PRIVATE MARKETS ALLOCATIONS

Report of the County Treasurer

Please note that the following recommendation is subject to consideration and determination by the Board before taking effect.

Recommendation: that the Committee approve the following further commitment in private markets:
(1) £250 million to the Brunel Infrastructure Portfolio.
(2) £100 million to the Brunel Private Debt Portfolio.
(3) £125 million to the Brunel Private Equity Portfolio.

1. Introduction

1.1. Private markets comprise investments not traded on a public exchange or market. They can be an important part of a pension fund's portfolio as:
- They are expected to generate higher returns as a result of the illiquidity premium available to producers of long term capital.
- They provide diversification of returns.
- They provide access to investment opportunities not usually accessible through public markets.
- They provide greater potential for outperformance through active, hands-on management.

1.2. Private markets investments typically comprise the following headings:
- Property/Real Estate.
- Infrastructure.
- Private Debt
- Private Equity

1.3. The strategic investment review conducted by Mercer investment consultants in 2017, and then refreshed in February 2019, proposed a long-term allocation of 25% in private markets, including the 10% allocation to property. The Fund has made new commitments to infrastructure and private debt funds over the last two years, bringing the current allocation up to around 14%. This report looks specifically at infrastructure, private debt and private equity, on the basis that the 10% target allocation to property remains unchanged. It reviews the direction of travel and proposes that additional commitments be made to move towards the long-term target allocation.

1.4. The process for making private market investments is to make commitments that will then be drawn down over a period of time. It is unlikely that 100% of the commitment made will ever be drawn, and therefore to achieve a percentage allocation it is necessary to over-commit, i.e. to commit a higher amount than your investment target. Private market funds are typically closed ended, which means that capital will be returned towards the end of the life of the fund, and therefore needs to be redeployed. The Brunel approach is to provide a window for clients to commit funds for a two-year period, and therefore any new commitments will need to be made by 31 March 2020 for drawdown over the two years from April.

2. Infrastructure

2.1. The Devon Pension Fund currently has infrastructure investments of £171.5 million. These can be summarised as follows:

Infrastructure Fund	Current Value as at 30 Sept 2019 £m
UBS Archmore Infrastructure Fund	27.0
First State European Diversified Infrastructure Fund	48.6
Hermes Infrastructure Fund	41.6
Aviva Realm Infrastructure Unit Trust	18.6
Aviva Realm Ground Rent Fund	18.4
Brunel Infrastructure Portfolio	17.3
TOTAL	**171.5**

2.2. This equates to 3.7% of the total fund investments, compared to a current target of 6%. The Fund has undrawn commitments of £157 million to the Brunel infrastructure portfolio, which if drawn would take us up towards the current target. It is anticipated that further significant sums should be drawn before 31 March 2020. However, it should also be noted that the UBS Archmore Fund is due to close in 2022, and the First State Fund in 2024, so both those funds are likely to be returning capital to us over the next few years that will need to be redeployed.

2.3. The Fund's current Investment Strategy Statement states a 6% target allocation to infrastructure for 2019/20, with a medium term target of 8%. The longer term target set out in the Mercer report was 10%. Taking into account potential asset growth in line with actuarial assumptions, a 10% allocation in two years time could equate to around £500 million. Given the need to over-commit, as set out in paragraph 1.4 above, and the potential for return of capital from our current investments, it is proposed that a further £250 million be allocated to infrastructure, in order to take the total investment up to 10%.

2.4. This commitment would be notified to Brunel and be committed to their infrastructure portfolio. Brunel will then combine the Devon commitment with those received from other funds and seek opportunities to deploy the capital to infrastructure funds and opportunities that they will source.

3. Private Debt

3.1. Private debt is a broad term that refers to any investment in privately negotiated debt. Borrowers often choose private financing because it can be customised to their needs or when public debt is not available. The Devon Pension Fund currently has private debt investments of £80.8 million. These focus on direct lending to private companies, providing an attractive opportunity with a shorter investment term than infrastructure investments and a regular yield. The Fund's current investments can be summarised as follows:

Infrastructure Fund	Current Value as at 30 Sept 2019 £m
Bluebay Senior Loan Fund I	39.7
Golub Capital International Fund 11	41.1
TOTAL	**80.8**

3.2. A total commitment of £150 million (£90 million to Bluebay and £60 million to Golub) was made in June 2017 following a procurement exercise undertaken in collaboration with the Cornwall and Gloucestershire pension funds. Of this around £70 million remains undrawn. The undrawn figure again highlights the need to over-commit in order to reach the target allocation. Indeed the Bluebay fund is only a five year fund, with options to extend for a further two years, and so while the opportunity for further drawdowns remains, there is also a possibility of capital being returned. The private debt commitments comprise 1.8% of the total fund value, against a 2019/20 target of 2% and a medium term target of 3%.

