Avon Pension Fund

Your pension, your future

Investment Strategy Statement 2024

Summary version

Contents

Introduction

The Investment Strategy Statement (ISS) sets out our investment strategy, how we invest and what we consider when developing our strategy.

This version summarises the key aspects of the strategy. The full version below shows how the Fund meets its regulatory requirements.

Find out more by downloading our full length Investment Strategy Statement 2024 (PDF, 611.29KB).

Key point 1: our investment beliefs

Our investment beliefs underpin our investment strategy and guide decision-making around investment of our assets.

- Long-term investment horizon – this enables us to withstand volatility of markets over shorter timeframes
- Diversification is key to managing risk – as it means the value of the assets in the portfolios will not all move in the same direction at the same time
- Investing responsibly to make a positive contribution in the real economy will promote sustainable returns. Our net zero target is 2045 and we work with other like-minded investors to engage and encourage positive change
- Lower costs drive higher investment returns – the collective scale of pooling our assets within Brunel Pension Partnership drives efficiencies to reduce costs

Key point 2: our investment objectives

Our primary investment objective is to achieve a return on assets consistent with an acceptable level of risk that will enable us to pay our pension payments over time.

- The investment strategy must generate returns to stabilise and minimise employer contribution rates in the long-term
- It must also reflect the balance between generating returns consistent with an appropriate level of risk, protecting asset values from market falls and matching liabilities (or the pension benefits that have accrued)

Key point 3: our strategic asset allocation

The investment strategy is reviewed annually to ensure it is still meeting its investment objectives.

- The current risk return profile is consistent with the funding objective to provide as stable as possible contribution levels for employers

- The strategic allocation between equities, liquid and illiquid growth assets, and fixed income achieves the appropriate balance of risk and return to provide stability of contributions

Key point 4: our approach to responsible investing

The ISS sets out how responsible investing (RI) is integrated into the investment decision-making process and how we fulfil our role as a responsible steward of our assets. Particular attention is given to our ambitions around climate change.

Our approach to RI is based on the following principles:

- As a long-term investor we seek to deliver long-term sustainable returns
- Management of environmental, social and governance (ESG) risks is consistent with our fiduciary duty to members
- That climate change poses an existential threat to long-term investments as well as to the planet
- We believe in investing responsibly to make a real world impact
- There is increasing convergence between financial returns and climate-aware investments
- Working with like-minded investors to collectively engage companies and policymakers can drive positive change
- We have a duty to exercise our stewardship responsibilities as an owner
- We aim to be transparent and accountable

Key point 5: our climate targets

Our target is to reach net zero by 2045 (previously 2050), supported by the following targets in the period 2024-2030:

- By 2030 we will divest from all developed market equity holdings in high impact sectors that are not achieving net zero or aligning to net zero by 2050
- By 2025 and 2030 the carbon intensity of the listed equity portfolios will be reduced by 43% and 69% respectively (versus 2019 baseline)
- By 2030 we will reduce the carbon intensity of our corporate bond portfolio by 60% (versus 2019 baseline)
- 70% of financed emissions in material sectors will be covered by active engagement by the end of 2024 and 90% by 2027

Key point 6: our approach to risk management

The ISS sets out our approach to risk measurement and management. Evaluation of risks that may impact expected future returns is crucial in determining the appropriate measures to mitigate those risks.

