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LGPS Investment Outlook

2024

Welcome

In our 2022 Investment Outlook, we anticipated a turbulent year of weaker global growth, persistently high inflation and elevated geopolitical risk, not to mention the challenge of taking appropriate action on net zero. In hindsight, we were too pessimistic about growth. Most major economies, notably the US, have surprised to the upside, and only China has disappointed. But the other trends unfolded largely as expected.

Looking towards 2024, we expect inflation to continue falling steadily as the full impact of tighter monetary policy is felt and as the initial effects of post-pandemic stimulus programmes fade. We are, of course, assuming there are no major supply shocks arising from the tragic events in the Middle East. On growth and geopolitics, we remain cautious, but arguably the risks here are now better understood. There's also greater clarity on the direction of pooling than there was 12 months ago.

We hope that the clearer outlook will allow for more consideration of the investment opportunities created by the new market environment. These include credit markets; local investments in infrastructure, property and SME finance; and in businesses and assets facilitating the transition to net zero.

To help investors explore these opportunities, we offer our views on:

- The outlook for each key asset class in the year ahead
- How LGPS funds can maximise the benefits of pooling, taking into account the proposals outlined in the recent government consultation
- The opportunities generated by higher interest rates and the scope that may exist to de-risk portfolios
- Alternative ways of hedging inflation using derivatives
- The case for local investments and how to deal with the obstacles to deploying meaningful amounts of capital effectively
- Opportunity and risks relating to environmental sustainability and the provisions emerging from the ongoing Taskforce on Nature-related Financial Disclosures
- The role of private equity in a diversified, long-term investment portfolio.

We hope you find the articles of interest and invite you to reach out to our consultants if you'd like to discuss any of the topics covered.

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LGPS Investment Outlook: 2024

Global growth in 2023 confounded expectations

In 2023, global growth has been subdued – even by post-Global Financial Crisis (GFC) standards. But it's still been more resilient than expected. Consumer spending exceeded expectations, particularly in the US; government support dulled the impact of higher energy prices on European consumers; and China emerged from its zero-Covid restrictions earlier than hoped. Indeed, the latest batch of growth data for large economies confirmed that the recent economic resilience continued in Q3, as US consumers kept spending and Chinese growth benefited from a stimulus-driven pick-up after a soft Q2.

Nonetheless, the downtrend in the global composite purchasing managers' index – a measure of business confidence – suggests Q3 could be a high-water mark for the economy. Consumer spending in developed economies is likely to come under pressure as built-up pandemic savings dwindle, the delayed impact of interest-rate rises on disposable incomes grows, and the positive impulse from fiscal support wanes. Meanwhile, as the Chinese post-reopening recovery faltered, the authorities unveiled modest economic stimulus measures. However, the troubled property sector is weighing on sentiment, and concerns about debt levels limit the scope for debt-fuelled investment to support growth.

Against this backdrop, we think growth is likely to slow further. We don't expect it to collapse, but we think growth will drop to a lacklustre pace in 2024, followed by a modest recovery in 2025. While consensus forecasts for global GDP growth in 2023 have risen from 1.6% at the start of the year to 2.4%, 2024's forecast has fallen from 2.5% to 2.1%. And we think an even poorer outcome is possible.

Implications of the new rates reality

2023 has also been characterised by a dramatic shift in relative value, as bonds have cheapened significantly while equity prices have risen strongly. Not only does this mean that so-called 'risk free' assets now provide insurance while paying investors a real yield, this enduring period of higher interest rates – relative to the post-GFC era, at least – also has key implications for markets and medium-term returns.

Equity valuations look expensive relative to real sovereign bond yields (government bond yields less the rate of inflation), and indeed credit yields, which usually portends a period of risk-adjusted underperformance of the former versus the latter. While US real yields are most likely at their peak, we don't expect a return to post-GFC levels. This will limit the ability of equity valuations to defy gravity and keep rising without earnings growth.

In addition to the valuation support equity markets derived from low rates and yields, buybacks also helped to boost prices. However, the recent decline in share buybacks is expected to endure in a period where interest rates are materially higher, as companies prioritise paying down debts.

Inflation

While UK inflation remains above the Bank of England's (BoE) target, weaker energy and food inflation could be enough to push the headline figure much lower. Nonetheless, we expect inflation to remain stubbornly above target, in the absence of a more severe economic downturn, given tight labour markets as well as strong wage and service-sector inflation.

We feel the risks to inflation are considerably more two-sided than in the past decade, and we expect more volatile inflation in the years ahead. Compared to recent history, the most likely sources of upwards pressure on inflation include 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

The BoE's focus remains on returning headline inflation to its target. However, given aggressive rate hikes and slowing headline inflation, the bank rate has most likely peaked, and further declines in inflation should allow a modest easing of monetary policy in 2024. After the massive overshoot of inflation, we expect central banks to tread cautiously and err on the side of keeping rates higher, unless growth and inflation slow more sharply. This will limit the potential boost from lower interest rates in 2024 and 2025.

While we believe inflation, and ultimately interest rates, will decline from current levels and conceivably undershoot targets, we don't foresee a longer-term return to the ultra-low-rate environment that followed the GFC. We expect interest rates to bear a closer relationship to real growth and inflation, with higher volatility in the coming decade than in the last.

Asset class considerations

Government bonds

The large shifts in gilt yields in 2023 partly reflect expectations that rates will be higher and for longer than previously thought. However, the moves also reflect a fragile technical backdrop of heavy global government bond issuance. Indeed, given the weak real growth outlook and expected declines in inflation, we think the fundamental outlook for gilts has improved. In the presence of an independent central bank, and in the absence of catalysts that lead to higher long-term real growth, we think longer-term nominal – and, to a slightly lesser extent, real – yields are reasonably attractive.

We have little issue with the near-term path of interest rates implied by the market, but we don't think interest rates will remain as high for as long as is currently priced into markets. Given our belief that central banks will ultimately use the tools at their disposal to return inflation towards target, we also expect long-term implied inflation to fall. And we think this decline is more likely to be driven by falling nominal yields than rising real yields.

10-year returns (% pa)	Index-linked gilts	Nominal gilts
10-year spot yield	1.0	4.4
10/10 forward yield	2.0	5.5
Neutral 10/10 forward	1.3	3.8
Yield uplift	-0.4	-0.9
Capital gain/loss	0.8	1.7
Real return	1.3	
Nominal return	**4.4**	**5.2**

Credit

With weaker corporate earnings and higher borrowing costs starting to make their mark on debt affordability, the fundamental outlook for credit is challenging. However, expectations that growth slows but doesn't collapse, set against companies starting from a strong position on debt affordability, means that while defaults have risen above long-term average levels, they're only expected to rise a little further. Meanwhile, default forecasts have been revised lower in recent months.

Credit spreads are close to long-term median levels in both investment- and speculative-grade markets. Given the weak outlook and balance of risks, lower-risk, higher-quality credit looks more appealing. Because of our view that near-term interest rates are largely fairly priced by markets, we're agnostic between short-dated fixed and floating rate exposure. However, we hold a preference for asset-backed securities over investment-grade corporate credit in short-dated bonds. Investment-grade credit markets offer attractive yields, but this is driven by high government bond yields.

We retain a degree of caution regarding speculative-grade credit, as close-to-average spreads are set against a challenging fundamental outlook. However, we note that, despite unexceptional spreads, high absolute yields provide attractive value versus equity markets and a potential opportunity to de-risk from equities. Given the level of yields, the level of price decline required to incur a negative total return is well above long-term medians. This provides a cushion against a potential increase in spreads.

10-year returns (% pa)	Sterling investment-grade	US High Yield	US Loans
Initial spread	1.6	4.8	5.8
Neutral spread	1.6	4.2	5.0
Average spread	1.6	4.5	5.4
Revaluation	0.0	0.2	0.2
Credit losses	-0.1	-2.0	-1.6
Excess return	1.6	2.7	4.0
Risk-free return[1]	5.0	4.4	4.5
Nominal return	**6.5**	**7.1**	**8.5**

Equity

Given the subdued, albeit better than expected, growth environment, forecasts for full-year equity earnings growth in 2023 have fallen from around 3% at the start of the year to 0% by the end of Q3. Over the same period, equivalent forecasts for 2024 and 2025 have been revised slightly upwards, with full-year earnings growth a little above 11% expected in each of the next two calendar years. Slowing global activity is reducing corporate pricing power at the same time as borrowing costs are rising, creating a tough outlook for corporate earnings. Against this backdrop, these global equity earnings forecasts look vulnerable.

Cyclically adjusted global equity valuations, which are in line with long-term averages, look reasonable in absolute terms. However, valuations look stretched relative to 'safe' assets, with the equity risk premium proxied by the MSCI World cyclically adjusted earning yield less than 10-year US real treasury yields – as low as it's been since the GFC and well below historic averages. Valuation pressures would be eased by a decline in real yields. While we think that's quite likely, we expect the impact to be limited, as we don't anticipate yields to return to their very low levels of the post-GFC era.

10-year returns (% pa)	Global equities
Dividend income	2.3
Trend earnings growth	2.25
Reversion to trend earnings	-0.2
Revaluation	0.1
Real return	4.5
Nominal return[2]	**7.0**

[1] Return on 10-year gilt for sterling investment-grade, returns on 5-year gilt for US HY, and average cash rate for US loans.

[2] 10-year forecast US CPI inflations

Property

Property yields have risen significantly from a low in late 2022 but remain below long-term average levels. As with equities, valuations relative to safe assets are stretched – as expensive as they've been since the GFC. This feels like scant reward, given the challenging fundamental outlook. Real rental growth is rising as inflation declines but is still negative. The modest improvement in sentiment highlighted in the previous UK Commercial Property Market Survey by the Royal Institute of Chartered Surveyors has also reversed more recently: the latest survey showed renewed falls in occupier demand and rent expectations, as availability across industrials and office continued to rise. Highlighting the ongoing impact of the seismic shifts in post-pandemic working patterns, office vacancy rates hit a record high of 22% in August. This is compounded by ongoing technical weakness, as there is a substantial amount of selling pressure in the market, with thin transaction activity and some pooled funds deferring redemptions until well into 2024.

10-year returns (% pa)	UK commercial property
Income yield	2.3
Underlying income growth	-0.5
Depreciation	-1.0
Management costs	-0.5
Revaluation	0.0
Real return	4.0
Nominal return[3]	**6.3**

Private markets

We think relative value has shifted from equity to debt in the private markets, too. Private equity was a key beneficiary of the low-rate post-GFC era, as private equity managers were able to exploit cheap debt to leverage returns. While there will still be good opportunities to invest in high-growth companies in private equity markets, material rises in financing costs are likely to cause a 'shake-out' of manager performance, with low rates unlikely to be a tide that lifts all boats. We should, therefore, see a greater dispersion of fund returns, increasing the importance of manager selection. In this environment, we think better relative value opportunities exist for investors to benefit from, providing more expensive debt capital in the senior secured direct lending markets. Additionally, the continued retrenchment of commercial banks from these markets, alongside the ability of private debt markets to provide certainty of finance, is causing a shift in power back towards private debt investors. This is improving pricing, and we're seeing much better terms on new debt deals.

Summary

Global growth in 2023 has outperformed the downbeat forecasts made at the start of the year. But its pace has been subdued, and we think it's likely to slow further, weighing on the near-term fundamental outlook for equities and credit.

Inflation is likely to be sticky, and we expect central banks to proceed cautiously. However, long-term nominal yields now look high. At these levels, a return to our assessment of fair value would provide significant capital appreciation, in addition to income.

Investment-grade credit looks better value than speculative-grade credit. But with spreads close to long-term medians, the attractions largely reflect robust underlying government bond yields.

The challenging, and arguably still deteriorating, outlook puts pressure on equity earnings and UK commercial property rents. In absolute terms, global equity valuations are neutral, and UK property valuations are still a little stretched. Both look expensive relative to 'safe' assets, so any future reduction in real yields might provide only limited relief.

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[3] 10-year forecast UK CPI inflation

Pooling by 2025 - how to avoid that sinking feeling

Jumping in

Perhaps the most urgent of the potential outcomes of the government's consultation on LGPS investments is a requirement to pool all listed assets by 31 March 2025. For some, this will feel like being thrown in at the deep end and will raise a number of challenges to overcome to meet any new requirements. This short article discusses some of these challenges and ways to address them to keep your head above water.

What to push in the pool

The first step is determining which of your assets will fall under the government's definition of "listed". Until government provides this definition, we can make sensible assumptions that it will include the full range of the more traditional asset classes, and other liquid investment types, such as public equities, corporate bonds, gilts and likely other forms of higher-risk, liquid debt such as high yield bonds and emerging market debt.

However, this is complicated by the uncertainty surrounding passive assets. Many listed assets are managed passively in the LGPS, with very low management fees negotiated on a collective basis. This makes it extremely difficult for passive assets to be moved within the pool without costs going up, given the pools charge fees for the assets under their watch. Government will need to provide clarity here on what they require from funds.

Not taken a dip yet?

Once you have determined the investments that you think will need to be pooled, the next step is of course to look at what hasn't been pooled yet – and why.

Many listed assets within the LGPS remain outside of the pool for a wide range of valid reasons. These may include the pool not offering a solution, the pool's solution being not fully aligned to a fund's preferences, funds not having enough confidence in that solution to invest any or all of their assets (and so have only dipped their toe in the water), or simply wanting to diversify manager risk.

If you hold assets outside of the pool that the pool does have a solution for, the challenge will of course be why you haven't used that solution. Whatever the reason, it is looking likely that the pressure to readdress this position, and the bar to not using the pool, will be raised.

Therefore, funds should consider the strength of their reasons for not pooling assets. For example, if it is for diversification purposes, ensure you have proof of the diversification benefits your third-party fund holdings are offering. If it's because the pool's product is unsuitable for your fund, or at least not suitable enough to justify only using that solution, ensure you can clearly articulate why, what the specific issues you have are, why these are important, and the benefits of the characteristics of your third-party solution.

Throughout this process, it is important to come at it with an open mind, testing whether it would be better to pool the assets, rather than trying to prove that it wouldn't.

No diving!

When pooling, it is extremely important not to rush decisions, even to meet a potential deadline set by government. The LGPS has seen great success in its investments from its long-term approach to decision-making. Therefore, while there may be pressure to pool assets quickly, it is incumbent upon funds to ensure that pooled solutions are in line with your needs and give you confidence in the pool's ability to produce the required level of returns.

This requires strong due diligence of the solutions. While there is a need to be supportive of pools in these early days, as they ultimately need assets under management to gain the budget to build out the institutional quality processes, systems and teams to manage your investments adequately, there needs to be a minimum standard you require in order to invest. This is to guard against the risk of significant issues or losses. Gaining independent assurance of this standard being met is therefore imperative. They also need to point out any potential weaknesses and the ways in which the solutions should be improved over time.

We perform a deep dive to assess pooled solutions from a range of considerations, similar to how we look at traditional, third-party managers. These include the strength of the business, team, investment process and risk controls, as well as focusing in on key areas of challenge for the pools, such as staff turnover. This needs to be done in a collaborative manner with the pools to provide feedback and aid further development.

Crowded lanes

For assets where the pool has no solution, you should first explore the opportunity with your pool for them to launch a product in that area. Pools typically have rules around the minimum size of assets and number of partner funds to launch a new product, so it would also be best practice to canvass opinion from your partner funds to see if there would be wider interest. Use your regular meetings with the pool and partner funds to raise your requirements, then stay in regular contact with your pool to understand the likelihood of having a solution launched in the near future.

The question then comes of what to do if you cannot get your pool to launch a solution. This creates the challenge of deciding whether to continue holding these assets outside of the pool, or abandon them and instead invest in another asset class that the pool has a solution for. Here, the question is whether your holding is truly important and beneficial to your fund, and demonstrably so, enough to be able to justify holding those assets outside of the pool to government. If not, a decision needs to be made on what pooled solutions may be a suitable replacement, ensuring you consider the impact on your whole portfolio.

If you are successful in convincing the pool to launch a new solution, it more than likely won't be launched in time for the 2025 deadline. However, it will likely be more acceptable to government to hold assets outside of the pool if it is because you are waiting for a solution currently being launched. Pools are still in their development phase and so have very busy business plans of new fund launches already. They will therefore be unlikely to push a new fund launch out prior to the government's potential deadline. Similarly, you would likely not want them to. Investment fund launches should be carefully run, with accurate scoping of what investors want and a thorough fund design process. This should take place across numerous stages with constant input from the investing partner funds to ensure that the solution meets their requirements (subject to compromise with other partner funds!).

