

## Bath & North East Somerset Council

MEETING:	<b>AVON PENSION FUND COMMITTEE</b>
MEETING DATE:	<b>16 DECEMBER 2022</b>
TITLE:	<b>INVESTMENT STRATEGY AND BRUNEL UPDATE (for periods ending 30 September 2022)</b>
WARD:	<b>ALL</b>
<b>AN OPEN PUBLIC ITEM</b>	
<b>List of attachments to this report:</b> Exempt Appendix 1 – Brunel Monitoring Dashboard Appendix 2 – Investment Strategy Dashboard Appendix 3 – Mercer Quarterly Investment Performance 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, policy and operational aspects of the Fund.
- 1.2 Exempt Appendix 1 updates the Committee about Brunel and the wider pool covering delivery of service, performance, governance and risk management aspects of the pool.
- 1.3 Appendix 2 summarises progress in respect of the investment strategy (including the risk management framework), portfolio performance and responsible investment issues. Investment performance remains behind the strategic benchmark. Significant headwinds i.e., high inflation and the uncertain macro-outlook persist. Brunel portfolios continue to underperform on a medium-term basis due to active style tilts but have shown signs of alpha generation in the quarter, hence the direction of travel is positive.
- 1.4 The Mercer Investment Performance Report at Appendix 3 contains performance statistics for periods ending 30 September 2022. Mercer will present their paper at the meeting.
- 1.5 Section 8 sets out the proposed timeline of the Strategic Investment Review. The key objectives of the Review will be to determine the optimal asset allocation to deliver the required return in the funding plan to maintain stable and affordable contributions. It will also re-examine the role of the Risk Management Strategies, consider if new investment opportunities including Social/Local investing could be built into the strategy and whether the Fund's net zero ambition can be accelerated without detracting from the overriding return objective.

1.6 Further appendices to this report including Minutes of the Investment Panel and the LAPFF Quarterly Engagement Report are now available in the Modern Gov library.

## **2 RECOMMENDATIONS**

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

**2.1 Note the information set out in the report and appendices.**

**2.2 Note the outline and timetable for the Strategic Investment Review**

## **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 BRUNEL UPDATE**

4.1 The dashboard of key indicators covering strategic aspects of Brunel is set out in Exempt Appendix 1. It covers all aspects of service delivery, governance, finance and risk. It is updated quarterly to reflect current activity and developments and changes to ratings are highlighted in the commentary. A verbal update will be provided at the meeting.

### **4.2 Governance:**

- a) The next BOB meeting will be held virtually on 15th December.
- b) The Client Group (CG) meets monthly with mid-month update calls as required. Five sub-groups work with Brunel on specific aspects of the services to be delivered. Sub-group activity and output is discussed at each meeting/call.
- c) Quarterly performance and KPI reporting are reviewed by BOB consisting of
  - (i) RAG reporting on agreed metrics and commentary on action taken by Brunel if there is underperformance or areas of concern for each portfolio
  - (ii) Performance of each of the internal teams (Compliance & Risk, Investments, Operations) against their KPIs.

### **4.3 Investments:**

- a) Brunel now manages £4.5bn (at 30/09/22) of the Fund's assets (83%). This includes £721m in private market portfolios (invested capital).
- b) Brunel's quarterly investment performance and stewardship activity reports are included in the Investment Panel meeting agenda; Panel will highlight any issues or areas of concern via its normal investment reporting (covering all our managers) to Committee.
- c) The current focus of work is the 2022 Stocktake. This will review Brunel's climate policy and the approach the pool has taken given the evidence of progress/achievements over the last 2 years. The outcome (and Brunel's revised Climate Policy) will feed into our strategic investment review later in 2022/23.

### **4.4 Operational/Financial:**

- a) Brunel provides BOB with a business update at each meeting which includes high level monitoring of the budget and the transition plan. CG monitors the budget variances in detail on a quarterly basis, raising any issues with BOB.
- b) The project to improve investment reporting to clients is in full swing with a new provider appointed. New reports were published for 3Q 2022. Further refinements to Brunel performance reporting will be implemented over time.

