Report to:	**Pension Committee**
Date of meeting:	**12 July 2021**
By:	**Chief Financial Officer**
Title of report:	**Investment Strategy Review**
Purpose:	**This report provides Pension Committee with an overview of the investment strategy and direction of travel for the East Sussex Pension Fund.**

RECOMMENDATION

The Pension Committee is recommended to:

1) **note the Investment Strategy report (Appendix 1);**
2) **Agree the following proposed strategic asset allocation (as set out paragraph 4.1-4.7):**

Asset Class	%
Global Equity	40.0
Diversified Growth	17.0
Private Equity	5.5
Balanced Property	7.0
Inflation-Linked Property	4.0
Infrastructure Equity	11.0
Private Credit	5.0
Diversified Credit	10.5
Corporate Bonds	-
Index-Linked Gilts	-
Cash	-

3) delegate authority to the Chief Finance Officer, in consultation with the Chair, to take all necessary actions to give effect to the implementation of the above recommendation.

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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 East Sussex Pension Fund's (ESPF or the Fund) investments and needs to review this periodically to ensure it is still fit for purpose.

1.2 To assist the Committee 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. As well as high level asset allocation, Isio has focus on certain key specific areas of the portfolio, to provide recommendations on how the committee might evolve the strategy going forward.

2. Investment Strategy Review

2.1 The Committee requested a review of the current investment strategy, Isio has prepared some training on the salient points on the function of the investment strategy and areas for consideration by the Committee which is planned in advance of this meeting. The training will be recorded and sent to Committee Members unable to attend at the scheduled time slot.

2.2 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. an overall funding level of 100% or more. The assumptions underlying the Actuary's funding basis are important factors in determining the return requirement. 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 Class	%
Global Equity	40.0
Diversified Growth	20.0
Private Equity	5.5
Balanced Property	10.0
Infrastructure Equity	8.0
Private Credit	3.0
Diversified Credit	7.0
Corporate Bonds	3.5
Index-Linked Gilts	3.0
Cash	-

2.3 The current Investment Strategy is positioned so that it can achieve an expected return of 5.3% per annum. This level of return has been factored into the valuation calculations in the 2019 valuations. 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. The next triennial valuation will take place based on the data as at 31 March 2022, with new contribution rates for employers coming into effect from April 2023.

2.4 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. These are as follows:

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.

It is important to ensure the strategy is aligned with these principles.

2.5 Based on the estimated 31 March 2021 position and median predicted outcome going forward, the expectation is the Fund will be in a surplus of c. £540m in 3 years' time (up from c. £280m at the end of March 2021). Ultimately any surplus could be used to bring down the future service cost of the Fund to the employers.

2.6 Given the current investment risk in the strategy, there is a 1 in 20 chance that a deficit of c.£1,072m 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.

2.7 Given the current strong funding position, 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.

2.8 The Fund's key risks are equity exposure and the interest rates / inflation risk inherent within the value placed on the liabilities. The 40% strategic allocation to equities means that a fall in equity valuations would result in a material decrease in the Fund's assets (similar to that experienced over Q1 2020, although this was quickly reversed). The significant risk from inflation is due to the majority of the pension benefits in the Fund being directly linked to inflation. While the Fund's discount rate is not explicitly linked to interest rates, it is assumed that a change in long term interest rates will be reflected to some degree in a change in the expected future returns from the investment strategy, and consequently also in the Actuary's discount rate.

3. Proposed direction of travel

3.1 The Committee should look to **increase exposure to assets with direct inflation-linkage.** Rising inflation is a key risk to the Fund given the liability structure; and increasing the allocation to assets with direct inflation linkage would help address this risk. e.g. infrastructure and long lease property.

3.2 **Increase exposure to less liquid assets**. Given the Fund's long term horizon, and the overall level of liquidity in the current portfolio, there is scope to target less liquid opportunities e.g. private market debt, equity and infrastructure to a greater degree and earn an excess return for doing so.

3.3 **Increase alignment to Responsible Investment Policy**. The Fund has made strong progress incorporating ESG considerations into its investment strategy and this is expected to remain a key focus going forward.

3.4 **Pooling of assets**. The regulatory environment directs the pooling of assets going forward. This will need to be considered in conjunction with setting the investment strategy and implementation of decisions.

3.5 Strategy changes should be considered as a direction of travel rather than an instant change in investment. All investment changes will require comprehensive due diligence in advance of a specific subscription. In addition, it takes time to find new investments that suitably align to the risk and reward parameters that the strategic changes are looking to achieve. Illiquid assets often have queue of commitments, meaning that the money is not paid to the new investment manager until they have found a new assets to purchase with the committed investment, so the actual asset allocation can look different to the strategic allocation even where a new manager has been selected and the investment subscription is complete, it can take years for the commitment to be drawn down (meaning the cash is paid over). In addition, some asset classes also have exit costs associated with them while others are very volatile, so timing of moving any asset would be considered carefully by the Investment consultant, officers and a transition management team where appropriate. Multiple strategy changes could play out over a couple of years and could take longer if the Fund is reliant of the ACCESS Pool to offer a new asset class.

