Report to:	**Pension Committee**
Date:	**19 September 2023**
By:	**Chief Finance Officer**
Title of report:	**Investment Report**
Purpose of report:	**This report provides Pension Committee with an update on the investment activities undertaken by the East Sussex Pension Fund.**

RECOMMENDATION

The Pension Committee are recommended to:

1. **Note the Quarterly performance of the Investment portfolio**
2. **Agree to change the liquid investments where possible to distribute income back to the Fund**
3. **Approve the amended asset allocation set out in paragraph 4.22**
4. **Approve the revised Investment Strategy Statement Appendix 4**
5. **Approve the revised Statement of Responsible Investment Principles Appendix 5**
6. **Note the research into the efficacy of divestment and engagement and agree to publish on the Fund's website**
7. **Delegate authority to Chief Finance Officer to take all necessary actions to give effect to the implementation of the above recommendations.**

1. Background

1.1 Under the Local Government Pension Scheme (LGPS) Regulations, the Council is required to maintain a Pension Fund for its employees and other 'scheduled bodies' as defined in the Regulations. The Pension Committee is required to maintain an Investment Strategy Statement (ISS) to govern the Funds' investments and receives a quarterly investment monitoring report, from its investment consultant, Isio.

1.2 The ACCESS Joint Committee has been established as a result of the changes implemented in the 2016 LGPS Investment regulations to facilitate the arrangements relating to the collective investment vehicles, to allow the administering authorities to pool their respective investments. The ACCESS Joint Committee meets quarterly.

2. Investment Workplan

2.1 **Appendix 1** shows a workplan which will act as a reference point of all actions agreed at Pension Committee meetings and the forward investment plan.

2.2 The main focus over the next 12 months is:

- Implement the strategic changes in relation to fixed income
- Implementation of remaining/amended investment strategy changes not yet implemented including private debt
- Monitoring of index link triggers for investment
- Work with ACCESS to develop the governance and investment opportunities on the pool platform
- Submission of the Principles of Responsible Investment (PRI) reporting
- Submit the Fund's stewardship code for the calendar year 2022
- Engagement with investment managers on the engagement priorities defined in the Statement of Responsible Investment Principles
- Carry out Carbon Foot printing as at 31 March 2023 (this information is delayed, and will be included in the next report)
- Produce the climate report based on the Taskforce for Climate related Financial Disclosures (TCFD) framework for 2022/23
- Further investigation into climate scenarios
- Consider the creation of a standalone climate policy and biodiversity policy

3. Quarterly Performance Report

3.1 The Quarterly Performance Report for Q2 2023 is attached as **Appendix 2**. Since the last reported position, the valuation of the Fund has increased from £4.564bn as at 31 March 2023 to £4.574bn as at 30 June 2023 (an increase of £0.01bn). This performance reflects a positive absolute return of 0.2% in the quarter to June. However the Fund underperformed its benchmark in the period by -1.8%.

3.2 Although performance across the Fund was positive for the period, there was mixed relative performance across equity mandates, illiquid holdings continued to see write downs in performance, and the absolute return funds disappointed.

3.3 Longview, UBS Osmosis, Storebrand, and Baillie Gifford provided strong absolute (4.6%, 4.1%, 3.6% and 3.1% respectively) but mixed relative returns (0.7%, 0.2%, -0.3% and -0.2%) for the quarter. With Ruffer, Harbourvest and Adams Street providing both negative absolute (-6.3%, -2.6% and -2.0% respectively) and relative returns (-8.0%, -6.2% and -5.6%).

3.4 The longer term returns at Fund level remain strong, with equity assets adding significant value over the last decade.

4. Strategy Review

4.1 The Fund has completed its March 2022 triennial valuation of the Fund to ensure that the Fund's investment strategy is suitable in relation to the funding expectations of the actuary. Isio has undertaken a detailed review of the Fund's overall investment strategy in order to quantify the inherent risks and to consider options for the evolution of the asset allocation.

