LONDON BOROUGH OF CAMDEN	**Ward:** All
REPORT TITLE: Investment Strategy Review	
REPORT OF: Executive Director Corporate Services	
FOR SUBMISSION TO: Pension Board	**DATE:** 8 October 2020

SUMMARY OF REPORT:

This report presents the results of an investment strategy review by our Investment Consultant, Isio, on the Fund's strategic asset allocation. The Pension Committee agreed:

1. To agree in principle to move to the asset allocation recommended in strategy 1 in the non- equity strategy paper (Appendix A);
2. To receive a report on implementation of the Long Lease Property allocation (5%) in September evaluating the London CIV's inflation plus sub-fund alongside other options;
3. To receive a report on how to achieve the increase in inflation linked assets (additional 5%) in November;
4. To agree in principle equity allocations recommended in the equity strategy paper (Appendix B) which reduces equity exposure from 60% to 50% and sets the active equity proportion within equities to 40%;
5. To receive a paper in November on how to fill the 30% equity allocation (Appendix B) to a more specific ESG focussed allocation and consider operational issues in how to trim the active equity managers and implement the strategy.

Local Government Act 1972 – Access to Information
No documents required to be listed were used in the preparation of this report.

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RECOMMENDATIONS:

The Pension Board is asked to note the contents of this report

Signed by
Interim Director of Finance **Agreed**

Date **29 September 2020**

1. INTRODUCTION AND BACKGROUND

1.1 The Fund reviews its strategic asset allocation periodically (every 2-3 years). This work is ideally completed just after a triennial valuation which means that members have an up to date view of the liabilities and can understand how best to match these with an investment strategy.

1.2 Over recent years the Fund has reviewed its strategy in June 2012 adding a Hedge Fund and diversified growth fund (DGF) allocation, September 2015 (item 12) which led to a review of the mandate with Aberdeen (global equity), a search for a private equity manager and a rebalancing of passive equity away from UK equity and levelling up with global equity and September 2017 (item 7).

1.3 At the last review in 2017 the Pension Committee agreed to remove the allocation to Hedge Funds and to allocate this money (5% of the Fund) to Infrastructure in principle. At that time the London CIV was still aiming to formulate and fill an Infrastructure mandate and has subsequently appointed StepStone as its 'Head of Infrastructure'. Members took the decision to appoint to the Infrastructure mandate in February 2019 (item 11).

1.4 One of the most important decisions Members of the Pension Committee ever make is the Fund's asset allocation and performance analysis consistently shows that asset allocation is the main driver of Fund performance. Individual managers within each asset allocation are important, but not as important as the overall strategy and asset allocation. Furthermore, the fit and nature of asset classes is important for funds to ensure they have liquid assets to finance spend on benefits as they fall due.

1.5 The Fund's Investment Consultant, Isio, have been commissioned to review the current Fund structure. Members will be more familiar with the KPMG brand which in February 2020 spun out a management buyout firm called Isio. The lead Partner is still responsible for our account, David O'Hara, supported by Andrew Singh (as before) and Hermione Rigg. All three have been involved in the strategy review work.

1.6 In thinking about our strategy it is useful to think about where other Local Government Pension Schemes (LGPS) have positioned their asset allocation. Whilst this provides a useful comparison of course our Fund has its own characteristics in terms of longevity of its members, maturity of the fund (whether we pay out more benefits than contributions each year and how that is changing over time) and the Fund's appetite for risk.

