Pensions Committee

2.00pm, Wednesday, 24 June 2020

Annual Investment Update – Lothian Pension Fund

Item number 5.12

1. Recommendations

The Pensions Committee (Committee) is requested to:

1.1 note the asset allocation, investment performance and funding update of the Lothian Pension Fund.

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Annual Investment Update – Lothian Pension Fund

2. Executive Summary

2.1 This report provides an update on the investments and funding position of the Lothian Pension Fund to 31 March 2020.

2.2 Over the twelve months to 31 March 2020, investment market returns were mixed. Listed equities were notably weak as governments around the world took extreme measures to contain the developing pandemic - they lost a third of their value in less than four weeks towards the end of the financial year. Other assets were more resilient, particularly sovereign bonds. Global equities returned -6.7% to sterling-based investors while index-linked gilts, a good proxy for Fund liabilities, rose by 2.1% over the year.

2.3 The Fund aims to achieve a return in line with its strategic benchmark, over the long term, with a lower-than-benchmark level of risk. Over five years, the Fund has delivered returns slightly below the benchmark, but with lower risk, having returned +6.8% per annum compared with the benchmark +7.1% per annum (with ex-post risk of 7.3% for the Fund vs. benchmark risk of 8.0%). Over the year, the Fund returned –3.6%, which was behind the benchmark return by 3.4%, largely due to stock selection within portfolios, a reversal of last year's outcome.

2.4 Lothian Pension Fund's funding level (the ratio of assets to liabilities) was 98% at 31 March 2017. Although investment values have grown since then, liability values have grown faster as interest rates have fallen quite significantly due to the deflationary impact of the COVID-19 lockdowns. Hence, the overall funding level is expected to be lower at 31 March 2020. Preparations for the 2020 valuation are underway.

3. Background

3.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2020.

3.2 The investment performance of the Fund has a significant impact on the funding-level and potentially on the contributions required by employers.

3.3 The objective of the Fund's overall investment strategy is the achievement of the return assumed by the Actuary in excess of the gilt return that is consistent with acceptable and stable contribution rates. With such a return, it is expected that the Fund will be able to pay pensions as they fall due.

3.4 For reporting purposes, Fund assets are divided into five Policy Groups, which are broad asset classes that reflect the nature of the investments. Although individual investments within each group will have different risk and return characteristics, each Policy Group targets a long-term return in relation to the return from UK gilts. The return target provides perspective on the expected risk of each group in relation to Fund liabilities. These are detailed in the Statement of Investment Principles.

3.5 In order to provide suitable investment strategies for the differing requirements of employers, the Fund now operates four investment strategies. The assets in each strategy are shown in the table below. Employers fund their liabilities with the strategy that reflects their ability to tolerate risk.

Investment Strategy	Assets (£m)	Weight
Main Strategy	6,771	91%
Mature Employer Strategy	80	1%
50/50 Strategy	72	1%
Buses Strategy	519	7%
Total	7,442	100%

At end March 2020

3.6 Most employer liabilities are funded under the Main strategy, which adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. The strategy retains significant exposure to real investments, such as Equities and Infrastructure, which have a history of protecting or enhancing purchasing power over the long term.

3.7 A small number of employers are funded in the Mature Employer strategy (MEG), which invests in a portfolio of UK index-linked gilts and cash to reduce funding level and contribution rate risk as these employers approach exit from the Fund.

3.8 The 50/50 strategy enables another small group of less mature employers to fund liabilities with a 50/50 mix of the Main strategy and the Mature Employer strategy.

3.9 The Buses strategy was introduced on 31 January 2019 when the assets and liabilities of Lothian Buses Pension Fund were consolidated into the Lothian Pension Fund. It is the same strategy that the Lothian Buses Pension Fund followed previously (agreed by Committee in 2016) when it was managed as a separate Fund.

3.10 The four investment strategy allocations to the five Policy Groups at 31 March 2020 are presented in the table below.