3.3. It is therefore proposed to commit a further £100 million in order to bring the total investment up to 3% of the Fund. The Brunel Private Debt portfolio specification is attached as Appendix 1 to this report. The focus will be senior secured lending, which will be similar to the two funds currently invested in. This means that the loans are at the safer end of the capital structure of the companies borrowing the money. As with infrastructure, Brunel will then combine the Devon commitment with those received from other funds and seek opportunities to deploy the capital to appropriate private debt funds.

4. Private Equity

4.1. The Devon Pension Fund has no current allocation to private equity, although it was an area that Mercer included within their suggested 5% allocation to private markets, comprising private debt and private equity investments.

4.2. Private equity is a broad term that refers to any investment in privately owned equity i.e. not listed on a public exchange. Typical investments include the following:

- Buyout: Buyouts make up the largest strategy group in terms of the amount of capital and number of firms. The essence of a buyout is that the investor gains control of the company. The use of meaningful debt in the capital structure of such companies is a leveraged buyout. Sector specialists may be advantaged in this competitive market environment.
- Venture capital: A type of private equity that provides capital to new or growing businesses, often with limited revenue. Venture funds invest in start-up firms and small businesses with perceived, long-term growth potential.
- Special situations: Special Situations represents a catch-all category of strategies that do not fit into the venture capital or buyout sectors, including distressed and turnaround strategies that usually involve companies that have gone into decline.
- Secondaries: Involves acquiring existing interests in a private equity fund from an existing Limited Partner.

4.3. These can be very attractive investments, often producing higher returns than listed equity, and also producing an income yield that is attractive to funds such as the Devon Fund who need cashflow to meet pension payments.

4.4. A key risk with private equity investments is vintage risk. This is the risk that if the investment is made at the wrong point in the economic cycle then it may not achieve the desired outcome. Therefore private equity investments should be spread over different vintage years in order to diversify the risk. If a commitment is made to the Brunel Private Equity Portfolio, then that investment will be spread over a two year period. However, it would still be prudent for any commitment to be built up over a period of time.

4.5. Given the Brunel policy of providing a two year investment cycle with a deadline for client funds to make commitments, if the Devon Fund wishes to make an investment in private equity it will need to do so before 31 March 2020, or wait until the next commitment window in 2022.

4.6. Given Mercer's recommendation for a 5% allocation to private markets, and the 3% target allocation to private debt, it is proposed that the Fund targets an initial 2% allocation to private equity in the current commitment window, that could be reviewed in two years' time. Given the need to over-commit it is suggested that an initial commitment of £125 million is made. The Private Equity Portfolio specification is attached at Appendix 2.

5. Funding of Commitments

5.1. As previously agreed by the committee, the increase in private market commitments should be funded by reducing the allocation to diversified growth funds (DGFs). Mercer's recommendation was that the DGF allocation should be reduced and phased out over time, as Brunel should be able to provide all the different asset classes that the Fund currently gets exposure to from its DGF investments. The DGF allocation will also transition to Brunel in the next few months and whether a smaller allocation should be retained will be reviewed as it reduces in size.

6. Conclusion

6.1. As outlined above, it is proposed that the Devon Fund make additional commitments of £250 million to the Brunel Infrastructure Portfolio, £100 million to the Brunel Private Debt Portfolio and £125 million to the Brunel Private Equity Portfolio. These will be committed to be drawn down by Brunel during the period from 1 April 2020 to 31 March 2022.

