Mercer

welcome to brighter

Investment Strategy Review

Clwyd Pension Fund Committee

February 2023

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Clwyd Pension Fund

Investment Strategy Review: Proposed Timeline

Due to market conditions Investment Strategy Review was pushed back to be taken to the Committee in early 2023

Mercer Actions

Officer Actions

April 2022

(1) April 2022
Preliminary meeting with Officers to discuss economic and market background at investment day

(1) April 2022
Officers to attend investment day meeting
29 April 2022

(2) August 2022
Asset class discussion meeting with Officers (including training if required)

September 2022

(3) September 2022
Post receipt of preliminary actuarial valuation results, initial analysis performed and presented at meeting with Officers

(3) September 2022
Officers to attend valuation results meeting
15 September 2022

(4) September/ October 2022
Further analysis undertaken based on Officer feedback and finalised valuation data

November 2022

(5) November 2022
Final analysis and recommendations made to Officers

(6) November 2022
Officers to agree final recommendations prior to Committee meeting
23 November 2022

(7) November 2022
Presentation of analysis and recommendations to the Committee at
~~23 November 2022~~

February 2023

(8) February 2023
Communicate changes to the Fund's investment managers

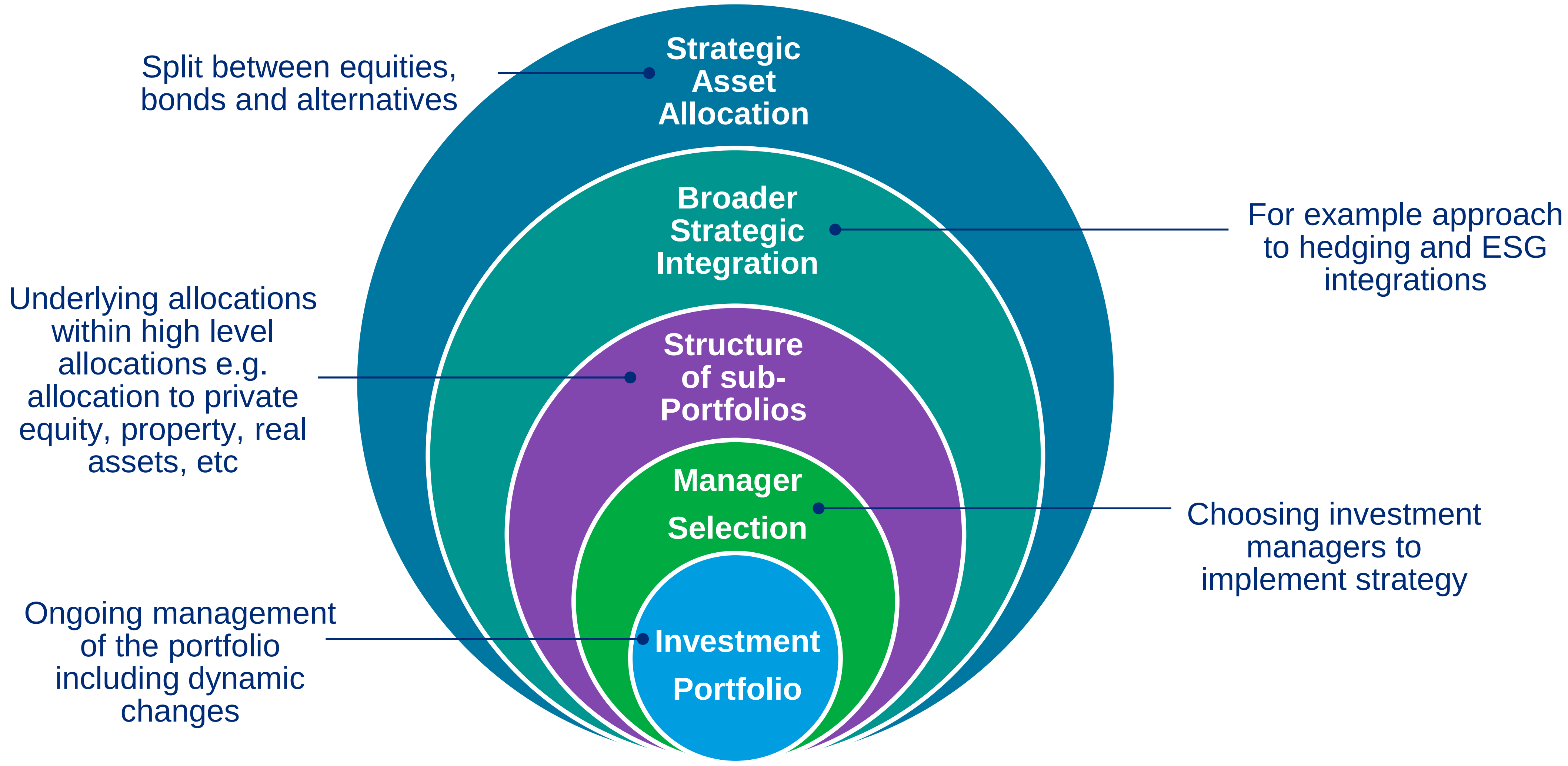
(8) February 2023
Communicate changes to Fund's investment managers discuss progress at committee meeting on
15 February 2023

(9) February 2023
Implement changes to the investment strategy and update ISS

Ongoing
Monitoring and governance

The timescales above are indicative and will depend on the amount of time taken to complete each step
Numbers in brackets show stages of project plan; previous stages must be completed before subsequent stages can start

Setting the Investment Strategy



Top level strategic decisions account for 80/90% of returns and should be the area of focus

Linking Funding and Investment

2022 Actuarial Valuation Summary (Past Service Position)

	31 March 2022	30 September 2022
Past Service Discount Rate	CPI + 1.50% p.a.	CPI + 2.40% p.a.
Surplus / (Deficit)	£126m	£36m
Funding Level	105%	102%

The table above is based on the provisional 2022 actuarial valuation results and approximately updated to 30 September 2022.

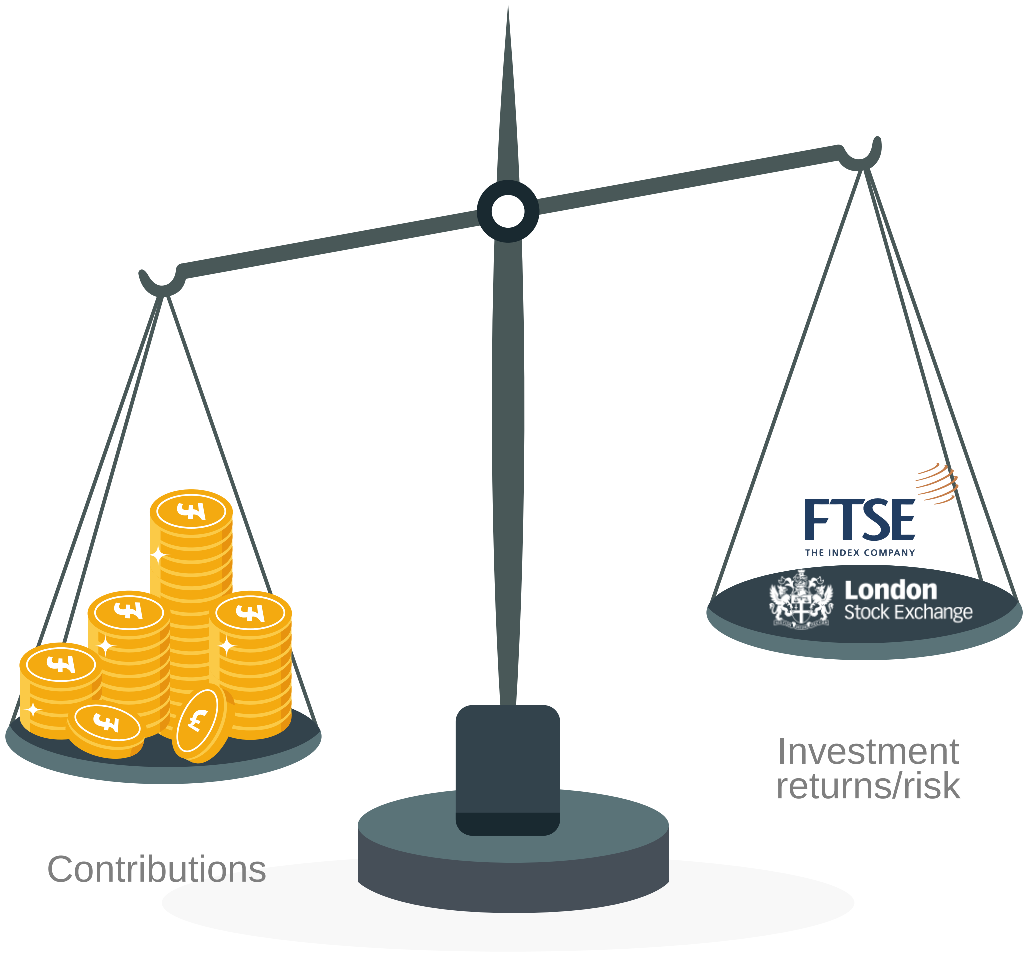
Fund assets have grown by c£620m between 2019 and 2022 actuarial valuations

