Pensions Committee

2.30 p.m., Wednesday, 24 June 2015

Annual Investment Update – Lothian Pension Fund

Item number	5.9
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an update on the investments and funding position of the Lothian Pension Fund to 31 March 2015.

The Fund's Investment Strategy 2012-17 is being implemented gradually. Fund risk declined further over the year, due to the reorganisation of equity and bond mandates and small adjustments to asset allocation.

Over the twelve months to 31 March 2015, investment markets returns were very strong (global equities, index-linked gilts and property all grew at a double digit rate).

The Fund produced a return of 16.5% over the year. The benchmark return was 14.4%.

The Fund's actuary completed the triennial valuation during 2014 and reported that Lothian Pension Fund's funding level (the ratio of assets to liabilities) was 91.3% at 31 March 2014. Despite very strong investment markets over the 2014/15 year, the decline in market yields has lead to a deterioration of the funding level which is estimated to be 84% at 31 March 2015.

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Report

Annual Investment Update – Lothian Pension Fund

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That the Committee notes the performance, funding update and asset allocation of the Lothian Pension Fund.

Background

2.1 The purpose of the report is to provide an update on the investments and funding position of the Lothian Pension Fund to 31 March 2015.

2.2 The investment performance of the Fund has a significant impact on the funding level and potentially on the contributions required by employers.

Main report

Market Background to 31 March 2015

3.1 The UK economy has made a solid recovery since the dark days of the global financial crisis in 2008/09. Unemployment has shrunk to 6% from a peak of 8% in 2009, and the employment rate of 73.3% is the highest since records began in 1971. The public sector deficit has halved since 2010. In 2014, the UK economy expanded by 2.8%, although it slowed in the first quarter of 2015. US economic growth has been robust for the last few years, and even laggard countries and regions such as Japan and Europe are now displaying some springtime green shoots of recovery.

3.2 Asset markets continue to respond positively to low interest rates and unconventional monetary policies (bond buying by central banks) aimed at stimulating economic growth. Perhaps unsurprisingly, government and corporate bond markets made handsome gains as investors anticipated strong central bank buying support for these assets. Equity markets benefitted too. The US equity market is now comfortably in excess of its two previous peaks, Japanese equities continued to perform well and the UK stock market is once again hovering around its historical high point. Even the continental European stock markets have shown signs of reviving, but after a long period in the doldrums, the outstanding equity market performer over 2014/15 was the Shanghai Stock Exchange in China, which soared 56%. Other asset classes, such as property also made attractive returns. The key feature in currency markets was US dollar strength. The only real disappointment was commodities, where oil and iron ore prices in particular fell sharply.

3.3 Looking ahead, investors are wondering how long the current positive environment for asset markets can last. Given that the low interest rates and unconventional monetary policy (so-called quantitative easing) are inextricably linked with prices in asset markets, the fear is that this element of support will be withdrawn and interest rates will rise. This is front and centre of mind in one of the two largest economies in the world, the USA, where wage inflationary pressure could cause the economy to overheat. This is not the case across the globe. The European Central Bank has only recently resorted to stimulating the economy with quantitative easing and the other giant economy in the world, China, seems quite out of sync with the USA, having recently embarked on a policy of cutting interest rates in the face of a slowing economy and low inflationary pressure. So, the timing of less supportive central bank policies is far from clear (further market gains are quite possible), but that tightening monetary policy will cause increased volatility and declines in bond and equity markets with high valuations is crystal clear. It appears unlikely that the high returns of 2014/15 will be sustained over the long term.

3.4 Other than monetary policy, there are a number of issues that will affect asset market returns in an unpredictable way going forward. There are numerous high profile geopolitical risks preying on investors' minds. These include Greek debt, Chinese expansion, the Ukraine conflict, war in Syria and fallout from the lower oil price in producing countries such as Norway, Russia, Venezuela and Saudi Arabia. These geopolitical risks are manageable to the extent that it is in nobody's interests to let them get out of control. Uncertainty is a constant in the investment backdrop and it is the uncertainty which creates the opportunities for investors to earn returns higher than those available from risk-free assets. With the benefit of economic growth and advancement over the coming years and decades, a diversified portfolio of assets should provide that risk premium over the long term.

