From:	Chairman Kent Pension Board Acting Corporate Director - Finance
To:	Kent Pension Board – 11 June 2024
Subject:	Investment Update (31 March 2024)
Classification:	Unrestricted

Summary:

To provide a summary of the Fund's investment strategy, asset allocation, performance, and responsible investment activity.

Recommendation:

The Board is asked to note the report and to nominate a Board Member to serve as an observer for the Responsible Investment Working Group.

FOR INFORMATION

1. Introduction

1.1 This report provides the Board with an update on the Fund's investment activity and performance, as well as on responsible investment developments that have taken place since the Board's last meeting.

2. Investment Strategy

2.1 As reported to the Board at its last meeting, the Pension Fund Committee agreed an implementation plan at its December 2023 meeting to introduce changes to the portfolio agreed by the Committee as a result of the 2023 investment strategy review.

2.2 Since the Board's last meeting, the implementation plan has been enacted in line with expectations.

<u>Emerging Markets Equities</u>

2.3 A key milestone has involved the identifying the most appropriate investment solution for the Fund's new 5% strategic allocation to Emerging Markets Equities. Under the implementation plan, the Committee agreed to implement the allocation via the ACCESS pool, which has recently created two sub-funds (managed separately by asset managers Columbia Threadneedle and Robeco) via a competitive process for member authorities to access this asset class.

2.4 Over Q1 2024, officers worked with the ACCESS pool operator (Waystone) and the Fund's Investment Consultant (Mercer) to identify the best implementation route, using products available on the pool. As a further part of the Fund's due diligence, the Chairman and Vice Chairman of the Committee, alongside officers, met with both Robeco and Columbia Threadneedle in March 2024.

2.5 As a result of this exercise, the Committee agreed to implement an equal-weighted (50/50) investment in both the Columbia Threadneedle and Robeco managed sub-funds at its meeting in March. The Committee had already agreed in December, to fund the emerging markets allocation by redeeming sufficient assets from the WS ACCESS UK Equity Fund, which would reduce the overweight exposure to UK Equities.

2.6 The Committee delegated authority to manage the transition arrangements to the Head of Pensions and Treasury in consultation with the Chairman. A transition timetable was subsequently devised by officers with trading taking place over April and May 2024. The transition was completed in full on 16 May and a total of £400m of assets was removed from UK Equities and invested in the two Emerging Markets Equities sub-funds (£200m each).

Private Equity and Infrastructure

2.7 The Committee also reviewed a commitment analysis for the Fund's infrastructure and private equity allocations at its March meeting. As previously reported to the Board, transfers into and out of these asset classes cannot be enacted instantaneously given their illiquid nature and the Fund's current approach to accessing private equity and infrastructure exposure is via regular commitments to "closed end" funds. Closed-end funds are common investment vehicles in illiquid asset classes. They involve upfront commitments of capital from investors which are subsequently drawn down over time during an investment phase. Capital (including returns) is then returned to investors as the funds mature and, eventually, expire. A natural feature of investment strategies involving closed end funds is that investors need to make regular commitments to ensure actual investment exposure remains consistent with the investor's target weight for the asset class. Such an approach also builds in "vintage" diversification, which is an important risk consideration in alternative asset classes where timing can have a significant impact on realised performance.

2.8 As a result of the commitment analysis, and in respect of private equity, the Committee agreed to commit a $160m to the HarbourVest Global Fund 2024. HarvourVest manages the majority of the Fund's existing exposure, and this decision represents a pragmatic solution to help to ensure that the Fund's actual exposure to private equity remained close to the Fund's 5% target for this asset class in the near to medium term.

2.9 For infrastructure, the commitment analysis indicated that the Fund has a less pressing need to make additional commitments immediately, and officers recommended that further work be undertaken to identify the future optimum investment arrangements for this asset class.

Risk Management Framework

2.10 Another key component of the investment strategy review is the renewal of the equity protection programme and the establishment of the Risk Management Framework. In broad terms, this exercise has involved the replacement of the legacy "static" equity protection programme with a new "systematic" equity protection programme and simultaneously the introduction of a new allocation to index linked gilts, which will serve a dual role as both collateral for the equity protection programme and as an outright investment allocation.

2.11 Given the implicit complexity of this aspect of the implementation plan, the Committee delegated some decisions of a more technical and operational nature to the Head of Pensions and Treasury in consultation with the Risk Management Group to ensure the necessary and appropriate governance and oversight took place. All activity surrounding the design and construction of the Risk Management Framework has involved dedicated support from the Investment Consultant.

2.12 The RMG has met on three occasions over 2024 to date and the implementation has proceeded as planned. The legacy equity protection programme was gradually wound down between January and April 2024 and the replacement systematic equity programme was incrementally established on the same timescale, with implementation complete by 15 April 2024. In addition, the new index linked gilts portfolio was designed and constructed during Q1 2024 and was fully implemented by 21 February 2024. In total, £532m was invested in gilts, funded from existing collateral assets held in either cash or near-cash instruments.

<u>Stage 2 – Intra Asset Class Review</u>

2.13 The recent transactions surrounding Emerging Markets Equities and the Risk Management Framework concluded the major actions needed to bring the Fund's actual asset allocation into alignment with its (target) strategic asset allocation.

2.14 As reported to the Board at its last meeting, as an important second order consideration, officers plan for the Committee to review the underlying portfolio composition within each asset class. This will help ensure that individual mandates continue to remain consistent with the Fund's investment strategy and also help identify further opportunities to progress the pooling of assets. The key parameters of the review are as follows:

- Performance evaluation
- Opportunities for progressing pooling
- Passive vs active implementation
- Mandate size
- Diversification
- Style biases
- Sustainability and positioning for the climate transition
- Impact

2.15 Officers have now commenced the review on asset class by asset class basis and starting with the Equities allocation (which dominates the Fund's risk and return profile) in Q2. This work will be followed by a review of the fixed income mandates and will then conclude with the alternative asset classes. Further details and a progress update will be brought to future meetings of the Board.

3. Fund value and asset allocation

3.1 As of 30 April 2024 (the latest available data), the Fund's value was £8.07bn compared to £7.84bn as at 31 December 2023, the position previously reported to the Board. The table below sets out the current asset allocation versus the Fund's new strategic asset allocation and its revised rebalancing policy.

Asset Class	Strategic Asset Allocation (%)	Tolerance Band (%)	Current Asset Allocation (%)	Variance	Status
Equities	**53**	**+/- 10**	**53**	**1**	**In range**
UK Equities	10	+/- 2.5	12	2	In range
Global Equities	38	+/- 5	39	1	In range
Emerging Market Equities	5	+/- 2.5	3	-2	In range
Fixed Income	**22**	**+/- 5**	**23**	**-1**	**In range**
Credit	15	+/- 5	15	0	In range
RMF (Index Linked Gilts)	7	-	6	-1	N/A
Alternatives	**25**	**+/- 10**	**24**	**-1**	**In range**
Absolute Return	5	-	5	0	N/A
Infrastructure	5	-	5	0	N/A
Private Equity	5	-	5	0	N/A
Property	10	-	9	-1	N/A
Cash	**0**	**5**	**1**	**1**	**In range**
Total	**100**		**100**		

3.2 The current asset allocation is broadly aligned with the new strategic asset allocation, allowing for approved tolerance bands. The UK Equities and Emerging Market Equities allocations are marginally overweight and underweight, respectively. As noted above (para. 2.6), the transition between these two asset classes was not completed until 16 May 2024 (at which point, the allocations achieved their target weightings). Given the current asset allocation is within tolerance, officers will not be recommending to the Committee that any rebalancing is undertaken at its meeting in June.

4. Investment performance: quarter to 31 March 2024

4.1 The Fund's investments returned 2.0% in the three months to 31 March 2024, compared to the benchmark return of 4.3%. The relative negative return vs the benchmark is largely attributed to the Fund's equity protection programme, which detracted (as expected) during another strong quarter for global equities. The programme reduces the overall volatility associated with equities by limiting losses and gains vs the benchmark.

4.2 ***UK equities*** generated lower returns than other regions with the FTSE All Share index gaining 3.8% over the quarter. The Fund's UK equity manager, Schroders, trailed the benchmark during the quarter with a return of 2.7% (versus the benchmark return of 3.8%).

4.3 ***Global equities*** performance was positive over the quarter, returning 9.2%. Commodities stocks benefited from renewed optimism in the economic outlook and cyclical assets outperformed during the quarter on expectations that a sharp recession may have been averted. Developed markets continued to outperform emerging markets and the US and Japan indices posted the best returns with 11.3% and 11.6% in sterling terms, respectively. Emerging markets returned a relatively low 3.4% despite a rebound in Chinese stocks as well as good performance in South Korea, Taiwan, and Saudi Arabia stocks.

