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INFRASTRUCTURE IMPLEMENTATION - UPDATE
LONDON BOROUGH OF ISLINGTON PENSION FUND

Background

The Pensions Sub-Committee agreed a revised investment strategy for the Islington Council Pension Fund ("the Fund") at its November 2014 meeting. The revised strategy maintained the Fund's 75% growth, 25% defensive split and included a 15% flexible allocation to infrastructure and social housing, with the allocation between the assets dependent on market conditions. It was agreed that this allocation is to be funded from the Fund's corporate bond allocation.

The Fund has been awaiting the introduction of the London CIV infrastructure allocation. As there has been no progress made to date, the Pensions Sub-Committee has agreed to proceed with implementation in order to move closer towards its agreed long-term strategy. In addition as part of the 2016 Actuarial Valuation, the liability discount rate is no longer based on volatile gilt yields and instead adopts a CPI Plus approach. Therefore, the risk reduction benefit of investing in bonds is lessened and there is scope for risk reduction achieved through investing in potentially inflation-sensitive assets. This enhances the strategic rationale for investing in infrastructure as discussed as part of the 2017 investment strategy review (but noting that the degree of inflation-sensitivity will vary by investment). We have therefore updated our paper issued in September 2015 that outlined the most appropriate mandate specification (based on the current market environment).

Decisions made so far

Following the decision to invest in infrastructure, the Pensions Sub-Committee and Officers of the Fund had further discussions on the objective of the allocation, as 'Infrastructure' can encompass listed equity, private equity or private debt investments in a range of infrastructure assets with varying degrees of risk and economic exposure. In March 2015, the Pensions Sub-Committee agreed the following parameters for the infrastructure allocation:

- As the allocation is to be funded from the corporate bond allocation and be within the defensive allocation, it should have a defensive role in the portfolio.
- Both private equity and debt investments should be considered.
- Public-Private Partnership ('PPP'), Core and Core Plus (ideally with an inflation component) investments should be considered.

The implementation of such an allocation was discussed in May 2015, with the size of the allocation and the level of asset diversification required from the allocation within a suitable governance structure under consideration. The following parameters were agreed:

- No direct investments or co-investments on diversification and governance grounds.
- Global allocation preferred for diversification.
- Vintage year diversification desirable; mandate to be 'ongoing' and secondary funds may be considered.

Mercer remains comfortable with these objectives agreed by the Pensions Sub-Committee in 2015.

As a reminder, we have set out below the three different implementation routes that the Pensions Sub-Committee has previously considered:

Implementation route	Overview	Key advantages	Key disadvantages
"Self-Build" by investing in direct pooled funds	The investor self-builds an allocation to funds that choose direct infrastructure investments that are suitable for the Fund's objective. Under an "advisory approach", Mercer can help aid in the construction of an infrastructure portfolio of "top pick" funds. The Pensions Sub-Committee remains in control of the construction and implementation of the infrastructure programme and Mercer helps in an advisory capacity.	· The Pensions-Sub Committee would retain discretion over the construction and implementation of the allocation. · The Pensions-Sub Committee can draw on the investment advisor's expertise and due diligence (if an advisory approach is chosen).	· Need for in-house expertise and thorough due diligence. · Building an allocation through a portfolio of individual funds, with adequate manager, investment and vintage year diversification, would mean significant governance required. · The portfolio is likely to be more concentrated. · Significant assets required in order to gain sufficient diversification. · Under an advisory approach, costs will be incurred to ensure thorough due diligence.
Third-party fund- of-funds	Invest in an "off-the-shelf" fund run by a manager that chooses underlying infrastructure funds to invest in.	· Theoretically, a third-party fund-of-funds should achieve the highest level of diversification and therefore a lower volatility of returns. · Potential for value enhancement through portfolio construction and investment selection. · Almost no in-house resource or expertise required. · Consolidated valuation and performance is provided – no need for investor to consolidate this from the underlying infrastructure funds.	· As an individual investor there is no ability to influence the strategy followed by the fund-of funds. Many fund-of-funds allocate to opportunistic investments in order to enhance the return target. · As an individual investor there is no ability to influence the terms and fee arrangements of the underlying infrastructure funds. · Achieving a strong alignment of interests at several levels can be an issue, as investors have limited ability to influence the governance structures in place with third-party fund-of-funds. · Potential lack of transparency in the way that the fund-of-funds operates, particularly regarding the payment of fees. · An additional level of fees is paid. · Relatively small universe of suitable vehicles in the third-party fund-of-funds space.

