Review of the Investment Strategy Statement, Responsible Investment Framework and Climate Strategy

PREPARED FOR:

Derbyshire Pension Fund: Pensions and Investments Committee

DECEMBER 2023

MJ HUDSON
Allenbridge

Review of the Investment Strategy Statement, Responsible Investment Framework and Climate Strategy, for Derbyshire Pension Fund

This report has been prepared by Anthony Fletcher, the "External Investment Adviser" of the Derbyshire Pension Fund (the Fund). The review was undertaken at the request of Derbyshire County Council as the Administering Authority for the Derbyshire Pension Fund.

The Fund is required by regulation to have an Investment Strategy Statement (ISS) in place, and to review it following any material change in the factors which are judged to have a bearing on the stated investment policy and at least every three years as required by the Regulations.

The Fund's ISS has been drawn up to be in compliance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 ("the Regulations"), as updated by the Department for Communities and Local Government most recently in July 2017. It has been prepared subject to consultation with such persons as Derbyshire County Council considers appropriate.

Anthony Fletcher's role is to provide an independent review of the ISS and to make suggestions for changes that may be considered in light of the regulations and the investment objectives of the Fund. It should be noted that nothing contained in this review constitutes investment advice nor should it be relied on as such.

Meeting date 6th December 2023
Date of paper 17th November 2023

At the request of Derbyshire County Council as the Administering Authority for the Derbyshire Pension Fund, I have carried out a review of the Investment Strategy Statement, the Responsible Investment Framework and the Climate Strategy and to the best of my knowledge and belief, I have found them to be consistent with the stated investment aims of the Derbyshire Pension Fund and compliant with the regulations as set out in Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2017.

Statutory background

Regulation 7(1) requires an administering authority to formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State.

The Investment Strategy Statement required by Regulation 7 must include: -

a) A requirement to invest money in a wide variety of investments;

b) The authority's assessment of the suitability of particular investments and types of investments;

c) The authority's approach to risk, including the ways in which risks are to be measured and managed;

d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The Investment Strategy Statement must also set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment. This, in effect, replaces Schedule 1 to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("the 2009 Regulations").

Under Regulation 7(6) and (7), the statements must be published by 1st April 2017 and then kept under review and revised from time to time and at least every three years.

Further to my statement above, I note that the Fund's Investment Strategy Statement and Responsible Investment Framework addresses all the requirements set out in the regulations.

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Background

As part of the ongoing need to ensure the Derbyshire Pension Fund's Investment Strategy Statement (ISS) has a reasonable expectation of achieving the long-term investment objectives of the Fund, the Officers and I have reviewed the ISS and the Strategic Asset Allocation Benchmark which were last updated in the fourth quarter of 2020.

The new ISS takes into consideration the output of the Triennial Valuation report produced by Hymans Robertson, based on the Fund's funding position on 31st March 2022 and developments in the medium and long-term trends seen in investment and securities markets.

As part of its fiduciary responsibility, the Fund has always taken into consideration all the material factors which may influence the risk and reward opportunity and the probability of delivering sustainable and stable long term returns through a diversified portfolio of investments.

In conducting this review, the Officers have also updated the Responsible Investment Framework (RIF) and the Climate Strategy (CS). The RIF focuses on the Fund's policy on Environment, Social and Governance and how these factors can influence risk and reward, the CS specifically focuses on the risks arising from climate change and how the Fund will seek to measure and mitigate these risks. The RIF and CS work in tandem with the ISS and the Funding Strategy Statement (FSS), thereby aligning the Fund's investment beliefs, processes and long-term objectives with its fiduciary duties.

The Fund's new RIF is an update of the previous framework agreed by the Pension and Investments Committee in September 2020, the updated RIF is, like the ISS, is consistent with the requirements of the relevant regulations and statutory guidance. While it is a requirement that the Fund has its own policies on responsible investment and climate strategy, it is important to collaborate with its pooling partners and LGPS Central Ltd to have a consistent approach to certain agreed themes to achieve effective engagement and stewardship. These themes are noted in section 8 of the RIF document. Like the RIF itself, these themes are subject to ongoing monitoring and will be reviewed as required or at least every 3 years.

In recognition of the importance of climate change and the impact this could have on the long-term performance of investments, the Officers have also updated the policy document that formally sets out the Fund's approach to incorporating the implications of climate change into the Fund's investment processes. The full consideration of climate change as an influence on investment returns is not new, the Officers, their Advisers, Investment Managers and LGPS Central, as long term investors have always taken into consideration any factor that may have an influence on the long term sustainability and performance of an investment.

The revised CS document contains a number of updates and better targeted commitments that more clearly set out the climate strategy objectives of the Fund and the actions it will take to achieve those objectives. The Officers have committed the Fund to be a signatory of the UK 2020 Stewardship Code and it has joined the Institutional Investors Group on Climate Change (IIGCC). They have also better defined the "carbon metrics" that will be used to measure progress on transition to a lower carbon future.