4.4 Four out of five of the Fund’s active global equity managers underperformed their benchmark this quarter. The exception to this was the Fund’s global active value manager, Schroders who returned 9.5%.

4.5 The increase in the global equity valuations meant that the value of the Fund’s equity protection assets decreased by £168m during the quarter, as expected.

4.6 ***Fixed income***. Bond yields were higher over the quarter (meaning bond values declined) as market expectations of imminent cuts in interest rates faded following higher than expected growth and inflation data. The Fund’s fixed income managers all outperformed their benchmarks during the quarter, with M&G Alpha Opportunities having the highest outperformance with a return of 3.5% vs the benchmark return of 2.3%. As part of implementation of the new Strategic Asset Allocation, the newly established index linked gilts portfolio, managed by Insight, contributed £38m to the Risk Management Framework which equates to a gain of 6.6%.

4.7 ***Property*** returns of 0.4% were an improvement from the -1.2% in the previous quarter and were led by the retail and industrial sectors whilst the office sector detracted from performance. The DTZ direct property portfolio, where most of the Fund’s property assets are invested, achieved a slightly better return than the benchmark of 0.5%.

4.8 Both ***absolute return*** managers were negatively impacted by the rise in bond yields which was marginally offset by gains from equities. Pyrford returned a positive 0.6% although it underperformed the RPI + 5% benchmark of 2.3%. Ruffer produced a negative performance of -0.7%.

4.9 The ***private equity*** mandate also benefitting from improved valuations this quarter although the ***infrastructure*** mandate detracted.

5. Longer term performance

5.1 For the year ended 31 March 2024, the Fund achieved a return of 3.7% against a benchmark return of 10.4%, an underperformance of 6.9%.

5.2 Against a backdrop of gradual disinflation and renewed expectations of interest rate cuts, bonds have performed well over the last year. All the Fund’s bond managers have significantly outperformed the cash benchmark in the 1-year period. CQS were the best performing manager with a return of 13.7% against a benchmark of 9.2%, followed by the M&G Alpha Opportunities fund, which returned 12.4%.

5.3 Equities have also rallied with several major indices reaching record highs. However, the fund’s active managers have underperformed the benchmark. Much of this underperformance by the Fund’s active managers can be attributed to an underweight holding of the “Magnificent-7” tech stocks, which have driven the concentrated rally in the global equities, although the rally has become broader based in the most recent quarter with commodities benefiting from the improved economic backdrop. Given the rally in global equities over the past 12 months, the equity protection programme has detracted from overall Fund returns.

5.4 Relative performance from the absolute return managers against their inflation plus 5% target over the past 12 months has been negative, which is in part explained by the relatively high level of inflation that has persisted over the period. Ruffer detracted more significantly than Pyrford with a return of -5.9% (Pyrford: 4.9%). Property as an asset class has had a challenging year with benchmark returns being negative, and the Fund’s property managers have largely produced negative returns. The DTZ directly managed portfolio returned -0.9% against a bespoke benchmark of -0.3% over the year.

5.5 For the three-year period, the Fund achieved a return of 2.6% compared to its strategic benchmark of 6.6%, an underperformance of 4.0%.

5.6 Benchmark equity returns have been strong during the three-year period with UK and Global equity indices returning 8.6% and 10.1% respectively. The Fund’s value-style managers, Schroders and M&G, have outperformed the benchmark with 10.5% and 10.2% returns, respectively whilst the Fund’s growth-style manager, Baillie Gifford, significantly underperformed with a return of -5.4% against a regional benchmark return of 8.7%. As noted in section 2 above, officers have commenced a review of the equities portfolio to ensure it remains aligned with the Fund’s long term investment objectives.

5.7 The equity protection programme has detracted from performance over this period too, as equities have rallied. As noted above, the program reduces the overall volatility associated with equities by limiting losses and gains vs the benchmark.

5.8 The private equity and investment allocations have been the best performers in the three-year period while the absolute return managers have struggled against their inflation-linked benchmarks, given elevated levels of inflation over the performance horizon as noted above.

6. Responsible Investment Update

6.1 The Responsible Investment Working Group (RIWG) has met three times since the last Board meeting, on 6 March 2024, 30 April 2024 and 30 May 2024.

