Staffordshire Pension Fund

Investment Strategy Review

December 2019

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1 Executive Summary

In conjunction with the recent actuarial valuation, it is appropriate for the Panel to be reviewing the Fund's high-level investment strategy and asset allocation.

High level strategy

In order to assess the appropriateness of the high-level strategy, we carried out asset liability modelling in conjunction with the actuarial team earlier this year. Our modelling scenarios focused on varying investment strategies under different assumptions on future levels of contributions.

The results of this modelling were presented to the Pensions Panel in June.

The conclusions were as follows: -

- The current investment strategy provides a good chance of meeting the long-term funding objective based on the current level of contributions being paid.
- Maintaining the current contribution strategy would allow a modest reduction in growth assets.
- However, on the basis that a lower level of contributions is preferred in the medium / long term, the current high-level investment strategy should be maintained for now.
- A material improvement in the funding position could offer some scope for modest reductions in risk in future.
- We are not recommending any reduction in investment risk by switches from Return - seeking assets into Defensive low risk bonds.
- However, the Panel should continue to consider the scope for diversification of the return-seeking assets – including any new opportunities that might arise from pooling.

A number of discussions and decisions have been taken in relation to the asset allocation over the last twelve months. The aim in this paper is to bring those all together and also to **propose a 'direction of travel' for the Fund over the next 2-3 years.**

Return Seeking assets

In line with the conclusions on the high-level strategy, we have recommended continuing to diversify the Fund's return seeking assets.

In our summary, the target allocation to equities falls by 4% though we anticipate further possible reductions in future. We support a more than proportionate reduction from the UK given the material allocation currently. We support the continuing use of both active and passive management for UK and global equities – with the addition of some factor-based investment (FBI) where alternative market indices are chosen by the Fund with returns then being delivered by an index-tracking mandate.

In time, the balance between active, passive and factor-based investment may evolve, and this may also depend on the emergence and/or success of vehicles offered by LGPS Central.

We believe the Fund should target a meaningful allocation to infrastructure, albeit there remains some uncertainty as to how that can best be implemented. We also advocate the termination of the hedge funds mandate as the other income-based investments become established.

Defensive assets

As the allocations to other return-seeking assets will take some time to establish, we will retain the current position in bonds.

A summary of our conclusions is shown in the table below

Asset Class	Mandate	Current Manager	Current Benchmark (%)	Long Term Benchmark (%)
UK Equities	Active	Aberdeen Standard	6.25	5.0
UK Equities	Passive	Legal & General	6.25	5.0
Global Equities	Active	Longview, JP Morgan, LGPS Central	23.0	25.0*
Global Equities	Passive	Legal & General	24.0	20.5*
Global Equities (Factor Based)	Passive	TBC	5.0	5.0*
Private Equity	Active	Various	3.5	3.5
Total Equities			**68.0**	**64.0**
Property		Colliers	10.0	10.0
Private Debt		Various	5.0	5.0
Infrastructure		TBC	1.0	5.0
Hedge Funds		Goldman Sachs	2.0	-
Total Other Return-Seeking Assets			**18.0**	**20.0**
UK Corporate Bonds	Active	LGPS Central	6.5	5.0
UK Index Linked	Passive	Legal & General	6.5	5.0
UK Gilts			-	5.0
Cash			1.0	1.0
Total Defensive			**14.0**	**16.0**
			100.0	**100.0**

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

2 Introduction

Addressee

This report is addressed to the Pensions Panel ('the Panel') and officers of the Staffordshire Pension Fund ('the Fund'). The report should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. Where this is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Approach to reviewing the investment strategy

In conjunction with the recent actuarial valuation, it is appropriate for the Panel to be reviewing the Fund's high level investment strategy and asset allocation.

We regard the 'high level' investment strategy as the overall allocation between 'return-seeking' assets and 'defensive' assets. The former are designed to produce attractive returns over the long term to help keep contributions affordable for employers and to achieve and maintain a well-funded position. They involve a moderate or high level of investment risk. 'Defensive' assets, largely government or investment grade corporate bonds, are held in order to manage the overall level of risk within the Fund's strategy. The appropriate split between these types of assets is driven by the desired level of long term returns and the degree of investment risk deemed acceptable.

Once that broad split has been decided, each component can be broken down into a detailed asset allocation and range of mandates. At this second stage the decisions relate, for example, to the appropriate allocations to UK or overseas equities, to property, private debt or other alternative assets, between the use of active and passive management and also between government and corporate bonds.

It is also important that consideration of the Fund's asset allocation and investment mandates acknowledges the ongoing development of the sub-fund range being considered by the LGPS Central pool

High level strategy

In order to assess the appropriateness of the high-level strategy, we carried out asset liability modelling in conjunction with the actuarial team earlier this year. Our modelling scenarios focused on varying investment strategies under different assumptions on future levels of contributions.

The results of this modelling were presented to the Pensions Panel in June. The results are summarised in section 3 of this report.