4.2 Isio presented initial considerations for the investment strategy to the Pension Committee members at the July strategy day where collaborative discussions took place to identify the preferred direction of travel with the strategy.

4.3 The objectives of the Investment Strategy is to deliver a return that improves the funding level over time (to achieve future lower employer contribution rates), with as little volatility in the funding level as possible (to maintain stability of contributions as far as possible), and maintain sufficient assets to meet liabilities i.e. a minimum funding level of 100%.

4.4 The assumptions underlying the Actuary's funding basis are important factors in determining the return requirement.

4.5 As the Fund grows, it will also be important to ensure that stability, relative to sponsor budgets, is maintained. The Fund's current strategy is shown below:

Asset Style	Asset Type	Asset Class	Active/Passive	Asset Allocation %
Growth	Global Equities	Quality	Active	10.0
		Growth Paris Aligned	Active	5.0
		Sustainable Growth	Active	10.0
		Climate Aware Smart Beta	Passive	10.0
		Resource Efficient	Passive	5.0
	Private Equity	Global	Active	5.5
Defensive Growth	Diversified Growth	Absolute Return	Active	10.0
		Real Return	Active	7.0
	Fixed Income	Diversified Credit	Active	10.5
		Private Credit	Active	5.0
Defensive Growth / Inflation Protection	Infrastructure	Global Private	Active	10.0
		Global Listed	Active	1.0
Defensive Growth / Income / Inflation protection	Real Estate	Balanced Property	Active	7.0
Income / Inflation protection	Real Estate	Long Inflation Linked Property	Active	4.0

4.6 The current investment strategy is expected by ISIO to achieve an expected return of 7.8% per annum. The 2022 valuation has factored in a 4.8% discount rate. The discount rate is used to discount future payments to and from the Fund to value of accrued liabilities and future contribution requirements. The discount rate is designed as a best estimate by the actuary of the investment return for each broad asset class in the Fund's long-term investment strategy, then combine these and make an overall explicit adjustment for expenses and prudence, to try and reduce the impact of volatility and assumptions not bearing true. The expected return at March 2023 of the actuary in calculating the discount rate and for setting contributions was 5.7% returns. The discount rate used to calculate the funding level and allocate assets to scheme employers moves continually and is linked to CPI inflation. To move the expected return of the strategy down i.e. to remove some of the investment risk in the portfolio would also require the Actuary to adjust the valuation calculations which could result in increased contributions from employers.

4.7 It is important to highlight the actuary and the investment consultant calculate best estimate returns differently. The actuary calculates returns based on CPI inflation but with an allowance for capital growth and in the case of equities, future dividend yield. As a result they suggest the long-term best estimate return of the current portfolio as at 31st March 2023 was 5.7%. In contract the Investment Consultant calculates returns using a gilts plus model and so the return on all asset classes will have increased as a result of the increase in gilt yields. Isio in their report suggest the current investment portfolio will generate best estimate return of 7.8%.

4.8 Changes in the investment strategy will impact on the funding level of the Fund and significant changes to the strategy need to be considered in liaison with the Fund Actuary to understand the impacts to the funding level and resulting employer contribution rates.

4.9 The Committee should consider the strategic direction of the Fund in relation to its clear principles in relation to Environmental, Social and Governance (ESG) issues which are summarised in the Statement of Responsible Investment (RI) Principles.

4.10 Based on the estimated 31 March 2023 position and median predicted outcome going forward, the expectation is the Fund will be in a surplus of c. £1,600m in 3 years' time (up from c.£795m at the end of March 2023). Ultimately any surplus could be used to bring down the future service cost of the Fund to the employers.

4.11 Given the current investment risk in the strategy, there is a 1 in 20 chance that a deficit of c.£80m or more could arise in 3 years' time –this would trigger a need for the deficit contribution rate to be paid in addition to the cost of future accrual.

4.12 Given the current strong funding position, the Investment consultant suggests there is scope to reduce investment risk and lessen the impact of any potential downside scenarios, essentially narrowing the range of potential outcomes. Reducing investment risk, and narrowing the range of potential return outcomes, would reduce the potential variability of contribution rates at future valuations. This could be done with minimal impact to expected returns.

