City of Westminster

Committee Report

Decision Maker:	**PENSION FUND COMMITTEE**
Date:	**21 October 2021**
Classification:	**General Release**
Title:	**Fixed Income Strategy Review**
Wards Affected:	**All**
Policy Context:	**Effective control over council activities**
Financial Summary:	**There are no direct financial implications arising from this report.**
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1. EXECUTIVE SUMMARY

1.1 This report details a review undertaken by the Fund's investment advisor, Deloitte, on the current fixed income mandates and strategic asset allocation. In addition, the report will explore the benefits of an allocation to private debt alongside the existing fixed income allocations.

2. RECOMMENDATIONS

2.1 The Committee is recommended to:

- consider adding private debt to the 19% fixed income asset allocation, splitting the portfolio equally between buy and maintain bonds, multi asset credit (MAC) and private debt.
- make a decision regarding the current MAC fund, on whether to proceed with the LCIV's proposal of adding a second, complementing manager.

3. BACKGROUND

3.1 The Fund's strategic asset allocation policy allocates:

- 65% to equities,
- 19% to fixed income,
- 11% to infrastructure, and
- 5% to property.

The current fixed income portfolio consists of a 13.5% allocation to buy and maintain credit, through the Insight Buy and Maintain bond strategy and 5.5% to multi asset credit, via the LCIV MAC Sub Credit fund.

3.2 Based on investment values as at 30 June 2021, the following projected allocations are assumed once the infrastructure allocations are fully drawn down. It should also be noted that the Committee is considering a 5% allocation to affordable housing, to be financed by a reduction in the equity asset allocation.

Asset Class	**Projected Allocation (%)**	**Current Benchmark Allocation (%)**
Global Equity	67.6	65.0
Fixed Income	18.8	19.0
Property	4.0	5.0
Infrastructure Equity	3.6	11.0
Renewable Infrastructure	5.3	
Cash	0.7	0.0
Total	**100.0**	**100.00**

4. LCIV MAC SUB FUND

4.1 During April 2021, the London CIV announced the introduction of a complementary second manager in the LCIV MAC Fund. The second manager will focus on higher credit quality with key exposures to investment grade, high yield and emerging market debt. The second manager (PIMCO) has historically achieved above the benchmark of LIBOR + 4-5%, but with 25% less volatility than the existing fund.

4.2 Each manager will be allocated a 50% holding within the fund, with rebalancing to be done on a mechanistic basis when a 10% deviation is triggered. The return objective will remain unchanged, while the annual management fee is expected to decrease and ESG capabilities to rise.

4.3 With the inclusion of the second manager within the MAC mandate, the Fund's total exposure to investment grade credit will increase to 75% of the total 19.5% allocation to fixed income. Given the current 13.5% allocation to investment grade credit via the Insight Buy and Maintain Bond Fund, the Fund's overall allocation should be reconsidered.

5. PRIVATE DEBT

5.1 There is a wide range of private debt opportunities available within the current market. These strategies provide loans direct to businesses requiring capital, with the loans secured against the company. The returns typically consist of an upfront fee and floating rate interest payments, which are usually priced at LIBOR plus a margin.

5.2 Private debt instruments usually offer higher yields than traditional fixed income investments, particularly in the current low interest rate environment. The asset class would also provide additional diversification within the fixed income allocation, with returns displaying a low correlation to traditional markets.

5.3 Deloitte has expressed a preference for senior secured funds, as these provide a greater level of protection in event of defaults. It should be noted that private debt strategies are typically structured as close-ended vehicles and are, by nature, an illiquid asset class. Therefore, speed of deployment should be a consideration when selecting a manager, as funds are unlikely to be drawn for immediate investment.

5.4 The London CIV holds a private debt strategy on its platform with £290m committed as at 30 June 2021 and circa £40m called to date. The fund has a closed-ended structure and will seek to achieve its return objectives by investing its assets into underlying funds, which make loans to European and North American middle market companies. London CIV selected mandates are managed by Churchill Asset Management and Pemberton Asset Management, with the pool company having undertaken a robust due diligence and legal agreement assessment process.

6. ALTERNATIVE FIXED INCOME STRATEGIES

6.1 The Fund currently has an estimated future cashflow deficit of circa £25m per annum, which is required to be funded from the investment portfolio. The LCIV MAC Fund is currently the only fixed income mandate distributing income, with the Insight Buy and Maintain Fund reinvesting any distributions. However, even if both mandates were switched to a distribution share class, there would still be an annual cashflow deficit of circa £14m.

6.2 An additional fixed income mandate to provide income would be optimal, given its purpose is to provide growth and a stable regular income stream. Deloitte has set out the following three strategies, considering how private debt would complement the existing fixed income mandates and the subsequent impact on risk and returns.

6.3 **Strategy 1: Transition half of MAC holdings to private debt**

One option would be to transition 2.8% of the MAC allocation to private debt, whilst maintaining the current 13.5% allocation to the Insight Buy and Maintain Credit fund. This would result in a slight increase in the expected return of circa 0.1% and small decrease of circa 0.1% in volatility. However, this option would not have a significant impact on the risk/return profile and delivers little additional income.

6.4 **Strategy 2: Split the fixed income allocation equally between MAC, Insight and private debt**

A second option would be to partially divest from the Insight Buy and Maintain strategy and split the allocation equally amongst MAC, Insight and Private Debt. Given the illiquidity premium attached to private debt and reduced exposure to investment grade credit, expected returns could increase by circa 1.3% per annum. Moreover, this income yield would be expected to increase by circa 1.0% per annum (£3.6m). However, it should be recognised that volatility would increase by circa 0.7% due to the illiquid nature of private debt vehicles.

6.5 **Strategy 3: Transfer MAC allocation to private debt**

A third option to consider is fully divesting from MAC and transferring the entire 5.5% allocation to private debt. Expected returns would increase by circa 0.3% and volatility would reduce by circa 0.2% per annum. The income yield would only increase marginally by 0.1%, falling short of the required cashflow needs.

7. RECOMMENDATIONS AND NEXT STEPS

7.1 The Committee is invited to discuss and agree the most appropriate strategic fixed income asset allocation for the Fund going forward, including a decision on the current MAC portfolio.

7.2 Deloitte has recommended the second strategy, splitting the fixed income allocation equally among MAC, Insight and Private Debt. This would increase the expected return as well as volatility. However, the impact at total Fund level would be a circa 0.3% per annum increase in expected return and a circa 0.1% per annum increase in volatility. Income distributions would also be expected to increase by £3.6m per annum to £12.4m, going some way to finance the cashflow deficit, alongside equity distributions and expected future infrastructure income flows.

If you have any questions about this report, or wish to inspect one of the background papers, please contact the report author:

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BACKGROUND PAPERS:

None

APPENDIX:

Appendix 1: Deloitte Fixed Income Strategy Review