1.7 Our Performance adviser, PIRC, undertake annual analysis on their cohort of 64 LGPS funds with a value of £193bn. Table 1 below shows the 2019 results:

Table 1: PIRC average vs Camden asset allocation

Asset class	PIRC Average asset allocation	Camden Strategic Asset allocation	Actual Fund asset allocation
Equities (active and passive)	**55%**	**50%**	**59.9%**
UK	14%	25%	15.4%
Overseas	41%	25%	44.5%
Bonds	**19%**	**15%**	**11.2%**
UK	9%	3%	3%
Global	4%		
Absolute return	5%		6%
Multi Asset credit	1%	12%	2.2%
Cash	**3%**	**0%**	**0.3%**
Alternatives	**11%**	**10%**	**2.9%**
Private Equity	5%	5%	2.8%
Infrastructure	3%	5%	0.1%
Absolute Return	3%		
Diversified growth	**3%**	**15%**	**13.8%**
Property	**9%**	**10%**	**12%**
TOTAL	**100%**	**100%**	**100%**

1.8 What this shows is that although the Fund's *strategic* asset allocation to equity is lower than the average (50% v 55%) in reality our *actual* equity allocation is in fact higher (59.9% v 55%).

1.9 In the bond asset class our strategic allocation is lower than the average (15% v 19%) and the actual proportion is even lower at 11.2%. This is explained by the fact that many other funds are more mature than our Fund (their benefits paid are greater than contributions in) and this means these funds need to keep assets in less volatile asset classes like bonds to ensure less volatility and cash is available to finance benefit spend.

1.10 The Fund is successful at managing its cash with only a small amount tied up in cash and lower than the average fund.

1.11 In Alternatives we have only relatively recently invested in Private equity (July 2016) and Infrastructure (October 2019) and so whilst the Fund holds a proportion close to the average (10% v 11%) we are slowly building up our investments in reality in these call structures (2.9% to date) as and when investment is called by these alternative fund structures.

1.12 On DGFs our Fund has made a greater use of these as we replaced both of the Hedge Fund managers with these types of mandate. Initially Blue Crest was replaced by Standard Life GARS (April 2016) and then Brevan Howard was replaced by Ruffer (March 2018) as a transitionary manager on the way to the ultimate target investment in Infrastructure. Given the falls in equity markets recently these funds will have held their value well but pre coronavirus these DGFs were not capturing all the market upside. One would traditionally expect these vehicles to capture some, but not all, of the upside but with lower volatility. A review of the DGFs was undertaken by KPMG in July 2019 and it was agreed to transition the assets of these two managers into the new Infrastructure allocation.

1.13 The Fund has long held investments in property as a reasonably sizeable proportion (10% since 2010) and continues to hold 12% versus the average of 9%. This is diversified equally between UK and global property. As the global manager, Partners' model returns cash once fully invested and so this proportion of the Fund will naturally reduce over time. At some point a decision will need to be taken to either invest in the next Partners fund or allocate to another mandate (perhaps if the CIV can offer this asset class). The Fund has allocated to three Partners Funds (the 2009, 2013 and 2017 funds) over the years.

1.14 PIRC have recently released their 19/20 Fund statistics. It is interesting to think about these in the context of our strategy as it provides an insight into how the Fund has performed compared to other LGPS funds over varying time periods. Some headlines are:

- **Overall Fund performance** - the universe median return was -4.1% in 1 year and 1.7% in 3 years. However over longer periods more normal returns were recorded (4.8% over 5 years, 6.8% in 10 years, 5.1% over 20 years and 7.7% in 30 years).
- The Camden Fund has not performed well in comparison over the shorter time horizons – placing 83%ile in 1 year, 88%ile in 3 years, 82%ile in 5 years, 93%ile in 10 years but 54%ile in 20 years and 64%ile in 30 years. The 20 and 30 year returns are extremely close to or identical to the median – so performance in the 10 year and shorter periods have not impeded much longer term performance
- The above poor ranking is explained by the fact that the Fund has always had an equity manager with poor performance over the past ten years. This includes Fidelity, Aberdeen and more recently Harris. Given that equity managers have more than 25% of the portfolio how the Fund performs is largely dictated by how these individual managers perform
- In the longer term (10, 20 and 30 years) the spread between top quartile and bottom quartiles is less than 1% so returns are compressed – this suggests things even out over very long periods

