

London Borough of Barking and Dagenham Pension Fund

Interim investment strategy review

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June 2024

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Executive summary and introduction



Executive summary – recommendations

Asset class	Current (%)	Strategy 6 (%)	Allocation Change
Growth	74.0	69.0	(5)
Equities	50.0	53.0	3
DGFs	13.0	7.0	(6)
Private Equity	9.0	9.0	-
Hedge Funds	2.0	-	(2)
Income	21.0	26.0	5
Property	4.0	6.0	2
Infrastructure	8.0	10.0	2
Global credit	9.0	10.0	1
Protection	5.0	5.0	-
Fixed Interest gilts	5.0	5.0	-
Total	100.0	100.0	-
Expected Return (% p.a., 10 yrs)	7.9	8.0	+0.1
Expected Volatility (% p.a., 1 yr)	15.4	15.6	+0.2

Key questions for discussion

- **Re-allocating from growth:** How might the hedge funds allocation be re-allocated? Should the Fund consider reducing the DGF allocation and instead diversify in other ways to deliver more stable, and predictable returns?
- **Income generating assets:** Should the Fund further diversify its investments and increase the focus on income generating assets such as Property, Credit, Infrastructure or Private Debt?

Initial recommendations for discussion

- With the removal of hedge funds and the reduction of the DGF allocation, the Fund would benefit from further diversification of the investment strategy, and more stable returns, if it were to re-allocate these monies towards Income-focussed assets (primarily liquid credit and illiquid assets). The modelling we have carried out supports such a change in the strategic asset allocation for the Fund, and we also view the outlook for long-term returns in listed credit markets and illiquid assets as attractive, when considering the Fund's needs for returns.
- Any adjustments to the investment strategy would also need to consider funding implications and should be discussed with the Fund Actuary, although we expect that such strategic changes (as we recommend) are unlikely to cause problems, given the existing wide margin between the discount rate and best estimate returns on the Fund's assets.
- **Strategy 6 would be our recommendation for consideration by the Officers/Pensions Committee.** This strategy involves a reduced allocation to growth assets (hedge funds and reduction in DGFs) and an increased allocation to a range of income assets including investment grade bonds, property and infrastructure. This strategy brings about a very small increase in expected return and volatility, but we do not believe this materially changes the Fund's risk exposures and future outcomes.
- We have discussed these recommendations with the Fund's Officers, who believe this is a sensible way to develop the investment strategy.

Introduction

This paper is addressed to the Pensions Committee and Officers of the London Borough of Barking and Dagenham Pension Fund (the “Fund”). The purpose of this paper is to set out our analysis on the investment strategy in order to assess the effectiveness of the current investment strategy in meeting the Fund’s objectives, and consider whether a different strategy would be more suitable.

The Fund decided to undertake an interim review of its investment strategy as part of a re-evaluation of the diversified alternatives component of the Fund’s strategy. This follows on from the 2023 investment strategy review that was carried out in conjunction with the Fund’s 2022 actuarial valuation. For the interim review, we have conducted analysis utilising stochastic modelling based on market conditions as at 31 March 2024 and summarised the results in this paper. The report presents the conclusions of our review on the Fund’s strategic asset allocation and also sets out key investment structure and implementation considerations for the Fund.

We accept no liability where the report is used by, released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given. We provide comment from an investment but not a legal or tax perspective.

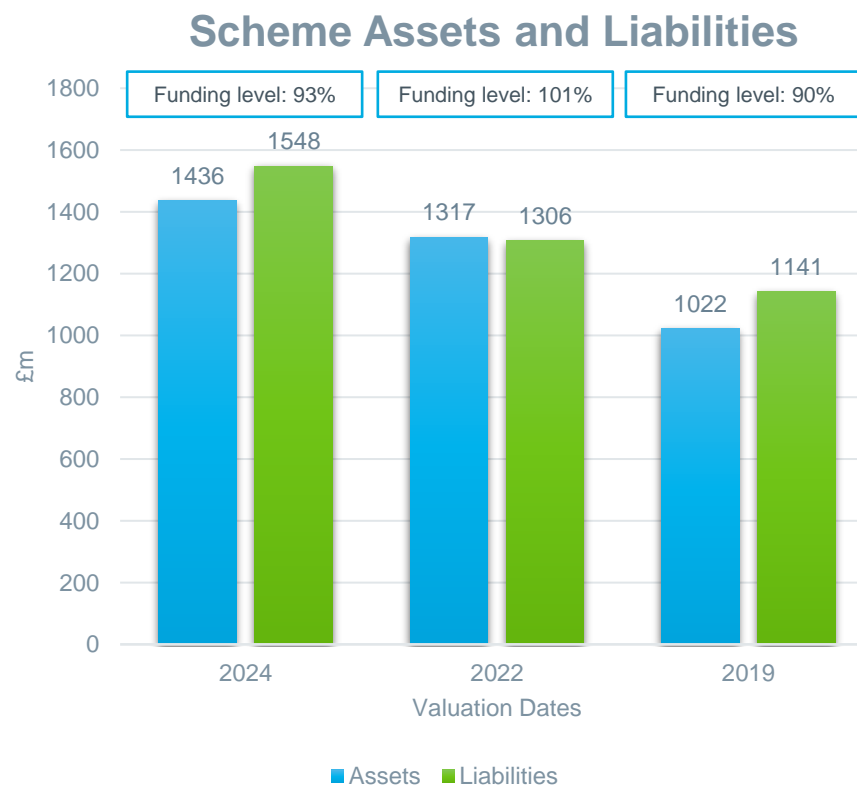
This work complies with Technical Actuarial Standard 100. The analysis in this paper is at 31 March 2024 and based on the liabilities and funding position as at the 31 March 2024 date, based on information provided by the Fund’s actuary, Barnett Waddingham.

Background:
funding position and
setting investment strategy



Funding position

- The main factor driving improvement in the funding level from 2019 to 2022 was better-than-expected investment returns.
- As part of the 2022 actuarial valuation, the discount rate applied by Barnet Waddingham was 4.3% p.a. As illustrated in the chart on the right, this resulted in a funding level of 101% as at 31 March 2022. Note that this funding level was calculated using a smoothed asset value, as per Barnett Waddingham's methodology. The asset value quoted in the chart represents 98.1% of the unsmoothed asset value as at 31 March 2022.
- When we carried out the strategy review in mid-2023, as noted in our advice at that time, the estimated funding position as at 31 December 2022 was 106%.
- Since the 2023 investment strategy review, the funding position has regressed primarily due to increases in the valuation of the liabilities and as at 31 March 2024 the funding level stands at 93%. The current discount rate adopted by the Scheme actuary is 3.9%, however this is expected to increase, as per the comment from the Fund's actuary, Barry McKay, who noted that he would: *"expect the discount rate to increase {as part of 2025 actuarial valuation} from current levels for several reasons and so you may want to consider this if you are considering changes to the Fund's long-term investment strategy and asset allocation"*



Reminder: strategic versus structural considerations

Strategic asset allocation

The Fund's **investment strategy**, also known as the '**strategic asset allocation**' ("SAA") is the single most important determinant of investment outcomes. Of particular importance is the split between **Growth** assets such as equities, **Income** assets such as property, infrastructure and credit and **Protection** assets such as UK gilts. This was updated as part of the 2023 investment strategy review and this interim review builds upon this taking into account changes to the Fund's circumstances and the long-term outlook for markets.

Stochastic modelling / projections

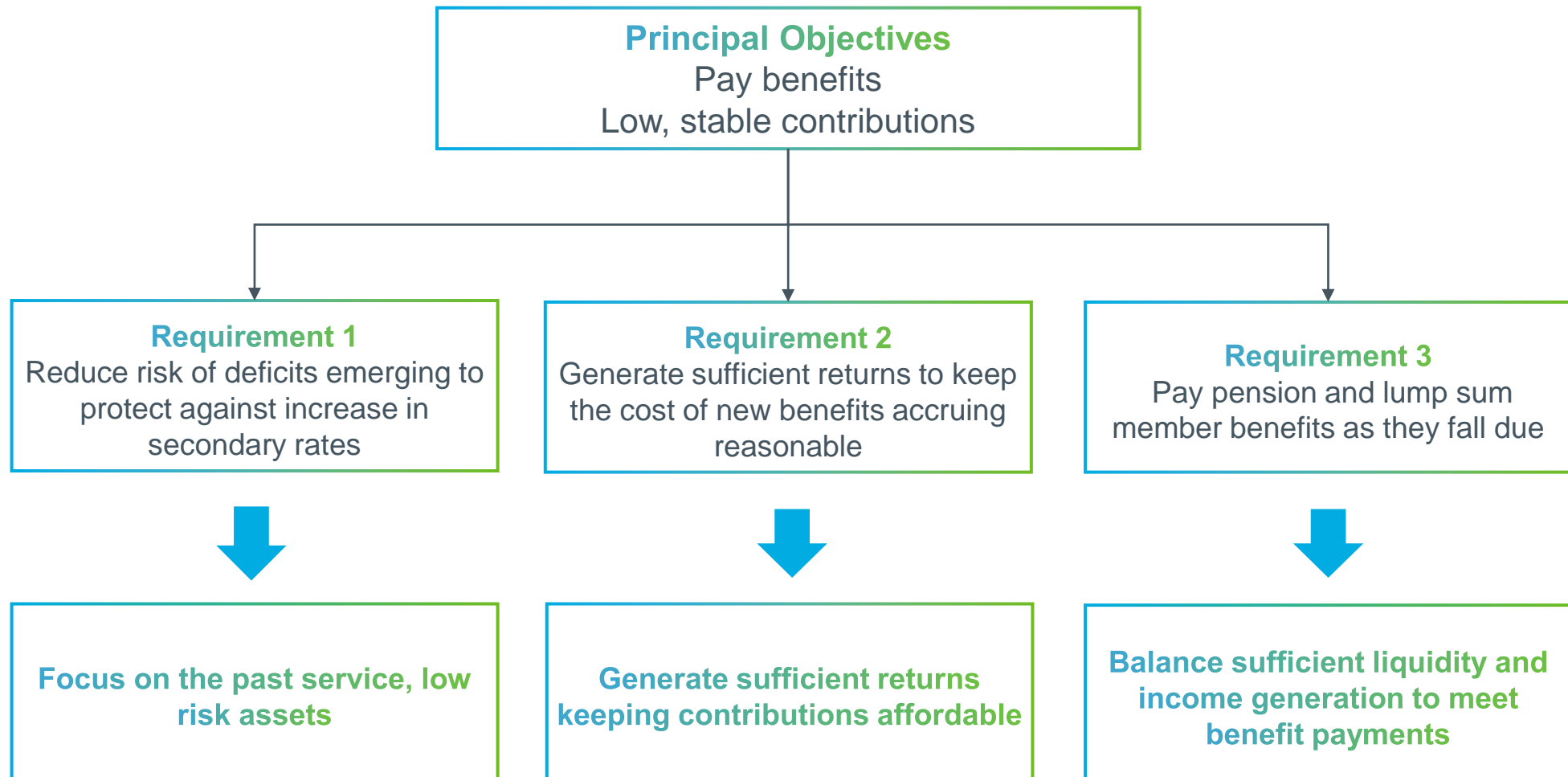
Our approach to reviewing the SAA is to re-evaluate the current strategy against a number of plausible alternatives using stochastic projections as well as qualitative considerations such as resilience to strategic risks, portfolio complexity and governance requirements. Our stochastic projections model investment performance across a wide range of macroeconomic scenarios and calculates key metrics such as expected return and portfolio volatility, which can be used to compare different strategies. This is a **lighter touch approach** than the full asset liability modelling that was undertaken for the 2023 review. **It only considers investment performance and does not model Fund-specific cashflows or the impact of changes to liabilities.** This approach is well suited for an interim update to the strategy building on the knowledge gained from the 2023 review.

