Agenda Item No: 4

DEPLOYMENT OF INVESTMENT FUNDS

To:	**Commercial and Investment Committee**		
Meeting Date:	**17th January 2020**		
From:	**Director, Business Improvement & Development**		
Electoral division(s):	**All**		
Forward Plan ref:	**N/a**	*Key decision:*	**No**
Purpose:	**The Committee is asked to consider the proposed request to invest £20m into a Multi-Class Credit portfolio**		

Recommendation: **The Committee is requested to:**

1. **Recommend to the General Purposes Committee that £20m of capital receipts funding is re-assigned from financing commercial property to the asset classes outlined within the paper;**
thereby supporting the investment activities outlined within the Commercial Strategy 2019-21 and our Investment Strategy and requiring a corresponding increase in borrowing of £20m to replace the capital receipts funding for commercial property.

2. **Delegate responsibility to the Director of Business Improvement and Development, in consultation with the Chair of Commercial & Investment Committee, to appoint the required Investment Manager.**

3. **To note the principles around the future direction of travel for the investment portfolio predicated on a more detailed paper setting out the future direction coming to C&I Committee.**

	Officer contact:	*Member contact:*
Name:	Christopher Sutton	Cllr Joshua Schumann
Post:	Commercial Senior Transformation Advisor	Committee Chairman
Email:	Christopher.Sutton@Cambridgeshire.gov.uk	Joshua.Schumann@cambridgeshire.gov.uk
Tel:	01223 724359	01223 706398

1. BACKGROUND / OVERVIEW

1.1 The Commercial & Investment Committee, through its Commercial Board and Investment Group oversees the activity relating to our commercial investments. This has historically focused on UK commercial property through the acquisition of buildings in the local vicinity and investment in a UK property fund. The current size of the investment portfolio is c. £160m all centred on property, though diversified by type and geography.

1.2 Acknowledging the Committee's desire to scale our portfolio, our strategic investment advisers (Redington Ltd) have been working to develop a clear investment strategy to help us to generate a long term income from our investment activities for the purposes of maintaining and improving local services whilst minimising (where possible) the associated risk.

1.3 Together, we have identified the need to progress our investment goals through:

- A broader range of income sources – to reduce the reliance on a single source e.g. a small number of tenants.
- Greater diversification across asset classes, regions and sectors – to increase the risk adjusted return and reduce the overall portfolio risk.
- Use of an asset manager – to ensure the portfolio is being monitored and managed professionally and evolved as required when market events occur to generate the best possible investment return.
- Improve liquidity by investing in assets that do not take the same time to sell or dispose of as commercial property allowing for more flexibility and to be able to respond to alternative investment opportunities within appropriate timescales.

1.4 This paper sets out the proposal to deploy the first wave of capital as part of the new portfolio development aimed at achieving our investment goals and enhancing diversification, income generation and liquidity of the overall portfolio, which today is almost entirely focused on property.

1.5 For clarity, the following definitions are being used within the report;

- ***Asset Backed Securities (ABS)*** – are financial securities backed by assets such as residential mortgage loans, commercial loans or consumer loans.
- ***Asset manager*** – as it relates to property. The individual is responsible for management and implementing the strategy of individual property assets or a group of buildings. They report and are directed by the Investment / Fund Manager.
- ***Corporate Bonds*** – debt securities issued by corporations and sold to investors. Backing for corporate bonds is typically the payment ability of the corporation in question, although physical assets may also be used as collateral.
- ***Current Yield*** – The annual income return that the Investment Manager is achieving today
- ***Expected Return*** – Redington long-term (10 year) forecast of the expected total return per annum.
- ***Expected volatility*** - A statistical measure of the dispersion of returns for a given security / index. It represents how large an asset's price swing around the mean price.
- ***Investment grade (debt)*** – Corporate bonds, ABS or other fixed income securities which are rated at 'BBB-' or higher by the credit rating agencies (Standard & Poor's,

Moody's or Fitch). A company with an investment grade credit rating is expected to have a lower risk of default than a sub-investment grade company.

