East Sussex Pension Fund

Review of equity portfolio structure

February 2021

isio.

Document Classification: Confidential

Executive summary (1)

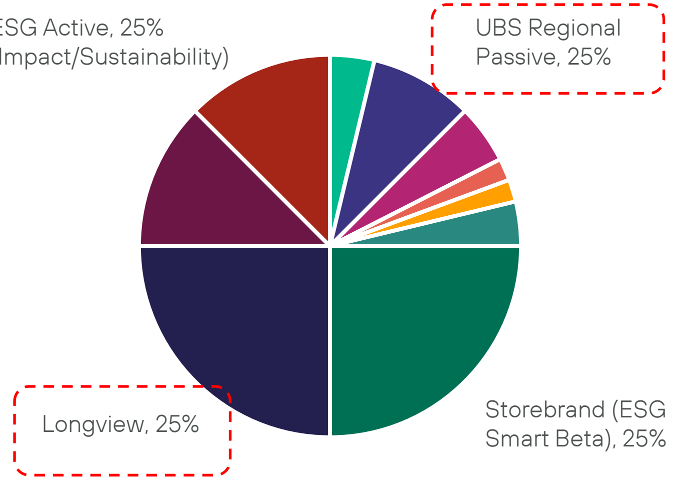
Executive summary

- The current equity portfolio is split equally between active and passive management (including the 'smart beta' exposure). This offers a good balance between overall management cost and diversification. The approach also enables the Fund to implement a robust policy in relation to responsible investment and capturing opportunity from the transition in economies towards a lower carbon future.
- The current structure provides good diversification by region, market capitalisation and manager style. The UBS portfolio is the most diversified in terms of underlying holdings, but least well aligned with the Fund's responsible investment objectives.
- We believe that the Fund should seek to retain a balance between active and passive management, but believe that there are better alternatives to structure the passive allocation. Recognising the Fund's objectives and the structure of the existing mandates, we believe an actively managed allocation in the range of 50% to 65% with the remainder invested in passively managed mandates aligned to the Fund's objectives is appropriate.

Passive

- We recommend the Committee reviews the passive equity exposure invested with UBS and considers an alternative index exposure to bring better alignment to the Fund's objectives and direct consideration of ESG issues.
- Unfortunately UBS does not currently offer a product that meets the Fund's requirements. We note that the Committee recently disinvested from the closest related UBS product following underperformance. We believe an allocation to the Osmosis Resource Efficiency index provides a strong proposition given the Fund's objectives and this could be considered alongside an increase in the Storebrand allocation. We propose that an Emerging Market exposure is retained – there are now a number of ESG tilted emerging market indices being made available which could be explored if desired (but these are not currently available via UBS).

Current equity strategy – 40% of overall strategy



Active

- While we do not recommend any immediate action in relation to the Fund's holding in the Longview Global Equity Fund, we are monitoring the position closely given recent asset outflows, business/team changes and relative underperformance over 2020. We propose that the Committee should monitor this mandate and formally revisit this again towards the end of 2021.
- Longview offers manager style diversification given their historical focus on valuation when selecting stocks. We believe this diversification is beneficial and this is an important consideration if any changes are implemented.
- Given the focus of the existing active managers, we believe the addition of a core manager (accessed via the pool) would offer increased diversification of the overall structure. Selecting a manager with strong ESG credentials will be critical.

Executive summary (2)

Proposed alternative equity portfolios

Approach	Mandate	Current (50% active)	Alternative 1 (50% active)	Alternative 2 (57.5% active)	Alternative 3 (62.5% active)
Passive/ Systematic	Storebrand Global ESG Plus	10%	12.5%	10%	13%
	UBS Developed markets	8.5%	-	-	-
	UBS Emerging markets	1.5%	2.5%	2%	2%
	Osmosis Resource Efficiency	-	5%	5%	-
Sustainable/ impact	WHEB Sustainability	5%	5%	5%	5%
	Wellington Global Impact	5%	5%	5%	5%
Active	Longview Global Equity	10%	10%	8%	10%
	'Core' Active (ACCESS pool) – selected to complement existing active managers	-	-	5%	5%

Comments:

- The table above illustrates 3 alternative equity portfolio structures that we believe are better aligned with the Fund's objectives and responsible investment aims. Alternative 1 retains the 50:50 split between active and passive management by introducing exposure to a resource efficient index. Recognising that neither the Storebrand or Osmosis indices will not invest in Emerging Markets, we propose to retain a higher emerging market allocation to provide this exposure (moving this more in line with market capitalisation within the passive allocation).
- Alternative 2 provides an increased exposure to active management and an allocation to the Osmosis index to provide increased diversification. We believe that this approach is appealing, particularly if Osmosis can be accessed via UBS cost effectively. The passive emerging market exposure has been moved towards market capitalisation and we would propose a small reduction in the Longview mandate to balance the active mandates.
- Alternative 3 provides an approach where a new passive manager is not required, which may be simpler if Osmosis is not available via UBS. We believe a 15% allocation to Storebrand is the maximum the Fund should consider given this remains a relatively new approach for the Fund.

Introduction

Introduction

Addressee

- This report is addressed to the East Sussex County Council ("the Council") as the Administering Authority of the East Sussex Pension Fund ("the Fund").
- This report considers the current equity portfolio and proposes a way forward for the passive equity allocation managed by UBS. It also provides views on currency hedging and the Longview Global Equity Fund given recent changes with the manager.

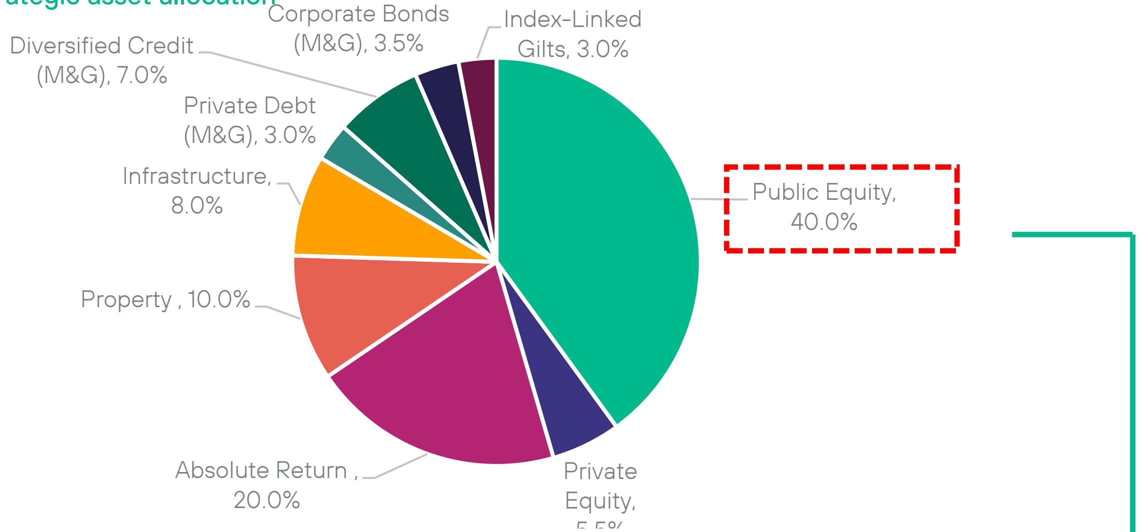
Background

- At the June 2020 meeting, the Pensions Committee ("the Committee") agreed to the following changes to the Fund's strategy and equity allocation:
- Maintain a 40% allocation to global equities, but adopt the following structure:
    - 10% Active impact equity (WHEB Sustainability Fund & Wellington Global Impact Fund);
    - 10% Longview Global Equity;
    - 10% smart-beta passive equity with ESG / climate tilting (Storebrand); and
    - 10% passive market-cap with UBS (passive manager on ACCESS).
- Since June, the Fund has implemented the active impact equity, and smart-beta ESG passive equity portfolios. The Committee has asked Isio to assist them in reviewing the UBS portfolio and to provide views on Longview.

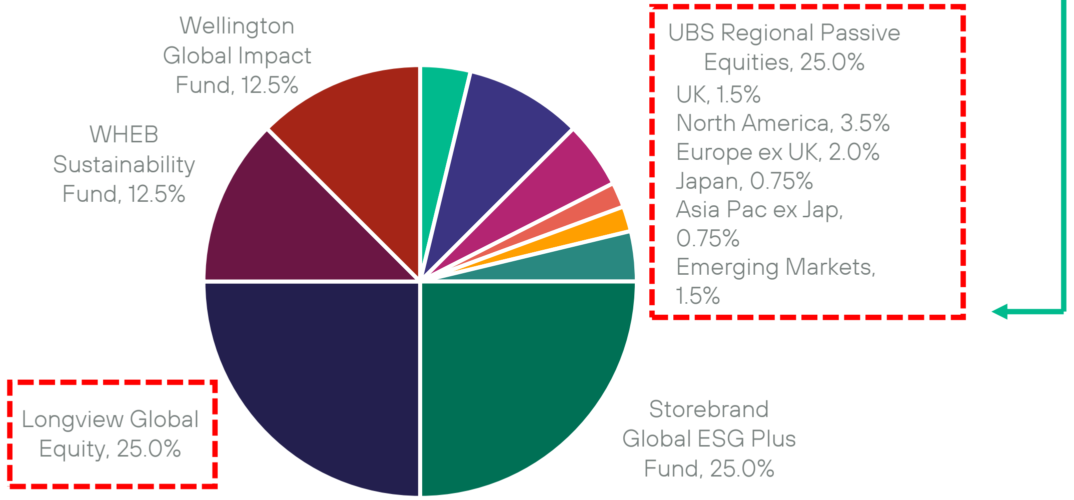
Scope of this report

- Review of the equity portfolio structure.
- Consideration of the options to evolve the portfolio through reallocation of the 10% allocation in UBS passive market-cap (within and outside the ACCESS pool).
- Isio's views on Longview and potential alternative options for this mandate.
- Currency hedging considerations.

Strategic asset allocation



Public equity allocation



Current equity portfolio

Summary of mandates

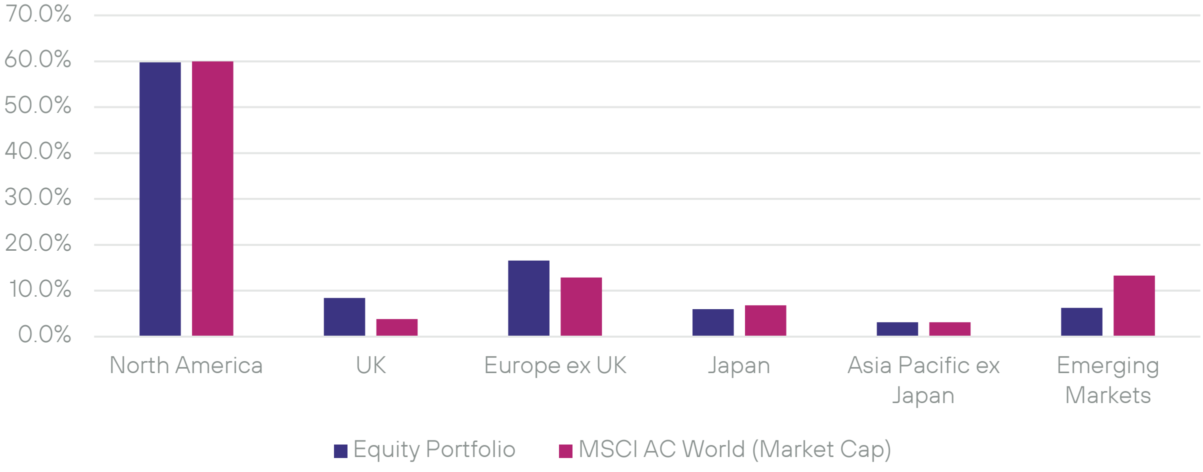
Fund summary

Fund	UBS Regional Passive Market Cap	Longview Global Equity Fund	Storebrand Global ESG Plus Fund	WHEB Sustainability Fund	Wellington Global Impact Fund
Regional focus	Global: UK (1.5%); NA (3.5%); Eur ex UK (2.0%); Jap (0.75%); Asia Pac ex Jap (0.75%); EM (1.5%)	Global	Global	Global	Global
Management style	Passively managed	Active: Style agnostic	ESG + Smart Beta (Systematic)	Active: Sustainable / Growth at reasonable price	Active: Impact / Growth
Benchmark Name	Various (FTSE)	MSCI World	MSCI World	MSCI World	MSCI AC World
Investment Objective	Track the relevant index	Outperform the benchmark by 3.0% gross of fees over 3-year rolling periods	Benchmark with significantly reduced climate risk	Generate long term returns while advancing sustainability and prosperity	Generate long term returns while while addressing major social & environmental challenges
Market Capitalisation	Large cap bias	Mostly large cap (All >£5bn)	95% Large cap	Mid cap bias	Mid cap bias
ESG Approach	Voting & Engagement	ESG integration & Stewardship (Voting & Engagement)	Excludes fossil fuels and climate negative stocks; invests in climate solutions; Voting & Engagement	9 positive social (4) and environmental (5) impact themes, & invest in solutions to sustainability challenge	Impact: Focus on life essentials, human empowerment, & the environment; Qualitative & quantitative approach
Number of stocks	3,985 (Total)	32	744	47	61
AuM	£5.8bn	$25.8bn	£3.0bn	£1.1bn	$930m
Fees	*Please refer to private meeting pack*				

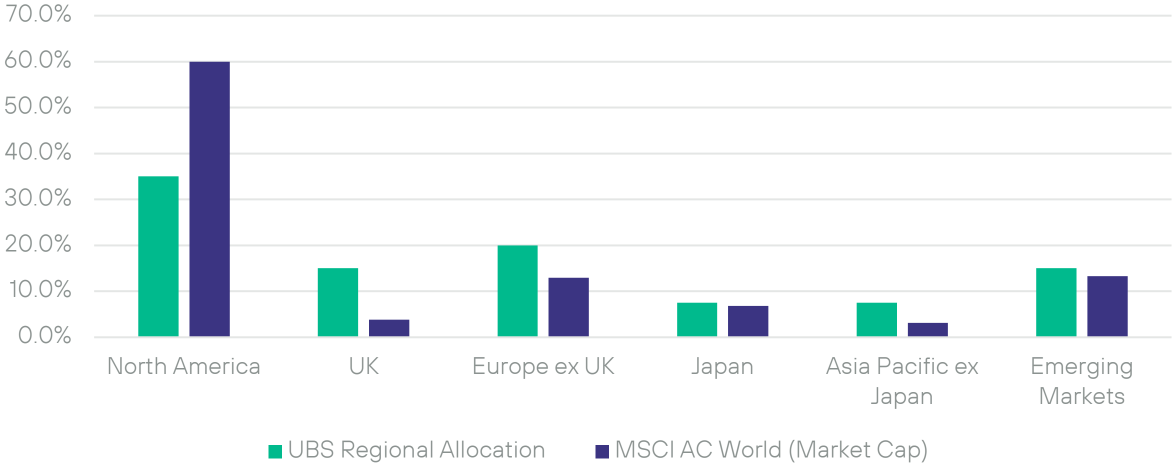
Source: Investment Managers as at 31 December 2020

Regional breakdown

Regional exposure – overall equity portfolio vs. market cap



Regional Exposure – UBS vs. market cap



Source: Investment Managers as at 31 December 2020.

Key Takeaways:

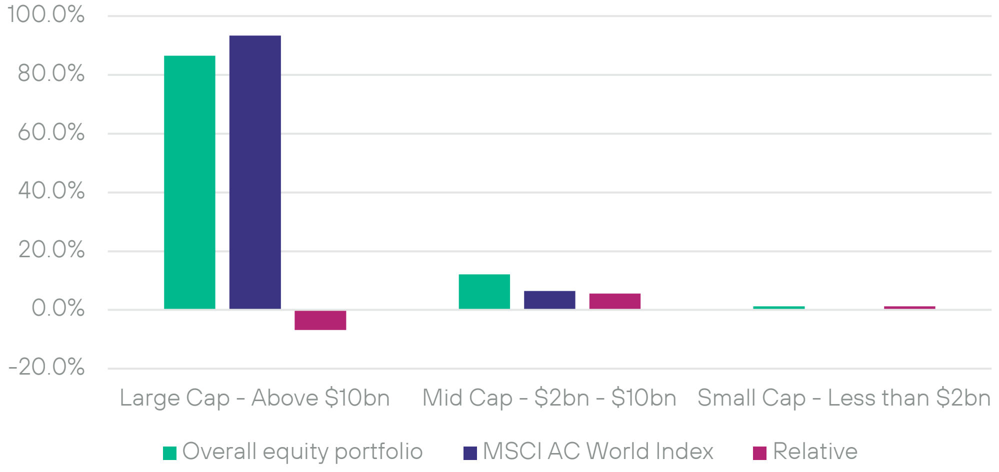
- The regional breakdown of the overall equity portfolio is currently relatively closely aligned to broad global equity markets.
- There is currently a slight overweight to Europe (including UK) of c.5% relative to the MSCI AC World index and an underweight position to Emerging markets of c.7%.
- Storebrand, Wellington, and WHEB exhibit some bias to UK and Europe compared to the benchmark resulting in a relative overweight to the region. However, Longview has a strong bias to US stocks and Storebrand is also modestly overweight in North America which somewhat balances the regional exposures.
- The Longview, Storebrand and WHEB mandates do not incorporate any (or minimal) emerging market exposure, and while Wellington is somewhat overweight to emerging markets relative to its benchmark, this still creates a structural underweight to emerging market stocks. Clearly a wide range of developed market companies will have significant exposure to or revenue from emerging market economies and the active managers will consider this dynamic when selecting stocks.
- We believe that the passively managed element of emerging markets should be targeted to achieve broad alignment with market cap exposure – this would represent a small increase in exposure relative to the current position.
- The current UBS portfolio currently comprises regional allocations to global markets, but has an underweight to the US and an overweight to Europe (including the UK). This regional bias has been detrimental in recent years given the strong outperformance of the US equity market.

Market capitalisation breakdown

Market capitalisation breakdown

Allocation	Strategic allocation	Market cap vs. index
UBS	10%	Neutral
Longview Global Equity Fund	10%	Neutral
Storebrand Global ESG Plus Fund	10%	Neutral
WHEB Sustainability Fund	5%	Bias to mid cap
Wellington Global Impact Fund	5%	Bias to mid cap

Market Cap Breakdown relative MSCI AC World Index



Source: Investment Managers as at 31 December 2020.
Notes: UBS use FTSE benchmark and define large, mid and small cap bias relative to the universe, with the top 70% classified as large cap, next 20% as mid cap, and final 10% as small cap. We expect this to result in a similar breakdown to the MSCI classification.

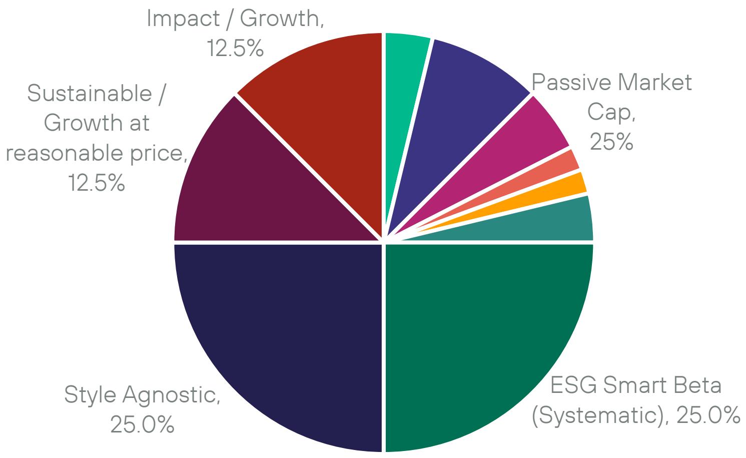
Key Takeaways:

- The majority of the existing portfolio is invested in large cap stocks. This is similar to the overall market index.
- There is a slight bias at present towards mid a smaller stocks (around a 7% overweight) relative to the broader market. This bias is a result of the WHEB and Wellington portfolios.
- This is to be be expected given the investments in the WHEB Sustainability Fund and Wellington Global Impact Fund, both of which have a degree of focus on investing further down the market cap spectrum and make investments in some mid and small cap names, given the unconstrained / benchmark agnostic investment approach.
- We have no concerns with the current market cap breakdown, but the current profile should be considered when making new allocations to an active manager.
- Appendix A1 provides more detailed analysis of the market cap breakdowns for the individual mandates.

Style breakdown

Style breakdown

Allocation	Strategic allocation	Management style
UBS Regional Passive Market Cap	10%	Passively managed
Longview Global Equity Fund	10%	Active: Style agnostic
Storebrand Global ESG Plus Fund	10%	ESG + Smart Beta (systematic)
WHEB Sustainability Fund	5%	Active: Sustainable / Growth at reasonable price
Wellington Global Impact Fund	5%	Active: Impact / Growth



Source: Investment Managers as at 31 December 2020.

Key Takeaways:

- Active managers typically adopt different 'styles' of portfolio management which can be in or out of favour relative to overall markets for long periods. It is important to ensure that there is a diverse range of styles in order to provide a robust portfolio across a range of different market environments.
- The existing portfolio is relatively well balanced from a style perspective, with a slight bias towards growth/quality. This is relatively common for portfolios with a strong focus on ESG factors. The majority of active managers in this space are seeking to capture growth opportunities as economies transition.
- Growth has strongly outperformed value over the last decade – low interest rates have provided a tailwind for growth. Growth stocks in general also performed strongly through the COVID crisis, which accelerated trends towards the use of technology which has already been in place over the last decade.
- As economies emerge from the current COVID crises, many commentators believe that value stocks could see a strong recovery (particularly given the discount to growth stocks now present). We believe maintaining a diversified approach in relation to investment style remains appropriate.
- Longview's style can be classified as style agnostic or 'Growth at a reasonable price' meaning they do not have any ongoing style bias. Longview does seek to invest in businesses with attractive cash-based valuations, they have historically had a slight bias towards more value stocks, although more recently the manager has tilted more towards growth companies.
- Appendix A1 includes a more detailed evaluation of the average style characteristics of the mandates.

Our thoughts on structure

Overall structure

- The current portfolio structure is well diversified by region, market cap and by underlying manager style.
- The passive allocation provides a low cost and low governance solution to gaining exposure to global equity. We believe maintaining a balance between active and passive is appropriate and suggest an actively managed allocation in the range of 50% to 65% with the remainder invested in passively managed mandates aligned to the Fund's objectives is appropriate.
- We believe this provides a good balance between ongoing overall costs and the risk of significant underperformance versus the broad market. It also keeps any manager style bias at an overall level moderate and can provide strong alignment with the Fund's responsible investment approach.
- The existing UBS passive allocation is not particularly well aligned to the wider responsible objectives of the Fund and simply takes market capitalisation exposure to all stocks in the regional universe.
- Whilst an increase in Storebrand is appealing, we note this is a relatively recently developed proposition. We would therefore suggest this is capped at 15% of the overall Fund.
- In order to avoid increasing underlying stock concentration of risk. We believe that a Low Carbon, ESG tilted or resource efficiency index alongside Storebrand will offer a better alignment to the Fund's objectives whilst still retaining a diversified portfolio. Depending on the alternative index selected, this may require a separate Emerging market allocation to be maintained.
- We can see three broad options for the UBS mandate
    1. Retain a passive portfolio, but review the alternative global equity index options employed to implement this.
    2. Replace the UBS mandate with a combination of a new actively managed portfolio and allocate to an alternative index.
    3. Replace the UBS mandate with a combination of a new actively managed portfolio and increase the Storebrand passive allocation.

1. Alternative index

- We believe that there are alternative indices that offer a better alignment to the Fund's responsible investment objectives whilst still delivering cost effective market exposure and a well diversified portfolio.
- There is a limited choice currently on offer from UBS. We understand the Committee disinvested from the UBS low carbon fund based on concerns of underperformance vs the index and this remains the only ESG focussed passive product available through UBS.
- Engagement with UBS to understand whether it can offer a new proposition or an alternative manager is likely to be required. We are currently pursuing this with UBS. This route may marginally increase costs.

2. Split between alternative index and a new active manager

- Given the focus on responsible investment, introducing a new active manager has an appeal given the potential constrained universe of passive indices that are aligned with the Fund's requirements (and the relative recent development of some of these approaches). Adding a manager that complements the existing active managers would provide improved diversification given the concentrated nature of the existing mandates.

3. Split between Storebrand and a new active manager

- We believe that an increase in Storebrand is appealing, though we note this is a relatively recent allocation for the Fund and has not yet been fully tested. We would therefore suggest this is capped at 15% of the overall Fund.

Our view

- On balance, we believe that retaining a passive portfolio is beneficial in terms of providing diversification and cost effective market exposure. However, we believe alternative indices offer better alignment to the Fund's wider objectives and suggest that this is reviewed. Introducing a new active manager to increase diversification alongside this has an attraction. We consider alternative indices and options in the following section.

UBS Passive portfolio

UBS passive range on ACCESS

Fund summary						
Manager	UBS					
Fund	World ex UK	World Equity	World Equity Optimised Volatility	World Quality Companies	All World & Developed World Equity Fundamentally Weighted	Climate Aware
Regional focus	Global ex UK	Global	Global	Global	Global / Developed	Global / Developed
Tracked Index	FTSE Developed ex UK	FTSE Developed	MSCI World Min Vol (GBP Optimised)	MSCI World Quality	FTSE RAFI All World 3000 FTSE RAFI Developed 1000	FTSE Developed
ESG Objective or Process	Not specific focus: voting & Engagement only	Not specific focus: voting & Engagement only	Not specific focus: voting & Engagement only	Not specific focus: voting & Engagement only	Not specific focus: voting & Engagement only	Tilt exposures to companies which contribute towards positive climate change
Number of stocks	2,001	2,124	350	302	All World: 2,763 Developed: 1,037	1,656
AuM	£1.4bn	£924.9m	£449.3m	£477.2m	All World: £1.4bn Developed: £677.3m	£1.1bn
Fees	Please refer to private pack					

Source: Investment Manager as at 31 December 2020.
Notes: Grey shade indicates the Fund was previously considered and have made the decision to disinvest.

Passive indices with sustainable focus (1)

Index Approach	Low Carbon Index	Engagement across an array of ESG factors (Market Cap)		Engagement across an array of ESG factors (Multi-Factor)	Resource Efficiency
Regional focus	Global	Global	Global	Global	Global
Engagement/exclusion	Engagement, together with the exclusion of pure coal assets and high carbon producing stocks	Engagement with the exclusion of pure coal, weapons, and high climate impact or carbon producing stocks (plus UN Global compact violaters for Market Cap)			Excludes firms that do not disclose sufficient data on energy, water and waste usage, as well as violators of the UN Global Compact principles. Ex-fossil fuel option available.
Example tracked Index	MSCI World Low Carbon Target Index	Solactive GBS Dev. Mkts Large and Mid Cap Index	MSCI World ESG Focus Low Carbon Screened Index	FTSE AW ex CW Climate Balanced Factor Index	MSCI World
ESG objective	Minimise Carbon exposure subject to a tracking error of 0.3%	Maximise average ESG score subject to a tracking error of 0.5%	Maximise average ESG score and reduce carbon exposure subject to a tracking error of 0.5%	Maximise average ESG score subject to a tracking error of 0.5%	Target maximum resource efficiency exposure whilst minimising tracking error to the benchmark
Carbon Intensity (t CO^2e / \$m invested)	78 (-56% vs FTSE All-World)	94 (-47% vs FTSE All-World)	97 (-45% vs FTSE All-World)	159 (-11% vs FTSE All-World)	67 (-63% vs FTSE All-World)
Number of stocks	1,300	1,545	549	2,331	765
Typical fees and TER	Please refer to private pack				

Source: Isio, investment managers. Notes: 1 Data provided using MSCI methodology, we have scaled in-line with FTSE methodology in order to enable comparability with the other indices.

Passive indices with sustainable focus (2)

Index Approach	Low Carbon Index	Engagement across an array of ESG factors (Market Cap)	Engagement across an array of ESG factors (Multi-Factor)	Resource Efficiency
Pros	▪ Large, established index ▪ Lowest expected tracking error typically - 0.3% p.a. ▪ Focus on low carbon producing companies means some high carbon producers may be excluded ▪ Similar stock coverage compared to wider index ▪ Attractive TER available	▪ Addresses wider environmental, social and governance factors ▪ Low target tracking error - 0.5% p.a. ▪ Similar number of stocks compared to wider index ▪ Attractive TER available	▪ Addresses wider environmental, social and governance factors ▪ Low target tracking error - 0.7% p.a. ▪ Similar number of stocks compared to wider index ▪ Attractive TER	▪ "Smart beta" systematic approach and so follows a more active management style compared to alternatives ▪ Aims to outperform the benchmark by 0.5-1.0% p.a. ▪ Approach simple and intuitive ▪ Back testing performance results are positive ▪ Has an ex-fossil fuel option if desired
Cons	▪ Narrow focus on minimising carbon ▪ Ignores wider social and governance issues	▪ Some sector exclusions (more than the low carbon index) but not expected to be key driver of portfolio construction ▪ Established index but AuM lower than some alternatives given it more recently to market ▪ ESG scoring is a developing science and inconsistencies remain	▪ Underlying allocations not expected to reflect market cap index ▪ Some sector exclusions but not expected to be key driver of portfolio construction ▪ Established fund but AuM lower than alternatives ▪ Factor exposure introduces bias which can change through time	▪ Potential for underperformance vs. market cap ▪ Product is relatively new to market with limited live track records ▪ Fees higher than other passive alternatives but lower than active equity managers ▪ Partially dependant on collaboration with pool index provider
Isio View	If the Fund's primary concern is the risks posed by fossil fuel/carbon emissions then this index could be an appropriate option. It is established, has the lowest target tracking error versus the wider index and low management fees. Whilst the index does not have specific exclusion policies, it will in effect exclude high carbon emitting corporates.	This index is focused on broad ESG issues, which we think is attractive, along with low target tracking error and low fees. We note there are some exclusions but do not expect this to be a key driver of returns. Avoids style drift by maintaining the same sector allocations to the market cap index. There is some inconsistency in ESG scoring methodologies, but we expect this to improve over time.	This index is focused on broad ESG issues, which we think is attractive, along with low target tracking error and low fees (albeit a bit higher than the market cap version). We note there are some exclusions but do not expect this to be a key driver of returns. However, we favour the market cap approach as it avoids additional bias and is often cheaper to implement.	We find the approach intuitively appealing and whilst simple, we also believe that this has the ability to add value. The approach is more active than fully passive products and hence carries a slightly higher cost. Optimises for resource efficiency, while targeting sector, regional and style factor neutrality. While somewhat similar in systematic approach to Storebrand, it differs in that Storebrand focus solely on low carbon in line with the climate transition. However, we note a low carbon variant of the fund is available.

