CLWYD PENSION FUND COMMITTEE	
Date of Meeting	Wednesday, 29 November 2023
Report Subject	Funding and Investment Performance
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

The purpose of this report is to update the Committee on the Economy and Markets, and the Performance of the Fund's investments, as well as the funding and risk management framework. The reports cover the period ending 30 September 2023, and are attached as appendices to this report.

Economy and Markets

- Global equities posted small returns over the quarter returning +0.9%, whilst fixed interest and index-linked gilts returned –5.7% and -6.4%, respectively.
- Both the Federal Reserve and the Bank of England raised interest rates over the quarter, this coupled with headline UK inflation remaining high at 6.7% for the year to September and drove market movements over the quarter.

Performance Monitoring Report

- The Fund's total market value decreased in value by £57m to £2,229.4m over the three month period.
- Fund performance over 3 months, 12 months, 3 years and 5 years; -2.2%, +1.7% +4.5% p.a. and +3.9% p.a., respectively.
- Fund performance is ahead of the composite benchmark for the 3 year period, though behind in relation to other periods.

Funding and Risk Management

- The estimated funding position at 30 September 2023 of 105% is in line with the expected position.
- The total gain since inception of the synthetic equity strategy to 30 September 2023 is c. £90.5m. The currency hedging positions have made a loss of £16.5m in total since inception to 30 September 2023.
- Since the last update, a number of interest rate triggers were hit in August 2023, allowing the Fund to purchase gilts at attractive levels.

RECOMMENDATIONS	
1	That the Committee note the report and the various actions taken in relation to the funding and risk management framework.

REPORT DETAILS

1.00	INVESTMENT PERFORMANCE AND ECONOMIC RELATED MATTERS
1.01	**Economic and Market Update** The economic and market update for the quarter from the Fund's Investment Consultant is attached in Appendix 1. The report contains the following key sections: • **Economic and Market Background** – an overview of markets in the quarter, including commentary on key economic indicators • **Equity Market Review** – information on the performance of equity markets during the quarter and key drivers of markets • **Bond Market (Fixed Income) Review** – provides an update on bond yield movements and interest rates for the period • **Currencies, Commodities and Alternatives Review** – provides an update on the performance of Sterling against other currencies as well as highlighting movements in major commodity and alternatives asset classes for the period
1.02	Developed market central bank actions were mixed over the quarter, with some deciding to pause hiking interest rates, and others continuing to increase policy rates. Headline inflation continued to slow and core inflation fell in most regions. Inflation expectations also continued to decline over the quarter. UK GDP is estimated to have increased to 0.2% in the second quarter of 2023. Headline inflation in the UK fell to 6.7% in August and September from 7.9% in June. The Bank of England maintained interest rates at 5.25%. Global equities returned 0.9% in sterling terms and -2.2% in local currency terms as the dollar appreciated versus sterling. UK real yields rose most in the long end of the curve, led by spill over effect from the US real yields move. UK inflation remains considerably above target. Real yields, for all maturities remain in positive territory. Market based measures of inflation expectations, in the form of breakeven inflation were flat over the quarter. The UK 10-year breakeven rate finished the quarter at 3.85%. Market based measures of inflation expectations for the US rose over the quarter. 10-year global government bond yields rose sharply over the quarter. Across developed markets, curves steepened after prolonged flattening since the start of the central banks' policy tightening. In the UK, short-dated gilts were volatile and fell sharply post lower than expected inflation numbers and the BoE's dovish hikes. Intra quarter UK yields surpassed the levels witnessed during the gilt crisis in September 2022 but finished the quarter around 4.5%.

1.03	**Performance Monitoring report** Over the three months to 30 September 2023, the Fund's total market value decreased in value by £57m to £2,229.4m. The Total Fund has increased in value by £13.4m in 12 months to 30 September 2023, not accounting for net cashflows. Movement over the 12 month period saw positive equity and multi-asset credit performance. Whilst rising gilt yields, impacted the CRMF portfolio, causing a detraction in value. Since the end of Q3 2023, at the time of writing, gilt yields have decreased. Further information on the CRMF mandate is provided in 2.0 below.
1.04	The performance against benchmark is shown on Page 8 of the report, and repeated below:

Total	**Quarter (%)**	**1 Year (% p.a.)**	**3 Years (% p.a.)**	**5 Years (% p.a.)**
Total Fund	**-2.2**	**+1.7**	**+4.5**	**+3.9**
Total Benchmark	-0.6	+6.5	+4.1	+4.4

