

Report to: **Pension Committee**

Date: **24 February 2022**

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 Investment Workplan (appendix 1);**
 - 2) **note the Quarterly Investment Report from the Investment Advisor, Isio (appendix 2)**
 - 3) **note the Investment Correlation report (appendix 3)**
 - 4) **note the investment strategy recap (appendix 4)**
 - 5) **note the Inflation Report (appendix 5) and agree next steps**
 - 6) **note the ACCESS update and approve:**
 - **a nomination of a substitute representative of the County Council at the ACCESS Joint committee meetings.**
 - 7) **Note the update on the external assurance reports**
 - 8) **Note the update on the announcement by the Department of Levelling Up, Housing and Communities**
 - 9) **Consider under the Fund's principle to engage with policy makers on ESG and Investment issues, whether the Fund wishes to call on the UK government to become a core member of the Beyond Oil and Gas Alliance (appendix 6)**
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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 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. Action Log and Investment Workplan

2.1 Appendix 1 shows a Workplan which will act as a reference point of all actions agreed at Pension Committee meetings. Unless otherwise stated, items in the workplan are

to be considered by the Committee or a comment provided explaining why the item is not to be covered at this time.

2.2 The Investment Workplan details the areas of work that are anticipated over the next 12 months.

2.3 The main focus over the next 12 months is ongoing review into and undertaking of climate modelling scenario analysis for the Fund and implementation of the revised investment strategy, where investment opportunities are possible, as agreed at the 12 July 2021 Pension Committee meeting.

2.4 The Committee are asked to note that the United Nations Principles for Responsible Investment (PRI) is not accepting submissions in 2022, so the Fund's first submission will be deferred until January-March 2023 submission date.

2.5 The Fund has not yet completed the draft for its Submission under the Stewardship Code 2020 requirements although is close to doing so; this will be deferred to the June 2022 meeting once the report has been finalised for approval prior to submission.

3. Quarterly Performance Report

3.1 The Quarterly Performance Report is attached as Appendix 2. Since the last quarter, the valuation of the Fund increased from £4.6bn as at 30 September 2021 to £4.7bn as at 31 December 2021 (an increase of £0.1bn). A positive absolute return of 3.6% over the quarter, underperforming its respective benchmark by 0.7%.

3.2 Over the period, the private equity mandates (Harbourvest and Adam Street) continued to deliver strong returns. Benefitting from lagged portfolio valuations continuing to catch up with public market counterparts. Real Return Funds out-performed benchmark with notable returns from Newton in the quarter.

3.3 Equity, while positive generally lagged the benchmark, in particular the active sustainable portfolios who were adversely impacted by the failure to pass a clean energy bill in the US.

4. Investment Correlation

4.1 At the November 2021 Committee meeting, the Committee expressed a desire to see general correlation trends across the Fund's underlying investment managers, in particular, it was asked whether mandates with more inflation linkage in their underlying assets would act as effective diversifiers during inflationary periods.

4.2 Isio have prepared an Investment manager correlation analysis for the Fund (appendix 3). The key takeaways from this analysis should be primarily focussed on the longer 3 and 5 year analysis periods. With that in mind, and based on the managers available, the portfolio appears well diversified in regard to correlation of managers.

4.3 In particular the Fund's:

- equity managers returns are all relatively highly correlated, with each other;

- real asset managers (infrastructure and property) exhibit negative or low correlations with the Fund's other mandates;
- multi-asset mandates provide effective diversification, particularly Ruffer Absolute Return, which shows low or negative correlations with all other mandates; and
- private equity managers also exhibit low or negative correlations with the other mandates.

5. Investment Strategy Recap

5.1 At the July 2021 meeting, the Committee considered an investment strategy review presented by Isio and agreed the following changes to the Fund's strategic asset allocation:

- Reduced target allocations for diversified growth, balanced property, corporate bonds and index-linked gilts.
- Increased target allocations for infrastructure equity, inflation-linked property, private credit and diversified credit.

