REPORT ON INVESTMENTS POLICY AND GOVERNANCE FOR THE NOTTINGHAMSHIRE LOCAL PENSION BOARD

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27th May 2022

1. Purpose of the Report

1. This report provides an overview of how Nottinghamshire Pension Fund ("**The Fund**") invests its assets. It covers the legal framework, investment strategy decision-making, and implementation. The Investment Strategy Statement ("**ISS**") is the core document. I finish with the assurances I am comfortable offering the Board on the future ability of the Fund to pay pensions on time and in full.

2. Legal framework

2. Nottinghamshire County Council ("**NCC**"), as an administering authority of the Local Government Pension Scheme is required by Section 53 of the Local Government Pension Scheme Regulations 2013 to maintain a pension fund. NCC delegates its functions utilising Section 101 of the Local Government Act 1972 to the Pension Fund Committee ("**PFC**"), which carries overall responsibility, including that for investment.

3. NCC also appoints the Section 151 Officer, in its case the Chief Finance Officer, who has responsibility for the investment arrangements. Day-to-day decision-making is further delegated to a team of four Officers.

4. The Local Government Pension Scheme Regulations 2016 govern the investment of the Fund's assets. The current (2017) statutory guidance in force is expected to be updated within the next 12 months. The Scheme Manager (i.e. NCC) is required to maintain the ISS to show how it satisfies the guidance and regulations.

3. Investment strategy decision-making

5. The following objectives underpin the Fund's investment activity. It will:

- meet all its financial obligations on a continuing basis.
- invest in a diversified range of assets.
- take proper advice on diversification and the suitability of types of investment.
- conduct its business and to use its influence in a long-term responsible way.

6. I make some further comments in turn on these in the next few paragraphs. The Investment Beliefs at the back of the ISS, set out in more detail the beliefs which the PFC have agreed on when making investment decisions.

7. The LGPS is a statutory rather than a trust-based scheme, but **there is a fiduciary duty to Scheme members and employers to deliver a financial return to pay pensions**. This was confirmed by legal opinion sought by the LGPS Scheme Advisory Board in 2014. While Scheme Managers may take non-financial considerations into account, one of the

conditions is that this must not involve significant financial detriment to members.

8. The Fund invests its assets to obtain a long-term return of 5.8%. This is 1% higher than the 4.8% which the actuary assesses is required to meet the Fund's obligations. The higher target allows some leeway for poor outcomes, and if delivered as expected will have the effect of lowering contribution levels in the very long term. However, aiming for a higher return implies taking more investment risk. If the return is for any reason not achieved, there is a greater chance that future contribution levels may have to rise.

9. **Diversification means investing in a wide range of assets** so that the outcome for any one asset class, if adverse, will not have too large an impact overall. In practice the Fund invests funds into the asset classes described below in four groupings defined by their objective:

   - Growth - provides returns so that the Fund can meet its actuarial return.
   - Income - provides secure cashflow to pay pensions.
   - Inflation - mitigates the effects of higher inflation on liabilities and future cashflow.
   - Liquidity - provides cash in bank to pay pensions on time.

10. **Equities** are investments in companies which should over time deliver growing dividends to the Fund. They comprise the Growth component. Listed equities are quoted on stock markets and are marked to market every day. Private equity is a growing asset class investing in similar companies but with less transparency or liquidity. In compensation they are expected to deliver a higher return.

11. **Bonds and Credit** comprise the Income component. In normal times they provide some ballast for the fund as well as secure income. In recent years, however, bond yields have fallen to very low levels, and the Fund has had to turn to other asset classes for income.

12. **Infrastructure and real estate** comprise most of the Inflation component and include both listed and private vehicles. Infrastructure aims to provide steady inflation-correlated income from long-term regulated contracts. This provides a good match for pension fund liabilities as well as diversification from equities. Real estate revenue is also contractual, but unregulated and more sensitive to the economic cycle. The Fund has historically invested mainly in commercial property, but over the past ten years has widened the universe to include residential and other assets.

13. The Diversified Growth Fund, also within the Inflation grouping, has a remit to return inflation +4% and invests in a wide range of strategies. It additionally provides some limited tactical asset allocation capability.

14. Cash is held in either a bank or money market account to ensure money is available to pay pensions on time.

15. **The Scheme Manager is required to take proper advice in managing its investments**. This is to mitigate the risk of poor decision-making, as most PFC members will not have investing expertise. In the context of the LGPS, proper advice means the advice of a person whom the authority reasonably considers to be qualified by their ability in, and practical experience of, financial matters. This is not the same as the Financial Conduct Authority's definition of advice, as the advice required does not constitute a regulated activity. In practice the Independent Adviser fulfil this role. I attend all PFC meetings, lead strategic asset allocation reviews and discussions, and am available to officers and committee members at all times for advice.

