Supplementary Agenda

Meeting **Pension Fund Committee**

Venue: **Remote Meeting held via Microsot Teams**

Date: **Friday, 5 March 2021**

Time: **10.00 am**

Councillors: **Helen Swiers, Filey division (Vice-Chair)**
Patrick Mulligan, Airedale division
Mike Chambers
Cliff Lunn, Selby Brayton division
Don MacKay, Tadcaster division
Andy Solloway, Skipton West division
Angus Thompson, Richmondshire North division
Christian Vassie, City of York Council
Jim Clark, Harrogate Harlow division
Brian Hazeldine, UNISON

Chair of Pension Board (Non-Voting): John Weighell (Chairman)

Pursuant to The Local Authorities and Police and Crime Panels (Coronavirus) (Flexibility of Local Authority Police and Crime Panel Meetings) (England and Wales) Regulations 2020, this meeting will be held using video conferencing with a live broadcast to the Council's YouTube site. Further information on this is available on the committee pages on the Council website - https://democracy.northyorks.gov.uk

The meeting will be available to view once the meeting commences, via the following link - www.northyorks.gov.uk/livemeetings

Business

11. **Investment Strategy Review - Report of the Treasurer** **(Pages 3 - 24)**

Barry Khan
Assistance Chief Executive
(Legal and Democratic Services)
County Hall
Northallerton
25 February 2021

Enquiries relating to this agenda please contact Stephen Loach Tel: 01609 532216
or e-mail stephen.loach@northyorks.gov.uk
Website: www.northyorks.gov.uk

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NORTH YORKSHIRE COUNTY COUNCIL

PENSION FUND COMMITTEE

5 MARCH 2021

INVESTMENT STRATEGY REVIEW

Report of the Treasurer

1. PURPOSE OF REPORT

1.1. To recommend a new investment strategy for the Fund.

1.2. To recommend commitments to Border to Coast's infrastructure and private credit funds.

1.3. To ask for delegated authority to be given to the Treasurer and Chair of the Committee to make the final decision on investing in Border to Coast's Multi Asset Credit fund, should it remain within the Fund's investment strategy.

1.4. To update Members on the equity protection and currency hedging positions.

2. BACKGROUND AND CURRENT INVESTMENT STRATEGY

2.1. In 2019 the Committee approved changes to the investment strategy. This was primarily to reflect the solvency position of the Fund, which had moved from significantly below to significantly above 100%. Investment performance has been exceptionally strong over the period since the global financial crisis.

2.2. The investment strategy included a reduced allocation to equities and an increase to alternatives. This was intended to reduce overall risk and improve diversification. Given the move to alternative asset classes, it was recognised this would take a number of years to fully implement.

2.3. Since then, the Committee has reflected on the significant changes made in 2019, how the Fund's investments have been impacted by the Covid-19 pandemic, and how the outlook for investment markets has changed as the world emerges from it.

2.4. These issues led the Committee to take a view that a review of the investment strategy was required. In particular, it was considered that the allocation to equities had been reduced too much in the 2019 review, and should be higher than 45%. One reason is that it will take many years for the target allocation to other growth assets including infrastructure to be reached, so a higher allocation to equities may be appropriate.

3. 2021 INVESTMENT STRATEGY REVIEW

3.1. The investment strategy review has been taking place in the first quarter of 2021, focussed around three workshops. At the time of writing two have taken place and a third is planned for the day before this meeting, 4 March 2021. Support has been provided by Aon throughout.

3.2. Ahead of the first workshop Members of the Committee were invited to complete a survey on investment beliefs and objectives. The aim was to collect views on a number of issues including:

- long term financial goals and an acceptable funding level
- the main drivers for maintaining a healthy funding level
- the appetite to reduce investment risk and/or reduce funding risk as an acceptable funding level is reached
- actions which could be taken to address the position should the funding level fall below 100%
- the benefits of diversification
- the desired level of the Committee’s understanding of individual asset classes

3.3. The first workshop took place on 28 January 2021. A significant part of this was a review of the survey results. It identified that there was a range of opinions on the questions asked but in most areas there was a significant majority view. This provided a useful starting point for the workshop, which also considered:

- the link between the investment strategy and the funding strategy
- examples of how investment and funding objectives impact on the funding level and on employer contributions
- differences between the assumptions behind the current investment strategy and Members views expressed in the survey
- views in relation to individual asset classes and what constitutes a suitable opportunity set

3.4. The second workshop took place on 12 February 2020. This session started with setting out the high level funding and investment beliefs and objectives which had been discussed and agreed by the Committee at the first workshop. The main points were:

- to aim to reduce investment risk without reducing the funding level
- to aim to reduce investment risk without reducing prudence in the funding strategy or increasing employer contributions
- to simplify the structure of the Fund by reducing the number of asset classes and managers

3.5. The workshop then went on to consider the market outlook, investment risks and investment opportunities. These factors were assessed alongside the Committee's views on the types of investments considered as having the potential to be part of the Fund's asset allocation strategy.

3.6. Using Aon's interactive asset allocation model, starting with strawman allocations then progressing to feeding in views expressed at the session, a number of asset allocation permutations were considered. The main issues discussed were:

- an acceptable minimum and maximum allocation to equities
- allocations to other growth assets, being property and infrastructure, to supplement equities
- whether the allocation to private credit should be increased
- the balance of allocations to the fixed income asset classes of government bonds, corporate bonds and multi-asset credit

3.7. This discussion was all in the context of maintaining the target level of return set out in the funding strategy, 5.4%, and reducing the level of risk from the current position to closer to the level within the funding strategy.

3.8. It was clear from the model that it was possible to have an allocation to equities of 50%, which is 5% more than the current strategy, while maintaining the risk and return levels close to the funding strategy, through having improved efficiency of diversification in other asset classes.

3.9. This option left room for higher allocations to property and infrastructure. It also allowed for some flexibility between the liquid fixed income asset classes and private credit.

3.10. A higher allocation to equities was intuitively more challenging. The model illustrated this, including the relatively limited scope to increase the allocations to property and infrastructure from the current levels of 5%.

3.11. Although the permutations were gradually distilled down to a small number of viable options, there was not enough time to reach a conclusion.

3.12. The third workshop is taking place on 4 March 2021 and its purpose is to see the investment strategy review through to completion. This session is expected to include confirmation that the chosen investment strategy meets Members requirements, in terms of having an investment return around 5.4%, and materially reducing investment risk.

3.13. A verbal update will be brought to the meeting, including a proposed asset allocation structure. The Committee will be asked to make a decision on what the new strategy should be.

3.14. Following the approval of a new investment strategy, asset allocation ranges will be considered, to assist with managing the Fund including through rebalancing activity. This will be brought to the Committee in May 2021.

4. OPTIONS FOR NEW INVESTMENTS WITH BORDER TO COAST

4.1. The Committee has decided that all new investments should be made through Border to Coast, where suitable opportunities are available. This includes in private markets, where Border to Coast has a programme comprised of separate investment funds in private equity, private credit and infrastructure. The Fund's Investment Strategy includes allocations to private credit and infrastructure, but not to private equity.

4.2. Due to the nature of private markets investments it is not possible to quickly allocate money and achieve the target allocations. Instead, periodic commitments must be made over a number of years to gradually build up the allocations. Once the targets have been reached, further commitments must be made to maintain the values of the investments at or around the target levels.

4.3. The Fund's private credit and infrastructure programmes are in the process of being built up towards the targets but there is a long way to go.

4.4. In the first quarter of each calendar year there is the opportunity to make new commitments to Border to Coast private markets programme.

