HYMANS ROBERTSON

Sixty second summary

COVID-19: LGPS investment implications

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In these strange times that we find ourselves, administering authorities of the LGPS are faced with some of the biggest challenges yet. While the LGPS has always been able to think longer-term, the impact of COVID-19 has highlighted potential risks to the longer-term sustainability of the scheme and the security of underlying employers.

We have identified 5 key actions that Funds should be taking now in light of the environment that they now find themselves in, namely:

- Understand the impact on scheme funding and agree a response to any material deterioration
- Review the impact on employers and their ability to meet funding obligations
- Consider whether your investment strategy remains suitable, including managing the timing of any planned changes, triggers and ongoing liquidity
- Review business continuity plans and manage implications for ongoing administration
- Have a strategy for communicating with members

In this note, we have expanded on the 3rd bullet point and have provided a check list for Funds that helps them answer the question "how can I be sure I've left no stone unturned with regards to my Fund's investments?".

Cashflow and liquidity

- **Cash outflow**: Be clear on what cash outflows are essential in both timing and amount, and then stress test these in light of a potential increase in requests for TVs, retirements etc. We would typically expect benefit payments and investment manager capital calls to be considered as essential in terms of both the timing of the payment and the amount. Cash outflows where Funds may have some degree of control over the timing of the payment includes payments such as expenses.

- **Cash inflow**: Be clear on the expected sources, timing and value of cash inflows, and then stress test these in light of economic weakness of employers and markets more generally. The main sources of income are likely to be primary and secondary contributions, and income or redemption proceeds distributed from the Fund's investments. The stress test should then consider the impact if contributions were to be suspended for a period of time and the income from the Fund's assets was less than expected (e.g. some direct lending portfolios may retain expected redemptions to cover FX margin calls and equity dividend income could fall by 50% or more in the short term).

- **Liquidity**: Understand the liquidity profile of the Fund's assets in terms of the speed at which cash can be raised in order to meet the essential cashflow needs. As part of this assessment, consideration should be given to the direct cost of raising cash e.g. bid-mid spreads, dilution levies etc, and also the indirect cost of raising cash e.g. crystallising losses. This should include liquidity requirements within funds managed by portfolio managers or pools, such as settlement of FX positions in currency hedged funds, as well as an understanding of any potential spreads or liquidity issues associated with some cash funds.

- **Collateral requirements:** Ensure a thorough understanding of the Fund's assets that could require collateral to be posted in order to maintain the intended exposure and risk controls. Where a Fund has a number of investments with collateralised positions, it is important to understand the potential order of magnitude of a collateral call, the driver of the call being made and the likelihood of that occurring.

Strategic considerations

- **Funding position:** Understand movement in the funding position relative to the agreed target and the current plans in place to achieving this. Consideration should then be given to any changes to the current plan, including where appropriate, the possible achievement of long-term objectives for specific employers, particularly those heading towards cessation.

- **Risk management plans:** To what extent has the Fund's balance of risks shifted? Has a dominant risk now emerged that the authority should consider putting plans in place to mitigate? Is the existing risk management plan still fit for purpose and is there scope to de-risk now to slow the pace of/reduce the extent of further losses?

- **Expected returns:** Understand the impact on the future expected return on assets, and the extent to which this may be negatively impacted by defaults and being a forced seller and hence crystallising losses. It may also be necessary to revisit agreed strategic changes based on modelling which builds in these expected returns.

- **Transition activity**: Be clear on the appropriateness of planned and in-progress transition activity in light of the market conditions for trading. Consideration should be given to whether it is still relevant and if so should it be paused, accelerated or decelerated.

Underlying assets

- **Characteristics of assets**: Consider conducting a deep dive of all investment mandates to ensure a thorough understanding of the key features of the Fund's assets and any change to the initial proposition e.g. credit quality, term, diversification, counterparty exposure etc, together with the outlook for those asset classes. Consider whether there should be any impact on mandate guidelines, such as tightening or loosening constraints e.g. if there is a high yield credit limit on investment grade portfolio, should this be increased to allow for additional downgrades.

- **Interim investment options to fund illiquid assets**: Review if investment options remain appropriate where assets are being held in interim options ahead of funding illiquids. Do the risk characteristics of interim options versus target assets remain appropriate and is the liquidity and mark to market risk understood?.

Governance considerations

- **Policies and processes**: Where automated policies and processes exist as part of the Fund's governance arrangements, these should be revisited. The review should consider whether the existing arrangements remain appropriate in their current form, or whether they need to be amended e.g. introducing an interim manual intervention step or suspending the policy for an agreed period of time.

Examples of such policies and procedures include rebalancing, de-risking and re-risking (including triggers), and cashflow policies. Consideration should also be given to the approach taken for income distribution.

- **Investment sub-committees**: Terms of reference for sub-committees should be re-visited to ensure timely, effective decisions can be made and implemented.

- **Authorised signatories/signing requirements**: The signing requirements for implementing a transition of assets should be revisited and updated if required. For example, ensuring all investment managers have the latest authorised signatory list and ensuring that the trading requirements are understood. For the latter this will include being clear on notification periods, settlement periods, acceptance of electronic signatures etc.

Key questions

There is no right answer; however, by addressing each of the areas outlined in the above check list, authorities will be putting themselves in the position that they are well armed to answer the following critical, imminent questions, in the context of the Fund's longer-term plans:

- Is there enough cash to meet the cashflow needs over the next 3-6 months?

- Is there sufficient sources of liquidity available to ensure that when the cash buffer runs out that there is a well to go to for further cash?

- Are the actions of the Fund consistent with maintaining the long-term sustainability of the funding position and limiting further deterioration?

Get in touch

If you would like more information or wish to discuss your scheme in the context of the above, please contact your usual Hymans Robertson consultant.

HYMANS ROBERTSON
CLUB VITA

London | Birmingham | Glasgow | Edinburgh **T** 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk