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City of Westminster Pension Fund

Asset Allocation Considerations

Introduction

This paper has been prepared for the City of Westminster Pension Fund (the "Fund") and has been written following discussion with the Pension Fund Committee (the "Committee") at the last Committee meeting on 11 March 2021. Our considerations take into account the Fund's current investment portfolio composition compared with that of the current strategic asset allocation and what the Fund's distribution of assets would look like following the full draw down of commitments to the Fund's illiquid investments.

Within this paper we also provide an introduction to the residential property asset class following the training session on property markets at the March Committee meeting and discussion around inflation-linked opportunities. In the second section of this paper we provide details of sectors encompassed within residential property which we feel represent a suitable investment opportunity for the Fund to consider as part of an inflation protection mandate.

Current Allocation

The table below reflects the Fund's asset allocation as at 31 March 2021.

Manager	Asset Class	Current Allocation (£m)	Current Allocation (%)	Current Benchmark Allocation (%)
LGIM	Global Equity (Passive – Future World)	398.7	22.8	25.0
LCIV	Global Equity (Global Alpha Growth)	429.8	24.6	20.0
LCIV	Global Equity (Global Equity Core)	337.3	19.3	20.0
Longview	Global Equity	69.2	4.0	0.0
	Total Equity	**1,235.0**	**70.6**	**65.0**
Insight	Buy and Maintain	241.1	13.8	13.5
LCIV	Multi Asset Credit	98.6	5.6	5.5
	Total Bonds	**339.7**	**19.4**	**19.0**
Aberdeen Standard	Property	71.3	4.1	5.0
	Total Property	**71.4**	**4.1**	**5.0**
Pantheon	Global Infrastructure	29.7	1.7	5.0
Macquarie	Global Renewable Infrastructure	6.0	0.3	3.0
Quinbrook	UK Renewable Infrastructure	7.3	0.4	3.0
	Total Infrastructure (inc. renewables)	**13.3**	**0.8**	**11.0**
	Cash	59.4	3.4	-
Total		**1,748.7**	**100.0**	**100.0**

Source: Northern Trust
Figures may not sum due to rounding

In addition, it should also be noted that after previously agreeing to fully disinvest from the LCIV UK Equity Fund (Majedie), the LGIM All World Equity Index Fund and the Hermes UK Property Fund, a total of £132k can be attributed to the Fund as at 31 March 2021 in respect of its previous holdings in these funds, representing less than 0.1% of total Fund assets. These amounts relate to recoverable taxes for the three funds, alongside c. £40k in cash which remains in LGIM's transition account.

As at 31 March 2021, the Fund's equity allocation is 5.6% overweight the current strategic benchmark allocation due to recent positive equity market returns. There is still a remaining residual allocation to Longview, which will be used to fund the remaining Pantheon commitment and renewable infrastructure commitments. The Fund's remaining unfunded commitment to the Pantheon Global Infrastructure Fund III stands at c. $46.2m, following a capital call for payment by 11 June 2021, c. 50% drawn for investment, having committed $91.5m in February 2019.

In 2020, the Committee agreed to fully disinvest from the Fund's 5% core property allocation with Hermes, with the proceeds realised from the Hermes UK Property Fund on 15 January 2021. The proceeds received from this disinvestment will be used to fund the €55m commitment to the Macquarie Renewable Energy Fund 2 and the £50m commitment to the Quinbrook Renewables Impact Fund, following the manager selection exercise in December 2020. This represents a c. 6% renewable infrastructure equity allocation, with the Committee agreeing to reduce the Fixed Income allocation to 19% at the last Committee meeting.

Projected Allocation (once illiquid investments are fully drawn)

In order to consider what the Fund's asset allocation would look like once the aforementioned commitments to illiquid investments have been fully drawn for investment by the respective investment managers, we have projected the Fund's investment portfolio based on the value of the Fund's assets as at 31 March 2021. We have assumed that the forthcoming capital draw downs will be sourced from a combination of the remaining Longview investment and the c. £0.1m remaining cumulative investments in the LCIV UK Equity Fund, the LGIM All World Equity Index Fund and the Hermes UK Property Fund, with the remainder taken from the Fund's cash holdings. This would be expected to leave the Fund with c. £9.5m in cash, which we feel is an appropriate buffer to protect against changes in exchange rates which may affect the value of future drawdowns.

Asset Class	Current Allocation (%)	Projected Allocation (%)	Current Benchmark Allocation (%)
Global Equity	70.6	66.7	65.0
Fixed Income	19.4	19.4	19.0
Property	4.1	4.1	5.0
Infrastructure Equity	1.7	3.7	11.0
Renewable Infrastructure	0.8	5.6	
Cash	3.4	0.5	-
Total	**100.0**	**100.0**	**100.0**

The Fund's commitments to the Macquarie Renewable Energy Fund 2 and the Quinbrook Renewables Impact Fund are expected to be fully drawn for investment by the beginning of 2023. Pantheon anticipates that the Fund's commitment will be fully drawn by the end of the second quarter of 2023, however if Pantheon is successful across each of the deals in its current investment pipeline, comprising of three large transactions, the Global Infrastructure Fund III could be expected to be fully drawn by the second quarter of 2022.

Is now the time to de-risk?

Equity markets rebounded strongly in 2020 from the lows at the beginning of the year amid the global pandemic and have continued strongly into 2021. The FTSE All Share rose 26.7% over the 12 months to 31 March 2021, while global equity markets rose more than 50% in local currency terms. The FTSE All World is now 20% higher than its level at the start of 2020 (pre pandemic).

Valuations remain dependent on continued stimulus and the assumption that widespread vaccination will lead to an end of restrictions and significant consumer-led economic growth. Whilst this positivity may ultimately prove well-founded, there remains a risk that the roll-out of the vaccine may underwhelm and the efficacy of current vaccine alternatives may be tested by continued mutations of the virus.

Equity markets have had volatile periods recently, largely as a result of inflationary fears. With valuations so reliant on monetary support, it is feared that a sharp rise in inflation will force central banks to tighten policy sooner than expected, and an increase in interest rates would diminish the future earnings growth of certain stocks.

The results from the 2019 actuarial valuation showed significant improvements in the funding position, with Westminster City Council's funding level increasing from 70% in 2016 to 86% on 31 March 2019. The funding position of the whole Fund also improved, increasing from 80% to 99% over the same dates. With the performance of equity markets since 2019 and recent yield rises the funding position today is likely to be even stronger.

Given the strong funding position and continued performance from equity markets, we would suggest now may be an opportune time to crystallise some equity market gains and reduce the overall allocation to equities by 5%. Given our discussion on inflation and training session at the last Committee meeting on property markets, we would suggest the Committee considers an allocation to property which does not overlap the current long lease property allocation, such as areas of residential property. Potential asset classes are discussed in the next section of this paper.

The table below shows the estimated impact on risk and return of a potential 5% reduction to equities and allocation to residential property.

Asset Class	Current Allocation (%)	Projected Allocation (%)	Current Benchmark Allocation (%)	De-risking Option (%)
Global Equity	70.6	66.7	65.0	60.0
Fixed Income	19.4	19.4	20.0	19.0
Property	4.1	4.1	5.0	10.0
Infrastructure Equity	1.7	3.7	10.0	11.0
Renewable Infrastructure	0.8	5.6		
Cash	3.4	0.5	-	-
Total	**100.0**	**100.0**	**100.0**	**100.0**
Expected Return	**4.6% p.a.**	**4.6% p.a.**	**4.6% p.a.**	**4.5% p.a.**
Volatility	**12.2% p.a.**	**12.1% p.a.**	**12.0% p.a.**	**11.5% p.a.**

Residential Property

While core property investments have fared well in the past, and the ASI Long Lease Property Fund continues to deliver stable returns, alternative opportunities have recently presented themselves within small sections of the market. The fundamental driver for these changes is associated with the current undersupply of housing, relative to a rapidly growing UK population, with home ownership a higher priority within the UK compared to other developed economies alongside further foreign investment. It is anticipated that the residential market conditions will drive several sub-trends including affordable housing, shifting attitudes to rental accommodation and changes in demand for certain geographic locations.

In addition, due to the increased focus on ESG factors and impacts on financial returns, property asset managers have followed wider markets in improving their approach to ESG when acquiring or constructing a new asset, alongside developing current portfolios. Within property investment markets, there has also been a drive to further understand the ESG impacts from counterparties and tenants. Going forward, it is likely to be important to ensure that these ESG based considerations have an impact and directly influence returns rather than act as a form of 'green washing'.

Returns in the UK commercial property markets are forecast to weaken over the next five years compared to the previous five. Yields are at all-time lows and rental growth is starting to slow, not considering the impact COVID-19 has had and will have on the UK property market going forward. Investors and managers are therefore looking for opportunities in alternative sectors of the real estate market, in particular, segments of the residential market.

Affordable Housing

Affordable Housing ("AH") are homes aimed at low-income workers who are not currently in a position to be able to buy or rent properties. There is a recognised housing shortage in the UK, with net additions not equalling the Government's target of 300,000 per year, and an average annual shortage of over 100,000 p.a. This has led to a substantial reduction in affordability, with median house prices in England increasing by over 200% in the past 20 years compared to median salary, which has increased c. 60%.

AH homes are delivered directly by the public sector or by housing developers fulfilling their Section 106 obligations (that large developments need to have a proportion of affordable homes) and selling properties to Housing Associations. There are several different affordable housing sub-markets, as listed in the table below.

	Regulated	Tenant rent indexation	Description
Social Rent	Yes	CPI +1%	Tenants rent at <60% of market rent
Affordable Rent	Yes	CPI +1%	Tenants rent at 70-80% of market rent
Key Worker Rent	No	CPI	Tenants rent at c. 85% of market rent
Shared Ownership	Yes	RPI +0.5%	Occupants buy a share of a property (e.g. 25%-50%) and pay a regulated rent on the remainder.
Rent to Buy	No	CPI	Tenants rent newly built homes at market rate. Option to purchase at a 20-25% discount during tenancy of up to five years.

The properties can be let to local councils, housing associations or directly to tenants through a variety of tenancy agreements. The majority of lease agreements are government backed, therefore providing additional levels of security.

It is estimated that c. 60% of returns from AH investment strategies come from rental income, with the remaining c. 40% a result of capital appreciation and house price inflation.

Social Supported Housing

Social Supported Housing ("SSH") is purpose-built, permanent accommodation for vulnerable individuals with physical and/or psychological difficulties, which resultantly means they are unable to live and work independently. Subsequently, individuals in this situation receive housing benefits from the central government, with The Care Act (2014) creating a statutory duty for the local government to provide long term, safe and secure accommodation within the community. Within the agreement for these purpose-built properties, an annual inflation indexed lease is agreed with a housing association, who is in turn responsible for the administrative tasks (e.g. collecting housing benefits from the tenants) as well as ensuring that care is provided to the tenant.

Previously, these individuals have been homed in accommodation such as hospitals, where they were likely to have shared accommodation with other individuals with similar conditions. However, this is rarely the most appropriate course of action given the fact that both privacy and tailored care can be a requirement for each individual. Mencap, a UK charity for people with a learning disability, estimates that by 2030 around 60,000 individuals will need this specialised form of accommodation, increasing from c. 39,000 in 2015 – based on this forecast there currently exists a large undersupply of purpose-built properties in the market, with demand unlikely to slow down given the long-term occupancy period.

In addition to the lack of appropriateness for the resident, hospital care can also be expensive. It is estimated that residents living in SSH cost the government c. £200 per week less than being in a residential care home and c. £2,000 per week less than remaining in in-patient care.

The underlying assets are expected to receive a return through both capital appreciation and income from the individual leases. As this is a relatively new asset class, historic performance is not yet available. However, funds currently raising are targeting a cash yield of c. 5-6% p.a. There are also other sub-sectors within SSH, as listed in the table below.

	Lessee	Income source	Description
Social supported housing	Registered provider	Housing association funded by DWP	Homes for adults with care needs who require specialised services and/or support
Children's services houses	Care provider	Local Authority funded by MHCLG	Children under the age of 18 with care needs
Senior supported housing	Registered provider	Local Authority funded by DWP and MHCLG	Self-contained homes specifically designed to facilitate the provision of care to older people with care needs
Homelessness housing	Local authority / registered provider / charity	DWP with private top up	Homes for individuals and families who are homeless
Asylum housing	Private provider	The Home Office	Homes for asylum seekers who have applied for permanent residence in the UK and whose rent is funded by the Home Office

Private Rented Sector

The private rented sector ("PRS") can be defined simply as the purchase or development of property purely for the purpose of long-term rental for individuals. PRS predominantly includes Build to Rent ("BTR") developments which are purpose-built, professionally managed and designed to take advantage of economies of scale. It is estimated that over £3bn was invested in BTR in the UK over the year to September 2020, 4.6% more than over the entire 2019 calendar year[1]. This recognisable growth has stemmed from a structural undersupply of new housing and demand for quality rental homes, especially for families, where shifting attitudes towards renting coupled with housing affordability issues has led to an estimated one in three current tenants likely to still be renting after retirement[2]. PRS market growth can also be attributed to the decrease in the number of private landlords in the UK, with the government increasing the level of taxation applied to individuals who own more than one property – which has proved to provide a relative advantage to larger scale PRS investment firms where the increase in costs has less of an impact on overall affordability compared with that of a private investor.

Typically, PRS portfolios consist of properties situated in large UK cities, such as large apartment blocks with a bias towards London and the South East, where there is a clear barrier to ownership due to the characteristically high

[1] Savills. December 2020. *Spotlight: The UK Private Rented Sector.* {https://www.savills.co.uk/research_articles/229130/308605-0}
[2] Landlordzone. July 2015. *One in Three will Rent in Retirement.* {https://www.landlordzone.co.uk/news/one-in-three-will-rent-in-retirement/}

purchase costs; alongside sites with houses of various sizes to suit the varying requirements of different individuals, located within a commutable distance to large UK cities and close to schools with encouraging ratings by Ofsted.

PRS investment managers principally fund the construction of a large portfolio of new homes and can often include an allocation to acquired newly-build and fully let properties from third parties. A lease is usually agreed with a housing association, who is in turn responsible for advertising the properties, finding renters, collecting rent and property management.

Given that construction primarily takes place taking account of certain designs and specifications, which have been agreed in advance of the commencement of any construction based on relevant experience and data, long-term PRS maintenance costs are anticipated to be predictable and therefore simple to manage. Investment returns are primarily driven by current rental income and future expected rental increases, typically in line with inflation, with long-term stable income achieved through the contracts agreed with the underlying tenants.

Key Differences

Both Affordable Housing and Social Supported Housing are in short supply and should therefore benefit from strong demand in terms of the ability of investment managers to deploy capital. Both asset classes also benefit from cross party support and have the potential to deliver a positive social impact. Although a relatively smaller market, SSH provides a significant cost saving to the Government and NHS and therefore may be slightly more protected from regulatory risk than AH.

That said, regulatory risk exists in both the AH and SSH sectors. The vast majority of AH is rent controlled, where the Government could alter social rents. While this is not the case for SSH, a future government could extend rent controls to include SSH in the future.

Each of the three residential property opportunities will incur relatively high operating costs such as maintenance costs, given homes are let to individuals. Operating costs are likely to be highest within SSH, given the unique aspect of the homes. Operating costs will be higher where strategies are letting directly to tenants rather than via housing associations or through other intermediaries.

Occupancy rates are expected to be high in AH given the demand and generally lower rental rates, with investment strategies with higher allocations to pure social and affordable rent sectors likely to achieve the highest occupancy rates. Occupancy in SSH is expected to be lower given the complexity of the associated homes, the need for capex and the operational aspect of aligning the right individual to the right property.

While PRS vacancy levels are also expected to be low, given the supply and demand imbalances in the UK and lack of affordable homes, rent collection levels can be significantly impacted during periods of economic turmoil. For example, since the onset of the COVID-19 pandemic, PRS investment managers have recognised rent collection rates as low as 70%, given that rent is paid directly by individuals and not backed by a counterparty such as the UK government.

All three sectors will be exposed to construction risk. While this can be mitigated to an extent via counterparty diversification and covenants, failure to meet key milestones can result in lengthy ongoing legal battles. A fund making a purchase with planning permission only will also be exposed to development risk and forward purchase risk in the event of cost overruns.

As mentioned, both AH and SSH sectors have potential to deliver a significant social impact. Investors should also consider further ESG benefits that can be achieved by developing sustainable and energy efficient properties, and investors must be aware of the reputational risks associated with both sectors. However, the social impact of PRS investments is materially less than AH and SSH. Where AH and SSH are recognised to be helping those in need, the PRS market can be seen to be contributing to the lack of affordability for housing for individuals, further growing the supply/demand imbalance.

In general, while the PRS sector has recognised considerable growth over the previous decades, we do not believe the asset class represents as attractive an opportunity as AH and SSH. The growth in the PRS market has lacked the scale and evolution which is required to provide high quality housing and deliver professional management expertise in a cost-

effective manner, and it remains to be seen how ongoing cost improvements can be made from an economies of scale perspective without impacting the quality of homes.

In addition, it is recognised that much of the growth in the PRS market has occurred as a result of increased government pressure on individual buy to let landlords, through increased taxes on second home ownership. While this has benefited PRS thus far, the regulatory and political risks cannot be ignored. The PRS market relies heavily on free market rental pricing and the lack of a competitive product. Should government policy change, for example to target a higher proportion of home ownership in the UK, this could materially impact the profit-making ability of PRS investment managers.

Key Statistics

	Affordable Housing	Supported Living	PRS
Target investments	S106 housing units in new developments, custom orders to housebuilders	Purpose built housing for those who cannot live/work independently – often built in multi-unit complexes	Housing for individuals, including flats and houses of varying size – primarily in prime locations
Typical lease length (years)	20+ years	20-40 years	Dependent on property type and location – ranging from c. 5 years to the remaining lifetime of the tenant
Typical yield (% p.a.)	4.0-6.0% p.a.	5.0-6.0%	5.0-6.0% p.a.
Expected returns (% p.a.)	5.0-6.0% p.a.	6.0-8.0% p.a.	Wide range – dependent upon closed or open-ended strategy, and composition of portfolio
Typical occupancy (%)	Dependent on type (90-95% estimate)	80-90%	95-100%
Inflation linkage (%)	Dependent on type (Council/Housing Associations often 90-100% linked)	95-100%	c. 90% through the ability to periodically adjust rent levels

Next Steps

Following consideration of this paper, the Committee should agree upon the desired strategic benchmark for the investment portfolio as a whole and, in doing so, consider whether it is willing to investigate residential property further as an opportunity.

If the Committee wishes to make a residential property allocation, the desired sub-sector or sub-sectors of the market should be decided upon. At which point we will consider a number of providers within the relevant sub-sector/sub-sectors and agree upon a shortlist of providers before arranging a selection exercise where the providers will be asked to present their funds to the Committee. Our search will include options available now or in the future through the London CIV. We will provide a selection report with our full due diligence on each provider and the strategy, as well as the risk/return characteristics and inflation linkage of each strategy, and how this relates to the characteristics of the Fund and its liability profile.

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- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

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