Mary Davis

Electoral Divisions: All
Local Government Act 1972
List of Background Papers - Nil
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BRUNEL
Pension Partnership

PPD Private Debt

Portfolio Objective	To provide exposure to a portfolio of private debt instruments, offering reasonably attractive returns, primarily in the form of income, based on credit risks and the illiquidity premium.
Performance Target (net)	To outperform the benchmark by 4% p.a. over a rolling 3 – 5 year period.
Benchmark	GBP 3M LIBOR (will change to SONIA if LIBOR is discontinued or unreliable)
Investment Strategy and key drivers	The Portfolio will comprise a diversified set of private debt investments, aimed at providing moderately high returns primarily through income. Increasing regulation on banks has led to them withdrawing from significant sections of their traditional corporate lending markets, focusing on more secure lending. This has created an opportunity to provide direct lending to these companies at attractive rates, as long as investors are prepared to accept the lower liquidity and the more significant costs involved in finding and checking suitable private lending opportunities. The Portfolio will primarily be invested with specialist managers to achieve the fund objective. Managers will be selected to cover a range of market niches. Investments will be diversified by geography and by sector and may be denominated in a range of currencies. Currency exposure will only be hedged if possible at the fund vehicle level.
Risk/Volatility	Absolute risk/volatility: Moderate to high. Relative/Active risk: Moderate to high.
Liquidity	Illiquid. Investments are likely to be fundamentally illiquid in nature, with no ability to request early realisation. Some cash returns may come from the relatively rapid payback period of many loans (c. 3 years). There is likely to be some secondary market assuming the loans are performing as expected.
Income	Income could potentially be paid out, although income and capital are often combined in fund distributions.
Investment Styles	The Portfolio is likely to have significant exposure to the credit cycle, although actual return experience will be driven by specific default experience. The portfolio is expected to have limited interest rate sensitivity (“Duration”). Senior and/or secured loans will make up a significant proportion of the portfolio, although there will be scope to invest in more junior parts of the capital structure. Structured credits and credit based on traditional royalty streams could also be considered for this portfolio.
Responsible Investment	In accordance with Brunel’s policy. As a minimum, managers will be expected to consider ESG risks and sustainability when evaluating and monitoring investments.

	Where possible, carve-outs or exclusions will be sought by Brunel from areas of concern, although this will not always be possible given the commingled nature of most Funds.
Reporting	In accordance with the Reporting and Monitoring Framework.

BRUNEL
Pension Partnership

PPE Private Equity

Portfolio Objective	To provide exposure to a portfolio of private equity investments, offering potentially exceptional net returns, albeit with high risk, illiquidity and high costs. Impact investment will be considered, subject to meeting the return objective.
Performance Target (net)	To outperform the benchmark by 3% p.a. over a rolling 7 – 10 year period.
Benchmark	MSCI ACWI Index.
Investment Strategy and key drivers	Private equity historically has offered very good returns, benefitting from the illiquidity premium and active long-term governance. Costs however, can significantly undermine long-term returns. Private Equity will be broadly defined and may include higher risk return investments in areas such as infrastructure and property (development). Investments will include a mix of Private Equity investment strategies (Co-Investment, Secondary and Primary funds) and stages (including but not limited to 'Buyout', Growth', 'Venture' and 'Turnaround'). The portfolio will be global in outlook in search of a diversified set of opportunities, with an average lifecycle of 10 – 15 years. New opportunity sets will be identified at least annually. The aim is to provide significant capital growth for the investor with funds returned over the lifecycle of the investments. Currency is unlikely to be hedged.
Risk/Volatility	Absolute risk/volatility: High to very high. The illiquid nature of the investment may create an illusion of lower short-term volatility, but values are significantly influenced by the equity market. Relative/Active risk: High. Manager skill can vary substantiality, and good outcomes depend on finding the best managers.
Liquidity	Illiquid. Investments will be fundamentally illiquid in nature and should be expected to be held for the 10 -15 years life of the investment with no ability to request early realisation. There is likely to be some secondary market for some of the assets in the portfolio.
Income	Income is not expected to be a major part of the returns and usually combined in fund distributions.
Investment Styles	Diversified.
Responsible Investment	In accordance with Brunel's policy. As a minimum, managers will be expected to consider ESG risks and sustainability when evaluating and monitoring investments. Where possible, carve-outs or exclusions will be sought by Brunel on behalf of all Clients from areas of concern, although this will not always be possible given the commingled nature of the Funds
Reporting	In accordance with the Reporting and Monitoring Framework.