TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 8

PENSION FUND COMMITTEE REPORT

10 MARCH 2021

DIRECTOR OF FINANCE – IAN WRIGHT

Strategic Asset Allocation Update

1. PURPOSE OF THE REPORT

1.1 To ask Members to agree to a revision to the Pension Fund's strategic asset allocation and that a short consultation should be carried out with employers in the Fund to explain the purpose of the proposed changes.

2. RECOMMENDATION

2.1 That Members note this report, agree to the revised asset allocation set out in paragraph 6.4 and agree that a revised Investment Strategy Statement (ISS) including the updated asset allocation should be circulated to Pension Fund employers for comment. Any substantive changes agreed to the revised ISS following the consultation will be brought to the next Committee meeting, but if there are no such changes the ISS will be published in due course.

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 Pension Fund at the end of the quarter the allocation was published (31 March 2019) and at the end of the last quarter (31 December 2020):

Asset Class	Target Strategic Allocation	Maximum	Minimum	As at 31.03.2019	As at 31.12.2020
GROWTH ASSETS		**98%**	**60%**	**86.7%**	**90.7%**
UK Equities	**22%**	80%	40%	30.2%	28.1%
Global Equities	**28%**			45.3%	48.9%
Property and Property Debt	**15%**	20%	10%	8.6%	7.6%
Alternatives	**15%**	20%	10%	2.6%	7.1%
PROTECTION ASSETS		**40%**	**2%**	**13.3%**	**8.3%**
Bonds	**18%**	40%	2%	0%	0%
Cash	**2%**			13.3%	8.3%
Total Pension Fund value				£4,084m	£4,385m

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 However, while the Pension Fund remains heavily invested in equities its assets are subject to significant volatility. While this can be tolerated to a certain extent given the Pension Fund’s long investment time horizon, this volatility can cause issues for the Pension Fund’s employers if the triennial valuation coincides with a low point in valuations.

4.4 As an indication of this volatility, the graph on the following page shows the actuary’s assessment of how the funding level of the Fund has change over the period since the effective date of the last valuation (31 March 2019). There is also a graphic showing how the estimated surplus will have fluctuated. Some of this variation is a consequence of movements in asset values (principally equity values) and some is due to a change in the actuary’s views on future long term investment returns (the actuary is now more pessimistic on this). Note, this funding level update is very much an estimate - see the “Method” notes on the page following the graph for more details of the assumptions used.

Change to funding level since the valuation at 31 March 2019

Funding level at 31 Dec 2020
111%

Funding level at 30 Sep 2020
105%

Funding level at 31 Mar 2019
115%

Surplus at 31 Dec 2020
£430M

Surplus at 30 Sep 2020
£187.8M

Surplus at 31 Mar 2019
£527.3M

See notes on method overleaf

Method

- This funding update is consistent with the calculations for the formal actuarial valuation as at 31 March 2019. The assumptions used have been modified only insofar as is necessary to maintain consistency with the approach set out in the latest Funding Strategy Statement, reflecting the change in the effective date and in relevant market conditions.
- The funding update is projected from the results of the formal actuarial valuation as at 31 March 2019 and is therefore approximate. Since the update is not based on up-to-date membership data, it becomes more approximate the longer the period of time that has elapsed since the last actuarial valuation.
- The funding update takes account of the following over the period since the last formal actuarial valuation:
  - Cashflows into and out of the Fund estimated based on the 2019 valuation results;
  - Actual price inflation and its impact on benefit increases.
- Demographic experience since the last formal actuarial valuation has been assumed to be in line with the assumptions set out in the 2019 Valuation Report.
- This update is designed to give a broad picture of the direction of funding changes since the actuarial valuation but does not have the same level of reliability as, and therefore does not replace the need for, formal actuarial valuations.
- It does not reflect any changes to assumptions which would be made if a full actuarial valuation were to be carried out to reflect, for example, changes to the investment strategy or economic outlook.
- For the purpose of this funding update, we have used an un-audited value of the assets as at 31 December 2020 provided by the Administering Authority
- The whole of fund total employer contribution rates shown in this funding update allow for the following:
  - a recovery period ending 31 March 2042 when in surplus and 31 March 2040 when in deficit;
  - a target funding level of 105% when in surplus.
- The assumptions used in this funding update are as follows:

	Discount rate	Pay growth	Pension increases
31 March 2019	4.45%	3.1%	2.1%
30 September 2020	4.30%	3.1%	2.1%
31 December 2020	4.30%	3.2%	2.2%

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 Pension Fund moved to its current strategic asset allocation, the Pension Fund's advisors have consistently cautioned against investing in bonds whilst acknowledging that while the Pension 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.

