APPENDIX 2

REPORT ON OPTIONS FOR PHASE 3 OF INVESTMENT STRATEGY (FIXED INCOME) PREPARED FOR

London Borough of Bromley Pension Fund

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This report by your adviser, Alick Stevenson of AllenbridgeEpic Investment Advisers (AllenbridgeEpic), reflects on and amplifies the discussions at the Pension Investment Sub Committee Fund meeting held on 11 February 2014.

Meeting 11 February 2014

Mr Stevenson confirmed that Phase 1 and Phase 2 of the restructuring programme had been completed in December 2012 and December 2013 respectively, leaving Phase 3 (fixed income) to be completed in 2014.

The allocations to fixed income investments were held by Baillie Gifford and Fidelity Investment Management in pooled vehicles which reflected historic asset allocations (UK and overseas sovereign debt, investment grade corporate bonds and small allocations to below investment grade bonds). The UK Gilt Fund (Baillie Gifford) invested in UK government bonds which were currently yielding returns at or slightly below UK domestic inflation.

The Scheme Actuary had prepared an outline cash flow forecast which highlighted the probability of the cash flow of the fund moving from positive to neutral to negative in a relatively short period of years.

It was agreed that whilst the completion of the planned restructuring might be delayed, it was appropriate to consider alternative forms of fixed income investment which would provide a more committed and longer term income stream than that provided by shorter term fixed income investments. AllenbridgeEpic was asked to prepare a paper for consideration at the next PISC meeting. The Committee then discussed the current fixed income portfolios and noted their lack of diversification and low returns, the latter partly caused by the continued intervention by the Central Banks in keeping interest rates at historic lows.

The Committee agreed that some changes could be effected to the current portfolios held by Baillie Gifford (in order to improve returns pro tem) without having to go out to external tender and that the suggested changes could be incorporated within the existing Statement of Investment Principles.

It was further agreed that the Chairman and the Director of Finance were authorised to approve a reallocation of assets subject to receiving a firm recommendation from AllenbridgeEpic.

Subsequent to a detailed review of the options available to the fund and a review of the potential transition costs, the following recommendation was received from AllenbridgeEpic.

"In our view the investment objectives set out in the Statement of Investment Principles can be better achieved by investing in a single bond fund with a broad investment objective than two separate funds with a narrow investment objective. Accordingly it is recommended that the Committee approves an asset transfer from the Baillie Gifford Active Gilts Fund and Investment Grade Credit Fund to the Baillie Gifford Sterling Aggregate Plus Bond Fund with effect from 1 April 2014."

This recommendation was reviewed by the Chair and the Finance Director and a decision was taken to implement the recommendation. The transition was completed during the second quarter of 2014.

The table below summarises some of the key deliverables of several asset classes within the fixed income spectrum which provide some measure of inflation linked support to the long dated liabilities of the Fund

Assets providing identifiable cash flows over longer periods

	Property		Infrastructure	
	Long lease	Snr real estate debt	Snr debt	Renewable energy
Asset characteristics				
Yield	5-7%	3.5-5.75%	Swaps +2.5-3%	8-9%
Underlying asset	loans to high quality co's secured on property	investment lending, refinancing/ acquisition	transport social projects regulated utilities	wind and solar projects
Liquidity	moderate illiquidity secondary market exists	illiquid limited secondary market exists	moderate illiquidity secondary market exists	moderate illiquidity secondary market exists
Cash flow characteristics				
secure cash flows?	yes	yes	yes	yes
inflation related cash flows?	yes RPI/CPI LPI. Fixed & open market reviews	typically floating. Linked/fixed may be available	typically floating. Linked/fixed may be available	yes RPI/CPI protection
how "known" are the cash flows?	well defined	well defined but issuer can call loan	well defined but issuer can call loan	well defined contractual cash flows
how "long dated" are cash flows?	15 -20 years	5 -10 years	up to 35 years	25 -30 years
Risk characteristics				
primary risk drivers	lease credit risk. Operating lease has residual risk	credit events well divers'd Strong recovery characteristics	credit events well divers'd Strong recovery characteristics	wind & solar resource risk regulatory & counterparty risk
Typical credit rating of investment	A/BBB	A/BBB	Investment grade	not rated
key risks	vacancies/ voids/capex incentives	prepayment risk/repayment at maturity refinancing	risks vary on nature of infrastructure project	poor estimate of resource life regulatory change counterparty default

Key risks

Uncertain cash flows: Opportunities should be assessed cautiously to determine the level of security and certainty in the cash flows. Risks include, but are not limited to, flexibility for the issuer to change the terms, risk of early redemption, cash flows linked to prices or production, or any uncertainty in cash flow timing. Assets that do not have the desired characteristics may nevertheless have a useful role to play, providing the Committee has a clear understanding of that asset's nature and risks.

