AllenbridgeEpic
investment advisers

APPENDIX 1

REPORT PREPARED FOR

London Borough of Bromley Pension Fund – Phase 3

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Phase 3 of Revised Strategy

The Third Phase of the investment reorganisation that of reorganising the fixed income assets and investing a percentage of these assets with investment managers offering funds which have an "illiquidity premium", continues. The latest update is provided below.

Why invest in illiquid assets?

What percentage should be invested?

From where should any investment be funded?

In my paper dated 31 July 2014, (copy attached), I highlighted various opportunities whereby investment returns could be potentially improved by allocating a percentage of the current fixed income assets to investments which contained an "illiquidity premium".

The PISC, whilst not rejecting the concept, felt that an investment of up to 50% (£60m approx.) of the strategic allocation to fixed income might be too high and that they would wish to review the percentage further. After some discussion it was agreed that AllenbridgeEpic should conduct further research into assets matching the criteria contained in the paper, and to report back to Committee at its next regular meeting (2 December 2014).

The fund value at the end of September 2014 was £655.9m and the allocation to fixed income had a value of £109.6m (16.7%). This is currently underweight the long term strategic benchmark of 20% (£131.2m).

Why invest in illiquid assets?

Key benefits

Enhanced returns which can deliver predictable cash flows at returns higher than those currently available in the sovereign credit markets

Inflation protection generated by cash flows contractually obligated to move with inflation measures
Longer investment horizons which can enable pension funds to meet longer term liabilities whilst giving them some inflation protection and enhanced returns.

Illiquidity risk is implicit in the above positive comments. The assets described in the table on page 3 of my previous paper have limited or seriously limited liquidity. This point should be taken into account when discussing any allocation to these assets.

Key risks and mitigators

Liquidity risk: The pension fund may be faced with an unforecasted need to pay out benefits, possibly due to a change in government/LGPS regulations, or a transfer out of the fund of assets related to an admitted body or bodies, or even a Council driven voluntary redundancy programme. The need to free up cash or sell assets could incur costs or disrupt the investment strategy. This is known as liquidity risk.

In light of the long term nature of these investments, it is necessary to balance this requirement with an appropriate allocation or predetermined action with the Fund's ability to meet unforeseen liability transfers.

Uncertain cash flows: Opportunities should be assessed cautiously to determine the level of security and certainty in the cash flows. Risks include, but are not limited to, flexibility for the issuer to change the terms, risk of early redemption, cash flows linked to prices or production, or any uncertainty in cash flow timing. Assets that do not have the desired characteristics may nevertheless have a useful role to play, providing the Committee has a clear understanding of that asset's nature and risks.

Mitigators

The fund currently reinvests dividend income from equities and the regular coupon payments from fixed interest assets.

Changing this current policy to one of regular distributions would assist in cash flow management.

An appropriate allocation of assets to illiquids is unlikely to create a liquidity crisis within the fund given the current allocations to equities and high quality fixed income assets which could be sold in a matter of days to meet an unforeseen demand. ***It is also unlikely that a call of such magnitude would be unforecasted and not capable of being managed in a professional manner.***

What percentage of assets should be invested?

An allocation to illiquid assets must satisfy the Committee appetite for both diversification and risk and whilst illiquid assets have higher return expectations (the illiquidity premium") the Committee must feel comfortable with the allocation.

In supporting a proposal for an allocation to illiquid assets there is much empirical evidence within local authority pension schemes for this "asset class" with many funds having allocated to property assets, some to social housing projects and other to infrastructure. In addition, many schemes have allocations to private equity.

A statement such as 50% of the fixed interest long term strategic asset allocation is, in some ways misleading, as the 50% allocation is against the overall 20% allocation at total fund level and in Bromley Pension Fund's case would equal just 10% of total fund assets.

At the 40% level this equates to exposure at total fund level of 8% (£52m)

At the 30% level this equates to exposure at total fund level of 6% (£40m)

Options for funding investments are discussed in a Part 2 Appendix.

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