4. Proposed Portfolio

4.1 Isio has provided a proposed new structure to the Fund's Strategic Asset Allocation which is anticipated to slightly increase the expected return from 5.3% to 5.5% and subsequently raise the expected surplus of the Fund. This would also provide a better 3 year 1 in 20 downside position. The suggested changes would also increase the assets with a direct linkage to inflation to circa 15% from the current linkage circa 11%. The alternate Strategic asset allocation is provided below showing the movement between asset classes:

	Current	Proposed	Movement
Asset Class	%	%	%
Global Equity	40.0	40.0	-
Diversified Growth	20.0	17.0	(3.0)
Private Equity	5.5	5.5	-
Balanced Property	10.0	7.0	(3.0)
Inflation-Linked Property	-	4.0	4.0
Infrastructure Equity	8.0	11.0	3.0
Private Credit	3.0	5.0	2.0
Diversified Credit	7.0	10.5	3.5
Corporate Bonds	3.5	-	(3.5)
Index-Linked Gilts	3.0	-	(3.0)
Cash	-	-	-

4.2 Isio will talk through the planned strategic changes, reasoning and impact as they present their report in **Appendix 1**.

4.3 The Fund has delivered strong investment returns in recent years during a period in which most asset markets have trended upwards, with the equity exposure being particularly beneficial, however, liabilities have also increased since the last valuation, meaning the funding position has remained neutral, as at 31 March 2021, at 106% funded. The proposed strategy changes have been recommended to address the current investment risks that the Fund is facing. The latest Funding Position report from the Actuary is included in **Appendix 2** for information on how the funding position has moved since the last valuation and the importance of maintaining sufficient return on investments

4.4 Whilst equity risk remains one of the Fund's biggest risks, the Fund should maintain its existing strategic allocation to equities as a long term driver of overall return, and focus on increasing allocations to assets with direct inflation exposure, to help address the risk of rising inflation. In addition investing more into less liquid assets allow the fund to target a premium for being able to tie up its capital, as a long term investor.

4.5 Isio recommend that the Fund should seek to continue building out the real assets portfolio, with a particular focus on opportunities within infrastructure. This would serve not only to increase the portion of Fund assets with direct inflation exposure, helping to address a significant risk facing the Fund, but could also be implemented to further demonstrate the Fund's commitment to sustainable investments. Alongside this, the Fund could consider introducing exposure to property assets with a direct inflation linked income stream to further increase the inflation protection.

4.6 Isio recommend the Fund's allocation to corporate bonds should be switched into diversified credit, which exhibits a more attractive risk/return profile (as a result of its wider opportunity set and active management). This strategy change would also help to improve the ESG positioning of the Fund and reduce climate risks, as this portfolio has relatively high investment in fossil fuel companies compared to its other holdings – although this is more through utilities companies than energy extraction, such as, oil and gas majors.

4.7 Further commitments to commercial real estate debt and private debt more broadly should be considered, in order to harvest the premium available and to broaden the Funds private debt exposure.

5. Implementation

5.1 To consider the implementation of the proposed changes, officers would first look to which assets classes are available through the ACCESS pool and where these are not currently in place the anticipated timeline to be on the pool. Officers will also take into consideration any developments in the issuance of further pooling statutory guidance from the Ministry and Housing Communities and Local Government (MHCLG).

5.2 Where strategic changes cannot be implemented within the ACCESS pool, the Fund would need to consider whether it could access the asset class temporarily until such time as the Pool can bring the asset class on line and work with the pool to implement the required changes to access via the pool. A temporary investment would be more possible in liquid asset classes, or though open-ended investments of more illiquid asset classes. There can be significant costs exiting certain assets and the Fund would never want to be a forced seller of assets during a position of a market failure.

5.3 The Fund currently has 13 managers and 19 individual mandates, any restructuring of the Funds assets should be done with a view to minimise any increase to the number and complexity of the Fund arrangements to avoid further governance requirements.

5.4 ACCESS has a pipeline for work to bring Private Equity, Infrastructure and Real Estate available within the pool, these are not anticipated to be in place until 2022/2023 with a prioritisation for Private Equity in importance. Officers have reached out to other ACCESS funds and are aware a number of them have existing exposure to the same open ended infrastructure Fund that would be worth officers and advisers looking at as part of an implementation stage associated with this investment class,

5.5 ACCESS is currently working to launch 4 Multi Asset Credit sub funds (Diversified Credit) in October 2021, these are currently going through final implementation stages. One of the four is M&G Alpha Opportunities which the Fund currently invests. It is hoped that the proposed increased allocation to this asset class would be investable within the ACCESS pool when the new sub funds are launched.

5.6 After speaking with other ACCESS members, it does not appear that Long Dated Inflation linked property is a priority or existing investment of our counterparts, so may not be on the radar for the ACCESS Pool for a number of years.

6. Conclusion and reasons for recommendation

6.1 The Funds investment strategy is the primary driver for the return and investment risk of the Fund's assets. This needs to be regularly monitored to ensure that the Fund's strategic asset allocation balances the need to generate sufficient return against the investment risks the Fund is challenged with. The proposed new structure is an evolution of the current strategy to address the increased risk that inflation is believed to pose to the Fund's liabilities. Whilst also maintaining an acceptable level of return.

6.2 The Pension Committee is recommended to note the Investment Strategy report (**Appendix 1**) and agree the proposed strategic asset allocation:

Asset Class	%
Global Equity	40.0
Diversified Growth	17.0
Private Equity	5.5
Balanced Property	7.0
Inflation-Linked Property	4.0
Infrastructure Equity	11.0
Private Credit	5.0
Diversified Credit	10.5
Corporate Bonds	-
Index-Linked Gilts	-
Cash	-

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