Detailed asset allocation

Over the course of this year, we have also been reviewing the detail of the Fund's asset allocation and mandates in light of the results of our analysis on the high-level strategy.

Under the new pooling regime, the selection of individual investment managers will become a pool decision once the LGPS Central sub-funds have been established and Fund assets transferred in. Therefore, our focus in this review is on asset classes and mandates, as opposed to reviewing the individual investment managers which the Fund or Pool currently employs.

The specific recommendations are set out in Sections 4 to 6 of the report

3 High level investment strategy

Background

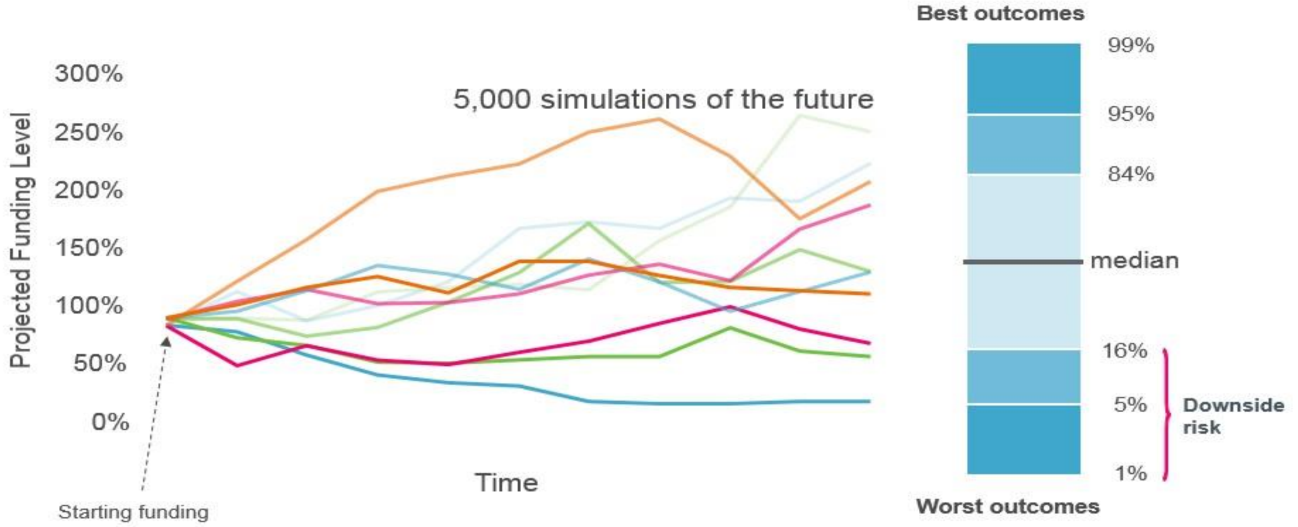
The strategic analysis discussed in this section aims to test the current investment and funding plan. Our analysis is supported by asset liability modelling. We have modelled results for 20 years into the future and looked at a range of investment and contribution strategies.

We have considered the current investment strategy, as well as asset allocations with respectively 15% and 25% less in return-seeking assets. We also considered three alternative fixed contribution strategies, one based broadly on the level of contributions currently being paid into the Fund and two lower fixed levels. These lower fixed contributions are not an option currently but allow us to assess the implications of targeting lower contribution levels in the future.

Full details of the reliances and limitations of our modelling were set out in our presentation, 'Review of high level investment strategy (June 2019)' along with a full set of assumptions. However, in summary, the modelling involved:

- Generating 5,000 "economic scenarios" showing various combinations of asset class returns, inflation rates, yield curves and salary increases
- Projecting forward the Fund's position in each of the 5000 scenarios in order to compare what might happen to the funding level depending on the choice of investment strategy.

Assets and liabilities are projected forward under the simulations and ranked in order as shown in the diagram below. This allows us to look at the distribution of outcomes and extract meaningful metrics in addition to simply looking at the median outcome.



