Exploring employer investment strategies

Addressee and purpose

This paper is addressed to Surrey County Council in its capacity as Administering Authority to the Surrey Pension Fund ("the Fund"). The purpose of this paper is to discuss the need for the Fund to consider implementing tailored investment strategies, complementing the categorised employer funding strategies already in place, to help employers achieve better funding outcomes. This paper has been prepared by Hymans Robertson LLP in our capacity as actuaries to the Fund.

Background

The Fund is made up of many participating individual employers (c. 200) who have a diverse range of funding profiles. For example, one employer may be well funded and consist purely of active members whereas another may have no active members and be poorly funded.

In the past few years the Fund has adopted a more flexible approach to funding and contribution strategy. The introduction of the individual employer categorisation means that the funding strategy now recognises the diversity between employers. However, at present, the Fund operates a single investment strategy which applies to every employer.

Tailoring both funding and investment strategies to different groups of employers would help improve risk management, reduce the risk of adverse outcomes for employers and reduce the risk of complaints against the Administering Authority (and the associated reputational damage).

Bearing the above in mind, and as part of the 2019 valuation, the Fund should investigate whether this 'one size fits all' approach to the investment strategy is still appropriate or whether multiple investment strategies could be implemented for different groups of employers.

This paper sets out:

1 What we mean by 'multiple of investment strategies'

2 The benefits to the Fund in operating multiple investment strategies

3 Why employers in the Fund have differing objectives and why they may be best served by alternative investment strategies

4 Analysis that can be carried out to investigate the need for multiple strategies

5 The next steps to consider

What do we mean by 'multiple of investment strategies'

The Fund currently operates a single investment strategy which applies to every employer. The high level strategy can be simplified as assets invested 80% in growth and 20% in defensive holdings. Growth assets are high return seeking assets such as equities which, by nature, come with relatively high volatility of returns. Defensive assets are lower risk assets such as government bonds, in contrast, provide lower but more certain returns.

By offering multiple investment strategies to employers, the Fund would instead offer investment mixes for the allocations to growth and lower risk assets. An example of the strategies could be:

- Strategy 1 - Main Fund: 60% growth / 40% lower risk

  This strategy may be suitable for long term, reasonably well funded, secure employers.

- Strategy 2 – Reduced Risk: 40% growth / 60% lower risk

  This strategy may be suitable for employers with no guarantor or targeting full funding on a gilts basis i.e. a flightpath to cessation.

- Strategy 3 – Recovery: 80% growth / 20% lower risk

  This strategy may be suitable for poorly funded employers.

The above are purely illustrative but the selection of suitable strategies would be a key stage in the implementation process to ensure that they deliver the best outcomes for the Fund employers.

Benefits to the Fund

The introduction of multiple investment strategies provides the following benefits for the Fund.

- Better funding outcomes for employers which therefore reduces the overall risk to the Fund
- Increased flexibility for setting employers funding plans
- Meets increasing needs of employers and provides them with a better service, particularly where they have bespoke objectives such as targeting exit on a gilts cessation basis
- Keep pace with other funds in the LGPS (as at start of 2018, 5 funds have implemented this solution with more considering it alongside planning for the 2019 formal valuation)
- Realise full benefit of the HEAT tool (see the Appendix for a recap on how the mechanics of the HEAT tool)

The ultimate aim of the Fund is to ensure all member's benefits can be paid in future. By introducing multiple investments strategies the Fund can ensure that each employer has the best possible funding outcome, tailored to their own circumstance which can only stand to benefit the overall Fund aim.

Employers objectives

In the past, the Fund primarily consisted of long term, secure employers such as Councils and other scheduled bodies. However, in recent years the diversity in the participating employers in the Fund has increased dramatically. The Fund now has councils, colleges, contractors, academies and charities, all with different objectives for their LGPS participation.

In order to assess whether the differing objectives of these employers would be best served by multiple investment strategies, the Fund should consider undertaking some analysis which aims to group similar employers based on risk metrics and funding objectives. This analysis builds on that undertaken for the purposes of the categorisation for setting employer contribution rates. From this analysis a rationalisation of whether these groups require multiple investment strategies can follow.

The risk metrics we believe should be considered as part of the analysis are set out below, together with some reasoning as to why each may indicate a need for an alternative strategy.

Maturity: liability profile

Mature employers are more likely to require investment income to meet their benefit outgo whereas less mature employers will benefit from reinvesting any investment income. Mature employers will also be funding any deficits with a small (in comparison to the deficit) payroll which can cause problems. These problems could be mitigated by considering multiple investment strategies.