Investment Strategy and Objectives

3.5 The Pensions Committee approved the Investment Strategy and Objectives 2012-17 for Lothian Pension Fund during the final quarter of 2012.

3.6 The Fund adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer. The investment strategy is set at the broad asset class level of Equities, Index-Linked Gilts and Alternatives, which are the key determinants of investment risk and return. Investment strategy includes Equities and Alternatives on the assumption that these assets will deliver better performance than Index-Linked Gilts in the long-term.

	Long term Strategy Allocation 2012-17 %	Permitted Range %
Equities	65	50 – 75
Index-Linked Assets	7	0 – 20
Alternatives	28	20 - 35
Cash	0	0 - 10
TOTAL	**100**	

3.7 The strategy makes a small reduction in the allocation to Equities (including private equity) and a small increase in the allocation to Index-Linked gilts and Alternatives. It recognises a gradually changing risk profile for the Fund, but retains significant exposure to real investments, such as Index-Linked Gilts and Equities, which have a history of protecting or enhancing purchasing power, after the effects of inflation have been taken into account.

3.8 The Fund's investment objectives are:

- Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
- Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.

Investment Performance to 31 March 2015

3.9 The Fund has achieved returns in excess of the strategic allocation over the last year and over the longer term timeframes shown in the table.

% per annum	1 Year	5 Years	10 Years
Lothian Pension Fund	+16.5%	+9.5%	+8.9%
Benchmark	+14.4%	+8.8%	+7.6%
Relative	+2.0%	+0.7%	+1.3%

3.10 The benchmark shown in the table comprises equity, index-linked gilt and cash indices as well as an inflation-linked index for the alternatives allocation. Returns relative to the benchmark over a one year period need to be placed in the context that there are no ideal benchmarks for many of the assets held in the Fund, especially the Alternatives. The Fund's benchmark for Alternatives is inflation plus 3.5% per annum, which makes sense over the long term as the Fund's liabilities are linked to inflation. However, over shorter periods, there is less information content in the relative returns of the Fund because the development of asset prices is much more volatile than the development of UK retail or consumer prices. The Investment Strategy Panel assesses the underlying risks of the portfolios that make up the asset allocation to ensure that these are consistent with the long term objectives of the Fund.

3.11 The Fund's return over the year was ahead of the benchmark return despite restructuring activity during 2014 and the first quarter of 2015. Asset allocation proved beneficial as the Fund is underweight the relatively low returning Alternatives and overweight higher returning Equities. Within Alternatives most assets were ahead of their benchmark returns.

3.12 The direction of the Fund's performance when markets are increasing and decreasing is one way of measuring the volatility. It has been a relatively short time since the lower volatility objective and strategy was put in place and markets volatility has been relatively benign. Nevertheless, performance over 2014/15 does indicate that the Fund is delivering lower volatility. Fund performance over the last 12 months was:

- better than the strategic allocation when markets fell (3 out of 3 months) with average performance of 0.69% better than the strategic benchmark and;
- marginally worse than the strategic allocation when markets were rising (5 out of 9 months) with average performance 0.03% worse than the strategic benchmark.

3.13 The structure of the equity pool of assets and the currency hedge were helpful in achieving this outcome of lower volatility. The Fund hedges exposure to overseas equities where hedging is expected to reduce Fund risk and does not hedge exposure where hedging is expected to magnify Fund risk. Over 2014/15, the impact of currency hedging on overseas equities exposure was significantly positive - it generated a positive return as well as reducing Fund risk, its primary purpose.

3.14 Notable performance within each asset class is as follows:

- The Fund's Equity investments, managed by the internal team and several external managers, combined to produce a return of 16.1% over the year. Both developed and emerging markets produced strong returns in sterling terms although the UK market could only manage a mid-single digit gain.
- The Fund's Index-Linked investments delivered a return of 23% over the year with the index-linked gilt portfolio rising 24% as real yields fell to new lows and with the Fund's small gold holding rising only 3% in sterling terms by virtue of being priced in US dollars.
- The Fund's Alternative investment performance was 13% over the year. Within Alternatives, the bond portfolio generated very strong returns of 28%, while the timber assets returned 25% and listed infrastructure returned 23%. These standouts were offset by lower returns from other real assets, which returned 7%, held back by the write-down of a troubled

infrastructure fund. The bond portfolio was restructured early in the year when the corporate bond portfolio was replaced by a US Treasury portfolio, which benefited from price gains and the US dollar strength.

