Pensions Committee

2.00pm, Wednesday, 29 June 2022

Annual Investment Update – Lothian Pension Fund

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 2022.

2.2 Over the twelve months to 31 March 2022, the total Fund return was +10.8%, which compares with the benchmark return of +8.8%. Investment market returns were mixed over the period. UK equities and UK property delivered double digit gains, as did global listed equities, as measured by MSCI ACWI (in GBP), which rose by 12.4%, boosted by sterling weakness. Debt markets, including sovereign bonds and corporate bonds, registered small gains or single digit losses.

2.3 Lothian's predominantly lower risk equities performed well gaining 13.4%. The Fund's real asset investments performed even better returning 13.8% as the property assets delivered gains of over 20%. Weaker, but still better than benchmark, returns came from non-gilt debt assets, which rose 4.1%. The LDI category comprising gilts generated low single-digit returns, slightly below its benchmark – nominal gilt exposure detracted from returns.

2.4 The Fund aims to achieve a return broadly in line with its strategic benchmark, over the long term, with a lower-than-benchmark level of risk. Despite strength over the last twelve months, the Fund has delivered returns below the benchmark over the five-year period, which reflects a very strong period for higher risk assets, but with lower risk. It returned +6.5% per annum compared with the benchmark +8.6% per annum (with ex-post risk of 6.7% for the Fund vs. benchmark risk of 8.8%). Over ten years, the Fund has gained 9.7% per annum, lagging the benchmark gain of 10.0% per annum, but with lower risk (ex-post risk of 6.8% vs. 8.0%).

2.5 Lothian Pension Fund's funding level (the ratio of assets to liabilities) is formally assessed on a triennial basis, with the most recent figure of 106% at the March 2020 valuation. Based solely on the movements of the Fund's assets and a proxy for the Fund's liabilities, the funding level will have improved over two consecutive years to end March 2022 as the Fund's assets have increased in value while the liabilities are estimated to have declined in value due to rising rates. The next triennial valuation at 31 March 2023 will be undertaken during 2023 and concluded by 31 March 2024 at the latest.

3. Background

3.1 The purpose of the report is to provide an update on the investments of the Lothian Pension Fund to 31 March 2022.

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

3.3 The Fund's investment strategy was approved by the Pensions Committee in June 2021. The objective of the strategy is to achieve an investment return that the actuary prudently assumes will be consistent with acceptable and stable contribution rates. The expectation is that with such a return, the Fund will be able to pay pensions as they fall due.

Employer Strategies

3.4 To provide suitable investment strategies for the differing requirements of employers, the Fund 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.

Employer Group Strategies	Assets (£m)	Weight
Main Strategy	8,845	92.9%
Mature Employer Strategy	27	0.3%
50/50 Strategy	47	0.5%
Buses Strategy	606	6.4%
Total	9,525	100%

3.5 Most employer liabilities are funded under the Main strategy, which adopts a long-term investment strategy, aiming to generate an investment return that will minimise the cost to the employer within reasonable and considered risk parameters. 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.

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

3.7 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 MEG strategy.

3.8 The Buses strategy, which was introduced on 31 January 2019 when the assets and liabilities of Lothian Buses Pension Fund were consolidated into the Lothian Pension Fund, is a 55/45 mix of the Main Strategy and the MEG strategy.

Policy Groups

3.9 For reporting purposes, Fund strategy is 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.

3.10 The table below presents the policy group allocations of the four investment strategies at end March 2022 along with the total fund strategy, which is the weighted average of the four strategies.

Employer Strategies

Policy Groups	Main Strategy	Mature Employer Strategy	50/50 Strategy	Buses Strategy	Total Fund Strategy
Equities	60%	0%	30%	33.0%	58.0%
Real Assets	20%	0%	10%	11.0%	19.3%
Non-Gilt Debt	10%	0%	5%	5.5%	9.7%
Gilts	10%	100%	55%	50.5%	13.1%
Cash	0%	0%	0%	0.0%	0.0%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Totals may not sum due to rounding

Governance

3.11 Implementation of the investment strategy is currently delegated from the Pensions Committee to the Service Director: Finance and Procurement, 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 provides strategic advice to the Pensions Committee and officers on long term objectives and investment risk, and monitors implementation activity.

4. Main Report

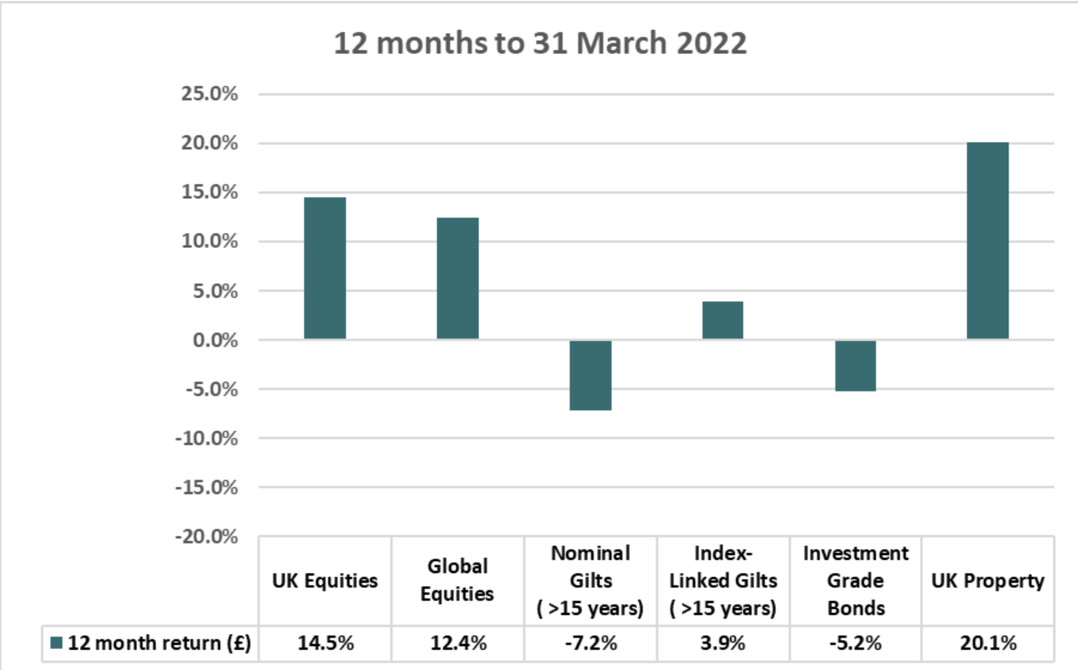
Market background to 31 March 2022

4.1 For the 12 months to 31 March 2022, UK equities (MSCI UK IMI) returned +14.5%, while global equities returned +12.4% (MSCI ACWI, in GBP). Returns for sterling-based investors were boosted by a weaker pound (global equities returned +7.3% in USD terms and underpinned by strong returns from developed markets (+15.4% in GBP) in contrast to emerging market equities (MSCI EM), which fell (-7.1% in GBP), in part reflecting the different pace at which economies are recovering from COVID-induced slowdowns.

4.2 Supply chains across the global economy experienced significant disruption as some countries re-opened and others locked back down. Rising energy prices, boosted by a combination of rebounding demand and an unexpected shortfall in renewables generation, have also been a major factor in inflation moving progressively higher over the past year.

