Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**15 DECEMBER 2023**
TITLE:	**INVESTMENT STRATEGY (for periods ending 30 September 2023)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Investment Strategy Dashboard Appendix 2 – Mercer Quarterly Investment Performance Report Appendix 3 – Quarterly LAPFF Engagement 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 Appendix 1 summarises progress in respect of the investment strategy (including the risk management framework), portfolio performance and responsible investment issues. 1-year and 3-year investment performance remains behind the strategic benchmark driven largely by declines in property valuations and LDI assets.

1.3 The Mercer Investment Performance Report at Appendix 2 contains performance statistics for periods ending 30 September 2023. Mercer will present their paper at the meeting.

2 RECOMMENDATIONS

The Avon Pension Fund Committee is asked to:

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

2.2 **Agrees the recommendation from Investment Panel to reduce the dynamic equity protection hedge ratio to 50% and;**

2.3 **Agrees implementation of 2.2 is delegated to FRMG.**

3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund for the three years commencing 1 April 2023 will impact the next triennial valuation which will be calculated as at 31 March 2025. The returns quoted are net of investment management fees.

4 INVESTMENT STRATEGY

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

4.1 The Fund's assets were £5,268m on 30 September 2023 and delivered a net investment return of -2.9% over the quarter. The decline in the value of Fund assets over the quarter was driven mainly by the LDI portfolio and equity assets. Overseas property and secured income portfolios also detracted.

4.2 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 2023)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	-2.9%	-2.1%	1.5%
Avon Pension Fund (excl. currency hedging)	-2.3%	-3.8%	1.7%
Strategic benchmark (no currency hedging)	-0.1%	4.8%	7.0%
Currency hedge impact	-0.6%	1.7%	-0.2%

B – Portfolio Performance

4.3 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 4 of the Mercer report at Appendix 2.

4.4 The third quarter saw a decided change in tone and outlook. Although interest rates are no longer rising rapidly, the expectation is that they will now remain at higher levels for longer. This weighed on both global equity and bond markets. Brunel's portfolios were mixed during the quarter, with a number rising in absolute terms, whilst others fell. The Global High Alpha portfolio returned -0.6% during the quarter, underperforming the benchmark by 1.2%. The underweight to the energy sector combined with slower than expected revenue growth from stocks in IT, healthcare and financials weighed on performance.

The Global Sustainable Equity portfolio delivered a return of -4.1% over the quarter, underperforming its benchmark by 4.7%. Many sustainable strategies struggled to outperform during the period due to the inherent 'growth' investment style of these funds. Since inception in 2021, this portfolio has underperformed its benchmark by 5.6%. Metrics designed to assess the quality of the underlying companies in the portfolio highlight sound financial underpinnings, which are expected to be rewarded over time. We believe the long-term proposition for sustainable stocks remains intact.

The Multi Asset Credit (MAC) portfolio delivered an absolute return of 1.9%, flat against both its primary (cash +4%) benchmark and its secondary benchmark, which comprises loans and high yield bonds. Since inception the MAC portfolio has delivered -0.7% in absolute terms, underperforming the cash benchmark by -6.9%. The Diversifying Returns Fund (DRF) generated an absolute return of 2.0% matching its primary (cash +3%) benchmark. Since inception the DRF fund has generated +2.5%, underperforming its cash benchmark by -2.1%.

In private markets, deal flow has tentatively began to pick up, thanks to increased certainty in interest rate movements. However, raising capital remains difficult with many private equity and debt funds extending fundraising periods. Likewise, global property transactions were down over 50% according to CBRE and property funds continue to be plagued by redemptions. The Fund's core infrastructure mandate delivered an absolute return of 3.3% over the quarter, reflecting increased demand for airport, pipeline and seaport assets. The Brunel infrastructure portfolios are still in build-up but performance data is starting to become more meaningful. A very mild 2023 has negatively impacted many operating renewable businesses as a result of low production rates causing lower than anticipated revenues. Lower production rates have been offset somewhat by higher power prices. Brunel's exposure to renewables is well diversified by geography, technology and revenue profile, however the known risks around supply chains, cost of capital and certain types of subsidy regimes continue to be monitored.

The two long lease property funds held in the Secured Income portfolio have been impacted by rising rates, resulting in valuation declines. Both long lease property funds received large redemption requests in 2022 and are still in the process of selling assets to raise cash. M&G has paid down approximately 80% of redemption requests and Aberdeen has cleared approximately 40% of its redemption queue. Further asset disposals are expected. The operational infrastructure component of the Secured Income portfolio, which has benefitted from higher power prices over the past year, continues to offset depressed long lease property valuations.

Finally, private debt benefitted from its focus on traditionally resilient sectors such as healthcare, professional services, and established software which helped the portfolio deliver an interim IRR of 13.8%. The Brunel Private Debt portfolio benefits from the defensive, high quality underlying credits that are typically senior in the capital structure and sponsor-backed. This portfolio remains in build-up phase with c.60% capital deployed at the end of the quarter.

4.5 **Returns versus the strategic assumptions:** Equity and liquid growth assets classes are generally delivering in line or exceeding expected returns based on the 2023 investment strategy review. Property is below its modelled return and the other private market mandates are largely still in build-up phase or do not have a sufficient track record to properly compare against strategic return assumptions.

5 INVESTMENT PANEL ACTIVITY

5.1 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.

5.2 The Panel last met on 1 December. Minutes of the meeting will be made available to Committee members in due course. The most substantive item discussed during the meeting was the modelling output of the dynamic equity protection strategy. There was unanimous support to reduce the hedge ratio to 50% from 100% of underlying equity exposure. Panel members considered the trade-offs between asset performance drag and risk reduction, and specifically the impact on the discount rate and employer contributions as part of their decision to recommend the strategic change to Committee. The main reasons Panel supported the reduction are set out below:

(I) **Mitigation of asset performance drag.** The dynamic EPS has detracted c.2.0% p.a. from underlying equity returns since inception, which is equivalent to c.0.8% at total fund level. Historical scenario modelling supports the argument that the dynamic EPS creates a drag on returns in all but the most extreme scenarios.

(II) **Implications for the discount rate.** On balance the impact of reducing the hedge on the discount rate, and by extension employer contributions, was deemed marginal with the materiality of several other competing factors likely to have a far greater effect on employer contributions at the next valuation.

(III) **Fee savings.** The quantum of fee savings from a reduction in the hedge ratio largely offset any projected impact on contributions, further underscoring the performance drag associated with the strategy.

(IV) **Risk reduction.** A meaningful degree of risk reduction under a downside scenario is maintained with a 50% hedge, while minimising the opportunity cost associated with a 100% hedge ratio.

(V) **Collateral.** The collateral position materially improves based on a 50% hedge ratio, freeing up capital to deploy elsewhere such as opportunistically increasing the interest rate hedge ratio.

6 RESPONSIBLE INVESTMENT ACTIVITY

6.1 **Quarterly Stewardship Summary**: Hermes engaged with 153 companies held by Avon in the Brunel active equity portfolios on a range of 521 ESG issues. Environmental topics featured in 35% of engagements, 60% of which related directly to climate change. Social topics featured in 31% of engagements, where conduct and culture, human rights and diversity featured prominently. Of the 18% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 123 meetings (1,234 resolutions). At 69 meetings they recommended opposing one or more resolutions. 86% of the issues Hermes voted against management on comprised board structure and remuneration.

6.2 Details of LAPFF lead initiatives and engagement work can be found at Appendix 3.

7 RISK MANAGEMENT

7.1 An effective governance structure, defining clear responsibilities, and ensuring that the decision-making body has an adequate level of knowledge and access to expert advice, is a key aspect of the risk management process.

8 EQUALITIES STATEMENT

8.1 A proportionate equalities impact assessment has been carried out using corporate guidelines and no significant issues have been identified.

9 CLIMATE CHANGE

9.1 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 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.

10 OTHER OPTIONS CONSIDERED

10.1 None.

11 CONSULTATION

11.1 The Council's Director of One West has had the opportunity to input to this report and has cleared it for publication.

Contact person	Nathan Rollinson, Investments Manager 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.	