SOUTH YORKSHIRE
PENSIONS AUTHORITY

Report of the Member Working Group on Impact Investment

February 2023

Contents

Acknowledgement

The Member Working Group would like to acknowledge the work of Pensions for Purpose in facilitating its meetings and the contribution to its deliberations made by officers of the South Yorkshire Mayoral Combined Authority and the Border to Coast Pensions Partnership.

Introduction

At its Annual Meeting in June 2022 the Pensions Authority determined to form a Member Working Group on Impact Investment with the Terms of Reference set out at Appendix A. The Working Group was a response to two different but complimentary pressures.

1. The requirement set out in the Government's "Levelling Up" White Paper for LGPS funds "to publish plans for increasing local investment including setting an ambition of up to 5% of assets invested in projects which support local areas."

2. A desire by elected members and the South Yorkshire Mayor to achieve more local impact from the Pension Fund's investments.

Both these pressures are set within the context of the Authority's fiduciary responsibilities which are to ensure that funds are available to pay pensions when they fall due which is achieved by delivering investment returns that at least match the assumptions made by the actuary.

This report sets out the work undertaken by the Member Working Group and its recommendations which will be incorporated into the Authority's Investment Strategy Statement.

The Member Working Group and Its Process

The Membership of the Working Group was as shown below:

Barnsley MBC	Doncaster CC	Rotherham MBC	Sheffield CC
M Stowe	D Nevett	D Fisher	A Dimond
			A Sangar
			G Weatherall

The Group worked through a programme of meetings as set out below:

Date	Objective
23rd September 2022	Introductory session understanding impact investment
26th October 2022	"Levelling Up" the investable opportunity and the Fund's current exposure
14th December 2022	Discussion with SYMCA Officers about sub regional priorities and input from Border to Coast in relation to their developing thinking
17th January 2023	Agreement of priority impacts
15th February 2023	Sign off of final report for the Pensions Authority

The meetings of the Working Group were facilitated by Charlotte O'Leary and Martin Pattinson from Pensions for Purpose. Pensions for Purpose is an impact investment knowledge sharing platform which is supported by the Pensions Authority. As well as bringing expert knowledge of the impact investing marketplace and the art of the possible to the Working Group the use of an external facilitator meant that the Authority's Officers were not steering members' debates. The Authority's Director and Assistant Director – Investment Strategy supported the work of the Group.

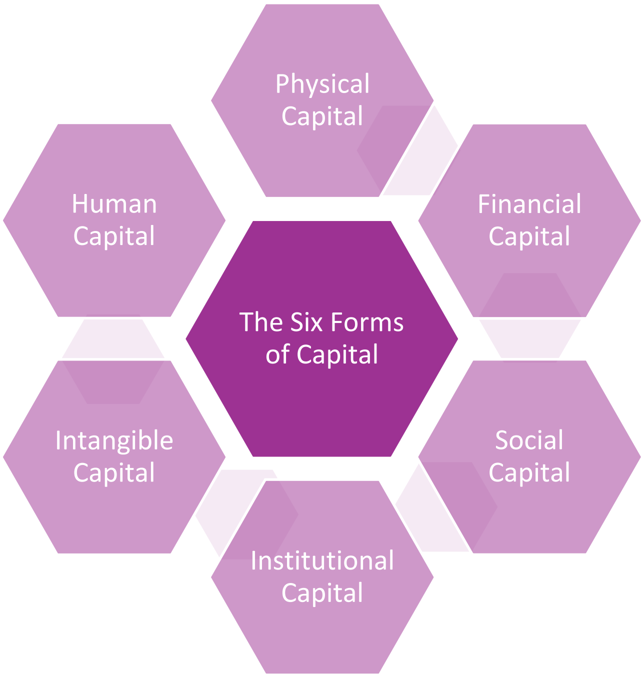
Attendance by members at meetings of the Group was as shown below:

	23/09/22	26/10/22	14/12/22	17/01/23	15/02/23
A Dimond	✓	✓	✗	✗	✗
D Fisher	✓	✓	✓	✓	✓
D Nevett	✓	✓	✓	✓	✗
A Sangar	✓	✓	✗	✗	✓
M Stowe	✓	✓	✓	✓	✓
G Weatherall	✗	✗	✗	✓	✗

The materials from these meetings have been made available for all Authority members in the online reading room.

Levelling Up and Pension Fund Investment

"Levelling Up" is the term used by the Government for a programme of activity intended to address deep seated regional inequalities, which negatively impact both the overall economic performance of the UK but also the life chances of people living in specific parts of the country. The White Paper setting out the Government's programme in this area identifies six forms of capital in which investment is required in order to achieve the various "levelling up" missions which are identified as objectives for 2030. These are shown in graphic below:



Some of these forms of capital represent things which a pension fund can invest in, for example new factories, housing, or business start-ups while others such as improving the level of skills or roads and bridges really require action by individual businesses or the state (whether local or national).

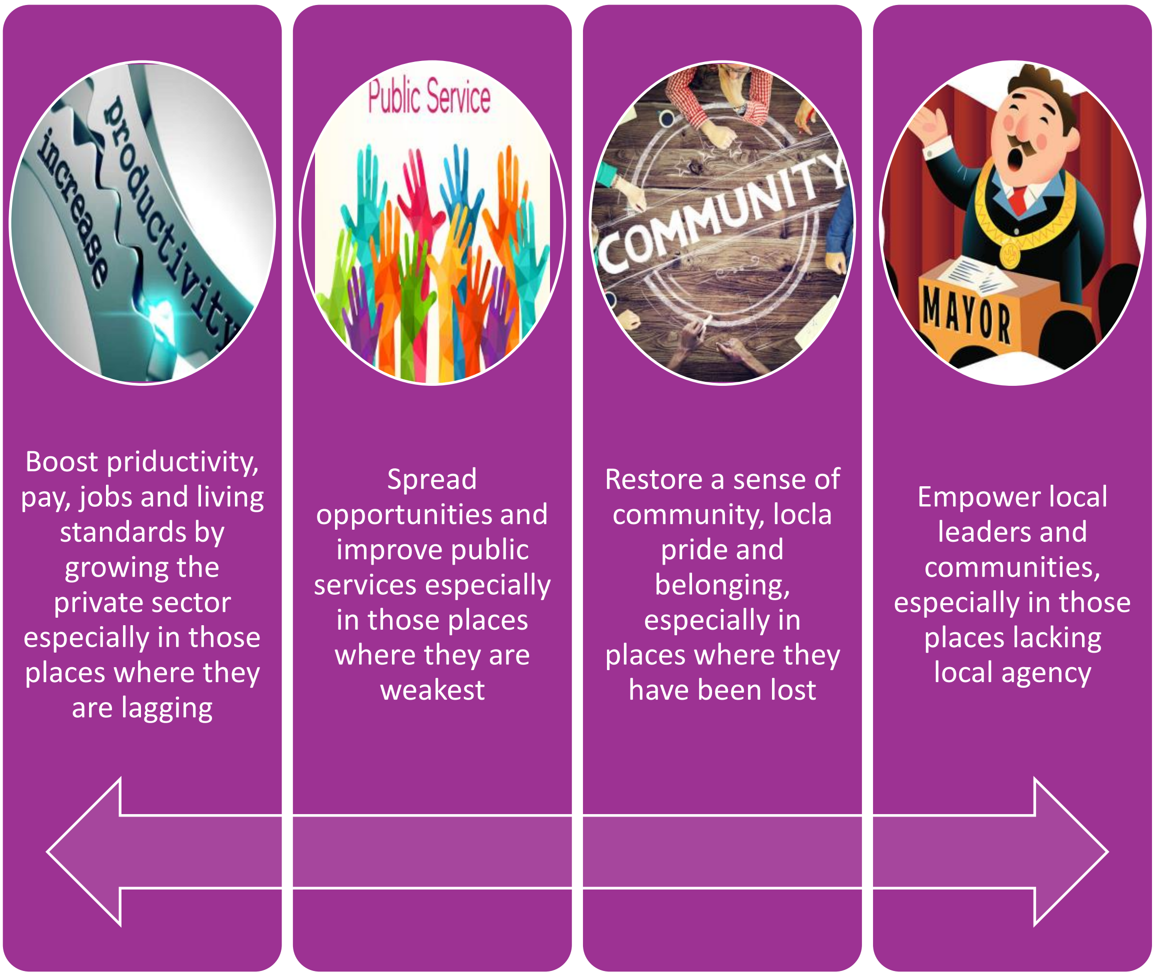
In simple terms institutional investors such as the Pension Fund can invest in:

- **Physical Capital** – Either through owning or financing the development of physical assets.
- **Financial Capital** – Through the provision of either equity or loan capital to businesses
- **Intangible Capital** – Through investment in venture capital and start-ups which capture innovation.

It is also possible to invest in some forms of social capital depending on how it is defined or viewed, for example the Authority has an investment in a fund which manages cemeteries and crematoria, which could be viewed as social capital, although it might equally be viewed as a property investment making it a physical capital investment.

All of these types of investment can give returns which meet the Authority's required rate of return within the current risk appetite, which is, of course, the Authority's overriding investment objective.

So, there are types of investment that the Pension Fund can make which will support “levelling up”, but if these are genuinely going to support the process then each investment will in some way need to address the various “levelling up” missions and the underlying longer-term objectives. The missions are:



So, the conclusion is that there are some opportunities for the Pension Fund to find return through addressing the types of capital required for “levelling up” if that capital can be focussed in the right places. In addition the types of investment that could be made are within the scope of the current investment strategy and strategic asset allocation,, meaning that allocating to investments focussed in some way on “levelling up” does not mean a change in the Authority’s overall investment strategy. Thus, this is simply SYPA seeking new places to find the required returns (business as usual) which coincidentally meets the “ask” from government.

Investing to Achieve "Levelling Up" in Places

A focus on "levelling up" in addition to return in relation to any investment requires two additional lenses to be added to the toolkit for analysing any investment opportunity, the first is does it achieve an impact in relation to one of the "levelling up" missions and the second is does it achieve that impact in a place which requires such investment in order to address its entrenched inequalities. So, in essence the "ask" from government of the Local Government Pension Scheme in relation to "levelling up" is to allocate some funds towards what is called "Place Based Impact Investment" (PBII).

