From:	Chairman Kent Pension Board Corporate Director of Finance
To:	Kent Pension Board – 28 November 2023
Subject:	Investment Update
Classification:	Unrestricted

Summary:

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. Over the course of 2023 the Pension Fund Committee has undertaken a review of the Fund's investment strategy. This process has now concluded, and the report provides the Board with an overview of the strategy review process and the outcome.

Recommendation:

The Board is asked to note the report.

FOR INFORMATION

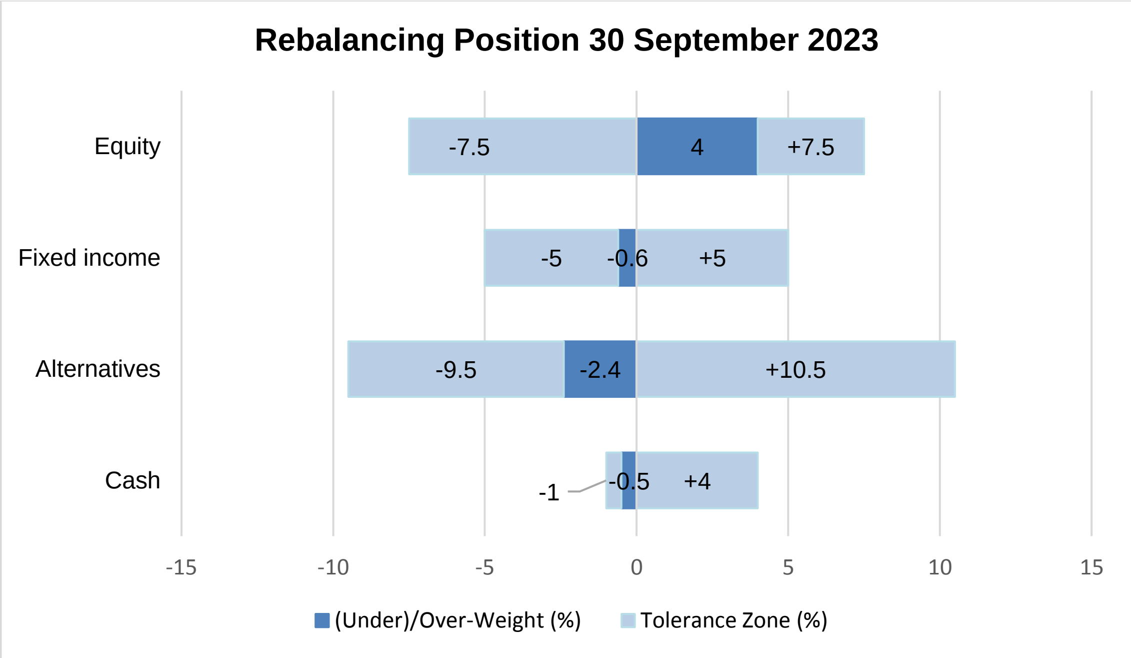
1. Introduction

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. Over the course of 2023 the Pension Fund Committee has undertaken a review of the Fund's investment strategy. This process has now concluded, and the report provides the Board with an overview of the strategy review process and the outcome.

2. Fund value and asset allocation

2.1 As of 30 September 2023, the Fund's value was £7.83bn, an increase of £91m over the quarter.

2.2 Within its equity allocation, the current asset allocation is biased towards global equity and underweight UK equity versus the strategic target. Notwithstanding this, the overall equity allocation (along with all other asset classes) is within the formal tolerance ranges established under the Fund's Investment Strategy Statement (as shown in the chart below).



2.3 Moreover, as the Pension Fund Committee has now concluded its investment strategy review (discussed further below under section 6), deviations between the current asset allocation and the *new* strategic weights will be addressed via implementation of the new strategy.

2.4 Therefore, officers will recommend to the Committee at its December meeting that no rebalancing is undertaken at this stage.

2.5 A copy of the Fund Position Statement is at Appendix 1.

3. Investment performance quarter to 30 September 2023

3.1 The Fund's investments returned 1.56% in the three months to 30 September 2023, against a benchmark return of 1.08%, with the performance of the Fund's equity protection programme compensating for negative returns from the Fund's equities allocation.

3.2 ***UK equities*** performed relatively well versus global peers due to strong performance in the basic materials and energy sectors. The Fund's UK equity manager, Schroders, trailed the benchmark marginally during the quarter with a return of 0.94% (versus the benchmark return of 2.35%).

3.3 ***Global equities*** fell in local currency but had a positive return in sterling terms as the dollar appreciated versus sterling. Japanese equities were the best performing region and emerging markets generated positive returns. US equities were worst performing followed by European equities with the rally in the so-called "magnificent seven" tech stocks (e.g., Nvidia & Microsoft) having slowed down. Energy sector performance was the exception in all the markets. The MSCI World index in GBP terms returned 0.62% over the quarter.

3.4 Against this backdrop, most of the Fund's active global equity managers lagged the benchmark returns this quarter. The exception to this was the Fund's global active value manager Schroder which outperformed the benchmark with quarterly returns of 3.0%.