5.3 For some time now the Pension 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.

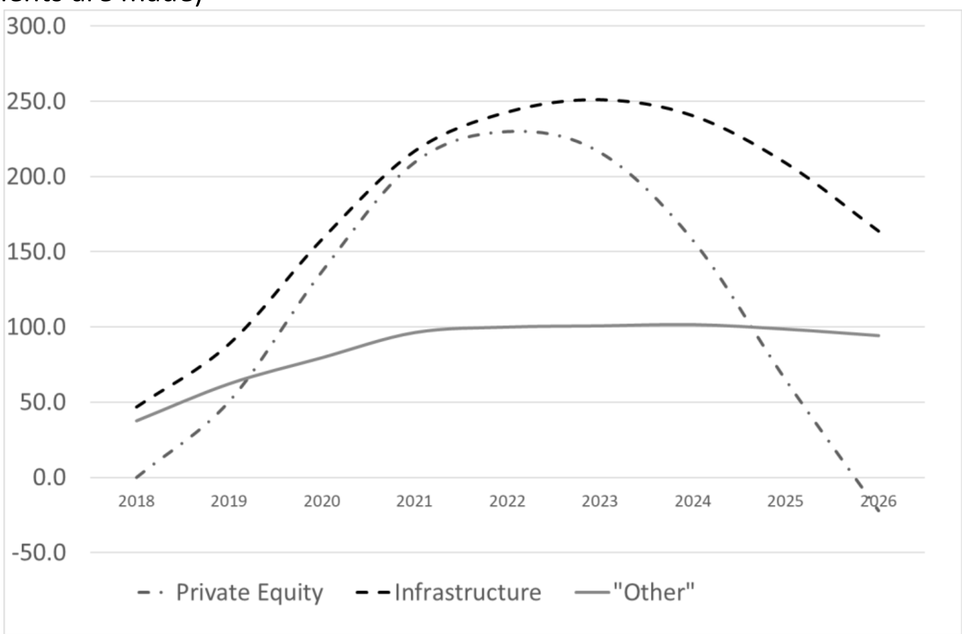
5.5 Over the 21 month period shown in the table in paragraph 4.1 above, investments in alternatives increased from 2.6% to 7.1% of the Pension Fund. Although this is still less than half the 15% target allocation, it represents considerable progress given the necessarily slow pace of investment into this asset class. As at 31 December 2020 total ***commitments*** to private equity, infrastructure and other alternatives were approaching £910m, or more than 20% of the Pension Fund's value at that time, split as follows:

	Total committed	Total draw down at 31/12/2020
Border to Coast infrastructure (2019/20 and 2020/21):	£150m	£21m
Other infrastructure managers:	£212m	£105m
Border to Coast private equity (2019/20 and 2020/21):	£150m	£15m
Other private equity managers:	£305m	£76m
Other alternatives (various managers):	£93m	£69m
Totals	£910m	£286m

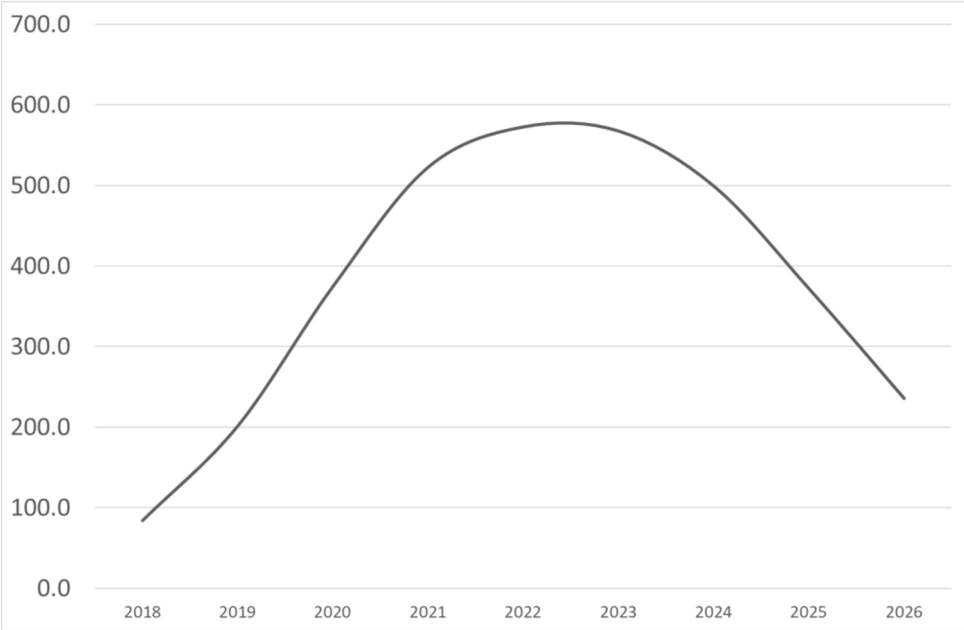
However, as is shown in the above table, only just under a third of this money had been drawn down and ***invested*** by managers at that point, and a proportion of this had been paid back in distributions.

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 Pension 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 Pension 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 Pension 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 Pension Fund's allocation to property / property debt has reduced over the 21 month period in paragraph 4.1. This is due to a number of factors:

- The value of the Pension Fund's indirect and direct property portfolio has been adversely affected by the impact of the global pandemic and subsequent market conditions.
- The Pension 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 Pension 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.

5.9 The issues set out above – the unattractiveness of bonds, the necessarily slow increase in investments in private equity, infrastructure and other alternatives, and the difficulty in significantly increasing the direct property portfolio, mean no progress has been made to date in reducing the Pension Fund's equity exposure. This is despite a phased sell-off of £125 million of US equities over the 15 months to 31 December 2020.

6. REVISED ASSET ALLOCATION

6.1 Officers have been working with the Pension Fund's investment advisors Peter Moon and William Bourne to review the strategic asset allocation, with a view to setting a long-term and a short / medium term target for asset allocation. The latter target will allow the Committee to judge more quickly whether appropriate progress is being made in reallocating the Pension Fund's assets.

6.2 The revised strategic asset allocation includes the following features:

- A significantly lower allocation to UK equities – this partly reflects the fact the UK market is increasingly concentrated on a number of sectors such as consumer staples, financials and commodities, meaning the market's performance is to some extent linked to the performance of those sectors. It also reflects a recognition that future growth may be limited in the UK compared to other global regions.
- A recognition that infrastructure investments can be classed as 'protection' rather than 'growth' assets – this acknowledges the long-term secure nature of the types of infrastructure the Pension Fund invests in.
- Property debt is also reclassified as part of 'other debt' as a 'protection' asset, and so separated from property which remains classified as a 'growth' asset.
- A short / medium term target of 65% equities by 31 March 2022. This may be challenging and will require careful implementation. The longer term equity target increases slightly from 50% to 55%.

6.3 The current strategic asset allocation is as follows:

Asset Class	Target Strategic Allocation	Maximum	Minimum
GROWTH ASSETS		**98%**	**60%**
UK Equities	**22%**	80%	40%
Global Equities	**28%**		
Property and Property Debt	**15%**	20%	10%
Alternatives	**15%**	20%	10%
PROTECTION ASSETS		**40%**	**2%**
Bonds	**18%**	40%	2%
Cash	**2%**		

6.4 This is the proposed revised strategic asset allocation:

Asset Class	Long Term Target Strategic Asset Allocation	31 March 2022 Target Strategic Asset Allocation
GROWTH ASSETS	75%	78%
UK Equities	**10%**	**12%**
Overseas Equities	**45%**	**53%**
Property	**10%**	**7%**
Private Equity	**5%**	**3%**
Other Alternatives	**5%**	**3%**
PROTECTION ASSETS	25%	22%
Bonds / Other debt / Cash	**15%**	**14%**
Infrastructure	**10%**	**8%**

7. NEXT STEPS

7.1 If Members agree to the proposed revised strategic asset allocation:

- The table in paragraph 6.4 will be incorporated into an updated ISS and circulated to Pension Fund employers for comment. Any substantive changes agreed to the revised ISS following the consultation will be brought to the next Committee meeting, but if there are no such changes the ISS will be published in due course.
- Officers will work to implement the revised strategic asset allocation and will report back to future Committee meetings on progress.

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