SOUTH YORKSHIRE
PENSIONS AUTHORITY

Subject	**Approval of Border to Coast Investment Mandates**	**Status**	For Publication
Report to	Authority	**Date**	13 June 2019
Report of	Head of Investment Strategy		
Equality Impact Assessment	Not Required	Attached	No
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1. Purpose of the Report

1.1 To secure approval for the investment mandates for the next round of Border to Coast Investment mandates.

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2 Recommendation(s)

2.1 Members are recommended to:

a. Approve the investment mandates for the following Border to Coast products as set out in the body of this report:
  i. Infrastructure
  ii. Private Debt
  iii. Multi-Asset Credit
  iv. Index Linked Gilts

b. Agree, in principle, a commitment to the Investment Grade Credit fund subject to the results of further due diligence following the completion of procurement for this fund.

c. Note that the level of commitment to the Fixed Income products will be determined at the time of launch by the Head of Investment Strategy having regard to the Strategic Asset Allocation under existing delegation arrangements.

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3. Link to Corporate Objectives

3.1 This report links to the delivery of the following corporate objectives:

Investment Returns

To maintain an investment strategy which delivers the best financial return, commensurate with appropriate levels of risk, to ensure that the Fund can meet both its immediate and long term liabilities.

Alternatives and fixed income are likely to form key elements of the revised investment strategy which will be considered later in the year given the increased focus required on the generation of investment income and the impetus to de-risk given the improved funding level.

Responsible Investment

To develop our investment options within the context of a sustainable and responsible investment strategy.

The responsible investment policies collectively agreed by the 12 Border to Coast partner funds which have been significantly influenced by the Authority apply equally to all these mandates and in relation to the fixed income mandates will form a key part of the assessment process for managers responding to the procurement exercise. Actively applying responsible investment policies to these asset classes represents a significant development reflecting the greater resources which Border to Coast can bring to bear on these issues.

4. Implications for the Corporate Risk Register

4.1 The actions outlined in this report specifically address the identified risk that Border to Coast does not develop products which meet the requirements of the Authority's investment strategy.

5. Background and Options

5.1 Border to Coast have now reached a stage in developing the mandates and investment structures for the next round of products to be launched covering the remaining alternatives asset classes and various fixed income products. In the same way as has been done for previous products this report sets out the detail of these mandates for endorsement prior to officers undertaking the work necessary to transition assets or make new investments in the new structures.

Infrastructure

5.2 As an asset class infrastructure covers a very wide range of types of investment from railway rolling stock to sewage works and, under the definition used by the Government, housing. This asset class has been an increasing focus of investment within SYPA's Alternatives Portfolio in recent years, as reported to the Investment Board in October the intention is to commit an increased sum to this asset class in order to achieve a level of investment consistent with the Strategic Asset Allocation.

5.3 The broad mandate proposed by Border to Coast is summarised in the table below:

Strategy	Proposed Range[1]
Core (income generation and some inflation linkage)	30 –60%
Core+ (both capital growth and income generation with some inflation linkage)	20 –50%
Value Add/Opportunistic (capital growth with limited inflation linkage	10 –30%

Geography	Proposed Range[1]
North America	20 –40%
Developed Europe (inc. UK)	40 –60%
Asia	10 –30%
Rest of World	0 –20%

Exposure	Maximum Commitment[1]
Single Direct Fund	10%
Single Fund of Funds	20%
General Partner (or Affiliate)	25%
Single Co-investment	5%
Listed investments	10%
Non-OECD countries	25%

1. Indicative ranges based on a total commitment over a 3 year period.

5.4 These proposed ranges provide a balance of investment in infrastructure equity (not debt) between geographies and strategies with the aim of achieving an absolute return of at least 8% over the long term.

5.5 Because of the nature of the fund raising cycle for infrastructure Border to Coast intend to begin making commitments to new infrastructure investments before this summer.

5.6 As previously reported Border to Coast anticipate that because of the greater scale of investment that they will be making and because of a greater ability to consider co-investment that fee savings relative to market norms will be achievable.

Private Debt

5.7 Private Debt covers a number of different types of transaction and tends to be run through closed end funds in the same way as private equity and infrastructure. By its very nature it represents a higher risk appetite and therefore return expectation than other debt related asset classes such as the various forms of fixed income. This mandate will form part of the Border to Coast Alternatives structure.

5.8 The aim of the mandate is to achieve an attractive risk-adjusted return based on a combination of current cash yield and to a lesser extent non-cash yield and repayment of principal over the medium term by investing in a diversified global portfolio of third party private credit opportunities and co-investments.

5.9 As with any investment mandate a range of limits are proposed which ensure that there is an appropriate level of diversification in order to manage risk. However, these limits also have to respect the availability of product in the market. The proposed limits are set out below:

Strategy	Proposed range1
Direct Lending	30 –80%
Property/Infrastructure	0 –50%
Mezzanine/Speciality	0 –30%
Stressed/Distressed	0 –30%

5.10 **Direct lending** involves loans to companies which as they are invested into what are termed the senior level of the capital structure are more secure than some other types of investment, hence the greater proposed exposure.