Policy Group	Main Strategy	Mature Employer Strategy	50/50 Strategy	Buses Strategy
Equities	65%	0%	33%	35%
Real Assets	18%	0%	9%	18%
Non-Gilt Debt	10%	0%	5%	20%
Gilts	7%	100%	54%	28%
Cash	0%	0%	0%	0%
Total	**100%**	**100%**	**100%**	**100%**

Totals may not sum due to rounding

3.11 Asset-liability modelling undertaken at the time of the latest strategy review in 2018 showed that the allocation to Equities is by far the key determinant of investment risk and return. Based on the modelling, the Committee agreed to consider reducing the Equities allocation if funding levels increased significantly and work was carried out to identify appropriate triggers for such action. Any change to strategy would be implemented by changing allocations to the Main Strategy or the Buses Strategy. This is because the MEG Strategy is entirely invested in Gilts and the 50/50 Strategy is invested 50% in the Main Strategy and 50% in the MEG Strategy. There was no change to the Main Strategy during the year.

3.12 Any reduction in Equities requires a redistribution of allocations to other Policy Groups. Allocations to Real Assets, such as property and infrastructure, and Non- Gilt Debt, such as corporate bonds, are due to the attractive, long-term expected returns and/or the diversification they provide. The Equities allocation itself emphasises low risk equity exposure – it is specifically designed to provide downside protection in times of market stress while participating in some, though not necessarily all, of any upward movement. Committee should expect returns to deviate meaningfully from the benchmark over shorter time periods.

3.13 Implementation of the investment strategy is delegated to the Executive Director of Resources, who in turn delegates to the Head of Finance, who takes advice from the Joint Investment Strategy Panel (JISP), comprising independent advisers and senior officers from LPFI Limited, the Fund's FCA authorised investment vehicle. The JISP assesses the underlying risks and the long-term objectives of the Fund.

3.14 Over recent years, the expansion of the internal team, most recently with the addition of a property team to manage indirect and direct property assets, has increased the Fund's capability, improved the cost structure of the Fund and lead to the development and implementation of innovative and low-cost investment strategies to meet the significant funding challenges faced by the pension funds.

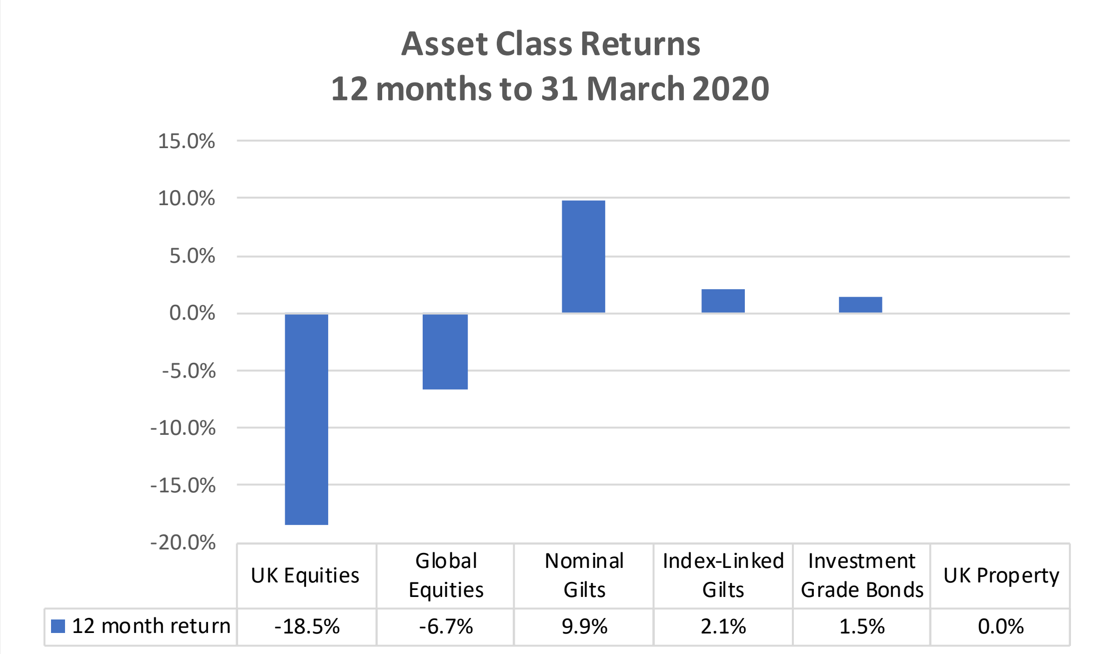
4. Main Report

Market background to 31 March 2020

4.1 For the 12 months to 31 March 2020, UK equities (FTSE All Share) returned -18.5% and global equities (MSCI ACWI in sterling) returned -6.7%. The fall in global equities for sterling-based investors was mitigated by a weaker pound (global equities returned -10% in local currency terms). Sterling had strengthened over 2019 as UK political uncertainty cleared with the election of a majority Conservative government in December. However, sterling then sold off sharply in March 2020 (along with equities) in response to the widening COVID-19 (coronavirus) pandemic. 12-month equity returns were dominated by the outsized moves in the first quarter of 2020 when UK and global equities (in sterling) returned -25.2% and -16.0%, respectively.

