AN UPDATE FROM THE ACTUARY

I am delighted to provide my update from an actuarial perspective on the activities of the Clwyd Pension Fund (CPF) during 2017/18. As the Fund's Actuary, I provide advice to the Fund and its employers in relation to managing and monitoring the many financial and demographic risks they face. I also have a specific role in guiding the overall direction of the Fund via my seat on both the CPF Advisory Panel and the Funding and Risk Management Group (FRMG) which was established to specifically manage the “Flightpath” strategy. The Advisory Panel provides an opportunity for all of the Fund's professional advisors to collaborate, in conjunction with the Fund Officers, to help the CPF achieve its long term objectives. I feel that, as a group, we have continued to make excellent progress over the year with a number of important enhancements made to the Flightpath framework.

RISK MANAGEMENT

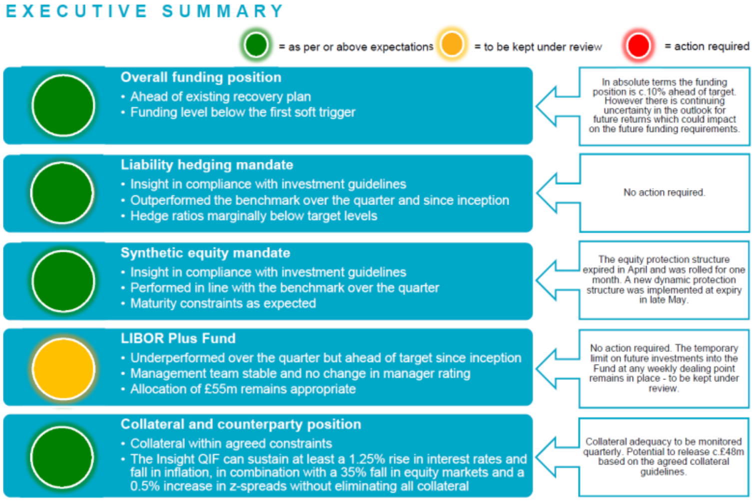
FLIGHTPATH STRATEGY

A critical aspect of managing risk relates to the Flightpath strategy which is central to providing stability of funding and employer contribution rates in the long term. This strategy was originally put in place from 1 April 2014 to support the overall objective to be fully funded (a solvency level of 100%) in 10 to 12 years. The various triggers built into the Flightpath strategy were reviewed alongside the actuarial valuation and the updated triggers are now incorporated into the operation of the strategy.

Over 2017/18, the level of risk hedging (the “hedge ratio”) within the framework did not change (remaining at approximately 20% for interest rates and 40% for inflation rates) as the market yields and the funding level remained below the relevant trigger points.

The funding plan was ahead of the target set as part of the 2016 valuation as at 31 March 2018. Overall the funding position was estimated to be 89% as at 31 March 2018 which was 10% ahead of target. Whilst this was a favourable position, there was concern that due to market volatility this improvement may be lost or much reduced hence the implementation of the Equity Protection element of the strategy. This strategy was updated on 24th May 2018 (see comments below).

The CPF is also in a relatively unique position as the Flightpath strategy has provided protection given the level of risk hedging in place.



Whilst monitoring the funding position is central to my role, it is also important that we ensure other operational aspects of the Flightpath run by Insight Investment Management (Insight) are working correctly, as this is vital to the success of the strategy. Therefore we monitor on a monthly basis using a red/amber/green ("RAG") rating system and the summary at March 2018 is shown. It can be seen that all aspects were at least in line with expectations except in relation to the LIBOR plus fund. The amber rating is shown as Insight have put a cap on the level of new investment into the fund so they can maintain liquidity. Whilst the CPF is not expected to make any future investments into this fund, it was considered prudent to keep this under review hence the amber rating. It has had no impact on the Flightpath.

RESTRUCTURE OF THE HEDGING MANDATE

Whilst the main objective of the Flightpath strategy is to manage risk, it is important to identify opportunities to maximise the operational performance of the mandates.

We identified an opportunity to restructure the mandate to provide a higher yield on the assets for the same level of risk control. This involved buying assets with a higher yield/return and selling an equivalent asset with a lower yield/return. It was agreed by the Pension Fund Committee that the restructure should proceed subject to a net gain of at least £25m being realised. The trade was completed in March 2017 and an expected long-term gain of £36.5m (net of costs) over 50 years was achieved from this restructure, which was a very positive outcome. Given this value will accrue over a very long time-frame; the position will be monitored by the FRMG. Depending on market conditions, a significant proportion (subject to the minimum total gain of £25m) could be realised much earlier. Since the restructure, the Fund has benefited by around £13m in immediate gains as at 31 March 2018 and is expected to achieve a guaranteed gain of a further £10m, resulting in a total expected gain of £23m. As this total gain has increased to £28m at 31 July 2018 (over 70% of the total expected gain in 18 months) it has been agreed to capture the opportunity to lock-in this gain early and to mitigate the possibility of losing this significant return in a short period.

IMPLEMENTATION OF EQUITY OPTION PROTECTION

The funding position has continued to improve post 31 March 2018 and was at 92% at the end of July. In order to protect the Fund's current strong position, the CPF insures itself against potential falls in the equity markets via the use of an "Equity Protection contract". The aim is to provide further certainty in employer contributions (all other things equal) in the event of a significant equity market fall. The Fund implemented a protection strategy against falls below a fixed market level (known as a "static" strategy), set as 15% or more of the market level at the point of implementation. This was in place from 24th April 2017 and ran until 24th May 2018.

On 24th May 2018, a new "dynamic" Equity Protection strategy was put in place. This was after rigorous analysis and value for money considerations by the FRMG. The strategy protects against falls of 15% or more of the average market position over the previous 12 months. This protection level will vary depending on market movements and the main benefit compared to a static strategy is that the protection level will increase if markets rise. This will be financed by giving up some potential upside return on a monthly basis. Whilst more complex to set up, the dynamic strategy also provides advantages versus the previous static approach such as:

1. Expectation of better long-term risk adjusted returns (after fees and transaction costs) except in some extreme scenarios; and,
2. Improved flexibility and on-going governance as it allows the structure to easily adapt to changing requirements including switching the protection off if necessary.

The strategy is implemented on a daily rolling basis to best capture changes in market conditions. Given this complexity however, it was agreed that a single counterparty bank would package and deliver the strategy, implemented via Insight. Mercer went through a process of determining the most cost effective counterparty bank and it was agreed that JP Morgan would deliver the strategy.

The strategy will be monitored monthly alongside the Flightpath (above).

LOOKING FORWARD

Of course, the political and economic landscape remains uncertain due to the UK and EU BREXIT negotiations. This could have a material effect on the level of UK inflation and also the expected asset returns, both of which are crucial to the financial health of the Fund and the contributions required from the employers. It should be highlighted that the Flightpath strategy will continue to provide protection to the funding position against these potential challenges relative to other LGPS Funds. We will also continually monitor the operation of the strategy to identify ways of improving its performance whilst maintaining the overall risk management objectives. An interim funding review as at 31 March 2018 will be completed over 2018/19 and this will be reported over the next few months. The intention is to provide employers with an update of their funding position and contributions following the recent positive returns to aid in budget planning ahead of the 2019 valuation. It will also help further embed the employer risk management framework which will consider an employer's ability to support their obligations to the Pension Fund by considering their covenant. It is therefore my continued confidence in the strong governance structure within the Fund which means we are well placed to navigate any uncertainty and volatility that arises.

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