4.5 The Brunel Working Group (BWG) is next due to meet 12<sup>th</sup> December ahead of the December BOB meeting.

## 5 INVESTMENT STRATEGY

### A – Funding Level and Investment Performance (‘Amber’ Ratings)

- 5.1 The Fund’s assets decreased by £91m in the quarter (-1.2% net investment return) ending September 2022 giving a value for the Fund of £5,365m.
- 5.2 The liabilities are expected to have risen c.1.6% due to the rise in inflation. The combined effect of this, allowing for cashflows over the period, saw the estimated funding level decrease to c.89%. The deficit was estimated to have widened over the quarter to £675m.
- 5.3 Manager performance is monitored in detail by the Investment Panel. The Fund’s investment return and performance relative to the benchmark is summarised below.

**Table 1: Fund Investment Returns** (Periods to 30 September 2022)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	-1.2%	-6.0%	2.2%
Avon Pension Fund (excl. currency hedging)	0.4%	-3.1%	2.7%
Strategic benchmark (no currency hedging)	1.5%	0.6%	5.8%
Currency hedge impact	-1.6%	-2.9%	-0.5%

### B – Portfolio Performance

- 5.4 Brunel reports on the performance of the assets they manage on behalf of the Fund. The Brunel quarterly performance reports are available in the Modern Gov library.
- 5.5 Brunel listed market portfolios delivered moderate performance during the quarter. Listed equity portfolios delivered positive absolute returns while Credit and DRF portfolios declined by c.1%. Style characteristics were less of a driver of underlying manager returns this quarter with underperformance driven largely by stock selection, which is expected in high conviction, active portfolios. Underperformance on a 1-year basis is largely attributed to the growth/quality and ESG bias in the portfolios hence they remain ‘amber’ rated. The DRF and credit portfolios underperformed in part because their performance is measured against a cash benchmark. Both portfolios were broadly in line with secondary benchmarks made up of comparable assets. Pace of capital deployment across the Brunel private market portfolios is currently on track.
- 5.6 The currency hedge that forms part of the Fund’s Risk Management Framework is rated ‘amber’. As GBP has fallen the currency hedge has caused a drag on returns. The significant decline in the value of GBP against the USD has led to

a -2.9% drag on returns over a 1-year period although post period end GBP has recovered from c.1.12 to c.1.20 against the USD.

- 5.7 The 'amber' RI factors reflect current work in progress. Enhanced climate metrics and disclosures form part of the ongoing Brunel climate stocktake.
- 5.8 **Returns versus the strategic assumptions:** Global Sustainable Equity returns are below expected returns due to portfolio biases. Multi Asset Credit is also behind due to negative returns from fixed income markets in 2022. The private markets mandates are either still in build-up phase or do not have a sufficient track record to properly compare against strategic return assumptions.

## **6 LIABILITY DRIVEN INVESTMENT UPDATE**

- 6.1 Prior to the 'mini-budget' announcement the Fund had implemented a revised interest rate trigger framework to capture opportunities presented by rising UK interest rates. As a result of the subsequent extreme move in yields in late September, a number of the triggers within the framework were breached within a short timeframe taking the hedge ratio on interest rates from c.12% to c.40% as a percentage of assets. As such, the framework was suspended and it was agreed by FRMG that the case for reactivating the trigger framework would be revisited once we have confirmed the role and scope of LDI as part of the overarching investment strategy in 1Q 2023.
- 6.2 In addition to breaching a number of interest rate triggers, rising interest rates and the fall in equity markets experienced over the period led the Fund to breach its collateral top-up notification point. As a result, steps were taken to recapitalise the risk management framework by drawing on assets contained within the risk management framework as well as transferring in additional assets in the form of listed equities to ensure all risk management strategies were supported with adequate collateral, while the Fund's overall asset allocation remained stable.
- 6.3 A robust collateral monitoring framework, which specifies where collateral should be sourced from in the event of extreme market volatility combined with a nimble governance process (in the form of FRMG), meant the Fund did not become a forced seller of assets and maintained a strong collateral position throughout. At the end of September, the Fund could sustain a 2.7% rise in interest rates, a 3.6% fall in inflation or a 35% fall in the value of the equity protection strategy relative to the hedged exposure (all in isolation) before the early warning test triggered.
- 6.4 Reactivation of the trigger framework, as well as a broader review of LDI, will be examined as part of the forthcoming strategic review. Post-event, regulatory scrutiny of LDI mandates has increased and will likely lead to higher collateral buffers being required for those Funds who operate leveraged LDI programmes. Officers and FRMG are currently working with the investment manager to determine the appropriate level of collateral and any implications it may have for the Fund's wider investment strategy.