4.2 Government bond yields reached record lows in August 2019 as investors sought relative safety as recession fears mounted, in the process pushing the amount of negative yielding sovereign debt to an all-time high. However, the prospect of an initial trade agreement between the US and China buoyed equities, and bond yields rose during the fourth quarter of 2019. Equity markets continued to perform strongly into early 2020, seemingly discounting any major economic impact from the January coronavirus outbreak in China. As international outbreaks emerged in mid-February, volatility rose.

4.3 At the beginning of March, Russia and Saudi Arabia started an oil price war as negotiations on production cuts to offset declining demand broke down. Combined with the increasing spread of the coronavirus pandemic, risk assets sold off sharply through to mid-March and equity market volatility rose to its highest level in the last 30 years. The Bank of England, the US Federal Reserve and other central banks reduced their benchmark interest rates close to zero to support their economies through the ongoing crisis. UK and US government bond yields ended the year to 31 March 2020 near their all-time lows.



4.4 The speed and severity with which lockdowns have impacted economies has been plain to see. The economic record books are being rewritten. One example at the time of writing was the frightening change in US weekly initial unemployment claims, which surged from just over 200,000 at the beginning of March to almost 7 million in a single week, a figure that vastly exceeded the prior record of circa 700,000 during the global financial crisis of 2009. If the scale of the economic impact is staggering, so too is the scale of the monetary and fiscal stimulus that resulted. Fiscal measures alone have been estimated at circa 6% of global GDP. With the UK lockdown still in force at the time of writing, it remains to be seen whether the 30% rebound in equities since the mid-March lows is an overly optimistic reaction to declining numbers of COVID-19 cases or an accurate predictor of a brighter future. What seems certain is that economic resources will be allocated differently in the post-lockdown world.

Asset Allocation and Strategy Implementation

4.5 As described above, the overall Fund strategy is made up of four investment strategies. The strategic allocations, which are the weighted average of the four employer strategies, are shown in the table below along with the actual allocations.

Policy Group	Actual Allocation 31 March 2019	Actual Allocation 31 March 2020	Strategic Allocation 31 March 2019	Strategic Allocation 31 March 2020
Equities	59.9%	58.3%	62.3%	62.0%
Real Assets	19.8%	22.0%	17.7%	17.7%
Non-Gilt Debt	5.2%	7.8%	10.7%	10.5%
Gilts	9.1%	6.9%	9.3%	9.8%
Cash	5.9%	4.9%	0.0%	0.0%
Total	100%	100%	100%	100%

Note: numbers may not sum due to rounding

4.6 Over the year, the actual allocation in Equities has fallen slightly and remains below the strategic allocation. Initially, this was the result of income withdrawal from the three large, internally managed, global portfolios and income and capital distributions from private equity, which were held in cash. Latterly, the weighting to equities reduced as a result of the significant equity market correction during Q1 2020. The allocation to Real Assets has increased over the year as attractive investments have become available and, latterly, as valuation adjustments in private markets have lagged those in listed markets, where price discovery is much quicker as assets trade daily. A reduction in the allocation to Gilts was implemented as the government's intention to align RPI with CPI over the next few years will negatively impact the valuation of index-linked gilts, which are linked to RPI. The increase in Non-Gilt Debt reflects the intention to diversify the Fund into relatively low risk assets as market liquidity and valuations allow. The Cash weighting is available to invest when attractive investments become available in the other Policy Groups. The actual allocations lie comfortably within the permitted ranges defined in the Statement of Investment Principles (SIP).

4.7 The Fund implements strategy by allocating to several investment mandates across the five Policy Groups. Most assets are managed by Lothian's internal investment team, but external mandates are awarded where access to investments is not available to the internal team, for example in private markets where the Fund achieves investment exposure to assets such as infrastructure and timber through externally managed investment vehicles. The table below details the actual allocations to Policy Groups and investment mandates.

