THE MEMBER BACKING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

February 2024

SECURE INCOME

MADE SIMPLE GUIDE

ACKNOWLEDGEMENTS

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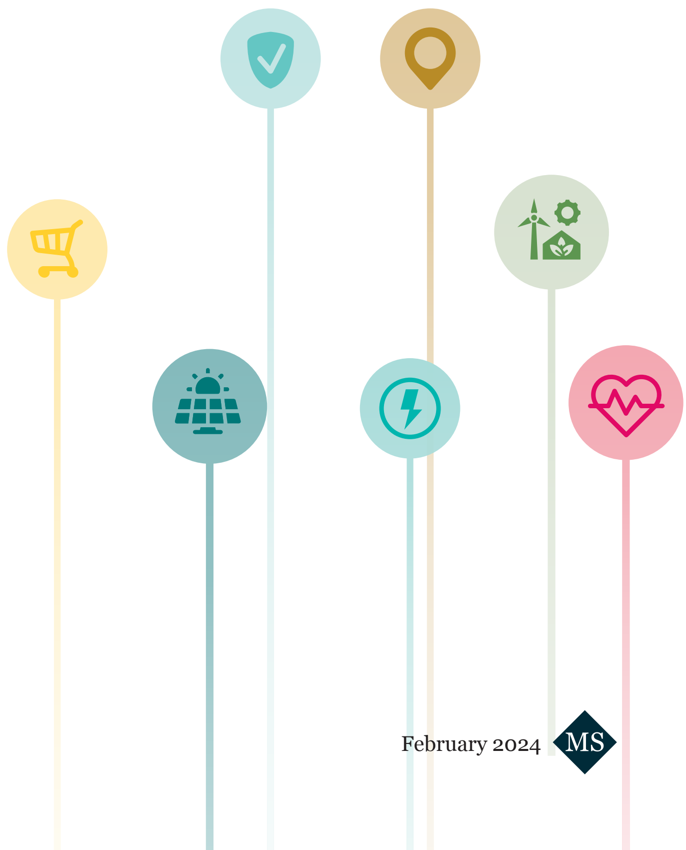


1. INTRODUCTION

THIS SECURE INCOME MADE SIMPLE GUIDE WILL SHOW WHY SECURE INCOME CAN PLAY A ROLE IN HELPING PENSION INVESTORS ACHIEVE THEIR INVESTMENT OBJECTIVES AND THAT NOW COULD BE AN EXCELLENT TIME TO CAPTURE THE OPPORTUNITY AT AN ATTRACTIVE PRICE.

Higher inflation can put additional strain on pension schemes' ability to pay out pensions as they fall due. There is an increased focus on cashflow, including developing "cashflow waterfalls", to ensure that pensions can be paid without the scheme needing to sell assets, perhaps at an inopportune time. In addition, some schemes are looking to de-risk their investment portfolios and increase investment in productive finance.

Secure income is an asset class that can potentially help solve several of these challenges.

This Secure Income Made Simple Guide will:

- Introduce the concept of secure income.
- Explain how secure income assets can benefit a range of pension investors.
- Explore some of the underlying secure income asset classes in more detail.
- Highlight some of the potential risks associated with secure income investment and how these can be mitigated.
- Go through some of the other considerations associated with investing in secure income such as ESG, portfolio construction and implementation.

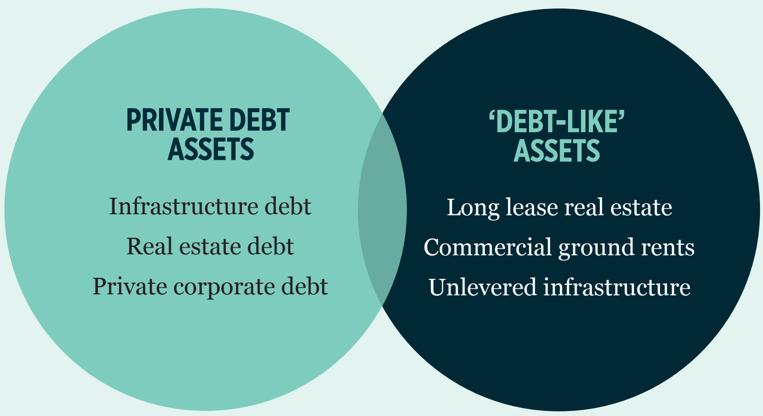
2. WHAT IS SECURE INCOME?

SECURE INCOME IS DEFINED IN THIS GUIDE AS: PRIVATE ASSETS THAT GENERATE PREDICTABLE CASHFLOWS SECURED AGAINST REAL ASSETS OR OTHER FORMS OF COLLATERAL.

WHICH ASSETS FALL WITHIN SECURE INCOME?

The secure income universe is wide and can be broadly split into private debt and "debt-like" assets. Debt-like assets involve creating a debt-like income stream secured by equity ownership of a real asset.

Examples of assets included in each of these buckets are provided below. More detailed asset definitions are provided later in this guide.



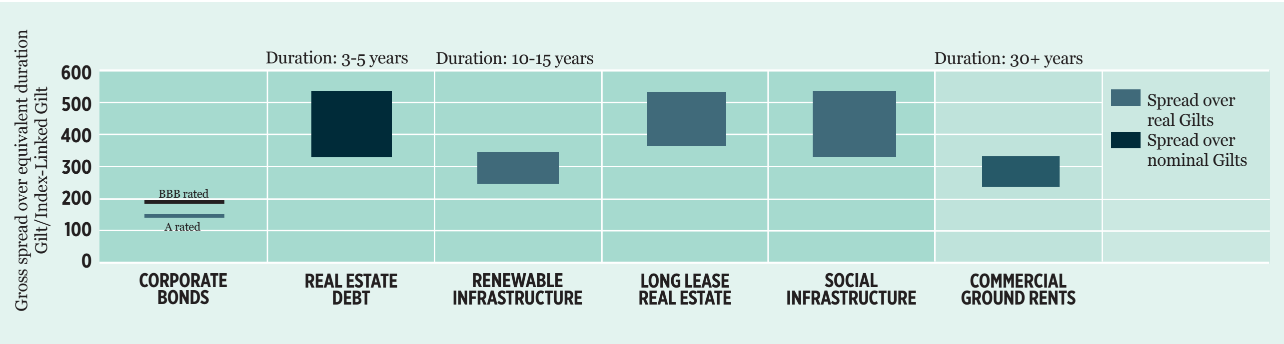
3.
WHY USE SECURE INCOME?

SECURE INCOME CAN MEET A RANGE OF INVESTOR NEEDS. THE TABLE BELOW SUMMARISES SOME OF THE INVESTMENT OBJECTIVES OF INVESTORS ALONGSIDE HOW SECURE INCOME CAN HELP. WE ELABORATE ON THESE TOPICS IN THE FOLLOWING SECTION.

WHAT ARE INVESTORS LOOKING FOR?	HOW CAN SECURE INCOME HELP?
Competitive risk-adjusted returns	Diversified source of attractive risk-adjusted returns
Predictable income to meet cashflows	Typically investment grade income backed by real assets
Inflation protection	Explicit/contractual inflation linked cashflows
Strong ESG credentials	Tangible, measurable social and environmental benefits

ILLUSTRATION OF SPREADS OVER GILTS PROVIDED BY DIFFERENT TYPES OF SECURE INCOME INVESTMENTS

The table below shows the spreads over Gilts provided by different types of secure income investments, expressed as a spread over nominal or index-linked gilts in line with most pension scheme investment return targets.



Sources: AlphaReal (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at End December 2023. The future returns and opinions expressed are based on AlphaReal internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by AlphaReal nor as advice of any nature. Real Estate Debt: 5-year interest and fees cashflow from senior investment term-loan secured against core real estate where interest is comprised of a margin over either SONIA or BoE base rate. Renewable Infrastructure: 15+ year inflation-linked cashflows from unlevered wind and solar infrastructure assets subject to Feed-in Tariff (FIT) or Renewable Obligation Certificate (ROC) regimes. Long Leases: 15+ year inflation-linked leases on commercial real estate. Traditional sale & leasebacks fall within this market. Social Infrastructure: 15-20+ year inflation-linked leases on operational real estate across the housing, healthcare and education sectors. Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

HOW COULD SECURE INCOME ASSETS BENEFIT DIFFERENT INVESTOR TYPES?

