Non-Executive Report of the: **Pensions Committee** 14th March 2018	
Report of: Zena Cooke, Corporate Director, Resources	**Classification:** Unrestricted
Revised Investment Strategy Statement and Investment Options Considerations	

Originating Officer(s)	Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report introduces a revised Investment Strategy Statement (ISS), which has been updated to reflect the work done on carbon and environmental footprints of the Fund and to reinforce the investment approach of the Committee.

The report also outlines the work done so far by officers and advisers in achieving further diversification of the Fund's return seeking portfolio and protecting its current buoyant equity asset value by considering the following:

- an allocation to Multi-Asset Credit (MAC);
- Equity gains protection; and
- Allocating to long-term illiquid asset classes (long lease, private debt and infrastructure.

Recommendations:

Pensions Committee are recommended to:

- approve the revised Investment Strategy Statement attached as Appendix 1 of this report;
- agree delegation to the Corporate Director, Resources the ability to implement a downside protection with regard to the equity risk of the Fund as deemed appropriate; subject to officers working with advisers to identify and implement a suitable strategy for the Fund;
- agree a target allocation of 6% to Multi-Asset Credit (MAC);
- approve recommended MAC strategy/manager (a sub fund to be launched on London CIV platform); and
- approve reduction of Fund assets allocation from 6% to 3% for each absolute return manager.

1. REASONS FOR THE DECISIONS

1.1 The Investment Strategy Statement has been set out to reflect the funding position of the Fund and the investment beliefs of the Committee.

1.2 Adherence to the principles set out in the Strategy will enable the Fund to take an ordered and prudent approach to the management of its assets, helping to manage the long term costs associated with the Pension Fund.

1.3 The full consideration and approval of the ISS ensures that the Pensions Committee are fulfilling their responsibilities as quasi Trustees of the Fund and that the Fund's investment objectives and policies are clearly set out in line with the Local Government Pensions Scheme (Management and Investment of Funds) Regulations 2016.

1.4 The Investment Strategy Statement (ISS) is a statutory document for LGPS funds, as required by Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

1.5 There has been a change (amendments to the Social, Environmental or Corporate Governance section to reflect work carried out and investment beliefs of the Committee) to the Fund's investment strategy since the last ISS was approved in November 2017; this report brings back a revised copy of the ISS incorporating these changes.

2. ALTERNATIVE OPTIONS

2.1 The Committee could decide to continue with its existing statement. It is however, considered best practice to publish a revised updated statement which reflects the up to date Fund position and investment beliefs of the Committee.

3. DETAILS OF REPORT

AMENDMENTS TO THE ISS

3.1 The ISS must be reviewed and revised by the Council as administering authority when any material changes take place such as changes to the investment beliefs; changes to the types of investment held; or the balance between the types of investments in the Fund. The updated ISS incorporates the changes set out below, to ensure that the ISS remains current.

3.2 At the meeting of the Committee in November 2017, the following matters were agreed:

- Removal of the dedicated UK equity allocation and switch to global equity exposure. This is due to the significant overweight position of the Fund in respect of UK Equity, relative to a market cap weighted index, and hence a materially lower allocation to the US and other regions.
- Allocation to Low Carbon global equities to represent 30% of total equity allocation, 15% of the total assets of the Fund. A Low Carbon Passive Global Equity, which is designed to track broad market indices but with lower carbon footprints; in some cases significantly lower. Allocation to passive global equities to represent 30% of total equity allocation, 15% of the total assets of the Fund.

- To hedge 50% of the overseas currency exposure relating to the global equity allocation. As the Fund has benefitted greatly from lack of currency hedging, the Adviser believes there is an opportunity to bank some of these gains by introducing currency hedging.