	Q3 continued to be a difficult period for some of the Fund's underlying managers to achieve benchmark performance, given the current market environment and the absolute benchmarks some funds have. For example, the Multi-Asset Credit mandate is targeting SONIA +4.0%, whilst the Best Ideas Portfolio is targeting UK Consumer Price Index +3.0% p.a. Therefore, whilst performance has been broadly flat over the quarter for both these portfolios, the high hurdles in place have proved a challenge to achieve. During the challenging market environment, the Fund has continued to monitor all assets closely and has made several active tactical decisions. As detailed in Appendix 3, the Fund has been able to benefit from periods of volatility by locking in at favourable yields, as interest rates have increased. The recent increases in interest rates have increased return expectations for the Fund's assets, which has in turn increased the Fund's discount rate, leading to a decrease in the value of the Fund's liabilities. Overall, the estimated funding position at 30 September 2023 of 105% is in line with the expected position.
1.05	The strongest absolute returns over the quarter came from the Infrastructure (3.3%) and Private Equity (3.2%) allocations within the Private Markets portfolio. The liability hedging portfolio decreased by -8.5% over the quarter to 30 September 2023, as real yields increased

	Over the 12 months to 30 September 2023, the WPP Multi-Asset Credit Fund generated the strongest returns of +8.4%. Total equities also generated strong positive returns, returning +4.7% for the period. The performance of individual managers is shown in Appendix 2 and is regularly reviewed by Officers and advisers.
1.06	All portfolio allocations held sit within the agreed strategic tolerance with the exception of Infrastructure within Private Markets, which is marginally underweight.
	FUNDING, FLIGHTPATH AND RISK MANAGEMENT STRUCTURE UPDATE
1.07	**Update on funding and the flightpath framework** The monthly summary report as at 30 September 2023 from Mercer on the funding position and an overview of the risk management framework is attached in Appendix 3.
1.08	The estimated funding level is 105% at 30 September 2023, which is in-line with the expected position when measured relative to the 2022 valuation expected funding plan. The expected funding level will reduce over time as employers are using part of the valuation surplus in line with the agreed employer contributions commenced from 1 April 2023. The overall investment environment has continued to be challenging over 2023-to-date amid rising inflation and interest rates. A soft funding level trigger of 110% is in place to prompt future Funding & Risk Management Group (FRMG) de-risking discussions and based on the formal protocol agreed by the Committee. The funding level is below this trigger currently but if breached, this would prompt further discussions and analysis on whether the Fund can take de-risking actions to provide more certainty for employers without inadvertently putting upwards pressure on contributions in future. This trigger will be kept under review over time.
1.09	The level of liability hedging as reported by Insight on the 2019 actuarial valuation basis (gilts+ a fixed margin equivalent) was approximately 68% for interest rates and 40% for inflation at 30 September 2023. The liability hedging portfolio performed negatively (but in line with expectations given market conditions) over the quarter to 30 September 2023 as real yields rose across all maturities. The hedging implemented to date provides access to a lower risk investment strategy by maintaining a sufficiently high real yield/return expectation to achieve the funding and contribution targets. A number of interest rate triggers were hit in August 2023, allowing the Fund to purchase gilts at attractive levels. This has increased the interest rate hedge ratio from c. 67% to c. 68%. Following the 31 August 2023 FRMG meeting, interest rate triggers were paused given potential collateral constraints and pending further discussions from a wider investment strategy review to take place in the early part of 2024. Collateral remains in a healthy position, with the portfolio currently able to withstand an interest rate rise in excess of 5% whilst supporting suitable stresses on the other hedging exposures (equity and FX), without drawing

	on the existing collateral waterfall. With regard to this, the portfolio is in line with guidance issued by the Pensions Regulator (TPR) in April 2023 as per paragraph 1.10 below.
1.10	The Fund remains in compliance with the TPR guidance on collateral levels, with comfortable levels of collateral to support the current hedges in place and to take advantage of opportunities through the market based interest rate and inflation trigger framework should they arise. The Fund has a robust governance framework to monitor collateral levels and take action quickly as needed, and further liquidity can be sourced from liquid assets held outside the Insight mandate at short notice if required.
1.11	Based on latest data available from Insight, Mercer's analysis shows that the management of the Insight Liability Hedging mandate is rated as "green" as at 30 September 2023, meaning it is operating in line within the tolerances monitored by Mercer. The Cash Plus Fund is rated "green" as the Fund had sufficient collateral to withstand the stresses as at 30 June 2023, although additional collateral was required to bolster the position and enable the Fund to take advantage of opportunities. The Cash Plus Fund has underperformed since inception and marginally outperformed over Q2 2023. The collateral waterfall has returned £6.5m at 30 June 2023 since implementation at 31 January 2019. The collateral waterfall structure is reviewed on an ongoing basis. Further work has been carried out to understand the liquidity of the wider investment strategy and where capital could be sourced at short notice, should it be required in future to supplement available collateral within the Flightpath. Following completion of this work, the remaining assets within the collateral waterfall were divested to help fund the allocation to WPP Sustainable Equity in line with the agreed strategy. Officers and Mercer are satisfied that following this divestment, the portfolio will continue to comfortably comply with the latest TPR guidance as noted in 1.10 above.
1.12	**Update on Risk Management framework** **(i) Synthetic equity and equity protection strategy** Within the Risk Management Framework the Fund gains exposure to equity markets via derivatives and protects the majority of this exposure against potential falls in the equity markets via the use of an equity protection strategy. This provides further stability (or even a reduction) in employer 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 large falls in equity markets. Importantly over the longer-term the increased certainty allows the Actuary to include less prudence/buffer in the Actuarial Valuation assumptions; this translates into lower contributions at each valuation (all other things equal), whilst maintaining the equity exposure. The Fund has a bespoke synthetic equity and equity protection strategy,

