

Chris Hitchen on Key Issues for Long-term Investors from Greenfield Assets to Action on Climate Change

On November 19-20, 2015, the OECD/Euromoney Long-term Investment Financing Conference took place in Paris. Chris Hitchen, Chief Executive Officer, Railways Pension Trustee Company (Railpen), spoke at the event, taking part in a panel discussion on long-term investment in a volatile market.

Key points:

- As a return-oriented pension fund, the Railways Pension Trustee Company (Railpen) has an annual real return target of inflation plus 4%, which it aims to make by market returns plus an additional 100 basis points from variety of means.
- In the last couple of years, it has revised its governance and investment strategies in order to meet its investment objectives. It is now focussed on greater use of in-house investment and a more direct approach to areas such as private equity and hedge funds.
- Another live debate is over possible action on climate change. Chris Hitchen commented: “We are driven by our fiduciary duty and are very cognisant of the fact that we don’t want to deliver pensions in a world that is so diminished that it is not worth living in. For me, all of these things join up by thinking what is likely to lead to the best long-term returns.”

The Railways Pension Scheme is one of the UK’s largest pension funds, managing over £21 billion in assets for over 100 employers and over 350,000 members and pensioners. Its assets are managed by the Railways Pension Trustee Company (Railpen) and its chief executive, Chris Hitchen, spoke to IIN European content director Matt Craig.

On Railpen’s return-seeking approach

“We do set out our stall to be a long-term investor and frankly we need to be. Unlike many other pension funds we are primarily return-oriented, rather than liability-matching oriented. The railways pension scheme is sectionalised for different employers and the largest part is train operating companies and Network Rail. It is open to new entrants, so it is still accruing final salary benefits. Also we have a shared cost funding approach, so the long-term cost matters both to employers and members. Our job is producing good long-term real returns, and in order to do that we have to ride out market cycles to some extent.

“We have a relatively high allocation to real assets and we think in terms of risk factors, not assets, for asset allocation. The equity risk factor is by far our most important return driver. In a low return environment, we don’t want to leave many scraps on the table, so we do some judicious tilting of the portfolio to take account of the relative valuations between assets.”

On its real return target

“We have a long-term real return target of for most assets. We aim to achieve RPI (the Retail Price Index, a UK inflation measure) plus 4% a year in our main Growth Pool. We know that in order to get that we have to take what the market gives us and add 1% on top of that by a combination of methods.

“As a way of judging how we are doing, we have a reference portfolio, which is a simple equity-bond composite. We set out to beat it by 100 basis points over a rolling three-year period by a combination of means, including investing in illiquid assets and some use of tilting, as well as setting a strategy which is geared towards sources of value.

Improving Governance

“We did quite a lot of work with Roger Urwin at Towers Watson on the way we thought about governance [*Railpen’s Investment Transformation Programme which started in 2013*]. We did this thinking on re-organising governance and decision-making a couple of years ago, but we are still putting some of the building blocks, to make the fund governance as good as it can be, into place. We want to be a world-class investor and believe it is partly about having world-class governance. The trustees agreed to replace their investment committee with a professional investment board, the majority of whom are professionals with investment knowledge. We also have complete ownership of the investment outcomes, which means that there is a much greater tendency to manage assets in-house, so we have greater control. One corollary of that is reducing the amount spent on external managers and cutting out complexity. Unless we clearly see the value added, we are much more judicious in our approach to using external managers.”

Using Real and Illiquid Assets

“For real estate, we have been fortunate in having a stable outsourced real estate team for 25 years. With any team one has to keep succession issues under review. For private equity, we are looking to invest directly and are trying to find places where our capital is wanted, but we do not want to compete head-on with say, the large Canadian funds, as they can write pretty big cheques. We will certainly collaborate if opportunities come up, but some institutions seem to require a lower rate of return than we do. We are quite choosy about what we are willing to invest in; we are only going to invest where there is a need for our money and our expertise is valued as part of the partnership. Origination is the difficult part of private markets and we accept that we are going to need to work with people to get access to the best opportunities.”

The Infrastructure Mismatch

“The problem with the first wave of infrastructure vehicles from the mid-2000s is that they contained blended pools of assets managed in a private equity style. That meant there was a misalignment of incentives between us and the manager; we wanted long-term, inflation-linked cash flows and they wanted capital appreciation. Many funds learnt from that experience.

“We now participate in the Pensions Infrastructure Platform [a UK platform for pension funds to collaborate on infrastructure investment] and I think that has considerable potential to change the terms of trade between UK pension funds and infrastructure providers. There are precedents for it, such as the IFM in Australia, which is a successful infrastructure manager owned by Australian superannuation funds. We are moving in the right direction, but there is probably quite a way to go. The problem right now is that there is still a shortage of supply of the right kind of asset and yields tend to be bid down to the point where they are not attractive.”

Infrastructure and Co-Investing

“Different funds have different requirements; we are not the same as other PiP members. There is some flexibility in the PiP structure to allow different members to take different pieces of a transaction and collectively we are still stronger than we are individually. Co-investing very much fits with our approach of trying to reduce our overall costs, on the basis that costs are certain but returns are not. It is one way to get costs down, but it is important to be careful here, as there are a number of studies showing that returns from co-investments are lower than returns from funds in the private equity space. This could be due to particular vintage years attracting too much money, but it shows that you have to take each opportunity on its merits. If the numbers stack up with the risk-return profile we look for, we will do a deal, but if not, we won't.”

On Governments Replacing Infrastructure

“Larry Summers made the point; if you can't renew infrastructure when interest rates are near zero, then when can you do it? The counter argument is that Japan tried this and built a lot of roads to nowhere in the nineties. There is a tendency for governments to see institutions as free pools of capital that they can use to achieve political objectives, whereas I interpret our fiduciary duty differently. It drives everything we do and whilst we very much want to be part of the solution, it has to be on terms which are financially acceptable to our members and stakeholders.”

Greenfield Infrastructure Assets and Railpen's Approach

Because our scheme is sectionalised, every employer has their own liability balance sheet, so we can't run one investment strategy. We have to cluster them as far as we can. We have a small number of pools of capital and the largest pool is the growth pool. Our diversified growth fund is aiming to achieve inflation plus 4%. We also have an illiquid growth pool, which is really private equity in various forms, where we aim to achieve inflation plus 5% to 6%. At the other end of the scale, we have a long-term income fund where we are happy to take on illiquid investments with a stable cash flow, so its target is inflation plus 1% to 2%. So greenfield infrastructure has to stack up against private equity.”

“One piece of thinking that we are still working through is that an asset could potentially move through our framework of different return pools over its lifecycle, for example starting as a greenfield asset in private equity, moving through to an illiquid asset providing a stable cash flow. But it would have to make sense for an asset to fit into each strategy over each stage of its life-cycle”.

Hedge Funds

“We do have some hedge funds, but fewer than we used to. It was treated as an asset class in portfolio construction, even though we knew it wasn’t, and was run as a highly diversified fund of funds. We have now changed our approach to hedge funds and we use them now if they can provide something very specific; a source of return we cannot obtain elsewhere, or for vital investment intelligence which we get from a manager. We try to identify the underlying source of returns in a portfolio and that makes us reluctant to pay alpha prices for inflated beta.”

Emerging Markets

“We try not to follow a market cap weighting and increasingly we are expressing the equity portfolio by exposure to a number of different alternative risk premia. This gives a different blend of risk and return to building up an equity portfolio through conventional asset allocation. We also think about emerging markets separately although there are two schools of thought here. One is that valuations are more attractive than developed markets and we certainly have run overweights in emerging markets historically. The other school of thought is that the world is increasingly about knowledge companies, rather than manufacturing companies and these are found more in developed markets, than emerging markets. This is an investment debate we are having on where long-term growth will come from.”

Climate Change and Divesting or Engaging with Carbon Producing Companies

“It is live debate here and there are several strands to our approach. A significant part of our approach is to engage with companies, because we believe that company management should be a major part of our approach as an asset owner. We really want company management to manage our capital for us, so we look through the fund manager to the management of underlying companies. We are trying to encourage companies to see this holistically and to take a long-term view themselves. If certain companies, or even certain industry sectors don’t get it, should we avoid them? It is something that is under active consideration but we have not yet concluded our thinking on this. We are driven by our fiduciary duty and are very cognisant of the fact that we don’t want to deliver pensions in a world that is so diminished that it is not worth living in. For me, all of these things join up by thinking what is likely to lead to the best long-term returns. So for instance, are we holding too much in what could become stranded assets and so not conducive to long-term returns? Essentially, it is a financial argument framed by a long-term perspective.”