# Consolidating our Pension Surplus

June 2023

NOTE: Analysis undertaken by Hymans focused on the non-MDX obligations as we are potentially considering a separate investment strategy for MDX obligations. However, having consulted with Hymans, they would be comfortable extrapolating the conclusions to the whole of Fund including MDX. We are having separate discussions with MDX around their investment strategy reflecting their specific risk profile, but we would not want to have a strategy for MDX that was intrinsically more risky than for the rest of the Fund

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**1. Summary**

Updated Hymans analysis indicates that our Funding position has increased by 20% since the 31 March 2022 valuation (95% to 115%). This is because:

- long-term interest rates have increased (reducing present value of our liabilities);
- asset values have remained steady.

However, this position could quickly unwind. For example, a modest 0.5% reduction to long-term interest rate expectations combined with a 15% fall in asset values would see this position revert to substantial deficit.

We have investigated how to consolidate the surplus and, following advice from Hymans, are recommending to the Committee a 20% shift of assets from our liquid equity to our liquid credit funds (choosing these funds are they are easiest to move and also provide the most risk reduction based on Hymans analysis).

**Hymans analysis suggest this action would reduce our downside risk over a three year period by £80m (assuming a 1-20 likelihood) and marginally increasing the probability we would be fully funded over a 20 year period. This paper (and attached Hymans analysis) provides further information.**

**2. Context**

Since 31 March 2022 we have experienced an unprecedented increase to the level of long-term 'risk free' interest rates. The risk free rate has increased from around 1.6% at 31 March 2022 to around 3.6% at 31 March 2023 (levels not generally seen since 2011).

This increase in risk free interest rates is good for long-term investors, such as pension schemes, who can secure a higher level of return for a given level of risk and this has been reflected in the Fund's financial position, which is summarised in the table below (extracted from Hymans' report), where the Fund is assessed to have a Funding Level of 115% and £190m surplus at 31 March 2023.

## Funding position

- We have shown in the table below a summary of how the funding level has improved during the period March 2022 to March 2023, as well as a number of important assumptions that underpin the Fund's investment strategy. Our ALM analysis has used March 2023 as its starting point.

| | Mar-22 | Mar-23 |
|---|---|---|
| **Funding Level**<br>*Surplus* / *(deficit)* | **95%**<br>(c.£70m) | **115%**<br>c.£190m |
| **Discount rate p.a.**<br>(expected returns over 20y with 75% likelihood) | **4.7%** | **6.2%** |
| **CPI p.a.**<br>(expected CPI inflation over 20y with 50% likelihood) | **2.7%** | **2.3%** |

*Source: Hymans Robertson*

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**3. Impact of funding improvement on contributions**

The change in financial position of the Fund may have a significant impact on contributions when they are next assessed at 31 March 2025. A summary of the council's current contribution rate is provided below.

| Rate | 2022 Rate | Comment |
|---|---|---|
| Primary | 19.1% | Cost of new benefits provided |
| Secondary | 9.3% | Under Hymans model the Secondary Rate acts as a 'balancing item' to target full funding with a certain probability – notionally though this reflect deficit payments. Should be significantly lower if we have a surplus position. |
| Total | 28.4% | |

We may only benefit from a reduction in contribution rates if the funding level remains high (and, to a certain degree, if interest rates remain high) when contributions are next assessed. Recognising this, we are considering how we can consolidate the surplus position. This has particular importance given the wider cost pressures within the council's Medium Term Financial Strategy.

Contribution rate stability is an important LGPS principle i.e. even with a surplus our actuary may still recommend a modest change in rates – this is a discussion we will have at the time, but we believe this action may increase our case to reduce rates if we feel it appropriate.

**4. How can we consolidate this position?**

The main way to consolidate the funding position of a pension scheme is to hold assets that give a contractual return (e.g. Bonds, ideally long term bonds). This is because assets that give a contractual return better match our pension liabilities (which are also a form of contractual obligation) – i.e. we match a contractual liability with a contractual asset.

