Report for: Pensions Committee and Board 18 January 2018

Item number: **14**

Title: Investment Considerations – Residential Real Estate

Report authorised by: Clive Heaphy, CFO and S151 Officer

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Ward(s) affected: N/A

Report for Key/ Non Key Decision: Non Key decision (Pensions Committee)

1. Describe the issue under consideration

1.1. Haringey Pensions Committee and Board has previously requested that officers prepare a report examining the potential to invest in residential real estate which potentially has high ESG credentials, including consideration of initiatives undertaken by other Local Authorities.

2. Cabinet Member Introduction

2.1. Pensions Committee

3. Recommendations

3.1. That the Pensions Committee and Board note the contents of this report, including the comments of the Independent Advisor and the appended report from Mercer;

3.2. If the Pensions Committee and Board wishes to pursue residential real estate as an asset class any further, that they agree to write to the London CIV, to formally request that they give due consideration to the inclusion of residential real estate in the CIV's business plan: specifically residential real estate with high ESG credentials.

4. Reason for Decision

4.1. As this report details in later sections, the only investment option that is realistically workable for a Fund of Haringey's size and resources, would be through a pooled investment vehicle with a specialist fund manager. In line with the pooling agenda, the most sensible course of action here would be to approach the London CIV formally, and request that this is an area they consider adding to their business plan. The London CIV business plan includes the various asset classes that they intend to bring onto their platform in coming years.

5. Other options considered

5.1. Broadly, there are two options when it comes to making a pension fund investment:

- Direct Investment
- Delegated Investment (through a fund manager)

<u>Direct Investment</u>

5.2. Direct Investment requires in house specialist resourcing for a particular investment sector. A relatively large team is required in order to complete investments successfully, with specialist skills, the ability to stay abreast of all sector developments, regulatory changes and to complete appropriate due diligence on all investments completed, and then manage/monitor investments going forward.

5.3. With the exception of cash investments, this is an investment approach that has historically only been adopted by a very small number of LGPS Funds. The size of individual LGPS Funds, and the requirement for a properly diversified investment portfolio means that having in house specialist teams would be an inefficient and extremely costly approach for the vast majority of funds. However, with the advent of the pooling agenda, this approach could become more viable if in house specialist teams are set up within the LGPS pools (rather than the funds themselves), and collaboration will mean that the costs of these teams are spread throughout pool investors.

5.4. Along with the majority of LGPS funds, Haringey has never used a direct approach for investment to date. The pension fund investment and accounting team has two individuals, who also dedicate part of their time managing other council services.

Delegated Investment

5.5. Haringey's pension fund is 100% invested via a 'delegated' approach – by employing sector specialist fund managers for different sectors and asset classes, thus allowing the fund to enjoy the benefits of a properly diversified investment portfolio.

5.6. This is the most common approach within LGPS, however officers note that there are a very small number of funds who manage equity investment in house. These funds are primarily large metropolitan area Funds, such as Greater Manchester and Merseyside, with investment teams of over 20 individuals, and with assets under management of around or over £10bn. One of the most significant hurdles to overcome in this area would be the recruitment and retention of suitably qualified staff: public sector pay levels do not compare favourably to private sector fund manager counterparts.

5.7. It is clear that all investments which Haringey Pension Fund makes must continue to be via the 'delegated' route: engaging qualified fund managers with specific sector specialism to ensure the best outcomes are sought for the fund, and its members.

6. Background information

6.1. Members of the Pensions Committee and Board have previously requested that officers prepare a report to the committee examining what scope there is (if any) to invest in residential real estate such as social housing, including the potential to invest locally, and what initiatives have been completed by other Local Authorities.

The need for diversification

6.2. One of the key considerations for LGPS Funds is the requirement to properly diversify the investments held by the fund. This is done via setting out the strategy to be adopted in the Investment Strategy Statement. Diversification reduces the risk of losses that the fund could incur by exposure to one particular asset class or geographic region.