Policy Groups and Investment Mandates – 31 March 2019 and 31 March 2020

Policy Groups & Mandates	Manager	Actual Allocation 31 March 2019	Actual Allocation 31 March 2020
EQUITIES		**59.9%**	**58.3%**
Global Low Volatility	Internal	**16.0%**	**13.2%**
Global High Dividend Yield	Internal	**12.9%**	**13.7%**
Global Stable Multi-factor	Internal	**12.8%**	**12.1%**
Global Stable Equities	Nordea	**3.9%**	**3.9%**
Global Value	Harris	**3.6%**	**2.4%**
Global Alpha	Baillie Gifford	**1.6%**	**1.6%**
UK All Cap	Internal	**1.9%**	**2.9%**
UK Mid Cap	Internal	**1.6%**	**1.2%**
Europe (ex UK) Quality	Internal	**1.6%**	**2.7%**
US Value	Internal	**2.1%**	**2.7%**
Private Equity	Various	**2.0%**	**1.7%**
Currency Hedge	Internal	**0.0%**	**0.2%**
REAL ASSETS		**19.8%**	**22.0%**
Property	Various	**7.1%**	**7.4%**
Other Real Assets	Various	**12.8%**	**14.7%**
NON-GILT DEBT		**5.2%**	**7.8%**
Other Bonds	Various	**5.2%**	**7.8%**
GILTS		**9.1%**	**6.9%**
Index-linked Gilts	Internal	**9.1%**	**6.9%**
CASH		**5.9%**	**4.9%**
TOTAL FUND		**100.0%**	**100.0%**

Note: numbers may not sum due to rounding

Equities

4.8 A key objective of the Fund's investment strategy is to avoid unrewarded risk, and significant steps were taken more than 6 years ago to achieve this. The current equity strategy evolved by shifting from a regional to a global manager structure with a significant proportion of assets managed internally. The intention was to create relative stability appropriate to a long-term pension fund. The current equity investment strategy has remained broadly unchanged for several years now. With the structure of the equity exposure in more of a 'steady-state', there were no major changes over 2019/20.

4.9 The Equity policy group is expected to perform relatively well when equity markets are weak and produce good positive absolute returns in rising equity markets, whilst providing attractive levels of income.

4.10 None of the Fund's equity portfolios are constrained by market capitalisation indices, or the tracking error measurement of risk, which is regarded as a suboptimal approach to portfolio construction. Instead, the focus is on capital preservation and the sustainability of income generation. The Fund's independent performance measurer, Portfolio Evaluation, reports that the Fund's equity risk over the last 1, 3 and 5 years was between 88% and 91% of benchmark risk. Additionally, analysis of behaviour in rising and falling markets shows that the Fund's equities broadly underperform in a rising market and outperform in a falling market, in-line with strategy.

4.11 Almost 85% of the Fund's listed equities are managed internally with the majorityof these in low cost, low turnover strategies, which are expected to enhance the Fund's risk-adjusted returns over the long term.

4.12 The Fund also hedges exposures to the currencies of overseas listed equities with the explicit aim of reducing volatility rather than seeking to generate improved returns. The Fund therefore maintains exposure to currencies that are expected to reduce volatility, such as the US Dollar and Japanese Yen which tend to fall as equities rise, and hedges exposure to currencies that are expected to increase volatility, such as the Australian Dollar which tends to rise as equities rise.

4.13 Given the focus on risk reduction, new commitments to private equity investments were discontinued as they tend to be more volatile investments involving greater financial leverage. As historic investments mature, cash is being returned and the portfolio exposure reduced from 2.0% of the Fund at end March 2019 to 1.7% at end March 2020.

4.14 The internally managed global equity portfolios generate significant dividend income, which has been moved to cash in recent years to reduce the equity allocation, trading activity and transaction costs. This withdrawal amounted to approximately £130million during 2019/20, but with the equity allocation moving notably below target, cash was invested in equities on four occasions during the year, most recently in March 2020 to take advantage of extreme equity market weakness. The equity allocation remained slightly below the strategic target at 31 March 2020.

