East Sussex Pension Fund – Investment Strategy review

This paper has been prepared for the Officers and Pensions Committee (the "Committee") of the East Sussex Pension Fund (the "Fund") for the purpose of summarising the results of the investment strategy modelling and recommended changes, as discussed in the Investment Strategy Day on 24 July 2025. This advice is being provided as our role as Investment Advisors to the Fund.

It has not been prepared for use for any other purpose and should not be so used. The paper should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. We accept no liability where the paper is used by or disclosed to a third party unless we have expressly accepted such liability in writing. Where this is permitted, the paper may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Where the subject of this note refers to legal or tax matters, please note that Hymans Robertson LLP is not qualified to give such advice therefore we recommend that you seek independent advice on these matters.

Background

On 24 July 2025, the annual Investment Strategy Day was held to discuss the suitability of the current investment strategy and to compare it against possible alternatives.

As part of this work, Hymans Robertson conducted an Asset Liability Modelling ("ALM") exercise that projects the future evolution of the Fund's assets and liabilities under a range of different scenarios. This determines the likelihood of reaching the long-term objectives (and associated risk metrics) under the current investment strategy and different potential investment strategies.

The table below shows the current long-term strategic benchmark for the Fund:

Table 1: Current long term strategic benchmark

Asset class	Strategic asset allocation
Listed equity	40.0%
Private equity	5.5%
Diversified growth funds	17.0%
Property	7.0%
Infrastructure	11.0%
Private credit	5.0%
Credit	10.5%
Index linked gilts	4.0%
Total	**100.0%**

The Fund has a strong allocation to return generating assets such as equities and diversified growth funds. These assets are expected to deliver long-term capital gains. Income assets such as the property, infrastructure and private credit allocation are expected to provide a steady stream of income and contribute to the overall stability of

the portfolio by offering returns with less volatility and diversification benefits. Lower-risk assets, such as the index-linked gilts, are held to protect the Fund during adverse market conditions and periods of high inflation. Whilst the Fund currently holds a wide range of assets which are expected to provide sufficient levels of return and diversification, the aim of the strategy review is to test whether this remains optimal, given the changes in the funding position and contribution rates as part of the actuarial valuation, as well as the market outlook.

Strategies modelled

The Fund's current long-term strategic benchmark is shown in Table 2 below along with three alternative strategies. These alternative strategies consider a position in which de-risking is conducted and a position in which new commitments to alternative funds is made. The changes to the strategy are not particularly significant. This is due to the significant uncertainty driven by pooling currently, with the Fund needing to join a new pool. This means that the implementation options for the Fund's strategy are currently unknown, meaning we do not want to consider large changes to the target asset allocation at this time.

Table 2: Current and modelled investment strategies

Asset class	Current	De-risk	Milder de-risk	More alternatives
Listed equity	40.0%	40.0%	40.0%	40.0%
Private equity	5.5%	5.5%	5.5%	6.5%
Diversified growth funds	17.0%	11.0%	14.0%	8.5%
Property	7.0%	7.0%	7.0%	7.0%
Infrastructure	11.0%	11.0%	11.0%	14.5%
Private credit	5.0%	5.0%	5.0%	9.0%
Credit	10.5%	10.5%	10.5%	10.5%
Index linked gilts	4.0%	10.0%	7.0%	4.0%
Total	100.0%	100.0%	100.0%	100.0%

A summary of each strategy is as follows:

1) **Current investment strategy** – the current strategy is diversified in nature with allocations to public and listed equity, property, infrastructure and credit (amongst other asset classes). The largest allocation is to listed equities which comprises 40.0% of the total portfolio.

2) **De-risk** – This strategy involves reallocating 6.0% of the Fund's holdings from diversified growth funds into index-linked gilts. It should be noted that the Fund's diversified growth fund allocation provides income, whereas the index-linked gilts currently do not, which will affect the Fund's cashflow position.

3) **Milder de-risk** – Similar to the de-risked strategy reported above, this strategy involves a 3.0% reduction of the Fund's holding from diversified growth funds into index-linked gilts. Due to a number of preset 'triggers' being hit during 2024 and early 2025, whereby 3% of Fund assets were sold from diversified growth funds and transferred into index-linked gilts as yields rose, the Fund's actual holdings are already close to this strategy.

4) **More alternatives** – This strategy focuses on new commitments to alternative investments by reallocating 8.5% of assets from diversified growth funds to private equity, private credit and infrastructure.