Summary of analysis

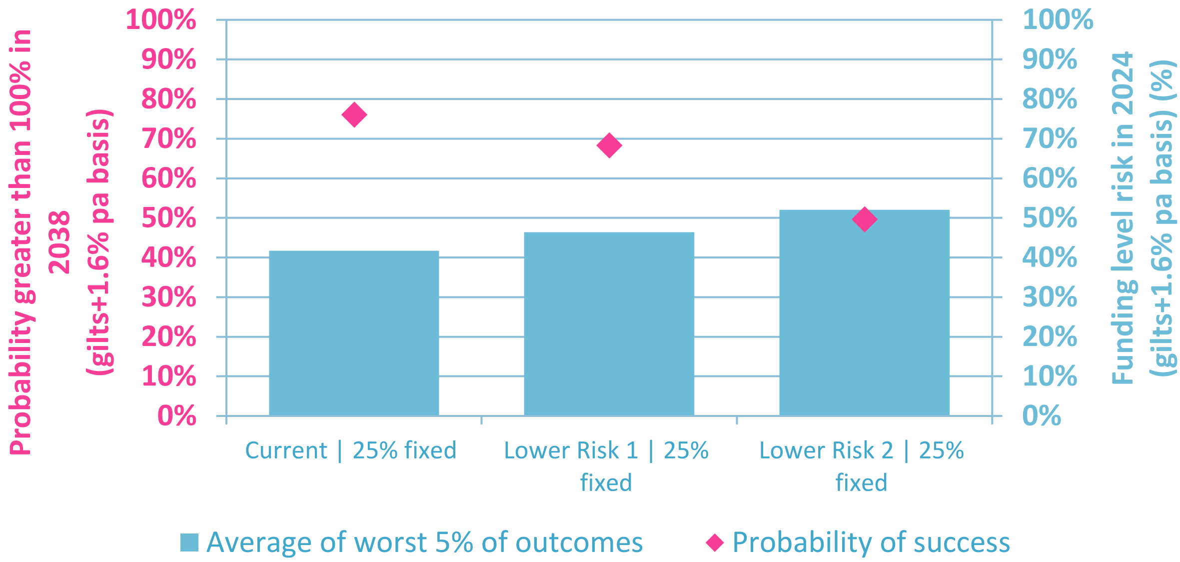
For each of the scenarios we considered, we assessed the chances that the objective (of being fully funded at the end of the projection period) would be met – shown as a pink diamond and read from the left-hand scale. We also considered a measure of downside risk – the funding level at the next valuation in the event of a 'poor outcome', defined as the average of the worst 5% of outcomes – shown by a blue bar and read from the right-hand scale.

Summary of analysis

For each of the scenarios we considered, we assessed the chances that the objective (of being fully funded at the end of the projection period) would be met – shown as a pink diamond and read from the left-hand scale. We also considered a measure of downside risk – the funding level at the next valuation in the event of a 'poor outcome', defined as the average of the worst 5% of outcomes – shown by a blue bar and read from the right-hand scale.

We initially considered what scope there was for the Fund to change the level of investment risk whilst maintaining the current level of contributions (circa 25% at an aggregate Fund level) throughout the projection period.

Decreasing the level of investment risk whilst maintaining current contributions (25%)

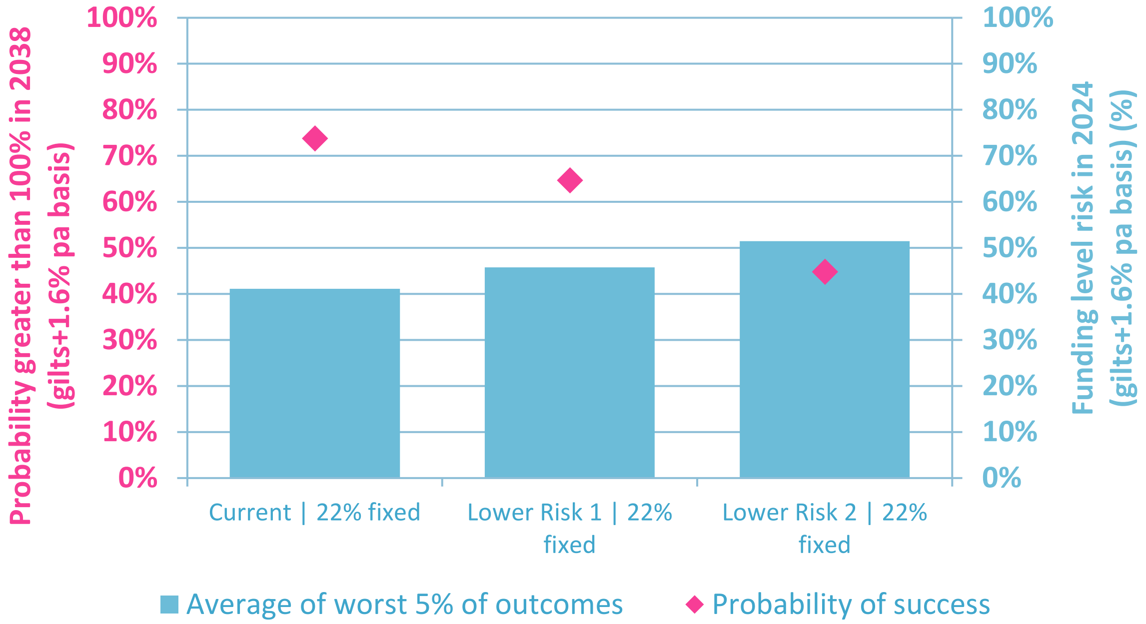


By moving to lower risk strategies, the chance of being fully funded in 20 years falls, but with a better funding position at the 2024 valuation date under the worst 5% of outcomes.

The chart suggests that a modest reduction in risk might be considered, but this assumes that contributions remain fixed at current levels, whereas we understand there is a desire from employers to target lower contributions than are being paid at present in response to an improvement in the funding position.