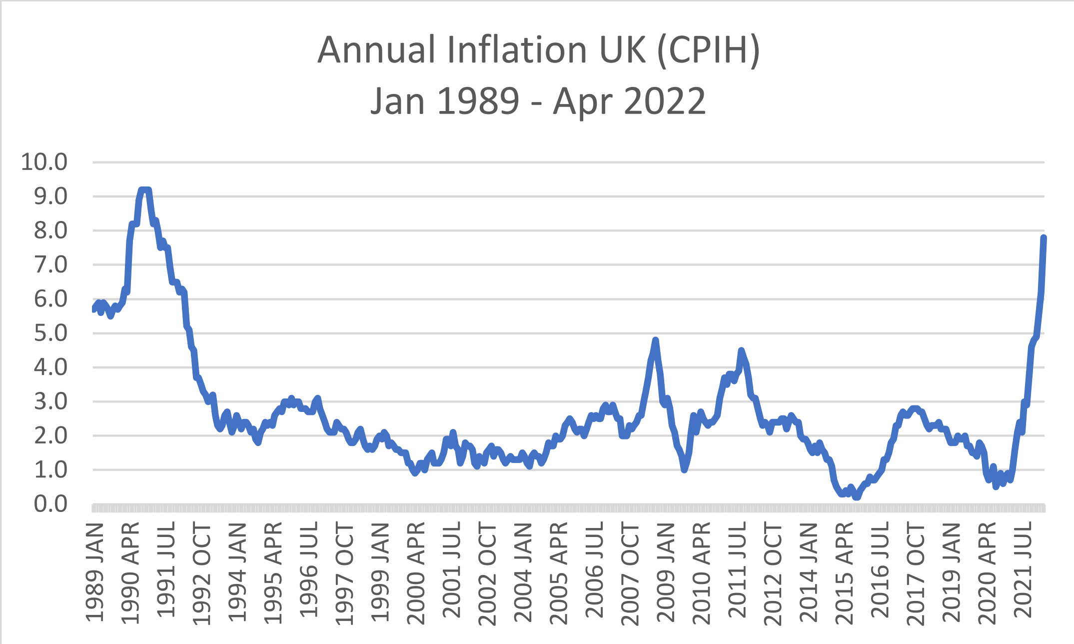
4.3 Against this backdrop, government bond yields rose over the period. Previous talk of inflation being “transitory” seems to have receded, with most central banks around the world having started to move rates higher. Corporate bonds, which had traded in a relatively narrow range over much of 2021, sold off during Q1 2022 as government bond yields rose and credit spreads widened. In the UK, 10-year gilt yields rose from 0.97% to 1.61%, which equates to a fall in value of 4.9%.

4.4 The graph below shows index returns over 12 months to 31 March 2022 for a range of asset classes.



Source: FTSE, Bloomberg, MSCI, Portfolio Evaluation (MSCI UK IMI, MSCI ACWI, FTSE Actuaries Gilts >15 Yrs, FTSE UK Govs Index Linked >15 Yrs, iBoxx £ Non-Gilts, MSCI UK Balanced Portfolios Quarterly Property Index – all GBP total return)

4.5 Loose monetary policy, brought about by decades of disinflation, has collided with soaring commodity prices, brought about by a combination of underinvestment in production growth and the invasion of Ukraine by Russia impacting commodities supply. Meanwhile, the pandemic continues to disrupt society and economic growth, with China currently in rolling lockdowns across much of the country. While many central banks are now tightening monetary policy through higher rates to combat inflation, many believe that the global economic outlook has already begun to deteriorate, and the concern is that central banks may tighten too far. The heightened volatility in markets observed in early 2022 seems likely to continue for some time yet.



Source: ONS, April 2022

Asset Allocation and Strategy Implementation

4.6 As described above, the overall Fund strategy is made up of four investment strategies. The strategic allocation to policy groups is the weighted average of the four employer strategies. The strategic allocations at end March 2021 and end March 2022 are shown in the table below along with the actual allocations. The strategic allocations changed over the year as a result of the revision to investment strategy approved by the Pensions Committee in June 2021. The actual allocations changed as a result of the relative movements of investment markets described above and investment activity during the year.