In all of the alternative strategies mentioned above, assets are taken from the Fund's holdings in diversified growth funds. When looking for sources to take money from to fund the increases in other asset classes in order to de-risk the strategy, the Fund's only viable options were diversified growth funds and equities. As a long-term investor in need of strong returns, we would not necessarily like to see the Fund's equity allocation fall much below 40% - they provide strong long-term returns, liquidity and income. To a lesser extent, while diversified growth funds provide downside protection and support tactical asset allocation during periods of market volatility, the broader investment universe has generally underperformed relative to return expectations.

For the 'de-risk' and 'milder de-risk' strategy, the increased allocation to index-linked gilts is designed to take advantage of the Fund's strong funding position and the currently attractive real yields. Index-linked gilts also provide inflation protection and act as a safe haven asset, offering stability during periods of market stress.

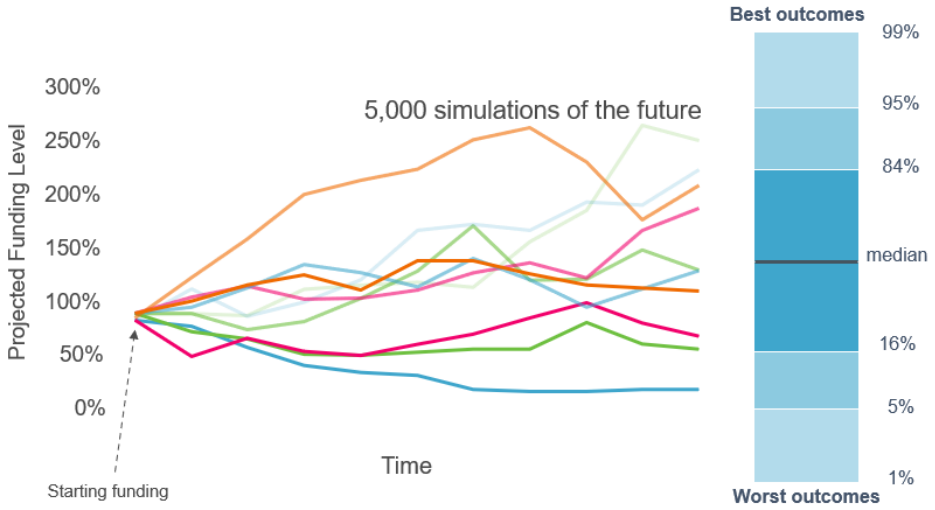
For the 'more alternatives' strategy, the timing of movement in assets under this strategy is not yet known and is dependent on the Fund's new pool arrangement and whether suitable investment funds are available for investment. Delays can be expected in implementing this strategy in the absence of suitable investment funds being available.

ALM modelling

What is a stochastic ALM?

We run 5,000 simulations of the future for each strategy. The modelling uses market-consistent rates of return and volatilities and long-term characteristics of major asset classes. We rank the 5,000 simulations from best to worst to give a range of potential outcomes and focus on:

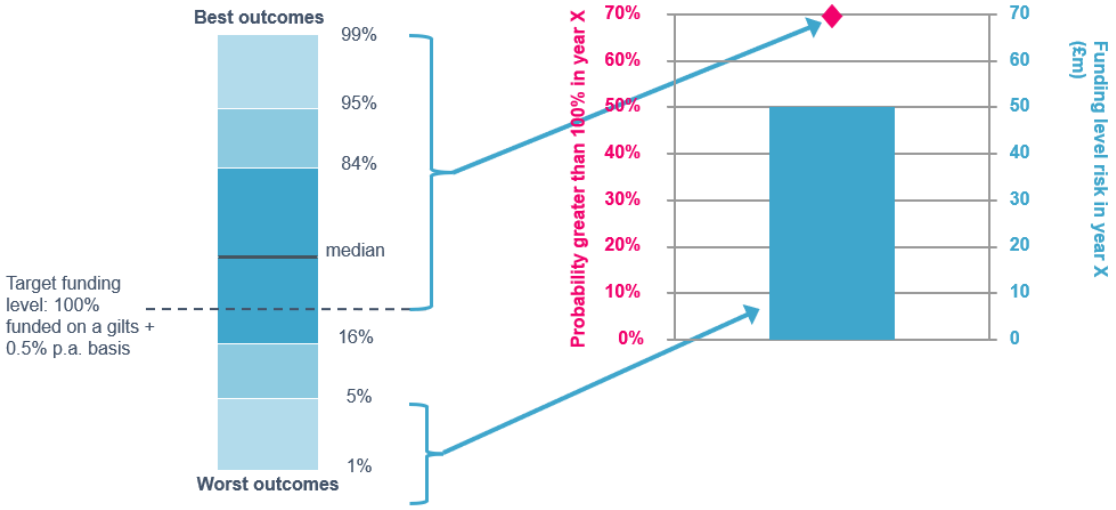
- **Probability of success** – of being 100% funded level over the long term.
- **Funding level risk** – how bad could it get by next valuation. We consider the worst outcomes over 3 years.



