Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**16 SEPTEMBER 2010**	**AGENDA ITEM NUMBER**
TITLE:	**ANNUAL REVIEW OF PROPERTY INVESTMENTS**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of Attachments: Appendix 1 – Overseas portfolio investment structure Exempt Appendix 2 – Partner's IMA Guidelines (Current and Proposed) and Partner's rationale for change Appendix 3 – Definitions of terms within Partners IMA Guidelines		

1 THE ISSUE

1.1 The Fund invests in property via property funds, with the UK portfolio managed by Schroders and the overseas portfolio managed by Partners.

1.2 The illiquid nature of property assets heightens the importance of portfolio planning when compared with managers of more liquid assets, and requires the property managers (and therefore the Fund) to take a long term investment horizon. Each manager's investment strategy (and how that strategy is implemented) is reviewed annually in the light of new investment opportunities and reinvestment of any asset sales within each portfolio.

1.3 The managers presented their investment strategy to the Investment Panel at the workshop on 16 September and this report sets out the current investment strategy for each manager.

2 RECOMMENDATION

The Panel recommends that the Committee:

2.1 **Approves the changes to the IMA guidelines for the property portfolio managed by Partners**

2.2 **Authorises the Panel and/or Officers to review the property portfolios annually and agree changes to the investment guidelines as appropriate, referring any strategic changes for agreement by the Committee**

3 FINANCIAL IMPLICATIONS

3.1 The monies earmarked for investment in property but not yet invested, are currently managed by BlackRock within a multi-asset passive portfolio. The officers manage the cash flow requests from the property managers.

3.2 When the decision was taken to invest 10% of assets in property the value of the Fund was £2.4bn thus the 10% allocation was £240m and this amount was set aside for investment in property. However, by the time the property managers were appointed in 2009 the Fund value had fallen to £1.8bn thus the initial monies allocated to property at that time was £180m or £90m to each manager.

3.3 The allocation to each manager will be increased by £20m to bring the allocation to each manager in line with the strategic benchmark (to be funded from the assets earmarked for investment in property) and this first annual review of the managers' strategies takes this into account.

4 SCHRODER – ANNUAL REVIEW OF UK PROPERTY PROGRAMME

4.1 Schroder began investing the Fund's assets in 2Q09 and set out an investment programme to be fully invested within 2 years. As at 2Q10, £75.5m or 84% of £90m has been invested. The remaining amount has been fully committed by Schroder, and is awaiting calls from the underlying fund managers, the timing of which is at the discretion of those managers and mainly depends upon them finding direct property assets to purchase.

4.2 Schroder invest in a range of property funds controlled by different asset managers, a "multi-manager" approach. This approach aims to achieve diversification (of assets/sectors, managers and styles), and provide access to specialist management and a variety of asset types. This approach benefits from scale.

4.3 Within Schroder's portfolio the Fund holds investments in 13 separate funds/unit trusts that are both open ended and closed ended funds. The target allocation is 55% in 'core', 35% in 'value added' and 10% in 'opportunistic', where core investments are properties whose key element of return is stable rental income, value added investments are properties that seek returns from both capital appreciation and income, and opportunistic investments which focus mainly on capital gains through active asset management.

4.4 Schroder's investment process involves 'top down' research on the market and other macro factors and a 'bottom up' element focussing on each individual investment and the underlying assets. These are brought together in the portfolio construction process which incorporates risk controls.

4.5 The portfolio has investment restrictions. These include a maximum sector variance of +/- 10% to the benchmark, a maximum 20% in a single fund, a maximum 30% with a single manager, and a minimum of 12 funds.

4.6 Schroder presented their strategy to the Investment Panel at the workshop held 16 September 2010. The portfolio is positioned to reflect Schroder's "house" view on the various UK property sectors. Currently it has overweight positions to shopping centres, retail warehousing, central London offices and alternatives, with an underweight allocation to high street retail, rest of UK offices and

Industrial. The target weightings, once the final investments have been drawn down, will move Industrial to an overweight position leaving only high street retail and rest of UK offices as underweight.

4.7 In the early phases of any property mandate whilst the portfolio is being established, performance data is less meaningful. The Officers are monitoring performance over this period, but it is only after a period of 2 years from inception that performance data becomes a meaningful reflection of value added by the investment process (from inception, i.e. including transactions costs). In Schroder’s case this will be around 2Q 2011.

