local authority pension funds: investing for growth

prepared by a research consortium of the Smith Institute, the Centre for Local Economic Strategies (CLES), Pensions Investment Research Consultants (PIRC) and the Local Authority Pension Fund Forum (LAPFF)

THE SMITH INSTITUTE

About the Local Authority Pension Fund Forum

The Local Authority Pension Fund Forum (LAPFF) exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders while promoting social responsibility and corporate governance at the companies in which they invest. Formed in 1990, the forum brings together a diverse range of local authority pension funds with combined assets of over £100 billion.

About Pensions Investment Research Consultants

Pensions Investment Research Consultants (PIRC) is the UK's leading independent research and advisory consultancy providing services to institutional investors on corporate governance and corporate social responsibility. Since 1986, it has been the pioneer and champion of good corporate governance within the UK.

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The Centre for Local Economic Strategies (CLES) is the UK's leading member and research organisation, with charitable status, dedicated to regeneration, local economic development and local governance. CLES brings together a network of subscribing organisations, including regeneration partnerships, local authorities, regional bodies, community groups and voluntary organisations.

Established in 1986, CLES undertakes a range of activities including policy research, production of publications, training, an information and briefing service, events and a consultancy trading arm, CLES Consulting. CLES also owns New Start Magazine, the international magazine for making better places.

The project is supported by major funds from across the country, including: the Local Authority Pension Fund Forum; Greater Manchester Pension Fund; Merseyside Pension Fund; South Yorkshire Pension Authority; West Midlands Pension Fund; West Yorkshire Pension Fund; and Northern Ireland Local Government Officers' Superannuation Committee.

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Foreword

Paul Hackett, Director of the Smith Institute, Alan MacDougall, Managing Director of Pensions Investment Research Consultants, and Neil McInroy, Chief Executive of the Centre for Local Economic Strategies

The economic and policy context for investment in the UK has experienced significant change over the past five years. The recession and persistent credit squeeze has not only affected the immediate prospects of the private, public and social sectors, it has prompted a fundamental rethink about what we should be investing in and where new sources of finance might come from. Pension funds, including those of local authorities, have become an important item on this new agenda, with much talk in Whitehall and town halls about directing pension fund investment towards upgrading the nation's infrastructure and kick-starting major capital projects.

Local authority pension funds, which hold investments and assets of more than £120 billion, already make substantial investment in the UK. But in this time of fiscal austerity and uncertainty, can they do more to invest for wider economic and social benefit? This unique and extremely timely study tests out what the demand and scope for such investment might be; takes an impassioned look at what has been achieved and can be achieved; highlights the key opportunities and barriers to change; and makes some practical recommendations to government, local authority pension funds and their partners.

There are no quick fixes. Patience, due diligence and fiduciary responsibility are watchwords for all local authority pension funds. Reforms to the system take time, and demand consensus. However, there are positive signs of change, not least around impact investment and pooled funds.

We hope our findings enhance the debate about investment for local growth not only among pension fund experts and professionals, but also among local authority members and officers, and those in central government. We also hope to stimulate much wider interest and a more constructive dialogue between the sector and politicians, policy makers, opinion formers and the public (many of whom are members of local authority pension schemes). There is still more work to be done on this topic, but we believe that rigorous studies like this can provide the much-needed solid evidence base that trustees and managers need if they are to do things differently in future.

The project included extensive desk research; case studies; interviews with pension managers, fund managers, local authority members and officers; peer review meetings with Local Authority Pension Fund Forum (LAPFF) members; and three round table seminars in Manchester, Barnsley and London. We hope the results reflect the views we received.

We would like to thank all those who took part in the project, especially those who attended the round tables. We would also like to thank the LAPFF members for sponsoring this project and for the information and advice they gave, in particular Brian Bailey, whose knowledge and guidance was invaluable. And finally we would like to offer a very special thanks to Rupert Greenhalgh, the lead researcher, whose work is of the highest standard.

Executive summary

Executive summary

Context
This study is the first of its kind in the UK. It aims to provide a detailed assessment of how pension funds can use their substantial resources to deploy capital in ways that derive wider economic benefit. As such, the study's objectives are to:

- test out what the demand for impact investments might be;
- review what has been achieved and what can be achieved by such investments;
- identify the key opportunities and barriers to change; and
- make recommendations on what stakeholders might do to enable changes in practice.

The study is based upon the results of interviews and workshops with local authority pension fund officers, local authority economic development officers and external fund managers. The main lines of enquiry were informed by a detailed literature review and a call for evidence that was sent out to 100 funds across the UK. The response from these forms the basis for the structure of the report.

General context
The recent turbulence in the world's economy has resulted in the diversification of investment portfolios and mitigation of risks in investment decisions over the past 18 months. Almost all funds have responded by increasing their exposure to "alternatives" – private equity and infrastructure. Infrastructure investment was cited in approximately four-fifths of the research interviews.

Impact investments
Trustees are showing growing interest in and action towards developing new and alternative sources of investment.

Fiduciary responsibilities and "finance first" were cited as the main reasons for not developing extensive impact investments. Impact investments, for wider economic benefit, mostly centred on developing infrastructure – mainly UK office property. Most regarded established infrastructure as the most attractive in terms of long-term income streams, awareness of risks and a track record of data on occupation, rents and yields.

Whilst maximising returns remained paramount for all funds, most funds stated that they would be interested in developing impact investment in the future, provided that: rates of return and the right risk profile could be achieved; there were no conflicts of interest; the investment schedule was clear; there was a track record of delivery; and investors had a clear exit strategy.

The question of social return cannot intrude on return or fiduciary responsibilities. No funds said they would be prepared to accept lower returns in exchange for achieving social benefit. Equally, current examples of layered investments were also in a minority, despite a growing interest in learning more about these types of opportunity.

While fiduciary responsibility was a first-order concern for funds, there was also a significant interest in the issue of pooling resources, mergers and the barriers to scaling up investment. Most funds recognised that infrastructure investments were likely to be more attractive to the larger funds that had scale and would be able to bear the due diligence, legal, administrative and other management costs.

Key barriers to impact investments
The main barriers arising in relation to developing impact investments (particularly for infrastructure funds) were managing reputational risks associated with new investments and potential conflicts of interest, especially where local infrastructure schemes were concerned. Despite these perceptions, investment for wider impact was certainly much higher up the agenda of all the funds interviewed.

Conflict of interest was the primary worry for almost every fund interviewed, and to a lesser extent there were concerns about the risks of investing locally, along with the fact that some employers in a fund (such as outsourced admitted bodies) might not be locally based or derive any real benefit, and so might question such policies.

Impact investments were perceived to be more resource-intensive than conventional investment practice, in terms of management and the knowledge requirement for trustees. Funds were concerned that more complex fund portfolios would put additional pressure upon pension panel members, who already had limited time to devote to their trustee responsibilities.

Investment consultants were regarded as the main gatekeepers, best placed to support and advise on changes in asset portfolio, such as investments for wider economic impact. The other gatekeepers were typically identified as one or two elected members that had a particular interest in particular types of, for example, environmental and social investment, and who were prepared to act as champions to take changes forward.

The qualifications of investment officers were identified as paramount for good fund management.

A number of common areas of future training were identified during the interviews, including: setting up joint ventures, pooling arrangements and associated legal issues; developing framework agreements for procurement and commissioning external managers; and understanding complex alternative investments such as layered property investments, joint ventures, and the use of derivatives and hedge funds to manage exposure to certain investments.

Potential for delivering social and environmental impacts
Scaling up the social investment sector will require the development of consistent and robust evaluation processes, in order to raise confidence and attract new investment. The majority of funds interviewed said they thought that this area of investment was largely untested, requiring more information on the historic levels of risks and rates of return to be generated.

Environmental or green investments were, however, seen as a growing asset class, offering a range of subsectors, industrial operations, and localities which could be used to diversify risk and returns across an investment portfolio. The main opportunities identified were linked to government policy relating to waste management, energy sources and carbon targets, and resource efficiency.

While there has been a significant amount of discussion across UK pension funds regarding social housing, there was very little current evidence of take-up of social housing investment products. However, they are proving attractive enough to stimulate requests for further consultancy advice and debate about future development. Most funds suggested they were waiting for others to lead "demonstration projects".

It was widely considered that the development of alternative investments, including those for wider economic benefit, would require external consultancies to "push" on these types of issues (such as social impact investments) if they were to have future traction.