Note: Isio views based on information from investment managers.

Our views

Passive index choice

- Given the desire to pool assets, there would be a clear benefit in retaining UBS to implement the passive exposure. However, the current product offering is limited and offers little that aligns with the Fund's responsible investment objectives.
- There are now a range of approaches that better reflect the Fund's objectives whilst offering a well diversified portfolio that does not sacrifice return whilst better incorporating elements of the Fund's responsible investment policy. Implementing this will require engagement with UBS or a move to an alternative provider.
    - Low carbon index: this offers a well diversified portfolio that is expected to track the broader index within 0.3% p.a. and low management fees. his involves a relatively narrow focus on low carbon as the priority, and may exclude firms that could support the transition.
    - ESG scored market cap index: this offers a well diversified index that is expected to track the wider index within 0.5% p.a. whilst tilting exposure towards companies with better E, S and G scores. Whilst this achieves a significant carbon reduction (albeit less that a low carbon index approach), the ESG scoring methodology is a developing science and there is some inconsistency across providers. This can lead to inconsistent stock selection across various index providers.
    - ESG Multi-factor: this introduces other intentional style biases that the managers expect to achieve outperformance over time. We are sceptical of the value added by this, given the limited track record and back testing, and believe active managers are better placed if outperformance is desired.
    - Resource efficient index: this provides a well diversified and neutral portfolio exposure by tilting towards the companies that are most resource efficient. This is intuitively appealing, which provides a strong reduction in overall carbon emissions whilst also retaining a focus on a wider range of responsible investment issues.
- Given the Committee's responsible investment policy and strong focus on addressing climate change as a priority, we believe that the resource efficient index offers a good alignment.
- We recommend the Committee explores with UBS whether any of these alternatives can be offered. If this is not achievable, we recommend that the Committee seeks to engage with a new provider to implement the exposure based on the preferred approach. We would expect the appointed manager to employ a very strong engagement approach.

Longview

Longview Global Equity Fund research view

Overview
• *Please refer to private meeting pack*

Things to Flag
• *Please refer to private meeting pack*

Summary

Longview Global Equity Fund

- We do not believe any immediate action is required in relation to the Fund's holding in the Longview Global Equity Fund. However, we do have some concerns given the recent asset outflows, business/team changes and relative underperformance over 2020. We will continue to monitor these issues closely and suggest that the Committee formally reviews the position towards the end of 2021.
- Whilst we are not recommending any action at this stage, we note that replacing Longview might enable the Committee to further align the Fund's strategy to your responsible investment approach.
- Longview does offer balance to the portfolio given the portfolio's historic value tilt, and therefore the Committee will need to be mindful that any new allocation would need to compliment the existing allocations in terms of investment style. Many impact funds will naturally exhibit a quality/growth bias given the stocks that are included/excluded in their portfolios, but this could potentially be managed through any manager selection process,
- We note the full list of Global Active funds available on ACCESS in Appendix A2.

Currency hedging

Hedging currency reduces day to day volatility

	Period	Hedged	Unhedged	50/50
Return (Ann.)	5 Year	12.2%	14.5%	13.4%
	10 Year	10.8%	11.4%	11.2%
	Full Period	8.1%	8.5%	8.4%
Volatility (Ann.)	5 Year	15.5%	16.2%	15.2%
	10 Year	14.1%	14.7%	13.9%
	Full Period	14.9%	15.7%	14.9%
Sharpe ratio	5 Year	0.56	0.68	0.66
	10 Year	0.52	0.54	0.56
	Full Period	0.31	0.32	0.33

Currency hedging

- Hedging overseas currency risk back to sterling will reduce day to day volatility created as a result of volatility in exchange rates. This is often equated with reducing overall risk, but in practice hedging to Sterling can compound equity market risks during more extreme market environments – during these periods unhedged exposure to the US dollar and Japanese Yen tends to provide a safe have that has helped to protect capital during severe market sell offs.

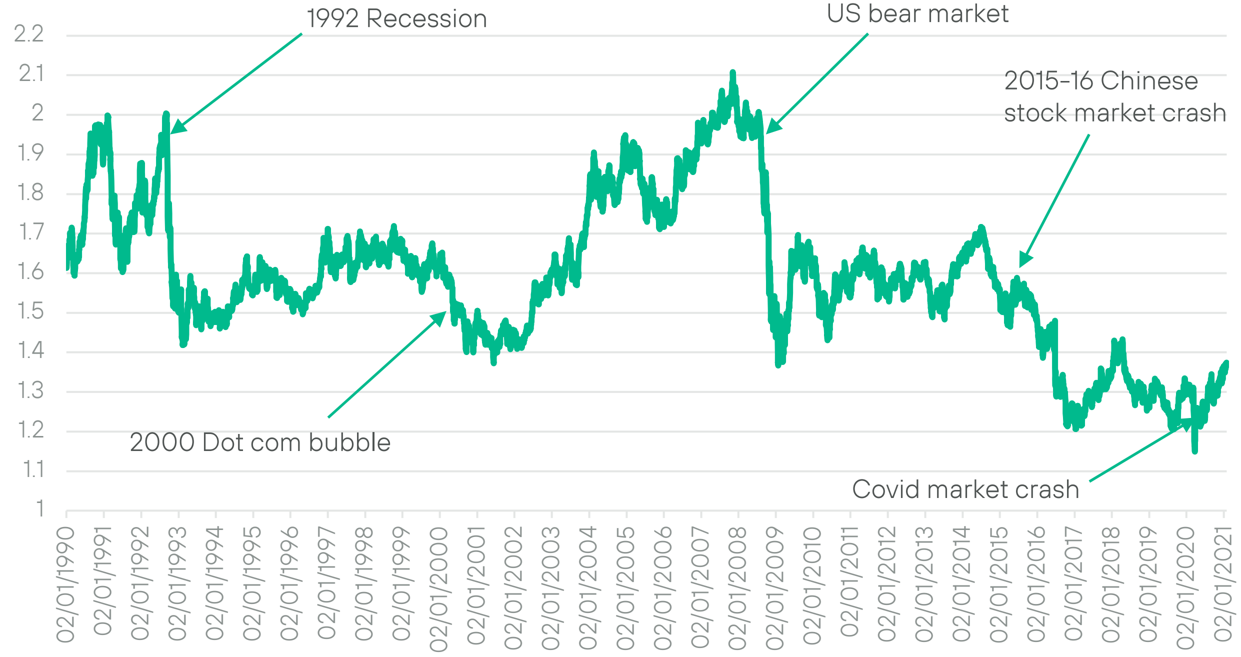
Day to day volatility is reduced

- The table opposite looks at the returns on the FTSE World index over the last 27 years for currency hedged, unhedged and a 50/50 hedge. We illustrate returns, volatility and Sharpe ratio numbers over various periods.
- Unhedged equity performance is marginally higher, largely driven by stronger performance over the last 5 years where Sterling has fallen versus the US dollar.
- We can observe that an unhedged portfolio has been marginally more volatile, though this is relatively minor as a proportion of overall risk.
- Over the long term, the Sharpe ratios (a measure of risk adjusted return) are broadly similar and favour the unhedged portfolio.
- The data indicates that hedging currency will reduce day to day volatility, however this is not cost free and can also compound risks during market downturns. We consider this overleaf.

