Nottinghamshire County Council

Report to Pension Fund Committee

7 March 2024

Agenda Item: 5

REPORT OF SERVICE DIRECTOR – FINANCE, INFRASTRUCTURE & IMPROVEMENT

WORKING PARTY

Purpose of the Report

1. The Pension Fund Working Party meets twice a year or additionally where circumstances require and is open to all Pension Committee Members to attend. The purpose of the Working Party is to discuss key issues in more detail and to make recommendations to Pension Fund Committee. This report sets out details of the items discussed at the most recent meeting on 11 January 2024 and makes recommendations as follows:-

    1) Reduce the outperformance target to 0.8% as part of the gradual process of de-risking the Fund as it becomes more mature.
    2) Reduce the allocation to Growth by 3% through a 1% reduction in each of Developed Markets, Emerging Markets and Private Equity.
    3) Increase the allocation to Income by 1%. Amend the income category subclass allocations as shown in Table 1.
    4) Increase the allocation to Liquidity by 2%.
    5) Amend the Inflation category subclass allocations as shown in Table 2.

Information and Advice

2. The Working Party met on 11 January 2024. The agenda and attendees are listed in Appendices A and B, and details of the discussions and recommendations for each item are set out below.

Strategic Asset Allocation

3. The Working Party considered a report from William Bourne, independent adviser to the fund. The report considered the market environment and the financial and climate risks in the Fund.

4. The Fund reviews its strategic asset allocation (SAA) annually to ensure it is appropriate. The report reviewed the Fund's SAA in the light of last year's triennial valuation and the current economic outlook. The option of de-risking the current strategic asset allocation was considered alongside specific proposals for inflation and credit. The Working Party agreed to make the following recommendations to committee.

Recommendation 1. Reduce the outperformance target to 0.8% as part of the gradual process of de-risking the Fund as it becomes more mature.

5. It is recommended that the outperformance allowance (i.e., the emphasis on affordability) be reduced to 0.8% as part of the gradual process of de-risking the Fund as it becomes more mature. The resulting target return which the portfolio is designed to deliver is 5.5%.

Recommendation 2. Reduce the allocation to Growth by 3% through a 1% reduction in each of Developed Markets, Emerging Markets and Private Equity.

6. As part of the de-risking journey it is recommended to take 1% out of the allocation to each of DM, EM, and PE to reduce the allocation Growth assets by 3% to 57%. The implementation of this change is likely to take some time for Private Equity and holdings may increase before they decrease due to the time lag between commitment and draw down.

Recommendation 3. Increase the allocation to Income by 1%. Amend the income category subclass allocations as shown in Table 1.

Table 1

Income subcategory	Current SAA %	Proposed SAA %
Fixed Income	6.5	6.5
Gilts	1.6	2.0
Corporates	4.9	4.5
Credit	3.5	4.5
MAC	1.3	1.8
EM debt	0.4	0.4
Private	1.8	2.3
TOTAL	**10.0**	**11.0**

7. Given the opportunities available in Credit relative to gilts and corporates, the recommendation is to focus the additional 1% allocation to Income in 2024 on this sub-class with 0.5% each being added to Multi asset credit and Private credit.

8. Within Fixed Income the allocation to conventional gilts is increased slightly, offset by a reduction in the allocation to Investment Grade Corporate Bonds.

Recommendation 4. Increase the allocation to Liquidity by 2%.

9. A 4% weighting to Liquidity is recommended, as it is the one asset class guaranteed to provide some diversification at times of financial stress, and the opportunity cost is now low as interest rates for cash are much higher than in recent years. Subject to the return profile being considered attractive, the Liquidity allocation may also be invested in an extension of the Aegon Buy and Maintain corporate bond portfolio. In addition to a higher return this will provide secure cashflow over the next two years and reduce exposure to individual banks.

Recommendation 5. Amend the Inflation category subclass allocations as shown in Table 2.

Table 2

Inflation subcategory	Current SAA %	Proposed SAA %
Index Linked Gilts (ILG)	0	3.5
Infrastructure	9.8	9.3

Real Estate	12.6	9.0
Aegon Sustainable DGF	5.6	6.2
TOTAL	**28.0**	**28.0**

10. ILGs have the potential to give full protection against inflation and match future cashflows, even though not necessarily act as a full matching asset against liabilities. Now that yield levels have returned to something like normal, they should be considered the core asset within the Inflation category. However it is important to purchase at a good entry price so the time of future investment is uncertain. An initial investment in £30m of ILGs was made in October 2023. The allocation to ILGs is funded from a small reduction to Infrastructure and a larger reduction to Real Estate.

11. The Aegon Sustainable Diversified Growth Fund is a strategy which aims to beat inflation by 3% a year by investing in a range of listed investments including equity, infrastructure, and fixed income. Because it does not receive steady income, the short-term returns are not as predictable as the other three assets. However, over the long-term it has broadly delivered its target return. It has two additional important attributes. One is that it is less correlated with the other three asset classes in this category. That makes it a better diversifying asset and attractive for that reason. The second is that the manager can allocate tactically. In more volatile markets and lower economic growth, some ability to take advantage of market opportunities is valuable. For these reasons a small increase in allocation is recommended.

12. The liquidity and pricing of Infrastructure and Real Estate, and the importance of ILG yields at purchase will influence the timing of the implementation of this change.

Climate Risk Considerations

13. In accordance with the LGPSC Climate Risk Report's recommendations climate change considerations have been integrated into the advice and recommendations in the report.

14. LGPS Central provided an updated scenario analysis to the Fund in 2022. LGPSC's reports demonstrate the Fund is managed in a way which mitigates climate risk and is consistent with a pathway to net zero.

Summary

15. The following table shows the current and proposed high level strategic asset allocations.

Table 3

Outcome	Asset Classes	Current SAA %	Proposed SAA %	Range %
Growth	Listed and Private equity	60.0	57.0	47-67
Inflation protection	Property, Infrastructure, Index Linked Aegon DGF	28.0	28.0	23-33
Income	Fixed Income	10.0	11.0	6-16
Liquidity	Cash, Aegon short term bonds	2.0	4.0	0-10

Members Questions

16. At recent meetings Members had asked two questions which were responded to in a paper provided by William Bourne.

a) Why does the Fund not engage in currency hedging?
b) An update on the Fund's exposure in tobacco

17. The complexities and risks of hedging currency exposure were outlined and no case was identified for engaging in a general currency hedging programme. The Fund has benefitted from the weakening of sterling, a benefit which would have been lost had a hedging programme been in place.

18. A detailed review of tobacco investment was made in winter 2021/22. The Fund's listed exposure to tobacco at 31 December 2021 was less than 0.5% of the Fund. The majority of the Fund's exposure was through the market cap passive funds. The transition cost of moving these investments to alternative passive funds would be significant, but more importantly the ongoing management costs of the passive investments against a more expensive index would be considerable, especially relative to the scale of investments excluded. Moreover to introduce a formal exclusion across the Fund would require changes to some of the Fund's other investment arrangements at significant one off and ongoing costs, (including to some funds where there is no actual exposure to tobacco currently). As a result of this Members acknowledged that under these circumstances it would not be possible to justify the costs and risks of an exclusion policy but wish to keep the Fund's exposure under review.

19. Exposure has continued to be reviewed and has remained low. However in response to the Member's question a formal review was undertaken for the Working Party. This found that the exposure to tobacco has reduced further. No further action is recommended.

Climate risk training

20. Climate risk training was provided by LGPS Central. The topic of this year's training was "Investing During the Time of Climate Change". The presentation considered how to monitor climate risk and opportunities and the impact Pension Funds can have through capital allocation, stewardship and manager engagement activities.

Statutory and Policy Implications

21. This report has been compiled after consideration of implications in respect of finance, the public sector equality duty, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATIONS

It is recommended that Committee amends the Strategic Asset Allocation to:

1) Reduce the outperformance target to 0.8% as part of the gradual process of de-risking the Fund as it becomes more mature.
2) Reduce the allocation to Growth by 3% through a 1% reduction in each of Developed Markets, Emerging Markets and Private Equity.
3) Increase the allocation to Income by 1%. Amend the income category subclass allocations as shown in Table 1.
4) Increase the allocation to Liquidity by 2%.
5) Amend the Inflation category subclass allocations as shown in Table 2

Nigel Stevenson
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For any enquiries about this report please contact: Tamsin Rabbitts

Constitutional Comments (LPW 15/02/2024)

The proposals in this report are within the remit of the Nottinghamshire Pension Fund Committee.

Financial Comments (TMR 07/02/2024)

The financial implications are noted in the report.

Background Papers and Published Documents

Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

- none