STRATEGIC ASSET ALLOCATION IMPLEMENTATION

Report by Director Finance & Corporate Governance

JOINT MEETING OF PENSION FUND COMMITTEE AND PENSION FUND BOARD

14 December 2021

1 PURPOSE AND SUMMARY

1.1 **The purpose of this report is to provide the Committee and Board with an update on the implementation of the revised strategic asset allocation approved on 10 June 2021.**

1.2 Following the 2020 triennial valuation a review of the strategic asset allocation was undertaken by Isio, the Fund's investment advisor. The recommendations from the review were approved by Committee on 10 June 2021. Delegated authority was given to the Director of Finance & Corporate Governance to implement the revised allocation.

1.3 The 30% allocation to Active equites included a detailed split between managers and funds. Further discussion with Baillie Gifford highlighted ESG changes to the UK Fund which will allow the Fund to maintain its UK positions and still meet the ESG aspirations of the Fund, whilst avoiding transition costs. It is therefore proposed the detailed split if revised to the allocations shown in para 4.3

1.4 Good progress has been made in private credit, passive equites and long lease property since the strategy was approved in June. Further work is also underway with the completion of the Infrastructure procurement and agreement on the type of residential property investment.

2 RECOMMENDATIONS

2.1 **It is recommended that the Pension Fund Committee:-**

(a) Note the progress made to date on the implementation of the revised strategic asset allocation

(b) Agree the revised strategic asset allocation for active equities as detailed in para 4.3 and;

(c) Delegate authority to Director Finance & Corporate Governance, in consultation with the Chair of the Pension Fund Committee, and based on advice of the Investment Advisor to undertake a procurement exercise for a Residential Property manager.

3 BACKGROUND

3.1 The Pension Fund is required by the Local Government Pension Scheme (LGPS) Regulations to have an up-to-date Statement of Investment Principles (SIP). A key part of the SIP is the strategic asset allocation which sets the allocation of investments across the different asset classes.

3.2 The primary aim of the Fund is "To provide for members' pension and lump sum benefits on their retirement or for their dependants' benefits on death before or after retirement, on a defined benefits basis". To meet this aim the Pension Fund must ensure it sets levels of contributions that will build up a fund of assets sufficient to meet all future benefit payments.

3.3 The Fund while setting the contributions rates aims to ensure the rates payable by employers are as stable as possible. To reduce the volatility of contribution rates the Fund must ensure there is stability and the required level of returns from the investments.

3.4 Following the 2020 triennial valuation a reviewed was undertaken of the strategic asset allocation. The revised asset allocation was approved on 10 June 2021. Delegated authority was given to the Director of Finance & Corporate Governance to progress the implementation.

4 IMPLENTATION UPDATE

4.1 The table below details the approved allocation and the required movements from the previous strategic asset allocation.

Asset Group	Previous Allocation	Revised Allocation	Move-ment
Passive Equities	6%	10%	4%
Active Equities	34%	30%	(4%)
Total Equities	**40%**	**40%**	**-**
Diversified Alternatives	7.5%	4%	(3.5%)
Diversified Credit	10%	10%	-
Index Linked Gilts	5%	6%	1%
Direct Lending/Private Credit	10%	10%	-
Junior Infrastructure Debt	2.5%	2.5%	-
Senior Infrastructure Debt	5%	5%	-
Property - Balanced	5%	-	(5%)
Property – Long Lease	10%	12%	2%
Property – Residential		2.5%	2.5%
Infrastructure Equity	5%	8%	3%

4.2 The investments held with UBS in the UK Passive Equity have been fully disinvested and the procurement to replace this with an ESG focused passive mandate has been completed with the Committee approving the appointment of LGIM on 16 September 2021. The required "on boarding" has been completed and funds will be drawn down in December/January.

4.3 The review also refined the breakdown of the Active Equities allocation. Further discussions in relation to the implementation of the new equity portfolio were held. These discussions were specifically in relation to the Baillie Gifford UK Equity mandate. Since the initial decision was made to terminate the UK Alpha mandate, Baillie Gifford have announced that they are now planning to align the UK Alpha strategy with the objectives of the Paris Agreement (in line with the approach already used for their Global Alpha strategy). This development would serve to increase the ESG credentials of the Fund without the need to switch the existing holdings to the Baillie Gifford Positive Change strategy thereby removing any potential transaction costs which could be incurred as part of the implementation. The outlook for UK equities (vs global equities) was also discussed, given the attractive valuations which UK equities offer relative to the rest of the world. As a result of these discussions a revised target equity portfolio for implementation is proposed and is detailed in the table below.

Fund	Original	Revised	Proposal
Baillie Gifford UK Alpha	4%		4%
Baillie Gifford Global Alpha	18%		
Morgan Stanley Global Sustain	12%	13%	13%
Baillie Gifford Positive Change		2%	
Baillie Gifford Global Alpha Paris Aligned		15%	13%
	34%	30%	30%

4.4 The Baillie Gifford active global fund has been fully transitioned into the "Paris Aligned Global Equity Fund" which further enhances the Funds' ESG credentials.

4.5 Instructions have now been submitted to reduce the current investment in diversified alternatives with LGT. The first tranche of these funds will be returned on 1st April 2022.

4.6 Due to the maturing nature of the investments held in direct lending/private credit mandates, and the requirement to maintain the allocation at 10%, the Pension Fund has committed to a further two investments with existing managers Partners Group and Permira. All on boarding documents have been completed and the first drawdown of £5.2m from Partners Group occurred on 21 July 2021.

4.7 The balanced property fund with UBS is in the process of being fully disinvested. Following a number of meetings with UBS instructions where issued to sell the Pension Funds holdings on secondary market by 26th April, expect for one holding which will be retained until Q3 2022 in an attempt to maximise the sale proceeds realised. UBS have commenced the sale and have currently returned 26% of the funds.

4.8 The approved 2% increase in Long Lease property has been fully implemented. A secondary opportunity was highlighted by Blackrock which fully met the value to the additional investment approved. The Fund agreed to purchase the full secondary opportunity which has resulted in the full additional allocation being funded and a small element for future growth of the overall Fund.

4.9 Residential Property is a new asset class for the Fund with an approved allocation of 2.5%. Training was provided to the Investment and Performance Sub Committee on 27th September covering the characteristics and opportunities within the residential area. Following this training it is recommended the Fund focus the Residential allocation in the Affordable Rented or Socially focussed areas. These will provide high inflation linkage, limited exposure to house prices, together with a high ESG impact. Isio will be produce a shortlist of prospective managers to present to the Appointment Sub Committee. The outcome of this will be presented to the Committee in March.

4.10 A procurement exercise has also been undertaken to appoint a manager for the additional 3% allocation to infrastructure. The outcome of the procurement exercise is detailed in a separate report.

5 IMPLICATIONS

5.1 Financial

(a) The revised asset allocation will require the establishment of new portfolios within the Fund. To minimise the costs of procurement Officers in conjunction with the Investment Advisor will investigate the use of existing Managers where possible.

(b) The procurement exercise for residential property will take place during Q1 2022 with Isio providing a short list of managers. The cost of the exercise will be £18,000 and will be fully funded by the Pension Fund.

5.2 Risk and Mitigations

(a) The Fund is becoming more mature as the number of deferred and retired members now exceeds those currently contributing. This has resulted in a negative fund cash flow as the monthly payments to Pensioners are now greater than the contributions collected through payroll. The Fund therefore needs to generate more liquid cash in order to pay pensioners and the current arrangements, whereby dividends are directly reinvested back into the portfolios. The mix of investments required to meet the funds cash flow obligations requires to be kept under review to ensure the Fund generates the monthly cash income required by the Fund to allow payment of pensioners.

(b) The terms of the scheme allow for annual inflation linked increases in pension payments. There is a risk that this may result in increased liabilities which outstrip any the future growth in investments. To mitigate this risk the investments require to be diversified into assets which match the inflationary growth in liabilities in the best way possible.

(c) In line with the corporate risk management approach, the Pension Fund maintains a full risk register which is fully reviewed on an annual basis and reports are submitted to the Joint Pension Fund Committee and Board on a quarterly basis updates on ongoing

mitigation actions. Any new risks identified are added to the risk register on an ongoing basis.

5.3 **Integrated Impact Assessment**
There is no impact or relevance to Equality Duty or the Fairer Scotland Duty for this report. This is routine good governance required under the Local Government Pension Scheme (Governance) (Scotland) Regulations 2014. Nevertheless, a light touch assessment has been conducted and this will be published on SBC's Equality and Diversity Pages of the website to demonstrate that equality, diversity and socio –economic factors have duly been considered when preparing this report.

5.4 **Sustainable Development Goals**
The implementation of the revised strategic asset allocation and the Funds Responsible Investment Policy, will further strengthen the Funds commitment to sustainable investment.

5.5 **Climate Change**
The implementation of the revised strategic asset allocation and the Funds Responsible Investment Policy, will further strengthen the Funds commitment to climate change.

5.6 **Rural Proofing**
It is anticipated there will be no adverse impact on the rural area from the contents of this report.

5.7 **Data Protection Impact Statement**
There are no personal data implications arising from the proposals contained in this report.

5.8 **Changes to Scheme of Administration or Scheme of Delegation**
No changes are required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer/Chief Legal Officer, the Chief Officer Audit and Risk, the Director (People Performance & Change), the Clerk to the Council and Corporate Communications and any comments received will need to be incorporated into the final report.

Approved by

David Robertson **Signature .....**
Director, Finance and Corporate Governance

Author(s)

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Background Papers:
Previous Minute Reference: Pension Fund Committee and Pension Fund Board, 10 June 2021.

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Pension & Investment Team can also give information on other language translations as well as providing additional copies.

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