Real Assets

4.15 Over recent years, the Fund's strategy has been to increase the actual allocation to the Real Asset policy group, which includes investments in property, infrastructure and timber funds and assets. The long term and defensive nature of most of these assets provides an element of diversification to the overall investment strategy and the objective is to provide attractive risk-adjusted returns that are expected to be somewhat lower than listed equities over the long term. Most of these investments are unlisted and increasing exposure is dependent on sourcing attractive opportunities. The Fund's longstanding commitment to infrastructure investing has resulted in a large and diverse portfolio of Real Asset investments.

4.16 The Fund's actual allocation has increased slightly this year from 20% to 22%, which is largely attributable to the performance relative to equites rather than a net increase in investments. Property, infrastructure and timber asset returns were all better than those of listed equities, but it should be noted that there is typically a lag in valuation changes for unlisted investments.

4.17 During 2019/20, several investment opportunities were appraised, resulting in approximately £165m being invested in UK, European and global infrastructure assets. Commitments were made to eight secondary fund interests and three co-investments. Despite £187m of proceeds being distributed to the Fund over the year, including two very successful realisations, the exposure to infrastructure increased slightly to 13% from 11.3% of the Fund's investment value.

4.18 Likewise, the actual allocation to Property increased from 7.1% to 7.4% entirely due to relative movements in asset prices. The Fund made no new commercial real estate purchases but made one sale.

4.19 Despite the small change in the portfolio, there has been considerable activity relating to this asset class:

- a small team of property professionals was recruited to manage the commercial real estate portfolio, including both direct UK properties and indirect property investments;
- the direct UK property assets were transferred in-house;
- key service suppliers were appointed;
- several asset management initiatives were undertaken to reduce void exposure and secure income returns; and
- as many tenant's revenue streams disappeared overnight as a result of the COVID-19 lockdown, an unexpected challenge arose to determine the best long-term approach to managing the situation. There is, of course, considerable uncertainty about the impact on tenants' businesses, but some impact on Fund cash flows is reflected in valuations at the end of March 2020.

4.20 The smallest sub-category in the Real Assets policy group is timber. Valuations were relatively resilient, and with no new investments over the year, the investment value increased modestly from 1.6% to 1.7%.

Non-Gilt Debt

4.21 The Non-Gilt Debt allocation has been increasing in recent years as the Fund strives to improve diversification and secure returns in excess of gilt yields. The actual allocation was increased gradually over 2019/20 from 5.2% to 7.8% with additional commitments to private debt as well as the drawdown of existing commitments and new investments in investment grade corporate bonds. Given very low sovereign bond yields and historically low spreads in credit markets, the Fund remains below the long-term strategic allocation.

Gilts

4.22 The Fund's allocation to Gilts declined over the year, from 9% to 7%, which is below the long-term strategy target of 10%. The risk associated with index-linked gilts was raised by the UK government plans to align RPI with CPI between 2025 and 2030 – this would have a meaningful detrimental impact on future returns, which are already negative in real terms and expensive in an international context - yields are relatively low and inflation expectations relatively high. The Fund retains exposure as index-linked gilts do provide diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund's liabilities.

Unfunded Commitments

4.23 Across a number of policy groups, the Fund makes commitments to unlisted investments and the timing of these can be uncertain as it depends on the manager being able to purchase assets. Details of outstanding commitments at 31 March 2020 are shown in the table below. Unfunded commitments of £255m compares with £280m at 31 March 2019.

Unlisted Unfunded Commitments	£m	% of Fund assets
Private Equity	39	0.5%
Infrastructure	114	1.5%
Real Estate	2	0.0%
Private Debt	102	1.4%
Total Commitments	**255**	**3.4%**

Strategy Changes

4.24 In June 2019, the Committee agreed that the Buses Strategy should be adjusted in line with the investment strategy 2016-21 that it had approved for the Lothian Buses Pension Fund in 2016 and reconfirmed in 2018. The strategy changed the risk / return profile of the assets over a five-year period reflecting the fact that the liabilities of the employer are maturing. As the estimated funding level had improved more quickly than expected, the risk reduction was achieved during 2019/20 by reducing the equity allocation from 51.5% to 35% and increasing the allocation to gilts and non-gilt debt (see strategic targets in table above). No other strategy changes were made over the year.