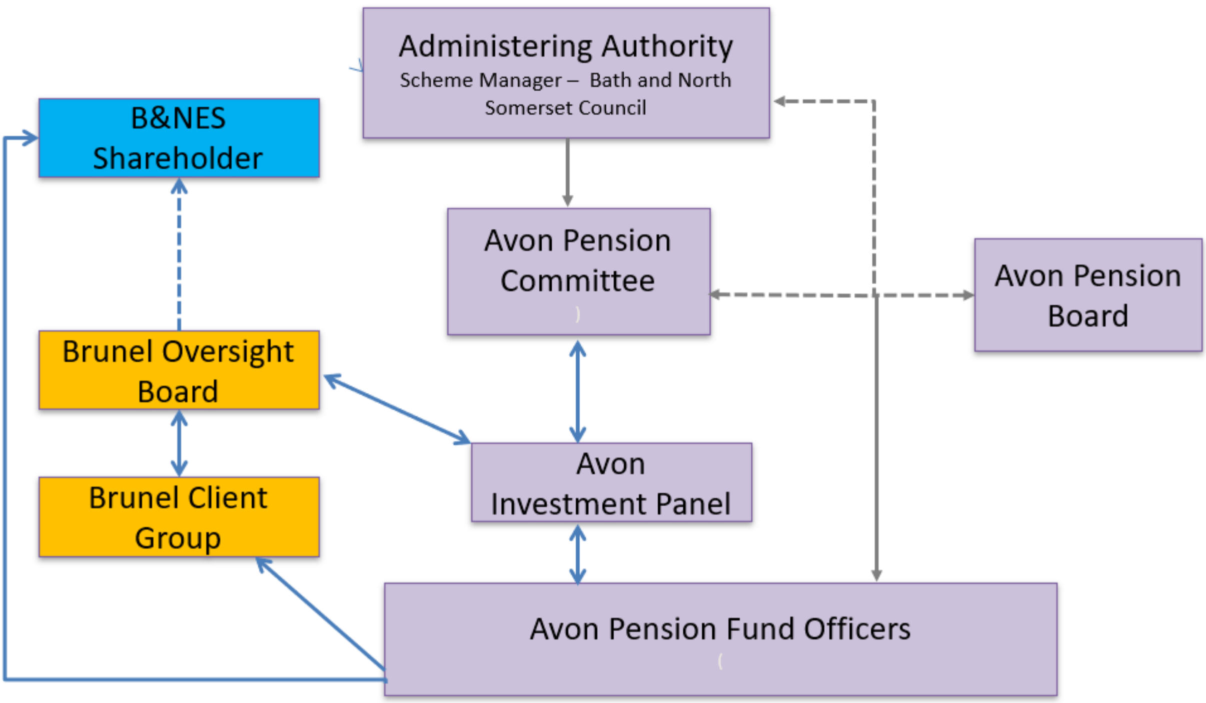
The primary risk facing the Fund is that its assets are insufficient to pay the pension benefits over time. The main risks to employers are the volatility of contribution rates and affordability.

Investment governance framework

Strong governance ensures the Fund runs smoothly and meets regulations. Governance refers to the way in which an organisation is managed at the highest level, and the systems in place for this.

Bath & North East Somerset Council are the administering authority and are legally responsible for the Fund. The council delegates these responsibilities to the Avon Pension Fund Committee, which is the formal decision-making body. This diagram shows how the governance of Avon Pension Fund works, including its relationship with Brunel Pension Partnership, our pension pool.

Investment governance framework diagram



What is pooling?

Together with nine other administering local government pension funds, we pool our assets through the Brunel Pension Partnership Limited (Brunel). Pooling assets with other Local Government Pension Scheme (LGPS) pension funds has many benefits including:

- Economies of scale and lower costs
- An enhanced approach to responsible investment
- Access to a wider set of investment opportunities and markets
- Greater investment expertise through dedicated research and investment specialists

The other members of Brunel are the Buckinghamshire, Cornwall, Devon, Dorset, the Environment Agency, Gloucestershire, Oxfordshire, Somerset and Wiltshire LGPS funds. Each of the 10 funds is an equal shareholder in Brunel Pension Partnership Ltd.

Within pooling there is a clear division of responsibilities and decision-making which is summarised below:

Avon Pension Fund's roles and responsibilities

- Sets strategic asset allocation
- Allocates assets to Brunel portfolios
- Formulates, implements and monitors risk management strategies
- Is a member (along with other pool funds) of the Brunel Oversight Board which oversees the pool to ensure Brunel delivers each client's investment strategy

Brunel roles and responsibilities

- Creates focused investment portfolios to meet asset allocation requirements
- Selects external investment managers or pooled funds for each portfolio and then manages each portfolio
- Manages all of the Fund's listed assets, pooled funds and UK property funds
- Manages new private market allocations

Although the investments of the Fund are pooled with those of other funds, the administration of your pension benefits remains with Avon Pension Fund.