4.13 The Fund's key risks are equity exposure. The 40% strategic allocation to equities and 7.5% to private equity means that a fall in equity valuations would result in a material decrease in the Fund's assets.

Proposed direction of travel

4.14 The Committee could consider reducing allocations to the public and private equity reflecting strong funding position. By continuing the direction of travel of reducing overall investment risk and reducing potential volatility in the funding position.

4.15 The Committee should consider the underlying composition of the equity mandate allocations are reviewed now that the resource efficient passive mandate is in place, to balance the share of investment between the resource efficient mandate and the smart beta ESG plus mandate.

4.16 The Fund should consider introducing strategic allocation to index linked gilts increase inflation protection in asset portfolio to manage a key risk faced by the fund of persistently high inflation. Prevailing yields are attractive and the Fund has already started to purchase index linked gilts in line with the previously agreed trigger based framework.

4.17 The Fund should continue to progress an increased private credit allocation reflecting strong opportunity in this asset class. Private credit markets currently offer attractive yields, on an absolute basis and relative to liquid credit, and market dynamics favour those who are able to delay capital for the long term (such as the LGPS). Private credit assets will generate cashflow for the Fund over the short to medium term to meet increased cashflow needs.

4.18 The Fund should consider reinstating a more balanced approach in liquid credit given the higher interest rate sensitivity of Investment Grade Corporate Bonds as their relative attractiveness compared to Diversified Credit has increased. Retaining an Investment Grade Corporate Bonds mandate given their overall yield is appealing in the short to medium term.

Current Income

4.19 There is a significant risk to the Fund with regard to the cashflows due to the inflation linkage to liabilities and the small reduction to contributions allowed to some employers following the triennial valuation. The Fund will see that income from activities relating to members is lower than the spend to pay pensions, so there is a need for the investments to contribute to the income of the Fund in a more significant manner going forward. The first mitigation for the Fund should be to taking income distributions where it can from its investments. This will allow the Fund to rebalance the portfolio and provide a cashflow that can be used to cover the Fund's benefit payments without having to sell assets. The Fund currently looks to hold around £40m in cash in its Northern Trust account to cover capital calls for the illiquid assets.

4.20 Currently all the illiquid assets are all set up to distribute the income generated to the Fund the closed ended investments will also be returning capital to the Fund as they mature.

4.21 By switching the Fund's liquid investments to distribute cash the Fund could receive about £50m in cash from these investments a year. It should be noted that not all the investments are able to distribute income to the Funds, officers will investigate where distributions can be released. Below is a table setting out the Fund's current income reinvestment status of our investments and income received for the period 2022/23.

Asset Type	**Asset Class**	**Currently Distributing**	**Income generated 2022/23 £m**
Liquid assets			
Global Equity	Smart Beta	No	10.5
	Active Impact	No	-
	Resource Efficient	No	4.6
	Paris Aligned	No	1.2
	Global Equity	No	5

	Active Impact	No	-
Diversified Growth	Real Return	No	7.4
	Absolute Return	No	11.5
Fixed Income	Diversified Credit	No	5.4
	Corporate Bonds	No	3.5
	Index Linked Gilts	No	-
Infrastructure	Global Listed	No	1.1
Total Liquid assets			**50.2**
Illiquid assets			
Private Equity	Global	Yes	17.3
	Global	Yes	16
Real Estate	Balanced Property	Yes	11.7
Infrastructure	Global Private	Yes	2.9
	Global Private	Yes	-
	Global Private	Yes	8.7
	Global Private	Yes	13.1
Private Credit	Private Credit	Yes	8.1
Total illiquid assets			**77.8**
Total assets			**128**