We therefore also tested the implications of lower risk investment strategies in conjunction with lower target level of future contributions (22% and 18%). With a lower target level of contributions, the reductions in chances of success are more material and suggest that no reduction in investment risk should be considered at the current time.

Decreasing the level of invest risk with fixed contributions of 22%



Conclusions

- The current investment strategy provides a good chance of meeting the long-term funding objective based on the current level of contributions being paid.
- Maintaining the current contribution strategy would allow a modest reduction in growth assets.
- However, on the basis that a lower level of contributions is preferred in the medium / long term, the current high-level investment strategy should be maintained for now.
- A material improvement in the funding position could offer some scope for modest reductions in risk in future.
- We are not recommending any reduction in investment risk by switches from Return - seeking assets into Defensive low risk bonds.
- However, the Panel should continue to consider the scope for diversification of the return-seeking assets – including any new opportunities that might arise from pooling.

4 Framework for setting asset allocation

We regard the Fund's investments as being divided into three main components, each with a different objective.

Return seeking assets – Equity

The objective of the equity component is to provide attractive returns over the long term to help fund the benefits and keep employer contributions at an affordable level. It is acknowledged that returns will be delivered in a volatile and unpredictable pattern, and that short and medium term returns may be poor.

Historically, equities have been a reliable source of excess return over bonds when assessed over the long term. It is possible to construct a well-diversified global portfolio at very low cost in terms of manager fees and governance time. The nature of the investment is easily understood by all stakeholders in the Fund from members to employers, and the ownership aspect also gives the Fund some influence over the way businesses are managed.

For these reasons, we believe that local authority funds will continue to have a material allocation to equity investments even as funds mature and funding positions improve.

Return seeking assets – other asset classes

The objective of the other return seeking assets is to provide attractive returns over the long term, with those returns being delivered either (1) in a pattern likely to be materially different than that from equities and/or (2) in a relatively stable pattern over time.

The more stable pattern of returns might be due to the return being largely dependent on a regular and reasonably predictable level of income. The returns may be broadly equivalent to those from equities or somewhat lower, but still in excess of those expected from low risk bonds.

The volatile pattern in which equity returns are delivered can become a particular problem when a pension fund becomes increasingly cash negative as assets may need to be sold at low points in the market.

Many asset classes in this category are still likely to have some degree of correlation with equity returns – and therefore they are unlikely to fully protect the Fund in the event of a pronounced crisis of investor sentiment.

Defensive assets

The objective of the Defensive assets is to provide a return broadly similar to the movement in value placed on the Fund's liabilities and/or a degree of liquidity to the Fund in times of market crisis. The returns from this component are not expected to help towards keeping contributions affordable in the future.

The size of allocation to this category essentially serves to control the level of investment risk being taken by the Fund. However, the extremely low level of yields available on low risk bonds assets in the current environment has made allocating to this category quite unattractive.

5 Return seeking assets – equity

In line with the conclusions on the high-level strategy in section 3, we have recommended continuing to diversify the Fund's return seeking assets.

Equities are expected to remain a reliable source of return for the Fund over the long term. However, as the Fund membership continues to mature and as the funding level has now reached a more comfortable position than it has been for some time, there is benefit in increased investment in assets which deliver a more stable pattern of returns albeit still in excess of those available from low risk bonds. Modest reductions in equity investment should continue to be considered to the extent that other attractive asset classes can be identified and accessed in a cost-effective way.

In our summary, the target allocation to equities falls by 4% though we anticipate further possible reductions in future.

The Fund's equity assets are currently invested as follows.

Asset Class	Mandate	Managers	Current Allocation (%)	Current Benchmark (%)
UK Equities	Active	Aberdeen Standard	6.0	6.25
UK Equities	Passive	Legal & General	7.0	6.25
Global Equities	Active	Longview, JP Morgan, LGPS Central	24.8	23.0
Global Equities	Passive	Legal & General	28.0	24.0
Global Equities (Factor Based)	Passive	TBC	-	5.0
Private equity	Active	Various	3.5	3.5
Total			**69.2**	**68.0**

As at 30 September 2019

Equity Allocations – UK and overseas

The overall split between UK and overseas equities (excluding private equity and allowing for the UK's inclusion within global indices) is currently in the region of 25% / 75%.

The UK stock market makes up only about 5% of global stock market capitalisation but UK pension funds have historically held a much larger weight to reflect factors such as the reduced currency risk and degree of influence they have on market regulations as a domestic investor. The allocation to the UK stock market does not reflect a pure exposure to the UK economy – most of the largest companies listed in the UK (such as HSBC, Royal Dutch Shell, GlaxoSmithkline, Unilever, etc.) are global businesses which have only limited operations in the UK. However, the large UK allocation can lead to the Fund having quite large investments in those global companies which have chosen to have their shares listed here.

The overall split between UK and overseas equities (excluding private equity and allowing for the UK's inclusion within global indices) is currently in the region of 25% / 75%.

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Use of active and passive management

A combination of active and passive management is also employed for the Fund's global equities. A third leg to the Fund's approach – namely tracking a dedicated index chosen specifically by the Fund to have certain (factor-based) characteristics - is discussed in the section below.

The long-term track record of active equity managers – in terms of persistency of outperformance - has been mixed at best. Although 'average manager' performance is never likely to appear impressive over the longer term, the key is to be able to identify in advance an above-average manager. Where that is possible, the potential added value for the Fund can be very significant.

The responsibility for selecting managers is passing to the LGPS Central team as part of the pooling agenda. In principle, a dedicated investment team focused solely on manager selection and monitoring should have an improved chance of picking the right managers when compared to individual funds. The pool also offers manager diversification within a single fund.

The newness of the team and strategy at Central has led to the Fund retaining some active equities with two existing managers, Longview and JP Morgan. Longview has an excellent long-term performance record for the Fund and the new fee deal with JP Morgan offers strong value for money. The Fund will have the choice of allocating further assets to the Central fund in future if confidence in the strategy increases or alternatively opting for a passive alternative. Having half of the Fund's global equities managed on an active basis would imply an eventual allocation of circa 20%-25% of Fund assets invested in the Central fund spread across three managers. Although this is not uncomfortable in terms of underlying manager exposure (circa 7%-8% of Fund assets each), it does represent a very high exposure to a single Central team and strategy. For that reason, we may need to re-assess our thoughts on the balance between active and passive management at that point.

An additional active management option would be for a sustainable equity mandate, though consideration of this would need to flow through from the wider discussions on ESG issues that the Panel are starting to have.

Factor Based investment – through index tracking

As discussed previously, we support exposure to this type of low-cost factor-based investing.

Factor investing breaks the link between index weighting and share price with the aim of providing incremental return and a measure of diversification from market cap weighted indices for similar levels of risk. Fees are only slightly higher than those charged for tracking traditional market cap weighted indices.

The break between index weighting and share price means periodic rebalancing to fundamental weights is required. Although this increases transaction costs, it is also a source of relative return as the rebalancing will typically involve selling stocks that have outperformed and purchasing stocks that have underperformed. This is a more methodical method for attributing stocks than a typical market cap approach, where stock holdings are driven by market sentiment. There is evidence that exposure to alternative ‘factors’ has provided better risk-adjusted returns than broad cap-weighted indices over the long term.

Discussion on the appropriate index to be used by the Fund continues. We favour multi factor indices on the basis that timing the optimum exposure to different factors is very difficult in practice. In terms of implementation, this may be through management by LGPS Central or by an external manager.

We have proposed an initial allocation of only 5%. This reflects the fact that this is a new approach to investment for the Fund and many of the strategies have a limited ‘real life’ track record. In time, we would regard this approach as having the potential to account for a higher proportion of the Fund’s equities. As an aside, the current JP Morgan mandate is actively managed but uses a process with many similarities to factor-based index construction.

Private Equity

Although it represents a higher risk / return investment than the Fund’s listed equities, we continue to believe that the asset class can deliver returns comfortably ahead of those from listed equities over the long term and contribute meaningfully to the Fund’s overall returns.

It is important that there is no hiatus in committing to new programmes until LGPS Central have established a fully credible vehicle. The intention should be to hold the current funds to maturity. We have prepared a separate paper on the Fund’s private equity programme.

Summary

Overall, we have proposed a reduction in quoted equities of 4% with 2.5% coming from the UK. We anticipate factor-based investing becoming more prominent in time, perhaps at the expense of active management though this may depend on the evolution of the Central pool and guidance on pooling from the Government.

Asset Class	Mandate	Managers	Current Benchmark (%)	Long Term Benchmark (%)
UK Equities	Active	Aberdeen Standard	6.25	5.0
UK Equities	Passive	Legal & General	6.25	5.0
Global Equities	Active	Longview, JP Morgan, LGPS Central	23.0	25.0*
Global Equities	Passive	Legal & General	24.0	20.5
Global Equities (Factor Based)	Passive	TBC	5	5.0*
Private Equity	Active	Various	3.5	3.5
Total			**68.0**	**64.0**

* Long term balance may depend on evolution of pooling agenda

6 Return seeking assets – other asset classes

We believe there are attractions in increasing allocations to asset classes which can provide more stable returns over time. In many cases, this could be where a relatively predictable income stream represents a large component of total return.

One of the constraints in this area however is the limited liquidity associated with many of the investments. This makes it difficult to make immediate injections of new cash in many areas. Allocations will tend to increase over a phased period.

The Fund's other return-seeking assets have the following target allocations:

Asset Class	Managers	Current Allocation (%)	Current Benchmark (%)
Property	Colliers	8.2	10.0
Private Debt	Various	4.3	5.0
Infrastructure	TBC	-	1.0
Hedge Funds	Goldman Sachs	1.7	2.0
Total		**14.2**	**18.0**

As at 30 September 2019

In principle, one of the benefits of asset pooling within the LGPS is that it should allow partner funds to have a greater diversification of investments without introducing additional complexity at an individual Fund level. Monitoring of the underlying managers and investments will be carried out centrally and governance requirements will be minimised. Funds will be able to hold a larger number of smaller allocations in specific asset classes whilst still benefiting from economies of scale on fees through aggregation.

Property

We regard UK property as being an excellent diversifying asset for the Fund. As returns are delivered largely in the form of rental income over time, the investment should tend to have a much more stable pattern of returns than the Fund's equity investments and the underlying property assets also provide some longer-term protection against inflation.

The nature of the Fund's current mandate means that the manager can in principle consider investing in any of the 'alternative' property sectors beginning to emerge, such as residential property. However, it is important to bear in mind that the current definition of the mandate (benchmark + outperformance target + guidelines) could inhibit investment in some sectors which might still be attractive to the Fund (i.e. a lower risk / lower return investment, for example).

The asset class looks quite expensive currently by historical standards, so we are not uncomfortable with the mandate being underweight at present. It is an asset class which in future could potentially increase in terms of allocation though we do not see any need to review the benchmark allocation at this particular time.

We would regard overseas property as a separate asset class with a separate (and higher) target return. Accessing overseas market returns is hampered by the significant costs associated with investing in overseas property markets so we have a preference for higher risk/return opportunistic investing in non-UK markets. If

LGPS Central were to launch a fund in this area, we would be open-minded and look at the parameters but certainly for now, we don't see any need for an allocation to the asset class.

Our strong preference is for there to be separate UK and overseas property offerings from pools. The nature of the Fund's current direct mandate should mean that it will be unaffected by pooling.

Private debt

The Fund has established a meaningful allocation to private debt over the last 2-3 years.

We believe the current trend for pension funds to provide more direct finance to businesses at the expense of banks will continue and that the rewards will be earned by those pension funds which are prepared to withstand a degree of illiquidity. At a time when yields on traded bonds have fallen to very low levels, there is still a material premium to be earned (of 1% - 2% p.a.) for less liquid forms of debt, reflecting the fact that the majority of investors cannot commit capital to these markets and are restricted to investing in more liquid bonds.

The credit quality tends to be reasonably strong and the loans generate a strong income stream from the outset. Potential returns in the region of 5% p.a. appear attractive against our current expectations from equities which are in the region of 6% p.a. Therefore, the Fund is not giving up much in terms of expected returns by switching assets from equities into private debt, where returns should be delivered in the form of a high and regular income stream.

As private debt funds are closed ended, there is no requirement to implement any pooling of the current investments. These holdings will be retained by the Fund until they reach the end of their fixed lives and all investment proceeds have been repaid to the Fund. Ultimately, LGPS Central are likely to offer some form of private debt vehicle but we understand that this is not currently a priority for them. Also, given the range of risk and return parameters available across this form of investment (ranging from senior secured to distressed debt) we would need to be comfortable that any new vehicle was targeting our preferred part of the market. Our strong preference currently is for a focus on senior secured loans with only a limited allocation to any higher risk loans.

The current target allocation of 5% is close to being achieved. We will likely be comfortable in increasing this target further in future though a greater priority in the short term would be to diversify the exposure to 'income' assets by establishing investments in infrastructure as discussed in the next section.

Infrastructure

We believe that infrastructure is in principle an attractive investment for the Fund given the long-term inflation linked liabilities and the ability to tie up capital for a period of years.

Infrastructure within the various geographies comes in a wide variety of forms, which can be classified into the following five sectors:

- **Social Infrastructure** e.g. Education facilities, Healthcare facilities, Prisons, Courts, District Heating, Public Buildings;
- **Transport Infrastructure** e.g. Toll Roads, Bridges, Tunnels, Airports, Sea Ports, Ferries, Car Parking, Rail and Mass Transport systems;
- **Communications Infrastructure** e.g. Cable Networks, Broadcast and Communication Towers, Satellite Systems;
- **Energy Infrastructure** e.g. Oil and Gas Pipelines, Power Generation, Gas Storage, Transmission and Distribution networks, Regulated Electricity assets;
- **Environmental Infrastructure**, e.g. Waste Treatment and Distribution, Waste and Recycling, Desalination Plants, Renewables.

One of the other advantages of investing in infrastructure lies with the diversification benefits that it offers. In particular, the financial characteristics of these types of assets differ from those of investments in quoted equities and bonds. The most important difference, and one of the most attractive features for pension scheme investors, is the relative lack of sensitivity of projects to changes in financial conditions (i.e. equity market rises and falls, etc.). The value of infrastructure investments is not directly affected by economic and geo-political events, at least in the near to medium term, resulting in added diversification benefits.

In our previous discussions, we intended initiating investment in infrastructure once a suitable vehicle was available through pooling. However, it is taking some time for LGPS Central to put together a credible infrastructure offer. At this point, it seems there is a real risk that either we could be waiting for quite a long time or alternatively a final product is agreed which we are not comfortable in endorsing.

Most infrastructure funds are closed ended, so (as with private debt and private equity) there would be no requirement to implement any pooling of existing investments once a satisfactory pooled solution becomes available. Any holdings at that point would be retained by the Fund until they reach the end of their fixed lives and all investment proceeds have been repaid to the Fund. For that reason, the Fund could begin establishing its infrastructure allocation now directly with managers and then move at a later date to pooling commitments if and when officers and advisers are satisfied with the Central offering.

The drawback with beginning a programme outside of the pool now is that time and effort (and cost) is expended to establish investments with managers which will then stay outside of the pool as ‘legacy’ assets for perhaps the next 10-15 years. However, investment in this relatively illiquid asset class takes time to establish and arguably the build-up of infrastructure investment has already been delayed by the onset of pooling. This also helps send a message to the pool that the Fund is not a ‘captive’ investor.

LGPS Central will be bringing forward new proposals on how they anticipate a pooled solution working.

Hedge Funds

We do have some reservations about investment in hedge funds. Hedge funds tend to lack transparency of the underlying assets and returns, and it is difficult to determine how much of the performance can be attributed to genuine manager skill as against merely benefiting from the underlying market movements or positioning.

The asset class incurs high management fees – at the underlying manager level and fund-of-funds level – and we are sceptical therefore of the value that can be added over time net of all fees relative to the level of risk that is being taken.

We acknowledge that the current Goldman Sachs mandate is designed to have a low correlation with equity markets and therefore is expected to provide some resilience to returns in time of market weakness, though the allocation of 2% of Fund assets means this is not material at a total Fund level.

We believe that the other asset classes discussed in this section can provide stable returns from more solid underlying investments, and in which we have more confidence that the returns will be delivered.

We do not anticipate hedge funds featuring in a dedicated fund within the LGPS Central range. The pool currently have a preference for a Target Return fund comprising a wider range of investment types. Current indications are quite vague on what investments might be expected to feature in this new fund so at this point allowing significant discretion over allocation across different types of investment to the Central team.

We recommend the termination of the current hedge fund allocation with the proceeds from selling the current allocation being used as a source of funds for other strategic changes which we discuss in this paper.

Higher yielding credit

One other common source of income driven return is investment in higher yielding forms of credit. The range of investments whereby investors are rewarded for taking on credit risk rather than equity risk is very broad and the traditional government and investment grade corporate bond universes capture only the lowest risk components of the credit universe.

The other areas of the credit markets involve taking on a higher level of credit risk in return for a higher expected return. (Private debt is one example, though investors there are also being rewarded for a degree of illiquidity in their investment). In principle, the attractions are that long term returns should be in excess of those expected from low risk bonds (defensive assets discussed below) thereby contributing to the overall portfolio return but without exposure to the potential volatility of equity investments.

The bonds tend to be quite short dated compared with conventional bonds (reflecting the higher credit risk) which means that their prices are affected less by changes in interest rates. The long-term return to investors is primarily from the higher yield minus the impact of any company defaults, rather than price movements. Returns can be volatile in the short term however as bond prices do fluctuate in line with general investor sentiment.

The universe would include instruments such as high yield bonds, traded loans, asset-backed securities, mortgage-backed securities, emerging market government and corporate bonds. The universe requires an active management approach in our view, but a number of specialist managers have established good records within these areas.

A common theme within our discussions on current asset valuations has been to highlight the relatively tight credit spreads available on these types of bond investments as investors have pursued a ‘hunt for yield’ in recent years. For that reason, we have been reluctant to recommend investment away from low risk bonds. However, LGPS Central are looking to launch a fund in this area and we have recommended that the officers have some input into the structuring of that as in our view this is a fund which could well offer an attractive investment in the future.

Summary

Increasing investment in this area is impacted by the time taken to establish allocations in illiquid investments and the availability of funds within LGPS Central. It should therefore be seen as a long-term direction of travel

Asset Class	Managers	Current Benchmark (%)	Long term Benchmark (%)
Property	Colliers	10.0	10.0
Private Debt	Various	5.0	5.0
Infrastructure	TBC	1.0	5.0
Hedge Funds	Goldman Sachs	2.0	-
Total		**18.0**	**20.0**

7 Defensive Assets

The Fund's low risk defensive assets are currently invested as follows:

Asset Class	Mandate	Managers	Current Allocation (%)	Current Target (%)
UK Corporate Bonds	Buy and Maintain	Insight	7.7	6.5
UK Index Linked	Passive	Legal & General	8.1	6.5
Cash	-	-	1.0	1.0
Total			**16.8**	**14.0**

As at 30 September 2019

The high-level modelling suggests there is little attraction in increasing the allocation to defensive assets at this time. Low risk bonds offer very poor prospective returns for long term investors given current yields. Their role in the strategy is to provide a degree of protection against further falls in bond yields putting pressure on the funding position (although the process used for setting contributions is not determined directly by short term yield levels.)

Investment Grade Corporate Bonds

Given the low level of current yields, we have a preference for holding high quality investment grade corporate bonds in preference to fixed interest gilts. From a risk management perspective, gilts do represent the lowest risk investments for the Fund and have the advantage of providing protection to returns in times of market stress and liquidity in times of market disruption. However, these risk reduction benefits need to be weighed against the impact on long term expected returns for the Fund and on balance we would still have a preference for a well-diversified exposure to high quality corporate bonds, with additional yield over government bonds of around 1.5% p.a. at present.

In the event that gilt yields return to more palatable levels in future, the relative attraction for the asset class within the strategic benchmark can be reviewed, though we do not expect this in the short to medium term. We would be wary of trying to tactically move between the asset classes in the short term depending on credit spreads.

We have a preference for corporate bonds to be subject to some form of active credit selection rather than being managed passively against a market index (which means that an investor will be most heavily invested in those companies which have issued the largest quantities of debt). We also believe that a lot of managers do have strong credentials in carrying out credit analysis of individual companies and industry sectors.

The new actively managed LGPS Central corporate bond fund includes an exposure to global corporate bonds. Although we would have a preference for a sterling corporate bond mandate, the new fund does hedge any foreign currency risk and also restricts itself to high quality issues. Trends in developed economy yields have followed a similar pattern in recent times so the fund still offers some protection against a lower yield environment.

Index Linked Gilts

Index linked gilts provide some protection against short to medium term inflation shocks albeit long term prospective returns seem poor from current levels. There is no corresponding inflation linked corporate bond universe that can be held as a higher yielding proxy paying for an active manager to manage a pure index linked gilt portfolio and these assets can be managed at extremely low cost by a passive manager. Under pooling, the passive government bond mandate with Legal and General can continue to be held outside of the pool.

Cash

As the Fund continues to make commitments to illiquid asset classes and waits for those commitments to be drawn down, it will be necessary to run with a modest balance of cash in the Fund. For performance measurement purposes, a higher cash level can be a drag on performance and it is common for funds to include a small cash allocation in their formal benchmark to reflect this. For that reason, we continue to support a 1% cash allocation in the Fund's strategic benchmark.

Summary

The long-term benchmark included below effectively crystallises the current allocation of just over 16%, i.e. there is no requirement to sell down the holdings in the short term.

In addition, although we might assume equal allocations to fixed interest government and corporate bonds at some point in the future, we would not advocate moving to that position now.

Asset Class	Mandate	Managers	Current Benchmark (%)	Long Term Benchmark (%)
UK Corporate Bonds	Active	LGPS Central	6.5	5.0
UK Index Linked	Passive	Legal & General	6.5	5.0
UK Gilts	Passive	Legal & General	-	5.0
Cash	-	-	1.0	1.0
Total			**14.0**	**16.0**

8 Conclusions

In this report, we have included the conclusions of our modelling of the high-level investment strategy and brought together discussions relating to the detailed asset allocation which have been happening throughout 2019.

Our aim in this paper is to propose a 'direction of travel' for the Fund over the next 2-3 years. We acknowledge that further detailed discussions may need to take place in relation to a number of the proposed changes.

One of the further complexities with the review of strategy is that the Fund's assets will continue to be aggregated into a range of funds to be made available by the Central pool, unless the funds on offer fail to meet the Fund's requirements. We have taken into account the latest state of progress on pooling in this report.

We have drawn together the various proposals contained within our paper in the following table for discussion.

Asset Class	Mandate	Current Manager	Current Benchmark (%)	Long Term Benchmark (%)
UK Equities	Active	Aberdeen Standard	6.25	5.0
UK Equities	Passive	Legal & General	6.25	5.0
Global Equities	Active	Longview, JP Morgan, LGPS Central	23.0	25.0*
Global Equities	Passive	Legal & General	24.0	20.5*
Global Equities (Factor Based)	Passive	TBC	5.0	5.0*
Private Equity	Active	Various	3.5	3.5
Total Equities			**68.0**	**64.0**
Property		Colliers	10.0	10.0
Private Debt		Various	5.0	5.0
Infrastructure		TBC	1.0	5.0
Hedge Funds		Goldman Sachs	2.0	-
Total Other Return-Seeking Assets			**18.0**	**20.0**
UK Corporate Bonds	Active	LGPS Central	6.5	5.0
UK Index Linked	Passive	Legal & General	6.5	5.0
UK Gilts			-	5.0
Cash			1.0	1.0
Total Defensive			**14.0**	**16.0**
			100.0	**100.0**

We look forward to discussing these issues with the Pensions Panel in December.