Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

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Item 5

8th September 2021

Investment strategy – Rebalancing strategy

Purpose of Report:

To present a revised rebalancing strategy including a relative value framework.

Recommendations:

The Committee is asked **to APPROVE** the revised rebalancing strategy and frameworks set out in this report.

Ward No(s):

Citywide: ✓

Local member(s) advised: Yes ☐ No ☐

consulted: Yes ☐ No ☐

1 Background

In March 2021 the Committee considered a report which set out the conclusions of a review of Strathclyde Pension Fund's Investment Strategy and Structure. The Committee agreed that the current strategy should be maintained subject to some changes to the structure of individual investment categories. These changes have since been implemented.

The objective of the rebalancing strategy is to ensure that the Fund does not diverge too far from the long-term investment strategy and structure agreed by the Committee. The strategy is also expected to add value over time by:

- locking in the gains when a particular asset class outperforms relative to the others; and
- buying into relatively cheap asset classes when they have experienced a period of underperformance

The current rebalancing strategy was approved by the Committee in March 2017. In light of the changes which have been implemented since then, this paper presents a review of the re-balancing strategy and framework.

2 Current Rebalancing Strategy

The existing strategy takes a 3-level, top down approach as follows:

- Level 1 Asset Class
- Level 2 Mandate type
- Level 3 Portfolio

The methodology at each level is similar.

- A target allocation is set for each asset class / mandate type / portfolio.
- A range above and below that target is set.
- Actual positions are reviewed periodically.
- Where, on review, an asset class / mandate type / portfolio is outside its range, action will be considered to bring it back towards its target allocation.

3 Review

The strategy has been reviewed by the Investment Advisory Panel based on a series of papers produced by the Fund's investment consultants, Hymans Robertson. Conclusions of the review are that:

- a revised rebalancing framework should be agreed to reflect the current mandate and portfolio structure;
- the existing methodology should be retained and applied to the revised framework; and
- a relative value framework should be introduced with a view to adding further value by periodically adjusting the target allocations to different protection assets based on market pricing and medium term market views.

4 Revised Rebalancing Framework

A revised framework showing the targets and proposed ranges for each of the levels is set out in **Schedule 1**.

5 Relative Value Framework

The table below summarises the methodology for the proposed relative value framework.

Decision	Starting Point
Objective	To generate additional value and reduce risk of capital losses by varying implementation of the 7.5% allocation held in protection assets.
Neutral allocation for decisions	Based on current strategic target as per rebalancing framework, i.e. 6% investment grade credit (50/50 UK/US), 1.5% index-linked gilts.
Asset class options	Ability to allocate to investment grade credit, index-linked gilts, fixed interest gilts and cash.
Benchmark Options	Changes implemented through existing benchmarks only.
Framework principles	Decisions made based on the following principles: ▪ Comparison of credit spreads with historic levels. If credit spreads are significantly low it implies risk of capital loss versus government bonds and a trigger to switch away from corporate bonds to government bonds or cash; ▪ Comparison of forward looking interest rates implied by gilt yields with a trajectory from current cash rates to long-term expected or fair value interest rates (based on expected long-term real yields + inflation). If yields look too low, it implies holding more cash; ▪ Comparison of implied inflation with central long-term inflation expectations. If the premium over long-term expected inflation is high, it acts as a trigger to hold fixed interest bonds or cash. Detailed metrics for decision making and triggers for allocation shifts are set out in **Schedule 2**.
Frequency of framework application	Positions to be reviewed quarterly or after significant shifts in spreads or yields. Changes likely to be relatively infrequent
Framework review	Triennial.
Responsibilities	Hymans Robertson to provide supporting data and information for framework monitoring to Officers/IAP.

6 Implementation

Implementation of the rebalancing process will continue to be delegated to the Investment Advisory Panel (IAP). As currently, rebalancing activity will not be carried out automatically, but only after due consideration of the causes and effects. **Schedule 3** provides details of how the rebalancing strategy will be implemented in practice.

Rebalancing decisions will be reported to the Committee in the quarterly Investment Advisory Panel report.