5.2 The Investment Strategy Recap report (appendix 4) provides an overview of the Investment Strategy and the rationale for these changes and compares our actual asset allocation to the strategic asset allocation.

5.3 The priority risk factor to the Fund identified as part of the Investment Strategy review was Inflation risk which was a key driver for the recommended Investment Strategy changes.

5.4 This report also sets out the current expectation as to where the changes to the strategic asset allocation should be funded set out below:

- Diversified credit will be funded from the sale of corporate bonds
- Infrastructure equity will be funded from absolute return
- Private credit allocation will be funded from index-linked gilts
- Inflation-linked property will be funded from balanced property

5.5 The exact sources of funding should be re-assessed at the time of drawdown, given the capital is expected to be implemented in stages over the next 12-18 months and any rebalancing required within the actual allocation.

6. Inflation Report

6.1 At the November 2021 Committee meeting, a request was made for more information about the potential impact of inflation and the resulting policy response on The Fund's assets. The Fund requested William Bourne, its independent advisor, to prepare a report to the Committee to share his views on this topic (appendix 5).

6.2 This report sets out the background to the recent rise in inflation, and four potential scenarios for the medium-term future, defined as five to ten years. It looks at how the Fund's assets might behave, using both a qualitative approach based on causality and a stochastic model to provide some mathematical grounding. William has also provided some potential next steps for the Committee to consider in regard to the inflation risk to the Funds investment. These are:

- Await next Strategic Asset Allocation (SAA) review (2023) before implementing any major changes
- Postpone reductions in Newton and Index linked Gilts (ILG) allocation until after the next SAA review
- Consider allocating to broader more flexible strategies at the next SAA review
- Explore whether an overlay to mitigate risks under Stagflation is feasible

6.3 The Committee is asked to consider the next steps proposed and take into account inflation risk as a key risk in investment decisions both in the interim and once the triennial valuation is complete and the next formal investment strategy review is undertaken.

7. ACCESS Update

ACCESS Governance

7.1 Currently there is a substantial amount of governance related work that is being undertaken by ACCESS which has been taking place as a result of the review of the ACCESS Governance Manual. The Governance Manual is there to support the Inter Authority Agreement (IAA) which is the primary document governing the interaction between the ACCESS Authorities and the role of the Joint Committee and Section 151 officers. The IAA is the legal agreement between the 11 Authorities that sets out the statutory responsibilities of ACCESS. The Governance technical leads were asked to review the Governance Manual following agreement by the Section 151 Officer Group.

7.2 Following an initial review of the Manual and conversations with all participating Authorities, the technical leads identified several themes both regarding the Governance Manual itself and wider governance of the Pool. As a result a project was launched to focus on areas of highest risk to the delivery of the ACCESS objectives and the governance, policies and procedures needed to achieve them. The key time critical tasks within the ACCESS Business Plan were considered to be:

- implementation of approach to alternative / non-listed assets;
- the development and implementation of Environmental, Social and Governance (ESG) / Responsible Investment (RI) guidance;
- consideration of the future arrangements for Operator Services to the ACCESS Pool; and
- determination of future sub-funds.

7.3 Once progress had been made in relation to these themes it was proposed, a third party is engaged to carry out an audit of ACCESS governance as recommended by the Governance Working Group.

7.4 The ESG/RI Guidelines are being reviewed due to the changing nature of this aspect of the investment governance. ACCESS is supported by Minerva in drafting the guidelines. The document is intended to be a reflection of the collective views of the partner funds to create a set of RI Guidelines for the Pool. Under the LGPS Regulations, each Administering Authority retains responsibility for complying with the Investment Regulations (which is the statutory source of the requirement to take ESG factors into account). Similarly, RI is an aspect of discharging fiduciary duties which are the remit of Administering Authorities, not the Pool.

7.5 Therefore, the ESG/RI Guidelines do not go beyond policies already in place or intended to be in place at each Council and do not supersede or replace the Investment Strategy Statement or policies of each Administering Authority. Instead, ESG/RI Guidelines are considered complementary to those documents. The draft guidelines have been considered by the Pension Committee at its meeting in November 2021. Other ACCESS authorities are currently reviewing the document prior to the next Joint Committee meeting 7 March 2022 for the next stage of the approval process.