6.3. For asset classes such as equity and fixed income, where investment is split across a significant number of investment holdings, allocations can be significant portions (over 50%) of a fund's total investments. For alternative asset classes such as private equity, real estate or infrastructure, allocations are significantly lower: normally no more than 10% per allocation. This is normally due to the far lower number of individual investment holdings for these asset classes, higher levels of illiquidity and higher levels of price volatility. To contextualise this based on Haringey's current investments: the current global equity portfolio constitutes 45% of total investments, and is spread across share holdings in thousands of individual companies. The fund's infrastructure debt allocation constitutes 3% of total investments, and this is spread across just five individual infrastructure projects.

6.4. In order to achieve proper diversification and protect the interests of fund members and employers, any potential new investment in a specialist area of the real estate market would need very careful consideration to ensure that it was suitable for the Fund's investment requirements. Areas that are associated with potentially higher levels of risk (both actual and perceived risks) should be limited to relatively small allocations, in the order of, say, no more than 1% of total fund assets, subject to further review of an actual investment opportunity. This leads to no overreliance on the performance of a single asset, and no undue risk caused by underperformance of a single asset.

6.5. This is a relatively small amount: other funds with larger investment portfolios can clearly invest larger amounts in single assets and maintain the same proportionate level of risk.

The impact of investment performance on employer contributions

6.6. Every three years, the fund is valued, and employer contributions are set for the next three year period for all participating employers. For the majority of Haringey employers, staffing costs (including employer's pension contributions), make up a significant proportion of their annual revenue budgets. To give an idea of the magnitude of this, Haringey Council paid employer contributions of £26.8m to the fund in 2016/17.

6.7. A downturn in the performance of the fund's assets is likely to have a direct impact on the valuation of the fund, and contribution rates that employers must pay. Therefore, if the fund invested in assets which did not perform well over the next three year period, employer contribution rates would very likely rise: thus creating budget pressures for the Council, schools in the borough and other smaller community and private sector organisations who participate in the fund. For example, a 10% absolute value increase in employer contributions for Haringey Council would result in a £2.68m budget pressure for the Council. Academy Schools and smaller community bodies may be particularly adversely affected by increased Employer contributions.

6.8. It is therefore important that all investment decisions are made with investment performance and characteristics as the key principal drivers. Environmental, social and corporate governance (ESG) considerations are however, a vital secondary consideration.

The risks surrounding local investment by pension funds

6.9. LGPS funds are usually administered by London Boroughs, County Councils or Metropolitan Authorities. These local authorities who act as 'Administering Authorities' for LGPS funds suffer a direct link between their revenue budget health and the economic prospects within their geographic area. LAs increasingly depend on economic growth to generate revenue budget resource in order to provide public services for their residents, through business rate collections and council tax receipts. An LA which is experiencing a local economic downturn will suffer from reduced tax receipts, and the associated budget pressures.

6.10. Were LGPS funds to invest heavily in local assets, this would magnify some of these revenue budget risks. Investment in local assets in a poorly economically performing area would likely lead to losses which the pension fund would incur. All else being equal, these losses would be expected to impact on the pension fund's valuation, which could then in turn increase the employer contributions required of the administering authority and other employers. The authority would then be in a position whereby it faced twofold budget pressures: increasing pension fund contributions, and reducing tax receipts. Tying the economic fortunes of both a pension fund and the authority that administers it to one small geographic area is not a diversified approach to investment, and has the potential to be disastrous for an administering authority. For this very reason, local investment by LGPS funds is an extremely uncommon practice.

6.11. There are also significant reputational risks posed by LGPS funds investing locally. Investment in residential real estate must be handled extremely sensitively: should any fund invest in residential real estate and suffer some form of asset underperformance, or poor performance in asset management such as tenant servicing/relations, this is likely to produce a highly emotive public reaction which should not be underestimated.

Private Rented Sector (PRS)

6.12. Officers are aware of a very small number of professional fund managers who invest in, and even have specific funds dedicated to PRS investment. This is mentioned in the report of Mercer which is appended. This was not a topic that the Committee and Board raised initially, however this is clearly an area of residential real estate investment which could be investigated further if the Committee and Board wish.

Projects completed by other LGPS Funds

6.13. One London Borough has historically made a commitment to investment in social housing. However, although this commitment was made several years ago, the fund has not to date completed any actual investments. This commitment was not intended to be invested locally within the borough.

6.14. One County Council Pension Fund has made an investment in residential property within a town in their County. The fund entered into a joint venture with a housing association, funding 70% of a £8m development of 40 properties. The fund in question has a 0.3% allocation to this investment in its Investment Strategy Statement. However, it should be noted that this is a private rented sector investment, and not a scheme whereby rents would be discounted from market rates.

6.15. One large metropolitan pension fund covering several LAs outside London has invested £25m in a joint venture with one of the ten unitary LAs who is an employer in the fund, this equates to roughly 0.1% of total assets of the fund in question This venture aims to stimulate new home building and provide residential property across several sites within the metropolitan area. Having examined publicly available documents, officers have found that this scheme offers a mixture of outright purchase and rental property: however all rentals are at market rates.

6.16. One further County Council Pension Fund has invested £20m in a Real Estate Investment Trust (REIT or a form of pooled investment vehicle) joining a number of other private investors and charities. The manager of this vehicle does not develop or manage social housing directly, but purchases assets which it then leases back to other registered providers on long term leases with rents linked to inflation. The portfolio in this fund is weighted towards specialist social housing, such as supported living property. The investment is not within the Fund's local area, but across the UK, and constitutes around 0.4% of total fund assets.

6.17. Another County Council has invested a sum of £300m with a residential property company which aims to provider affordable housing across the UK. The company does this largely through shared ownership schemes, including schemes where non-new build properties are purchased through shared ownership and pay inflation linked rent on the unpurchased share of the property. The investment is not geographically constrained within the County. This LGPS Fund has total investment assets of around £8bn.

6.18. Outside of London there has clearly been some but limited activity in residential real estate investment, including a very small number of cases where a Pension Fund has invested in housing in the area the Pension Fund covers. This is likely, in part, to be influenced by the size and resource of LGPS funds outside London, and the disparity in property prices within and outside London.

Conclusion

6.19. Any new investment completed by Haringey fund must be done based on sound investment advice received from the fund's investment consultant, who would assess how a new investment class would impact on the fund's overall risk and liability profile.

6.20. As is documented throughout this report, due to the need for diversification and the risks of investing locally, if Haringey does consider investment in residential real estate in the future, this should be through a pooled investment vehicle where the fund can gain exposure to a number of individual assets. A specialist fund manager should be engaged to manage the investment.

6.21. Due to this requirement to act collaboratively with other investors, the London CIV appears to be the best way to pursue residential real estate investment. It is therefore recommended that the Committee and Board formally write to the London CIV if they do wish to pursue investigations into this asset class.

7. Comments of the Independent Advisor

7.1. I would suggest that the Committee and Board very carefully consider both the information provided by and observations of the Officers contained in this report and their recommendations. I would also suggest that very careful consideration is given to the report on Social Housing Investment provided by the Fund's appointed Investment Advisor, under the LGPS (Management and Investment of Funds) Regulations 2016, Mercer.

7.2. Investment in Residential Real Estate including investment in the geographic area covered by the Pension Fund, which might include direct investment, is permitted under the LGPS (Management and Investment of Funds) Regulations 2016 and associated Statutory Guidance. This could potentially include social housing. The fact that an investment is permitted does not however mean that it should be pursued.

7.3. The Statutory Guidance of July 2017 which accompanies the 2016 Investment Regulations includes the following statements "Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme….." and

"Investments that deliver social impact as well as a financial return are often described as "social investments"…… some part of the financial return may be forgone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund." The first point to note is that financial return must, under the 2016 Investment Regulations, remain the "predominant concern." While social impact can be taken into account it must not result in "risk of significant financial detriment to the fund."

7.4. As already stated the Pension Fund must make any investment decision primarily on financial grounds. Therefore, it would be improper to seek to invest in Social Housing or any form of Residential Real Estate simply to assist the Council in its role as a Housing Authority or primarily for any other housing related purpose.

