

**REPORT OF THE GROUP DIRECTOR, FINANCE AND CORPORATE RESOURCES**

<b>Infrastructure Investment - Initial Strategy Decision</b>  <b>Pensions Committee</b> <b>24th June 2020</b>	<b>Classification</b> <b>PUBLIC</b>	<b>Enclosures</b> <b>Two(Exempt)</b>
	<b>Ward(s) affected</b>  <b>ALL</b>	<b>AGENDA ITEM NO.</b>

**1. INTRODUCTION**

- 1.1. This report sets out an initial proposal for the Pensions Committee to make an allocation to infrastructure as part of the Fund’s opportunities pot. It summarises the aims and objectives of investing in infrastructure and sets out its risk return profile as an asset class. It also recommends potential next steps for the Committee’s approval.
- 1.2. The report is accompanied by a paper from the Fund’s investment consultant, Hymans Robertson, which provides formal investment advice to support the decision.

**2. RECOMMENDATIONS**

- 2.1. The Committee is recommended to:
  - Approve a total allocation to infrastructure of up to 5% of the Fund. Within this, it is recommended that the first priority for implementation be renewable infrastructure, either through a balanced fund or by using a dedicated renewable infrastructure fund alongside a balanced fund, as a means to continue and support the Fund’s carbon objectives.
  - Approve an allocation to renewable infrastructure of 30% - 50% of the total infrastructure allocation. As the renewables market develops, and it becomes clearer what level of impact the renewable infrastructure allocation can have on the Fund’s carbon exposure, this level may increase.

**3. RELATED DECISIONS**

- 3.1. Pensions Committee 29th March 2017 – Investment Strategy Statement

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

- 4.1. An allocation to infrastructure is being considered to help shift the Fund’s asset mix towards income-generating assets and provide a good proxy match for the Fund’s long term liabilities. In the longer term, this should help the Fund to achieve its long

term funding targets. The report is supported by investment advice from the Fund investment consultant, Hymans Robertson; the advice provided is set out in Appendix 1 to this report.

- 4.2. Given the relative complexity of investing in infrastructure, the move is likely to result in an increase in manager fees. However; the increase is justifiable when considered in the context of the suitability of infrastructure within the Fund's investment strategy.

## **5. COMMENTS OF THE DIRECTOR OF LEGAL AND GOVERNANCE**

- 5.1. The Committee has responsibility 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 (4), in ensuring that the authority is taking proper advice in the appointment of investment managers.

## **6. BACKGROUND TO THE REPORT**

- 6.1. As part of its 2017 review of the Fund's investment strategy, the Committee approved an allocation of up to 5% for an "opportunities pot", which could involve a range of asset classes, including infrastructure. The Committee has not as yet allocated any funds as part of this pot, as the focus has been on pooling and on the implementation of the new investment mandates.
- 6.2. This paper recommends that the Committee consider using the opportunities pot to make an allocation to infrastructure, potentially building up to the 5% upper target. Within the suggested allocation, it is recommended that consideration is given to renewable infrastructure, either through a balanced infrastructure fund or by using a dedicated renewable infrastructure fund alongside a balanced fund, as a means to support the Fund's carbon objectives.
- 6.3. The report sets out some background information on investment in infrastructure and summarises the key risks and benefits. It also introduces more detailed information on renewable infrastructure and the types of infrastructure fund available, and considers the next steps in the allocation process should the Committee approve the initial recommendations in this report.
- 6.4. The report is supported by a paper from the Fund's investment consultants, Hymans Robertson. This provides a broad overview of Hymans' view of infrastructure investment and its suitability for the Hackney Fund, and helps demonstrate that the Fund is compliant with Regulation 9 (4) of the LGPS (Management and Investment of Funds Regulations 2016), by ensuring that the authority is taking proper advice in the appointment of investment managers.

- 6.5. Andrew Johnston from Hymans Robertson will be attending the Committee meeting to provide a training session on investment in infrastructure.

## **7. INTRODUCTION TO INVESTMENT IN INFRASTRUCTURE**

- 7.1. Historically, relatively few UK pension schemes have invested in infrastructure as a result of the complexity of the asset class and difficulties in accessing suitable investments efficiently. However, it is now rapidly increasing in popularity as schemes are recognising the potential benefits and the asset class is becoming increasingly accessible, even to smaller pension funds.
- 7.2. The UK Government strongly supports infrastructure investment by UK pension funds. The Ministry of Housing, Communities and Local Government (MHCLG), in their recent draft guidance to LGPS pension funds, included a strong steer to consider investing in infrastructure projects. It suggested LGPS funds should be moving towards infrastructure investment at similar levels to overseas pension funds of comparable size.
- 7.3. Infrastructure describes assets that societies require to function well. Infrastructure assets can be a suitable asset for pension funds as they can provide high income streams with a long duration that can be linked in some way to inflation, either explicitly or implicitly. Clearly, this is of interest for pension funds looking for long term inflation-linked cash flows to match liabilities.
- 7.4. Thanks to the monopolistic position that some infrastructure companies enjoy and the essential nature of the assets and services they provide, returns can be fairly predictable and resilient to market cycles. This can mean a low correlation of infrastructure with other asset classes and therefore good diversification for pension funds who can forgo liquidity and take a long term view.
- 7.5. The aim of investing in infrastructure will, therefore, typically be to access some combination of:
- further diversification of growth assets;
  - reasonably high income distribution;
  - a proxy match for longer term liabilities.

The nature of the investment can be chosen so as to prioritise one of these factors over the others. However, in practice, the investments available will involve some compromise relative to the ideal.

- 7.6. The key risks of infrastructure investment include:
- Liquidity risk: Due to the size of some assets, the limited number of potential buyers and regulatory approval requirements, divestments of infrastructure assets can take considerable time
  - Development and Construction risk: Projects still in the development or construction stages face higher construction and demand risks than assets already in operation. Investors can choose to avoid these risks by investing only in existing infrastructure; however, those willing to take these added risks may be compensated with higher returns
  - Political and regulatory: Different countries/regions have different political, regulatory and legal frameworks. Especially in jurisdictions with relatively

shorter regulatory histories, regulatory decisions may be inconsistent, increasing uncertainty for investors. Investing in politically stable regions with established legal and regulatory frameworks can reduce these risks.

- Sub-sector: Each infrastructure sub-sector has different risk factors and return drivers. Constructing a well diversified portfolio can help ensure correlation between the different sector risks is low.
- Leverage risk: the use of leverage will magnify losses if returns are impacted by adverse economic conditions.
- Income risk: the risk that assets generate less income than expected.

7.7. Historical return data for infrastructure as an asset class is limited. The best source of information is an organisation called Preqin, which collects a wide variety of data on alternative assets and publishes a global quarterly infrastructure index. The data gathered by Preqin suggests that there is a wide dispersion of returns amongst infrastructure funds but that, on average, high single digit returns can be achieved. The target returns for balanced infrastructure funds are generally in the region of 7% - 12% p.a.

7.8. Appendix 1 to this report sets out more information on the risks and benefits of infrastructure investment, as well as providing more detail on the types of funds available.

## **8. RENEWABLE INFRASTRUCTURE**

8.1. Renewable infrastructure refers to a sub-set of infrastructure that is focused on harnessing energy from renewable sources. This includes energy generation, storage and distribution. There are three main sectors within renewable infrastructure:

- Solar – harnessing the energy created from the sun.
- Wind – generating energy from wind. Wind turbines can either be located on land (onshore) or at sea (offshore).
- Hydro – harnessing the power of flowing water (e.g. tidal flows).

8.2. These three sub-sectors comprise the majority of the renewables market although there are other well established sub-sectors, such as biomass and energy conversion. While renewable infrastructure investing has traditionally centred on energy generation, assets relating to the storage and distribution of energy are a small but growing part of the investible opportunity set.

8.3. Two key factors have contributed to the rise in interest in renewable infrastructure: policy shifts from governments looking to transition away from using nuclear or fossil fuels to meet their energy requirements; and the substantial drop in the costs of building and maintaining these assets and generating renewable energy.

8.4. As with broader infrastructure mandates, one of the key determinants of expected returns that investors can expect to receive relates to the stage at which investment is made in the lifecycle of a project. Expected returns are directly linked to the level of risk taken so investors should expect to receive a higher return for investing in renewable projects before they are built compared to buying assets once they are fully operational.

- 8.5. The majority of returns from renewable infrastructure investment should come from the income received once the energy generated is sold to the wider market through the use of either government-backed contracts or Power Purchase Agreements. Government-backed contracts help set a price for a fixed period of time and are used more often in countries where governments are trying to attract investment in renewables. Power Purchase Agreements (“PPA”): PPAs are agreements that fix the price per unit of electricity over the term of the agreement. They are often struck between the owner of the renewable asset and a corporation looking to source its energy from renewables.
- 8.6. The expected returns on renewables are currently slightly lower than those on balanced infrastructure, partly as a result of the high levels of money flowing into the sector compared to the volume of suitable deals. For example, typical expected returns on renewable infrastructure are in the range of 5% - 8%, or slightly higher for funds which take on development and construction risk, whereas typical expected returns on balanced infrastructure funds are in the region of 7% - 12% p.a.
- 8.7. More information on renewable infrastructure can be found in the briefing note included at Appendix 2 to this report.

## **9. TYPES OF FUND AVAILABLE**

- 9.1. If the Committee chooses to approve an allocation to infrastructure, this will need to be made via a pooled fund or funds. These can be either closed ended or open ended and may be individual primary funds, run by a single manager, or a fund of funds arrangement. Funds vary widely in terms of their location and sector focus.
- 9.2. Individual infrastructure funds (primary funds) typically invest in around 6-10 assets/projects. The number of assets is limited as there is a finite life to the fund. With a closed-ended fund investment, money is drawn down on a just in time basis so investors continue to meet cash calls some years after the initial commitment.
- 9.3. The majority of infrastructure funds are closed-ended and most have a 10-12 year life. To benefit from the longevity of asset lives and potential inflation protection, the assets need to be held for a longer period of time than that offered by most closed-ended funds. There are some specialist funds with more focused strategies offering exposure to the asset class over a longer period and if the fund chooses to allocate to a closed-ended fund, it is recommended this type of strategy is considered.
- 9.4. A small number of open-ended, or “evergreen” (that is, with an infinite life), infrastructure funds are available to UK pension fund investors. The few established open-ended infrastructure funds that we are aware of are now offering something quite different to what the closed-ended funds have to offer. They have 12-16 platform investments through which they can invest new capital and benefit from efficiencies. These funds offer the benefit of immediate transparency in terms of the assets held and cash yield generated. They may also have better access to deals where a long term owner is preferred.
- 9.5. Open ended funds are therefore potentially one of the best options to meet the

requirements of pension funds for investing in infrastructure; however, there is a lack of choice as only a few exist and it is not easy for new funds to be created. It should also be remembered that, despite their open ended structure, these funds remain illiquid, with redemptions paid out at the manager's discretion.

- 9.6. A fund of funds (FoF) approach involves a single manager investing in a range of infrastructure funds on behalf of a client. A portfolio will typically include around 10-20 unitised holdings in a range of closed-ended funds offered by other mainstream and specialist managers. A FoF will typically not invest in an underlying open-ended fund given the mismatch in the underlying structure.
- 9.7. The main advantage of the FoF approach is that investors can gain exposure to a wider range of managers, funds, specialist sectors and investment vehicles, without the associated governance burden. There is diversification of risk, but that comes at a cost by introducing an additional layer of fees. Careful consideration is therefore required to justify this.

## **10. NEXT STEPS**

- 10.1. It is proposed that the Committee begin to consider approaches to implement an allocation to infrastructure, and potentially building up to the 5% upper target allocation for the "opportunities pot". Within this it is recommended that consideration is given to renewable infrastructure, either through a balanced infrastructure fund or by using a dedicated renewable infrastructure fund alongside a balanced fund, as a means to continue and support the Fund's carbon objectives.
- 10.2. The proposed approach to implementation is to focus first on identifying a suitable allocation to renewable infrastructure, which should be set at 30% - 50% of the total allocation. As the renewables market develops, and it becomes clearer what level of impact the renewable infrastructure allocation can have on the Fund's carbon exposure targets, this level may increase.
- 10.3. Hymans Robertson have suggested a proposed minimum threshold for the size of fund relative to the size of the proposed investment. It is suggested that any investment in a single renewable infrastructure fund is limited to a maximum of 20% of that fund's total value (and ideally lower), with the investment being split across a number of different infrastructure funds if necessary. The same suggested limit would also apply to balanced funds.
- 10.4. There are a number of options the Fund could use to implement an allocation to infrastructure - officers are currently exploring these and, should these initial recommendations be approved, more detailed recommendations around implementation will be presented at a future Committee meeting. A pooled or collaborative approach to implementation is recommended if a suitable mandate meeting the Fund's strategic objectives can be identified.
- 10.5. Potential implementation options include the following collaborative and pooled approaches:
  - The London CIV fund with Stepstone, which currently has commitments of £400m from six London Borough Pension Funds. The fund's initial investment is to a renewable energy fund, but it is anticipated that over

time its allocation to renewables is expected to fall. The Fund is targeting a minimum of 25% in renewable infrastructure.

- Collaboration between London Boroughs to carry out a joint selection exercise to find a mandate which achieves the shared objectives. A number of Boroughs, including Hackney, are currently working with the London CIV on its Seed Investor Group for renewable infrastructure to test if a suitable renewables mandate can be identified.
- Pooled infrastructure offerings, such as PIP and GLIL, which the Fund may be able to access.

10.6. More information on implementation, including the recommended source of funds, is included in Appendix 1 to this report.

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### **Appendices**

Appendix 1 - EXEMPT - Hymans Robertson - Infrastructure Advice

Appendix 2 - EXEMPT - Hymans Robertson - Renewable Infrastructure Briefing Note