Implemented investing/ fiduciary (bespoke fund of funds)	Fund selection decisions are delegated to a specialist (manager), who chooses underlying infrastructure funds on the Fund's behalf (as the only investor)	· Enhanced ability to customise the mandate from both a strategy and governance perspective. · As the allocation does not depend on discrete fund-raising periods, there is the potential to manage commitment amounts based on market conditions, and/or with a more holistic basis with the rest of the portfolio. · Potential for value enhancement through portfolio construction and investment selection. · Almost no in-house resource or expertise required. · Consolidated valuation and performance is provided – no need for investor to consolidate this from the underlying infrastructure funds.	· An additional level of fees is paid. · As an individual investor there is no ability to influence the terms and fee arrangements of the underlying infrastructure funds. · Requires a larger minimum investment than a third-party fund of funds to achieve adequate diversification.

It is our understanding that the Pensions-Sub Committee does not wish to consider the fiduciary route.

Mandate Specification

The decisions noted above clarified the mandate for the Fund's infrastructure allocation. The table below sets out the areas typically specified when seeking a mandate and suggested the potential or indicative targets (updated based on the current market environment), given the discussions with Officers in 2015.

Considerations	Islington Indication
Target return (gross IRR)	c.8% - 10% Gross IRR
Target cash yield (gross % p.a.)	c. LIBOR + 2.0% - 3.0%
Target risk profile	Defensive, income focused
Target geographies	Global with UK bias
Target sectors	Regulated, core and core plus (if strong inflation component)
Target development stage	Predominantly brownfield
Target capital structure	Predominantly equity, some debt
Target number of underlying managers	7-10[1]
Target number of underlying funds	7-10 (initial allocation)
Target number of underlying assets	50-75
Target vintage diversification	Rolling programme, consider secondary[2] opportunities

[1] Theoretically, 7-10 underlying managers still seems reasonable as a target. However in practical terms, a more realistically achievable range would be 6-8 underlying managers. This is because we have seen a number of managers move up the risk spectrum over recent years (to varying degrees) given return compression. Whilst they are high-quality in nature, they may not fit with the Fund's target risk profile. It may ultimately be possible to make 7-10 underlying manager allocations that are consistent with this risk profile, but that may take time and/or involve a degree of compromise in certain areas (e.g. risk / return profile, manager/fund quality etc).

[2] It should be noted that in the current market environment secondary investments are relatively scarce, and (in general) are trading around NAV rather than at significant discount (for high-quality managers/funds, they would likely trade at premium). As such, they should be seen as being an opportunistic (rather than 'guaranteed') investment as part of the portfolio build-out. Even if they are accessible, they would likely be for portfolio build-out rather than

Considerations	Islington Indication
Target allocation to direct/co-investments	0%
Average maturity / term of programme	c. 15 years - ability to invest in longer term PPP projects, balaced with shorter term secondary and debt opporutnities[2,3]
Investment period for programme	Initial 5 years and then rolling (for vintage year diversification)
Approach to ESG integration	Preference for managers who integrate ESG considerations into investment process
Fee schedule	TBC (base fee preferred?)
Performance reporting arrangements	Report on portfolio as a whole quarterly (with monthly information)

Next Steps

The decisions taken in 2015 resulted in an initial agreed mandate specification and understanding of the role and aims of the portfolio. As the Pensions Sub-Committee has now agreed to proceed with implementation, the next step is to conduct a search for a manager to build the portfolio.

As further clarity on the timing of any CIV infrastructure allocation is not forthcoming, we suggest that the Pensions Sub-Committee proceeds with implementation, bearing in mind the longer term nature of implementing an investment in this asset class.

Important Notices

return enhancement. In addition, we have seen a trend towards continuation vehicles (i.e. funds being rolled on rather than liquidated at the end of their terms) – whilst these can be a source of secondary opportunities, these continuation vehicles are also typically long-dated in nature (i.e. 15- 20 years+).

[3] This seems a reasonable estimate given the target strategy and likely types of fund investments, but it should be noted that the portfolio could end up being 'barbelled' in terms of its maturity, i.e. closed-ended equity infrastructure funds and junior debt funds with terms of 10 – 12 years at one end, and (senior) infrastructure debt funds and long-dated PFI/PPP funds with maturities of 20-30 years at the other end. Unless there is a recycling of capital over time, beyond the first 15 years, the portfolio is likely to consist entirely of infrastructure debt and PFI/PPP funds.

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Nick Sykes
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