Key summary messages for central government

The government needs to show leadership, expediency and greater clarity on how some of its ideas around using pension funds for infrastructure investment would work in practice – including legislation, guidance and financial support to enable the pooling of funds. Most funds feared a rush to pension funds with the expectation that they would be in "a position to support any type of local or national infrastructure".

The government should take a more active role in supporting those areas that wish to move towards pooled investments. Some funds suggested that more could be done to merge funds across the UK (for scale rather than efficiency savings). Others expressed some caution over being forced into mergers that were not in the interests of their funds.

Many fund managers were reluctant to invest in areas where government policy has a significant bearing on the potential returns on investment, with many citing the recent changes to energy feed-in tariffs and the knock-on effects for business investment in the micro-generation sector. They stated that the government's role must be to provide a stable long-term policy environment that provides fund managers with the confidence to invest for wider economic benefit.

Key messages for local government

Dialogue across local authority and local enterprise partnership boundaries is vital in presenting investment opportunities. There were divergent views about the geographic scale at which wider impact investment should operate, including the potential for pooled funds at pan-regional or city-regional level (in some of the UK's larger city-regions).

A pooling of ready opportunities for investors should be considered, provided that they were heavily informed and forged by what the investment market required/would be receptive to.

Pooling was seen as a way for smaller funds to benefit from larger organisations' experience, capacity and ability to bear due diligence costs. Taking this a step further, a number of funds were also interested in receiving more guidance on the legal issues affecting "pooling and service-level agreements" between authorities to build economies of scale to develop funds, in particular where smaller funds could piggy-back on larger funds in their region.

Funds also highlighted the importance of local authorities in making places more attractive for investment, including their role in economic development, providing strong leadership and governance, delivering quality public services and managing local infrastructure. Addressing bottlenecks in planning and fast-tracking planning applications were the most common examples given as ways to make places more attractive for investment.

Some funds cited the potential to blend sources of finance to kick-start "recyclable funds", where commercial investment is matched against sources of European funding. However, they also stated that there needed to be a shift away from authorities' reliance on funding. The notion of "soft money" was raised as a huge risk for how future investments are perceived, in terms of ensuring that investments are not perceived as depending solely on subsidies.

Moving the agenda forward: key recommendations

The report concludes by making five key recommendations.

Recommendation 1: Better information and clearer guidance

Local authority pension funds should work with the Local Authority Pension Fund Forum (LAPFF), relevant government departments, external investment fund managers and the Chartered Institute of Public Finance & Accountancy to develop guidance and technical papers on impact investment and pooled investment vehicles.

Recommendation 2: Demonstrable case studies and training on matching impact investment within fiduciary duties

LAPFF should work with investment intermediaries and consultants to develop good-practice case studies, for promotional use by "champion trustees" on how impact and infrastructure investments can be used effectively within their fiduciary duties to enhance the risk/reward profiles. LAPFF needs to explore member support/funding for the development of a series of training seminars for pension fund officers that highlights emerging finance vehicles which "layer" investments, combining high- and lower-risk investments (for instance, including property assets to underwrite risk).

Recommendation 3: Legislative adjustments – enhancing potential for flexibility

The government should consider reviewing and exploring potential changes to restrictions on investments (as set out in *The Local Government Pension Scheme Schedule – Management and Investment of Funds*), to enable local authorities to have sufficient flexibility to address the issues and recommendations set out in this report, in particular those relating to limits for investment in limited partnerships.

Recommendation 4: Create an enabling platform – a clearing house

Local authority pension funds and other relevant partners, including LAPFF, should lobby government to fund an independent external agency to act as a clearing house, gathering data from a wide range of (impact) projects around the UK, supporting transparent valuation and consistent financial reporting standards of impact/infrastructure projects. The agency would support the development of a combined national framework and standard for assessing economic, social and environmental value: of interest to the public, politicians, commissioners, social investors and local communities.

Recommendation 5: A new pooled vehicle

The potential should be explored for a core group of larger pension funds to contribute funding for the commissioning of an independent manager to help determine and deliver a way forward for pooled impact investment funds. The aim of the fund manager would be to develop a joint investment agreement that would see a group of five or more signatories each putting £5 million to £10 million into a pooled vehicle, with a view to inviting local authorities/public-sector bodies to put forward bids for the investment, including the leverage of other sources of public and private investment.

1. Introduction

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1.1 Context and terms of reference

The UK has over £1.6 trillion of assets under management in pension funds – 9% of the world's total, a sum larger than the UK's GDP.[1] Within the public sector alone, there are over 100 separate local government pension schemes, with a market value of £143 billion in March 2011.

It is clear that the government sees the use of institutional investors, such as pension funds, as an important source of future investment, in particular for national infrastructure.[2] These funds have the potential to help supply long-term, stable growth capital – at scale. At the same time the public sector is looking for new sources of investment to bridge capital funding gaps with private finance. The social sector is also looking at the potential role which it, and sources of impact investment, can play in the development and delivery of local services.

With intense competition for the resources available to public services, regeneration, transport, infrastructure and business support, it will be a huge challenge to maintain momentum and investment in many of the local plans and development programmes across the UK. Regaining this momentum will require fresh approaches to securing investment. It will also require greater flexibility from both the public and private sector in developing investment vehicles which are supported by a wider range of investors and finance.

This study is the first of its kind in the UK, and aims to provide a detailed assessment on how local authority pension funds can use their substantial resources to deploy capital in ways that derive wider economic benefit. As such, the study has the following objectives:

- to test out what the demand for impact investments might be;
- to review what has been achieved and what can be achieved by such investments;
- to identify the key opportunities and barriers to change; and
- to make recommendations on what stakeholders might do to enable change.

The study is not intended to be a comprehensive benchmarking exercise, nor is it a detailed guidance note for investment managers. However, we provide case studies to illustrate transferable practice, in the hope of encouraging investors to create a new wave of investment for more resilient local economies.

1.2 Participation

The study findings are not attributable to any specific organisation (see Appendix 1 for participants); they are founded on a combination of the following research inputs:

- a call for evidence, telephone and face-to-face interviews with local authority pension fund officers, national and international investment fund managers;
- interviews with relevant UK representative bodies for investment; and
- workshops held with pension fund officers, external fund managers and local authority economic development and regeneration officers.

1.3 Report structure

The remainder of this report is structured around the following sections:

- Section 2 provides an overview of the drivers of change influencing investment, including the current market for investment and government policy.
- Section 3 provides analysis of the main findings and themes identified in a national call for evidence and interviews undertaken with investment officers and external fund managers.
- Section 4 draws on the findings of the research and a series of round-table discussions to identify recommendations for action.

2. Drivers of change

2. Drivers of change

This section aims to explore some of the issues influencing the use of local authority pension investments for wider economic benefit, including the challenges of growing investment, recent changes to government policy and the developing market for impact investment.

2.1 Growing investment

The recession has left an indelible mark on investment levels across the UK, and a lack of access to finance continues to act as a drag on growth.[3] Levels of investment by the public sector, for example on capital expenditure (investing in new assets, or adding value to existing fixed assets), remain around half of what they were throughout the 1970s, and equate to just over £1 in every £10 of local government spending.[4] Between 2007 and 2010, capital receipts[5] fell by £2.6 billion.[6]

A combination of restrictions on raising capital finance and public-sector cuts (£6.68 billion by 2015) gives little doubt that these conditions have contributed to a decline in the overall quality of infrastructure, leaving the UK in a challenging position compared with many of its peer economies. Local authorities continue to remain under intense pressure to finance existing services and initiatives, let alone invest in infrastructure to address the issues that continue to affect their long-term competitiveness – such as worsening concentrations of deprivation and worklessness.

New sources of funding, such as the £600 million Big Society Bank (launched in April 2012)[7] will not be able to completely fill holes in investment, leaving funding gaps in many areas across the UK. As a result there is an urgent necessity to find new ways of leveraging additional investment to meet the expectations and need that have built across the country. In short, the ability to recycle and reinvest public resources alongside other sources of local investment – including pension funds – must become the norm in order to stretch public- and private-sector resources further.