Balance of risk and return

Future Service

Higher contributions

Lower contributions



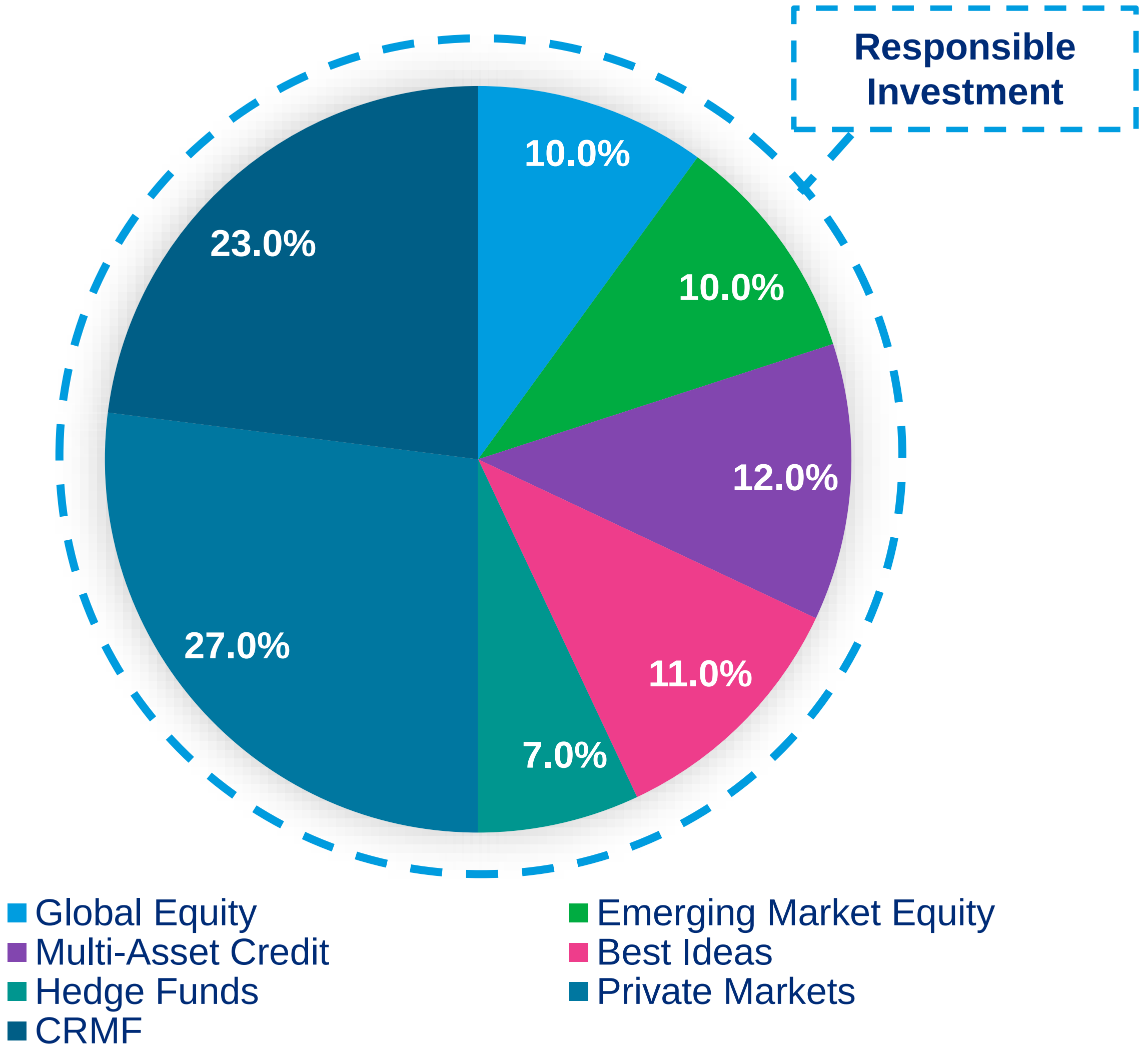
Higher returns and higher risk

Lower returns and lower risk

Future cost of accrual is also an important consideration and can sit at odds with the desirable level of risk when the Funding Level is strong

Investment Strategy – various roles in Fund's asset portfolio

Current Target Position



Asset allocation position

Global Equity – Growth asset. Consider introducing new Active Sustainable Fund within the Welsh pool.

Emerging Market Equity – Growth asset. Providing risk premium returns.

Best Ideas Portfolio – Diversified portfolio of growth assets directed by the Officers. Potential to introduce sustainable assets with an ESG focus to enable decarbonisation of Fund.

Hedge Funds – Diversifier within the portfolio, providing active returns with a low correlation to other investments within the Fund.

