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

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Prepared for: Pensions Policy & Investment Committee ("the Committee")

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Options for Absolute Return Bonds mandate

Introduction

As part of the Fund's 2017 investment strategy review, it was agreed that the Fund could reduce its overweight position to equities which would crystallise funding level gains, reduce the equity risk in the investment strategy and bring it closer to its strategic allocation.

Subsequently a bond portfolio review was carried out in April 2018. As part of the review, the Committee discussed the Fund's existing allocations to corporate bonds, index-linked gilts and absolute return bonds ("ARBs"). These were reviewed for their on-going suitability within the Fund's portfolio.

At subsequent Committee meetings the Councillors raised concerns about the poor performance of the Fund's current ARBs mandate with Insight Investments ("Insight"). It was therefore agreed that the mandate would be kept under review while acknowledging that the mandate only represented c. 3% of total Fund assets.

Given the continued poor performance of Insight ARBs mandate, the Committee asked Aon to provide an overview of the role that ARBs is providing within the Fund's bond portfolio as well as putting forward alternative options should the Committee lose conviction in the investment strategy and/or manager. The purpose of this paper is to therefore consider the merit of the current ARBs mandate and consider other options available to the Committee.

Recap: Absolute Return Bonds

The focus of ARBs strategies is on preservation of capital and management of the portfolio’s liquidity. ARBs strategies target stable and uncorrelated returns from investing long and short positions across a wide opportunity set within fixed income.

A normal objective for ARBs managers is to produce a positive return with low volatility. ARBs strategies look to add value irrespective of market direction through implementation of long or short positions based on the manager's view.

ARBs managers use a wide range of credit instruments in the fixed income universe including: Government Investment Grade, High Yield Bonds, Loans, Asset Backed Securities, Emerging Market Debt ("EMD"), Cash, Currency, Derivatives and Mortgages. Many of these instruments are the same as those used by traditional bond managers but ARBs managers have fewer constraints on how the opportunity set is accessed.

The challenge in recent years has been that a low volatility environment and low interest rate environment has not been conducive to strong performance. However, we believe that ARBs can have merit within a wider portfolio.

Role of ARBs in portfolio

ARBs offer not only diversification from some of the Fund's high return assets, but also within fixed income. As a result of their wider opportunity set, they offer a return source which is diversified from index-linked gilts and corporate bonds. The Fund's index-linked gilts and corporate bonds have been beneficiaries of falling yields over the years however our expectation is that yields will rise going forward, leading to capital losses (assuming they are not held to maturity).

Further, they access a broad spectrum of the credit universe, in a similar but broader manner to multi asset credit. However, it should be noted that returns are heavily driven by manager skill and not market performance or beta. In addition, fees for the asset class are high, reflecting the unconstrained and active nature of the asset class.

ARBs performance

Current ARBs manager: Insight

The Fund’s current ARBs manager, Insight, has returned 0.48% p.a. (to 31 August 2018) since inception (December 2013) net of fees, below its LIBOR + 4% p.a. target.

In previous meetings the Committee has expressed disappointment with the performance particularly given the high levels of fee (75 bps) associated with the strategy.

The table below shows analysis of performance and risk of Insight versus a subset of other ARBs 'Buy' rated Aon investment managers. We have shown performance of Insight versus managers with a similar performance target and also for lower risk ARBs funds.

Comparison of performance metrics

ARBs style	*Aggressive*		*Moderate*		*Conservative*	
Investment manager	**Insight Bonds Plus 400**	**Manager 1**	**Manager 2**	**Manager 3**	**Manager 4**	**Insight Bonds Plus 200**
Absolute Performance (p.a.)	1.68%	3.01%	2.34%	1.50%	1.66%	1.42%
Volatility (p.a.)	3.35%	2.52%	1.66%	1.73%	1.26%	1.77%
Sharpe ratio	0.35	0.90	0.96	0.57	0.91	0.52
Maximum drawdown	-5.78%	-4.99%	-1.84%	-1.34%	-1.37%	-2.90%
Correlation to Global Credit	-0.18	0.06	0.47	0.18	-0.17	-0.17
Correlation to equities	0.36	0.63	0.37	0.28	0.60	0.37

Source: Manager data / eVestment. 5 year data to 30 June 2018. Returns in base currency and gross of fees.

The recent market environment has been challenging for many ARBs strategies with performance returns being modest across a range of ARBs managers. The Fund's ARBs strategy has been one of the most volatile ARBs funds, but this is to be expected given its high target of LIBOR + 4% p.a. Although performance has been disappointing, the Fund's ARBs strategy fulfilled its role as a portfolio diversifier; it has exhibited low correlation to global credit and equities as do the other ARBs funds in the sample.

A key decision for the Committee is whether they want to retain exposure to absolute return bonds.

In the next section we consider what options are available if the Committee no longer has conviction in the Insight mandate and wishes to redeploy the Fund's assets elsewhere.

Options for redeployment

There are a number of options available to the Committee if they wish to redeploy the assets currently invested with Insight.

Option 1 – terminate ARBs and deploy across other fixed income assets

- Bonds would be a suitable asset class to invest in as the Fund is underweight to this area. The Committee could consider investing across other existing bond assets including gilts, corporate bonds and multi-asset credit. On a relative value basis we have a preference for multi-asset credit as it is more attractive than gilts and corporate bonds. The Fund is already considering an allocation to multi asset credit.

Option 2 – terminate ARBs and deploy across other existing assets

- The Committee could invest assets in existing asset classes which are underweight compared to their strategic allocation.
- The Fund is overweight to equities (including private equity) and the Committee is looking to decrease the overweight position in order to reduce risk. Therefore equities are not a suitable asset class to invest in at the current time.
- The Fund is underweight to UK property, infrastructure and inflation protection illiquids. The Committee could consider an allocation to these asset classes however they are highly illiquid and it would be difficult to invest assets quickly. Further, the Fund is already holding a material cash balance, a portion of which is earmarked for investment in illiquid assets.
- The Fund is underweight to hedge funds so this may be a suitable place to redeploy funds. Hedge funds offer an attractive risk/return profile, however, are typically more risky than ARBs and the management fees are high compared to other asset classes. However, we understand the reservations regarding the fees associated with this area and the Committee should consider whether the high fees are prohibitive to future investments in this area.

Option 3 – terminate ARBs and deploy across new assets

- The Committee could consider investing the funds from ARBs in a new asset class.
- The Committee may wish to align the choice of asset class with suitable opportunities available on the London CIV. It would also be possible for the Committee to consider options outside the London CIV.
- However, it is important to note that a new asset class would require additional governance from the Committee and possibly introduce additional complexity into the investment strategy.
- If the Committee desires to pursue this route then we would look to undertake further work to provide suitable options for the Fund in light of the risk and return requirements.

Key decisions and Summary

- The primary decision for the Committee is whether to retain exposure to absolute return bonds.
- The manager could be invited to present to the Committee to explain recent performance prior to a decision being made.
- If the Committee decides to terminate the Insight ARBs mandate then key decision is whether to redeploy across existing asset classes or new asset classes.

Appendix – Absolute return bonds

Introduction

ARBs have a wide fixed income investment universe and wider discretion than traditional bond portfolios that have, at their core, a large duration and credit quality tilt. The manager of ARBs can instead focus on identification of the key micro and macro opportunities that fall within its skill set, reflecting its own views and abilities.

Unconstrained by a benchmark, ARBs aim to provide more stable absolute returns than traditional fixed income strategies, hence preserving an investor's capital. To do so, these funds invest in a wide array of fixed income instruments, currencies and derivatives and can take both long and short positions. This allows the manager to shift allocations between different sectors as views and market conditions change.

Strategies

ARBs typically operate with fewer sector or asset class constraints than traditional fixed income managers. This provides a greater opportunity set and can produce superior risk-adjusted returns (and better diversification). Examples of strategies employed to generate excess return include:

- Tactical trading strategy, which attempts to profit from forecasting the overall direction of the market or its component.
- Fixed income arbitrage strategy, which is designed to take advantage of perceived mispricing among related fixed income securities, such as a single issuer’s debt and equivalent Credit Default Swap (CDS).
- Mortgage arbitrage strategy which, similarly to fixed income arbitrage, attempts to capture the mispricing on the individual/ tranche of Mortgage Backed Securities (MBS) and their related derivative.
- Derivatives arbitrage strategy, which is based on exploiting the difference in pricing between a series of options or between options, futures and the money market.

The manager can switch between these strategies depending on their area of expertise and time in the market cycle.

ARBs have the flexibility to use financial instruments from all available sectors of the fixed income and derivative markets (both developed and emerging). The width of solutions available to the ARBs managers allows them to be more accurate in reducing any unintended risk.

Manager Skill

The skill of the fund manager's stock selection and market views is key in delivering returns from short term opportunities. To achieve a 'Buy' rating, managers are scrutinised to ensure:

- A good track record of key investment professionals in managing investments in the absolute return framework;
- A structure of the product that encourages construction of portfolios based on best ideas rather than fixed allocations;
- The ability to generate excess returns consistently and effectively whilst managing downside volatility;
- A risk management framework that ensures the positions are sized appropriately for the risk each brings to the portfolio;
- A focus on adding value through both Directional strategies (making

calls on whether certain stocks, markets or sectors will fall or rise) and Relative Value strategies (for example, taking opposing positions in two similar stocks when a pricing discrepancy exists) and not just by taking market risk.

ARBs have typically low correlations to traditional fixed income and other assets classes.

The table below outlines how ARBs strategies offer more opportunities to add value than other fixed income mandates:

Increased Opportunity Set

ARBs have typically low correlations to traditional fixed income and other assets classes.

The table below outlines how ARBs strategies offer more opportunities to add value than other fixed income mandates:

	UK Gilts	Corporate Bonds	Global Bonds	Absolute Return Bonds
Views on interest rates	✓	✓	✓	✓
Views on market sectors		✓	✓	✓
Views on companies		✓	✓	✓
Views on global regions			✓	✓
Views on currencies			✓	✓
Extensive use of Derivatives				✓

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