Liquidity risk: The Pension Fund may be faced with an unforeseen need to pay out benefits, possibly due to a change in government/LGPS regulations, or a transfer out of the fund of assets related to an admitted body or bodies, or even a Council driven voluntary redundancy programme. The need to free up cash or sell assets could incur costs or disrupt the investment strategy. This is known as liquidity risk. In light of the long term nature of these investments, it is necessary to balance this requirement with an appropriate allocation or predetermined action with the Fund's ability to meet unforeseen liability transfers.

Key benefits

- Enhanced return which can deliver predictable cash flows at returns higher than those currently available in the sovereign credit markets.
- Inflation protection generated by cash flows contractually obligated to move with inflation measures.
- Longer investment horizons which can enable pension funds to meet longer term liabilities whilst giving them some inflation protection and enhanced returns.
- Illiquidity risk is implicit in the above positive comments. The assets described in the table on page 3 have limited or seriously limited liquidity. This point should be taken into account when discussing any allocation to these assets.

Investment horizons

One of the problems facing investors when considering the "illiquid" asset classes is the "mean time to full investment", which means the time taken to fully invest the amount of assets allocated to that particular asset class and investment manager(s) once the investment management agreement is completed.

Time to full investment

- Property Long Lease Fund is currently between 12 and 24 months.
- Real Estate Debt approximately 12 to 36 months dependent on the sub asset class.
- Infrastructure between 2 and 5 years
- Renewable Energy between 2 and 3 years.

It should be noted that these are periods during which the Pension Fund is not invested in the new asset class, albeit it has the funds invested elsewhere.

Whilst not across the board, several managers will charge commitment fees on the undrawn funds from date of signature to their deployment. Not all funds do this and this is one of the "must ask" questions should the Fund consider such an investment.

It is also worth noting that there are one or two funds that currently offer a blended infrastructure pooled product which enables a new investor to be fully invested in a very short period of time as they are able to invest in projects already running.

In my INVESTREP for the second quarter 2014 I showed the fund as being overweight DGF and equities and underweight fixed income based on the current strategic asset allocations as referenced in the Statement of Investment Principles.
Any changes agreed by the PISC will need to be recorded in the Statement of Investment Principles once the asset classes, managers and investment targets are known.

Fund values and asset allocations

Asset Class		Actual 30-Jun £m	Actual %	SAA %	SAA values £m		Over/ under weight £m
DGF		70.3	11.0	10.0	63.7		6.6
Global equities		460.9	72.4	70.0	445.9		15.0
Fixed interest		105.8	16.6	20.0	127.4		-21.6
Total		637.0	100.0	100.0	637.0		0.0

Potential Asset Allocations

Asset Class		Actual £m	Actual %	SAA %	SAA values £m		Over/ under weight £m
DGF		70.3	11.0	11.0	70.3		0.0
Global equities		439.5	69.0	69.0	439.5		0.0
Fixed interest		67.4	10.6	20.0	67.4		0.0
Income assets		60.0	9.4		60.0		
Total		637.2	100.0	100.0	637.2		0.0

Numbers may not compare due to rounding

Comment and Recommendation

Diversified Growth Funds provide a widely diversified portfolio of assets in which the fund would not be able to invest on a segregated, or even pooled basis. It would place an immense cost and governance burden on the Fund and would require a complex Statement of Investment Principles and regular rebalancing. The Fund invests with two managers, Baillie Gifford and Standard Life. Baillie Gifford closed to new money in the first quarter of 2014. The Fund was able to negotiate a once and for only "top up" to the Fund following the successful conclusion of the Global Equity transition. This transfer was concluded during the second quarter of 2014.

