CLWYD PENSION FUND COMMITTEE

Date of Meeting	7 October 2020
Report Subject	Funding, Flightpath and Risk Management Framework Update
Report Author	Head of Clwyd Pension Fund

EXECUTIVE SUMMARY

- The estimated funding position at the end of August is 92%, which slightly behind the expected position from the 2019 actuarial valuation.
- The level of interest rate hedging remains at 20%. The inflation hedge was reduced in March 2020 from 40% to 20% due to concerns that the value of inflation-linked assets could fall as a result of the government's proposal to reform RPI to the lower CPIH measure. In September, the inflation hedge was rebalanced back to 40% to reduce this risk. It is estimated that the changes made to the inflation hedge ratio over the year has led to a £4m gain for the Fund.
- As at 31 August 2020, the synthetic equity strategy had made a gain of c. £36m since inception of the strategy in May 2018. This gain incorporates the impact of the synthetic equity currency hedge, described in further detail below.
- The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £5.0m since inception on 8 March 2019 to 31 August 2020 due to the weakening of sterling over that period. Further, the Fund's overseas developed market physical equity holdings are currency hedged and has made a gain of c. £7.5m since inception of the strategy in August 2019 to 31 August 2020 due to the strengthening of sterling over that period. The level of currency hedging of the Fund's total equity portfolio remains at 75%.

RECOMMENDATIONS	
1	That the updated funding and hedging position for the Fund, and the progress being made on the various elements of the Risk Management Framework is noted.
2	That the impact of the equity protection strategy is noted.
3	That the impact of the currency hedging strategy is noted.

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 August 2020 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 includes a reminder of the principle objectives of the framework. Some of the areas are being kept under review given current market volatility.
1.02	The estimated funding level is 92% with a deficit of £178m at 31 August 2020, which is slightly behind the expected position when measured relative to the 2019 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 c. 4% to c. 88% with a corresponding increase in deficit of £95m to £273m. For the purposes of this report the funding position has been measured on consistent actuarial assumptions with the 2019 valuation.
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 approximately 20% for interest rates and 40% for inflation at 31 August 2020. 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 Cash Plus Fund is rated "amber" following underperformance over the first half of the year as a result of increased credit spreads driven by the economic impact of the Covid-19 pandemic. Collateral is within the agreed constraints and the efficiency of the collateral position has been improved following the implementation of a collateral waterfall framework with Insight last year. Overall, the collateral waterfall has generated an additional £1.5m return since implementation at 31 January 2019 to 31 August 2020 versus the previous structure. No action required.
1.06	***Changes to the inflation hedge ratio*** The Fund chose to reduce the inflation hedge from 40% to 20% in early March 2020 given the risk that RPI reform could cause the valuation of RPI linked assets to fall.

	Due to the impact of the Covid-19 pandemic on consumer demand, inflation expectations fell materially and a number of market triggers to increase the inflation hedge ratio where hit in April and May taking the inflation hedge to c. 30%. There has been an unprecedented amount of central bank and government intervention to manage the crisis. At risk of being seen to be doing too little, policymakers are more likely to overshoot and do too much. As consumer demand starts to increase, this could lead to an increase in inflation expectations. Further, the prospect of a no-deal Brexit on the price of imported goods further adds to the risk of inflation rising. However, the RPI reform consultation announcement which was due in April 2020 has been delayed to Autumn 2020 with no fixed date provided as yet by the government. This still has the potential to reduce the value of RPI-linked assets if RPI is reformed to the lower CPIH measure. However, given what the current workload of the government, there is a chance that the consultation outcome is delayed further and this increases the chance of an inflation spike in the interim. On balance, it was determined that there was greater probability of inflation rising materially, offsetting the potential reduction due to RPI reform. To mitigate that risk, at the end of August, the inflation hedge was rebalanced back to the strategic 40% target outside of the automated trigger mechanism. It is estimated that the changes made to the inflation hedge ratio over the year has led to a £4m gain for the Fund
1.07	***Update on Risk Management framework*** (i) Synthetic equity protection strategy The Fund gains exposure to equity markets via derivatives and protects 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 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. Importantly over the longer-term the increased security allows the Actuary to include less prudence in the Actuarial Valuation assumptions; this translated into lower deficit contributions at the 2019 valuation, whilst maintaining the equity exposure supports a lower cost of accrual than under traditional de-risking methods. The level of protection for the Fund was increased by 5% from 12 month average market levels of 15% to 10% last year, the cost of which will be offset by the Fund's participation in losses beyond 30%. Protecting for such extreme unlikely scenarios is proportionately expensive and not necessarily required by the Fund as it has the governance and implementation framework in place in order to act quickly and bank the returns from the protection in the event of an equity market drawdown.

	The strategy was tested during the midst of the Covid-19 pandemic, which saw equity markets fall substantially. Over March, markets fell by 15% whereas the protection strategy offset this impact to only 10%. Since then, markets have recovered materially. As at 31 August 2020, the synthetic equity strategy had increased by c. £36m since inception of the strategy in May 2018. Relative to simply investing in passive equities (and assuming no costs to do so), the strategy has underperformed by c. £41m since inception. The underperformance is largely driven by the sharp rally in equity markets causing the value of the protection to fall. However, this downside protection is still critical to the overall strategy of protecting against large falls in markets due to the ongoing economic uncertainty.
1.08	(ii) Implementation of currency hedging A strategic currency hedging policy was implemented in March 2019. By currency hedging the market value of the synthetic equity portfolio, and leaving the physical equity portfolio unhedged from a currency perspective, this policy achieved a c.50% currency hedged position of the overall equity portfolio. The strategic hedge ratio was based on analysis that indicated such a level minimised risk over the long term. The uncertainty surrounding Brexit has resulted in a significant depreciation of the pound. Whilst this has resulted in gains for the Fund due to the overseas equity exposure, currency risk remains a major risk to the Fund and a strengthening pound would have a detrimental impact on the Fund's deficit as overseas assets would be worth less in sterling terms. Whilst Brexit uncertainty continues, sterling has remained weak resulting in a loss on the strategy's currency hedge of c. £5.0m relative to an unhedged position as at 31 August 2020. In addition, the Fund implemented a currency hedge of 100% of the physical developed overseas equities in order to lock-in gains from the recent sterling weakness and reduce the risk of a materially strengthening pound. This was implemented in August 2019, and relative to currency rates at this point, sterling has strengthened. Since inception to 31 August 2020, the strategy has increased in value by £7.5m. The currency hedge ratio on the overall equity portfolio is approximately 75%.

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

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. 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 as a result of Brexit uncertainty.

5.00	APPENDICES
5.01	Appendix 1 - Monthly monitoring report – August 2020

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, Head of Clwyd Pension **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