

Pensions Committee**Friday, 1 December 2017, 10.00 am, County Hall, Worcester****Agenda**

Item No	Subject	Page No
8	Equity Protection Strategy	41 - 58
9	Alternatives Investment	59 - 82

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PENSIONS COMMITTEE
1 DECEMBER 2017**EQUITY PROTECTION OPTIONS STRATEGY**

Recommendation

- 1. The Interim Chief Financial Officer recommends that the planned appointment of River and Mercantile to implement a static options equity protection strategy be noted.**

Purpose of the Equity Protection Strategy

2. The Fund's Actuary has calculated that due to the increase in the value of the fund's assets since the actuarial valuation held on 31 March 2016, at the end of June 2017, the Fund had a deficit but was c. £442m ahead of the funding plan. Since June 2017 the Fund's assets have continued to increase in value to c. £2.7bn.
3. Given that most of the improvement seen since the 2016 valuation is attributable to the rally in equity markets over the period, the Actuary has recommended that the Fund consider using an equity protection strategy to:
 - a) Reduce the likelihood that further deficit contributions will be required at the 2019 valuation; and
 - b) Seek to "bank" some of the recent upside with a few to potentially reducing contributions at future valuations.
4. An alternative approach to equity protection would be to simply de-risk by moving funds from equities to other asset classes. The challenge with this approach is that it would also reduce return commensurately which would have an impact on the affordability of providing future benefits.

Equity Protection Strategy update

5. Following the Pensions Committee decision to grant delegated authority to the Interim Chief Financial Officer, in consultation with the Chairman and Vice-Chairman of the Committee, to work with advisers to implement an equity spread protection strategy for the Fund's equities, Fund officers, working with the Fund's independent Financial Adviser, undertook further research with potential providers for the solution. The research covered active 'complex' solutions alongside static options hedge solutions.
6. The research indicated that the active more complex solutions, which involved rolling options hedge positions on a one month or three month basis performed well when back tested against a gradual rising equity market environment but were unlikely to perform as well in a gradual falling equity environment and back testing was not available to access this risk. Active solutions also incur significant management fees ranging from 20bps to 50bps along with higher transaction costs. The timeline for

implementation is longer than a static hedge solution and would require a higher governance requirement for the Fund.

7. A static options hedge solution would incur management fees under 5bps and an implementation timeline of between one and two months. The static options can be implemented for a period of 18 months to cover the period to the next actuarial valuation in 2019, at which stage a further review could be undertaken, in-line with the actuarial valuation process, to optimise the solution and align the equities protection to the Fund's funding strategy.

8. Fund officers requested bids / quotes from four providers of static hedge solutions. After taking advice from the Fund's Independent Financial Adviser, the bid requests focused on providing downside protection to the Fund's passive UK, U.S. and European equities with a combined market value of c. £1.2bn. To avoid paying a premium up front cost for the options, it was determined through research that the Fund can sell returns above 5% per annum, which is the actuary's required return from the Fund's assets for future rate liabilities, and gain substantial downside protection.

9. The bids were scored by the Fund's Independent Financial Advisor and the Fund's Finance Manager. The two highest scoring bidders were asked to present to the Pension Investment Advisory Panel on 24 November 2017. Following the presentations the Panel recommended that River and Mercantile be appointed to implement and manage the static options equity protection strategy.

10. Fund officers will work with River and Mercantile during December 2017 and January 2018 to design and implement a strategy that optimises the level of downside protection gained from selling returns above 5% p.a. from the Fund's passive UK, U.S. and European equities over an 18 month period.

Contact Points

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Specific Contact Points for this report

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Supporting Information

- River and Mercantile presentation report (Appendix)

Background Papers

In the opinion of the proper officer (in this case the Interim Chief Financial Officer) the Equity Protection Strategy Report to the Pensions Committee on 6th October 2017 is a background paper to this report.

Worcestershire County Council Pension Fund

Equity Protection



Masroor Ahmad
Managing Director, Derivatives

- River and Mercantile since 2006
- Industry since 1992
- 25 years derivatives trading experience
- BSc Economics and Accountancy, City University London



Jason Wood
Client Engagement

- River and Mercantile since 2014
- Industry since 1991
- 26 years derivatives trading experience
- BSc Economics, St Andrews University



Mark Davies
Managing Director, Derivatives

- River and Mercantile since 2004
- Industry since 2002
- 12 years derivatives trading experience
- Fellow of the Institute and Faculty of Actuaries
- MA MEng Engineering, Cambridge University

Tailored derivatives

Made accessible

What you would like from this strategy

Tailored strategy

Value for money

Easily governable

Ahead of our peers; invested in this area

Focus on education...

...and accessibility

Recognition – LGPS mandates

How we would design

How we would implement

How we would keep your assets safe

How much return do you need? **5% p.a.**

How much premium? **Zero**

How much protection? **TBC**



Work with you to
iterate using our
tools

What do we implement?

Page 50



At maturity:
Market rise above target: **Negative**
Market fall: **Positive**

The team have been doing this for 25 years

Using our trading experience

Think like a counterparty

- Reduces cost and adds value
- We have been there

Tools

- Simple as possible
- Liquid as possible

Trading

- Understand counterparties
- Aim for no market impact

Segregated mandate

Segregated mandate

- Contracts with counterparty directly

Efficient

- Transparent
- Lowest cost

Future-proofed

- Tool flexibility
- Collateral flexibility

Made accessible

- We make this easy for you

How do we keep your assets safe?

Trading experience

Controls

Collateral



London
Stock Exchange

£16bn Derivatives Mandates
115 Pension Scheme Clients

24 specialists
Supported by group resource

Listed business

Leading provider

Stable Team

Why River and Mercantile?

Commitment

- Your strategy is what we do

Experience

- Our significant market experience means you achieve the best value

Governance

- We make it easy for you

Don't take our word for it

"The team spent a great deal of time educating the Officers of the Pension Fund ..."

"This resulted in a relatively smooth process which did not require significant input from the Pension Fund."

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PENSIONS COMMITTEE
1 DECEMBER 2017

ALTERNATIVES INVESTMENT

Recommendations

1. The Interim Chief Financial Officer recommends that:
 - a) the following top-up commitments: £25m First State; £25m Stonepeak be approved;
 - b) she be granted delegated authority to commit £25m to Hermes Fund II, subject to appropriate due diligence being undertaken by Bfinance and sign-off by the Chairman of the Committee; and
 - c) she be granted delegated authority to undertake a search for a £50m allocation to a new corporate private debt mandate. Any commitments to corporate private debt vehicles, and an associated amendment to the Fund's Investment Strategy Statement, will be subject to approval by the Committee.

Background

2. In December 2016 the Committee approved recommendations to move to a new strategic asset allocation for the Fund as part of the Fund's strategic asset allocation review. (Minute no. 65 refers) The aim of the asset allocation change is to achieve lower volatility without reducing total returns to enable a closer correlation between the Fund's assets and the longer term liability profile. The new structure is summarised below in table 1:

Table 1: Summary Changes to the Strategic Asset Allocation

By Review Year	2013		2016	
Asset Type by %	Allocation	Tolerance	Allocation	Tolerance
Equities	80	75 – 90	75	70 - 85
Bonds	10	5 – 15	10	5 – 15
Infrastructure and Property	10	5 – 10	15	5 – 15

3. In February 2017 BFinance were appointed as a specialist procurement adviser to assist with the tender for property and infrastructure pooled funds. BFinance services included portfolio design of the proposed investments in terms of style, size and geographic exposure along with analysis of proposals from interested managers and

preparation of a report in order to select a short list of suitable specialists capable of managing the mandates successfully.

4. As a result of BFinance's analysis four managers were recommended for appointment by the Pension Investment Advisory Panel and then approved for appointment by this Committee: Invesco, AEW, Stonepeak and First State.

Infrastructure Managers

5. The appointment of Stone Peak, a specialist U.S. infrastructure manager, and First State, a specialist European infrastructure manager, provided good diversification away from the Fund's UK focused infrastructure investments. Stonepeak and First State were recommended by BFinance, following an in depth procurement, as the highest rated managers in these regions and are expected to provide returns in line with the Fund's requirements.

Property and Infrastructure Commitments

6. This Committee's decision to increase the allocation to pooled property and infrastructure funds from 10% to 15% of the Fund's market value converted to a Sterling value of an additional commitment of £170m in June 2017. However due to the analysis undertaken by BFinance, modelling the drawdown profile and distribution profile of the Fund's infrastructure and property pooled funds, an additional £210m was required to meet a peak of 88% deployment in 2018/19. A £250m commitment would have been required to ensure a c. 100% deployment, and therefore 15% of the current market value of the Fund to be invested at a peak in 2018/ 19. The Committee approved a £210m commitment to allow for further deployment of capital over the next twelve to eighteen months to help increase vintage year diversification and take advantage of any market opportunities as they arose given the changing market environment.

7. Since June 2017 the market value of the Fund's assets has increased to c. £2.7bn and following further modelling undertaken by Bfinance an additional £75m is now recommended to be committed to ensure c. 100% deployment of the strategic asset allocation to pooled property and infrastructure funds.

Fixed Income Allocation

8. The Fund has a strategic asset allocation to fixed income assets of 10% of the total fund value. At present, the Fund's actual allocation to fixed income is c. 6% via a segregated account with JP Morgan Asset Management and as such is under-allocated by c. 4% (c. £110m) relative to the strategic asset allocation target. The c. 4% underweight position is due to the Fund's equities outperforming corporate bonds and an active decision not to rebalance the weights to these asset classes. The Fund is therefore overweight to equities due to the underweight position in corporate bonds.

9. Taking into consideration the current funding position of the Fund at c. 100% and the Committee's recent decision to implement an equity protection strategy it is recommended that the overweight position to equities is reduced and alternative investment options are considered.

Bfinance analysis and recommendations

10. Based on analysis of the Fund's real assets portfolio and evaluation of market opportunities, set out in the Appendix to this report, **Please note that the Appendix contains exempt information (on salmon pages) and should members wish to discuss the information included in the Appendix they would need to consider passing the appropriate resolution and moving into exempt session.** Bfinance recommend a further £75m allocation to infrastructure is implemented. This would comprise of a £50m allocation to the overseas infrastructure funds selected in June 2017 (First State Investments and Stonepeak). In addition, it is proposed that the Committee consider making a £25m allocation to the latest fund launched by Hermes Infrastructure (Hermes Infrastructure Fund II) to maintain the proportion of UK and overseas commitments to infrastructure, subject to appropriate Bfinance due diligence. The due diligence and refresh of the original infrastructure pooled fund search to include Hermes Fund II is required due to Hermes Infrastructure Fund II being a new investment with different assets and investment risks and not a top-up into an existing Infrastructure Fund in which the Fund currently invests.

11. Bfinance also considered the underweight position to Corporate Bonds and have assessed alternative investment options outside of Bonds given the current interest rate and market environment. Bfinance recommend that in the current market environment, corporate private debt offers an attractive risk adjusted return with strong downside protection and yield. Further details regarding corporate private debt vehicles are provided in Appendix 1 to this report.

12. The Pension Investment Advisory Panel have considered the recommendations from Bfinance and endorse the recommendation regarding the £75m commitment to Infrastructure pooled funds. The Panel also endorse an initial £50m allocation to corporate private debt, subject to full due diligence being undertaken on the corporate private debt vehicles in the market.

Contact Points

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Supporting Information

- BFinance report (**Exempt information – Salmon pages**)

Background Papers

In the opinion of the proper officer (in this case the Interim Chief Financial Officer) the following is a background paper to this report:

Strategic Asset Allocation Report December 2016

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

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