worcestershire county council

AGENDA ITEM 8

PENSIONS INVESTMENT SUB COMMITTEE
3 MARCH 2020

RIVER AND MERCANTILE EQUITY PROTECTION UPDATE AND RESTRUCTURING CONSIDERATIONS FOR WORCESTERSHIRE PENSION FUND

Recommendation

1. **The Chief Financial Officer recommends that:**

   a) **The presentation provided by River & Mercantile (R&M) on the Equity Protection strategy detailed in the Appendix be noted;**

   b) **The appropriate form of restructuring of the existing Equity Protection Strategy be agreed; and**

   c) **The Chief Financial Officer be granted delegated authority in consultation with the Chairman of Pensions Committee, the Chairman of the Investment Sub Committee and the Fund's Independent Investment Advisor to undertake the restructuring of the Equity Protection Strategy as agreed under b) above, and any other future restructuring that may be necessary.**

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 background and 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.

5. 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

6. At the March 2019 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 asked to bring future detailed option proposals to the June Pensions Investment Sub Committee and recommendations were brought to the Pensions Committee on the 21 June 2019. The strategy at the time expired between the 15 August 2019 and October 2019.

7. A caveat to the discussions was that the Actuary believed 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.

8. A recap of the aspects that were considered:

   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 must 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 like paying an insurance premium); and

   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 Funds future investment strategy.

9. It was agreed at the June Pensions Committee that:

   a) The Equity Protection current static strategy be extended to mid-2020 to protect employer contributions and provide certainty to the Actuary that the Equity Protection is in place when the actuary certificate must be signed off;

   Progress – This was completed and included in the 2019 valuation

   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 Chairman of the Pensions Committee; and.

   Progress – This was actioned on October 2019 and a summary is provided in the table below

Revised Equity Protection levels implemented

Mandate & Market	Initial Market Level	87% when protection kicks in	70% when protection ends	Level at which cap is achieved	% Level at which cap is achieved	Dividend yield	Total Return including Dividend yield
EDOS 5 - S&P	2,895.90	2,519.40	2,027.10	3,162.60	9.21%	1.54%	10.75%
EDOS 6 - ESTOXX	3,282.80	2,856.00	2,297.90	3,453.50	5.20%	3.24%	8.44%
EDOS 7 - FTSE	7,270.90	6,325.70	5,089.60	7,612.50	4.70%	4.07%	8.77%
EDOS 8 - FTSE	7,157.30	6,226.90	5,010.10	7,530.60	5.21%	4.13%	9.34%

Notes an example: Should the S&P go above the 3,162.6-market value cap then WPF will not benefit from total returns above this level being 10.75%. Likewise, the S&P market value is protected from market falls between the market value of 2895.9 (87%) and 2,519.40 (70%)

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 Funds future investment strategy.

Progress – This was included as part of the Strategic Asset Allocation report to Committee on the 13 December 2019. It was agreed:

a) To use the Equity Protection strategy as a tool to manage and mitigate the risk of having still a relative high equity exposure but review regularly and update at Pensions Investment Sub Committee;

b) To agree trigger points were discussions should take place to discuss if any action such as restructuring or even exiting the Equity Protection strategy; and

c) That Fund officers with the support of the Fund's current Investment Advisor closely monitor the existing strategy and bring back more detailed information on how the strategy has performed at least on a quarterly basis to Pensions Investment Sub Committee.

10. Following this recommendation 6 weekly reviews have been implemented with R&M and discussions were held with R&M on the 6 January 2020 and after due consideration no action was recommended. A further review took place on the 14 February 2020 and given the improved equity returns since the revised levels of protection and market cap implemented in October 2019 it was felt appropriate to consider restructuring the mandates in relation to the S&P 500 (US Passive Equity mandate) and Eurostoxx (European Passive Equity mandate).

11. The presentation attached as an Appendix by R&M provides a number of potential restructuring options for consideration by the Investment Sub Committee.

12. **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

County Council Contact Points
County Council: 01905 763763
Worcestershire Hub: 01905 765765

Specific Contact Points for this report
Rob Wilson
Pensions Investment, Treasury Management & Capital strategy manager
Tel: 01905 846908
Email: RWilson2@worcestershire.gov.uk

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: