

INVESTMENT STRATEGY STATEMENT

March 2020

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 3 March 2020, 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 Funding Strategy Statement (dated 1 April 2020).

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 is one effective way 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. 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.
- As an investor with a long time horizon, ESG issues are likely to have a material impact on investment risks and returns and contribute to our ability to meet investment objectives. Therefore, considering these issues is consistent with the fiduciary duty of the Committee. Long-term sustainability issues, particularly climate change, present risks and opportunities that require explicit consideration, both today and into the future. Stewardship can help to create and preserve long term value for companies and markets as a whole.

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 is currently assessed to have a deficit, in respect of historic benefits accrued, and so the asset strategy is focused on achieving returns in excess of gilts, without taking undue risk in order to reduce this deficit. Having a thorough understanding of the risks facing the Fund is crucial and these are covered later in this statement.

The target asset allocation as at March 2016 for the fund is set out in the table below and has an allocation of 75% to growth assets and 25% to defensive assets:

Asset class	Allocation %	Role (s) within the strategy
Equity:		
UK	16.0	Long term growth in excess of gilt returns and expected inflation. Includes diversification of UK and Global equities for market growth and currency exposure
Global	34.2	
Total	50.2	
Bonds	25.0	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	15.8	Diversified source of returns Some inflation protection Source of income Exposure to illiquidity premium
Cash	1.0	Cash flow to meet statutory liabilities, including monthly pension payroll payments.

Following detailed investment strategy reviews in both 2016 and 2019, the revised investment strategy will target an asset allocation of 65% to growth assets, and 35% to defensive assets, of which 10% will be invested in real assets. The Fund will look to deliver this new strategy and asset allocation over the medium term and will work with the Fund's investment consultant to implement this

new strategy. The table below provides an overview of the role each asset plays in achieving the Fund's objectives is set out in the table below:

Asset class	Allocation %	Role (s) within the strategy
Equity: UK Global Global Climate Aware Emerging Market Total	 2.0 31.0 2.0 5.0 40.0	Long term growth in excess of gilt returns and expected inflation. Includes diversification of UK and Global equities for market growth and currency exposure
Bonds	25.0	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*	10.0	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.

*The Fund has allocated to a range of Real Assets, High Lease to Value Property (HLV), Infrastructure Debt and Private Residential Property (PRS), with the allocations split evenly.

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 triennial strategy review as part of the actuarial valuation process, but is kept under constant review; noting that strategic changes are an evolutionary process.

The triennial 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

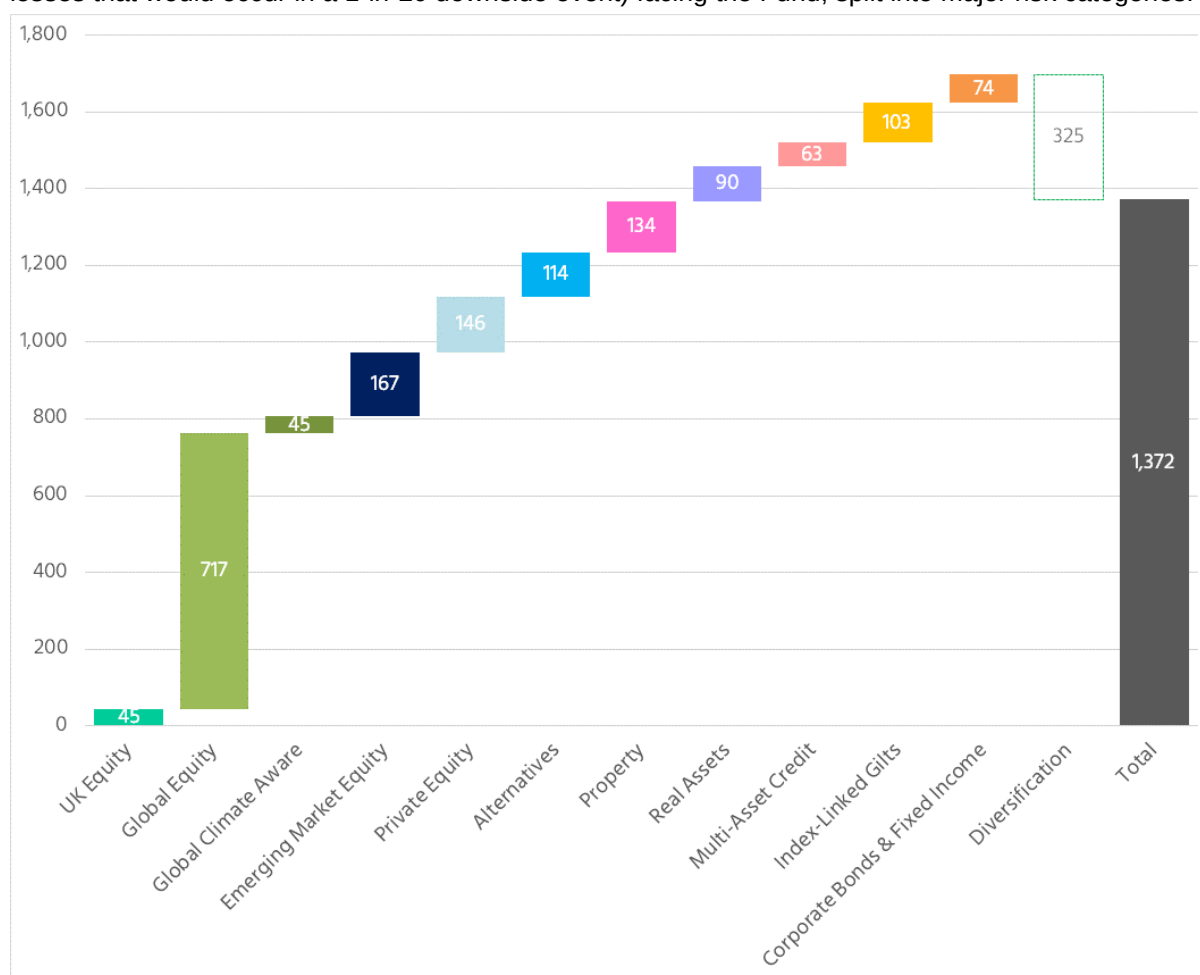
- The level of risk that the Fund can tolerate in absolute terms, and in relation to its funding level and deficit
- An analysis of the order of magnitude of the various risks facing the Fund is established in order that a priority order for mitigation can be determined
- The desire for diversification across asset class, region, sector, and type of security

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 VaR¹ (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.



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. Further detail on the risks and any mitigation actions that the Fund takes to address them are detailed below.

¹ VaR calculation based on the valuation results of 31 March 2019.

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 is a long term investor but does require income over and above contributions received in order to pay pensions. A strategy is therefore being 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.

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 though 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.

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 <http://www.yourpension.org.uk/Hertfordshire/Fund-information/Policy-statements.aspx>.

3.2 Cashflow Risk

The Fund's cash flow position is currently positive but the Fund is gradually becoming more mature and this position is monitored by the Fund's officers and Fund Actuary at each triennial valuation. This will become an important consideration in setting and monitoring the Fund's investment strategy and asset allocation to illiquid and liquid assets. This issue is currently addressed at total Fund level. As part of the lead up to the next triennial valuation the Fund will look to develop sub-strategies to address the differing funding levels of the employers within the scheme. The Fund also receives investment income which could be used to pay benefits rather than be re-invested if and when the Fund becomes cash flow negative.

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 <http://www.yourpension.org.uk/Hertfordshire/Fund-information/Policy-statements.aspx>.

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 <http://www.yourpension.org.uk/Hertfordshire/Fund-information/Annual-reports.aspx>.

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

The Committee believes that ESG, including climate change, risks should be taken into account on an ongoing basis and are an integral part of the Fund's strategy and objective of being a long-term investor. Climate change is a systemic risk that will impact investments at the asset class, sector and company level and will require increasing consideration. Understanding climate change risks from an investment perspective and developing a plan to manage this is a current area of focus.

The Committee believes that good stewardship via engagement with the underlying companies through our investment managers is key in relation to strong corporate governance and managing ESG risks, which in turn will enhance returns. Details of the Fund's policies can be found later in this 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
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:

Asset class	Manager	% of Fund strategic assets	Benchmark	Reason for not investing via the ACCESS pool
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	10.0%	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 Capital, Pantheon	5.0%	FTSE All-Share index	Existing illiquid asset programmes will run off at normal lifecycle to avoid 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.

5 Environmental, Social and Corporate Governance ('ESG') and Stewardship policies

ESG issues are likely to have a material impact on investment risks and returns and contribute to our ability to meet investment objectives. Therefore considering these issues is consistent with the fiduciary duty of the Committee. Long-term sustainability issues, particularly climate change, present risks and opportunities that require explicit consideration, both today and into the future.

The Fund is a long-term investor and is committed to being an active owner by promoting good stewardship. Stewardship can help to create and preserve long term value for companies and markets as a whole. The Fund wishes to promote a policy of dialogue on responsible investment issues, through its investment managers, with company management. It also recognises the importance of collaboration for effective engagement.

The Fund invests via pooled funds and therefore has given underlying investment managers full discretion in assessing ESG factors, including climate change, and to exercise voting and engagement rights on its behalf. Managers are expected to undertake their stewardship obligations in line with their corporate governance policies and current best practice, including the UK Stewardship Code (the 'Code'). The Fund supports the Code and is intending to become a signatory to the 2020 Code. The Fund encourages its underlying investment managers to comply with the Code through regular reviews of their compliance with it.

The Committee considers, amongst other factors how ESG, climate change and stewardship is integrated within the investment processes when appointing a new manager and when monitoring investment managers. In recognition of the importance of climate change from a risk/return perspective the Committee has made an allocation to a climate aware equity index fund. Further allocations to strategies that target long-term ESG themes and opportunities may be explored in the future.

Investment managers' approaches to ESG, climate change and stewardship are monitored on an annual basis to ensure they are appropriate and in keeping with the Fund's policy. Going forward, as part of this reporting the Committee will receive an annual report from its Investment Consultant on the ESG credentials of its investment managers, the carbon intensity of their equity portfolios and their approach to stewardship. The Fund's approach to ESG reporting is being developed further over time.

The Committee has not set any investment restrictions on the appointed equity managers in relation to products or services, but sensitive topics remain an area of ongoing consideration.

The Committee recognises that ESG and stewardship are rapidly developing topics and is committed to developing its understanding and approaches in these areas. The Committee recognises the importance of working collaboratively with ACCESS to make the Fund's ESG approach effective, particularly in the appointment of managers who integrate financially material ESG risks effectively within their investment processes.