<u>Private Credit</u>

4.5. The Fund's private credit programme is comprised of investments with Arcmont, Permira and Border to Coast. The Arcmont and Permira investments were made in 2016, which was prior to the creation of Border to Coast. £65 million was committed to each of these two managers. £75 million was committed to Border to Coast, covering the 2019 and 2020 years.

4.6. At the December 2020 quarter end the value of the programme was 2.3% of the total value of the Fund. This was primarily made up of the two mature investments with Arcmont and Permira, at 2.2%. The commitment to Border to Coast was only 0.1% but this investment is at an early stage, and will increase steadily in value as the money is put to work with the underlying managers.

4.7. The current target is 5% but this may be changed as a result of the investment strategy review.

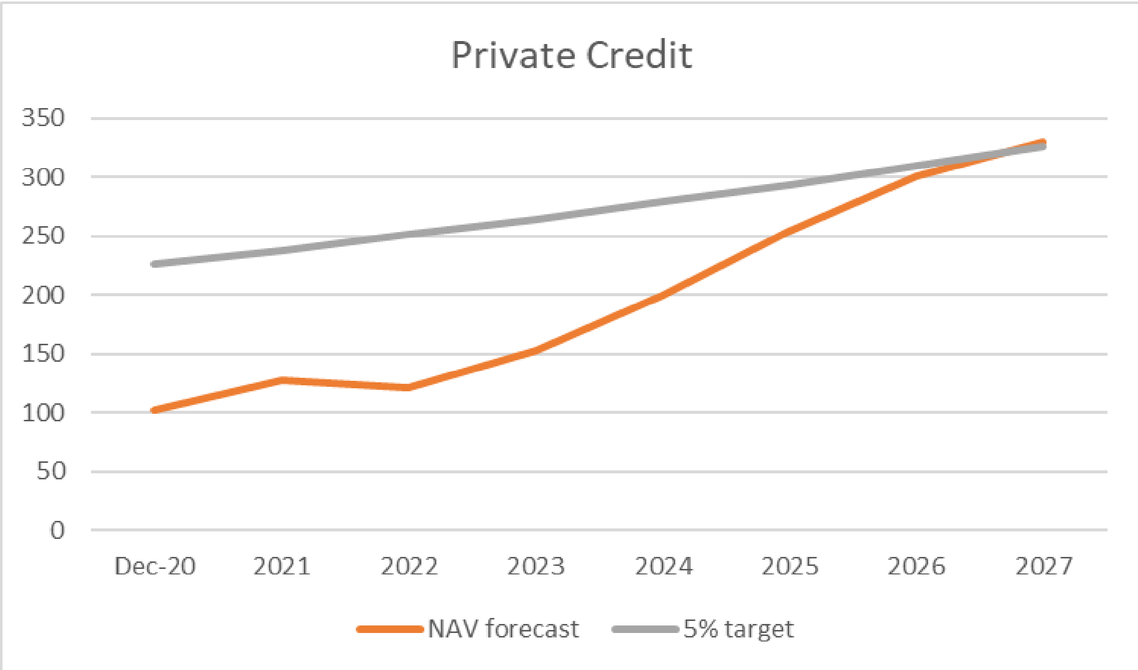
4.8. The three managers have provided forecast valuations covering the next seven years. Although a lot can happen in financial markets over that time period, this provides useful information on the likely direction of travel of the Fund's existing private credit programme value. It is also a basis on which to model future commitments with the aim of reaching the target allocation, and to model the commitments required to stay there over the long term.

4.9. The target allocation is assumed to grow in Sterling terms by 5.4% per annum, which is the rate assumed in the Funding Strategy, determined as part of the 2019 Valuation.

4.10. Although the recent review of the Investment Strategy may have concluded that this return expectation has changed, the difference will not be material, and will not change the recommendation of the amount to be committed to Border to Coast.

4.11. The factor that would change the recommended commitment level is what the target level for private credit is to be. This is not known at the time of writing this report. However the base case assumption is for this to be 5%. Should the target be higher or lower than this, appropriate commitments have also been calculated in each case.

