Pensions Panel

28 January 2019

Investment Strategy

Report by Director of Finance, Performance and Procurement

Executive Summary

The Pensions Panel have considered the Fund's investment strategy in the context of the de-risking triggers being exhausted and the strong funding position being maintained by the Fund. This resulted in the decision to reduce its allocation to 'growth' assets in favour of an allocation to 'income' assets.

The Panel has considered investment in infrastructure and private debt, which both fulfil the criteria of being income focused assets. As part of their meeting discussion in November 2018 some Members of the Pension Panel raised concerns on the risks associated with private debt investments. However there was a request that further detail was provided for consideration. The report proposes the types of investments within each asset class within the Panel's risk and return expectations and in recognition of the market with infrastructure investment being focused on global, core brownfield investments across a broad range of income sources and any allocation to private debt being focused on global senior secured direct corporate lending. In this context the Panel could expect to achieve long term returns of 7-10% p.a. net of fees for infrastructure investments and 5-7% p.a. net of fees and costs (based on current LIBOR rates) for private debt.

In respect of any interim arrangement, whilst acknowledgement that any investment in infrastructure or private debt may take a period to build to the target allocation, Hymans would recommend retaining the existing equity holdings until the new income assets were ready to draw funds.

Recommendation(s)

1. The Panel considers the options presented in the report and within the presentation provided during the meeting.

2. Officers are asked to work with the Panel's advisers to develop a Specification for the Fund's income asset allocation for consideration at its meeting on 29 April 2019, based on the Panel's feedback during the meeting.

Background

1. The Pension Panel's Business Plan includes a priority relating to the Fund's Investment Strategy in respect of the Fund's strong asset performance, the need to ensure that the investment strategy remains aligned to meet its long term objectives and in the context of Environmental, Social and Governance (ESG) issues.

2. In addition, the Pension Fund's risk register includes the risk that there are insufficient funds to meet pension obligations resulting in the Fund changing to a higher risk investment strategy and that the Pension Fund does not provide a clear and suitable investment strategy for Fund managers to follow.

3. Following the decisions made by the Pensions Panel in respect of the Pension Fund's investment strategy framework it is appropriate for the Pensions Panel to consider asset types in consideration of its 'income' strategic allocation.

4. As reported at its last meeting, the Pensions Panel have considered the Fund's investment strategy in the context of the de-risking triggers being exhausted and the strong funding position being maintained by the Fund. This resulted in the decision to reduce its allocation to 'growth' assets in favour of an allocation to 'income' assets. The strategic allocation is shown in the table below. The additional allocation to 'income' assets was in part achieved by the re-categorisation of the direct property portfolio, reflecting the mandate guideline to generate a reliable income. However the Panel needs to make a decision on the appropriate asset class for its additional target allocation to income focused investments.

Asset Type	Asset Class	Allocation	Geography
Growth	Listed Equity	40.0%	Diversified
Growth	Private Equity	00.0%	Diversified
Income	Direct Property	10.0%	UK
Income	TBD	10.0%	TBD
Protection	Bonds	40.0%	Diversified

5. The Pension Panel has determined a set of Investment Beliefs to inform its decision making. These are shown in Appendix A.

Income Assets

6. At its informal meeting in September 2018 and their formal meeting in November 2018, the Pension Panel considered some potential options for new income focussed asset classes, with a preference towards infrastructure and private debt. The rationale for considering these asset classes were as follows:

- The current market outlook for these assets looks attractive relative to many other asset classes. Whilst the Panel believes that it should not take short term tactical asset allocation positions it is considered that both have a strong income component to the return stream giving some visibility and increased confidence over the expected returns that can be achieved and is therefore a longer term strategic asset allocation.

- Both are relatively illiquid investments but this is aligned to the long term investment horizon available to the Fund, which can benefit from the illiquidity premium. The Pensions Panel believes that illiquid investments should be considered where an attractive premium return is expected to be available, though the total allocation within the Fund will be limited.

- Both offer attractive levels of risk adjusted returns which are aligned to the investment and funding requirements of the Fund. The Panel considers that the level of risk within the investment strategy should be considered in conjunction with the funding position of the Fund. Different levels of risk may be taken at different funding levels.

