



LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ACTION AGREED BY INVESTMENT SUBCOMMITTEE (ISC)

Purpose of the Report

1. The purpose of this report is to provide the Committee with details of an investment agreed by the Investment Subcommittee (ISC) at its meeting held on 14th June 2017.

Background

2. The Fund's investment consultant, Hymans Robertson, identified an investment opportunity that was felt to be appropriate for inclusion within the 'Opportunity Pool' portfolio, and the investment manager(Christofferson Robb & Company) were invited to present the opportunity to the ISC.
3. The 'Opportunity Pool' is a concept whereby the Fund has a certain amount of capital that can be deployed into investment opportunities that do not fit neatly into the remaining asset allocation split, but where the potential returns are thought to be sufficiently high to justify an investment. The Fund's target asset allocation weighting for the opportunity pool is between 4% - 6% and there is an expectation that the net investment return will be 10% p.a. or more.
4. As a general rule opportunity pool investments will tend to be highly specialist in their nature, and they will often be investments that arise as a result of a market dislocation or a general misunderstanding about the risk and return profile of the asset type. The manager will often operate in a highly niche market and be one of a handful of investors with the skills to access the opportunities.

CRC Capital Relief Fund III

5. Following a presentation by the manager, an investment of £40m was agreed by the ISC with an expectation that the investment would be funded in September 2017. Attached as an appendix is a report that was produced for the ISC which provides details of the investment opportunity.

Recommendation

6. The Committee is asked to note the report.

Equality and Human Rights Implications

None specific

Background Papers

None

Officers to Contact

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INVESTMENT SUBCOMMITTEE – 14TH JUNE 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT IN CRC CAPITAL RELEASE FUND III

Purpose of the Report

1. To provide information in respect of a recommended investment in the CRC Capital Release Fund III (CRC III).

Background

2. The Fund has a target allocation of 4 – 6% of total Fund assets to the 'Opportunity Pool' concept. In broad terms these should be considered as investments that are expected to produce returns that are at least as high as those expected from equities markets, but which will provide an element of diversification from broad-based equity markets. They will generally not fit comfortably elsewhere within the Fund's overall asset allocation strategy, and will almost always be investments that take advantage of market opportunities that exist at a point-in-time but that appear unlikely to persist indefinitely.
3. At present only 1.9% of the available Opportunities Pool funding is invested, and this is all within the specific opportunities within debt markets (via three M & G Debt Opportunities Funds). A further c.£40m has been committed to Opportunity Pool investments but is currently 'undrawn' (M & G Debt Opportunities Fund III and Markham Rae Trade Capital Partners), and it is anticipated that most of this will be invested within the next 12 -18 months. This will take the Opportunity Pool up to about 3% of total assets of the Fund.
4. The first two M & G Debt Opportunities Funds are, however, fully invested and are in their distribution stage. Over the last 12 months £41m of capital has been returned from these two funds and it is probable that further significant capital sums will be returned over the coming 12 months. The Opportunity Pool may, therefore, not increase significantly in size as the drawdowns are likely to be offset to a meaningful degree by distributions.
5. There is no reason to make Opportunity Pool investments unless they are considered likely to be better (on a risk-adjusted basis) than where the money would otherwise be invested. Once the Opportunity Pool is fully utilised there will be no room to fit in other opportunities that may come along, unless there is a strategic change to the benchmark agreed by this committee, and it has always been the case that waiting for the right opportunity is a better option than simply deploying capital into the best options available at any point in time. The ultimate

aim is for the Opportunity Pool to consist of about 6 -8 investments, and for all of these to be capable of adding meaningful value at a total Fund level. The expectation is that these individual opportunities will be for between ½% and 1½% of total assets each, with the size varying depending on the risk and potential return that is expected from each one.

6. CRC III is a fund that will effectively buy portfolios of loans from banks and be paid an insurance premium from the bank to do this. The investment manager (Christofferson, Robb and Company) is highly specialised in this area and has been carrying out these transactions since 2002, and has been able to produce very good returns for investors. Although the premium paid to the manager by the banks is significant given the overall risks associated with the portfolios, it is still financially advantageous for them to do this because it frees up capital for them to use elsewhere within their business.
7. This report is not intended to be an exhaustive analysis of the investment opportunity, and the Hymans Robertson note that is attached as an appendix provides further details. Christofferson, Robb and Company has also produced a presentation and will be in attendance at today's meeting to explain the investment more fully.

What is Bank Capital Release?

8. Within the banking regulatory environment, capital has to be held as backing for loans that have been made. If a bank wishes to increase its lending activity it has to hold more regulatory capital and this capital can be expensive (having averaged a cost of c.15% over recent years).
9. By arranging a mechanism for transferring the risk of loans made, banks can receive approval from the regulators to hold less regulatory capital against existing loans and this frees up capital to support further lending activities. Because capital is expensive for banks they can afford to pay a healthy premium to the counterparty that the risk is being transferred to. The risk transfer and the approval by regulators makes bank capital release attractive to both the bank and the investor.
10. In very simplistic terms, CRC III will assume part (and occasionally all) of the risk of default on the loan portfolios that it invests in. These portfolios have to pass certain 'quality' assessments before they are considered and the default risk can be estimated with reasonable accuracy in advance. It is only in the event that the default rate is much higher than anticipated, and much higher than has ever occurred historically, that returns to investors start to be eroded to a meaningful extent. The target investment return for the fund is around 10% p.a. (net of all costs) and this is a highly attractive return to investors, and a return that fits in well with the expectations for the Opportunity Pool.
11. CRC III is clearly not risk-free but the manager has a long track record of avoiding meaningful defaults, and has produced highly credible returns to investors. Whilst the assets managed by them have increased in size, this has been matched with

increasing investment opportunities and there is a high probability that any commitment can be deployed in a speedy manner.

Recommendation

12. The Investment Subcommittee is recommended to approve a £40m commitment to invest in the CRC Capital Release Fund III.

Equal Opportunities Implications

None specific

Background Papers

Attached as appendix

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