From:	Chairman Kent Pension Board Corporate Director of Finance
To:	Kent Pension Board – 12 March 2024
Subject:	Investment Update
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.

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 concluded its review of the Fund's investment strategy at its September meeting and is now in the process of implementing agreed changes. At its December meeting, the Committee reviewed an implementation plan and approved a series of recommendations, which in concert enable the orderly instantiation of the new strategic asset allocation. The key components of the implementation plan are summarised as follows:

a) Reduce UK Equity exposure from the current overweight position to the new target weight of 10% through the termination of synthetic UK equity exposure and via redemptions from the Fund's physical UK equity investments.
b) Implement a new 5% emerging market equities allocation via the ACCESS pool. Officers will develop a proposal for the optimum allocation structure using products available on the pool for consideration by the Committee at its meeting in March 2024.
c) Implement the new 7% index linked gilts allocation via the Fund's existing risk management mandate with Insight (which enables the use of gilts as collateral)
d) Reduce the overweight position in Absolute Return funds to the new strategic weighting of 5%, including rationalisation of the underlying

composition of the Absolute Return portfolio by moving from two mandates within this asset class to one.

2.2 These actions are proceeding broadly in line with expected timescales with the Committee being given a verbal update at a recent informal strategy meeting.

2.3 In addition to the above the Fund will also need to bring its actual allocations to private equity and infrastructure towards the (marginally increased) strategic targets of 5% (for each of the two asset classes). Transfers into and out of these asset classes cannot be enacted instantaneously given their illiquid nature and the Fund's default approach to accessing private equity and infrastructure exposure is via regular commitments to closed-end funds. Officers plan to bring a commitment analysis to the March meeting of the Committee to guide the Fund's future commitment sizing to these asset classes.

2.4 From an investment governance perspective, the current priority is to bring the actual investment portfolio into line with the new strategic asset allocation (as set out above). However, 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. Officers intend to provide the Committee with an indicative timetable for undertaking this review at its March meeting.

3. Investment Strategy Statement

3.1 The Fund is required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the "Regulations") to prepare and publish an Investment Strategy Statement (ISS), which must be in accordance with guidance issued from time to time by the Secretary of State for Levelling Up, Housing and Communities.

3.2 The ISS is a central part of the Fund's investment governance architecture, documenting the principles, beliefs and policies by which the administering authority manages the investment assets of the Fund.

3.3 As a result of the investment strategy review, and to take account of the new strategic asset allocation, the Committee approved a revised version of the Fund's ISS at its meeting in December (the previous version was agreed in September 2021).

3.4 The new strategic asset allocation also necessitated a review of the Fund's rebalancing policy, which is one of the Committee's key risk management tools as it establishes ranges around the portfolio target weights, beyond which the Committee would ordinarily consider rebalancing activity to bring the actual portfolio into alignment with the approved strategic asset allocation.

3.5 The Committee also took the opportunity to update other areas of the ISS to aid readability and to better capture the Committee's current investment governance practices.

3.6 The updated and approved version of the ISS is found at appendix 1 and additional or revised wording has been highlighted to enable the Board to easily identify changes. Following its approval, the revised ISS was published on the Fund's website.

4. Fund value and asset allocation

4.1 As of 31 January 2024, the Fund's value was £7.84bn (compared to £7.83bn as at 30 September 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**	**0**	**In range**
UK Equities	10	+/- 2.5	15	5	Overweight
Global Equities	38	+/- 5	38	0	In range
Emerging Market Equities	5	+/- 2.5	0	-5	Underweight
Fixed Income	**22**	**+/- 5**	**23**	**1**	**In range**
Credit	15	+/- 5	15	0	In range
RMF	7	-	8	1	In range
Alternatives	**25**	**+/- 10**	**24**	**-1**	**In range**
Absolute Return	5	-	5	0	N/A
Infrastructure	5	-	4	-1	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**		

4.2 The current asset allocation is broadly aligned with the new strategic asset allocation, allowing for approved tolerance bands, with the exception of UK Equities and Emerging Market Equities, which are overweight and underweight, respectively. As noted above (para. 2.1) the Committee has approved decisions to bring these positions into line with the new target weights and therefore officers will not be recommending to the Committee that any (additional) rebalancing is undertaken at its meeting in March.

