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60-second summary

Optimising investment strategy at the 2023 valuation

Julie Baillie
Senior Actuarial Consultant

Funding plans that are optimised for each employer in an LGPS fund result in the best possible funding outcomes. The contribution strategy is the key focus and outcome of a valuation, but don't forget about optimising the other tool at your disposal – the investment strategy.

In the absence of investment returns, LGPS benefits would cost upwards of 70% of pay. A return of 4% pa brings this down to around 20% of pay. Achieving this return, whilst balancing the associated risk with investing in financial markets, is key to the long-term sustainable funding of LGPS benefits.

Where and when to focus

Your focus should be on the high-level strategic asset allocation. This is the key driver of long-term investment performance, a widely accepted principle backed up by plenty of external studies. You should spend time considering and reviewing your long-term strategy allocation as part of the valuation exercise to make sure it's still optimised for your requirements.

Deciding when to focus on investment strategy is a bit chicken and egg – which one comes first, deciding contributions or reviewing investments? The two are so heavily dependent on each other that it makes most sense to consider them in tandem. Otherwise, you run the risk of setting contribution rates that may not be appropriate based on your desired investment strategy, or you set an investment strategy that puts too much pressure on the affordability of contribution rates.

Optimising in 2023

Traditionally, investment strategy has been optimised only at fund level to suit the 'average' employer – for most, this employer is usually the largest in the fund eg a main council. However, funds today have an increasing number of employers. All of these have different objectives (of contribution affordability vs. funding position stability) and funding profiles (eg current funding position and future cashflow profiles). Employers also have varying levels of engagement, depending on where they are in their LGPS journey.

In response to diverging employer needs we have seen significant evolution in contribution strategy in recent years. So far, however, the investment strategy is still usually set as "one for all". For some employers, this is unlikely to be the optimal strategy.

Themes at 2023 valuation

For 2023, this tension between a whole fund approach and meeting the needs of individual employers may arise due to:

- Strong funding position: this may present the opportunity to de-risk, especially important for employers approaching exit. However, there may be some employers still in deficit who need additional exposure to growth assets to help improve their funding position.
- Increasing employer diversity: the increase in the number and type of employers in the fund, all with differing objectives, will challenge the viability of a single approach to all.
- More employer engagement: interest by employers in managing pension costs continues to grow, with more seeking independent advice. With this additional interest, it's fair to assume that expectations on funds will grow, with demand for more options to help employers manage their risks.

If this is the case for your fund in 2023, for any employers, then there is a course of action you can take.

Employer focused investment strategies

A simple solution is to implement different investment strategies for different employers to meet their specific needs. An example of an effective strategy could be:

- core strategy which serves the majority of employers;
- higher growth strategy for those with a weaker funding position and need for additional returns to return to full funding; and
- lower growth strategy for those employers on the path to exit seeking to reduce funding position volatility.

We see that employer focused investment strategies are the long-term direction of travel in the LGPS, given the themes already mentioned. We are, however, aware that the thought of implementing this can seem quite daunting. The good news is that it's not as hard as it sounds.

Implementing different investment strategies

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. Based on our experience to date of supporting funds implement this, we've set out a high-level route map from a single investment strategy to multiple strategies.

- **Identify groups of similar employers in the fund.** This is something your actuary can do for you by analysing readily available risk metrics such as funding level, cashflow profile and maturity.
- **Rationalise the groups to a smaller number.** There will likely be several groups of employers that, despite their differences, have very similar investment objectives. We can usually cut down the number of groups to around 3 or 4. At this stage you'll likely consider whether you think it's appropriate to proceed.
- **Identify an appropriate investment strategy for each group.** Your investment consultant can help you by carrying out an investment strategy review.
- **Implementation.** You can use HEAT to track investment strategies and individual employer asset values.

It’s possible to carry out all these steps as part of the 2023 valuation. Alternatively, you can use this valuation to investigate if there is a need for such a solution and then carry out the above steps during 2024 and 2025 to be ready to implement in time for the next actuarial valuation.

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.