CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 5th September 2018
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Clwyd Pension Fund Manager

EXECUTIVE SUMMARY

Members should note that:

- On a consistent basis the estimated funding position at the end of July is 92% which is around 12% ahead of the expected position from the 2016 actuarial valuation. However, there still remains uncertainty regarding future inflation and investment return expectations.

- The level of hedging remains at 20% for interest rate and 40% for inflation at 31 July 2018.

- No triggers have been breached since the interest rate triggers were re-structured in September 2017. Mercer recommended no change to the interest rate trigger levels of part of the flightpath healthcheck.

- The LDI restructure completed in March 2017 was expected to achieve a net long-term gain of c. £36.5m over 50 years via a relative value trade. A £25m "soft trigger" was set in the original agreement which was to be used to identify when it would be considered appropriate to realise the gain early. Mercer identified that the soft trigger had been breached and recommended that the trade was closed out. This was on the basis that c.70% of the expected gain had been achieved in the first 18 months and was therefore significantly ahead of the expected time period. The current gain is market sensitive and there have been changes in external factors which increased the risks of the gains being lost or reduced. Insight have been instructed to close out the position and realise the gain. As at 31 July 2018, this was c. £28.8m, of which £18.6m can be realised immediately. The final realised gain will be assessed once all transactions are completed.

- The new dynamic equity protection strategy was implemented on 24 May 2018. As at 31 July 2018, the dynamic protection strategy had returned £9m or 2.5% since inception of the strategy. The Fund is protected from falls in equity markets of 19% or more from current levels. More detail is provided separately in the Mercer report in Appendix 1.

- Due to the further positive performance of the flightpath framework since its implementation and the closing out of the relative value trade, Mercer has indicated that there is an opportunity to release £100m in cash from the

	collateral holding to potentially invest in other assets. Crucially, releasing this cash will not impact on the overall risk management profile of the flightpath strategy as all exposures to underlying returns and triggers will remain the same. Officers are working with Mercer and JLT to identify a suitable investment for this additional cash and will update Committee on their findings in due course.

RECOMMENDATIONS	
1	That the Committee note the updated funding and hedging position for the Fund and the progress being made on the various elements of the Risk Management Framework.
2	That the Committee note the LDI strategy is in the process of being restructured again in order to crystallise the positive mark-to-market gain.
3	That the Committee note that the Officers are working with their advisors in order to identify possible areas to invest the £100m cash that can be released due to the overall positive performance of the flightpath framework.

REPORT DETAILS

1.00	**FUNDING, FLIGHTPATH AND RISK MANAGEMENT STRUCTURE UPDATE**
1.01	***Update on funding and the flightpath framework*** The monthly summary report as at 31 July 2018 from Mercer on the funding position and an overview of the liability hedging mandate is attached in Appendix 1. It includes a "traffic light" of the key components of the Flightpath and hedging mandate with Insight. The report will be presented at the meeting including a reminder of the principle objectives of the framework.
1.02	The estimated funding level is 92% with a deficit of £155m at 31 July 2018 which is 12% ahead of the expected position when measured relative to the 2016 valuation expected funding plan. Uncertainty continues to be prevalent in the investment environment due to ongoing external political and fiscal factors. To illustrate the impact, a reduction of 0.25% p.a. in the assumed future investment return/real discount rate would reduce the funding level by 4% to 88% with a corresponding increase in deficit of £94m to £249m.
1.03	None of the interest rate triggers have been breached since they were re-structured in September 2017.
1.04	The level of hedging was around 20% for interest rates and 40% for inflation at 31 July 2018. The hedging implemented to date provides access to a lower risk investment strategy but maintaining a sufficiently high real yield expectation to achieve the funding targets.

1.05	Based on data from Insight, our analysis shows that the management of the Insight mandate is rated as "green" meaning it is operating in line within the tolerances set by our strategic risk advisors. An amber rating remains on the Libor plus fund due to the temporary limit on future investments into the fund. This should not affect the operation of the mandate but it will be kept under watch. There is also an amber rating relating to the collateral position and the potential for £100m to be released from the strategy (see section 1.08).
1.06	***Update on Risk Management framework*** (i) Restructuring the Insight Portfolio As reported previously, in 2017 Insight and Mercer identified an opportunity to restructure Insight's mandate to be more efficient for the Fund. This involved buying assets with a higher yield/return and selling an equivalent asset with a lower yield/return, known as a relative value trade. The net long-term gain achieved would be £36.5m over the lifetime of the c.50 year trade (made up of a total gain of £38m minus transaction costs of £1.5m). The Fund's hedge ratios remained at 20% for interest rates and 40% for inflation. This £36.5m gain over the lifetime of the trade can be split into two parts: a) Locking into a lower inflation rate has an expected value of £10.2m over the 50 year period b) The relative value trade has an expected lifetime value of £26.3m Whilst the gain is expected over a 50 year period, the relative value trade experiences changes to its value as markets vary. Put simply, if markets fall relative to the yield the Fund has locked-in, then the Fund's position is more valuable than the current market and the Fund can sell the relative value position for a profit. This value is monitored on a monthly basis to see if a gain can be crystallised earlier if market conditions allow. A soft trigger of an overall gain of £25m for the restructure was imposed. The value of the relative value trade was £18.6m as at the end of July 2018, and when combined with the £10.2m gain from locking in a lower inflation rate, the overall gain is £28.8m which is above the soft trigger. As part of the healthcheck of the flightpath mandate, Mercer advised that given c.70% of the 50 year expected gains had been achieved in c.18 months, now was an opportune time to close out the trade and lock-in the gains as there was a risk that markets would reverse and the accelerated gains would be lost. Closing the trade out now also removes the risk of being forced to unwind the trade in the future at a time when the market value is potentially negative, for example due to external factors to do with pooling or changes in the regulatory regime. The Officers were in agreement that gains should be "banked" and the relative value trade exited as soon as possible. This change has no impact of the level of hedging or the expected return on the portfolio. Critically, closing out this gain does not impact on the risk profile of the flightpath.

	The £18.6m gain of the relative value trade would be realised immediately, whilst the £10.2m gain from locking in a lower inflation rate would be accrued over a 50 year period. These immediate gains can be used to invest elsewhere in the portfolio along with the further release of collateral as noted in this report. Insight have started the process of unwinding the trade, with completion expected by mid-September. The final realised gain will be assessed once all transactions are completed.
1.07	(ii) Dynamic equity protection implementation and progress It was previously approved by Committee that, subject to fair market pricing, protection against potential falls in the equity markets via the use of Equity Options should be implemented. This was to provide further stability (or even a reduction) in employer deficit contributions (all other things equal) in the event of a significant equity market fall although it is recognised it will not protect the Fund in totality. It should be noted that, having an equity protection policy in place will protect from any large changes in equity markets which is currently prevalent given the long period of strong equity returns that we have seen. Importantly over the longer-term the increased security allows the Actuary to include less prudence in the Actuarial Valuation assumptions; this would translate into lower deficit contributions at the 2019 valuation whilst maintaining equity exposure supports a lower cost of accrual that under traditional de-risking methods. This will be quantified in the 2018 interim review. The Fund's static protection structure (akin to an insurance policy) ended on 23rd May 2018 and the new long term, dynamic equity protection strategy was implemented on 24th May 2018. As a reminder, a dynamic strategy, even though relatively more complex to set up, addresses some of the key issues with a static strategy where protection is fixed or static for a given time period. Namely, in upward trending markets, the dynamic strategy ensures that the protection remains at 15% below the average market level in the preceding 12 months. As markets have trended upwards, the current market position is 4% higher than the 12 month average market position. That means that the strategy provides protection from falls of 19% or more from the current market position. Further, it was decided that the downside protection should be financed through giving up a portion of potential upside participation. That is, the Fund participates in the first 5% of market rises on a monthly basis but is then capped for rises above 5% over a month. The Fund will receive premium if equity market returns are 5% or less on a monthly basis. Whilst some of the upside return is capped there is still the potential to achieve a return of up to 60% a year if markets rose steadily (i.e. 5% each month for a year) hence giving the Fund access to material equity upside whilst providing downside protection (to reduce deficit recovery costs). As at 31 July 2018, the dynamic protection strategy had returned c. £9m or 2.5% since inception of the strategy. Relative to investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £0.9m or -0.25% since inception. The majority of this

	underperformance is due to paying for protection; however this has been partially offset due to collecting premium through selling upside so the net cost of the protection is reduced. The protection will be monitored on an ongoing basis and the committee papers have been updated as part of the reporting in Appendix 1.
1.08	(iii) Collateral position Due to the positive performance of the framework since its implementation, Mercer indicated that there is an opportunity to release cash collateral from the Insight strategy to invest in higher returning assets. Mercer have calculated, and Insight have confirmed, that £100m (inclusive of the gain of unwinding the relative value trade) can be released from the strategy whilst still supporting the current positions and maintaining the flightpath strategy. This still leaves sufficient collateral in the event of market moves or in the event of any triggers being hit in line with the agreed guidelines. The Officers with the advice of JLT and Mercer are considering proposals on where best to redeploy this cash and the Committee will be updated in due course.

2.00	**RESOURCE IMPLICATIONS**
2.01	None directly as a result of this report but significant resources was taken for officers and advisors to implement the changes in a short timescale.

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 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 Equity option strategy will provide protection against market falls for the synthetic equity exposure via the Insight mandate only.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – July 2018

6.00	LIST OF ACCESSIBLE BACKGROUND DOCUMENTS
6.01	Report to Pension Fund Committee – Flightpath Strategy Proposals – 8 November 2016, Report to Pension Fund Committee – 2016 Actuarial Valuation and Funding/Flightpath Update – 27 September 2016 and Report to Pension Fund Committee – Funding and Flightpath Update – 22 March 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) **The Fund – Clwyd Pension 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) **The Committee – Clwyd Pension Fund 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) **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. (g) **ISS – Investment Strategy Statement** The main document that outlines our strategy in relation to the investment of assets in the Clwyd Pension Fund Further terms are defined in the Glossary in the report in Appendix 1.