Annual Cashflow Policy Review

Addressee and purpose

This paper is addressed to the Pensions Committee ("the Committee") of the London Borough of Havering Pension Fund ("the Fund"). It reviews the Fund's current cashflow position and sets out an update to the Fund's cashflow policy.

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Executive Summary

- The aim of the cashflow policy is to ensure that the level of cash held is proportionate to the Fund's needs. These needs reflect the Fund's ongoing operational cash requirements, balancing contribution, and investment income with benefit and expense payments, alongside the investment requirements of the Fund.
- Operational cash requirements are largely predictable in nature. Over the course of 2024, it is expected that cash outflows and inflows will be broadly matched each quarter, with a small surplus (£0.3m) emerging each quarter. Unpredictable cashflows arise from transfer payments, deaths, and early retirements although experience suggests that these are likely to remain relatively modest.
- Additional cashflow uncertainty arises from the currency hedging programme, with currency contracts being settled monthly. The maximum monthly cash settlement over that last two years has been c.£2.7m, providing an indication of the potential call on cash. The Fund does receive some notice of the cash settlement amounts, allowing for assets to be realised as necessary.
- The current cashflow policy has a target cash balance of £6m, with amounts being permitted to vary between £3m and £8m before corrective action is taken to either invest or redeem funds. We recommend these amounts are updated to £7.5m, with an operational range of £4m to £12.5m.
- This recommendation follows the methodology previously followed: the proposed cash buffer comprises one month of predictable cashflows (£3.5m) and two months of unpredictable cashflows (£2m), plus allowance for currency settlements (£3m). The proposed change in cash buffer also reflects the increase in the average size of the Fund since the current arrangements were introduced.
- Consideration should also be given to the current capital commitments of the Fund, with approximately £60m of undrawn commitments, and approximately £25m due to be drawn over the year. This will be somewhat, but not wholly offset by capital receipts from maturing funds. We propose the policy recognises that cash may additionally be retained to meet such capital calls.
- To the extent that the current cash balance exceeds the recommended operational threshold, even when considering potential capital drawdowns, we propose working with Officers to establish the excess cash balance that can then be invested within the current strategy.
- We have proposed updated policy wording for adoption by the Committee as Appendix 1 to this paper and propose that the policy be reviewed at least every three years or in the event that predictable cashflows increase by 20% from current levels.

Introduction

Cashflow management is an integral element in the administration of any pension fund. The Fund's overriding objective is to meet its ongoing benefit obligations to members, as they fall due – this may include predictable payments, such as the monthly pension payroll, or more unpredictable payments, such as transfer value payments, retirement lump sums, death benefits and expenses. In addition, known capital commitments must also be considered. The funding of several commitments to the Fund's closed-ended mandates (being those managed by Stafford Capital, LCIV Renewable Infrastructure Fund only, Churchill and Permira) must also be factored into these considerations.

To be able to meet the Fund's cashflow requirements, the Fund should maintain ready access to an appropriate level of cash. Cash may be obtained from payments into the Fund in the form of contributions, income received from the Fund's assets, the sale of the Fund's assets and marginally from interest earned on cash balances held within the Fund's Bank Account. In developing a cashflow management policy, it is desirable that:

- The cash balance maintained is not so large that it reduces the potential for future investment returns.
- The cash balance maintained is not so small that it creates a risk that the cash balance will be easily exhausted and thus disinvestments will be required frequently or at short notice.
- Assets are realised in the most cost-efficient manner possible.

Working Cash Balance

In establishing an acceptable working cash balance, we aim to determine a sum that is sufficient to cover expected operational cash outflows, whilst also providing a buffer to meet any unpredictable payments together with any deterioration in cash inflow.

It is also necessary to consider the timing of cashflow. During any month or quarter, if benefits are paid before contributions are received, or capital calls received before capital distributions, then the cash balance will see a temporary fall until replenished.

The Fund currently holds cash in both a bank account and a Northern Trust cash account. In 2019, the Committee set a working cash balance target of £6m – to ensure that the Fund had access to cash, with sufficient leeway to meet all cash outflows without facing a forced disinvestment from elsewhere in its investment strategy.