4.12. The chart below assumes a 5% target, a commitment of £120 million in 2021 and commitments of £75 million each year thereafter.



4.13. The shape of the Net Asset Valuation (NAV) line reflects the decline in the valuations of the investments with Arcmont and Permira, as money is gradually paid back to investors. Both of these investments are forecast to have reached the end of their lives around the end of 2023, where the NAV's fall to zero. This is the reason for the dip in 2022. Overlaid with this is the gradual build-up of NAV in the investment with Border to Coast.

4.14. The performance and NAV over time of the Arcmont and Permira funds have been broadly in line with expectations.

4.15. The commitments included in paragraph 4.12 may appear large, given that 5% currently equates to around £230 million. Cumulative commitments, including £120 million to Border to Coast this quarter, would be £325 million.

4.16. There are two reasons for this. The first is that the investments have a finite life, as is being seen from the fall in the forecast NAV's for the Fund's two mature investments.

4.17. The second is that NAV's in private credit typically peak at around 75% of the commitment level. This is because of the nature of the underlying investments, which are loans to private companies. These loans usually require the borrowers to pay an arrangement fee on day one of the loan, and to make periodic loan repayments throughout the term. During the earlier part of a private credit funds life, known as the investment period, this money is reinvested, rather than be repaid to investors at the same time as money would need to be called from investors to make new loans.

4.18. Based on the forecast NAV's received from the managers, and the possible target allocation for private credit being somewhere in the range of 0% to 10%, commitments in 2021 as shown in the table below are considered appropriate. Indicative commitment levels for subsequent years are also shown.

Target	2021 Commitment	2022 and later years commitments
%	£m	£m
0	0	0
2.5	45	35
5	120	75
7.5	150	125
10	200	170

4.19. In each case, the forecast is for the target to be reached at around 2026 or 2027.

4.20. It is of course possible to reach the target sooner by making larger commitments in the current and next few years. However this is not the best approach. Larger commitments early in the development of the programme would require that smaller commitments or no commitments at all be required in the following few years, to avoid shooting past the target. Also, irregular commitments would lead to a more volatile NAV, decreasing the likelihood that it can be managed close to the target allocation.

4.21. The figures in the table above represent a compromise. This is between the desire to smooth out commitments, and the need for an added boost in 2021 to accelerate the development of the programme.

4.22. At a target level of 10% a single commitment of £200 million may seem uncomfortably large. However Border to Coast will invest this money into seven or eight underlying managers. The Fund's investments with these underlying managers will therefore individually be fairly small.

4.23. A decision is needed on the commitment level for 2021. Decisions on commitments for later years will need to be made in the first quarter of each year.