Secure income investments and pension liabilities share similar characteristics: both are long-dated and *inflation-linked*. Some investors that may have interest in this type of cashflow profile are:

- **Defined Benefit (DB) pension schemes.** The much publicised "LDI crisis" has left many DB schemes with improved funding positions. Secure income assets can help secure pensioner outcomes for schemes looking to run-off their liabilities on the low dependency basis outlined in the latest DB Funding Code.
- **Insurers.** Improved funding in DB has meant record demand for buy-in/buy-out. Insurers have therefore increased allocations to secure income assets that can match these new liabilities. Changes to UK Solvency II regulation should see increased insurer demand for a broader range of secure income assets that could now qualify as "matching adjustment". This bodes well for DB pension schemes holding these assets, as they may become attractive to insurers as part of the buy-out transaction.
- **Local Government Pension Scheme (LGPS) funds.** LGPS funds weren't major holders of LDI assets, so escaped the LDI crisis largely unscathed. Most are in a strong funding position, but conscious of increasing cash outflows. Given the open nature of these funds, they are long-term investors and therefore natural investors in secure income assets – especially given the potential to align these investments with net zero and levelling up ambitions.
- **Defined Contribution (DC) pension schemes.** As illiquid assets become more widely utilised in the DC space, secure income assets should become a core building block for decumulation solutions looking to provide income to those in retirement. As a result, there is also a case for building a secure income component to DC member portfolios in the de-risking phase. Many of the 2023 Mansion House reforms, alongside more of a focus on ESG, are also supportive of increasing secure income assets in DC portfolios.

4. EXAMPLE SECURE INCOME ASSETS

BELOW WE HAVE PROVIDED EXAMPLES OF SOME OF THE MORE PROMINENT SECURE INCOME ASSET CLASSES UTILISED BY INSTITUTIONAL INVESTORS. THESE EXAMPLES ARE INTENDED TO BRING TO LIFE SOME OF THE NUANCES ASSOCIATED WITH SPECIFIC ASSET CLASSES IN THE SECURE INCOME SPACE. IT'S WORTH HIGHLIGHTING THAT THESE ASSETS ARE GENERALLY UNLEVERED OR HAVE VERY LOW LEVELS OF LEVERAGE, AS LEVERAGE CAN REDUCE SECURITY OF CASHFLOWS.

LONG LEASE REAL ESTATE - SOCIAL INFRASTRUCTURE

Social infrastructure targets investments in essential real estate, often underpinned by government funding, thus creating secure inflation-linked income. AlphaReal groups these assets into three pillars (Health, Housing and Education) which we estimate to represent a £50 billion-plus investment opportunity. Structured appropriately, these assets can deliver measurable social benefits without sacrificing returns.
An example asset is summarised below:

IN 2023 ALPHAREAL'S SOCIAL LONG INCOME FUND INVESTED IN A SPECIAL EDUCATIONAL NEEDS & DISABILITIES (SEND) SCHOOL IN KENT. THIS CREATED ADDITIONALITY THROUGH CONVERTING A REDUNDANT PREP SCHOOL IN MAIDSTONE, KENT INTO A SEND SCHOOL.

Competitive Risk-Adjusted Returns	Expected IRR of c.8.5% p.a.
Predictable Cashflows	25 yrs. with sustainable rental levels
Inflation Protection	5 yearly RPI linkage (1,4)
Strong ESG Credentials	Provision of 60 new 6th form places. Converting an existing building saves embodied carbon when compared to new build

COMMERCIAL GROUND RENTS (CGRS)

CGRs are an increasingly popular financing tool used by real estate owners, who sell the freehold of the property and lease it back for 60+ years. They have been one of the fastest growing secure income assets, with the institutional market expected to reach £20 billion within the next decade. These assets can provide investors with investment grade income and contractually inflation-linked returns. For the avoidance of doubt, this is a different asset class to residential ground rents.
An example asset is summarised below:

IN 2023, ON BEHALF OF AN INVESTOR, ALPHAREAL PROVIDED FUNDING TO A LEADING PROVIDER OF SOCIAL CARE. THE GROUP IS A LEADING PROVIDER OF SPECIALIST SOCIAL CARE SERVICES SUPPORTING OVER 5000 ADULTS AND CHILDREN WITH A WIDE RANGE OF COMPLEX NEEDS ACROSS THE UNITED KINGDOM.

Competitive Risk-Adjusted Returns	Expected IRR of c.6.1% p.a.
Predictable Cashflows	60 yrs. with sustainable rental levels
Inflation Protection	Annual RPI linkage (0,5)
Strong ESG Credentials	The transaction provided exposure to an entity which provides quality care to children and adults. The group is actively involved in enabling children, young people and adults with complex needs to make their own life choices, develop confidence and enhance their quality of life.

RENEWABLE INFRASTRUCTURE EQUITY

The renewable infrastructure opportunity is driven by the transition to cleaner energy. We estimate the investible opportunity set in the UK (across on-shore wind, solar and battery storage) to be £18 billion. For investors these assets can tie in with their net-zero ambitions while providing attractive returns and inflation protection.
An example asset is summarised below:

IN 2023, ON BEHALF OF INVESTORS, ALPHAREAL INVESTED IN A GREENFIELD SOLAR OPPORTUNITY IN BUCKINGHAMSHIRE.	
Competitive Risk-Adjusted Returns	Expected IRR of 8% p.a.
Predictable Cashflows	40 years, investment grade
Inflation Protection	40% contractual inflation linkage
Strong ESG Credentials	Provides c.25MW of energy, which is equivalent to offsetting c.7,000 CO_2e

REAL ESTATE DEBT – SOCIAL INFRASTRUCTURE CREDIT

There is a sizeable investment opportunity in social infrastructure credit – which provides senior secured lending on essential real estate. This is due to operators in the space having substantial refinancing requirements, as well as further retrenchment of banks away from the sector. Alongside ESG benefits, these loans can provide investors with attractive returns over interest rates (SONIA).
An example asset is summarised below:

IN 2023, ON BEHALF OF INVESTORS, ALPHAREAL PROVIDED A LOAN TO A LEADING CARE HOME OPERATOR, SECURED AGAINST A PORTFOLIO OF CARE HOMES ACROSS THE UK.	
Competitive Risk-Adjusted Returns	Provides an attractive spread over SONIA
Predictable Cashflows	3 year senior loan, secured against real estate
Inflation Protection	Floating rate
Strong ESG Credentials	Elderly care represents a core social infrastructure pillar. All homes rated by the Care Quality Commission.

5. POTENTIAL RISKS OF SECURE INCOME INVESTMENTS

AS WITH ANY INVESTMENT, THE KEY TO SUCCESS IN SECURE INCOME IS RISK MANAGEMENT.

Summarized below are three common risks associated with secure income. These risks are more prominent in some areas than others and there are nuanced risks associated with individual assets of which investors need to be aware. These risks are best mitigated by using experienced secure income managers alongside appropriate oversight from advisers.

DESCRIPTION	MITIGANT(S)
Illiquidity Many secure income assets have investment time horizons of 10 years+. Investors with shorter time horizons need to be confident they can sell their assets when needed.	▸ Many secure income funds are structured as open-ended funds, generally with 6-12 month liquidity, allowing investors some flexibility over when they can redeem. ▸ A growing secondary market in secure income assets from a broad range of different investor types makes it easier to sell underlying assets when needed.
Credit The risk that counterparties (e.g. tenants) default or defer payments, leading to lower returns than expected.	▸ Asset managers should provide an assessment and on-going monitoring of counterparties creditworthiness, taking action when required. ▸ Building a diversified portfolio limits concentrated exposures. This can be achieved for example by investing in commingled funds. Many secure income strategies have underlying collateral (e.g. property) which offer extra protection, and potentially enhanced returns, in the event of a default.
Origination Secure income assets can be difficult to source and there is often a lot of competition for assets. This can lead to managers taking longer than expected to deploy capital at the desired levels of risk / return.	▸ Work with managers with a strong track record of origination, with existing partnerships in place with developers. This will allow them to originate ideas off-market, without relying on brokers. ▸ Larger deals in the secure income space are often heavily bid on by large investors, like insurers. The ability to allocate to smaller deals can allow your manager to deploy capital more quickly and achieve better returns. ▸ A broader range of sectors and geographies in your secure income allocation will provide a bigger opportunity set of potential deals, allowing your manager to deploy capital more quickly.

6.
CONSIDERATIONS WHEN INVESTING IN SECURE INCOME

IMPACT / ESG CONSIDERATIONS

Being real asset backed, many secure income assets can positively benefit the environment and/or society. Specific to both these areas:

Environment: Secure income assets like renewable infrastructure are an essential part of our journey to decarbonization and net zero. Natural capital is a growing part of the secure income space, supporting the health of the planet and its biodiversity.