- ***Investment manager –*** is responsible for investment decision making to ensure the portfolio is managed in accordance with the investment objectives, policies and regulations.
- ***Liquidity*** – how quickly an asset can be converted back to cash.
- ***Manager Fees*** – the fees charged by the investment management company to actively manage the portfolio.
- ***Multi-Class Credit*** – a type of investment fund that can invest in a wide variety of fixed income assets with a focus on sub-investment grade credit (high yield and leveraged loans), to provide diversified exposure to the credit market. These are typically not constrained to a specific benchmark index.
- ***Ongoing Charge Fund*** – Total cost of investing in the fund, including the managers buying and selling costs and all the administrative costs.
- ***Value at Risk (VaR)*** – the minimum value that an investment would expect to lose (at risk) in a downside scenario that has a given probability of occurring and over a specific time horizon.

2. FUND DEPLOYMENT

2.1 The current strategy of direct property investment has enabled the Council to expect annual revenue returns of approximately £7.8m gross (5.3% return). The Council are in a good position to manage any capital value decrease (over the long term) and can control when assets are disposed to reduce capital losses. There is a further opportunity through diversifying our portfolio to also reduce the risk to the revenue income from the portfolio. Given the authority's appetite for risk, where possible it is advisable to reduce the possible fluctuation in portfolio value and protect revenue returns through reducing the Value at Risk.

2.2 Based upon the Council's requirements and funding capacity, the proposed next step is to deploy £20m of capital receipts within a Multi-Class Credit fund.

2.2.2 Key features of this asset class are shown in the table below;

Feature	
Expected Return	3.6%
Current Yield	c.5.5%
Expected Volatility	6.9%
Manager Fees	0.9% p.a.
Liquidity	Quarterly

Data as at 30th September 2019

2.2.3 It is expected that in year 1 the revenue return for the £20m investment will be £1.1m (net of fees).

2.3 The advantages of Multi-Class Credit are;

- Diversified exposure (see Appendix 1 below)
- Contractual income generation reducing fluctuation risk to our revenue income

- Improved liquidity allowing us to release cash and provide more flexibility to the way we invest
- Active management provides additional return and downside protection
- Not constrained to a benchmark

2.3.1 The disadvantages of this approach are;

- Allocation of capital within the fund may be more defensive than high yield indices
- As the investment is spread over varying assets, it is difficult to monitor the performance against similar investments
- The returns from the fund can fluctuate depending on the performance of the assets invested

2.3.2 These disadvantages will be mitigated through the implementation of effective governance arrangements and active monitoring through the combination of the Commercial Team, Investment Group and Redington.

2.4 The impact of this investment decision on our wider portfolio will be;

- Reduction in the average Value at Risk across the portfolio
- Estimated income per annum – increase from £7.8m to £8.9m
- % of investment in Property – 88% down from 100%
- % in Non-property – 12% up from 0%

4.0 DECISION MAKING AND APPRAISAL

4.1 Members of the C&I Investment Group, Head of Finance and S151 Officer have received presentations by Redington on the proposals which have included detailed discussion of;

- What the investment needs to achieve
- Unconstrained investment approach vs property investments
- The asset class universe
- The trade-offs between our investment objectives
- Portfolio options modelled on these trade-offs
- Appropriate governance arrangements

4.1.1 The recommendation of the C&I Investment Group is to proceed with the identified next step of diversifying and growing the investment portfolio through the proposed investment.

4.2 Members of the C&I Investment Group are kept informed as part of the procurement of the Investment Manager (see below).

4.3 The deployment of these funds is in line with the authority's overall investment strategy.

5.0 IMPLEMENTATION

5.1 It is expected that funds will be deployed in April 2020. The level of complexity and monitoring and choosing where to invest our funds requires more skill and knowledge than our previous investments. Therefore we will need to procure an Investment Manager to manage this particular element of the portfolio. Redington Ltd will be able to provide support to us in this area through the current contract incurring no additional cost, by;

- Developing the correct specification and mandate
- Effectively assessing the Investment Managers
- Ensuring the process is not just a 'beauty parade' and the Council is able to understand and justify the award

5.2 It is anticipated that this may allow future capital receipts to be deployed as phase II of the portfolio development which would allow investment across other asset classes such as Global Sustainable Equity and Securitised Opportunities in order to maintain and strengthen the portfolio and ensure further diversification and risk reduction.

5.3 There has, rightly, been increasing scrutiny on the investment practices of local authorities with concerns raised over the sustainability of investments and whether appropriate governance arrangements were in place to make investment decisions. It is proposed that C&I Committee will retain their high impact strategic decision-making function, whilst delegating day to day oversight responsibility and administrative tasks to the Head of Commercial / Commercial Team who can intermediate with our Investment Manager to ensure the fund is effectively monitored as well as continuing to feed into the Investment Group.

5.4 Although these investments will be financed as part of the capital programme, they are governed by the Financial Investment Strategy (which is part of the treasury management strategy). As it stands this constrains the County Council from investing in counterparties and financial products below a relatively "safe" rating (for investments which are rated). In order to achieve the level of financial return that would justify an investment of this nature, it appears that the funds held will be spread across a range of ratings or security levels. The Council will consider this matter further, subject to further advice, and the member working group's appraisal of risk appetite. In the event that an amendment or exemption to the treasury management policy is required, this will need confirmation by the Full Council.

6. Funding

6.1 The proposed investment will be funded through £20m of capital receipts. These receipts will be made available by requesting or swapping a further £20m of borrowing to fund our commercial property investments from General Purposes Committee through the integrated finance management report. This will release £20m of capital receipts currently being badged against our commercial property acquisitions for investment in a Multi-Class Credit pooled fund. An alternative is to identify £20m of new capital receipts in the 20/21 financial year, however at this stage it does not seem likely that the Council will receive this level of capital receipts in 2020-21

6.2 General Purposes Committee has recently agreed £73m of borrowing to fund commercial property acquisitions this year, and this recommendation will increase that figure to £93m. The recommended extension has been in prospect during the Autumn and was initially considered alongside the benefit analysis for the financing of commercial property. On a recurrent basis, after applying additional borrowing costs and an MRP to commercial property as a result of the £20m borrowing extension, the Council has additional financing costs of £0.8m, however this is more than offset by the net return from the proposed £20m investment in multi-class credit, where the return is £1.02m. Therefore the expected net impact to the Council from these twin changes is additional investment income of £220k per annum.

7. Risk

7.1 As with any investment, the value can go down as well as up. Appointing a best in-class fund manager should help mitigate any potential loss in value from our investment.

7.2 The later we deploy our capital, the less income that will be generated in the next financial year impacting commercial returns. This deployment risk will depend on the length of the procurement process required. This income will be needed to offset the additional borrowing costs incurring from re-assigning capital receipts (6.2).

8. Future Direction

8.1 It is proposed that the authority’s current approach to investing is reviewed by the Commercial Team in order to reflect the following principles:

8.1.1 Identification of a five year plan to run alongside the MTFS to identify annual maintenance and enhancement to our current investment portfolio as well as new investments each year. This plan could align to the Business Planning cycle to enable decisions of prioritisation of capital receipts and other funds deployment.

8.1.2 A percentage return from the portfolio will be allocated for maintaining our assets in line with portfolio development and returns maximisation

8.1.3 While the property portfolio is diversified across the county and by sector, continued diversification will be key to reducing the risk across the portfolio and ensuring long term returns for the authority, as such the Commercial Team and the authority’s investment advisors will continue to explore appropriate and new diversification opportunities within the constraints outlined in our long term investment strategy.

8.1.4 It is anticipated that a new governance model will be required to effectively manage the growing investment portfolio. In order to ensure robust and timely portfolio management, and monitoring of fund managers on a regular basis certain restructuring may be needed but C&I Committee will maintain its strategic oversite.

8.2 A more detailed paper, specifying what these principles will mean for day-to-day management of the portfolio will be brought to C&I before the end of financial year. At this stage, we are only seeking C&I to note and endorse the general principles outlined above and not to see them enacted.

9. ALIGNMENT WITH CORPORATE PRIORITIES

9.1 Developing the local economy for the benefit of all
9.2 Helping people live healthy and independent lives

9.3 Supporting and protecting vulnerable people

The Council's Corporate Strategy, with these priorities at its core, identifies a number of key objectives that are directly linked to commercial activity, with this proposal supporting the implementation of that strategy.