7.6 At the last meeting of the ACCESS Joint Committee in December 2021, agreement was reached on a set of criteria for future sub fund requests to be considered. This will

enable ACCESS to provide a clear process around how a request for a new sub fund will be reviewed against and the criteria that needs to be satisfied. The guiding principles are:

1. Strategy - The strategy adds to, and does not unnecessarily duplicate, the existing sub-funds that ACCESS have already created.
2. Availability - The strategy must be open and capacity available for new investors.
3. Value for money - The new sub-fund will deliver cost savings to the requesting Authority(ies) and other ACCESS members.
4. Scale and commitment - Requesting Authority(ies) should align with the primary or the secondary guidelines on scale and commitment to be considered as “suitably meaningful”.
5. Investment manager relationships - This section facilitates a discussion regarding how a recommended Investment Manager enhances the Pool: for example, it may be the proposed sub-fund is managed by an Investment Manager already managing a sub-fund(s) within the Pool and will thereby further deepen the relationship with ACCESS and may lead to incremental fee savings.
6. Reasonableness test - To preserve the design of the Authorised Contractual Scheme (ACS) and ACCESS’s overall pooling model, to minimise cost and complexity, it should be the obligation of any requesting Authority that they satisfy themselves and the other ACCESS Authorities that their request is reasonable.

7.7 The current Operator Agreement will continue until its end date, 5 March 2025. The Joint Committee received a proposed timeline and rationale at it is last meeting. A final recommendation will be made to the Joint Committee once the procurement lead authority is identified and has reviewed the proposals. The steps that have been proposed include:

1. Procurement Lead Authority agreed
2. Inter Authority Agreement review
3. Preparation
4. Formal procurement

and, in the event of change of Operator,

5. Preparation for transition:
6. New contract commencement
7. Transition of services to new Operator

7.8 Essex County Council are currently undertaking an Internal Audit of ACCESS as the Host Authority. The objective of this audit is to evaluate the control design and test the operating effectiveness of key controls in place over the ACCESS Support Unit (ASU). The audit will cover the period from as far as 12 months prior to the time of the audit. It was agreed as part of the 2020/21 Internal Audit review that the 2021/22 review will seek input from the administering authorities Internal Audit leads when drawing up the terms of reference.

ACCESS Joint Committee Representation

7.9 At the ACCESS Joint Committee meeting 6 December 2021 there were concerns around the meeting being quorate due to the possibility of members of the Joint Committee needing to self-isolate due to the rising prominence of the omicron variant. ACCESS authorities were asked if they could confirm if they able to attend and if they would be sending substitutes if they were not able to attend.

7.10 The representative on the ACCESS Joint Committee is Councillor Fox as approved by the Governance Committee. In December Cllr Fox was unable to attend and East Sussex were asked to send a substitute however under the East Sussex County Council constitution that there is currently no ability for East Sussex County Council to provide a substitute representative to an ACCESS Joint Committee meeting. The ACCESS Joint Committee arrangements require representatives to be from the Pension Committee of the underlying Fund.

7.11 To address this issue, it is suggested that the Pension Committee puts forward a recommendation to the Governance Committee for the appointment of a substitute for all ACCESS Joint Committee meetings.

7.12 If the Committee agree to a substitute representative, officers will put forward a recommendation to the Governance Committee for consideration.

8. External Assurance Report

8.1 As part of the ongoing investment governance that is performed by the Fund, officers monitor the external assurance reports that are provided by the Fund's investment managers. These reports detail the internal controls of the managers and provide an opinion as to the effectiveness of these controls.