Multi-Asset Credit – Diversified portfolio of bonds with the aim of providing moderate returns.

Cash and Risk Management Framework (CRMF)– Complex framework providing protection against a variety of risks, such as interest rates, inflation, equity, FX and cashflow.

Private Markets – Key growth assets providing access to illiquidity premium:

Property – Inflation sensitive growth asset, exposed to UK, European and US property.

Private Equity – Diversifying growth asset providing access to the illiquidity premium.

Local/ Impact – Diversifying growth asset providing access to the illiquidity premium with an impact/ sustainable focus on the underlying funds.

Infrastructure – Diversifying growth asset providing illiquidity premium and in some cases access to inflation-linked returns and positive ESG characteristics.

Private Credit – Diversifying growth asset providing access to the illiquidity premium.

Key Considerations

- **Funding level remains “strong”** – no need for fundamental change to “fix” a funding gap.
- **March 2022 position** - CPI +1.5% p.a. discount rate at valuation date vs. CPI +2.7% p.a. expected investment return (based on Mercer Capital Market Assumptions as at 31/03/22) under the current target investment strategy.
- **September 2022 position** – CPI +2.4% p.a. discount rate at valuation date vs. CPI +4.8% p.a. expected investment return (based on Mercer Capital Market Assumptions as at 30/09/22) under the current target investment strategy.
- **Private Market and Equity returns (and risk)** continue to dominate investment strategy.- the Fund can continue to build on the progressive allocations to date made in respect of sustainability and impact
- **Inflation risks** remain prominent
- **Interest rate risk** - officers have recently increased interest rate protection within the Cash and Risk Management Framework, the dynamic nature of the framework remains vital to ensuring it continues to add value .
- Scope to increase **sustainable/impact allocations** within liquid assets, the Fund will be allocating to the new **Active Sustainable Equity Sub-Fund** that the Wales Pension Partnership are developing.

This investment strategy review only requires “light touch” adjustments to Fund’s current position

Note: Discount rate is based on past service discount rate.

Themes and Opportunities 2023

Déjà New concept

Recovery from a global pandemic, missions to the moon, runaway energy prices due to regional conflict …
…The early 1970s or the early 2020s? –
Both (H3N2 / COVID, Yom Kippur War / Ukraine, Apollo / Artemis).

History Rhyme

Resources conflict, weak growth, soaring inflation, and unconventional fiscal policy leave investors looking to the lessons of yesteryear on how to be equipped for whatever comes next. With the withdrawal of liquidity, markets will have to stand on their own two feet, increasing the value of capital.

Position for Transition

The decline in commodity availability has highlighted the need for energy security, energy innovation and a long overdue overhaul of ageing infrastructure. Necessity is the mother of invention, and our current challenges will drive the next wave of technologies in energy, the environment, healthcare, and beyond.

Degrees of Freedom

'Degrees of freedom' is mathematics speak for wiggle room. This theme speaks to the power of quality governance: the ability to capitalise on opportunities, the capacity to make and manage sophisticated investments, particularly in private markets, and the potential to dynamically diversify.

Themes and Opportunities 2023

What Déjà New means thematically

History Rhyme

Inflation playbook
Cyclical vs structural inflation risks, investing during an inflation regime

End of free money
Fed put expiry, zombies, liquidity, income comeback, policy decoupling

Balance of power
Hot and cold wars, energy, food, assess exposures

Position for Transition

Resource code
Planetary boundaries, circular economy, infrastructure

The age of engagement
Managing stakeholder needs just transition, biodiversity, impact

Mother necessity
Clean tech, hard-to-abate, adaptation, healthcare, cybersecurity

Degrees of Freedom

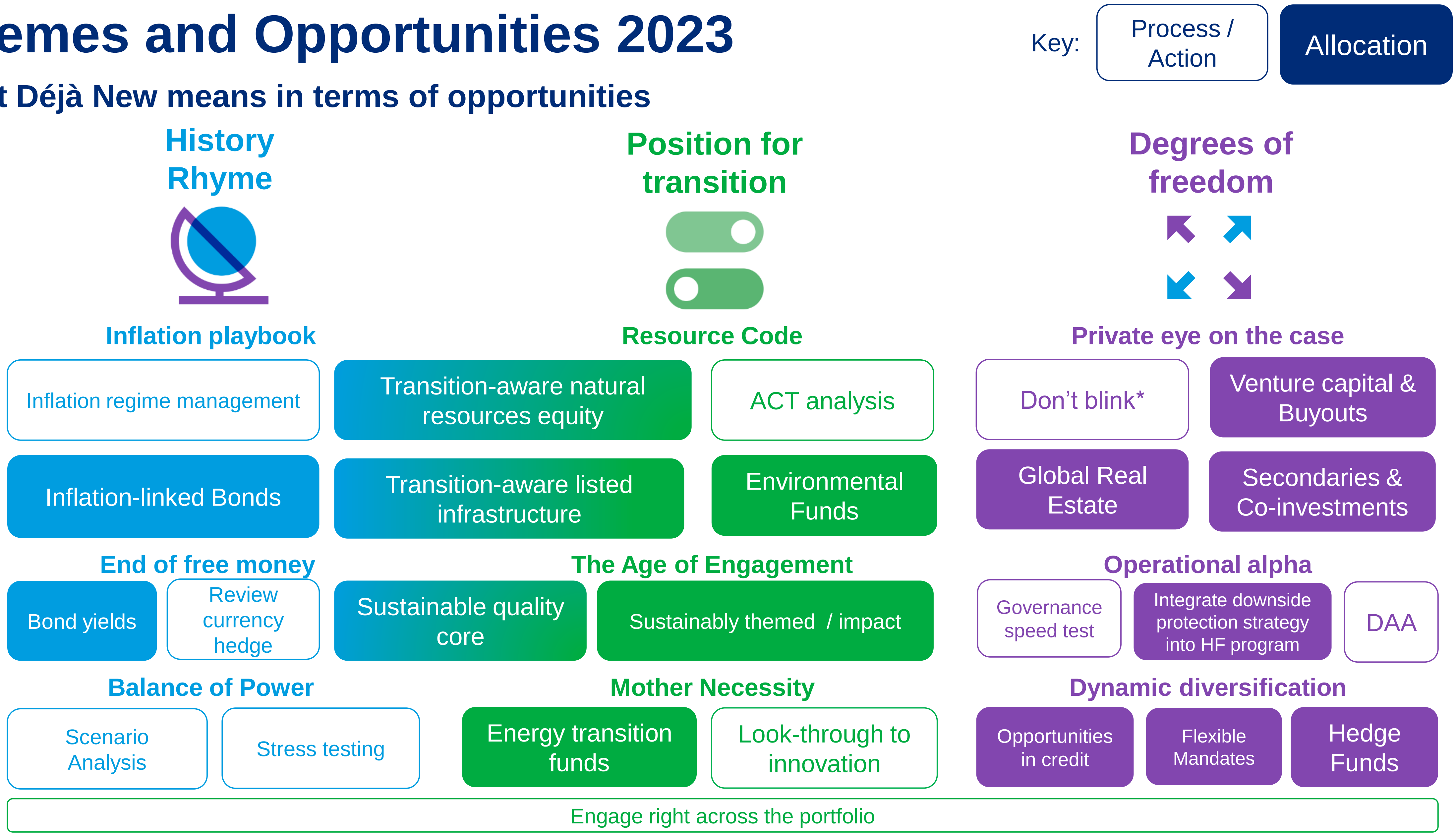
Private eye on the case
Accessing innovation, changing dynamics and product proliferation

Operational alpha
Governance with speed and quality helps capture dislocations

Dynamic diversification
Downside protection, dynamism within strategy, alpha, real assets

Themes and Opportunities 2023

What Déjà New means in terms of opportunities



*Maintain private markets program and commitments schedule

Rationale for recommended changes

Equity Portfolios

Increase the strategic allocation to **Global Equity** to **15.0%**

Decrease the strategic allocation to **Emerging Market Equity** to **5.0%**

	Previous strategic allocation	Proposed strategic allocation	Change
Global Equity	10.0%	15.0%	↑
Emerging Market Equity	10.0	5.0%	↓

- Mercer believe that an increased de-globalised world reduces the advantages of having ***significant overweight*** exposure to emerging markets, as witnessed in the last couple of decades. The political instability in various segments of emerging markets is leading to lumpy return profiles.
- As a result Mercer recommend reducing the strategic asset allocation to emerging market equity and increasing the allocation to global equities to bring it more closely aligned with MSCI AC World Index weightings.
- In addition Mercer recommends allocating all of the Fund’s proposed weight of 15% in Global Equities to the WPP Sustainable Active Equity Sub-Fund (post launch).

Rationale for recommended changes

Hedge Funds and Impact/Local portfolios

Decrease the strategic allocation to **Hedge Funds** to **5.0%**

Increase the strategic allocation to **Local/Impact** to **6.0%**

	Previous strategic allocation	Proposed strategic allocation	Change
Hedge Funds	7.0%	5.0%	↓
Local/Impact	4.0%	6.0%	↑

Hedge Funds

- Mercer recommend a reduction in the strategic allocation to Hedge Funds from a previous allocation of 7.0% to 5.0%.
- The fundamental restructure of the Hedge Funds mandate (undertaken as part of the 2019/20 investment strategy review) has produced returns in excess of the target.
- Significant market volatility in recent years has provided strong context for an asset allocation position that has a low beta to equities and exposure to a dynamic strategy aiming to add value in different market environments.
- Mercer still believe the mandate has an important role to play through its allocation in the wider asset portfolio, though the ability to hedge a range of investment risks also exists through the CRMF.
- A new strategic weight of 5% is therefore recommended.

Local/Impact

- The Local/Impact portfolio plays an important role in the Fund’s asset portfolio allowing investments to be made across a range of illiquid asset classes: Private Equity, Private Debt, Infrastructure and Real Estate.
- The forthcoming DLUHC Consultation will, amongst other aspects, focus on the Levelling Up agenda and how the LGPS can play a part in this. The focus will be on LGPS Funds allocating to “local” (Local has been stated to mean UK) investments at a minimum of 5% of total assets.
- Mercer recommend increasing the strategic allocation to the Local/Impact portfolio from 4.0% to 6.0% funded through the reduction to the Hedge Funds allocation.
- Given the allocation is multi-asset in nature it does not lend itself to creating significant concentration risk and it would allow for an ambitious approach to impact to be further demonstrated.

Investment Strategy Modelling

Portfolio's Modelled – 30 September 2022

	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
Global Equity	10.0	11.1	15.0	10.0
EM Equity	10.0	9.1	5.0	10.0
MAC	12.0	9.7	12.0	10.0
Hedge Funds	7.0	7.3	5.0	7.0
Best Ideas	11.0	11.6	11.0	12.0
Private Markets	27.0	30.2	29.0	28.0
CRMF	23.0	17.1	23.0	23.0
Cash	-	3.9	-	-
Total	**100.0**	**100.0**	**100.0**	**100.0**

Interest Rate Hedge (%)	50%	50%	50%	50%
Inflation Hedge (%)	40%	40%	40%	40%

Recommended Strategy

Investment Strategy Modelling

Key return Percentiles – 30 September 2022

Return metrics (20 years)	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
Expected absolute return	8.0% p.a.	8.0% p.a.	7.9% p.a.	7.9% p.a.
Expected return over CPI	CPI +4.8% p.a.	CPI +4.9% p.a.	CPI +4.7% p.a.	CPI +4.7% p.a.
Risk (3-year 95% VaR) (£m)	£861m	£873m	£855m	£857m
Probability of achieving Past Service Discount Rate of CPI +2.4% p.a.	81.5%	81.2%	81.0%	80.9%
Probability of achieving Future Service Discount Rate of CPI + 2.5% p.a.	80.5%	80.2%	80.0%	79.8%

	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
60% Confidence	CPI +4.1% p.a.	CPI +4.1% p.a.	CPI +4.1% p.a.	CPI +4.1% p.a.
68% Confidence (proposed past service discount rate)	CPI +3.4% p.a.	CPI +3.4% p.a.	CPI +3.3% p.a.	CPI +3.3% p.a.
70% Confidence	CPI +3.4% p.a.	CPI +3.4% p.a.	CPI +3.3% p.a.	CPI +3.3% p.a.
80% Confidence	CPI +2.5% p.a.	CPI +2.5% p.a.	CPI +2.4% p.a.	CPI +2.4% p.a.

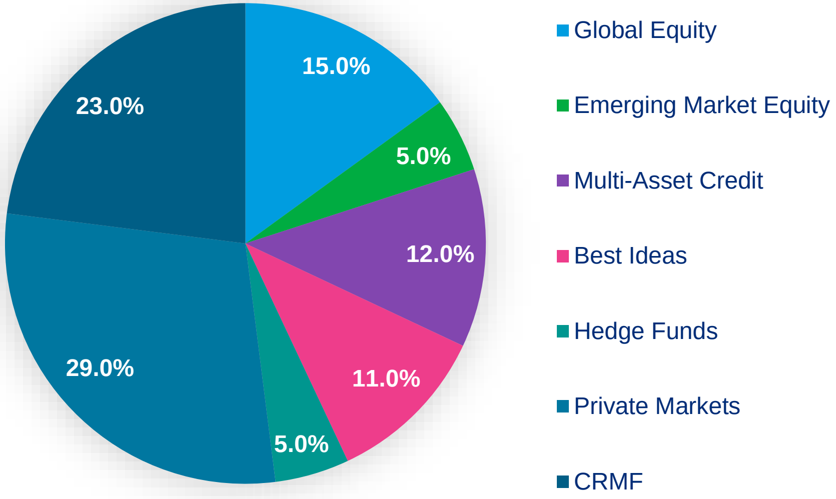
Note: Future Service Discount Rate yet to be agreed.

