Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**28 JUNE 2024**
TITLE:	**INVESTMENT STRATEGY (for periods ending 31 March 2024)**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Mercer Quarterly Investment Performance Report Appendix 2 – 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 Investment performance over the quarter met the benchmark return however over longer timeframes the Fund is behind the benchmark. Return drivers are discussed in further detail in section 4 of this report.

1.3 The Mercer Investment Performance Report at Appendix 1 contains performance statistics for periods ending 31 March 2024. Mercer will present their paper at the meeting.

1.4 Key responsible investment updates, including notable Brunel updates and metrics designed to show how the Fund is delivering against its net zero goals, are included in sections 6 and 7 of this report. Appendix 2 summarises the voting and engagement activity undertaken on behalf of the Fund by the Local Authority Pension Fund Forum (LAPFF). The Fund undertakes in-depth carbon analysis on an annual basis and publishes the results in its Annual Responsible Investment Report, which is cleared by Committee in September.

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 decisions made by the Investment Panel at its 5 June 2024 meeting, namely:**

(1) To appoint Octopus Real Estate to manage a £50m allocation to affordable housing.

(2) To keep the LDI trigger framework on pause in light of the Fund's liquidity position over the next two years.

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 £5,818m on 31 March 2024 and delivered a net investment return of 2.3% over the quarter which was in line with the benchmark. The increase in the value of Fund assets over the quarter reflected strong equity markets, with Brunel’s listed portfolios all positive on an absolute basis, although flat on a relative basis.

4.2 Over 1 year the Fund returned 7.8% in absolute terms and -2.0% in relative terms, where most portfolios underperformed their respective benchmarks. Of the listed equity portfolios, underperformance was most pronounced in the Global Sustainable Equity Portfolio, with Global High Alpha also lagging its benchmark return. Underperformance over this period is attributed to underweight positions in the ‘Magnificent 7’ stocks as well as structural underweights to the energy sector and a bias toward quality and growth stocks, which typically do less well in a higher interest rate environment.

4.3 The main drivers of underperformance over 3 years included the active equity mandates, the equity protection strategy and Overseas Property and Secured Income.

4.4 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 2024)

	3 Months	12 Months	3 Years (p.a)
Avon Pension Fund (incl. currency hedging)	2.3%	7.8%	3.2%
Avon Pension Fund (excl. currency hedging)	2.3%	7.1%	3.6%
Strategic benchmark (no currency hedging)	2.4%	9.8%	7.1%

1.1. The liabilities are estimated to have increased by c.0.6% over the quarter. Taken together with the asset return, the funding level stood at 98% at March-31 (c. £107m deficit).

1.2. The Value-at-Risk increased over the quarter to £1,701m (from £1,371m) primarily as a result of the reduction in the equity hedge from 100% to 50%.

B – Portfolio Performance

4.5 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. The Fund’s top 10 equity positions and a brief summary of portfolio level performance can be found below. Further detail for both Brunel and legacy portfolio performance can be found in Section 4 of the Mercer report (Appendix 1).

Table 2: Top 10 Equity Holdings

Security Name	Sector	Country	Value of Holding	% of Fund assets
Microsoft	Information Technology	United States	£84.5m	1.5%
Amazon	Consumer Discretionary	United States	£64.5m	1.1%
Mastercard	Financials	United States	£42.3m	0.7%
Alphabet	Communication Services	United States	£36.8m	0.6%
NVIDIA	Information Technology	United States	£36.2m	0.6%
Novo Nordisk	Health Care	Denmark	£30.1m	0.5%
ASML	Information Technology	Netherlands	£26.9m	0.5%
Taiwan Semiconductor	Information Technology	Taiwan	£26.3m	0.5%
UnitedHealth	Health Care	United States	£25.2m	0.4%
Visa	Financials	United States	£23.7m	0.4%
TOTAL	**--**	**--**	**£396.5m**	**6.8%**

* Table excludes cash and legacy assets. Estimated aggregate position using Brunel Portfolios

4.6 **Listed Markets.** Absolute returns were positive reflecting the strength in global equity markets over the period. Global High Alpha returned 9.9%, just 0.1% below the benchmark (MSCI World). The Global Sustainable Equity portfolio returned 9.2%, also 0.1% behind its benchmark (MSCI ACWI). Market sentiment for sustainable investing continued its positive trend that began in Q4 2023 however, over one year to end March 2024, the portfolio remains significantly behind the benchmark. Stock selection, particularly the underweight to 4 of the ‘magnificent 7’, was the main driver of relative performance at a sector level. Both active equity portfolios exhibit a style bias toward ‘quality’ and ‘growth’ stocks, the latter tends to underperform in environments where interest rates are rising. Additionally, the structural underweight to the energy sector has acted as a drag on returns. The Diversified Returns Fund and Multi Asset Credit portfolios both outperformed their respective benchmarks over 1 year, benefitting from improved risk sentiment.

