



REPORT PREPARED FOR

**Dyfed Pension Fund**  
**Pension Committee**  
**Equity Restructure**  
11 January 2021

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## Restructure of Equity Allocations.

With the need to consider climate-related risk and with the Wales Pension Partnership (WPP) portfolios now established, it seems appropriate that the Committee consider the structure of the £1.27Bn legacy BlackRock equity portfolio, so as to allow the equity portfolio to work harder in achieving the Fund's goals in terms of long term performance and climate risk.

### Options for reducing Carbon footprint.

#### 1. WPP – Baillie Gifford (BG) Paris-Aligned Strategy.

BG have developed a low-carbon version of their Global Alpha strategy, which forms a 40% allocation in the WPP Global Growth active equity portfolio. The new variant offers the same performance and risk objectives, with a Carbon-intensity starting at 25% of the MSCI ACWI index *and* reducing each year to align with the “1.5 Degree warming” scenario outlined in the Paris agreement. This comes at the “cost” of a slightly higher active risk (4.6% vs 4.3% tracking error) and a higher growth tilt.

In our view this strategy offers the same performance objectives and fees as the original and only a marginal increase in traditional risk profile. It also incorporates a material reduction in climate risk, and an element of continuous improvement in Carbon intensity in line with the investment strategy of the DPF.

#### 2. BlackRock Global Low Carbon Reduced Fossil Fuels Strategy

BlackRock have an established low-Carbon global (MSCI World) passive Fund. They are upgrading this to an even lower-Carbon (“Reduced Fossil Fuels”) passive global equity strategy, also managed vs MSCI World, which offers a Carbon-intensity of 22% of the MSCI World index, with a 50bps tracking error. It also screens out companies with exposure to fossil fuel reserves and all thermal coal. It is expected that the upgrade would be completed in Q1 2021. Given the timing for upgrading the BlackRock Fund, it's probably simplest that Dyfed wait until BlackRock has finished upgrading their fund, before allocating to it.

Whilst we have restricted our review to the suitability of this one fund in line with your instructions, we note that there are a limited number of other credible passive low carbon managers, and these are not likely to offer material differences. BlackRock is a credible passive manager and, being the incumbent investment manager, choosing them should minimise transition cost/risk, as well as avoiding the costs and time delay associated with a full tender.

## Restructure of Equity holdings

The Committee should consider balancing risks from a number of areas:-

- Active risk / relative performance: The BlackRock active equity portfolios target half the level of active risk / outperformance to that targeted by the WPP strategy, so a similar level of exposure to active management may be achieved while allocating only part of the BlackRock active assets to WPP. Equally the past long-term relative performance of the BlackRock active strategies has been unremarkable net fees (below). While not established so long, the WPP portfolio offers a more balanced global exposure, both in terms of regions, and in terms of manager styles (given the WPP's combination of growth, quality and value styles).

Strategy	Outperformance target	-1 year (%) to 31 Oct	-5 years (% p.a.)
BlackRock US	+ 1 % p.a.	+0.39	-0.66
BlackRock Japan	+ 1 % p.a.	+1.34	+0.19
WPP Global growth	+ 2 % p.a.	+0.75	n/a

- Climate Risk / Reduced Carbon Emissions : Assuming all the current BlackRock portfolios have a Carbon exposure (tCO2/\$m sales) similar to the index, then I estimate that moving the WPP Baillie Gifford sleeve (including the proposed additional 5% allocation) to the “Paris aligned” strategy, would reduce the carbon footprint of the Dyfed equity holdings by c.4% vs current levels, and moving 10% to the BlackRock

“reduced fossil fuels” strategy might reduce the carbon footprint of the Dyfed equity holdings by a further 12%, delivering an estimated reduction of some 16% in total.

- **Regional risk:** The global portfolios (WPP or BlackRock) both have >50% of assets in the US, so it makes sense to use the US regional portfolio to fund these (particularly as US has outperformed and is now the most expensively valued equity region (21.3x P/E). Japan has also performed well recently, but is still attractively valued (16.0x P/E) and has some defensive characteristics (“safe haven” currency, low leverage) so we recommend retaining that for now, especially given the underweight to the US (the other more defensive region). While the UK market is one of the most attractively valued (14.4x P/E), along with EM, the portfolio has a very large (overweight) allocation here, and it typically has a high Carbon footprint, so we recommend reducing this allocation slightly.
- **Manager concentration risk:** This is primarily a concern for the active managers, and WPP in particular. While the Global Growth strategy does consist of 3 underlying managers, it represents a significant proportion of Dyfed’s overall assets, and so we would recommend limiting the allocation to 30% of total assets, at least until the strategy has a longer-term record.  
We did also consider whether to allocate to the WPP Global Opportunities strategy, but we do not recommend that, on the basis that, with 7 more underlying managers, this would add an unnecessary degree of additional diversification / complexity to Dyfed’s active equity exposure.

In response to the Council’s challenge, it is likely that Dyfed will want to make changes over a period of time, to control timing risk, so the proposed transition may be seen as the first step. We are currently exploring transition costs/options with BlackRock, but given the high level of overlap in the portfolios, these are likely to be modest.

% Dyfed Fund	Active risk (%)	30 Sept allocation	Proposed Transition	Resulting Allocation
Passive UK	-	19.7	-3.6	16.1
Passive EM	-	8.5		8.5
Passive Regional	-	4.1		4.1
Active US	<2.0	11.4	-11.4	-
Active Japan	<2.0	3.5		3.5
Passive Low-C global	<0.5		+10.0	10.0
WPP Global	c.4.0	25.0	+5.0	30.0
<b>Total Equity</b>		<b>72.2</b>	<b>-</b>	<b>72.2</b>

Regional Weights

% Dyfed Equities	MSCI ACWI Index	30 Sept allocation	Proposed Transition	Resulting Allocation
N. America (US and Canada)	62	35	-2	33
UK	4	30	-4	26
Europe ex UK	13	10	+3	13
Dev. Asia	10	10	+2	12
Emerging Markets	11	15	+1	16

**PROPOSAL 1:** That the Committee allocate 10% assets to the BlackRock “Reduced Fossil Fuels” passive global equity strategy, funding this from the BlackRock US active and UK passive portfolios, as shown above

**PROPOSAL 2:** That the Committee increase by 5% the allocation to WPP Global Growth, funding this from the BlackRock US active and UK passive portfolios, as shown above.