PENSIONS INVESTMENT SUB COMMITTEE
12 JUNE 2019

RIVER & MERCANTILE EQUITY PROTECTION UPDATE AND FUTURE CONSIDERATIONS FOR WORCESTERSHIRE PENSION FUND

Recommendation

1. **The Chief Financial Officer recommends that the Pensions Investment Sub Committee:**

   a) **Note and comment on the presentation provided by River & Mercantile on the Equity Protection strategy detailed in the Appendix; and**

   b) **Recommends to the Pensions Committee that:**

      i. **The Equity Protection current static strategy is extended to mid-2020 in order to protect employer contributions and provide certainty to the Actuary that the Equity Protection is in place when the 2019 actuarial valuation results and contribution requirements have to be signed off;**

      ii. **Those options are explored as to whether more upside participation can be implemented over this period without giving up too much downside protection is delegated to the Chief Financial Officer in in consultation with the Chairman of the Pensions Committee; and**

      iii. **The Equity Protection Strategy be considered as part of the Asset Allocation review that will be conducted from June 2019 through to around November 2019 to ascertain as to whether this should become an integral part of the Fund's future investment strategy.**

Purpose of the Equity Protection Strategy

2. It is worth reiterating the purpose of the Equity Protection Strategy that was implemented as follows:

- Reduce the likelihood that further deficit contributions will be required at the 2019 valuation due to a fall in equity markets, and

- Seek to "bank" some of the recent upside with a view to potentially reducing contributions at future valuations.

3. An alternative approach to equity protection was considered which 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

4. A static options hedge solution was implemented to provide equities downside protection through to the next actuarial valuation. This was 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. The Strategy focused on providing downside protection to the Fund's passive UK, U.S. and European equities which have a combined market value of c. £1.1bn (including the Equity Protection) which equates to around 40% of the overall Fund value at the end of March 2019.

5. At the March 2019 meeting of the Pensions Committee, it was noted that further discussions had been held with River and Mercantile (R&M) on Equity Protection options on the 28 February 2019 and at that time no further action was required. R&M were to bring future detailed option proposals to the next Pensions Investment Sub Committee on the 12 June with recommendations brought to the Pensions Committee on the 21 June 2019. The current strategy expires between the 15 August 2019 and October 2019.

6. Attached as an Appendix is a presentation from River & Mercantile that provides an update on the current structure, as well as some current and potential future considerations.

Discussions with the actuary ' Mercers'

7. Initial discussions have taken place with the Actuary early in May to highlight the initial 2019 actuarial valuation outcomes. This described:

a) A recap on 2016 assumptions and existing funding strategy in place;
b) National issues affecting the fund;
c) Where we are now based on very preliminary 2019 valuation results; and
d) Where we are going, the key next steps for the 2019 valuation.

8. The Actuary provided a paper that showed that the pension deficit on the anticipated 2019 actuarial valuation assumptions is estimated to be £245m with a funding level of 92% (allowing for the reduced future return outlook since the 2016 actuarial valuation). Further details can be found on the update on the Actuarial Triennial review report on the same agenda. As part of this update a specific paper was presented and discussed on the impact of the Equity Protection on employer contributions. River & Mercantile were in attendance along with the Fund’s Independent Investment advisor.

9. This emphasised that the Fund had implemented an Equity Protection Strategy as at the 31 March 2018 for a specific reason; to protect from the risk of falls in the investment markets leading to a deterioration in the Pension Fund’s funding position with consequent increased contributions at the next valuation.

10. Given the expiry date, it was felt a good time to review whether the current structure should continue or whether an alternative long term approach should be adopted. A number of potential strategies were considered:

a) We no longer require the protection strategy, and the options are left to expire and not renewed;
b) The same static strategy is renewed;
c) A different static strategy which offers different downside protection and upside potential is adopted; and
d) A longer-term dynamic strategy is better suited to the Fund's objectives.

11. The paper provided by the Actuary considered these options for a number of different market scenarios to illustrate the impact competing structures have on contributions. It also provided a more in depth analysis of the static approach (protection for a certain fixed length of time) and dynamic approach (a longer term tool to control equity downside risk).

12. The caveat to all this was that the Actuary believes that the Fund could benefit from using an Equity Protection Strategy in terms of providing increased certainty and affordability of contributions if markets were to deteriorate.

13. In discussions it was felt that there were a number of aspects to consider being:-

a) **The Governance angle** to protect from the risk of increased employer contributions. This would mean extending the current static strategy to around mid-2020 slightly past the formal sign-off date for the 2019 actuarial valuation (31 March 2020). As part of this consideration it would be investigated as to whether more upside participation can be implemented over this period without giving up too much downside protection. This would also provide the Actuary certainty that the Equity Protection is in place when the actuary’s rates and adjustments certificate has to be signed off;
b) **The Risk profile** as technically the Equity Protection strategy does help provide diversification in the portfolio and reduces the risk profile as part of the valuation (admittedly at a cost similar to paying an insurance premium);
c) **A longer term dynamic strategy.** This needs to be considered as part of the Asset Allocation review that will be conducted from June through to around November 2019 to ascertain whether the Equity Protection Strategy should become an integral part of the Fund’s future investment strategy.

14. The Pensions Investment Sub Committee is therefore asked to recommend to the Pensions Committee that:

a) The Equity Protection current static strategy be extended to mid- 2020 in order to protect employer contributions and provide certainty to the Actuary that the Equity Protection is in place when the 2019 actuarial valuation has to be signed off;
b) Those options be explored as to whether more upside participation can be implemented over this period without giving up too much downside protection be delegated to the Chief Financial Officer in consultation with the Chair of Pensions Committee; and
c) The Equity Protection strategy be considered as part of the Asset Allocation review that will be conducted from June through to around November 2019 to ascertain as to whether this should become an integral part of the Fund’s future investment strategy.

Future Reporting
15. The Equity Protection Strategy value is currently reported quarterly as part of the overall performance data provided for the Fund. If the extension of the Equity Protection is agreed, then we will look at the way that this is reported in future. The aim will be to report what the underlying value of the Fund would have been with and without the Equity Protection in place.

16. **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.**

Supporting Information
Appendix - presentation from River & Mercantile that provides an update on the current structure, as well as some current and potential future considerations.(**Exempt – Salmon pages**)

Contact Points

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Background Papers
In the opinion of the proper officer (in this case the Chief Financial Officer) there are no background papers relating to the subject matter of this report: