Deloitte.

City of Westminster Pension Fund

Fixed Income Allocation Considerations

Introduction

This paper has been prepared for the City of Westminster Pension Fund (the "Fund") and has been written following discussion with the Pension Fund Committee (the "Committee") at the last Committee meeting on 24 June 2021.

With the London CIV ("LCIV") Multi Asset Credit fund potentially changing, the Committee asked us to consider the impact of this change as well as whether an allocation to private debt would provide any benefit to the current fixed income portfolio and strategic allocation..

Current Allocation

The table below reflects the Fund's asset allocation as at 30 June 2021.

Manager	Asset Class	Current Allocation (£m)	Current Allocation (%)	Current Benchmark Allocation (%)
LGIM	Global Equity (Passive – Future World)	429.4	23.3	25.0
LCIV	Global Equity (Global Alpha Growth)	459.5	24.9	20.0
LCIV	Global Equity (Global Equity Core)	358.2	19.4	20.0
Longview	Global Equity	73.3	4.0	0.0
	Total Equity	**1,320.4**	**71.6**	**65.0**
Insight	Buy and Maintain	246.4	13.4	13.5
LCIV	Multi Asset Credit	100.5	5.5	5.5
	Total Bonds	**346.9**	**18.8**	**19.0**
Aberdeen Standard	Property	73.0	4.0	5.0
	Total Property	**73.1**	**4.0**	**5.0**
Pantheon	Global Infrastructure	34.6	1.9	5.0
Macquarie	Global Renewable Infrastructure	5.6	0.3	3.0
Quinbrook	UK Renewable Infrastructure	11.0	0.6	3.0
	Total Infrastructure and Renewable Infrastructure	**51.2**	**2.8**	**11.0**
	Cash	52.2	2.8	-
Total		1,844.0	100.0	100.0

Source: Northern Trust
Figures may not sum due to rounding

Currently, the Fund's 19% strategic fixed income allocation consists of a 13.5% allocation to the Insight Buy and Maintain Credit Fund, which primarily invests in investment grade corporate bonds, and a 5.5% allocation to the LCIV Multi Asset Credit Sub Fund. Resultantly, the strategic fixed income allocation is currently split 71% to investment grade credit and 29% to multi-asset credit ("MAC").

Projected Allocation (once illiquid investments are fully drawn)

Similar to the analysis undertaken in the report "Asset Allocation and Residential Property Asset Class Review" which was provided to the Committee in June 2021, below we set out what the Fund's asset allocation would look like once the commitments to illiquid investments (Pantheon, Macquarie and Quinbrook) have been fully drawn for investment by the respective investment managers.

We note that the Committee are currently considering a 5% allocation to affordable housing, with the investment being funded from the listed equity allocation. We have therefore included this in the table below.

<table>
<tr><th>Asset Class</th><th>Current Allocation (%)</th><th>Projected Allocation (%)</th><th>Current Benchmark Allocation (%)</th><th>De-risking Option (5% moved from equities to affordable housing) (%)</th></tr>
<tr><td>Global Equity</td><td>71.6</td><td>67.6</td><td>65.0</td><td>60.0</td></tr>
<tr><td>Fixed Income</td><td>18.8</td><td>18.8</td><td>19.0</td><td>19.0</td></tr>
<tr><td>Property</td><td>4.0</td><td>4.0</td><td>5.0</td><td>10.0</td></tr>
<tr><td>Infrastructure Equity</td><td>1.9</td><td>3.6</td><td rowspan="2">11.0</td><td rowspan="2">11.0</td></tr>
<tr><td>Renewable Infrastructure</td><td>0.9</td><td>5.3</td></tr>
<tr><td>Cash</td><td>2.8</td><td>0.7</td><td>-</td><td>-</td></tr>
<tr><td>Total</td><td>100.0</td><td>100.0</td><td>100.0</td><td>100.0</td></tr>
<tr><td>Expected Return</td><td>4.7% p.a.</td><td>4.7% p.a.</td><td>4.7% p.a.</td><td>4.6% p.a.</td></tr>
<tr><td>Volatility</td><td>12.3% p.a.</td><td>12.2% p.a.</td><td>11.9% p.a.</td><td>11.5% p.a.</td></tr>
</table>

Between 31 March 2020 and 31 March 2021, the Fund received a combined total of £5.8m in distributions from the LCIV Global Alpha Growth Fund, the LCIV Multi Asset Credit Fund and the Pantheon Global Infrastructure III Fund.