Structural considerations

Investment structure specifies how the Fund's exposure to each asset class is implemented and covers second-order considerations such as the use of active or passive management, regional equity exposures; the type of infrastructure or credit mandates to be used. For this review we have focussed on the high-level investment strategy analysis and recommendations, and are happy to provide any support or advice to the Fund once the revised investment strategy is agreed, although in this paper we do comment at a high-level on possible implementation options.

The subsequent slides set out the key steps in an investment strategy review.

Reminder: the Fund's objectives



Strategic Considerations



Reminder: our strategic framework

To help focus the analysis involved in the strategy review we have used our growth/income/protection ('GrIP') framework, as per the diagram below, to frame the analysis and the different strategies to be tested.

GrIP framework

- A** Liabilities are just a series of cashflows
- B** Best estimates of cashflows is key
- C** Invest assets to meet cashflows

Your objectives



Growth

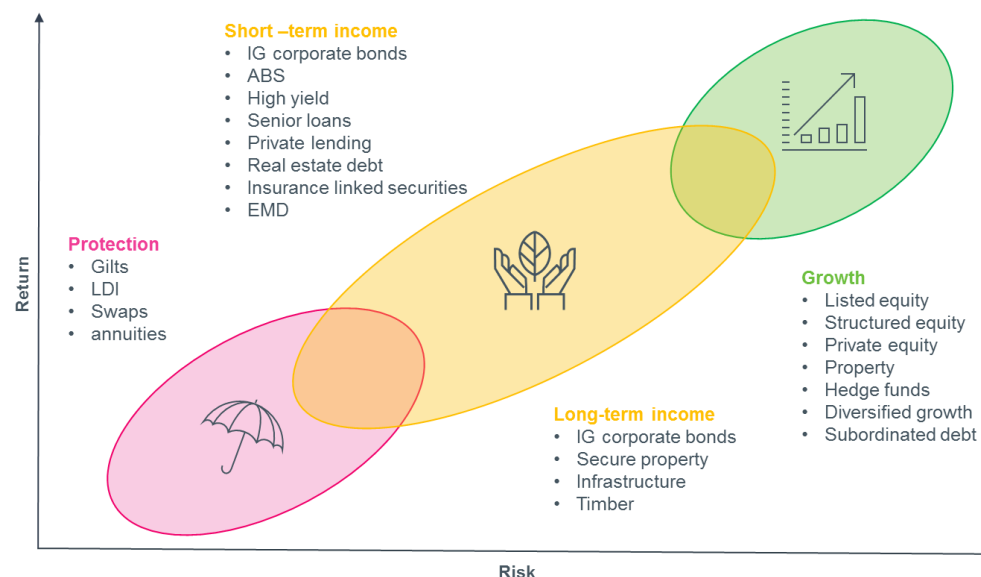


Income



Protection

GrIP opportunity set



Focused on delivering predictable outcomes

Current Investment Strategy

The table below sets out the Fund's investment strategy and actual asset allocation as at 31 March 2024.

Asset class	Current Strategy (%)	Actual Allocation* (%)
Growth	74.0	75.9
Equities	50.0	52.1
DGFs	13.0	13.0
Private Equity + Hedge Funds	11.0	10.8
Income	21.0	20.9
Property	4.0	3.7
Infrastructure	8.0	6.6
Global credit	9.0	10.6
Protection	5.0	3.2
Fixed Interest gilts	5.0	3.2
Total	100.0	100.0

*Total assets of £1.4bn with a funding level of 93% as at 31 March 2024.

High level observations

- Heavy **Growth** focus of assets comprising nearly $\frac{3}{4}$ of the Fund's target allocation. Driven largely by equities but with a high allocation to DGFs which have had mixed performance, rely heavily on manager-skill and are often unpredictable.
- Some asset class diversification through investments in Private Equity, Property and Infrastructure but could consider increased allocation to **Income** assets that would help diversify and deliver stable returns.
- Small allocation to **Protection** assets. Attractive yields provided by market expectations of shifts in interest rates, combined with low-risk make for an attractive proposition. The Fund could look to grow this albeit credit may be more attractive.

Market trends since the 2023 strategy review

As ever, market conditions have evolved since the last investment strategy review in May 2023. Current trends **should not unduly influence the long-term strategic asset allocation** of the Fund. However, they provide important context to the advice presented in this paper. During the intervening 12-month period:

- **Global equities have performed strongly, up 21%**, with performance dominated by a tech focused surge by a limited number of mega-cap stocks in the US.
- Underlying inflation has been more persistent than expected leading to:
 - reduced expectations for interest rate cuts;
 - **yields increasing** across all maturities – between 36 and 69 basis points.
- The macroeconomic outlook has become more positive, and a softer landing is priced in by markets:
 - **Credit spreads have narrowed** significantly (by c.50 bps for 20-year maturity, A rated bonds) and are low relative to historic levels.
 - Gilts and shorter dated credit are now relatively more attractive than higher maturities.
- Relative to their benchmarks, **diversified growth funds have continued recent underperformance**. This has partly been driven by rising yields, and limited equity exposure and poor asset allocation.
- In our view, illiquid assets have continued to act as a strong return seeking diversifier and are particularly well-suited to the requirements of open-ended DB pension funds, including the LGPS.
- Tactical considerations such as mandate flexibility, and the availability of liquidity are as important as ever to be able to dynamically adjust to unforeseen circumstances.

Modelling 6 alternative strategies

Six alternatives to the current investment strategy are considered:

Strategy 1 – Minimum disruption

- Removing the hedge fund allocation and reallocate capital to the global credit mandate.

Strategy 2 – Increase listed credit

- Removing the hedge fund allocation and reduce DGFs in order to increase the credit allocation by 8% (across global and buy and maintain (“B&M”) credit).

Strategy 3 – Increase listed credit and private debt

- Removing the hedge fund allocation and reduce DGFs in order to introduce an allocation of 4% to B&M credit and 4% to private debt.

Strategy 4 – Increase illiquids

- Removing the hedge fund allocation and reduce DGFs in order to introduce an allocation of 8% allocation to a broad illiquids mandate (private equity, property, infrastructure, private debt).

Strategy 5 – Increase illiquids and listed credit

- Removing the hedge fund allocation and removing DGFs entirely in order to introduce an allocation of 8% to a broad illiquids mandate and a 7% allocation to B&M credit.

Strategy 6 – Modestly increase illiquids and listed credit

- Removing the hedge fund allocation and reducing DGFs by around one-half, in order to increase allocations to credit, property and infrastructure.

Modelling 6 alternative strategies

The table below compares the current investment strategy with six selected alternative strategies that re-allocate and rebalance c.2-13% out of growth assets and into income assets.

Asset class	Current (%)	Strategy 1 (%)	Strategy 2 (%)	Strategy 3 (%)	Strategy 4 (%)	Strategy 5 (%)	Strategy 6 (%)
Growth	74.0	72.0	66.0	66.0	68.0	61.0	69.0
Equities	50.0	50.0	50.0	50.0	50.0	50.0	53.0
DGFs	13.0	13.0	7.0	7.0	7.0	-	7.0
Private equity	9.0	9.0	9.0	9.0	11.0	11.0	9.0
Hedge funds	2.0	-	-	-	-	-	-
Income	21.0	23.0	29.0	29.0	27.0	34.0	26.0
Property	4.0	4.0	4.0	4.0	6.0	6.0	6.0
Infrastructure	8.0	8.0	8.0	8.0	10.0	10.0	10.0
Global credit	9.0	11.0	11.0	9.0	9.0	9.0	10.0
Buy and maintain credit	-	-	6.0	4.0	-	7.0	-
Private debt	-	-	-	4.0	2.0	2.0	-
Protection	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Fixed interest gilts	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expected return (% p.a., 10 yrs)	7.9	7.9	7.9	8.0	8.2	8.1	8.0
Expected volatility (% p.a., 1 yr)	15.4	15.3	14.8	15.0	15.7	15.2	15.6

The remainder of this section will set out the results of our strategic modelling and the next section will address implementation considerations.

Modelling 6 alternative strategies

The alternative strategies presented on the previous slide focus on the following key themes:

Growth allocation

- **Maintain or slightly increase equity allocation** – this will continue to drive strong returns over the long term for the Fund.
- **Remove the hedge fund allocation** – given the separation of the diversified alternatives mandate on account of the Abrdn private equity sale, and recognition that a standalone hedge fund allocation of 2% is unsuitable.
- **Reduction in DGFs** – assessing whether reducing the DGF allocation in favour of different growth or income assets, will reduce the volatility of returns/improve diversification and how this impacts overall liquidity for the Fund.

Income allocation

- **Increasing the allocation to Income-focussed assets** – assessing whether increasing the allocations to Income assets will provide more stable and predictable levels of return. This could involve increasing holdings in existing mandates, or introducing new mandates.
- **Adding private debt** – diversifying asset with potential for strong return, income and lower volatility than equity or DGF mandates, although is very illiquid.

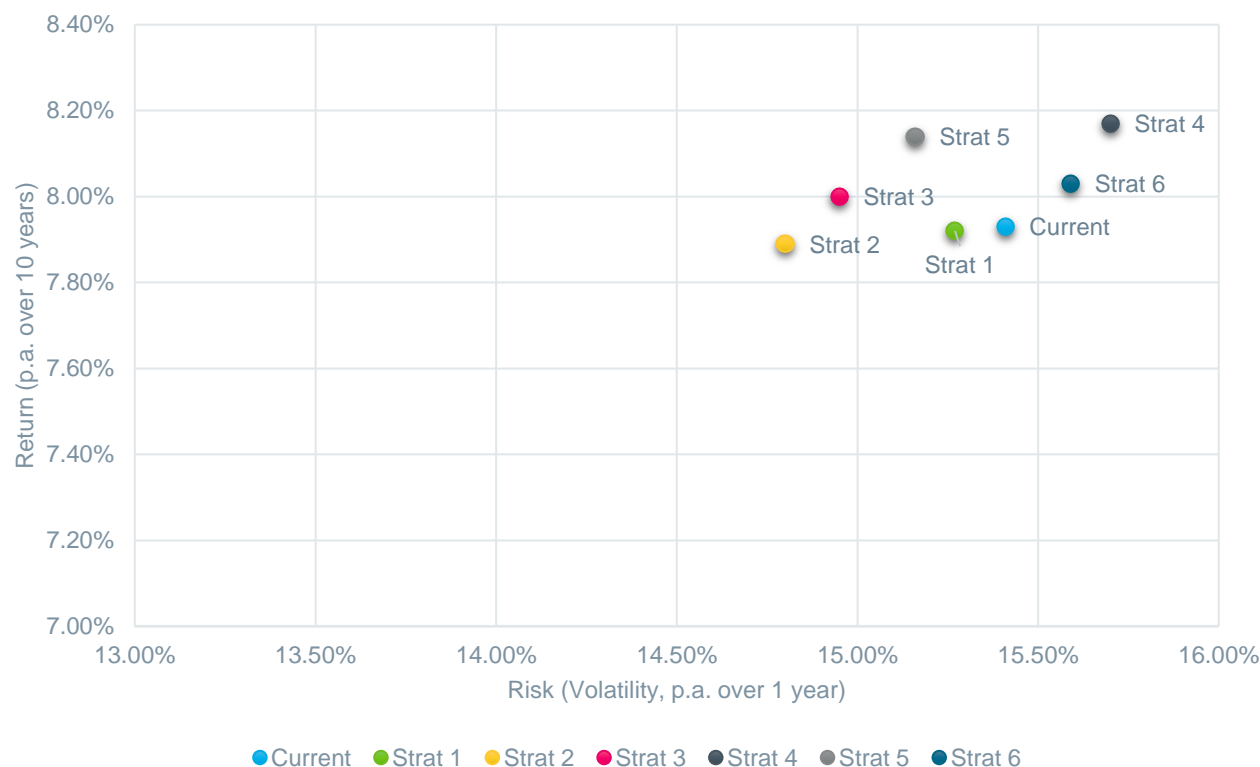
Protection allocation

- **Maintain allocation to protection assets** - given current yields, gilts could be considered an attractive addition to the portfolio, albeit we have a preference towards credit assets given yield levels.

Modelling 6 alternative strategies: results

- The adjacent chart shows portfolio level risk and return for the each of the 6 alternative strategies in comparison to current (**blue dot**).
- The increased allocations to credit and illiquid assets have a marked impact, reducing overall correlation between the risk return profiles of the assets in the portfolio, leading to improved expected return and increased diversification (and lowering overall volatility).
- This is particularly clear for strategies 3 and 5 which are expected to deliver increased returns with a lower level of volatility, in comparison to the current strategy.
- **Having discussed our initial recommendations with Officers there is a preference towards Strategy 6 which modestly changes allocations and risk/return, and would be straightforward to implement, which we would support.**

Portfolio level risk and return



Alternative strategies – considerations re liquidity

- While a primary consideration on strategic asset allocations for your Fund is the long term expected returns of a strategy, relative to the expected volatility of returns, it is **essential to maintain sufficient liquidity and therefore flexibility** in a strategy to be able to adapt to changing conditions and unforeseen events.
- The table below sets out the proposed alternative strategy 6 compared to the current strategy in terms of asset liquidity, and we note that whilst we are supportive of increasing allocations to illiquid assets (on the grounds of diversification and return potential) there may be ways, outside of LCIV, to implement illiquid investments via secondary markets, which can offer some pricing opportunities:

Asset class	Current (%)	Strategy 6:
Liquid Assets (%)	79	75
Illiquid Assets (%)	21	25

- Strategy 6 would involve a modestly higher allocation to illiquid assets, which we understand that the Officers believe would be reasonable and easy to accommodate.

Proposed investment strategy

Asset class	Current (%)	Strategy 6 (%)	Allocation Change
Growth	74.0	69.0	(5)
Equities	50.0	53.0	3
DGFs	13.0	7.0	(6)
Private Equity	9.0	9.0	-
Hedge Funds	2.0	-	(2)
Income	21.0	26.0	5
Property	4.0	6.0	2
Infrastructure	8.0	10.0	2
Global credit	9.0	10.0	1
Protection	5.0	5.0	-
Fixed Interest gilts	5.0	5.0	-
Total	100.0	100.0	-
Expected Return (% p.a., 10 yrs)	7.9	8.0	+0.1
Expected Volatility (% p.a., 1 yr)	15.4	15.6	+0.2

- After consultation with the Fund's Officers, our recommendation is to consider **Strategy 6** as it would be straightforward to implement, and would offer a modestly higher level of risk/return for the Fund through increased diversification. This strategy brings about a very small increase in expected return and volatility, but we do not believe this materially changes the Fund's risk exposures and future outcomes.
- We have held initial discussions with the Officers regarding how this strategy would be implemented, and would work with them to consider investment opportunities in infrastructure and property that have been created by current market conditions. The Committee would be updated on these additional investments in due course.
- Given the expected return of the strategy 6 is still well in excess of the 2022 valuation discount rate, there may even be scope to take a more significant de-risking step at some point in the coming years, but we note that this may have an impact on funding and future employer contributions. We also note the actuary's comment about potential for discount rates increases in 2025, which should be borne in mind.

Next Steps

Timescales	Item	Comment
July 2024	Pensions Committee meeting	Committee to discuss strategy recommendations from Hymans Robertson and supporting implementation recommendations from Fund Officers
Q3-Q4 2024	Implementation process	<p>In order to implement the new strategy, Fund Officers/Hymans Robertson will provide further recommendations on new mandates and asset transfers. This will include:</p> <ul style="list-style-type: none">- Consideration of any relevant investment options available via the London CIV, or non-LCIV secondary market opportunities- Review of existing DGF managers – noting LCIV’s project to reduce DGF options from 4 to 2
Early 2025	Investment Strategy Statement	Once there is a plan in place for implementing the revised investment strategy, the Fund’s Investment Strategy Statement will be updated by Fund Officers / Hymans Robertson.

Appendix 1: market conditions and outlook



Market movements since 2023 investment review

Strong equity performance alongside gradually rising yields have continued the trends observed just before the last investment review. However, inflation expectations have shifted to be higher for the next decade.