Allocation to Multi-Asset Credit (MAC)

3.3 At the September meeting the Adviser presented and discussed the expected returns from Absolute Return Bonds (ARB), he believes these are very dependent on the skills of individual managers which are difficult to predict and is wholly reliant on the investment managers. The Adviser advocates a reduction of ARB allocation from 12% to 6% and believes that the reduced ARB allocation should be complemented by a 6% allocation to Multi-Asset Credit (MAC), where the returns are likely to be driven by markets rather than just manager skill.

3.4 The Committee decided to wait and see what the London CIV would be offering in this investment space (Multi-Asset Credit). An officer of the Fund and other London Local Authorities (LLAs) officers worked with LCIV officers to search and select appropriate strategies and funds for LCIV platform.

3.5 London CIV proposed two sub funds and the sub funds were referred to the Fund investment consultant for further due diligence and recommendation as to which sub-fund is suitable to Tower Hamlets Pension Fund investment strategy. Please see Mercers paper on multi asset credit.

Allocation to long-term illiquid asset classes (Long Lease, Private Debt and Infrastructure)

3.6 There has been a dramatic growth in the 'long lease' real estate market in the UK over the past decade. The five largest managers now control close to £10bn of assets, either in Funds or in Separate Accounts. This growth has been driven by a series of broader and asset class specific trends including:

- The lowering of yields in other asset classes, specifically in bond markets;
- An increased desire for liability matching products, so those with long duration; and
- Increased scale of the 'long lease' market based on the appetite for corporate entities to sell and leaseback their assets, and the expertise of real estate managers in managing such exposures.

3.7 The market has grown over the past decade and is starting to develop in continental Europe. Running alongside this growth has been increasing concerns over the pricing of long lease assets.

3.8 It is in this context that this report provides a high-level review of the long lease market, and explores other investment options, specifically Infrastructure and Private Debt, that could be considered as substitutes for long lease investments.

Long Leases

3.9 Scope of market; Long lease assets tend to comprise one of the following three types, with the largest being those involved in sale and leaseback. They all tend to benefit from long duration and in-built income growth, whether from inflation linked leases or pre-agreed fixed rental increases. The three types are:

- Sale and leaseback - former owner occupied assets that have been sold and leased back to the occupier over a long period of time, generally over 20 years.
- Income strips – the owner occupier also sells the asset to the investor but has the right to repurchase at the end of the lease, usually 30 years.
- Ground rents – where the owner sells the freehold interest to the investor who leases it back to the occupier for a very long period, generally over 100 years.

3.10 Although they possess these general characteristics there are significant variations in terms of the underlying quality of the assets (both the property/location and the credit quality of the occupier/covenant), pricing, the nature of the income profile, and the experience of the manager.

3.11 The weight of appetite for these assets has led to a surge of growth over the past decade, with the most established funds include the following (NAV's at end 2017, based on The Association of Real Estate Funds (AREF) data:

- The M&G Secured Property Income Fund - £3.7bn
- Standard Life Investments Long Lease Property Fund - £2.2bn
- LPI (Limited Price Inflation) Income Property Fund - £1.1bn
- BlackRock UK Long Lease Property Fund - £675m
- PGIM Real Estate UK Ground Lease Fund - £642m

3.12 Although Long Lease Assets can provide attractive duration and inflation linked characteristics, the weight of capital into the sector has raised concerns over their pricing. By the end of 2017, CBRE (world largest Commercial Real Estate) reported that net initial yields stood at 4.9% for sale & leaseback, 3.6% for income strips and 3.1% for Ground Lease Assets, with distribution yields tending to be 50-100bp below these figures. Further evidence of aggressive pricing is the reporting by Property Match that investors are prepared to pay premiums to gain access to long lease funds through the secondary market.

Alternatives to Long Lease Strategies

3.13 The downward pressure on the yields for Long Lease Assets has led to increasing interest in other asset classes that provide similar investment characteristics. In this respect, there is considerable interest in Private Debt and Renewable Infrastructure assets.

- ***Private Debt***: non-bank lenders provide loans to small or medium sized companies at different levels of seniority. This market has grown significantly since the financial crisis given the retreat of traditional bank

lenders and the strong demand from private companies and their sponsors.

- ***Renewable Infrastructure***: Having once been a niche subsector within the infrastructure asset class, renewable energy has emerged to become an asset class in its own right and is set to play key role as the decarbonisation agenda continues.

3.14 The key characteristics of the two asset classes are set out below, in comparison with Long Lease strategies.

Characteristic	Asset Class		
	Long Lease	**Private Debt**	**Renewable energy**
Performance behaviour (Core/Senior)			
Yield			
Return (net IRR)			
Equities diversification			
Cashflow quality			
CPI linkage			
Duration			
Cashflow credit			
Other characteristics			
Size of universe			
Current pricing			
Leverage			
Liquidity: Cashflow			
Liquidity: Capital			
ESG			

Note: Five-fold rating with Green indicating strong characteristic and Red indicating weak characteristic.
Sources include bfinance; Bloomberg; Deutsche Bank; JPM; Hamilton Lane; Partners Group; preqin

Characteristic (for Core/Senior exposure)	Asset Class		
	Long Lease	**Private Debt**	**Infrastructure Renewable energy**
Performance behaviour			
Yield	2-4%	4-7%	5-7%
Return (net IRR)	5-7%. Target CPI+2-3% + some terminal value growth	6-8%	6-8%
Diversification to Equities	Medium	High	Medium
Cashflow quality			
CPI linkage	High – generally directly CPI-linked	Weak – no inflation linkage but often floating rates	Medium – often have direct or indirect inflation linkage

Characteristic (for Core/Senior exposure)	Asset Class		
	Long Lease	**Private Debt**	**Infrastructure Renewable energy**
Duration	15-25 years	2-5 years	10-25 years
Cashflow credit quality	Medium - generally good corporate credit	Weak – generally mid-market PE sponsored companies	High – often supported with government subsidies
Other characteristics			
Size of fund manager universe	5-10	50+	50+
Current pricing	Very aggressive	High	Aggressive
Leverage	Medium – very low except for Ground Rents which tend to involve some leverage	Low – UK / European products often unleveraged	Medium – low leverage at fund level
Liquidity: Cashflow	Low – low yield relative to duration	High – short duration and fast feedback	Medium – main driver of return over longer duration
Liquidity: Capital	Medium – most of the funds are 'open-ended'	Low – generally accessed through closed ended funds	Low – few open end funds
ESG	Low – little scope to influence the ESG activity of the underlying credit / occupier	Medium – ESG embedded into credit screening. Focus on defensive, non-cyclical businesses with low headline risks. Beneficial to improve sustainability of underlying businesses.	High – inherently a very ESG friendly asset class. Managers concerned about social impact and improving reporting.

3.15 In conclusion, in an era of low interest rates, concerns over inflation and desire for liability matching assets, Long Lease strategies have come onto the agenda for many investors. The behaviour of long lease assets means they can play an important role for many investors but this short research note has identified three important considerations for such investors:

1) Diversity of long lease strategies. 'Long Lease' strategies comprise a broad spectrum including Sale and Leaseback, Income Strips and Ground Rents, each with particular characteristics in terms of duration, yield, credit quality etc. Within each category there is an increasing number of managers from which to select, with significant variations in their strategies (geographic and property type exposure, duration etc) and depth and quality of teams.
2) Increased concerns over pricing of long lease strategies. The relatively small size of the market coupled with the strong weight of capital has compressed yields raising concerns of aggressive pricing. This should be a concern for investors anticipating a rise in interest rates as these assets are more 'bond-like' than other real assets.
3) Alternative investment options, including Private Debt and Renewable Infrastructure. These alternative asset classes possess many the characteristics of 'long lease' assets, as well as a series of other potential benefits, such as diversification and ESG potential. They also face concerns over pricing, but the universe tends to be larger than for long lease assets with a broader range of managers, many of whom have strong track records in delivering robust returns through market cycles.

3.16 Each of the asset classes covered here can play important roles in the Fund as they all have strengths, but also a range of potential issues. Given the strong appetite from investors for these asset classes, an overriding concern would be to scrutinise manager capability and discipline through the investment process, particularly related to the quality of the underlying assets and their residual values.

Equity Gains Protection

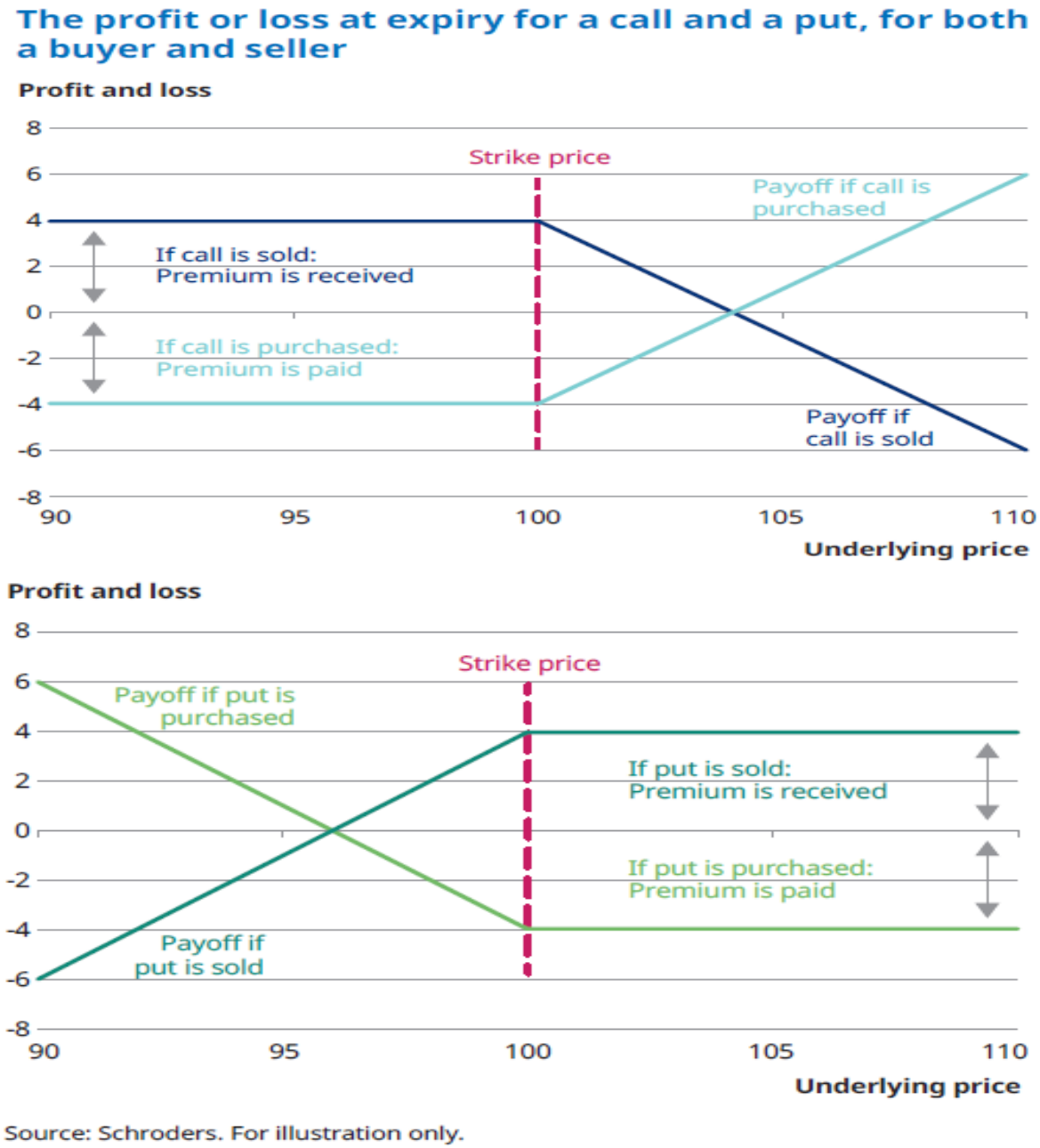
3.17 Options can be used by Funds who want to maintain their exposure to equity holdings but also want greater control over the effect on the scheme funding level. Options can also be used to give greater certainty over the potential returns generated from an equity portfolio.

