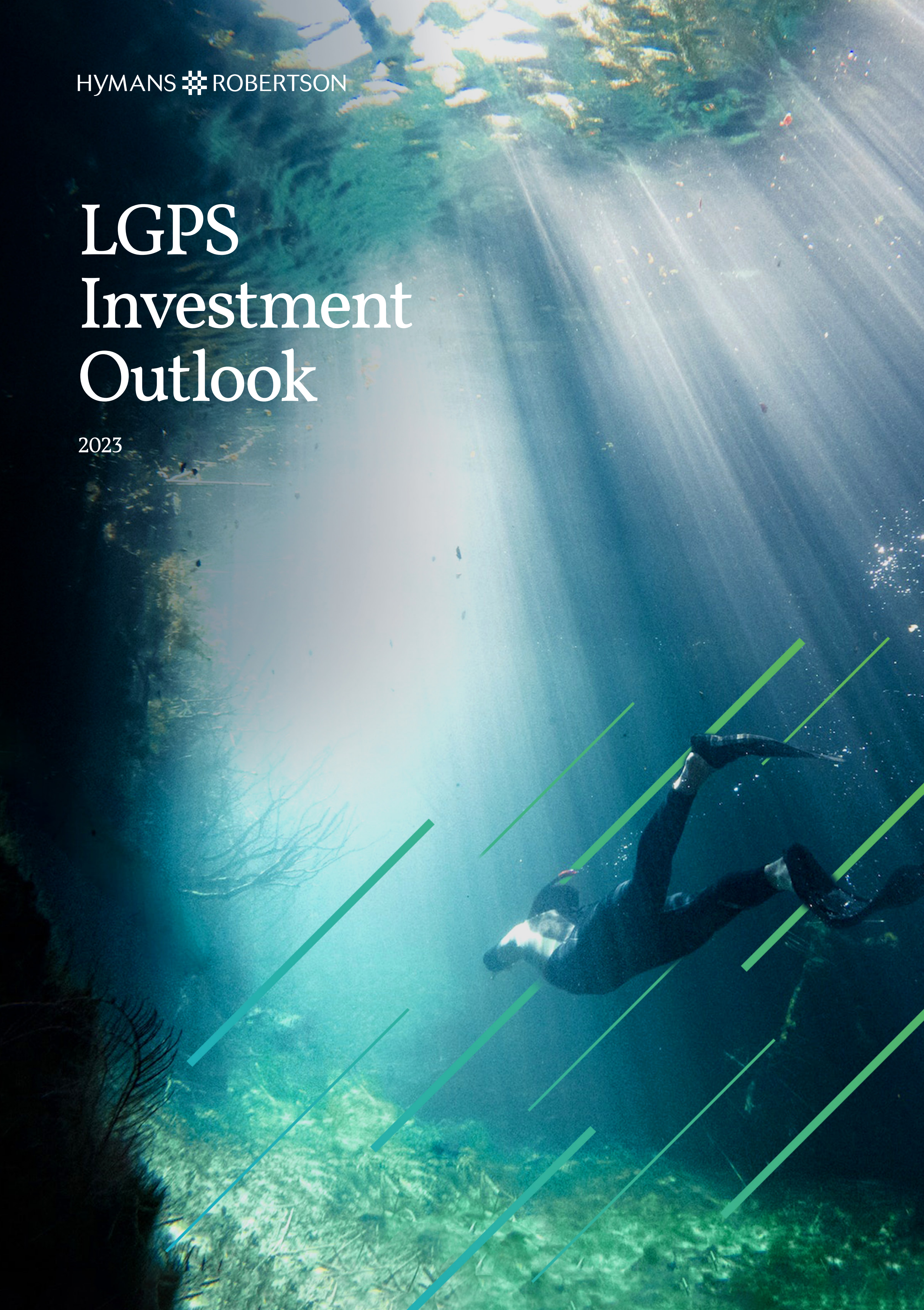

HYMANS ROBERTSON
LGPS Investment Outlook
2023

Welcome

Welcome to our first LGPS Annual Investment Outlook.

The aim of the publication is to provide our perspective on key investment issues facing the LGPS in the year ahead. 2022 proved to be a turbulent year and we expect 2023 to be similar. The weak outlook for global growth, persistently high inflation and elevated geopolitical risks are likely to create significant challenges for LGPS funds, but also new investment opportunities. At the same time decarbonisation remains a key imperative for the sector.

To help investors navigate these challenges and opportunities, we offer our views on:

- Our outlook for each key asset class in the year ahead
- A heads-up on prospective regulations and the likely implications for LGPS funds
- The Levelling Up agenda and its role in stimulating local investment opportunities
- Achieving Net Zero in private markets and the challenges and opportunities that are likely to arise
- The implications of becoming cashflow negative far sooner than expected due to high inflation, and how funds might respond
- The rationale for continuing to invest in the UK despite the headwinds facing our economy and capital markets
- The role renewable infrastructure can play in funds' Net Zero roadmaps.

We hope you find the articles of interest and, of course, our consultants would be happy to discuss any of the topics covered with you.

Phillip Pearson
Head of LGPS Investment
phillip.pearson@hymans.co.uk

LGPS Investment Outlook

From adversity comes opportunity

Since the Covid pandemic, inflation has risen higher, and for longer, than most market participants expected in many countries, including the UK. This inflationary pressure was first driven by the large increases in government spending, central banks providing additional monetary support, disruption to supply chains, and a shift in demand from services to goods during the pandemic. This was then exacerbated by the global supply shock emanating from the Russia-Ukraine conflict and upwards pressure on wages from tight labour markets.

In response, central banks, led by the US Federal Reserve (Fed), have rapidly raised interest rates, and begun selling the bonds they owned, accumulated through successive rounds of quantitative easing (QE) over the past decade. This tightening of financial conditions caused a dramatic, and correlated, fall in asset prices across financial markets in 2022, with bonds and equities both incurring steep losses.

Furthermore, as high inflation and interest rates weigh heavily on consumers and businesses, global growth is forecast to slow considerably in 2023, with many major advanced economies expected to enter recession.

However, the pain felt in markets over the past year has created opportunities. The headwind to returns posed by high valuations has eased and is, in some cases, becoming a tailwind. Longer-term, forward-looking return expectations have moved significantly higher across the major asset classes given the current lower prices and higher sovereign bond yields and policy rates.

Despite the much more attractive long-term entry points across markets, near-term challenges remain, as markets contend with the fundamental impact of high inflation and interest rates that has already shaken valuations.

Near-term gloom need not dim longer-term prospects

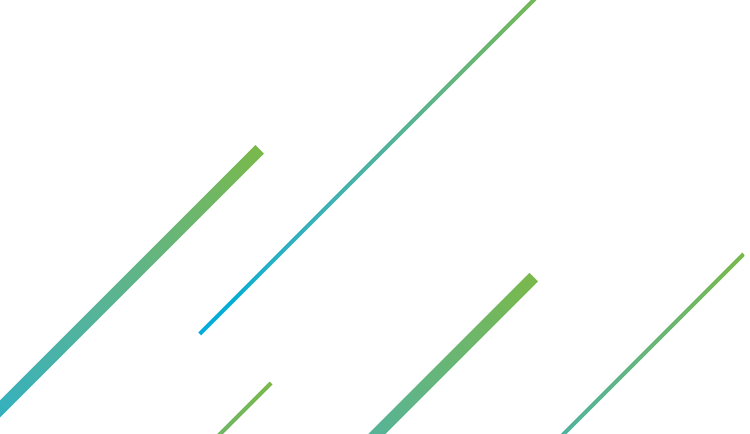
The near-term outlook has darkened given the prospect of a forthcoming global recession, or at least several quarters of low growth, as high inflation and tighter monetary policy weigh on consumers and businesses. Forward looking indicators, such as the global composite purchasing managers indices, point to an increasingly steep downturn in global economic activity, with output falling sharply in both the manufacturing and service sectors. With demand weak, geopolitical tensions and market volatility high, and inflation pressures still elevated, the indices point to a very challenging near-term outlook.

However, longer-term global growth prospects are not expected to be materially impacted by near-term headwinds. Longer-term forecasts suggest that the current drivers of high inflation and low growth will pass, whilst the secular trends and structural themes behind markets remain intact.

Inflation

Year-on-year inflation remains very high in the major advanced economies but is expected to moderate in 2023 and fall back towards central bank targets in 2024, as commodity prices fall, supply chain pressures ease and the impact of central bank monetary tightening takes effect.

We feel the risks to inflation are considerably more two-sided than in the past decade and expect more volatile inflation in the years ahead. Compared to recent history, it is expected that there will be some upwards pressure on inflation from some lasting impact on, or re-orientation of, supply chains, the fading disinflationary impact from technology adoption and further globalisation, tighter labour markets, and the costs associated with achieving net-zero carbon emissions.



Interest rates

It is important to note that while market forecasts suggest a substantial moderation in inflation over the next 2 years, they also suggest this will require further interest rate increases on top of those already seen. Central banks are likely to continue to focus on the risk that inflation becomes embedded, rather than their central forecasts which show inflation moderating rapidly. As a result, we believe central banks will continue to raise rates in the first half of 2023 until slowing demand brings about a sustained decline in inflation. That said, the pace of rate rises may be slowed if the impact of tightening begins to filter through to economic activity.

Beyond the near-term, we expect interest rates to remain low relative to a historical context, but we do not see a return to the ultra-low rates we have seen since the Global Financial Crisis (GFC). This will be driven by the inflationary issues mentioned above, market pressures such as central banks being warier of higher and embedded inflation, and increased demand for borrowing from governments to service their high and growing debts (just as central banks withdraw their capital from this market).

Asset class considerations

Government bonds

Given the rapid rise of interest rates, as well as the level of expected interest rates, the headwinds to government bond valuations that have kept us cautious for several years have dissipated. Markets have moved to price in the rate rises and UK yields now look reasonably attractive relative to our assessment of long-term fair value. Government bonds are now better placed to be used as a source of income and diversification over the longer-term than they have been since the GFC.

The near-term backdrop of high inflation and falling real growth lends relative fundamental support to index-linked, over conventional, gilts. However, the relative valuation assessment between conventional and index-linked gilts is less clear cut. The level of long-dated inflation that is priced into markets looks a little high. Shorter-dated index-linked gilts currently look to offer better value. We therefore prefer index-linked to conventional gilts at shorter terms, but conventional to index-linked gilts at longer-terms.

Credit

Rises in government bond yields and credit spreads mean credit yields are at enticing levels, relative to both long- and short-term history.

Despite attractive long-term entry points across credit assets, the near-term outlook favours taking less risk and investing in safer bonds. Speculative-grade credit spreads are above long-term median levels but are less attractive relative to their own history than investment-grade markets. On average, businesses appear to be in reasonable financial shape relative to history but will likely come under pressure as the economic outlook deteriorates. This will likely be more troubling for speculative-grade credit markets, where borrowers are more highly leveraged and more sensitive to an economic slowdown. We expect defaults in high yield bond and loan markets to rise from the historic lows of recent years but note the improvement in the average credit quality of speculative-grade credit markets over the past decade, which may prevent credit spreads reaching the heights seen in previous recessions.

Nonetheless, we prefer investment- to speculative-grade credit over the near-term, particularly short-duration investment-grade corporate credit and asset-backed securities.

Across credit markets, we are less cautious about duration than previously, given significant rises in underlying government bond yields. This is particularly pertinent for loans which, relative to high yield bonds, have higher leverage and lower interest coverage and, due to their floating-rate nature, rising interest rates will hit the borrowers faster.

Emerging market debt presents an attractive opportunity, with materially positive real yields and attractive term premia in many local currency markets. Markets may also be supported from a change in Fed policy and spreads which are at very elevated levels relative to history.

Equity

Cyclically adjusted price-to-earnings ratios, a measure of the cheapness or expensiveness of a stock or stock market, are now modestly below long-term median levels, having fallen from their peak at the beginning of 2022. This means the recent drag on expected returns from elevated equity prices has evaporated in 2022, presenting a much more attractive entry point for a long-term investor.

However, we might expect to see more compelling cheapness in the near-term if the news flow remains negative. Full-year earnings forecasts for 2022 and 2023 still point to reasonable earnings growth, but average earnings momentum is poor, and the level of real earnings has started to fall – declines can often be extended in time and extent.

The US dollar strengthened considerably in 2022. Even allowing for the UK's more challenging growth and inflation dynamics, sterling, alongside many other major currencies, looks historically cheap against the dollar: sterling is close to 30% below long-term fair value, as measured using purchasing power parity, versus the dollar. An impending period of sub-trend global growth may continue to support the US dollar in the near-term as investors view it as a safe haven currency, but any return towards fair value for sterling could be a meaningful drag on unhedged overseas equity returns for non-US investors.

Property

Index-level data, based on assessed values of properties, suggest UK commercial property yields remain relatively low, whilst the fundamental outlook deteriorates sharply.

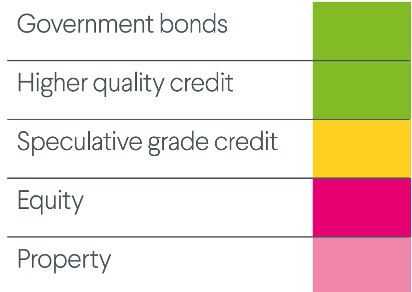
However, more timely transaction data indicate that property yields are actually rising relatively quickly. Given the extent of selling across pooled property funds, there is potential for long-term, strategic investors to buy in to the market at significant discounts to net asset value (NAV) and gain exposure to these higher yields.

However, investors should expect further pressure on the market in the near-term: the recent RICS survey indicates a rapid weakening of the UK market as power shifts towards renters, as occupier demand and rent and capital value expectations incur steep falls and availability and inducements offered to entice tenants rise rapidly. Additionally, prior rises in government bond yields are placing valuations in the lowest yielding sectors under pressure.

Private markets

We are anticipating, and starting to see, investors in certain private markets which currently have little, or no, secondary market liquidity, wanting to sell, often for non-economic reasons. These are likely driven by an inability to continue to take the assets' illiquidity. We expect increasing secondary market activity and opportunities in assets such as private debt, as UK private sector defined benefit pension scheme funding levels improve and schemes approach buyout more rapidly over the coming decade than previously thought. Longer-term investors, such as LGPS funds, stand well-placed to provide much needed liquidity in exchange for discounted access to portfolios of invested assets.

Summary of views



Asset class	
Government bonds	
Higher quality credit	
Speculative grade credit	
Equity	
Property	

A meaningful reset in asset markets in 2022 has greatly improved the forward-looking long-term return outlook across both bond and equity markets. However, whilst entry points are much more attractive, we foresee potential further near-term weakness and volatility.

