AGENDA ITEM 7

FALKIRK COUNCIL

Subject: **PENSION FUND – REVIEW OF INVESTMENT STRATEGY**
Meeting: **JOINT MEETING OF THE PENSIONS PANEL AND COMMITTEE**
Date: **12 MARCH 2015**
Author: **CHIEF FINANCE OFFICER**

1. INTRODUCTION

1.1 This report provides the Panel and Committee with an update on the progress of the Fund's review of investment strategy.

1.2 The report highlights the level of risk associated with various investment strategies, the options for reducing that risk and how the chosen investment strategy can be put into practice.

1.3 A short paper from Hymans Robertson is attached as an appendix to the report.

2. BACKGROUND

2.1 At the joint meeting of Panel and Committee on 11 December 2014, it was agreed that the review of Fund investment strategy should proceed on the following basis, recognising that the approach would be to work sequentially from a) to d):

a) Determine the level of risk that the Committee was prepared to tolerate
b) Determine the mix of growth and defensive assets that the Fund should target
c) Determine the mix of assets that the Fund should hold in order to meet its objectives
d) Determine the managers who should manage these assets?

2.2 It was recognised that this process would take time to work through and would ultimately require input from Hymans Robertson as investment advisers and from the in house investment team.

2.3 Information relating to the process was given to Panel and Committee members at the Investment Workshop on 2 February 2015.

3. INVESTMENT STRATEGY AND RISK MANAGEMENT

3.1 The Fund's objective is to be 100% fully funded by 2035 (i.e. in 20 years).

3.2 There are, however, no guarantees that full funding will be achieved in this timeframe and accordingly, it is important that Panel and Committee understand the risks that are inherent in the funding strategy. This includes the upside risk (i.e. the risk of not being fully funded) and the downside risk (i.e. the risk of having a very poor funding level).

3.3 The key components of the current strategy are as follows:

- Deficit being repaired over a 20 year period
- Expected asset outperformance is the return on Gilts + 1.6%
- Current asset mix is 10% Bonds and 90% Other Assets

3.4 Based on Hymans actuarial modelling, the current strategy has the following chances of success/failure:

- there is a 80% chance that the Fund will be 100% (fully) funded after 20 years
- there is a 5% chance that the funding level will be 50% or worse after 20 years
- there is an 85% chance that the funding level will be at least 70% by 2017

3.5 By increasing the level of bonds relative to other assets, it is possible to reduce the levels of risk without materially affecting the chances of achieving full funding. The table below shows how the chances of success are affected as the investment strategy is altered:

	Investment Strategy Options			
	10% Bonds 90% Other	20% Bonds 80% Other	30% Bonds 70% Other	40% Bonds 60% Other
Probability of being fully funded after 20 years	80%	80%	80%	79%
Funding level based on the average of the worst 5% economic outcomes	50%	55%	60%	65%
Probability that funding level will be at least 70% by 2017	85%	88%	90%	91%

3.6 The key messages from the table are that:

- Reducing growth assets to 60% does not adversely affect the 100% funding objective
- Increasing bond exposure helps reduce the risk of poor funding outcomes

3.7 Hymans modelling indicates that the Fund could adopt a lower risk strategy (i.e. increase bond exposure). This could be applied on a gradual basis with a de-risking plan put in place to control the process. The plan would consist of a series of triggers which would prompt the Fund to change its bond exposure as funding levels changed. Triggers could be reviewed at subsequent valuations to ensure they remained relevant, and indeed in the interim, if the landscape changed materially.

3.8 Whilst having a de-risking plan in place would demonstrate good risk management of the Fund, it is worth noting that gilt yields have fallen since March, 2014 and the funding level of 85% in March 2014 is now likely to be closer to 80%. Taken in conjunction with the fact that gilts are now even more expensive than they were in March last year, means that there is no immediate sound basis on which to put a "de-risking" plan into action.

3.9 Representatives from Hymans Robertson are attending the meeting and will be able to answer questions on a possible de-risking strategy.

4. IMPLEMENTING THE STRATEGY

4.1 Once the high level investment strategy has been determined, the next stage of the investment review is to implement any changes, such as asset type, asset allocation and managers, which may be required to enable the Fund to meet its strategic objectives.

4.2 This part of the review will look at factors such as current market influences, prospective returns from asset classes and underlying strategies within each of the asset pools. This will include:

- The balance between active and passive management
- The arguments for a non-market cap passive mandate
- The composition of the bond portfolio
- The review of existing managers and mandates
- The costs of realigning the portfolio

4.3 In order to progress the review, it is suggested that the Committee may wish to form a sub-group to work on these issues with the Chief Finance Officer, the internal team and Fund advisers. It is recognised that the scope of work involved may require initial recommendations only to be brought to the next joint meeting of Committee and Board and further recommendations brought to a subsequent joint meeting.