3.5 The fall in the global equities in local currency meant that the equity protection program gained £126m during the quarter.

3.6 ***Fixed income*** markets continued to struggle on account of concerns that interest rates would need to remain higher for longer to address persistent inflation. However, it was a good quarter for high yield and corporate bonds (especially financials) and, accordingly, the Fund's two multi asset credit managers (M&G and CQS) performed well this quarter, beating the cash benchmark of 1.37% with returns of 2.76% and 2.56%, respectively. GSAM and Schroders (who target interest rate risk in addition to credit within their investment strategies) performed less well and marginally underperformed their benchmarks.

3.7 ***Property*** experienced negative capital returns during the quarter, but positive income yields meant overall returns were broadly flat over the quarter: the total return for the MSCI property index was -0.25% with alternative and industrial sectors providing positive total returns and office and retail sector continuing to suffer losses. The Fund's property managers outperformed the benchmark with the exception of DTZ, where the manager realised losses on two disposals.

3.8 Both ***absolute return*** managers underperformed against the RPI linked benchmark of 1.7% but the ***private equity*** and ***infrastructure*** mandates benefitted from improved valuations this quarter.

4. Longer term performance

4.1 For the year ended September 2023, the Fund achieved a return of 2.67% against a benchmark return of 6.74%, an underperformance of 4.07%.

4.2 The performance from the Fund's UK and value style equity managers has been additive, as have strong returns from fixed income managers GSAM, M&G and CQS. Moreover, the property mandates, whilst having produced negative returns, have outperformed the benchmark. However, Baillie Gifford, who manage 13.3% of the Fund's assets have underperformed the benchmark over the year and the equity protection programme has detracted in the past 12 months too. The absolute return managers have also underperformed their inflation plus style benchmarks.

4.3 For the three-year period the Fund achieved a return of 4.78% compared to its strategic benchmark of 7.16%, an underperformance of 2.38%

4.4 During this period all the Fund's equity managers except M&G have underperformed the benchmark and the alternative investments have generally produced near or above benchmark returns. The fixed income managers have been the best performers in the three-year period and the absolute return managers produced the worst performance against their RPI linked benchmark return of 13.76% in this prolonged period of high inflation.

5. Responsible Investment Update

5.1 The Responsible Investment Working Group (RIWG) met on 2 October and 27 October and is due to meet again on 24 November.

5.2 At its meeting on 2 October, the group received a training session led by Minerva which focused on the Sustainable Development Goals (SDGs) and their applicability to an asset owner such as the Kent Pension Fund. The 17 SDGs have been developed by the UN for governments to address global challenges such as climate change, poverty inequality & peace and justice, with a target date to achieve these goals by 2030. Minerva explained how investors such as the LGPS can focus on SDGs to develop their stewardship activities and provided examples of their work with, and progress made by other local authority pension funds using SDG frameworks to achieve their ESG goals. Officers consider that the SDG framework will be a helpful tool for the Kent Pension Fund to direct engagement activities with its fund managers.

5.3 The RIWG explored these themes further at its next meeting, which feature a workshop led by *Pensions for Purpose* (PFP) regarding impact investment. Impact investing involves investing with an aim to make a positive impact on society and/or the environment, whilst also generating a suitable financial return. The objective of both of these sessions has been to understand the relevance of sustainable and impact investing to the Kent Pension Fund, and officers will take forward the findings in progressing the RIWG's workplan in the new year.

5.4 Since the Board's last meeting, the RIWG has also recommended that the Committee undertakes a review of its responsible investment (RI) beliefs, which were originally established as the result of a survey amongst Members in October 2021. Much progress has been made by the Fund since then, and it is acknowledged that there are likely to have been several developments in best practice which could influence the beliefs of the Committee and also that these should be taken into account before reviewing the RI policy. Officers are currently considering options for facilitating the RI beliefs review and have provisionally scheduled the review to take place at the Committee's meeting on 22 February 2024, which is customarily reserved as a training day for the Committee.

5.5 At its upcoming meeting on 24 November, the RIWG is due to consider the results of the *Analytics for Climate Transition* assessment being carried out by the Investment Consultant, Mercer on behalf of the Fund. The analysis will enable the Fund to understand the transition potential of its underlying investments, which is a necessary precursor to establishing a credible, proportionate and realisable net zero target. The RIWG will use the assessment to consider a net zero target which officers expect will subsequently be recommended to the Pension Fund Committee at its December meeting for adoption.

6. 2023 Investment Strategy Review

6.1 At its meeting on 26 September, the Pension Fund Committee concluded its review of the Fund's investment strategy, which has been a key business item during 2023. The strategy review is consistent with, and builds on, the findings of the 2022 actuarial valuation and has been conducted by Mercer (the Fund's retained Investment Consultant). The output represents the culmination of a considerable amount of collaborative work involving the Committee, officers, and the Investment Consultant at various stages. The underlying approach follows an ethos of *evolution* rather than *revolution*, with the resulting strategic asset allocation representing enhancements to the existing investment strategy.

