East Sussex Pension Fund

Strategy: Recap & Considerations

July 2022

Introduction

Addressee

- This report is addressed to East Sussex County Council as Administering Authority of the East Sussex Pension Fund ("the Fund").
- This paper provides a recap of the agreed strategy and reviews the implementation plan in the light of the evolving market environment.

Background

- At the July 2021 meeting, the Committee reviewed the overall investment strategy and agreed the following changes to the Fund's strategic asset allocation:
  - A reduced target allocation to diversified growth, index-linked gilts, corporate bonds and balanced property.
  - A higher target allocation to inflation-linked property, private credit and diversified credit.
  - A higher allocation to infrastructure equity.
- It was agreed that the changes would be implemented on a phased basis recognising the practical challenges of deploying capital into illiquid assets and accessing the right investment vehicles via the ACCESS pool.
- Recent months have seen a significant regime shift in markets, with rising realised inflation and a shift in central bank policy to raise interest rates to address this. This shift in the environment, couple with the macro-economic uncertainty arising from this and the war in Ukraine has resulted in a significant sell off across a range of asset markets.
- This report reviews the overall strategy at a high level and considers whether the implementation plan remains appropriate given the change in market environment.

Scope of this Report

- This report
  - Provides a recap on the agreed changes to the strategy and the rationale for these.
  - Provides an overview of how market conditions have changed in recent months, with a particular focus on fixed income markets.
  - Considers the target investment strategy and whether this remains appropriate given the current market conditions.
  - Considers the implementation of any changes to the strategy and the timing of these.

Rationale for strategy evolution

Rationale for the agreed strategic changes

- The strategic changes which were considered and agreed by the Committee in July 2021 were agreed on the basis that they would:
  - Increase exposure to assets with a direct link to inflation

    (inflation-linked property & infrastructure equity)

    Rising inflation was seen as a key risk to the Fund given the liability structure, and increasing the allocation to assets with an inflation linkage would help address this risk.
  - Increase exposure to less liquid assets

    (inflation-linked property, infrastructure equity & private credit)

    Given the Fund's long term horizon, and the overall level of liquidity in the asset portfolio, it was agreed there was scope to target less liquid opportunities and earn an excess return for doing so.
  - Increase alignment to the Fund's Responsible Investment Policy

    (revised equity portfolio & infrastructure equity)

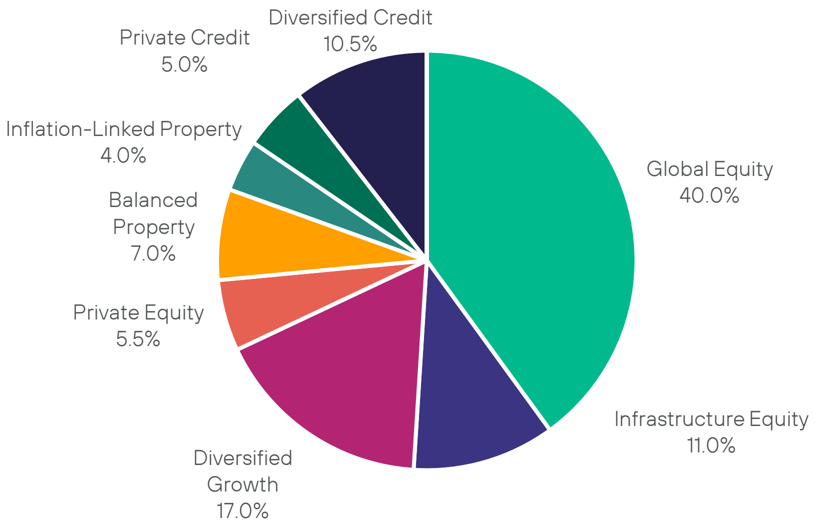
    The Fund has made strong progress incorporating ESG considerations into its investment strategy and wished to continue to build on this.
  - Increase the overall diversification of the Fund's holdings

    (inflation-linked property, infrastructure equity, private credit & diversified credit)

    By adding asset classes which can provide diversification at both overall strategy and manager level, the Committee could improve the expected risk-adjusted return for the Fund.

- The revised strategy is expected to deliver a slightly higher expected return with a level of downside risk broadly similar to the prior strategy.
- It was expected that the revised strategy would be implemented in a phased manner over the next 12-18 months (depending on the availability of assets via the ACCESS pool and the timing to deploy capital into less liquid markets).