8.2 No qualified reports have been identified in relation to any other manager apart from the UBS external assurance report for the period 1 January 2020 to 31 December 2020. The reasons this was qualified are :

- UBS was unable to provide sufficient evidence to demonstrate a quality control check was completed for new security setups in their accounting system.
- UBS were unable to provide sufficient evidence to demonstrate a quality control check was undertaken during the reconciliation of dividend income in their accounting system.
- UBS did not effectively restrict privileged user access to a new accounting system application. Highly privileged access was granted on a permanent basis to technology and Simcorp staff. As a result, the system of controls was not suitably designed and did not operate to achieve a control objective.
- UBS did not effectively restrict privileged user access to a back-office application used for processing derivatives and swaps. EY determined there were not sufficient controls in place to identify users with unauthorised access to the application. As a result, the system of controls was not suitably designed and did not operate to achieve a control objective.

8.3 The UBS Management response to these was, all securities and dividend income events were set-up accurately and no clients were impacted. These controls only related to securities and income events recorded on the GIMII application. Additionally, UBS performed a review of user activities and confirmed no unauthorised changes had been made.

8.4 The Fund clarified with UBS if any of the control issues identified would have affected any of the Fund's investments. UBS confirmed that the Fund's assets were no longer using the GIMII accounting system at the time of audit, as these had been transitioned to the Simcorp Dimension (SCD) accounting platform in February 2019.

8.5 Furthermore an Operation Risk Issue (ORI) was put in place to address the risks identified following the 2019 Audit. The purpose of the ORI was to ensure standardised

checks were in place and ensure evidencing of the controls were more efficient. This was still in its initial stages at the time of the audit and was formally closed in January 2021 with the standardised checks and evidencing in place from November 2020. This has now been completed so should not be an issue in the next report.

8.6 The SCD was a multi-year project which concluded in March 2021. In order to safely commission, rollout and migrate to SCD it was necessary to create a number of privileged roles. As the product matured the standing access to these roles should have been reviewed. The roles were appropriate for access by the user, just not on a standing basis. The issues were discovered internally in December 2020 and remediation measures instituted.

8.7 The Fund is satisfied that there was no impact to the assets held by UBS due to communication with the manager but will be reviewing the 2021 UBS report to ensure these items have been resolved.

9. Announcement from the Department of Levelling Up, Housing and Communities

9.1 On the 2 February the Department of Levelling Up, Housing and Communities announced their flagship Levelling Up White Paper, setting out their plan to transform the UK by spreading opportunity and prosperity to all parts of it.

9.2 Within this paper it announced that *“the UK Government is asking Local Government Pension Schemes (LGPS) funds, working with the LGPS asset pools, to publish plans for increasing local investment, including setting an ambition of up to 5% of assets (this equates to £16bn over the whole of the LGPS) invested in projects which support local areas.”*

9.3 After this announcement the Scheme Advisory Board (SAB) put out a statement that said, *“We understand that in this context local refers to UK rather than local to a particular fund and that there will be no mandate beyond the requirement to have a plan. Further details will emerge over the period up to an expected summer consultation which we understand will also include the outstanding climate risk and reporting regulations and the pooling guidance.”*

9.4 The expectation at this point is that the consultation will not be published until after the May elections. A key point within this consultation will be around how LGPS Funds maintain their fiduciary duties whilst also having to respond to this plan to invest up to 5% of their investments into projects which support local areas. Another piece of clarity needed from the consultation is how we determine what a local investment is and if this has to be in addition to any investments we may have that meet the criteria.

10. Beyond Oil and Gas Alliance (BOGA)

10.1 At the meeting of the Pension Committee on 25 November 2021, Cllr Hilton put forward a request for a paper to be brought to the next Pension Committee, to ask for the Committee to issue a public statement, calling on the UK Government to commit to becoming a core member of the Beyond Oil & Gas Alliance.

10.2 A paper has been provided in appendix 6 outlining information on BOGA which was created in November 2021 at COP26, with commentary on the UK's current position as to becoming a core member, gleaned from news reports, as no official announcement has been identified on the Government website.

10.3 The Fund's responsible investment beliefs include engagement with Governments and policy makers.

10.4 Members of the Committee are asked to consider whether a public statement should be made calling for the UK Government to sign up in line to the initiative.

11. Conclusion and reasons for recommendation

11.1 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.

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