30 September 2022

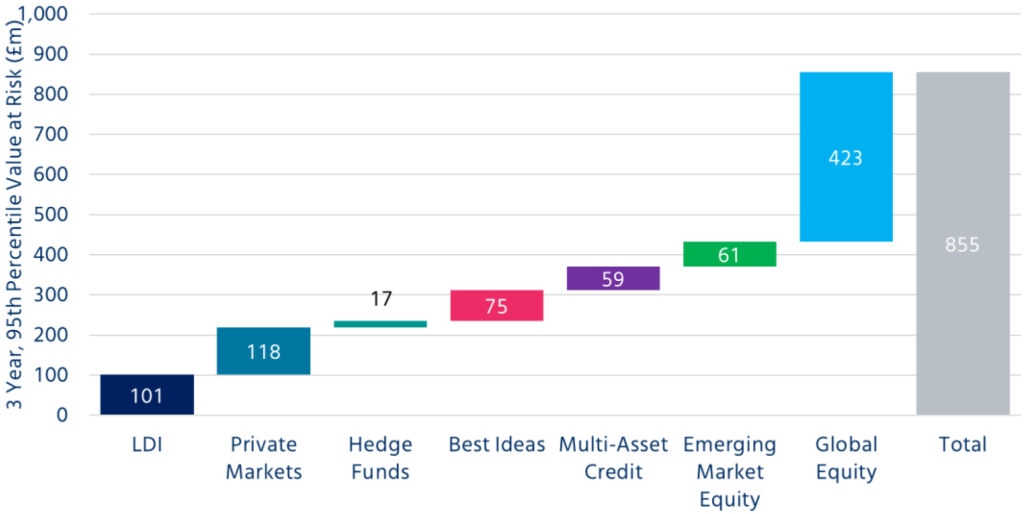
Investment Strategy Modelling

Alt 1 Asset Allocation

Asset allocation



Risk (3-year 95% VaR)



Key metrics

	Alt 1
Expected return (CPI + X)	CPI +4.7% p.a.
Expected absolute return	7.9% p.a.
Probability of achieving Past Service Discount Rate of CPI +2.4% p.a.	81.0%
Probability of achieving Future Service Discount Rate of CPI +2.5% p.a.	80.0%
Risk (3-year 95% VaR)	£855m
	Real Return
60% Confidence	CPI +4.1% p.a.
68% Confidence	CPI +3.3% p.a.
70% Confidence	CPI +2.5% p.a.
80% Confidence	CPI +2.4% p.a.

Hedging

Interest Rate Hedge Ratio	50%
Inflation Hedge Ratio	40%

Mercer Source: Mercer. As at 30 September 2022. Expected returns from Mercer's UK Capital Markets Assumptions as at 30 September 2022. Value at Risk includes allowance for diversification.

Recap on the Fund’s Net Zero Commitments
Total Fund and Listed Equity

For the Fund as a whole:
- to have at least 30% of the Fund’s assets allocated to sustainable investments by 2030
- to expand the measurement of the carbon emissions of the Fund’s investments to 25 include all assets by the end of 2023

Within the Listed Equity portfolio:
- to achieve a reduction in carbon emissions of 36% by 2025 and 68% by 2030 to target at least 30% of the Listed Equity portfolio to be invested in sustainable assets by 2030
- to reduce fossil fuel exposure relating to oil and gas by 70% by 2025 and 90% by 2030
- to reduce fossil fuel exposure relating to coal by 90% by 2025 and 95% by 2030
- to engage with the biggest polluters within the Fund’s Listed Equity portfolio as part of an overarching stewardship and engagement strategy, to achieve:
  - by 2025, at least 70% of organisations in carbon-intensive sectors have clearly articulated and credible strategies to attain net zero or are subject to engagement to achieve this objective
  - by 2030, at least 90% of organisations in carbon-intensive sectors have clearly articulated and credible strategies to attain net zero or are subject to engagement to achieve this objective

Further climate change scenario analysis based on latest Mercer model (including three temperature scenarios) to be undertaken in Q1 2023