Source: Datastream, Isio calculations. The full period covered is from end of 1993 (27 years).

Risk management and market stress

USD/GBP Exchange rate – During times of wider market stress



Source: Datastream

Hedging can compound equity downturns

- The largest component of the overseas equity currency exposure is the US$. Historically, the US$ has been viewed as a safe haven and has offered an offset to equity market risk (performing strongly in times of crises). Sterling exposure has (relative to the US Dollar and Yen) compounded equity gains/ losses in times of equity market crisis.
- The chart opposite illustrates the behaviour of US$ and Sterling over the past 30 years. Sterling has fallen sharply relative to the US dollar during a number of past market crises – the dollar exposure offers unhedged investors some protection at the overall portfolio level.
- It is of course overly simplistic to say that these relationships will hold true in the future, but the historical behaviour indicates that the risk reduction offered by hedging back to Sterling has tended to 'fail' when it is needed most.
- The Fund is currently inherently exposed to significant inflation risk (the liabilities are linked to inflation without a cap). In a scenario where UK inflation increases relative to elsewhere, we might expect Sterling to depreciate. In this scenario, the hedge would potentially compound other risks within the Fund.
- We believe that leaving currency exposure unhedged offers an attraction for the Fund.

Hedging is not cost free

It is not cost free

- Whilst currency hedging is expected to reduce overall day-to-day volatility, it is not cost free and there are a variety of direct and indirect costs involved in an ongoing hedging programme.
- Currency forward contracts create cashflows as profits or losses are realised. In the case of losses, there is a requirement to fund this by posting collateral to the counterparty bank from time to time.
- The disinvestment required has an associated cost. These can be significant if currency markets are volatile. Whilst some of the collateral calls might be managed through ongoing cashflow, there will ultimately be some element of cost incurred over the long term.
- There is also the "cost" of entering into the forward contracts from the spread on the buying and selling of these contracts. Currency transactions are one of the most frequent and largest investment activities in the financial world. The currency markets are liquid, and costs have declined significantly over the last 20 years. Recent Vanguard research has estimated that the transaction cost to hedge an international bond portfolio is less than 0.20% a year for investors hedging back to a liquid, developed-market currency, such as Sterling. Although these costs are expected to be low, hedging currency would represent a new cost to the Fund.
- Another consideration is the time and governance required by the Committee to manage the administration and detailed reporting of the underlying programme. The cash calls are typically required at short notice which can create operational difficulties if a robust process is not in place.
- Lastly, the currency hedging overlay manager would also charge a fee for managing the programme on the Council's behalf.

Our view

- From a strategic perspective, we believe that leaving currency unhedged is preferable in terms of providing diversification during extreme market environments and also in avoiding the inherent cost and governance burden involved in introducing a hedging program.
- Whilst Sterling has fallen in terms of purchasing power relative to the US$ over the past decade, the scale of change is not overly significant. Sterling has also recovered sharply since the lows experienced in March 2020 following agreement of the Brexit deal – we don't see a compelling opportunity to hedge from a tactical perspective.

Summary

Summary

Summary

- The current equity portfolio is split equally between active and passive management (including the 'smart beta' exposure). This offers a good balance between overall management cost and diversification. The approach also enables the Fund to implement a robust policy in relation to responsible investment and capturing opportunity from the transition in economies towards a lower carbon future.
- The current structure provides good diversification by region, market capitalisation and manager style. The UBS portfolio is the most diversified in terms of underlying holdings, but least well aligned with the Fund's responsible investment objectives.
- We believe that the Fund should seek to retain a balance between active and passive management, but believe that there are better alternatives to structure the passive allocation. Recognising the Fund's objectives and the structure of the existing mandates, we believe an actively managed allocation in the range of 50% to 65% with the remainder invested in passively managed mandates aligned to the Fund's objectives is appropriate.

Passive

- We recommend the Committee reviews the passive equity exposure invested with UBS and considers an alternative index exposure to bring better alignment to the Fund's objectives and direct consideration of ESG issues.
- Unfortunately UBS does not currently offer a product that meets the Fund's requirements. We note that the Committee recently disinvested from the closest related UBS product following underperformance. We believe an allocation to the Osmosis Resource Efficiency index provides a strong proposition given the Fund's objectives and this could be considered alongside an increase in the Storebrand allocation. We propose that an Emerging Market exposure is retained – there are now a number of ESG tilted emerging market indices being made available which could be explored if desired (but these are not currently available via UBS).

Active

- While we do not recommend any immediate action in relation to the Fund's holding in the Longview Global Equity Fund, we are monitoring the position closely given recent asset outflows, business/team changes and relative underperformance over 2020. We propose that the Committee should monitor this mandate and formally revisit this again towards the end of 2021.
- Longview offers manager style diversification given their historical focus on valuation when selecting stocks. We believe this diversification is beneficial and this is an important consideration if any changes are implemented.
- Given the focus of the existing active managers, we believe the addition of a core manager (accessed via the pool) would offer increased diversification of the overall structure. Selecting a manager with strong ESG credentials will be critical.

Currency hedging

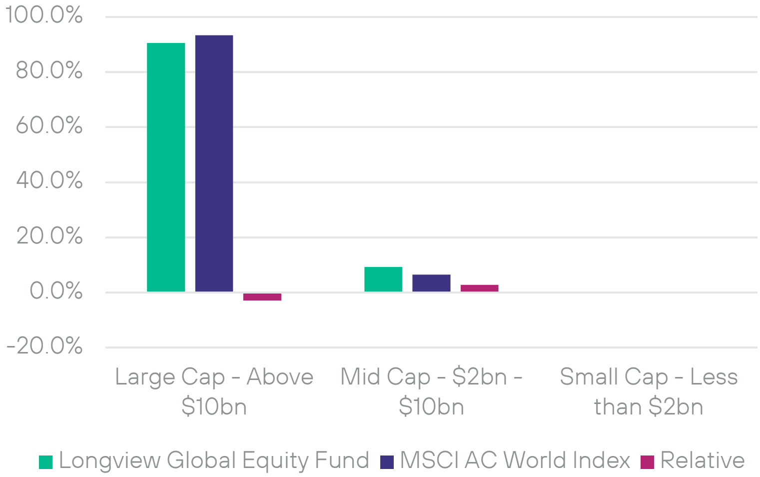
- We recommend global currency exposures remain given the inherent protection this provides the equity allocation in stress market conditions. We believe this is more important than the reduction in day to day volatility particularly given the inherent costs involved

Appendices

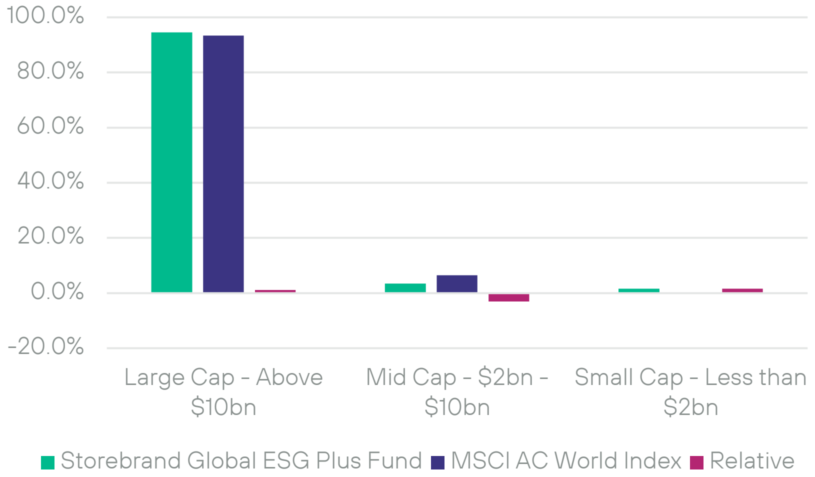
A1: Current managers - market cap analysis

