Bath & North East Somerset Council

MEETING:	**LOCAL PENSION BOARD - AVON PENSION FUND**	
MEETING DATE:	**23 May 2023**	**AGENDA ITEM NUMBER**
TITLE:	**INVESTMENT AND FUNDING STRATEGY UPDATE**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: None		

1 THE ISSUE

1.1 Every three years the Fund is required by the regulations to undertake a triennial valuation which sets the long-term funding strategy. As future investment returns are a key component of the funding strategy, the investment strategy is also reviewed to ensure it can deliver the expected return.

1.2 This report summarises:

a) The outcome of the 2022 actuarial valuation

b) Revised investment strategy agreed by the Pensions Committee in March 2023.

2 RECOMMENDATION

2.1 The Board notes

a) The outcome of the actuarial valuation

b) The revised investment strategy.

3 FINANCIAL IMPLICATIONS

3.1 There are no direct implications related to the Pension Board in connection with this report.

4 ACTUARIAL VALUATION 2022

4.1 The actuarial valuation assesses the funding position of the Fund as a whole, as well as for each individual employer and sets the contribution rates due from all employers for the 3 years commencing 1 April 2023.

4.2 The LGPS regulations require each administering authority to prepare and publish a Funding Strategy Statement (FSS) which the actuary must have regard to as part of the valuation process. The 2022 FSS was agreed by the Pension Committee in September 2022 following a consultation with employers and the Pension Board. It sets out all the key assumptions which the Actuary will use in preparing the actuarial valuation, together with the Administering Authority's policies in the areas where it has discretion to manage the funding position of the Fund.

4.3 The long-term funding objective is to achieve 100% solvency over a reasonable length of time and have a funding plan that will maintain this position. As market conditions change between valuations, the assumptions may need to change at subsequent valuations in order to meet this objective; hence contribution rates will vary from one valuation to the next. The Fund's approach is that the assumptions used will be chosen with sufficient prudence for this objective to be reasonably achieved in the long term at every valuation.

4.4 Alongside this overarching objective, employer contributions are set to achieve long-term cost efficiency, meaning the funding plan must provide equity between different generations of taxpayers. Therefore contributions must not be set at a level that is likely to give rise to additional costs to future taxpayers or that put too high a burden on current taxpayers. Given the difficult economic and public sector funding environment at the time of the 2022 valuation, significant consideration was given to both the solvency and long-term cost efficiency objectives.

4.5 The current valuation at 31 March 2022 has concluded and a summary of the outcome is in the table below.

Fund Outcome:

	2019	2022
Deficit	£284m	£238m
Funding Level	94%	96%
Value of assets	£4,818m	£5,822m
Value of Liabilities	£5,102m	£6,020m
Average employee contribution rate	6.4% of pay	6.4% of pay
Average future service rate (employer)	17.2% of pay	18.6% of pay
Past service recovery period (years)	13	12

4.6 The main drivers of the valuation outcome are:

a) The average deficit recovery for the Fund has reduced from 13 years in 2019 to 12 years in 2022 which is line with the medium-term target.

b) The investment return over the 3 years to 31 March 2022 was approximately 6.5% p.a. compared to an expected return in 2019 of 4.15% p.a. resulting in the assets being £384m higher than projected at 2019.

c) The discount rate used to value the past service a liability is based on the expected return on the assets relative to CPI. At 31 March 2019 the equivalent discount rate was CPI +1.75% p.a. This was reduced to CPI +1.50% in 2022 due to a fall in investment return expectations. This compares to a best estimate for investment returns of CPI+2.5% which shows the degree of prudence built into the assumptions.

d) The fall in return expectations has also affected the Future Service Rate (FSR). The 2019 discount rate of CPI +2.25% was reduced to reflect the challenging economic outlook at 31 March 2022, in particular headwinds from inflation and therefore pressure on the real return outlook and increased risk of stagflation in the near term. Therefore the discount rate for future service was reduced to CPI + 2.00% p.a.

e) At each valuation the actuary uses an analysis of the life expectancy experienced by the Fund and other LGPS funds alongside improvement trend models from the Continuous Mortality Investigation (CMI) to assess the adequacy of the longevity assumptions. The longevity assumption is made up of two elements, the current life expectancy (or baseline assumption) and an assumption of future improvement / deterioration around the baseline assumption. The baseline assumption for the 2022 valuation reflects the Fund's mortality experience since 2019. For the long-term life expectancy improvement assumption, the latest 2021 CMI tables have been used which show a slowing in the rate of improvement evidenced by mortality data. As a result, the higher mortality has reduced liabilities overall.

f) Whilst the final McCloud remedy regulations are awaited, in line with guidance issued by DLUHC, an allowance for the cost of the McCloud remedy is included in the liabilities, resulting in an increase of c1.1% at the Fund level. There is no impact on the FSR as the extension to the final salary underpin to CARE benefits ceased in respect of benefits earned from 1 April 2022.

g) Overall the changes in the financial and demographic assumptions have increased the average FSR by 1.3% of pay p.a. The impact of the change in membership profile (and other factors) is an increase of 0.1%, giving an overall average increase in the FSR of 1.4% of pensionable pay.