As at 31 December 2023, the Fund's total cash balance was c.£35.6m; inclusive of the Bank Account and the Northern Trust cash account.

Operational cashflows

When considering the Fund's cashflows, we have also looked at these from the perspective of which are likely to be predictable over time and those which are subject to greater uncertainty.

- **Predictable Cashflows**: The Fund's predictable cash inflows arise from contributions and investment income from those assets where the Fund receives an ongoing income distribution. Monthly pension payments are the primary predictable outflows.
- **Unpredictable cashflows**: The Fund's unpredictable cash inflows are likely to be transfer values into the Fund and, less materially, the interest earned on the Fund's cash balance at the bank. Unpredictable cash outflows are likely to be transfer values out the Fund, any lump sum death benefit payments and payments relating to .early retirements,

Looking at the last two full years, we can observe the following cashflows in relation to benefit payments and contribution income.

Mandate	21/22	22/23
Contributions	49.1	53.1
Investment Income	3.9	2.5
Pensions	(32.9)	(34.4)
Lump Sums	(3.9)	(6.9)
Death benefits	(0.7)	(1.2)
Transfers out	(4.6)	(3.8)
Expenses	(5.5)	(5.9)
Surplus	**5.4**	**3.4**

Source: Report & Accounts

Unpredictable cashflows arising from transfers and death benefits have been relatively low (c.£5m per annum) or around £0.4m per month. Experience therefore suggests that there is limited need to make significant allowance for unpredictable benefit cashflows.

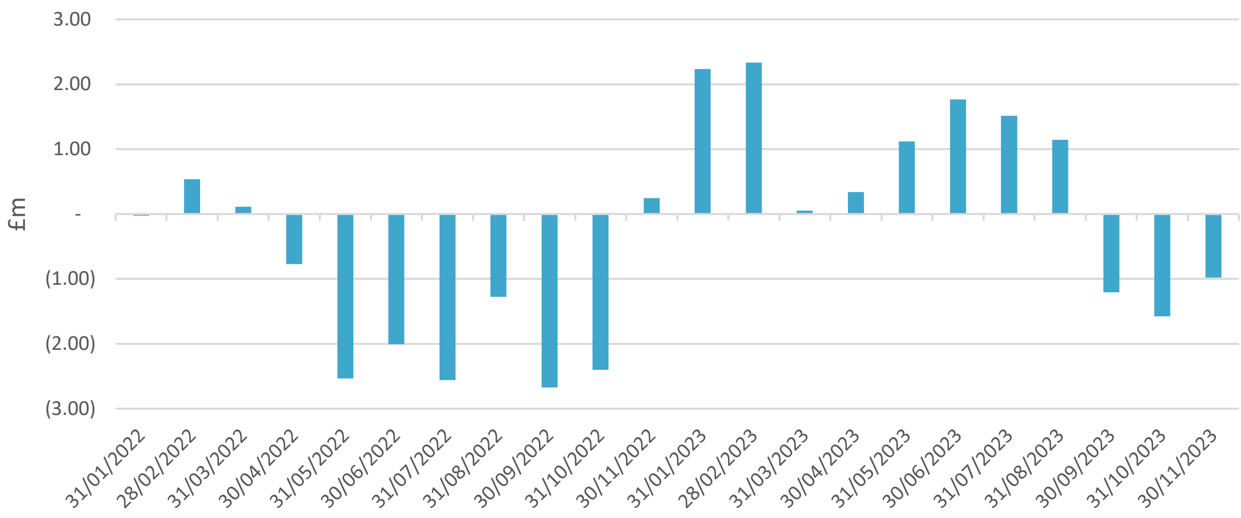
Taking account of both experience and projected cashflows, we propose allowing for £3.5m/month of predictable cashflows and £0.5m/month of unpredictable cashflows within the cashflow management policy. Following the current principle of allowing for two months of unpredictable cashflows, this suggests a cash amount of £4.5m be used as a buffer.