6.2 The strategy review has taken place over three distinct phases: in March the Committee focused on identifying key considerations; broad principles underpinning the new strategy were established in June; and at its September meeting the Committee finalised the precise allocation option it would utilise to achieve its new investment strategy.

Phase I

6.3 At the outset of the review, the Fund convened an *Investment Strategy Away Day* (3 March 2023), attended by Members of the Committee, and led by the Investment Consultant. The purpose of that meeting was to identify the key issues that the Committee would need to take into consideration during the review. At the March Committee meeting, the Committee distilled the key immediate areas for consideration as follows:

- Optimising risk and returns considering the Fund's improved funding position and improving diversification;
- Reviewing the regional composition of the Fund's listed equities allocation;
- Reducing exposure to diversified growth mandates; and
- Reviewing the Fund's exposure to illiquid asset classes, whereas a long-term investor it can access liquidity premia.

Phase II

6.4 Officers and the Investment Consultant used these priorities to develop proposals for a new investment strategy. At its meeting in June, the Committee considered an initial report on the findings of the investment strategy review and reached the following key decisions:

a) Reduce the overall exposure to equities and increase exposure to fixed income via the introduction of an allocation to index linked gilts;
b) Rationalise the listed equities allocation by reducing the allocation to UK equities and adding one to Emerging Markets;
c) Remove the strategic allocation to cash;
d) Re-organise the allocation to illiquid / alternative asset classes by varying the target allocations to property, private equity, and infrastructure; and
e) As a result of the above changes reduce the allocation to diversified growth funds.

6.5 Taken together, these changes result in a diversified investment strategy that takes advantage of updated capital market expectations and is aligned with the actuarially required return posited under the 2022 triennial valuation.

Phase III

6.6 At its June meeting, the Committee further noted that there were two possible asset allocation options available to achieve the desired balance of expected risk and return established under the proposed new investment strategy:

a) The first option involved removing the existing equity protection overlay and introducing the required strategy updates entirely through changes to underlying asset class allocation target weights.

b) The second option retained an equity protection overlay and involved less radical (albeit still meaningful) changes to the underlying strategic allocation target weights.

6.7 It is important to note that both options essentially represented different available means of achieving a similar expected result. However, the final composition of the strategic asset allocation was contingent on whether the Committee decided to retain an equity protection overlay once the current programme expires in early 2024. The Committee was advised that this matter would need to be investigated in detail by the Risk Management Group (RMG, formerly the Equity Protection Working Group), who would report back with a recommendation at the Committee's September meeting.

6.8 The RMG met on 27 July and noted that the equity protection overlay provided the Fund with an efficient means to manage the volatility emanating from its global equity allocation, without requiring the Fund to physically sell down its equity position. As such equity protection provided the Fund with greater flexibility in establishing its targeted risk exposure.

6.9 Whilst the above benefits were recognised, the RMG also noted that maintaining the overlay necessitated a higher governance burden. However, it was recognised that the Fund had gained experience in overseeing a derivatives overlay programme over the past two years and that the Committee already had the requisite governance arrangements in place with the establishment of the RMG. As a result, the RMG recommended to the Committee that the Fund continue using the equity protection overlay which the Committee resolved to agree.

6.10 Consequently, the Committee was also able to finalise the new strategic asset allocation (SAA) which is shown below against the existing (former) SAA. The Committee ratified the new SAA at its September meeting.

	Previous SAA	**New SAA**	**Change**
Total Equities	55.5%	53.0%	-2.5%
UK	23.5%	10.0%	-13.5%
Global	32.0% (protected)	38.0% (protected)	+6.0%
Emerging Markets	0.0%	5.0%	+5.0%
Total Fixed Income	16.0%	22.0%	+6.0%
Credit	15.0%	15.0%	-
Index Linked Gilts	0.0%	7.0%	+7.0%
Cash	1.0%	0.0%	-1.0%
Total Alternatives	28.5%	25.0%	-3.5%
DGFs	8.0%	5.0%	-3.0%
Property	13.0%	10.0%	-3.0%
Infrastructure	3.5%	5.0%	+1.5%
Private Equity	4.0%	5.0%	+1.0%
Total	100.0%	100.0%	-

Implementation

6.11 Aside from agreeing to retain the equity protection programme, the Committee also agreed some technical aspects relating to future design of the equity protection programme based on advice from the Investment Consultant and the considerations of the RMG.

6.12 Further, technical matters relating to the implementation of the replacement equities protection programme required further investigation and accordingly these matters were delegated by the Committee to the Head of Pensions and Treasury to work through in consultation with the RMG.

6.13 The Committee will receive a progress update on these implementation matters at its meeting in December, where it will also consider a plan for the implementation of the wider strategic changes discussed above (i.e., the asset allocation changes).

6.14 The Fund's Investment Strategy Statement is being reviewed to take account of the outcome of the investment strategy review and will be submitted to the Pension Fund Committee for approval in December.

Appendices

Appendix 1 – Funding Position Statement (30 September 2023)

James Graham – Pension Fund and Treasury
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