4.7 **Private markets.** New deal volumes have been growing from recent lows. In infrastructure, despite continued volatility across the political, economic and investment landscapes, infrastructure as an asset remained broadly resilient, feeding through to the Brunel Infrastructure portfolios.

In Secured Income, open-ended long lease property funds have suffered heavy redemptions in recent years from liquidity shocks and investors withdrawing from the sector on liquidity concerns. Our underlying property fund managers continue to dispose of assets to fund these redemptions and more sales are expected over 2024. Despite recent outflows, the property portfolio continues to show strong fundamentals such as rent collection at pre-pandemic levels, low vacancy rates and record high distribution yields. Post period end a final £35m capital call was made by Cycle 3 Secured Income. The Fund's £705m commitment to Secured Income is now fully invested.

4.8 **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.

Local Impact Portfolio – Affordable Housing Fund

5.2 The Panel last met on 5 June 2024. Minutes of the meeting will be made available to Committee members in due course. The most substantive item discussed during the meeting was the proposal to appoint Octopus Real Estate as the manager of the Fund's £50m initial commitment to affordable housing. The £50m represents c.30% of the fund's overall allocation to local impact and will be split between a national pooled fund (£40m) and a purpose built co-investment vehicle (£10m), which will invest in affordable housing schemes in the Avon region.

5.3 Following a shortlisting exercise by Officers, Mercer provided full suitability advice on the main fund, the co-investment structure and the sizing of the allocation. The strategy has recently been awarded Mercer's highest research rating of 'A/ESG1'[1].

5.4 Panel voted unanimously in favour of the recommendation to appoint Octopus, citing a number of reasons, including:

(I) The managers diversified approach to tenure types which include discounted market rents, shared ownership and other forms of regulated Affordable Housing which target low- to middle-income households and key workers.

(II) A 'direct-let' model of implementation which allows direct oversight of the relationship between tenants and the landlord, thereby reducing reputational risk associated with strategies that use third-party landlords.

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[1] *A = Strategies assessed as having above average prospects of outperformance*
ESG1 = The highest ESG rating is assigned to strategies that Mercer believes to be leaders in integrating ESG and active ownership into their core processes, and provide clear evidence that ESG overall, is core to idea generation and portfolio construction

(III) Strong environmental and social impact characteristics at both the Firm and Fund level. The Fund itself has adopted a 2040 Net Zero target and leverages the expertise of its retail energy arm to deliver savings to tenants via reduced energy bills.

(IV) A clear approach to deploying capital locally and the ability to work with local 'Approved Partners' (i.e. Housing Associations, Local Authorities and other third-party developers that operate in the region) to help source and develop a robust pipeline of local opportunities.

5.5 Legal advice is being sought on the terms governing both the national pooled fund and the co-investment vehicle ahead of finalising the Fund's subscription.

Liquidity Analysis & Cash Management

5.6 Panel members considered the Fund's liquidity needs over the next 2 years, taking account of both the net benefit outgo and remaining capital calls arising from the Brunel private markets portfolios.

