Review of the Investment Strategy Statement

PREPARED FOR:

Derbyshire Pension Fund: Pensions and Investments Committee

Review of the Investment Strategy Statement 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.

Meeting date 9th September 2020
Date of paper 31st August 2020

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, I have found them to be consistent with the objectives 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.

Background

As part of the ongoing need to ensure the Derbyshire Pension Fund's Investment Strategy Statement (ISS) remains inline with the long term objectives of the Fund, the inhouse investment team and I have reviewed the ISS and the Strategic Asset Allocation Benchmark which were last updated in the fourth quarter of 2018.

The new ISS takes into consideration the output of the Triennial Valuation report produced by Hymans Robertson, based on the Fund's position at 31st March 2019 and developments in the medium and long term trends seen in the investment and securities markets.

As part of its fiduciary responsibility, the Fund has always taken into consideration all the 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 inhouse team have in the interests of improved communication and transparency created 2 new documents outside of the ISS, namely; 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 new 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 duty.

The Fund's new RIF is an extension and update of the previous framework that was in the past included as a section within the ISS. The new RIF is, like the ISS, 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, 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 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 investments, the inhouse team have also created a new policy document that formally sets out the Fund's approach to incorporating the implications of climate change into the Fund's investment processes. Again, a consideration of climate change is not new, the inhouse team and its asset managers as long term investors have always taken into consideration any factor that may have an influence on the long term sustainability of an investment.

The new CS document clearly sets out the objectives of the Fund and the actions it will take to achieve those objectives, while recognising that the variation, relevance and quality of, the data on climate impact currently available can be of poor quality and in some cases inconsistent. Despite the issues around data, 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 contained some good news, as a result of the strong investment returns achieved since the last valuation in 2016, the funding level has improved from 87% to 97%. This means the shortfall in the value of assets needed to meet the pensions of scheme members has fallen significantly. This improvement means that the Fund could consider taking a lower level of investment risk in future and still be expected to meet its obligations. This is consistent with the approach of the actuary who has reduced the future expected investment return from 4% pa (in 2016) to 3.6% pa over the next 20 years and only 3.3% pa thereafter.

Changes to the Strategic Asset Allocation Benchmark

The improvement in the funding level means that the Fund can continue on the path of reducing exposure to higher volatility Growth Assets from 57% to 55% and increase its exposure to Income Assets from 23% to 25%. The change will be used to increase the allocation to Infrastructure, where returns are often inflation linked and contractual in nature which should improve the overall probability of achieving the total return target. No change to the exposure to Protection Assets is being suggested at this time.

Growth Assets 55%: The overall allocation is only being reduced slightly from 57% to 55% and there is no change in the 4% allocation to Private Equity, however within the allocation to publicly listed equity there are some significant changes that will need to be phased in over time. It is proposed that the allocation to UK equity is reduced from 16% to 12% and the allocations: 8% Europe ex-UK, 12% North America and 4% Pacific ex-Japan are reduced to 0% with the allocation to Global Sustainable Equity increasing from 3% to 29%. The genuine diversifiers of Japan and Emerging Market equity will remain at 5% each. Substituting the regional allocations for an allocation to global equity looks significant but drilling down into the global benchmark index reveals a similar distribution of regions and allows Derbyshire's fund managers more scope to be dynamic in terms of their regional allocations.

Income Assets 25%: This category consists of Property, MAC and Infrastructure. The 2% reduction in Growth Assets noted above has been deployed to Infrastructure increasing the allocation from 8% to 10%. It is also proposed that the overall allocation to Property remains unchanged but indirect investments are reduced by 1% and direct investments increased by 1%. Like the changes to the mix of equity above, these changes will be phased in over time to give the managers time to get invested. It is also proposed that non sterling denominated income assets should be currency hedged just as they are for protection assets.

Protection Assets 20%: The weight and mix of protection assets remains unchanged. I believe it is prudent to have some allocation to both Gilts and Index Linked Gilts because of their proven diversification characteristics, despite their extremely low expected returns and my belief that at the current level of yield they will not provide as much protection as they have in the past.

Strategic Asset Allocation, Permitted Ranges and Performance Benchmarks

The revised Strategic Asset Allocation is set out on table 1 below, it is proposed that because of the magnitude of the changes to equity allocation and the time needed for the infrastructure and property managers to get invested that the new Strategic Asset Allocation Benchmark is phased in over time. With an intermediate stage from January 2021 and the final new benchmark in place by January 2022.

