Bond portfolio review overview

London Borough of Enfield Pension Fund ("the Fund")
July 2018

Prepared by Aon

Presentation to London Borough of Enfield Pension Fund

Empower Results®

2017 Investment Strategy Review

Recap

- The Fund conducted an investment strategy review in 2017. As part of these discussions the Committee discussed the overall investment strategy, in particular the fact that the Fund's equity allocation is the largest source of risk in the Fund and strong recent returns present an opportunity to crystallise funding level gains and reduce risk in the investment strategy.

- It was discussed and agreed that the Fund could reduce its equity weighting by c.5%, which would bring it closer to its strategic allocation.

- The proceeds could be utilised within the fixed income portfolio which would in turn bring the fixed income portfolio towards it's strategic allocation. Fixed income was deemed an appropriate area to invest given its lower risk profile and role as a defensive asset for the Fund.

- As a reminder, over the period since the previous strategy was set in 2014, the Fund has had an overweight position to equities, expressed predominantly via an underweight to bonds, as a result of:
  - A medium term view on the relative attractiveness of equities versus bonds;
  - The general strong performance of equity markets.

Purpose

- In April 2018 the Committee discussed the contents of a bond portfolio review undertaken by Aon. The purpose of this presentation is to provide an overview of the discussion and decisions that were made during the meeting.

- A separate paper containing follow up discussion on the bond portfolio has been tabled for the July PP&I Committee meeting.

Key questions considered as part of review

Strategic allocation

What is their role within the portfolio? How much should we allocate to bonds?

Current portfolio

Is the current structure of index-linked gilts, UK corporate bonds and absolute return bonds suitable?

Wider credit opportunity set

What other assets are suitable? What are their merits?

Illustrative Portfolios

What is the appropriate balance between assets? We assess portfolios on a quantitative and qualitative basis.

Implement

Appointing the appropriate managers to implement the strategic allocation.

Strategic allocation

- The table on the right shows the 31 December 2017 asset allocation of the Fund, subsequent to the agreed near term cash movements including the expected capital calls from illiquid managers and release of cash from redemptions.
- It was discussed and agreed that an initial c. £50m (final amount to be confirmed) would be allocated to fixed income, through a disinvestment in the Fund's equity allocation.
- At the April 2018 meeting the Councillors agreed a new strategic allocation, as also indicated by the table on the right.

	(£m)	(%)	Agreed Strategic Allocation
Listed Equity	452.7	40.0	35.0
Private Equity	55.9	4.9	5.0
Hedge Funds	116.7	10.3	10.0
Property	90.2	8.0	10.0
Infrastructure	48.1	4.3	6.0
Fixed income	**208.1**	**18.4**	**24.0**
Inflation protection illiquids	54.1	4.8	10.0
Cash	**105.9**	**9.4**	**-**
Total	1,131.8	100.0	

Source: Northern Trust, Managers. Figures shown are as at 31 December 2017.
Note: Numbers may not sum due to rounding.
Due to the equity-like nature of the Lansdowne long / short equity hedge fund investment, the valuation has been split 50:50 between equities and hedge funds..

Key discussion items

Current allocation

- The Councillors discussed the current allocation to corporate bonds, index-linked gilts and absolute return bonds. The focus of the bond portfolio review was on the Fund's credit assets.
- It was discussed that the allocation to bonds should provide a lower risk profile relative to the Fund's equities (and other growth assets), diversification benefits and align with the Committee's governance structure, preferences and direction of travel with the London CIV.

Wider credit opportunity set

- It was discussed that the credit spectrum is wide but the opportunity set of assets that is suitable for the Fund is narrower, given our specific requirements.
- The wider credit opportunity set was discussed, particularly in the context of the London CIV's pipeline of assets and the Fund's risk, return and governance requirements.
- The Committee received training on the wider credit spectrum and the types of assets involved.

Illustrative portfolios

- Aon put forward a range of portfolios with different characteristics. The range of portfolios encompassed two themes: *Keep it Simple* and *Further diversification.*
- The Councillors discussed the quantitative and qualitative analysis undertaken by Aon.
- A discussion on the benefits of a global mandate and accessing a broader range of credit assets was undertaken. The discussions focussed not only on the risk/return considerations but that of wider factors such as governance and the London CIV.

Summary of key decisions made

Strategic allocation

- The Committee agreed to use a portion equity allocation, £50m (c. 5%) of Fund assets, in order to fund an increase in the fixed income allocation.
- The initial allocation of c. £50m is subject to change depending on the weight of equity and bond assets at the time of implementation.

