

Funding and Investment considerations at 30 June 2021

Introduction and Purpose

This paper is addressed to the Pensions Committee (“the Committee”) of the London Borough of Hackney Pension Fund (“the Fund”). In it we consider the suitability for altering the investment strategy given recent asset outperformance.

Many LGPS Funds across the country have benefited from strong asset returns over the period since the 2019 actuarial valuation, primarily driven by strong returns across Growth and Income assets. This has, in many cases and as is the case for the Fund, led to funding levels improving to a “fully funded” position. The Fund has therefore asked us to consider whether it would be appropriate to now consider reducing risk in the investment strategy by increasing the Fund’s allocation to protection assets (bonds). In this paper we consider:

- How recent asset outperformance has impacted the Fund’s funding level;
- What the improved funding level means for the Fund’s ability to meet future benefit payments; and
- Proposed next steps

The data, assumptions and methodology underlying the results in this paper is contained in the Appendix.

Recap of 2020 investment strategy review

The investment strategy review in 2020 considered the suitability of the current investment strategy and whether there was scope to de-risk in certain scenarios. Some of the key modelling results are summarised in the following table:

Inputs			
Investment strategy	2020 investment strategy	Alternative strategy 1 (De-risk to protection assets; +10% Protection)	Alternative strategy 2 (Diversifying to income; +10% Income)
Council contribution rate (assumed to be paid indefinitely)	30% of payroll	30% of payroll	30% of payroll
Results			
Likelihood of achieving funding target in 2036	60%	57%	63%
Average of the worst 5% of funding levels in 2036	45%	48%	47%

Following discussion with Fund Officers and the Committee, it was agreed that Alternative Strategy 2, which has

an 83% allocation to Growth and Income assets and a 17% allocation to Protection assets, would be implemented. Implementation of the revised strategic asset allocation is currently underway.

As part of the modelling exercise, we also considered:

- A scenario whereby assets were 10% higher: in this scenario the likelihood of achieving the funding target in 2036 improved by around 6-7% for all investment strategies considered
- A scenario whereby assets were 10% higher and the Council contribution rate was reduced to 20% (assumed to be paid indefinitely): in this scenario the likelihood of achieving the funding target in 2036 reduced by around 15-17% for all investment strategies considered. (It should be noted that modelling with notional fixed contribution rates occurs to isolate the impact of the change in investment strategy and wouldn't be used to set a contribution strategy specifically).

From these results it was inferred that strong future asset outperformance *may* provide an opportunity to de-risk to Protection assets (as in Alternative strategy 1), **however any decision to do so should always be considered alongside consideration of the Council contribution rate.** Investment returns and employer contributions work in tandem to fund future benefit payments, therefore balancing investment risk and affordability of contributions is key.

How has recent asset outperformance impacted the Fund's funding level?

