London Borough of Hammersmith and Fulham Pension Fund

Investment Strategy Update

June 2021

Introduction

This paper has been prepared for the Pensions Fund Committee ("the Committee") of the London Borough of Hammersmith & Fulham Pension Fund ("the Fund"). The purpose of which is to provide the Committee with information on the Fund's current investments and analysis estimating the current interest rate and inflation exposure of the assets in relation to the liabilities.

Background

The Fund's overall investment strategy allocation has undertaken some changes since the previous review in January 2020 due to changes in market views during the global pandemic and the need for swift action. In addition, over the period since the last review, several of the Fund's current investments have been in the process of drawing or returning capital as part of their investment life cycles alongside all assets delivering their respective returns further affecting the overall allocation.

In order for the Committee to understand the impact of each of these factors on the Fund's strategic allocation, the table overleaf has been prepared using values provided by Northern Trust as at 31 March 2021 with future allocations estimated based on committed capital. Within the table, the Fund's current and expected future asset allocation is shown alongside the current and expected future benchmark, with notable changes highlighted in green which are further explained below.

Manager	Asset Class	31 Mar 2021 (£m)	31 Mar 2021 (%)	Current B'mark (%)	Future Allocation (£'m)[1]	Future Allocation (%)[1]	Future B'mark (%)
LCIV	Global Equity Core	174.8	14.4	15.0	174.8	14.4	15.0
LGIM	Low Carbon Equity (passive)	381.4	31.4	30.0	381.4	31.4	30.0
	Total Equity	**556.2**	**45.8**	**45.0**	**556.2**	**45.8**	**45.0**
LCIV	Absolute Return	280.7	23.1	10.0	160.7	13.2	12.5[3]
LCIV	Global Bond	107.3	8.8	10.0	107.3	8.8	10.0
	Total Dynamic Asset Allocation	**388.0**	**32.0**	**20.0**	**268.0**	**22.1**	**22.5**
Partners Group	Multi Asset Credit	13.9	1.1	0.0	0.0	0.0	0.0
Oak Hill Advisors	Diversified Credit Strategy	80.0	6.6	7.5	80.0	6.6	7.5
Partners Group	Direct Infrastructure	32.0	2.6	5.0	48.8[2]	3.9	5.0
Aviva	Infrastructure Income	25.5	2.1	2.5	25.5	2.1	2.5
ASI	Multi Sector Private Credit	55.9	4.6	5.0	55.9	4.6	5.0
	Secure Income	**207.4**	**17.1**	**20.0**	**210.4**	**17.2**	**20.0**
M&G	Inflation Opportunities	0.0	0.0	10.0	0.0	-	0.0
ASI	Long Lease Property	61.2	5.0	5.0	61.2	5.0	5.0
ARC	Ground Rents	-	-	-	60.0	4.9	5.0
Man GPM	Affordable Housing	-	-	-	30.0	2.5	2.5
	Total Inflation Protection	**61.2**	**5.0**	**15.0**	**181.2**	**15.0**	**12.5**
Northern Trust	Trustee Bank Account	-	-	0.0	-	0.0	0.0
	Total	**1,213.2**	**100.0**	**100.0**	**1,216.2[2]**	**100.0**	**100.0**

Source: Northern Trust, note figures may not sum due to rounding
[1]Estimated based on 31 March 2021 figures and proposed allocations
[2]The Fund's commitment to the Partners Group Direct Infrastructure 2015 Fund is denominated in Euro thus any drawn down amount will fluctuate in GBP terms over time. As such the future figure to be drawn down in GBP terms has been estimated by Deloitte based on remaining commitment figures provided by Partners Group and the GBP:Euro exchange rate as at 31 March 2021.
[3]Includes 2.5% of the 10% M&G disinvestment, yet to be allocated elsewhere.

The notable developments to the Fund's strategy and allocation that are expected to occur in the coming periods include:

- The further realisation of the Partners Group MAC investment following the end of the fund's investment period in July 2017, with subsequent distributions occurring since. Partners Group have proposed to extend this by three years until 28 July 2024.

- The continued draw down of the Partners Group Direct Infrastructure 2015 Fund following the Fund's commitment in 2015, which is expected to occur predominantly over the remainder of 2021. Further details of which can be found in the *'Partners Infrastructure Update'* paper.

- On 1 September 2020, the Fund fully disinvested from the M&G Inflation Opportunities V Fund, with the decision to disinvest a result of the Fund's high exposure to the UK commercial property market as well as the impact the global pandemic was having on commercial property and M&G's rental collection. On 1 October 2020, the disinvestment proceeds were subsequently received from M&G, and on 16 October 2020, the proceeds were transferred into the LCIV Absolute Return Fund (c. £113m), managed by Ruffer, as a temporary allocation.

- On 16 February 2021, a manager selection exercise was carried out by the Fund to replace the M&G Inflation Opportunities V Fund within the inflation protection allocation. The asset classes included ground rents, affordable housing and supported living by various managers, with the Committee deciding to allocate c. 5% to the Alpha Real Capital ("ARC") Index Linked Income Fund and a c. 2.5% allocation to the MAN GPM Community Housing Fund. Both allocations total to £90m and will be taken from the overweight Ruffer allocation (temporary hold for the M&G disinvestment proceeds).

- In addition, the Committee made a 'decision in principal' to allocate c. 2.5% to the Henley Secure Income Fund ("Henley SIPUT Fund") within the supported living asset class subject to Henley showing that certain factors and metrics had developed to a level the Committee were comfortable with within an appropriate time frame. Such factors and concerns have not been satisfied and with the fund holding a final close on 30 June 2021, the decision to invest was not taken. Further details of the developments of this decision can be found below.

Henley Update

The Henley Secure Income Property Unit Trust ("SIPUT") presentation during the manager selection exercise focused on the fund's approach to the supported living sector, development and construction of purpose-built residential accommodation.

The questions from the Committee at the meeting to Henley mainly focused on the some of the fund's characteristics, notably the current occupancy rates and how the manager would approach and address this going forward.

Following the meeting, as part of the formal decisions taken by the Committee a 'decision in principal' was taken with respect to the Henley SIPUT Fund such that Fund would make an allocation to Henley providing that the underlying characteristics including occupancy improved. The Committee delegated the monitoring of Henley to the Officers and Deloitte, with the view to final decision by the Committee during at a Pension Fund Committee meeting later this year.

There was a call on 29 April 2021 between Henley, Deloitte, Officers and Michael Adam. On this call, Henley shared their projections for occupancy improvements, diversification of registered providers and capex completion. The occupancy level was c. 83% excluding capex and c. 77% including capex. Henley stated the fund was on track to reach 90% occupancy by year end.

While the reasoning for occupancy rates to be below expected/target levels was understood, as well as the rationale for this to continue improving throughout the year, it was still not at a level deemed satisfactory by Officers (in agreement with Deloitte and Mike). With the SIPUT closing on 30 June 2021, the Officer recommendation is to not make an investment in Henley SIPUT.

Interest Rate and Inflation Exposure

To analyse the current and future investment strategy and opportunities of the Fund, one area that can be considered is the impact of changes in interest rates and inflation. When either increases or decreases it is likely that the present-day value of both the Fund's assets and liabilities will change, creating an element of funding volatility as the relative movement of each may be different.

Although the Fund's liabilities are valued through a "best-estimate minus" discount rate by the Scheme Actuary, which considers the allocation of the Fund's assets and their return assumptions, due to the market interactions between these assets and changes in interest rates, the underlying expected return on each may change. A proportion of the Fund's liabilities will also be valued with an inflation assumption that will change with economic developments and expectations.

Overall, it is expected that as interest rates increase/decrease (increasing/decreasing the discount rate used), the value of the Fund's liabilities will fall/rise. Conversely, as expected inflation increases/decreases, the value of the Fund's liabilities will be expected to rise/fall.

Changes in interest rates and expected inflation can also impact the value of assets within investment markets. For asset classes that are underpinned by a series of future cashflows such as bonds, the present value of these assets will often be dependent on a discount rate that itself is dependent on current interest rates plus a spread (representing credit risk for example). Similarly, if the future cashflows are linked to inflation such as index-linked gilts, then the present-day value will be discounted at an expected rate of inflation.

As assets are generally not just valued using a discounted cashflow model and are dependent on other factors, as highlighted earlier, the asset's values may change to a different extent than the underlying changes in interest rates or inflation.