Society: Secure income includes essential social infrastructure that can support levelling up and other social objectives. Different forms of secure income assets can positively contribute towards many of the United Nations Sustainable Development Goals (UNSDGs).

ESG, in particular climate, is also a potential risk for secure income assets due to their long-term nature. These risks should be incorporated into the process when considering and monitoring any secure income investment.

PORTFOLIO CONSTRUCTION CONSIDERATIONS

Secure income assets can fit in a range of different portfolios thanks to their multiple positive investment characteristics. Some investors are migrating away from traditional asset definitions such as ‘property’ or ‘infrastructure’ towards definitions that more accurately reflect the role of the asset in the portfolio (e.g. income).

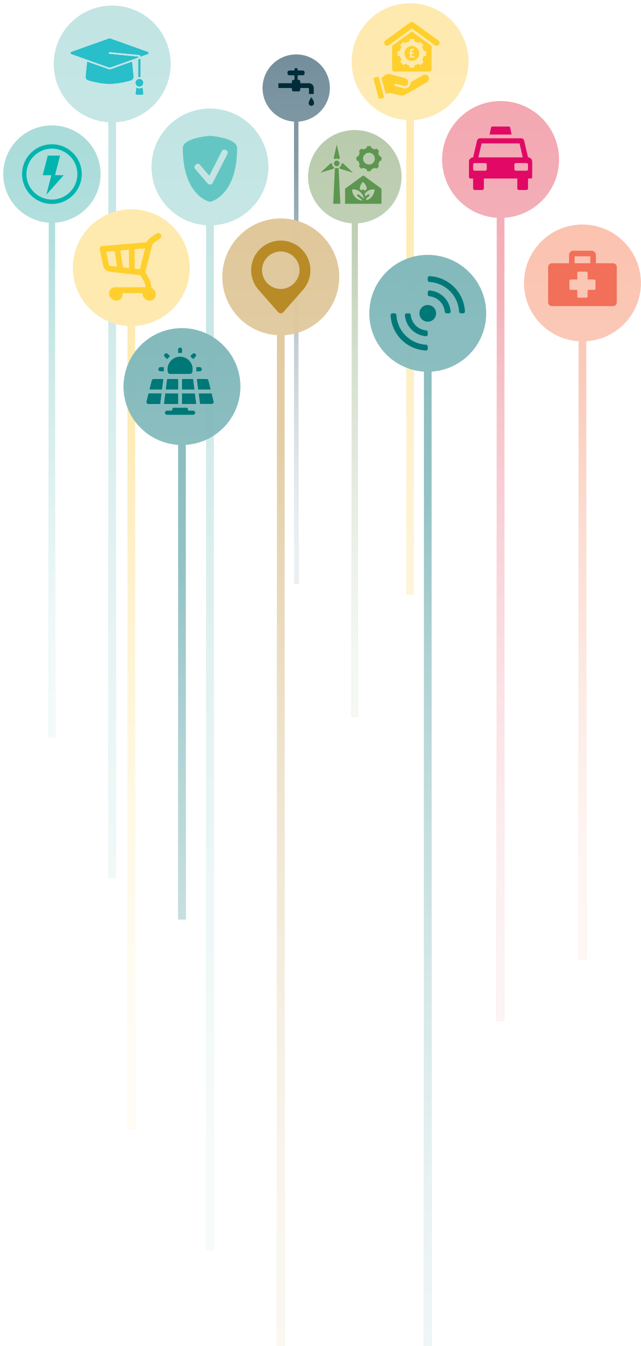
In our view, secure income assets can have a place in the:

Income/matching portfolio: Secure income assets are often a natural fit in this part of the portfolio thanks to the income provided helping to match the liability cashflows of the investor. This includes investors focusing on a cashflow driven investing (CDI) approach.

Growth portfolio: The expected returns from most secure income assets are usually similar to or above the long-term expected returns from equities. Given their diversification benefits, they may also help improve overall risk-adjusted returns in a growth portfolio.

Impact portfolio: An increasing number of investors are including a specific impact allocation within their portfolio. As detailed, secure income assets have a range of positive ESG characteristics that can provide real-world environmental and / or social impact.

Matching adjustment: For insurers, certain secure income assets that provide fixed cashflows (e.g. CGRs) may be eligible for inclusion within their matching adjustment portfolios. Upcoming reforms to Solvency II regulations should open a wider range of secure income assets for this purpose.



