TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 8

TEESSIDE PENSION BOARD REPORT

8 FEBRUARY 2021

DIRECTOR OF FINANCE – IAN WRIGHT

Asset allocation progress update

1. PURPOSE OF THE REPORT

1.1 To present Members of the Teesside Pension Board (the Board) with information on how the Pension Fund is progressing towards its long term strategic asset allocation.

2. RECOMMENDATION

2.1 That Board Members note this report.

3. FINANCIAL IMPLICATIONS

3.1 There are no specific financial implications arising from this report.

4. BACKGROUND

4.1 The Pension Fund's target strategic asset allocation is set out in its Investment Strategy Statement which was last updated in February 2019. The following table shows the strategic asset allocation alongside the actual allocation of the fund at the end of the quarter the allocation was published (31 March 2019) and at the latest date reported to the Pension Fund Committee (30 September 2020):

Asset Class	Target Strategic Allocation	Maximum	Minimum	As at 31.03.2019	As at 30.09.2020
GROWTH ASSETS		**98%**	**60%**	**86.7%**	**89.2%**
UK Equities	**22%**	80%	40%	30.2%	26.8%
Global Equities	**28%**			45.3%	47.7%
Property and Property Debt	**15%**	20%	10%	8.6%	7.8%
Alternatives	**15%**	20%	10%	2.6%	6.8%
PROTECTION ASSETS		**40%**	**2%**	**13.3%**	**10.9%**
Bonds	**18%**	40%	2%	0%	0%
Cash	**2%**			13.3%	10.9%
Total Fund value				£4,084m	£4,084m

4.2 The Investment Strategy Statement highlights that the target allocation is a long term goal, and that while bonds continue to be viewed as expensive, the allocation to equities is likely to be towards the high end of the range:

` “Note this target allocation will take time to implement, in particular the allocation to alternatives may remain underweight for some time, owing to the timescale typically involved in investing efficiently in this asset class. Also, the allocation to bonds is only likely to be implemented once this asset class is appropriately priced. In the meantime it is likely that the Fund’s equity allocation will be above target.”

4.3 The Board asked at its previous meeting for further information on why it was taking a long time to implement the agreed allocation. For instance, the Fund’s overall allocation to equities has only reduced by one percent of the overall Fund value between 31.03.2019 and 30.09.2020 (from 75.5% to 74.5%) while there has been a larger fall in the amount allocated to protection assets – a drop of 2.4% of Fund value between the same two dates.

5. ASSET ALLOCATION APPROACH

5.1 The Pension Fund Committee sets the overall asset allocation based on recommendations from officers and advisors. The practical implementation is delegated to officers, with the advisors providing market updates every quarter to the Committee to inform decision-making on short-term and longer-term asset allocation.

5.2 Over the two years since the Fund moved to its current strategic asset allocation, the Fund’s advisors have consistently cautioned against investing in bonds whilst acknowledging that while the Fund remains relatively well funded, it would make sense to reduce the equity allocation to take some volatility out of the portfolio. However, other liquid return-seeking assets are not particularly attractive and investment in some categories of private market investments is seen as a better alternative. Property offers some risks and opportunities, and holding cash can potentially reduce risk in the short term. This stance is epitomised in the following extract from Peter Moon's report to the December Committee:

"Stock markets are clearly not looking absolutely cheap at current valuation levels. If we get downward earnings revisions they will start to look expensive. This puts us in an invidious position, because in quoted markets, equities look to be the only game in town. Given the explosion in government debt worldwide investors could be considered certifiably insane if they start committing large amounts of cash for this area. The pricing of debt is incredibly generous to governments and this has had a knock on impact on most bond and credit markets.

There will be major changes in the property sector as discussed above. This uncertainty could cause an increase in yields across the whole market. The certainty is that there will be marked relative yield changes between sectors of the market. This should mean that we find attractive opportunities within property. The difficulty might be in restructuring the portfolio efficiently as sales may well be problematic.

Within alternative investments there are likely to be products arriving which will be attractive especially in this low interest rate high liquidity environment. The increasing size and diversity of this area should enable us to invest more at attractive rates of return.

The lack of attractive investment alternatives has increased the viability of cash as an asset despite its zero return. Its abundance might put one off as an investor however."

