APPENDIX A

Cashflow Management Framework

London Borough of Southwark Pension Fund

This paper provides information on the Fund's cashflow requirements.

At a glance…

The Officers of the London Borough of Southwark Pension Fund (the "Fund") have requested that Aon provide advice in relation to implementing a formal policy to support the Fund's ongoing cashflow requirements.

The Fund's cash outflows related to pension payments are set to increase from April 2023 (c.10%) to reflect the high levels of inflation observed in the UK economy over the past year.

Based on forecasts we estimate that the Scheme will be cashflow negative over the year. This could be greater than projected as the Fund looks to increase its allocation to illiquid investments and additional cash will be required to fund new investments. With no new commitments the cash shortfall (defined as the amount of cash outflow not covered by contributions, lump sum payments and investment income) over the next year is projected to be c.£34m.

Currently the Fund does not have a formal framework or policy in place to support ongoing cashflow requirements. To date, the Fund has utilised a combination of the bank account and the Blackrock Liquidity Fund as the primary sources of liquidity, with a large amount of cash (c.£45m as of 31 December 2022) held in the latter.

As such, we propose that the Pension's Advisory Panel ("PAP") agree a formal cashflow management policy to ensure that the Fund has access to sufficiently liquid assets to meet predicted cashflow requirements and flexibility to meet additional cashflow requirements. Also, the cashflow policy shall seek to minimise the level of cash balances held by the Fund to maximise investment returns.

Why bring you this note?

The purpose of this paper is to provide an overview of the Fund's cashflow requirements and propose a cashflow management strategy which reflects regular cashflows as well as recent and future commitments to illiquid investment mandates

Next steps

- PAP to formally agree on the cashflow management recommendations outlined in this paper
- Update the Fund's Investment Strategy Statement
- Review cashflow requirements on an annual basis

Prepared for: The Pensions Advisory Panel
Prepared by: Aon
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Background

The Blackrock Liquidity Fund, Blackrock Passive Equity Fund and LGIM Passive Equity Fund have historically been the main vehicles utilised the meet the Fund's cashflow requirements. Recently, the Fund held £45m (c.2.3% of assets) in the Blackrock Liquidity Fund. which is approximately 33% larger than the Fund's estimated cash shortfall for the next year. Holding excess assets in cash is inefficient from a portfolio management view but has been necessary to meet cashflow requirements.

Over the last 12-24 months, the Fund has made several investments into illiquid mandates which have different cashflow needs. As part of the move to net zero carbon emissions it has been agreed to allocate further assets to investments in the renewable infrastructure, ESG/Impact, low-carbon universe. These additional investments will each have their own cashflow profile. As such, it is likely that the Fund will have additional cashflow requirements beyond the estimated shortfall of c.£34m.

Currently there is no cashflow policy in place to fund these investments and surplus cash is being held in reserve to meet these needs alongside ad hoc disinvestments.

