Item 7

CT/13/28
Investment and Pension Fund Committee
7 June 2013

INFRASTRUCTURE STRATEGY

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

Recommendation: That the Committee approves the suggested infrastructure strategy for the Pension Fund and the proposed next investment in the asset class is made through the Aviva funds.

1. Introduction

1.1. At the May 2007 Committee meeting a commitment of USD 50 million was made to a UBS International Infrastructure fund. This decision was made as part of the Fund's investments in a range of smaller funds which offer diversification from the large equity holdings.

1.2. Subsequently, the Committee has decided to create a target of 2% of the Fund's strategic benchmark for infrastructure. To achieve this target the Committee needs to approve a strategy for future investments in infrastructure.

2. Operation of infrastructure funds

2.1 The legal structure of many infrastructure funds is as some form of partnership. Investors become limited partners by making a commitment to invest a certain amount over the life of the fund. This commitment is legally binding and cannot easily be sold on. The fund manager (also called the General Partner) identifies investment opportunities and decides when and in what amount each cash 'call' should be.

2.2 While infrastructure funds typically have a total life of 10-15 years the manager will often only call money for new investments for a short period. For example between years 1 and 6 a manager may call a large proportion of the commitments, with very little being called at later dates. Similarly, while most of the assets will be realised towards the end of the life of the fund, some may be realised earlier. The effect of this is that the total amount an investor initially commits to an infrastructure fund will not be the same as the actual exposure at any point in the future. Combined with the possibility that the manager may not identify suitable investment opportunities, an investor may at times need to prudently 'overcommit' - e.g. if an investor wants to invest £100 million in infrastructure they may need to make commitments of £125 million. Equally, the fund's value may become greater than the original commitment depending on how assets are realised and money is distributed to investors.

2.3 As well as considering the level of commitments, an investor also needs to predict how the underlying value of the investment changes over the life of a fund. As investments are made the value of the underlying assets will increase until they reach a peak, before being realised and then declining to nil at the end of the life of the fund. An investor such as a Pension Fund which requires a constant allocation to infrastructure of say 2% must therefore commit to a range of funds at different stages of their life cycle to ensure that it maintains the required exposure. The investor must consider how much to commit, potential currency movements and the need to gain exposure to different market environments.

2.4 The Devon Pension Fund is invested in the UBS International Infrastructure fund which has a life of 15 years (with a possibility of a 5 year extension). The fund is 6 years old and is moving from its investment phase, when all then target assets have been acquired, to its 'asset management phase' when value is added by improving businesses.

2.5 The original commitment of USD 50 million is now almost fully called and the underlying assets are currently valued at approximately GBP 35 million. This is currently around 1.1% of the Pension Fund's assets, and is below the Committee's 2% target for infrastructure. It is unlikely that the existing infrastructure assets will ever increase to 2% of the Pension Fund's assets.

3 Proposed infrastructure strategy

3.1 The Pension Fund's current target allocation of 2% is probably too low to create a diverse range of infrastructure funds or to have any significant impact on the Fund's risk-return position. It is therefore proposed that the target is increased to 4%. As infrastructure is an income generating asset class with some inflation-linked returns this increase in allocation would be beneficial to the Pension Fund given that income and inflation are future risks. This new allocation could be achieved by reducing the Bonds/Cash allocation from 18% to 16%.

3.2 The Fund should also seek to make regular commitments to the asset class to gain exposure to different market conditions. As a guideline, the Fund should aim to commit to at least one new infrastructure fund every two years. It is proposed that the decisions over the choice of fund and commitment levels are made by officers in discussion with the Fund's investment adviser, and reported back to the Committee.

3.3 The pattern of commitments needs to consider the expected growth in the underlying infrastructure assets relative to the predicted future growth of the Pension Fund's total assets. The growth patterns of individual infrastructure funds will be different and will need to be assessed in consultation with the manager. The commitment pattern will also need to respond to currency movements and sharp movements in Pension Fund assets. The aim should be to ensure that the Fund's future exposure to infrastructure remains close to the Committee target allocation.

3.4 As the Pension Fund is currently overweight to equities and underweight infrastructure, it is proposed that a commitment of £60 million is made to new infrastructure funds this year as the first step in an on-going infrastructure strategy. A suitable infrastructure offering from Aviva has been identified by the Fund's officers and adviser which offers the following characteristics:

- An institutional, long-term core strategy which targets inflation linked returns from infrastructure and property assets
- Access to pools of assets which are restricted to a few institutional fund managers (e.g. ground rents on suitable properties)
- The ability to invest in a single multi-strategy approach or to decide our own allocation to the underlying strategies (Ground Rent, Infrastructure, Social Housing and Commercial Assets)
- A simple Unit Trust structure to invest into the partnership, which reduces administration and the need to invest directly as a partner

3.5 It is proposed that the new commitment is made to the Ground Rent, Infrastructure and Commercial Asset funds as Social Housing is still an emerging asset class for investment purposes. As the investment is through a unit trust structure which will pay regular distributions there is less need to consider the complications of commitment patterns as highlighted above. This structure is similar to the Property Unit Trusts in which the Pension Fund has been invested for many years.

4. Conclusion

4.1 The proposed infrastructure strategy aims to ensure that Pension Fund remains close to the Committee's target allocation. A regular pattern of commitments is required which needs to constantly be reviewed to consider future expectations for asset growth.

Mary Davis

Electoral Divisions: All
Local Government Act 1972
List of Background Papers – Nil
Contact for Enquiries: Richard Bettley
Tel No: (01392) 383621 Room G97