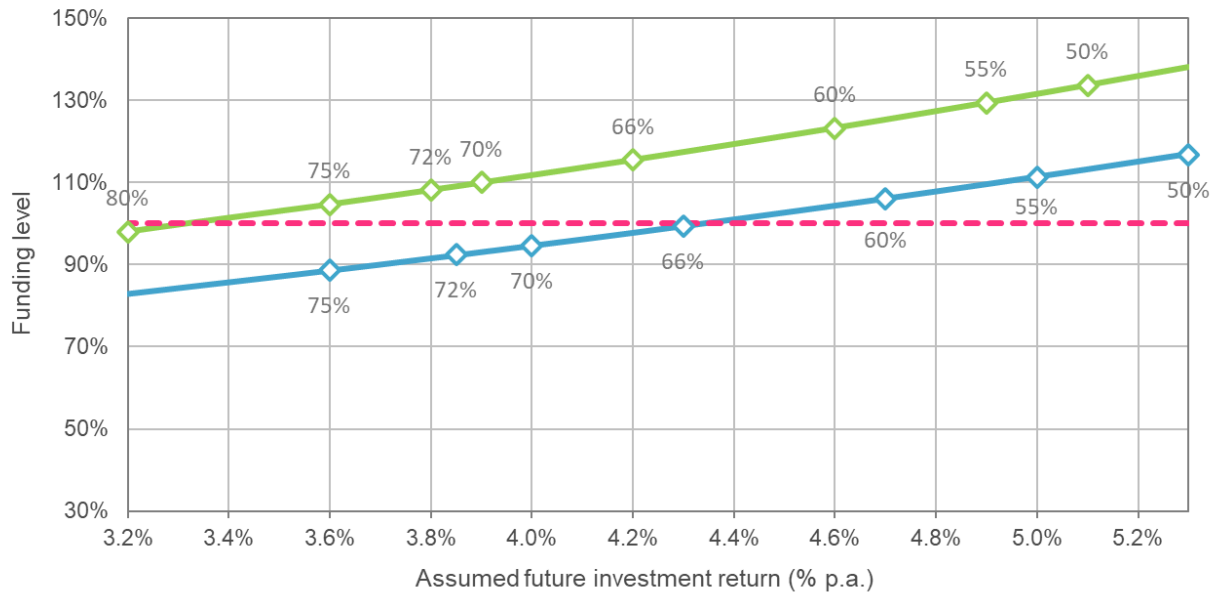
As at 30 June 2021, the Fund's asset value was £1,895m, increased from £1,575m at the last valuation. The investment return since March 2019 has been c24%, being the main driver of this increase.

The funding level is derived as the ratio of the value of the Fund's assets to the value of its accrued liabilities. Actual benefit payments in the future will be in respect of both service accrued up to today ("past service") and service that will be accrued in the future ("future service"). However, the funding level presented is only in respect of **past service** benefits.

The funding level is only a snapshot in time based on a single set of assumptions about the future and is therefore sensitive to the choice of assumptions, in particular the expected future investment return assumption.

Chart 1 below shows how the funding level varies with the future investment return assumption at 30 June 2021 (green line). For comparison, we have also shown the results of the same analysis as at 31 March 2019 (blue line). Along each line we have highlighted points which show the likelihood of the Fund's assets achieving the corresponding assumed future investment return. The likelihoods are those that were estimated at the relevant date i.e. 31 March 2019 or 30 June 2021.

Chart 1



From this chart, we can see that regardless of the investment return assumption used, there has been an improvement in the funding position at 30 June 2021 compared to the 2019 valuation, reflecting an increase in assets held today per pound of benefit to be paid out in future.

The outlook for future investment returns has broadly stayed the same since the last formal valuation. At 30 June 2021, we estimate that the Fund’s asset allocation has a 72% likelihood of achieving an annual return of at least 3.8% p.a. (at 31 March 2019, the equivalent return was 3.85% p.a.).

Based on the Fund targeting an annual future investment return which has a 72% likelihood of being achieved, the past service funding position has improved from a 92% funded (deficit of £130m) to 107% funded (surplus of £123m). The improvement has been largely driven by strong investment performance since 31 March 2019.