Understanding the output

The outputs from the simulations are translated into probabilities and a measure of risk, as shown in the chart on the right below. The primary axis shows the **probability of success**, whereas the secondary axis shows the

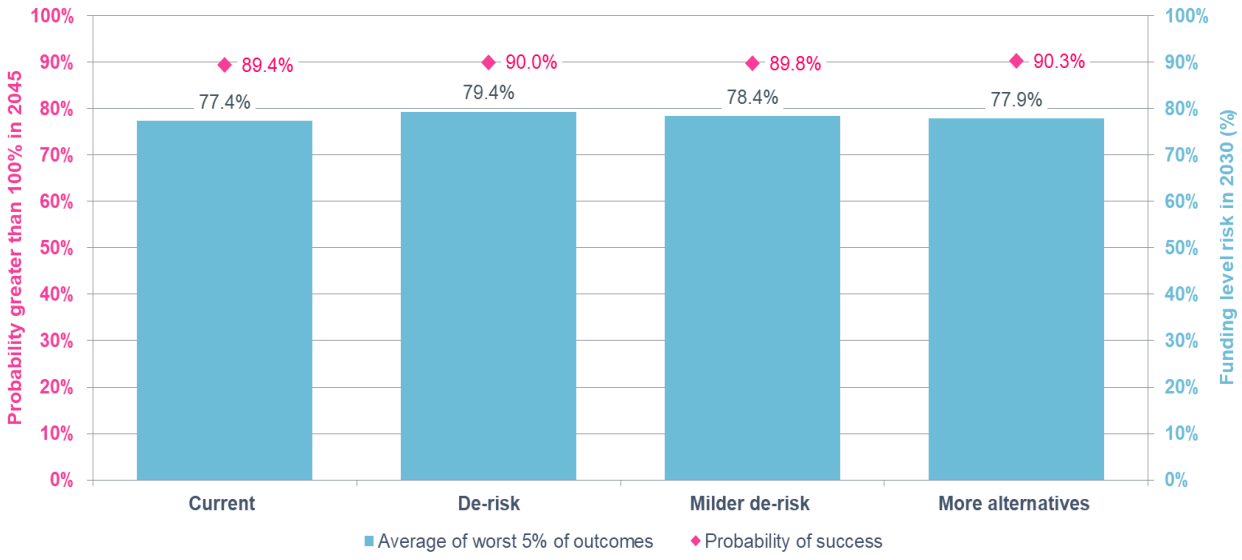
funding level risk. In the example below, the probability of success is 70%, which means that 3,500 out of the 5,000 simulations are above the target funding level. Funding level risk is the average of worst 5% of outcomes over x years, typically 3 years as a short-term risk measure.



ALM modelling results

When assessing the results of the modelling, we consider the probability of success of each strategy considered, overlayed with funding level risk. The probability of success is considered for a 20-year period whilst we assess funding level risk over a 5-year period. Chart 1 below plots the results of each modelled strategy.

Chart 1: Probability of success versus risk



The modelling results indicate that the current strategy gives the Fund an 89.4% probability of remaining fully funded by 2045. This percentage is high and reflects the robustness of the current strategy in place, as well as the Fund's current strong funding position. However, when assessing the results of the alternative strategies modelled, there is a modest increase in the likelihood of the funding level being greater than 100%. This modest increase is

greatest under the ‘more alternatives’ strategy due to an increased return expectation, followed by the ‘de-risk’ strategy.

In assessing the impact on funding level risk in 5 years’ time (i.e. in 2030), funding level risk is expected to be modestly higher under the alternative strategies modelled in comparison to the current strategy. Funding level risk in 2030 is expected to be lowest under the ‘de-risk’ strategy, as would be expected. However, the impacts are again relatively small.