Proposed Portfolio

4.22 Isio has provided a proposed new structure to the Fund's Strategic Asset Allocation which is anticipated to slightly decrease the expected return from 7.8% to 7.7%. This would provide a better 3 year 1 in 20 downside position from £1,680 to £1,663m (a 7% improvement). The suggested changes would also maintain the assets with a direct linkage to inflation at 18.5%. The proposed changes will slightly reduce the percentage of less liquid assets to 28.5% from the previous 32.5%. The proposed strategic asset allocation is provided below showing the movement between asset classes:

Asset Style	Asset Type	Asset Class	Active/Passive	Asset Allocation %	Change %
Growth	Global Equities	Quality	Active	10.0	-
		Growth Paris Aligned	Active	5.0	-
		Sustainable Growth	Active	10.0	-
		Climate Aware Smart Beta	Passive	7.5	(2.5)
		Resource Efficient	Passive	7.5	2.5
	Private Equity	Global	Active	5.5	-
Defensive Growth	Diversified Growth	Absolute Return	Active	10.0	-

		Real Return	Active	7.0	-
	Fixed Income	Diversified Credit	Active	7.0	(3.5)
		Corporate Bonds	Active	3.5	3.5
		Private Credit	Active	5.0	-
Defensive Growth / Inflation Protection	Infrastructure	Global Private	Active	10.0	-
		Global Listed	Active	1.0	-
Defensive Growth / Income / Inflation protection	Real Estate	Balanced Property	Active	7.0	-
Income / Inflation protection	Real Estate	Long Inflation Linked Property	Active	-	(4.0)
Inflation protection	Fixed Income	Index Linked Gilts	Passive	4.0	4.0

4.23 Isio will talk through the planned strategic changes, reasoning, and impact as they present their report in **Appendix 3**.

4.24 The Fund actuary has advised that the planned changes in the table in 4.22 will not impact on the funding level.

5. Investment Strategy Statement

5.1 The Fund is required to produce an Investment Strategy Statement (ISS) under regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

5.2 The Investment Strategy Statement required under Regulation 7, must include:

a) A requirement to invest money in a wide variety of investments;
b) The authority's assessment of the suitability of particular investments and types of investments;
c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

5.3 As a result of the changes to the investment strategy proposed changes in the Investment Strategy Review, officers have reviewed and updated the Investment Strategy Statement (ISS) to reflect the proposed changes. The revised ISS can be seen in **Appendix 4** to this report.

6. Statement of responsible investment principles

6.1 The East Sussex Pension Fund (ESPF) Investment Strategy Statement is a statutory requirement codified in the Local Government Pension Scheme (Management and Investment of Funds) (England) Regulations 2016. The Statement of Responsible Investment Principles although not required by statute complements and amends the ESPF's Investment Strategy Statement and explains the Fund's approach to the oversight and monitoring of the Fund's investment activities from a Responsible Investment and Stewardship perspective.

6.2 As part of a review of the Investment Strategy Statement Officers have also reviewed the Statement of Responsible Investment Principles (SRIP). In refreshing the SRIP, officers have incorporated discussions at the investment strategy workshop over RI beliefs, engagement priorities suggest by Committee members, additions to the statement to align with best practice and to include areas identified from the PRI reporting where improvements can be made.

6.3 As a result the proposed changes to the statement of responsible investment principles can be seen in **Appendix 5** to this report.

7. ACCESS Update

7.1 Since December 2016 the East Sussex Pension Fund has been working with 10 other administering authorities through the investment pooling arrangement called ACCESS. On the 30 June 2023 there was £24.8bn invested in the authorised contractual scheme (ACS) managed by the pool operator Link Fund Solutions, with a further £10.7bn invested in the UBS passive ACCESS governance arrangements. East Sussex had a total of £2.06bn in ACCESS governed investments, £1.93bn across 6 ACS sub-funds and a further £0.13bn through the UBS passive arrangement.

7.2 The formal Joint Committee was held on 4 September 2023 the agenda is provided at appendix 9 and the following items are highlighted:

- An update on the activities that were achieved against the original business plan and outturn spend for the year were provided. The spend came in at £1.558m for 2023/24, £572 underbudget. This equates to a cost to the Fund of £0.142m for the year.
- The Joint Committee accepted the recommended 2023/24 budget to support the business plan from Section 151 Officers (totalling £1.559m or £142k per council).