Pool rules

With the pressure to pool only increasing, this creates a number of challenges for funds, such as needing to make important decisions on what to continue to pool and what can justifiably continue to be held outside. It will also create a need for funds to work with their pools to create the solutions they believe they need.

In order to manage all of this, we propose the following pool rules are followed.

POOL RULES

NO SECOND GUESSING
Wait for clarity from the government on its requirements before taking action

NO RUSHING
Don't rush decisions to meet potential deadlines. Ensure all choices are thoroughly considered

NO DIVING
Make sure you have thoroughly reviewed any pooled solutions before investing

DON'T GO ALONE
Work with your partner funds to achieve what you want from your pool

NO ROUGHHOUSING
Work collaboratively with your pool and partner funds and be prepared to compromise

BE PREPARED
Ensure you are ready and have a plan to pool, or to justify why you are not

Sink or swim, in or out

The potential benefits from pooling are large and funds should do their best to access them. However, the benefits are of course not guaranteed and rely on the pool enabling you to access them. This means that a balance is needed. Funds need to support their pools to enable them to access those benefits, whilst doing what's best for their members and employers by only investing assets where there is confidence it will be rewarded.

The increased pressure from government may tip that balance slightly more towards pooling more quickly, but care must still be taken, and it is important to not blindly rush to meet potential targets.

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Local investment opportunities (Levelling Up)

Summary

Local investments offer potentially attractive financial returns as well as the opportunity to have a positive economic and social impact on the communities in which they're made. So it's not surprising there's been longstanding interest from LGPS funds and other long-term investors. Despite this, there is evidence that the amount of capital being deployed is insufficient, particularly in those regions that need it most. How can this be, in the UK, which benefits from large pools of long-term capital, strong inward investment and sophisticated capital markets? We believe there are a number of specific challenges to deploying capital effectively and that these will become more apparent in 2024 as LGPS funds increase their commitments. This article explores these challenges and what funds can do to address them.

Background

Over the last few years, interest in local investments has increased sharply across the LGPS. In part, this has been driven by the government's flagship Levelling Up policy, which seems to have attracted bipartisan support. But the opportunity to generate attractive financial returns while having a positive environmental, economic and social impact has arguably been a more important motivation.

Local investments cover a wide range of asset types including:

HOUSING focus on social/affordable housing and care homes.

INFRASTRUCTURE projects with regional focus, rather than those of national significance, in areas such as broadband/mobile communications, urban transport, EV charging points, small-scale renewable energy, schools and primary healthcare.

COMMERCIAL PROPERTY including the revitalisation of high-street shopping, the repurposing of surplus office space and the provision of better industrial facilities to support local businesses.

SME FINANCE debt and equity finance for innovative, high-growth companies.

In some of the UK's most deprived locations, complex urban regeneration programmes involving different types of assets and multiple sponsors have attempted to reverse decades of environmental, economic and social decay.

Investors should be aware that there can be significant risks to investing in this area. Particularly for brownfield developments in areas where the six 'capitals' identified by the Levelling Up white paper – human, financial, social, physical, intangible and institutional capital – have been severely depleted.

But the rewards can be significant too, both in terms of the financial return to capital providers and the positive impacts on the environment, quality of life, health/longevity, job creation and economic growth. An adequate supply of high-quality housing, for example, is known to have a significant impact on health outcomes and the ability of businesses to attract workers. Productivity growth likewise depends on good infrastructure. Meanwhile, the SME sector has long been the primary source of net job creation in the UK. Delivering real impacts in these areas, and measuring them accurately, is challenging, but the potential rewards are enormous.

Recent developments

There have been a number of developments supporting investment in these areas, including:

- Proliferation of new investment funds, from both specialist managers and major investment houses.
- Involvement of LGPS pools using their expertise and the aggregate capital base of their partner funds to construct local investment solutions.
- A comprehensive policy framework (Levelling Up) and specific interventions from government, including the creation of a series of funds designed to seed investment in specific areas: British Business Bank Regional Investment and UK Growth funds (growth capital), UK Shared Prosperity fund (improving communities and place), Getting Building fund (infrastructure), Towns fund (urban regeneration) and Levelling Up fund (infrastructure, urban regeneration and culture).
- Improved information, including the ONS sub-national data strategy.
- A more flexible definition of what constitutes a local investment in terms of asset type, economy (rural, provincial town, metropolitan) and geography (borough, region, UK-wide).

In the last few years, many funds have expressed an interest in local investments, or renewed their commitment to the area. Many of those have already made relevant investments. But there's evidence that many UK communities are still being held back by lack of financial capital, despite capital markets having generally been awash with liquidity for the 15 years since the Global Financial Crisis. What's holding back the flow of capital?

We believe this is a crucial and timely question, as we expect 2024 to be the year when those investors who have committed to local investment face the reality of deploying meaningful amounts of capital effectively.

Obstacles to investment

We've identified two categories of obstacle to the smooth flow of capital into local investments: 'internal' obstacles that are within the capacity of capital providers and their investment managers to address, and 'external' obstacles that require intervention from central/local government to facilitate increased investment. In the latter case, intervention might involve leadership, coordination, new policies/regulations or carefully targeted funding.

'Internal' obstacles include:

- **Lack of familiarity/risk tolerance** – this will require committees to better understand the nature of the available investment opportunity, to determine the level and nature of risks they're prepared to take, and to scale commitments accordingly.
- **Efficient origination** – local investments are typically 'smaller ticket', geographically remote from the UK's main financial centres and promoted by less sophisticated sponsors. Committees must engage managers with appropriate regional networks, utilise aggregation platforms such as the British Business Bank wherever possible and leverage the scale benefits of their pool.
- **Governance capacity** – the investment case for individual assets may be relatively straightforward, and the local impact benefits clear, but decision-making must still be objective and building a portfolio with adequate diversification is likely to require a fairly large number of investments. Committees will have to delegate most of the decision-making, despite the understandable temptation to be involved in projects with local impact.

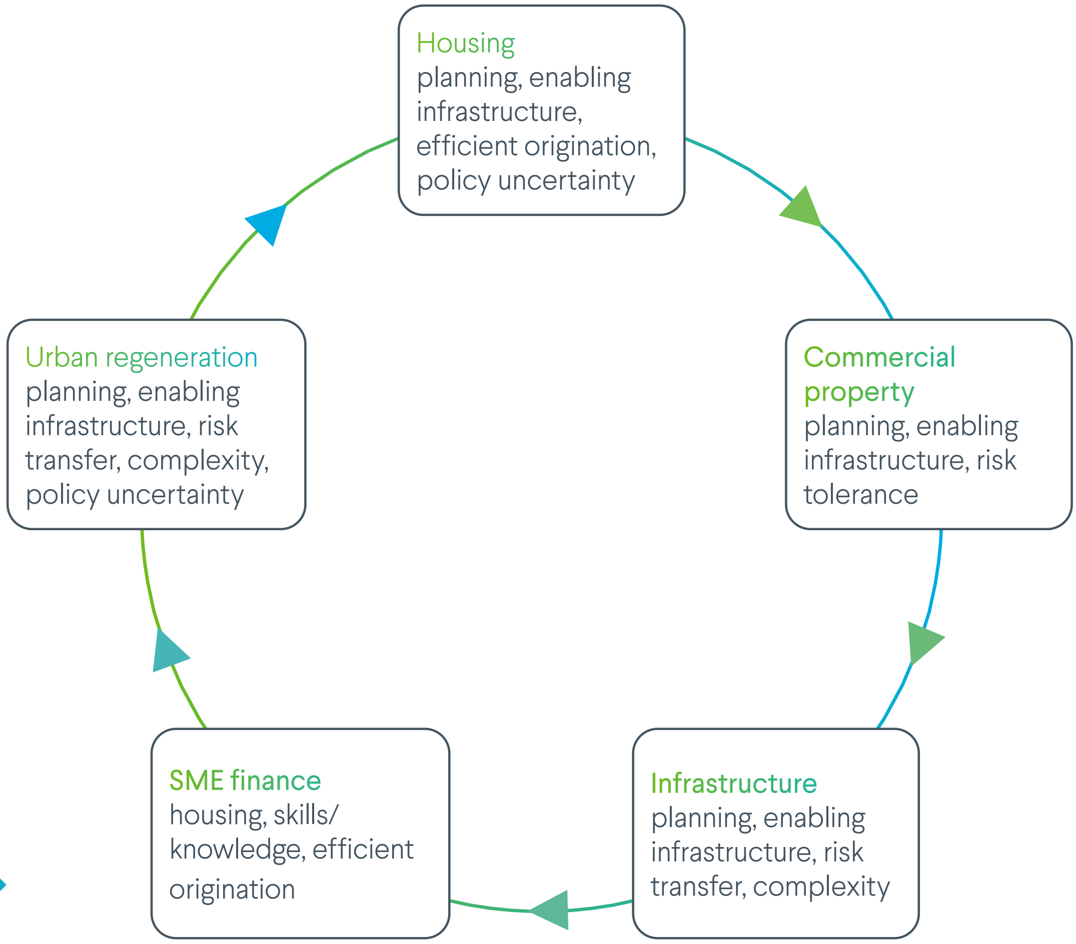
'External' obstacles such as the following represent a greater challenge for investors and their managers:

- **Planning system** – complexity and delays beset most classes of local investment; the system urgently requires reform and a bias towards positive change.
- **Enabling infrastructure** – local investments like renewable energy require supporting infrastructure such as grid connections, which are expensive and time consuming to secure.

- **Risk transfer** – most local investments depend on proven technologies and established patterns of demand, but some, such as new urban transport systems, may involve risks that the private sector is unable to take on at a reasonable cost.
- **Skills/knowledge** – most local investments require access to skilled labour, which may be missing, particularly in areas that require them most, highlighting a clear role for government investing in education and R&D.
- **Policy uncertainty** – the returns on many local investments are generated over many years, during which time a high level of policy certainty may be necessary to achieve cost-effective financing and, ultimately, success.
- **Complexity** – this represents perhaps the greatest challenge for some local investments, as the examples below highlight.

In areas that have suffered years of neglect and severe depletion of the six Levelling Up capitals, the success of individual projects may depend on concerted action on a range of issues over a sustained period. It's hard for individual project sponsors to coordinate all that is required for success. A large greenfield housing development or urban regeneration scheme, for example, may require concurrent investment in local infrastructure, schools and healthcare centres, commercial property and leisure facilities and involve multiple sponsors and other stakeholders. There's a clear leadership role for local government in these situations, to manage the complexity involved, but only if it's empowered and resourced to deliver. The proposals in the white paper around further devolution and funding models are, therefore, critical elements of any Levelling Up programme.

The success of most local investments depends on progress in at least some of the above areas. But the key dependencies vary between the asset classes, as the graphic below shows:



Conclusion and next steps

Making successful local investments is challenging, and arguably more so than investing in large, listed companies. But the financial rewards and the positive environmental, economic and social impacts on the communities in which the investments are made are potentially more attractive. Some of the challenges are for investors and investment managers to address, but others will benefit from supportive interventions from central government.

We believe there are a number of actions LGPS funds can take to maximise the likelihood of success:

- Determine the fund's risk tolerance and identify the types of investments that align with it.
- Set realistic objectives for financial return, local impact and the amount of capital to be deployed.
- Engage with the fund's pool to ensure the benefits of scale are fully realised.
- Select investment managers with the local expertise and networks needed to originate, execute and manage successful investments.
- Enlist the support of councils in the locations where the investments are to be made.
- Lobby central government for action on the 'external' obstacles identified above.
- Be patient.

We wish LGPS funds making local investments in 2024 every success!

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Private equity opportunities for LGPS clients

The government has identified private equity as an area it wishes to see more investment in by the LGPS – there's a potential requirement to invest 10% of assets in this asset class. This view was justified by the relatively high returns of this asset class historically, but also by a mention of investment in "venture and growth capital" to help spur the UK economy. That said, the government's potential requirement did not set out a need for the private equity investments to be in the UK. In this article, we provide a summary of private equity to help if you're considering increasing your allocation to this asset class.

What is private equity?

Private equity investment involves acquiring companies with a high potential for growth and/or revenue generation with a view to selling them at a higher valuation in the future. Investment managers will seek to add value by making operational or financial improvements in the acquired company following investment.

Private equity represents a higher-risk form of equity investment than listed equity. An allocation can be complementary to a listed equity allocation, as it provides exposure to different sectors of the economy. We believe that investors should be rewarded (net of fees) with a return higher than listed equities to compensate for the increased risk of executing the business strategy, the illiquidity of private equity funds, and the use of leverage (debt) to acquire the company.

Typical investment strategies in private equity

The main types of private equity investments are venture capital, growth capital and buyouts. Each of these relate to the stage of a company's development during its lifecycle.

COMPANY LIFECYCLE

VENTURE CAPITAL (VC) is a private equity investment made in an early-stage startup company.

GROWTH CAPITAL is an investment made in companies that have proven their idea and need further capital to expand or restructure, usually under the existing management team.

BUYOUTS relate to acquiring a company that is more mature and could be improved through a private ownership structure, or by accessing the skills and specialist expertise that a private equity firm can provide.

There is a lot of academic evidence to suggest that median returns from private equity funds are no better than from listed markets, but upper quartile managers can deliver returns of 3–5% pa above listed markets. The differentiating factor is the manager's skill in executing the investment strategies outlined above, rather than anything specific to private equity. Many managers quote typical expected net internal rates of return (IRRs) of 15–20% pa for private equity investments.

What investment factors should you be aware of?

There are various factors that investors should be aware of before considering an investment in private equity. We've outlined some of these below.

Different types of funds

There are four ways to access private equity: primary funds, secondary funds, co-investment funds or a fund of funds.

A primary fund is one that is currently raising capital to make direct private equity investments across a number of companies (known as portfolio companies).

A secondary fund is an investment in a primary fund that has already raised money or has been investing for a few years. In a secondary transaction, an existing investor in the fund sells its holding to another investor in a private sale.

A co-investment fund invests directly in a minority stake in the target company alongside another private equity manager or a primary fund.

A fund of funds allows investors to gain exposure to several private equity funds through a single fund. The fund manager will typically invest in a portfolio of primary, secondary and co-investment funds with a view to providing adequate diversification.

The fund of funds approach is commonly used by LGPS investors to gain exposure to private equity. Some managers allow investors to construct a tailored composition of primary, secondary, and co-investment funds to better suit individual fund needs.

Private equity is a long-term and illiquid investment

Private equity funds tend to be illiquid. The investor commits to a 10–14-year fund and has limited control over when the underlying companies are sold and the profits distributed. The investor can exit the fund only when it has reached the end of its life, or by selling their holding to another investor if they wish to exit the fund early.

Fund of funds may have a longer investment horizon and fund life (14–18 years, on average) than the other types of private equity funds as they take longer to invest committed capital. This is, to some extent, mitigated by fund of funds investing in secondary and co-investment funds, which should produce returns more quickly as they are investing in existing primary funds and companies.

Investors should note the long holding period. They would also be committed for a long period before they would be able to assess whether the investment has been successful.

Returns are influenced by market conditions

Private equity investments are subject to 'vintage year' risk, whereby the capital committed to a private equity fund is invested over a single period in the market cycle, which may or may not be a good year to be investing in private equity. This risk can be mitigated by phasing in the investment over multiple years to make private equity investments throughout the market cycle.

Fee structures can be a bit complicated (and expensive)

Private equity fund fees typically comprise a management fee (the annual management charge, or AMC), a performance fee, and expenses for the fund.

In the first few years of the fund's life, AMCs are charged on the total amount committed to the fund. This can cause an issue of fees being charged on money that the manager has not yet invested. In subsequent years, the AMCs are based on the portfolio value and they reduce over time as the investments are sold.

Performance fees make up most of the private equity managers' remuneration, and are usually payable in the last few years of the fund's life. They are charged for returns in excess of a certain level, or a 'hurdle rate' and are designed to align investors' and managers' interests and motivate performance. Expenses for the fund relate to setting up the fund and ongoing expenses for external advisers (management consultants, brokers, auditors, bank fees, etc), which are usually less than 1% pa over the life of the fund.

For fund of funds, a further layer of fees (both AMCs and performance related) will be payable.