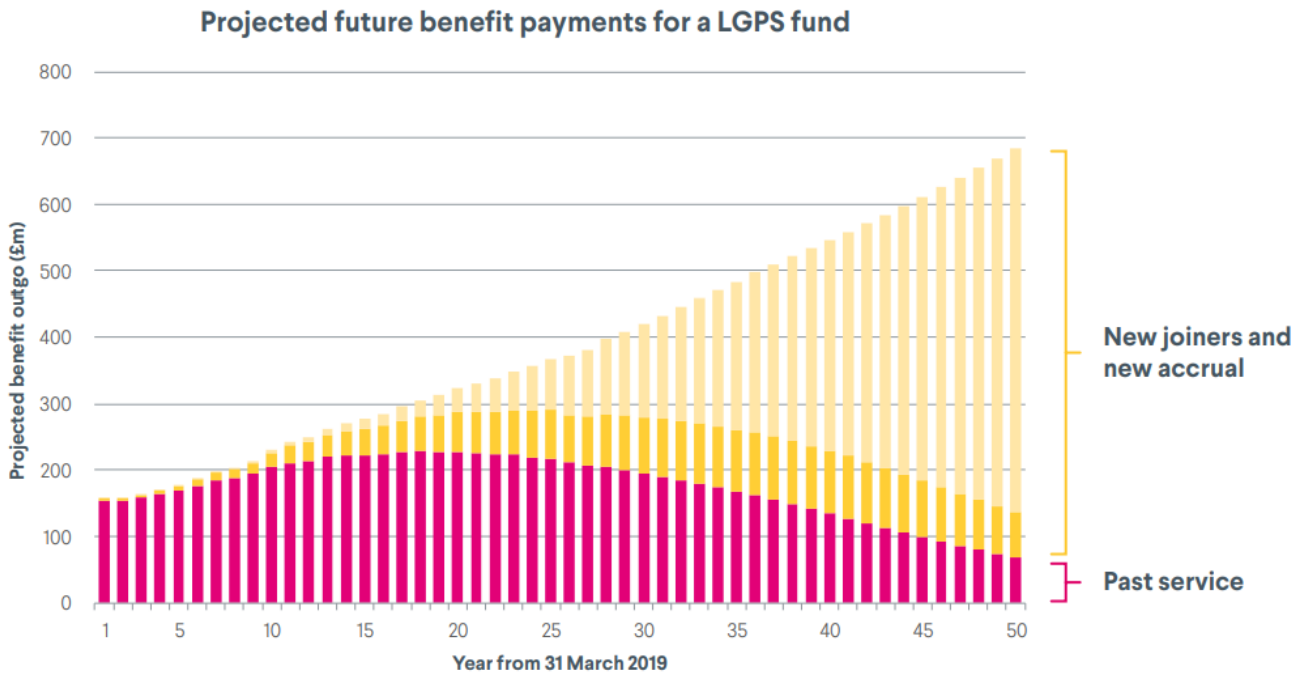
The future investment return required to be notionally fully funded has fallen from 4.3% p.a. to 3.3% p.a. The likelihood of the Fund’s assets achieving this required level of return has increased from 65% to 79%. Therefore, the Fund is now more likely than not to achieve the future returns needed to be fully funded.

What does the improved funding level mean (and what does it not mean)?

If thinking only about the past service funding position then it would appear that the Fund has met its objective. However, being 100% funded in a scheme like the LGPS which is both open to future accrual and new entrants, is not the endgame. To put this in context, the benefits that relate to past service only account for about 30% of the benefit payments that will be paid out in future.

Chart 2 below shows the projected future benefit payments from a typical LGPS fund based on the assumptions made at the 2019 actuarial valuation:

Chart 2



From this chart, we can see that around two-thirds of the benefit payments made over the next 50 years will be in respect of benefits that have yet to be accrued. This will include benefits earned by existing members (new accrual) and benefits earned by new members who begin service in the LGPS after the valuation date (new joiners). The Fund’s strong funding level tells us that assets held today are more likely than not to cover past service benefits, but we can see from this chart that the benefits still to be earned are of greater significance. Indeed, the majority of the London Borough of Hackney’s current contribution rate in payment (30% of pay) is the *Primary contribution rate* (18.5% of pay), which is the element of contribution that aims to meet the cost of future benefit accrual. The *Secondary contribution rate*, which aims to target a funding position over an agreed time horizon, is the smaller element (11.5% of payroll).

The improved past service funding position at 30 June 2021 is likely to have a positive impact on Secondary rate contributions at the next valuation, all else being equal. However, as at 30 June 2021, longer term future market conditions for valuing benefit costs are expected to be more challenging and are applying upward pressure to the future service cost (compared to March 2019). The increased cost of future accrual will lead to an increased Primary contribution rate.

Conclusions and next steps

Recent strong asset outperformance has served to increase the Fund’s funding level. The fund is now (as at 30 June 2021) “fully funded” on a prudent valuation basis which means it is more likely than not to be able to meet the cost of benefits accrued to date. However, consideration of the funding level does not in itself answer the question “Can the fund meet all future benefit payments?” because it does not consider the benefits which will be accrued in future.

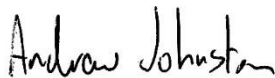
Having said this, recent strong asset outperformance is good news for the Fund and will help to meet the cost of past and future service benefit payments, all else being equal. This outperformance may also provide the Fund with an opportunity to reduce risk within its investment strategy by increasing its allocation to Protection assets (bonds).

An *Asset Liability Modelling (ALM)* exercise, such as that undertaken by the Fund Actuary in 2019 to help set the contribution strategy, and by the Fund Investment Consultant in 2020 to help set the investment strategy, considers how the investment strategy and contribution strategy operate **in tandem** to meet the cost of **past and future service** benefits. Rather than focusing on a single set of actuarial assumptions at a snapshot in time (like the simplistic funding level metric), an ALM exercise seeks to ascertain the likelihood of the fund meeting its benefit obligations over a long time horizon (typically 20 years) and a variety of possible future economic scenarios.

To allow the Fund to act quickly on any opportunities recent asset outperformance might present, we would propose to bring forward the 2022 Council contribution rate review to Q4 2021, and carry out a review of the Fund's investment strategy as part of this exercise. In doing so, the Fund can work with its Actuary and Investment Consultant to agree a contribution and investment strategy which together have a high likelihood of meeting the Fund's long-term objectives.

We would be happy to prepare a full modelling proposal should the Committee wish to proceed with this proposal.

Prepared by:-



Andrew Johnston
Investment Consultant



Laura McInroy FFA
Fund Actuary

13 September 2021

For and on behalf of Hymans Robertson LLP

Reliances and limitations

This paper has been prepared for London Borough of Hackney as Administering Authority of the London Borough of Hackney Pension Fund for the purpose described above. It has not been prepared for use for any other purpose and should not be so used. The paper should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. We accept no liability where the paper is used by or disclosed to a third party unless we have expressly accepted such liability in writing. Where this is permitted, the paper may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

The following Technical Actuarial Standards are applicable in relation to this advice, and have been complied with where material and to a proportionate degree:

- TAS100

This report together with the formal valuation report for the Fund (issued March 2020) and the Fund's Funding Strategy Statement set out the aggregate of my advice.

Appendix – Funding position, Data, Assumptions and Methodology

Funding position

	31 March 2019	30 June 2021
Assumed future investment return (based on a 72% likelihood of success)	3.85%	3.80%
Salary increase assumption	2.60%	2.60%
Pension increase assumption	2.30%	2.30%
Assets (£m)	1,575	1,895
Past service liabilities (£m)	1,706	1,772
Surplus/(Deficit) (£m)	(131)	123
Funding level	92%	107%
Future investment return required to be 100% funded	4.3%	3.3%
Likelihood of achieving this return	65%	79%
Likelihood of Primary Rate of 18.7% of pay meeting the cost of future benefit accrual	71%	51%

Assumptions and methodology

Liabilities

All demographic and financial assumptions underlying the benefit projections are as per the 31 March 2019 formal valuation with the exception of the future inflation assumption (which affects the rate of future pension increases, CARE revaluation and salary increases).

Further details about the assumptions can be found in the 2019 formal valuation report dated March 2020.

The future long-term inflation assumption used in the benefit projections as at 30 June 2021 is 2.3% p.a.. Therefore, as at 30 June 2021 we have assumed that:

- Future pension increases are 2.3% p.a.
- Future CARE pot revaluation is 2.3% p.a.
- Future salary increases are 2.6% p.a.

The benefit projections assume that membership experience since 31 March 2019 has been in line with the assumptions made. At a whole fund level, this assumption is reasonable to make and, for the purpose of this paper, we do not expect this to result in a material inaccuracy.