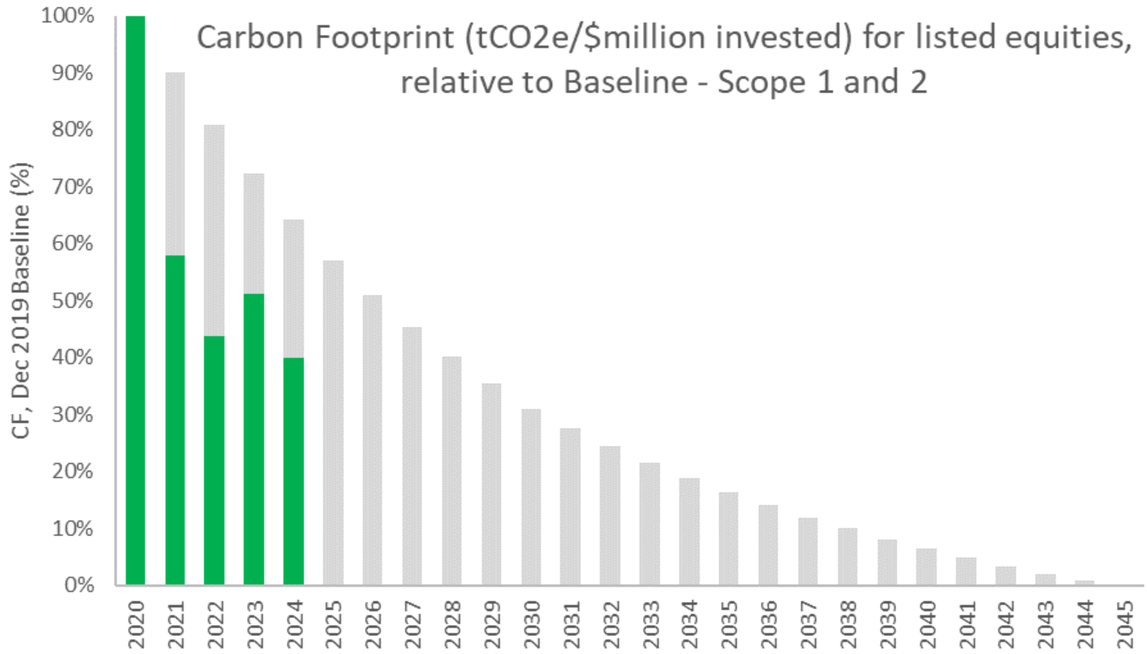
5.7 A key source of liquidity (in addition to existing income generating assets) is the excess cash collateral in the BlackRock QIF that was released following the reduction in the equity hedge. Rather than use this excess collateral to reinstate the LDI trigger framework (which has been suspended since October 2023) and increase the level of liability hedging, Panel agreed to keep the trigger framework on pause so as not to create pressure on the Fund's near-term liquidity position. Instead, any excess liquidity will be invested in money market funds which are generating a yield of 4-5% and offer instant withdrawals. The decision on which cash funds to invest in was delegated to Officers and Mercer.

5.8 The current interest rate and inflation hedge ratios are c.40% and c.22%, respectively. Officers and Mercer are exploring the option of reinstating the inflation triggers in isolation as increasing the inflation hedge is not expected to be as capital intensive as increasing the interest rate hedge further. Currently inflation is significantly above the target hedging levels, therefore no immediate increase in hedging is expected to take place in the event the inflation triggers are reinstated.

Finally, Panel considered possible sources of funding for a dedicated 2% Natural Capital allocation, agreeing that the best source is the existing overseas property portfolio which is currently being wound down. The Committee expressed an interest in Natural Capital at its Climate Workshop last year, recognising its role in helping the Fund achieve its climate targets. Further information on Natural Capital investing will be presented to the Committee in due course.

6 2045 NET ZERO TARGET

6.1 The Fund reviews its progress against its net zero targets annually. The most recent analysis shows the Fund has decreased its carbon footprint (scope 1 & 2) by 60% relative to the 2019 baseline year. Furthermore, it is currently ahead of the proposed decarbonisation pathway to achieve the interim reduction targets of 43% by 2025 and 69% by 2030 as well as to reach net zero emissions by 2045.



6.2 Note the 2030 target has been retained whilst the net zero date was brought forward from 2050 to 2045 following the climate review in 2023. As such, the rate of carbon reduction required from 2030 is greater under the new target trajectory.

6.3 The listed equities portfolio is much more carbon efficient when compared to the wider market (57% below the MSCI ACWI as at December 2023).

6.4 In order to reach the 2030 interim decarbonisation target, the listed equities carbon footprint is required to reduce by a further 22%. The 2025 target has already been achieved.

6.5 On a forward-looking basis progress is likely to rely more heavily on underlying company decarbonisation, including through engagement, than strategic asset allocation changes which have made a significant contribution to decarbonisation progress to date. Therefore, decarbonisation progress is expected to be more challenging to 2030.