7.3 The Chair of Access was re-elected for another term, and committed to continue to bear down on investment management costs, noting that cross fertilisation of funds would accelerate progress.

7.4 A third party review by Barnet Waddingham has recently concluded, and the report will be shared at the Committee's next meeting on 4 December 2023.

8. Divest/Engagement Report

8.1 At the July 2022 meeting the Committee requested that officers and the Fund's external advisers conduct a piece of work concurrent with the completion of the triennial valuation which:

1. Assesses the fiduciary and legal consequences of fossil fuel divestment for the Fund;

2. Examines how such a move aligns with relevant guidance and advice;

3. Explores how practical an act it would be within the context of the ACCESS pool; and

4. Reviews evidence on the efficacy of such an approach in promoting the energy transition.

8.2 Isio the Fund's investment consultant have led on the production of this piece of work with input from the Fund's legal advisers. The consultants produced three detailed chapters of analysis and research with the production of a summary report for publication for the benefit of the Funds beneficiaries. Attached to this report is the summary report (**Appendix 6)** detailing the findings of the work and a document setting out the definitions (**Appendix 7**) which set out what is meant within the report when certain phrases are used.

8.3 The research has highlighted that neither engagement nor divestment has been entirely effective to date in bringing about the low carbon transition alone, albeit there remain challenges in analysing the effectiveness of these processes (as compared with the numerous other influences in climate outcomes). It is however clear that the fossil fuel industry has not made the adjustments required to align with a low carbon future and a step change is needed to tackle the climate emergency. This requires escalation in the name of climate action, with investors working alongside companies and governments towards change through engagement with investee companies, effective governance processes for investment managers, engagement with policy makers and the ability for Investment managers to divest from holdings where there is an insufficient energy transition plan or where there is a financial risk of holding those investments.

8.4 The Pension Committee has a fiduciary duty to invest the Fund's assets in the best interests of beneficiaries – and "the fiduciaries' investment powers must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question", as well as with the aim of diversification of investments.

8.5 If the Fund were to implement a fossil fuel divestment policy, the impacts could be significant. For example, combining Isio modelling efforts and manager investment analysis, immediate divestment could cost the Fund circa £79m, including an £18m shortfall in returns (alongside a 12% increase in the 3-year 1 in 20 Value at Risk and reduction in diversification), £61m incurred in transaction costs (with £60m of this coming from infrastructure equity and private equity haircuts). The exit costs of the private markets would be reduced if managed out of the portfolio over the longer term, however this may restrict the ability to invest in best in class value for money asset classes in the future which would impact diversification of the portfolio, investment returns and correlation of the portfolio to market changes. The costs identified in the research are likely to be an underestimate, as they ignore costs, such as the losses of efficiencies of scales from pooling investments, additional custodian fees from ex-fossil fuel segregated mandates, and governance and staffing costs relating to the additional burden of implementing and monitoring the divestment strategy across the Fund, as examples.

8.6 As a result of the completion of research, the Fund will continue to focus on a robust investment strategy in line with the regulatory requirements managing all risks in line with its approved policies.

9. Conclusion and reasons for recommendation

9.1 Investments are regularly monitored to ensure that the Fund's strategic asset allocation set out in the Fund's Investment Strategy Statement (ISS) is being complied with and to keep the Committee informed of any significant concerns with the investment managers, retained to implement the Fund's strategic asset allocation.

9.2 The Pension Committee are recommended to, note the Quarterly performance of the Investment portfolio; agree to change the liquid investments where possible to distribute income back to the Fund; approve the amended asset allocation set out in paragraph 4.22; Approve the revised Investment Strategy Statement Appendix 4; approve the revised Statement of Responsible Investment Principles Appendix 5; note the research into the efficacy of divestment and engagement and agree to publish on the Fund's website; delegate authority to Chief Finance Officer to take all necessary actions to give effect to the implementation of the above recommendations.

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