

The Management of Local Investment Allocations

Introduction

At the request of the Pension Fund Committee this report sets out proposals for the management of a local investment allocation (of around 3% of the Fund) which forms part of the Fund's agreed investment strategy.

Local investment presents a range of challenges in terms of the potential for conflicts of interest and pressures to compromise decision making criteria which the proposals set out in this report aim to address.

At all times it needs to be borne in mind that local investment is not an end in itself but simply a further route by which the Pension Fund can meet its overriding objective of ensuring that funds are available to pay benefits when required.

The Rationale for Local Investment

While the overriding objective of the Pension Fund's Investment Strategy must be to ensure funds are available to pay benefits when required, it must be accepted that the Fund does not exist in a vacuum and it represents a pool of assets owned by Lancashire people and organisations which can, to some extent, be used to support Lancashire where that support does not conflict with the overall objective.

Thus local investment, which meets the overall investment objective, can form an appropriate part of the investment strategy assisting the Fund in achieving a broader range of objectives from its investments, for example creating growth in the local economy which has a positive impact on the revenue streams of fund employers, while not losing sight of its overall responsibilities.

Defining Local

Local investment in the context of Pension Funds has a reasonably flexible definition, for example the Greater Manchester Fund views the North West region as the scope of its very successful local allocation although actual investment does tend to favour the former metropolitan county area.

For the purpose of this paper local is defined as the Lancashire Sub Region, i.e. the 1974 County Area covered by the County Council and the two unitary councils of Blackburn with Darwen and Blackpool. This may need to be reviewed in the light of actual experience and while it may be appropriate for investment in real assets it may be less appropriate for investment in specific businesses, should the Fund consider that in future.

Types of Local Investment

There are in essence two types of local investment opportunity which might be presented to the fund:

- a) Investment in local businesses. Such investments might be in the form of either equity or loan capital. Historically the local private equity funds promoted by the former Regional Development Agencies which LGPS Funds were "persuaded" to support did not perform well, although this is not necessarily an indicator that investment directly into businesses is likely to underperform, if it is entered into for the right reasons.
- b) Investment in real assets. Generally this will take the form of investment in property, which again might be either in the form of equity or the provision of loan capital. The Fund has previously discussed supporting investment by a local NHS organisation through the provision of loan capital. While this was not successfully concluded for commercial reasons it provides a template for the sort of negotiating and due diligence processes required. The Fund has also been offered "first refusal" on the sale on of a development being partly supported by the Local Enterprise Partnership, although any formal discussions on this are 12-18 months away.

The Investment Panel has discussed the types of local investment with which the Fund might engage at length and concluded that, taking account of the Fund's risk appetite, the fact that the investment strategy favours real assets which generate an ongoing income stream, and the potential resource implications of managing an allocation in this space that initially any allocation should focus on real assets, specifically property investment.

The Investment Panel's recommendation is that a manager be appointed who would perform for the local investment portfolio the same role as Knight Frank perform for the property portfolio. This would ensure that proposals are examined as objectively as possible and ensure that the portfolio of investments receive appropriate management attention once an investment has been made.

The Investment Mandate

As with all the Fund's investment allocations it is necessary to set out clearly the parameters within which a local allocation should operate in the form of an investment mandate. This sets out limits, or benchmarks around a range of factors which affect the risk profile of the allocation. The following characteristics have been discussed by the Investment Panel, but will need to be firmed up for formal approval by the Committee should the arrangements set out in this report be approved.

- Each individual investment within the allocation will be agreed by the Investment Panel, in the same way as for the core property portfolio.
- Minimum target return – This is suggested as an 8% Internal Rate of Return (IRR) after allowing for any fees. This is in line with the Fund's Infrastructure portfolio.
- A minimum lot size will be specified.

- Investment Duration
- Balance between equity and loan capital
- Exposure to construction risk, if any. At this stage the Investment Panel have considerable reservations about taking on exposure to construction risk
- Asset pricing will be agreed by the Fund's Independent Valuer.
- Investment will **not** be made in schemes in which Lancashire County Council has a direct financial interest or which represent the provision of the Council's (or any other local authorities') statutory functions (e.g. the provision of roads or school places).

A framework of this sort is intended to give officers and fund managers a clear remit within which to work while also setting out clear arrangements for managing any potential conflict of interest between the two roles of the County Council, as a traditional local authority and as the Administering Authority for the Pension Fund.

Achieving a Supply of Investment Opportunities While Supporting Lancashire's Economic Aspirations

If the Fund is to deploy a local investment allocation successfully it needs to do so within the context of the achievement of Lancashire's economic growth agenda, which is what will deliver a supply of potential opportunities. Much of this is currently being driven through the work of the Lancashire Enterprise Partnership and initiatives such as the Preston City Deal and the Fund will want to develop means of engaging with these processes that give it access to a supply of suitable potential projects for investigation.

At the same time any manager appointed by the Committee would need to actively seek out other suitable investments meeting the investment mandate in order to ensure that the Fund can achieve the best overall range of investments possible in this space.

Managing the Portfolio

As indicated above it is the strong recommendation of the Investment Panel that an appropriate external manager be appointed to undertake both the evaluation of opportunities and the ongoing management of any allocation of this sort. Should the Committee agree to this a procurement strategy paper for this allocation will be brought to the next meeting of the Committee in line with the usual process.

Conclusion

Local investment can have a place in the assets of the Pension Fund; however, it is vital that the focus on the over-riding investment objectives of the Fund is maintained through ensuring robust appraisal and due diligence processes which are demonstrably independent and therefore able to provide an objective appraisal of any opportunities presented to the Pension Fund.