Our Investment Strategy

The investment strategy is regularly reviewed and invests in a broad range of assets including equities, bonds and less liquid assets such as property and infrastructure. This achieves the appropriate balance of risk and return to provide stability of contributions.

The current strategic asset allocation

Case study 1: local investments

We have allocated an initial 3% (around £160 million) to a Local Impact portfolio. Local impact investments cover a wide range of investment opportunities that aim to deliver social impact as well as a financial return.

A large proportion of the opportunities will be focused in the south-west. National opportunities will also be considered to allow greater flexibility to meet our investment objectives.

We will focus our attention on sustainable infrastructure assets and affordable housing strategies, as well as some sector specialist opportunities such as small business funding.

Progress to date

We are already putting our capital to work. We have made our first investment into 'Wessex Gardens'. This fund will invest in renewable infrastructure and energy transition assets across the south-west of England. We are investing £50 million to this fund alongside five other Brunel funds, with the investments totalling £330 million.

Next steps

We are actively engaging with investment managers in the affordable housing space and anticipate making a commitment in this area soon. This will have significant impact at a local level, targeting general needs accommodation for families and individual households that are struggling to find affordable housing in both the private rented and owner-occupied markets.

Our responsible investment priorities

We believe investing responsibly can positively impact financial performance.

Our approach is to integrate RI across our investment decision-making process for the entire portfolio.

The Fund's main RI priorities are:

- Climate change
- Biodiversity
- Diversity, equity and inclusion
- Cyber security
- Cost and tax transparency
- Circular economy and supply chain management
- Human rights and social issues

Case study 2: focus on climate change

Climate change is a strategic investment priority as we acknowledge the immediate systemic and material financial risk it poses. We have developed climate change objectives and supported Brunel in the development of its comprehensive Climate Change Policy.

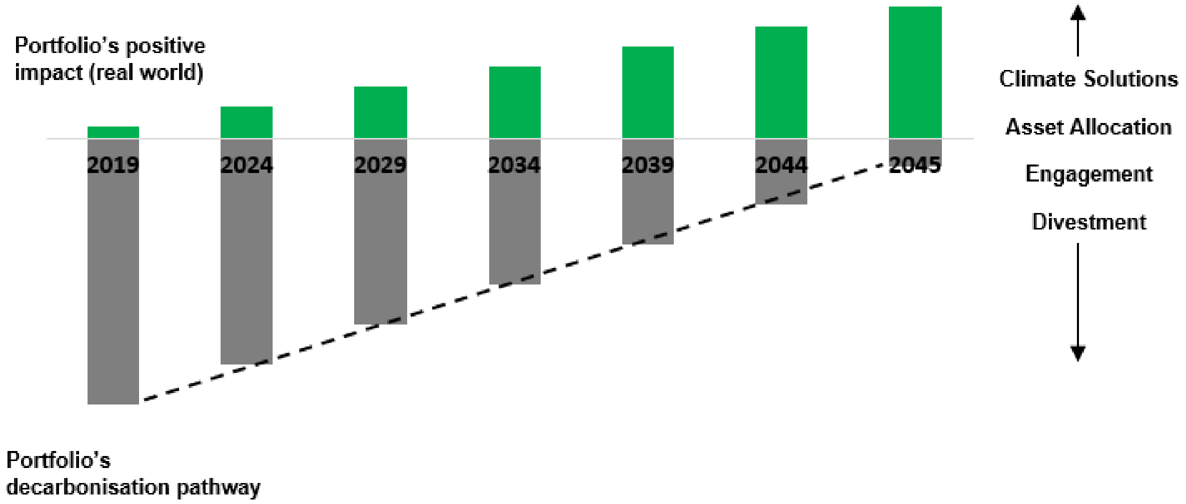
We believe that low carbon and transition aligned strategies that significantly reduce financial exposure to fossil fuel reserves and carbon emissions, combined with robust engagement, is currently the most effective approach to meeting our climate objectives.

We endorse and support collaborative engagement and climate policy advocacy work through membership of various industry leading climate advocacy bodies, such as Climate Action 100+, to drive positive change.

We monitor and disclose our carbon exposure annually to inform strategic decisions relating to climate change and to monitor progress of our climate targets.