Altogether, we believe that, whilst there are some large risks in the global economy and markets, current conditions offer an opportunity for long-term investors to buy in at relative lows, particularly compared to recent history, in order to achieve higher long-term returns. However, it may be wise to not move to exploit these opportunities immediately, as further and better buying opportunities arise in the near-term future through continued market volatility.

New Investment regulations and consultations for 2023

Competing demands for LGPS stakeholders in 2023

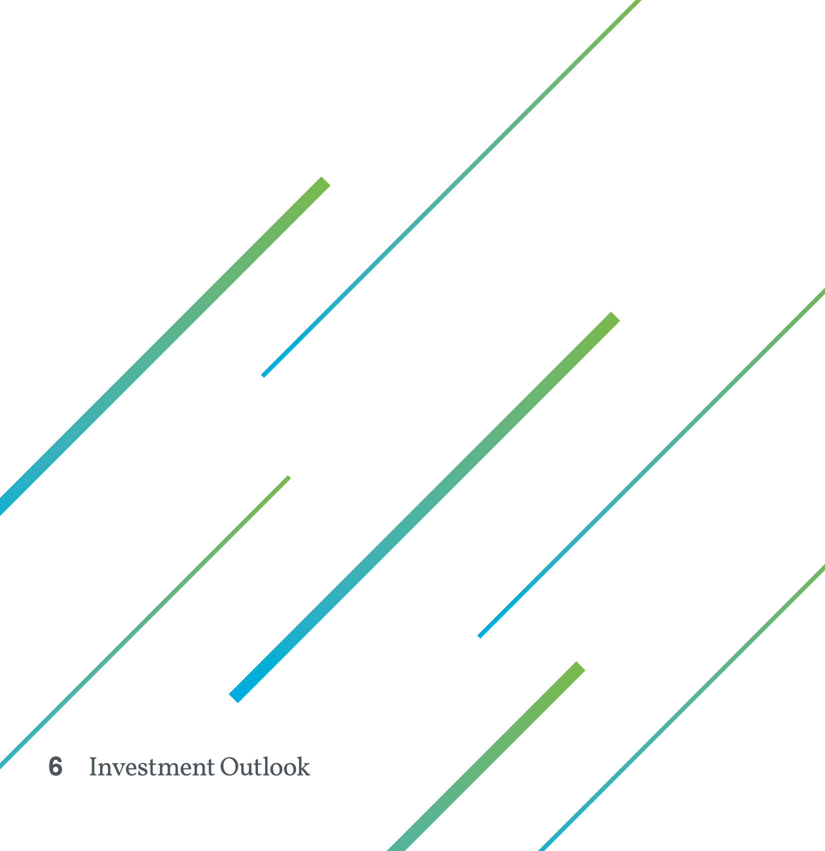
One of the many challenges facing LGPS stakeholders is keeping on top of, or where possible ahead of, the ever-shifting regulatory landscape. In 2022 we saw the long-awaited consultation on climate risk reporting. However, other consultations in the pipeline, and the resulting regulations that will likely follow, are expected to be launched in the coming months. Here we provide a quick overview of investment-related developments we expect to see in 2023 and what these might mean for governance budgets given the ever-competing demands on Officers' and Committees' time.

Climate risk reporting – or TCFD for the LGPS

The consultation on climate risk reporting for the LGPS closed on 24 November. This followed new regulations coming into force requiring large private sector schemes to report on climate risks in line with the Taskforce for Climate related Financial Disclosures (TCFD). While the LGPS consultation mirrored many of the requirements for private sector schemes there were a range of specific differences reflecting the characteristics of the LGPS. These included more specifics on climate metrics, the important role of pools and plans for centralised and collated reporting.

We understand the intention is for new regulations to be in place by April 2023, with LGPS funds first having to report following the 2023/24 scheme year. Whilst this may seem some way off, many funds will want to start planning now to ensure they are suitably prepared to meet the new requirements. A common first step will be to carry out gap analysis against the four key TCFD pillars. Even funds who have already been voluntarily reporting against TCFD will need to check they are meeting the requirement of the new regulations, particularly where this might require more data from managers and pools.

The time (and cost) to meet the new requirements should not be underestimated. With the content of the consultation now known, funds have a better idea of what is required and planning work should now begin in earnest.



Three for one?

The next investment-focussed consultation widely expected from DLUHC is a bumper edition covering at least three different areas; pooling, levelling up and regulations to replace the CMA order on the investment consultancy and fiduciary management industry.

1 Where next on pooling?

In December 2022, we saw a public announcement from Jeremy Hunt referred to as the "Edinburgh reforms" which included "Consulting, in early 2023, on issuing new guidance on Local Government Pension Scheme asset pooling". While this consultation has been long expected this was a rare public commitment on timing.

Whilst the Government's focus of previous consultations was on achieving the benefits of scale, strong governance and decision making, reduced costs and excellent value for money and the structure of pools, it is not yet clear where the focus will be from Government for this latest formal consultation on pooling. A huge amount of progress has been made across all the pools in England and Wales on developing investment solutions that meet the needs of partner funds, but there is plenty of work still to do.

A key question will be whether the Government are happy with the direction and pace of pooling to date – will there be increased pressure to continue to transition assets not yet within the pool, will there be more prescriptive requirements around pooling structures? Whatever the focus, it will be important that all funds and pools respond to reflect their needs and ensure any regulation and guidance on pooling helps to achieve better outcomes for the LGPS.

2 Levelling up

Despite the changes in leadership, the Government appears committed to the levelling up agenda. However, what in practice this means for the LGPS is still unclear. A lot of the focus of initial discussions was on a specific number; 5%. What was maybe less clear is what the 5% actually represented - this is something we cover in more detail in a separate article on page 10.

Within the 300 plus pages of the Government's levelling up white paper, it stated they would "work with local government pension funds to publish plans for increasing local investment including setting an ambition of up to 5% of assets invested in projects which support local areas".

With many funds building allocations to infrastructure and climate-focussed solutions, the timing of this will be key to allow them to adapt existing allocations to allow for the potential impact on risk and return results of any new allocation requirements, or even to give time to collect relevant data.

3 Replacing the CMA order requirements

Possibly the least contentious of the consultation areas is new legislation required to replace the CMA order following its review of the investment consultancy and fiduciary management industry. Regulations came into force in 2022 to replace the order for private sector schemes resulting in a sun-setting of the order. However, some aspects of the order still apply to the LGPS. They require funds to set objectives for their investment consultants and submit an annual declaration to the CMA.

We would expect regulation to follow that of the private sector in many respects, with funds following a similar process as they do under the CMA order for setting and reviewing objectives and reporting on this within the annual scheme return to the Pensions Regulator. Although this should be relatively straight forward it is still another commitment for LGPS funds to meet in future.

The return of Good Governance

Although this update focusses on the more investment-specific consultations and regulations, another big consultation expected in 2023 is on Good Governance. From an investment perspective, key elements of this are likely to be :

Knowledge and understanding – with specific requirements for Committees to carry out their role. If any fund is struggling with planning, delivering and monitoring investment-related training, then there may be actions required to address this.

A requirement for a **roles and responsibilities matrix** setting out who does what. Some funds may not be very clear about where certain decisions lie in their current governance structures.

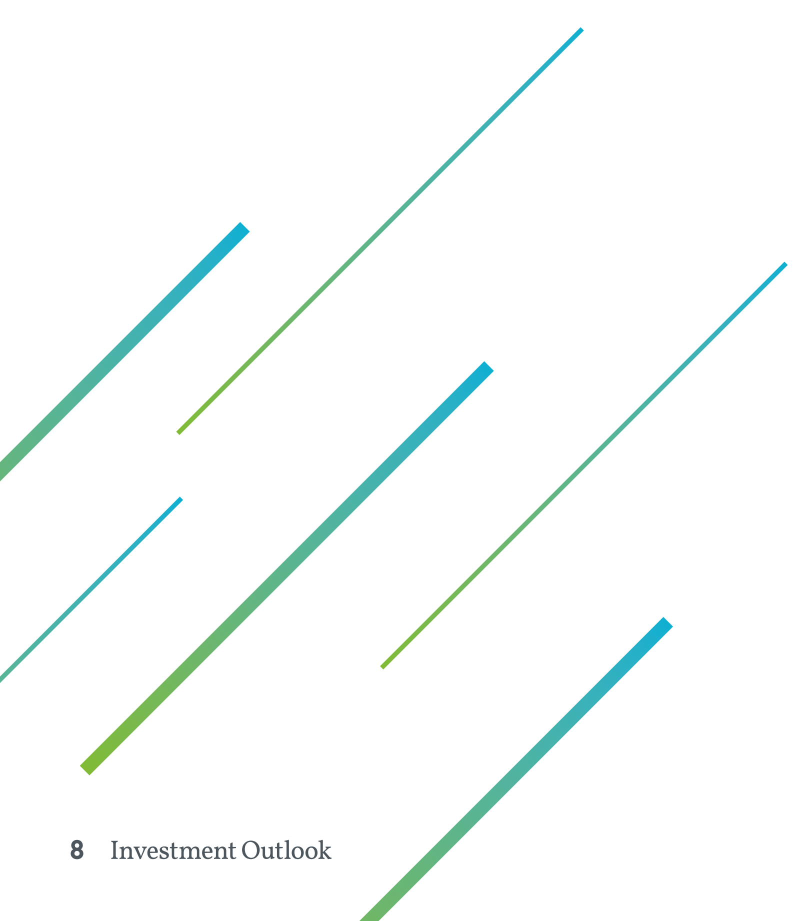
Conflicts of interest – particularly when managing relationships with pools and any requirements from the consultations above if including more locally focussed investments.

And the list goes on...

We have focussed above on the consultations and regulations that have been the most well sign-posted, but we expect the list to go on. Other notable developments could also include Boycotts, Divestment and Sanctions, capital markets regulations and the Taskforce for Nature-related Financial Disclosures. As ever the LGPS will need to engage with the relevant stakeholders to ensure any new regulation results in positive change rather than diverting time to tick more boxes.

Preparing for the year ahead

2023 is likely to be a busy time for the LGPS, not just with investment and funding plans but in responding to consultations and meeting new regulatory requirements. It's important to start planning early, thinking about business plans and what support might be needed to ensure you can drive positive change and help shape the regulatory landscape to achieve better outcomes for the LGPS.



Levelling up and local investment

Since Michael Gove's white paper on "Levelling up the United Kingdom", much attention has been given to the potential implications for the LGPS. The paper suggested that LGPS Funds should invest 5% of their assets locally in order to "unlock £16b of new investment." Since then, all eyes have been on the launching of a consultation, the wording of which is expected to provide some further clarity on what guidance or requirements may be put on the LGPS regarding investing locally. This consultation is now expected in early 2023.

Whilst much is unknown about the potential implications of this upcoming consultation, it is expected that there will be some form of pressure on funds to invest at least 5% of their assets in investments that support the UK economy. It is likely that funds will also have to demonstrate their ability to consider and assess opportunities to make these investments.

The situation gives rise to many questions including what exactly is meant by 'local'; whether the 5% would be additional to current investments; and what asset classes would be included. Some clarification has been provided but fixed definitions are not so far forthcoming. This makes it difficult for funds to make any firm plans. However, some work can be done now to understand how potential requirements could be met if and when the situation becomes clearer. Funds can also revisit their views on how attractive an investment opportunity the UK may be, which we discuss in another article within this publication.

The challenges for the LGPS

This pressure from government on how funds invest is not a new concept. There have been previous instances of this, such as the push for the LGPS to use pooling to invest more in UK infrastructure. As then, the key challenge for funds now, is how they achieve this whilst still earning the returns they require, and without taking excessive amounts of risk. After all, the LGPS exists to provide the prescribed benefits to its members, rather than assisting the UK government in closing any gaps between more affluent and less developed areas of the country, though there is potential for funds to achieve both.

The whitepaper identifies four asset classes - infrastructure, housing, regeneration, and SME finance - as key areas of investment to assist in the levelling up agenda. Whilst infrastructure is an established asset class with institutional standard UK-focussed funds readily available, and there are also a growing number of housing funds of this quality, SME is a much more niche area of investment. Regeneration is not yet defined, but it is likely to encompass a wide range of asset classes

A key question to address early on is what is 'local' means. Initial indications from the government suggest they will see this as UK-wide. However, funds may wish to define this differently and focus on investments closer to home. Here, a balance must be struck between having an impact in the local area and ensuring access to a wide range of diversified investment opportunities.

This diversification point is also important. When limiting a search for investment opportunities from its widest possible scale, there is the potential for sub-optimal investment outcomes. Whether this refers to limiting from global investment to just the UK; to a smaller area of the UK; limiting to certain asset classes; or to certain sub-sectors of that asset class that have a genuine impact, it means some attractive investment opportunities are likely to be missed.

The types of assets being invested in, and their potential importance to the local area or the UK more widely, may also present some important risks. The reputational risk of having a fund's name associated with a failed project is notable, especially around sensitive issues such as the provision of homes or services.

Finally, the ability of funds to source and assess suitable investment opportunities is also a challenge that will be new to most. The risks of this are largely driven by the chosen implementation method. It is important that a fund is also able to demonstrate that their investment of choice will not negatively impact the financial returns for the fund compared to investing in a non-local investment with similar levels of risk.

How does the LGPS invest?

Whilst there are challenges to this, the pressure to invest in previously overlooked areas can also open up some attractive opportunities. The important question being how these opportunities can be accessed. Fortunately, there are a range of ways to invest in projects that meet the government's levelling-up agenda:

Standalone projects:

There will be some investment opportunities which LGPS Funds will be able to invest in directly. Although only the largest funds are likely to have the capability to do so. They will have the governance resources to assess these opportunities and an asset base large enough so that a single project would not become a significant share of their portfolio. Indeed, some large LGPS funds do already do this.

There are several advantages associated with this approach. The fund will have a direct impact on levelling up and will help to deliver the benefits provided by their chosen project. They are also unlikely to have to pay the fees traditionally due to an investment manager, though will probably still carry the costs of outsourcing the asset management. It also gives the fund control over the investments it makes, assets it holds and how they are managed. However, there are also associated risks and challenges.

Sourcing and pricing these deals can be challenging, as funds are likely to be competing against established investment managers. The due diligence may also be complex and something that many LGPS funds do not have the capabilities to complete.

As mentioned earlier, it also raises the risk of having a fund's name directly tied to an asset providing benefits to the community. Whilst this is a positive when things are going well, any controversies are directly tied to the fund and its name may suddenly be in the headlines for the wrong reasons. This reputational risk may be unpalatable for many, especially for investments within the fund's existing area of activity. Similarly, investing in areas where the fund is already active may also give rise to conflicts of interest.

Investment funds:

Sourcing local opportunities through investment funds that fulfil the government's guidance will offer funds a number of potential advantages. Investment funds are by far the most common vehicle used by the LGPS and they are therefore experienced in investing in and monitoring them.