Table 2 shows the final revised Strategic Asset Allocation, performance benchmarks and permitted ranges for tactical asset allocation expected to be in place from January 2022.

The Fund's liabilities are exclusively denominated in UK pounds. It is therefore prudent to have some exposure to investment assets that are denominated in UK pounds and benchmarked in the UK and to increase the proportion of overseas assets that are currency hedged. However, it is also reasonable for reasons of diversification of risk and return to have exposure to assets which are denominated in other currencies, located in other geographic regions and in sectors that may not be available in the UK. The decision to increase the exposure to global sustainable equity should increase the Fund's level of diversification and dynamic asset allocation between regions and is consistent with the revised Responsible Investment Framework and the Climate Strategy. I therefore support the Fund's change in Strategic Asset Allocation from regional to predominantly global equity as it should widen the range of asset classes, geographies and sectors available for investment.

Over the last 10 years, all equity markets have produced strong relative returns, but it is expected that over the next 10 to 15 years, the returns from developed equity markets, in particular, may be lower and, as recently demonstrated, the volatility of those returns could be higher. Reducing risk by having a lower total weight, together with further diversification within equity, as well as a higher allocation to Income Assets rather than Growth Assets, is a reasonable approach.

Over the last 30 years, bonds have produced high levels of total return as interest rates and inflation have fallen. As a result, nominal and real government bond yields have fallen to very low levels and are probably at their lower boundary. While bonds provide excellent diversification characteristics and predictable cash flows, from a strategic point of view, I believe it is appropriate maintain the current low weight to government bonds.

The decision to increase the exposure to Income Assets and to Infrastructure in particular is a good idea for several reasons. This is an asset class which also derives more of its total return from income rather than growth. Infrastructure investment can provide diversification benefits to traditional asset classes, the cash flows generated by infrastructure are contractual, long term and often inflation linked making them consistent with the long term objectives of a pension fund.

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

Asset Class	**Current SAAB 1st January 2019**	**Proposed Intermediate SAAB January 2021**	**Proposed Final SAAB expected January 2022**	**Final Change**
UK Equities	16.0%	14.0%	12.0%	(4.0%)
North American Equities	12.0%	6.0%	-	(12.0%)
European Equities	8.0%	4.0%	-	(8.0%)
Japanese Equities	5.0%	5.0%	5.0%	-
Asia Pacific Ex-Japan Equities	4.0%	2.0%	-	(4.0%)
Emerging Market Equities	5.0%	5.0%	5.0%	-
Global Sustainable Equities	3.0%	16.0%	29.0%	26.0%
Private Equity	4.0%	4.0%	4.0%	-
Growth Assets	**57.0%**	**56.0%**	**55.0%**	**(2.0%)**
Infrastructure	8.0%	9.0%	10.0%	2.0%
Multi-Asset Credit	6.0%	6.0%	6.0%	-
Direct Property	5.0%	6.0%	6.0%	1.0%
Indirect Property	4.0%	3.0%	3.0%	(1.0%)
Income Assets	**23.0%**	**24.0%**	**25.0%**	**2.0%**
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	**100.0%**	**100.0%**	**100.0%**	**-**

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Table 2. Final Strategic Asset Allocation, Permitted Ranges and Performance Benchmarks. January 2022

% Asset Category	Asset Allocation	Permitted Range	Performance Benchmark
Growth Assets	**55.0**	**+/- 8**	
Total Equities	51.0	+/- 8	
UK Equities	12.0	+/- 4	FTSE All Share
Japan	5.0	+/- 2	FTSE World Japan
Emerging Markets	5.0	+/- 2	FTSE Emerging Markets
Global Sustainable	29.0	+/- 8	FTSE All World
Private Equity	4.0	+/- 2	FTSE All Share + 1%
Income Assets	**25.0**	**+/- 6**	
Property	9.0	+/- 3	IPD UK Quarterly Property Index
Infrastructure	10.0	+/- 3	LIBOR 3m + 2%
Multi-Asset Credit	6.0	+/- 2	40% Libor 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
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	**100.0%**		

I have reviewed the asset categories, % allocation, permitted ranges and performance benchmarks in the table 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

External Investment Adviser

31st August 2020

Appendix

References

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

Derbyshire Pension Fund.

Ministry for Housing, Communities and Local Government: -

Local Government Pension Scheme

Guidance on Preparing and Maintaining an Investment Strategy Statement

July 2017.

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