The AMCs, performance fees, expenses and the fund-of-fund fees means a combined fee level would be 5–6% pa of the invested capital. These fees act as a very significant hurdle before delivering net returns to investors.

Capital is drawn down over time, and returns are paid as distributions

Private equity funds are typically closed-ended, which means they have a finite life where they go through the phases of drawing down capital, investing that capital, and finally returning capital and profits to investors when the underlying assets are sold by the manager.

Investments in closed-ended funds will reduce over time as the manager pays out distributions, in contrast to open-ended funds which remain broadly constant and change in value only in line with the underlying assets.

The typical return profile of a primary private equity fund is illustrated by the following 'J-curve' chart. Cashflows and returns are generally negative in the first few years of the fund as capital is deployed. The negative returns are generally due to management fees, investment costs and poorly performing early investments that are marked down. Over time, the fund should experience unrealised gains as the value of the underlying companies increases. Eventually, the value created should turn to realised gains when the fund is able to liquidate its holdings.

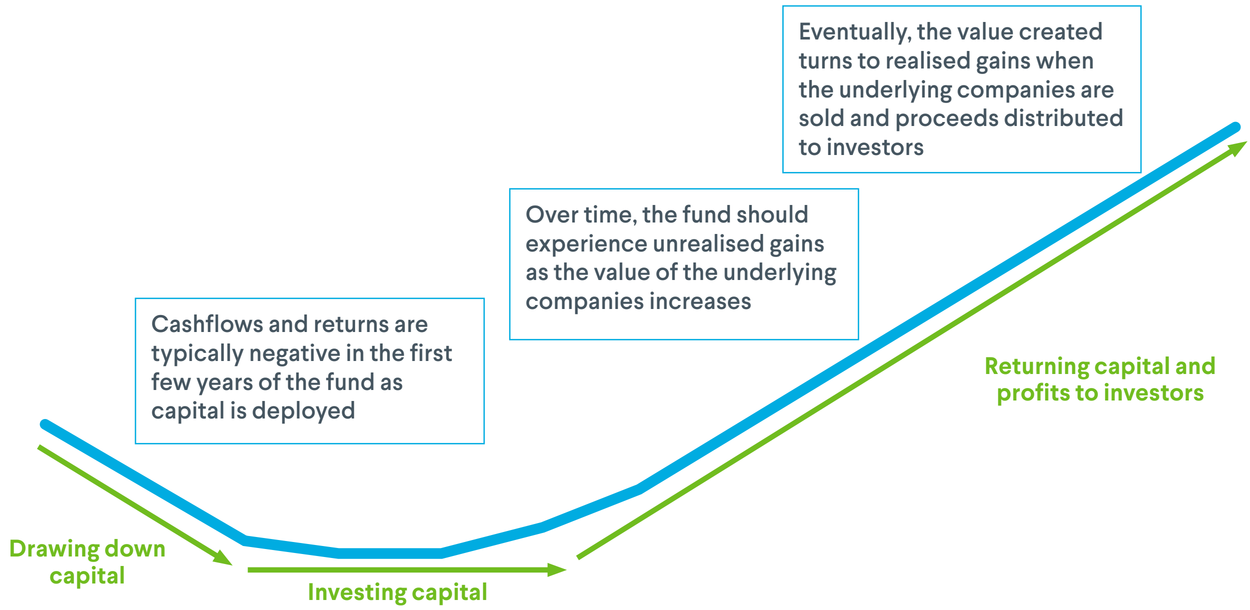
The ease with which an investment is realised depends on a few factors, most notably the quality of the business and the market environment affecting the return achieved. The other types of private equity funds (secondary, co-investment and fund of funds) typically have a shorter J-curve and start producing returns earlier in the fund's lifecycle (subject to market conditions).

What are the risks?

The key risks in private equity investment are manager selection risk and 'vintage year' risk, although both of these can be mitigated to a large extent through diversification.

Various other risk factors could affect the performance of private equity investments. These include capital risk, counterparty risk, currency risk, environmental, social and governance (ESG) risk, funding risk, incentivisation risk, leverage risk, liquidity risk, operational risk, political and regulatory risk, selection risk, systematic risk, and tax risk.

We believe investors should take the time to understand each of these risks in more detail and seek their consultant's advice on which risks (if any) may play a part in their individual portfolios.



Source: Hymans Robertson

A note on UK private equity opportunities

Although the UK private equity market is smaller than the US or European markets, it offers exposure to attractive sectors with a different customer base and the opportunity to access businesses at different stages of maturity.

UK-focused private equity funds can be split into two broad groups. The first group focuses on venture capital and growing start-ups, and the second focuses on medium and large companies that are either publicly or privately owned.

The venture capital funds typically provide capital to innovative companies in the information technology, financial services, business services and healthcare sectors in the UK. The growth and buyout capital funds do not have a particular sector focus, but tend to focus on small and medium buyouts in the UK.

Some funds in these two broad groups may also focus on a particular region of the UK, but most tend to invest across regions. Within the small number of regionally focused funds, the majority invest in venture capital investments in a particular region, with fewer funds focusing on regional growth and buyout transactions. Some of the regionally focused funds may be government backed (eg through an investment by the British Business Bank). Others may not have a dedicated focus for the region, but are active, there for transactions that form part of their UK-wide fund.

A UK or regionally focused allocation can form part of a more diversified private equity portfolio or as a separate multi-asset, UK-focused allocation.

Private equity ESG

Private equity managers will consider ESG issues both at the firm level and when evaluating individual investment opportunities. At the firm level, the objective is to ensure that the firm's culture and internal policies incorporate the values of the UNPRI.

For individual investments, a strong ESG rating is usually indicative of a mature, sophisticated organisation that prioritises responsible investing throughout their business. Many managers use a combination of a reputational risk rating tool (such as RepRisk) and evaluating reported ESG incidents in the firm weighted by severity, frequency, and type of incident. These factors are combined in a scorecard to be discussed in detail alongside the financial analysis.

ESG reporting from private equity funds is still developing. Some funds may provide quantitative reporting on their ESG activities, but more generally, private equity funds will provide annual case studies to demonstrate their ESG activities. We are seeing continual improvement in this area – many private equity managers can customise reporting to meet LGPS clients' requirements.

Our views

We believe that a private equity allocation should enhance the return profile of a portfolio and provide some diversification, but it does increases illiquidity within the portfolio.

Our experience in private equity markets allows us to support clients throughout their journey of investment. We have a deep understanding of current and historical trends in the market, which can help support informed decision-making. We can also assist with tailoring the portfolio to individual client needs while ensuring that it has adequate diversification and in selecting private equity managers or individual funds. For further details, please reach out to your regular Hymans Robertson contact or the author of this article.

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Taskforce on Nature-related Financial Disclosures (TNFD)

Funds across the LGPS are getting to grips with the requirements of the Taskforce on Climate-related Financial Disclosures (TCFD) for assessing and reporting climate risks within their asset portfolios. Climate change and net zero are regular fixtures on the agenda for many LGPS Committees, but there's also a growing awareness of the importance of tackling the related issue of biodiversity loss. Nature is our first line of defence against climate change, with natural ecosystems absorbing around half of human emissions. There is no route to net zero without prioritising biodiversity.

What is the TNFD?

After two years of development and consultation, the Taskforce on Nature-related Financial Disclosures formally launched its framework and final recommendations in September 2023. These will help reverse nature and biodiversity loss by encouraging companies and financial institutions to report – and act on – nature-related issues.

Businesses and society are highly dependent on nature and the services it provides, with at least $44 trillion of economic value generation directly reliant on nature. Governments are increasingly recognising the importance of halting nature loss, with over 190 countries committing to a set of ambitious goals and targets under the Global Biodiversity Framework in December 2022.