Should the Committee opt to partially disinvest from equities, with the proceeds invested in residential property as previously recommended, the Fund's expected income yield and volatility are expected to respectively increase and decrease further. However, as a result of the reduction in equities, which is the main driver of investment return in the current portfolio, the Committee may wish to consider if expected return can be increased by adjusting an alternative area of the portfolio.

LCIV Multi Asset Credit Sub Fund

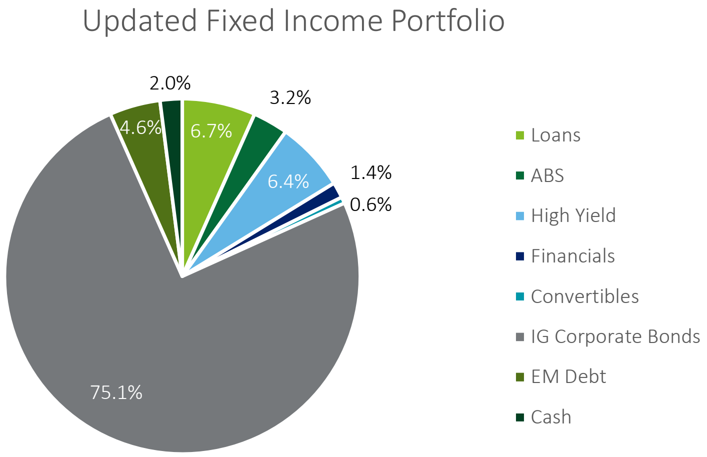
In June 2021, we provided the Committee with a report which delivered an update on the LCIV Multi Asset Credit Sub Fund (the "MAC Sub Fund"). This paper followed the announcement by the London CIV in April 2021 that PIMCO will be added as the second manager in the LCIV MAC Sub Fund, alongside the Sub Fund's current manager CQS.

After an extensive manager selection process, the London CIV selected PIMCO as an additional, complementary manager to sit alongside CQS in the LCIV MAC Sub Fund on the basis of historic performance, downside protection against the current strategy, strong ESG credentials and competitive fees, as well as considering how the combined strategy would perform as a whole on a risk and return basis.

The MAC Sub Fund will consist of a 50:50 allocation between CQS and PIMCO, subject to rebalancing on a mechanistic basis, triggered by a 10% deviation from the agreed split, with the underlying return objective remaining unchanged and the overall annual management charge expected to decrease whilst the Sub Fund's ESG capabilities are expected to rise.

We see no cause for concern with the addition of PIMCO to the mandate. The Sub Fund will benefit from reduced manager risk, although as per our previous updates we see no immediate cause for concern with CQS.

The chart below illustrates the expected composition of the Fund's strategic fixed income portfolio once PIMCO has been added to the MAC Sub Fund, based on an illustrative allocation provided by the London CIV and the Fund's strategic benchmark allocations to the MAC Sub Fund and Insight.



The opportunity set of the MAC Sub Fund, and therefore the Fund's fixed income portfolio will widen slightly with the addition of Emerging Market Debt, and the overall credit quality is expected to increase with CQS' portfolio made up predominantly of allocations to leveraged loans, asset backed securities and high yield bonds.

While we would not typically classify investment grade credit as being a significant part of a Multi Asset Credit strategy, the inclusion of investment grade credit within the MAC Sub Fund means that the fixed income portfolio is expected to consist c. 75% of investment grade credit. The Fund has a 13.5% allocation to investment grade credit via the Insight Buy and Maintain Credit Fund, and so if this allocation was to increase significantly within the MAC Sub Fund, the Fund's overall allocation may need to be reconsidered and reviewed.

Private Debt

Private debt investments provide loans directly to businesses requiring capital, with private debt funds typically consisting of a portfolio of loans issued to companies as an alternative to liquid corporate bond markets and bank loans, where the loan is secured against the company. The loans are relatively short term in nature and early repayment is common. The seniority of the underlying loans, and therefore the level of security and credit risk, determines the risk and return characteristics of the private debt portfolio.

Following the financial crisis in 2008, bank finance became increasingly difficult to obtain for small to medium sized enterprises. As lending capacity became constrained and regulation increased, these businesses saw higher rejection rates, were asked to pay increased interest rates and were more likely to be required to provide collateral. With the size of these organisations precluding them from raising finance in public debt markets, an opportunity arose for pension funds and other institutional investors to 'fill the gap' and lend directly to such businesses.

The underlying returns consist of an upfront fee plus ongoing interest payments, which, historically, are usually priced at LIBOR plus a margin (called a spread). The floating rate nature of the interest payments means that, unlike liquid corporate bonds, the asset offers investors with limited interest rate hedging.

Private debt is considered a good alternative to traditional fixed income investments, offering higher yields than investment grade credit, with private debt delivering particularly attractive risk-adjusted returns in a low interest rate environment. Private debt would deliver additional diversification to the Fund's fixed income portfolio with the underlying returns displaying low levels of correlation with traditional public markets.

There exists a wide range of private debt opportunities available in the market. With the underlying credit risk dependent on the position in the capital structure, we have a strong preference for senior secured only funds to provide investors with greater protection in a default event. Investment managers may also implement certain portfolio restrictions with regards to leverage and revenue risk within the underlying strategy, but reduced covenants on loans, higher leverage levels and a willingness to move down the credit spectrum are all tools being used by managers to preserve return levels.

While less senior and less restricted products would be expected to be higher returning, such strategies will result in higher risk investments at a time where corporate indebtedness remains higher in the aftermath of the impact of COVID-19 lockdown restrictions. The level of risk within any portfolio should be a vital consideration and selecting an appropriate manager with adequate skill will be key.

Private debt is, by nature, an illiquid asset class where funds are typically structured as closed-ended vehicles. As such, should a commitment to private debt be made, funds are unlikely to be drawn for investment immediately and therefore speed of deployment should be a key consideration in selecting an investment manager. The illiquidity premium attached to such investments should be expected to dictate a higher expected return compared to publicly traded liquid debt.

Alternative Fixed Income Strategies

The table below sets out the current fixed income strategic allocation alongside the key investment characteristics of the fixed income portfolio, independent from the remainder of the portfolio.

Asset Class	Current Benchmark Allocation (%)
Buy & Maintain Credit	13.5
Multi Asset Credit	5.5
Total	19.0
Expected Return	2.6% p.a.
Available Income Yield	2.5% p.a. or £8.8m p.a.
Volatility	7.2% p.a.

It is estimated that the Fund has a future cashflow requirement of c. £25m per annum, which is required to be funded from the investment portfolio. As discussed earlier in this paper, over the previous year the Fund received c. £5.8m in income from distributing investments. Although the fixed income portfolio has the potential to deliver an income of £8.8m p.a., it is currently distributing c. £3.3m from the LCIV MAC fund only. Even if the Buy & Maintain Credit fund was switched to a distribution share class, there would still be an annual shortfall of c. £14m.

It would be optimal to produce income from the fixed income portfolio as opposed to other investments as their purpose is to provide growth and return.

Below, we set out a number of potential alternative fixed income strategies, considering how a private debt investment would fit into the fixed income portfolio and the corresponding impact on the risk and return characteristics of the fixed income allocation.

Alternative Strategy 1: Transfer half of MAC allocation to private debt

One option would be to maintain the current Insight Buy and Maintain Credit Fund allocation, but invest half of the current MAC allocation into private debt.

The table below compares this alternative strategy with the current strategic fixed income portfolio.

Asset Class	Current Benchmark Allocation (%)	Alternative Strategy 1 (%)
Buy & Maintain Credit	13.5	13.5
Multi Asset Credit	5.5	2.8
Private Debt	-	2.8
Total	19.0	19.0
Expected Return	2.6% p.a.	2.7% p.a.
Available Income Yield	2.5% p.a. or £8.8m p.a.	2.6% p.a. or £8.9m p.a.
Volatility	7.2% p.a.	7.1% p.a.

Totals may not sum due to rounding.

Observing the table, it can be recognised that the volatility of the fixed income portfolio has reduced slightly, owing to the less volatile nature of private debt in comparison to MAC, with the income yield also increasing slightly owing to the higher yielding nature of private debt investments. However, given that the allocations to private debt and MAC are small in the context of the total fixed income portfolio and relative to the Buy & Maintain Credit Fund allocation, this change in strategy does little to impact the risk/return of the fixed income portfolio and delivers little additional income.

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

Another option would be to partially disinvest from Insight and invest a third of the total fixed income strategic allocation into private debt, whilst topping up the MAC allocation to represent a third of the fixed income strategic allocation – with each strategy equally represented within the total fixed income portfolio.

The table below compares this alternative strategy with the current strategic fixed income allocation.

Asset Class	Current Benchmark Allocation (%)	Alternative Strategy 2 (%)
Buy & Maintain Credit	13.5	6.3
Multi Asset Credit	5.5	6.3
Private Debt	-	6.3
Total	19.0	19.0
Expected Return	2.6% p.a.	3.9% p.a.
Available Income Yield	2.5% p.a. or £8.8m p.a.	3.5% p.a. or £12.4m p.a.
Volatility	7.2% p.a.	7.9% p.a.

Totals may not sum due to rounding.

As a result of the illiquidity premium attached to private debt investments, alongside the impact of the reduced exposure to the lower returning investment grade credit, Alternative Strategy 2 sees the expected return emanating from the fixed income portfolio increase by c. 1.3% p.a. relative to the current benchmark allocation, alongside a c. 1.0% p.a. increase in income yield. It should however, be recognised that the portfolio's expected volatility would increase under Alternative Strategy 2 as a result of the heightened default risk within the private debt portfolio.

Alternative Strategy 3: Transfer MAC allocation to private debt

The Committee may also wish to consider the impact of fully disinvesting from MAC and transferring the proceeds directly to private debt. The impact of Alternative Strategy 3 on the fixed income portfolio is provided in the table below.

Asset Class	Current Benchmark Allocation (%)	Alternative Strategy 3 (%)
Buy & Maintain Credit	13.5	13.5
Multi Asset Credit	5.5	-
Private Debt	-	5.5
Total	19.0	19.0
Expected Return	2.6% p.a.	2.9% p.a.
Available Income Yield	2.5% p.a. or £8.8m p.a.	2.6% p.a. or £9.0m p.a.
Volatility	7.2% p.a.	7.0% p.a.

Totals may not sum due to rounding.

While this strategy would increase expected return and reduce volatility (largely as a result of the illiquid nature of private debt), the available income yield would only increase marginally and still fall someway short of the Fund's cashflow needs.

Conclusion

We recommend that the Committee considers fixed income Alternative Strategy 2, adding a private debt allocation and splitting the fixed income portfolio equally between investment grade credit, MAC and private debt. This would increase the expected return and volatility of the fixed income portfolio, however the impact it would have at the total Fund level would be a c. 0.3% p.a. increase in expected return and a c. 0.1% p.a. expected increase in volatility relative to the current strategic benchmark.

Under Alternative Strategy 2, the available income from the fixed income portfolio would increase from £8.8m p.a., based on the target benchmark allocation and assuming the Insight Buy and Maintain Credit Fund income facility is switched on, to £12.4m p.a. While this remains short of the annual c. £25m requirement, it should be noted that the Fund is expected to receive c. £2m p.a. in distributions from the LCIV Global Alpha Growth Fund, where the income facility is switched on, and that the Fund could expect to receive c. £15m p.a. from the infrastructure and renewable infrastructure investments once these are fully drawn for investment.

Next Steps

Following consideration of this paper, the Committee should first agree upon the desired strategic fixed income benchmark. If the Committee wishes to make a private debt allocation, the desired level of risk should be decided upon, defined by the seniority of the underlying loans and the existence of relevant covenant agreements and restrictions. Our analysis has been based on senior secured direct lending in the European mid-market. At which point we will consider a number of providers within the relevant guidelines and agree upon a shortlist of providers before arranging a selection exercise where the providers will be asked to present their funds to the Committee. Our search will include options available now or in the future through the London CIV. We will provide a selection report with our full due diligence on each provider and the strategy, as well as the risk/return characteristics of each strategy, and how this relates to the characteristics of the Fund and its liability profile.

Deloitte Total Reward and Benefits Limited

October 2021

Risk Warnings

- Past performance is not necessarily a guide to the future.
- The value of investments may fall as well as rise and you may not get back the amount invested.
- Income from investments may fluctuate in value.
- Where charges are deducted from capital, the capital may be eroded or future growth constrained.
- Investors should be aware that changing investment strategy will incur some costs.
- Any recommendation in this report should not be viewed as a guarantee regarding the future performance of the products or strategy.

Our advice will be specific to your current circumstances and intentions and therefore will not be suitable for use at any other time, in different circumstances or to achieve other aims or for the use of others. Accordingly, you should only use the advice for the intended purpose.