HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	12 December 2023
Title:	Investments: Pension Fund Cash Monitoring Report and Annual Cash Investment Strategy 2024/25
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 2023/24 to 31 October 2023 and recommends the Annual Cash Investment Strategy for 2024/25.

Recommendations

2. That the Annual Cash Investment Strategy for 2024/25, as detailed in paragraphs 26 to 37 of this report, 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 2023/24.
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.

Executive Summary

5. 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 2024/25 for approval.
6. 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.
7. 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

8. The Pension Fund's Cash Investment Strategy Statement does not include a strategic allocation in cash as an asset class but it must manage its cash position. The Pension Fund receives cash each month from contributions by employees and employers and income and returns of capital from its illiquid investments (property and alternative investments). It must also manage the obligations to pay pensions and other service providers, plus the capital calls to continue to build-out its illiquid investment portfolios.

9. All of the Pension Fund's liquid investments are invested in pooled funds, either via the ACCESS pool, or investment manager's own funds (for Multi-asset Credit and Asset-backed Securities). Cash in these accounts is retained by the investment managers for reinvestment.

External context

10. The following paragraphs explain the economic and financial background against which the Annual Cash Investment Strategy is being set, which has been provided by the Fund's advisor Arlingclose.

Economic background

11. Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this level in September and then again in November 2023. The November 2023 quarterly Monetary Policy Report (MPR) forecast a prolonged period of weak Gross Domestic Product (GDP) growth with the potential for a mild contraction due to ongoing weak economic activity. The outlook for CPI inflation was deemed to be highly uncertain, with near-term risks to CPI falling to the 2% target coming from potential energy price increases, strong domestic wage growth and persistence in price-setting.

12. Office for National Statistics (ONS) figures showed CPI inflation was 4.6% in October 2023, a greater than expected fall from 6.7% the previous month. Core CPI inflation fell to 5.7% from 6.1%. Looking ahead, using the interest rate path implied by financial markets the BoE expects CPI inflation to continue falling, declining to around 4% by the end of calendar 2023 but taking until early 2025 to reach the 2% target and then falling below target during the second half 2025 and into 2026.

Credit outlook

13. Credit Default Swap (CDS) prices are used as an indicator of credit risk, where higher premiums indicate higher perceived risks. CDS prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent and the takeover of Credit Suisse by UBS. After then falling back in Quarter 2 of calendar 2023, in the second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

14. On an annual basis, CDS price volatility has so far been lower in 2023 compared to 2022, but this year has seen more of a divergence in prices

between ringfenced (retail) and non-ringfenced (investment) banking entities once again.

15. Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini-budget. Moody's also affirmed the Aa3 rating in recognition of the UK's economic resilience and strong institutional framework.

16. Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.

17. There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets.

18. However, the institutions on the Pension Fund's treasury adviser, Arlingclose's, counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Interest rate forecast

19. Although UK inflation and wage growth remain elevated, the County Council's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's (BoE) Monetary Policy Committee will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. Arlingclose sees rate cuts from Quarter 3 2024 to a low of around 3% by early to mid 2026.

20. Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

Performance of cash investments

21. The Pension Fund's cash investment holding was £189.5m as at 31 October 2023 which represents around 2% of the Pension Fund's total value. As at 31 October 2023 the weighted average return on the Pension Fund's cash investments was 5.25%pa, which should be considered within the context of a UK Bank Rate of 5.25%pa. Current investments returns are therefore in line with this rate.

22. The cash position at 31 October 2023 and the movement since 31 March 2023 are shown in Table 1.

Table 1 – Cash investment position	31/03/23 Balance £m	Net movement £m	31/10/23 Balance £m	31/10/23 Income return %
Banks and building societies:				
- Unsecured	4.89	5.25	10.14	4.47
Money market funds	35.32	144.03	179.35	5.30
Total	**40.21**	**149.28**	**189.49**	**5.25**

23. 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 2023/24, which was approved by the Pension Fund Panel at its meeting in December 2022. A summary of current investments is provided in Table 1.

24. 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.

25. As previously reported to the Panel and Board, as a result of the significant amount of contributions received in advance, the Pension Fund has an average monthly deficit from dealing with members of £4m (after taking income from its credit and property portfolios), before funding additional property and alternative investments. The Pension Fund has had to fund net calls of £333m for its alternative investments and property portfolios from 1 April to 31 October 2023. To date this has been funded from the £321m of contributions paid in advance by employers on 1 April 2023. Once any excess cash is used to fund the new allocation to Investment Grade Credit (described in further detail below) any ongoing monthly shortfalls will be funded by selling listed equities and asset-backed securities as outlined in the Fund's Investment Strategy, to ensure the total cash balance remains above a minimum level of £60m in line with Hymans Robertson's advice.

Annual cash investment strategy

Strategy context

26. In the past 12 months, the Pension Fund's cash investment balance has ranged between £40.2m and £374.2m. The Fund's cash balance in this period has been higher than would ordinarily be expected, firstly due to receipt of three years' contributions paid in advance in April 2023 by some employers. In addition, current cash levels are elevated in anticipation of finalising the Pension Fund's 5% allocation to Investment Grade Credit as agreed at the last meeting of the Panel and Board in September 2023. This

allocation will be funded from the Pension Fund's current cash investments and the overweight allocations to equity and asset-backed securities (ABS). Once finalised, the cash investment balance is expected to be maintained at a minimum level of £60m, in line with Hymans Robertson's advice.

27. The following Annual Cash Investment Strategy, for the period to 31 March 2025, has been prepared with the advice of the treasury management advisers, Arlingclose. The strategy is intended to manage 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.

28. 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

29. Credit ratings are obtained and monitored by the 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.

30. 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

31. 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.

32. 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

33. The cash limits recommended for 2024/25 remain consistent with the 2023/24 cash investment strategy to allow for the suitable investment of forecast cash balances.

34. 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 £25m. 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	£25m each
UK Central Government	Unlimited
Any group of pooled funds under the same management	£25m per manager

Approved investment counterparties and limits

35. 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 treasury management advisers, Arlingclose, in order to place cash on deposit, within the limits shown in Appendix 1.

Liquidity management

36. 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.

37. 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

38. 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.

39. 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.

40. 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.

Investment advisers

41. 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

42. 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

43. 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.

44. 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).

45. 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	£25m	Unlimited
Secured investments*	2 years	£25m	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	£25m	Unlimited
Strategic pooled funds	N/A	£25m	£100m
Real estate investment trusts	N/A	£25m	£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-/A3. 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.