Report to:	**Pension Board**
Date of meeting:	**8 February 2024**
By:	**Chief Finance Officer**
Title:	**Additional Voluntary Contributions Report**
Purpose:	**To provide an overview of the existing AVC arrangements and commentary on service provision for review.**

RECOMMENDATIONS

The Pension Board is recommended to note the report

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1. Background

1.1 This report has been prepared to assist the East Sussex Pension Fund (the Fund) with the management and governance of the Additional Voluntary Contribution (AVC) arrangements with Prudential.

2. Supporting information

2.1. AVC's are a way for Fund members to increase their benefits above their entitlement under the Local Government Pension Scheme (LGPS) based on their employment service. AVC's build a pot of money of additional benefits under an arrangement with an AVC provider. For the Fund this provider is Prudential. The contributions into AVC's are deducted from a members pay before tax, so tax relief is automatic. The members access to the AVC options are directly through their scheme employer payroll.

2.2. There were 1,107 active members and 268 deferred members with an AVC 's as at 30 June 2023. This is around 4.5% of active and 1.1% of deferred members. The total value of AVC's were £17.2m (excluding terminal bonus for the with profits funds), with an average pot size is £12.9k.

2.3. Annual contributions by members into the AVC funds amounted to £2.3m during the 2022/23 financial year around £2.1k per member per year.

2.4. Total payments out of AVC's in the year were £3.1m with an average AVC pot paid out of £31.1k.

2.5. The AVC arrangement currently consists of 10 self-selected funds which are open for new investment, there are 7 actively managed funds with 3 passively managed funds. In addition, members have access to two lifestyle options:

(a) that is designed for a member planning to take all their AVCs as cash on retirement or

(b) retirement options where only 25% of the fund is aimed at cash on retirement. The lifestyle invests in a range of predominantly growth seeking assets (equities, property etc.) when more than 10 years from retirement and gradually de-risks into consolidation assets (bonds and cash) over the 10 years to selected retirement date.

2.6. The Board has been provided this paper for awareness. The Pension Committee is required to consider the on-going suitability of the AVC offering available to members. Noting that members will have a range of potential risk appetites, members will have a range of understanding of investments products. The Committee will need to consider the offering in light of the performance of both funds and the provider on review of this paper after this Board meeting.

3. Executive Summary

Responsibility

3.1. It is the Pension Committee's ongoing governance responsibility to ensure that:

- The fund options made available remain appropriate.
- The AVC provider offers a good quality service that meets the needs of members and the Fund.
- The charges paid by members are competitive and offer good value to money.

3.2. The Pension Board is provided the information in this report to consider the status of the AVC offering from an oversight perspective.

Key findings

3.3. Overall, there are no aspects of the investments that are of major concern, however the following should be noted:

- Prudential are one of the largest AVC providers in the UK and have significant experience in administering AVC arrangements for local authorities. Prudential is financially strong and compares well across the industry.

- The default investment fund for ESPF members under the AVC arrangement is the Prudential With-Profits Fund. This fund aims to provide competitive long-term real returns whilst smoothing the peaks and troughs of day-to-day market movements. Whilst considering if this remains the default option for investors. Key reflections for this are:
  - Risk appetite of default investors
  - How engaged with investments a default investor might be
  - What understanding of investments a default investor may have

  Considering these factors explored further in the document it is not felt that there is any need to amend the default selection at this point.

3.4. Prudential's charges for the unit-linked funds are consistent with other AVC arrangements.

3.5. The Current offering covers the main asset classes that the average AVC investor would need to provide a bespoke investment choice to meet their needs. However possible areas that could improve the options would be the addition of:

- Sharia compliant equity option and:
- Active equity management options

4. Current investment options

Overview of current investment options

4.1. The Prudential provide a range of 10 Investments fund (full list of investments provided in the table below) that members can choose from. This consists of 3 equity, 5 multi asset, 1 gilt and 1 cash fund. This provides a wide range of investments options to members and covers a wide level of risk appetite.

4.2. There are also 2 lifestyle options available to members to invest in which look to de-risk the members investments as they approach retirement.

4.3. There is currently £17.2m (excluding terminal bonuses) invested within the East Sussex Pension Fund offering with the largest being the Prudential With-Profits Fund (Default option) fund at £8.8m (51.2% of invested assets).

4.4. There is one Environmental Social and Governance (ESG) option within the offering this is limited to a pure equity fund and does not form part of the Multi Asset offering. Currently 69 people (7%) invest in this fund which equates to 3.3% of investments or 27.3% of the equity only investments.

4.5. All 10 funds have been invested in with contributions being made to all open funds during the year the smallest contribution was to the Prudential Dynamic Growth I Fund with £20k or 0.9% of contributions being paid in.

4.6. There are six funds that have been closed to new members. Two of the closed funds have no value or active members. No contributions have been made to the Prudential UK Equity Fund during the year. The Prudential International Equity fund and the Prudential Global Equity remain open to existing members to continue to contribute. 8.7% of investments remain in the closed funds with 8.1% being in the Prudential Deposit Fund.

4.7. Performance (detail can been seen in Appendix 1) for the current open investments in general these have performed in line with their benchmarks. However, it is not clear as to how difficult these benchmarks are to achieve for some funds as they are internally determined or in the case of the with-profit funds no benchmark or costs are disclosed in the fund literature.

4.8. From the returns provided the higher risk assets have provided in general a higher return over the 3, 5 and 10 year investment periods. With the exception being, the Prudential Long-Term Gilt Passive Fund which has large negative performance figures for the 3 and 5 year period with the marginal positive for the 10 year figure.

Funds available for investment

Investment Fund Name	Asset Class, Active or Passive	Prudential's risk rating
Prudential UK Equity Index Fund	Equities, Passive	High
Prudential Overseas Equity Index Fund	Equities, Passive	Medium to higher risk

Prudential Positive Impact Fund	Equities, Active	Medium to higher risk
Prudential Discretionary Fund	Multi-Asset, Active	Medium
Prudential Dynamic Growth IV Fund	Multi-Asset, Active	Medium
Prudential Long-Term Gilt Passive Fund	Government Bond, Passive	Medium
Prudential Dynamic Growth I Fund	Multi-Asset, Active	Lower to medium risk
Prudential Dynamic Growth II Fund	Multi-Asset, Active	Lower to medium risk
Prudential With-Profits Fund *(Default option)*	Multi-Asset, Active	Lower to medium risk
Prudential Cash Fund	Deposits, Active	Minimal risk

4.9. It should be noted that AVC investors have the ability to invest in multiple funds.

Environmental, Social and Governance (ESG)

4.10. There is one ESG offering in the arrangement – the Prudential Positive Impact Fund. The fund gains its positive impact exposure through the M&G Positive Impact Fund. The fund is a concentrated portfolio of global stocks, investing in companies that make a positive social and/or environmental impact alongside a financial return. The fund embraces the United Nations Sustainable Development Goals framework and invests in companies focused on areas including climate action, pollution reduction, circular economy, health and wellbeing, education and innovation, and working conditions.

4.11. The objective is to support and influence their contribution to the world's major social and environmental challenges. The fund manager has discretion to invest in companies with limited exposure to fossil fuels but which are driving or significantly participating in the transition to a more sustainable economy. There are 87 members invested in this fund which equates to 6.5% of member exposure to the investment options. This fund was added to the options available in February 2020.

Lifestyle funds

Prudential Lifestyle Fund Name	Fund within lifestyle
Targeting 100% cash	Dynamic Growth IV & Dynamic Growth II & Cash
Targeting retirement options	Dynamic Growth IV & Dynamic Growth II & Cash

4.12. Members have access to two lifestyle options (a) that is designed for a member planning to take all their AVCs as cash on retirement or (b) retirement options where only 25% of the fund is aimed at cash on retirement. The lifestyle invests in a range of predominantly growth seeking assets (equities, property etc.) when more than 10 years from retirement and gradually de-risks into consolidation assets (bonds and cash) over the 10 years to selected retirement date. Currently 331 members are invested in a lifestyle investment.

Default fund

4.13. The Prudential arrangement offers a default investment, where members' contributions will be invested unless they make an active choice otherwise.

4.14. For East Sussex Pension Fund the default investment is the Prudential With-Profits Fund. This is due to the With-Profits Fund aim to offer the prospect of a competitive long-term real return whilst smoothing the peaks and troughs of day-to-day market movements.

4.15. The value of with-profits funds is not directly exposed to fluctuations in the value of the underlying assets. Instead, returns are 'smoothed' through the addition of bonuses (regular and final) which aim to provide members with a steady rate of return. The level of bonuses applied, which are not guaranteed, will vary depending on a number of factors and will make an allowance for the charges associated with running the fund.

4.16. There are 693 members invested in this fund which equates to 51.8% of member exposure to the investment. However only 38.0% of new contributions go into this investment. There is also very limited switching between the with profits investments and other investment offerings. As such the choice of a default is likely to determine where a significant proportion of all AVC investments go.

4.17. Members have the potential to achieve higher returns by transferring from the With-Profits Fund into unit-linked alternatives. However, in doing so, members would then equally expose the fund value they have built up to potential negative returns. By contrast annual bonus rates in the With-Profits fund once applied, cannot be taken away.

Closed Funds

4.18. The following funds have been closed, however members who have selected these prior to closure can retain their holding.

Investment Fund Name	Asset Class, Active or Passive	Prudential's risk rating	Investment pot % value	Existing members still contributing?
Prudential Deposit Fund	Cash/Cash Equivalent, Active	Minimal Risk	7.1%	Y
Prudential Fixed Interest Fund	Government Bond, Active	Lower to medium risk	Nil	N
Prudential Global Equity Fund	Equities, Active	Medium to higher risk	0.2%	Y
Prudential Index-Linked Fund	Government Bond, Active	Medium to higher risk	Nil	N
Prudential International Equity Fund	Equities, Active	Medium to higher risk	0.3%	Y

Prudential UK Equity Fund	Equities, Active	High	0.1%	N

5. Commentary on alternate investments

Overview of alternate investments

5.1. The analysis of the current investments above does shows that the investment choices available to the AVC investors cover the range of asset classes that an average AVC investor would need. There is no suggestion that there is a major absence of options available or that the investments are significantly underperforming their benchmarks.

5.2. There are many LGPS funds that use Prudential to run their AVC arrangements with 7 of the other 10 ACCESS partner funds using Prudential. Of these 4 offer the with profits fund as the default option the other 3 do not state a default option in their documentation.

5.3. 3 of the 7 ACCESS Funds offer substantially different options to East Sussex with 2 offering 18 different investments however there is limited additional asset classes provided by these. The main asset class distinction offered is a sharia compliant investment option which is provided by 1 of these Funds. The main point of difference between these options and East Sussex is around active management choices, non-prudential funds and a wider set of both the pure equity and fixed income opportunities.

5.4. The other ACCESS fund with a substantially different offer has just 3 investments with only with-profits fund, the discretionary fund and the cash fund available.

5.5. The remaining 4 ACCESS Funds offer 14-15 choices all of which are either offered by East Sussex or which were closed to new investments in 2008 and are detailed in the table above.

5.6. The offerings provided by other ACCESS Funds give an indication that ESPF are in line with other pension funds of a similar size, geographic area and membership.

Sharia Compliant Investment

5.7. The asset class offering not currently offered to East Sussex AVC investors is the Sharia compliant investment. This is a unique investment option that could be available through the Prudential offering; no other similarly focused investment options to align with other religions are available.

5.8. The Scheme Advisory Board commissioned a report from an expert in Islamic finance to provide advice as to whether the LGPS is Sharia complaint following legal advice on the issue of members opting out of the scheme on the basis of their religious (principally Islamic) beliefs. The report was published on 23 January 2024. The findings of the report were that Muslim employees can continue to contribute to, and benefit from the LGPS.

