| CLWYD PENSION FUND COMMITTEE | |
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| **Date of Meeting** | Wednesday, 20 March 2024 |
| **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. Separate reports covering these areas for the period ending 31 December 2023 are attached as appendices to this report.

**Economy and Markets**

- The Federal Reserve and the Bank of England kept interest rates stable over the quarter. Headline UK inflation fell from 6.7% in September to 4.0% in December. Bond yields fell sharply over the quarter driven by expectations of rate cuts in 2024.
- Global equities posted strong performance over the quarter returning +6.3%, whilst fixed interest and index-linked gilts returned +14.4% and +10.5%, respectively.

**Performance Monitoring Report**

- The Fund's total market value increased by £161m to £2,390.2m over the three month period.
- Fund performance over 3 months, 12 months, 3 years and 5 years; +7.8%, +9.6%, +4.9% p.a. and +6.6% p.a., respectively.

**Funding and Risk Management**

As at 31 December 2023:

- The estimated funding position was 108%, which is ahead of the expected funding level from the 2022 valuation by 4%.
- The total gain since inception of the synthetic equity strategy was c. £131.3m.
- Overall, the action to hedge the Fund's developed equity currency risk has resulted in a loss of £25.6m 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.
- The yield trigger framework is currently suspended.


| RECOMMENDATIONS | |
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| 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** |
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| 1.01 | **Economic and Market Update**<br><br>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:<br><br>• **Economic and Market Background** – an overview of markets in the quarter, including commentary on key economic indicators<br>• **Equity Market Review** – information on the performance of equity markets during the quarter and key drivers of markets<br>• **Bond Market (Fixed Income) Review** – provides an update on bond yield movements and interest rates for the period<br>• **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 | The fourth quarter of 2023 started with low expectations owing to high long-term interest rates and renewed geopolitical tensions in the Middle East. Markets reached their lows near the end of October due to risk-off sentiment. However, in November, slowing inflation in the US and other regions raised hopes that interest rates may have peaked, boosting investor confidence.<br><br>Headline inflation in the UK fell to 3.9% in November from 6.7% in September (although it did tick up to 4.0% in December). The positive inflation momentum was driven by declining energy prices. The Bank of England maintained interest rates at 5.25%.<br><br>Global equities returned 6.3% in sterling terms and 9.3% in local currency terms as sterling appreciated against the dollar.<br><br>UK real yields fell across the entire curve, led by lower-than-expected inflation updates, which drove more rate cuts for shorter-term interest rates. UK inflation remains considerably above target. Market based measures of inflation expectations, in the form of breakeven inflation fell significantly over the quarter. The UK 10-year breakeven rate finished the quarter at ~3.48% (c.35bps down over the quarter). |
| 1.03 | **Performance monitoring report**<br><br>Over the three months to 31 December 2023, the Fund's total market value increased by £161m to £2,390.2m, allowing for net cashflows.<br><br>Movement over the 12 month period saw positive performance from all asset classes with the exception of property.<br><br>Since the end of Q4 2023, at the time of writing, gilt yields have risen. |

Further information on the CRMF mandate is provided in 2.0 below.

1.04 The performance against benchmark is shown below:

| Total | Quarter (%) | 1 Year (% p.a.) | 3 Years (% p.a.) | 5 Years (% p.a.) |
|---|---|---|---|---|
| **Total Fund** | **+7.8** | **+9.6** | **+4.9** | **+6.6** |
| Total Benchmark | +7.5 | +13.3 | +4.8 | +6.5 |

A full performance breakdown of each of the underlying mandates is provided in Appendix 2.

Over the quarter both of the Fund's equity mandates with WPP marginally underperformed their respective benchmarks, whereas the Multi-Asset Credit mandate outperformed.

The Fund's 1 year performance was lower than the benchmark. This was primarily caused by private market returns lagging behind their respective benchmarks, which are predominately absolute or Cash + in nature. Most notably the Fund's Property, Private Equity and Private Debt mandates underperformed their respective benchmarks by 15.5%, 7.3% and 4.5%. The listed equity portfolio also detracted from relative performance over the 1 year period, underperforming its benchmark by 3.5%.

The declines in long term interest rates over Q4 2023 have decreased the Fund's discount rate, leading to an increase in the value of the Fund's liabilities. However, the Fund's funding level has improved over the quarter, mainly due to strong absolute equity returns.

