HYMANS ROBERTSON

Sixty second summary

Growth, Income and Protection

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For an LGPS Pension Committee, setting the investment strategy is likely to be the most important financial decision it will make for the Fund. When deciding on the right investment approach a range of often competing factors need to be considered such as the Fund's current funding position, future liabilities and tolerance to risk. In this 60-second summary, we explain how our Growth, Income and Protection framework can help make this decision an easier one.

Overcoming hurdles, one at a time

The first hurdle Committees are likely to face is choice – a bewildering array of investment types and asset strategies. How do you narrow the focus? Our Growth, Income and Protection framework does just that. It asks key questions that help ascertain which investments will ensure the Fund can pay benefits and keep contributions sustainable and affordable. We'll touch on each of these questions below.

How do we earn adequate returns?

Benefits are met from two potential sources, investments and contributions. Generating higher returns on investments can mean less reliance on contributions to pay benefits. Every pound earned by a Fund's investments can be a pound of contributions that employers don't have to make. To earn adequate returns, we need to invest in higher-risk assets, such as public and private equities which we call **'Growth'** assets.

How do we ensure we have the cash to pay future benefits?

If a Fund is paying out more in benefits than it receives in contributions, it will need to generate cash from its investment portfolio. If this requires a Fund to realise assets to meet these cash needs then timing can be problematic– selling assets at market lows to pay benefits could mean missing out when the price of the assets recover. This can significantly hamper long-term returns and future funding, turning a long-term investor into one getting by year-to-year – or even month-to-month. To guard against this outcome, the key is to invest in **'Income'** assets.

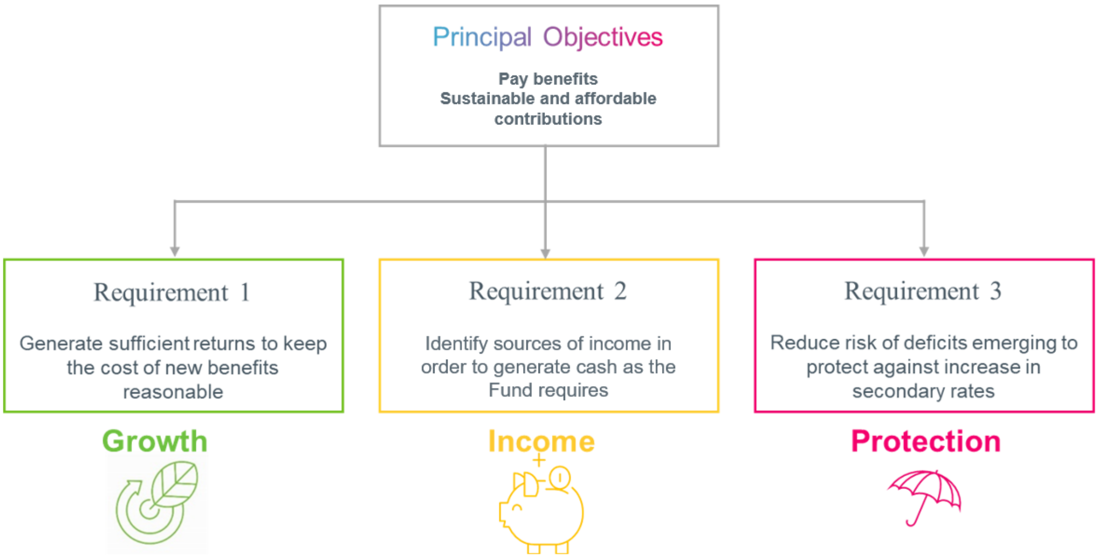
Income assets generate a return that's attractive, but typically lower than 'Growth' assets. They also provide a smoother path of returns through visible income streams, which means it's less of an issue if you need to disinvest. Most importantly, these assets pay actual cashflows to the investor which reduce the likelihood of having to sell assets at low levels. Income assets include traditional core property, infrastructure, higher-risk bonds and forms of secured lending.

How do we manage the risk of a deficit appearing?

The appearance (or growth of) a deficit may lead to higher contributions. To manage this risk, many Funds choose to invest in defensive, low-risk assets. These assets are typically less volatile and offer protection during significant market falls, protecting the Fund's asset value and funding level. These assets fall into our **'Protection'** category, and traditionally include government bonds and investment-grade corporate bonds.

One challenge that's emerging is the very low or negative yields on offer from these assets. This tests a Fund's ability to meet the first requirement of adequate returns. Similarly, the market prices of these assets can be volatile, which is not aligned to the traditional role of a defensive asset. Consequently, our framework can help Funds to consider alternative asset classes that provide the desired defensive characteristics while earning a positive rate of return.

The framework in action



How do we formulate our strategy?

The driver of the size of your allocations to Growth, Income and Protection assets will reflect the relative importance of each of these requirements to your Fund. For example:

- A Fund with a large deficit will need to focus more on Growth and less on Protection assets
- A Fund that is significantly cashflow-negative will need to focus more on Income assets than a cashflow-positive Fund
- A Fund that has seen material funding level increases since the last actuarial valuation will likely need to plan for the most effective solution to managing risk through either Income or Protection assets.

When this high-level decision has been made, our modelling tools can define the optimal allocations to Growth, Income and Protection assets to meet your Fund's requirements. In our experience, this framework focuses decision-making on the key issues that have the largest impact on long-term risks and returns.

To find out more about how our Growth, Income and Protection framework can help your Fund meet its long-term goals, contact your usual Hymans Robertson consultant.

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