7 **Allocations at 30th June 2021**

Schedule 4 sets out the current allocations in comparison to rebalancing ranges and targets, together with some commentary.

8 **Relative Value Framework as at 30th June 2021.**

Schedule 5 sets out the relative value framework metrics at 30th June 2021, together with some commentary.

9 **Further Amendment**

The Fund currently has undrawn commitment of **5.3%** of total Fund to private debt, real estate and infrastructure investments (including the direct investment portfolio). Once these illiquid asset exposures are more fully invested and closer to target, it is proposed that the rebalancing range on equity at Level 1 should be amended from **+/- 10%** to **+/- 7.5%**.

10 **Policy and Resource Implications**

Resource Implications:	
Financial:	Re-balancing assets or switching between protection assets will incur trading costs. These will be considered as part of the implementation process of the strategy.
Legal:	None
Personnel:	None
Procurement:	None
Council Strategic Plan:	Strathclyde Pension Fund aligns with the theme of a well governed city.
Equality and Socio Economic Impacts:	
Does the proposal support the Council's Equality Outcomes 2017-22	Equalities issues are addressed in the Fund's Responsible Investment strategy, in the scheme rules which are the responsibility of Scottish Government and in the Fund's Communications Policy which has been the subject of an Equalities Impact Assessment.
What are the potential equality impacts as a result of this report?	No specific equalities impacts.
Please highlight if the policy/proposal will help address socio economic disadvantage.	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.

Sustainability Impacts:

Environmental:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.
Social, including opportunities under Article 20 of the European Public Procurement Directive:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.
Economic:	ESG (Environmental Social and Governance), and local impacts are addressed in the Fund's Responsible Investment strategy.

Privacy and Data Protection impacts:	None.

11 RECOMMENDATIONS

The Committee is asked **to APPROVE** the revised re-balancing strategy and frameworks set out in this report.

<u>Appendices</u>

Schedule 1 Revised Rebalancing Framework
Schedule 2 Relative Value Framework
Schedule 3 Implementation Framework
Schedule 4 Asset allocation as at 30th June 2021
Schedule 5 Relative Value Framework as at 30th June 2021

Schedule 1

Revised Rebalancing Framework

Level 1 – Asset Class

Asset Class	Target Step 2 (%)	Range (%)
Equity	52.5	42-63
Hedging/Insurance	1.5	1-2
Credit	6	5-7
Short Term Enhanced Yield	20	17.5-22.5
Long Term Enhanced Yield	20	17.5-22.5
Total	100	

Level 2 – Mandate Type

Asset Class	Mandate Type	Target (%)	Range (%)
Equity	Passive	24	19-29
	Global	15	12.5-17.5
	Specialist	5.5	4-7
	Private Equity	7.5	5-10
	DIP Equity	0.5	0-2
	Total	52.5	42-63
Hedging/Insurance	Passive Index-Linked	1.5	1-2
Credit	Passive Credit	6	5-7
Short Term Enhanced Yield	Absolute Return	6	5-7
	Multi Asset Credit	4.5	3-6
	Private Debt	4.5	3-6
	EMD	2.5	2-3
	DIP STEY	1.5	0-2
	Cash	1.0	0-5
	Total	20	17.5-22.5
Long Term Enhanced Yield	Property	12.5	10-15
	DIP LTEY	5.0	1-5
	Global Infrastructure	2.5	2-3
	Total	20	17.5-22.5
Total	Total	100	