4.8 There are no operational issues to bring to the Panel’s attention and performance was reviewed at the workshop.

5 PARTNERS – ANNUAL REVIEW OF OVERSEAS PROPERTY PROGRAMME

5.1 Partners began investing in 3Q09. As at 2Q10, £32m or 35% of £90m has been invested; however the whole amount has been committed to investment programmes.

5.2 Partners presented their strategy to the Panel at the workshop held 16 September 2010. The investment approach adopted by Partners is commonly used for private equity investment. Investment is through “closed end funds” with a finite life. As a result, each investor has to agree their “commitment” or amount they will invest for the finite period at the outset and the manager will gradually invest the committed funds over time. This approach is preferred for less liquid long term investments where the investment programme cannot be disrupted by large scale redemptions (which happens within “open ended funds” such as unit trusts). It also allows investments across “vintage” years (the year in which the first investment is drawdown from the committed capital, which enables the manager to spread the investments over the investment cycle, i.e. allows an element of market timing). The main disadvantage is that the investment is less liquid than open ended property funds. A fuller explanation of the investment structure is in Appendix 1.

5.3 The underlying funds in which Partners invests the Fund’s monies have finite lives of up to 10-12 years with a facility to extend this by up to 3 years if the market conditions make it difficult to sell the investments within the 10 year period. In practice, investments within each fund may be realised over time within the 10 years, and these “distributions” will need to be re-invested if the Fund is to retain its target exposure.

5.4 As a result, Partners will review the investment strategy and the implementation of that strategy annually and propose changes as appropriate to accommodate changes in the market outlook and re-investment of distributions. The annual review may necessitate changes to the IMA guidelines within which the overall investment programme is constructed to reflect the market outlook.

5.5 The current IMA guidelines are in Exempt Appendix 2 (see Appendix 3 for guideline definitions). The overall investment strategy is reflected in the allocations between Core, Value-added and Opportunistic investments as these types of property investments have differing risk/return characteristics and in aggregate they generate the overall risk/return profile for the portfolio. The other portfolio guidelines i.e. allocations between geographic regions and type of investment instrument, reflect how the overall strategy will be implemented. As the outlook for property (in terms of the range of investment opportunities available) will change over time, so these guidelines will evolve over time.

5.6 Given the current outlook for property, Partners have not sought to invest in "core" investments (high quality, income generating assets). In current market conditions where there are many distressed sellers of property assets (not distressed assets), they have favoured value added investments. They think that over the next 18 months, the property cycle will favour core investments again so anticipate investing more in core investments going forward.

5.7 In addition, they favour "secondary" investments where fund units or assets are bought from a seller (rather than primary investment, where the assets have yet to be developed or acquired). Secondary investments generally have lower risk than primary investments as the visibility of the underlying assets are far greater.

5.8 Lastly, in general they favour Asia and the Pacific region over the US and Europe, as the property markets in the US and Europe have been more affected by the credit crisis and economic slowdown than the developed markets within Asia and the Pacific.

5.9 To accommodate their revised investment outlook Partners have proposed amendments to the IMA guidelines to increase the allocation to secondaries, direct investments, and Asia, whilst reducing the minimum allocation to primary investments. The proposed changes are set out in Exempt Appendix 2 along with the rationale provided by Partners for the changes. Definitions of terms in the Guidelines can be found in Appendix 3. Partners are not proposing changes to the strategic guidelines on the allocations between core, value added and opportunistic investment types. The Panel are asked to recommend the revised guidelines to the Committee.

5.10 At this early stage of investing the portfolio, performance data is less meaningful due to the low investment level and initial transaction costs. The Officers are monitoring performance over this period, but it is only after a period of 2 years from inception that performance data becomes a meaningful reflection of value added by the investment process (from inception, i.e. including transactions costs). In Partners case this will be around Q3 2011.

5.11 There are no operational issues to bring to the Panel's attention and performance was reviewed at the workshop.

6 FUTURE ANNUAL REVIEWS

6.1 The Panel is asked to consider whether the annual reviews of the property mandates should be delegated to the Investment Panel and/or Officers rather than being presented automatically to the Committee. The reasoning for having delegated powers is that the Panel and Officers will have greater insight and knowledge to make a judgement of the managers' investment guidelines. Any changes of a strategic nature i.e. that materially affect the risk return profile of either property portfolio will be referred to full Committee.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary.

9 CONSULTATION

9.1 N/a

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 No decisions are being made. The issues being considered to make a recommendation to the committee are contained in the report and comments are sought in the report.

11 ADVICE SOUGHT

11.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	
Please contact the report author if you need to access this report in an alternative format	