100 HYMANS # ROBERTSON

Conference highlights

LGC Investment Seminar Scotland (21-22 October 2021)

Iain Campbell
Investment Consultant

With COP26 on the horizon at the other end of the M8, climate change featured regularly at LGC's Scottish investment conference in Edinburgh. If there is anything in the following session summaries which you would like to discuss further, then do get in touch with your usual contact.

Day 1 - What should be keeping the LGPS awake at night

Suzanne Hutchins, Investment Leader, Newton Investment Management

- One of the key challenges at the moment is deciphering fact from opinion – the data points are all over the place. A big regime shift is afoot e.g. slowing of globalisation, tolerance for higher inflation.
- Market opportunities include energy and banking stocks (short duration and can respond quickly to the economic cycle). Investment in China needs aligned with the current changes being implemented. For example, a big focus on food security so companies in this area may offer value.
- You need to pick your moment on climate change and identify opportunities that align with current trends of net zero, electrification and the circular economy.

Investment strategies for very well-funded pension funds

Laura Colliss, Pensions Manager, North East Scotland Pension Fund & Eric Lambert, Independent Investment Adviser

- Laura noted a big funding level improvement in recent years, with her Fund well in excess of 100%. The Fund's assets have grown from £4.3bn in March 2020 to around £6bn now, causing a lot of work to try and rebalance the allocation back to benchmark.
- Eric's view is that the perfect funding level figure is between 100% and 105%. However, one of its biggest problems is the daily volatility, and funds should avoid worshipping the false god that is the funding level.
- Three options to utilise funding surplus; 1) offset some of the future benefit cost, 2) leave as a risk reserve, 3) de-risk.

- Take care if considering de-risking - this could be rebadged as 'de-returning' and reducing future returns will increase the cost of future benefits.

Ensuring investment in affordable housing works for your fund and your community

Alice Wilcox, Head of LGPS Partnerships, CBRE Investment Management

- Affordable in this context focuses on regulated tenures, split between three main areas - general rented, shared ownership and other tenures.
- Over the last 10 years, c.150k houses p.a. have been built, but household formation has been around 210k p.a. This partly explains why UK's social housing waiting list has not fallen below 1 million over the last 20 years.
- When making an investment decision in this area, the social impact dimensions need to be carefully considered alongside financial factors.
- The biggest risk is the potential impact of a change in government policy. There is also reputational risk for investors to consider as the tenants are individual people (rather than businesses in commercial property).

From climate change to climate transition: how real assets can help deliver a lower carbon world

Luke Layfield, Fund Manager (Real Assets), Aviva Investors

- There is a confusing array of options when mapping a path to net zero, and real assets have a different pathway to equities and bonds.
- For real assets, the journey includes:
    - **Exclusion of bad assets** i.e. greenhouse gas emitters. This doesn't advance net zero overall; the assets will exist in someone else's portfolio and you could undermine your return needs.
    - Instead, look for **Green Solutions** to avoid and reduce emissions. Real assets allow you to invest aligned to your risk-return needs.
    - **Transition** - encourage companies to clean up their act and de-carbonise. Focus on re-purposing existing assets rather than generating further carbon by building new assets.
    - **Offsetting** - real assets give you more control. For example, the use of Carbon Capture Woods where new trees are planted today to offset future emissions (4m new trees = 240k tonnes of carbon from the atmosphere).
    - **Reporting** - so you can see where you are on the journey. The current perception is that real asset reporting on carbon is behind listed equities but progress is being made to rectify this.

Birds of a feather discussion session

Delegates attended a number of informal gatherings without a pre-planned agenda. Brief notes from each:

- Does politics have a place in implementing our investments?
    - At a pension fund level, no. However, at national level, the answer is probably/maybe.
    - The key issue that it always come back to is fiduciary duty.
- Why do we get washed out – new fad green washing, ESG washing
    - Be healthily sceptic! Always challenge the people in front of you when they are making claims.
    - Consistency of data and how it is reported is needed to help avoid greenwashing.
- Are reporting requirements a necessary burden or just a lot of red tape?
    - Yes, they are necessary but sometimes they can go too far.

    - Too onerous for some smaller companies that don't have the resource or scale to manage.
- Has Coronavirus improved our communications to beneficiaries?
    - Online has probably benefitted most but there are those who have a negative experience of it.
    - Going forward, continue to make use of new technology but don't leave some people behind.
- Is the LGPS too unique to be sustainable in terms of people and resources?
    - No, but training and keeping people in the LGPS is crucial to its longer-term success.
    - Scottish pooling? Less necessary than for E&W as Scottish funds already work collegiately.
- What role do pension schemes have in creating a more equal world?
    - Primary role is to meeting member needs. The climate agenda is driving action.
    - Funds should consider that their investments are positioned to do no harm as a minimum.

Day 2 - Hot topics from the LGPS

Iain Campbell, Investment Consultant, Hymans Robertson

Iain outlined five opinions:

- **Stop overweighting UK equities** – only be overweight position if there is a strong view that the UK will outperform, which is very difficult to forecast. The UK market has underperformed global markets over recent years, partly due to the significant underweight to tech stocks.
- **Plenty of juice left in private markets** – these are complex and illiquid; many investors either can't or won't invest in them, so they may actually be undersubscribed. They are helpful for improving diversification and implementing RI beliefs.
- **Get out of gilts** – typically held for defensive reasons. However, gilts are now very volatile and offer negative real yields so are no longer suitable. Asset backed securities offer a better solution.
- **Change the way you find "value" –** traditional methods exclude very valuable assets of certain types of companies, making them look expensive, e.g. staff expertise, data, software and digital platforms. This causes certain types of company, mainly tech, to be underweighted in value portfolios. Funds should ensure their value managers and indices are not using these outdated methods.
- **Climate risk is not priced into markets** –the impacts and timescales are too uncertain to currently be priced into markets. This leaves investors exposed to these risks. There are opportunities to invest in the 'solution providers' to climate change who are not yet being given the credit they deserve.

Reflections on the challenges and opportunities facing the LGPS from a new Chief Executive

David Vallery, Chief Executive Officer, Lothian Pension Fund

- David's previously been involved in life assurance, banking and global consultancy.
- His LPF priorities include excellent administration services, achieving appropriate risk-adjusted returns, managing risks and reducing complexity, and maintaining a strong team and a great place to work.
- Initial impressions? LGPS governance is complex, and funds' long-term time horizons allow them to leverage opportunities. Good governance around Pension Committee decision making is key to the long-term success. He continues to be on a learning curve around the involvement of politics.
- Challenges include managing the scale and size of LGPS funds, ensuring the LGPS continues to be attractive to all new joiners, handling pressure from varied lobby groups, and constant regulatory change.

Bringing more science to multi-alternative investing

Philip Waller, Portfolio Manager, Alternatives Solutions Group, J.P. Morgan Asset Management

- Discussion about core real assets in a world where inflation is high and interest rates are likely to remain low or negative throughout this market cycle.
- Real estate, infrastructure, transportation and timber land should be considered depending on goals.
- Ensuring diversity is key. Manager dispersion can be lower i.e. holding relationships with a small number of managers important, with the 'active' element focussed around allocation weights.

Impact of the new regulator code of practice

Clare Scott, Independent Adviser

- TPR's oversight has increased the focus on governance and administration standards, with some high profile LGPS interventions.
- Unlike E&W, Scottish funds run joint Committee/Board meetings. This is good for collaboration but may mean Board members step into decision-making rather than oversight.
- The new single CoP covers both private & public schemes and is under consultation. Implementation has been delayed until summer 2022 – main LGPS concern is around the definition of "Governing Body" and may need redefined to avoid confusion for the LGPS.
- Planning for best practice in new CoP can start now e.g. in relation to knowledge, training and understanding for committee and board members.

The role of private debt in cashflow management

Shalin Bhagwan, Head of Pensions Advisory & EMEA Consultants, DWS

- Funds' challenges are to improve funding levels, pay benefits without being forced asset sellers and reduce volatility of returns. Equities and credit can address these - equities only meet the first challenge but credit can meet all three, depending on where in the market you invest.
- The benefits of private debt relative to investment grade corporate bonds and high yield bonds was discussed, with private debt offering the strongest returns at around 5% with relatively low risk of losses. He termed this the 'proximity premium' - private debt can put strong covenants in place, take security of assets backing the bonds in default, and step in and resolve issues with companies before they default.
- A range of traditional asset classes, from government bonds to equities, were shown along the efficient frontier with equities earning a return of c. 5% pa with a volatility level of c. 25%. Private debt can achieve these 5% pa returns with only 10% volatility.

The road to net zero: how Strathclyde Pension Fund is tackling the climate emergency

Richard McIndoe, Director, Strathclyde Pension Fund (SPF)

- SPF has created a climate change strategy and track progress against this. The Fund first did TCFD reporting in 2019 and has been very useful in finding gaps in its climate strategy.
- Richard discussed 4 areas where the TCFD framework helped SPF's climate approach:
  - **Governance** – climate change is embedded fully in its governance structure. It is now treated as a major, standalone risk as they would with inflation, rather than just an ESG risk.
  - **Strategy** –scenario analysis has alerted them to the fact that negative climate change scenarios would be very bad for the Fund.
  - **Risk management** – they are a signatory to the PRI and ensure all managers are too. Sustainalytics is used for broader engagement, and IIGCC, Climate Action 100+, CDP and LAPFF for more climate-focussed engagement. Their investment consultant, Hymans, has

  - recently been reappointed with the tender focussing heavily on addressing climate risk. They have a £1.7bn direct investment portfolio which targets “impact investing” and £500m is invested in renewable energy assets alone.
  - **Metrics and targets** – data can be thin and misleading, but the quality is improving rapidly. It is used to understand the issue in their portfolio rather than to drive the solutions. They have only just begun to address targets, with a Net Zero by 2050 ambition being set this year. They have also publicly stated that they will continue to develop their approach as they understand the issue better.
- A divestment framework is in the process of being drafted e.g. companies that show no ambition to adapt to be Paris-aligned will be divested, companies that have work to do but are making progress will be held but engaged and monitored, whilst companies that are part of the solution will be held in the portfolio.

Climate change, net zero, measurement and the impact on your fund’s investment strategy

Nick Stanbury, Head of Climate Solutions (Investments), Legal & General Investment Management

- Currently the impacts of climate change, either from a successful transition to a low carbon economy or a failure to address it, are not priced into markets but will be one day.
- Transitioning to net zero is the single biggest rebuilding project ever undertaken. Nick believes there are two possible scenarios:
  - A smooth and well planned transition – cost is expected to be 2-3% of global GDP spread over the next 30 years, with a 10-15% hit on global equity markets. Transition risks should be concentrated in a small number of sectors and a small number of companies within each, so some opportunity to avoid these.
  - A disorderly transition - no action happening within the first 10 years. Cost of the delay means a 10-15% hit on global GDP spread over 20 years. Here the impacts are far more widely spread over the economy with very few places to hide in global markets.
- LGIM have inspected company statements around climate change to look at their actual actions. They believe only 3% of companies are currently aligned to a 1.5C temperature increase.