5.3 For some time now the Fund's investment team has been working on increasing the allocation to illiquid 'alternative' investments - private equity, infrastructure, other alternatives, in order to match the long term strategic allocations to these investments. This process began before Border to Coast had developed a programme of alternative investments and involves a combination of money allocated directly to fund managers, and money allocated to Border to Coast for the pooling company to invest via fund managers it has selected.

5.4 Investing money in alternatives typically takes longer than investing in more liquid investments – the process involves deciding how much to commit to a manager, waiting for that manager to draw down that commitment (usually in stages, as the manager finds suitable investment opportunities) and receiving money back from the manager (distributions) as those investments are ultimately completed or sold. Depending on the type of investment, the investment process can take a number of years and usually by the time all the committed capital is being put to work by the manager some of it has started to be returned to the investor as early projects are completed.

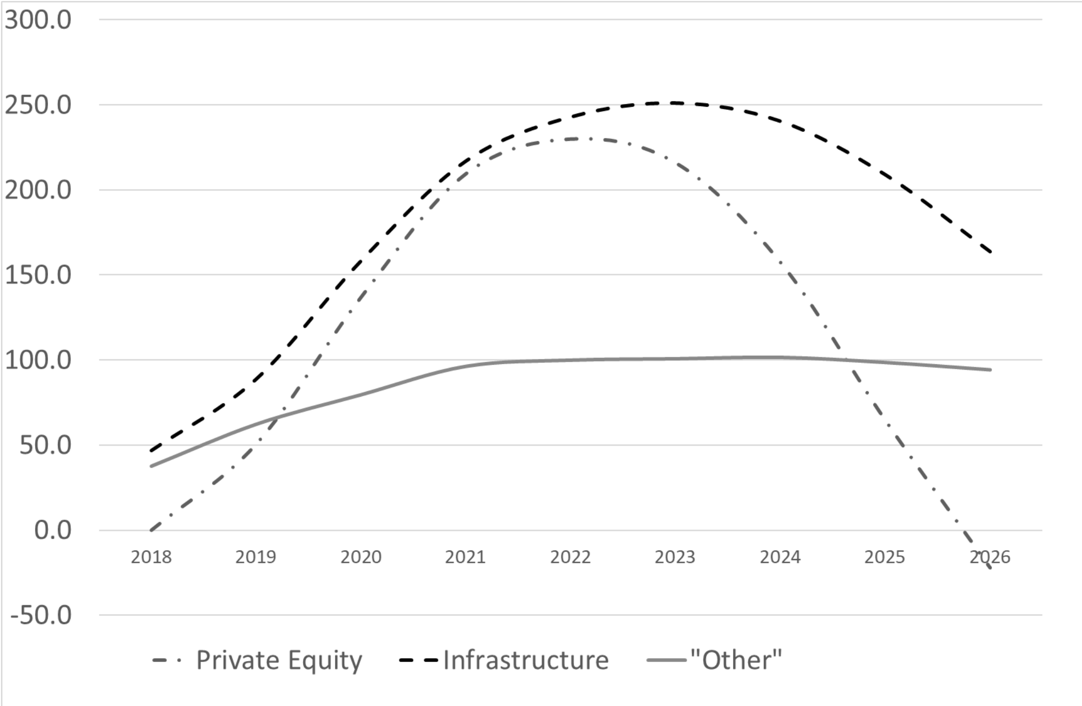
5.5 Over the 18 month period shown in the table in paragraph 4.1 above, investments in alternatives increased from 2.6% to 6.8% of the Fund. Although this is still less than half the 15% target allocation, it represents considerable progress given the necessarily slow pace of investment into this asset class. As at 30 September 2020 total ***commitments*** to private equity, infrastructure and other alternatives were approaching £900m, or more than 21% of the Fund's value at that time, split as follows:

	Total committed	Total draw down at 30/09/20
Border to Coast infrastructure (2019/20 and 2020/21):	£150m	£16m
Other infrastructure managers:	£198m	£100m
Border to Coast private equity (2019/20 and 2020/21):	£150m	£11m
Other private equity managers:	£305m	£93m
Other alternatives (various managers):	£75m	£70m
Totals	£878m	£290m