Policy Group	Actual Allocation 31 March 2021	Actual Allocation 31 March 2022	Strategic Allocation 31 March 2021	Strategic Allocation 31 March 2022
Equities	60.0%	58.5%	62.1%	58.0%
Real Assets	18.2%	17.3%	17.7%	19.3%
Non-Gilt Debt	9.2%	7.6%	10.5%	9.7%
LDI	5.6%	8.5%	9.6%	13.1%
Cash	7.1%	8.1%	0.0%	0.0%
Total	100%	100%	100%	100%

Note: numbers may not sum due to rounding

4.7 Over the year, the actual allocation to **Equities** has fallen modestly, consistent with the reduced strategic allocation. Over the course of the twelve months, ~£272m in cash was withdrawn from the equity policy group (equivalent to ~3.3% of total fund value at end March 2021). The **Real Assets** allocation also reduced modestly over the year, but this was because of strong distributions of income and capital from existing private market investments, which exceeded new commitments in the first half of the year. The **Non-Gilt Debt** allocation fell slightly over the year, broadly consistent with the revised strategy allocation. A combination of private debt distributions, maturing fixed income securities and market movements caused the change - the asset class performed relatively weakly over the year. The largest change in allocation over the twelve-month period was the increase in the **LDI** policy group. This was triggered by a higher revised investment strategy allocation. Given the extremely low interest rates engineered post-COVID by central banks and the expectation that inflation would rise, gilts purchases were undertaken slowly over the year as interest rates rose. The net result of the changes was an increase in **Cash**, which is a temporary, defensive position supported by the fund's advisers. This proved to be a better option than nominal gilts, which fell over the year to end March 2022. The actual allocations lie within the permitted ranges defined in the Statement of Investment Principles (SIP).

4.8 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 2021 and 31 March 2022

Policy Groups & Mandates	Manager	Actual Allocation 31 March 2021	Actual Allocation 31 March 2022
EQUITIES		**60.0%**	**58.4%**
Global Low Volatility	Internal	**13.1%**	**13.5%**
Global High Dividend Yield	Internal	**13.4%**	**13.5%**
Global Stable Multi-factor	Internal	**13.7%**	**12.4%**
Global Stable Equities	Nordea	**3.5%**	**3.7%**
Global Value	Harris	**1.4%**	**1.4%**
Global Alpha	Baillie Gifford	**2.2%**	**1.9%**
UK All Cap	Internal	**3.1%**	**2.8%**
UK Mid Cap	Internal	**1.6%**	**1.2%**
Europe (ex UK) Quality	Internal	**2.7%**	**2.6%**
US Value	Internal	**3.4%**	**3.8%**
Private Equity	Various	**1.7%**	**1.8%**
Currency Hedge	Internal	**0.0%**	**0.0%**
REAL ASSETS		**18.2%**	**17.3%**
Property	Various	**6.4%**	**6.1%**
Other Real Assets	Various	**11.8%**	**11.2%**
NON-GILT DEBT		**9.2%**	**7.6%**
Other Bonds	Various	**9.2%**	**7.6%**
LDI		**5.6%**	**8.5%**
UK Gilts	Internal	**5.6%**	**8.5%**
CASH		**7.1%**	**8.1%**
TOTAL FUND		**100.0%**	**100.0%**

Note: numbers may not sum due to rounding

Equities

4.9 The current equity investment strategy has remained broadly unchanged for several years now. Over the course of the last twelve months there were no new or complete sale of existing mandates.

4.10 Income continues to be withdrawn from the three large, internally managed global portfolios, with ~£132m withdrawn over the 12-month period. In addition to this, a further ~£110m was withdrawn from the SMuRV portfolio in Q4'21, consistent with the reduced strategic allocation to equities.

4.11 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.

4.12 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 87% and 91% of benchmark risk.

4.13 As of 31 March 2022, approximately 88% 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.

4.14 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.

4.15 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 though strength in listed private equity over the last 12 months (+24.4%) has resulted in the allocation increasing marginally to 1.8%.

Real Assets

4.16 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 whilst providing diversification. 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.

4.17 The Real Assets allocation also reduced modestly over the year, but this was because of strong distributions of income and capital from existing private market investments, which exceeded new commitments in the first half of the year. In private markets, it is not possible to match purchases with sales at the same point in time. The Fund continued to source new investments to achieve the target allocation and was a net investor in the policy group in the second half of the year in both infrastructure assets and property, including the well-publicised acquisition of the Titan logistics / industrial unit in central Scotland. The allocation to Real Assets fell from 18.2% to 17.3%.

