Alternative fixed income allocation

LCIV Global Bond fund

This paper is to provide further analysis on the LCIV Global Bond Fund as an appropriate strategy, for the newly agreed strategic allocation of 5% to alternative Fixed Income.

At a glance…

We recommend that the 5% allocation to alternative Fixed Income is invested in the LCIV Global Bond Fund. This is to provide diversification benefits within the portfolio away from UK corporate and government bonds, and retain the defensive characteristics of holding credit.

Background

The Committee reviewed the Fund's investment strategy in 2021 and agreed a new strategic allocation which includes a 5% allocation to alternative Fixed Income.

In September 2021 we discussed three options available on the LCIV, the LCIV Multi Asset Credit (MAC) Fund; the LCIV Global Bond Fund; and the LCIV Private Debt Fund.

We understand that Committee met with the manager of the LCIV Global Bond Fund, PIMCO, at a monthly manager meeting to discuss the underlying strategy, the PIMCO Global Credit Fund, in more detail.

Following the recent presentation from the LCIV to the Committee on their Global Bond Fund, this paper will focus on providing further information on this strategy to enable the Committee to make a decision on whether to invest 5% of assets in the LCIV Global Bond Fund. It will cover:

- Aon's view on global credit, including commentary on investing in the current economic environment
- Characteristics of the LCIV Global Bond Fund
- Commentary on how this fits with the Fund's other fixed income mandates
- Proposed next steps for the Committee

Why bring you this note?

To provide our view of the LCIV Global Bond Fund and how it could fit within the Fund's portfolio.

Next steps

- Discuss this note at the Committee meeting on 31 March 2021.
- Decide on whether to invest the 5% allocation to alternative fixed income in the LCIV Global Bond Fund or if further analysis on any alternatives is needed.
- Aon to work with Officers to implement any changes decided.

Prepared for: London Borough of Enfield Pension Fund
Prepared by: Aon
Date: 31 March 2022

Our view on global credit

The rise in shorter duration government bond yields has dented corporate bond performance of late. Expected returns are at the lower end, despite risks from rising interest rates or spreads being significant.

High institutional demand for investment grade bonds as a quasi liability-matching asset has compressed risk premiums and kept spreads over government bonds low.

As such our central view is that credit valuations are expensive, and this coupled with uncertainty surrounding the macro and market environment leave us cautious on credit in general.

However, as a long term strategic allocation we believe the defensive characteristics and income generation meant that the 5% strategic allocation remains a suitable option for the Fund. Active managers, in particular, are well placed to navigate the current turbulent market environment given the ability to shift between different credit markets and add value.

Our view on the PIMCO Global Bond Fund

Whilst Aon do not directly rate the LCIV Global Bond Fund, we rate PIMCO very highly as a large global fixed income manager and ‘Buy’-rate similar credit products, including other global credit strategies that are comparable.

PIMCO has an innovative approach to asset markets and a good long term track record in delivering performance objectives. The firm’s portfolio management hallmark is its significant emphasis on developing top-down macro views. The global credit team’s at PIMCO are knowledgeable and we are comfortable in the manager’s ability to add value in a risk-controlled manner across a range of market conditions.

The fund’s long-term performance to 31 December 2021 has been good, outperforming the benchmark (Barclays Aggregate – Credit Index Hedged (GBP) Index) by 32bps p.a. since inception in November 2018, and by 53bps p.a. over the 3-year period. More recent performance has also been encouraging, with the fund outperforming the benchmark by 59bps over the 1-year period to 31 December 2021.

Fit within the portfolio

We have included current credit exposure below:

			31 December 2021		Strategic
			£m	%	
Bonds	**Type of credit**	**Region**	**341.2**	**22.0**	**24.0**
BlackRock Passive Gilts and ILGs	*Gilts, ILGs*	*UK*	*95.3*	*6.1*	
Western Active Bonds	*Corporate bonds*	*Global*	*107.1*	*6.9*	
Insight Absolute Return Bonds	*Multi-Asset Credit*	*Global*	*31.9*	*2.1*	
London CIV Multi-Asset Credit	*Multi-Asset Credit*	*Global*	*57.0*	*3.7*	
Diversified Liquid Credit	*Short-Dated Credit, Asset Backed Securities*	*Global*	*49.9*	*3.2*	
Alternative fixed income			**-**	**-**	**5.0**

Source: Aon, Northern Trust

This strategy is a more traditional, long only credit strategy that invests in investment grade corporate bonds on a global basis. Relative returns are predominantly driven by a combination of security selection and sector allocation, with a lesser focus on duration and yield curve management.

Corporate bond strategies can offer varying yields depending on the underlying credit rating of the securities. The LCIV mandate is focused primarily on investment grade and may offer a lower yield than other alternatives. It will, however, be able to provide a greater level of cash flow than the existing MAC/ARB strategies.

The Fund currently has a significant allocation to UK Corporate Bonds through its holding with Western. Furthermore, with an allocation to Gilts and Index-Linked Gilts in the BlackRock portfolio, the Fund's current bond portfolio does have a bias towards the UK. Whilst we believe that allocations to UK Corporate Bonds, Gilts and Index-Linked Gilts still have merit within the Fund's strategy, our view is that the Committee should seek to add diversification by investing more globally.

Investing in a global bond fund would bring added benefits of diversification, by broadening the scope of potential investments. The Fund would be subject to less idiosyncratic risk from the UK economy and could therefore expect to see lower volatility from its non-government bond investment.

The LCIV Global Bond Fund will have some overlap in holdings with the Fund's other mandates, in particular the Multi-Asset Credit funds, though the additional diversification it brings to global credit markets outweighs this in our view.

Further details about PIMCO's Global Bond Fund, and the alternatives available through the LCIV can be found in the appendix.

Recommendation

We recommend investing the Fund's new 5% allocation to alternative Fixed Income in the LCIV Global Bond Fund, as:

- We have high conviction in the underlying manager in the global credit space and ‘Buy’-rate similar global credit strategies with PIMCO, albeit not this one for the reasons outlined above.
- We view global credit as a good diversifier within the portfolio away from, UK Corporate and Government bonds in particular.

We note that there will be some overlap between the LCIV Global Bond Fund and the Fund’s current bond holdings, but we are comfortable with this and believe the diversification benefits outweigh.

Next steps

If the Committee agrees to invest the Fund’s 5% alternative fixed income allocation in the LCIV Global Bond Fund, we will support the Officers to implement the change if instructed.

Appendix – Alternative fixed income strategies

CQS & PIMCO
LCIV Alternative Credit Fund (Active, Aon "Not Rated")

- The Fund has already had an allocation to the LCIV Alternative Credit Fund (previously named the "LCIV MAC Fund") since November 2018.
- The fund is currently managed by CQS and PIMCO, after the LCIV recently selected PIMCO as a complementary manager to CQS.
- This change was made on 31 January 2022 and the fund now targets an equal allocation to CQS and PIMCO.
- As a reminder, the LCIV MAC Fund has an objective to return Cash + 4- 5%, p.a. over a rolling 4-year period, net of fees.

PIMCO
LCIV Global Bond Fund (Active, Aon "Not Rated")

- The LCIV Global Bond Fund is an actively managed portfolio that invests at least two-thirds of its assets in investment grade global corporate and credit instruments.
- The fund is similar to the Fund's current mandate with Western, in that it invests in corporate bonds, but it adopts a global approach to investing as opposed to the UK focus that Western have.
- The objective is to outperform the Barclays Aggregate – Credit Index Hedged (GBP) over a rolling three-year period, net of fees.
- Following approval from the FCA, the ESG enhancement of the LCIV Global Bond Fund has officially started on 10th January 2022.
- LCIV and PIMCO have agreed on a 6-month transition period where PIMCO's portfolio managers will exit (or not roll over) the positions gradually in the best interest of the portfolio.
- The portfolio has 5.8% of holdings currently captured by the ESG exclusions as of 28th February 2022 compared to 11.0% as of 30 June 2021. These positions will continue to be exited, to approach 0% exposure by the 10th July 2022.
- We view this as a positive step forward for the strategy in terms of ESG integration and welcome this considered approach to exiting the exclusion list positions.

Daniel Carpenter
Associate Partner
020 7086 9043
daniel.carpenter@aon.com

Kara Robinson
Investment Consultant
0131 456 3046
kara.robinson@aon.com

Max Meikle
Investment Consultant
020 7086 1042
max.meikle.2@aon.com

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document. Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard. Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

Aon Solutions UK Limited's Delegated Consulting Services (DCS) in the UK are managed by Aon Investments Limited, a wholly owned subsidiary, which is authorised and regulated by the Financial Conduct Authority.