

The CARE Scheme (the Scheme)

Hedging of Interest Rate and Inflation Risks

1. Background

- 1.1. The Trust intends to change the Scheme's investment strategy to better manage the inflation and interest rate risks to which the Scheme is exposed. In this respect, this Annex looks at our bonds, or liability-focussed assets.
- 1.2. At present, the Scheme's funding position is exposed to the risk of either falling (real and nominal) long-term interest rates and/or rising inflation expectations. Having a policy to manage these risks helps us to reduce the chance of funding levels deteriorating further (and the consequential need for higher contributions). In essence we are trying to improve the security of members' benefits without imposing additional costs upon sponsoring employers.

2. What exactly is the proposed change?

- 2.1. The Trustee plans to invest in funds that combine physical bonds (cash, gilts, corporate bonds) with derivative instruments called swaps, that together protect against (or 'hedge') the interest rate and inflation risks referred to above. You may have heard of this as Liability Driven Investment or LDI.
- 2.2. More information about this type of investment is provided on a 'Frequently Asked Questions' leaflet, available on our website at www.thepensiontrust.org.uk > Document Library > Scheme Literature > CARE > Consultation Documents.
- 2.3. The actual choice of manager for these investments is subject to a competitive tendering exercise due to be completed this Summer. However, based on the work we have carried out to date, a summary of the current and proposed portfolio distribution for the Scheme is as follows:

Investment	Current %	Proposed %
Growth assets (total)	72.5	72.5
Liability-focused assets:		
- Fixed-interest gilts	11.0	10.5
- Sterling non-gilts	16.5	-
- Medium dated index-linked LDI fund	-	2.0
- Long dated index-linked LDI fund	-	3.0
- Sterling corporate bonds	-	12.0
Total	100%	100%

Please note: The percentages within the liability-focussed assets have been rounded; actual values might vary at the point of investment depending on market conditions and the chosen manager.

3. Impact upon expected return and risk

- 3.1. The purpose of this change is to manage risk better without reducing expected return which would otherwise impose additional contributions upon you, the Scheme's sponsors.
- 3.2. To check this point we have engaged the Trustee's investment advisors to measure these statistics for both the current and proposed portfolios. The results for the Scheme are as follows:

Statistic	Current	Proposed
Expected return (above gilts)	3.1% p.a.	3.1% p.a.
Risk*	£3.9m	£3.7m

*The risk metric here is a standard industry measure for the potential deterioration in assets minus liabilities, over a one year period, at a 1 in 20 chance level.

- 3.3. As you can see, there is no deterioration in the Scheme's expected return, but the risk value is reduced. As a result there is no adverse impact of this proposed change upon the assumptions used to produce the actuarial valuation result.

4. What now?

- 4.1. The Trustee believes that this investment is in the best interests of members, without requiring any additional contributions from sponsoring employers.
- 4.2. **Once you have considered the details of the Trustee's planned investments in LDI funds, please complete 'Feedback Form 1' by 14 October 2011. In this respect, please let us know if you believe there are any specific reasons why you think this investment should not go ahead for the Scheme.**