Agreed Strategic Asset Allocation



Recap: Strategy

Mandate	Previous Strategy (%)	Agreed Strategy (%)
Global Equity	40.0%	40.0%
Infrastructure Equity	8.0%	11.0% (+3.0%)
Private Equity	5.5%	5.5%
Absolute Return	20.0%	17.0% (-3.0%)
Balanced Property	10.0%	7.0% (-3.0%)
Inflation-linked Property	0.0%	4.0% (+4.0%)
Private Credit	3.0%	5.0% (+2.0%)
Diversified Credit	7.0%	10.5% (+3.5%)
Corporate Bonds	3.5%	0.0% (-3.5%)
Index-linked Gilts	3.0%	0.0% (-3.0%)

Strategy implementation

- The agreed plan to implement the strategy involved the following key steps.
  - Global Equity – Onboard Baillie Gifford and Osmosis and fund this from the UBS passive mandate (complete)
  - Infrastructure – Implement higher allocation through commitment to IFM. This was expected to be largely funded from the absolute return mandates.
  - Diversified credit – Aim is to select a manager from the ACCESS platform and fund this from the sale of corporate bonds, given the low yield at the point of the strategy review, and to improve overall diversification of the credit allocation.
  - Private credit and Inflation-linked Property – The implementation approach was to be confirmed depending on ACCESS timescales to make propositions available. ACCESS is not yet able to provide firm timescales and do not anticipate allocation via the ACCESS platform a possibility over the short term. The intention was to fund private credit from index linked gilts and inflation linked property from the existing Balanced Property allocation.
- It was agreed that the precise source of funding should be reviewed at the point of capital being drawn into new mandates.

Notes: Data as at end May 2022. Current positions and change vs current position do not sum to 100% and 0% respectively, as the figures shown exclude 1.7% currently held in cash.
Sources: Northern Trust, Isio calculation

Recap: Implementation

Mandate	Agreed Strategy (%)	Current (%)	Agreed vs. current (May 2022) (%)	Decision on mandate taken/ expected	Primary Funding Source	Anticipated timescale to implement
Global Equity	40.0%	40.2%	-0.2%	Q4 2021 (Osmosis & BG)	-	Complete
Infrastructure Equity	11.0%	5.3%	+5.7%	Q1 2022 (IFM)	Absolute Return	Q1 2023 subject to deal manager flow
Private Equity	5.5%	8.9%	-3.4%	-	-	Natural evolution
Absolute Return	17.0%	22.3%	-5.3%	-	-	
Balanced Property	7.0%	9.0%	-2.0%	-	-	
Inflation-linked Property	4.0%	0.0%	+4.0%	Q4 2022	Balanced Property	>12-18 months (if by ACCESS)
Private Credit	5.0%	0.9%	+4.1%	TBC – 2023?	Index-linked Gilts/ Private equity	>12-18 months (If by ACCESS)
Diversified Credit	10.5%	6.3%	+4.2%	Q3 2022	Corporate Bonds/ Cash	Q3/ Q4 2022
Corporate Bonds	0.0%	3.0%	-3.0%	-	-	
Index-linked Gilts	0.0%	2.5%	-2.5%	-	-	

Notes: Data as at end May 2022. Current positions and change vs current position do not sum to 100% and 0% respectively, as the figures shown exclude 1.7% currently held in cash.
Sources: Northern Trust, Isio calculation

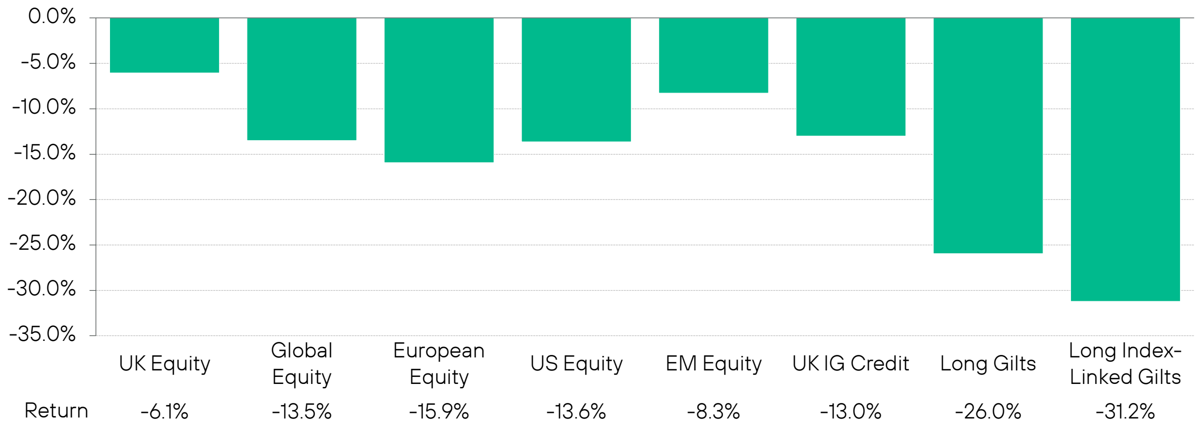
- The implementation of the target investment strategy has been delayed due to the availability of funds on the ACCESS pool. Limited information has been provided in relation to the timescales of relevant mandates becoming available on the ACCESS pool. The Committee may wish to consider where implementation off pool is a viable alternative in order to progress the Fund's investment strategy towards target in the near term.

Current market conditions

Recent market conditions

- Market conditions over 2022 to-date have been extremely volatile, largely due to Russia's invasion of Ukraine, increasing global interest rates in response to surging inflation, slowing global economic growth and the ongoing impact of Covid-19.
- We have seen a spike in gilt yields, as central banks have raised interest rates, and also indicated the likely ongoing need for monetary policy tightening over the coming months. Furthermore, increasing pessimism around the global economy, and the likelihood of a 'hard landing' to monetary tightening, has led to sell off in risk assets. These factors have combined to drive negative returns for credit, equity and gilt markets simultaneously.
- June has seen a continuation of these themes, with further sell-offs across both equity and fixed income markets. As such, the Fund's liquid assets – notably equities, absolute return, corporate bonds and gilts – have all fallen in value since the figures highlighted on the previous page.

Year to Date Market Returns (17 June 2022)

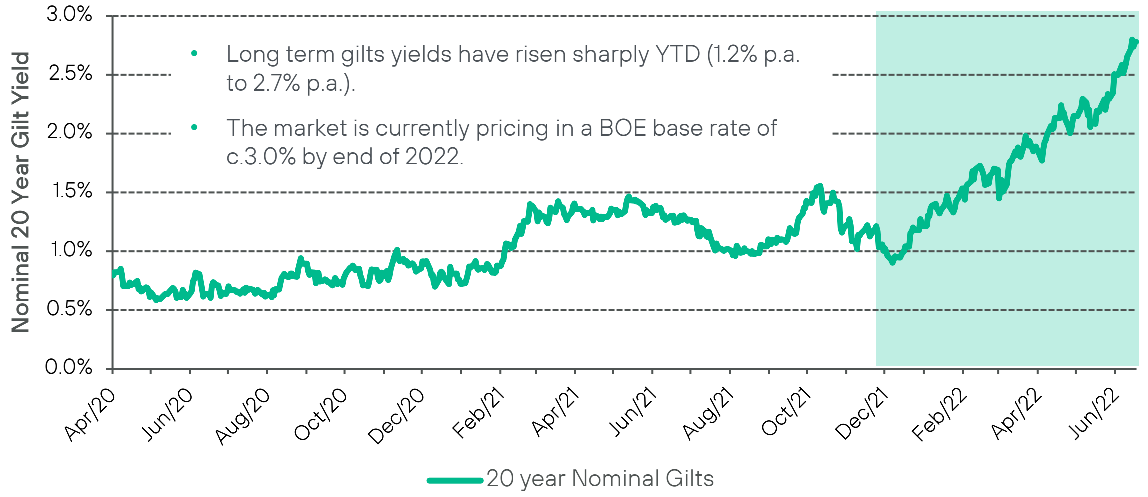


Market overview

Mandate	YTD	June to-date
Sterling non-gilts (IG)	-13.0%	-3.4%
Sterling High Yield Credit	-10.2%	-3.4%
Nominal gilts (over 15y)	-26.0%	-4.9%
Index-Linked Gilts (over 5y)	-31.2%	-5.4%
Global Equity (£ hedged)	-19.3%	-9.7%
Global Equity (unhedged)	-13.5%	-7.7%

Notes: Data to 17 June 2022 (latest available). **Sources:** Refinitiv, Eikon, Isio calculations.

Gilt yields (20 year Nominal Yields)



Assessment of current target strategy (1)

Strategic change	Strategic rationale	Key considerations based on current market environment	Recommendations
Remove corporate bonds to fund an increased allocation to diversified credit	• Introduce greater flexibility for a manager to access attractive parts of the credit market • Increase expected return in a wider range of market conditions • Corporate bonds offering relatively low yield	• Rising gilt yields have pushed down the value of corporate bonds, and increased their yield. • Diversified credit funds remain well placed to navigate ongoing volatility through active management, including views on interest rates.	➢ Retain existing plan and timescale, with a new diversified credit manager able to take advantage of wider credit spreads. ➢ Implementation could be phased to mitigate volatility in yields.
Reduce allocation to absolute return to fund an increased allocation to infrastructure equity	• Increase the Fund's level of inflation protection • Enhance the yield of the overall portfolio • Diversify the sources of growth exposure	• Absolute return managers well placed to navigate ongoing volatility through active management • Ruffer provides significant inflation protection given current positioning • There is the potential for infrastructure valuations to be impacted by rising real yields.	➢ Maintain absolute return allocation (particularly Ruffer – given its inflation protection) until the infrastructure equity mandate is drawn ➢ Retain the current plan given we expect funding could not take place in c. 9-18 months (depending on IFM deal flow). ➢ Reassess ahead of drawdown based on market conditions at that time.