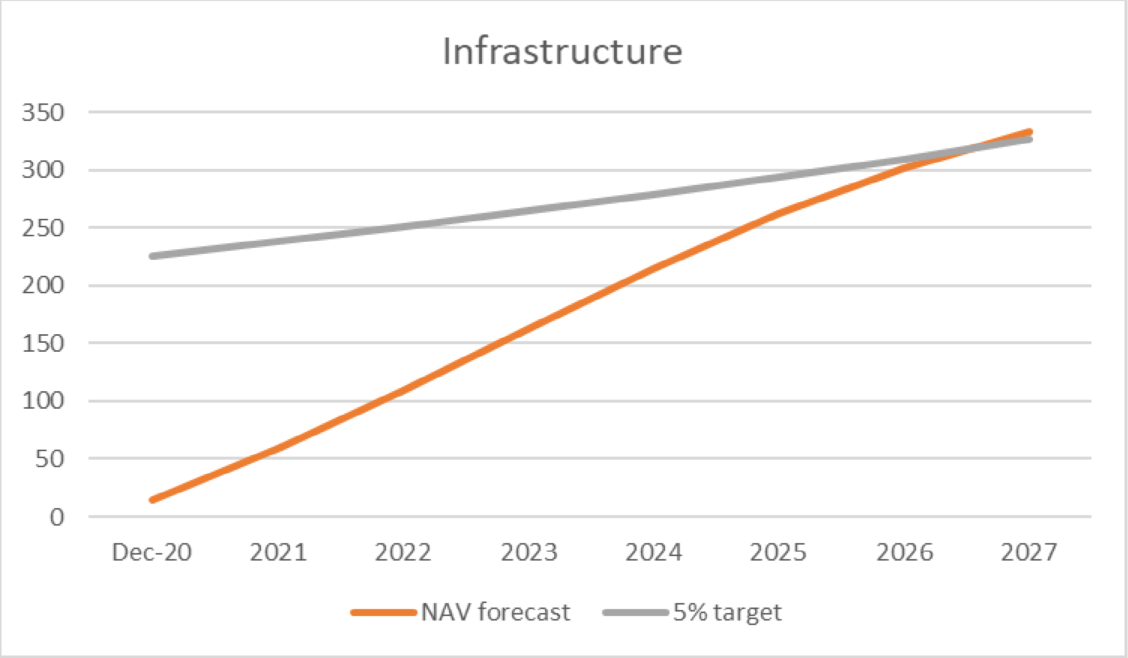
Infrastructure

4.24. Prior to the creation of Border to Coast, the Fund did not have any infrastructure investments. The Fund's programme consists of commitments solely to Border to Coast. £70 million was committed in 2019 and £50 million in 2020.

4.25. At the December 2020 quarter end the value of the programme was 0.4%. As with the private credit investment with Border to Coast, the infrastructure investment is at an early stage, and will increase steadily in value as the money is put to work with the underlying managers.

4.26. The same approach has been taken as for private credit, in forecasting the NAV of the existing investment and modelling potential future commitments based on appropriate scenarios. A target range of 5% to 10% has been assumed, to reflect Members views at the recent investment strategy workshops and the risk constraints illustrated by Aon's asset allocation model.

4.27. The graph below assumes a 5% target, a commitment to Border to Coast in 2021 of £100 million, and illustrative commitments of £50 million each year thereafter.



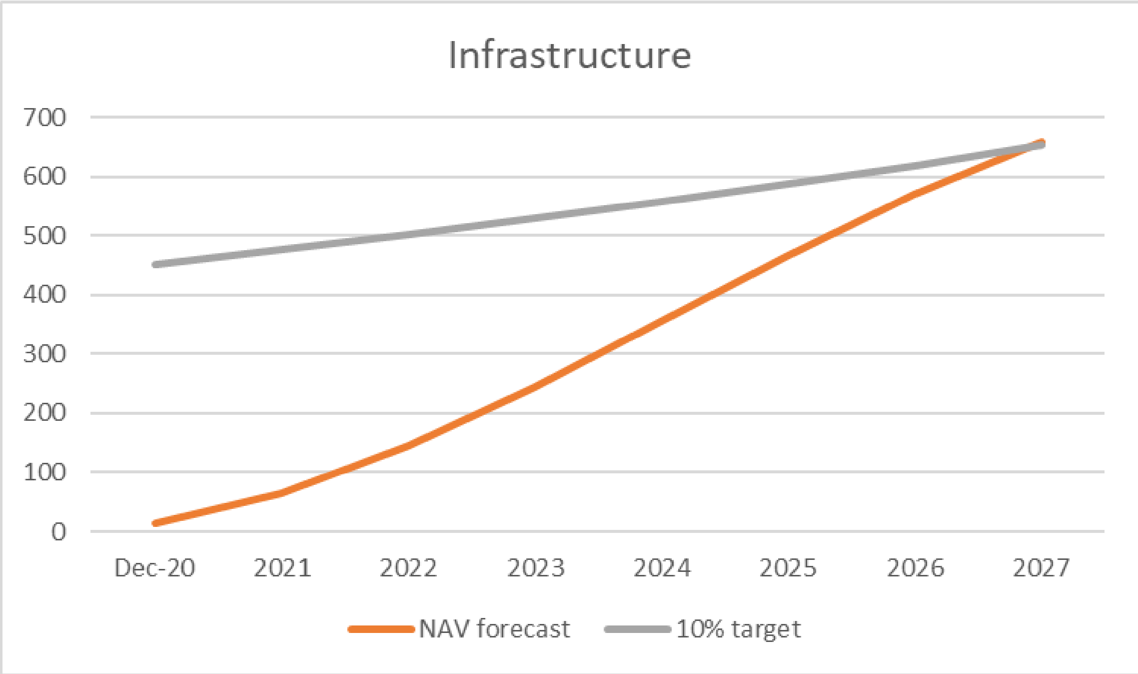
4.28. It is recognised that Members may have decided on a higher target than 5% but this level has been shown in the graph above to bring out the differences to private credit, particularly in the level of longer term commitments. These longer term commitments are forecast to be around 50% higher in private credit.