7.5. While direct investment by the Haringey Fund in Residential Real Estate within the Borough is possible it raises a number of potentially complex issues/risks including possible serious investment and reputational risk. In particular, the Haringey Fund, like all London Borough Funds, lacks both the staffing resources and expertise to plan, execute and manage/monitor any form of direct Residential Real Estate investment whether or not in the form of social housing. Direct investing by the Haringey Pension Fund, in Residential Real Estate, whether within or outside the Borough, is not practical.

7.6. Delegated investment in Residential Real Estate, by an asset management firm, solely in Haringey is, I believe, not a realistic option when compared to investing across the whole of urban England or even the South East or Greater London. Any reputable asset manager, who has the capacity to effectively deliver Residential Real Estate (and there are few asset managers who have this capability) would almost certainly consider the opportunity to constrained and risky on geographical grounds alone as Haringey is geographically a very small area compared even to Greater London. The few asset managers who offer Residential Real Estate (primarily private residential for "professionals") do so on a wide geographic basis that will include not only various parts of London but urban areas of the south and major conurbations in the midlands/north of England.

7.7. A number of London Boroughs and LGPS Funds outside London have recently invested in the Private Rental Sector (PRS) but these have been with (a very few) asset managers PRS products which invest in geographic locations they deem suitable without reference to individual investors. This type of housing is aimed typically at young professionals with good incomes who in previous times would very likely have become owner occupiers. These products are therefore neither local investment or social impact products.

7.8. In conclusion I strongly support and concur with the Officer recommendations and in particular that if the Pensions Committee and Board wishes to pursue Residential Real Estate they write to the London CIV to request the inclusion of Residential Real Estate in the CIV's business plan and specifically that this be Residential Real Estate with high ESG credentials.

8. Contribution to Strategic Outcomes

8.1. None.

9. Statutory Officers comments (Chief Finance Officer (including procurement), Assistant Director of Corporate Governance, Equalities)

Finance

9.1. The appended report from Mercer highlights the difficulty of finding investments of suitable scale and likely returns in this area. Whilst commitment to ESG issues is clearly an important key consideration for Haringey Pension Fund, the overriding aim of the fund's investment strategy must be to improve the funding position with the aim of reaching fully funded status, whilst maintaining stability of employer contributions. Any changes to the Fund's investment strategy must be consistent with these principles.

9.2. Before any new fund managers or asset classes are introduced to the pension fund, proper due diligence will be undertaken, and sound professional advice will be sought. Officers will ensure that the Pensions Committee and Board receive adequate and appropriate training on any new investment techniques or asset classes prior to these being undertaken by the pension fund.

9.3. The report from officers and the paper from Mercer are intended for informational purposes and do not recommend specific investment related actions to be taken at this stage.

9.4. With the fiduciary duty in mind, it is important to note, that the Committee and Board must make purely rational decisions in relation to the investment of the fund – i.e. all decisions must benefit the members and employers in the fund. Investment returns have a direct impact upon the affordability of the participating in Haringey Fund for employers, and nationally can impact upon affordability for members if employee contribution rates are raised, (as has been the case in recent years). Investing in an asset class which has lower than expected returns compared to other asset classes and which exposes the fund to additional levels of risk would clearly be imprudent, and could be subject to legal challenge on the grounds of irrational decision making.

Legal

9.5. The authority must invest the funds in accordance with the Investment Strategy. The Investment Strategy must in accordance with Regulation 7 of the The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment. Members are reminded of their fiduciary duty to the Pension Fund and its members i.e. the members must act in good faith for the benefit for the Pension Fund and its members. The members have a duty to exercise reasonable care, skill and diligence. In making a decision on the recommendations set out in this report members should take in to account the advice of the professional advisors set out in this report and provided at the meeting.

Equalities

9.6. There are no equalities issues arising from this report.

10. Use of Appendices

10.1. Confidential Appendix 1 - Mercer

11. Local Government (Access to Information) Act 1985

11.1. N/A

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