Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**
MEETING DATE:	**5 JUNE 2024**
TITLE:	**Liquidity Review**
WARD:	ALL
AN OPEN PUBLIC ITEM	
List of attachments to this report: **Exempt Appendix 1 – Mercer Report: Holistic Liquidity Review**	

1. THE ISSUE

1.1. The Fund's projected cashflow position over the next two years is subject to ongoing benefit payments and existing private markets commitments, which are still being invested and therefore not distributing cash. This requires a prudent approach to liquidity given the timing and uncertainty of private market drawdowns. However, the Fund has a good liquidity position and this paper focuses on how this liquidity should be managed.

1.2. Cash requirements can be partially offset by using current and potential sources of income, including income generated by the UK property and Secured Income portfolios, among others.

1.3. In order to bridge any shortfall (due to timing of capital calls) the Fund can use excess collateral which was released by reducing the equity hedge to 50% in March.

1.4. Exempt Appendix 1 sets out options for redeploying excess collateral outside of the QIF and the associated impact on the Fund's LDI trigger framework.

1.5. The final section of Exempt Appendix 1 discusses possible funding sources for a dedicated Natural Capital allocation.

2. RECOMMENDATION

The Avon Pension Fund Investment Panel:

2.1. **Agrees to keep the LDI trigger framework on pause, noting the Fund's projected cash requirements over the next two years**

2.2. **Assuming 2.1 is approved, delegates how to invest excess collateral to Officers in consultation with Mercer**

2.3. **Delegates the decision to select an appropriate funding source for a Natural Capital allocation to Officers in consultation with Mercer.**

3. FINANCIAL IMPLICATIONS

2.4. Any changes to the risk management framework can affect the level of employer contributions in the future.

2.5. Investment management and advisor fees are provided for in the 2024/25 budget.

4. CURRENT LIQUIDITY POSITION

4.1. Mercer have undertaken a liquidity review exploring current and potential sources of income and how best to use collateral that currently forms part of the Fund's risk management framework.

1.1. The analysis shows that collateral released from the unwind of the equity protection strategy can either be used to reactivate the LDI trigger framework or can be redeployed outside of the risk management framework and used to fund ongoing benefit payments or private markets capital calls.

1.2. On balance Mercer recommend using the excess collateral to reinforce the Fund's cash position. The remaining collateral in the QIF will be sufficient to back the existing interest rate and inflation hedges and significantly above the collateral buffer recommended by the regulator. No further hedging will take place until the trigger framework is reactivated.

1.3. Income is the other source of liquidity and this will become more important as the cashflow matures over time. Income from the private market and property portfolios is already reinvested into those portfolios. Officers will discuss with Brunel whether there are other portfolios or underlying funds that could distribute income and how this could be achieved.

5. EXCESS COLLATERAL – INVESTMENT OPTIONS

5.1. There are a number of options available to the Fund for the reinvestment of excess collateral, which focus on capital preservation and offer daily liquidity terms. Officers will work with Mercer to determine the appropriate allocation between strategies. Options include:

a. BlackRock Exchange-Traded Funds (ETFs) - The Fund has typically used the BlackRock ETF portfolio to manage excess liquidity whilst awaiting private markets drawdowns. This provides market exposure of a similar risk and return profile to the Fund's wider investment strategy and is very liquid. The key drawback of this strategy is its uncertain capital preservation given the risk profile.

b. Liquidity Funds – These funds pay a yield roughly equivalent to the current cash rate of ~5%, are focussed on capital preservation and offer near instant liquidity. The Fund already uses liquidity funds via its custodian (State Street) to invest surplus cash. BlackRock also offer a suite of liquidity funds that would allow them access to the excess collateral at short notice, should the need arise. With interest rates at current levels, liquidity funds are an attractive option.

c. Alternatives to cash – Mercer have explored a number of highly-rated alternatives to holding cash and ETFs, which offer a yield pickup of c.1-1.5% versus cash funds for minimal additional risk. The issue with these funds is their relative immaturity and limited number of underlying investors. For this reason, Mercer do not feel comfortable making a recommendation until a positive track record is established.

6. FUNDING FUTURE PRIVATE MARKETS ALLOCATIONS

1.1. Longer term the Fund anticipates making a dedicated allocation to Natural Capital within its overall 32.5% target allocation to private markets. How we will invest is yet to be determined, however it is useful from a planning perspective to understand potential sources of funding, which could include either a reduction in property or infrastructure.

1.2. Based on current market conditions, existing exposures and the longer-term outlook the most attractive option is to reduce the Fund's legacy overseas real estate portfolio, freeing up capital for Natural Capital without requiring any redemptions from other mandates. Pages 25-30 of Exempt Appendix 1 discusses these options in greater detail.

1.3. In order of priority liquidity will be sourced in the following order (the liquidity waterfall):

a. From the ETF/cash portfolios

b. Rebalancing from overweight allocations to bring exposure back to target

c. LDI Solution depending on the collateral buffer within the portfolio

d. Synthesizing equity portfolios

e. Reduce allocations to liquid assets (least favoured due to impact on expected return and transition costs).

7. RISK MANAGEMENT

7.1. An effective governance structure, defining clear responsibilities, and ensuring that the decision-making body has an adequate level of knowledge and access to expert advice, is a key aspect of the risk management process.

8. EQUALITIES

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

9. CLIMATE CHANGE

9.1. 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 addresses 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 Committee.

10. OTHER OPTIONS CONSIDERED

10.1. None

11. CONSULTATION

11.1. The Head of Pensions has had the opportunity to input to this report and has cleared it for publication.

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