4.29. Infrastructure investments have a longer life than private credit loans, so the rate of replacement is lower. Less income is generated through the investment period so there are limited opportunities to offset this against money needed for new investments. These factors also mean that NAVs reach around 90% of the commitment level, rather than 75% in private credit.

4.30. Based on the forecast NAV's received from the managers, and the possible target allocation for infrastructure being somewhere in the range of 5% to 10%, commitments in 2021 as shown in the table below are considered appropriate. Indicative commitment levels for subsequent years are also shown.

Target	2021 Commitment	2022 and later years commitments
%	£m	£m
5	100	50
7.5	150	90
10	200	120

4.31. The forecast NAV from a £200 million commitment in 2021, with indicative commitments of £120 million each year thereafter, and a target of 10% is as follows.



4.32. A decision is needed on the commitment level for 2021. Decisions on commitments for later years will need to be made in the first quarter of each year.

5. MULTI ASSET CREDIT

5.1. At the meeting on 22 November 2019 the Committee decided to invest in Border to Coast's Multi Asset Credit (MAC) fund, subject to further due diligence being satisfactorily completed. This decision was made at a time when PIMCO had been appointed as the core manager of the MAC fund, but the managers of the satellite sleeves were still to be appointed.

5.2. Since then, the Fund has been able to transfer money into PIMCO's Diversified Income Fund, with a view to the money being invested with Border to Coast in due course. At the end of December 2020 the investment was worth £198 million and was 4.4% of the total value of the Fund.

5.3. As the launch of the MAC fund is still some way off, this has been a useful option to help with de-risking out of equities. It will take a long time for money to be called in relation to infrastructure and private credit, and options to invest in liquid assets are extremely limited.

5.4. As reported to the Committee at previous meetings, the satellite managers for the MAC fund have been appointed. The fund arrangements have now been finalised, and transition planning is underway.

5.5. Aon has been commissioned to do a final piece of due diligence, which is appended to this report. This was to help address two particular concerns expressed by the Committee, being:

- whether the balance between the different sleeves reflects an appropriate level of risk, and with full consideration of the drivers of and the correlations within those risks

- whether sufficient flexibility exists to make timely asset allocation decisions outside of the routine review process

5.6. The report comments that the MAC fund has been constructed in line with partner fund requirements and provides suitable diversified exposure through a blend of strategies. Portfolio risks are regularly monitored to ensure they remain consistent with the performance targets and risk profiles.

5.7. PIMCO has the flexibility to make wholesale changes within their mandate. Border to Coast has set ranges for each sleeve to provide a framework for allocation changes, and will undertake periodic reviews in light of market conditions. This is in addition to the annual review process.

5.8. The report also highlights a number of key considerations which will be helpful to officers in their discussions with Border to Coast, both in the run up to the launch date, and in the subsequent monitoring arrangements.

5.9. Aon's conclusion is that there are no major concerns to going ahead with investing in Border to Coast's MAC fund.

5.10. However the investment strategy and asset allocations are due to be agreed at this meeting of the Committee. Subject to there being a decision to have an allocation to MAC in the strategy, Members are asked to give delegated authority to the Treasurer in consultation with the Chair of the Committee to make the final decision for the assets to be transferred.

5.11. This delegation is to ensure that a decision can be made immediately prior to the transfer, based on a final assessment being made at the time assets are to be transitioned, which is unlikely to coincide with a Committee meeting. Should any issues come to light between now and the launch date they will of course be raised at intervening meetings.

6. EQUITY PROTECTION

6.1. At the December 2020 quarter end two tranches of equity protection were in place. £400 million of global equity protection was to run to January 2021, with £400 million to July 2021.

6.2. In November 2020 Members decided to allow the equity protection in place to January 2021 to be allowed to come to an end, rather than be renewed. A decision on the July 2021 tranche of protection would be made at a later date.

6.3. Following the expiry of the first tranche of protection, the collateral requirements were reassessed to ensure that a sufficient level would be retained for the remaining equity protection. This assessment also covered the temporary currency hedging arrangements, both of which are managed by Legal and General within the same fund structure.

6.4. £45 million of collateral, in the form of gilts and index linked gilts is available for redeployment to the Fund's other managers.

6.5. As the investment strategy review has been taking place in the first quarter of 2021, these assets have continued to be passively managed by Legal and General for the time being. The intention is to move the assets to be actively managed by one of the other managers of the Fund, once the strategy review has been completed. The most likely destination will be Border to Coast's fixed income funds but this depends upon the outcome of the review.

6.6. There will be the opportunity to review the remaining tranche of equity protection at the May 2021 meeting of the Committee.

7. CURRENCY HEDGING

7.1. In September 2020 currency hedging was implemented through Legal and General, who set this up in the same investment vehicle which houses the equity protection arrangement. This was intended as a temporary measure to help manage the risk to Sterling of a hard Brexit, as well as the risk that the UK economy struggles to recover over the medium term.

7.2. The main points are as follows.

- At the trigger level of $1.20:£1, 25% of US equity exposure to be currency hedged, equivalent to £220 million
- At the trigger level of $1.155:£1, 25% of US equity exposure to be currency hedged, equivalent to £220 million
- At the trigger level of $1.40:£1, 100% of US currency hedging to be removed
- At the trigger level of €1.05:£1, 25% of Euro equity exposure to be currency hedged, equivalent to £50 million
- At the trigger level of €1:£1, 25% of Euro equity exposure to be currency hedged, equivalent to £50 million
- At the trigger level of €1.15:£1, 100% of Euro currency hedging to be removed

7.3. The Government was able to negotiate a deal with the European Union. This averted a potential short term Sterling crisis. However, concerns over the UK economy over the medium term remain.

7.4. At the time of writing the exchange rates are $1.41 and €1.16 to the pound. Both are significantly higher than the rates at the time the currency hedging was put in place.

7.5. As currency hedging is intended to be a short term tactical response to specific circumstances, its appropriateness will need to be periodically reviewed. This is with the intention of removing it, if it is considered that the reasons to maintain it are no longer strong enough, even if the trigger levels have not been reached.

7.6. There will be the opportunity to review currency hedging alongside the review of equity protection, at the May 2021 meeting of the Committee.

8. RECOMMENDATIONS

Members are to:

8.1. Determine the new investment strategy of the Fund.

8.2. Determine the commitments to Border to Coast's private credit and infrastructure programmes, based on the allocations to these investment classes in the investment strategy.

8.3. Give delegated authority to the Treasurer and Chair of the Committee to make the final decision on investing in Border to Coast's Multi Asset Credit fund, should it remain within the Fund's investment strategy.

8.4. Note the positions on equity protection and currency hedging.

GARY FIELDING
Treasurer to North Yorkshire Pension Fund
NYCC
County Hall
2 March 2021

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