5. Investment performance: quarter to 31 December 2023

5.1 The Fund's investments returned 1.42% in the three months to 31 December 2023, compared to the benchmark return of 3.05%. The relative negative return vs the benchmark is largely attributed to the Fund's equity protection program, which detracted (as expected) during a strong quarter for equities. The program reduces the overall volatility associated with equities by limiting losses and gains vs the benchmark.

5.2 ***UK equities*** exhibited a relatively poor performance compared to global peers, despite strong showings from the Financials and Consumer Goods sectors. Small caps produced significantly higher returns than large caps, with returns of 6.3% and 2.3% respectively. The Fund's UK equity manager, Schroders, trailed the benchmark marginally during the quarter with a return of 2.12% (versus the benchmark return of 3.14%).

5.3 ***Global equities*** performance was positive over the quarter, returning 6.3% in sterling terms. This was lower than the local currency returns of 9.3%, due to the appreciation of sterling versus the dollar. The "Magnificent-Seven" continued their rally and played a big role in the strong performance, supported by expectations of interest rate cuts and a soft landing in the US. Emerging markets did not perform as well as developed markets during the quarter, due to the ongoing struggles with China's property sector.

5.4 Following the above, and despite an underweight holding to the "Magnificent-Seven", most of the Fund's active global equity managers outperformed the benchmark returns this quarter. The exceptions to this were the Fund's global active value manager, Schroders, and the global thematic equity manager, Sarasin.

5.5 The increase in the global equity valuations meant that the equity protection program decreased by £195m during the quarter.

5.6 The ***Fixed income*** managers all outperformed during the quarter to 31 December 2023, amidst shifting market dynamics. All four managers outperformed their benchmarks, with GSAM having the highest outperformance with a return of 6.05% vs the benchmark return of 0.86%. This notable performance occurred against a backdrop of sharp declines in 10-year global government bond yields, which are attributed to the lower-than-expected inflation figures, as well as dovish stances seen from the central banks. UK real yields also experienced declines across the yield curve, again influenced by inflation data as well as the expectation of interest rate cuts. Additionally, spreads on UK investment grade credit tightened over the quarter, which is a factor in the strong performance seen from the Fund's fixed income managers.

5.7 ***Property*** returns continued to decline during the quarter and the Fund's property managers lagged the benchmark return of -1.35% except for the DTZ-(previously Kames/Aegon) managed Active Value fund which is in wind down stage and managed to release higher than book value on some disposals. The DTZ Fund achieved a slightly better return than the benchmark of -0.9% vs -1.16%.

5.8 Both ***absolute return*** managers benefitted from the rally in bond and equities and outperformed the RPI linked benchmark of 1.3% during the quarter, with the ***private equity*** mandate also benefitting from improved valuations this quarter.

6. Longer term performance

6.1 For the year ended December 2023, the Fund achieved a return of 2.98% against a benchmark return of 8.65%, an underperformance of 5.67%.

6.2 Against a backdrop of gradual disinflation and renewed expectations of interest rate cuts, bonds have performed well over 2023. 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 12.45% against a benchmark of 4.66%.

6.3 Despite strong returns from fixed income managers over the year, performance has lagged on a total Fund level. This has been mainly caused by relative underperformance from each of the Fund's equity managers, with the exception of Baillie Gifford who produced a 1-year return of 14.56% vs the benchmark of 13.26%. 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 mainly driven the rally in the global equities. The equity protection also had a negative impact on the Fund returns.

6.4 Moreover, the absolute return mandates largely underperformed versus the benchmark with Ruffer detracting significantly after trailing the benchmark by 16.72%. Property as an asset class has had a challenging year with a benchmark return of -0.51% and Fund's property managers lagged the benchmark, except for DTZ which returned 1.08% over the year.

6.5 For the three-year period, the Fund achieved a return of 2.47% compared to its strategic benchmark of 6.12%, an underperformance of 3.65%.

6.6 Benchmark equity returns have been strong during the three-year period with UK and Global equity indices returning 9.18% and 8.24% respectively, and value style investments leading the rally. Unsurprisingly during the three-year period, the Fund's value managers Schroders and M&G have outperformed the benchmark with 11.09% and 9.37% returns, respectively whilst the Fund's growth manager Baillie Gifford significantly underperformed with -7.48% against a regional benchmark return of 7.19%.

6.7 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.

6.8 The alternative investment 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 13.66% in this prolonged period of high inflation.

7. Responsible Investment Update

7.1 The Responsible Investment Working Group (RIWG) met on 24 November 2023. A further meeting is scheduled for 6 March 2024.

7.2 As previously reported to the Board, a key workstream for the Committee during 2023 has been investigating the feasibility of setting a net zero commitment. At its meeting on 24 November, the RIWG were presented with the results of the *Analytics for Climate Transition* assessment, carried out by the Investment Consultant, Mercer on behalf of the Fund. The analysis explored the feasibility of setting a net zero commitment and contained proposals around a suitable net zero commitment for the Fund. Members considered the proposals ahead of the Pension Fund Committee on 12 December 2023.

7.3 At its December meeting, the Committee subsequently approved a net zero commitment for the Fund which is summarised as follows:

a) Adopt a Net Zero target of 2050;
b) Adopt the IPCC decarbonisation curve;
    a. Adopt equity portfolio decarbonisation targets of a 43% reduction by 2030 and a 69% reduction by 2040 in line with the 2022 IPCC Curve
    b. Engage with fixed income managers to understand feasibility of climate targets, working towards target setting for this allocation;
c) Adopt a 15% target in sustainable assets by 2030 (including climate solutions).

7.4 It is important to note that these recommendations have been developed to take account of the Fund's specific circumstances and the transition potential of the current investment portfolio, and in such a way that they are **realisable**. A net zero target of 2050 provides the opportunity to effect real world change whilst also ensuring the policy is investable today and without sacrificing the Fund's capacity to achieve sufficient diversification within its portfolio.

7.5 The use of interim targets and the adoption of the Intergovernmental Panel on Climate Change's (IPCC) decarbonisation curve is critical as it increases the **credibility** of the Fund's strategy. By committing to shorter term goals alongside a long term, headline net zero target, the Committee signals to its stakeholders that it is serious about its ambition.

7.6 The adoption of the IPCC decarbonisation curve also provides an effective tool to be used in the Fund's future stewardship activities. In order to achieve its ambitions, the Fund will require the support of its appointed asset managers. The decarbonisation curve provides a basis for engaging and evaluating existing and potential asset managers' performance. Moreover, the adoption of a 15% target in sustainable assets enables the Fund to direct capital to investment opportunities that both will benefit from the transition and enable it (i.e., climate solutions). Taken together these observations show that the proposals have the potential to be **impactful**.

7.7 Finally, the commitment is **ambitious**. In targeting a net zero date consistent with IPCC targets, the Fund is aligning itself with global efforts to enact the transition to a low carbon economy that aims to keep temperature rises within sustainable levels.

7.8 Following their adoption, the net commitment was published on the Fund's website. The Fund will undertake a formal review of its target on at least a five yearly basis.

7.9 The Committee held an informal meeting on 22 March 2024, which focused on strategy development with respect to investment activity, and in particular responsible investment. The core agenda item for the day was a review of the Fund's current responsible investment beliefs, facilitated by specialists Pensions for Purpose. The session used the UN Sustainable Development Goals as a framework for identifying responsible investment priorities. The initial results identified that climate and nature and clean energy were particularly relevant to the Fund's investment strategy going forwards but also that the themes of affordable housing, education and responsible consumption warranted further investigation. Officers will consider how to use the results to inform the Committee's workplan, ensuring consistency with the Committee's fiduciary duties.

7.10 At its meeting on 6 March 2024, the RIWG will consider updates to the Fund's RI policy and the draft RI workplan for 2024/25. The current RI policy was established in 2020 since when the Committee's activity in this area has progressed significantly (not least due to the recent net zero commitment).

Appendices

Appendix 1 – Investment Strategy Statement

Appendix 2 – Quarterly Performance Report (31 December 2023)

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