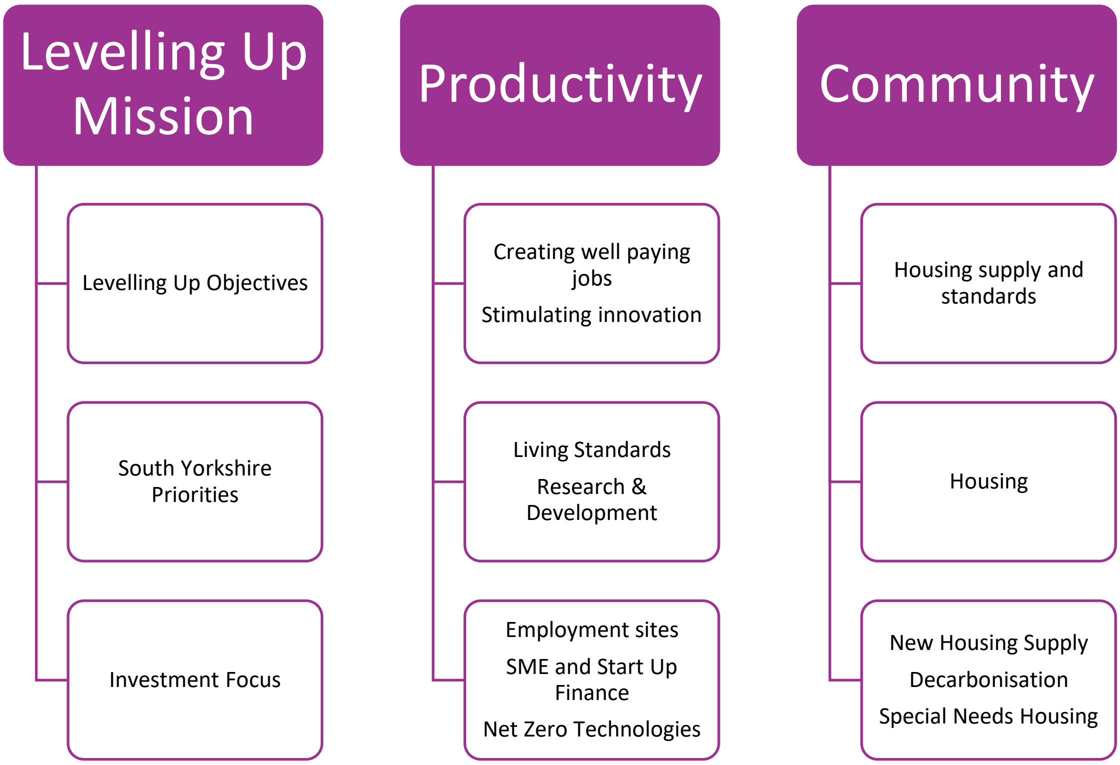
However, with many investments it is not possible up front to specify the geography over which capital will be deployed, for example a venture capital fund may not have a full pipeline of identified deals when it is raising funds. Equally there are some types of investment where it would not be appropriate from a risk point of view for all the assets to be concentrated in one geography. So, while members might want to prioritise investment in South Yorkshire there may be very good reasons why fund managers do not want to be restricted in this way. It is also the case that some investments outside South Yorkshire can have benefits for the area, for example improving the port infrastructure at Immingham might provide better export access for South Yorkshire business.

The debate in the Working Group was clear that there is a desire to prioritise investment in South Yorkshire within any allocation towards PBII, although there is an acceptance that where we are investing in managers' product we will not be able to dictate this although we might be able to negotiate what are called "sidecar" arrangements to maximise the Authority's share of the genuine local exposure. Equally there may well be some funds with a slightly wider geographical footprint including South Yorkshire that we would wish to support. An example of this would be the Northern Gritstone Fund which invests in university spin out companies including those from the University of Sheffield (we have not invested in this fund due to being over allocated to Private Equity, but would have done had this not been the case).

There are a number of ways which a goal in relation to place could be framed and more work is required to work out the art of the possible given the starting position (see below) but it would need to be set on the basis of gradually ratcheting up South Yorkshire exposure as existing investments are realised and capital can be redeployed in a more targeted way.

Beyond the issue of geographical targeting there is the question of what particular impacts the Authority would like to achieve through this form of investment and how they relate to the levelling up missions and the attached metrics.

Discussion within the Working Group identified the following as being potential areas of focus. These focus on the two "levelling up" missions, productivity, and community, which are more obviously investable. However, there may well be second order impacts on objectives which contribute to the other missions, for example housing investment or regeneration type investment such as the Authority's support for Little Kelham and Eyewitness Works might positively impact on the sense of civic pride. The graphic below also shows how these areas of focus link to the priorities identified by the South Yorkshire Mayoral Combined Authority in their presentation to the Working Group.