Currency management

In addition to its normal day-to-day cashflow requirements, the Fund has a currency management solution which requires the Fund to settle losses on the underlying forward contracts (e.g. due to a fall in Sterling relative to overseas currencies) monthly. Conversely, the Fund will benefit from gains and thus positive cashflow when Sterling rises relative to overseas currencies.

The Fund needs cash to settle these currency contracts but may also receive cash in settlement of currency contracts. These amounts are by their very nature unpredictable but represent an element of the operational cashflow to be capture by the Fund's policy. To illustrate the variability in cash payments, the following chart illustrates the realised gain/loss settlement amounts from the currency hedge over the two years to December 2023.

Chart 1: Monthly cash settlement amounts from (positive)/to (negative) the currency hedge.



Source: Russell Investments

Based on experience over the last two years, the largest single monthly payment was c.£2.7m with payments out of the Fund being required around 50% of the time. However, over a seven-month period, the Fund was required cash of c.£14.2m to settle cumulative currency contracts. This was then followed by a nine-month period where the Fund received cash settlements of c.£10.8m.

Currency management therefore contributes significantly to uncertainty within the Fund's monthly cashflow requirements and emphasises the need for a reasonable cash buffer. Given currency markets may demonstrate trending, it is reasonable to allow for more than one month of downside variability in the development of the cash management policy. We suggest that the cash buffer to allow for currency variability consider one month of potential payments, recognising the largest historic settlement amount of c.£3m. Given Russell provide notice of settlement amounts, this provides additional flexibility to meet any additional payments.

Variation of cash amount

Based on the proposals set out above, the target cash balance should be increased to £7.5m. This increase is also reflective of the overall increase in the size of the Fund over time.

Whilst the actual cash balance will vary from month to month in line with experience, it is appropriate to establish thresholds which limit the overall maximum and minimum levels of cash that may be held within the Fund. We propose the following limits:

- A lower limit of £4m, this being slightly greater than the amount needed to pay one month of expected pension payments.
- An update limit of £12.5m, this triggering an investment of £5m (c.0.5% of total Fund assets) into the broader investment strategy.

If the cash amount falls outside these ranges, Officers would be expected to take corrective action as set out in the policy below.

Redemption from physical assets

Cash may be released from physical assets through redemptions from underlying funds. Redemptions from physical assets should have regard to the Fund's rebalancing policy, and liquidity of specific investment funds (i.e. reflecting the fact that some underlying funds cannot be redeemed at short notice). We have set out more detail below.

Rebalancing

The Committee monitors the Fund's actual asset allocation on a regular basis to ensure that it does not materially deviate from the target allocation. The Committee has adopted a rebalancing policy which is triggered if the Fund's asset allocation deviates by 5% or more from the strategic allocation.

In order to avoid excessive rebalancing, the assets are not brought back to the absolute strategic benchmark, but to a position that is approximately halfway between the tolerance level and the target allocation. This also takes into consideration that there is a time lag between reporting a variance, and the rebalancing of the funds.

The above process will realise cash from time to time, which can be used to support the Fund's cashflow requirements. However, rebalancing is relatively infrequent in practice.

Disinvestments

In the event that short term cash is required, it is necessary to evaluate the Fund's asset allocation to determine the most appropriate source of funds for disinvestment. Such disinvestments would take account of the underlying liquidity of each of the Fund's investments and the administrative complexity of instructing disinvestments. As such, property, infrastructure and private market mandates will be excluded as a potential source of short-term cash (beyond income received by the Fund).

If disinvestment is needed, we recommend that consideration is given only to equity, multi asset and fixed income assets (managed by LCIV, LGIM or RLAM). This covers 62.5% the overall asset allocation.

Increasing investment income

Whilst cash balances may be topped up by periodic disinvestments, a number of the pooled funds in which the Fund is investment offer the option to distribute income. Where predictable benefit outgo falls below regular contribution income (albeit this is not currently envisaged over the short term), then the Committee could switch assets into income generating share classes.

Whilst no action in this regard is currently required, we recommend that this be retained as an option if needed.

Capital commitments

The second element of the cashflow policy is to recognise the Fund's undrawn capital commitments as these influence the overall level of cash that the Fund may wish to retain. As at 30 September 2023, the Fund had outstanding commitments to the following funds:

Funds	Committed Capital	% undrawn	Capital to be called
Stafford Capital Global Infrastructure SISF II	c.£24.7m	10.3%	£2.5m
Stafford Capital Global Infrastructure SISF IV	c.£26.0m	25.2%	£6.6m
LCIV Renewable Infrastructure Fund	£25.0m	57.7%	£14.4m

Funds	Committed Capital	% undrawn	Capital to be called
Churchill Senior Loan Fund II	c.£24.3m	3.8%	£0.9m
Churchill Senior Loan Fund IV	c.£20.8m	20.1%	£4.2m
Permira IV Fund	£36.0m	13.2%	£4.8m
Permira V Fund	£43.0m	62.4%	£26.8m

Source: Investment managers

In total, the Fund has approximately £60m of capital calls currently outstanding albeit not all of this is expected to be called.

- Stafford SISF II has c.£2.5m of outstanding although no further capital calls are expected over the next 12 months. However, Stafford SISF IV still has c.£6.6m of outstanding capital to be drawn with the majority of this is expected be called over the next 12 months.
- The outstanding commitment of c.£14.4m to the LCIV Renewable Infrastructure Fund is anticipated to be gradually called over the next 12 months, resulting in the LCIV Renewable Infrastructure Fund being close to c.55.7% funded at the end of 2024.
- No further capital calls to Churchill II are expected over the next 12 months. Churchill IV still has c.£4.2m of outstanding capital to be drawn with further capital calls expected over the next 12 months.
- Both Permira IV and Permira V have material outstanding capital commitments to be drawn with drawdowns into both funds expected over the next 12 months.

In total, expected capital calls to the Fund's current closed-ended mandates are c.£24.9m over the next 12 months. We set out as an Appendix 2 the overall cashflow forecast for 2024, noting that significant cash inflows are also expected to be received from the private market mandates. This can be considered alongside the potential capital commitments and thus a lower amount could be retained to meet future capital calls.

We recommend that the cashflow policy permit the retention of additional cash sums to meet potential capital commitments although this should not permit the longer-term retention of cash where timings are unknown. We therefore propose to work with Officers to establish how much cash should be retained to meet forthcoming capital calls and thus whether any surplus cash can be invested in the current strategy.

Recommendations

We have set out an updated cashflow policy as Appendix 1. We recommend that this policy be adopted by the Committee.

In the event that the Fund's cash outflow profile was to materially change, for example if the Fund's benefit payments increased by more than 20%, then we recommend this policy be reviewed. We also recommend that this policy be reviewed every three years, recognising the additional information provided by the valuation process, including the impact on contribution rates.

We look forward to discussing this paper with the Committee.

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For and on behalf of Hymans Robertson LLP

General risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, infrastructure, private credit, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix 1: Proposed Cashflow Policy

Based on the Fund's current cashflow requirements and investment strategy, we propose the following policy be adopted:

- A target working cash balance of £7.5m to be set, this being the sum of
  - £3.5m, the approximate predictable monthly outgo.
  - £1m, approximately two times the average unpredictable monthly outgo
  - £3m, being the maximum expected settlement amount for 1.5 times the highest monthly unpredictable outgo over the previous 12-month period (allowing for illustrative settlement payments on the currency management arrangement based on historic experience).
- This cash balance is sufficient to cover over 2 months of forecast benefit payments if contribution payments were delayed for any reason.
- The cash balance will be replenished by monthly contributions by income received from the UK property and private markets investment arrangements.
- The cash balance will be reviewed monthly immediately following the receipt of contributions and is permitted to vary between £4m and £12.5m. If the cash balance falls out of these limits, then Officers should take the following action:
  - If the cash balance is below £4m, Officers should instruct the redemption of assets from the most overweight liquid asset allocation to return the cash balance to £7.5m. In practice, this is expected to realise assets from either equities or the absolute return mandate.
  - If the cash balance rises above £12.5m, Officers invest the excess cash so as to reduce the cash balance to £7.5m. Cash should be invested in the most underweight liquid allocation although Officers may consult with the Fund's investment adviser the most appropriate investment for the excess cash.
- The cash balance may be retained above the upper limit at the discretion of the Statutory Section 151 Officer to meet unforeseeable volatile unpredictable payments.
- Where the Fund has undrawn capital commitments into private market or other less liquid strategies, the Fund may retain additional cash to meet such commitments. These amounts will be considered as being in addition to the working cash balance set out above.
- This cash management policy should be reviewed every three years following the actuarial valuation, in the event of any material changes to the Fund's cashflow profile, or in the event of an increase in predicable monthly cash outflow of 20% from current levels.

Appendix 2: Summary of estimated quarterly cashflows over 2024.

Mandate	Q1 2024	Q2 2024	Q3 2024	Q4 2024
Cash Balance (Start of Quarter)	**35.6**	**36.8**	**36.4**	**41.3**
Total Cash Inflows	**22.1**	**20.0**	**19.4**	**25.0**
Asset Cash Inflows	***10.5***	***8.3***	***7.7***	***13.3***
LCIV Global Bond Fund	0.5	0.5	0.5	0.5
UBS Property [1]	0.3	0.3	0.3	0.3
JP Morgan [2]	0.4	0.4	0.4	0.4
Stafford Capital Global Infrastructure SISF II	6.1	1.1	2.9	0.2
Stafford Capital Global Infrastructure SISF IV	1.4	0.4	0.4	0.7
Churchill Senior Loan Fund II [3]	0.4	0.4	0.4	0.4
Churchill Senior Loan Fund IV [4]	0.4	0.4	0.4	0.4
Permira IV	0.5	4.2	1.9	9.8
Permira V	0.5	0.6	0.6	0.7
Operational Cash Inflows	***11.5***	***11.7***	***11.7***	***11.7***
Contributions [5]	9.3	10.2	10.2	10.2
Interest Received [6]	0.8	-	-	-
Transfers In	1.4	1.5	1.5	1.5
Total Cash Outflow	**-20.8**	**-20.5**	**-14.5**	**-19.3**
Asset Cash Outflows	***8.4***	***7.9***	***1.9***	***6.7***
Stafford Capital Global Infrastructure SISF IV	2.3	0.8	0.8	0.8
LCIV Renewable Infrastructure Fund [7]	0.8	0.8	0.8	0.8
Churchill Senior Loan Fund IV	1.0	1.0	-	-
Permira IV	0.2	0.2	0.2	0.2
Permira V	3.9	5.0	0.0	4.9
Operational Cash Outflows	***12.5***	***12.6***	***12.6***	***12.6***
Benefit Payments [8]	8.3	8.9	8.9	8.9
Lump Sums	0.8	1.0	1.0	1.0
Expenses	3.3	2.7	2.7	2.7
Overall Net Cashflow	**1.2**	**-0.5**	**4.9**	**5.7**
Cash Balance (End of Quarter)	**36.8**	**36.4**	**41.3**	**47.0**

[1] Based on a 1-year distribution yield of 2.6% p.a. as at 30 September 2023 (latest available).

[2] Based on a 6.0% p.a. operational income in the medium term.

[3] Based on a target distribution yield of 6-7% p.a. and as such, we have used an estimated distribution yield of 6.5% p.a.

[4] Based on a target distribution yield of 7-8% p.a. and as such, we have used an estimated distribution yield of 7.5% p.a.

[5] Based on the average level of contributions paid in the year to 31 December 2023 – net of pension payroll deductions, Q1 2024 includes a refund to the Fund of c.£900.0k for agency surplus (voluntary contributions) and includes a 3.0% increase from April 2024 (for salary uplifts/payroll increases).

[6] Based on the expected interest due from the Fund for invested cash deposits.

[7] Based on the average capital called in the year to 31 December 2023.

[8] Based on the average level of benefit payments paid in the year to 31 December 2023 – includes a 6.7% increase to benefits payroll from April 2024.