Level 3 – Portfolio

Asset Class	Mandate Type	Manager	Target (%)	Range (%)
Equity	Passive	L&G Global	18	15-21
		L&G RAFI	6	4-8
	Unconstrained Global	Baillie Gifford	7.5	6-9
		Lazard	2.5	1.5-3.5
		Veritas	2.5	1.5-3.5
		Oldfield	2.5	1.5-3.5
	Specialist	Lombard Odier	1	1-2
		JP Morgan	3	2-4
		Genesis	1.5	1-2
	Private Equity	Pantheon/ Partners	7.5	5-10
	DIP Equity		0.5	0-2
	Total		52.5	42-63
Hedging/Insurance	Passive Index-Linked	L&G Index Linked	1.5	1-2
Credit	Passive Credit	L&G Corporates	6	5-7
Short Term Enhanced Yield	Absolute Return	PIMCO	4	3-5
		Ruffer	2	1.5-2.5
	Multi Asset Credit	Barings	2.75	2-3.5
		Oak Hill Advisors	1.75	1-2.5
	Private Debt	Barings	1.25	0-2
		Alcentra	1.25	0-2
		ICG Longbow	1	0-2
		Partners Group	1	0-2
	EMD	Ashmore	2.5	2-3
	DIP STEY		1.5	0-2
	Total		20	17.5-22.5
Long Term Enhanced Yield	Property	DTZ	10	8-12
		Partners Group	2.5	2-3
	DIP LTEY		5	1-5
	Global Infrastructure	JP Morgan	2.5	2-3
	Total		20.0	17.5-22.5
Total			100	

Schedule 2

Relative Value Framework

Asset category	Neutral Strategic Allocation	Key Alternative	Key Metric	Triggers for allocation changes:
Investment grade corporate bonds	**6%**	**Nominal gilts**	Sterling and US Benchmark index spreads over gilts/ treasuries vs historic levels	**Neutral allocation**: <+/-50bps from 20 year median; **Increase**: if spreads are more than 50bps above 20 year median (equivalent to 75th percentile); **Halve neutral allocation**: if spreads are more than 50bps below 20 year median (equivalent to below c. 20th percentile); **Remove allocation:** if spreads are more than 60bps below median (c10th percentile).
Nominal gilts	**-**	**Cash**	Forward yield vs expected path of cash rates to fair value yield; Difference between gilt yield and cash yield	Implied interest rates **below** expected path to fair value yield implies hold **cash over gilts**. **Above or in line** favours **gilts over cash**. **Hold gilts** when some modest premium for holding longer dated debt expected, reflecting growth and inflation risk. **Hold cash** in favour of nominal gilts if there **is no premium.**
Index-linked gilts	**1.5%**	**Nominal gilts**	**Implied Inflation**	**Neutral allocation:** pre 2030 RPI between 2.75% and 3.25% and post 2030 CPI between 2.0% and 2.5%, and nominal gilts acceptable. **Prefer index-linked gilts** to nominal gilts if implied (post 2030) CPI inflations is less than 2.5%. **Hold less** is implied (post 2030) CPI is more than 2.5%.

Schedule 3

Implementation Framework

Factors

The following factors will be reviewed by the Investment Advisory Panel in considering a decision to rebalance.

- Distance from the target - greater distance suggests more likelihood that rebalancing should take place.
- Correlation between the underweight and overweight areas.
- Prospects of the underweight and overweight areas.
- Cash flow requirements.
- Cost and liquidity issues.

Questions

The following questions will be considered before agreeing whether and how to re-balance.

- Do we understand why the over/underweight exists?
- What are the triggers for reversal?
- Is rebalancing or ignoring rebalancing more consistent with the Fund's long-term objectives?
- Potential for loss if the Fund is/is not re-balanced?
- Have we considered the counter arguments?
- What opportunities would we be giving up?
- What is the impact of it going wrong if the re-balancing is/ is not implemented?
- Cost effectiveness?

Liquidity

The majority of the Fund's investments - listed equities and bonds - are very liquid and can be traded quickly and at relatively low cost. This facilitates re-balancing or trading of these assets. However, a significant proportion of assets is relatively illiquid. This includes private equity, private debt, and real estate. These allocations operate on a familiar basis of:

- commitment
- drawdown
- investment
- exit and
- repayment.

Ultimately they are self-liquidating, but the process from commitment to eventual repayment can take 10 or more years with little or no opportunity in the interim to reduce, increase or dispose of the investment. Management of these allocations is therefore less precise or immediate. The established role of the IAP in respect of private equity, debt and real estate is to:

- monitor performance and liquidity
- agree new allocations to the managers previously appointed by the Committee with a view to maintaining allocations within the agreed ranges and
- agree the source of funding for these allocations.