Non-Gilt Debt

4.18 Exposure to Non-Gilt Debt also fell slightly over the year, broadly consistent with the revised strategy allocation. A combination of private debt distributions, maturing fixed income securities and market movements caused the change - the asset class performed relatively weakly over the year. The allocation to Non-Gilt Debt fell from 9.2% to 7.6%.

LDI

4.19 The largest change in allocation over the twelve-month period was the increase in the LDI policy group (gilts). This was triggered by a higher revised investment strategy allocation. Given the extremely low interest rates engineered post-COVID by central banks and the expectation that inflation would rise, gilts purchases were undertaken slowly over the year as interest rates rose. The exposure to LDI rose from 5.6% to 8.5%.

Cash

4.20 The net result of the changes was an increase in cash, which is a temporary, defensive position supported by the fund's advisers. This proved to be a better option than nominal gilts, which fell over the year to end March 2022.

Unfunded Commitments

4.21 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 2022 are shown in the table below. Unfunded commitments of £218m compares with £220m at 31 March 2021.

Private Markets Unfunded commitments	£m	% of Fund assets
Private Equity	32	0.3%
Infrastructure	102	1.1%
Timber & Agriculture	56	0.6%
Property	2	0.0%
Private Debt	27	0.3%
Total Commitments	**218**	**2.3%**

Investment performance to 31 March 2022

4.22 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 (CPIH) and average weekly earnings (AWE)

Annualised returns to 31 March 2022 (% per year)	**1 Year**	**5 Years**	**10 Years**
Lothian Pension Fund	10.8%	6.5%	9.7%
Benchmark	8.8%	8.6%	10.0%
Relative	*2.0%*	*-2.1%*	*-0.3%*
Liability proxy	-7.2%	0.9%	5.0%
Consumer price index (CPIH All Items)	6.5%	2.6%	2.0%
Average Earnings (AWE)	9.9%	4.1%	3.0%

4.23 The Fund aims to achieve a return broadly in line with its strategic benchmark, over the long term, with a lower-than-benchmark level of risk. Over the twelve months to end March 2022, the Fund produced an absolute return of +10.8%, which was ahead of the benchmark return of +8.8%. With risk below benchmark, it achieved its long-term objective over the short 1-year timeframe. Returns were predominantly driven by equities and real assets, which both produced double digit gains over the period. The Fund's equities gained 13.4% over the year, modestly ahead of the global index (MSCI ACWI in GBP) return of +12.4%. Within the real assets category, the return of +13.8% was led by strength in both the direct (+22.5%) and indirect (+16.3%) property investments.

4.24 Five-year returns were lower than benchmark at +6.5% p.a. vs +8.6% p.a. and over ten years the comparison was +9.7% p.a. vs +10.0% p.a. As noted above, these figures will be impacted for some time by the difficult experience of 2020 and the boom in financial asset prices over recent years.

4.25 On the risk side of the equation, the Fund has achieved its returns with notably lower levels of volatility than its benchmark (approximately 76% of benchmark risk over five years and 85% over ten years), so from a risk / return perspective the outcomes were in line with or better than expected over 1, 5 and 10-year timeframes.

4.26 The returns from the Fund's broad policy group benchmarks over 1 and 5 years are as follows (policy group returns not available for 10 years):

To end March 2022

Policy Group	1 Year (%)		5 Year (% pa)		10 Year (% pa)	
	Fund	Benchmark	Fund	Benchmark	Fund	Benchmark
Equities	13.4	12.4	7.4	10.5		
Real Assets	13.8	6.4	7.7	6.8		
Non-Gilt Debt	4.2	-5.0	3.2	2.5		
LDI (Gilts)	2.7	3.9	3.1	3.3		
Total Fund Return	10.8	8.8	6.5	8.6	9.7	10.0
Total Fund Risk*	8.4	9.4	6.7	8.8	6.8	8.0

**1 year predicted; 5 & 10 years ex-post (source: Portfolio Evaluation)*

4.27 In the table above, absolute returns have been strong from both equities and real assets. Within equities, while the 12-month relative return is positive, the 5-year figure is -3.1% p.a.. Lothian's lower risk equities have, unsurprisingly, lagged the notable equity market gains. This was particularly evident through 2020, when the Fund's lower risk exposure was negatively impacted by Covid and associated lockdowns, relative to the benchmark. This will continue to impact longer-term figures for some time. Despite this, absolute equity returns remain strong at +7.4% p.a.. Real assets have gained 13.8% over 12 months and 7.7% p.a. over 5 years and are ahead of their gilts +2.5% p.a. benchmark.