6.6 Full analysis including carbon intensity and transition alignment metrics, as well as the proportion of Fund assets invested in climate solutions are included in the Responsible Investment Annual Report, which will be presented to Committee in September. The 2022/23 Report, which articulates some of the critical trade-offs the Fund faces in respect of investment decision making and climate, is available to read here: Avon PF RI Report.

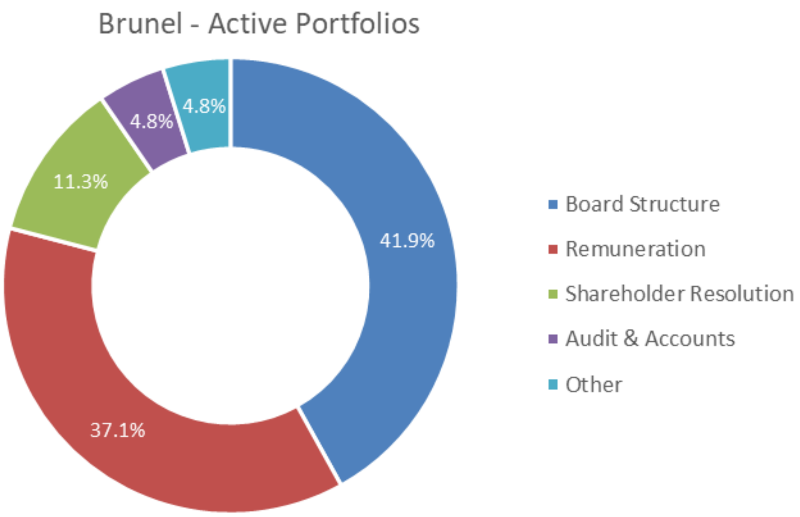
7 QUARTERLY STEWARDSHIP SUMMARY

As a responsible investor, we actively endorse collaborative engagement and seek to use our power as a shareholder to encourage corporate change. Voting and engagement are delegated to the Brunel Pension Partnership for the actively managed equity portfolios and to Legal and General Investment Management (LGIM) for the passive portfolios. The voting records of Brunel and LGIM at company meetings held over the last quarter are summarised in the following table:

Votes cast at company meetings in the quarter to 31 March 2024:

	Quarter to 31 March 2024		
Manager	Number of Meetings	Number of Resolutions	Votes against management recommendation
Brunel/LGIM - Passive Portfolios	128	1805	368
Brunel - Active Portfolios	23	578	62

7.1 The votes against management recommendations will reflect matters where there is concern that the company is not addressing the relevant issue and managing it effectively. The Fund would expect that votes against management should be primarily on the priority areas set out in the Fund's Investment Strategy Statement. An analysis of the issues where votes have been cast against management recommendations is set out below:



7.2 Brunel conduct significant engagement with investee companies on behalf of the Fund. A breakdown of the engagement undertaken over the last quarter is summarised as follows:

Company engagement in the quarter to 31 March 2024:

	Quarter to 31 March 2024	
	Number of Companies	Number of Issues
Brunel - Active Portfolios	220	797

7.3 Further information on Brunel's engagement activity can be found on their website using the following link: [Brunel Website]

Voting Activity Spotlight: Shell PLC Shareholder Resolution:

Resolution Details	Management Advice to SH	Brunel Vote	Notes
Shareholder Resolution – Resolution 23 Filed by: Follow This Shareholders support the company, by advisory note, to align its medium-term emissions reduction targets covering the GHG emissions of the use of its energy products (Scope 3) with the goal of the Paris Climate Agreement. AGM date 21 May 2024.	Vote AGAINST resolution	Vote FOR resolution Note: not held in LGIM Passive portfolio	Brunel was one of 27 leading investors that backed this resolution alongside Follow This. The resolution was designed to give Shell a shareholder mandate to drive the energy transition. The co-filing demonstrates Brunel's commitment to tackling the climate crisis at its source. Outcome: the resolution received 18.6% support from shareholders.

7.4 Details of LAPFF lead initiatives and engagement work can be found at Appendix 2.

8 RISK MANAGEMENT

8.1 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.

9 EQUALITIES STATEMENT

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

10 CLIMATE CHANGE

10.1 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.

11 OTHER OPTIONS CONSIDERED

11.1 None.

12 CONSULTATION

12.1 The Council's Director of Financial Services, Assurance & Pensions has had the opportunity to input to this report and has cleared it for publication.

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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.	