We have also allowed for additional benefit accrual between 1 April 2019 to 30 June 2021. This allows comparison with the Fund's asset value as at 30 June 2021.

To calculate the expected future investment returns, we have used our proprietary Economic Service Scenario ("ESS") model, and the same methodology used at the last formal valuation. Further details about the ESS model, and the calibration of the model as at 31 March 2019, can be found in the 2019 valuation formal report dated March 2020.

The calibration of the model as at 30 June 2021 is detailed below. The following figures have been calculated using 5,000 simulations of the ESS, calibrated using market data as at 30 June 2021. All returns are shown net of fees. Percentiles refer to percentiles of the 5,000 simulations and are the annualised total returns over 5, 10 and 20 years, except for the yields which refer to the simulated yields for at that time horizon. Only the overall Fund portfolio returns are shown, however similar information for separate asset classes is available on request.

	% p.a.	Portfolio returns	Inflation (CPI)	17 year real yield
5 years	16th %'ile	-0.6%	0.8%	-2.4%
	50th %'ile	3.7%	2.4%	-1.5%
	84th %'ile	7.9%	3.9%	-0.6%
10 years	16th %'ile	1.0%	0.8%	-1.8%
	50th %'ile	4.2%	2.5%	-0.6%
	84th %'ile	7.2%	4.1%	0.6%
20 years	16th %'ile	2.5%	0.7%	-0.7%
	50th %'ile	5.0%	2.2%	1.0%
	84th %'ile	7.5%	3.8%	2.7%
	Volatility (1 year)	9%	1.3%	

The current calibration of the model indicates that a period of outward yield movement is expected. For example, over the next 20 years our model expects the 17 year maturity annualised real (nominal) interest rate to rise from -2.3% (1.2%) to 1.0% (3.2%).

Assets

The asset value as at 30 June 2021 has been provided to us by the Fund. To derive the level of likelihood associated with certain level of expected future returns, we have used the ESS model as described above and the Fund's current strategic asset allocation:

% allocation	
Global Equities	36%
Global Emerging Market Equities	4.5%
Multi Asset	7.5%
Total growth	48%
Private lending	20%
Property	10%
Infrastructure	5%
Total Income	35%
Fixed Income	17%
Total Protection	17%
Total	100%

Model limitations

The models used to calculate the results in the paper make some necessary simplifying assumptions. I do not consider these simplifications to be material and I am satisfied that they are appropriate for the purposes described in this report.

Funding Risks

Please see the FSS for details of the funding risks that apply to the future ability of the Fund to pay all members' benefits. These include, but are not limited to:

- Market risks – these include investment returns being less than anticipated or liabilities increasing more than expected due to changes in market conditions underlying the financial assumptions (e.g. inflation or pay increases above that assumed etc.).
- Demographic risks – these include anything that affects the timing or type of benefits (e.g. members living longer than anticipated, fewer members opting into the 50/50 option, etc.).
- Regulatory risks – the LGPS is a statutory scheme. There is a risk that central Government legislation could significantly change the cost of the scheme in future.

In particular, the benefit structure of the LGPS is currently under review as a result of the consultation on the McCloud and Sargeant judgement, HM Treasury's and Scheme Advisory Board's cost-sharing valuations as well as the recent outcome of the Goodwin tribunal. Benefit changes as a result of these issues may materially affect the value of benefits earned by members both in the past and future. I have made no direct allowance for these changes and may need to review my calculations once the outcomes are known.

- Administration and Governance risks – failures in administration processes can lead to incorrect actuarial calculations. For example, where membership data is not up to date (e.g. leaver forms not being submitted in a timely matter) material inaccuracies in respect of the level of deficit and contributions may occur at future valuations.
- Resource and Environmental risks – i.e. risks relating to potential resource constraints and environmental changes, and their impact on Fund employers and investments: such risks exist and may prove to be material. Given the lack of relevant quantitative information available specifically relevant to the Fund, I have not explicitly incorporated such risks in this advice. The Administering Authority may wish to seek direct advice on these risks.