Investment performance to 31 March 2020

4.25 The Fund's performance over the last year and over longer-term timeframes is presented in the table below, both relative to benchmark and with other relevant long-term measures - a liability proxy (over 15-year gilts index) and two inflation measures, the consumer price index (CPI) and average weekly earnings (AWE)

Unlisted Unfunded Commitments	£m	% of Fund assets
Private Equity	39	0.5%
Infrastructure	114	1.5%
Real Estate	2	0.0%
Private Debt	102	1.4%
Total Commitments	**255**	**3.4%**

4.26 The Fund return was relatively weak over the past year but remains broadly in line with its objective of meeting the strategic benchmark return over five- and ten-year periods with lower risk. It should be noted that the Fund is not expected to behave like the benchmark in the short term for two main reasons: portfolios are not constructed to track the market capitalisation benchmarks and private market assets are not suited to short term measurement. The liability proxy has been incredibly strong over the year as interest rates continued their multi-year decline, most recently influenced by the deflationary impact of lockdowns due to COVID-19. In contrast, UK CPI and AWE have grown at low and relatively stable rates for many years.

4.27 The Fund's focus on risk-adjusted returns and lower volatility has been broadly in place since 2013 involving a change in structure that included a greater focus on lower volatility equities. One way of assessing the success of the strategy is by measuring the direction of the Fund's performance when markets are increasing and decreasing. Over the period since the change in structure, the Fund's returns have been delivered with lower volatility than the benchmark.

4.28 From March 2015 to March 2020, the Fund performed:

- better than the strategic allocation when markets fell (19 out of 60 months) with average performance of 0.3% better than the strategic benchmark and,
- worse than the strategic allocation when markets were rising (41 out of 60 months) with average performance 0.2% behind the strategic benchmark, demonstrating that the Fund is positioned relatively defensively, in line with

strategy, and is generally expected to deliver outperformance when equity market returns are poor.

4.29 The returns from the Fund's broad asset class benchmarks over 1 and 5 years are as follows:

Policy Group	1 Year		5 Year	
	Fund	**Benchmark**	**Fund**	**Benchmark**
Equities	-9.7	-6.7	5.6	6.6
Real Assets	6.4	20.1	9.6	8.8
Non-Gilt Debt	3.7	1.6	5.4	4.0
Gilts	2.3	2.0	7.2	7.1
Total Fund Return	-3.6	-0.2	6.8	7.1
Total Fund Risk	12.1	12.2	7.3	8.0

4.30 While it is true that over recent years, the Fund's equities have typically provided good relative downside protection, performance over the last 12 months has been somewhat disappointing. The increasing dominance of a relatively small number of large, mainly US, information technology companies explains a large part of the difference. To illustrate: the 12-month market capitalisation benchmark total return in GBP was -6.7%. An equally weighted return for the same index of companies was -13.9%. That is to say that the average return of an index company was -13.9% (and the 5-year figure was +3.3% per annum). The outperformance of a few, highly valued growth companies is not unprecedented and could continue for some time, but history suggests that it will not last forever and that the temptation to chase yesterday's strongest performers should be avoided. Patience and a long-term focus are critical.

4.31 The Real Assets benchmark is also worthy of mention as it increased by over 20% in 2019/20. No major asset class produced as high a return. The benchmark reflects the long-term target for real assets of gilts +2.5% per annum, not a short-term target. The nominal gilts used as a benchmark benefited from the pandemic fear and uncertainty to the point that the prospective nominal return on a 10-year bond is now as low as 0.3% per annum.

4.32 Over the year to 31 March 2020, notable performance within each asset class was as follows:

- The Fund's equity investments, managed by the internal team and two external managers, combined to produce a return of -9.7% over the year, lagging the equity benchmark return of -6.7%. Relative strength over the 12-month period came from the Europe ex UK portfolio (+5.6%), private equity (+3.7%) and Baillie Gifford Global Alpha (-1.1%). The Nordea (-5.4%) and

GLOVE (-5.8%) portfolios also outperformed but to a lesser extent. This was offset by notably weak returns in the UK portfolios, where there was greater underlying market weakness with UK All Cap (-21.2%) and UK Mid Cap (-24.7%) experiencing sizeable declines, particularly during the Q1 2020 market selloff. From a global equity perspective, both SMuRV (-17.9%) and Harris (-19.5%) struggled as their exposure to the value style of investing was unhelpful.