- **Equity** – in periods from 1, 3, 5 and 10 years Camden ranks 3rd quartile but in 20 and 30 years is 2nd quartile. Whilst this is not the worst outcome the fact that there has been a higher allocation to equity has been detrimental to performance
- **Fixed income** - Camden has struggled with our fixed income manager – with performance ranking fourth quartile in all periods or just in to the third quartile in 20 years. This is explained by firstly Goldman Sachs and then Insight underperforming. We are in the process of replacing insight with CQS
- **Alternatives** - One of the bright spots is in the 1 year alternatives Camden has number 1 spot and over 3 and 5 years ranks 7th and 33rd %ile (in other words top quartile over all those periods). This is explained by strong performance by HarbourVest
- **Property** – the Camden Fund also looks good with returns in the top third in time periods out to 10 years (taking number 2 spot in 5 and 10 year timeframes)
- **DGFs** - we know there have been issues with Standard Life and Ruffer and the diversified growth fund results reflect that we have struggled – with returns around the 66%ile

1.15 Information on London Funds' asset allocation is not dissimilar from the PIRC data in Table 1. Table 2 sets out asset allocation across London Funds in 2018 (which is the only data available). This shows that funds across the PIRC universe have been quicker in to illiquid asset classes such as private equity and infrastructure.

Table 2 – London LGPS Funds' asset allocations – London CIV

Asset class	**London Funds**	**PIRC average**
Equity	59%	55%
Bonds	18%	19%
Cash	2%	3%
Private equity	2%	5%
Infrastructure	1%	3%
Absolute return/ DGF	10%	6%
Property	7%	9%
TOTAL	**100%**	**100%**

1.16 The most important function of the asset allocation and the investments is to close the gap between assets and the liabilities. At the 2016 valuation the Fund was estimated by our actuary to be 76.5% funded but after significant equity gains in the period up to 2019 Hymans estimated as at March 2019 that the Fund was 103% funded (and using a different

basis). This assumed that the Fund continued with an asset allocation which is similar to the current allocation and that returns would 'hold up' and the Fund would not significantly de-risk which would lead to lower returns. The 2019 valuation assumed that the Fund's current investment strategy implied there was a 70% likelihood of achieving a return of at least 4.5% per annum, as at 31 March 2019, over the next 20 years

1.17 Isio estimate that the current funding has dropped back to 93% as at March 2020 given sharp falls in asset pricing in March 2020. It is important to remember that these are only snap shots of our assets and liabilities and that the significant disruption to markets could either improve further as we return to a more usual environment or deteriorate if a second wave or prolonged recovery is experienced. The Fund's investment horizon however should be measured over triennial valuation periods or decades not months or quarters. Therefore it is important to consider the Investment Strategy Review through the lens of future years and decades and not shorter term considerations.

2. NON-EQUITY STRATEGY REVIEW

2.1 Isio have undertaken a detailed asset liability modelling exercise using liability data from the recent Triennial valuation. Their report is included in Appendix A and focuses on the non-equity parts of the portfolio. (Please note that page references to Appendix A in this report start from page 1 and are shown in the bottom right hand corner of Appendix A and are used throughout this report to aid reference.) They have considered our Fund's objectives and devised a number of strategies and compared their risk and return characteristics alongside further analysis (page 26).

2.2 On page 11 of Appendix A Isio set out a risk analysis (known as Value at Risk) of the strategic asset allocation and one based on where assets are currently positioned. This shows that in the worst 5%ile (worst 1 in 20 likely outcomes) the Fund has £619m of downside risk over the next two years (using the strategic asset allocation). If they run this on the current asset allocation, given a higher equity proportion, the Value at Risk is £660m.

2.3 This is broken down into risk between various components comprising inflation risk and asset class risks. Most of the risk in both scenarios is driven by inflation risk (c£320m) and equity risk (£416m – £498m) which together total c£800m of risk and form the vast majority of the risk in the Fund. In fact whilst diversification risk reduces overall risk to £619m or £660m the inflation and equity risks are larger than total VaR.

2.4 Liquidity of assets (page 12) in order to meet day to day pension benefit spend shows that the Fund is liquid (80% of assets can be accessed within 1 month).

2.5 The analysis of cash flow requirements based on contributions and benefit spend is also analysed (page 13). This data is based on data from the Pension Shared Service and the Actuary and shows that in the next five years the net cash outgo is no more than £13m per annum and can be met from investment income but this is not big enough to require a drawdown on capital sums invested. This is positive, as once capital is required to fund revenue day to day expenditure it alters investment horizons and alters investment strategy to ensure a certain degree of liquidity is maintained.

2.6 Appendix A then shows potential paths for the funding trajectory (page 14). The median case shows the current deficit of £116m (93% funding as at 31 March 2020) improves over the next 15 years and achieves 100% funding in roughly 5 years' time.

2.7 In thinking about how the Fund's asset allocation could develop to meet future risks and opportunities Isio have considered the Fund's thinking on responsible investment and have considered the Investment Beliefs Statement.

2.8 Some of the emerging thought underpinning Isio's work are (page 22) to:

- Trim the equity allocation whilst still allocating a good proportion to equity – de-risking away from volatile equities but still harnessing equity
- Reduce exposure to DGFs which have struggled to deliver to expectations. The Fund is already committed to exiting positions with Standard Life GARS and Ruffer to fund its infrastructure mandate
- Match the liability inflation risk with inflation linked assets to reduce the CPI related inflation risk of pension benefits liabilities
- Make use of the Fund's long term investment horizons to capture the illiquidity premium of long term investments

2.9 Appendix A then sets out a number of real and private debt asset classes and their characteristics as alternatives to the current investment classes used (pages 24 and 25). The real assets are all linked to inflation and offer inflation protection. The private debt assets are included to provide a higher return and tap into the illiquidity premium.

2.10 The current strategy with 4 alternative strategies are presented on page 26. This shows the expected returns of each strategy and the value at risk (the worst 1 in 20 modelled returns), how assets are linked to inflation, fees and new asset classes being introduced. Members will be mindful that introducing new asset classes and managers requires a governance overhead which should not be underestimated and obviously requires time and skill to manage and monitor.

2.11 What this shows is that expected return is slightly reduced from 4.8% for all options (ranging between 4.6-4.7%) but this is offset by reduced Value at Risk (£619m reduced from between £577m to £491m). All four scenarios increase dramatically inflation matching form 8% currently to more than 18%. This also increases illiquidity to 25% or more from current 20% with fees also being reduced.

2.12 The table below summarises the movement required in strategies from the current strategic asset allocation. There are no changes proposed to private equity, multi asset credit or property asset allocations.

Table 3 Changes to Current Strategic Asset Allocation

Strategy:	1	2	3	4
Existing asset classes				

Equity			-10%	-10%
ILGs	+5%	+7%	+7%	+7%
DGF	-10%	-15%	-7.5%	-15%
Infrastructure		+1.5%	+3%	+3%
New asset classes Long lease property/ residential property	+5%	+6.5%		+7.5%
Private debt			+7.5%	+7.5%

3. NON-EQUITYCONCLUSIONS AND NEXT STEPS

3.1 The Value at Risk analysis, that examines what would happen in the worst 5% of cases, has identified that equity risk and inflation risk are the two largest overwhelming risks in the Fund. To mitigate against these risks further the proposed strategies diversify away from equity and increase index linked gilts and allocations to private debt and real assets such as long lease property with inflation linked returns.

3.2 Given the huge quantitative easing programme the Bank of England has expanded from £435bn to £745bn recently and the unprecedented Government response to the coronavirus pandemic, rapidly expanding public borrowing, the outlook looks inflationary. This is matched internationally with similar policy responses to the pandemic across major economies. Therefore aiming to reduce inflationary risks within the portfolio is considered a worthwhile goal.

