

REPORT OF SERVICE DIRECTOR – FINANCE, INFRASTRUCTURE & IMPROVEMENT

STRATEGIC ASSET ALLOCATION 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 31 January 2022 and makes recommendations as follows:-
 - 1) Invest 5% of the Fund in the LGPS Central Global Sustainable Equity fund
 - 2) Change the equity benchmark used to monitor equity investments in the Specialist portfolio to a composite consisting of 50% FT Japan, 50% FT Europe inc. UK in GBP (sterling).
 - 3) Reallocate the Darwin investments to the Inflation category, specifically Darwin Leisure Property and Darwin Leisure Development Funds to real estate, and Darwin Bereavement Fund to infrastructure.
 - 4) Reduce the Strategic Asset Allocation (SAA) private equity allocation from 6.5% to 6.0% and raise listed Developed Market (DM) equity from 48.5% to 49%. Amend the final sentence of the Investment Strategy Statement (ISS) para 53 to allow commitments to exceed asset allocation.
 - 5) Amend the SAA Inflation category subclass allocations as shown in Table 1.
 - 6) Continue to monitor the exposure to the tobacco sector.

Information and Advice

2. The Working Party met on 31 January 2022. 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. In the last 12 months the market has continued its recovery after the COVID-19-related lockdowns. Officers have implemented last year's recommendations including a review of private assets. The Pension Fund Committee (PFC) has reviewed a second Climate Risk Report by LGPS Central (LGPSC).

4. The Fund reviews its strategic asset allocation annually to ensure it is appropriate. The report reviewed the Fund's SAA in the light of the current economic outlook and information provided by LGPSC and made the following recommendations.

Recommendation 1. Invest 5% of the Fund in the LGPSC Global Sustainable Equity fund.

5. In 2021, the PFC approved in principle a 5% allocation (approx. £320m) to a proposed LGPSC sustainable fund. LGPSC has now designed and procured three external managers for this fund.

Recommendation 2. Change the equity benchmark for the Specialist portfolio to a composite consisting 50% FT Japan, 50% FT Europe inc. UK in GBP.

6. Following various investment decisions and pooling implementations the only equity holdings remaining in the Specialist portfolio are the RWC funds. As their mandates invest exclusively in Japan and Europe (inc UK), the suggested equity benchmark is a more effective benchmark for monitoring purposes.

Recommendation 3. Reallocate the Darwin investments to the Inflation category, specifically Darwin Leisure Property and Darwin Leisure Development Funds to real estate, and Darwin Bereavement Fund to infrastructure.

7. Darwin's long-term aim of providing inflation-correlated income fits better in the Inflation than the Growth category.

Recommendation 4. Reduce SAA private equity allocation from 6.5% to 6.0% and raise listed DM equity from 48.5% to 49%. Amend the final sentence of ISS para 53 to allow commitments to exceed asset allocation.

8. The Fund invests in private funds for the most part through limited partnerships. The Fund commits an agreed amount (the commitment), which the manager calls as and when a new asset is purchased (the drawdown). It takes time to draw down commitments, and the manager may make distributions to investors before the close of the investment period. The amount invested is always therefore lower, often substantially so, than that committed. This proposal enables greater commitments to be made to Private Equity Funds with the objective of better matching the strategic asset allocation for this asset subclass.

Recommendation 5. Amend the SAA Inflation category subclass allocations.

9. Following volatility in the property market the inflation category is underweight. This enables a review of the allocation between the subclasses within this category. The following changes are recommended. These will take place over time reflecting the illiquidity of many of these assets.

10. Table 1

	<u>Current</u>	<u>Proposed</u>
Listed Infrastructure	2%	2.8%
Unlisted Infrastructure*	6%	7.0%
Commercial property	12%	9.8%
Other property	3%	2.8%
Index Linked Gilts	0%	0.0%
Aegon DGF	5%	5.6%
TOTAL	28%	28%

Climate Risk Considerations

11. In accordance with the LGPSC Climate Risk Report’s recommendation 9 climate change considerations have been integrated into the advice and recommendations in the report. The progress made at COP26 towards a net zero carbon target was noted, though it is clear that this will require all countries to work together to get there by 2050. Even in the most positive scenario the world will still rely on fossil fuels to a greater or lesser extent to bridge the gap until renewables can take over.
12. There have been no developments in climate change science over the past twelve months which makes one particular scenario (e.g. a 1.5 or 2.0 degree rise) significantly more or less probable. LGPSC will review this in depth every three or so years, and any material change will be integrated into the SAA. 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

13. The following table shows the current and proposed high level strategic asset allocations which are unchanged.

Table 2

Outcome	Asset Classes	31/12/2021 portfolio %	Long term SAA %	Proposed 2022 target %	Range %
Growth	Listed and Private equity	61.7	60.0	60.0	55-65
Inflation protection	Property, Infrastructure, Index Linked Aegon DGF	22.0	28.0	28.0	18-35
Income	Fixed Income	11.2	10.0	10.0	5-15
Liquidity	Cash, Aegon short term bonds	5.1	2.0	2.0	0-10

Review of tobacco investment

14. The Working Party considered a report from William Bourne, independent adviser to the fund. The report considered the Fund's weightings in tobacco-related investments, whether a financial case can be made for exclusion, whether a non-financial case can be made for exclusion, and the practical implications of such a decision. The legal and regulatory background was discussed.
15. The Fund's listed exposure to tobacco at 31 December 2021 is less than 0.5% of the Fund. Members noted and welcomed that this is a significant reduction on the 2% exposure held in 2017.
16. The current low valuations of tobacco companies and their expected inflation-correlated future dividend stream make it impossible to make a financial case for a blanket exclusion. This together with the low level of exposure to the sector mean there is no financial case for exclusion.
17. In order to make a non-financial case the Fund would have to meet the two Law Commission tests:
 - The decision does not involve a risk of significant financial detriment to the fund.
 - Trustees have good reason to think that scheme members would share the concern.
18. While the case can be made that there would be little risk of significant financial detriment from an investment perspective from exclusion, the cost of implementing this in the passive funds would be significant. However smoking is a legal activity and Members are aware of the proportion of smokers in Nottinghamshire with an element of this likely to be reflected in the membership of the pension fund. Under these circumstances more evidence would be required that scheme members would share the concern.
19. Finally, the practical and cost implications of such a decision were considered. The majority of the Fund's remaining exposure is 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).

Recommendation 6. Continue to monitor the exposure to the tobacco sector.

20. 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.

Climate risk training

21. Climate risk training was provided by LGPS Central. The topic of this year's training was the net zero commitment recently made by LGPS Central. This was a formal commitment to transitioning investment portfolios to Net Zero greenhouse gas emissions (GHG), using the Institutional Investor Group on Climate Change's ('IIGCC') Net Zero Investment Framework to

achieve Net Zero emissions across both internally and externally managed portfolios by 2050 (or sooner), focusing initially on Listed Equities, Corporate Bonds, Sovereign Bonds and Real Estate. In accordance with the objectives of the partner funds that own and invest through LGPS Central (including ourselves), the aim is to achieve a real reduction in GHG emissions rather than an avoidance of them.

22. The full statement can be found on LGPS Central's website.

Statutory and Policy Implications

23. 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

- 1) Invest 5% of the Fund in the LGPSC Global Sustainable Equity fund
- 2) Change the equity benchmark used to monitor equity investments in the Specialist portfolio to a composite consisting 50% FT Japan, 50% FT Europe inc. UK in GBP.
- 3) Reallocate the Darwin investments to the Inflation category, specifically Darwin Leisure Property and Darwin Leisure Development Funds to real estate, and Darwin Bereavement Fund to infrastructure.
- 4) Reduce SAA private equity allocation from 6.5% to 6.0% and raise listed DM equity from 48.5% to 49%. Amend the final sentence of ISS para 53 to allow commitments to exceed asset allocation.
- 5) Amend the SAA Inflation category subclass allocations as shown in Table 1.
- 6) Continue to monitor the exposure to the tobacco sector.

Nigel Stevenson

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For any enquiries about this report please contact: Tamsin Rabbitts

Constitutional Comments (KK 18/02/2022)

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

Financial Comments (TMR 18/02/2022)

25. 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