	which is implemented through a Total Return Swap ("bespoke TRS") contract with JP Morgan, held within the Insight QIAIF (the fund that implements the risk management strategies on the Fund's behalf). The TRS contract is for a fixed term of 3 years up to 2024 and can be rolled over if required. The Fund implemented c. £215m of exposure in long-only synthetic equity positions in October and November 2022 to replicate the exposure removed from equity sales to support the collateral position within the Flightpath on a temporary basis. The October 2023 maturing long-only synthetic equity position was rolled over and switched to reference the MSCI World Climate Paris Aligned (PAB) benchmark. The other long-only synthetic equity position maturing on 1 November 2023 was allowed to roll off in order to bring the Fund's actual equity exposure closer to target. Both positions consisted of broad developed market exposure and were implemented through vanilla equity total return swap. Unlike the custom TRS, these vanilla swaps have no protection in place and rise and fall with equity markets. As at 30 September 2023, these swaps had experienced a gain of c. £16m since inception. Once the collateral waterfall asset sale proceeds settle in November, they will be used to fund the strategic allocation to the WPP Sustainable equity mandate. It has been decided that the synthetic equity exposure won't be adjusted at this point pending the wider investment strategy review. This means the Fund will be running a small overweight allocation to equities in the interim. As at 30 September 2023, the total performance since inception of the bespoke TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £90.5m.
1.13	**(ii) <u>Currency hedging gain/loss</u>** The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £20.6m since inception on 8 March 2019 to 30 September 2023 due to the material weakening of sterling over that period, particularly versus the US dollar. The Fund's overseas developed market physical equity holdings are currency hedged and have made a loss of c. £16.5m since inception of the strategy due to the material weakening of sterling versus the US dollar over that period. Overall the action to hedge the Fund's developed equity currency risk has resulted in a loss of £37.1m since inception of the strategies, although this is expected to be fully offset by rises in value of the overseas equity holdings due to these same currency movements.
1.14	**(iii) <u>Update to the reported interest rate and inflation hedge ratios for Q4 2023 reporting cycle onwards</u>** The current liability hedging basis that Insight use for the interest rate and inflation hedge ratios within their reporting is based on market conditions as at the 2019 Actuarial Valuation. The FRMG is currently updating the liability benchmark for the 2022 Actuarial Valuation and as part of this, and following advice from Mercer, the hedging basis Insight use will be revised.

	Once the hedging basis is updated, the hedge ratios will be re-expressed on the new basis. Mercer have confirmed there will be no change to the gilt exposure in £ terms gained through the risk management framework as a result. However, given the large increases in real yields since the last time the hedging basis was updated, the reported interest rate and inflation hedge ratios will be lower than Insight are currently stating once the basis is updated for the Q4 2023 reporting cycle onwards. Insight report hedging levels relative to a gilts basis, whereas the Fund's Actuary uses a CPI-linked discount rate. This is calibrated so liability values are broadly equal at each triennial actuarial valuation, and Mercer have been using Insight's stated hedge ratios in their regular reporting and monitoring to the Fund. In between actuarial valuations and recalibrations, if there has been significant changes in real yields (gilt yields relative to CPI inflation), the Insight reporting basis can diverge from the Actuary's funding basis. This is what has been observed following the significant rises in gilt yields over the past 18 months. Therefore, Mercer have advised that the hedge ratios Insight have been reporting are not a true reflection of the actual level of hedging within the Fund. However, these have been reported to the Committee in order to be consistent with the Insight reporting and trigger framework levels. Given the recalibration carried out by Mercer following the 2022 actuarial valuation to re-align the Insight basis with the Fund's funding basis, there will be a step change in the reported hedge ratios from Q4 2023 onwards. It is important to note that Mercer have advised that this has no impact on the actual gilt exposure and therefore risk levels within the Fund, rather it is a reflection of the limitations in the methodology for reporting the hedge ratios. To address this issue, Mercer are moving to reporting interest rate and inflation hedge ratios as a proportion of the Fund's total asset value. This is a more representative and meaningful measure of the interest rate and inflation exposure within the Fund's portfolio. Making this change will avoid the hedge ratios reported to Committee deviating materially again in future following large changes in market conditions. To illustrate the impact, as at 30 September 2023, the interest rate hedge ratio on the old Insight basis is 68%. Going forward under the new approach, the interest rate hedge ratio is 32% of a proportion of the Fund's assets. Mercer have advised that the change is for reporting purposes primarily, ensuring the hedge ratios are expressed in a more meaningful way given the changes in market conditions. There is no change to the amount of asset hedging exposure, meaning the risk levels within the Fund are not impacted and there is no impact on the Fund's funding position. Further, Mercer have advised the Fund should not be looking to increase hedging directly as a result of these changes, which are purely cosmetic in nature. Further consideration will be given to the hedging strategy as part