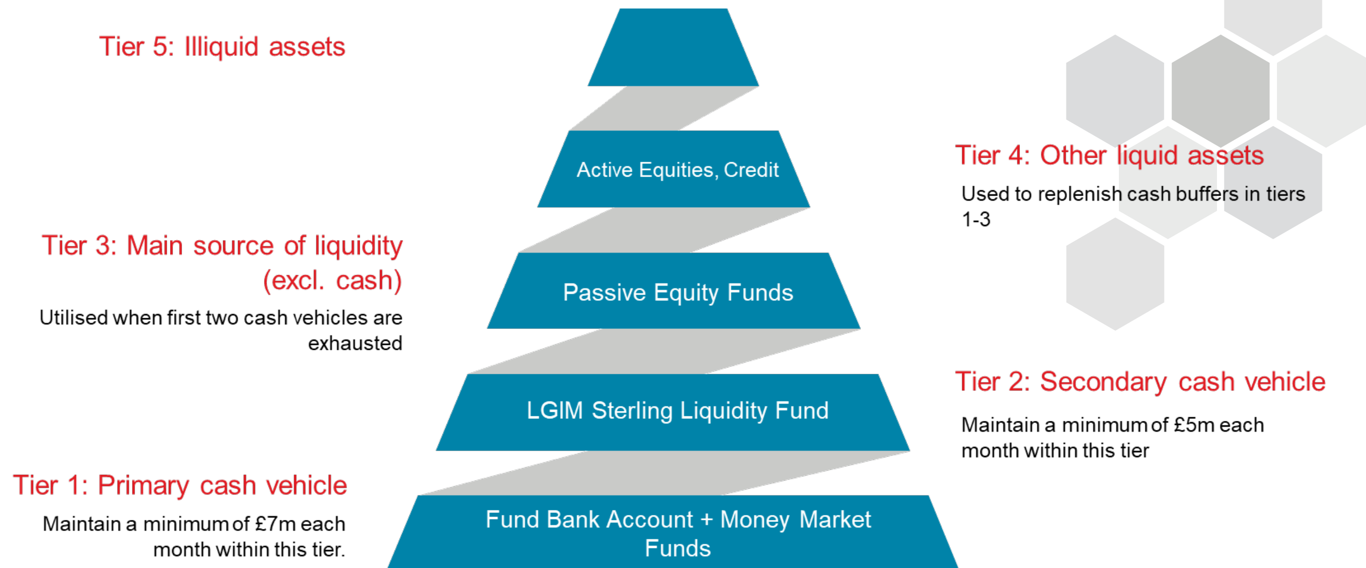
Recommendation

We propose a tiered cashflow policy to ensure there is sufficient liquidity to meet predicted cashflows and flexibility to meet unexpected liquidity requirements. The aim will be to reduce the governance requirements in managing cashflow and reduce the risk of not meeting payments as they fall due.

We have measured liquidity as the ease and speed with which the Fund is able to access cash. This will enable the Fund to achieve the following:

1) Ensure effective day-to-day liquidity management such that the Fund can meet its regular cashflow requirements (i.e., pension payments, transfers, and drawdowns of capital)
2) Hold a sufficient cash buffer to support any immediate, urgent, or unexpected cashflow requirements (e.g., one of the Fund's existing illiquid investments issues a larger than anticipated capital call due to favourable market conditions).
3) Meet capital calls in a timely manner and ensure that distributions of investment income are not held in the bank account for extending periods of time.
4) Through holding a lower accumulative amount of cash, albeit across multiple sources of liquidity, the Fund should be able to hold a greater amount of capital in return seeking assets
5) An established cashflow management policy will form the basis for implementing a framework for how capital is deployed to fund new investments

Details of the proposed tiers are provided below.



Tier 1: Primary cash vehicle

Regular cashflows are expected to be £6-7m per month with uncertainty around the exact timing and value of payments. To avoid the risk of not meeting payments we recommend that there is a minimum cash buffer of £7m, utilising the Fund bank account and money market instruments as appropriate vehicles for holding the cash. The money market instruments will be accessed via a portal which is also used by the Council.

The rationale for this level of cash is two-fold:

1. The Fund shouldn't maintain a cash balance which is too high given this would be considered an inefficient use of capital.
2. Similarly, it would be operationally inefficient if the cash buffer is insufficiently low and consistently needs topping up intra-month.

The bank account offers no investment return and so cash within this account should be held at a minimum to ensure the portfolio is as efficient as possible. Initially the minimum balance will be £750k although the Officers have authority to change this amount based on their experience of managing cashflows.

The Officers will monitor the cash buffer with a view to either top it up back to the minimum amount or reinvest any excess cash. This will be done using the assets held within Tier 2 (see below).

Tier 2: Secondary cash vehicle

The Blackrock Liquidity Fund is a low-risk investment but has a 5-day settlement period which is not ideal in meeting pension obligations or deploying cash to meet capital calls or invest in new opportunities. As such, we recommend that the Fund use a similar fund that is managed by LGIM – LGIM Sterling Liquidity Fund, which is daily dealt, has a two-day notice period, and a one-day settlement period.