5.11 **Property/Infrastructure** strategies are essentially mortgages usually involving lending on commercial property or the building of assets such as airports.

5.12 **Mezzanine/Speciality** loans tend to be more complex structures and/or investments in the more junior (and therefore less secure) parts of the capital structure. While potentially higher risk investments the effectiveness of the manager's credit underwriting is a key part of the risk management process.

5.13 **Stressed/Distressed** are loans where a counterparty is in a stressed situation. In these cases there is often a mis-pricing of the risk involved in the transaction which creates the investment opportunity. Again the quality of the underwriting process is key.

Geography	Proposed range1
North America	30 –70%
Developed Europe (inc. UK)	20 –50%
Asia	0 –20%
Rest of world	0 –10%

Exposure	Maximum Commitment[1]
Single Fund	15%
General Partner (or affiliate)	25%[2]
Single Co-investment	5%
Listed	10%

1 Based on total estimated commitments over a 3 year period and calculated at the point of commitment.
2 Based on a potentially shorter fund raising cycle with potential overlap during a 3 year cycle

5.14 The performance target will be set as an absolute return which will be calculated as a premium above base rate.

5.15 In terms of responsible investment it is more difficult in the credit space for fund managers to exert influence as they are not owners of the investee companies. However, Border to Coast will be requiring reporting from fund managers on at least an annual basis, will be writing specific RI commitments into investment agreements and will be following up breaches. While previously SYPA did examine fund managers policies in relation to RI this is a much more active approach than was previously possible.

5.16 As with the other alternative asset classes it is anticipated that fee savings will be generated through the greater scale of individual investment and the identification of co-investment opportunities.

5.17 Private debt offers investors the opportunity to access different parts of a company's capital structure while still achieving attractive returns. It has formed a key part of SYPA's Alternatives portfolio and it is proposed, as reported to the Investment Board in December, to maintain investment through the Border to Coast structure at the same level as previously. The intention is that Border to Coast will begin making commitments to private credit funds in the autumn. Given the much more even pattern of fund raising in this asset class this should not pose any difficulties for the Authority.

Investment Grade Credit

5.18 Investment Grade Credit is the first of the three fixed income products which Border to Coast are currently developing. This mandate is analogous to the Authority's current mandate with Royal London. The mandate will invest in higher quality bonds issued by corporate entities, using a low turnover approach. Given the acknowledged weakness of corporate bond indices the procurement process is intended to identify managers whose process does not pay regard to any index but instead selects bonds solely on the basis of credit quality and duration.

5.19 This product will be offered as a sub fund within the existing Authorised Contractual Scheme (ACS) with a number of managers with complimentary approaches aiming to achieve a target which outperforms a credit benchmark by around 0.6% over five years. This combination of characteristics would very much indicate that the managers appointed are likely to be running strategies very similar to that currently being provided by Royal London.

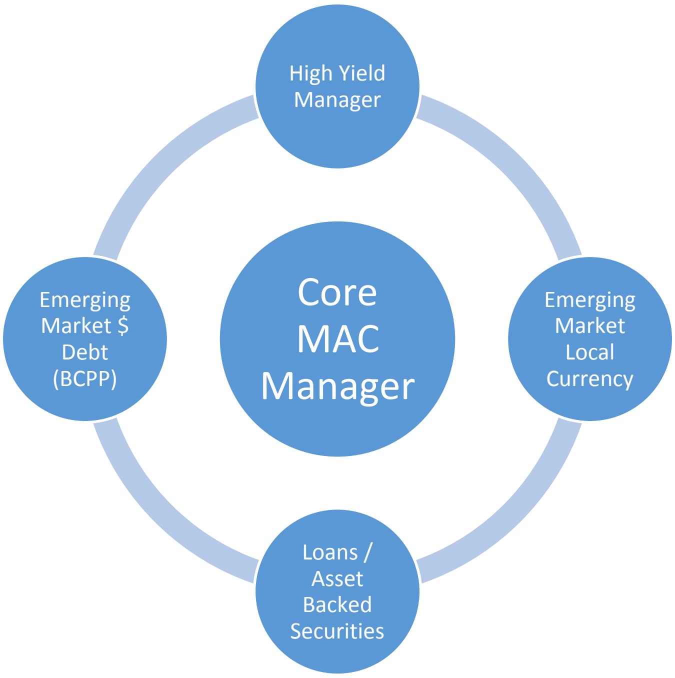
5.20 Officers and advisers have discussed this product at length and will be having further discussions with Border to Coast prior to this meeting of the Authority. Advisers feel very strongly that the "buy and maintain" approach currently provided by Royal London delivers a cost-effective and successful approach to an asset class that has previously proved problematic for the Authority. Consequently advisers are concerned that the procurement process which Border to Coast has to engage in may result in a combination of managers which delivers something other than a "buy and maintain" strategy. In particular advisers are concerned about the ability to deliver a product where the underlying managers genuinely ignore an index and simply use it for reference reporting purposes.

5.21 It is clear that further due diligence is required on this area before a decision to invest can be made. However, it is clear that investment grade credit is likely to form part of the strategic asset allocation following the strategy review, although the scale of the allocation may well change. For this reason it is intended to make a commitment in principle to this product with a final decision following the procurement process when it will be possible to make a judgement on the results likely to be delivered by the actual combination of managers and the costs involved relative to the cost of the current mandate. Other partner funds have taken a similar approach to other products and this does not delay the necessary work which Border to Coast need to undertake.

Multi-Asset Credit

5.22 Multi-Asset Credit (MAC) is a sub asset class comprising a wide range of different fixed income products. The Authority's current Emerging Market and High Yield Bond portfolios fall within the scope of the proposed MAC mandate. Previously the Authority has not had the internal resources or the scale necessary to invest in other types of assets which form part of the MAC universe and therefore pooling opens up an opportunity set which the Authority could not previously access.

5.23 The diagram below sets out the proposed core/satellite structure of the MAC mandate which will be structured as a sub fund within the existing Authorised Contractual Scheme.



5.24 This approach will allow the Core MAC Manager to determine the credit allocation within their sleeve and input to Border to Coast who will make decisions regarding any tactical (re)allocations between the various sleeves. As well as the asset classes identified above the opportunity set will include leveraged loans and there will be the option in limited circumstances to take exposure to investment grade and sovereign debt. The detailed investment restrictions will be developed with the Core Manager once appointed, this will be followed by the appointment of the various satellite managers.

5.25 The current design assumes that the Emerging Market $ Debt mandate will be managed internally by Border to Coast. As well as allowing Border to Coast to make full use of the internal capabilities inherited from partner funds this will reduce the blended fee for the overall product generating savings for those funds previously operating in the MAC space with only external managers. For SYPA the move from a wholly internally managed position to a hybrid of internal and external management will increase costs. However, this is not a like for like comparison as SYPA did not previously invest across the full range of assets involved in MAC and to do so would have required incurring external fees.

5.26 The performance target for the long term will be based on a spread of 3-4% over a benchmark interest rate, which should be sufficient to meet actuarial assumptions.

5.27 In the first instance it is assumed that the assets in the current high yield and emerging market bond mandates will transfer into the MAC sub fund. The final level of allocation will clearly depend on the results of the investment strategy review, as this is an asset class where income can be relatively easily harvested in order to meet the cash flow requirements of the Fund.

Index Linked Gilts

5.28 Index linked gilts represent the most traditional of the fixed income sub asset classes and Border to Coast are currently proposing to offer an internally managed ACS sub fund with a modest out performance target of 15-25bps and the opportunity to hold off benchmark positions in corporate and supra-national index linked bonds in order to generate this excess return. Final details in terms of the overall duration of the portfolio remain to be finalised but there is a general acceptance that this should be as long as possible, which mirrors the current position for most partner funds. This proposal therefore broadly mirrors the mandate for SYPA's current index linked allocation and it is hoped that the low fees attached to what is still an actively managed mandate will encourage some movement of other funds passive allocations into this product. Because a significant proportion of current allocations (across all partner funds) are being used as collateral for equity protection strategies it will not be possible to launch this product until the latter part of 2020 when it is clear exactly the scale of assets which could transfer after partner funds have made decisions about whether or not to continue equity protection strategies as part of their investment strategy reviews.

5.29 In relation to the various fixed income products the Head of Investment Strategy will determine the amount of assets to either transition into or invest into each fund, taking account of the strategic asset allocation at the time and the findings of the Investment Strategy Review when available. This reflects the current delegation arrangements.

6. Implications

6.1 The proposals outlined in this report have the following implications

Financial	The fees charged in relation to the fixed income products are likely to be somewhat higher than those of the existing mandates, given the involvement of more external management. However, the return target is somewhat greater and if this is achieved it is felt that this will negate any fee increase. In relation to the alternatives mandates it is expected (as reported to the Investment Board in December) that Border to Coast will be able to negotiate some fee savings in comparison to fee levels achievable by the Authority acting alone. At this stage no estimate has been (or can be) made of the benefits delivered by the superior risk adjusted returns which were expected to be a key benefit of the pooling process and which would be expected to outweigh the cost increases caused by the move away from a wholly internally managed position. The transition of fixed income assets will be a particularly complex exercise with associated explicit and implicit costs, which could impact on performance. The details of these costs and their impact will be reported on following the completion of the transition.

Human Resources	None
ICT	None
Legal	The legal structures for the Alternatives products have been subject to external legal review on behalf of the 12 partner funds which raised no fundamental issues. The fixed income products will be additional sub funds of the existing Authorised Contractual Scheme (ACS) and therefore while there will need to be a review of the detailed prospectus for each fund no fundamental legal issues are raised by extending this structure.
Procurement	The procurement of managers for the Fixed Income mandates will be conducted through processes compliant with the relevant regulations. In relation to the Alternatives mandates fund selection is not a procurement and therefore it is a matter that remains at the discretion of Border to Coast as the fund manager.

Sharon Smith

Head of Investment Strategy

Background Papers	
Document	**Place of Inspection**
None	