In order to demonstrate progress on the Fund's Climate Strategy it will produce an Annual TCFD Report. Report on the progression against the Fund's carbon metrics and sustainable investment targets on an annual basis. Include carbon metrics in Fund's Annual Report. Disclose the Stewardship reports of the Fund's key investment managers on a quarterly basis.

It is important to note that there remain significant variations in the relevance and quality of, the data on climate impact currently available in all asset classes. However, despite the issues around the quality of data and the potential for better metrics to be developed, the Fund has pledged, based on the current metrics available, to seek to reduce the carbon impact of its investments over a reasonable period of time. As the quality of data and the standardisation of reporting improves it should become easier to fulfil the climate strategy objectives.

As well as incorporating the updated policies on responsible investment and climate change, the review has taken into consideration the Triennial Valuation and the future expected returns and volatility of different asset classes.

The Triennial Valuation shows that despite recent market volatility, the investment returns achieved since the last valuation in 2019, continue to improve the funding level, which has increased from 97% to 100%. This means that at the time of the Triennial Valuation, the value of assets was equal to the estimated value of the Fund's Past Service Pension Liabilities. While this is good news, it is still subject to risk as market returns, inflation, and actuarial factors such as longevity and membership of the scheme changes all the time and will have a direct impact on the estimate of the funding level. Indeed, as part of the 2022 triennial valuation the actuary has increased the Discount Rate used to calculate the present day value of the Fund's liabilities from 3.6% pa in 2019, to 3.8% pa over the next 20 years. Although the Actuary did also increase the probability of achieving the discount rate, or as I would describe it the future average rate of return estimated to deliver the current pensions promise.

Changes to the Strategic Asset Allocation Benchmark

The steps taken by the Fund over the last two valuations to reduce the volatility of returns by reducing the Fund's exposure to higher volatility Growth Assets and increase its exposure to Income Assets has helped to improve the funding level and the reliability of total returns. At the same time, it should have improved the proportion of the total return which comes from income which is helpful as the Fund becomes more mature and has cashflow needs to pay a greater number of members in retirement.

The proposed changes to the Fund's Strategic Asset Allocation seek to take this a stage further with another reduction in the allocation to higher volatility Growth Assets from 55% to 50% and an increase in exposure to Income Assets from 25% to 30%. The change will be achieved mainly by increasing the allocation to Infrastructure, where returns are often inflation linked and contractual in nature. There are also smaller increases to both Property and to Multi-Asset Credit (MAC). All of these changes are aimed at improving the overall probability of achieving the total return target, by reducing risk which is no longer required due to the improved funding level. No change to the exposure to Protection Assets is being suggested.

Growth Assets: It is proposed that the overall allocation to growth assets is reduced from 55% to 50% and the mix of investments should also change; it is proposed that the allocation to Private Equity is increased from 4% to 6%, and the allocation to Sustainable global equity is increased from

29% to 36%. All the changes would be funded by a reduction in the allocation to UK equity from 12% to 8% together with a reduction in the direct regional allocations to Japanese and Emerging market equity from 5% each to zero.

Substituting the regional allocations for an increased allocation to global equity looks significant but it will not materially change the distribution of region's that can be allocated to and should allow Derbyshire's fund managers more scope to be dynamic in terms of their regional allocations. Arguably the Fund Managers should be better resourced to make these tactical asset allocation decisions than the Pension Fund.

The proposed increase in Private equity exposure recognises that increasingly over the last 20 years more companies are remaining private for longer. This means that potentially more of the value creation is realised by private market investors before the company becomes listed on a public market. It should also be noted that because of the nature of the ownership structure with private equity, the managers should have more direct influence over the ESG policies of investee companies than they may have with publicly listed companies. Whilst this increased exposure increases liquidity risk, the 6% allocation means that overall liquidity remains more than adequate.

The increase in global sustainable and private equity and the reduction of the UK equity allocation could increase the volatility of returns. In practice I do not perceive these risks as significant for the following reasons ;

Firstly, whilst an allocation to the UK does not carry any direct currency risk or non-UK regulatory and jurisdictional risk. In practice, with over 50% of the earnings from the companies listed on UK market indices coming from global companies, those same risks apply to the earnings of UK listed companies.

Secondly, whilst global sustainable and private equity investments could be described as more "growth" like in nature, meaning that even more of their returns are potentially driven by capital gains, in my view this risk is mitigated by the lower overall exposure of Growth Assets and potentially by the investment philosophy of the managers chosen by the Officers and LGPS Central to invest the allocation.

Further, it is worth noting, an increase in global sustainable equity is also consistent with the transition to a lower carbon future and the achievement of net zero. The investee companies in this strategy are the companies that are better placed to benefit from transition or have adopted policies that will enable them to be sustainable in a lower carbon future. This policy is therefore consistent with Derbyshire's Responsible Investment Framework and Climate Strategy.

Income Assets: This category consists of Property, MAC and Infrastructure. If agreed the 5% reduction in Growth Assets noted above would be deployed 3% to Infrastructure increasing the allocation from 10% to 13%. It is also proposed that the overall allocation to Property and MAC is increased by 1% each from 9% to 10% for Property and from 6% to 7% for MAC.