Assets that give a discretionary (i.e. non contractual) return (e.g. equity) are more risky for pension funds (although may provide greater upside potential) – one caveat to this statement is in relation to inflation risk, which is considered in a further section.

**5. Fund Cashflow Profile**

A benefit of increasing our allocation to income related assets is that it will support payment of our annual pension payroll without requiring disinvestments (we are approaching becoming cashflow negative i.e. our benefit outgo exceeds our contribution income).

The strategy we are proposing works in consolidating our funding position for benefits already promised. In time we may consider designing a new framework that fully utilises existing assets to meet benefit payments with a different framework to deploy new contributions towards a more growth tilted allocation – this may allow us to benefit from higher equity returns to fund new benefits whilst protecting the position for benefits earned.

The detail of this can be looked at as a second stage.

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**6. Inflation**

Inflation is a high risk for the LGPS as it provides uncapped inflation linked pension increases. Within the 115% funding level modelled, Hymans have used an average inflation assumption of 2.3%, which broadly allows for inflation at current levels trending down to around 2.5% in the shortish term (next five years) and 2.3% in the very long-term (i.e. slightly higher than the Bank of England target). The 115% funding level allows for the impact of the c10% pension increase applied in 2023.

There is a risk that inflation turns out to be higher than within Hymans modelling – if this happens our surplus would erode. This is a significant risk factor that retaining a higher proportion of equity may mitigate, however, we make the following comments in relation to this:

- Equity may provide a lose hedge to inflation in the very long-term, but the hedge to inflation over a shorter term is unclear.
- We are not proposing to switch to a 30% equity allocation "forever more" and would retain the flexibility to revert to a higher equity in the future
- Whilst the Fund's equity allocation would reduce substantially, the Fund will still retain other 'real assets' – e.g. Infrastructure and Real Estate Funds which also provide an inflation hedge

We do not believe holding higher equity is necessarily the strongest mitigating strategy for inflation and so if the Committee does have retained concerns we should explore alternative inflation hedging strategies beyond increasing our equity allocation.

**7. Analysis undertaken**

Hymans have analysed the impact on funding outcomes for several different asset allocations. The risk analysed is as follows:

- A 1 in 20 downside position over a three year period (a valuation cycle); and
- Probability of being fully funded over a 20 year period

The investment allocations considered by Hymans are in two groups:

| Strategies considered | Explanation |
|---|---|
| "Quick Fix" | Strategies based on funds that we currently invest – i.e. can be allocated to quickly following the 4 July PFC meeting |
| "Alternative" | Alternative funds that may support even more efficient consolidation of the position (which we may explore as a second phase) |

Within the analysis we placed a lower limit for equity allocation at 30% of the Fund (from a 'sense check' perspective we would not wish to reduce equity to below this level but could consider a lower allocation than 30% as a next step if the PFC wished us to).

The recommendation of switching 30% from liquid equity to liquid credit reflects the most optimal strategy under the "quick fix" scenarios.

Hymans analysis is attached.

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**8. ESG and Pooling Considerations**

The proposal within this paper have been framed from a strategic rather than ESG / Pooling perspective, but the following points are relevant to this proposal:

- Consolidating our funding position increases the probability that the council can reduce its contributions, which may be utilised to progress the council's wider goals, particularly around Planet, Places and People, all of which has an indirect ESG impact
- Reducing our overall risk means we may, in time, utilise a higher risk budget towards new impact funds with high upside potential and strong ESG outcomes
- A key objective for selecting the LCIV Global Bond fund was its ESG credentials and the proposal increases our allocation to that Fund beyond the current 5% strategic allocation
- The proposal will increase our overall allocation to LCIV pooled funds (at the expense of our passively managed pooled funds held with LGIM) – arguably, we have greater influence through an ESG lens with money invested with LCIV over LGIM

We will bring a separate paper to the Committee setting out a framework for making decisions in relation to the council's NetZero objectives. It is likely that this process will require us to rethink some of our existing funds. Recognising that this may take some time to work through we felt it was important to take steps to consolidate the Funding position as market conditions can change and we may miss this opportunity.