How we will achieve 2045 net zero

Illustrative journey to net zero by 2045



We will utilise the following strategies:

1. Engagement and divestment (focusing on companies in high impact sectors)
2. Decarbonisation within our portfolios
3. Collaboration with industry groups
4. Asset allocation decisions
5. Product innovation to invest in climate solutions and transition-aligned assets
6. Policy advocacy
7. Voting and stewardship

Policy of the exercise of rights (including voting rights)

Voting is an integral part of the RI and stewardship process. Voting is now delegated to Brunel as they manage all our equity assets. They have a single voting policy for all assets under their management and actively attend and vote at company meetings (AGM/EGMs) on our behalf. Brunel publishes its voting policy on their website. They also provide us with voting records on a quarterly basis for the portfolios we are invested in.

Federated Hermes EOS provides us with specialist expertise on voting issues and participates in a broad range of engagement themes.

We publish a Responsible Investment Report annually which includes analysis of the voting and engagement activity across the portfolios.

Risk measurement and management

The principal risks affecting the Fund and the actions to mitigate them are set out below:

Risk 1 Investment risk

We do not achieve the return required to meet the cost of the benefits paid by the Fund due to market performance or investment manager underperformance.

Addressed by

- A diversified investment strategy
- Regular monitoring of portfolios and manager performance
- Testing the investment strategy under different market conditions

Risk 2 Covenant risk

Risk that the financial strength of an employer deteriorates, and they are unable to pay the contributions due.

Addressed by

- Monitoring the financial strength of the Fund’s employers on an annual basis
- Adopting a lower risk investment strategy for certain employers and orphaned liabilities (where employers have exited the Fund)

Risk 3 Regulatory & political risk

The potential for adverse regulatory or political change which could affect asset values or prevent us from accessing our assets.

Addressed by

- Ongoing horizon scanning and consideration of our risk register
- Responding to consultations on changes to LGPS regulations and guidance which may affect scheme funding or investment criteria

Risk 4 Governance risk

Committee members do not have sufficient expertise to evaluate and challenge the advice they receive.

Addressed by

- Periodic member self-assessment
- Training policy in place based on CIPFA Knowledge and Skills Framework for LGPS funds
- Expert advice commissioned to support strategic and implementation decisions

Case study 3: Risk Management Strategy

The Risk Management Framework consists of three bespoke risk management strategies:

1. Liability Driven Investment Strategy
2. Lower Risk Strategy
3. Equity Protection Strategy

These strategies help to de-risk the Fund by placing less reliance on growth assets (such as equities) to fund future pension benefits and protect the funding position. They are reviewed annually to assess whether a material change in market conditions requires any adjustment to ensure they still meet the strategic objectives.

Liability Driven Investment (LDI)

The liabilities of a pension scheme are associated with three risks:

1. Interest rates: the lower the interest rates, the higher the cost of the pension benefits (or liabilities)
2. Inflation: the higher the inflation expectations, the higher the cost of the pension benefits (or liabilities)
3. Longevity: the higher the life expectancy, the higher the cost of the pension benefits (or liabilities)

LDI is a strategy that mitigates the interest rate and inflation risks related to a pension scheme’s liabilities. The clue is in the name – it invests in assets whose returns are sensitive to the same risks faced by the liabilities. Such assets include government bonds, as well as interest rate and inflation derivatives.

The idea is that the value of the assets within the LDI portfolio will fluctuate in line with the value of the liabilities, that is, they provide a ‘hedge’, hence keeping the funding level stable as interest rates and inflation levels change.

Lower Risk Investment Strategy

This strategy invests in corporate bonds that provide a less volatile return than the main investment strategy which includes equity assets. This strategy also benefits from the inflation hedging undertaken within the LDI portfolio, resulting in greater stability of contributions for employers.

Equity Protection Strategy

This strategy is designed to protect the Fund against significant falls in equity markets. Put simply, it acts like an insurance policy protecting against adverse movements in the stock market. It is structured using derivatives to adapt to market conditions over time which serves to dampen volatility of asset values and minimise risk.

As with all types of insurance there is a cost to implementing this which can detract from overall returns. Therefore, we only hedge 50% of our equity assets to balance the risk versus reward of these types of strategies.