2.2 Local authority pension fund performance

The fallout from the credit crisis has continued to drive investment markets globally and has had a significant impact on pension returns on investment. Bank of New York Mellon has suggested that, over the past five years, the estimated weighted average for pension funds was 3.2% – slightly behind inflation (as measured by the RPI), and behind potential returns from investments such as government gilts over the same period.[8]

There were 1.6 million employees in the Local Government Pension Scheme (LGPS), with a market value of £143 billion in March 2011. Whilst this represents a significant tranche of investment, pension schemes have suffered significant losses, up to third between 2007 and 2009.[9] Our own desk research, which included a light-touch review of pension performance, suggested that many funds were operating at between 85% and 95% of expected levels.[10]

LGPS statistics illustrate the growing pressures on funds. The number of people leaving the scheme rose in 2010/11, which, because of redundancies and retirements, has also led to an increase in benefits paid (£6.73 billion in 2010/11, compared with £5.61 billion in 2008/09), while income from employees' contributions stood at £1.97 billion, representing little change on the 2008/09 level of £1.93 billion. At the same time investment from income fell from £2.87 billion in 2008/09 (26.6% of total income) to £2.7 billion (23.5%) in 2010/11.[11]

These trends have led to an increasing interest in the diversification of investment portfolios in order to manage exposure to risk. Typically, funds have aimed to combine higher-risk overseas equities with more stable longer-term investments, including bonds, property and other "alternative" investments, which have risen by over 85% to £600 million in the course of the past two years.

2.3 Developing a market for impact investment

As the language of impact investing gains resonance, questions asked with increasing frequency and relevance are: "When is an investment an impact investment?" and "How can we use investment to deliver sustainable economic growth?"

For the purposes of this report, "impact investing" and "investing for growth" were defined as "investments made based on the practice of assessing not only the financial return on investment, but also relevant and proportionate consideration of the economic, social and/or environmental impacts of the investment". Investment in UK infrastructure was also covered in this definition and this can clearly cut across each of these domains, as well as different types of asset such as property, building resource efficiency, utilities/energy, waste management and transport. Indeed, the Coalition government has set itself the task of facilitating some £250 billion worth of infrastructure investment, through "smarter use of public funding and improving private-sector investment models".[12]

This links with last year's publication of the National Infrastructure Plan,[13] calling for £30 billion to be invested over the next decade, and recent media coverage suggesting that £20 billion of this investment could potentially come from both private and local government pensions.[14] US pension funds have a track record of investing in infrastructure and regeneration programmes, typically through three types of asset classes: fixed-income, equity real estate and private equity (early and later-stage venture capital).

Impact investments are a relatively new segment of the financial market, which has emerged from an increasing convergence of: the social investing sphere, which seeks to combine wider economic impact with profit generation in order to become more self-sustainable; and an increased awareness in the traditional for-profit asset classes that value creation can only occur with due regard to both the sustainability requirements of society and delivering long-term economic growth.

Investors and investments within the field of impact finance range broadly. Investors include development finance institutions, private wealth managers, commercial banks, pension funds, investment funds, companies and community development finance institutions – operating across multiple business sectors such as water, housing, education, health, energy and microfinance. Key to the success of a majority of investments is that they are expected to generate financial returns alongside wider economic and social returns. Recent research[15] into the requirements of investors also found that they are likely to engage if impact investments can offer:

- an expectation of market or close to market returns;
- some guarantee or mitigation of risk while approaching market-level returns;
- liquidity, which helps to reduce perceived risk;
- robust measurement and evidence of the returns generated by the investment;
- larger-sized investment opportunities, for example through pooled funds; and
- fund managers with a track record in which key institutions can develop confidence.

The impact investment market today is typically dominated by government-backed funds and a small number of banks and trusts (Charity Bank, Ecology Building Society, Triodos UK and Unity Trust Bank), which were collectively responsible for around 70% of investment activity in 2010/11.[16] Their focus is on lower-risk, secured lending and represents a more traditional form of impact investing that has been a familiar feature of the sector over a number of years.

However, if a vision is to be realised of a more vibrant impact investment market that blends together higher-risk opportunities with more secure returns, then this will need wide-scale development of the institutions, knowledge, experience and skills of the organisations and fund managers surrounding impact investment, as much as the type of asset class itself. Therefore, this study takes a broader look at the potential blockers and drivers of growth in the use of impact investment, including the following themes, which will provide the main framework for the remainder of this report:

- pension performance, attitudes to risk and portfolio diversification;
- barriers to developing investment for wider economic impact;
- potential for pooling investments and achieving scale returns on investment;
- delivering social impacts;
- resource limitations, including knowledge, capacity and skills;
- the demand for investment; and
- lobbying messages to help scale up impact investment.

2.4 Government policy and strategy

There is a variety of recent legislation and government strategy relevant to this study, most notably the Localism Act[17] and the Public Services (Social Value) Act 2012,[18] as outlined below.

2.4.1 The Localism Act

The Coalition government, under the Localism Act, has made a series of reforms to allow authorities to act in their own financial interest to generate value-for-money outcomes, to raise money, and to allow authorities to engage in activities outside their powers of well-being:[19] "We have to create the conditions for communities to invest in their own success, give councils proper power over spending, as well as more control over the tax they raise and keep."[20]

These reforms are part of the Coalition's "localism" agenda, which aims to devolve more freedoms and flexibilities required for local authorities to develop innovative approaches to delivering services and securing investment. Incentives include localising council tax benefit, reform of council housing financing, development of local enterprise partnerships and enterprise zones, changes to the planning system, City Deals and plans for referendums to establish more local mayors.

How radical these reforms prove to be will not be fully clear until after the Local Government Finance Bill[21] has come into force later in 2012. However, it does present an opportunity to support new investment and funding tools and to provide greater flexibility over revenue streams, including the retention of a proportion of local business rates. It also aims to encourage greater collaboration between commercial, public and social sectors, to encourage growth in the following ways:

- **Local authorities and the social sector:** leveraging land and infrastructure assets; providing revenue; growing planning powers; and providing high-quality support services.
- **Government agencies:** managing land assets; providing project design and delivery expertise; and delivering direct funding or enabling finance.
- **Private sector:** providing financial resources and know-how; project management and delivery expertise; and the ability to bear risks that the public sector would prefer not to hold.
- **Local employees and communities:** building strong social capital; and locking in local economic benefit through earnings, local spending and investment.

2.4.2 The Public Services Act

The Public Services (Social Value) Act became law on 8 March 2012. It emphasises the importance of increasing public value through investment in public services and supporting wider economic impacts, which can be generated by the private sector, the voluntary and community sector and by informal community networks – as well as by governments.

The bill brings in a statutory requirement for public authorities, at the pre-procurement stage of any services contract (and at this stage, services contracts only), to have regard for economic, social and environmental well-being in their areas. It aims to make the concept of "social value" more relevant and important in the placement and provision of public services. This will provide an opportunity for local authorities to support new models of service delivery and encourage them to explore new ways of enabling and attracting investment for social and wider economic benefit.

2.4.3 HMG: Growing the Social Investment Market 2012
This strategy, published in July 2012, sets out afresh the government's vision of a thriving social investment market where social ventures can access the capital they need to grow, allowing them to do more to build a bigger, stronger society. It sets out the steps for achieving the vision, explaining how government and others can act, including the role of the "Big Society Bank" as a wholesale investor and champion of the market.

The document also sets out how government can continue to have a central role to play in developing this important market, including a focus on:

- increasing the number of credible social investment opportunities, by supporting social entrepreneurs with promising ideas to start up new social ventures through the development of "social incubators" that provide space, finance and support;
- supporting more social impact bonds to get off the ground and enabling social ventures to deliver large public-service contracts through a potential dedicated outcomes finance fund; and
- making it easier to invest in social ventures by reviewing and removing the legal, regulatory and financial barriers to social investment and social enterprise.

2.4.4 Pensions Investment Platform
The National Association of Pension Funds (NAPF) and the Pension Protection Fund (PPF) are working together to create a Pensions Infrastructure Platform (PIP). The PIP will be a new £2bn fund which will be created around the long-term needs of pension funds for long-term, inflation-linked, low risk infrastructure assets free from construction risk and with low leverage. The fund is planed to launch in the first quarter of 2013. Joanne Segars, Chief Executive of the NAPF, has said: "Pension funds are keen to invest in infrastructure, but often find it difficult to do so. Skills gaps, small fund sizes, investment fees, and fears over construction risk are all obstacles at the moment. We think one possible solution is in sight. We are well under way with the development of a new pensions infrastructure platform to help give pension funds large and small access to this important asset class."

3. Study findings

3. Study findings

This section provides the results of interviews with local authority pension fund investment officers, external fund managers and relevant representative organisations linked to the pensions sector. It summarises the results of a call for evidence that was sent out to over 100 funds across the UK. It also draws upon three round-table discussions held in the summer of 2012: two sessions held with local authority pensions fund officers and economic development, regeneration and housing officers, and a workshop with external fund directors in London.

