

<b>Bath &amp; North East Somerset Council</b>	
MEETING:	<b>AVON PENSION FUND COMMITTEE</b>
MEETING DATE:	<b>23 JUNE 2023</b>
TITLE:	<b>INVESTMENT STRATEGY AND BRUNEL UPDATE (FOR PERIODS ENDING 31 MARCH 2023)</b>
WARD:	<b>ALL</b>
<b>AN OPEN PUBLIC ITEM</b>	
<p>List of attachments to this report:</p> <p>Exempt Appendix 1 – Brunel Monitoring Dashboard</p> <p>Appendix 2 – Investment Strategy Dashboard</p> <p>Appendix 3 – Mercer Quarterly Investment Performance Report</p> <p>Appendix 4 – Quarterly LAPFF Engagement Report</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, 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. Despite strong performance from the Fund's listed equity portfolios over the quarter, 1-year and 3-year investment performance remains behind the strategic benchmark driven largely by declines in property valuations and LDI assets. Significant macro headwinds i.e., high inflation and the uncertain economic outlook persist.
- 1.4 The Mercer Investment Performance Report at Appendix 3 contains performance statistics for periods ending 31 March 2023. Mercer will present their paper at the meeting.
- 1.5 Section 7 provides an update on the implementation of changes agreed as part of the 2022/23 Strategic Investment Review.

## **2 RECOMMENDATIONS**

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

- 2.1 Note 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 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 8th June.
- 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 £4.6bn (at 31/03/23) of the Fund's assets (86%). This includes £908m 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.

### **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. Further refinements to Brunel performance reporting will be implemented over time.

## **5 INVESTMENT STRATEGY**

### **A – Funding Level and Investment Performance ('Amber' Ratings)**

5.1 The Fund's assets increased by £155m in the quarter (3.0%% net investment return) ending March 2023 giving a value for the Fund of £5,384m.

5.2 The liabilities are expected to have risen c.4.7% due to the rise in inflation. The combined effect of this, allowing for cashflows over the period, saw the estimated funding level decrease marginally to c.95%. The deficit was estimated to have widened over the quarter to £268m.

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 31 March 2023)**

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	3.0%	-7.3%	6.1%
Avon Pension Fund (excl. currency hedging)	2.4%	-6.2%	6.1%
Strategic benchmark (no currency hedging)	3.1%	-1.3%	11.1%
Currency hedge impact	0.6%	-1.1%	0.0%

## **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 presented to the Investment Panel. A summary of Brunel portfolio performance can be found in Section 5 of the Mercer report at Appendix 3.

5.5 Positive performance in listed equities and fixed income (including LDI assets) offset the negative performance of illiquid growth assets during the quarter. Property valuations continue to be negatively affected by the higher interest rate environment. The majority of gains in equities were driven by a small number of large-cap growth stocks, which the Fund is broadly underweight. Despite this strong stock selection across the Brunel listed equity portfolios delivered modest outperformance. The Multi Asset Credit (MAC) portfolio outperformed its cash benchmark despite volatility in the sub-investment grade sector sparked by fears around the stability of the banking sector. The Diversified Returns Fund (DRF) ended the quarter flat in absolute terms where short interest rate positioning was the lead detractor. Aggregate Fund underperformance on a 1-year basis is largely attributed to the DRF, MAC and property portfolios, which are benchmarked against cash rates. Pace of capital deployment across the Brunel private market portfolios is currently on track, however a slowdown in deal flow due to higher interest rates and the fallout from the collapse of Silicon Valley Bank may curtail capital calls in the short-term.

5.6 GBP strengthened against the US Dollar over the quarter, with the currency hedge contributing 0.60% to returns. Over the year broad-based Sterling weakness meant the currency hedge detracted 1.1% from returns.

5.7 **Returns versus the strategic assumptions:** Absolute returns for the global equity mandates compared to the strategic returns modelled at the last strategic review have been generally positive, with the exception of the most recently incepted Paris-aligned mandate, due to the timing of its point of inception. The DRF and MAC mandates have fallen short of return assumptions largely due to negative performance versus the cash benchmarks in 2022. Property and Secured Income have been mixed, however all of the infrastructure and private debt assets have outperformed.

## **6 INVESTMENT PANEL ACTIVITY**

6.1 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.

