Croydon Council

REPORT TO:	**PENSION COMMITTEE** **14 May 2013**
AGENDA ITEM:	**6**
SUBJECT:	**Review of the Property Portfolio**
LEAD OFFICER:	**Director of Finance and Assets (section 151 officer)**
CABINET MEMBER	**Deputy Leader (Statutory) and Cabinet Member for Housing, Finance and Asset Management**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: Understanding the risk and return characteristics of assets classes and how they are able to contribute to the overall performance of the Pension Fund.	
FINANCIAL SUMMARY: This report describes the characteristics of the property asset class and discusses the role that property investments could play within the overall investment strategy.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

For general release

1 RECOMMENDATIONS

1.1 The Committee are recommended to:

1.2 Agree the core-satellite approach to the property portfolio with an 80:20 split to the core approach as set out in paragraph 3.4 of the report;

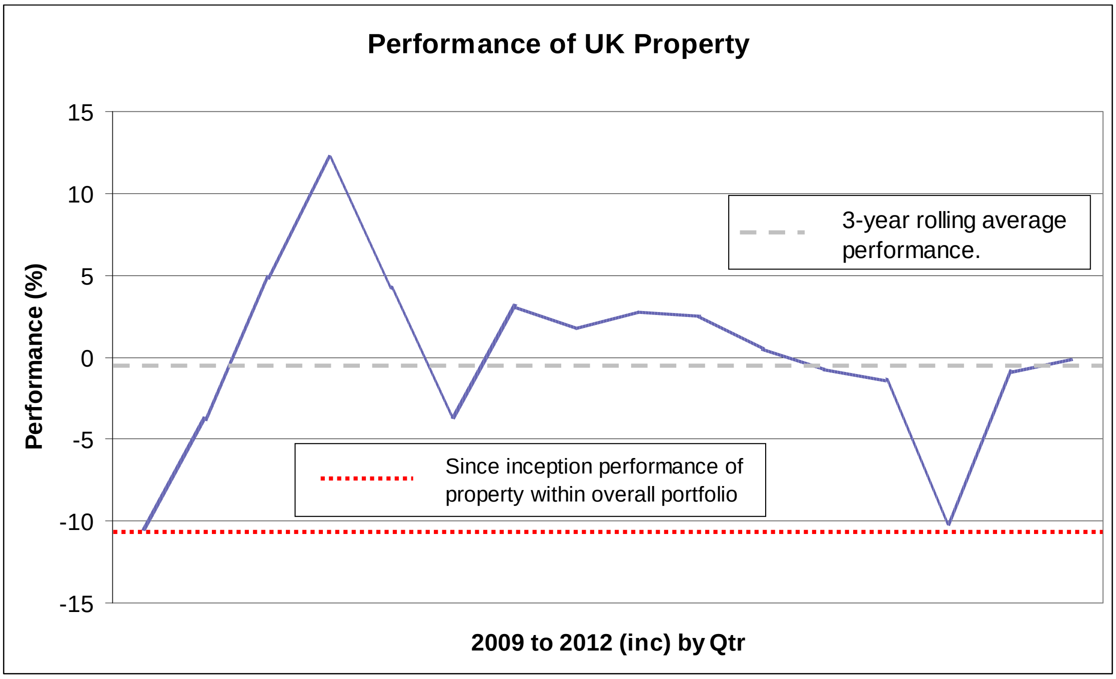
1.3 Maintain the existing multi-manager portfolio with Schroders (at its current level) and allow the Director of Finance and Assets (s.151 Officer) to work with the Council's advisors to allocate the remainder of the allocation in line with para.1.1 of the report.

2. EXECUTIVE SUMMARY

2.1 At the meeting held on the 5th of March the Committee approved a revised Investment Strategy (Min.A08/13), including an increase in the property allocation from 7% to 10%. As a result, officers commissioned AON Hewitt to produce a paper outlining options for restructuring the property portfolio. This report outlines and discusses the options presented in that paper.

3. DETAIL

3.1 The inclusion of property as an asset class within the Croydon Pension Fund portfolio originates with the review of the asset allocation strategy in 2008. This review assessed the range of asset classes open to Local Government Pension Schemes. Property scored weakly against its function matching liabilities, as a generator of return and to diversify from equity risk. With the benefit of hindsight this assessment has proven to be accurate: as markets collapsed after the fall of Lehman Brothers, marking the beginning of the Global Financial Crisis, property, as an asset class, correlated closely to most other asset classes in terms of performance. This chart shows the performance of UK property over the four-year period, with the lower dotted line representing the performance of the property component of the Fund since inception.