INTERACTING WITH LIABILITY DRIVEN INVESTMENT (LDI) PORTFOLIO

Many corporate DB funds have an LDI portfolio that helps manage the interest rate and inflation risks associated with their liabilities. In theory, some secure income assets also provide interest rate and inflation protection. Therefore, some investors and their consultants look to take secure income allocations into account when tailoring LDI portfolios, especially as the cashflows from these assets can be a good match for pension liability cashflows.

IMPLEMENTATION CONSIDERATIONS

There are a range of different approaches to allocating to secure income assets. Often this is based on the size and governance of the investor. The main approaches include:

Pooled fund: The most common route to investment in secure income assets is alongside other investors via specialist pooled funds. These will usually focus on a particular strategy within the secure income space.

Fund of fund: More governance constrained investors can allocate to specialist secure income fund of funds, allowing them to access multiple managers with one allocation.

Direct and co-investment: Larger investors with in-house teams can hold individual secure income assets on their balance sheets. Often this will still involve working with managers and brokers to access specialist areas within the space. Co-investment is an option here, especially for larger deals.

7. KEY TAKEAWAYS

TO HELP PLSA MEMBERS CONSIDERING FUTURE STRATEGIES TO MEET YOUR INVESTMENT OBJECTIVES, THIS SECURE INCOME MADE SIMPLE GUIDE HAS:

- Defined secure income as private assets that generate predictable cashflows secured against real assets or other forms of collateral.
- Explained the key benefits secure income assets can provide to different types of pension investors, which includes providing diversification and secure cashflows.
- Explored underlying secure income asset classes in more detail including social infrastructure, real estate debt, renewable infrastructure and commercial ground rents.
- Highlighted how risks like illiquidity, credit and origination can be mitigated.
- Reviewed other considerations associated with investing in secure income like ESG, portfolio construction and implementation – highlighting the versatility of these assets to suit a wide range of investors.

The next step is to consider how secure income assets could benefit your fund. We'd suggest speaking to your advisers about how these could be added to your toolkit to help secure member benefits and meet wider objectives, as outlined in this guide.

8. GLOSSARY

- **Cashflow driven investment (CDI).** CDI is a method of hedging cashflows by matching cash outflows (e.g., pension liabilities) with cash inflows.
- **Cashflow waterfall.** An order of where assets will be sourced from when cash outflows are required.
- **Co-investment.** Co-investments typically take the form of a stake directly in a private asset, alongside a co-mingled fund or other investors.
- **DB funding code.** The Pension Regulator's (TPR's) DB funding code coming into force on 1 April 2024. This code outlines how DB pension schemes should de-risk and allocate investments towards low-dependency funding.
- **Levelling up.** The UK Government's levelling up white paper identifies 12 key missions to be achieved by 2030, with the collective objective to facilitate equal opportunity within communities geographically dispersed across the UK.
- **Liability driven investment (LDI).** LDI aims to manage funding level risk (i.e. the variability of the pension scheme's assets compared to its liabilities). This usually means using a range of assets, such as swaps and gilts, to construct an investment strategy that closely matches the behaviour of pension liabilities.
- **Mansion House reforms.** A set of initiatives and proposed reforms of UK pension funds, including support for investing in productive finance.
- **Matching adjustment.** Allows insurers to discount the valuation of their long-term liabilities under Solvency II at a more favourable discount rate where certain eligibility criteria are met, thereby reducing the assets required to be held against those liabilities.
- **Net zero.** The objective to reduce greenhouse gas emissions to as close to zero as possible (usually by 2050), with the small amount of remaining emissions absorbed through natural carbon sinks and new technologies like carbon capture.
- **Productive finance.** Refers to investments that have the potential to generate societal benefits alongside an investment return.
- **Prudential Regulation Authority (PRA).** The PRA is the regulator for around 1,500 UK financial institutions, including insurance companies.
- **Solvency II.** Solvency II is the prudential regime for insurance and reinsurance undertakings in the EU. Following Brexit, the PRA is proposing changes to Solvency II regulations for UK insurers and reinsurers.
- **SONIA.** The Sterling Overnight Interbank Average Rate (SONIA) is a measure of the overnight interest rate paid by banks for borrowing in the sterling market.
- **United Nations Sustainable Development Goals (UN SDGs).** Define 17 targets or goals set by the UN for delivery by 2030. They include a mix of ESG issues such as education, gender equality, climate action, the eradication of hunger and poverty.

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