- As explained above, it is important to note that the true value and returns on the unlisted investments in the Alternatives portfolio will not be known until assets are realised, perhaps not for several years. Investments are made in Alternative asset classes due to the attractive expected long-term returns and the diversification they aim to provide. Short term performance data should therefore be treated with caution.

Funding Level

3.15 The funding level is the ratio of the pension scheme's assets to liabilities. At the last actuarial valuation at end March 2014, the funding level was 91.3%.

3.16 Over 2014/15, index-linked gilts (and hence the value of the liabilities) increased by more than equities and alternative investments. As a result the funding level has deteriorated and is estimated to be 84%at 31 March 2015.

Asset Allocation and Strategy Implementation

3.17 The implementation of the Investment Strategy 2012-17 is proceeding at a measured pace as investment opportunities become available and as research on opportunities is completed. This is reflected in the interim strategy allocation shown in the table below.

3.18 At 31 March 2015, the Fund had an overweight position in equities and cash, and was underweight index-linked assets and alternatives, especially Other Bonds, compared to the interim strategy at 31 March 2015. The table below shows the changes in actual allocation over the financial year 2014/15 and the current interim strategy allocation at end of March 2015.

	Manager	Actual Allocation 31 March 2014 %	Actual Allocation 31 March 2015 %	Interim Strategy Allocation 31 March 2014 %	Interim Strategy Allocation 31 March 2015 %
EQUITIES					
UK All Cap	Internal	2.3	2.0	2.0	2.0
UK Mid Cap	Internal	2.3	2.0	1.8	1.8
Europe (ex UK)	Internal	2.3	2.0	2.1	2.1
US	Internal	2.3	2.3	2.1	2.1
Pacific	Baillie Gifford	3.5	0.0	3.9	0.0
Pacific	Invesco Perpetual	3.2	0.0	2.8	0.0
Emerging Markets	Mondrian	2.1	2.1	2.5	2.3
Emerging Markets	UBS	2.1	2.4	2.5	2.3
Global High Dividend Yield	Internal	14.8	13.3	14.6	14.3
Global Low Volatility	Internal	17.1	17.5	17.5	17.5
Global Value	Internal	0.0	6.6	0.0	6.5
Global	Cantillon	5.5	5.2	5.0	5.0
Global	Nordea	3.8	4.0	3.7	3.7
Global	Harris	4.1	4.0	3.5	3.5
Private Equity	Various	5.6	4.8	6.0	5.0
Currency Hedge	Internal	0.2	0.6	0.0	0.0
Transition Account	Internal	0.0	0.3	0.0	0.0
Subtotal		**71.2**	**69.1**	**70.0**	**68.0**
INDEX-LINKED ASSETS					
Index-linked gilts/gold	Internal	3.9	6.1	5.0	7.0
Subtotal		**3.9**	**6.1**	**5.0**	**7.0**
ALTERNATIVES					
Property	Various	8.8	8.4	10.0	10.0
Other Real Assets [1]	Various	7.6	7.6	8.0	8.0
Other Bonds [2]	Various	4.6	2.9	6.0	6.0
Alternatives Cash	Internal	1.4	2.1	0.0	0.0
Subtotal		**22.4**	**21.0**	**24.0**	**24.0**
Cash	Internal	2.4	3.8	1.0	1.0
TOTAL		**100.0**	**100.0**	**100.0**	**100.0**

[1] Includes infrastructure and timber; [2] includes sovereign bonds, corporate debt and private debt.

Equities

3.19 A key objective of the Fund’s investment strategy is to reduce risk, including risk within the equity pool of assets. Further steps were taken during 2014/15 in this direction. A new internal global mandate was funded from the Asia Pacific equity holdings previously managed by Baillie Gifford and Invesco Perpetual, whose mandates were terminated in the second half of 2014. Both managers had produced very good performance for the Fund since inception. The new portfolio has lowered overall risk slightly and is expected to perform relatively well when equity markets are weak and produce absolute returns in rising equity markets, as is the whole equity pool of assets.

a. None of the Fund’s equity portfolios are constrained by market capitalisation indices, and hence by the tracking error measurement of risk, which is regarded as a suboptimal approach to portfolio construction. Instead the focus is capital preservation and the sustainability of income generation. The Fund’s independent performance measurer, Portfolio Evaluation, estimates that the Fund’s equity risk is now approximately 92% of the risk of the equity benchmark. This compares with 98% as at 31 March 2012.
b. The transition to the new portfolio has increased the equity assets managed by the internal team. Approximately three quarters of the Fund’s equities are managed internally with the majority of these in low cost, low turnover strategies, which are expected to enhance the Fund’s risk-adjusted returns over the long term.
c. The Fund also hedges exposures to the currencies of overseas listed equities with the explicit aim of reducing volatility rather than making a return. The Fund therefore maintains exposure to currencies that are expected to reduce volatility, such as the US Dollar and Japanese Yen – fall as equities rise – and hedges exposure to currencies that are expected to increase volatility – rise as equities rise, such as the Australian Dollar. The hedge was very beneficial to the performance of the Fund over the year (+0.4%). Hedging the Australian and Canadian Dollars made gains for the Fund and reduced volatility, while hedging the Euro made large gains as the Euro weakened, but did not reduce volatility.

Index-Linked Assets

3.20 The Fund’s strategy entails a small increase in index-linked assets (gilts, bonds and gold), which provides diversification, some insurance against an unexpected rise in inflation and a return broadly in line with the Fund’s liabilities. Over 2014/15, the allocation to index-linked gilts increased to 5.9% from 3.5% due to both market appreciation and new purchases. In addition, further restructuring of the portfolio was undertaken to extend its duration with the purchase of gilts of longer maturities to reflect the long-term nature of Fund liabilities. The long term attractions of the asset have lessened over the course of the year and the Fund remains underweight the strategy allocation weight.

Alternative Investments

3.21 The Fund's strategy is to increase the actual allocation to alternative investments, which includes assets such as property, infrastructure, bond-like assets and timber, to provide greater diversification and attractive returns. Many of these investments are unlisted and increasing exposure is dependent on finding attractive opportunities. Despite considerable investment activity, the actual allocation fell slightly from 22.6% to 20.9% over 2014/15 for a number of reasons, including the restructuring of the other bond portfolio where the actual allocation was reduced and the relative strength of the other major asset classes, equities and index-linked gilts.

- The allocation to commercial property has fallen over the year as rental income has not been reinvested and as unlisted property has distributed capital.
- A strong pipeline of infrastructure investment opportunities allowed the Fund to make a number of investments and commitments with a focus on secondary fund interests, selective primary fund commitments and co-investments alongside the Fund's existing manager/fund relationships. The investment value of the Fund's infrastructure has, however, remained static held back by strong distributions from several successful investments and by one disappointing investment. The data in the table above includes cash distributions, which are being held for future investments, including capital calls related to existing commitments.
- The other sub-category in Other Real Assets is timber. 2014/15 was a productive year for the Fund in this category as the long periods of monitoring and appraisal of opportunities bore fruit and new investments were made, which increased the Fund's exposure to this alternative investment from 1.2% to 2.0%.
- As reported to Committee in June 2014, the Other Bond category was restructured. Activity in this category has been limited as attractive bond investments have become increasingly difficult to find as yields of the have fallen further. With a target return of 3.5% in excess of inflation for the Alternative portfolio, most bond related investments require the use of leverage to achieve such a target and are generally relatively risky. However, the Fund had made one investment in a relatively low risk, private debt fund during the year. Research continues in this area with a view to making further investments if they provide additional diversifications and produce secure returns. It is hoped that with the passage of time, better opportunities will present themselves.

3.22 The Fund makes commitments to unlisted investment and the timing of these is uncertain as it depends on the manager being able to purchase assets. Details of outstanding commitments as at 31 March 2015 were as follows:

	Unfunded Commitments in Local Currency			**TOTAL**
	US$ m	**Euros m**	**£ m**	**£ m**
Private Equity	65	11	3	55
Infrastructure	14	46	-	43
	79	57	3	98

3.23 Implementation of the investment strategy requires a continuing assessment of internal and external management options, appraisal of the risks of internal and external management and the required resources and financial implications of greater internal management (including systems and staffing). Over recent years, the internal team has been expanded, which has facilitated further in-sourcing of investment functions as well as the development of innovative and low cost investment strategies to meet the significant funding challenges faced by the pension funds. The Fund continues to outsource investment management services for specialist mandates, which complement the portfolio strategies employed internally. The internal team currently manages over £3bn, approximately two thirds of the Fund's assets.

Scrutiny & Transparency of Investments

3.24 On 29 April 2015 Scottish Parliament's Local Government and Regeneration Committee met to consider local authority pension funds' investment in infrastructure. The Committee took evidence from a number of parties including Scottish Public Pensions Agency, UNISON, Scottish Futures Trust and a number of LGPS officers. The Committee was critical over what was perceived to be a lack of transparency of investments. A link to the report of the meeting is provided later in this report. Since the meeting, the Fund has received a request for information regarding:

- the Fund's Statement of Investment Principles including the social, environmental or ethical policy;
- investment in Scottish or UK infrastructure projects;
- consideration of the investment in Pensions Infrastructure Platform;
- work undertaken in partnership with other Scottish Local Government Pension Funds to invest in Scottish or UK infrastructure projects;
- current barriers to investing in infrastructure projects.

3.25 The Fund's response to the Scottish Parliament's request for information is provided in Appendix 1.

3.26 The Scheme Advisory Board for the Scottish Local Government Pension Scheme met for the first time on 30 April 2015. They discussed and agreed a workplan which includes 'Collection and Consistency of Fund Data' and 'Transparency of Investments'.

3.27 Details of the Lothian Pension Fund's investments are reported regularly, both in Committee reports and in the Report & Accounts, both of which are publicly available. The Fund is also subject to regular Freedom of Information requests to which it responds promptly. A complete list of holdings is also made available on the Fund's website. However, there may be further requirements for the Fund to produce additional information and/or in different formats.

Conclusion

3.28 The absolute performance of Lothian Pension Fund over the twelve month period was 16.5%. Five year performance is 9.5% per annum. Over ten years, the Fund returned 8.9% per annum.

3.29 At the 2014 triennial actuarial valuation the funding level was 91.3% at the end of March 2014. The actuary has provided an updated estimate for the funding level of 84% at end of March 2015. This deterioration largely reflects the fact that the strong performance of the Fund's assets was offset by the fall in real gilt yields, which caused the value of liabilities to increase.

3.30 Implementation of the investment strategy has progressed steadily over the last twelve months. Increased exposure to and restructuring of the index-linked asset portfolio was pursued; the other bonds portfolio was reorganised; a new global equity portfolio lowered risk further; and a strong pipeline of real asset opportunities was reviewed.

3.31 The Investment Strategy Panel and internal team continue to focus on implementation of the investment strategy with a focus on increasing the allocation to alternative investments where possible and on researching and funding complementary strategies.

Measures of success

4.1 The investment performance of the Lothian Pension Fund is crucial to the achievement of the required investment return which impacts on the funding level and employers' contributions. The objectives for the investments are:

- Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
- Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.

Financial impact

5.1 The report details the investment performance of the Lothian Pension Fund. The investment performance has a significant impact on the funding levels and potentially on the contributions required from employers.

Risk, policy, compliance and governance impact

6.1 Investment strategy is a key determinant of funding level, risk and volatility of employer contribution rates. The Fund's investment strategy is aimed at reducing the risk without sacrificing returns.

6.2 There is no governance impact as a result of this report. Committee delegates the implementation of investment strategy to the Director of Corporate Governance, who takes advice from the Investment Strategy Panel. The Investment Strategy Panel is an important element of the governance of the pension fund investments.

Equalities impact

7.1 There are no equalities implications as a result of this report.

Sustainability impact

8.1 The Statement of Investment Principles (covered elsewhere on the agenda) sets out the Funds' approach as responsible asset owners, and details how voting, engagement and other Environmental, Social and Governance activity will be undertaken. Compliance with it is expected to contribute to the sustainability of the Funds' investments.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=9931

Alastair D Maclean

Director of Corporate Governance

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Links

Coalition pledges	
Council outcomes	CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed
Single Outcome Agreement	
Appendices	Response to the Scottish Parliament's Local Government and Regeneration Committee

Lothian
PENSION FUND

Appendix 1

Claire Menzies-Smith
Senior Assistant Clerk
Local Government and Regeneration Committee
Room T3.40
The Scottish Parliament
Edinburgh EH99 1SP

Date 12 June 2015

Your ref

Our ref

Dear Ms Menzies-Smith

Budget Strategy Phase 2016-17 – Local Government Pension Funds

I write with reference to your letter dated 15 May 2015, addressed to Alastair Maclean, Director of Corporate Governance, The City of Edinburgh Council, to which I have been asked to respond. Please find below the response to your questions on behalf of the Lothian Pension Fund, the Lothian Buses Pension Fund and Scottish Homes Pension Fund.

Statement of Investment Principles

The Funds' Statement of Investment Principles is available on our website: http://www.lpf.org.uk/info/70/statement_of_investment_principles. Responses to your questions are as follows:

1. <u>When your statement is next due for review</u>

   Our statement is reviewed annually and is next due to be reviewed by Pensions Committee on 24 June 2015.

2. <u>Details of your social environmental or ethical policy and how it is implemented having regard to fiduciary duties</u>

   Details of the Funds' policy on environmental, social and governance issues (ESG) can be found in the Statement of Investment Principles. While fiduciary duty remains paramount in all decision making, the Pensions Committee believes that it has a responsibility to take environmental, social and governance (ESG) issues seriously and where appropriate, to act upon them. As such, ESG considerations are embedded within the investment processes of the Fund and its investment managers.

Infrastructure Investment

1. <u>Details of any investment you have made in Scottish or UK infrastructure projects</u>

At 31 March 2015, the Funds had approximately £300 million invested in infrastructure. Infrastructure makes up 6% and 5% of the assets of Lothian Pension Fund and Lothian Buses Pension Fund respectively.

Whilst some investments are invested in single infrastructure projects, most of the Funds' infrastructure holdings are funds which are invested across geographies, typically Europe or UK. The value of the investments in a specific country is not readily available. However it is estimated that over 70% of the Funds' infrastructure investment is based in the UK, with approximately 50% (of the 70%) in social infrastructure, 20% in transportation, 15% in regulated utilities with the remaining invested in energy, renewable and communications. Further detail on the Funds' infrastructure investments is provided in the Appendix.

2. <u>Whether your Fund has considered investing in the Pensions Infrastructure Platform when it opens to non-founder members</u>

The Funds had an established infrastructure investment programme before the Pensions Infrastructure Platform (PIP) was founded and continues to have a strong pipeline of investment opportunities in leading projects in this sector. Dalmore, the first investment manager selected by the PIP, is one of the Fund's existing managers - Lothian Pension Fund invested in Dalmore's first infrastructure fund.

We attended the PIP seminar in February 2015 and will continue to monitor its progress and consider the PIP's investment propositions as they become available.

3. <u>Whether your Fund has worked in partnership with other Scottish Local Government Pension Funds to invest in Scottish or UK Infrastructure projects</u>

Lothian Pension Fund currently collaborates on a shared service basis with Falkirk Council Pension Fund to share specialist investment staffing resource to assist with monitoring investments as well as to identify UK infrastructure investment projects of mutual interest. Recent due diligence has resulted in a commitment by both funds to a renewable energy investment in Scotland. Work continues on sourcing other potential infrastructure investments by Lothian and Falkirk on an efficient and collaborative basis.

4. <u>Details of the current barriers to investing in infrastructure projects</u>

We believe the current barriers to investing in infrastructure projects are as follows:

Human resources – expertise to be able to conduct appropriate levels of due diligence and deal execution
The due diligence required to make and monitor infrastructure investments can be intensive, as the asset class tends to be unlisted and a broad spread of investments is needed to diversify risk. Relying on a fund-of-funds investment manager to undertake that due diligence can be expensive.

Lothian Pension Fund has an established internal investment team, with specialist infrastructure resource, which has been built up over a number of years. This has enabled the Fund to invest in infrastructure through commitments to primary funds, purchases in the secondary market and co-investments. Legal and analytical resource was added in recent years in recognition of the desire to increase infrastructure investment and the complexities of investing. The ability to provide execution certainty (both commercial and legal) is critical to operating effectively in this sector and building up the necessary market presence to be offered an attractive pipeline of suitable opportunities.

The recruitment and retention of key staff is one of the highest risks on the Lothian Pension Fund risk register. In order to manage this risk, the Fund has recently established a new legal structure for the purposes of strengthening internal controls and pursuing authorisation from the Financial Conduct Authority.

Access to projects/fund managers and co-investment rights
The infrastructure sector often involves "off market" transactions, which require a presence in the sector to be able to access such investments.
The Funds' presence and expertise in this sector, and its ability to execute deals efficiently, means it can access projects and benefit from preferential commercial terms. In addition, co-investment opportunities with existing managers have enabled the Funds to gain direct access to projects, which provides the benefit of greater transparency and beneficial commercial terms.
However, Lothian Pension Fund is a relatively small investor in the infrastructure market and with increasing interest in the asset class from other, larger, investors, there is a risk that access to projects could be more difficult for the Fund in the future.

Risk/Return
Some infrastructure investment opportunities lack the risk/return characteristics needed to deliver the Funds' requirements. Lothian Pension Fund's performance target for infrastructure investments is 3.5% above inflation.

Local Government Investment Regulations
Lothian Pension Fund has long held the view that the Local Government Pension Scheme (Management and Investment of Funds) regulations would benefit from significant review and that the existing limits on investments should be replaced by a prudential code. In particular, the limits on investment in partnerships are a

potential impediment to large scale infrastructure investment which is typically structured as a limited partnership. The existing limits are 2% (of total assets) in a single partnership and 5% in all partnerships. There is scope in the regulations for a fund to increase these to 5% and 15% respectively and the Lothian Pension Fund has used this additional headroom.

Please do not hesitate to contact me, if you need any further information.

Yours sincerely,

CLARE SCOTT
Investment & Pensions Services Manager
Lothian Pension Fund

APPENDIX: Selected UK/Scottish Infrastructure as at 31 March 2015

Fund	Details of UK/Scottish investments
Listed Infrastructure	LPF's investment in the listed HICL infrastructure company is worth c£24 million. HICL is a UK focused infrastructure investment company with 89% of its assets invested in the UK. The fund has 39%, 23%, 19% and 13% invested in Health Service, Education, Accommodation and Transport, respectively. At 31 March 2015, the Group had 13 investments in Scotland, accounting for 13.8% of the portfolio by value. LPF also has a c£11 million investment in the listed 3i Infrastructure fund, which has 68% investment in the UK mainly in transportation and regulated utilities sectors.
EIG European Clean Energy	In 2006, LPF committed €15 million to the EIG European Clean Energy fund which has 26% invested in a UK wind farm asset.
Alinda Infrastructure	LPF committed £15 million in 2006 to Alinda Infrastructure Fund, which currently has 17% invested in a UK airport.
Dalmore Capital Fund	In 2012, LPF committed £25 million to Dalmore Capital Fund which has 100% of its assets invested in the UK. In 2013, LPF further committed £25 million to a UK Schools and Hospitals projects including Scottish schools.
EISER Infrastructure Fund	Lothian Pension Fund committed €25 million to this fund. It currently has 47% assets in the UK including a UK airport and a gas distribution company.
DeAWM managed Pan-European Infrastructure Fund I	LPF's commitment was €35 million. It has 63% invested in UK Ports and a water supply company. After the disposal of its German asset, the holdings in the UK will increase to 85%.
Macquarie Infrastructure Funds	Since 2011, LPF has made various investments in Macquarie managed infrastructure funds. Funds I and II have 40% - 50% invested in UK infrastructure including transportation, water supply, communications and car parks. The latest (fund IV) recently made its first investment in the UK which includes 3 UK airports.
NIBC Infrastructure fund	LPF committed €17 million in 2014 to NIBC Infrastructure Fund which has 56% invested in the UK including stakes in MAS (motor area service) as well as school and hospital projects.
Water	LPF has a £20 million commitment in a UK water supply company via a co-investment with KKR.
Renewable	LPF has recently committed £8m to a Scottish mini-hydro project through a co-investment.

***Please note that the details contained in this letter and, in particular, the schedule are strictly private and confidential and not for further disclosure or publication.**