The main lines of enquiry were informed by a detailed literature review (see bibliography) which forms the main basis for the structure of the report. Relevant policy implications and recommendations flowing from the research are outlined in the final section.

3.1 Fund performance and portfolio diversification

The study asked questions about the performance of funds, the general climate for investment, materiality given to environmental, social and governance issues (ESG), and whether or not significant changes had been made to funds over the course of the last 18 months. The interviews also discussed the extent to which trustees understood the market for making investment for wider economic benefit and for their perceptions on potential risks and returns.

All funds operate an asset mix policy which creates a framework for making investment decisions that have an improved prospect of generating returns consistent with the funding investment target. Their goals include:

- maintaining sufficient liquidity from fixed-income securities and cash flows to pay pensions;
- having large sums of capital available to complete private market transactions; and
- providing a cushion against market catastrophes and preserving their credit rating.

It was clear that all fund managers interviewed had witnessed a difficult 18 months in terms of financial performance of their funds, stemming initially from the credit crisis and subsequent stock-market meltdown, and rising costs of pension plan benefits reflecting the rising age profile of members:

We've been through a period of considerable change in terms of the fund [performance] and economic changes… We have worked over the last year to reduce our exposure to equities.

While there was a clear understanding that fund portfolios were long-term investments (typically exposed to peaks and troughs in market performance), the recent economic turmoil, lower-than-expected returns and pressure on pensions to meet their liabilities have led almost all fund managers and trustees to want to "take some risk off the table".

Mitigation of risks and the diversification of investment portfolios have been at the forefront of investment decisions over the past 18 months, with the aim of ensuring that there is no overexposure to any one asset or risk (timing, credit, liquidity, legal and other external risks). This was recognised by most of the funds and all external fund managers:

Long-term diversification will be vital… The more innovative funds will move beyond bonds and equities and will be looking at things like infrastructure, which is doing a similar job as index-linked gilts, but offering a better rate of return in the longer run.

With public funding sources under increasing pressure, many funds had decided to review their strategy. Aside from a few funds who suggested that there would be no "knee-jerk" reactions or were broadly happy with their funding strategy, most funds said they had looked to increase exposure to "alternative investments". These were, in the main, most likely to include private equity (including early and later-stage venture capital) and infrastructure (mostly property).

A couple of funds interviewed said that they were interested in the potential for using derivatives and hedge funds to give them more flexibility, but were cognisant of some of the legal difficulties that have surrounded this issue in case law in the past:

We've taken a look at alternatives such as hedge and derivatives to give the fund more flexibility, but we're taking advice on this to see what is possible.

Infrastructure investment was cited in approximately four-fifths of the research interviews as a key area for portfolio diversification. Around half of these already had infrastructure investments (through external fund managers), and the other half were taking advice (typically through consultants, or in discussion with other external partners) on the potential for future property investment:

They [trustees] have considered social housing, but have not made any active investments in this area yet. If there is a payoff from this type of investment then they would certainly look at it, but at the moment they are waiting to see what materialises around the debate on infrastructure.

Some of the larger funds interviewed identified a proactive approach as a way of mitigating the potential risk of being overwhelmed by a deluge of developers and members putting schemes forward for finance. Funds saw this approach as part of the process of working with external fund managers on property funds, and then when the time came they would have "an established seat at the table to flag up the stronger, well-evidenced, local opportunities".

The workshops with pension fund officers highlighted the progress that some of the larger funds had made in terms of developing recyclable investment funds and other property ventures that have been developed jointly with local authority partners. The discussion groups also highlighted that more could be done to promote what property development investments were available throughout the UK, and more support should be given through government and intermediaries to help local authorities develop "solid investment proposals":

It would be useful to have a single agency or platform to promote opportunities for investment... Equally, more could be done in terms of raising the quality of proposals that are requesting investment.

3.2 Materiality of impact investments

The interviews highlighted the need to clarify what was meant by the terms "impact investment" and "investing for growth". Many saw these as referring solely to social investments, and additional effort was made during the interviews to discuss the potential to develop infrastructure and environmental investments for wider economic (including local, regional and national) impact.

While there was growing interest in and action by trustees towards developing new and alternative sources of investment within their investment strategy, there was much less evidence (other than in some of the larger funds) of impact investments that extended beyond active engagement with companies to address environmental, social and governance (ESG) issues.

There was a growing recognition that ESG issues were an important part of developing a more sustainable long-term investment. These issues are typically dealt with by the delegated authority given to external fund managers and their compliance with the Stewardship Code and UN Principles of Responsible Investment:

The main duty is placed upon external funding managers who, as part of their contract, are required to select investments by making relevant and proportionate ESG consideration.

Funds used their position as shareholders to actively encourage good corporate governance in those companies in which they invested, typically by outsourcing proxy voting to external consultants, and through membership of the LAPFF acting collectively on governance issues:

LAPFF provides a very useful link into ESG issues and influencing change.

Most funds suggested that most of the recent conversations around alternative/impact investments centred on developing infrastructure – mostly UK office property investments. The call for evidence also highlighted the fact that established infrastructure (rather than green-field developments) proved most attractive in terms of long-term income streams, awareness of risks and a track record of data on occupation, rents and yields.

Some pension funds highlighted that complex products could put "pressure on the fund's resources" in terms of time needed to understand, promote and manage these investments, and a minority suggested that this could – without clear communications – create confusion and turn away investors.

The added complexity from such investment could run the risk of reducing transparency, putting pressure on staffing resources (in terms of management and developing staff in new areas of investment), and could – in extreme cases – put investors off.

Many investors (including institutional investors and pension funds) typically have a natural asset allocation model that allows them to allocate specific "sector buckets" rather than the specialist niche areas that impact investments present. Some fund managers suggested that the development of impact investments as an asset class in their own right (for example, within pension portfolios), such as "social finance investment", would help to address this issue:

It is not always obvious in which asset class infrastructure, for example, fits. In some locations it might be familiar, but for the majority there is not a specific allocation for infrastructure and therefore the issue always remains unhelpfully open to debate, or overlooked.

The interviews and workshops identified that the development of strategy tools, case studies and demonstration projects (typically by larger funds) would help to address the perception of a "restrictive fiduciary duty", which is seen by many investors as one of the main barriers to impact investment. The workshops also highlighted that different approaches to demonstrating fiduciary responsibility could actually help develop and deliver impact investment in the longer term:

The difficulty for many local authorities and pension funds is that it is a huge leap of faith and experience, jumping from receiving EU gap funds and moving to new forms of investment... There needs to be smaller demonstrable steps (by larger funds) that will convince others to follow.

It is critical to get over perception that impact investments (social, environmental, property) have suboptimal returns... Demonstrating the impact of some of the "first-overs" would show how funds have acted in the best interest of their beneficiaries.

Typically asset class allocations are adjusted a little behind the curve; there is little one can do about it apart from information and showing what can be achieved in niche opportunities, and getting investment managers to invest in a counter-cyclical way.

There were mixed views about investing directly in local infrastructure. External fund managers and consultants were largely averse to "local-only" types of impact investment. Many funds described local investments as posing a double risk, should local initiatives fail to deliver. The general consensus was that fiduciary responsibility and "finance first" must be *the* overriding factors in all investments:

Whatever happens, we would strongly recommend that there is not a forced exposure to specific types of [local] investment... We would never advise on that; pension funds must be allowed to choose the most flexible strategy for themselves.

I think the panel understand their fiduciary responsibilities and whilst we have investment for wider impact such as property, *this is certainly not a local-only approach. The result is a danger of accumulating conflict-of-interest and risk.*

Many of the investment officers from smaller funds said that it was very difficult to accommodate direct local investments within their funding strategies, due to the lack of information about potential risks and a lack of track record relative to other strategic options. Developing a robust evidence base and an information platform which demonstrates the types of investment and potential for returns from regional infrastructure projects was commended as one way forward:

Growing these types of investments requires an all-encompassing evidence base on what needs to be done to prove the potential for investment in many places.

There could be some form of agency or clearing house that helps promote a platform showing what investments are available and to help provide additional support for building and valuing propositions.

