worcestershire county council

AGENDA ITEM 8

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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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.