CLWYD PENSION FUND COMMITTEE

Date of Meeting	8 November 2016
Report Subject	Flightpath Strategy Proposals
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

At the 27th September Committee, a review of the Flightpath framework was proposed in light of current market conditions and the 2016 valuation. A cost / benefit analysis was needed before moving forward on elements of the project not included in the Business Plan and this has now been completed. The purpose of the report is to provide an update on the Flightpath strategy proposals and make recommendations for some changes which are not usually delegated to Officers.

It is proposed that the Fund move forward with the following elements of the review:

(i) Restructuring the current Insight LDI portfolio to make improve the efficiency of the mandate to the benefit of the Fund (net of initial transaction costs);

(ii) Implement "equity options" to protect against the impact on contributions of falls in the equity element of the current Insight mandate given the current market position.

(iii) As part of the Business Plan an in conjunction with (i) and (ii) update the funding, interest rate and inflation triggers and potential actions within the flightpath structure. This was in the current Business Plan.

RECOMMENDATIONS	
1	It is recommended that Committee approve the updated interest and inflation figures plus the revised process for implementing the funding level trigger actions.
2	Note the actions being taken within the current framework in the restructuring of the Insight portfolio and implementation of the equity option protection against market falls (subject to reasonable market pricing of the options).

REPORT DETAILS

1.00	**Flightpath Strategy Proposal**
1.01	To ensure the Fund is managing risk at the most efficient levels with the intention to be in a better position to capture opportunities as cost effectively as possible, the Officers, Mercer and JLT have now reviewed the overall framework. This comprises: 1. *Reviewing the flightpath plus updating the interest rate and inflation triggers.* This review has taken into account for the current market outlook (post Brexit) plus updated Fund benefit cashflows following changes to the membership profile, updated market conditions and the actuarial valuation. This was already in the Fund's Business Plan. The Committee are required to approve any updated triggers to be incorporated into the Flighpath framework. 2. *Restructure the current LDI portfolio.* Insight and Mercer have identified an opportunity to restructure Insight's mandate that will be more efficient for the Fund. This will require a certain level of transaction costs and work has been done by Mercer which has been reviewed by both JLT and Officers to assess its cost versus its value to the Fund. 3. *Subject to fair pricing implement the use of "equity options" to protect against market falls on the Insight mandate.* This is being explored to provide further downside protection given the current equity market levels. Initial work has been done by Mercer which has been reviewed by both JLT and Officers to assess its cost versus its value to the Fund – further work is required, particularly in respect to market pricing but the initial due diligence has now been completed.
1.02	***Reviewing the flightpath plus updating the interest rate and inflation triggers*** Officers have been working with Mercer and JLT to review the flightpath and update the interest rate and inflation triggers. These discussions have been based on the liability cashflows from the most recent actuarial valuation, the revised actuarial basis and also the proposed contribution schedule based on preliminary discussions with the Unitary Authorities. The philosophy behind the flightpath is to maximise returns subject to an acceptable level of risk. As part of this approach the intention is to reduce risk <u>at reasonably affordable levels</u> subject to attractive market opportunities. Progress has been made in respect to refreshing the interest rate and inflation triggers. The intention is to capture attractive, low risk, returns above CPI through a series of triggers to stabilise the cost of the Fund to employers. The current proposal is that the triggers be revised to fit with the 2016 actuarial valuation approach and updated position.

As well as the interest rate and inflation triggers it is proposed that the funding level triggers and actions are updated. A key change is that when the trigger is breached the appropriate action delegated to Officers could be:

- No action; or
- increasing the interest rate and inflation hedging levels;
- reduce the level or nature of the growth assets;
- changing other aspects of the framework such as the level of the equity options; or
- a combination of the above.

The key reason for this more wide ranging potential actions is that in volatile market conditions it is often not possible to say that one particular action will be in the best interests of the Fund. Indeed in some instances no action may be the most appropriate action.

The appropriate governance structure will be agreed and documented in the form of a Risk Management Group comprising the Officers (to whom the decision is delegated), Actuary/risk advisor (Mercer) and investment advisor (JLT). It is proposed that in the normal course of events the funding plan will continue to be monitored monthly in more detail as a matter of course and consideration is given to the impact of market conditions on risk and funding cost levels. However, the funding level will still be monitored (approximately using market indices) on a daily basis.

The first funding level trigger where action will definitely be considered as above will be set at 85% which is an increase from the current structure where first trigger was 80%. This is to reflect views on the new market environment.

Details of the proposed interest/inflation triggers are included as an appendix. A recommendation to Committee to approve these revised triggers and the implementation as soon as reasonably practical by updating the instructions for Insight.

To provide some context for deriving the interest/inflation triggers the proposal is based on a long term view of inflation expectations and UK economic growth. The starting point for deriving the triggers is to calculate the “fair value” for both interest rates and inflation, namely we:

1. Assume a fair value for CPI is 2% which is equal to the current Bank of England target
2. Assume RPI will be 1% higher than CPI in the long run (we need this assumption as it is only currently possible to buy inflation linked bonds that reference RPI)
3. Assume the UK economy will grow at a rate of 1% above RPI in the long term

This implies that a fair value for CPI is 2% and a fair value for interest rates is 4% (namely inflation plus long term expected growth of the UK economy). In other words, the long term fair value expected return on UK gilts would then be CPI + 2% per annum.