3.3 Given the Fund is a long term investor with liabilities stretching well in to the next century it is sensible to build up more investments that harness the illiquidity premium – investing long term to harness additional yield that is not available to other investors with shorter term horizons. Therefore investing in long lease property is considered a good investment idea.

3.4 Strategy 1 would reduce DGFs by 10% (of the Fund) and add 5% to index linked gilts and create a new long lease property mandate. The recently launched CIV’s inflation plus fund would closely match these objectives and is available for investment. A report would need to be brought back to the next Committee to evaluate this sub Fund. Effectively the Fund would be exiting two DGF managers (already planned) and implementing one new long lease style manager with an increase to the existing L&G index linked gilts mandate.

3.5 Appendix A shows that implementing strategy 1 would slightly reduce returns from 4.8% to 4.6%. Hymans comment that these alternative investment strategies will have a lower likelihood of achieving the investment returns assumed for the 2019 valuation. This makes it a little less likely that the Fund (and each employer within the Fund) will achieve their funding target at the end of their time horizon. They also set out that these are not dramatic changes being proposed, so they would not suggest reviewing the contribution rates derived at the 2019

valuation if any of these strategies were put in place. At the next valuation Hymans will reassess the investment strategy returns.

3.6 VaR would be reduced by 7% down from £619m to £577m. Given that the increase to index linked gilts and long lease property are both linked to inflation this would increase assets linked to inflation by 10% from 8% to 18%. These are all laudable outcomes and only introduces one new manager (but a net reduction by one manager after exiting the two DGF managers).

3.7 Therefore it is considered that strategy 1 offers the best next stage for the Fund whilst not diluting equity further than its strategic allocation of 50% (options 3 and 4 go further and reduce equity to 40%). Option 2 has the overhead of introducing two new asset classes (long lease property and private debt) and at this stage it is not recommended that the Fund moves so quickly. Private debt is also one of the latest popular asset classes with the hunt for higher yields in a low return environment seeing a lot of capital being invested and therefore prices becoming elevated. Furthermore, there are concerns about credit quality of underlying positions and the fundamental shock to the operation of business models may mean higher bad debts.

3.8 The Independent Investment Adviser endorses strategy 1 as the next stage for the Fund. She is supportive of the decision to reduce the equity allocation to bring it back into line with the strategic benchmark. She also supports the decision to allocate to long lease property which offers a stable, inflation-linked investment with a reasonable expected return, and prefers this to index-linked gilts for an LGPS fund, where some variability in inflation-linking can be tolerated in exchange for the higher expected return on the investment. She agrees that the CIV's inflation plus sub-fund is worth considering, subject to a fuller due diligence considering issues such as the deployment rate, the internal credit rating process, investment restrictions on the fund, and allocations of deals between the sub-fund and Aviva's annuity business. Whilst private debt has been a relatively successful asset class in recent years, the threat of default on loans to businesses in the current economic climate makes this a less attractive asset class in the short term.

3.9 Therefore officers and advisers recommend that the Committee agrees to implement option 1 by reducing the overweight equity allocation to finance a new 5% allocation to long lease property. In principle this mandate could be fulfilled by the CIV's inflation plus sub-fund and it is proposed that a further report is brought back to the September committee to evaluate this Fund and other opportunities. At this stage it is recommended that Isio are asked to look at how the allocation to inflation linked assets can be achieved by either increasing index linked gilts or using another asset class with similar characteristics. A further report will be brought back to the November Committee.

4. EQUITY STRATEGY REVIEW

4.1 Isio were also asked to look at the equity part of the portfolio and their report forms Appendix B. This currently comprises an overall actual asset allocation of 60% versus a strategic asset allocation of 50% and so is 10% overweight.

4.2 Within equity, assets are split roughly 50:50 actively managed equities to passively managed funds (trackers). Active managers are Baillie Gifford

(30%) and Harris (21%) with Legal and General (L&G) managing a UK passive fund (22%) and a passive global fund (28%).

4.3 Isio’s report is referenced throughout with page numbers starting from page 1 of their report and located in the bottom right hand footer of each page in Appendix B are used throughout this report to aid cross referencing.

4.4 The regional breakdown (page 8 Appendix B) shows that consolidating all funds together there is an underweight to US equity and an overweight to UK equity. The sector analysis (page 9) shows that the Fund is overweight financials (23% v 14%) and underweight technology (10% v 19%).

4.5 The style breakdown (page 10) explains that Baillie Gifford are a growth manager (looking for companies with above average growth) and Harris are value managers (who look to buy stocks cheaply and sell once they reach target prices). Isio set out that there is limited evidence to show active managers can consistently add value after fees and so the Fund should focus on passively managed funds.

4.6 Members will be familiar with the analysis of past performance (page 11) of Baillie Gifford and Harris with BG outperforming since inception and Harris significantly under-performing.

4.7 The Environmental, Social and Governance (ESG) processes of each equity manager are set out on pages 15-16 and this is an important factor in our decision making in order to move up the spectrum of capital and also achieve secondary objectives through voting and stock selection to further our investment beliefs.

4.8 Page 18 Appendix B sets out that the focus of this equity review should be to reduce reliance on UK equities, increase ESG impacts and reduce active management. Officers and advisers are wholly supportive of these objectives.

4.9 The CIV currently offer two active ESG funds both managed by Royal Bank of Canada. The sustainable equity fund seems a better fit for the Fund as it uses engagement rather than exclusion to select stocks and has a slightly better return. Recently a speech by Sarah Breeden from the Bank of England highlighted the fact that given the scale of the change required simply divesting will not lead us to the net zero economy.

4.10 There are also passive equity funds available which reduce exposure to carbon intensive stocks and have a low tracking error (0.3-0.5%). The proposed equity allocation is to reduce active management to 40% within the equity section of the portfolio and replace the UK passive allocation with an ESG focussed fund. It is proposed that Isio are asked to look in detail at the options for introducing an ESG manager and a report is brought back to the November meeting to set out the options in detail and consider implementation in detail.

4.11 The Independent Adviser endorses the recommendation to consider passive ESG focussed equity funds, whilst also shifting the passive/active split more towards passive. She prefers the sustainable equity sub-fund which does not have exclusions, because this allows the fund (a) to continue to engage with companies that are held and (b) to continue to allocate to transitioning companies, if and when they

commence on a journey towards Paris alignment. This means that the Fund can enjoy any return pickup arising from that transition.

4.12 Isio have also produced a report containing additional information on the non-equity portfolio review which is attached at Appendix C. This is a Part II appendix as it contains confidential information and is therefore not available to the public.

5. FINANCE COMMENTS OF THE EXECUTIVE DIRECTOR CORPORATE SERVICES

5.1 The finance comments of the Executive Director Corporate Services are included in the report.

6. LEGAL COMMENTS OF THE BOROUGH SOLICITOR

6.1 The Local Government Pension Scheme Guidance on Preparing and Maintaining an Investment Strategy Statement dated July 2017 provides in Regulation 7(2) (a) The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, that there should be an investment of money in a wide variety of investments. A properly diversified portfolio of assets should include a range of asset classes to help reduce overall portfolio risk. If a single investment class is not performing well, performance should be balanced by other investments which are doing better at that time. A diversified portfolio also helps to reduce volatility. This report demonstrates that the Pension Committee is discharging its responsibility of reviewing their diversification policy to ensure that the overall target return is not put at risk.

7. APPENDICES

Appendix A – Non-equity portfolio review

Appendix B – Equity portfolio review

Appendix C - PART II Additional information on the non-equity portfolio review **(NOT FOR PUBLICATION)**