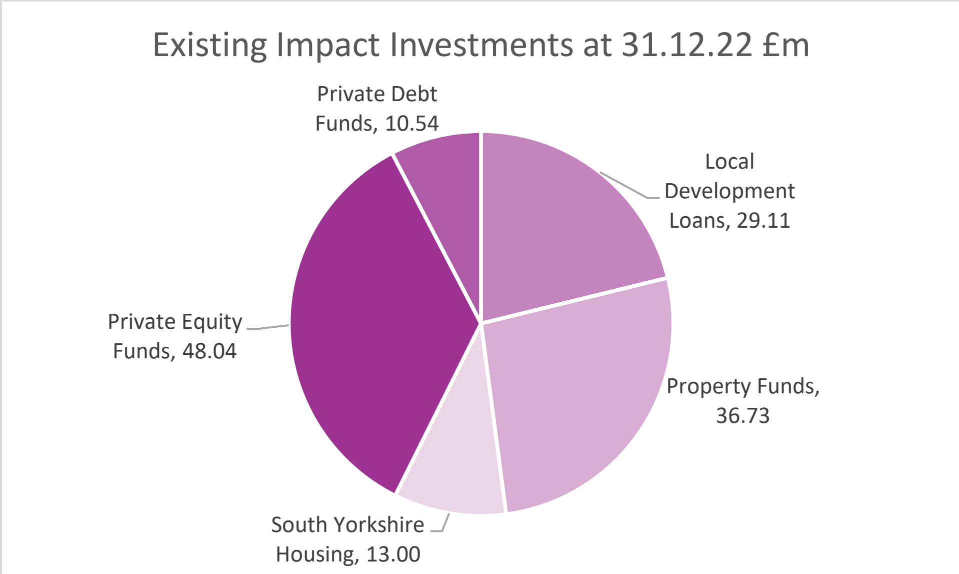
This illustrates the fact that it should be possible to develop a portfolio of investments which has a positive impact on the "levelling up" missions while also addressing specifically South Yorkshire priorities while still achieving the Authority's expectations in terms of return.

It is also important to note that these types of investment are within the Authority's existing risk appetite as they are types of investment that we already make. This is important because the overall level of investment risk we are prepared to take should not be altered if we alter how we make particular types of investment.

However, we are not starting with a blank sheet of paper as set out in the next section.

The Starting Point

As at 31st December 2022 existing impact focussed investments within the various alternatives portfolios and the property portfolio totalled £137.42m in drawn cash made up as shown below



This portfolio consists of 22 different investments made across vintages from 2010 to date (more details are in Appendix 2). These represent around 1.5% of the Fund rising to 2- 2.5% when undrawn commitments are considered.

While these funds were not chosen because of a more local South Yorkshire impact there will be some and they were selected in the first place because their impact focus gave a differentiated source of return.

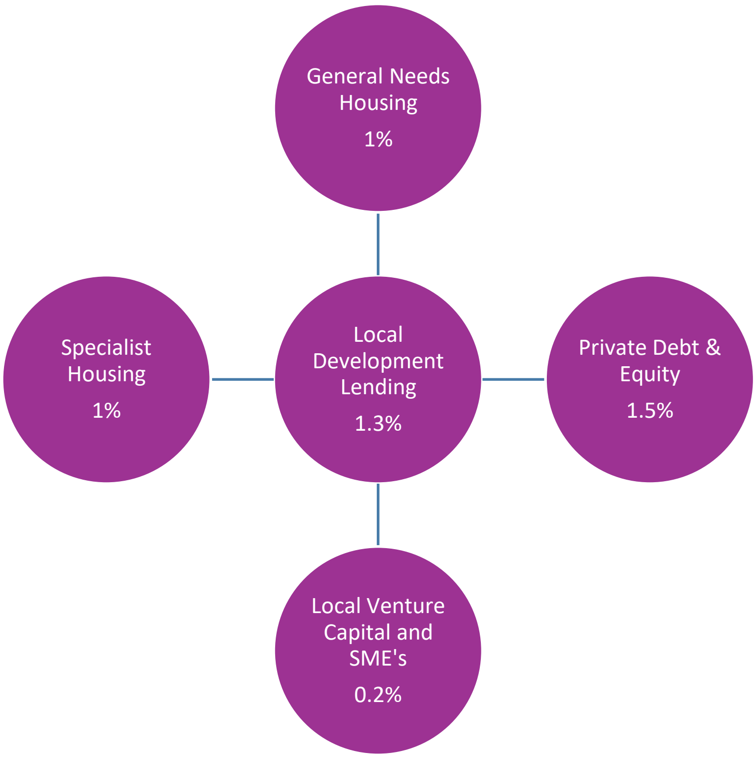
Therefore, it seems sensible to use this portfolio as the basis for building a more structured impact portfolio, with a clearer, though not entirely, South Yorkshire focus. This will mean that as the existing funds are realised resources will be reinvested in new funds selected to meet the new portfolio brief. This will avoid the so-called J curve effect that is present as investments of this sort build up and are gradually drawn down, and is a realistic and pragmatic approach to portfolio reconstruction in the alternatives space.