7. As part of their meeting in November the Panel raised concerns on the risks associated with Private Debt investments.

8. Since the Pension Panel last met, the Ministry for Housing, Communities and Local Government have issued a Consultation on Statutory Guidance on Asset Pooling for Local Government Pension Schemes. Extracts have been included as Appendix B. This is relevant in the context of infrastructure investment, local investments, investments outside the ACCESS asset pool and investment in other asset pools. The latter matters are relevant for infrastructure and private debt considerations where the Guidance proposes:

   - Pool members may invest through pool vehicles in a pool other than their own where collaboration across pools or specialisation by pools can deliver improved net returns.

   - During the period of transition where Pools are put in place the agreed range of pool vehicles, an individual Authority may make new investments outside the pool, if following consultation with the pool company, they consider this is essential to deliver their investment strategy. This exemption only applies until the pool vehicles needed to provide the agreed asset allocation are in place.

Infrastructure

9. As part of their Consultation on Asset Pooling, MHCLG have proposed the following definition of Infrastructure assets as:

Facilities and structures needed for the functioning of communities and to support economic development. When considered as an investment asset class, infrastructure investments are normally expected to have most of the following characteristics:

- *Substantially backed by durable physical assets;*
- *Long life and low risk of obsolescence;*
- *Identifiable and reliable cash flow, preferably either explicitly or implicitly inflation-linked;*
- *Revenues largely isolated from the business cycle and competition, for example, through long term contracts, regulated monopolies or high barriers to entry;*
- *Returns to show limited correlation to other asset classes.*

10. It goes on to propose that key sectors for infrastructure include transportation networks, power generation, energy distribution and storage, water supply and distribution, communications networks, health and education facilities, social accommodation and private sector housing and that whilst conventional commercial property is not normally included (except where it forms part of a broader infrastructure asset) helps urban regeneration or serves societal needs, all residential property should be included in this definition of infrastructure.

11. This definition reinforces that the investment universe within infrastructure is very broad.

12. Hymans recommends that the Fund's Strategy should look to generate target returns in the region of 7-10% p.a. net of fees. This could be achieved by focusing on:

Recommendation	Rationale
Core brownfield infrastructure equity but with some ability to invest in some value-add initiatives and potential development as part of a broader strategy.	The stage of the asset is a key driver to risk and return. A greenfield asset has some level of development or construction requirement and risk. A core brownfield asset on the other hand is a developed asset albeit that it may still require some expenditure and expansion but is viewed as the safest way for infrastructure investors to secure long term yields that generally match liabilities. Whilst there two definitions are not perfect. Some investments could be made towards non-core infrastructure (such as Government services, social infrastructure, rail rolling stock, energy metering, telecommunication towers, student accommodation and data centres) or some greenfield infrastructure development (dependent on expertise) to provide some higher return. IT would also provide diversification.
A broad range of income sources across different sectors and a mix of exposures to contractual income and economic activity.	The income source is a key drivers for risk and return eg, sector, contractual income and exposure to economic activity result in different volatility A broad range of income sources should ensure diversification of risk and blend lower return and income investments with higher return investments
Global infrastructure predominately on OECD countries in order to avoid niche strategies or concentrated exposures to particular markets.	A global mandate provides a broader and more diverse opportunity set and allows greater relative value assessments where there could be potential pricing pressures. Locally focussed infrastructure and housing investments should be considered separately from the core allocation to infrastructure due to the more bespoke nature of these investment, the likelihood of concentration risk and potential conflicts of interest that would need to be addressed as part of any investment opportunity.

13. The ACCESS Joint Committee requested that Officers progress to look at options for pooling infrastructure investments. The full report is appended. (Appendix C – Part II item). This report was considered prior to the MHCLG Consultation on Asset Pools.

14. Without knowing the outcome of the pooling solution, it is recommended that the implementation route in the short to medium term could be via open ended strategies, closed-ended strategies or funds of funds but should exclude listed infrastructure funds and infrastructure debt only strategies.

15. Over the longer term, the Government wishes to see a variety of platforms being available to implement the infrastructure investment strategies including direct and co-investment opportunities.

Private debt

16. Like infrastructure, private debt is a broad asset class offering a wide range of opportunities with different risk and return characteristics.

17. Hymans would recommend that the Fund's Strategy should look for an expected returns in the region of LIBOR plus 4-6% p.a. net of fees and costs and have a priority on security of income. LIBOR is currently c.0.9%. This could be achieved by focusing on:

Recommendation	Rationale
Senior secured direct corporate lending (first or second lien) where it is possible to generate attractive returns. This could potentially include an allocation to real estate lending and infrastructure debt, mezzanine (junior debt) and other forms of debt and potentially a small allocation to equity.	The quality of the loan terms applied and the purpose of the loan (where in a capital structure a loan sits and the covenants in place around this and whether the loan is corporate debt, infrastructure debt, property debt etc) are key drivers to the risk and return. Senior secured direct corporate lending allows the fund to access attractive returns and the income stream this offers. However the recommendation allows some flexibility for managers to have limited access to wider illiquid debt opportunities for relative value purposes and manage risk and return needs and to give access to some deals where a wider exposure is desired by the borrower.
Global in nature but with a focus on markets with strong lender protections and regulatory controls eg. North America and Europe. Approaches should be considered with a bias to either region where consistent with the manager's skill set.	This will allow the Fund to achieve a broad diversified opportunity set but ensuring investor protections are in place for the Fund. Flexibility in the recommended global bias to Europe or North America should be determined largely by credibility of manager choice but return and risk requirements would be maintained regardless of solution.

Managers who show evidence of a robust process for sourcing, underwriting and structuring transactions and in risk management, in particular the avoidance of issuer default, the management of prepayment risk (to mitigate against any potential deterioration in yield expectations), implementation risk and liquidity risk (given the set terms of the Fund and co-investor risk).	It is important the manager has the ability to deploy capital by originating loans without compromising on credit quality, ensuring penalties are in place to manage risks and achieve required returns.
Manager who show strong workout capabilities, including restructuring, in the event of issuer default.	Should a company get into difficulty it's important that the Fund has a manager that can step in, restructure debt if needed and even take control of the company to ensure you are paid as a lender.

18. Whilst being mindful of the work underway by the ACCESS Joint Committee it is unlikely that there will be a formal opportunity to invest in private debt via a pooling arrangement in the next 12 months. Therefore the implementation route could include open ended strategies, closed-ended strategies or funds of funds but would most likely be sourced through closed ended, limited partnership funds, with terms of typically 7 years plus (comprising a one - two year investment period and 5 year repayment period).

Allocation sizes to new asset classes

19. The strategic review agreed an additional target allocation of 10% to income focussed assets.

20. The Panel has previously expressed a preference for avoiding a large number of separate manager relationships and has in the past considered any allocation to an asset class should exceed 5% to be sufficiently meaningful to have the desired impact on the risk and return profile of the Fund. This would allow the Panel to allocate to only one of the asset classes, or to both.

21. Hymans would recommend that the Panel considers an allocation of 5% each to infrastructure and private debt. The two asset classes, while both income focussed, have different risk and return characteristics that would sit well together as part of a broader income allocation.

22. However should the Panel only wish to pursue one asset class then a starting allocation of 5% might be considered with a view to increasing this to 10% if no other asset opportunities were considered. A 10% allocation to infrastructure would be feasible but Hymans would note that it may take time to build depending on the route of implementation. For private debt 10% would be quite a sizeable allocation and may be harder to build given the shorter term nature of the fund terms.

23. In the context of the above, and given that either investment may take some time to fund given their more illiquid nature, the Panel may wish to consider interim investment options.

Interim Investment Options

24. Both infrastructure and private debt investment opportunities are relatively illiquid. The nature of the investment means that funds are generally drawn down and invested over a period of time which could typically be between one and five years. The Panel may therefore wish to consider potential interim investment options where the Panel could allocate capital ahead of it being drawn down to fund the income solutions. These have been set out in Appendix D alongside comments from Hymans in respect of their suitability.

25. Hymans view is that as a long term investor the Fund can withstand short term volatility and has already taken steps to reduce risk. They would therefore support retaining the existing equity holdings until the new income assets were ready to draw funds. However, if the Panel are concerned about the level of risk Hymans preference would either be to move the funds into gilts or cash/cash plus solutions. This could either be done through physical asset sales and purchases or through a derivate overlay.

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Appendices
Appendix A - Investment Beliefs
Appendix B - Local Government Pension Scheme Statutory guidance on asset pooling
Appendix C - ACCESS Report - (Part II paper for members of the Panel only)
Appendix D - Interim Investment Options

Background Papers
None