5. CONCLUSION

5.1 The current investment and contribution strategies mean that the Fund has an 80% chance of being fully funded after 20 years and only a 5% chance of having a funding level less than 50% over the same period.

5.2 Actuarial modelling suggests that there are opportunities for the Fund to reduce its exposure to assets, such as equities, without materially affecting the chances of the Fund achieving a 100% funding position. Committee may wish to adopt a lower risk strategy and put a "de-risking" plan in place, although due to current financial conditions there would be no need to put such a plan into action immediately.

5.3 The potential for the Fund to alter its assets and review asset allocations will be considered in the coming weeks. This is to ensure that investments remain aligned with Fund objectives and that mandates are operating satisfactorily. A sub group of the Committee could be an effective way of taking these matters forward.

6. RECOMMENDATIONS

6.1 The Panel and Committee are asked to note the contents of this report and invited to comment as appropriate.

6.2 The Committee is asked:

i) to note the range of investment strategies set out in paragraph 3.5;

ii) to recognise the risks associated with these strategies;

iii) to determine which of the strategies should be adopted;

iv) to agree that a de-risking plan be put in place to allow risk to be further reduced as the funding level improves;

v) to agree that a sub group of the Committee be convened to make recommendations regarding the implementation of the strategy and the range of asset classes, asset allocations and managers to be deployed by the Fund; and

vi) to ask the Chief Finance Officer to report progress on these matters to the next meeting of the Committee.

Chief Finance Officer

Date: 4 March 2015

Contact Officer: Alastair McGirr

<u>LIST OF BACKGROUND PAPERS</u>

NIL

Investment Strategy

Addressee

This paper is addressed to the Officers and Pensions Committee ("the Committee") of the Falkirk Pension Fund ("the Fund"). It follows on from the training session held on 2 February 2015. The slides that were used at the training session have been attached to this paper as an Appendix. This paper provides a summary of the training and sets out options for consideration for the future investment strategy for the Fund. It has not been prepared for use for any other purpose. The paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent.

We accept no liability where the report is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Setting objectives

The Fund's Statement of Investment Principles states that the Fund's objective is 'to provide pension and lump sum benefits on death, before or after retirement … In meeting this objective, the Fund will also seek to keep contributions as low and as stable as possible through effective management of its assets.' This objective is consistent with the published objectives of other LGPS funds.

This objective is partially quantified by the actuarial valuation of the Fund. The valuation establishes the target funding basis which determines the level of assets the Fund aims to hold to meet the liabilities. At the most recent valuation as at 31 March 2014, the Funds had a funding level of 85%, a shortfall of £283m was identified and an appropriate contribution strategy was put in place to partially fund the deficit. The contribution strategy alone will not be sufficient to restore the fund to full funding and there is reliance on the Fund's investment strategy to deliver returns which will assist in returning the Fund to a full funding position.

In order to help identify the optimal investment strategy, it would be helpful to further refine the Fund's objective and to transform the qualitative statements above into quantitative measures which could then be reflected in modelling work which could help to identify the appropriate level of risk to be taken now and in the future as the funding level evolves.

When full funding is achieved, the Fund will still need some growth, but significantly less than is needed today.

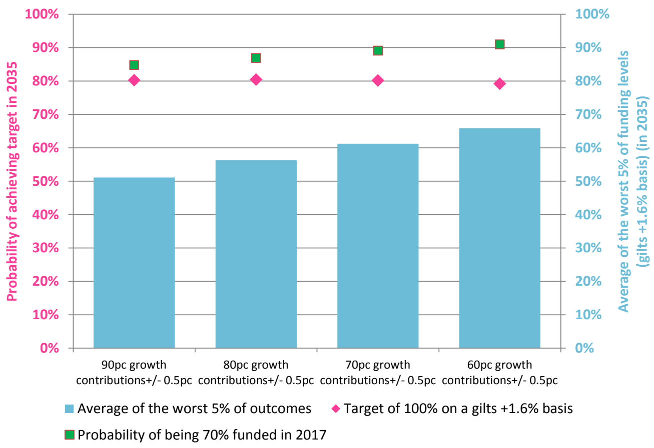
As an example these measures could be;

- The probability of being fully funded by 2035 should be greater than 75%
- The probability of the funding level being below 60% in 2035 should be very small, say 10-20%
- The probability of the funding level falling below 70% at the next valuation in 2017 should be less than 20%.

The Committee should discuss and agree the measures that are consistent with their appetite for risk. Chart 1 below shows the output from modelling that was done based on membership data at 31 March 2013 and calibrated to market data as at 30 June 2014.

From the employers' perspective we need to balance the investment strategy with the contributions strategy. In our experience employers are content to accept relative stability in contributions, which could result in less potential for reductions in contributions, in return for a reduced risk of higher contributions.