LGPS funds can rely on the expertise of their managers to source, assess, price, and purchase the assets, as well as manage them once they are within the portfolio. They also offer access to a wider range of projects for the same investment value, providing diversification. Finally, investment funds offer a degree of separation from the underlying assets, as the investment fund is typically the legal owner of the assets, helping manage reputational risks.

However, using investment funds reduces the control you have over investment strategy, asset selection and the management of that asset. This may be problematic for some when investing in such sensitive assets, and it may reduce how 'local' your investments are (though this may not necessarily be a bad thing). This will also likely be the highest cost option.

Pools:

LGPS pools are often touted as the potential solution to new challenges, whether it's investing in UK infrastructure, meeting TCFD requirements or levelling up the UK. Some pools have already launched funds that are likely to tick the levelling up box, whilst some are in the planning stages of launching solutions specifically designed to meeting this new potential guidance. In some cases, the investments are being biased towards the areas that fall within the partner funds of that pool.

The pools provide the advantages of having dedicated resource to managing these funds on behalf of the partner funds, and being closer to the partner funds than traditional third-party managers, so they are more able to influence the investment strategy of that fund. This is helped by the partner funds being the only investors in any pool funds.

Similarly, partner funds could even be well-placed to help source deal flow for a pooled local investment vehicle.

Partner funds can use their ties with local councils to find areas in need of capital that may present investment opportunities suitable to the pooled fund's objectives.

Pooling assets with partner funds will also help with diversification, gaining access to a wider range of investments with the same capital outlay. Using the pool would also help to meet potential requirements regarding further impending guidance – on pooling.

The challenge, however, is the lack of control in the perceived equality of where investments are made across the areas covered by the pool. Within any area of the UK, there are areas that are more developed that may present relatively better investment opportunities than others. This may cause a bias towards those areas, and lead to some questions of fairness if those areas are viewed as being least in need of support. Therefore, investing a fund's money in this manner will not guarantee investment capital will come to that fund's local area.

Next steps

Whilst the fact that the consultation has not yet been launched leaves a significant amount of uncertainty around timescales and potential requirements regarding local investment, it is not too early to begin planning for how funds will tackle this.

Funds should work to define what they consider as 'local', driven by their risk appetite – both investment and reputational. Implementation options should then be considered, taking into account factors such as the levels of governance funds are able to assign to local investment, and how much control they would like over the asset selection and management.

If done correctly, the LGPS has the opportunity to not only provide members with their prescribed benefits but also contribute to a better place to live.

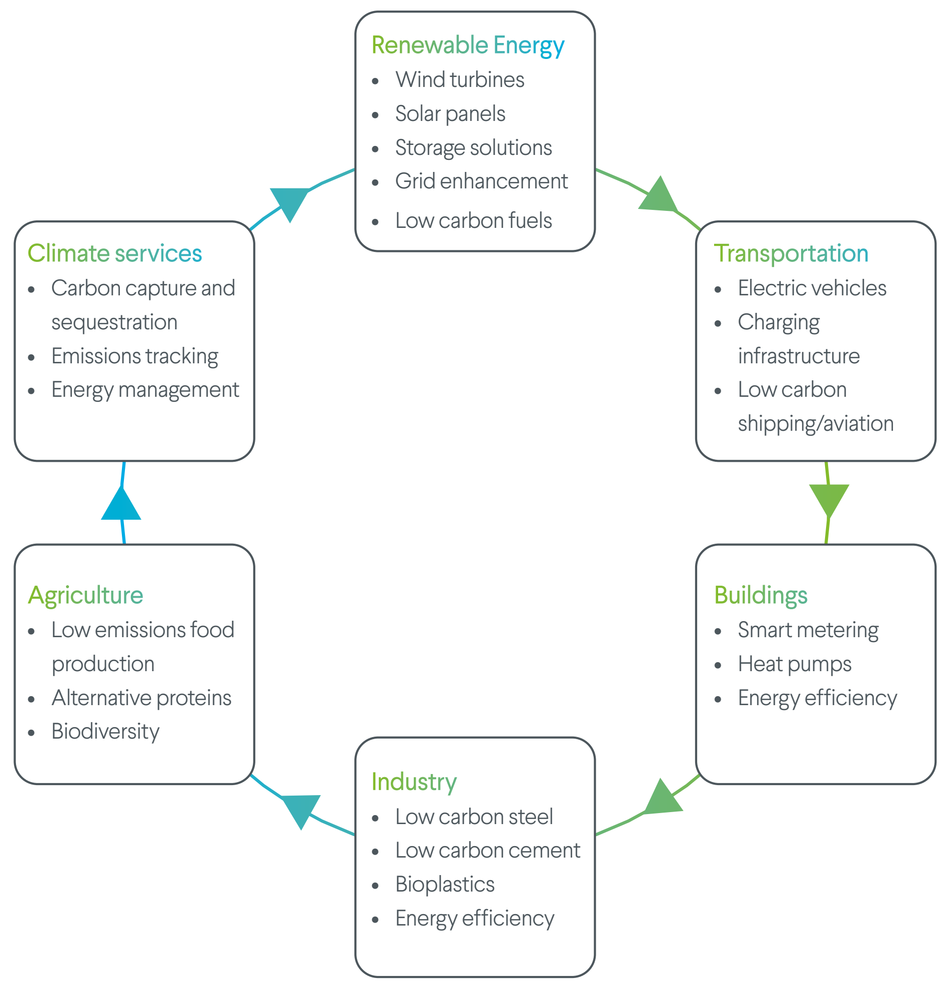
Levelling up and local investment

Decarbonisation and investing in private markets have been two major investment themes for the LGPS in recent years. Private markets offer investors significant decarbonisation opportunities but also create real challenges to delivering their Net Zero goals. How should investors respond?

Opportunities and challenges

Private markets can make a significant contribution to tackling climate change and achieving Net Zero. They offer exposure to low/negative emissions asset classes such as timberland, which can offset emissions elsewhere in the portfolio. They also offer exposure to companies providing decarbonisation solutions, many of which are innovative businesses with strong growth potential. The graphic below highlights some of the many investment opportunities now emerging.

Chart – Decarbonisation enabling solutions



Furthermore, private markets investments are characterised by close, often bilateral relationships between investment managers and company management teams which allow for more effective engagement on climate change than is possible with large, listed companies.

At the same time, delivering Net Zero through private markets creates some significant challenges for investors. First is the lack of robust data to measure current climate risk exposure and the impact of strategies to reduce it. The lack of transparency clearly increases the risk of greenwashing. In addition, private markets investments are typically less liquid and more complex than their listed equivalents, which may be unwelcome when LGPS funds' cashflows and governance arrangements are coming under increased strain.

As Mark Carney put it in his speech at The Guildhall in February 2020 *"climate change is an existential threat but could also become the greatest commercial opportunity of our time"*.

How should LGPS funds respond?

We believe the following actions are important, as they would be in tackling any significant investment risk or opportunity:

Set ambitious, but realistic objectives

Ambitious because climate change calls for action on an unprecedented scale and pace, and LGPS funds cannot afford to let their portfolios fall behind the decarbonisation curve. They also have an important role to play in financing the transition. Realistic because the actions taken should not, and in many cases need not, put at risk their primary purpose of paying pensions.

Agree clear policies

Clear policies on a range of matters are needed to guide investment decision making and portfolio management actions. In particular, it will help to have a clear view on the importance attached to climate change compared with other Environmental, Social and Governance ("ESG") issues when tackling the trade-offs inherent in real world investing. For example, is it acceptable to put at risk food security and biodiversity when investing in biofuel production? Policies should be closely aligned with funds' investment beliefs.

We find similar trade-offs in many areas of Net Zero investing. Companies that are facilitating decarbonisation may represent attractive investment opportunities but have high current greenhouse gas emissions. Divestment/exclusion of high emissions companies is a swifter way of reducing the direct impact of climate change on a portfolio, but retaining and engaging with such companies may lead to better long-term investment outcomes for the investor and climate outcomes for society. Clear policies and priorities in these areas will help LGPS funds and their investment managers make the right investment decisions in a timely manner.

Develop robust plans, be patient

We believe it is important to have a clear view on what LGPS funds need to do to deliver their Net Zero objectives and what they can do over different timescales, taking into account practical constraints. In every situation there will be a range of actions funds can take on capital allocation and asset stewardship, and many of these will be found in private markets. However, it will take time to determine the best approach in each case and, in some cases, waiting may be the best approach! Given the generally poor quality of data available in private markets today, we have an incomplete picture on climate risk and the track record of potential solutions remains uncertain.

Due diligence

Stakeholders are already putting great pressure on LGPS funds to take action on climate change, and this is very likely to intensify in the coming years. We would encourage funds to resist this pressure and take the time to properly understand the universe of investment opportunities and to apply the same high standards of due diligence to specific investments as they would have done in the past. This is particularly so in private markets given their relatively low level of transparency and liquidity. A green investment is not necessarily a good investment and may not actually be all that green.

There have already been many examples of climate-related investments which have proved, on closer inspection, to be lighter green than first thought. Examples include technology companies, which turned out to have relatively high emissions levels once their scope 3 (supply chain) emissions were taken into account, and agricultural/forestry solutions which do sequester carbon but suffer high emissions of other more potent greenhouse gases. Indeed, the longstanding investment principle – if you don't understand an investment, don't invest – seems more relevant than ever.

Monitor and adapt

The future path of climate change, and how societies react to it in terms of new technologies, business practices and changes in behaviour, remains highly uncertain. New challenges and new opportunities are emerging every day, particularly in private markets. In this environment, we believe it is more important than ever to closely monitor the performance of investments and their effectiveness in addressing climate change, and to be prepared to adapt investment strategies and plans accordingly.

Conclusion

Despite the challenges, we remain confident that LGPS funds, with the right approach, are well placed to transform climate change from an existential threat into an opportunity that will sustain investment returns for many years to come.

Planning your investments for cashflow negativity

If you felt the market volatility of 2022 brought on by rocketing levels of inflation was stressful enough, I'm afraid there is more pain coming down the line. The decades-high levels of inflation seen have meant that LGPS benefit payments are expected to see the largest inflation-driven increase in recent memory.

The significant increase in benefit payments will accelerate the maturity of cashflow positions by an amount equal to years' worth of previous rises. Not only this, but contribution income will not rise by the same degree due to lower than inflationary pay increases, potential active member opt-outs as the cost-of-living crisis bites and reductions to rates at some funds on the back of the 2022 valuations.

These changes are pushing many into cashflow negative territory far quicker than would have been predicted at the start of 2022, or significantly worsening the positions of those already making net payments out of the Fund each month.

Cashflow negativity shouldn't cause immediate panic, as LGPS funds have large pots of assets to make up the difference. However, sourcing that cash from these assets does raise a number of risks, even for a long-term investor.

The risks of cashflow negativity

Governance:

Funds have largely been used to having surplus cash to invest on a monthly basis. Whilst this can be a headache for Officers, the option of holding it in cash is always available, of which the biggest downside is the opportunity cost. However, when needing to disinvest regularly, there is no convenient equivalent – the money needs to come from somewhere and a decision is required to do this, and in a timely manner also. Whilst there are a number of ways to make this process less time consuming for Officers, it will become a new and increased governance burden for funds. If not planned properly, it has the potential to distract from more important, longer-term issues of much more financial significance.

Forced selling:

Making regular disinvestments from assets in calm market conditions is not necessarily an issue. Where it can become problematic is during periods of volatility. Here, investors run the risk of becoming forced sellers after market falls, crystalising those losses and missing the recovery on the portion of assets sold. This can markedly impact long-term money-weighted returns, ie the £ return investors actually earn. Income generated by assets may be able to alleviate some of this risk, though the impacts of taking income, rather than reinvesting it, on asset allocation over the longer-term must be considered.

Reduced illiquidity budget:

One of the many benefits of the LGPS being a long-term investor has been its ability to exploit the "illiquidity premium". By locking up money in private assets for years at a time, improved risk-adjusted returns have been exploited by investing in asset classes such as private equity and debt, infrastructure and property. These asset classes also provide risk and return exposures different to traditional, public markets, helping to also diversify investment strategies. However, when cash is required on a regular basis, this reduces an investor's ability to tie up as much capital for as long. Whilst some private assets are helpful for providing income to meet these payments, it can take a long time, and further cash outflow, to get these into a position to provide enough income to have a meaningful impact on a Fund's position. This delay stresses the cashflow position further in the meantime.

Asset allocation drift:

Over time, as an investor needs to source disinvestments, these have the potential to move an asset allocation away from target. Certain asset classes may be favoured for disinvestments for reasons such as low trading costs, being quick and easy to trade and the short-to-medium-term market conditions looking unfavourable. Meanwhile, assets that are illiquid, costly to trade, or are looking attractively priced are ignored. These short-term issues can build up over time, leading to an investment strategy straying markedly from the long-term target – which is by far the largest driver of long-term returns.

What can be done to manage the risks?

The only lever you can pull to reduce or remove a cashflow negative position is to increase contributions. Where this is not appropriate or possible, cashflow negativity is an issue that needs to be addressed. So, what can be done to manage this and the associated risks?

Measure it:

First, you need to measure your near-term cashflow position and estimate the degree and how quickly that is expected to change over time. This will help to inform the amount of cash of you will need on a regular basis and when it may start to become an operational challenge. Here, modelling will be required, and an efficient starting point would be the 2022 valuation data, results and projections. However, different assumptions might be required - particularly in the shorter term.

Stress testing will also form a key element of any cashflow management – both to inform planning and to satisfy the likely wide range of stakeholder views. This testing should capture the many unknowns that will impact a fund's cashflow position in the future, such as inflation, salary growth, prepayments, employer exits and large changes to the Fund membership. Here, building actions into a plan of how to react to certain scenarios will help funds to navigate difficult periods.

Make a plan:

Once you've measured your cashflow position, you need to form a plan for sourcing the cash that you require, both in the near term and also into the future as the cashflow position develops. Depending on how you make this decision, it can take significant time and governance. Some key considerations include how the decision on where to source the assets from will be made – a hard and fast rule, or flexible to reflect things like market outlook or rebalancing? Who makes this decision, what data is required to make it and when it needs to be made are all key issues to be addressed? Here, it may be helpful to design a cashflow waterfall, essentially an order of where assets will be sourced from when disinvestments are required

Adapt and evolve:

Finally, any plan will not a be "set it and leave it" strategy. Your cashflow position will change regularly, both through gradual maturing of the membership but also potentially in large lumps, around actuarial valuations and large member or employer activity. Therefore, the modelling should regularly be updated to ensure the most up to date cashflow picture is being used. Similarly, your investment strategy isn't fixed either and can be adapted over time to be better suited to your evolving cashflow position, both in terms of immediate changes and planning further into the future.

What can you do in your investment strategy?

There are changes that can be made to an investment strategy to make it better suited to being cashflow negative:

Take income from assets you hold:

Many investments generate some form of income that investors can take as cash, rather than reinvest. Equities pay dividends, bonds pay coupons, properties receive rent. These holdings could be used to produce a source of income that would reduce or prevent the need to sell assets (which can be problematic during market volatility). However, these will impact your expected returns and may lead to an increased requirement to rebalance your asset allocation.

Increase allocations to income-generating assets:

Given the advantages taking income can have, it may be suitable to increase the amount of income generated by an investment strategy. Here, the focus should be on secure, contractual cashflows that can be relied upon when needed. These include bonds (with a preference for lower credit risk borrowers), private debt and some forms of property. As ever, any changes to an investment strategy need to keep the required rate of return and risk tolerances at the core of the design.

Reduce illiquid holdings:

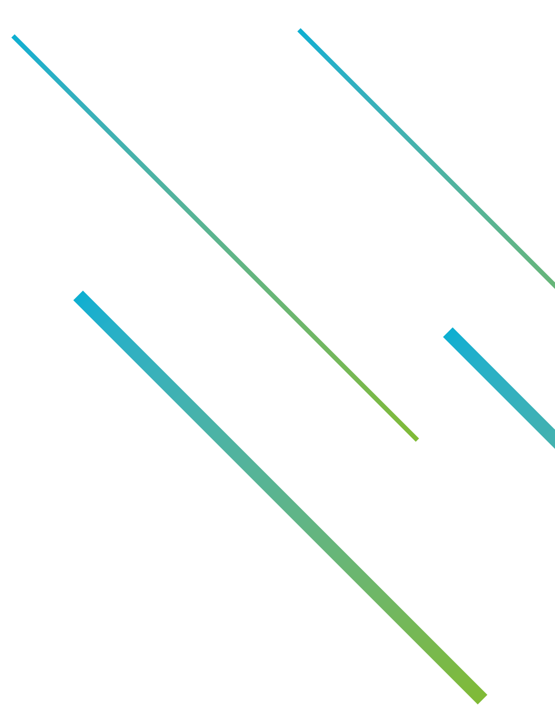
as already discussed, illiquid assets cannot be used for disinvestments to meet outgoing cashflow. A larger allocation would mean a greater reliance on taking assets from elsewhere in the portfolio, increasing the potential for the asset allocation to drift away from the long-term strategy and overweight these illiquid assets.

Where from here?

Whilst cashflow negativity will be a new challenge for many Funds to consider, and one that may not yet appear a significant issue, it has the potential to cause severe headaches and investment risks in the not-too-distant future.

Measuring and planning are required to get a grip on this issue, so that actions can be taken to prevent the need for cash from having significant impacts on long-term risk and returns as well as severe operational issues in the meantime. It will also help you to adapt and evolve over time as your position continues to change.

So, get ahead of this before it becomes an issue for your fund.



Investing in the UK

Many LGPS funds hold significant allocations to the UK, through equities, bonds and property. This home bias is possibly best explained as both a hangover from times when funds were only allowed to invest in the UK and the reassurance provided by investing in familiar assets. Home bias is a phenomenon which is seen in many countries and consistently over time. However, there are drawbacks, such as lack of diversification. In this article, we look in more detail at the LGPS's UK bias and how funds can ensure the advantages outweigh the disadvantages.

The case for the UK

It would not be unreasonable at the present time to summarise the case for investing in the UK in the following terms:

- Weak growth outlook, 2023-25 cumulative: +2.6%[1]
- High consumer price inflation, November 2022: 10.7%[2]
- Self-imposed restrictions on transacting business with its major trading partner
- Large current account and budget deficits, again amongst the weakest in developed markets[3]
- Relatively low levels of capital investment and deteriorating industrial relations
- Dwindling share of global capital markets: 3.8% (compared with 8.3% ten years ago)[4]
- Sporadically dysfunctional political system

Hardly a compelling investment proposition! Which makes it easy to forget that the UK has a number of strengths which we take for granted, but which many countries lack, even amongst developed markets. Apart from the obvious advantage, for sterling investors, of reduced currency risk, we would highlight:

- An investor/creditor-friendly legal system, which is widely respected and adopted around the world
- An open economy and competitive business environment underpinned by relatively stable tax and regulatory frameworks
- A highly sophisticated system of financial intermediation which can provide exposure to practically any kind of investment risk
- Relatively liquid and efficient capital markets, for both public and private assets, underpinned by large volumes of pension fund and insurance company capital
- World-beating companies in specific sectors such as life sciences, aerospace and creative industries underpinned by a strong scientific research base
- Multi-national companies providing convenient (currency risk managed) exposure to different economic sectors and regions worldwide

It's also worth noting that UK equities in particular continue to trade at materially lower valuations than global equities. This partly reflects the headwinds faced by UK companies noted above, but it likely also suggests UK stocks are better value than their global peers.

[1] Consensus Forecasts, October 2022
[2] Office for National Statistics, December 2022
[3] Minus 5.9% and minus 6.6% respectively, The Economist, December 2022
[4] UK share of MSCI ACWI equity index, November 2022 vs November 2012

What to do about a home bias

We typically advise clients to invest globally so as to diversify risk and optimise returns, and not to retain large legacy overweight positions in mainstream UK assets. But we would certainly not recommend abandoning the UK as an investment target. Instead, where you do invest in the UK, or even overweight it, we recommend applying the following principles:

Consider those asset classes where the UK "punches above its weight" in terms of the volume and diversity of investment opportunities. In real estate, for example, opportunities in all parts of commercial and residential property markets and at all points on the risk spectrum are now fairly readily accessible. At the same time, investors can be confident that the assets they've invested in or security interest they've taken are enforceable. Infrastructure is another good example. The nationalisation of major utilities in the 1980/90s, the Private Finance Initiative in the 1990s/2000s and more recently the boost provided by the UK's ambitious decarbonisation plans have created a large, and diverse pool of investible assets.

Focus on those sectors in which the UK excels and where fast growing and highly profitable companies are likely to flourish. The UK may lack champions in the digital technology sectors which have propelled growth in the 2010/20s, or traditional sectors such as manufacturing which have boosted earnings. But with some patient research, attractive investment opportunities can be found in sectors such as life sciences, aerospace and creative industries, and it is likely that the companies involved will have a need for additional capital.

Capitalise on the wide variety of UK assets available to investors. Unlike other jurisdictions, investors can invest in almost any type of asset, at any point in its capital structure, and in almost any format. The principle of caveat emptor still applies though: if an opportunity looks too good to be true, it probably is. And if investors cannot understand an opportunity, its likely nor does the issuer/sponsor.

Take time to evaluate and due diligence opportunities properly. The best investment opportunities may not be found in the equity and bonds issued by large UK listed companies, nor in the funds promoted by the largest London-based fund managers. Identifying and evaluating opportunities in private markets and in funds offered by specialist managers is likely to require more time and effort, but investors may well be rewarded by better long-term investment outcomes.

Conclusion

The proponents of Brexit have consistently argued that the freedoms afforded by leaving the European Union (and arguably also the challenges created by doing so) would unleash accelerated growth and high levels of innovation, and we sincerely hope this proves to be the case. If it does, overweighting the UK may well improve long-term investment outcomes. But we would recommend investors carefully consider the size of the overweight and their strategy for investing the capital committed.

