

# INVESTMENT STRATEGY STATEMENT

April 2023

Hertfordshire Pension Fund  
Local Government Pension Scheme



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# 1 Introduction

## 1.1 What is this document?

This is the Investment Strategy Statement (“ISS”) of the Hertfordshire Pension Fund (“the Fund”), which is administered by Hertfordshire County Council, (“the Administering Authority”). The ISS is made in accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (“the Regulations”). This document replaces the Fund’s Statement of Investment Principles.

The ISS has been prepared by the Pension Committee (“the Committee”) having taken advice from the Fund’s investment adviser, Mercer. The Committee acts on the delegated authority of the Administering Authority.

The ISS, which was approved by the Committee on 28 November 2022, is subject to periodic review at a maximum every three years or following any significant change in investment policy. The Committee has provided the Pension Board with an opportunity to review and comment on the contents of the Fund’s investment strategy and will continue to work with the Pension Board to review its operation.

This ISS has been designed to be a living document and is an important governance tool for the Fund. This document sets out the investment strategy of the Fund, provides transparency in relation to how the Fund investments are managed, and acts as a risk register.

This ISS also supports the development of asset pooling, which represents a major change in the way LGPS funds manage assets. The implementation of the Fund’s investment strategy will be mainly through assets held by the ACCESS Pool (more details provided in section 4).

The Committee seeks to invest, in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund’s latest Funding Strategy Statement.

## 1.2 Investment Beliefs

The Committee has, as part of the process of creating this Investment Strategy Statement agreed a set of ‘Investment Beliefs’ which are summarised briefly below:

- All investment decisions should be made on an objective basis supported by the most appropriate evidence available.
- The Hertfordshire Pension Fund has very long term liabilities and it is therefore believed that a long-term approach to investment matters is both appropriate and desirable.
- Risk and return are related. Riskier assets are expected to be held only when there is a reasonable expectation of higher returns being generated. There are some risks for which no additional return is expected; these should be avoided or mitigated.
- Diversification and hedging are effective ways of reducing the volatility of an asset portfolio and therefore reducing the volatility of the Pension Fund’s funding level.
- Investment risk is multi-dimensional and complex. The Fund is subject to a range of investment risks which are addressed in the investment strategy-setting process. The investment strategy shall be reviewed on an ongoing basis as market and specific risk and opportunities evolve. There are other risks such as regulatory risk, employer risk and longevity risk which are addressed elsewhere.
- Excess returns are not certain. The Committee aims to manage the Fund on a cost-effective basis and seeks correspondingly favourable terms from the Fund’s asset managers.
- The real world, of economies and markets, is complex. Simple explanations are unlikely to be robust. To reflect this complexity the Committee takes material time and effort to understand the

issues with which it is faced and also, from time to time, undertakes training on specific topics from specialist providers.

- Innovation and evolution can be of benefit to the long term investor. A willingness to consider new investment ideas is likely to bring value to the Fund in the longer term, especially if balanced with a consistency of thought and governance processes.
- Environmental, Social & Governance (ESG) issues, including climate change, create material risks and opportunities which will influence long term investment performance and the ability of the Fund to achieve its investment and funding objectives. Therefore, robust ESG and stewardship practices should be integrated throughout the investment process of the Fund. The Fund recognises that the management of Responsible Investment (RI) issues by ACCESS, the investment pool, and its partner Councils in the ACCESS pool is a reputationally important issue.

## 2 Investment Strategy and the process for ensuring suitability of investments

The Fund's objective is to pay benefits as they fall due and this requires the build-up of sufficient reserves in advance. The Fund's funding position, in respect of historic benefits accrued, and the cost of accruing benefits is reliant on the assets outperforming the risk free rate of return (defined as the yield on UK Government Bonds ("Gilts")) over the long-term. The asset strategy is focused on achieving returns in excess of gilts, without taking undue risk in order to ensure the financial health of the Fund and keep the cost of accruing benefits stable and affordable. Having a thorough understanding of the risks facing the Fund is crucial and these are covered later in this statement.

Following detailed investment strategy reviews in 2022, the table below sets out the revised investment strategic asset allocation along this an overview of the role each asset plays in achieving the Fund's objectives. The Fund will look to deliver the strategy including the make-up under each asset class over the medium term and will work with the Fund's investment consultant to implement this new strategy.