Overall, the estimated funding position at 31 December 2023 of 108% is ahead of the expected position when measured relative to the 2022 valuation expected funding plan.

1.05 The strongest absolute returns over the quarter from return seeking assets came from the WPP Infrastructure (12.2%) allocation and the WPP Sustainable Active Equity (6.5%) fund.

The liability hedging portfolio increased by 22.3% over the quarter to 31 December 2023, as real yields fell sharply.

Over the 12 months to 31 December 2023, the Cash and Risk Management Framework generated the strongest returns of 25.0%. WPP Multi-Asset Credit fund and Total Equities also generated strong positive returns of +10.3% and +9.1%, respectively for the period.

1.06 All portfolio allocations are within the agreed strategic tolerance with the exception of the WPP Sustainable Active Equity mandate, which is underweight, and the CRMF, which is overweight. These tolerances are being addressed as part of the interim investment strategy review.

1.07 **Update on Funding and the Flightpath Framework**

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| | The monthly summary report as at 31 December 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 was 108% at 31 December 2023, which is ahead of the expected position when measured relative to the 2022 valuation expected funding plan by 4%. 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.<br><br>A 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 framework for implementing any agreed actions upon achieving the 110% is currently being reviewed by the Committee (agenda item 5). |
| 1.09 | The level of liability 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.<br><br>Collateral remains in a healthy position, with the portfolio able to withstand an interest rate rise in excess of 5%, whilst supporting suitable stresses on the other hedging exposures (equity and FX), other assets. The level of collateral is stronger than guidance issued by the Pensions Regulator. The Fund has a robust governance framework to regularly monitor collateral levels and take action quickly as needed. Further liquidity can be sourced from liquid assets held outside the Insight mandate at short notice, if required.<br><br>Following falls in gilt yields in late Q4 2023 that increased the level of collateral, it was agreed to disinvest £50m from the Insight LDI portfolio to be used for liquidity purposes within the Fund. |
| 1.10 | 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.<br><br>The remaining assets in the Cash Plus Fund (comprised solely of the Insight Secured Finance II Fund) were sold as at 30 September to help fund the allocation to WPP Sustainable Equity in line with the agreed strategy. |
| 1.11 | **Update on Risk Management Framework**<br><br>**Synthetic equity and equity protection strategy**<br><br>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 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.<br><br>Importantly, over the longer-term the increased certainty from the equity |

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| | protection strategy 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.<br><br>The Fund has a bespoke synthetic equity and equity protection strategy, which is implemented through a Total Return Swap ("custom 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 May 2024 and can be rolled over if required.<br><br>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.<br><br>As at 31 December 2023, the total performance since inception of the custom TRS synthetic equity and equity protection strategy in May 2018 was an increase of c. £131.3m. |
| 1.12 | **Currency hedging gain/loss**<br><br>The currency risk associated with the market value of the synthetic equity strategy is hedged and has made a loss of £18.4m since inception on 8 March 2019 to 31 December 2023 due to the weakening of sterling over that period, particularly versus the US dollar.<br><br>The Fund's overseas developed market physical equity holdings are currency hedged and have made a loss of c. £7.2m since inception of the strategy due to the material weakening of sterling versus the US dollar over that period.<br><br>Overall, the action to hedge the Fund's developed equity currency risk has resulted in a loss of £25.6m 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. |

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

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

| 4.00 | **RISK MANAGEMENT** |
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| 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.<br><br>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):<br>• Governance risk: G2<br>• 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. 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** |
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| 5.01 | Appendix 1 – Economic and Market Update – 31 December 2023<br>Appendix 2 – Performance Monitoring Report – 31 December 2023<br>Appendix 3 – Monthly Monitoring Report – 31 December 2023 |

| 6.00 | **LIST OF ACCESSIBLE BACKGROUND DOCUMENTS** |
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| 6.01 | • Report to Pension Fund Committee – Overview of risk management framework – Previous monthly reports and more detailed quarterly overview.<br><br>**Contact Officer:** Philip Latham, Head of Clwyd Pension Fund<br>**Telephone:** 01352 702264<br>**E-mail:** philip.latham@flintshire.gov.uk |

| 7.00 | **GLOSSARY OF TERMS** |
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| 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

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| | period expressed in percent per annum.<br><br>(o) **Time-Weighted Rate of Return –** The rate of return on an investment removing the effect of the amount and timing of cash flows.<br><br>(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)<br><br>(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.<br><br>(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.<br><br>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/ |