5.9. Looking at the possible Sharia Complicit Investment fund in more detail, the aim of the Fund is to track as closely as possible the performance of the Dow Jones Islamic Market Titans 100 Index (the Islamic Index). The Index is comprised of the shares of companies in emerging and developed markets that are based anywhere in the world. The fund is passively managed and will aim to invest in the shares of the companies in generally the same proportion as in the Index.

5.10. The shares are selected by filtering the Index universe through screens for business activities and financial ratios to remove stocks that are not Shariah compliant. The fund will only invest in shares of companies that meet Shariah compliance principles as interpreted or approved by the Shariah Committee. The Shariah Committee monitors the fund throughout the year and issues an annual Shariah certificate on the fund's compliance with Shariah principles. This certificate is included in the annual report of the fund as confirmation of the Shariah compliance for that year. The fund will not invest in derivatives.

5.11. The performance of the Sharia Complaint fund to 30 June 2023 is set out below:

	Quarter	Annualised		
	2 2023	3 Years to 30/06/23	5 Years to 30/06/23	10 Years to 30/06/23
Fund	8.3%	12.6%	14.7%	14.7%
Benchmark	8.0%	12.9%	15.3%	15.3%

5.12. The current Prudential Overseas Equity Index Fund's performance offered by the Fund for comparison was:

	Quarter	Annualised		
	2 2023	3 Years to 30/06/23	5 Years to 30/06/23	10 Years to 30/06/23
Fund	0.0%	8.5%	7.0%	9.4%
Benchmark	0.7%	8.3%	7.3%	9.6%

5.13. The risk profile of this investment is classed as medium to higher risk the same as the overseas equity index fund. If the Fund were to provide this option, it would increase the passive equity offering.

5.14. In terms of the current investments AVC investors have £1.4m (7.8%) invested in passive equity funds. This is relatively small allocation. To date the Fund has not been asked to offer a Shariah compliant AVC Fund or had any requests for information associated with this as an investment option.

Active management options

5.15. Looking at the offerings of the other ACCESS Funds East Sussex provides a smaller number of actively managed pure equity and fixed income Funds, however a wide range of Multi asset active options are provided.

5.16. Within the AVC investments of the Funds members there is a relatively small amount invested within the pure equity or fixed income options available to the AVC investors, amounting to £2.3m 13.5% of investments (£2.0m in equity and £0.3m in Gilts) of this £0.6m 3.3% is invested in active managed equity funds. There is in contrast is £4.5m, 26.1% invested in non with profits multi assets funds representing 33.7% of members. £8.8m in with-profits investments 51.2% all the multi asset investments are actively managed investments.

5.17. The actively managed funds that have been closed by East Sussex have not significantly outperformed the passive managed funds that is offered to investors.

5.18. An active managed fund would necessitate for an AVC member to be more attentive to the performance of the investments, which may be an unrealistic ask of AVC investors these also come at a greater cost to the investor.

5.19. It is not evident from the amounts invested that a new active manage pure equity option is needed.

6. Review of the Default Option

6.1. The Prudential arrangement offers a default investment, where members' contributions will be invested unless they make an active choice otherwise. When the thought for an appropriate default investment is considered the attributes of how a default investor might act should for part of this consideration in this instance the following has been taken into account:

- Risk appetite of default investors
- How engaged with investments a default investor is
- Understanding of the investment a default investor may have.

Risk appetite

6.2. The risk that a default investor would be willing to take will be considered as a risk averse investor. For this characteristic the default fund for the investor would need to prioritise having a reliant amount at the retirement age rather than a volatile investment that may or may not provide a larger return.

Engagement with investments

6.3. The default investor has been considered as less engaged with investments and may not look or consider other options offered. For this characteristic the default fund needs to be something that provides steady growth over time and would not need to actively be considered by the investor.