	of the wider strategy review.

2.00	**RESOURCE IMPLICATIONS**
2.01	None directly as a result of this report.

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	None directly as a result of this report.

4.00	**RISK MANAGEMENT**
4.01	The Fund's investment strategy has been designed to provide an appropriate trade-off between risk and return. The Fund faces three key investment risks: Equity risk, Interest Rate Risk and Inflation Risk. Diversification of the Fund's growth assets away from equities seeks to reduce the amount of the equity risk (though it should be recognised that Equities remain an important long term source of expected growth). The implementation of the Fund's De-Risking Framework (Flightpath) has been designed to mitigate the Fund's Interest Rate and Inflation Risks.
4.02	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
4.03	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. The collateral waterfall framework is intended to increase the efficiency of the Fund's collateral, and generating additional yield in a low governance manner. Hedging the currency risk of the market value of the synthetic equity portfolio will protect the Fund against a strengthening pound which would be detrimental to the Fund's deficit. Hedging the currency risk of the developed market physical equity exposure will mitigate the risk of a strengthening pound.

5.00	**APPENDICES**
5.01	Appendix 1 – Economic and Market Update – 30 September 2023 Appendix 2 – Performance Monitoring Report – 30 September 2023 Appendix 3 – Monthly Monitoring Report – 30 September 2023

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. • Report to Pension Fund Committee – Overview of risk management framework – Previous monthly reports and more detailed quarterly overview. **Contact Officer:** Philip Latham, Head of Clwyd Pension Fund **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

7.00	**GLOSSARY OF TERMS**
7.01	A list of commonly used terms are as follows: (a) **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. (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) **Absolute Return –** The actual return, as opposed to the return relative to a benchmark. (d) **Annualised –** Figures expressed as applying to 1 year. (e) **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. (f) **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. (g) **Duration –** The weighted average time to payment of cash flows (in years), calculated by reference to the time and amount of each payment. It is a measure of the sensitivity of price/value to movements in yields. (h) **FSS – Funding Strategy Statement** – the main document that outlines how we will manage employers contributions to the Fund (i) **ISS – Investment Strategy Statement** The main document that outlines our strategy in relation to the

	investment of assets in the Clwyd Pension Fund (j) **LGPS – Local Government Pension Scheme** – the national scheme, which Clwyd Pension Fund is part of (k) **Market Volatility –** The impact of the assets producing returns different to those assumed within the actuarial valuation basis, excluding the yield change and inflation impact. (l) **Money-Weighted Rate of Return –** The rate of return on an investment including the amount and timing of cash flows. (m) **Relative Return –** The return on a fund compared to the return on index or benchmark. This is defined as: Return on Fund minus Return on Index or Benchmark. (n) **Three-Year Return –** The total return on the fund over a three year period expressed in percent per annum. (o) **Time-Weighted Rate of Return –** The rate of return on an investment removing the effect of the amount and timing of cash flows. (p) **TPR LDI Guidance** – Guidance issued by the Pensions Regulator in April 2023 covering the use of leveraged liability-driven investment by pension schemes (https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/liability-driven-investment) (q) **Vanilla/unhedged Synthetic Equity** – Derivative contracts that enable the Fund to gain exposure to broad equity markets with no embedded equity protection. The change in value of vanilla contracts is perfectly correlated to the change in the value of broad equity market indices. (r) **Yield (Gross Redemption Yield) –** The return expected from a bond if held to maturity. It is calculated by finding the rate of return that equates the current market price to the value of future cash flows. Further terms are defined in the Glossary in the report in Appendix 3 and a comprehensive list of investment terms can be found via the following link: https://www.schroders.com/en/uk/adviser/tools/glossary/