Current allocation

- The allocation to index-linked gilts will remain unchanged.
- The Committee requested further information on the link between duration of the index-linked gilts and the Fund's discount rate in order to better understand the link between investment strategy and the valuation of the liabilities.
- The corporate bond allocation will remain unchanged.
- The absolute return bond mandate will be kept under consideration. Performance since inception has been poor however absolute return bonds play a diversifying role within the fixed income portfolio as they have low sensitivity to interest rates and low correlation to traditional fixed income assets.

Wider Opportunity Set

- The Committee agreed that the additional allocation to fixed income should be allocated to a multi asset credit mandate given its favourable risk/return characteristics, ability to access to a broad range of credit assets in a governance efficient manner and its availability on the London CIV.

Illustrative portfolios

- The *Introduce Global* portfolio was considered to be an appropriate illustrative portfolio for the Fund.
- The portfolio contains index-linked gilts, UK investment grade credit, global credit in the form of multi asset credit and absolute return bonds.

Next steps

- It was discussed that a multi asset credit mandate, managed by CQS, was available on the London CIV and this should be considered. The Committee has previously received a presentation from the London CIV on its bond offerings, including the CQS mandate.
- The Committee also asked Aon to put forward a multi asset credit manager for comparison.
- A separate paper containing a quantitative comparison between CQS and one of Aon's 'Buy' rated managers has been tabled for discussion.

Appendices

Role of bonds

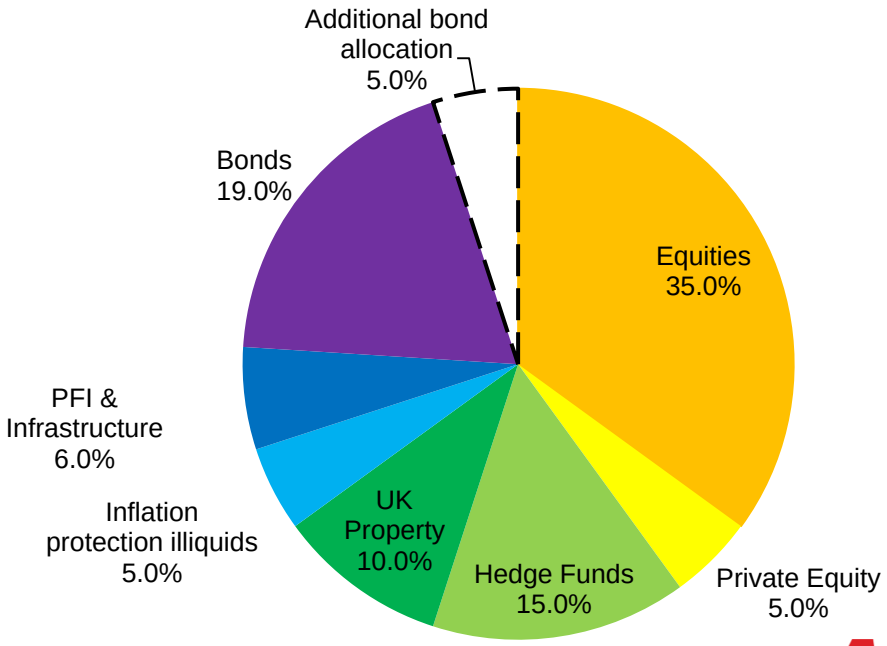
- Unlike pension schemes with a “gilts/swaps plus” approach, where there are assets available which broadly mimic the liability basis’s return, the Fund adopts a “risk based approach” whereby the resultant discount rate is derived from the expected return assumptions of the Fund’s investment strategy.
- Therefore, in essence, the optimal portfolio for the Fund is a well diversified mix of assets which provide a stable expected return over the long term.
- Therefore the bond assets that the Fund holds should be seen as diversifying assets; providing diversification and an appropriate return and risk profile.

Key criteria

We believe that the allocation to bonds should satisfy the following criteria:

- Risk reduction – provide a lower risk profile versus equities (and other riskier assets e.g. property and infrastructure)
- Diversification – provide diversification at an asset class and bond portfolio level, i.e. a low correlation versus other assets (we broadly consider this as equities and traditional UK investment grade credit)
- Align with the Committee’s governance structure, preferences and direction of travel with the London CIV