## **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.

7.2 The Panel last met on 25 November. At the meeting the Panel received a presentation from Brunel on the Cycle 3 infrastructure portfolio and discussed the key areas of focus for the forthcoming Strategic Investment Review. Discussions were had on the cashflow profile/illiquidity budget of the Fund and options for aligning the equities in the Risk Management Framework with the goals of the Paris agreement, with implementation of the latter delegated to Officers. A copy of the draft minutes will be made available in the Modern Gov library.

## 8 STRATEGIC INVESTMENT REVIEW

8.1 The key piece of work this year is the Strategic Investment Review. At the last review in 2019/20 we made significant changes by allocating to Private Debt and changing the allocation within equities to increase (i) the alignment with the low carbon transition and (ii) the allocation to sustainable/impactful investments as well as set interim decarbonisation targets. Initially it was anticipated that the 2022/23 review would be relatively light touch, focussing on the climate targets and Social/Local Impact investing. However, the significant changes in the economic and market environment during 2022 makes it necessary to review the asset allocation and risk management strategies more holistically in light of a higher interest rate and inflation environment.

8.2 To assist the process, prior to the workshop in February Mercer will prepare a number of short papers to summarise the key issues or analysis to be discussed at the workshop. The timetable is tight if the review is to be concluded before the next committee cycle; therefore if the discussions are not concluded by the 17 March committee meeting the review will be taken forward by the next committee.

8.3 The key areas of focus for the Review will be;

- (I) **Review of the Fund's core investment beliefs and principles** – how this influences the design of the investment strategy and its implementation, taking into account key investment and ESG objectives and any potential constraints.
- (II) **Overriding objective** – Consider a few potential strategies that meet the risk return profile and test each under differing investment/funding scenarios.
- (III) **Other principles and goals** – Consider the impact of asset allocation decisions on the ability to meet ESG/climate targets, and whether strengthening climate targets would constrain the asset allocation in any way.
- (IV) **Asset allocation** – Review of underlying asset classes and rationale for their inclusion in the strategy in light of current markets and long-term prospects, including:
  - Equities** – allocation; active vs passive management, Equity Protection Strategy role, level of protection, impact on collateral
  - Illiquid growth** – role of Local/Social Impact portfolio and its parameters; implications for allocation to other illiquid growth assets.
  - Currency hedging** - review level of hedging for overseas assets and impact on collateral.

**Liability Driven Investing** - revisit the case for using synthetic/leveraged exposure vs no hedging of liabilities

**Overall cashflow/liquidity** - consider liquidity budget; impact on overall allocation between liquid/illiquid assets.

1.1 The timetable for the Review is:

- a. **January 2023** – Officers and Mercer develop key areas for consideration
- b. **28 February 2023** – Committee workshop to agree objectives and investment beliefs, consider asset allocation options and risk management strategies to conclude preferred option.
- c. **17 March 2023** – Committee meeting to approve preferred option and timetable for implementing any changes.
- d. Following the Review the Investment Strategy Statement will be updated.

## **9 RESPONSIBLE INVESTMENT ACTIVITY**

9.1 **Voting and Engagement Summary:** Federated Hermes EOS provide voting and engagement services on behalf of the Fund. Summary reports available in the Modern Gov library disclose the number of companies and topics engaged on over the quarter.

9.2 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 which is also available in the Modern Gov library.

9.3 The Fund is currently a signatory to the FRC Stewardship Code. Post period end the Fund submitted its second annual Stewardship Code statement and will find out whether it has maintained signatory status in 1Q 2023.

## **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 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 Head of Pensions has reviewed this paper for publication.

<b>Contact person</b>	Nathan Rollinson, Investments Manager (Tel: 01225 395357)
<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>	