4.7 The 2022 valuation report was published by the 31 March 2023 regulatory deadline.

5 REVISED INVESTMENT STRATEGY

5.1 The Investment Strategy is designed to achieve the long-term funding objective, which is to generate returns to meet the Fund liabilities with an acceptable level of risk. The 2022 strategic investment review was undertaken at a challenging time for investment markets. Therefore the strategic focus re-examined the overall level of return and risk, the role of Risk Management Strategies in the overall policy framework and our net zero/climate targets.

5.2 The Strategic review was split into 2 phases with the 1st phase concentrating on risk and return and the 2nd on climate analysis and targets.

Phase 1 (1Q23) covered

a) The macro environment and implications for risk and returns and the role of LDI within the strategy

b) Are there any new opportunities for the Fund to consider? e.g. Social Impact Investing

c) Specific portfolio actions

Phase 2 (4Q23) will cover

a) The Fund’s 2023 climate analysis

b) Net zero targets

To ensure our climate analysis uses the latest and most comprehensive available data, we will use Dec 2022 data which will not be completed until 2Q23. Therefore the consideration of the Net Zero targets is delayed concluding in 4Q23 when the Pensions Committee will agree the new targets. Prior to the targets being set we will informally engage with stakeholders including the Pension Board in September.

5.3 Rising inflation and interest rates during 2022 focussed Phase 1 of the review on the impact of higher inflation and interest rates on future pension promises, expected returns, the Liability Driven Investing (LDI) strategy and the economic outlook.

5.4 The review explored potential asset allocation options to meet the risk return profile required to support the funding objective. The preferred asset allocation is set out in the table below:

Asset Class	Portfolios	Current Allocation	Target Allocation	Strategic Range
Equities		**41.5%**	**41.5%**	**36.5-46.5%**
	Global Equity	16.5%	10.5%	5.5-15.5%
	Global Sustainable Equity	15.0%	10.5%	5.5-15.5%
	Paris Aligned Equity	10%	20.5%	12.5-28.5%
Liquid Growth		**12.0%**	**12.0%**	**7.0-17.0%**
	Diversified Returns Fund	6.0%	6.0%	3.0-9.0%
	Multi Asset Credit	6.0%	6.0%	3.0-9.0%
Illiquid Growth & Income		**32.5%**	**32.5%**	**n/a**
	Core Property	7.5%	7.0%	
	Secured Income	10.0%	9.0%	
	Core Infrastructure	5.0%	4.0%	
	Renewable Infrastructure	5.0%	5.0%	
	Private Debt	5.0%	4.5%	
	Local, Social Impact	0.0%	3.0%	
Fixed Income		**14.0%**	**14.0%**	**n/a**
	Liability Driven Investments	12.0%	12.0%	
	Corporate Bonds	2.0%	2.0%	
Cash		**0.0%**	**0.0%**	**0.0-5.0%**
		100.0%	100.0%	

5.5 The revised strategic allocation is based on the following:

a) Risk Appetite: The Committee concluded that to maintain as stable as possible employer contributions, increasing returns and therefore risk was not warranted given the funding objective and funding level.

b) Preferred strategic benchmark: The current strategic benchmark allocations between equities, liquid and illiquid growth assets, and fixed income achieves the appropriate balance of risk and return to provide stability of contributions.

c) Diversification: The liquidity analysis concluded that the Fund was nearing its maximum allocation to illiquid assets. Therefore alternative allocations between equities and other liquid growth assets did not improve the risk and return expectations sufficiently to warrant changing allocations.

5.6 The main asset allocation change is the initial target allocation of 3% to Local, Social Impact assets. This would be funded from the 32.5% already held in illiquid assets. The focus of the portfolio will be the South West which is a sufficiently local regional footprint as restricting to the Avon area could be too narrow to have sufficient impact through a diversified portfolio. National opportunities would also be considered to provide greater flexibility to meet the investment objectives.

5.7 In addition the allocation between actively and passively managed equities was reviewed as it had drifted over time. The revised 50/50 split lessens the exposure to the inconsistency of active management, provides greater diversification of underlying holdings within the equity portfolio (as the active portfolios are concentrated), provides for a more systematic decarbonisation (as investing in Paris Aligned (PAB) Passive fund), and at same time achieves investment return and climate objectives. The Committee acknowledged that although lower cost than active, passive investing gives up potential excess returns generated by active management.

5.8 The LDI market issues in September 2022 highlighted the increasing complexity and regulatory requirements of managing LDI portfolios. An in-depth review of the LDI strategy will be undertaken by the Panel during 2023 to assess the contribution to risk reduction and the funding strategy as well as the implications of the more prudent collateral requirement on collateral management policy

5.9 The Investment Strategy Statement was updated following the review. It will be further updated once the LDI and Climate reviews have concluded.

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. In addition, it monitors the benefits administration, the risk register and compliance with relevant investment, finance and administration regulations.

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 in line with the Council's Climate Strategy. The Fund acknowledges the financial risk to its assets from climate change and is addressing this through its strategic asset allocation to Paris Aligned Global Equities, Sustainable Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Pensions Committee and the Fund's climate targets are being reviewed and will be changed before the end of 2023.

8 EQUALITIES

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

9 CONSULTATION

9.1 The report and its contents have been discussed with the Head of Pensions representing the Avon Pension Fund and the Service Director – One West representing the administering authority.

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