HYMANS ROBERTSON

Sixty second summary

Strategic focus and cash flow management in the LGPS

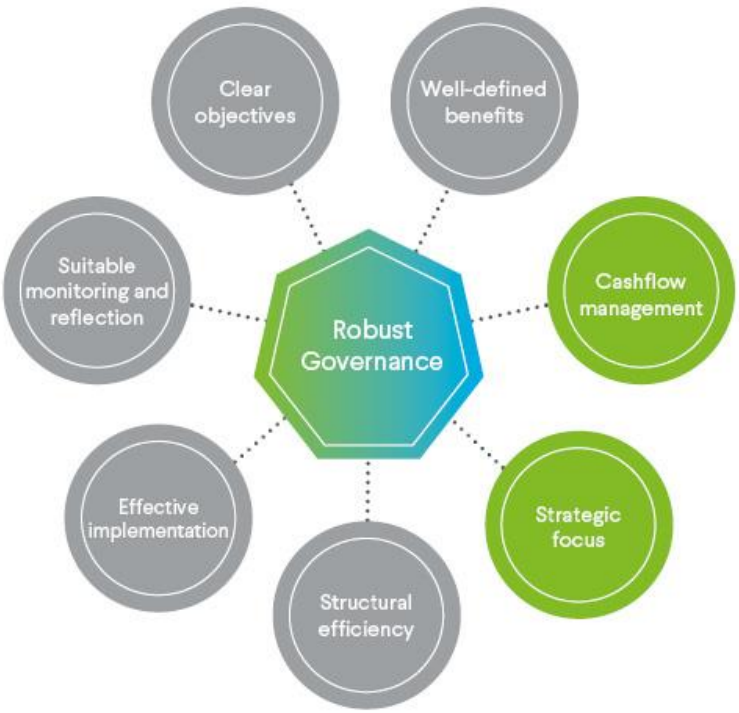
Key messages

- A pension committee's primary objective is to ensure the long-term sustainability of their Fund.
- To achieve this, a Committee must target the appropriate balance between investment risk and contributions. This balance, which will change over time, is unique to each Fund and driven by several factors.
- In addition to this focus on long-term sustainability, Committees must also focus on the shorter-term needs of meeting their ongoing cashflows. Committees need to understand the operational and strategic implications of their (and their employers') cashflow profiles.

The LGPS valuation year

The valuation year for the LGPS in England and Wales is in progress, and as Committees contemplate the implications for their investment arrangements, it is important that they focus on a number of key areas to achieve success (see diagram below).

In a previous 60 Second Summary we highlighted investment objectives and beliefs as core elements of a framework for robust investment governance - reiterating that Funds should have clear objectives upon which to set their funding goals and assess investment risk, and their investment arrangements should be grounded in a set of well-defined investment beliefs.

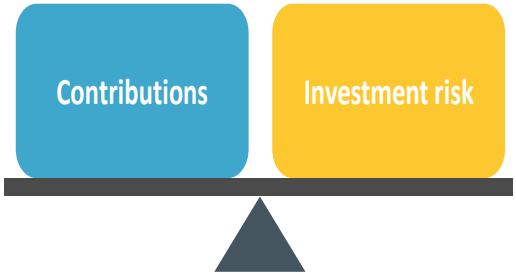


In this 60 Second Summary we take a closer look at **strategic focus** and **cash flow management** as individual elements of the framework. Other key areas shown in the chart will be explored in future 60 Second Summaries.

Strategic focus

It is essential for Funds aspiring to long-term sustainability to balance the contribution rate and the level of investment risk required to generate their required returns. A cohesive approach is needed, so that the rate does not become too costly in trying to meet any shortfalls in asset returns, or the risk excessive in trying to shoulder low contribution rates.

We encourage Committees, when reviewing their investment objectives, to seek stable and affordable contribution rates for open employers and plan for an orderly winding down for closed mature employers. It is then key to design an investment strategy that supports these goals, one which generates returns at a sufficiently high level to meet long-term funding objectives but has a discerning eye on risk. It is essential to develop a strategy to lead the Fund towards a balance that is right for itself.



Key questions to address:

- Is your required level of return still appropriate for your funding needs? Have you revisited your investment strategy to make sure it is still able to deliver the required return?
- How might your investment strategy evolve to adapt to changes e.g. in maturity and funding levels?
- Does the “one size fits all” investment strategy remain appropriate or is there scope to consider multiple strategies?
- Given a strategy should be unique to a Fund’s individual circumstances, does the use of peer group benchmarking for assessing performance remain relevant?

Cash flow management

Two Funds (or employers) with the same funding position may have different cash flow needs, based on their respective maturity profiles. As immature Funds accumulate cash and pay out less, they tend to be cash flow positive. Mature Funds on the other hand tend to be cashflow negative (i.e. benefits out greater than inflow) as a matter of course in their maturity cycle, and therefore should prioritise having ready availability of cash with which to pay out benefits, regardless of market conditions.

Managing cash flow has both operational and strategic implications. From an operational aspect it is important to have enough liquidity available, including having the appropriate amount of cash to meet these needs (but not too much to drag on returns) and that the cash is held securely. From a strategic perspective, the “sequence” of investment returns matters (a lot!). Funds with negative cash flows need a more stable pattern of returns than less mature Funds.

Key questions to address:

- How do you plan to meet shortfalls and avoid having to sell off assets in unfavourable market conditions?
- Have you revisited your investment strategy to better harness investment income to fund outflows?
- What cash flow monitoring have you put in place? What stress testing methods are you implementing to gain clearer perspective of factors like redundancies or transfers which might increase the volatility of cash flows? How realistic are your assumptions?
- What level of cash do you hold and how is it invested?

Summary

Focus on strategy and cash flow management are key areas of investment governance. The 2019 valuation is an opportunity for Committees to review their cash flow needs by requesting fresh projections based on current membership data and set an investment strategy with an aim to strengthen their funding positions. Please speak to your Hymans Robertson consultant for further information.