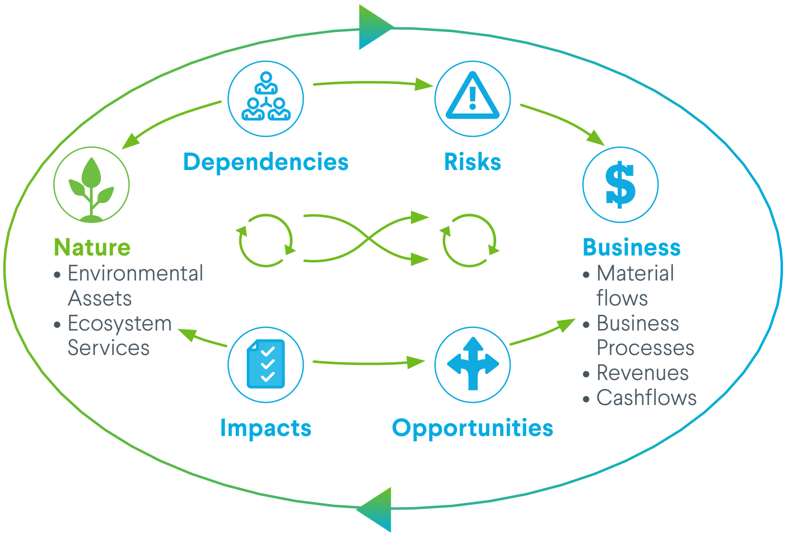
The TNFD is a market-led, science-based initiative to help address nature loss. It sets out a risk management and disclosure framework for companies and organisations to identify, assess and disclose their nature-related issues. It's designed to align with the TCFD framework and is expected to play a key role in future regulatory frameworks.

How does the TNFD work?

There are four building blocks at the heart of the framework, which are collectively called nature-related issues. These are set out below and in **Figure 1**.

- **Dependencies:** reliance of an organisation on natural ecosystem services
- **Impacts:** changes in the state of nature as a result of an organisation's actions
- **Risks:** potential threats to an organisation linked to nature dependencies and impacts
- **Opportunities:** commercial and growth opportunities related to nature-positive outcomes

Figure 1: Core components of the TNFD framework



Source: Core Components of the TNFD Framework © 2023 by TNFD is licensed under Attribution-NonCommercial-ShareAlike 4.0 International

Disclosures

The framework also gives guidance on risk assessment, data/metrics and nature-based scenarios, as well as setting out definitions and additional guidance. The TNFD's structure mirrors that of TCFD, with recommended disclosures across four pillars, as set out in **Figure 2**.

Figure 2: Four pillars of the TNFD's recommended disclosures

GOVERNANCE	STRATEGY
Disclose the organisation's governance around nature-related dependencies, impacts, risks and opportunities.	Disclose the actual and potential impacts of nature-related dependencies, impacts, risks and opportunities on the organisation's businesses, strategy and financial planning where such information is material.
RISK & IMPACT MANAGEMENT	**METRICS & TARGETS**
Disclose how the organisation identifies, assesses and manages nature-related dependencies, impacts, risks and opportunities.	Disclose the metrics and targets used to assess and manage relevant nature-related dependencies, impacts, risks and opportunities where such information is material.

Taking a consistent approach across sustainability reporting frameworks will support integrated disclosures covering both climate and nature, such as the standards set by the International Sustainability Standards Board and Global Reporting Initiative. The TNFD encourages organisations to address nature loss in line with the wider goals of the Kunming-Montreal Biodiversity Framework agreed at the COP15 conference in December 2022.

LEAP approach

A core element of the TNFD framework is a practical assessment process called the LEAP approach, which supports the integration of nature-related issues in reporting and decision-making.

This approach has four key phases:

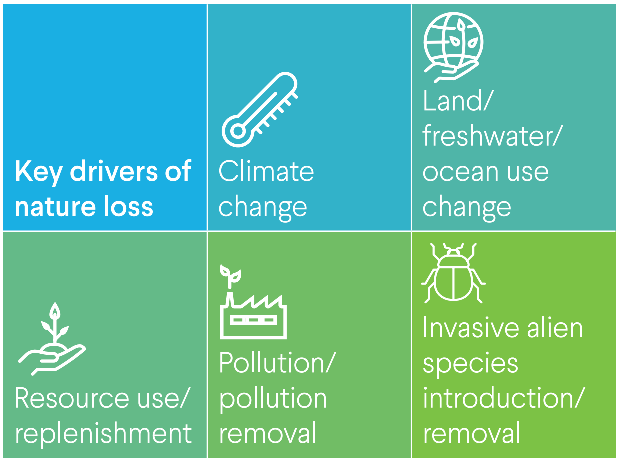
- **Locate** your interface with nature
- **Evaluate** your dependencies and impacts
- **Assess** your risks and opportunities
- **Prepare** to respond to nature-related risks/opportunities and report

This is voluntary guidance to support the internal assessment of nature-related risks and opportunities. The TNFD recognises that dependencies/impacts on nature are location-specific, and risks/opportunities will also vary according to organisation type and economic sector.

Metrics

The TNFD sets out a wide range of assessment metrics, which help inform decision-making, then focuses on a smaller number of disclosure metrics, including 14 core global indicators for reporting. Each metric references one of the drivers of nature loss set out in **Figure 3**. For instance, these core metrics cover plastic footprint, pollutants released, waste generated, species extinction and the value of assets or revenue assessed as vulnerable to nature-related risks. A wide range of case studies and further guidance can be found on the TNFD website.

Figure 3: Key drivers of nature loss



Source: Core Components of the TNFD Framework © 2023 by TNFD is licensed under Attribution-NonCommercial-ShareAlike 4.0 International

Next steps

There are concrete actions that LGPS Committees and Fund Officers can take now to address nature loss and prepare for alignment with the TNFD framework. These are split into three areas:

1 Education and engagement

- Read the TNFD Getting Started Guide.
- Committee training on TNFD, natural capital and biodiversity.
- Engagement with investment managers on nature-related issues.

2 Metrics and monitoring

- Initial assessment of portfolio exposure to nature-related impacts and dependencies.
- Understand the core TNFD metrics and agree which ones to focus on first.
- Set fund-specific targets to reduce exposure to nature loss.

3 Disclosure and strategy

- Develop integrated sustainability disclosures that incorporate TNFD guidance alongside TCFD.
- Consider impact related to specific themes (eg deforestation, marine life) and set policies.
- Invest in companies/ sectors supporting nature preservation.

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Higher yields and what these mean for the LGPS

For much of the last decade, discussions on investments have often been dominated by one particular phrase, "the search for yield". Having experienced a steady decline in yields of traditional lower-risk assets, such as government bonds and investment grade credit, investors were increasingly looking to new areas or having to accept a higher degree of risk to achieve the returns and the yield required to meet their investment goals. Argentina's oversubscribed 100-year bond is perhaps the peak example if this, given their record of eight previous defaults.

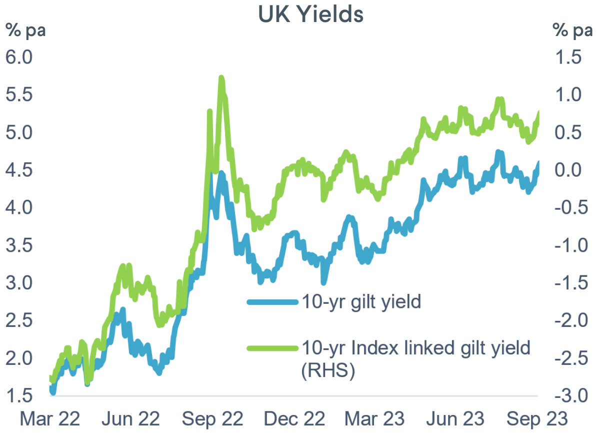
Since the onset of the current England and Wales LGPS actuarial valuation cycle in 2022, there has been a sizeable change in market conditions, where rising inflation has contributed to a shift back to a higher interest rate environment, last experienced over a decade ago. In this article, we outline some of the implications of a higher yield environment and what opportunities this provides to the LGPS.

Moving to higher ground

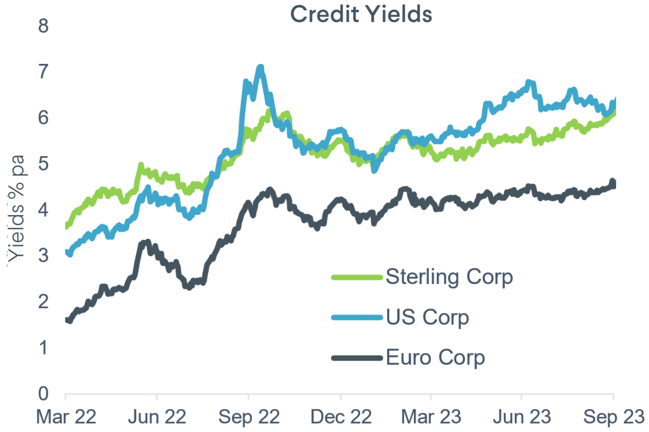
Charts 1 & 2 show the speed and extent of the movements in bond yields since March 2022. Many LGPS funds had reduced their exposures to bonds, particularly gilts, in light of the lower level of yields they offered. With a need to generate long-term real returns, assets like index-linked gilts, at an almost 3% pa negative real yield, had limited attraction for LGPS other than as a source of potential funding stability, liquidity, a 'safe haven' asset or degree of inflation protection. Any degree of inflation protection was largely negated in this recent period where the losses from the upward shift in yields outweighed the gains from the inflation linkage of these assets.

