CLWYD PENSION FUND COMMITTEE

Date of Meeting	13 June 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 April 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 December 2017.

- No triggers have been breached since the interest rate triggers were re-structured in September 2017.

- The LDI restructure completed in March 2017 is expected to achieve a net long-term gain of £36.5m. A gain could be crystallised earlier in certain market conditions. Since the restructure, the Fund has benefitted by around £13.6m at the end of April 2018. This position will continue to be monitored to highlight an opportunity to crystallise a gain earlier (subject to a minimum of £25m).

- The original Equity protection strategy (a static structure) was implemented on 24th April 2017 to protect against losses of more than 15% over a one year period relative to market levels at the start date. However this expired on 24th May 2018 and a new dynamic Equity Protection strategy with JP Morgan was put in place.

- After rigorous analysis and value for money considerations by the FRMG, a dynamic protection strategy was agreed (rather than renewing the static protection strategy previously in place). The strategy protects against falls of 15% or more of the average market position over the previous 12 months on the £360m of equity exposure in the Insight portfolio. This will be financed by giving up some potential upside return on a monthly basis. Whilst more complex to set up, the dynamic strategy provides advantages versus other approaches as follows:

1. Improved protection levels in upward trending markets 2. Expectation of better long-term risk adjusted returns (after fees and transaction costs) except in some extreme scenarios 3. Improved flexibility and on-going governance as it allows the structure to easily adapt to changing requirements including switching the protection off Due to the requirements of implementing the strategy on a daily rolling basis, it was agreed that the strategy would be delivered using a counterparty bank rather than an investment manager. Mercer went through a process of determining the best counterparty bank and it was agreed that JP Morgan would deliver the strategy via the existing Insight investment vehicle.

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 new dynamic equity protection strategy now in place which puts the Fund in a good strategic position in the run up to the next Actuarial Valuation

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 30 April 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 £153m at 30 April. In absolute terms the relative funding position is 12% ahead of the expected position at the end of April 2018 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 £91m to £244m.
1.03	None of the interest rate triggers have been satisfied 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 December 2017. 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. The only amber rating was given to 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.
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 that will 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. Insight implemented the trade subject to achieving a minimum level of benefit (net of transaction costs) of £25m. The net long-term gain achieved would be £36.5m over the lifetime of the trade of c50 years (made up of a yield gain of £38m net of transaction costs of £1.5m) which was a very positive result and lower trading costs than expected. The Fund's hedge ratios remain at 20% for interest rates and 40% for inflation. The mark-to-market of the relative value trade is monitored to see if a gain can be crystallised earlier if market conditions allow. Since inception, there is currently a mark-to-market gain of around £13.6m. A soft trigger of a mark-to-market gain of £25m was imposed, however, given current market conditions, Mercer along with Insight will be investigating whether there represents a good opportunity to potentially realise some of this value at the upcoming healthcheck of the flightpath mandate as set out in the business plan.
1.07	(ii) Equity protection on the Insight mandate 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. A static protection structure (akin to an insurance policy) was implemented on 24th April 2017 and ended on 24th April 2018. The static strategy protected against falls of more than 15% from market levels at the time of implementation, and an insurance "premium" was paid. This premium manifested as a slight reduction in return over the year. Over the 12 months, markets continued to increase, meaning that the protection level

was further away from current market levels.

Once the equity protection expired on 24th April 2018, in order to continue to protect employer contributions, it was agreed that the strategy should be "rolled on" for a further month until a new strategy could be implemented on 24th May 2018. During this period, the Officers worked alongside its advisors (Mercer and JLT) to implement a long term, dynamic equity protection strategy to cover £360m of equity exposure in the Insight mandate.

It should be noted that, having an equity protection policy in place will protect from any large changes in equity markets especially given the long period of strong equity returns that we have seen. In addition, 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. This will be quantified in the 2018 interim review.

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. The protection was to be rolled on a daily basis to ensure optimum efficiency.

In summary the dynamic strategy has the following benefits:

- **Adjusting the protection in upward trending markets** to improve protection over time.
- **Greater upside return potential –** potential to provide better risk adjusted returns (net of costs) versus the static structures except in certain volatile markets.
- **Governance benefits** - In principle the strategy remains 'live' until it is turned off (not the case with a static strategy which expires once the term is over). It therefore becomes part of the overall risk management strategy and flightpath allowing the strategy to be easily adjusted to reflect the current position and desired level of protection.

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. 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).

After rigorous analysis and discussion on different approaches (including variants on both a static and dynamic structure) it was concluded that the strategy should be delivered through the Insight mandate using a single counterparty investment bank. Investment banks have the infrastructure and experience to efficiently implement the structure on a daily rolling basis.

As part of the advice, Mercer assessed which counterparty bank would be the most appropriate to provide the protection strategy. This involved

	holding discussions with the bank to assess their suitability and Mercer considered three key criteria when deciding which bank would be best placed to implement the protection: - Value for money - Flexibility and exit costs - Capability and speed of implementation Based on the results of this analysis, Mercer recommended JP Morgan as part of the advice. The protection will be monitored on an ongoing basis and this will be included in future committee papers as part of the reporting. More detailed information will be supplied as part of these reports and also at future training events for the Committee. The impact on employer contributions will be considered as part of the 2018 interim funding review.

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 it 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 in the Insight mandate only.

5.00	**APPENDICES**
5.01	Appendix 1 - Monthly monitoring report – April 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.