As a result of this closure, I am not recommending a withdrawal of funds back to the 10% strategic asset allocation ***but am recommending a simple, minor adjustment to the current strategic asset allocation to the SAA from 10% to 11%.***

Global Equities have only recently been transitioned from regional mandates, with two new managers being appointed and with Baillie Gifford restructuring its existing equity holdings to reflect the award of their new global mandate.

I would also recommend that Baillie Gifford make a small reduction in their assets under management to fund the underweight position in fixed Interest. This would require a small adjustment in the SAA for Global equities from 70% to 69%.

The PISC should also note that this small adjustment should only take place if the fixed interest recommendations detailed below are approved.

Fixed Interest assets are held by Fidelity and Baillie Gifford, the latter only recently transitioning its two pooled funds into a Global Aggregate Fund.

The PISC is asked to note that the above changes to the SAA reflect an adjustment from the old asset allocations to those proposed and do not require any physical transition of assets between the asset classes and thus the fund will incur no transactional costs.

Monitoring of the overall percentage invested in each major asset class will continue on a quarterly basis, against the new SAA (if approved). Should the long term allocations move significantly, then the attention of the PISC will be drawn to the changes and an appropriate recommendation made.

Recommendation on Fixed Interest

This paper begins with a recap of the previous meeting and the interest expressed by the members in some longer dated investments, preferably with floating rates and some inflation proofing linkage.

It appears that the Central Banks are focused on keeping interest rates low for the at least the next few months and even then perhaps it will be 2015 before rates begin to rise. The reason(s) behind the increase will be the important economic factor(s) rather than the rise itself. Much interest is being seen in the market place for the type of assets which the Fund is seeking to access, with LGPS members seemingly committing on a regular basis to infrastructure funds, long rent product offerings and even capital release notes. The extent of these commitments has caused some investment manager funds to close to new money, whilst others have seen fit to extend their investment periods and even incorporate a commitment fee on undrawn funds.

It is clear from the recent cashflow forecast provided by the Scheme Actuary, that the Fund will turn "cash negative" within a relatively short period of years and will need to review its investment strategy to facilitate that change in a search for income to pay the then current liabilities. It seems logical therefore for the Fund to consider making part of that change when assets are still available at rates of return which appear attractive and which give the fund some much needed inflation proofing against its longer term liabilities.

Whilst PISC approval has already been minuted for Phases 1,2 and 3, a fresh approval is sought for a manager search which will recommend one or more managers to invest in "illiquid" assets over the longer term. The amount of assets on offer via this investment route would be approximately 10% (£60m) of the fund by value or half of the current fixed income long term strategic allocation. Managers must be able to offer their product in a "pooled fund" arrangement and be in compliance with all appropriate LGPS investment regulations.

The current fixed interest mandates (£106m approx) are held by Baillie Gifford and Fidelity and provide the fund with a well-diversified portfolio of global fixed interest investments and a combined out-performance target of 1.25% pa over rolling three years. This current investment is some £20m underweight the strategic asset allocation.

An allocation of approximately £60m to “illiquid” assets alongside a reduction in global equities would complement the current “liquid” fixed income investments. This would provide a fixed interest portfolio of approximately £120m with **liquid (short term) and illiquid (long term) exposure**, **an improved rate of return over time, coupled with some much needed inflation proofing against the liabilities**.

Members should note that funding for the proposed “illiquid portfolio” will need to come from either or both of the current fixed interest managers.

Approval is sought to instruct AllenbridgeEpic to review both managers, their portfolios and their relative merits and to recommend the source or sources of funds for the proposed “illiquid” portfolio.

Members should note that the timeline chart below provides a provisional timetable which is dependent on several variables:

Approvals to proceed
Timely and relevant responses from the initial search
Ability to schedule a PISC meeting to review (Nov)?
Due diligence
Documentation
Actual funding will depend on the asset class(es) chosen

Provisional Time line chart for Phase 3

	Aug 2014	Aug	Aug PISC	Sept	Oct	Nov provisional	DEC	TBA**
Phase 3 Fixed Income)								
Preparation of RFI*								
RFI to PT/MR								
RFI Issued								
RFI responses								
Long list review								
Long list review meeting								
Short list Presentation to PISC								
Documentation								
Funding								TBA

*RFI request for information

**TBA to be arranged and is dependent on the asset class (es) chosen