3.2 The property investment component of the Pension Fund has suffered from a combination of adverse market factors and negatively impacting management issues. As property values in Europe declined precipitously at the beginning of this decade fund managers struggled to derive a meaningful valuation for underlying assets. As a control mechanism pricing was suspended and with that limits on the redemption of assets. Pricing has subsequently been restored but there are still significant obstacles preventing investors from exiting this class in Europe. Although returns in Northern Europe, the UK and the US have regained some of their previous buoyancy there are concerns around investing in many regions and types of commercial property. Alongside these macro-economic factors, the Croydon investment was negatively impacted by our fund manager opting to exit this business precipitating a change of fund management and transitional disruption whilst the new fund manager sought to reshape the investment.

3.3 After a review of the existing asset allocation strategy late in 2012 the Committee decided to increase its allocation to investing in non-residential property, from 7% of the value of the portfolio to 10%. AON Hewitt, the Fund's investment advisors are supportive of this decision and because of their experience of European property funds, believe that the focus under the new strategy should be on the UK market.

3.4 AON Hewitt's view is that the most interesting opportunities in property investing are in areas such as ground rents, index linked property leases, property debt and opportunity funds alongside traditional property investing. Their proposal is that the Fund establishes a "Core – Satellite" approach, with a core portfolio, comprising 80% of the target allocation, investing in UK core property funds, ground rents and index linked property and a 20% satellite portfolio invested in UK property debt and opportunistic funds. This forms the essence of their recommendation to this Committee.

3.5 This recommendation raises a number of issues for this Committee to consider. These include:

- The additional governance and officer resource required to monitor and manage the additional fund manager relationships;
- The fee structures for running these investments, plus the costs associated with the selection and monitoring processes;
- The Committee's familiarity with the more esoteric of these types of investments; and
- How this proposal sits alongside the current arrangements for property investment, including the arrangements for residual assets.

3.6 AON Hewitt has drafted a paper that provides more colour to the discussion of this question. That paper, *'Property Portfolio Restructuring'*, together with two additional supporting papers, *'The case for investing in UK Property Debt'* and *'UK Commercial Ground Lease Investments'* are attached to this report as Appendices A, B and C respectively. That paper uses the Fund valuation as at 31/12/2012 as a basis for considering relative proportions of the Fund: for the sake of consistency this report adopts the same basis.

3.7 The current allocation to property investments within the portfolio is as follows:

Manager	**Fund**	**Region**	**AUM £m**	**Proportion of Fund Assets (%)**
Schroders	Multi-Manager	UK	26.9	4.1
Standard Life	European Property Growth Fund	Europe	4.7	0.8
Henderson	Indirect Property Fund	Europe	6.4	0.9
Total			**38.0**	**5.8**

3.8 Each of these three investment routes have been arrived at for different reasons. Schroders, who stepped in to fill the void caused by Hendersons closing their property fund of funds business, are still in the process of re-shaping the portfolio set up under Henderson's management: this is taking longer than anticipated due to illiquidity in the property market among other factors. The Standard Life fund was originally part of the now defunct Henderson's portfolio. To exit this fund at the moment would crystallise a capital loss. The Henderson fund has been placed into special measures to prevent a run on the fund. Therefore redemption is not immediately an option. The closing quarter of 2012 saw an improvement in the performance of the European funds. During the quarter, the portfolio return net of fees, was 2.2% against a benchmark return of 1.9%. Over a three year basis, performance net of fees is -9.7% against a benchmark of 8.0%. However, the main driver of performance over the quarter was the appreciation of the euro against sterling.

3.9 Should this existing portfolio form the core component of a 'core-and-satellite' model, described above, then the cash budget for the satellite part, to bring the investment in the asset class up to the 10% target weighting, will be circa £10.7m. In governance and indeed practical terms this will allow for one or possibly two, but no more, additional investments. If two and these are with fund managers with whom the Fund does not have a pre-existing arrangement, there will be five individual fund managers investing 10% of the portfolio. Certainly the alternate space is more resource intensive than the more traditional asset classes but there are distinct disadvantages to this approach. This includes the cost of accounting, performance management, reporting, legal, procurement and so forth associated with each new contract or subscription. Establishing meaningful relationships is more of a chore and understanding each product more challenging. Fees will almost always be charged at the most disadvantageous rates. There will often be minimum subscription limits too that may present a barrier to entry.

3.10 AON Hewitt's report states that the Schroders portfolio 'will provide the Fund with overall property market exposure through well regarded funds which can add value relative to the market.'

3.11 The report appended describes the characteristics of four sub-sets of the property asset class:

- Ground Rents
- Index linked / long lease funds
- Debt funds
- Opportunistic funds

The report provides details which are summarized here:

Ground Rents	Long-dated cash flows, in excess of 100 years, with good linkage to inflation and higher yield than index linked gilts.	Expected nominal returns of 5.0% - 5.5% net of fees, equivalent to 2.0% - 2.5% real returns.	Low risk.	Defensive part of the core portfolio.
Index linked / long lease funds	Index linked leases found mainly in the hotel, supermarket, care home and nursing home sectors.	Ranging from RPI + 3% to RPI + 5%.	Risk comparable with corporate index linked bonds.	Diversifier within core portfolio.
Debt funds	Lending proportion of the value of property or portfolio secured against underlying asset. Senior, mezzanine or whole debt.	5% - 6% for Senior debt. 12% - 13% for mezzanine debt. About 9% for whole loans. All estimates of returns are net of fees.	Partially protected from default by equity investors.	Return seeking within satellite allocation.
Opportunistic funds	Exploiting the pricing gap between prime and secondary property yields.	As this is a specialist area AON Hewitt suggest that a separate strand of work is required to assess the risk/ return associated with this type of fund.		Return seeking within satellite allocation.

This then is the range of potential property investments that might comprise the property component of the Fund portfolio going forwards: a core, 8% of the value of the Fund, made up of the existing Schroders, Hendersons and Standard Life funds, plus a ground rents fund and an index long lease fund; and a satellite, to be capped at 2% of the value of the Fund and invested in property debt and opportunistic funds.

3.12 The AON Hewitt paper suggests three options for implementing this strategy: these three are evaluated below.

3.13 **Option 1** is to widen the remit of Schroders multi manager structure so that the manager can build a portfolio that includes ground rents, index linked leases, property debt and opportunistic funds. Although the cost would be initially high in terms of fees because Schroders would ask for a management fee over and above the costs of the underlying fees, the authority would have the negotiating advantage of volume. In terms of governance it would be far more practical to deal with one property fund manager rather than possibly 7 separate managers. However, as the authority would be procuring a contract for services rather than acquiring shares in a unitized product and full OJEU process is necessary. This is potentially an area where the benefits of a shared procurement are evident. This would also provide an opportunity to test whether any manager would possess the requisite skill set to pick the best funds in each of these categories.

3.14 **Option 2** would be for the Pension Committee itself to take on the role of multi manager and select the individual underlying funds themselves. This represents a significant challenge for the committee as well as being a heavy charge on the resources of both Committee and officers. Going forwards it would mean that the Committee would take on responsibility for engaging with and monitoring the performance of 7 individual fund managers. As specified above the Committee would effectively write off two years work from Schroders reshaping the property portfolio.

3.15 **Option 3** proposed by AON Hewitt represents a hybrid of these two. The proposal is to continue with Schroders managing the core property portfolio. The Fund would invest directly, i.e. purchase unitized shares, in pooled index linked leases and ground rents funds and also in satellite funds. The AON Hewitt property research specialist team can advise on the choice of suitable funds. The problem with this solution is that it fails to address the governance issue of reducing the number of relationships that need to be maintained by the Committee and its officers. It also does not provide the authority with any leverage in setting fees as we will in each case be small investors.

3.16 The recommendations of this report are therefore as follows:

1. To adopt the core and satellite approach described above. The core will comprise the existing property investments, plus investment in a ground rents fund and an index linked long lease fund. The satellite will comprise investment in a property debt fund and if it is found to meet the criteria set out in this report some sort of opportunistic fund.
2. In keeping with the asset allocation strategy the overall allocation of funds to the property asset class will be equivalent to 10% of the overall value of the Fund, split between core and satellite on a ratio of 4 to 1.

4. CONSULTATION

4.1 Officers have consulted with investment advisors and committee members.

5. FINANCIAL CONSIDERATIONS

5.1 There are no specific financial considerations within this report.

6. COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

6.1 The Council Solicitor comments that there are no direct legal implications arising from this report.

(Approved by: Gabriel MacGregor, Head of Corporate Law on behalf of the Council Solicitor and Monitoring Officer**)**

7. OTHER CONSIDERATIONS

7.1 There are no Human Resources, Customer Focus, Equalities, Environment and Design, Crime and Disorder, Human Rights, Freedom of Information or Data Protection considerations arising from this report.

CONTACT OFFICER:	Nigel Cook - Head of Pensions and Treasury Management Interim Chief Executive's Department, ext. 62552
BACKGROUND DOCUMENTS:	None

Appendix A

Appendix B

Appendix C