6.2 The Panel last met on 8 March. Key discussion points/outcomes from the meeting are listed below:

- (I) **Liability Driven Investment** – The Panel discussed regulatory guidance on increased collateral buffers following the 2022 gilts crisis. Post period end, and under delegated authority, the Funding and Risk Management Group (FRMG) implemented a revised collateral framework which saw eligible collateral increase to c.500bps, well in excess of the minimum resilience level of 250bps recommended by The Pensions Regulator. The Panel is undertaking a fundamental review of the Fund's risk management strategies and recommendations will be presented to Committee in September.
- (II) **Paris-aligned Equity Solution** – In November 2022 Panel agreed to switch c.£700m of passive market-cap equities into a Paris-aligned equity product pending the outcome of tax and regulatory due diligence by Officers. The derivative-based product has been designed to release liquidity to support other areas of the investments portfolio while expressly supporting the low carbon transition. The switch, which was implemented in May, demonstrates better alignment with the Fund's overarching climate objectives and removes exposure to standard market-cap based indices, which exhibit higher carbon intensity and a lower degree of net zero transition alignment.

## 7 STRATEGIC INVESTMENT IMPLEMENTATION UPDATE

- 7.1 **Passive/Active Equity split** – At its last meeting the Committee concluded that a 50/50 split would lessen the exposure to the inconsistency of active management, would provide greater diversification of underlying holdings within the equity portfolio, provide for a more systematic approach to decarbonisation (if invested in Paris Aligned (PAB) Passive fund as proposed), and at the same time meet projected investment returns and climate objectives. In May officers redeemed £300m in aggregate from the Brunel active equity portfolios and invested the proceeds in the Brunel Paris-aligned passive portfolio. Total cost of the transition (inclusive of all frictional trading costs) was in line with the initial estimate of £400k, or 0.13% of total notional traded.
- 7.2 Committee have agreed to allocate an initial 3% (~£160m) of fund assets to a local impact portfolio. The portfolio will be asset class agnostic but is expected to centre around local affordable housing and renewable infrastructure opportunities. 'Local' in this context refers to the Southwest region. Officers are currently developing the governance framework that will specify how investment opportunities are assessed before entry into the portfolio. Elements of this portfolio may have to be managed outside of Brunel in which case Mercer would provide suitability advice for any prospective investments. All investments are expected to be managed by an external asset manager in order to retain objectivity and to avoid any potential conflicts of interest. Since agreeing the allocation, a number of compelling investment opportunities have arisen which officers are currently reviewing in consultation with multiple other Brunel partner funds. Flexibility around the governance and decision-making process is therefore required to ensure attractive opportunities are not missed.

Further information relating to 'live' investment opportunities and the local impact governance framework will be presented to the Investment Panel and Committee in due course.

## 8 RESPONSIBLE INVESTMENT ACTIVITY

- 8.1 **Stewardship Summary:** Brunel have appointed Federated Hermes EOS to provide voting and engagement services on behalf of the Fund. Hermes engaged with 272 companies held by Avon in the Brunel active portfolios on a range of 1034 ESG issues. Environmental topics featured in 34% of engagements, 72% of which related directly to climate change. Social topics featured in 29% of engagements, where conduct and culture, human rights and diversity featured prominently. Of the 30% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 111 meetings (1,209 resolutions). At 59 meetings they recommended opposing one or more resolutions. 60% of the issues Hermes voted against management on comprised board structure and remuneration. Further information relating to the voting and engagement work undertaken by Hermes on behalf of all Brunel partner funds can be found [here](#).
- 8.2 This quarter Brunel, alongside several other UK pension schemes, signalled their intent to vote against the reappointment of Shell & BP's chair citing a change in leadership, strategy and a paring back of prior commitments to materially cut oil and gas output. Collectively BP and Shell make the largest contribution to financed emissions across Brunel equity portfolios. The outcome of the vote and any steps taken by the companies in response will be shared in due course. Subsequently, Brunel announced that they would be convening a meeting (via the UK Asset Owner Roundtable forum) of major fund managers following the proxy season over a perceived misalignment between long-term interests and how investment managers are exercising proxy voting at key annual general meetings of European oil and gas majors. Details of the letter issued to all underlying Brunel asset managers can be read [here](#).
- 8.3 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 4.
- 8.4 The Fund successfully retained its FRC UK Stewardship Code signatory status for the year ending 31 March 2022. The Report is available to read [here](#).
- 8.5 **Climate Policy Updates:** During the quarter Brunel published a revised climate policy which prioritises metrics relating to alignment and credibility of alignment over carbon intensity, consistent with the real-world impact sought by IIGCC Net Zero Asset Owners Framework. The Policy can be read in full [here](#).

## 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 STATEMENT**

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 Strategy. The Fund acknowledges the financial risk to its assets from climate change and is addressing this through its strategic asset allocation to Transition Aligned 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 Director of One West has had the opportunity to input to this report and has 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>	