There are a few measures of maturity which could be used, including:

1. Liability profile (percentage of past service liabilities that are in respect of pre-retirement members);
2. Gearing ratio (liabilities divided by payroll); and
3. Mean duration of liabilities (typically rolling 20 years plus for long term, secure employers that remain open to new entrants and possibly say 10-12 years and shrinking for employers with a high average age who are closed to new entrants – these different categories of employer have a different investment time horizon).

The degree of maturity alone will not drive a decision to switch to a lower risk investment strategy. For example, a poorly funded, mature employer may not be able afford to take less risk because of the level of contributions that would be required. For affordability reasons, such an employer may need to stick with the riskier main fund growth strategy and bear the associated volatility, in the hope of repairing its deficit.

Funding level

The funding position of an employer is a measure of the relative amount of assets held to pay the liabilities. If an employer is poorly funded it may benefit from a more aggressive investment strategy with the aim that higher asset returns will return them to a well funded position. Conversely, if an employer is well funded i.e. over 100% they may prefer a less risky investment strategy which doesn't expose them to potential large investment losses particularly if their remaining period of participation in the Fund is short – in other words they may seek to limit the downside risk.

Net cashflow position

Net cashflow position is the measure of contribution income over benefit outgo. As employers mature the contribution income will fall whilst benefit outgo rises. At some point the net cashflow position will become negative i.e. more benefits are paid out than contributions received. At this point the employer will start using their assets to pay benefits which may have implications for their future funding and investment strategy i.e. it may need to yield relatively more income in order to have cash to pay benefits as they fall due rather than be a forced seller of assets.

Maturity: declining payroll

For closed employers, the employer payroll will gradually fall over time as members leave through retirement or withdrawal. As the payroll falls the contribution income will decrease and benefit outgo will rise. Analysing the point at which the payroll will have fallen by say 50% gives an indication of how quickly the employer is maturing.

The rate at which an employer is expected to mature may indicate a need to change their investment strategy either to increase or decrease their level of investment risk depending on the results of the other risk metrics.

Time horizon

Some employers have clearly defined future time horizons for their participation in the Fund (e.g. contractors with fixed term contracts). Other employers have a finite period of future participation (e.g admission bodies who are closed to new entrants and who may be required to pay a termination payment on a gilts valuation positiont at the point the last active leaves). We can therefore quantify or estimate the outstanding period of time to the end of the admission agreement, a factor that should be taken into account in the combination of metrics which might trigger a change to a lower risk investment strategy. This is particularly pertinent when an employer has ceased and has made a cessation payment on a gilts basis. Currently this is invested in the main fund and running the volatility inherent in that rather than being invested.

Results of the analysis

There are combinations of metrics outlined above that may be strong indicators that an alternative investment strategy would be suitable. An example would be a combination of strong **funding level** and short **time horizon**.

For instance, an admission body that is a) well funded (say 120-140% funded on an ongoing basis); and b) has a short outstanding period of participation in the Fund (say 3 years or less) would likely benefit from switching to a lower risk investment strategy.

The analysis would include commentary on where any combinations of metrics indicates an alternative strategy would be more suitable.

Next steps

The next step in the process would be for Administering Authority to consider:

1. Undertaking the analysis of the risk metrics as outlined above; and
2. Reviewing the analysis and the need for the multiple strategies in the Fund.

If the need for multiple strategies is confirmed and the decision made to implement this following the 2019 valuation then there would be work carried out in conjunction with Mercer, in their capacity as the Fund's investment advisor. The work would involve identifying the number of alternative investment strategies and the strategic asset allocation of each.

Reliances and limitations

The advice in this paper is intended for the Fund to make a decision on whether to investigate the possible use of multiple investment strategies for employers.

This document should not be released or otherwise disclosed to any third party without our prior consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability in writing.

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For and on behalf of Hymans Robertson LLP

4 September 2018

Appendix

Recap on the HEAT system for allocating assets

Hymans Robertson Employer Asset Tracker (HEAT) is a system developed by Hymans Robertson that tracks the assets held by each employer in a multi-employer LGPS fund. The system can also be used to facilitate the implementation of multiple investment strategies within the fund.

The high level operation of the system is:

- The LGPS fund provides data to Hymans Robertson
- Hymans Robertson enters the data into HEAT
- HEAT calculates up to date employer asset values
- Hymans Robertson users can generate reports from HEAT which can be passed on to the LGPS fund.

The HEAT system uses a simplified cashflow approach to track employer asset shares.

Each implementation of the system is for one LGPS Fund and will track and report the asset position for each individual employer in that Fund. The system can also be used to track the asset position of a pool or group of employers; to do this it sums the assets attributed to each employer in the pool or group.

