Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**5 AUGUST 2020**	**AGENDA ITEM NUMBER 8**
TITLE:	**EQUITY PROTECTION STRATEGY – TRANCHE 3 ROLLOVER & DYNAMIC HEDGING IMPLEMENTATION**	
WARD:	**ALL**	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Exempt Appendix 1 – Mercer Paper: Equity Protection Strategy Options		

1 THE ISSUE

1.1 The Investment Panel have delegated authority to consider the suitability of, and if deemed appropriate, implement a dynamic equity hedging strategy. As part of this process the Fund's current static strategy was extended in 1Q20 as an interim solution to allow the Panel time to consider the technical details and implementation options of a dynamic strategy.

1.2 Two tranches of the current strategy were rolled before March 2020; the third tranche was rolled for a shorter period of time as a result of the extreme market volatility experienced during March. Panel are asked to agree whether to roll tranche 3, aligning expiry with the prior two tranches, or to let it expire and accept that c.1/3rd of the Fund's equity holdings will remain unhedged while further work on dynamic hedging is undertaken.

1.3 In light of the significant equity market rebound since the final tranche was extended in March 2020 and persistent macroeconomic uncertainty as a result of COVID-19, the recommendation is to roll tranche 3 for a period that would bring it into alignment with the overall protection strategy. Details of the rollover of tranche three are set out by Mercer in Exempt Appendix 1 to this report.

1.4 In addition, the Panel has been tasked with assessing the suitability of dynamic hedging as a long-term alternative to static hedging. This involves an assessment of the governance, cost and risk implications of switching to such a strategy.

2 RECOMMENDATIONS

That the Avon Pension Fund Investment Panel agrees:

2.1 **To rollover tranche 3 of the equity protection strategy for a further period (set out on Page 8 of Exempt Appendix 1) to align with the prior two tranches, and to delegate the implementation to Officers and Mercer.**

2.2 **Which of the dynamic equity protection approaches set out Exempt Appendix 1, Page 19, best achieves the Fund's objective (to implement when the current static structure expires in 2021).**

2.3 **To delegate the design of the dynamic strategy to Officers and Mercers which will be brought to the November Panel meeting for discussion.**

3 BACKGROUND TO EQUITY PROTECTION STRATEGY

3.1 The Equity protection strategy protects the funding position of the Fund and is an important strategy to maintain affordability of contributions for scheme employers.

3.2 A static strategy was implemented initially to provide protection over the 2019 triennial valuation. The 2019 strategic review concluded that given the funding level was nearing 100%, protecting the funding position remained a longer-term objective and the static strategy was rolled over until options for more effective implementation using a dynamic strategy are considered.

3.3 The main benefit of a dynamic approach is its ability to reduce the variance in outcomes versus a static approach and lower ongoing governance. The value of a static approach at its rollover date is entirely dependent on market conditions at that time whereas a dynamic approach has multiple expiries resulting in greater control of volatility in equity portfolios over the long-term.

4 STATIC VERSUS DYNAMIC APPROACHES TO EQUITY PROTECTION

4.1 When considering which approach to implement, the key considerations are:

(1) Complexity of instruments used – static can be implemented via relatively simple option structures; dynamic can use options or more complex total return swap structures.

(2) Timing risk (impact of timing on the success of the strategy) – a static approach is exposed to timing risk; dynamic reduces this risk, the more frequent the ‘rolling’ the more the risk is reduced.

(3) Additional risks and how they can be mitigated – both have counterparty risk that needs to be managed.

(4) Costs, implementation and ongoing – costs for a static are known at the outset and then at each roll over plus there are advisory costs at each rollover; dynamic will incur ongoing transaction costs but have lower advisory costs.

(5) Governance burden – once a dynamic structure is agreed the governance burden is lower as roll-over decisions are not required.

4.2 The drawbacks of the static approach were highlighted at expiry of the final tranche in March 2020, where the fall in markets meant that the upside cap on the rollover structure was lower. A dynamic structure implements a rolling programme of protection which seeks to trade little and often, with the protection adapting to market conditions over time; this way it reduces timing risk.

4.3 A dynamic approach mitigates the governance burden associated with a static approach as the strategy is implemented using a rules-based method to avoid the need for repeat decision-making.

4.4 Any decision to pursue a dynamic approach should be weighed against the added complexity of initial set-up of such an approach. Members should be comfortable that the payoff of this approach is less certain as there is no finite expiry, rather it is dependent on the evolution of markets for the duration that the strategy is in place.

4.5 Where a static approach seeks to hedge the entire underlying equity exposure in a single contract, a dynamic approach breaks the exposure down into incremental amounts which means in upward trending markets, the average protection will increase over time and therefore reduce timing risk. Equally, in downward trending markets the protection adjusts, protecting the Fund from further equity market falls. As both dynamic and static approaches hedge the same total notional amount, transaction costs are expected to be very similar across both strategies.

5 IMPLEMENTATION CONSIDERATIONS

5.1 Mercer have put forward two dynamic implementation options for consideration. A ‘manager-led’ and a ‘bank-led’ approach. These are explained in more detail in Exempt Appendix 1.

5.2 The ‘manager-led’ approach is akin to the rolling the current approach for static options periodically and for this reason represents a lower governance burden in its initial set-up. It also benefits from using a diverse set of counterparties to ensure risk is not overly concentrated in any one institution. However, timing risk will still occur depending on the frequency of the periodic rollovers.

5.3 A ‘bank-led’ approach entails the appointment of a single counterparty bank who would design a custom index to replicate the buying and selling of the Fund’s defined options strategy, which the Fund would then gain exposure to via a total return swap. Daily collateralisation protects the Fund from counterparty default (in such an event the Fund would receive the current market value of the protection strategy). Re-implementing the strategy under such a scenario would require another bank to build an identical index and agree to the same terms e.g. fixed transaction costs.

5.4 Transaction costs are expected to be similar across both approaches. Ongoing management fees are expected to be higher under the ‘manager-led’ approach given the resource required to successfully implement a periodic rolling programme.

6 FINANCIAL CONSIDERATIONS

6.1 The static option rollover costs will be

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. An Investment Panel has been established to consider in greater detail investment performance and related matters, and to carry out responsibilities delegated by the Committee.

7.2 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund’s future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund.

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 in line with the Council’s Climate Strategy. The Fund acknowledges the financial risk to its assets from climate change and is in the process of addressing this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

9 EQUALITIES

9.1 An EIA is not required given the technical nature of the issues being considered.

10 OTHER OPTIONS CONSIDERED

10.1 None.

11 CONSULTATION

11.1 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	