


<p style="text-align: center;"><b>London Borough of Hammersmith &amp; Fulham</b></p> <p style="text-align: center;"><b>PENSIONS BOARD</b></p> <p style="text-align: center;"><b>6 February 2019</b></p>	
<p><b>EQUITY PROTECTION STRATEGY</b></p>	
<p><b>Report of the Strategic Director, Finance and Governance</b></p>	
<p><b>Open Report</b></p>	
<p><b>Classification - For Information</b></p> <p><b>Key Decision: No</b></p>	
<p><b>Wards Affected: None</b></p>	
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## 1. EXECUTIVE SUMMARY

1.1 This paper provides the Pensions Board Members a summary of:

- a. The different types of equity protection.
- b. The likely characteristics of these different options.
- c. Potential solutions and whether they are appropriate for the Hammersmith and Fulham Pension Fund.

## 2. RECOMMENDATIONS

2.1 The Board is requested to note:

- a. The different types of equity protection strategies available.
- b. The Pension Fund Sub-Committee's decision to not pursue any form of equity protection at this time.

### **3 EQUITY PROTECTION BACKGROUND AND STRATEGIES**

- 3.1 As at 30 September 2018, the Fund had an allocation to equities of 48%, split between a passive equity investment for LGIM (32%) and an active UK equity strategy with Majedie, (16%) split across three Majedie strategies (Global, Tortoise and Focus). Since the sale of the Fund's Tortoise and Focus funds with Majedie, this is now 33% and 14% respectively as at 4 November 2018.
- 3.2 With equity valuations now close to all-time highs, it should be considered whether the Fund is carrying a significant amount of risk in this area.
- 3.3 At the Pensions Sub-Committee meeting held on 4 September 2018, this was discussed further and, subsequently, a special training session was held on the subject to ensure the Pensions Sub-Committee was fully briefed on all areas of equity protection.
- 3.4 The Fund's investment consultant, Deloitte, hosted this training on 20 November 2018.
- 3.5 The Sub-Committee was informed that several Local Government Pension Schemes, including Surrey County Council and LB Islington Pension Funds, had implemented equity protection strategies over the last year.
- 3.6 Appendix 1 to this report sets out in detail the different types of strategies available that provide equity downside protection. However, the key areas of consideration are whether they are pooled or segregated mandates, and whether they provide downside protection at cost or provide this protection whilst foregoing a degree of upside at nil cost.
- 3.7 Pooled solutions are often overlaid by the incumbent manager of the portfolio, who will manage the associated derivatives strategy. Segregated solutions require the Fund to own and manage these derivatives. This is not desirable due to the complexity and potential risk that this brings, so a pooled approach would be the preferred solution.
- 3.8 Often the Fund can achieve protection on the downside by relinquishing a specified proportion of the upside. A possible scenario is that the Fund could forgo any gain above 7% on the portfolio but will be protected on any losses from -5% downwards towards a maximum loss of -30%.
- 3.9 It should be noted that this strategy is proven to be sub-optimal in the long term due to the large amounts of upside lost but is useful for managing downside risk over a shorter period of time, such as a year before the conclusion of the triennial cycle or maybe the entirety of a triennial cycle.
- 3.10 The other option is to purchase protection for a certain amount of downside. This would remove the upside loss, but it can be prohibitively expensive to implement depending on the desired level of protection and the chosen duration.

- 3.11 One of the most effective ways to manage equity downside is to vacate the asset category, selling equities and moving into an alternative, non-correlating, and perhaps less risky asset class.

#### **4 EQUITY PROTECTION APPROACH**

- 4.1 Given the complexities around using derivatives on active portfolios as discussed in the appendix, the Sub-Committee was advised against implementing such a strategy on the Majedie portfolio.

- 4.2 However, the Sub-Committee did discuss whether it should implement an equity protection strategy overlay on the largest of the Fund's equity portfolios, the passive holdings with LGIM. The main considerations were:

- The Fund could still protect around a third of its equity holdings without giving up too much upside. This would result in a hedge without making a bet on the market.
- LGIM had a ready-made pooled solution which would have been easy to implement subject to a reasonable fee.
- The solution could be implemented for a specified timescale that in line with the Fund's objectives.

- 4.3 It should be noted that as pricing moves for derivatives, the price on a nil cost basis to implement would not always be a viable option for the Fund. If the equity upside forgone is too much, it would be contrary to the assumed actuarial rate of return (decided at the 2016 actuarial valuation) and impact the discount rate of the liabilities.

- 4.4 Officers have had numerous discussions with advisors on whether adopting this strategy would be beneficial for the Fund, but concluded that it would not be beneficial for the following reasons:

- The Hammersmith and Fulham Pension Fund has a low allocation to equities in comparison to the Local Government Pension Scheme as a whole, and already having one of the lowest volatilities of the last ten years when compared with the LGPS universe.
- The diversification of the Fund into long lease property and infrastructure allocations provides less correlated returns to equity markets for the Fund.
- The allocation to Ruffer which, typically, will outperform during times of equity downturn with exposure to index-linked gilts and precious metal allocations, will provide a degree of insurance against an equity fall.
- The Fund still requires growth assets as it is not yet fully funded.
- There had already been a market correction of around 6% to 7% for the Dow Jones industrial and S&P500 indices from their recent October 2018 highs.
- There are significant costs of implementation for the protection strategies of around 40 basis points, so even the nil cost option would not be implemented at nil cost.

4.5 It is for the reasons above that the officers recommended for the Pensions Sub-Committee not to pursue this option further at the November meeting. The Sub-Committee agreed to not implement the option for the foreseeable future.

## **5 CONSULTATION**

5.1 Not Applicable

## **6 EQUALITY IMPLICATIONS**

6.1 Not applicable

## **7 LEGAL IMPLICATIONS**

7.1 None

## **8 FINANCE AND RESOURCES IMPLICATIONS**

8.1 Finance risks are outlined within the report.

## **9 IMPLICATIONS FOR BUSINESS**

9.1 Not applicable

## **10 RISK MANAGEMENT**

10.1 Risks are outlined within the report.

## **11 PROCUREMENT IMPLICATIONS**

11.1 None

## **12 IT STRATEGY IMPLICATIONS**

12.1 None

### **LIST OF BACKGROUND PAPERS USED IN PREPARING THIS REPORT**

<b>No.</b>	<b>Description of Background Papers</b>	<b>Name/Ext of holder of file/copy</b>	<b>Department/ Location</b>
1.	None		

### **LIST OF APPENDICES:**

Appendix 1: Equity Protection Strategies