To: Pension Fund Committee

From: Investment Panel - Aoifinn Devitt and Marian George, Independent Investment Advisors

Re: Strategic Asset Allocation 2023

Date: April 21, 2023

The Role of the Pension Fund Committee with respect to Strategic Asset Allocation

The LGPS pooling regime brought important changes to the division of responsibility between individual LGPS pension funds and the regulated entities or pools that now manage the majority of their assets. While the implementation of asset allocation and the investment management function is now delegated to the pools, which in the case of LCPF (the "Fund") is LPPI, the function of strategic asset allocation remains the responsibility of the Pension Fund Committee. LPPI, in its role as investment manager, may offer strategic allocation "advice" to the Fund, but the extent to which the Pension Fund Committee acts on this advice remains a matter for its own discretion. It alone has sovereign authority to determine the strategic asset allocation for the Fund.

***Assessing the Advice from LPPI**:*

As independent investment advisers to the Fund and members of the Investment Panel, we have regard to a series of different factors when setting the strategic asset allocation (SAA). These include:

- The overall funding level of the Fund (the value of assets versus the present value of future liabilities as determined by the Fund's Actuary) – this enables us to set an appropriate risk appetite.
- The cash flow profile of the Fund (i.e. contributions less benefit payments) and whether it is "negative" or "positive". If cash flow is "negative" we would be reliant on income generated by investments to meet pension payments. Considering this enables us to determine the income target for the Fund across various asset classes.
- The Fund's need for liquidity i.e. how much actual cash is required and when it is required to pay benefits or purchase illiquid assets – this dictates the liquidity profile of the asset class mix.
- The requirement to maintain stability of contributions at a level similar to those set in the 2022 actuarial valuation.
- The actuarial discount rate as determined by the Fund's Actuary, which is derived from the current level of inflation (CPI) as well as an additional "spread" based on reasonable expectations of future asset returns. The actuarial discount rate sets a baseline asset return requirement for the Fund to maintain a satisfactory funding level.
- The underlying return expectations for different asset classes.
- The opportunity set across different asset classes and how they are evolving.

We have considered each of these items in our discussions with LPPI (which included consideration of the LPPI advice note entitled 'Triennial Review of Strategic Asset Allocation') and have robustly interrogated the return projections across each of the asset classes in order to assess whether the proposed SAA is likely to deliver these requirements above.

At the inception of the strategic asset allocation process we asked LPPI to deliver a series of scenarios, which included both a higher and a lower risk version of their central proposal, as well as a proposal that would be unanchored by our current asset allocation – a so-called “blank sheet of paper” portfolio.

In our analysis of the various portfolios presented we took account of the following:

- As at March 2022 the funding level was 115%, the Fund was more than fully funded on the current actuarial basis and has a comfortable “buffer” against adverse market movements. However, the fund is “open” to new members and that its cash flow profile is tending towards negative (currently its cash inflows are lower than its cash outflows), therefore the Fund is reliant on the investment portfolio to generate income. This requires the portfolio to be oriented towards growth assets and not too defensively positioned or “de-risked”.
- Persistently high levels of inflation also suggest that liabilities will continue to rise at a greater rate than previously assumed in the actuarial valuation and LPPI’s model, and this, again, requires a growth orientation in the investment portfolio.
- The actuarial discount rate is somewhat prudent and assumes CPI of 3.1% plus 1.4% or 1.9% for past and future service contributions, respectively. As the discount rate is based on inflation, as inflation remains elevated the required target return will also depend on inflation. Again, the objective of beating this target drives a need to focus on return-generating assets with a growth orientation.

Our Recommendation:
We agreed with the recommendations of the LPPI Central Proposal (which is referenced in the main report as well as appendix A) and are comfortable approving them based on the following logic:

- **Global Equities - Recommended reduction by 0.5%** (Current SAA target 45.5% and recommended 45%)
  At the current funding levels an allocation of 45% to public equities is prudent as it maintains adequate exposure to this growth-oriented asset class (which also provides global currency diversification) and when combined with the private equity allocation brings the explicit equity target to 50% of the portfolio.
- **Private Equities – Recommend no change** (Current SAA target 5% and recommended 5%)
  The current target for private equity is prudent (5%) and should not be lowered as we are currently overweight (8.5% as at 28 February 2023) in this area and transitions away from this asset class take time due to its illiquid nature.

- **Fixed Income - Recommended increase by 3.5%** (Current SAA target 1.5% and recommended 3.5%)
  The recent rising interest rate environment has led to a more favourable return environment in traditional fixed income than in recent years. Raising the target to 5% in fixed income is appropriate – particularly as this is a liquid asset class that can act as a defensive holding during periods of equity market volatility. While fixed income will be exposed to further hikes in interest rates, we do not expect the trajectory of future rate rises to be as dramatic as the hiking cycle over the past 18 months, so expect this downside risk to be more limited.
- **Infrastructure – Recommended reduction by 1%** (Current SAA target 16% and recommended 15%)
  Property - Recommended reduction by 1.5% (Current SAA target 12.5% and recommended 11%)
  The same rising interest rate environment is putting pressure on returns in so-called real asset classes such as infrastructure and property. These asset classes generate income, often linked to inflation, so returns tend to be more "bond like". As the return available on lower risk government bonds increases, this makes the bond-like returns in riskier asset classes less relatively attractive. We are mindful of a contracting opportunity set in property due to structural changes in the industry post-Covid and expect that financing conditions may make infrastructure returns more challenging. For this reason we support slight reductions in the target allocations to infrastructure and real estate (-1% and -1.5%, respectively).
- **Cash – Recommended reduction by 0.5%** (Current SAA target 1.5% and recommended 1%)
  Finally, although cash is no longer a "drag" on returns as interest rates have risen, we support a small reduction in the target allocation to cash (-0.5%) as there will be sufficient liquidity as a result of the increased target to fixed income.
- **Diversified strategies - Recommend no change. However amended range** (Current SAA target 0% and recommended 0%)
  We have a 0% target to Diversified Strategies, which includes allocations to hedge funds, but LPPI has the discretion to allocate up to 5% to this area. In light of our 0% target we believed it prudent to reduce the range of this asset class to 0-3%. We do not believe that our diversified portfolio requires a separate allocation to this area nor that the track record or opportunity set is particularly compelling.
- We were comfortable with the modest reductions in expected return (6.6% to 6.57%) and the expected median funding levels (126.2% to 125.6%) that the model generated under the Central Proposal as there was a lower likelihood of adverse funding scenarios and an improved opportunity set in fixed income.

Our view of alternative portfolios:
We considered the alternative portfolios posited by LPPI. However, based on the scenario analysis conducted the alternative portfolios did not evidence any material impact on funding levels or risk measures to render any alternative portfolio more compelling. Furthermore, we

have a preference for lower “churn” or turnover in managers and asset classes as this can erode returns and it can be very difficult to time entry and exit.