4.28 Other policy group returns were modest over both the 12-month and 5-year periods.

4.29 Over the year to 31 March 2022, notable performance within each policy group was as follows:

- The Fund's equity investments produced a good return of +13.4% but, within this, results were mixed. In what was almost a mirror image of last year, weakness was seen from Baillie Gifford Global Alpha (-6.8%), UK All Cap (-5.5%) and UK Mid Cap (-4.1%) while strength was seen from the private equity (+24.4%), US (+22.1%), GLOVE (+19.0%), Nordea (+15.6%), GHDY (+15.3%) and SMuRV (+14.3%) equity portfolios.
- The Fund's Real Assets allocation returned +13.8% over the year. Returns from property (+21.3%) were the key driver of strength, while timber & agriculture (+18.4%), listed infrastructure (+13.1%) and infrastructure limited partnerships (+8.9%) also contributed strongly.
- The Fund's Non-Gilt Debt exposure produced a return of +4.1% over the year. Relative strength was seen in private debt (+7.2%) and US TIPS (+7.0%) with weakness from Baillie Gifford Corporate Bonds (-4.7%) and more defensive credit - Legal & General AAA-AA-A Fund – (-5.1%).
- The Fund's Index-Linked investments delivered a return of +2.7% over the year, lagging other policy group returns.

4.30 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

4.31 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

4.32 Based on the movements of the Fund's assets and a proxy for the Fund's liabilities, the funding level is expected to have improved over the year to end March 2022 as the Fund's assets have increased in value from end March 2021, while the liabilities are estimated to have declined in value due to rising rates.

4.33 The next triennial valuation at 31 March 2023 will be undertaken during 2023 and concluded by 31 March 2024 at the latest.

Conclusions

4.34 In general, the investment strategy changes were relatively small as one would expect from a long-term pension scheme. The changes to actual asset mix were also relatively minor. The largest actual change was the increase in LDI, which rose by 2.9 percentage points over the year.

4.35 The equity allocation was reduced somewhat over the year and is now broadly in line with the strategic target at 31 March 2022 (58.4% vs 58.0%). The largest deviation from strategy is the overweight position in cash (+8.1%), which reflects increasing concern about the valuation of other assets. With interest rates extremely low, the fund has underweight positions in LDI (8.5% vs 13.1%) and Non-Gilt Debt (7.6% vs 9.7%), both of which are vulnerable to rising interest rates. The Real Assets (17.3% vs 19.2%) policy group is also underweight but this is due to liquidity constraints and market movements rather than an intentional position. The Fund has operated comfortably within the prescribed ranges over the year.

4.36 The most significant investment activity during the year was the increase in LDI (+£324m) and the reduction in equities (-£272m), both of which were prompted by the revised strategic allocations.

4.37 The absolute performance of Lothian Pension Fund over the twelve-month period was +10.8%. Five-year performance is +6.5% per annum. Over ten years, the Fund returned +9.7% per annum.

4.38 The returns for the 12-month to end March 2022 are strong in absolute terms and ahead of benchmark (+10.8% vs. +8.8%). As a result of a relatively weak 2020 calendar year, five and ten-year returns are behind benchmark, though strong in absolute terms. These returns have been achieved at lower than benchmark risk, broadly in-line with strategy.

4.39 The funding level is expected to have improved over the year to end March 2022 as the Fund's assets have increased in value from end March 2021, while the liabilities are estimated to have declined in value due to rising rates. The funding level will be updated at the time of the triennial actuarial valuation in 2023.

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.