UBS Passive Market Cap

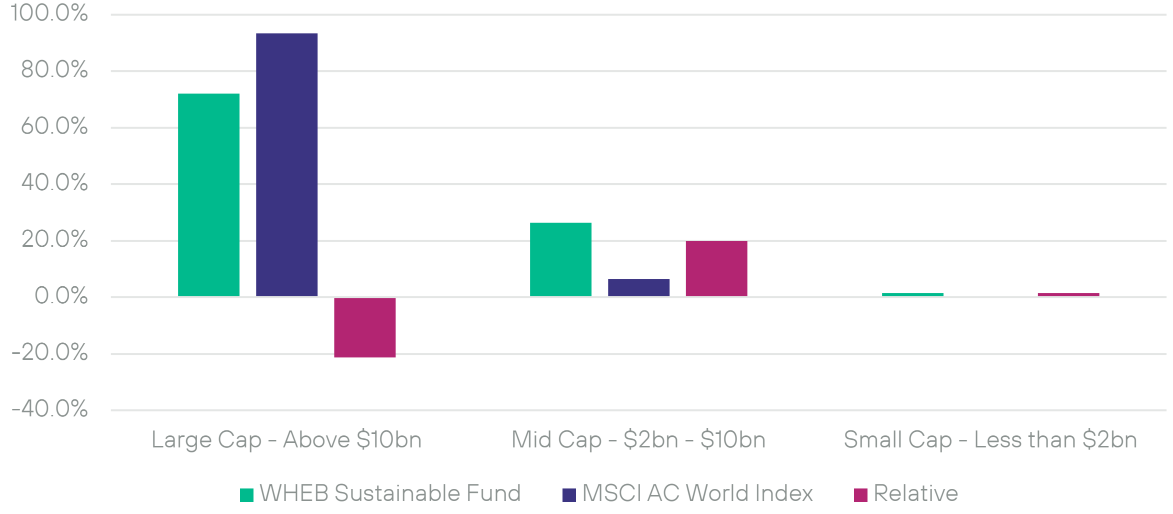
Longview Global Equity



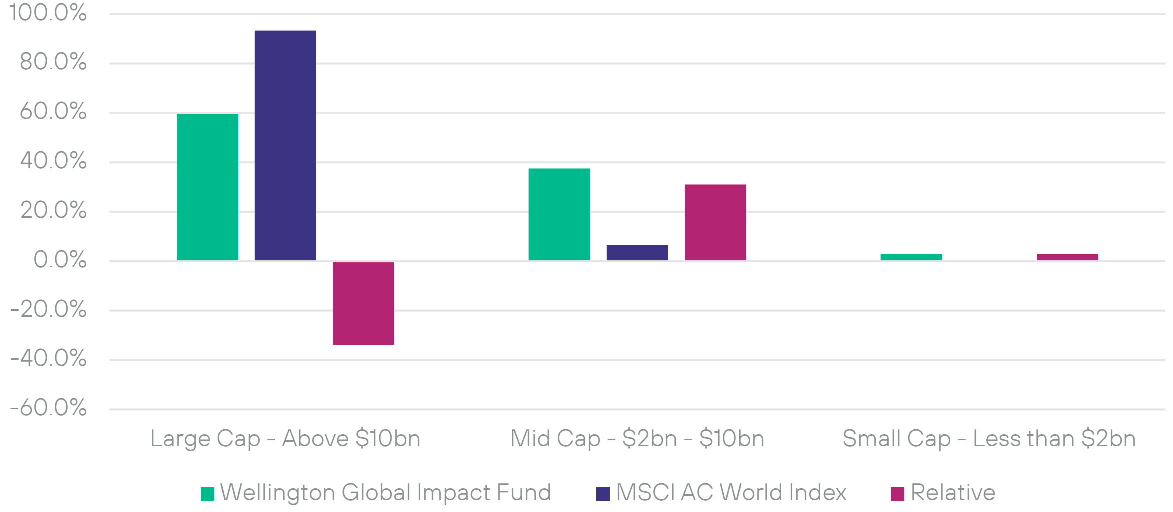
Storebrand Global ESG Plus Fund



WHEB Sustainability Fund

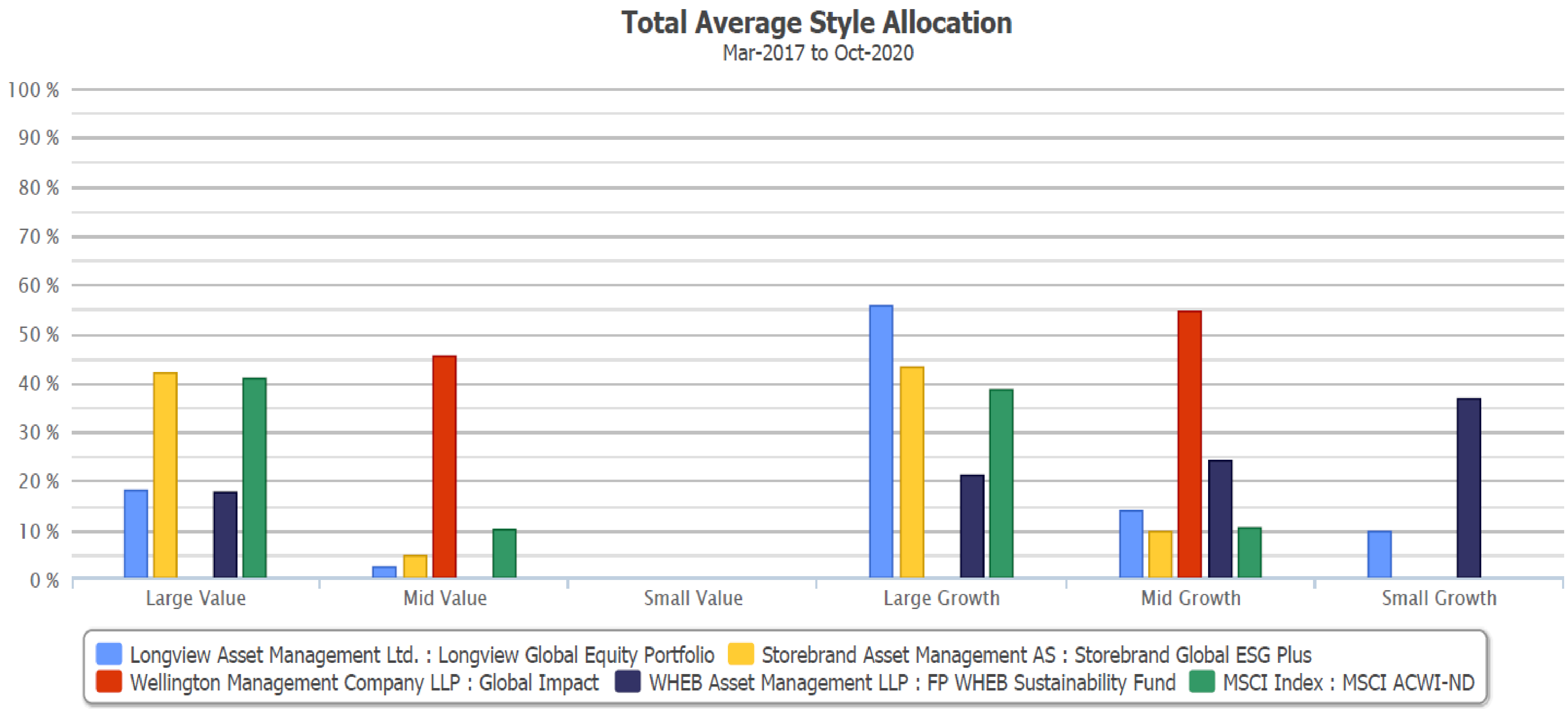


Wellington Global Impact Fund



Source: Investment Managers as at 31 December 2020.
Notes: UBS use FTSE benchmark and define large, mid and small cap bias relative to the universe, with the top 70% classified as large cap, next 20% as mid cap, and final 10% as small cap. We expect this to result in a similar breakdown to the MSCI classification.

A1: Current managers - style analysis



Source: eVestment.
Notes: Latest data available corresponding to all mandates.

A2: ACCESS - full active equity fund range

Below we show the full list of active equity products on the ACCESS platform.

ACCESS Active Equity Fund Range:

- LF ACCESS Long Term Global Growth Investment Fund - Baillie Gifford
- LF ACCESS Global Equity Core Fund - Baillie Gifford
- LF ACCESS Global Alpha Equity Fund - Baillie Gifford
- LF ACCESS Global Stock Fund (Master Fund) - Dodge & Cox
- LF ACCESS Global Equity (ex UK) Fund - FIL Pensions Management
- LF ACCESS Global Equity Fund – Longview
- LF ACCESS Global Equity Fund – Newton
- LF ACCESS Global Equity Fund - J O Hambro Capital
- LF ACCESS Global Equity Fund - Capital Group
- LF ACCESS Global Equity Fund - Mondrian
- LF ACCESS Global Active Value Fund - Schroders
- LF ACCESS Global Dividend Fund - M&G
- LF ACCESS Global Managed Volatility Equity Fund - Acadian
- LF ACCESS UK Equity Core Fund - Baillie Gifford
- LF ACCESS UK Equity Fund - Schroders
- LF ACCESS UK Select Fund - Blackrock
- LF ACCESS UK Equity Fund - Majedie

A3: Responsible Investment – the Fund’s core principles

The Fund’s core principles of responsible investment are:

1. Apply long-term thinking to deliver long-term sustainable returns
2. Seek sustainable returns from well-governed assets.
3. Use an evidence-based long term investment appraisal to inform decision-making in the implementation of RI principles and consider the costs of RI decisions consistent with our fiduciary duties.
4. Evaluate and manage carbon exposure in order to mitigate risks to the Fund from climate change.

The Fund will review the Fund’s passive equity benchmarks and consider increasing the use of indices tilted towards low carbon.

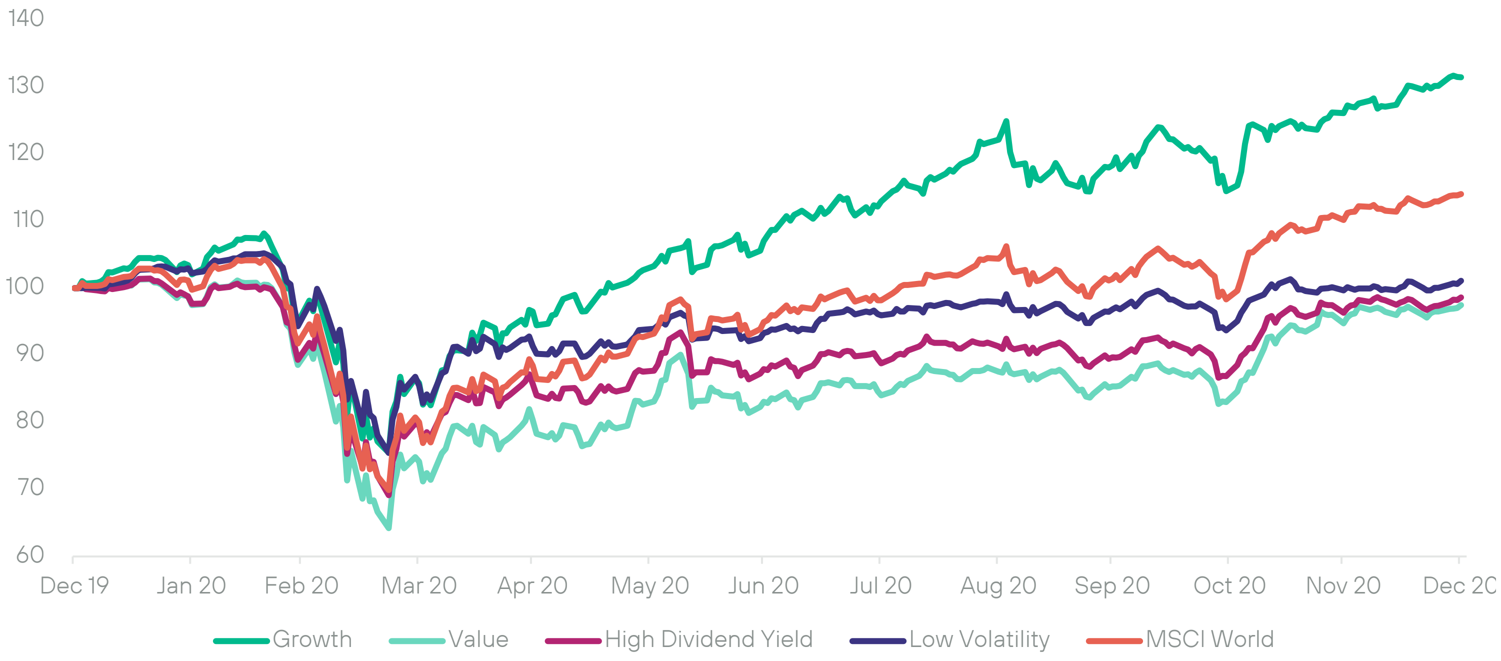
Engagement vs Exclusion

- East Sussex Pension Fund has never sought to implement a policy that explicitly excludes certain types of investments, companies or sectors except where they are barred by UK law. The Fund believes that its influence as a shareholder is better deployed by engaging with companies, in order to influence behaviour and enhance shareholder value. The Fund believes that this influence would be lost through a divestment or screening approach.

Isio view: Isio is supportive of this approach and is in favour of engagement, although worth noting the two can be used in conjunction and exclusion used as a tool for engagement and used as the “stick” as a last resort if engagement is not proving successful.

A4: Active management style analysis

Equity Management Styles – Cumulative Performance to 31 December 2020



Source: Datastream

Commentary

- As a style "Growth" has been outperforming wider markets for the past decade. This style has delivered very strong performance over the past year as COVID has impacted markets and interest rates have been driven ever lower. The gap between 'growth' and 'value' stock valuation metrics is as wide as it has ever been. Market leadership of different styles can change and there is a potential risk that the growth and value leadership may change. We saw a brief period of value stocks outperforming immediately post the COVID vaccine announcement, though this has dissipated more recently. A number of commentators believe that value stocks could shine if we see a strong economic recovery in 2021.

A5: Disclaimers

Past Performance and Opinions

- This report sets out the past performance of various asset classes and fund managers. It should be noted that past performance is not a guide to the future.
- Our opinions (and comparison vs criteria) of the investment managers stated in this report are based on Isio's research and are not a guarantee of future performance. These are valid at the time of this report but may change over time.
- Our opinions of investment products are based on information provided by the investment management firms and other sources. This report does not imply any guarantee as to the accuracy of that information and Isio cannot be held responsible for any inaccuracies therein. The opinions contained in this report do not constitute any guarantees as to the future stability of investment managers which may have an effect on the performance of funds.
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Thank you

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