Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**2 September 2019**	**AGENDA ITEM NUMBER**
TITLE:	**Annual Review of Risk Management Strategies**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Exempt Appendix 1 – Mercer Report – TO FOLLOW		

1 THE ISSUE

1.1 The Risk Management Framework encompasses three dedicated risk management strategies and a passive equity fund for collateral management purposes. The Liability Driven Investment (LDI) Strategy and the Buy-and-Maintain Corporate Bond (CB) Portfolio are designed to hedge interest rate and inflation risks arising from the Fund's liabilities, whereas the Equity Protection Strategy (EPS) is designed to shield the Fund from a large drawdown in the value of its underlying equity holdings. These strategies are linked to the funding strategy and de-risk the Fund by placing less reliance on growth assets to fund future pension benefits and to simultaneously protect the Fund's current funding position.

1.2 The Investment Panel reviews the strategies annually to assess whether there has been a material change in market conditions which requires an adjustment to any of the strategies to ensure they meet the strategic objectives. The annual review also considers any financial implications on the portfolio, specifically an increase in the collateral requirements. Any recommendation from the Panel to change a strategy requires approval by the Committee.

1.3 The Committee has delegated monitoring to the Investment Panel. The Panel monitors the collateral adequacy, the performance of the strategies and the performance of the manager, Blackrock.

1.4 Mercer will present their report at the meeting.

2 RECOMMENDATION

The Avon Pension Fund Investment Panel is asked to:

2.1 **Note Mercer's report reviewing the strategies and collateral position.**

2.2 **Recommend to the Committee that the existing trigger framework for the LDI strategy should be maintained.**

2.3 **Note Mercer's recommendation to put in place another static EPS for the short term (12-18 months) once the current strategy begins to roll off, before evolving the strategy into a longer-term dynamic approach. The Committee should be asked to consider these recommendations following the second Investment Strategy Review Workshop on 7 November 2019 and, if in**

agreement, delegate implementation of the new static EPS to the Investment Panel and Officers.

3 FINANCIAL IMPLICATIONS

3.1 The risk management strategies have been implemented to provide greater certainty that the funding plan will be achieved and therefore contribution levels will be stable and minimised. Any changes to the framework can affect the level of employer contributions in the future.

4 ANNUAL REVIEW OF LDI STRATEGY

4.1 The LDI strategy seeks to hedge real interest rates, in order to increase the certainty that the real returns assumed in the funding plan will be achieved.

4.2 The aim is to lock in attractive real yields (‘trigger points’). As the real yield is determined by nominal interest rates and inflation expectations – which move independently of one another – It is important to keep these under review for appropriateness as each can be hedged independently. The current objective is to hedge up to 70% of the assets as market conditions allow and there is a trigger framework in place, reflecting the market conditions when set, to achieve this hedge ratio.

4.3 This strategy utilises unfunded hedging instruments meaning there is limited or no initial outlay of capital to put the hedging in place. However, these instruments fluctuate in (mark-to-market) value through their life to maturity and must be supported by collateral, in the form of assets that can be sold to meet mark-to-market requirements. The collateral held by the Fund must be monitored to ensure there is enough to support the strategy.

4.4 At the last review the Panel recommended no change to the trigger framework in light of the long term nature of the strategy and the view that interest rates should start to rise over time.

4.5 Exempt Appendix 1 explains how the strategy has evolved over the last 12 months.

4.6 As per last year, the possible refinements are:

a) Increase the interest rate hedge ratio to be in line with the inflation hedge ratio

b) Lower the interest rate triggers to increase the probability of implementing them

Over the last year, interest rates have fallen, whilst preliminary valuation results indicate the Fund is still in a deficit, so both of the above actions would likely have negative implications for the discount rate and funding position, compared to the current framework. Therefore, the recommendation from Mercer is that no immediate changes should be made to the framework or the level of hedging in place.

4.7 The strategy will continue to be monitored closely so that options to increase the interest rate hedge or revise the trigger levels are reviewed when the funding level reaches 100%.

5 ANNUAL REVIEW OF EQUITY PROTECTION STRATEGY

5.1 The EPS is structured to protect the Fund from a sharp drawdown in equity valuations over the 2019 triennial valuation period as equities, although comprising c.40% of assets, contribute c.60% of downside risk (measured by Value at risk or VaR). The EPS will pay out a cash amount to compensate for any significant falls in the equity market and simultaneously allow the Fund to participate in upside gains to a predetermined level or ‘cap’.

5.2 The strategy sits within the pooled vehicle (‘QIF’ or Qualifying Investor Fund) established for the LDI strategy. To reduce the risk of the Fund having to sell assets at short notice to meet its obligations under the collateral agreements, units of a passively managed pooled equity fund are held within the QIF which will be sold and converted into eligible collateral in order to meet collateral calls as they arise. Should this situation materialise, derivatives will be used to replicate the equity assets sold in order that the strategic exposure to equities is maintained.

5.3 Exempt Appendix 1 explains how the strategy has evolved since inception.

5.4 The current strategy is due to expire in Q1 2020 so a decision is needed as to whether or not to continue with the EPS, and if so how it should be structured. The recommendation from Mercer is that the EPS should become a long-term component of the strategy and be evolved into a dynamic open-ended structure, given the Fund’s exposure to equity market risk. However, given the additional complexity of a dynamic approach and time needed to do the necessary Panel training and implementation work, the proposal from Mercer is to implement another static EPS for the short term (12-18 months) once the current strategy begins to roll off, before moving to a longer-term dynamic structure.

5.5 The Committee will need to first agree if and how an EPS should be incorporated in the Fund’s strategy going forward, following the second Investment Strategy Review Workshop on 7 November 2019. Subject to the Committee agreeing to continue with an EPS, implementation of the new static EPS should be delegated to the Investment Panel and Officers.

6 ANNUAL REVIEW OF CORPORATE BOND BUY-AND-MAINTAIN STRATEGY

6.1 During 2019, Blackrock were instructed to implement a buy-and-maintain corporate bond portfolio as part of a bespoke cash flow matching strategy for the Fund’s low-risk liability bucket.

6.2 The strategy was implemented in May 2019 at a cost of £76k to the Fund. The strategy was funded using a combination of legacy corporate bond holdings and cash in the QIF.

6.3 An annual review along with an in-depth review will be undertaken after each valuation or when a large liability falls into scope for the low-risk bucket upon termination.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 CLIMATE CHANGE

8.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and addresses this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 The issues to consider are contained in the report.

10 CONSULTATION

10.1 The Council's Section 151 Officer has had the opportunity to input to this report and have cleared it for publication.

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Background papers	Mercer Papers
Please contact the report author if you need to access this report in an alternative format	