These changes increase the balance of total return that the Fund achieves, with a higher level coming from income rather than potential capital gains. Because a higher proportion has been given to Infrastructure it is likely that this will increase the contractual income the Fund receives that is aligned with inflation. The increase in the property allocation will increase the scope of the Fund's managers potentially increase the diversification of the property portfolio by adding residential property, an opportunity where most of the return comes from rents that can be contractual and aligned with inflation.

Again, this approach is consistent with the Fund's RIF and CS commitments as it is likely to lead to an increased in investment in renewable infrastructure and may also lead to an increase in environmental and social impact the Fund achieves with out having an impact on its returns.

Protection Assets: The weight and mix of protection assets remains unchanged at 20%. I believe it is prudent to have a reasonable allocation to Gilts, Index Linked Gilts and global investment grade credit, because of the long-term diversification characteristics and their ability to match potential changes in the Discount Rate. In the last two years all bonds and in particular Index Linked Gilts have become much more attractive. Partly because of the overall increase in yields, but in the case of Linkers because real yields have increased to -2.5% to around +1%, which means they can provide protection in times of increased inflation or volatility and they will deliver a small positive return above inflation.

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Allenbridge

Strategic Asset Allocation, Permitted Ranges and Performance Benchmarks

The revised Strategic Asset Allocation is set out on table 1 below, it is proposed that the changes to the asset allocation be phased in over the next two years. In order to smooth the impact of the changes on the equity allocation, but also to allow the time needed for the private equity, infrastructure and property managers to find the appropriate investments. The intermediate stage benchmark will become effective from April 2024 and the final new benchmark will be in place by April 2025 at the latest.

Table 1. Changes in the Strategic Asset Allocation Benchmark (SAAB) over time.

Asset Class %	Current SAAB January 2022	Proposed Intermediate SAAB April 2024	Proposed Final SAAB expected April 2025	Final Change
UK Equities	12.0	10.0	8.0	-4.0
Japanese Equities	5.0	2.5		-5.0
Emerging Market Equities	5.0	2.5		-5.0
Global Sustainable Equities	29.0	31.5	36.0	+7.0
Private Equity	4.0	6.0	6.0	+2.0
Growth Assets	**55.0**	**52.5**	**50.0**	**-5.0**
Infrastructure	10.0	11.5	13.0	+3.0
Multi-Asset Credit	6.0	6.5	7.0	+1.0
Property	9.0	9.5	10.0	+1.0
Income Assets	**25.0**	**27.5**	**30.0**	**+5.0**
Conventional Bonds	6.0	6.0	6.0	-
Index-Linked Bonds	6.0	6.0	6.0	-
Corporate Bonds	6.0	6.0	6.0	-
Cash	2.0	2.0	2.0	-
Protection Assets	**20.0**	**20.0**	**20.0**	**-**
Total	**100**	**100**	**100**	**-**

Table 2 shows the final revised Strategic Asset Allocation, performance benchmarks and permitted ranges for tactical asset allocation expected to be in place from April 2025.

MJ HUDSON
Allenbridge

Table 2. Final Strategic Asset Allocation, Permitted Ranges and Performance Benchmarks. April 2025

% Asset Category	Asset Allocation	Permitted Range	Performance Benchmark
Growth Assets	**50.0**	**+/- 8**	
Total Listed Equities	44.0	+/- 8	
UK Equities	8.0	+/- 4	FTSE All Share
Global Sustainable	36.0	+/- 8	FTSE All World + fund specific benchmarks
Private Equity	6.0	+/- 2	Global Sustainable Equity + 1%
Income Assets	**30.0**	**+/- 6**	
Property	10.0	+/- 3	IPD UK Quarterly Property Index
Infrastructure	13.0	+/- 3	SONIA 3m + 2%
Multi-Asset Credit	7.0	+/- 2	40% SONIA 3m + 3% / 30% ICE BofA Global High Yield Index, GBP / 30% S&P & LSTA Leveraged Loan Index, GBP
Protection Assets	**20.0**	**+/- 5**	
Government Bonds	6.0	+/- 2	FTSE UK Government Fixed All Stocks
Inflation Linked Bonds	6.0	+/- 2	FTSE UK Index-Linked All Stocks
Global Non-Government Bonds	6.0	+/- 2	50% ICE GBP Non-Gilt Index (ex EM) / 50% ICE Global Corporate Index (ex GBP and EM), hedged to GBP Base
Cash	2.0	0 - 8	Sterling 7 Day LIBID
Total	**100**		

I have reviewed the asset categories, % allocation, permitted ranges and performance benchmarks in the tables above and find them both prudent and reasonable from the point of view of the Fund's objectives and my understanding of the regulations.

Anthony Fletcher

Independent External Adviser to the Derbyshire Pension Fund

17th November 2023

Appendix

References

Source material was provided by, including but not limited to, the following suppliers: -

Derbyshire Pension Fund.

Department for Levelling Up, Housing and Communities: -

Local Government Pension Scheme

Guidance on Preparing and Maintaining an Investment Strategy Statement

July 2017.