The opportunity in renewables infrastructure and the energy transition

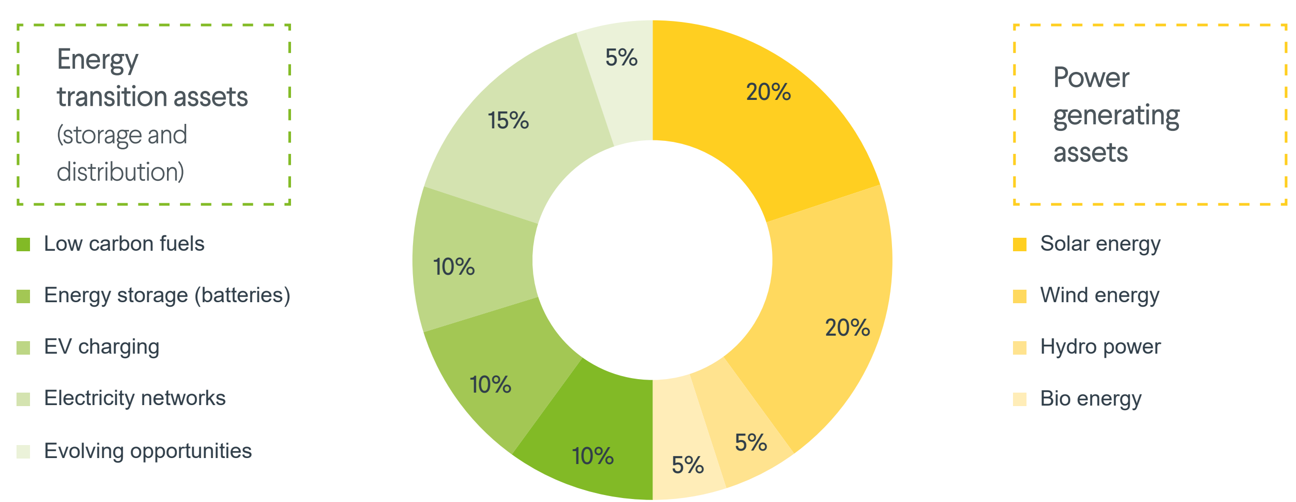
A developed investment opportunity

Renewable infrastructure presents a potentially attractive investment opportunity. The growing demand for clean energy has helped to create a genuinely investable asset class that can stand on its own two feet, no longer reliant on government subsidies.

So here is an opportunity for funds to use their capital to address climate change whilst still generating attractive levels of return.

Market opportunity

Renewable infrastructure traditionally referred to energy generated from renewable resources, such as wind and solar. More recently, it has expanded to include assets related to energy storage and distribution.



Note: Opportunities are not to scale. Evolving opportunities includes technologies currently being trialled (such as carbon capture and storage or technology to balance the grid) which could lead to enhancements in energy storage and distribution.

There has been a surge of interest and investment in renewable infrastructure over recent years due to political support and the increased demand for greener energy. Many countries and large corporations have made a firm commitment to achieving net zero emissions (typically by 2050). Recent geopolitical events and the sudden rise in inflation (partly driven by the rise in energy prices) have added further impetus for developed countries to achieve energy independence. The increased focus on clean energy coupled with the substantial drop in the costs of building and maintaining renewable assets will make the next few years an attractive time to allocate to renewable infrastructure funds.

In the early days, renewables were heavily reliant on government subsidies to make projects worthwhile but the declining costs mean this is no longer the case. Growing demand from large corporations (such as Amazon, Google etc.) for renewable energy means the output from these projects can now be sold on long-term contracts to companies with low credit risk. Although explicit inflation links can be difficult to find or secure, given the way power markets function, there is some implicit inflation linkage built into the income stream from these assets.

However, competition for ownership of these types of assets is also high, bringing down potential return. Therefore, investors may need to look beyond the traditional boundaries of this market to earn the same rates of return that were possible when government subsidies were available.

Investors should also remember that the wider energy transition sector will contain opportunities that extend beyond the generation, storage and distribution of renewable power, and will encompass related areas of environmental policy such as energy efficiency initiatives. Therefore, investors should cast their nets widely in this space to capture the vast range of opportunities.

Return expectations

Investors have generally benefitted from stable returns and the diversification benefits of owning the equity portion of infrastructure assets.

In common with other infrastructure assets, one of the key determinants of expected returns relates to the stage at which investment is made in the lifecycle of a project. Whether investing in renewable power generating assets or energy transition assets, investors can expect to receive a higher return for investing in projects before they are operational (development and construction stage) compared to buying assets once they are fully operational.

The construction period for renewable assets and the risks associated with this stage have reduced substantially over the last decade as the technologies have matured and experience of building such projects has increased.

Managers who specialise in developing or constructing such assets will typically sell the asset to a utility company (or a fund manager specialising in the operational stage) and rely on capital growth to provide returns to investors. Managers who focus on the operational stage rely on income payments from government subsidies or power purchase agreements with creditworthy organisations (such as utilities or large multinational companies) to provide the expected return.

Development strategies typically target an internal rate of return (IRR) of 10%+ pa over a 10-15 year period whereas combined construction and operations strategies tend to target IRRs of 5-8%+ pa over a longer period of 10–25 years. A few funds will target the development, construction and operational stages although it can be a bit difficult to show relevant expertise in each part of the investment cycle.

Given the investment timeframe, an investment in renewables should be considered long-term and illiquid. Some of the other key factors to consider are regulatory risk, country risk, risks relating to the phase of the investment cycle (eg not receiving development approval, risk of delays during construction or problems during the operational phase), competition for assets and leverage risk. Many of these risks are mitigated through careful selection of suitable investments, which gives us comfort that the target returns seem realistic for specialist renewable infrastructure managers.

Impact and ESG credentials

Not only are the characteristics of investing in renewable infrastructure attractive, and another compelling feature is the positive impact assets can deliver through contributing to a more sustainable planet. Many funds can quantify the impact on local communities (eg through jobs created, community benefits paid), contribution towards net-zero targets (such as carbon emissions avoided, biodiversity and water usage impacts) and show strong ESG credentials (supplier code of conduct, health & safety regulations). Unlike many other asset classes, the positive impact from a renewables allocation is measurable rather than anecdotal.

What does this all mean?

Renewable infrastructure has now emerged into a mature, large and growing investment opportunity offering some strong potential advantages to a traditional investment portfolio, as well as providing clear benefits for those with climate-related ambitions. However, be prepared to invest widely to achieve optimal returns and diversification.

London | Birmingham | Glasgow | Edinburgh   T 020 7082 6000 | www.hymans.co.uk

This communication has been compiled by Hymans Robertson LLP, and is based upon their understanding of legislation and events as at February 2022. It is designed to be a general information summary and may be subject to change. It is not a definitive analysis of the subject covered or specific to the circumstances of any particular employer, pension scheme or individual. The information contained is not intended to constitute advice, and should not be considered a substitute for specific advice in relation to individual circumstances. Where the subject of this document involves legal issues you may wish to take legal advice. Hymans Robertson LLP accepts no liability for errors or omissions or reliance on any statement or opinion.

This information is not to be interpreted as an offer or solicitation to make any specific investments. All forecasts are based on reasonable belief. Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of your investments based on information contained in this document. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, whether held directly or in a pooled or collective investment vehicle. 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 investment. As a result, an investor may not get back the full amount originally invested. Past performance is not necessarily a guide to future performance.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority. A member of Abelica Global. © Hymans Robertson LLP.

© Hymans Robertson LLP. Hymans Robertson uses FSC approved paper.