The outlook is now markedly different. Both nominal and index-linked gilts offer attractive yields, even when allowing for the inflation outlook. Investment grade credit now offers both strong absolute yields as well as a reasonable spread over gilts.

Chart 1 and 2: Significant movements in yields since March 2022



Source: Bloomberg



Source: ICE

Taking in the view

While the cycle of actuarial valuations rolls on, it is important to pause and step back now and again to take in the view, to look out for any new opportunities, or consider where funding and investment plans might be heading from here. The higher yield environment could present the LGPS with a range of potential opportunities from both a funding and investment perspective.

Investment risk – very simply, higher yields could provide opportunities for funds to take less investment risk. Expected returns will generally have increased as yields have risen. Required returns from a funding perspective may also be higher, but the ability to achieve these returns with greater certainty by investing more in traditional lower-risk assets like gilts and high-quality bonds is likely to have increased. But bear in mind that if returns are expected to be higher for low-risk bonds, they should also be higher for a range of other higher-risk assets.

Contributions – before dialling down investment risk, it's important to consider funding implications. Higher yields may mean the cost of funding benefits has reduced, but needs to be balanced against the impact of higher inflation. Given budget pressures in the public sector, some may prioritise contribution cuts for employers over de-risking. The decade of low yields has been tough for employers in the LGPS and the outlook may be more positive, so thinking ahead is important to ensure funding and investment plans are joined up.

Funding considerations – as well as higher yields impacting the balance of investment risk and contributions, there are also broader issues around funding that need to be considered. For those funds in surplus, there is a question of how this might best be managed, the benefits from maintaining a surplus, options to increase prudence or practicalities around managing the impact of employers wishing to exit the scheme.

The extent of the changes we have experienced over the last year or so means that it's a great time to consider your options and the opportunities presented by this new higher-yielding investment landscape.

Avoiding the pitfalls

While higher yields on gilts and corporate bonds look more attractive than they have done for a long time, there are still a range of factors to think about when considering increasing strategic allocations to these asset classes.

Diversification – over the last decade, the low yield on bonds increasingly saw funds try to reduce risk by diversifying allocations to a mix of alternative investments, including real assets and more diverse credit solutions. While the current outlook may provide opportunities to rebuild bond allocations, remember the importance of a diversified portfolio and continue to target a balanced exposure to different risk factors.

Relative risk – during the search for yield, funds allocated to a range of new and interesting asset classes. However, the shift to target higher yields, particularly in credit markets, also came with greater risks. With yields on 'safer' assets now higher, the same level of risk may no longer be needed. Some reweighting into higher-quality credit may provide better risk-adjusted returns.

Cashflows and liquidity – LGPS funds continue to mature, impacting net cashflow positions. This could be compounded by higher yields (potentially), reductions in contributions, or employers seeking to exit funds. Rebuilding allocations to bonds could increase the level of income your investments generate to help meet any shortfall, as well as increase exposure to liquid assets that can readily be used for regular rebalancing and provide more options when assets need to be sold.

Inflation – bonds provide varying levels of protection from inflation over the short or longer term (as we saw last year). While fixed income bonds offer high yields, they lock investors into a level of return that could be significantly eroded by higher inflation. When buying index-linked gilts, it's important to consider the level of inflation assumed in the price of that bond, but with real yields now in reasonably positive territory, investors are being much better compensated and protected from inflation.

Systemic and structural risks – the events of last year in particular have highlighted some systemic and structural risks in bond markets, primarily around the supply and demand for bonds and some concentrations of ownership which can lead to herding. Careful bond portfolio design is required to mitigate this.

Supporting growth – if considering reallocating into bonds, a decision would be required on where to fund this from. Higher-risk growth assets may be one option, but we are also mindful of the recent focus from government on supporting growth in the UK and the optics around the timing and extent of any strategic changes.

Climate and net zero alignment – with many funds already having set net zero targets and requirements on climate reporting likely to come, being able to factor this into bond allocations will be important. While less evolved than in equity markets, the ability to incorporate climate and ESG requirements in bond allocations is growing and a fresh look at bonds is likely to provide plenty of opportunities rather than barriers to achieve objectives in this area.

Looking forward

We are now in a world of higher yields where traditional lower-risk assets are providing better opportunities for long-term investors than they have in over a decade. This provides plenty of opportunities for LGPS funds to consider the role that an allocation to bonds can play as part of strategic asset allocations. While there needs to be careful consideration of the alignment of funding and investment strategies, we believe LGPS funds are well placed to benefit from higher yields on bonds.

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Inflation hedging using derivatives for the LGPS

How have inflation markets changed in the past two years, and how do they look currently?

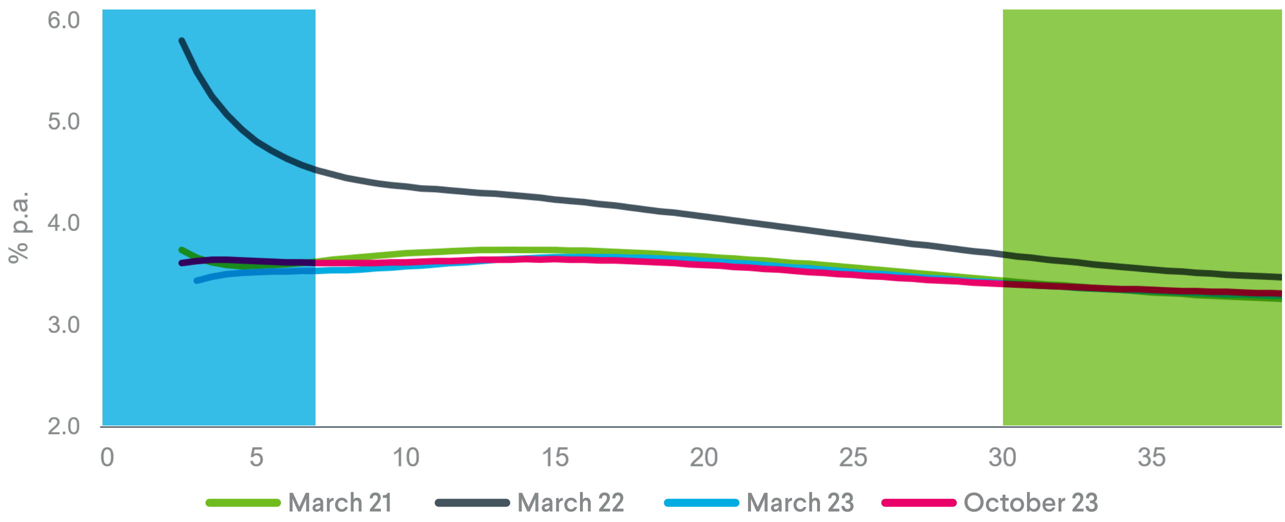
It's easy to forget how radically the inflationary environment has changed in the past two years. In late 2021, markets and the Bank of England were predicting the UK's short-term and longer-term Retail Price Index (RPI) inflation to remain at 3–4% pa, with other central banks forecasting similarly muted inflation. The prior decade's low economic growth, productivity, interest rates and inflation all seemed to be intrinsically linked, with little prospect of change.

But inflationary pressures had been identified in late 2021 and early 2022, even before the Russian invasion of Ukraine triggered commodity and energy-price inflation, which was exacerbated by supply-chain issues during 2022 and 2023. With hindsight, large monetary and fiscal stimulus (a long period of cheap money, followed by Covid-19) and upwards pressure on wages due to tight labour markets also added to domestically driven inflation pressures. Inflation subsequently rose further and for longer than most market participants expected.

