London Borough of Hammersmith & Fulham Pension Fund

Equity Protection Strategies

Introduction

This report has been prepared for the Pensions Sub-Committee ("the Sub-Committee") of the London Borough of Hammersmith & Fulham Pension Fund ("the Fund"). The purpose of this report is to provide a summary of equity protection fund structures including the advantages and disadvantages associated with different structures and the factors to consider when appointing an investment manager.

Equity Protection Fund Structures

The table below shows the advantages and disadvantages of a segregated and pooled approach.

	Pros	Cons
Segregated	Greater portability and transparency	Underlying derivatives in name of scheme
	More flexibility over levels of leverage	More onerous documentation requirements
		Potential open-ended liability depending on nature of derivatives used
		More time consuming to implement for LGPS
		Not all managers able/willing to provide pooled fund wrapper
Pooled	Access to manager's derivatives documentation	Admin charge for providing pooled fund structure
	Reporting provided by manager and can appear as single line in report & accounts	Limitations on leverage levels within certain fund structures (CSUF cannot have leverage, can have leverage in QAIF)
	Liability limited	
	Reporting easier	

Factors to Consider

Degree of precision

- Protecting all market exposures or focusing purely on major markets.
- Option to use local market index contracts where there exists potential mismatch between derivatives contracts and underlying equity exposure, however there is greater liquidity in the major markets – UK, US, Europe etc.
- An alternative is to use MSCI Index series – however these derivative contracts are dollar denominated and the currency issue is not straightforward to resolve. An advantage of MSCI is that the index series is total return while local market indices are usually just price. Local market index contracts will be in the local market currency – Eurostoxx is priced in euros.

Time horizon

- How long do you want the protection to run? If looking to protect up to next valuation, it is logical to protect up to the expected time of signing off the valuation report.
- Possible to buy protection 2 – 3 years out, but pricing/liquidity is thinner for longer dated structures.

What protection needed on the downside?

- Market pricing “thin” if looking for protection below -30%.
- The norm appears to be to accept small downside (-5%), with protection then down to somewhere in the region of -25% to -30%.
- Interesting to look at long run historic returns over rolling 1, 2 and 3 year periods.

Impact on expected return

- If implementing rolling programme of protection where selling away upside to fund the downside, this will impact level of expected return in actuarial assumptions.
- Need to take into account what returns are likely on the upside – no point in implementing if the maximum return possible on upside isn’t in line with assumptions used in valuation.

Cashflows

- Is the equity allocation likely to reduce over the term of the protection to meet pension payments?
- While structure can be altered, there will be costs associated with any restructuring.

Collateral

- What assets will be used for collateral?
- Option to sell equities and replace exposure with futures to release cash, or use gilts & cash.

Alternatives to equity protection strategy

- Given gains of equities in recent years, can you afford to reduce the equity exposure rather than implement a complex structure?

Conclusion

This paper should be considered in conjunction with discussions on equity protection strategies at the Committee meeting taking place on 20th November 2018.

The Sub-Committee may wish to consider whether they want to move forward with equity protection strategies following better understanding of this area and implementation options available.

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- Past performance is not necessarily a guide to the future.
- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

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