16. The Scheme Manager is required to invest in a responsible and sustainable way and the Investment Strategy Statement contains a separate section on the Fund's Responsible Investment beliefs. Officers implement investment through third party managers, and increasingly through LGPS Central ("**the pool**"), the shared investing entity set up with seven other authorities as required by the Investment Regulations. These entities rather than the PFC interact directly with the companies which the fund indirectly owns. **This does not remove the PFC's duty to ensure that the Fund invests sustainably.**

17. In practice the Fund receives quarterly reports from its managers on their activities including:

- Stewardship – how they as shareholders support companies to operate sustainably.
- Engagement – how they are influencing managers to change their ESG (Environmental, Social, Governance) behaviour for better.
- Climate Change – how they are aligning their activities to mitigate the impact of climate change.
- Voting – how they have voted the Fund's holdings at company AGMs.

18. In addition, the pool conducts regular reviews of the whole Fund's carbon exposure risk, and will in future provide assistance so that the Fund can comply with the expected new disclosure requirements.

4. Investment implementation

19. The Fund outsources implementation to third party managers through three structures:

- Segregated mandates, ie separate portfolios which can be customised and usually are liquid.
- Collective vehicles where the Fund invests alongside other investors. These may or may not be liquid but cannot be customised without the agreement of other parties.
- Limited partnerships, used mainly for private assets, which have fixed terms and where it is difficult (albeit not impossible) for the Fund to terminate earlier.

20. The high-level allocations agreed at the March 2022 PFC meeting are shown in Table 1.

Table 1: Pension Fund high level groupings

Grouping	Asset Class	Allocation (%)
Growth (60%)	Listed Equities	54
	Private Equity	6
Inflation (28%)	Infrastructure	9.8
	Real Estate	12.6
	Diversified Growth Fund	5.6
Income (10%)	Bonds	7
	Credit	3
Liquidity (2%)	Cash	2

21. The main managers used are Schroders (active equities), Legal & General (passive equities), Abrdn (real estate), and the pool (bonds, credit, active equities). The latter does not yet have products to cover all asset classes which the Fund may need, but is likely over time to become the main implementation platform.

22. The Fund allocates to other managers, mainly in private assets, for reasons of diversification and to access specialist areas. Table 2 shows the Fund's allocations by manager at 31st March 2022. Since then, an investment of £300m has been made into the pool's Global Sustainable Equities sub-fund, funded from Schroders.

Table 2: Fund allocations by Manager at 31/03/22

Manager	£m	%	Type
Schroders	2,015	30.6	Segregated/ Collective
Legal and General	1,275	19.4	Collective
Abrdn	652	9.9	Segregated
LGPS Central	855	13	Collective
Other	1,620	24.6	Collective/Partnership
Cash	162	2.5	
TOTAL	**6,578**	**100**	

5. Assurance

23. The funding ratio (i.e the ratio of assets to the present value of the liabilities) was 93% at the 2019 valuation and is likely to be a similar level at the 2022 valuation. That is an indication, though not a guarantee in any way, that the Fund is adequately funded to achieve its objective.

24. The demands on the Pensions Investments team, which currently comprises four full-time employees plus some additional management time and Treasury and administrative support, are changing. On the one hand, the pool is gradually taking over the implementation burden, including manager selection and monitoring. They have also provided significant resources to help the Fund with investment stewardship.

25. On the other hand, **the demands on the Scheme Manager are increasingly complex** and there is stakeholder pressure, particularly over climate change, to take actions which may not be in the long-term interests of members. Against this background the Board may like to consider both whether the resource provided is adequate and at the right grade, and whether key person risk is sufficiently mitigated.

26. Pooling has been mandated by the Government, and the new ISS guidance, due soon, may require Funds to move implementation to the pools faster. However, all pools including LGPS Central have limited track records or experience of tougher market conditions. They are additionally constrained by their governance structure and inability to pay competitive market rates to their staff. This is a concern to me.

27. Over the past twenty years, benign markets have led to investment returns higher than those assumed by the actuary. However, this environment is unlikely to continue. Inflation, partly because of the Russian war on Ukraine, has risen to forty-year highs in much of the West. Policymakers are raising interest rates to combat this, but may tip economies into recession if they continue. China, in the last few years the core driver of global growth, is attempting to suppress the latest COVID wave by lockdowns. This will result in their lowest growth rate since they emerged from Maoism.

28. Over the past seven years, the Fund has steadily been diversifying its assets away from equities. For example, in March 2022 the equity (including private equity) weighting was 60% compared to 71% in March 2016. New investment has been made into diversifying assets, in particular infrastructure and credit, with the intention of mitigating the risks of higher inflation and of lower growth.

29. As the Fund matures and pension pay-outs start to exceed contributions, it will need to use investment income to fill the shortfall. Cash management will become more important.

30. In summary, the Fund has a very long-term investment horizon and even a sustained period of poor returns will not affect its ability to pay pensions. I can offer an assurance that its assets are appropriately invested, though by the nature of investment markets this cannot be a guarantee. The greatest risks to the Fund come from governance, either a possible failure at the pool, or inadequate resources and key person risk at the Fund level.