MINUTES OF THE PENSIONS INVESTMENT COMMITTEE MEETING

Tuesday 5 September 2017 at 7pm

Present: Councillors Mark Ingleby (Chair), Simon Hooks (Vice Chair), Liz Johnston Franklin, John Muldoon, Olurotimi Ogunbadewa

Also Present: David Austin, Robert Browning, Andrew Elliot (Hymans Robertson), Nimisha Sodha (Hymans Robertson), Sarah Assibey

Apologies: Councillors Christ Best, Paul Maslin and Jamie Milne.

1. **Declarations of interest**

   No interests were declared.

2. **Minutes**

   The minutes of the last meeting be amended as followed:

   Para 7.3: “is LBL” be changed to “if LBL”

   RESOLVED that minutes of the last meeting are an accurate record.

3. **Schroders- Fund Manager Presentation**

   The Chair told the Committee that each of the Fund Managers will have 30 minutes for their presentation- 20 minutes to present and 10 minutes for questions.
   Naomi Green, Patrick Bone and Geoff Day introduced themselves and thanked the Chair for having them.

   3.1. The LBL Property Market Portfolio has remained the same over the last 12 months. It has been stable and robust. There has also been no change in the staff and people.

   3.2. The investment management agreement that exists between Schroders and LBL does not allow Schroders to invest in debt- although it does not specifically prohibit it. It is silent on the subject so therefore would need some amendment on the investment agreement.

   3.3. Discussing the Market Overview, over the last 12 months the property market has upheld a lot better than expected post the EU Referendum- that is partly because of the economy, particularly in the consumer spending sector. There are signs of slowing down, however, moving forward. In terms of inflation and average earnings growth, this slow would occur is because, over the last few years, the consumer has enjoyed a period of low inflation versus average earnings- there has been an increase in purchasing power and positive income growth. However, from 2017 going forward, inflation has moved above average earning; consumers are now beginning to feel the tension of costs, with incomes falling again.

3.4. However, interest rates in the UK remain low, whereas in the US they are beginning to rise Schroders in-house view is that interest rates will continue to fall up to 2019. The NPC, rather than focusing on the rate of inflation currently as a way to control interest rates, Schroders believe they will focus on wage growth. Because wage growth remains relatively modest at the moment, interest rates should remain low for some time

3.5. Another current concern is how Brexit will effect UK and EU trade. The UK is likely to retain free trade in goods, but not services- this will have an impact on the financial sector, particularly Central London. There may be a number of European headquarters relocate elsewhere on the continent. Although the London property market is not a favourable property market at this time, particularly the central London office property market, Schroders believe that vacancy rates could rise and put a downwards pressure on rent and therefore weaken investment performance.

3.6. The wider retail sector also looks challenging-retailers have been under pressure with rising costs and business rates (particularly in London and the South-East). Also with online spending and the threat of e-commerce means that retailers have to spend more for a business model that lends itself to retailing. There have been a number of high-profile administrations over the last year, reflected in the consistent high vacancy rates across the retail sector, which Schroders believe will continue. Out of town retail parks have generally fared slightly better than standard retailing. They are convenient element and accessible format, such as Click & Collect.

3.7. Favourable sectors include the convenience retail sector- supermarket operators in this space are generating more of these formats and closing down superstore formats. They are able to charge more for goods in this sector that they typically would in a superstore format. This accessibility is good, and generally they can pay 3 years rent, in just one week worth of trading.

3.8. Another favourable sector is regional offices- because these markets are unlikely to suffer from over-supply. Typical demand from occupiers comes from local and regional businesses, rather than international businesses that may be effected by Brexit, for example. The number of starts, in terms of new office developments in volumes of millions of sqft, over the last 8 years it has been a lot lower than the previous 8 years. So a lot of the regional markets around the big cities of the UK are seeing a very low level of availability in grade A office space. That has caused rents to rise and they are likely to come under pressure.

3.9. Schroders are also in favour of the alternative sector- areas like student accommodation, leisure, surgeries and healthcare. They tend to be more defensive to the changes in the economic environment. This sector is benefiting from structural change and have relatively stable rents. They have performed well- and with inflation at the level it is today, they should perform quite well going forward.

3.10. There is wide range across the sectors of the In House sector markets. An average "All Property" level Schroders believe by the end of 2017, All Property will produce a return of 4-5%. But the disparity between sectors is quite large, ranging from minus returns in weak retail markets and central London office markets strong returns of up to 6% in regional offices and industrial markets

3.11. Discussing the LBL Portfolio, by the end of June 2017 the valuation stands at just over £105m. There is a very diversified exposure in the UK property market, reflected in the number of investments. Portfolio cash stands at £1.4m and the value of this is 1.3%- £620k of that was committed to the regional office fund. Uncommitted Portfolio cash is very low at 0.7%. there has been quite a high turnover of the portfolio this year- the main reason for this is positioning the portfolio away from the central London property market and towards those parts of the market where there is more conviction i.e. regional offices, industrial alternatives etc.

3.12. The performance of the portfolio as a whole has been disappointing; the UK portfolio has outperformed every time period apart from "10 years". The reason for the underperformance continues to be continental Europe- Schroder's holding is Continental Europe are only 1% of the portfolio now. The underperformance of the first quarter was an accounting anomaly- without this anomaly we would have received a 1% return over the first quarter. The alternative and industrial sector have driven the strong performance, whereas continental Europe and the West End of London PUT have produced a lower return attribution.

3.13. The attribution over the last 3 years, the industrial fund has been the strongest driver of annual returns as well as some of the stronger balance funds i.e. Hermes Property Unit Trust and the Schroder Real Estate Income and UK Estate funds. The big detractors have been cash from real estate and the portfolio's exposure to continental Europe has diluted returns over 3 years.

3.14. The Schroder Real Estate Real Income Fund has been the strongest driver of the portfolio- 9.1% of the portfolio value. It has a high income return and is less volatile than broad real estate market. It is driven by a relatively high initial yield (6.1%). This invests in sectors like student accommodation and healthcare. Schroders believe this will be a very strong driver of returns because it is a diversified portfolio of alternative investments with defensive characteristics of long and stable leases, strong cash flow provision and favourable demographics.

3.15. The industrial Property Investment Fund is also believed to be a strong driver of returns, with the Fund return being consistently higher than the benchmark of the last decade.

3.16. The strategy going forward is to have less turnover in the portfolio. Schroders will continue to reduce exposure to weaker core funds and allocate proceeds to preferred sectors. Schroders also will consider opportunities in new strategies, for example a Partnership Fund.

3.17. Schroders are investing more in these partnership funds, because they give partners exposure to the parts of the market they cannot otherwise access elsewhere. Schroders have full access to the fund and are able to negotiate lower fees. All of the partnership funds have outperformed over every single time period, aside from Motor Retail PUT.

3.18. Schroders suggested Real Estate Debt as a part of the LBL portfolio. There is currently no real estate debt fund on the portfolio platform. Forecasts for property are more moderate- 4-5% over the next 4 years- there is an opportunity for attractive absolute and risk adjusted returns in a forecast low return environment.

3.19. Debt is less risky than equity- returns are derived from a fixed coupon and the ranking of debt in the capital structure is higher than equity. There is an opportunity here as a number of traditional lenders have withdrawn from lending on non-prime real estate and as a result margins are rising

Responding to comments and questions from Members of PIC, Schroders made the following points:

3.20. Schroders would invest approximately 10% from the portfolio in this debt- less than this amount may not be a meaningful amount. Continental Europe market has given back around 85% of the capital since 2011. Schroders aim to be fully out of the fund by the end of 2018- the funds life ends in October 2018.

3.21. In terms of the covenant strength of the Borough, it is crucial to the strategy. In the property market, the most volatile part is central London. However, the lowest spreads you can charge on a loan is in central London. Schroders believe there is the most risk on these buildings. The better lending proposition is in the regions and towns where there is more conviction on assets and less volatility.

On conclusion of their presentation, the Chair thanked Schroders representatives for their time.

The committee discussed the presentation and made the following points:

- Although the strategy and opportunities presented sound promising, the performance of the portfolio has been disappointing
- Although there is opportunity in Real Estate debt, but it may not be suitable in a traditional property fund
- There would need to be a changed in the IMA to permit investing in real estate debt, which the Committee are not completely comfortable doing.

4. Fund Manager Presentation- Invesco

Clive Emery and James McAuliffe, directors from Invesco, were welcomed to the committee meeting by the Chair. After introductions the presented the proposition For Lewisham Pension Fund, discussing the following points:

4.1. The Invesco Perpetual Global Targeted Returns Pension Fund, by the end of June 2017, had £18.5bn worth of assets. The commitment that if the fund was able to go beyond £20bn in assets, Invesco would initiate a review of capacity in illiquidity. Over the time period, it has now past £20bn, therefore this project has started. There will be an internal paper, finishing towards the end of the year, with an external document to be provided to LBL by the end of Q1 giving detail to the capacity and illiquidity.

4.2. There are two targets for the proposition of the fund- firstly to deliver 5% of the cash benchmark and an annualised 3 year rolling basis (similar to an equity-like return in the long term) and secondly to do that with less than half of the equity volatility. Invesco have 20-30 individual investment ideas across asset classes with a time horizon off 2-3 years.

4.3. Stage 1 of the process is to find a good idea by research carried out by the core investment team with broad multi discipline support. The second stage is to work out which of the ideas that have been approved will go into the fund. Lastly, which Ideas are diversified and correlated and will overall lower the risk of the fund.

4.4. The portfolio gross return has been 6.5% relative to the benchmark- the fund has delivered a 5.89% return over the last 12 months relative to its target of 5%. Its volatility over the last year was 2.99% which is 41.56% of equity volatility. Between calendar years 2014 and 2016 there have been different levels of performance. The key determinant for that is the hit rate- the number of ideas that make money versus lose money on a quarterly basis tend to be the driver.

4.5. Roughly 2 out of 3 of the ideas are performing- 23 of 36 ideas have made money. There is a positive asymmetric skew- the ideas that worked and have made money outweigh those that have lost money, partly because of the embedding of risk management. A third of the ideas have an embedded risk insurance to protect and reduce the volatility and the downside of exposure in that idea.

4.6. An important element of this fund is that we only target 5% over cash and Invesco are not paid above this target. The aim is to deliver an absolute return target with as little risk as possible.

In response to questions asked by Members, Invesco made the following statements:

4.7. In regard to UK lending, the levels of private debt have increased quite dramatically. The sensitivity to increase rates is a significant issue (particularly likely for the Bank of England going forward they will be slightly limited in their ability to raise rates) and is an ongoing concern. Invesco do not have direct aspects to that- they do have a few ideas in the UK where there are long term views on rates and a relative difference between long end and 30 year rates relative to the US. Invesco, however, have a UK equity idea which mirrors their investment funds. The team do not do individual stock selection but rather copy them because they have a very good track record.

4.8. There have been a number of European banks being bought at a euro and all their debt written off, minus senior debt. This is an example of the risk being paid for, does not seem to be a risk- the difficulty however, is the liquidity of the risk is not significant enough for the fund.

4.9. In regards to the ideas- it is automatic process to review the ideas. Each day, the performance of an idea is reviewed and in addition, at the end of every week the core team will look at the performance of the portfolio under each idea. They will also assess the different elements of one idea and may produce targets for individual ideas. The targets may be a trigger to review and adjust the ideas. They will assess relevance of the 4 targets that are set under each idea.

4.10. Within Invesco, there is currently a very significant focus on ESG. Because of the active management and approach that Invesco has generically, the focus social and governance is very strong. Invesco has one of the best records on property voting. Because they are limited to only investing in the major macro-markets, they are not looking at being in smaller areas, which ESG issues tend to be relayed

On conclusion of their presentation, the Chair thanked Invesco representatives for their time.