When reviewing these results, we are looking for the best balance of risk, return and ease of implementation. Of all of the strategies modelled, an appropriate balance can be found with the alternative strategy ‘milder de-risk’. The reasoning is as follows:

- The strong risk metrics of the current strategy, with only minor impacts of the alternative strategies, suggests there is no strong need to make significant changes to the Fund’s investment strategy.
- This ‘milder de-risk’ strategy provides slightly improved risk metrics compared to the current strategy and would not require money to be moved as the Fund is already at this allocation. This change would simply be changing the target allocations to move in line with the Fund’s actual current holdings.
- Whilst the other strategies provide slightly improved metrics compared to ‘milder de-risk’, they would take more work to implement at a time of great uncertainty, given the changes in pooling.
- The ‘more alternatives’ strategy would significantly impact the Fund’s cashflow position in the short-to-medium-term. Whilst alternative assets do generate income, a large amount of cash will first be required to be invested to build up the Fund’s allocations, and it will take time for those assets to then begin producing income.

Assessment of a stagflation environment

We also tested the alternative strategies under a stagflationary environment to see if any fared better and provided more protection. Stagflation is characterised by a period of low or stagnant economic growth occurring simultaneously with high levels of inflation. To assess the impact of stagflation on the strategies outlined in Table 2, we assume a scenario in which stagflation is witnessed in global markets over a three-year period.

In the United Kingdom, this stagflation environment is driven by a combination of structural and cyclical pressures including rising energy costs, climate related damage to infrastructure and food supplies, labour shortages and institutional malaise. Throughout the period, inflation is assumed to remain persistently above the Bank of England’s 2% target. The impact of stagflation on the modelled strategies is shown in Table 3 overleaf.

Table 3: Impact of stagflation

	Difference in 20-year 'Likelihood of Success' metric from base case scenario	Difference in 5-year 'Average of Worst 5% of Outcomes' metric from base case scenario
Current	-9.1%	-10.9%
De-risk	-8.8%	-10.8%
Milder de-risk	-9.1%	-10.8%
More alternatives	-9.1%	-11.2%

Note: Modelled as at 31 March 2025.

As expected, the results of the modelling show the risk metrics to worsen for each strategy in an environment with stagflation, with broadly similar impacts across all the four strategies modelled. Among them, the 'de-risk' strategy offers the best protection, all-be-it marginally, by allocating more to index-linked gilts, which helps mitigate the effects of falling equity returns and rising inflation. However, the advantages of this marginal difference over the other strategies remains minimal.

Strategy recommendations

As discussed in the results of the modelling, and at the Investment Strategy Day, **we recommend the Committee implement the 'milder de-risk' investment strategy.** This strategy involves a 3.0% decrease in the Fund's allocation to diversified growth funds with the proceeds invested into index-linked gilts (as illustrated in Table 4 below).

Table 4: Strategy recommendations

Asset class	Current	Proposed 'Milder de-risk'
Listed equity	40.0%	40.0%
Private equity	5.5%	5.5%
Diversified growth funds	17.0%	14.0% ↓
Property	7.0%	7.0%
Infrastructure	11.0%	11.0%
Private credit	5.0%	5.0%
Credit	10.5%	10.5%
Index linked gilts	4.0%	7.0% ↑
Total	100.0%	100.0%

This strategy is attractive due to:

- **The risk metrics,** which improves slightly compared to the current strategy.

- Given the significant **uncertainty created by pooling**, we do not believe making large changes to the strategy at this time would be sensible.

- This strategy is **easy and low cost to implement**. The Fund is already at its recommended target allocation to index-linked gilts and therefore, this change will require a simple adjustment to the target allocation to reflect this.

Summary and next steps

We have modelled three alternative strategies using the ALM. The results of the modelling show modest improvements in the strategies expected funding level, 20 years from now.

We recommend the Committee implement the 'milder de-risk' strategy. This strategy is easy to implement and is expected to modestly improve the Fund's probability of remaining fully funded by 2045.

Going forward, the Committee will also need to consider the Investment Beliefs for the Fund, as well as the implementation options within the Fund's new pool, in order to meet the government's new requirements regarding pooling in the best interests of the Fund.

We look forward to discussing this paper with you.

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August 2025

For and on behalf of Hymans Robertson LLP

Appendix

Modelling assumptions, limitations and risks
This modelling is based upon benefit cashflows as at 31 March 2024, adopting assumptions and methodology set out by the Fund Actuary in the provision of benefit cashflows as at 31 March 2024. The ESS reflects the latest calibration at 31 March 2025.

Cashflows
We have used cashflows provided by Barry McKay of Barnett Waddingham with summarised details about the membership, benefits and valuation assumptions in order to create a set-up for the Fund. The level of detail and accuracy in the modelling of the Fund's benefit cashflows is therefore lower than if full individual membership data had been used. The materiality of the approximations used depend on the type of analysis undertaken and the context of that analysis. It is therefore very important that no inferences are drawn from the modelling without getting written confirmation from us that the approximations will not be misleading. No allowance is made in the modelling for any deviations away from the demographic assumptions implicit in the cashflows.

We have not sought to validate or check any inputs independently and have relied on the accuracy of the cashflows, email correspondence and documents provided by the Fund Actuary.

Except where stated, we do not allow for any variation in actual experience away from the demographic assumptions underlying the cashflows. Variations in demographic assumptions (and experience relative to those assumptions) can result in significant changes to the funding level and contribution rates. We allow for variations in inflation (RPI or CPI as appropriate), inflation expectations (RPI or CPI as appropriate), interest rates and asset class returns. Cashflows into and out of the Scheme are projected forward in annual increments, are assumed to occur in the middle of each year and do not allow for inflation lags. Investment strategies are assumed to be rebalanced annually.

There are a number of different types of increases applied before and after retirement to benefits payable from the Scheme. We have made some assumptions when modelling the various types of increases.

We have estimated future service benefit cashflows and projected salary roll for new entrants after the valuation date such that payroll remains constant in real terms (i.e. full replacement). There is a distribution of new entrants introduced at ages between 25 and 65, and the average age of the new entrants is assumed to be 40 years. All new entrants are assumed to join and then leave service at SPA, which is a simplified set of assumptions compared to the modelling of the existing membership. The base mortality table used for the new entrants is an average of mortality across the LGPS and is not client specific, which is another simplification compared to the modelling of existing members. Nonetheless, we believe that these assumptions are reasonable for the purposes of the modelling given the highly significant uncertainty associated with the level of new entrants.

In modelling some of the LGPS benefits, we have assumed:

- Salary growth is assumed to have a floor of 0% and to be modelled in line with inflation plus (or minus) any additions applied.
- S148 salaries / national average earnings is assumed NOT have a floor and is projected in line with our projections of national average earnings and valued in line with inflation plus any additions applied.
- Non-accruing and accruing CARE benefits increase in line with CPI (no floor).

Economic Scenario Service (ESS)
The distributions of outcomes depend significantly on the Economic Scenario Service (ESS), our (proprietary) stochastic asset model. This type of model is known as an economic scenario generator and uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated each month (for example, the current level of equity market volatility) while other more subjective parameters do not change with different calibrations of the model.

Key assumptions include:

- The average excess equity returns over the risk-free asset and its volatility which affects growth asset returns
- The level and volatility of yields, credit spreads, inflation and expected (breakeven) inflation, which affect the projected value placed on the liabilities and bond returns.
- The gap between CPI and RPI. The market for CPI-linked instruments is not well developed and this is based on our judgement. Expected long-term RPI and CPI rates are in line with the current Bank of England targets. The RPI-CPI wedge, that is the average difference between projected RPI and CPI rates, is set to 1% p.a. over the short-term ultimately transitioning to zero after early 2030, when the RPI measure will switch to CPIH.
- The output of the model is also affected by other more subtle effects, such as the correlations between economic and financial variables.
- Real interest rates are assumed to (on average) gradually trend towards a long-term rate. This is based on a selection of yield normalisation levels (which can be interpreted as representing low, medium and high economic growth scenarios) reflecting the fundamental uncertainty around long-term average yield levels. Higher long-term yields would mean a lower value placed on liabilities and hence an improvement in the current funding position (and vice versa) unless the Scheme is fully hedged. The Expected Rate of Returns and Volatilities table below details the direction of interest rate movements based on the current calibration of the ESS.
- While the model allows for the possibility of scenarios that would be extreme by historical standards, including very significant downturns inequity markets, large systemic and structural dislocations are not captured by the model. Such events are unknowable in effect, magnitude and nature, meaning that the most extreme possibilities are not necessarily captured within the distributions of results.