3.18 An option is a contract between two parties that gives the buyer the right to buy or to sell an asset ("the underlying") at a specified point in time ("expiry"), at a price agreed at the outset ("strike"). The buyer pays a fee or "premium" for this privilege. These elements make the potential profit or loss at the expiry date easy to define. The option will also vary in value over its life.

3.19 There are two main types of options – calls and puts. A call gives the buyer the right to buy the underlying, whilst a put gives the buyer the right to sell the underlying. The graphs below illustrate the potential profit or loss at expiry for the buyer and seller of these two types of option1. In these (illustrative) examples the option strike price has been set at a price of £100. The premium is £4.

3.20 The graphs below show that the profit and loss profile from an option is analogous to that of an insurance policy – an investor can pay/receive a premium and if the pre-agreed event doesn't occur then there are no other financial implications. However, if the pre-agreed event has occurred at the

end of the contract's life then the financial implications are in direct proportion to the magnitude of the insured event (i.e. the difference between the underlying asset's market price and strike price). Further information and illustration from Mercers presentation booklet.



Source: Schroders. For illustration only.

3.21 The conclusion from this is that Options give Funds enormous flexibility. The ability to buy protection against adverse events, collar the potential returns and of course vary the risk/return profile on a myriad of asset classes represents an enormously powerful investment and risk management tool.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The Investment Strategy Statement details the decision by Committee on how the Fund's assets will be invested. The Strategy set has been prepared to maximise returns of Fund's assets within acceptable risk parameters and also

to facilitate a reduction in the burden of deficit funding that employers in the Fund are liable for.

4.2 The performance of the Fund's strategy is monitored through a quarterly report that is presented to the Committee. Recent performances have been good and generally either in line with or exceeded target.

4.3 The report recommends that the fund allocate 6% of the total fund value to a Multi-Asset Credit (MAC), diverting resources from the Absolute Return Bonds (ARB) portfolio. Currently total investment allocation in ARB is 12% of the Fund assets and this decision will mean a 50% reduction in investment in ARB as a consequent this will reduce the risk of total reliance on returns expectant from manager's skill.

5. LEGAL COMMENTS

5.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 govern the way in which local authorities are expected to deal with investment of pension funds. Local authorities should take a prudential approach to investment, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

5.2 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate having regard to these matters, for the Committee to receive information about asset allocation and ensure that funds are being managed in accordance with the Administering Authority's Investment Strategy Statement.

5.3 The Investment Strategy Statement must include those matters set out in Regulation 7(2) of the Local Government Pension Scheme (Management and Investment of Funds) Regulation 2016. Under Regulation 7(7) the administering authority must review and if necessary revise its investment strategy from time to time, and at least every 3 years, and publish a statement of any revisions.

5.4 The contents of this report and the recommendations set out ensure that the Administering Authority is compliant with the LGPS Regulations.

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1 This report helps in addressing value for money through planning to have a rigorous and robust investment strategy in place to aid in bridging the Fund's funding gap.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

9.1 Any form of investment inevitably involves a degree of risk.

9.2 To minimise risk the Investment Panel attempts to achieve a diversification portfolio. Diversification relates to asset classes and management styles.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- [None]

Appendices

Appendix 1 – Revised Investment Strategy Statement, March 2018

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report

Officer contact details for documents:

- Bola Tobun Investment &Treasury Manager x4733