Chart 1: Probability of meeting target by 2035, risk in 2035 and 2017



Under the current strategy (90% growth assets) there was

- an 80% chance of achieving full funding by 2035
- a 5% chance that the funding level would be 50% or lower by 2035
- c. 15% chance of the funding level falling below 70% at the next valuation

Reducing the growth assets from 90% down to 60% marginally reduces the probability of reaching full funding but also improves the downside in both the long and the short term.

Setting the investment strategy

The Fund should ideally take no more risk than it needs to achieve full funding over the agreed time horizon. Taking more risk than is required might make a small difference to the probability of reaching full funding but will also result in a potentially poorer outcome on the downside. When risk can be reduced without impacting on the probability of success then this option should be given serious consideration. The result should be a smooth progression from the high returns required today down to the lower level that will be required when full funding is achieved.

Funding level evolution

Including growth assets like equities in the investment strategy means that the expectation is that the assets will grow faster than the liabilities over the long term. As a result the funding level is expected to improve over time. For example if the fund were targeting full funding over 15 years and currently had a funding level of 82% then in 5 years' time the funding level would be expected to have increased to c 88%. It is only if the funding level gets ahead of 'plan' that de-risking should take place, otherwise there is a risk that the contribution rate takes the strain and has to be increased.

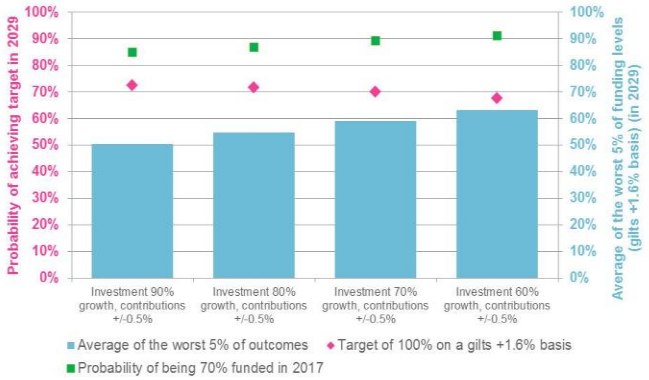
If the funding level increases faster than expected then there may be an opportunity to reduce the level of risk in the strategy. This would be done by reducing the Fund's exposure to equities. An extension of the modelling that has already been carried out for the Fund could be used to identify the appropriate funding level for reducing the level of risk while maintaining an acceptable chance of reaching full funding and reducing the volatility on the downside.

The modelling should also consider the impact on the contribution rate as there is a requirement to provide stability on the level of employer contribution rates. If the level of risk is reduced too quickly then the burden will be borne by the contribution rate. The presentation at the training session on funding issues and the interaction with investment strategy made this very clear.

Time horizon

The decision about de-risking is dependent on the timescale; if the objective was to achieve full funding earlier, say in 2029 rather than 2035, then it is likely that the exposure to risky assets will need to remain 'higher for longer'. This can be seen clearly if Chart 2 below is compared with Chart 1 above. 2029 is about the time when the Fund is likely to go cashflow negative (when benefit outgo exceeds contribution income.)

Chart 2: probability of meeting target in 2029, risk in 2029 and 2017



Feedback on objectives

We sought some feedback from those who attended the training session to firm up on the time horizon and the degree of certainty for achieving full funding that the Officers and Committee would be comfortable with. While the balance of opinion on timescale was that the appropriate time horizon was 2035, there was some support from the Committee for a shorter timescale, c 2026. A relatively high degree of certainty was common in the responses with the average pointing towards 80-90% probability of achieving full funding. On the potential for the funding level to deteriorate by the next valuation in 2017, the consensus was that a level of 70% or better was desirable and that a good degree of certainty (70-80%) was required around this not being breached.

Recommendations

In order to set an investment strategy for now and a plan for adapting the strategy as the funding level changes, the Committee should agree;

1. the time horizon for reaching full funding
2. the preferred probability of being fully funded at the time horizon
3. the acceptable lower 'limit' for the funding level and the acceptable probability of falling below this level at the time horizon
4. the probability that can be tolerated of the funding level falling below an agreed funding level at the next valuation in 2017

Following that, further modelling should be carried out which will help to define

a) a funding level trigger for reducing risk

b) the evolution of that funding level trigger over time

c) the size of the risk reduction that should be implemented if the trigger is reached

d) implications for contribution strategy

The agreed trigger should be reviewed at each formal valuation and a new trigger for further de-risking should be considered after the first trigger is implemented.

A robust process for monitoring the funding level on an appropriate frequency should be implemented to ensure that the Fund can act quickly if the trigger level is reached. This may require delegation to the Officers.

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February 2015

For and on behalf of Hymans Robertson LLP