The system can be used to operate a single investment strategy or multiple investment strategies. Where a single investment strategy is operated initially, the system can be easily manipulated at a future date to introduce additional investment strategies. We have outlined below how the system operates for each of the single strategy and multiple strategy cases.

Overview of the HEAT process – single investment strategy

HEAT works on calculating investment returns for 'Sub Funds' on a monthly basis. Where there is only a single investment strategy being operated, there will be only one Sub Fund.

The Sub Fund is the sum of the assets across all investment managers ('invested assets') together with the Fund's uninvested cash (i.e. that sitting within the Fund's bank account(s)).

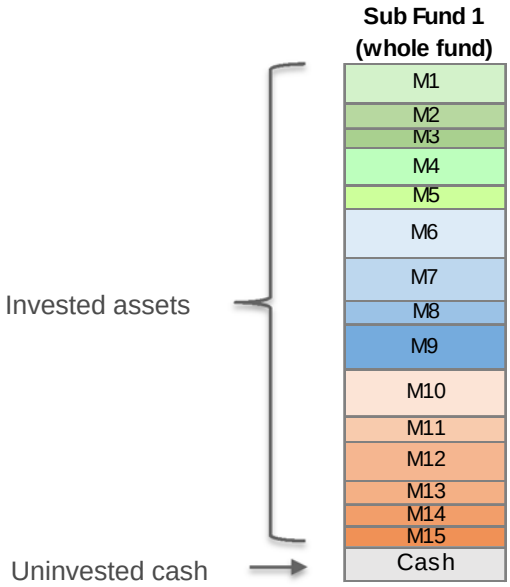
All Employers in the Fund are invested 100% in the Sub Fund, such that the sum of all of the employers' assets at any given month end equals the total value of the Sub Fund (and therefore the total value of the Fund).

At month ends, Employers are credited with investment returns (positive or negative) on the assets they notionally hold within the Sub Fund. Investment returns are derived from the change in the value of the Sub Fund over the month (after taking account for any inward or outward flow of assets in the month).

Employer cashflows are added to and subtracted from the Employer's asset holdings in the Sub Fund.

An example of a HEAT solution with a single investment strategy is shown in Figure A.

Figure A



Investment strategy	% in SF1	Employers
A	100%	1 - 40

Overview of the HEAT process – multiple investment strategies

HEAT calculates investment returns for notional 'Sub Funds' on a monthly basis. Where there are multiple investment strategies being operated, more than one Sub Fund will be required.

A Sub Fund is the sum of the assets across a collection of investment managers. Typically, the investment managers would serve a related purpose (e.g. growth assets). In addition to investment managers, each Sub Fund contains a notional, tracked portion of the Fund's uninvested cash (i.e. that sitting within the Fund's bank account(s)).

Employers are assigned to an investment strategy which is defined in terms of percentage holdings in each Sub Fund. For the avoidance of doubt, determining the investment strategy is not part of the HEAT scope of work.

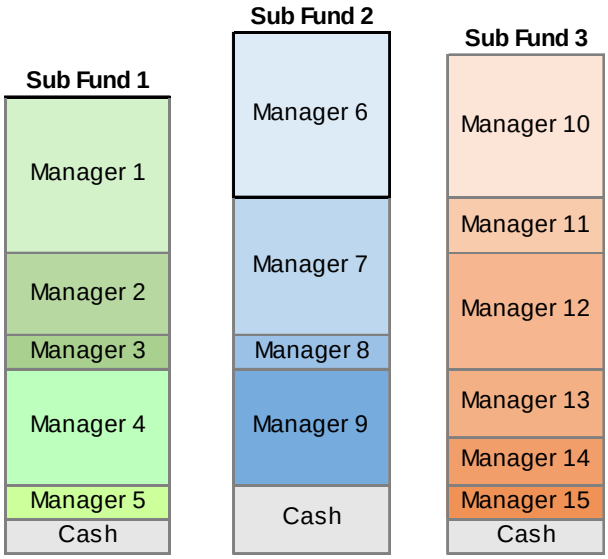
Employers are notionally allocated assets in each Sub Fund in accordance with their investment strategy. The sum of an employer's asset holdings across all Sub Funds is the Employer's total asset value.

At month ends, Employers are credited with investment returns (positive or negative) on the assets they notionally hold within each Sub Fund. Investment returns are derived from the change in the value of the Sub Fund's underlying assets (after taking account for any inward or outward flow of assets in the month).

Employer cashflows are added to and subtracted from the Employer's asset holdings in each Sub Fund in the proportions specified by the Employer's investment strategy.

An example of a HEAT solution with multiple investment strategies is shown in Figure B.

Figure B



Investment strategy	% in SF1	% in SF2	% in SF3	Employers
A	50%	50%		1 - 20
B		25%	75%	21 - 40

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