Relative Hedging

A method used to analyse a pension schemes sensitivity to interest rate and inflation movements relative to liabilities is to estimate the value change that would occur if either interest rate was to increase/decrease by the same value across both assets and liabilities.

The value change is generally estimated by taking the cashflow component of an asset or liability and changing either the interest rate or inflation assumption within the discount rate, with long-dated cashflows more sensitivity to the assumption changes due to increased levels of discounting. The sensitivity change that is generally used is a 1 basis point ("bp") shift, denoted by PV01 for changes in interest rate and IE01 for changes in inflation. By comparing the total change of the assets relative to the total change of the liabilities, a hedging level can be obtained.

We asked the Fund's investment managers to estimate the PV01 and IE01 of their respective portfolios. In some instances, where a 1bp change to interest rates or inflation did not have any material impact on the present valuation, the managers have used a larger discount rate adjustment (35bp or 50bp) and scaled back to get the impact of a 1bp move. In instances where PV01 and IE01 was not available, we have made an estimation using the duration of the portfolio and expected inflation linkage where appropriate. Given most of the Fund's investments are assets where values will be impacted by other market forces and cashflows are to an extent uncertain, this is not a precise hedge by any means, but does give some indication of the extent to which the Fund's assets will be impacted by changes in interest rates and inflation expectations.

The latest available sensitivity estimates of the Fund's liabilities are given in the 31 March 2019 valuation report. Based on the information provided by the investment managers we estimate that the Fund had c. 19% hedging level to interest rates and c. 46% inflation hedging level based on 31 March 2021 values. When including the future allocations to the Alpha Real Capital ground rents and Man Group affordable housing mandates, the interest rate and inflation hedging levels is expected to increase to c. 34% and c. 79% respectively. It should however be highlighted that these may be slightly inflated, given we are comparing the value of the assets as at 31 March 2021 with the value of the liabilities at 31 March 2019. If the value of the liabilities has increased since 2019, the estimated hedge levels will be lower.

The Fund's overall higher inflation hedging level is partly attributed to the liabilities being less sensitive to changes in inflation, with total assets being roughly equal in terms of interest rate and inflation sensitivity in estimated absolute terms.

It should also be noted that the majority of inflation sensitivity from the assets is via the ARC ground rents allocation and the ASI Long Lease allocation, both of which provider inflation-linked income through rental leases. As mentioned earlier, the inflation 'hedge' from both funds can be impacted by other market forces (such as defaults and occupancy levels), but is also not necessarily a true inflation hedge, given rental uplifts are often relatively infrequent (typically annual). Therefore, changes to inflation expectations would have not have an immediate impact on these assets to the same extent as it would on the Fund's liabilities.

The Fund's has a relatively small exposure to assets which we would expect to move more closely with the liabilities in terms of reacting to changes in interest rates and inflation expectations. Only the Fund's investment with PIMCO, which invests predominantly in investment grade corporate bonds, and Ruffer, which holds a significant allocation to index-linked Gilts would hold the characteristics we would expect of true hedging assets. Both funds combined deliver hedge levels of c. 7% and c. 25% relative to changes in interest rates and inflation expectations respectively.

Deloitte Comments

Firstly, given the caveats around using asset and liability valuations at inconsistent dates, we would recommend this analysis is undertaken again in line with the latest actuarial valuation to give a clearer picture. That said, this should give the Committee an idea of how the assets are likely to move and the degree of which the assets are exposed to changes to interest rates and inflation, relative to the liabilities.

From an overall allocation perspective, the Committee should consider the 2.5% allocation that remains with Ruffer, following the M&G disinvestment last year. We have prepared a separate paper on the Leisure Property Sector and will also be having a call with Henley on 22 June 2021 regarding a new fund opportunity which they believe may eradicate some of the concerns raised. We will provide a verbal update to the Committee at the Committee meeting on 28 June 2021.

Deloitte Total Reward and Benefits Limited

June 2021

Risk Warnings

- Past performance is not necessarily a guide to the future.
- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

Our advice will be specific to your current circumstances and intentions and therefore will not be suitable for use at any other time, in different circumstances or to achieve other aims or for the use of others. Accordingly, you should only use the advice for the intended purpose.