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AVON PENSION FUND – BOND ASSETS REORGANISATION

Background

At the September 2015 Panel meeting, it was agreed that the Fund's current holdings in Fixed Interest Gilts (c. 3% of the Fund's assets) and Overseas Government Bonds (a further c. 3% of the Fund's assets) would be switched to passively managed Index Linked Gilts in order to better match the nature of the Fund's liabilities (which are predominantly inflation linked).

While the current Statement of Investment Principles permits a modest increase in the Fund's Index Linked Bond holdings, the agreed switch would require a revised benchmark allocation to this asset class. This paper sets out a proposal to Committee for this change, together with the rationale for doing so, and provides a summary of the next steps on implementation.

Current benchmark allocation and ranges

The table below sets out the current benchmark asset allocation, together with permitted ranges:

Asset class	% of Fund	Range
Growth assets	**80%**	**65-85%**
Equities	50%	45-55%
Developed	40%	35-45%
Emerging	10%	5-15%
Diversified Growth Funds	10%	5-15%
Illiquid Growth	20%	15-25%
Hedge Funds	5%	0-7.5%
Property	10%	5-15%
Infrastructure	5%	0-7.5%
Other Growth	0%	0-5%
Stabilising Assets	**20%**	**15-35%**
Government Bonds	3%	0-10%
Index Linked Bonds	6%	3-10%
Corporate Bonds	8%	4-20%
Other (Overseas) Bonds	3%	0-5%
Cash	**0%**	**0-5%**

In order to implement this switch from fixed interest and overseas government bonds to Index Linked Gilts, Panel requests that the benchmark allocation is adjusted to reflect this change. While it could arguably be permitted under the current benchmark by widening the permitted ranges, this is a long-term switch for risk management purposes, and it is therefore more appropriate to reflect this via the central benchmark allocation. Panel proposes retaining a benchmark allocation of 0% to fixed interest gilts and overseas government bonds, with the existing permitted ranges, to allow future flexibility.

In addition, in order to increase the benchmark allocation to Index Linked Bonds to 12%, Panel requests that the permitted range for Index Linked Bonds is shifted from 3-10% to 9-15% (to permit some leeway around the 12% allocation to avoid unnecessary rebalancing, and to allow the full allocation of up to 35% in stabilising assets to be utilised if the maximum 20% is held in corporate bonds).

Finally, Panel proposes renaming the “Government Bond” and “Index Linked Bond” allocations to “Fixed Interest Gilts” and “Index Linked Gilts” to more accurately reflect the stabilising asset allocations.

Recommendation

Panel therefore requests that Committee approve a change to the benchmark allocation, permitted range of holdings and nomenclature for the stabilising asset portfolio, as follows:

Asset class	% of Fund	Range
Stabilising Assets	**20%**	**15-35%**
Fixed Interest Gilts	0%	0-10%
Index Linked Gilts	12%	9-15%
Corporate Bonds	8%	4-20%
Other Bonds	0%	0-5%
Cash	**0%**	**0-5%**

Rationale

The vast majority of the Fund’s projected pension payments have a direct linkage to inflation, while the direct inflation protection provided by the assets is limited at present.

Returns on index linked bonds are linked to inflation and therefore provide a better match to the liabilities than fixed interest bonds, which do not have this linkage In addition, the current fixed interest bonds are shorter duration (i.e. less sensitive to changes in interest rates) than the Fund’s liabilities, while the overseas bonds also introduce currency risk.

Increasing the holdings in Index Linked Gilts will therefore improve the matching characteristics of the stabilising assets against the liabilities with no reduction in the expected return on assets that would result in an increase in contribution requirements.

The proposed switch will also help expedite any future move to improve the level of liability protection through the use of leverage (an area the Panel is currently discussing and on which they will report back to Committee in 2016).

Implementation

Officers and Mercer are currently working with BlackRock to propose a segregated passively managed index-linked gilt portfolio to broadly match the Fund's liability profile. This will be implemented as efficiently as possible, with regard to both direct implementation costs and the timing of the switch from fixed-interest bonds to reflect inflation expectations.

Steve Turner
October 2015

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