Investment Risk Management:
All about Worcestershire Pension Fund's (the Fund's) Investment Pots
dated 19 04 2023

The Local Government Pension Scheme (LGPS) is a funded, defined benefit (DB) pension scheme i.e. members' benefits are a known amount at retirement and are paid out of the invested assets, rather than just the current income from this year's employer and employee contributions.

Employer and employee contributions are collected and invested continuously by the 86 regional / geographically based, stand-alone funds administering the LGPS nationally to pay for the benefit 'promises' at retirement / on death earned by the members of each respective fund.

By investing contributions in growth assets such as equities, it is anticipated that each fund's assets will, over time, deliver sufficient returns in excess of inflation and thereby reduce the contribution requirements on its participating employers to pay for the benefit 'promises' made.

Participating employers (or groups of similar employers) are treated separately in each fund: each distinct employer (or group of employers) has its own allocated share of fund assets and its own liabilities in the form of the benefit 'promises' made to its current and past employees.

Investment risk is typically the largest risk that a participating employer is exposed to, as member contributions are fixed by the LGPS regulations, and the employer is required to meet the rest of the cost: poor investment performance will result in participating employers having to make higher payments to ensure that there is sufficient money to pay for their previous benefit 'promises'.

It is not possible to construct a portfolio of investments which produces a stream of income closely matching employers' benefit 'promises'.

However, it is possible to construct a portfolio of investments which represents the 'minimum risk' investment position which would deliver a very high certainty of real returns and stable contributions.

Such a portfolio would consist of a mixture of long-term index-linked, fixed interest gilts and longevity swap instruments.

Whilst such a portfolio would provide greater stability of contributions, the employer costs would be very high, as the assets would not deliver investment returns to offset some of the cost.

The Fund therefore includes a range of growth assets within its investment strategy, with the aim of increasing expected real returns and reducing employer costs but within an acceptable level of risk.

Every three years an actuarial valuation of the Fund is undertaken to quantify the expected cost of paying for the benefit 'promises' made by its participating employers and to assess its participating employers' funding positions.

The key valuation assumptions are the expected rate of inflation and the expected rate of return on investments.

The key outputs of the valuation are the future contribution rate each employer (or group of employers) will have to make to pay for its future benefit 'promises' and the deficit recovery payments (if any, as an employer can be in surplus) each employer will have to pay to correct any underfunding of benefits already promised up to the valuation date.

Up until 31 March 2020 all of the Fund's employers (there were 287 employers with employee members on the Fund's pension administration system as at 31 March 2020 and 156 employer groupings in the Fund's 2019 actuarial valuation report, with the largest employer group comprising 33 town / parish councils,) had their assets, their contributions and the contributions of their employees invested in the same portfolio of investment assets.

The Fund's investment strategy involved taking a reasonable level of investment risk to aim to achieve a higher expected return and took account of the fact that a significant proportion of the Fund's membership is provided by public bodies which are expected to remain in the Fund over the long term and have a strong financial covenant.

As each employer (or group of employers) has its own share of the Fund's assets and its own liabilities, this 'one size fits all' approach did not allow employers to manage their investment risk on an organisational basis (to reflect their own objectives) or allow employers to reduce the potential volatility in their future, expected funding position and/or to target increased certainty of contributions and cost.

Therefore, with effect from 1 April 2020 the Fund introduced three investment pots: Growth, Medium and Cautious.

The pots are designed to take different levels of investment risk and to allow each of the Fund's employers to be allocated to a pot that reflects its:

- Type e.g. tax raising body, academy, admitted body, etc.
- Ongoing covenant strength, including any guarantee or security
- Size, maturity, and funding position
- Status e.g. open/closed to new members
- Objectives e.g. any plans to terminate its participation

The choice of investment pot will be reflected in each employer's (or group of employers') asset share, funding basis and contribution requirements.

The inflation and rate of return on investment return assumptions (or discount rate) for each investment pot at the 2019 actuarial valuation were:

	Growth pot	Medium pot	Cautious pot
Funding liabilities discount rate:	4.05% p.a.	3.8% p.a.	2.65% p.a.
Future service discount rate:	4.65% p.a.	4.4% p.a.	2.65% p.a.
CPI price inflation	2.4% p.a.	2.4% p.a.	2.4% p.a.

The above assumptions were changed at the 2022 actuarial valuation to:

	Growth pot	Medium pot	Cautious pot
Funding liabilities discount rate:	4.60% p.a.	4.35% p.a.	2.45% p.a.
Future service discount rate:	5.10% p.a.	4.85% p.a.	2.45% p.a.
CPI price inflation	3.10% p.a.	3.10% p.a.	3.10% p.a.

The target asset allocations, appointed investment managers as at 1 April 2023 and benchmarks for each investment pot were:

	Growth	**Medium**	**Cautious**	
Asset Allocation	**%**	**%**	**%**	**Manager, Method & Performance Target**
Actively Managed Equities				
Far East Developed	10.0	5.0	0.0	Nomura Asset Management - FTSE All World Asia Pacific Index + 1.5%
Emerging Markets	10.0	5.0	0.0	LGPSC active global emerging markets equity mandates with BMO, UBS and Vontobel - FTSE Emerging Market Index +2.0%
LGPSC Global Sustainable	6.0	3.0	0.0	LGPSC active Global Sustainable equity mandates with Liontrust and Baillie Gifford - FTSE – All World +2.0% to 3%
Passively Managed Equities - Market Capitalisation Indices				
United Kingdom	12.0	9.0	0.0	Legal & General Asset Management - FTSE All Share Index
North America	11.5	9.0	0.0	Legal & General Asset Management - FTSE All World North America Developed Series Index
Europe ex - UK	5.5	4.0	0.0	Legal & General Asset Management - FTSE All World Europe ex UK Index / Developed Series Index
Passively Managed Equities – Alternative Indices				
Global	15.0	5.0	0.0	Legal and General Asset Management: 60% STAJ - CSUF - STAJ MF36726/36727 (Quality Factor) 40% LGPSC All World Equity Multi Factor Climate Fund
Fixed Income				
Fixed Income	10.0	40.0	80.0	LGPSC Global Active Investment Grade Corporate Bond (Fidelity & Neuberger Berman) - Fund 50% GBP IG Corporate (Ex EM Issues) / 50 % Global IG Corporate ((ex IG Corporate & EM Issues) hedged to GBP +0.80% Bridgepoint Corporate Private Debt
Actively Managed Alternative Assets				
Property, Infrastructure and Private Equity*	20.0	20.0	20.0	Through a mix of Macquarie (was Green Investment Bank), Invesco, Hermes, Walton Street, Venn Partners, Stonepeak, Igneo (was First Sentier), AEW, Gresham House, etc.
TOTAL	**100.0**	**100.0**	**100.0**	

*NOTE: The Fund will allocate 5% to Private Equity by using the flexibility within the strategic asset allocation ranges that are available to build up to the 5% over time.

The target asset allocations for each investment pot reflect the Fund's views on the appropriate balance between generating required long-term returns, whilst taking account of market volatility, risk, and the nature of the Fund's liabilities.

The investment strategy underlying each investment pot will be reviewed formally at each actuarial valuation along with the Fund's overall investment strategy. This review will take account of any employer requests to move pots and any movements of employers between pots due to changes in employer funding position / employer covenant.
In addition, a high-level health check of asset allocation for each investment pot will be performed annually. This will allow for market changes and outlook, as well as underlying changes in the maturity and profile of the liabilities of the employers within each pot.

The Fund may initiate a formal review of asset allocation for each investment pot mid valuation at any time if there is a material shift of employers between pots and/or a material shift in the Fund's funding position in order to manage the overall risk more efficiently.

Employer allocations to each investment pot will also be reviewed at each actuarial valuation.

The relative financial strength of employers and their funding position is reviewed through the annual covenant assessment carried out by the Fund. This thorough assessment of the employer's financial metrics is performed using an online system provided by the Fund's actuary, and where a risk criterion is triggered, an employer will be subject to a more detailed review at least every six months, but more realistically with a quarterly focus.

Following the annual covenant assessment carried out by the Fund, if an employer is deemed to have a weaker covenant than other employers in the Fund, or is expected to exit the Fund in the near future, the Fund reserves the right to move an employer (typically following discussions with that employer) into either the Medium or Cautious pot to provide some protection against deterioration in funding position for the employer and the Fund as a whole. The employer will be advised of any such change in pot.

Any orphaned liabilities once an employer exits the Fund will generally be automatically moved into the Cautious pot, as these liabilities have no sponsoring employer and are ultimately underwritten by all employers within the Fund. The progress of employers in the Cautious pot will be monitored every year, as these employers are already invested in their 'target funding plan'.

An employer's allocation to a pot may also be reviewed by the Fund mid valuation at any time in the following circumstances:

- Material change in certain types of employers' funding position
- Material change in an employer's status or covenant
- Request from an employer to move investment pots, subject to the agreement of the Fund

<u>Note:</u> Employer requests to move pots should be made to Sherief Loutfy
Head of Pension Investment and Financial Planning, in the first instance. There will not be a specific cost of moving to a different pot. However, as moving pots will affect the expected future investment return on that employer's assets, the employer's deficit recovery payments and future service contribution rate will be recalculated by the Fund's actuary. The Fund will recharge the actuarial fees that will be incurred for such assessment to the relevant employer if it is employer instigated between valuations. Once this recalculation has been

done, the Fund will discuss the request to move pot with the employer before agreeing to the request.

In summary, investment pots have been introduced to:

- Help each employer to take the appropriate level of investment risk
- Give each employer the best opportunity possible to achieve its long-term funding objective whilst increasing certainty of cost

An employer will be able to monitor how their pot is performing from the information tabled at Pensions Committee on a quarterly basis and published at https://worcestershire.moderngov.co.uk/ieListMeetings.aspx?CId=391&Year=0

For the avoidance of doubt, investment pots do not remove all risk for employers within the Fund. Other risks e.g. inflation, life expectancy, etc. remain and further details on the risks identified from participation in the LGPS, as well as any counter measures being employed by the Fund, are available in the Funding Strategy Statement.

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