HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	10 December 2021
Title:	Investments: Pension Fund Cash Monitoring Report and Annual Cash Investment Strategy 2022/23
Report From:	Director of Corporate Operations

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Purpose of this Report

1. This report outlines the investment performance of the cash balances held by the Pension Fund in 2021/22 to 31 October 2021 and recommends the Annual Cash Investment Strategy for 2022/23.

Recommendations

2. That the Annual Cash Investment Strategy for 2022/23 be approved.
3. That, if the Annual Cash Investment Strategy referred to above is approved, that it be implemented from the date of this meeting for the remainder of 2021/22.
4. That the Director of Corporate Operations be authorised to manage the Fund's cash balance in accordance with the policy set out in this report.
5. That the current policy on rebalancing Index-linked gilts be suspended as detailed in paragraphs 26 to 30, be noted.

Executive Summary

6. This report provides an update on the management of the Pension Fund's cash balances and the Annual Cash Investment Strategy for those cash balances for 2022/23, which is outlined in paragraphs 34 to 53 for approval.
7. In accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, an investment policy must be formulated for the investment of the Fund's cash.
8. The production of an Annual Cash Investment Strategy is in line with the recommendations of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice 2017 Edition.

Background

9. The Pension Fund's Cash Investment Strategy Statement does not include a strategic allocation in cash as an asset class. However, the Pension Fund receives cash each month from contributions by employees and employers, income from some of its investments as well as the potential inflows of cash from monthly rebalancing, all of which need to be managed.

10. Where the Pension Fund is invested in pooled funds, cash in these accounts is retained by the Fund's external investment managers for reinvestment, but rental income from the Pension Fund's direct property portfolio, distributions from private equity investments, infrastructure investments, private debt and indirect property funds are credited to the Fund's cash balance.

11. The Pension Fund requires a cash balance to meet outgoings on pensions and benefits, existing commitments to invest in property and to fund drawdowns by the private equity, private debt and infrastructure funds, as well as covering day-to-day cashflow.

External context

12. The following paragraphs explain the economic and financial background against which the Annual Cash Investment Strategy is being set.

Economic background

13. The Bank of England (BoE) has held Bank Rate at 0.1% since March 2020 and has maintained its Quantitative Easing programme at £895bn since November 2020. In its November 2021 policy report, the BoE expects the UK economy to continue to grow to recover further from the effects of the pandemic, but at a relatively subdued level as growth is restrained by disruption in supply chains as well as some signs of weaker UK consumer demand. CPI inflation is now expected to rise to 4.5% through the winter, peaking at around 5% in April 2022, mainly due to the impact of utility bills, and further increases in core goods and food price inflation. However, the upward pressure on CPI inflation is expected to dissipate over time as supply disruption eases, global demand rebalances and energy prices stop rising, and so CPI inflation is projected to fall back materially from the second half of 2022.

14. The BoE's Monetary Policy Committee (MPC) judged that some tightening of monetary policy over the forecast period was likely to be necessary to meet the 2% inflation target sustainably in the medium term.

Financial markets

15. Ongoing monetary and fiscal stimulus together with improving economic growth prospects and successful vaccine rollout programmes continued to boost equity markets over the period. In the UK, the FTSE 250 index continued making gains over pre-pandemic levels and the more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

16. Inflation worries continued during the period but declines in bond yields between April and June suggest bond markets may be expecting any general price increases to be less severe, or more transitory, than was previously thought. However, an increase in gas prices in the UK and European Union, supply shortages and a dearth of HGV and lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, led to higher prices. UK government bonds remained positive over the period.

Credit review

17. Credit default swap spreads were flat over the period and are broadly in line with their pre-pandemic levels. Credit default swaps are used as an indicator of credit risk, where higher premiums indicate higher perceived risks.

18. Over the period credit ratings agencies, Fitch and Moody's, upwardly revised to stable the outlook on a number of UK banks and building societies on Arlingclose's counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

19. The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.

20. On 24 September 2021 Arlingclose published its review of its credit advice on unsecured deposits, judging that the UK has seen six months of positive GDP growth, and while forward-looking indicators suggest that economic growth has entered a slower phase as the UK heads into autumn, and the risks around both the continuing pandemic and a period of economic adjustment post government support remain, the likelihood of further significant economic fallout from the pandemic impacting on the financial viability of certain banks has diminished. As a result, Arlingclose has updated its treasury management advice, allowing maximum durations of 100 days for unsecured investments with some UK banks on their list of recommended counterparties.

Interest rate forecast

21. The County Council's treasury management adviser Arlingclose is forecasting that Bank Rate will rise in Quarter 2 of 2022 to subdue inflationary pressures and the perceived desire by the BoE to move away from emergency levels of interest rates.

22. Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise, the increases will not be to the extent predicted by financial markets. In the near-term, the risks around Arlingclose's central case are to the upside while over the medium-term the risks shift towards the downside.

Performance of cash investments

23. The Pension Fund's cash investment holding was £88.21m as at 31 October 2021 which represents around 1% of the Pension Fund's total value. As at 31 October 2021 the weighted average return on the Pension Fund's cash investments was 0.01%, which should be considered within the context of a UK Base Rate of 0.10%.

24. The current cash balance is lower than the position last year in part due to the impact of some employers paying contributions either one or three years in advance which causes cash balances to initially increase but steadily decrease over the period. The Fund is now over halfway through the initial three-year repayment period, the cash position is expected to further reduce until the end of March 2022 when further one-year prepayments are expected to be received. The cash position has also been impacted by the change in strategy regarding maintaining the Protection assets.

25. The cash position at 31 October 2021 and the movement since 31 March 2021 are shown in Table 1.

Table 1 – Cash investment position	**31/03/21 Balance £m**	**Net movement £m**	**31/10/21 Balance £m**	**31/10/21 Income return %**
Banks and building societies:				
- Unsecured	24.16	3.11	27.27	0.01
Money market funds	12.59	48.35	60.94	0.01
Local authorities	56.00	(56.00)	-	-
Treasury bills	5.00	(5.00)	-	-
Total	**97.75**	**(9.54)**	**88.21**	**0.01**

26. In a change to the approach to cash, as agreed by the Pension Fund Panel and Board on 12 February 2021, the Director of Corporate Operations reviews the Pension Fund's asset allocation to Protection assets on a quarterly basis, which is made up of Index-linked Gilts and cash. If the value of Index-linked Gilts is outside of the long-term strategic allocation of 22% by 5% (i.e. above 27% or below 17% of the total value of the Fund), the Pension Fund rebalances but only by adding or reducing 2.5% of the Fund at a time to maintain the asset allocation to Protection assets.

27. Since this change to the approach was agreed the actual allocation to Index Linked Gilts has remained above 17% of the Fund and no rebalancing action has been required to the allocation to Index-linked Gilts. Officers recently approached Hymans Robertson for updated advice regarding this policy as at that time equities had continued to strengthen making the likelihood of having to take rebalancing action more likely.

28. Hymans confirmed that they have seen further evidence of higher realised inflation and some inflationary pressures that are likely to persist some way into 2022. While there has been some movement in Index-linked gilt yields over this period yields remain at very low levels. Even with short term inflationary pressures longer term implied inflation continues to look expensive.

29. As the Fund is approaching another actuarial valuation in 2022, there will be an opportunity at that time to review funding and investment plans. Hymans are of the opinion that taking potential actions now could potentially reduce the expected level of returns on the Fund's assets ahead of the valuation and any strategic review. The potential rebalancing action into index-linked gilts Hymans believes would reduce the expected levels of returns given the current outlook.

30. Therefore, Hymans have recommended to suspend the rebalancing on index-linked gilts for the time being until the 2022 Actuarial Valuation has been completed or there is a marked improvement in long term inflation pricing.

31. The priority for cash investments is security and liquidity and the Pension Fund's aim is to achieve a yield commensurate with these principles. This has been maintained by following the Pension Fund's counterparty policy as set out in its Annual Cash Investment Strategy for 2021/22, which was approved by the Pension Fund Panel at its meeting in December 2020. A summary of current investments is provided in Table 1.

32. Whilst regulations provide an explicit power for pension funds to borrow for a period of up to 90 days for cash flow purposes, such as allowing scheme benefits to be paid and during a transition period when the investment of the Fund's assets is being changed, the Pension Fund's cash flow will be managed on the basis that the need for borrowing for the Fund is avoided and therefore all of the Pension Fund's cash investments are either overnight or for a very short duration.

33. The Fund continues to sell equities where necessary to raise cash to ensure the total cash balance remains above £60m and below the equivalent of 4% of the total value of the Fund, in line with Hymans' previous advice (which remains unchanged). As previously reported to the Panel and Board as a result of the significant amount of contributions received in advance, the Pension Fund expected an average monthly deficit from dealing with members of nearly £12m, before funding additional property and alternative investments. The Pension Fund has had to fund net calls of £206m for its alternative investments and property portfolios from 1 April to 31 October 2021. To fund this, and the ongoing monthly shortfall of contributions following the annual prepayment of contributions, the Fund has disinvested £225m of passive UK equities in line with its Investment Strategy, and has now fully redeemed its passive UK equities holding.

Annual cash investment strategy

34. In the past 12 months, the Pension Fund's cash investment balance has ranged between £48.2m and £189.0m.

35. Balances may increase for a short period at the beginning of April 2022 as prepayments of one year's employer contributions will be received as cash and then invested by the investment managers. At this stage the total value of prepayments for 2022/23 has not been confirmed, however on 1 April 2021 the Fund received £38.5m of prepaid employers contributions for 2021/22 and

the Pension Fund is likely to receive a similar level of payments in advance in April 2022.

36. It is expected that during 2022/23 balances will generally vary in accordance with the normal cashflow expectations as a result of contributions from employers and payments of pension, and the investment and returns of the property and alternative investment portfolios.

37. The following Annual Cash Investment Strategy, for the period to 31 March 2023, has been prepared with the advice of the County Council's treasury management advisers, Arlingclose.

38. The primary objective in relation to the investment of Pension Fund cash remains the security of capital. The liquidity or accessibility of the Fund's cash investments followed by the yields earned on these investments are important but secondary considerations.

Risk assessment and credit ratings

39. Credit ratings are obtained and monitored by the County Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

40. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments

41. The Pension Fund understands that credit ratings are good but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the County Council's treasury management adviser. No investments will be made with an organisation if there are substantial doubts about its credit quality, even though it may otherwise meet the credit rating criteria.

42. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally

reflected in credit ratings, but can be seen in other market measures. In these circumstances the Pension Fund will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions.

Investment limits

43. The cash limits recommended for 2022/23 remain consistent with the 2021/22 cash investment strategy to allow for the suitable investment of forecast cash balances.

44. On 1 April 2022 it is expected that some employers will choose to prepay one year's employer contributions; currently it is not clear what the total impact of this income will be on the cash balances, and so the limits in this cash investment strategy will be reviewed once there is further information available. It may be required that a set of temporary increased cash limits be agreed for a few days to allow the appropriate management of the higher balances as a result of the prepayment of employer contributions.

45. The limits below apply to the cash received into the Pension Fund's bank account that is managed internally by officers. The maximum that will be lent to any one organisation (other than the UK Government) will be £40m. A group of entities under the same ownership will be treated as a single organisation for limit purposes. Limits are also placed on fund managers as shown in Table 2.

Table 2: Investment Limits	**Cash limit**
Any single organisation, except the UK Central Government	£40m each
UK Central Government	Unlimited
Any group of pooled funds under the same management	£40m per manager

Approved investment counterparties and limits

46. Appendix 1 shows a table of counterparty types which the Pension Fund may invest its cash in, subject to the cash limits (per counterparty) and the time limits shown. The Pension Fund will continue to largely invest overnight with banks and money market funds, given that cash is largely held to meet immediate liabilities. Other more secure options that might mitigate the risk of bank bail-ins are available should the Pension Fund be required to hold larger amounts of cash for longer periods. Therefore, the Director of Corporate Operations and his staff will use the guidance of the County Council's treasury management advisers, Arlingclose, in order to place cash on deposit, within the limits shown in Appendix 1.

Liquidity management

47. The Pension Fund has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements.

48. The Pension Fund will spread its liquid cash over at least four providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

Other items

Investment training

49. The needs of the Pension Fund's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

50. Staff members regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

51. The Pension Fund's training policy states that all Panel and Board members should receive appropriate training relevant to their needs and understand fully their roles and responsibilities, which includes treasury management responsibilities, and the scrutiny of the treasury management function. All Panel and Board members were invited to a training session on 15 November 2021 and another workshop is planned for November 2022.

Investment advisers

52. The Pension Fund has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Director of Corporate Operations' staff and Arlingclose.

Markets in Financial Instruments Directive

53. The Pension Fund has opted up to professional client status with its providers of financial services, including advisers, brokers and fund managers allowing it access to a greater range of services, but without the greater regulatory protections afforded to individuals and small companies. As a Local Government Pension Scheme, this is the most appropriate status.

Climate Change Impact Assessments

54. Hampshire County Council utilises two decision-making tools to assess the carbon emissions and resilience of its projects and decisions. These tools provide a clear, robust, and transparent way of assessing how projects, policies and initiatives contribute towards the County Council's climate change targets of being carbon neutral and resilient to the impacts of a 2℃ temperature rise by 2050. This process ensures that climate change considerations are built into everything the Authority does.

55. The Pension Fund itself has a negligible carbon footprint, but it recognises that the companies and other organisations that it invests in will have their own carbon footprint and a significant role to play in the transition to a lower carbon economy. Therefore, the Pension Fund recognises the risk that environmental, social and governance (ESG) factors including the impact of climate change can materially reduce long-term returns. The Pension Fund has a role to play as an investor, in ensuring that its investment managers are suitably considering the impact and contribution to climate change in their investment decisions and acting as a good steward to encourage these companies to play their part in reducing climate change. This is explained further in the Pension Fund's RI policy: InvestmentStrategyStatementincludingRIpolicy.pdf (hants.gov.uk).

56. This report deals with the investment strategy for the Pension Fund's internally managed cash portfolio. In line with the CIPFA code, the Pension Fund's cash balances are invested prioritising security, liquidity and then yield. The cash portfolio is only required to pay pensions, other costs and new investments. There are no further climate change impacts as part of this report which are concerned with financial reporting.

CORPORATE OR LEGAL INFORMATION:

Links to the Strategic Plan

Hampshire maintains strong and sustainable economic growth and prosperity:	No
People in Hampshire live safe, healthy and independent lives:	No
People in Hampshire enjoy a rich and diverse environment:	No
People in Hampshire enjoy being part of strong, inclusive communities:	No
OR	
This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because of the ongoing need to manage the Hampshire Pension Fund's cash.	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

EQUALITIES IMPACT ASSESSMENTS:

1. Equality Duty

The County Council has a duty under Section 149 of the Equality Act 2010 (‘the Act’) to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
- Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

Due regard in this context involves having due regard in particular to:

- The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
- Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
- Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionally low.

2. Equalities Impact Assessment:

Equality objectives are not considered to be adversely affected by the proposals in this report as the proposals do not directly affect scheme members.

Treasury Investment Counterparties and Limits

Sector	Duration limit	Counterparty limit	Sector limit
The UK Government	2 years	Unlimited	N/A
Local authorities and other government entities	2 years	£40m	Unlimited
Secured investments*	2 years	£40m	Unlimited
Banks (unsecured)*	13 months	£25m	Unlimited
Building societies (unsecured)*	13 months	£25m	£40m
Registered providers (unsecured)*	2 years	£25m	£40m
Money market funds*	N/A	£40m	Unlimited
Strategic pooled funds	N/A	£40m	£100m
Real estate investment trusts	N/A	£40m	£40m
Other investments*	2 years	£25m	£40m

The table must be read in conjunction with the notes below

* Minimum credit rating

Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

Government

Loans to, and bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 2 years.

Secured investments

These investments are secured on the borrower’s assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in.

Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

Banks and building societies (unsecured)

Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts

Registered providers (unsecured)

Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

Money market funds

Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Pension Fund will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds

Shares or units in diversified investment vehicles consisting of bond, equity and property investments. These funds offer enhanced returns over the longer term but are more volatile in the short term and allow the Pension Fund to diversify into asset classes other than cash without the need to own and manage the underlying investments. This sector also includes cash plus funds which are also a type of pooled fund, but are used for short-term funds, with a lower risk appetite. Because strategic pooled funds have no defined maturity date, but are available for withdrawal after a notice period; their performance and continued suitability in meeting the Pension Fund’s investment objectives will be monitored regularly.

Real estate investment trusts (REITs)

Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Other investments

This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Pension Fund's investment at risk.

Operational bank accounts

The Pension Fund may incur operational exposures, for example through current accounts, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in and balances will therefore be kept low. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Pension Fund maintaining operational continuity.