Following from this, however, is a need to arrive at a brief for the optimum make up of an impact portfolio which addresses the priorities identified by the Working Group.

Designing a Place Based Impact Portfolio

The approach outlined to designing a Place Based Impact Portfolio is to build on the specifically place based investments which are already in place.

The design outlined below looks to create a portfolio built around the core of the existing local development loans portfolio and then make specific “satellite” allocations both with a specific South Yorkshire focus and where we will look to work with fund managers to secure additional South Yorkshire exposure through sidecars or other similar arrangements. The intention is to create a sufficiently diversified portfolio of investments across types of assets with some income generation to address the Pension Fund’s cashflow requirements. This design assumes an aspiration to move to the 5% of the Fund that is identified by the Government.



Within this portfolio the local development lending, general needs housing and local venture capital allocations (the spine in the centre of the above diagram) would be expected to be wholly South Yorkshire focussed while in the other elements we would look to work with managers to “tilt” their exposures in some way. The two housing allocations and the local development lending allocations would be expected to generate regular income

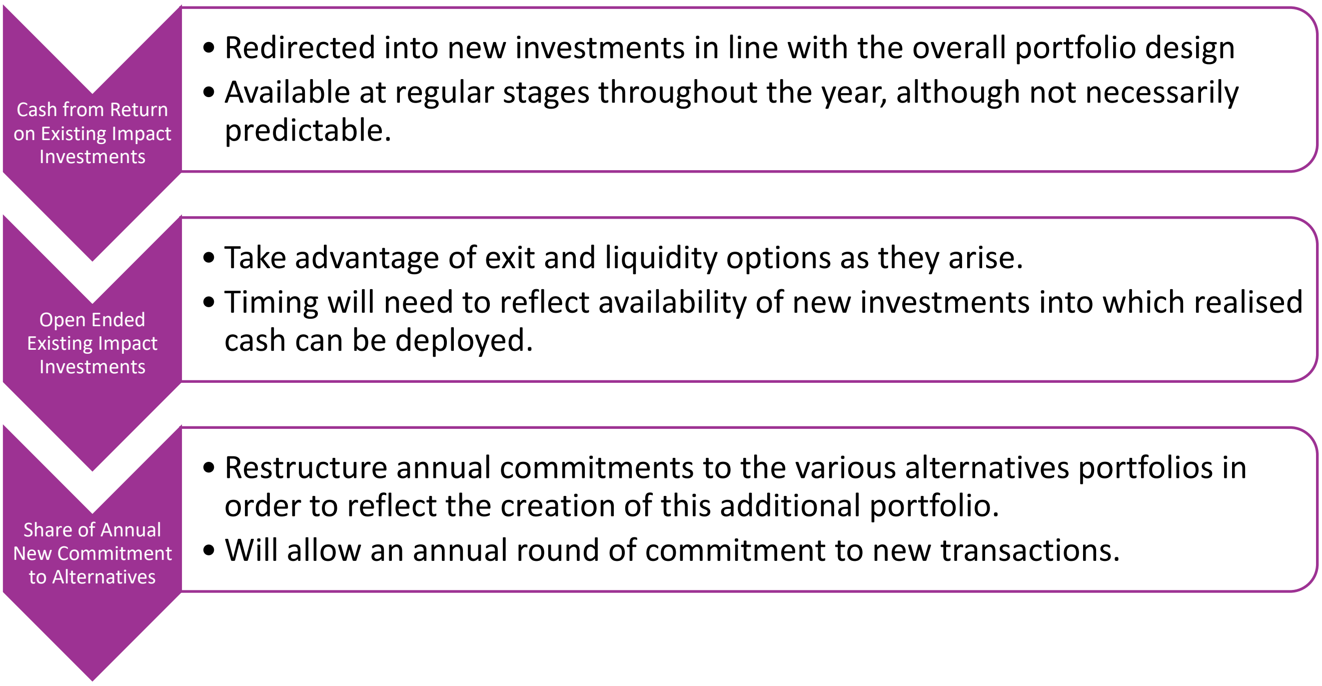
The Local Venture Capital and SME allocation is set deliberately low, at this point, as this will start as a pilot project with the possibility of growing over time. This would require the Authority to appoint a fund manager for the allocation. In an ideal world other local actors would invest in a fund structure of this sort alongside the Authority, although this need not be a pre-condition. A pilot is proposed in this area for a number of reasons. Firstly, it is not clear what the level of demand for this type of capital is and secondly, we currently do not have sufficient information on the risk/return characteristics of the underlying investments in such a fund to understand the level of downside risk. Ultimately if a pilot exercise is successful this element could be scaled up and the generic private debt and private equity portfolio reduced. This allocation could provide an opportunity to specifically target investment in businesses which are supporting the Net Zero transition.

A similar approach could be taken to the General Needs Housing allocation. In this case while we already have some South Yorkshire exposure this is limited to a fortuitous extension of a previous investment. Cornwall Pension Fund have a model here involving the appointment of an external manager which could potentially be applicable to the South Yorkshire context.

In general terms these investments will be outside of the pooling structures. However, in order to achieve the goal set out in the pooling guidance of having no more than 5% of assets invested outside of the pool and given that at least 1% of other assets will be outside of the pool longer term there is a need to accommodate some investment within this overall portfolio in the UK Opportunities product being developed by Border to Coast. This would provide some diversification within the Private Equity and Private debt element of the portfolio and would also allow the Authority to continue to influence the development of this product and in particular its impact objectives. The forthcoming consultation on LGPS Investment Matters may also provide an opportunity to debate issues of this sort in order to achieve greater clarity on what is and is not “pooled” and “poolable”.

Implementation

Implementation of a new distinct allocation of this sort cannot be a simple one-off transition as would be the case for a new listed equity mandate. Our existing impact investments are held in a range of fund structures most of which are closed end funds, i.e. they have a defined life and are at various stages of their life. Others are in open ended funds which do not have a defined life and can be more easily exited but are not instantly liquid. The implementation process to move to the desired portfolio is therefore likely to be made up of a number of elements as set out below:



This process means that this new portfolio will move to the new portfolio design and build up over a period of time in the same way as the existing alternatives portfolios have done and it will likely take between 5 and 10 years before there is a portfolio that is wholly in line with the proposed design and is reinvesting its own realised investments in the same way as, for example, the mainstream private equity portfolio is currently doing.

Having reflected on how an allocation of this sort should be reflected in the Strategic Asset Allocation and taken the advice of the Independent Advisers the most sensible approach seems to be to earmark the appropriate element of each of the underlying asset classes (e.g. private equity, and private debt) rather than show the Place Based Impact allocation as a specific line in the Investment Strategy Statement. This reflects the fact that the primary driver of these investments is to achieve the returns targeted in each asset class. For other reporting purposes it would be appropriate to draw out this portfolio separately.

There will be other aspects to implementation including the procurement of investment managers and fund selection for new investments which will need to be addressed as part of the usual business planning process.

Measurement and Reporting

Any impact portfolio needs to be able to demonstrate that the impacts that it is seeking to achieve are actually being delivered and in the context of “levelling up” it is important that this is demonstrated to stakeholders through appropriate reporting. In addition as for any portfolio we need to be able to demonstrate that the relevant return targets are being met.

The latter element is part of business as usual which can be fairly simply addressed, and is of course the primary measure of the success of any investment the Authority makes. However, the assessment and measurement of impact and in this case importantly where it is felt is a specialist field which will require the Authority to secure external assistance.

We have already participated in pilot work to develop a reporting framework for place based impact investment and we are continuing to expand the number of funds which this applies to which will allow the geographic impact of the current portfolio to be assessed focussing down to the impact in South Yorkshire which if the strategy outlined above is successful will grow over time.

The “levelling up” white paper contains metrics attached to the various mission and objectives and where appropriate these can be used within the reporting framework that has been developed, which may provide a basis for comparing the success of different approaches to place-based impact investing and hence promote the adoption of best practice.

Over time the measurement process will need to become more stringent and widen to include a degree of verification to avoid the risk of “impact washing”. Again, this is something which will require external assistance.

Conclusions and Recommendations

It is clearly possible for the Authority to invest in local assets which support the "levelling up" agenda and make a return. As well as having positive benefits through the impact of these investments they deliver return from different sources and places which is a positive in terms of managing the investment risks facing the Fund.

While it is possible to grow the level of investment in South Yorkshire over time it is not practical to achieve a properly diversified portfolio of investments entirely within the County and in many cases fund managers are unlikely to raise funds solely targeting the County. While there are things that can be done that will result in an increased exposure to the truly local area it has to be accepted that the suggested impact portfolio will never be wholly invested in South Yorkshire and for this reason a core and satellite approach to portfolio construction is proposed.

As a result the of the above and the proposals set out in this report the Working Group makes the following recommendations to the Authority.

1. The Authority should within its investment strategy commit to creating a place-based impact portfolio structured as set out on page 10 with an ultimate target allocation of 5% of the Fund's asset value, to be achieved by a process of earmarking parts of the relevant underlying asset class allocations.

2. The initial core of this portfolio should be the current impact holdings set out in Appendix 2.

3. The process of transition to the new portfolio should follow the broad approach set out on page 12.

4. Officers should work up more detail on the measurement and reporting framework and in particular the metrics to be used for agreement with members.

5. Officers should develop proposals for the procurement of investment managers for elements of the General Needs Housing and Local Venture Capital and SME allocations involving appropriate sub regional stakeholders.

6. Progress on delivering on these recommendations should be included in the regular investment reports provided to the Authority.

Appendix 1 – Terms of Reference

Objective

The core objective of the working group is to provide guidance to officers on the priorities to be addressed in terms of focuses for impact within any plan included in the investment strategy to address the emerging requirements for a "levelling up" plan.

Work Programme

The Working Group is likely to meet on 4 occasions up to December 2022 with meetings themed as follows:

Meeting 1 – Familiarisation with Impact Investing

Meeting 2 – The "levelling up" agenda and investment and finding ways to maximise SYPA's impact

Meeting 3 – How to invest in "levelling up"

Meeting 4- Priorities and a "levelling up" plan

External speakers will be asked to present at some of the meetings in order to provide a wider perspective and add to the input available from officers.

The aim is to arrive at a plan that can either form part of or sit alongside the Investment Strategy Statement for approval at the March 2023 meeting of the Authority.

Meetings

Meetings will be scheduled for 2 hours and will be undertaken in a hybrid format. As this is a Working Group these will not be public meetings, although papers will be circulated and minutes taken.

Membership

6 members on a politically proportional basis appointed at the Annual Meeting of the Authority.

Appendix 2 – Existing Holdings

Fund	Value at 31.12.22 £m	Vintage Year
Local Development Loans	29.11	
Property Funds		
Bridges Property III	7.88	2014
Bridges Property IV	7.13	2016
Bridges Property V	7.95	2020
St Brides White Rose	13.77	
St Bride's S Yorks Residential	13.00	
Total	**49.73**	
Private Equity Funds		
Bridges III	3.17	2012
Bridges IV (B)	3.90	2021
Foresight Regional	13.11	2016
Palatine II	3.28	2012
Palatine III	7.27	2015
Palatine Impact Fund II	1.82	2022
Panoramic	0.97	2010
Panoramic 2	3.11	2015
Westbridge	0.80	2012
Westbridge II	10.62	2018
Total	**48.04**	
Private Debt Funds		
Beechbrook	1.94	2015
Beechbrook II	8.60	2019
Total	**10.54**	
Total Impact Investments	**137.42**	