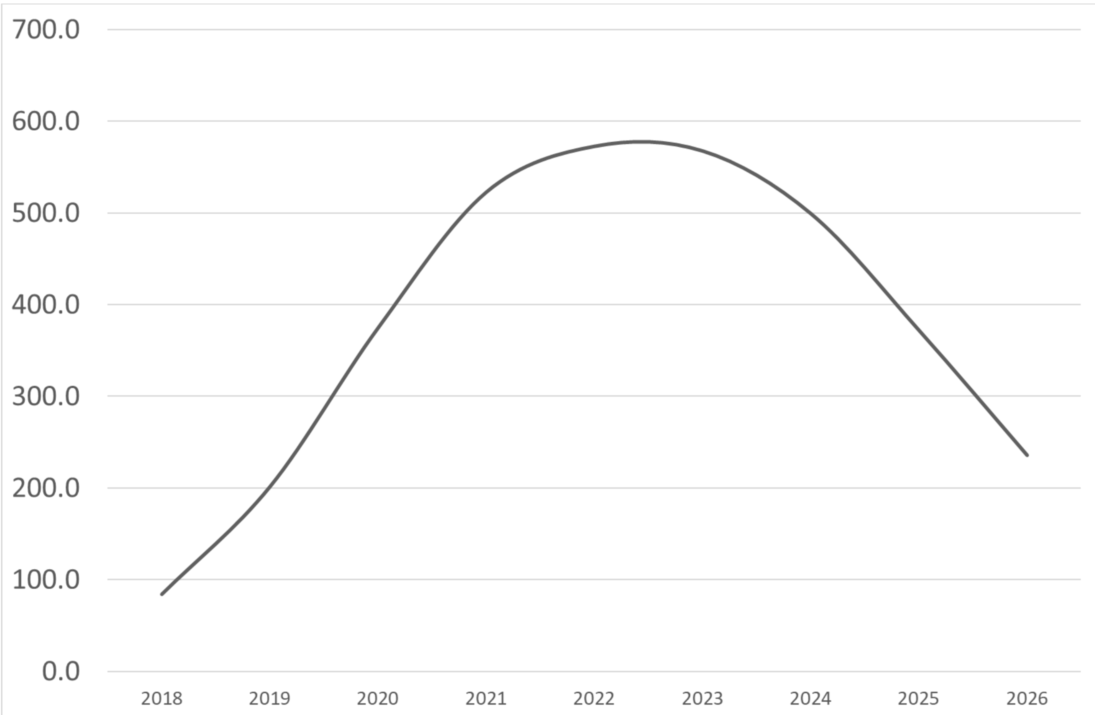
However, only around a third of this money had been drawn down and ***invested*** by managers at that point, and a proportion of this had been paid back in distributions.

5.6 Building and maintaining an illiquid investment portfolio takes time and also usually requires commitments in excess of the desired portfolio allocation. To illustrate this point, the following two graphs give an approximate indication of how the amount the Fund has invested in alternative asset classes is expected to fluctuate over coming years. Note, these graphs do not take into account future investment commitments that are likely to be made – in practice the Fund will make additional commitments in future to prevent the drop in allocation to alternatives in future years shown in these graphs. Also, various broad assumptions have been made about the pace at which managers will draw down and distribute capital which are unlikely to be completely accurate.

Graph A: Estimated investment in alternatives by asset class over time (assuming no further commitments are made)



Graph B: Estimated total investment in alternatives over time (assuming no further commitments are made)



5.7 The investment team continues to work with the Fund’s advisors and managers to ensure the required allocation to alternatives can be built and maintained in an effective and efficient manner.

5.8 The Fund’s allocation to property / property debt has reduced over the 18 month period in paragraph 4.1. This is due to a number of factors:

- The value of the Fund’s indirect and direct property portfolio has been adversely affected by the impact of the global pandemic and subsequent market conditions.
- The Fund has not been able to source and acquire additional property assets for its portfolio, although we continue to work with our property manager to locate suitable additional property assets for the Fund.
- Initial investigations into possible property debt investments were put on hold in March last year while the market was turbulent and unclear. This work will recommence and the investment team will continue to consider potential property debt investment options.

6. NEXT STEPS

6.1 Officers have been working with the Fund’s investment advisors to review the strategic asset allocation, as William Bourne pointed out in his report to the December Committee: “The independent advisors are reviewing the Strategic Asset Allocation set in 2018 with Officers, and a paper on this will be brought to the March 2021 meeting.”

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