10. SIGNIFICANT IMPLICATIONS

10.1 **Resource Implications**
The resource implications are set out in within the main body of the report which compare favourably in both the level of return and risk compared to our current portfolio.

10.2 **Procurement/Contractual/Council Contract Procedure Rules Implications**
Procurement guidelines will be followed in procuring an Asset Manager

10.3 **Statutory, Legal and Risk implications**
Our ability to achieve our investment goals will depend on a number of factors including how well we use our legal powers and delegations and the political appetite to accept new risk. We do have the legal power to undertake this proposal but there will be a level of risk associated with the deployment of capital in this way. There is the possibility that the value of the investment could increase or decrease over a particular time horizon. Active monitoring / governance and appointment of best-in-class managers will mitigate this.

10.4 **Equality and Diversity Implications**
There are no significant implications in this area.

10.5 **Engagement and Consultation Implications**
There are no significant implications in this area.

10.6 **Localism and Local Member Involvement**
Environmental, social and governance (ESG) factors will be used in measuring the sustainability and ethical impact of an investment proposals.

Members will be supported in understanding the opportunities, risks and benefits of different investment opportunities.

10.7 **Public Health Implications**
There are no significant implications in this area.

Implications	**Officer Clearance**
Have the resource implications been cleared by Finance?	Tom Kelly
Have the procurement/contractual/ Council Contract Procedure Rules implications been cleared by the LGSS Head of Procurement?	n/a

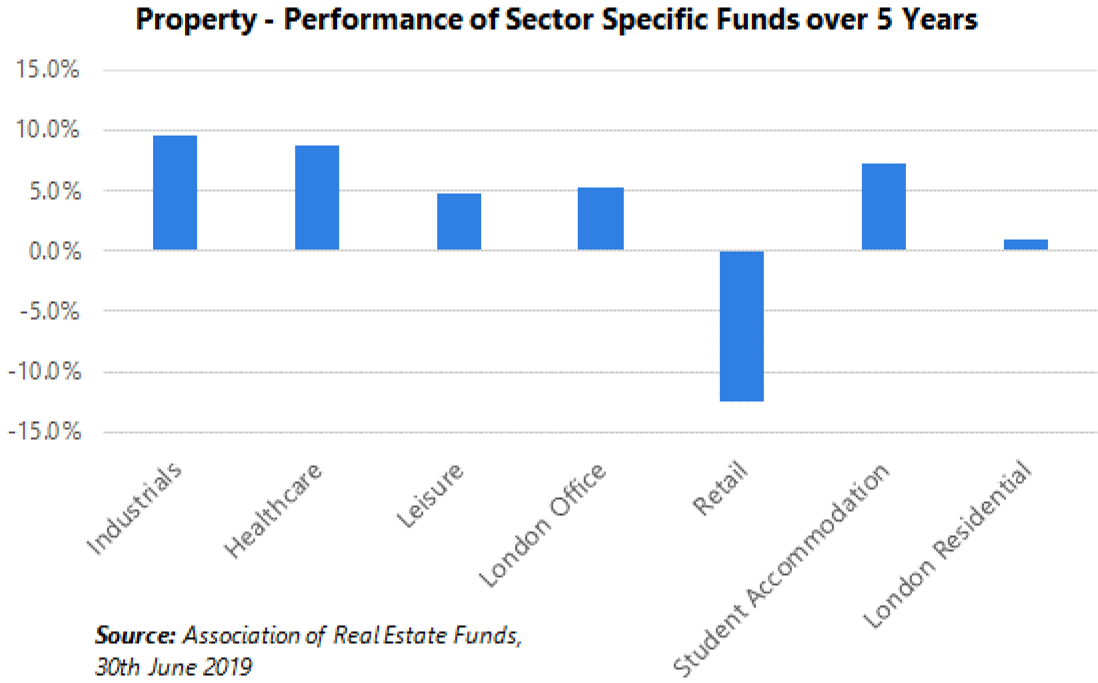
Has the impact on statutory, legal and risk implications been cleared by LGSS Law?	n/a
Have the equality and diversity implications been cleared by your Service Contact?	n/a
Have any engagement and communication implications been cleared by Communications?	n/a
Have any localism and Local Member involvement issues been cleared by your Service Contact?	n/a
Have any Public Health implications been cleared by Public Health	n/a

Source Documents	Location
Commercial Strategy	https://cambridgeshire.cmis.uk.com/ccc_live/Meetings/tabid/70/ctl/ViewMeetingPublic/mid/397/Meeting/775/Committee/31/Default.aspx

Appendix 1

3.0 BENEFITS OF DIVERSIFICATION

3.1 Over any single period a particular asset class or sector can perform well or badly, and it is challenging to predict which asset class will be the outperformer. For example, over the last five years there has been a big dispersion of the performance within property sectors (see chart 1 below). Therefore investing across different sectors protects against the impact of one sector underperforming.



