Hackney

REPORT OF THE GROUP DIRECTOR, FINANCE AND CORPORATE RESOURCES		
Alternative Credit – Consideration of Options **Pensions Committee** **12th September 2018**	**Classification** **PUBLIC** **Ward(s) affected** **ALL**	**Enclosures** **None** **AGENDA ITEM NO.**

1. INTRODUCTION

1.1 This report follows advice provided by the Fund's Investment Consultant, Hymans Robertson, on investment approaches to meet the Fund's current strategic aims of managing asset risk and reducing the Fund's exposure to equities. The report considers the processes available to the Committee to select a suitable strategy to meet these aims and recommends a suggested approach.

2. RECOMMENDATIONS

2.**1 The Committee is recommended to:**

- **Consider and note the report and the next steps in relation to the review of the private debt strategies available via both the London CIV and Project Monument as the preferred approach to selecting a suitable private debt strategy**

3. RELATED DECISIONS

3.1 Pensions Committee 12th September 2018 – Investment Strategy – Next Steps

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

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

3.3 Pensions Committee 29th March 2017 – Investment Strategy Statement

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

4.1 This report follows advice provided by the Fund's Investment Consultant, Hymans Robertson, on investment approaches to manage asset risk and reduce the Fund's exposure to equities. Whilst Equities are currently the main source of expected return and risk in the Fund's overall allocation, returns are unpredictable in the medium term with considerable potential for downside surprises.

4.2 A reduction in the Fund's equity allocation is being considered to 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 in line with the Investment Strategy agreed by Committee in March 2017.

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 higher than those for global passive equity; however, the 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 The report also helps to demonstrate that the Fund is compliant with Regulation 9 (3), in ensuring that the investment managers it uses have appropriate practical experience and are suitably qualified to make investment decisions on the Fund's behalf. It also helps demonstrate compliance with Regulation 9 (4), in that the authority is taking proper advice in the appointment of investment managers.

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

6. BACKGROUND TO THE REPORT

6.1 This report follows advice provided by the Fund's Investment Consultant, Hymans Robertson and presented in the report "Investment Strategy – Next Steps". The advice presented recaps on the Fund's Investment Strategy agreed at the March 2017 Committee meeting and the market background for an investment in alternative credit.

6.2 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. However, it also focuses on changes in the market environment since March 2017, and recommends that the Committee give primary consideration to illiquid private debt strategies.

6.3 However, there remains a place for a more liquid strategy (such as liquid Multi Asset Credit) within the Fund's overall investment approach. Whilst primary consideration should be given to selecting a suitable long term illiquid strategy, a more liquid mandate may also be required to help manage the potential cash drawdowns resulting from investment in an illiquid strategy. Given that it is proposed to fund the overall allocation from the Fund's global passive equity portfolio, investment in a more liquid credit strategy could offer a less volatile mandate from which to manage the irregular cash requirements of initial investment into a less liquid private debt strategy.

6.4 This report considers how such a strategy decision can best be implemented, taking into account the requirement placed on the Fund to pool its assets over time and the availability of pooled private debt arrangements.

7. POOLED OPTIONS AVAILABLE

7.1 Given central Government's requirement that the Fund pool its assets, it is recommended that the Fund first assess the available pooled options for suitability and compatibility with the Fund's overall strategic aims. Investments in private debt are inherently illiquid and represent a long term commitment; any pooled options meeting the Fund's strategic requirements should therefore be considered to help avoid committing capital outside of arrangements supporting the pooling of LGPS assets.

7.2 It is recommended that two currently or shortly available pooled options are considered as a first step. The first of these is available via the London CIV (LCIV) and is a global private debt fund investing primarily in middle market direct lending including unitranche loans, senior debt, junior debt and other similar debt, mezzanine and equity investments and equity co-investments. LCIV will delegate day to day management of assets to Ares Capital Management- Direct Lending Team

7.3 The Fund will target a return of 3mth LIBOR (GBP)+ 6-8% net of fees and will be a separately managed account with a closed ended structure and an estimated total fund term of 7-10 years. Although not yet open, LCIV is understood to have the correct permissions in place and the fund will open once it has a firm commitment from a London borough. It will take commitments from 12 months from opening

7.4 The Portfolio must have a minimum 75% in Senior Secured Loans and Senior Secured Floating Rate Notes. It operates allocation ranges for different geographies, with the ranges running from 25%-75% for Western Europe and the same for North America.

7.5 LCIV will also offer a Global Liquid Loans fund, also managed by Ares, through which it expects investors in the private debt fund to invest initially to manage the cash drawdown requirements. The loans to be held by the fund are similar to corporate bonds, except that they are privately issued; the majority are sub-investment grade with the portfolio's average credit rating being B+. The mandate will operate the same maximum and minimum allocations around seniority and the capital structure and geography as the private debt fund.

7.6 The second available option has been selected by Project Monument (a pool of LGPS investors including Ealing, Havering, Lambeth, Merton, and Wandsworth, with Bfinance managing the selection process). The process identified up 3 managers with which the funds will invest; one European and two US, with a split allocation ratio of 60:30:10 respectively. Boroughs may, however, select the allocation ratio most suited to their strategic aims.

7.7 The managers will use pooled structures also open to other investors, with the total fund life being 6-8 years. The mandates will invest in mostly floating rate loans, with a preference for senior and unitranche debt which must make up at least 70% of the assets invested. Assuming the recommended allocation to each manager is used, the mandates have an expected unlevered IRR of 6.9%, taking into account average target return expectations and standard fees.

7.8 The Project Monument mandates have no associated liquid mandate available. Different boroughs involved in the procurement are using different options to manage the cash requirements for investing; some boroughs have made use of LCIVs longonly MAC fund.

8. SUGGESTED PROCESS AND TIMELINE

8.1 It is recommended that the Committee officers and Hymans Robertson proceed to review the suitability of each of the available mandates, taking into account:

- The suitability for the Fund's overall strategy (including factors such as risk return profile, geography etc.)
- the structure and availability of the funds
- the extent to which each option meets the requirement to pool assets
- fees

8.2 Following this review officers will make a recommendation to the Committee, detailing the recommended strategy, recommended initial commitment (to a maximum of 10% of assets) and suggested approach to funding, including any proposed use of more liquid strategies. As this is potentially a relatively complex allocation, a further consultation and training meeting could be held with the Committee as an interim stage.

8.3 If one of the mandates described above is found to be a suitable match for the fund's strategy needs, it is intended that a recommendation be made at the next Committee meeting in December, for implementation in Q4 2018/19. If no suitable option is found, the December meeting will be used to consider next steps in making a strategic allocation

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