Responsible Investment Policy

6.2 Since the Board’s last meeting, officers have been working to update the Fund’s Responsible Investment (RI) Policy. At its meeting on 6 March, officers presented the RIWG with a gap analysis comparing several LGPS peers’ RI policies against the current RI Policy, along with recommendations from the Principles for Responsible Investment (PRI) for drafting a successful RI Policy. This exercise demonstrated that there were several opportunities to update the policy to bring it into alignment with best practice and to better reflect the Fund’s current RI practices (which have evolved since the original RI Policy was established in 2020, not least since the introduction of the Fund’s net zero commitment in December 2023. The exercise also provided an opportunity to incorporate the outcomes of the RI beliefs session held at the Committee's strategy development meeting in February 2024).

6.3 An initial draft revised RI Policy was reviewed by the RIWG at its meeting on 30 April. Following feedback from the group, officers incorporated suggested changes and presented a second draft at the RIWG's May meeting. Officers also took input from the Investment Consultant and the Pool's RI advisers, PIRC, in preparing the revised policy.

6.4 Officers have identified that the Board has an important role in the formulation of the Fund's RI Policy, given that the Board is comprised of scheme member and employer representatives. The Policy set outs the Fund's approach to managing material ESG risks and opportunities, which (if managed inadequately) can potentially have a negative impact on employer contribution levels. The Policy also notes that scheme members are likely to have an interest in enjoying their retirement in a sustainable and healthy economy, now and in the future, and therefore officers believe it is important that the Fund sets out its approach for stakeholders, which also aids transparency.

6.5 The revised RI policy will be presented to the Committee for approval at its meeting on 27 June. If the policy is approved, the final version will be published on the Fund's website and advertised to stakeholders through appropriate communication channels.

Other Matters

6.6 The RI Policy has been a key focus of the RIWG's workstream over recent meetings, but the group has also conducted several other pieces of business.

6.7 At its April meeting the RIWG reviewed the RI workplan for 24/25. The workplan will help guide the Fund's RI activities over the year. Major areas for consideration include the RI Policy (as above), engagement with ACCESS, stewardship activities, exploring impact investing, and building out the Fund's RI reporting approach.

6.8 At its meeting on 30 May 2024, the RIWG approved a more formal terms of reference for the group. The RIWG has operated on an informal basis to date and will continue to do so under the new terms of reference. However, officers recognise that having a documented terms of reference will enhance good governance and will help to ensure the RIWG's contribution continues to be effective. The terms of reference also rationalise the role of the Board in respect of the Group. The terms of reference state:

> "To allow the Pension Board to exercise their oversight role effectively, the Board is invited to nominate a member to attend the group meetings as an observer."

The Board is asked to nominate a member to attend RIWG meetings as an observer.

6.9 The RIWG also received a presentation from PIRC at its May meeting. PIRC have been appointed by ACCESS to develop the pool's RI reporting capabilities and output. Given the critical role that ACCESS play in facilitating the Kent

Pension Fund's responsible investment activities and reporting, officers have identified engagement with ACCESS as an important theme for the Fund's RI workplan. Key elements of PIRC's work with ACCESS were presented to the RIWG, which are summarised below:

- PIRC have undertaken a detailed review and gap analysis of the pool's current RI arrangements, comparing practices against other LGPS pools' arrangements. This analysis has identified several areas for consideration, including the potential need for dedicated in-house ESG/RI expertise, pool-led engagement activities and the option of using a voting and engagement provider. These areas are now being explored within ACCESS's governance framework.

- with support from the ACCESS ESG working group, PIRC have also been working on an inaugural Stewardship Code submission on behalf of the pool ahead of the Financial Reporting Council's October deadline. The draft submission will be reviewed in September, when the ESG working group will evaluate the likelihood of the submission meeting the FRC's reporting expectations.

- PIRC has reviewed the ACCESS Voting Guidelines (formalised in 2018), which has resulted in over 70 recommendations including presentational changes and detailed updates and expanded narrative regarding individual voting positions. PIRC are in the process of drafting revised guidelines following these recommendations.

Appendices

Appendix 1 – Quarterly Performance Report (31 March 2024)

Appendix 2 – Draft Responsible Investment Policy

James Graham, CFA (Pension Fund and Treasury Investments Manager)

Sangeeta Surana (Investments, Accounting and Pooling Manager)

T: 03000 416290 / 03000 416738

E: james.graham@kent.gov.uk / sangeeta.surana@kent.gov.uk

28 May 2024