Active Re-Balancing

The rebalancing strategy is largely passive – i.e. designed to redress imbalances which have occurred as a result of market movements or yield changes. The Panel may occasionally also consider a more active decision to re-position the Fund away from its long-term benchmark for a limited period. Any such decision would be referred to the Committee for approval before being actioned.

Asset Allocation as at 30th June 2021

Asset Class / Mandate Type	Manager	Target (%)	Range (%)	Actual (%)	Undrawn (%)
Equity		52.5	42-63	61.8	
Passive	L&G Global	18	15-21	21.4	
	L&G RAFI	6	4-8	6.8	
	Baillie Gifford	7.5	6-9	8.9	
U/c Global	Lazard	2.5	1.5-3.5	3.1	
	Veritas	2.5	1.5-3.5	3.0	
	Oldfield	2.5	1.5-3.5	2.8	
Specialist	Lombard Odier	1	1-2	1.8	
	JP Morgan	3	2-4	3.7	
	Genesis	1.5	1-2	2.0	
Private Equity	Pantheon / PG	7.5	5-10	8.0	4.1
DIP Equity		0.5	0-2	0.3	0.2
Hedging/Insurance		1.5	1-2	1.4	
Passive I/L	L&G I/L	1.5	1-2	1.4	
Credit		6	5-7	5.7	
Passive Credit	L&G Corp	6	5-7	5.2	
STEY		20	17.5- 22.5	18.7	
Absolute Return	PIMCO	4.0	3-5	3.7	
	Ruffer	1.0	1.5-2.5	1.9	
Multi Asset Credit	Barings	2.75	2-3.5	2.7	
	Oak Hill	1.25	1-2.5	1.8	
Private Debt	Barings	1.25	0-2	1.7	0.3
	Alcentra	1.25	0-2	1.3	1.0
	ICG Longbow	1.0	0-2	0.6	0.2
	Partners Group Private Debt	1.0	0-2	0.5	0.4
EMD	Ashmore	2.5	2-3	1.9	
DIP STEY		1.5	0-2	0.4	0.2
Cash	L&G / Northern Trust	1.0	0-5	2.3	
LTEY		20	17.5-22.5	12.5	
Property	DTZ	10	8-12	8.0	
	Partners Group	2.5	2-3	1.3	1.4
Global Infrastructure	JP Morgan IIF	2.5	2-3	2.1	0.9
DIP LTEY		5.0	1-4	2.9	1.0
Total		100			

There are currently a number of breaches of ranges:

- at level 1: Short Term and Long Tern Enhanced Yield are below their allocation range.
- at level 2: 1 Equity Mandate Type is above its target range, 1 of the Short Term Enhanced Yield mandate types is below its target ranges and 1 Long Term Enhanced Yield Mandate is below its target range
- at Level 3: 1 equity mandates is above its target range, 1 of the Short Term Enhanced Yield mandates is below theirs, 1 Long Term Enhanced Yield Mandate is below its target range

The principal reason for these breaches is that equity markets have performed extremely well over the last 12 months relative to other investment markets. In addition, the Fund is still building up exposure to private debt (Short Term Enhanced Yield) and global infrastructure (Long Term Enhanced Yield).

Having considered the current position, the Investment Advisory Panel agreed the rebalancing actions which are set out in the Investment Advisory Panel report to Committee.

Schedule 5

Relative Value Framework as at 30th June 2021

Asset	Neutral Target Allocation	Triggers/ view	Action	Proposed allocation
Credit (vs gilts)	**6%**	Average spread 0.46% below 20 year median	Retain credit	**6%**
Index linked (vs nominal gilts)	**1.5%**	Average implied inflation 0.6% p.a. above trigger	Reduce Index-linked gilts	**-**
Nominal gilts (vs cash)	**-**	Yield reversion over first 15 year, negative beyond 15 years so prefer cash to gilts	-	**-**
Cash	**-**	Prefer cash to nominal gilts	Hold proceeds from index-linked gilt sales in cash	**1.5%**

The index-linked holding has already been sold for cash as part of the 2021 investment strategy review. The framework metrics at 30th June indicate that cash is still preferred to index-linked gilts and that the 6% allocation to corporate bonds remains appropriate.