We recommend that a minimum amount of £5m is held with LGIM, and the purpose of this holding would be to meet any larger than expected transfers out or drawdowns of capital while avoiding regular trading into and out of equities.

We recommend LGIM have delegated authority to top-up the fund or reinvest any excess cash monthly using the LGIM equities. This will be managed under an Investment Manager Agreement ("IMA") with LGIM.

Tier 3: Main source of liquidity to fund new investments

The purpose of this tier is:

- Act as the main liquidity source to fund new investments
- Replenish cash buffers held in Level 2
- Offer a simple way to reinvest surplus cash and maintain expected returns

Historically the Fund has utilised the LGIM Passive Equity Fund and Blackrock Passive Equity Fund as alternative sources of liquidity to deploy capital in new investments. This has been driven by a combination of two factors 1) the Fund has traditionally held an overweight position to equities while we wait for opportunities to become available and 2) relatively lower transaction costs and favourable dealing terms vs. redeeming assets held in an active equity or active credit mandate.

We are comfortable in the passive equity funds being the preferred source to fund new investments and by default would categorise them to fall under this Tier. In addition, the upcoming Blackrock ARB and DGF fund redemptions can be used to offer additional Tier 3 liquidity until these assets are completely disinvested.

We would also consider the Fund's index-linked gilt funds to be part of this tier. However, fixed-income assets, in particular index-linked gilts, are key investments in helping pension schemes meet their liabilities by protecting the funding level from rises in inflation. As such, we advise a cautious approach is taken when considering redeeming assets held in these investments for cashflow purposes.

Tier 4: Other sources of liquidity

This includes the Fund's investments in active equity, active credit, and multi-asset strategies. Relative to other asset cases such as property, infrastructure, private equity, renewables and other alternatives, these assets have a better liquidity profile and therefore can be seen as an alternative liquidity source.

These assets are actively managed investments which are designed to use manager skill to deliver returns above the broad market. As such, depleting large amounts of capital from them would be an insufficient use of capital.

We view this tier as being a source to top-up the passive equity mandates and other cash vehicles if required with the purpose of supporting the Fund to quickly deploy capital to take advantage of new investment opportunities.

Tier 5: Illiquid investments

The Fund’s illiquid investments, in particular the sustainable infrastructure and ESG priority allocation have been an integral part of the Fund’s investment strategy to reduce carbon-weighted exposures over the last 5 years due to the nature of the underlying holdings. The pace of achieving net-zero by 2030 will very much be dependent upon how the global investment and technological environment evolves over the short-medium term. With many asset classes lagging the curve with respect to the availability of strategies with strong ESG/climate credentials, allocating more money to renewable infrastructure strategies in the short-term could prove to be an effective solution. This will offset the carbon exposures present in areas of the portfolio where it is currently impractical to transition towards greener assets. Thus enabling the Fund to continue making progress on its journey towards reaching net-zero by 2030.

Due to the nature of many illiquid investments, it is often the case that the Fund’s capital commitment to illiquid mandates will be drawn down over a period of 2-3 years. As such, from a governance perspective, it is really important this framework is revisited to assess the level of available cash prior to making commitments to illiquid investments

We recommend that this framework, including the cash flow buffers suggested in Tier 1 and 2 is reviewed on an annual basis to ensure that it is consistent with the cashflow requirements of the Fund. It should also be reviewed upon making a new investment or when there is a change to contribution rates or an uplift in the pension payments.

Next Steps

Once we have an agreed cashflow policy, the following steps will be required:

- Make amendments to the Fund's Investment Strategy Statement to reflect the cashflow policy and any other changes that may be required
- Select an appropriate vehicle to invest in money market instruments **(Tier 1)**
- Arrange the paperwork to invest in the LGIM Sterling Liquidity Fund and associated cashflow management policies.
- Arrange for the full redemption disinvestment form the Blackrock Liquidity Fund and work with Aon to decide on the best way to allocate the proceeds
- The cashflow policy should be reviewed on an annual basis to ensure consistency with the cashflow requirements of the Fund.

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