Assessment of current target strategy (2)

Strategic change	Strategic rationale	Key considerations based on current market environment	Recommendations
Reduce allocation to index-linked gilts to fund an increased allocation to private credit	• Provide access to the 'illiquidity premium' offered by private debt, enhancing overall expected return. • Index-linked gilts offering relatively low yield, and other asset classes able to provide directional inflation protection with higher yields.	• Rising real yields have pushed down the value of index-linked gilts and increased their yield (albeit still negative). Index-linked gilts now represent significantly better value to provide protection against long-term inflation.	➢ Maintain the index-linked gilt allocation. ➢ Given private credit not expected to be implemented in the short term, we recommend to engage with ACCESS on expected timescales for launch of their proposition and review based on this.
Reduce target allocation to balanced property to fund a new allocation to inflation-linked property	• Increase direct inflation protection. • Diversify the sources of growth exposure at a strategic level • More attractive prospects for alternative property than balanced going forward	• Property markets have so far remained relatively resilient to volatility; we believe now could be an attractive time to exit balanced property given market sentiment and pricing. • Residential property is likely to come under pressure given the current environment.	➢ Hold proposed allocation to inflation-linked property in index-linked gilts until ready to implement. ➢ This offers inflation protection in the interim and reduces property exposure in what we expect to be a challenging environment. ➢ Review the case for inflation-linked property in the current environment.

Fixed income implementation timeline

Q1 Committee Meeting (24 February 2022) - Completed

- Proposed method and timeline for implementing fixed income allocation for consideration.
- Committee to agree on approach & liquid fixed income evaluation criteria.

Q2 Committee Meeting: Diversified Credit Manager Due Diligence Update

- Isio/Officers to provide update to the Committee.
- Discuss diversified credit manager due diligence to date.

Jan 2022 | Feb 2022 | Mar 2022 | Apr 2022 | May 2022 | June 2022 | July 2022 | Aug 2022

Post Q1 Committee Meeting - Stage 1: Diversified Credit Manager Due Diligence

- Isio researched and shortlisted potential managers for the mandate.
- Officers involved in manager selection beauty parade for short listed managers and subsequently requested further information in relation to due diligence.
- Due diligence to determine the most suitable manager for the mandate remains ongoing.

Summary, considerations & next steps

Summary

- The revised strategy is expected to increase the portfolio's expected return, whilst broadly maintaining the previous level of downside risk.
- 2022 has seen significant market volatility, with material write-downs in the value of equity and fixed income markets.
- We continue to believe that the agreed direction of travel remains appropriate, but we believe that the implementation approach should be adapted to reflect evolving market conditions.
- We propose maintaining the absolute return allocation (particularly Ruffer – given the manager's current positioning, allocation to index-linked gilts, and its inflation protection) until the infrastructure equity mandate is drawn (anticipated in 9-18 months).
- While credit spreads have widened, impacting valuations of both corporate bonds and diversified credit, we believe a more diversified credit portfolio will benefit the Fund and provide some downside protection going forwards. We believe a more dynamic approach will be beneficial in the current environment. As such, we continue to recommend using the corporate bonds to fund the new diversified credit mandate. A phased implementation should be considered to mitigate market volatility.
- We propose retaining the index-linked gilt allocation over the short term given its recent material fall in value and the inflation protection offered. It is likely that it will be some time before ACCESS can offer a private credit vehicle – the Committee should continue to explore whether it is viable to proceed off pool if no firm timescales can be provided.
- We believe the Committee should consider trimming the core property exposure (which is currently earmarked for inflation-linked property) and hold this in index linked gilts in the interim.
- We also believe the Committee should re-visit the case for inflation-linked property in the current environment ahead of implementing the strategic allocation.
- Given the time lag involved in implementing the investment changes, primarily due to the time involved in the procurement of mandates, ACCESS availability, as well as the private market nature of some of the investments, it is expected that these changes will continue to be implemented in stages over the next 12-18 months.

Considerations & Next steps

- Committee to review the considerations in this paper, and agree whether the investment strategy remains fit for purpose.
- Committee to review the considerations in this paper around timing of implementation, and whether amendments should be made to the current plan.
- If agreement is to proceed, Committee agree to the continuation of due diligence for the diversified credit mandate.
- The Officers to make further progress regarding the proposed private credit allocation once further information is available from ACCESS regarding the timing of proposition availability and confirm timescales and evaluation criteria at this stage.
- The Committee should consider if they wish to re-visit the case for inflation-linked property.

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Thank you

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