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Managing risk in the LGPS – a spotlight on employer investment strategies

Utilising employer investment strategies to manage risk for LGPS employers

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LGPS employers are increasingly looking for more options within their Fund, to manage their risks and control their costs. Funds can use employer investment strategies as another tool to strike a balance between contribution stability and balance sheet movements.

LGPS employers have tailored funding plans, set to achieve employers' funding objectives. These funding plans hinge on the level of contributions that the employer pays in, but benefits aren't funded by contributions alone. Long-term investment returns are crucial to keep employer contributions affordable. However, with only a single investment option in a Fund, employers can face very limited options when trying to achieve their wider funding objectives. A single investment strategy will meet the funding objective for a Fund as a whole, but is it the best fit for all of its employers?

What's changed?

Employers are increasingly demanding a more bespoke approach, to be able to optimise an investment strategy to suit their own circumstances, often with advice from independent advisors. Funds are also directing more scrutiny towards employers in atypical circumstances, whether the employer is ready to engage or not.

For individual employers, or groups of employers, a Fund can set up a notionally separate investment strategy, alongside the main investment strategy which is likely to remain broadly suitable for most employers.

The most common use of an employer investment strategy in the current environment is to de-risk. This might be particularly attractive to an employer sitting now with a funding surplus, maybe for the first time in many years, and looking to protect that position. Similarly, if an employer will exit the Fund on a low-risk or gilts-type basis, then exposure to better-matched investments can reduce variation in their funding position.

What can be done?

Every Fund already has at least a single investment strategy. To construct employer investment strategies, the Fund simply works with their investment advisor to turn the single investment strategy into proposals for two or more strategies; it's the same process as for the single strategy, just carried out for smaller parts of the Fund.

It has been common in the past for funds to run employer investment strategies informally, tracking the assets of an employer as if all its assets are invested in gilts, say. However, whilst this might work well enough for a short period of time, for a single or small employer, it does inevitably have an impact on the remaining employers in the fund. If one employer is hoarding all the exposure to a particular allocation of the assets, and the remaining employers are exposed to whatever is left, then the asset allocation at a whole fund level no longer gives a good indication of the investment risks and expectations for those remaining employers.

A much more appropriate and robust approach is to formally identify an investment strategy for all the employers, for better management of both the investment and funding risks.

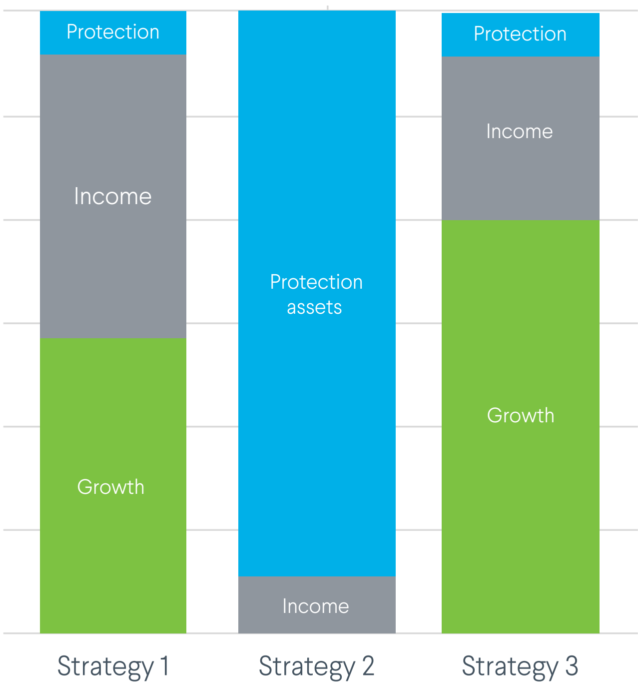
What might employer focused investment strategies look like?

Employer investment strategies don't have to be solely about de-risking. Employers whose objectives are balanced differently from a "typical" employer may want (or need) to take more investment risk. This may be to reduce their contributions by seeking more investment return, or even to keep their own contributions at the same level if the fund is otherwise pursuing a wider de-risking strategy.

An example of an effective set of investment strategies could be:

- core strategy which serves most employers, a mix of growth, income and protection assets.
- lower growth strategy for those employers on the path to exit seeking to reduce funding position volatility, very heavily weighted to protection assets.
- higher growth strategy for those with a weaker funding position and a need for additional returns to return to full funding.

Funds engaging with employer investment strategies typically set up three or four but can retire strategies or introduce new ones as needed.



Implementing different investment strategies

Funds in Scotland are already engaged in discussions for the 2023 valuations about funding strategies and employer circumstances so discussions about employer investment strategies can be wrapped into that too. Now would also be an excellent time for funds in England and Wales to carry out exploratory work to be ready for implementation at the 2025 triennial valuation, particularly if they need to undertake the first step of accurate and continuous employer asset tracking.

Of the LGPS funds that have adopted our Hymans Robertson Employer Asset Tracker (HEAT) to track each employer's asset share, around a third have already implemented employer focused investment strategies. In our informal poll as part of our **webinar** on 1 August, we found around 60% of our audience have already implemented individual investment strategies or were in the process of doing so, and we continue to see employer investment strategies become a standard option for funds and employers.

For any Fund, the next steps are set out in our high-level route map and include identifying appropriate groups of employers and possible investment strategies. If you'd like to understand more, you can of course get in touch with your usual Hymans contact who'll be happy to help.