	Given current market conditions it is unlikely that the proposed triggers will be hit in the short term unless there is a material change in the economic outlook. This is appropriate given the long term nature of the Fund and will mean the Fund does not "lock in" at unattractive levels.
1.03	***Restructure the current LDI portfolio*** Insight and Mercer have identified an opportunity to restructure Insight's mandate that will be more efficient for the Fund. This involves buying assets with a higher yield/return and selling an equivalent asset with a lower yield/return. The precise benefit to the Fund depends on prevailing market conditions. Mercer provided a cost/benefit analysis and based on market conditions at 30 September 2016 the restructure would have been expected to generate a relative gain over time of £30m with associated transaction costs of £3m (i.e. a <u>net benefit</u> of £27m). It is proposed that the restructure be implemented subject to the trade generating a minimum level of net benefit - for example at least a £25m net benefit. This figure and the details of this restructure are to be agreed between advisers and the officers.
1.04	***Subject to fair pricing implement the use of "equity options" to protect against market falls on the Insight mandate*** Market conditions are particularly challenging and we are expecting further volatility over potentially a long period. It proposed that, subject to fair market pricing, we implement protection against potential falls in the equity markets via the use of "Equity Options". In particular, the Fund's overall exposure to equity markets is around £750m – including developed market equities, emerging market equities and private equity. In 2008, equity markets fell as much as 50% - if this was to happen again then it would roughly equate to a c.£350m increase in the deficit which may then translate into an increase deficit contributions by as much as £30-35m per annum (all other things equal). In the current fiscal environment the budgetary impact of a major fall in equity markets may be damaging for the services provided by Employers. On balance protecting against the downside could be considered more critical than the potential upside impact that would come from a further sustained rally in equity markets. The proposal is that an equity option strategy be explored with a view to mitigating this downside risk subject to it not reducing the overall level of expected return. The officers and advisers are working on a cost/benefit analysis with the next step to approach the market for firm pricing before implementation. The initial proposal is to implement this at a "nil premium" cost by giving up some market upside potential.

2.00	**RESOURCE IMPLICATIONS**
2.01	None directly as a result of this report. Resource requirements from advisors and the Fund to assess and implement the framework will be included in the Business Plan.

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	None required.

4.00	**RISK MANAGEMENT**
4.01	This report addresses some of the risks identified in the Fund's Risk Register. Specifically, this covers the following (either in whole or in part): • Governance risk: G2 • Funding and Investment risks: F1 - F6
4.02	The recent market volatility has increased the relative risk levels in relation to CPF funding and risk framework. The Flightpath Strategy manages/controls the interest rate and inflation rate impact on the liabilities of the Fund to give more stability of funding outcomes and employer contribution rates. The proposed changes are designed to provide improved risk control and increase the likelihood of a more stable outcome for the Fund and its employers but at a reasonable market cost.

5.00	**APPENDICES**
5.01	1. Framework trigger proposals

6.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
6.01	Report to Pension Fund Committee – 2016 Actuarial Valuation and Funding/Flightpath Update – 27 September 2016;
6.02	Report to Pension Fund Committee – Overview of risk management framework – Previous monthly reports and more detailed quarterly overview. **Contact Officer:** Philip Latham, Clwyd Pension Fund Manager **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

7.00	**GLOSSARY OF TERMS**

7.01	(a) **Clwyd Pension Fund (the Fund)–** The Pension Fund managed by Flintshire County Council for local authority employees in the region and employees of other employers with links to local government in the region (b) **Administering authority or scheme manager** – Flintshire County Council is the administering authority and scheme manager for the Clwyd Pension Fund, which means it is responsible for the management and stewardship of the Fund. (c) **Clwyd Pension Fund Committee (the Committee)** - the Flintshire County Council committee responsible for the majority of decisions relating to the management of the Clwyd Pension Fund (d) **LGPS – Local Government Pension Scheme** – the national scheme, which Clwyd Pension Fund is part of (e) **FSS – Funding Strategy Statement** – the main document that outlines how we will manage employers contributions to the Fund (f) **Actuarial Valuation** - The formal valuation assessment of the Fund detailing the solvency position and determine the contribution rates payable by the employers to fund the cost of benefits and make good any existing shortfalls as set out in the separate Funding Strategy Statement. (g) **Actuary -** A professional advisor, specialising in financial risk, who is appointed by pension Funds to provide advice on financial related matters. In the LGPS, one of the Actuary's primary responsibilities is the setting of contribution rates payable by all participating employers as part of the actuarial valuation exercise. (h) **Flightpath** A framework that defines a de-risking process whereby exposure to growth assets is reduced as and when it is affordable to do so i.e. when "triggers" are hit, whilst still expecting to achieve the overall funding target. (i) **Deficit** The extent to which the value of the Fund's liabilities exceeds the value of the Fund's assets. (j) **Funding level** The difference between the value of the Fund's assets and the value of the Fund's liabilities expressed as a percentage. (k) **Hedging** A strategy that aims to reduce funding volatility. This is achieved by investing in assets that mimic changes in liability values due to changes in market conditions.

	(l) **Insight QIF – Insight Qualified Investor Fund** An investment fund specifically designed for the Fund to allow Insight to manage the liability hedging and synthetic equity assets. (m) **Nil Premium Structure –** a financial structure whereby the premium associated with purchasing downside protection is exactly offset by a premium received for giving up a degree of upside potential and hence “nil premium”. (n) **Equity option** A financial contract that can allows an investor to reshape their exposure to equity markets. In particular, an equity option strategy can be used to provide downside protection against falls in equity markets.