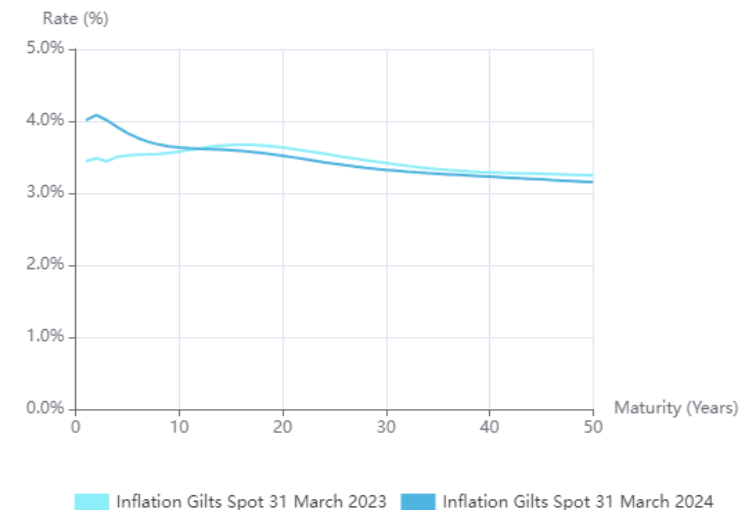
12 Months to 31 March 2024



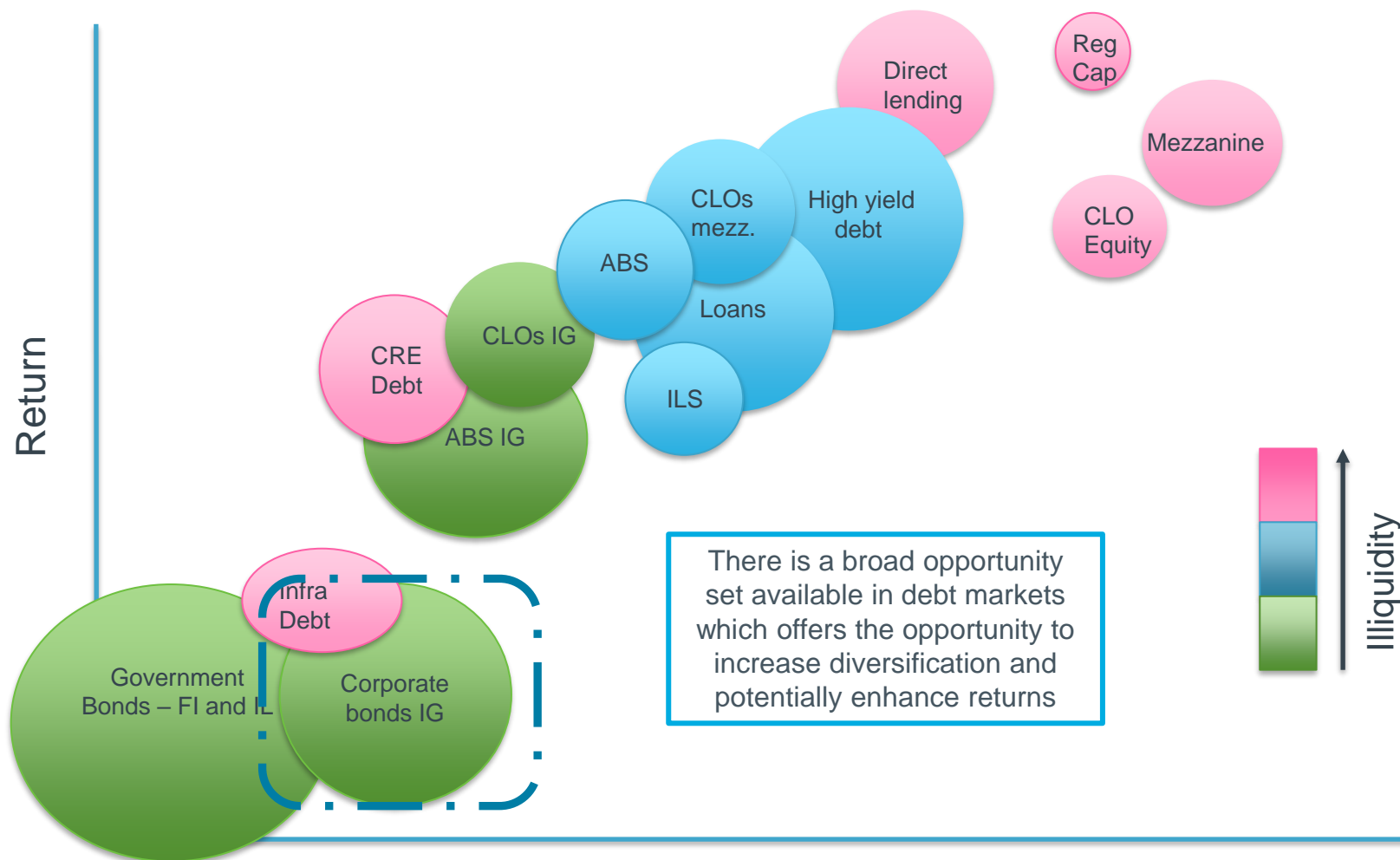
Nominal Curves



Inflation Curves



Universe of credit investments



Source: Ruffer, Bloomberg, Bianco Research

Current Outlook for Corporate Bonds

Background

Corporate bonds rank higher than equity in the capital structure – investment in the debt of a company is therefore less risky than investment in the equity of the same company. Returns come from the payment of interest by the issuing entity and the repayment of capital at the end of the term of the bond.

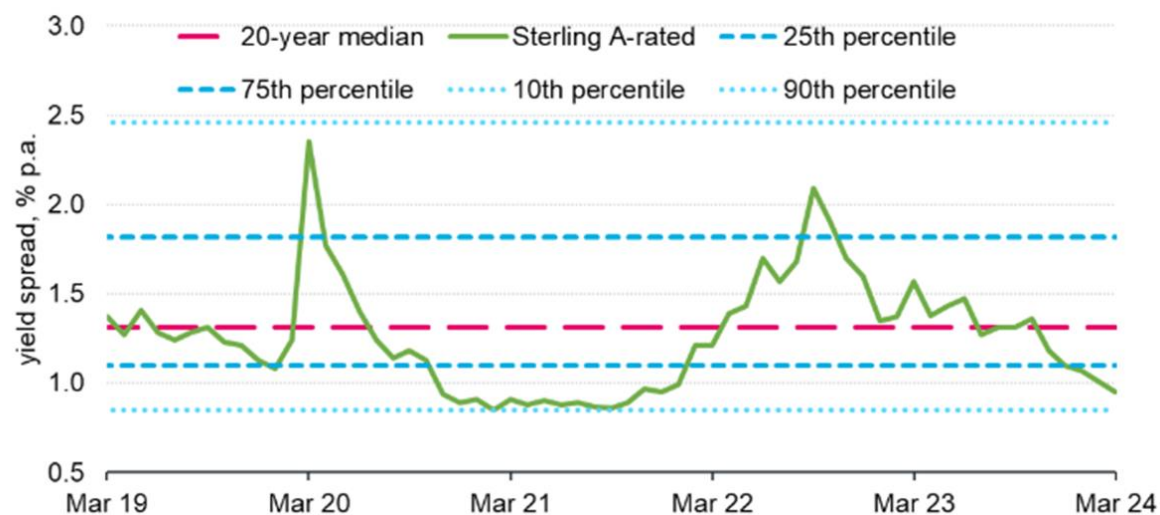
The primary risk within bond investment is default, i.e. that the issuer fails before all interest and capital is repaid. Credit ratings are set by agencies such as S&P and Moody's and ratings of AAA to BBB are known as “Investment Grade”. Corporate bond markets are very liquid and can easily be accessed through the London CIV.