**9. What other funds are doing?**

We are aware of only a few other LGPS Funds that that hold 30% in equity (most funds hold a significantly higher proportion). There are likely several reasons for this, for example Funds may:

- Be considering this move but have not implemented it yet
- Be Sitting on a higher surplus than Barnet and so feel that they have sufficient 'buffer' to weather a poor economic outcome over the period to the next valuation
- Not have fully analysed the position of having surplus and how to consolidate this position
- Not wish to appear as an "outlier" when compared with peers – i.e. there is an element of herd mentality within LGPSs
- Be feeling bullish about the equity market (or bearish over the bond market) and feel there is more upside opportunity to come and would rather take the risk
- Be concerned about inflation risk and feel an equity allocation is a better match for this – see inflation section for comments on this
- Be reducing risk in a different way (e.g. equity caps / collars)

A breakdown of London Fund asset allocations at 2019 and 2022 (sourced from LCIV) is set out in Appendix A to this document.

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**10. Impact on Returns and Discount Rate**

The table below summarises the expected returns of the proposed investment strategy with the current strategy.

| % p.a. | Current Strategic Allocation | Proposed Strategic Allocation |
|---|---|---|
| Expected Return | 8.0 | 7.3 |
| Risk (Volatility over 1 year) | 11.0 | 8.3 |

There is therefore a modest reduction of expected return of 0.7% p.a. - but the return is still 1.1% higher than the discount rate used to assess the 115% surplus position (6.2%) and, in our view, the reduction in return is more than compensated by the reduction in risk (i.e. our risk adjusted return would be higher).

**11. Transition considerations**

The rationale behind this proposal is to reduce risk and so we would wish to implement it as soon as possible following the Pension Fund Committee meeting.

Given the quantum of transition we would likely implement in tranches and may utilise our Trade Funds to manage overall transition costs. We will take advice from Hymans on the most optimal means to manage the transition.

A summary of the proposed changes is provided below:

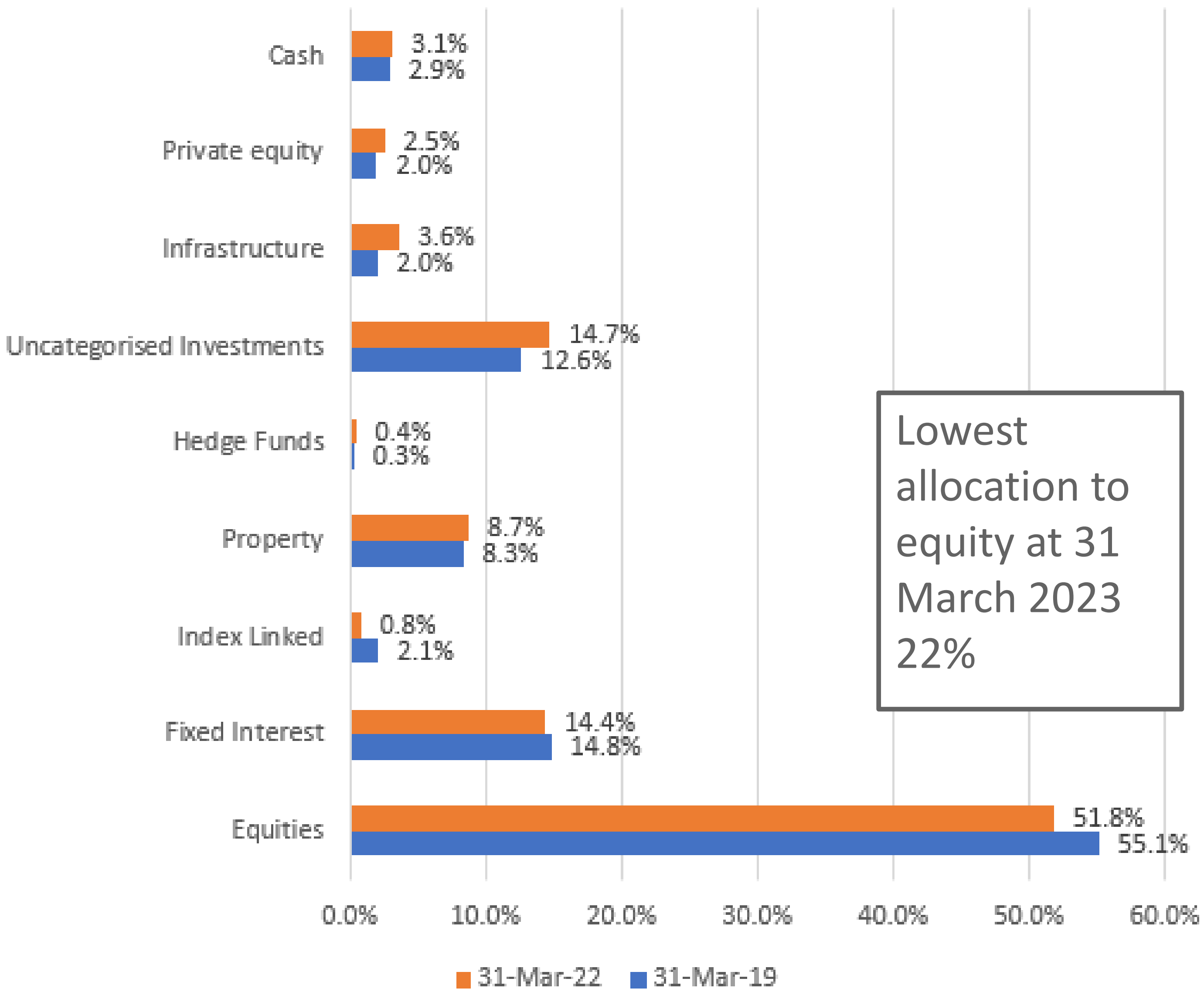
| | Current Strategic Allocation | Proposed Strategic Allocation |
|---|---|---|
| LGIM Future Worlds | 25% | 13% |
| LGIM RAFI | 10% | 6% |
| LCIV Emerging Markets | 5% | 3% |
| LCIV Sustainable Equity | 5% | 3% |
| **Liquid Equity** | **45%** | **25%** |
| Schroders (all maturities sterling) | 5% | 15% |
| LCIV Global Bonds | 5% | 15% |
| **Liquid Credit** | **10%** | **30%** |

The initial proposal, necessarily, uses the 'building blocks' of the funds available to us which is why we are proposing to reallocate to Schroders and LCIV liquid bond funds (utilising both funds to limit concentration risk to a particular fund).

We are discussing a new, longer duration, less actively managed, Bond fund with LCIV. This fund may facilitate further consolidation of our funding position. We are also considering our NetZero strategy. We may therefore bring further proposals to the Committee in due course within the 70% / 30% framework we have set out here.

# Appendix – Asset Allocation breakdown for other London LGPS Funds

The chart below (sourced from LCIV) shows a comparison in the asset allocation between the 2019 and 2022 triennial valuation dates amongst the 32 London LGPS Funds.




Two key points from this analysis:

1) There has been a modest decrease to equity allocation between 2019 and 2022 (c3%);

2) Average (public) equity at 2022 is around 7% higher than our current allocation (45%) and therefore higher than what we are proposing to move to within this paper (however, the increase in funding which may drive a lower allocation to equity happened subsequent to the 2022 valuation)

That said we are not aware of many other Funds making such a reduction to equity, possible reasons for this are summarised in this note