional real assets such as property and infrastructure can provide what we feel to be sufficient protection.

The Fund is vulnerable to the overheat scenario where inflation spins out of control and central banks need to respond. Where they scramble to rein it in, rate risk may become more significant than inflation risk, and floating rate strategies such as private debt may soften the blow. Long nominal bonds (gilts and corporate bonds) are very exposed in these scenarios, suggesting maintaining a low interest rate hedge ratio.

Under the pandemic stagflation scenario where growth and inflation pull the central bank in different directions, the addition of gold or commodities can help protect against tail inflation risks but these present governance and operational difficulties.

Under the hard landing scenario, downside protection that worked in the past such as government bonds will be of limited use for valuation reasons. The equity protection downside strategy will help manage downside risk and introducing gold could be considered as an alternative to government bonds.

Conclusion and next steps

The Fund is well positioned against growth-oriented and/or long term inflation scenarios. Outright inflation protection through the LDI portfolio but with a low interest rate hedge ratio, as well as allocations to equities, infrastructure and real estate with inflation sensitivity.

A next step for the Fund could be to review the level of inflation protection at a portfolio level across the different inflationary scenarios and the impact of different investment strategies. This would look to assess direct and indirect sensitivities.

The Panel could look to increase the inflation hedge ratio (for example, by 10%, up to the current maximum permitted under the risk management framework) via the BlackRock LDI mandate, which could be implemented quickly, however there are practical considerations around the level of collateral required to implement this change. The FRMG will be considering whether the hedge ratios remain appropriate in more detail.

A diversified exposure across a range of assets is a pragmatic solution to help the Fund mitigate various inflationary scenarios.

Shirley Marsh-Hughes asked if we were to increase Inflation Protection without having a high level of Interest Rates protection there would be a risk that we would become out of balance.

Steve Turner replied that it was not impossible to increase Inflation Protection, but that the Fund would have to depart from its current framework and analyse so that risk is not increased elsewhere within the portfolio.

The Panel were minded to note the information as set out in the reports.

34 RISK MANAGEMENT FRAMEWORK

The Investments Manager introduced this report and highlighted the following points to the Panel.

- The Liability Driven Investment (LDI) strategy was additive to returns with no triggers breached during this period.
- The Equity Protection Strategy (EPS) was additive to returns in September but has since detracted since inception. It is currently 'amber' (under review)

as it needs to be restructured following decision to change the equity allocations.

- All Risk Management strategies are performing as expected.
- The Funding and Risk Management Group (FRMG) has considered how many counterparties the additional global equity exposure should be split across, which counterparty should be selected and the process for implementation.

The Panel, having been satisfied that the public interest would be better served by not disclosing relevant information, **RESOLVED**, in accordance with the provisions of the Section 100(A)(4) of the Local Government Act 1972 that the public should be excluded from the meeting for this item of business, because of the likely disclosure of exempt information as defined in paragraph 3 of Part I of Schedule 12A of the Act as amended.

The Panel were minded to:

- (i) Note the current funding level and LDI hedging position
- (ii) Note the impact and performance of the equity protection strategy
- (iii) Note the current collateral adequacy position
- (iv) Note the current FRMG workstreams as summarised in sections 5-7 below

35 FORWARD AGENDA

The Group Manager for Funding, Investment & Risk introduced this report to the Panel.

Shirley Marsh-Hughes asked if the Taskforce on Climate-related Financial Disclosures (TCFD) report could be shared in advance of the December Avon Pension Fund Committee meeting.

The Group Manager for Funding, Investment & Risk replied that she would do so.

The Panel were minded to note the forward agenda.

The meeting ended at 4.10 pm

Chair(person)

Date Confirmed and Signed

Prepared by Democratic Services