- The Fund's currency hedge achieved its objective of reducing volatility of the Fund's equity returns, albeit modestly, over 2019/20.
- The Fund's Real Assets allocation returned +6.4% over the year. Returns from infrastructure limited partnerships (+11.1%), listed infrastructure (+9.1%) and timber & agriculture (+8.1%) were strong, while property returns (-1.5%) were slightly negative.
- The Fund's Non-Gilt Debt exposure produced a return of +3.7% over the year with the private debt allocation providing a more notable +6.1% return.
- The Fund's Index-Linked investments delivered a return of +2.3% over the year, broadly in line with benchmark as expected, with the holdings managed on a passive basis.

4.33 Returns relative to the benchmark over a one-year period need to be placed in the context that there are no ideal benchmarks for many of the assets held in the Fund, especially within the Real Assets policy group and more broadly across the various unlisted investments. The true value and returns on unlisted investments will not be known until assets are realised, perhaps not for several years.

Scrutiny & Transparency of Investments

4.34 Details of the Lothian Pension Fund's investments are reported regularly, both in Committee reports and in the Annual Report & Accounts, both of which are publicly available. The Fund is also subject to regular Freedom of Information requests to which it responds promptly. A complete list of holdings is also made available on the Fund's website.

Funding Level Update

4.35 The funding level is the ratio of the pension scheme's assets to liabilities. The most recent triennial actuarial valuation estimated the funding level at 31 March 2017 to be 98%. During the year, an interim liability estimate at 30 April 2019 was provided by the Fund actuary, resulting in an estimated funding level of 99%.

4.36 Since 30 April 2019, gilt yields have fallen sharply, increasing the valuation of the liabilities, though the increase has been partially offset by a decline in future inflation expectations (reducing the expected value of future liability payments). As asset values have fallen, the estimated funding level at 31 March 2020 is likely to be lower than the 30 April 2019 estimate and the 31 March 2017 valuation.

4.37 Work is currently underway on the formal 31 March 2020 valuation, which will incorporate the realised experience of the Fund (actual cashflows and member experience) and any changes to the financial and demographic assumptions used in the 2017 valuation.

Conclusions

4.38 Over the year, the Fund's strategic allocation to the different policy groups are broadly unchanged. The actual allocation to Equities, Gilts and Cash has fallen, while the allocations to real assets and non-gilt debt have increased, mostly due to relative market movements – equities were notably weak relative to other assets.

4.39 The equity allocation remained slightly below the strategic target at 31 March 2020 (-2%), with further underweight exposures to non-gilt debt (-3%) and gilts (-2%). Real asset (+2%) and cash (5%) were above strategic target. The allocations are all comfortably within permitted ranges. It should be noted that there is a normal lag with private market valuations and in the year of COVID-19, more than most, allocations may adjust slightly as the year progresses.

4.40 The most significant investment activity during the year were purchases of equities, most recently in March 2020 to take advantage of extreme equity market weakness; continuing purchases of infrastructure assets and purchases of non-gilt debt assets to further diversify the portfolio; and the sale of gilts reflecting the long term valuation impact of government plans to align RPI with CPI.

4.41 The absolute performance of Lothian Pension Fund over the twelve-month period was -3.6%. Five-year performance is +6.8% per annum. Over ten years, the Fund returned +8.1% per annum.

4.42 While the returns for the 12-month to end March 2020 are somewhat disappointing, longer term returns are positive and broadly in-line with strategy. Relative returns within equities are the main reason for the disappointing 12-month figures as the market capitalisation index return has significantly surpassed the performance of the average company.

4.43 At the 2017 triennial actuarial valuation, the funding level at 31 March 2017 was 98%. The estimated funding level at 31 March 2020 is lower than the 2017 valuation position. Work is currently underway on the formal 31 March 2020 valuation, which will incorporate the realised experience of the Fund (actual cash flows and member experiences) and any changes in financial or demographic assumptions used in the 2017 valuation.

5. Financial impact

5.1 The report details the investment performance and funding position of Lothian Pension Fund. The investment performance has a significant impact on the funding levels and potentially on the contributions required from employers.

6. Stakeholder/Regulatory Impact

6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.

6.2 There are no adverse governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

7.1 None.

8. Appendices

None.