Outlook

The increase in bond yields over recent years has significantly increased the attractiveness of fixed income assets, including investment grade credit. However, credit spreads are below historical averages and providing limited additional return over government bond yields (see figure).

Moreover, although slowing earnings growth may weigh on company debt affordability going forward, high interest coverage levels and lower leverage mean that we don't anticipate a very high level of defaults and downgrades.

Investment Grade Corporate Bond credit spreads



Source: ICE

Current Outlook for Illiquid Assets

2023 Recap

- Higher interest rates impacted illiquid assets, reducing leverage availability and affecting investor strategies.
- Fundraising challenges persisted due to investor caution towards illiquidity and market volatility, hindering new allocations.
- Many UK defined benefit private-sector pension schemes scaled back their illiquid assets exposures given they were now much closer to buyout, and needing more liquid assets to meet the buy-in price.

Private Equity

- Despite higher rates, positive return expectations endure, albeit potentially moderated compared to previous years.
- Continued scrutiny on deal quality and valuation as investors navigate a more discerning market environment.

Private Debt

- Favourable conditions for direct lending persist amidst a higher interest rate environment, potentially offering enhanced returns.
- Attention to credit quality crucial as rising rates may increase default risks, necessitating careful underwriting and monitoring.

Property

- Global property markets navigating significant value declines present both challenges and opportunities for investors seeking strategic acquisitions at more favourable prices.
- Limited transaction activity globally underscores market hesitancy, suggesting potential for prolonged adjustment periods before stabilization.

Infrastructure

- Inflation-linked returns present a resilient investment avenue amid rising inflation concerns, offering stability in uncertain economic climates.
- Increasing focus on infrastructure as a vehicle for natural capital investments underscores broader sustainability trends shaping investor preferences.

Summary

- Despite prevailing challenges, illiquid assets continue to offer promising risk-adjusted returns, emphasising the importance of strategic diversification.

Appendix 2: risk warnings and limitations



Reliances and limitations

The median returns and volatilities set out in this paper are calculated using 5,000 simulations calibrated using our Economic Scenario Service stochastic model (see below) based on market data as at 31 March 2024. All returns are geometrically annualised and net of fees.

Economic Scenario Service

- The distributions of outcomes depend significantly on the Economic Scenario Service (ESS), our (proprietary) stochastic asset model. This type of model is known as an economic scenario generator and uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated each month (for example, the current level of equity market volatility) while other more subjective parameters do not change with different calibrations of the model.
- Key subjective assumptions are the average excess equity return over the risk-free asset, the volatility of equity returns and the level and volatility of yields, credit spreads, inflation and expected (breakeven) inflation, which affect the projected liability and bond returns. The output of the model is also affected by other more subtle effects, such as the correlations between economic and financial variables.
- Real interest rates are assumed to (on average) gradually trend towards a long-term rate. This is based on a selection of yield normalisation levels (which can be interpreted as representing low, medium and high economic growth scenarios) reflecting the fundamental uncertainty around long-term average yield levels. Higher long-term yields would mean a lower value placed on liabilities and hence an improvement in the current funding position (and vice versa) unless the Scheme is fully hedged. Long term changes in yields also affect expected bond returns. Further information about these assumptions is available on request.
- While the model allows for the possibility of scenarios that would be extreme by historical standards, including very significant downturns in equity markets, large systemic and structural dislocations are not captured by the model. Such events are unknowable in effect, magnitude and nature, meaning that the most extreme possibilities are not necessarily captured within the distributions of results.
- Given the context of this modelling, we have not undertaken any sensitivity analysis to assess how different the results might be with alternative calibrations of the economic scenario generator.

Reliances and limitations (2)

Economic Scenario Service (continued)

- The returns presented here are time weighted returns over the specified period and are unaffected by the timing of any contributions received or pensions paid over that period. Such returns are, in general, a poor estimator of money weighted returns, which are sensitive to the timing of cashflows.
- The probability that a specific asset return will be exceeded will not usually equate to the probability that some funding plan based on this return will be sufficient to meet all the pension payments. Complex interactions between the assets, yields and cashflow timings can mean that the two probabilities are materially different, especially for more mature schemes.
- We would be happy to provide fuller information about the scenario generator, and the sensitivities of the results to some of the parameters, on request.

TAS compliance

The contents of this paper fall within the scope of Technical Actuarial Standard 100: Principles for Actuarial Work and complies with that standard.

Risk warning and disclaimer

Risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, property whether held directly or in a pooled or collective investment vehicle and illiquid assets such as private equity, private debt and infrastructure. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

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We have a research team that advises on shortlisting fund managers in manager selection exercises, which is separate from our client and other relationships with fund managers and therefore we do not believe there will be a conflict that would influence the advice given. We would be happy to discuss this and provide further information if required

Thank you

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