Hackney

REPORT OF THE GROUP DIRECTOR, FINANCE AND CORPORATE RESOURCES		
Investment Strategy – Next Steps Report and Training Session **Pensions Committee** **12th September 2018**	**Classification** **PUBLIC** **Ward(s) affected** **ALL**	**Enclosures** **One** **AGENDA ITEM NO.**

1. INTRODUCTION

1.1 This report recaps on the Fund's Investment Strategy agreed at the March 2017 Committee meeting and the market background for an investment in alternative credit. It provides details of both liquid and illiquid opportunities available to institutional investors across the asset class and reiterates the recommendation for the Fund to make an allocation to alternative credit of 10% of assets whilst also considering changes in the market environment since March 2017. Alternative credit is the subject of the Fund's training session at the Committee meeting and this report will form the basis of that training session.

2. RECOMMENDATIONS

2.1 **The Committee is recommended to:**

Approve the below approach to implementation, following the decision in March 2017 to make a 10% allocation to alternative credit to be funded from the Fund's global passive equity portfolio:

- **consideration of illiquid private debt strategies as a suitable approach to meet the Fund's de-risking aims**
- **consideration of more liquid alternative credit strategies as a means of managing the drawdown requirements of an illiquid strategy**

3. RELATED DECISIONS

3.1 Pensions Committee 12th September 2018 – Alternative Credit Options

3.2 Pensions Committee 21st March 2018 – Investment Strategy – De-risking Framework

3.3 Pensions Committee 29th March 2017 – Investment Strategy Review – Detailed Recommendations

3.4 Pensions Committee 29th March 2017 – Investment Strategy Statement

4. COMMENTS OF THE GROUP DIRECTOR, FINANCE AND CORPORATE RESOURCES

4.1 This report follows on from the high level Investment Strategy agreed at the March 2017 meeting of the Pensions Committee, which recommend that the Fund's exposure to equities be reduced from 60% to 50%. Whilst equities are currently the main source of expected return and risk in the Fund's overall allocation, returns are likely to be unpredictable in the medium term with considerable potential for downside movements.

4.2 The planned reduction in the Fund's equity allocation has therefore been agreed to help shift the Fund's asset mix towards assets that are less dependent on continued economic growth, potentially helping to protect recent funding gains. The shift is being proposed to help meet long term funding targets and no quantifiable estimate of future benefits can be made at the present time.

4.3 Given that the proposed strategy is to be funded from the Fund's global passive equity portfolio, the move is likely to result in an increase in fees. Fees for the management of alternative credit strategies are considerably higher than those for global passive equity; however, the likely fee increase is justifiable when considered in the context of the Fund's investment strategy and the preservation of recent funding gains.

5. COMMENTS OF THE DIRECTOR OF LEGAL AND GOVERNANCE

5.1 The Committee has legal responsibilities for the prudent and effective stewardship of the Pension Fund and a clear fiduciary duty in the performance of its functions. One of the responsibilities is ensuring compliance with the LGPS (management and Investment of Funds Regulations 2016)

5.2 This report helps to demonstrate that the Fund is compliant with Regulation 7(7) and 7(8), in demonstrating that the Committee reviews and revises its investment strategy where necessary and that fund money is invested in accordance with it.

5.3 In making the decision to reduce its exposure to fossil fuel assets as set out in Section 9 and its Investment Strategy Statement, the Fund has had regard to guidance issued by the Law Commission with regards to when Environmental, Social and Governance (ESG) considerations may be taken into account in investment decisions. As per the Pensions Regulator's (tPR) guidance, the Fund considers carbon risk to be a financially material factor and under Law Commission guidance may therefore take this into account in its investment decision making.

5.4 There are no immediate legal implications arising from this report.

6. BACKGROUND TO THE REPORT

6.1 This report follows on from the high level Investment Strategy agreed at the March 2017 meeting of the Pensions Committee. The strategy recommended a reduction in the Fund's equity exposure from 60.5% to 50.5%, with the proceeds used to fund an allocation to alternative credit. The main drivers behind the proposed change were high valuations for equities and their potential vulnerability to devaluation if bond yields started to rise. Implementing the change would move a proportion of the Fund from assets that are very dependent upon positive growth outcomes to assets with more predictable returns under variable economic conditions.

6.2 The Fund has continued to enjoy strong returns on its equity portfolio since March 2017. The drivers behind the agreed change remain valid and have been given additional impetus by significant improvements in the Fund's funding position. At 31st March 2017 the funding level was estimated as 78.6% (using rolled forward membership assumptions from the 2016 valuation); by 31st August 2018 this had increased to 87.9% on the same basis. The Fund's first trigger to take action to reduce its equity exposure is 88.0%; the funding level has briefly reached this point on two occasions during July and August 2018.

6.3 A review of the Fund's de-risking triggers at the March 2018 Committee meeting also recommended implementation of the agreed reduction in equity exposure. Work undertaken by Hymans on the de-risking triggers suggests that implementing the proposed change by moving 10% of Fund assets from equity to liquid and illiquid debt (and therefore increasing the proportion of income generating assets) would increase the funding level in the 5% of worst outcomes, i.e. reduce downside risk, whilst retaining a broadly similar probably of success across the Fund's target deficit reduction period.

7. ALTERNATIVE CREDIT OPTIONS

7.1 The attached paper from Hymans Robertson recaps on the market background for an investment in alternative credit and provides details of both liquid and illiquid opportunities available to institutional investors across the asset class. It reiterates the recommendation for the Fund to make an allocation to alternative credit of 10% of assets whilst also considering changes in the market environment since March 2017.

7.2 The original recommendation made in the Investment Strategy paper of March 2018 was for an allocation to a liquid multi asset credit mandate (or mandates). However, a recent contraction in market yields has made the investment case for a primarily liquid mandate less appealing and the paper therefore recommends that the Committee focus initially on illiquid mandates, specifically private debt. Given the long term nature of its liabilities, the Fund is able to tolerate investment in less liquid asset classes and is therefore in a position to benefit from the potential illiquidity premium on offer from this type of mandate.

7.3 However, an allocation to liquid credit will still have a role to play in the Fund's investment strategy and is likely to make up part of the 10% allocation. Whilst it is recommended to give initial consideration to selecting a suitable private debt strategy, allocation to a more liquid strategy could be used to manage cash drawdowns into an illiquid private debt mandate.

7.4 The Committee meeting and associated training session will provide opportunities to discuss the options paper in depth with the Fund's investment consultant. Further detail on the process for the Committee to identify and select a suitable strategy (or strategies) is available in the paper entitled "Alternative Credit – Options".

8. RISKS AND OPPORTUNITIES

8.1 The overall aim of an alternative credit allocation is to move a proportion of the allocation from assets that are dependent upon positive growth outcomes, to assets with more predictable returns which are less dependent on continuing economic growth. The range of credit markets and, in particular, the potential risks and returns they offer is very wide, with some more liquid options yielding barely above gilts whilst others offer cash plus 5-6%.

8.2 The key risk associated with any alternative credit strategy is credit risk i.e. risk relating to the borrower's ability or willingness to repay which may affect the return and income received. Borrower default can have a significant impact on returns in these strategies, and the strategy(ies) selected by the Fund needs to use a manager with experience across multiple market cycles, sound underwriting processes and experience of handling workout situations where a borrower is at risk of default.

8.3 Less liquid mandates, such as private debt will also be affected by liquidity risk, which relates to the ability to buy or sell an asset without affecting its market value. Private debt deals have a very limited, if any, secondary market and therefore attract an illiquidity premium over equivalent syndicated deals of around 1% per annum.

8.4 Other risks associated with these types of mandates include inflation risk, currency risk and reinvestment risk (some loans may be repaid early or refinanced – reinvestment risk is the risk that this returned capital cannot be reinvested at the same rate as originally). Interest rate risk, a key concern in bond mandates, is often mitigated in alternative credit mandates through the use of floating rate loans which provide some protection against rising interest rates.

9. IMPACT ON WIDER INVESTMENT STRATEGY

9.1 These proposals are likely to have a positive impact on the Fund's commitment to reduce exposure to carbon reserves. It is intended that the mandate be funded from the Fund's passive global equity allocation; a move to private debt should therefore see the Fund's absolute exposure decrease, as the investee companies in this type of mandate are less likely to be exposed to significant fossil fuel reserves (e.g. through fossil production) than those in a passive listed equity mandate.

9.2 Quantitative assessment of the carbon reserves exposure of investee companies in a private debt mandate is unlikely to be possible at this time; carbon data provision is still in its infancy and data is not generally available for unlisted investments. However, it is intended that a qualitative assessment be undertaken once a suitable strategy is identified, taking into account the sectors in which investee companies operate.

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Appendices

Appendix 1 – Investment Strategy – Next Steps