<b>Asset class</b>	<b>Allocation %</b>	<b>Role (s) within the strategy</b>
Listed Equity	40.0	Long term growth in excess of gilt returns and expected inflation. Includes diversification by geography, style, and sector and currency exposure.
Equity protection strategy	n/a	Risk management listed options based strategy used as an overlay to control the market risk underlying the listed equity portfolio.
Bonds	20.0	Dampens the volatility of funding level Income generating Liability matching properties Diversification of return source
Property	8.0	Diversification. Generates investment income; Returns expected to be inflation-sensitive Exposure to Illiquidity premium



Alternatives	16.0	Diversified source of returns Some inflation protection Source of income Exposure to illiquidity premium
Real Assets	15.0	Diversification Generates investment income and some inflation protection Exposure to illiquidity premium
Cash	1.0	Cash flow to meet statutory liabilities, including monthly pension payroll payments.

In addition to the equity protection strategy, the Fund may invest in strategies that utilise both exchange-traded and OTC derivatives, including, but not limited to, forward currency contracts, options, futures and swaps for investment purposes. Derivatives may be used for hedging or efficient portfolio management purposes or to create a synthetic equity exposure. Derivatives will not be used for speculative purposes. These instruments can be highly volatile and expose investors to a high risk of loss.

The Committee is responsible for the Fund's asset allocation which is determined via a formal strategy review, but is kept under constant review; noting that strategic changes are an evolutionary process.

The strategy review looks at both qualitative and quantitative analysis, covering:

- The required level of return that will mean the Fund can meet its future benefit obligations as they fall due
- The level of risk that the Fund can tolerate in absolute terms, and in relation to its funding level and deficit
- An analysis of the order of magnitude of the various risks facing the Fund is established in order that a priority order for mitigation can be determined
- The desire for diversification across asset class, region, sector, and type of security
- Broader strategic requirements that have significant levels of financial materiality e.g. ESG factors

## 3 Risk Measurement and Management

The Committee assesses risks both qualitatively and quantitatively, with the starting point being the triennial strategy review. Risks are considered, understood and then prioritised accordingly.

### 3.1 Investment Risks

The Fund is exposed to a number of different types of risk of which the most significant are related to investment and market risk. The chart below shows the VaR<sup>1</sup> (Value at Risk, essentially the minimum losses that would occur in a 1-in-20 downside event) facing the Fund, split into major risk categories.

<sup>1</sup> VaR calculation based on analysis as at 31 March 2022.

### Expected Risk (1 Year VaR £m)



As the above graphic illustrates, although equities are expected to outperform the liabilities over the long term, they are the Fund's largest single source of risk. The other significant source of risk is from changes in the present value of its liabilities which are sensitive to change in gilt yields and inflation expectations, although this is not explicitly shown in the above. Further detail on the risks and any mitigation actions that the Fund takes to address them are detailed below.

#### *Equities*

The largest risk that the Fund is running is in relation to its equity holdings. Should equity market conditions deteriorate significantly this will have a negative impact on the funding level. The Fund holds equities in order to provide the necessary returns to ensure that the Fund remains affordable. The Committee believes that the extra returns that are expected to be generated by equities compensate for the level of risk equities bring to the Fund, but mitigates this risk by investing significant amounts in diversifying assets; bonds, property and alternatives. The Fund also uses an equity protection strategy to dampen the impact of equity price volatility.

The Fund is a long term investor but does require income over and above contributions received in order to pay pensions. A strategy has been developed that would seek additional income from alternative assets and bonds, rather than from equities, in order to avoid being a forced seller at a low point in the market.

#### *Credit risk*

The Fund lends money to companies and institutions at a rate of return that compensates the Fund for the credit risk i.e. that the money plus interest isn't repaid. If the realised credit risk is higher than expected then the Fund is at risk of financial loss.

The Fund's employs specialist asset managers to assess the level of credit risk to ensure the risk is rewarded at the point of investment and on an ongoing basis.

### *Liabilities*

The Fund's liabilities are affected by both discount rates (gilt yield) and inflation; the pensions that the Fund will ultimately pay to members are linked to inflation and so as inflation expectations rise so do the expected cashflows that the Fund will have to pay in future. The Fund's liabilities are also sensitive to discount rates because of the method that the actuary uses to place a present value on all the future pension payments. The Fund will seek to invest in a range of assets that:

- provide returns in excess of inflation;
- in some cases provide an inflation-linked income, subject to a tolerable level of volatility;
- are sensitive to discount rates to reduce the impact that changes to the present value of the liabilities have on the funding level.

### *Alternatives*

The Fund has a significant amount of assets allocated to a range of alternatives, with specific allocations to property and private equity in addition to an alternatives mandate which invests in a range of asset classes. The risks that these investments bring at an individual level are not insignificant but the Committee believe that over the long term alternatives will provide returns that compensate for the risks being run. Additionally the level of diversification the assets provide helps to reduce the Funds reliance on returns from equities. Illiquid assets such as property are also a valuable source of income.

### *Active Manager Risk*

Investment Managers are appointed to manage the Fund's investments on its behalf. This risk is small relative to other risks; nevertheless the Fund still addresses this risk through diversification of its exposure to active managers and careful monitoring of their progress. The Fund maintains a balance between passive and active management; determining the most appropriate approach in relation to the asset class. The Fund has an active risk management programme in place that aims to help it identify the risks being taken and put in place processes to manage, measure, monitor and (where possible) mitigate the risks being taken. Key risks and mitigating controls are incorporated in the Fund's risk register which is monitored on an ongoing basis and reported to the Pensions Committee and LGPS Board quarterly.

### *ESG & Climate Change risk*

Effective management of ESG issues is a key determinant of long-term shareholder value and good risk management. Their consideration is part of this Fund's fiduciary duty to beneficiaries. The Hertfordshire Pension Fund therefore recognises the importance of its investment managers integrating all material financial and non-financial factors, including ESG considerations, into the decision-making process for fund investments and the ongoing monitoring of these same issues. The Hertfordshire Pension Fund recognises the systemic risk associated with climate change and supports the objectives of the Paris Agreement and believes that keeping global temperature rises well below 2°C relative to pre-industrial levels is entirely consistent with the Fiduciary duty of the Fund.

The Fund's portfolio is well diversified across asset classes, geography and asset managers. As different asset classes have varying correlations with other asset classes, by investing in a range of different investments, the Fund can reduce the total level of risk run to a material extent.

The other principal risks that the Fund is exposed to can be identified as:



- The Fund's investment strategy and asset allocation does not deliver the long term asset returns and growth required to meet the Fund's liabilities;
- The Funding level of the Pension Fund deteriorates;
- Scheme employers default on meeting their obligations to the Pension Fund and LGPS; and
- Third party risk – failure of Fund providers and regulatory non-compliance.

Details of these risks and a summary of control mechanisms can be found in appendix E of the Fund's funding strategy statement [funding-strategy-statement-2021.pdf \(hertfordshire.gov.uk\)](#)

### **3.2 Cashflow Risk**

The Fund is gradually becoming more mature and the Cashflow position is monitored by the Fund's Officers and Fund Actuary at each triennial valuation. This has become an important consideration in setting and monitoring the Fund's investment strategy and asset allocation to illiquid and liquid assets. The Fund receives investment income which could be used to pay benefits rather than be re-invested if and when the Fund becomes cash flow negative, the 2022 investment strategy review increased the allocation to real assets which are designed to produce inflation linked cashflows to ease Cashflow risk.

### **3.3 Demographic Risk**

The Committee reviews the demographic assumptions of the Fund every three years as part of its triennial valuation to mitigate the risk that any changes to longevity and other factors would have on the Fund. Measures to mitigate this risk include review of employer contributions, asset allocation and bond or other insurance. Further details on the assumptions used in the valuation can be found in appendix C of the Fund's funding strategy statement [funding-strategy-statement-2021.pdf \(hertfordshire.gov.uk\)](#)

### **3.4 Fund Governance Risk**

The Fund believes that there is a benefit to the Fund to be gained from good governance of its Committee in the form of either an increased return and/or decreased risk. Poor governance can lead to opportunities and risks being missed, and have a detrimental effect on the funding level and deficit.

Details of the Fund's governance structure can be found in the Governance Compliance Statement, details of which can be found in the Annual Report and Accounts [Hertfordshire Pension Fund | Hertfordshire County Council](#)

### **3.5 Environmental, Social and Governance ('ESG') Risks**

ESG issues, including climate change, create material risks and opportunities which will influence long term investment performance and the ability of the Fund to achieve its investment and funding objectives.

Therefore, robust ESG and stewardship practices should be integrated throughout the investment process of the Fund. The Fund recognises that the management of RI Issues by ACCESS, the investment pool, and its partner Councils in the ACCESS pool is a reputationally important issue.

The Fund's detailed responsible investment policy can be found as an appendix to this Investment Strategy Statement.

### **3.6 Asset Pooling Risk**

The Fund is a member of the ACCESS pool and may be exposed to additional risk during the transition of assets to the pool and may incur unexpected costs in relation to the transition of assets among managers. The pool will seek suitable professional advice during this transition period to budget and manage cost.

## **4 Approach to Asset Pooling**

### **4.1 ACCESS**

Hertfordshire is a member of the ACCESS pool along with the following 10 other pension funds:

- East Sussex
- Essex
- Hampshire
- Cambridgeshire
- Isle of Wight
- Kent
- Norfolk
- West Northamptonshire
- Suffolk
- West Sussex

All eleven funds are committed to working together collaboratively to meet the criteria for pooling and have signed an Inter Authority Agreement to underpin their partnership. Passively-managed investments were the first investments pooled by ACCESS in 2018, since then a number of equity and bond funds have been established by ACCESS and Fund investments migrated to these funds.

The ACCESS Funds have set out how they meet the pooling criteria, the pool's structure, governance arrangements and services to be shared in the submission made to the Government in July 2016, which is available on ACCESS's website <http://www.accesspool.org/>

All eleven ACCESS funds expect that all investments will be pooled apart from a minority of investments where there is a no value for money benefit to pooling. These have been / will be set out as part of the pooling criteria.

### **4.2 Assets to be invested in the Pool**

The Fund's intention is to invest its assets through the ACCESS Pool as and when suitable Pool investment solutions become available. An indicative timetable for investing through the Pool was set out in the July 2016 submission to Government. The key criteria for assessment of Pool solutions will be as follows:

1. That the Pool enables access to an appropriate solution that meets the objectives and benchmark criteria set by the Fund
2. That there is a clear financial benefit to the Fund in investing in the solution offered by the Pool, should a change of provider be necessary.

### 4.3 Assets held outside the pool

At the time of preparing this statement the Fund has elected not to invest the following assets via the ACCESS Pool, however this position will change in the future as the pool's capacity to manage these asset classes develops:

<b>Asset class</b>	<b>Current Manager</b>	<b>% of Fund strategic assets</b>	<b>Benchmark</b>	<b>Reason for not investing via the ACCESS pool</b>
Equity Protection	Insight Investments	n/a	n/a	A bespoke overlay based on the Fund's actual equity holdings so not feasible
Multi-Asset Credit (MAC)	BlueBay/Royal Bank of Canada	5.0%	SONIA Cash	Implementation route not available to meet strategic needs of Fund. Manager is in the pipeline for ACCESS fund launch.
Property	CBRE	8.0%	75% MSCI Global Funds Index (lagged one quarter) / 25% MSCI All Balanced Property Funds Index	This mandate is made up of illiquid assets which because of the nature of the entities invested in is likely to make pooling both extremely difficult to implement and more costly for the Fund.
Real Assets	Allianz, Macquarie, M&G and Legal & General	15.0%	Various	These mandates are made up of illiquid asset classes which because of the nature of both the fee structure and legal structure of the entities invested in is likely to make pooling both extremely difficult to implement and significantly more costly for the Fund.
Private Equity	HarbourVest, Standard Life	5.0%	FTSE All-Share index	Existing illiquid asset programmes will run off at normal lifecycle to avoid

	Capital, Pantheon			crystallising exit costs and loss of illiquidity premium earned.
Alternatives	LGT Capital	11.0%	3 month sterling LIBOR	This mandate is made up of illiquid and liquid asset classes which because of the nature of both the fee structure and legal structure of the entities invested in is likely to make pooling both extremely difficult to implement and significantly more costly for the Fund.
Operational Cash	Hertfordshire County Council	1.0%	7 day LIBID	The Hertfordshire Pension Fund needs to manage its cash flow to meet statutory liabilities, including monthly pension payroll payments, therefore a reasonable level of operational cash will be held outside the pool.

In the fullness of time, it is expected that the ACCESS Pool will have capacity and expertise to manage illiquid and alternative assets in a cost effective way, and therefore ultimately all the Fund's non-cash assets will be held in the pool.