3.3 Key barriers to developing impact investments

The main barriers arising in relation to developing impact investments, particularly for infrastructure funds, were: managing reputational risks associated with new investments and delivering fund managers' fiduciary responsibility to maximise returns for investors; and a potential for conflicts of interest, especially if the investment was linked to local schemes. Despite these perceptions, investment for wider impact and stimulating economic growth was certainly much higher up the agenda of all the funds interviewed than it had been three to five years ago:

These issues are definitely higher up the agenda than they were, but as a fund, maximising returns remain paramount, although we have bought into the concept that these issues are important factors in achieving these long-term required returns.

The key issue in this agenda is stressing fiduciary duties. All investment must stack up financially with the right return on investment; anything which limits investment (worst case into substandard investments) just goes against fiduciary responsibilities.

While maximising returns remained paramount for all funds, most funds (all but two) stated that they would be interested in developing investment for greater economic and social impact, provided that:

- rates of return and the right risk profile could be achieved, where rates of return were "understandably less than equities, but higher than bond rates";
- there were no local conflicts of interest;
- the investment schedule was clear and there was a track record of delivery; and
- there was a clear exit strategy: "investors need to know how they can get their money out".

None of the pension fund managers interviewed said they would be prepared to accept lower returns in exchange for achieving social benefit. However, the workshops highlighted that there was potential to structure or "layer" investments together – that is, blending higher-risk with lower-risk/safer long-term investments – in order to "ensure fiduciary responsibility is built into an investment product":

If the investment manager can be trusted to deliver returns on your behalf, and there is demonstrable proof that the investment portfolio/product will make risk-adjusted rates of return, for example by including a property layer as part of the investment, then there is no reason why impact investments cannot be developed and rolled out.

The workshops also highlighted a growing interest in learning more about how joint investment vehicles and asset-backed vehicles could work in future, for example, by using lessons learned from previous public-private partnership projects:

There's a lot the public sector can learn and share with the private sector in terms of managing joint investments and making them work.

Pension funds highlighted the perception that recent initiatives such as the Private Finance Initiative (PFI) have a "certain stigma attached", but despite this they also indicated that there was strong interest in developing joint investment vehicles and partnerships moving forward. Many respondents interviewed (particularly larger funds) said having a partnership, or joint venture, with multiple investment partners and external fund management support demonstrated a "stronger level of commerciality" than a stand-alone investment:

Despite all the stigma attached to PFI, there still appears to be a significant appetite to be involved in any future rounds of this type of development.

It works when there is sufficient third-party input, with the scheme scheduled correctly and more than two other investors putting money in; then you know they will have done the due diligence and got the legal frameworks in order.

Conflict of interest was the primary worry for almost every fund interviewed; and to a lesser extent there were concerns about the risks of investing locally, along with the fact that some employers in a fund might not be locally based or deriving any real benefit (that is, outsourced admitted bodies), which might put such policies in question:

The biggest thing is conflicts of interest… Local interest can cause future complaints. The general view is that all investments are appraised on their own merits… rather than for a particular impact type or geography of impact.

Most funds were more likely to show interest in third-party vehicles or external fund managers, describing the use of specialist/niche investment houses that were best placed to advise and manage infrastructure funds. Funds were keen to point out that the use of specialist fund managers was also an "expression of intent to add value to the fund":

Generating commerciality is the critical factor and helps reduce perceived risks… and this can be done by using external fund managers to provide value and market intelligence.

California Public Employees' Retirement System
The California Public Employees' Retirement System (CalPERS) manages retirement benefits for more than 1.6 million California public employees, retirees, and their families. It is the US's largest public pension fund (£237 billion) and its membership is divided approximately in thirds among current and retired employees of the state, schools and participating public agencies.

In 1990, the CalPERS investment committee established the Alternative Investment Management (AIM) programme to specialise in private-equity investments. The initiative was initially launched with a capital commitment of $475 million to nine private equity funds and one fund of funds, and currently has $925 million committed to AIM.

The goal of the AIM programme is to "capitalise on marketplace opportunities in order to achieve superior risk-adjusted returns". Consistent with this goal, in 2001 the CalPERS Investment Committee established and implemented the California Initiative to invest private equity in traditionally under-served markets, primarily, but not exclusively, in California.

The initiative seeks to discover and invest in opportunities that may have been bypassed or not reviewed by other sources of investment capital. The California Initiative's primary objective is to generate attractive financial returns, meeting or exceeding private equity benchmarks.

As an ancillary benefit, the California Initiative was designed to have a meaningful impact on the economic infrastructure of California's under-served markets, and invests in portfolio companies that employ workers who reside in economically disadvantaged areas and that provide employment opportunities to women and minority entrepreneurs and managers.

3.4 Potential for pooling investment
Another key barrier identified by funds was having the scale of investment needed to achieve the required returns on investment. Scale was seen as the critical success factor for overseas institutional investors, which have taken a greater interest in UK infrastructure in recent years.

Recent press has highlighted discussions within local authorities in London on how they can operate their pension funds together in order to save money on administrative costs, and on their giving a commitment to explore further the proposals for the creation of a London Pensions Mutual, as a pan-London investment fund estimated to be around £30 billion in total value.[22]

The interviews discussed whether or not most of the opportunities for impact investments – such as regional/national infrastructure – were outside the reach of most funds. Nearly all funds interviewed recognised that such investments could only be done at a scale which required the pooling of funds:

We need to look at pan-regional, perhaps even national scale, for impact investments in terms of property/physical development; and probably even for social impact investments.

All funds recognised that infrastructure investments were more likely to be more attractive to the larger funds that had scale and would be able to bear the due diligence, legal, administrative and other management costs. They recognised that even small percentages of larger funds would still be comparably larger in value than similar shares of investment in their own relatively smaller funds, and therefore infrastructure investments would be better carried out by external funds or through a pooled investment vehicle:

It is difficult to follow the largest funds to get the diversification needed, as 5% of our fund is not as large as the biggest UK funds; still considerable, but it would need additional investment to make infrastructure investment work.

Smaller direct investments, including those for wider economic benefit, don't always have the range of returns we require for the fund; equally, large infrastructure investment is just not affordable to us.

Ontario Municipal Employees' Retirement System
The Ontario Municipal Employees' Retirement System (OMERS) was established in 1962 to serve local government employees across Ontario. Today, it represents 947 employers and almost 420,000 members, retirees and survivors, including municipal workers, Children's Aid Society workers, firefighters, emergency services staff, police, transit workers and utilities workers.

OMERS has shown how a local government pension plan can take an active role in infrastructure investment. Through an investment arm, OMERS Ventures, OMERS has committed (as of December 2011) around 16% of its total assets ($55 billion) to various forms of infrastructure (including High Speed 1 in the UK). Through steadily increasing its stake (and investing alongside private companies), the fund has gained the type of knowledge and expertise that can arm it in the market for future investments.

The target investment size is $100 million to $300 million, but it is able to invest a higher amount if needed. Ownership can be sole owner, majority control, joint control or minority owner with appropriate shareholder rights. Investments could be management or leveraged buyouts, corporate divestitures, expansion capital for a proven business or a significant investment in a public entity.

We focus on investing in our businesses for long-term value creation… We have the ability to leverage the relationships of other investment entities and resources of OMERS which make investments in real estate, infrastructure assets and public equities.

Critical success factors include using investment relationships (often through local offices in global cities) to present additional investment opportunities and to broaden the range of investments to include capital for high-growth firms through its venture capital funds – OMERS Ventures.

Many funds called on central government to take a more active role in supporting those areas that wished to move towards pooled investments. Some funds suggested that more could be done to merge funds across the UK (for scale rather than efficiency savings). Others expressed some caution at being forced into mergers that were not in the best interests of their funds or beneficiaries:

They really need more information on the detail and how this will work in practice… In the interim any more discussion without this information could prove unhelpful.

When it comes down to it, there has been extremely little thought about how their ideas on infrastructure investment will translate into practice… particularly in terms of fiduciary duty considerations… There's an expectation that the funds should focus on UK investments.

There were divergent views about the geographic scale at which wider impact investment should operate, including the potential for pooled funds at pan-regional or city-regional level (for some of the UK's larger cities). Concerns were mostly driven by a perception that the use of funds for wider impact – for example, central government using pension funds for big-ticket infrastructure items such as High Speed 2– would mean that opportunities for much-needed regional and local investment would be lost:

There is a risk between the emphasis placed upon localism and the current rhetoric put forward about national infrastructure funds.

Some funds saw the current hiatus on policy and guidance about infrastructure investment in the UK as an opportunity to identify schemes which, with some seed funding or part of the risk underwritten by government, would provide good rates of return in the next 20 years:

It will need authorities to put proper, well-evidenced investment options on the table rather than waiting to counter pressures from government for "big" investment.

Political will and expediency were cited as the most important factors determining the future of pooling or merged funds dealing with impact investment. All funds recognised that a lot of recent discussion had taken place, but in practice there was likely to be little movement on this front for some time, potentially resulting in missed opportunities:

Work through pooling funds… it is not clear where this may go at the moment. There is potential for small funds to link to other funds… more of a watching brief at this very moment, but we would not write it off as a way forward.

[For impact investment] to be an option, government needs to be on the front foot. If it takes too long to sort… opportunities will be missed… The challenge is political will to make it work.

Case studies of funds in London and Manchester such as the Greater Manchester Property Ventures Fund, were cited by interviewees as examples of where funds had been designed to work at scale, across a city region, with the backing of authorities.

Greater Manchester Property Ventures Fund

GMPVF creates property investments by a process of site acquisition, building design, direct property development and property letting/management. The fund recently decided to increase its local investment allocation from up to 3% to up to 5% of scheme assets, potentially allowing for up to £500 million of investment in the region through a diverse range of assets. A pilot scheme is being worked up by the Greater Manchester Pensions Fund and Manchester City Council to develop a housing investment model that could deliver mixed housing development and that is capable of being applied across Greater Manchester.

The pilot project will see development on land owned by the council for the construction of up to 240 homes, with around a quarter being sold on completion and the balance being let. The stakes in the joint venture will reflect the capital invested by the fund and the land value provided by the council. The council hopes that if successful, the pilot scheme would lead to a development pipeline of five to 10 years towards a joint-venture housing development by Manchester City Council.

A small, but not insignificant number of smaller funds were interested in the potential to "piggyback" as a junior investor to some of the larger local authority pension funds:

There is potential to build funds that offer the smaller funds the opportunity to piggyback on larger ones, where the larger fund has already done the due diligence and legal reviews and is ready to share the investment… This is some way from being put into practice, though.

Taking this a step further, a number of funds were also interested in receiving more guidance on the legal issues affecting "pooling and service-level agreements" between authorities, to build economies of scale to develop funds; and would welcome support for developing impact frameworks to encourage joint approaches and sharing of risk and rewards:

It is about setting up the systems and evidencing the wider economic benefits which might accrue from one investment to different areas across the patch.

The workshops also highlighted interest from local authority pension funds in finding out more about how pooling could be made to work, either through the commissioning of an external fund manager, or potentially through a group of larger funds coming together and taking the lead on a pooled initiative. Some of the smaller funds interviewed expressed a preference for using specialist external fund managers, who could spread risk across a range of property assets and locations.

While pooling through external funds allows pension funds to share risks, many also highlighted the concern that potential fees and follow-on transaction costs could prove prohibitive:

The fee structures for particular infrastructure funds and carry costs are still too high and need to adjust… They have been off-putting for the last couple of years.

3.5 Delivering social and environmental impacts

The interviews asked both pension officers and external fund managers about their perspectives on social finance and whether it would prove to be a serious choice for pension investments; and, in particular, what it would take to scale up this type of activity in future. The main barriers cited by interviewees were lack of information platforms about the opportunities, and the potential scale of return from social investments not really being worth the start-up/due diligence costs:

Investors are largely unaware of the impact investment market in general.

Many investment opportunities are young and cannot absorb large amounts of capital, while the due diligence costs are significant and often of a fixed nature.

Some pension funds suggested that they hadn't seen any advisers recommending these types of products. Others pointed to lack of track record, insufficient benchmarks/ratings and lack of legislation to develop pooled investments (including social impact investment):

There's a need for the social investment sector as a whole to develop a promotion and information strategy to ensure different types of investors have better access to products.

Environmental/green investments were, however, seen as a growing asset class, offering a range of subsectors, industrial operations, and localities which could be used to diversify risk and returns across an investment portfolio. The main opportunities identified were linked to government policy relating to waste management, energy sources and carbon targets, in particular building energy and resource efficiency:

Smaller, nimble firms moving into the "green economy" have been able to show great ROI… First movers have already spotted the gaps in the market… but overall still at one end of the investment spectrum… The market will shift as absolute CO2 reduction over a whole portfolio becomes a factor in performance.

Scaling up the social investment sector will require the development of consistent and robust evaluation processes, in order to raise confidence and attract new investment. The majority of funds interviewed (with one or two exceptions) said they thought that this area of investment was, despite all the current rhetoric, largely untested, requiring more information on the historic levels of risk and rates of return to be generated.

Many funds are nowhere near impact bonds yet, it needs a stronger model to get more organisations involved. That's not to say it couldn't have potential… We are looking into it.

Other funds suggested that it needed external funds and "various proposers" to work as a whole to pull finance together and then approach local authority pension funds for a small slice to match (say, £2 million to £3 million). The initial scale put in by these operators would suggest seriousness of intent, as well as providing legal and financial due diligence, and the value added by experienced niche fund managers:

These can work, but the main success factor is having a good team of highly skilled and experienced niche managers around the investments to ensure that they stack up and are well managed… This gives investors confidence that it will deliver.

London Green Investment Fund

The London Green Investment Fund is a £100 million fund for investment in schemes to cut London's carbon emissions, launched in October 2009 by the mayor of London. It was originally made up of £50 million from the London European Regional Development Fund Programme, £32 million from the London Development Agency and £18 million from the London Waste & Recycling Board. The fund is part of the Joint European Support for Sustainable Investment in City Areas initiative (JESSICA) that was developed by the European Commission and the European Investment Bank.

The London Green Fund provides funding for two smaller funds – the Waste Urban Development Fund, which has been allocated £35 million, and the Energy Efficiency Urban Development Fund, which will receive £50 million. These are revolving investment funds, where funds invested in one project are repaid and then reinvested in new projects.

Foresight Group LLP has been appointed to manage the Waste UDF, which is known as the Foresight Environmental Fund. This will be used to target local waste and environmental infrastructure investments in the Greater London area which are aligned with the government's view on local solutions to local problems.

The Foresight Environmental Fund is targeting high rates of return from investment while fulfilling local infrastructure needs (energy and recycling), creating jobs, diverting waste from landfill and reducing CO2 emissions. It could be viewed as attractive from an economic perspective, thanks to its return profile, but it also meets local environmental and social needs.

Pension fund officers also said that far more work needed to be done by local authorities to evaluate impact and demonstrate attribution of their projects:

Not knowing why, when and where the fruits of the investment are going to drop [is a problem].

We can see LAs needing to develop relationships with organisations to understand social impact, needing greater evidence and attribution of impacts… First movers will probably be doing this.

Funds indicated a preference to link to market initiatives that are in place to build third-party systems to manage funds and evaluate impacts. Many pension funds cited the role of niche investment funds with relevant expertise leading the way on investments for socioeconomic benefit, in particular citing the skills and track record of their fund managers in these areas:

It all comes back to scale. Small social investments do not have the scale or risk profile that is attractive to give you the right returns on investment… A better route is through third-party fund managers.

Social housing funds were mentioned in discussions about social investments, and are proving attractive enough to stimulate requests for further consultancy advice and debate about future development. While there has been a significant amount of discussion across UK pension funds regarding social housing (and announcements from the Scottish government about developing a programme of housing investment), there was very little evidence of take-up throughout the interviews from either pension funds or external fund managers:

There is a feeling that infrastructure, including housing, may have something as a way forward in investing for wider impact, but it needs a heavyweight, independent finance person (or persons) to push it through at government level.

Most funds said that housing investment was being or had been "looked at", but they were waiting for others to initiate "demonstration projects". Despite the potential benefit of long-term income streams, the workshops suggested that the timing for social housing wasn't immediately right for funds. However, some funds said they would be interested at some point in the near future in gaining access to investment products that provided the added security of long-term returns from property investment without the associated property operational risk – that is, externally managed property funds:

There are a lot of conversations about housing at the moment, but there are many hidden risks, including the fact that we don't want to do direct investment or property management… We're yet to see such investments take off at scale across the UK.

It needs some form of government backing, which is unlikely, to flag social housing as a pilot area to take impact investment forward; otherwise it will remain a cottage industry.

The larger funds interviewed expressed an interest in how "blended" or "layered" property investments could work. For example, the potential for a local authority to provide land (and some form of guarantee for the development) working alongside institutional investors, developers and property consultants to promote mortgage lending and housing development:

The local authority puts the land in, the developer does the box – some access and properties – and looks to sell a third of the site straight away… The remaining two-thirds are social housing… We would be looking at around 3-5%, plus RPI on top.

Some funds expressed concern that such investments might lock investors in for long periods of time (over 10-20 years), whereas some venture funds preferred exit strategies closer to five to 10 years, so that money could be recycled more quickly. This suggests that a flexible approach needs to be built into some of the investment layers.

Other pension funds suggested they needed more information about these types of investment before they would be persuaded to progress further:

The blending of optimal with suboptimal rates of return could work, but there is little information available from consultants and advisers on how this would work.

The main consensus was that this would work with larger funds (which could afford the transaction costs) and within areas where the demand for housing was forecast to be strongest, in particular across the South East of England. Even here, some funds called on government to provide some form of incentive to help develop a cohesive approach to housing investment and development:

There still needs to be some form of tax break to help get housing market investments kick-started, otherwise it will be a piecemeal approach to development investment through "cattle markets" and not through traded funds.

Most funds reiterated the need for authorities to focus on making their locations more attractive for investment by providing strong leadership and governance, delivering quality public services and managing local infrastructure. Addressing bottlenecks in planning and fast-tracking planning applications were the most common examples given as ways to make places more attractive for investment:

If investment for wider economic impact is urgent, then so is sorting planning… It needs to be much more fleet-of-foot to help make places more attractive for investment.

The workshops also identified a need for local authorities to work closer with developers, investment consultants and pension funds to raise the quality of their investment propositions, which to date had been generally poor in quality:

The biggest challenge we have (for the pension fund managers) is finding new projects that are credible, have well-designed investment schedules and have good long-term returns.

3.6 Resources, knowledge and skills

The pensions landscape is characterised by a complex legislative framework. In addition to the legislation of individual schemes, there are industry-wide statutes that apply in whole, or in part, to public-sector schemes, including the way in which schemes interact with state pensions. Of key importance is a knowledge of the governance frameworks that apply within the pensions industry (such as the Myners principles); within individual schemes (such as the Local Government Pension Scheme governance statement requirements); and within the organisations that administer the schemes (such as the Chartered Institute of Public Finance & Accountancy and Society of Local Authority Chief Executives' framework *Delivering Good*

Governance in Local Government).

The interviews and workshops explored pension fund managers' perceptions of resource constraints and skill shortages, especially those linked to the growing diversification of investment portfolios into new and innovative products and assets; and potential gaps in knowledge relating to understanding investment risk and performance.

Interviewees were also asked about the key gatekeepers, tools and signposts that typically helped trustees to develop their own understanding, and which could be used to promote investment for wider economic impact.

Resource constraints were cited as a barrier to developing new areas of impact investment, and funds were concerned that more complex fund portfolios would put additional pressure upon pension panel members who already had limited time to devote to their trustee responsibilities:

Smaller funds lack time and resources, so spend on training for general awareness rather than niche areas such as (social) impact investments.

Impact investments were perceived to be more resource-intensive than conventional investment practice – in terms of overall management as well as knowledge requirements for trustees. Some smaller funds were also administered alongside treasury services, and in these circumstances time and resource pressures were highlighted as a challenge to developing skills and knowledge in new product areas, but these problems were not insurmountable:

There's a clear issue that larger funds can support larger in-house teams, and can put time and resources into this area (impact investments), but there is also evidence of smaller funds which have political backing to develop and resource some in-house expertise.

Despite the pressures on elected members' time, all funds had taken extensive steps to provide training for elected members and officers – either through external investment consultants or through fund managers – when bringing new products to the market:

It is difficult to plug members into training, given that they have other commitments in the council as well as full-time jobs… However, training is high on our agenda and we aim to make it mandatory.

Whilst a general level of skills and knowledge was a prerequisite (many funds had long-serving experienced trustees), funds did not expect their trustees to micro-manage investment actions and therefore they did not require them to have a detailed understanding of complex products:

Members don't need to have such detailed understanding as they are not micro-managers for the fund. They are there to provide strategic steering and guidance when required.

However, the qualifications of investment officers were paramount to good fund management, in terms of intelligent commissioning of external fund managers as well as in delivering day-to-day management of funds:

The important thing is to use experience and learn from it… The aim should be to build up internal knowledge and understanding over time.

A number of common areas of future training were identified during the interviews, including: setting up joint ventures, pooling arrangements and associated legal issues; developing framework agreements for procurement and commissioning external managers; and understanding complex alternative investments such as layered property investments, joint ventures, derivatives and hedge funds (including information about regulations on their use).

Some complained that the regulations on limits to pooling and the use of hedge funds were restrictive and that government should explore potential revisions to these:

It will be useful to have clearer guidance on issues with investments; for instance, limited partnership limits, and the exact definition of derivatives in terms of investment is not clear… There is little or no legislation on this. We would like to use these "alternatives" to provide flexibility to the fund.

The gaps are governance, legislation and advice to allow a pension fund to operate on behalf of others… There are limits to certain asset class investments which are restrictive.

Many funds used external consultants and the Chartered Institute of Public Finance & Accountancy tools and skills framework to develop their trustees' levels of understanding, as this is viewed as providing good coverage of the legislative knowledge required to see how all parts of investment fit together. Funds also reiterated the importance of leveraging the skills and experience of external fund managers and consultants, rather than trying to develop deep knowledge in too many different areas of investment:

The skills needed are already complex and diverse – for example, 18% of our portfolio is in property, and we are diversified across equities by theme, area, sector etc. External managers' skills are important to deliver our investments in the right way.

Investment consultants were regarded as the main gatekeepers, best placed to give advice and guidance on changes in asset portfolio, such as investments for wider economic impact. The workshops highlighted the feeling that more could be done through investment consultancy to help develop awareness of impact investments as an asset class, and that both the institutional pension sector as a whole and local authorities were on a steep learning curve about how to develop impact investment:

There is a gap in local authority thinking, a reliance on funding and an urgent need for consultants and other intermediaries to *help build serious investment propositions... There's a huge gap in skills and experience in these areas.*

The workshops also suggested that there was a greater role for developing trustees as gatekeepers for impact investment. These were typically one or two elected members (often ex-investment managers or treasury officials) who had a particular interest in, for example, environmental and social investment, and were prepared to act as champions to help promote these opportunities moving forward:

It is important to have long-term officers and members that provide consistent support, expertise and experience; this has been an important part of the fund's management.

Despite the positive approach to knowledge and skills development, pension fund managers still highlighted a lack of knowledge about opportunities available, reiterating the need for the social investment sector as a whole to develop a promotion and information strategy to ensure different types of institutional investors had better access to impact investment products:

We don't see the product advice or the depth of support in this area of investment, it is underdeveloped despite what we hear recently about opportunities... More work needs to be done by external financial advisers and other intermediaries.

3.7 Sources of investment

While the study does not aim to provide a detailed assessment of the supply of different investment products, interviewees were asked how they thought impact investments compared with other sources of finance, and whether there were other, cheaper sources, such as the Public Work Loan Board (PWLB) and prudential bank borrowing, which should be the first choices for finance.

A small number of funds interviewed (five) questioned whether local authority pension funds should be approached to support local projects and wider economic benefit (national infrastructure) at all. They were keen to stress that local authorities and pension funds were, and should be, separate organisations, as well as suggesting that local authorities should use prudential borrowing and PWLB finance as a "safer option" to kick-start stalled property developments:

Local authorities should look towards risk-free sources of investment, such as prudential borrowing and PWLB, rather than looking at pension schemes.

Some funds cited the potential to blend sources of finance to kick-start "recyclable funds", where commercial investment is matched against other sources of UK and European funding. However, the notion of "soft money" was raised as a huge risk for how future investments are perceived, in terms of ensuring that investments are not perceived as depending on subsidy or tax incentives:

Sometimes the public sector can provide "seed" investments, but this must not be seen as soft money, or an initiative being "propped up" by the public sector – there have been plenty of property developments that have stalled now that public subsidies have come to an end.

3.8 A role for government?

The interviews and workshops discussed whether there should be any key asks of government. Most funds highlighted the need to maintain employer contributions at a fairly stable level to achieve the targets set by central government. The 100% funding target limited the amount of investment risk that funds could take, leading to requests for government to underwrite some of the risk attached to new or more entrepreneurial impact investments. However, funds were unsure whether this would be forthcoming, given the current levels of debt on the government's balance sheet:

The government could give thought to broadening the scope for underwriting investments to de-risk some larger investments around the country. Government backing in this way gives investors greater confidence. Whether this happens remains to be seen.

All funds expressed their reluctance to pursue any approach which required them, through regulations, to "go down a particular investment route". Most funds commented that the government narrative about infrastructure investments had not been helpful (lacking clarity and guidance on issues such as pooling investment) and some feared a rush to pension funds with expectations that they would be in a position to support any type of local or national infrastructure:

More clarity can be provided by government on how infrastructure funds might work, but regulation must not weaken the returns on investment which can be achieved by the fund.

We can do practical things on impact investment, but we need to be supported to take sensible but small steps... Pension funds can get involved in this agenda but it is not and never should be a "milch cow" of local finance and investment.

Many fund managers were reluctant to invest in areas where government policy has a significant bearing on the potential returns on investment, with many citing the recent changes to energy feed-in tariffs and the knock-on effects to business investment in the micro-generation sector. They stated that the government's role should be to provide a stable long-term policy environment that provides fund managers with the confidence to invest for wider economic benefit:

There must be greater clarity and continuity, a drive for less noise with absolute focus on resource efficiency; conflicting messages or lack of expediency really un-nerve investors.

The workshops and a small number of interviews called for the provision of "safe harbours" where employers and funds could talk more freely to scheme members about fulfilling their fiduciary responsibilities and delivering value for money. Some interviewees suggested the greater use of dialogue between pension authorities and beneficiaries, asking them directly about their preference for their investment choices:

How do we know we are working in the best interests of our beneficiaries and delivering our fiduciary responsibility if we are not asking them about what they want... This includes talking about issues like social and environmental impact investment... Could we implement an opt-in for particular investment choices?

4. Conclusions and recommendations

4. Conclusions and recommendations

The following section draws together some common themes across the call for evidence, interviews and workshops, and makes practical recommendations for action.

Our research suggests a lack of clarity on the asset class for impact investment and a need to scale up knowledge of trustees about impact investments. A perception of suboptimal returns from impact investment remains among some funds; however, most stated an interest in these opportunities but "only if it stacks up financially", or if this area can be demonstrated as a credible asset class by "addressing the issue of fiduciary responsibility".

The research also suggests a need for co-investment (local authority pension fund and external fund managers) to eliminate the danger of perceived conflicts of interest, as well as investing at scale through external fund managers with a track record in impact investments – rather than making direct impact investments. The other critical factor will be to promote how fiduciary responsibility is/can be delivered operationally when making impact investments.

Our first recommendation relates to providing a better mechanism for developing information and knowledge, in effect taking this research work forward.

Recommendation 1: Better information and clearer guidance
Local authority pension funds should work with the Local Authority Pension Fund Forum (LAPFF), relevant government departments, external investment fund managers, and the Chartered Institute of Public Finance & Accountancy to develop guidance and technical papers on impact investment and pooled investment vehicles. The guidance documents should be linked to evaluation and lessons learned from progress towards delivering the first recommendation. Consideration should be made to including these outputs within the Statement of Investment Priorities guidance and promoting their use via online knowledge and skills development platforms.

Our second recommendation relates to the continued development of the skills and knowledge of local authority pension fund trustees and pension fund officers, and the important role of investment intermediaries in helping to develop impact investment.

While the research did highlight some minor skill shortages, these were typically addressed through the continuous programme of training provided for trustees as required by the Myners review. However, the research highlighted a need for greater input from investment intermediaries to support the scaling up of impact investment through the advice they give to institutional investors. This would also support the emergence of impact investment as an asset class in its own right.

Recommendation 2: Demonstrable case studies and training on matching impact investment within fiduciary duties
LAPFF should work with investment intermediaries and consultants to develop good practice case studies for promotional use by "champion trustees" on how impact and infrastructure investments can be used effectively within their fiduciary duties to enhance the risk/reward profiles. LAPFF should explore member support and funding for the development of a series of training seminars for pension fund officers that highlight emerging finance vehicles which "layer" investments, combining high- and lower-risk investments (for example, including property assets to underwrite risk). While advisers and fund managers need to be given more freedom and a greater mandate to consider impact investments, there also need to be higher levels of understanding in the funds they support.

Our third recommendation relates to requests from pension funds for greater flexibilities in how funds are managed in terms of the limits set out in statutory legislation; in particular, in relation to the limits set for investment in partnership vehicles, enabling the recommendations set out in this report to be taken forward.

Recommendation 3: Legislative adjustments – enhancing potential for flexibility
The government should review and explore potential changes to restrictions on investments (as set out in the *Local Government Pension Scheme Schedule – Management & Investment of Funds*), to enable local authorities to have sufficient flexibility to address the issues and recommendations set out in this report, in particular those relating to limits for investment in limited partnerships.

There were frequent requests for greater input and support from government throughout the research, ranging from information and guidance to a more proactive stance whereby government would underwrite some of the risk in impact investments. Given the current curb on public spending it is not clear that this would be forthcoming, especially with the current levels of debt on the government's balance sheet. The next two recommendations give practical steps which the government could make, along with relevant agencies, to support impact investment.

Recommendation 4: Create an enabling platform – a clearing house
Local authority pension funds and other relevant partners, including LAPFF, should lobby government to fund an independent external agency to act as a clearing house, gathering data from a wide range of (impact) projects around the UK, supporting transparent valuation and consistent financial reporting standards of impact/infrastructure projects. The agency would support the development of a combined national framework and standard for assessing economic, social and environmental value that would be of interest to the public, politicians, commissioners, social investors and local communities.

Recommendation 5: A new pooled vehicle
The potential should be explored for a "core group" of larger pension funds to contribute funding for the commissioning of an independent manager to help determine and deliver a way forward for pooled impact investment funds. The aim of the fund manager would be to develop a joint investment agreement

that would see a group of five or more signatories each putting £5 million to £10 million into a pooled vehicle, with a view to inviting local authorities/public-sector bodies to put forward bids for the investment, including the leverage of other sources of public and private investment.

Study participants

Study participants

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Christine Salter	Cardiff Council
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Nigel Keogh	Chartered Institute of Public Finance & Accountancy
Jonathan Hunt	City of Westminster
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Dave Lyons	Deloitte
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Eliot Ward	Wolverhampton City Council
Mark Forrester	Worcestershire County Council
Mervyn Jones	Yorkshire Housing Group

Notes

Notes

1 TheCityUK estimates are based on those of Watson Wyatt, OECD, Insurance Information Institute – cited in ClearlySo *Investor Perspectives on Social Enterprise Financing* (2011)

2 www.localgov.co.uk "Pickles Urges Councils to Prepare for Next Spending Review", 7 March 2012

3 British Chambers of Commerce *Quarterly Economic Survey Q1 2012*

4 DCLG *Local Government Financial Statistics England No 21* (2011)

5 Capital receipts comprise disposal of tangible fixed assets, intangible assets, leasing disposals, repayments of grants, loans and disposal of share and loan capital and disposal of other investments.

6 DCLG, op cit

7 http://www.bbc.co.uk/news/business-17602323

8 http://www.stockmarketwire.com/article/4287075/UK-pension-funds-in-the-red-with-returns-of-0-point-9pct.html, cited in Localis *Credit Where Credit's Due: Investing in Local Infrastructure to Get Britain Growing* (2012)

9 Localis, op cit

10 Given the long-term nature of pension investments, it is not uncommon for pension assets to vary against obligations.

11 DCLG *Local Government Pension Scheme Funds England 2010 to 2011* (2011)

12 HM Treasury *National Infrastructure Plan 2010* (2010)

13 http://www.hm-treasury.gov.uk/national_infrastructure_plan2011.htm

14 Sherman, J "Osborne to Raid £140bn Town Hall Pension Pot" in *The Times*, 11 January 2012

15 ClearlySo *Investor Perspectives on Social Enterprise Financing* (2011)

16 Ibid

17 http://www.legislation.gov.uk/ukpga/2011/20/contents/enacted

18 http://www.legislation.gov.uk/ukpga/2012/3/contents/enacted

19 Power of "well-being" – set out in the Local Government Act 2000

20 Speech by the deputy prime minister for the DCLG, "Community Budgets to be Rolled Out Countrywide", 2011

21 http://www.communities.gov.uk/localgovernment/localgovernmentfinance/lgfinancebill/

22 "London Councils Look to Pool Pensions" on publicservice.co.uk, 10 April 2012

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