Strategic allocation prior to April meeting



Key characteristics of asset classes

	UK IG Credit	Global bonds	Multi asset credit	Absolute Return bonds	Private Debt
Opportunity set	UK IG (BBB-) credit	Government bonds IG credit Emerging Market Debt ("EMD") High Yield ("HY")	**Previous plus** Bank Loans Asset Backed Securities ("ABS") Convertibles	**Previous plus** Extensive use of derivatives Currency positions Rates positions	Private Debt
Orientation	Long only	Long only	Long only	Long and short	Long only
Target Return (p.a.)	1-3% over benchmark (or 2-6% absolute)	*Depends on specific make up of the fund*	Cash plus 3-7%	Cash plus 2-5%	6-8%
Volatility	Tracking error of 2-6%	*Depends on specific make up of the fund*	Volatility of 4-10%	Volatility of 3-6%	Low NAV volatility
Correlation to equities	Low due to duration	Depends on the mandate but low – high	Medium - High	Low to negative	Mark to market - doesn't exist
Correlation to UK IG credit	1.0	Depends on the mandate but low – high	Medium - High	Low	Mark to market - doesn't exist
Benchmark	Physical bonds	Physical bonds	Physical bonds or Cash	Cash	N/A
Duration	6 to 15 years	6 to 15 years	0 to 6 years	-6 to 6 years	N/A
Typical fees	0.10% - 0.30%	0.10% - 0.40%	0.4% - 0.7%	0.4% - 0.8% Potential performance fee	0.75% - 1.25% base fee Performance fee of 15%-20%
Liquidity	Daily – Weekly	Daily - Weekly	Daily – Monthly	Daily to weekly	Illiquid (5-8 year term)

Based on Aon's Capital Market Assumptions as at 31 December 2017

Illustrative Portfolios

Theme		Keep it simple	Diversification			
Strategy	*Current allocation**	Simple approach	Introduce Global	Further Global	Illiquid	Global & Illiquid
Index-linked gilts	*34.0%*	34.0%	34.0%	34.0%	34.0%	34.0%
UK Investment Grade Credit	*34.0%*	53.0%	26.5%	-	38.0%	-
Global Credit	-	-	26.5%	53.0%	-	38.0%
ARBS	*13.0%*	13.0%	13.0%	13.0%	13.0%	13.0%
Private Debt	-	-	-	-	15.0%	15.0%
Cash	*19.0%*	-	-	-	-	-
Total	***100%***	**100%**	**100%**	**100%**	**100%**	**100%**
Expected net of fees return (10 year p.a.)	1.0%	1.9%	2.5%	3.1%	2.4%	3.3%
Expected volatility (10 year p.a.)	9.0%	8.0%	6.5%	6.3%	7.1%	5.9%

*Expected return and volatility numbers are based on the current holdings excluding cash

- The current allocation is based on the existing asset split (as at 31 December 2017) prior to the investment of the additional cash. The 19% cash allocation represents the value of cash (£50m) as a portion of the cash and bond portfolio.
- The portfolios considered and the weightings are illustrative and could be applied, within reason, to a smaller or larger bond portfolio size. The weights shown are illustrative and there are a number of portfolios that could have been considered.

Considering strategy through different lenses

- In this section we consider the strategies through alternative lenses to provide a fuller view of the suitability of each of the strategies. We consider:
  - **I. Impact on diversification**
  - **II. Proportion of assets available on CIV –** the expected % of the portfolio which is aligned, or is expected to be aligned in the near future, with the London CIV.
  - **III. Number of strategies –** the number of different products the Fund will hold, even if with two strategies are held with a single manager.
  - **IV. Fees –** the expected base management fee of each of the strategies as a percentage of Fund assets

Theme		Keep it simple	Diversification			
Key statistics	***Current allocation[1]***	**Simple approach**	**Introduce Global**	**Further Global**	**Illiquid**	**Global & Illiquid**
Impact on diversification		=	↑	↑↑	↑	↑↑
Proportion of assets available on CIV[2]	34%	34%	60.5%	87%	49%	87%
Expected number of strategies	3	3	4	3	4	4
Estimated fees*	0.18%	0.18%	0.18% - 0.25%	0.18% - 0.32%	0.27%	0.27% - 0.37%

*excludes the impact of any performance related fees

Note: The table above has been populated based on our expectation of the London CIV's pipeline of assets and approximate fee schedules

[1]Based on the current bonds held as at 31 December 2017

[2]Assumes BlackRock ILGs are on CIV given the negotiated fee schedule.

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- This report, and the work relating to it, complies with ‘Technical Actuarial Standard 100: Principles for Technical Actuarial Work’ (‘TAS 100’)
- *The compliance is on the basis that the London Borough of Enfield is the addressee and the only user and that the report is only to be used for the design of the bond portfolio. If you intend to make any other decisions after reviewing this report, please let us know and we will consider what further information we need to provide to help you make those decisions.*
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