Source: *Association of Real Estate Funds, 30th June 2019*

Chart 1

3.2 In addition, there is limited consistency of the best performing asset classes each year (see chart 2 below), therefore investing across different asset classes also protects against the impact of one asset class underperforming.

Annual Performance of Different Asset Classes

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Govt bonds 15,9%	EME 73,5%	REITS 36,4%	EMD 12,1%	REITS 18,3%	DM Equities 21,9%	REITS 44,8%	REITS 13,9%	HY bonds 17,7%	EME 21,0%	Govt bonds 4,6%
Cash 5,7%	HY bonds 54,4%	EME 27,5%	REITS 10,9%	HY bonds 17,8%	Portfolio 3,3%	EMD 20,2%	EMD 12,8%	Cmdty 15,1%	DM Equities 8,1%	IG bonds 1,3%
IG bonds -3,9%	DM Equities 26,7%	Cmdty 24,9%	Govt bonds 9,9%	EME 16,8%	HY bonds 2,7%	DM Equities 20,1%	DM Equities 11,0%	EME 14,9%	Portfolio 1,7%	HY bonds 0,8%
EMD -6,3%	Portfolio 25,4%	HY bonds 22,8%	IG bonds 7,8%	EMD 16,7%	Hedge Funds 2,1%	IG bonds 17,5%	HY bonds 8,4%	EMD 13,5%	Cash -0,3%	REITS 0,7%
Hedge Funds -19,3%	EMD 24,2%	DM Equities 20,1%	HY bonds 6,6%	DM Equities 14,7%	Cash 0,2%	Portfolio 16,2%	Govt bonds 7,7%	REITS 12,6%	HY bonds -3,0%	EMD 0,2%
Portfolio -20,9%	REITS 23,5%	EMD 19,8%	Cash 1,7%	Portfolio 10,7%	REITS -1,3%	HY bonds 13,9%	IG bonds 7,4%	DM Equities 11,4%	EMD -4,0%	Cash -0,3%
HY bonds -23,1%	IG bonds 15,5%	Portfolio 18,9%	Portfolio 1,2%	IG bonds 9,5%	IG bonds -4,0%	Hedge Funds 13,2%	Hedge Funds 7,3%	Portfolio 10,3%	REITS -4,0%	Portfolio -1,6%
Cmdty -32,3%	Cmdty 15,2%	Govt bonds 13,3%	DM Equities -1,8%	Hedge Funds 1,9%	EME -6,5%	Govt bonds 13,0%	Portfolio 6,4%	IG bonds 7,4%	IG bonds -4,2%	Hedge Funds -2,0%
REITS -34,1%	Hedge Funds 9,9%	IG bonds 13,2%	Hedge Funds -5,8%	Cash 1,2%	Govt bonds -8,4%	EME 11,8%	Cash 0,1%	Hedge Funds 5,6%	Govt bonds -5,8%	DM Equities -3,6%
DM Equities -37,2%	Cash 2,3%	Hedge Funds 12,5%	Cmdty -10,4%	Govt bonds 0,3%	EMD -10,6%	Cash 0,3%	EME -4,9%	Govt bonds 4,7%	Hedge Funds -6,9%	Cmdty -6,8%
EME -50,8%	Govt bonds -0,6%	Cash 1,1%	EME -15,4%	Cmdty -2,6%	Cmdty -13,4%	Cmdty -5,5%	Cmdty -16,1%	Cash -0,1%	Cmdty -10,7%	EME -9,9%

Source*: JPMorgan Asset Management* ***REIT****: Real Estate Investment Trust*

Chart 2