Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**20 November 2020**	**AGENDA ITEM NUMBER**
TITLE:	**Dynamic Equity Protection: Strategy Design**	
WARD:	**ALL**	
OPEN		
List of attachments to this report: EXEMPT Appendix 1 – Mercer Paper: Dynamic Equity Protection Strategy Design		

1 THE ISSUE

1.1 The Fund currently uses a static hedging structure. At its August meeting Panel agreed to implement a bank-led dynamic approach that uses a total return swap (‘TRS’) on a custom index. This approach seeks to build on the principles of the static structure i.e. offers the fund downside protection and finances this protection by giving a certain percentage of upside away. The main differences of a dynamic approach versus the existing static structure is that it trades ‘little and often’, seeking to limit timing risk, reduce volatility and improve overall risk-adjusted returns.

1.2 One of the significant challenges of implementing a dynamic structure is measuring its success. Benchmarking a static structure is relatively simple given that it has a finite life and its value is determined on a single expiry date. With a dynamic strategy the most intuitive way of presenting performance is to show the extent to which it has either added or detracted from equity market returns and how it has served to reduce volatility over a given period of time.

1.3 This paper considers the strategy design of a dynamic protection strategy, the performance of the strategy under various market scenarios as well as finer implementation points. Mercer will present their report at the meeting (see Exempt Appendix 1). Following this meeting Officers will continue to work with Mercer to refine the strategy, which will include the appointment of a counterparty bank, in order to meet the target implementation date in 2021.

2 RECOMMENDATION

That the Panel:

2.1 **Agrees to implement the bank-led dynamic equity protection strategy by using a “Put Spread Calendar Collar” structure and agrees the design parameters as set out in Exempt Appendix 1.**

2.2 **Delegates the implementation of the strategy, including the appointment of a bank counterparty, to Officers and Mercer.**

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 DYNAMIC PROTECTION STRUCTURES: STRATEGY DESIGN

4.1 Mercer have run a number of back-tests across different timeframes and using various dynamic implementation approaches to arrive at a recommendation that optimises risk-adjusted returns. The three main approaches include:

1. **Put spread** – offers ongoing protection with no limit to upside participation although a ‘premium’ is payable by the Fund.
2. **Put spread collar** – Same structure as the existing static approach where the protection is financed by giving away equity market gains beyond a certain point. This approach is structured to incur a nil upfront cost or ‘premium’.
3. **Put spread calendar collar** – Similar to option (2) but involves selling the upside more frequently to generate income (in the form of ‘premium’ received) while fulfilling the main objective of reducing volatility.

4.2 Mercer recommend implementing a Put spread calendar collar.

5 PUT SPREAD CALENDAR COLLAR: DESIGN CONSIDERATIONS

5.1 The main issues that will need to be considered as part of the recommended approach will be;

I. The increase in transaction costs that arise from more frequent trading relative to the potential to earn greater risk-adjusted returns under a put spread calendar collar approach.

II. Fixing the level of upside participation at inception of the strategy and the impact on the Fund’s required equity return.

III. Consideration of the initial complexity involved in the set-up phase relative to the reduced ongoing governance burden that comes from adopting a dynamic approach.

IV. The risk that the premium collected under a put spread calendar collar approach is insufficient to offset the cost of downside protection.

5.2 These risks are assessed in detail in Exempt Appendix 1 and are used to inform the parameters of the recommended structure.

6 RISK MANAGEMENT

6.1 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.

7 CLIMATE CHANGE

7.1 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, Sustainable Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

8 EQUALITIES

8.1 A proportionate equalities impact assessment has been carried out using corporate guidelines and no significant issues have been identified.

9 OTHER OPTIONS CONSIDERED

9.1 None.

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	None.
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