Summary of recommendations

	Current target allocation (%)	Proposed allocation (Alt 1) (%)	Change	Comments
Global Equity	10.0	15.0	Increase	Total Global Equity allocation to be held via WPP Sustainable Active Equity Sub-fund post launch
Emerging Market Equity	10.0	5.0	Reduce	Scale back given uncertainties in emerging markets
Best Ideas Portfolio	11.0	11.0	-	
Hedge Funds	7.0	5.0	Reduce	Reduce allocation, still role to play though hedging opportunities also via CRMF
Multi-Asset Credit	12.0	12.0	-	
Private Markets				
Property	4.0	4.0	-	Allocation remains overweight at present vs previous strategic recommendations – belief to reduce UK exposure still strong
Private Equity	8.0	8.0	-	
Local/ Impact	4.0	6.0	Increase	Fund can continue to build on progressive work to date
Infrastructure	8.0	8.0	-	
Private Credit	3.0	3.0	-	
Stabilising Assets				
CRMF	23.0	23.0	-	
Cash	-	-	-	
Total	**100.0**	**100.0**		
Expected return (% p.a.)	CPI +4.8% p.a.	CPI +4.7% p.a.	-	Slight decrease in overall expected returns
Risk (1 Year 95% Asset VaR)	£861m	£855m	-	Marginal decrease in risk
Probability achieving PSDR (CPI +2.4% p.a.)	81.5%	81.0%	-	
Probability achieving FSDR (CPI +2.5% p.a.)	80.5%	80.0%	-	

Note: Positions above cover September Modelling. PSDR = Past Service Discount Rate (CPI +2.4% p.a. as at 30 September 2022), FSDR = Future Service Discount Rate (CPI +2.5% p.a. as at 30 September 2022) – FSDR yet to be agreed. Expected return and VaR based on Mercer's UK Capital Markets Assumptions as at 30 September 2022.

Conclusion & Next Steps

- The Fund's current investment strategy only requires "light touch" changes.
- The recommendations are consistent with the Fund's Responsible Investment commitments and will demonstrate further progress on sustainability and impact investment.
- Subject to Committee approval of the proposed changes to the Fund's investment strategy, the proposed changes to the Fund's **Investment Strategy Statement (ISS) will be made.**
- **Subsequent implementation planning** to be undertaken by Officers with assistance provided by Mercer.

Appendix

Investment Strategy Modelling

Portfolio's Modelled – 31 March 2022

	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
Global Equity	10.0	10.6	15.0	10.0
EM Equity	10.0	8.9	5.0	10.0
MAC	12.0	9.9	12.0	10.0
Hedge Funds	7.0	6.4	5.0	7.0
Best Ideas	11.0	11.0	11.0	12.0
Private Markets	27.0	24.8	29.0	28.0
CRMF	23.0	25.2	23.0	23.0
Cash	-	3.2	-	-
Total	**100.0**	**100.0**	**100.0**	**100.0**

Recommended Strategy

Interest Rate Hedge (%)	50%	50%	50%	50%
Inflation Hedge (%)	40%	40%	40%	40%

Investment Strategy Modelling

Key return Percentiles – 31 March 2022

Return metrics (20 years)	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
Expected absolute return	5.9% p.a.	5.7% p.a.	5.8% p.a.	5.8% p.a.
Expected return over CPI	CPI +2.7% p.a.	CPI +2.5% p.a.	CPI +2.7% p.a.	CPI +2.7% p.a.
Risk (3-year 95% VaR) (£m)	£887m	£843m	£873m	£875m
Probability of achieving Past Service Discount Rate of CPI +1.5% p.a.	66.9%	65.2%	67.5%	67.3%
Probability of achieving Future Service Discount Rate of CPI + 2.0% p.a.	59.7%	57.7%	60.1%	60.2%

	SAA (%)	Actual (%)	Alt 1 (%)	Alt 2 (%)
60% Confidence	CPI +2.0% p.a.	CPI +1.8% p.a.	CPI +2.0% p.a.	CPI +2.0% p.a.
68% Confidence (proposed past service discount rate)	CPI +1.5% p.a.	CPI +1.5% p.a.	CPI +1.5% p.a.	CPI +1.5% p.a.
70% Confidence	CPI +1.3% p.a.	CPI +1.1% p.a.	CPI +1.3% p.a.	CPI +1.3% p.a.
80% Confidence	CPI +0.4% p.a.	CPI +0.3% p.a.	CPI +0.4% p.a.	CPI +0.4% p.a.

Note: Future Service Discount Rate yet to be agreed.

Tactical Allocation Portfolio

Best Ideas Portfolio

- Take advantage of short term, tactical opportunities.
- Asset allocation decisions based on a 12 month time horizon.
- The Mercer Tactical Allocation Group meets on a monthly basis to discuss tactical views based on a one year outlook – this forms a natural starting point for assessment of the Best Ideas portfolio’s tactical positioning.
- Monthly meetings between Mercer and Officers on Opportunities and Threats.
- Overall asset allocation within the Clwyd Pension Fund at each point in time is considered before arriving at decisions.
- Invested on the Mobius platform accessing a wide range of managers and funds.

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