**London Borough of Hammersmith & Fulham**

**Report to:** Pensions Sub Committee

**Date:** 29/09/2020

**Subject:** Investment Strategy Update - Asset Class Review

**Report of:** Phil Triggs, Director of Treasury and Pensions
Matt Hopson, Strategic Investment Manager

---

**Summary**

This paper and associated appendix provides the Sub-Committee with more detailed information on three asset classes that are being closely monitored by the Pension Fund's advisors. These are:

- Ground Rents
- Supported Social Housing
- Infrastructure Debt

**Recommendations**

The Sub Committee is requested to:

a. Note the report and consider whether these asset allocations should be taken to the next stage as a part replacement for the Fund's Inflation Protection portfolio with M&G.

**Wards Affected:** None

---

**LBHF Priorities**

| Our Priorities | Summary of how this report aligns to the LBHF priorities |
|---|---|
| • Building shared prosperity | Being an outperforming investor means that as part of the Pension Fund's fiduciary duty, its investments should be able to assist in making a positive financial contribution, sharing prosperity and lessening the financial impact on council tax payers. |

**Financial Impact**

The financial implications of these investments will be continually monitored to ensure that members' pensions are safeguarded.

## Legal Implications

None

---

## Contact Officer(s):

Name: Matt Hopson
Position: Strategic Investment Manager
Telephone: 020 7641 4126
Email: mhopson@westminster.gov.uk

Name: Phil Triggs
Position: Director of Treasury and Pensions
Telephone: 020 7641 4136
Email: ptriggs@westminster.gov.uk

Verified by Phil Triggs

---

## Background Papers Used in Preparing This Report

None

---

## Asset Class Review

### 1. Background

1.1. The Pension Fund Sub Committee agreed to terminate the M&G inflation protection mandate, this was due to a number of factors, but most notably the over exposure to long lease property that has built up in the portfolio, overlapping with the Fund's exposure to long lease property through Aberdeen Standard Investments.

1.2. Since then, the Fund's investment consultant, Deloitte, has narrowed down a list of prospective inflation protection strategies that warrant further investigation as potentially investment alternatives.

### 2. Investment Strategy

2.1. The Fund's investment consultant has explored three promising areas to undertake a more in depth review:

**Ground Rents**

2.2 This is investing purely in the freeholds of larger developments such as mixed use commercial sites.

**Benefits**

- Ground rent investments receive long-term expected cashflows through the rental agreements that are in place with the leaseholder. For some funds, these cashflows can be taken as income distribution and used for pension scheme cashflow management.

- The cashflows received can be inflation linked and rise over time. The inflation linkage is normally through RPI or CPI, with agreements in place to review the rent received with respect to inflation after a few years.

- The returns received generally have low correlation to other return seeking assets.

- If rental income received from the leaseholder stops, the owner of the ground lease is able to take ownership of the leasehold property, which normally has a higher value. This provides security against the risk of default from the other party.

**Risks**

- Counterparty Risk – a leaseholder may not honour its obligation to pay rent and default on the ground lease agreement. However, as highlighted the owner of the ground lease has security in the form of the leaseholder’s property, which it can inherit full ownership of.

- Valuation Risk – The value of a ground rent asset is the opinion of the valuers based on several assumptions. Ground rents are largely illiquid and traded infrequently, so valuations can be difficult to benchmark against.

- Illiquidity Risk – Ground rent leases can be difficult to buy and sell without suffering a discount. In exceptional circumstances, a fund may limit or suspend trading due to extreme market conditions or high levels of redemptions/withdrawals to protect an investor’s funds.

- Reputational Risk – The Fund may be associated with recent ground rents scandals involving residential houses.

**Supported Social Housing**

2.3 Investing in purpose built social housing specifically for individuals who may require special care or are unable to live and work independently.

**Benefits**

- The income received is ultimately funded by the UK central government, which clearly represents security. That said, this income is collected via housing associations which themselves carry credit risk. There is also a risk that the government may reduce housing benefits.

- Social Supported Housing has strong and direct ESG credentials, predominantly within a social capacity where providing care and housing to individuals in this situation can have a real and tangible benefit to both the individuals and the wider community.

- Due to a shortage of supply in this type of accommodation, there is strong demand in the market. In addition, the UK government has formally backed some leases for a period (i.e. 10 out of 25 years) to ensure they have uptake.

- The demand for the accommodation is dependent on the number of people who are in need of it, rather than the wider macro-economic and market environment. As such, demand can be seen as relatively uncorrelated to the market.

**Risks**

- Illiquidity Risk – due to the bespoke nature of the social supported housing assets it can be difficult to buy and sell without suffering a discount. A fund may also include additional liquidity restrictions to ensure that a fair return is achieved by holding onto assets for an appropriate duration or to restrict trading under certain market conditions.

- Political Risk – the return assumptions of an investment are based on the current benefits offered by the government, which could be changed or amended and adversely affect the return on investment.

- Administrative Risk – the administration of the social supported housing is carried out by not-for-profit housing associations. If administered poorly, there may be an increased likelihood that they are unable to meet payments or in worst case scenarios go bankrupt.

- Construction & Development Risk – due to the bespoke nature of the assets, they may need to be built or developed. If the construction and/or development of an asset is delayed or requires significant changes, the asset value might be materially affected.

- Property Market Risk – the underlying assets might be subject to changes in the wider property market. If property markets undergo a period of distress, the asset values may fall.

**Infrastructure Debt**

2.4 This is investing in the debt part of the capital structure (as opposed to equity which the fund has access through with Aviva and Partners Group) for infrastructure developments such transportation links and renewable energy.

**Benefits**

- Debt agreements with equity holders will receive fixed income repayments that are contractual at expected times. If the equity holder defaults on repayment, the arrangement may include clauses that take effect such as the equity holder not being able to take out any more debt financing or limiting dividend payments until the matter is resolved. The repayments may also include some inflation linkage.

- The underlying assets are likely to be either essential in use or have inelastic demand, meaning that even in the periods of low economic activity, the counterparty should be receiving income and be able to make repayments.

- Of the small amount of defaults that occur, the recovery rate is usually high. In comparison to corporate bonds, the expected loss on infrastructure debt is usually lower.

- UK investment grade infrastructure debt is often linked to inflation (RPI or CPI).

**Risks**

- Counterparty Risk – the counterparty (usually the infrastructure equity owner) to the debt agreement may default and not meet their obligations. As highlighted investment managers may include clauses that look to limit the occurrence of this and engage with those with high credit ratings.

- Similarly, the credit rating of the counterparty may change and affect the price of the bond. Investment managers may therefore look to only invest in counterparties who have higher credit ratings.

- Valuation Risk – the value of an infrastructure assets (including debt) is the opinion of the valuers based on several assumptions. Infrastructure assets are largely illiquid and traded infrequently, so valuations can be difficult to benchmark against and know the true market value.

- Illiquidity Risk – infrastructure assets are less liquid than assets traded on public markets. Subsequently, investors may not be able to disinvest quickly without suffering a market discount. Market conditions may also restrict the sale of an asset as there might be no available purchaser.

- Interest Rate Risk – the underlying contractual repayments of the debt agreement might be linked to the rate of interest. A change in the level of interest could lead to a material change in valuation of the debt.

- The Fund is also likely to gain some infrastructure debt exposure through the Aberdeen Standard diversified private credit portfolio.

## 3. Risk Management Implications

3.1. Risk are outlined in the report and associated appendix

## 4. Other Implications

4.1. None

## 5. Consultation

5.1. None

**List of Appendices:**

Appendix 1: Asset class review