Understanding of investments

6.4. Understanding of investments is considered as low for the default investor and they are therefore less likely to understand the investment they are in, or the options and risks involved with other investments. Therefore, the default investment would ideally be easy to understand and for the information and documentation to be accessible. Complexity should be kept to a minimum and transparency should be sought. The product needs to provide many different and contradictory attributes, it needs to provide good growth whilst being a stable fund to allow members to plan their retirement.

Current Fund

6.5. For East Sussex Pension Fund the default investment is the Prudential With-Profits Fund. This is primarily due to the aim of the investment to offer the prospect of a competitive long-term real return whilst smoothing the peaks and troughs of day-to-day market movements. This occurs as the value of with-profits funds are not directly exposed to fluctuations in the value of the underlying assets. Instead, returns are ‘smoothed’ through the addition of bonuses (regular and final) which aim to provide members with a steady rate of return.

6.6. The level of bonuses applied, are not guaranteed, vary depending on a number of factors and will make an allowance for the charges associated with running the fund. This characteristic makes the with-profits investment one of the least risky of the available choices within the portfolio offered by East Sussex. As a result, it has lower volatility whilst still providing reasonable growth.

6.7. The performance of the with profits investments has been similar to the Discretionary Fund but at a lower risk profile.

6.8. The with profit fund is a simple in theory product to explain to investors but there is a lot of complexity underpinning this. In particular the smoothing function makes the underlying investments within the with profits fund opaque along with the making the underlying performance difficult to assess. It is hard to get information on the exact management charge for the investment and to assess how the bonuses are calculated. Whist the premise is straight forward the ability for a non-investment minded investor to completely understand these investments is low.

6.9. With this being a default option for other similar LGPS Funds there is a level of comfort with this investment. However, this is not in and of itself a reason to maintain this as the East Sussex default fund.

Options for default investment

6.10. With 49.7% of investments within the default option and 38.0% of new contributions paid into this fund. Any change needs to be considered carefully as it would have an impact on 45.9% of the investments of the AVC membership.

6.11. Any decision to change the default investment the implications of this need to be considered as in would any existing arrangements stay in place, do all new investments go into a new default investment is this option left open for investment. It should be noted that if money invested in the With-Profits Fund is taken out at any time other than on death or normal retirement date, a Market Value Reduction (MVR) may be applied; this may have the effect of reducing the fund value.

6.12. The table below compares the 9 non-cash investments against the ideal investment for a default fund:

Criteria	Risk	3 Year Performance %	Complexity	Transparency
Ideal requirements	Lower to Medium Risk	5.6*	Simple	Transparent
Prudential With-Profits Fund	Lower to Medium Risk	6.9	Complex	Opaque
Prudential UK Equity Index Fund	Higher Risk	9.6	Simple	Transparent
Prudential Overseas Equity Index Fund	Medium to Higher Risk	8.5	Simple	Transparent
Prudential Positive Impact Fund	Medium to Higher Risk	8.2	Simple	Transparent

Prudential Long-Term Gilt Passive Fund	Medium Risk	(19.6)	Simple	Transparent
Prudential Discretionary Fund	Medium Risk	5.3	Complex	Opaque
Prudential Dynamic Growth IV Fund	Medium Risk	4.0	Complex	Opaque
Prudential Dynamic Growth II Fund	Lower to Medium Risk	0.8	Complex	Opaque
Prudential Dynamic Growth I Fund	Lower to Medium Risk	(0.8)	Complex	Opaque

*This is 1% above the actuary's discount rate at the 2022 Valuation.

6.13. From the table above in a simplistic form the Fund that offers the best alignment to the characteristics wanted by the default investment described above is the with profits fund then the Discretionary Plan. The discretionary fund is currently the second most popular option within the AVC offering with 17.9% of investment in this fund.

6.14. With-profits funds have commonly been used within AVC arrangements, and there are no particular concerns regarding the use of the Prudential With-Profits Fund as the arrangement's default.

7. Conclusion

7.1. The Board is asked to note the report.

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