During the past nine months, though, we've seen short-term UK inflation begin to ease, with headline inflation falling on the back of weaker commodity prices, reduced consumer spending, slowing growth and receding supply-chain issues. Interestingly, inflation markets are now pricing in the expectation that inflation will drop closer to 'normal' levels of 3–4% by 2025, while longer-term expectations have also fallen.

The chart below demonstrates just how significant an inflation shock was felt in March 2022 (the black line). But, more importantly, current levels of expected inflation appear to have largely reverted to those seen during 2021.

Chart 1. Implied UK spot inflation (RPI) from 2021 to date.



Short-term (~3–5y) expected inflation spiked significantly (March 2022) but has now returned towards 3.5–4.0% range seen during 2021.

Long-term expected inflation had also risen significantly by March 2022 but easing inflationary pressures and weak economic growth have driven long-term implied inflation back towards 3.3%.

Source: BoE/Hymans

How is it affecting the LGPS?

As inflation dynamics have changed, their effects on investment markets and pension schemes have been huge, and the LGPS has not been immune.

LGPS pension fund benefits have uncapped inflationary increases and, therefore, have huge underlying exposure to inflation. Because LGPS pension fund outgo is increased each April in line with the annual rate of RPI, the April 2023 inflationary increase of 10.1% had an immediate and acute impact on LGPS pension funds' cashflows. With many LGPS funds previously in broadly cashflow-neutral positions, such an inflationary increase has been a challenge to manage.

If we take a longer-term view, higher expected inflation may also impact LGPS funding levels as actuaries increase their inflation assumptions for liabilities, leading to increases in liabilities' value. Some of this potential damage to funding levels may not be felt until the 2025 actuarial valuations, and it's likely to be dependent on how actuarial inflation assumptions have been arrived at. However, risks undoubtedly remain.

What are our investment options to hedge these risks?

When we consider investments that will hedge inflation, it's essential we decide which risks we're looking to hedge against – either shocks to *short-term inflation*, which will typically have greater immediate impact on LGPS cashflow positions, or the risk of increases in *long-term expected inflation*, which we expect to have negative impact on actuarial assumptions and, in turn, LGPS funding levels. Understanding your fund's risk exposure to short-term inflation shocks or longer-term expected inflation increases should inform any investment decisions.

The LGPS has historically invested heavily in assets that *indirectly* hedge inflation – such as equities, property or infrastructure. These assets are expected to deliver strong returns in persistent, higher inflationary environments. However, in periods of short-term inflation shocks (as we've seen in 2022 and 2023), their performance is uncertain.

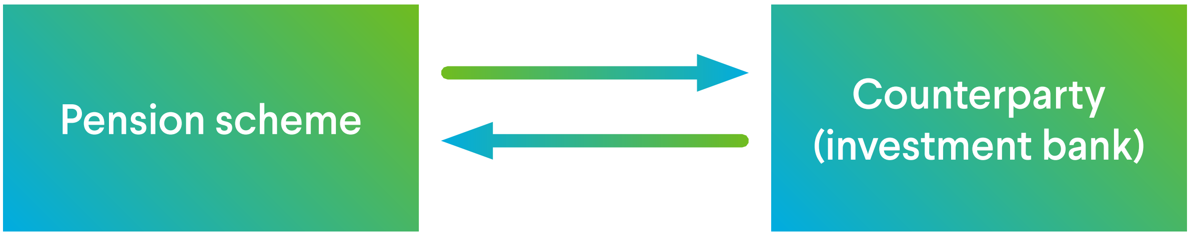
A number of investments *directly* hedge inflation, meaning that their values should increase if short- or long-term inflation expectations increase (ie index-linked gilts, inflation derivatives). While index-linked gilts are well known and are typically thought of as the best hedging solution for DB pension schemes, derivative-based approaches have been developed to help pension schemes manage their inflation risks. These approaches have typically been used by private sector schemes, as their closed-ended, mature nature means that inflation is a dominant risk for them. This has justified the time and money being spent on typically complex investment solutions being put in place, which has been hard to argue for in the LGPS. However, we believe there are some derivative-based solutions that may help to protect the LGPS in future.

Hedging short-term inflation shocks using inflation caplets

Inflation caplets are derivative contracts used to hedge against short-term inflation shocks. These involve *an annual payoff to the pension scheme in the event that realised inflation is above a certain level – say, 5% – in a given year*. In exchange, the pension scheme would pay a *fixed annual premium* to the counterparty. This type of payoff structure could be particularly helpful for pension schemes in managing the shorter-term cashflow risks surrounding inflation, as you get a payout when inflation is high. Pricing of caplets (ie the premium paid) is driven by both the volatility/uncertainty of future inflation *and* expected inflation levels, meaning that pricing has increased significantly in recent years. However, this still may prove an effective solution, particularly for those pension schemes with a larger degree of net cash outgo. We illustrate below how inflation caplets could be used to hedge short-term inflation risks.

In the example, a pension scheme agrees an inflation caplet contract with an annual premium of £3m, and the counterparty agrees to pay the pension scheme £5m for each percentage point that realised inflation is in excess of, say, 5%.

Pension scheme pays counterparty
a fixed premium of £3m



Counterparty pays pension scheme
£5m for each percentage point that realised inflation is in excess of 5%

If, for example, realised inflation (UKRPI) is 10% next year, then the pension scheme would pay the fixed premium of £3m and in exchange the counterparty would pay the scheme £25m helping to offset its increase in net pension outgo.

If, instead, realised inflation is 5% or below next year, then the pension scheme would pay the fixed premium of £3m, and the counterparty would make no payment to the scheme.

Conclusion

The falls in expected inflation since March 2022 could imply that we've suffered most of the 'inflationary pain', but there are sound reasons why inflation in future could prove higher and less predictable than in the past decade. A number of factors – labour shortages, a general political shift from globalisation and free-trade towards national priorities and tariffs, proactive fiscal policies and supply-chain disruptions, among others – point to an uncertain inflationary future. With this uncertainty in mind, we're supportive of our LGPS clients looking to reposition their investment portfolio to best reflect the short- and long-term inflationary risks to which they're exposed.

While long-term inflation risks for the LGPS can be addressed using derivatives, these are complex and will have operational burdens.

Short-term inflation risks, particularly around pension schemes' cashflows are also significant and may prove a challenge to the LGPS, particularly for those funds with large allocations to illiquid investments, lower levels of contributions, or a maturing membership. Inflation caplets may, therefore, prove an effective solution for some pension schemes.

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General Investment Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes but is not limited to equities, government or corporate bonds, derivatives and property, 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 investments. As a result, an investor may not get back the full amount of the original investment. Past performance is not necessarily a guide to future performance.

Derivatives

All forms of derivatives can provide significant benefits, but may involve a variety of significant risks. Derivatives, both exchange-traded and OTC, include options, forwards, swaps, swaptions, contracts for difference, caps, floors, collars, combinations and variations of such transactions, and other contractual arrangements (including warrants) which may involve, or be based upon one or more of interest rates, currencies, securities, commodities, and other underlying interests.

The specific risks presented by a particular derivative transaction depends upon the terms of that transaction and your circumstances. It is important you understand the nature of these risks before entering into a derivative contract.

In general, however, all derivatives involve risk including (amongst others) the risk of adverse or unanticipated developments of a market, financial or political nature or risk of counter-party default.

In addition, you may be subject to operational risks in the event that your manager(s) does not have in place appropriate legal documentation or internal systems and controls to monitor exposures of this nature.

In particular, we draw your attention to the following:

- Small changes in the price of the underlying security can lead to a disproportionately large movement, unfavourable or favourable, in the price of the derivative.
- Losses could exceed the amount invested. There may be a total loss of money/premium. Further, an investor may be called on to make substantial additional payments at short notice. Failure to do so in the time required can result in additional loss.
- The right to subscribe is invariably time limited; if such a right is not exercised within the pre-determined timescale, the derivative may be rendered worthless.
- Not all derivatives are liquid (that is, they may be difficult or, at times, impossible to value or sell). You may incur substantial costs if you wish to close out your position. OTC derivatives in particular can introduce significant liquidity risk and other risk factors of a complex character.
- OTC derivatives may result in exposure to the creditworthiness of the derivative counter-party.
- Derivatives used as part of 'protection' strategies may still expose the investor to an unavoidable difference between the underlying asset (or other interest) and the protection offered by the derivative.