The committee discussed the presentation and made the following points:

- The Invesco approach is very positive and diversified.
- Invesco will be receiving an investment of £75m

5. Investment Beliefs Questionnaire

5.1. The questionnaire, detailed and explained at the last meeting, was discussed. The Chair asked that the questionnaire be completed by 30 September 2017, returning to Hymans Robertson.

5.2. There will be a discussion at the next committee outlining the outcomes of the questionnaire which will be distributed to Members via email.

RESOLVED that after a brief overview of the questions the report was noted.

6. Multi-Asset Credit Procurement- Report by Hymans Robertson

The report follows from the Committee's decision to de-risk and diversify the Fund by reducing equity holdings and investing alternatives, specifically by focusing on the procurement of a new alternative credit mandate.

Fund advisors, Hymans, had included some questions for the Procurement meeting and introduced the scoring process from that meeting to satisfy the decisions making at the Procurement meeting

RESOLVED the report be noted

7. Investment Performance for the quarter end June 2017

Nimisha Sodha presented this report on the performance of the Pension Fund, citing the following points:

7.1. In terms of the broad market performance, equities were broadly flat over the quarter. Markets have adjusted to imply a better chance of a rate rise before the end of the year. Gilt yields rose over the quarter- this was owing to the announcement of the snap general election as investors grew concerned about the possibility of a tighter monetary policy

7.2. UK property continues to edge higher but still remains lower than the pre-referendum levels. The strongest gains are still coming from the industrial sector, where the rental growth is also slightly ahead of a modest overall rise.

7.3. Assets were up over the quarter by around £9.2m, and returns from all funds were positive over the quarter with Harbour Vest performing the strongest. Over the longer term periods, the funds continue to see positive performance from all funds.

7.4. There have been no changes to the manager ratings- in terms of asset allocation, there is quite a vast difference between the actual proportion and the target proportions. There is a specific allocation to cash which is relating to investing with Invesco. There was a structural change within the UBS mandate, which means the segregated funds are moved to the pool funds.

RESOLVED that the report be noted.

8. Pensions Investment Committee- Pensions Update

Robert Browning presented this report updating members of the following:

8.1. The MiFID II directive comes into force January 2018. Before that, LBL have to complete an “opt up” process, which is to classify as a retail client. The process will ask institutions involved to opt LBL up to this status.

8.2. To go down to retail status will drastically effect assets and investments because of the restrictions that will be in place. As part of this process, the scheme advisory board have produced a template letter questionnaire which encapsulates a number of tests that need to be met. The recommendations in this report are essentially asking members to give officers the delegated authority to carry out the process.

8.3. Because it is a standardised process, it will only need to be carried out once and then the template can be distributed to all the institutions involved with LBL. Its involves a number of quantitive test such as the size of our fund and whether the fund is an LGPS fund. The other test will include the experience of officers and members of the committee through training for example- essentially assessing the capability of the fund strategy

8.4. The applications would preferably be in by the end of September to give the institutions enough time to get back to the committee if there are any issues. officers will provide an update at the next meeting in November.

8.5. Regarding actions arising from the last meeting, UBS have not yet been approached regarding the amendment of their agreement to reduce their fee in terms of our current life fund structure, however, BlackRock have been notified of the Committees decision to remain in the current life fund structure and take advantage of a backdated fee reduction- they are in the process of amending their agreement.

8.6. The Pension Board will be recommenced and a meeting will be scheduled in the next quarter

8.7. The external audit of the financial statements for 2016/17 has been largely completed, with the final findings report to be agreed and reported to Audit Panel later in September.

8.8. Members are reminded of the rescheduled infrastructure training session due to take place in early October 2017. This will help inform decisions taken at Committee with regards to phase two of the rebalancing of the Fund.

RESOLVED that the report be noted and Members agreed the following recommendations as per the report:

- To note the potential impact on investments strategy of becoming a retail client under MiFID II
- To agree the immediate commencement of applications for elected professional client status with all relevant institutions in order to ensure that officers can continue to implement an effective strategy.
- In electing professional client status, to acknowledge and agree to forgo the protections available to retail clients
- To delegate responsibility to officers, for the purposes of completing the applications and determining the basis of each application

The meeting finished at 9.08pm.