APPENDIX 1

REPORT PREPARED FOR

London Borough of Bromley Pension Fund

Revised Investment Strategy – Phase 3 (Fixed Income)

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The process of reorganising the investments of the fund began in 2011 and was approved in 2012. The process was separated and managed in three phases,

Diversified Growth Funds	10%
Global equity portfolio	70% (80%)
Fixed income portfolio	20% (20%)

In addition, the appointed consultant (AllenbridgeEpic Investment Advisers), was instructed to consider and moderate the implications of these proposed changes on the governance budget in terms of both staffing levels and costs. It was noted that, whilst Baillie Gifford had performed well over many years and continued to deliver good investment returns in both equity and fixed income investments, Fidelity had slipped behind their benchmark with their equity returns although they continued to deliver strong results on fixed income.

The first phase was the creation of a Diversified Growth Fund portfolio which was concluded successfully in December 2012 with the appointment of Baillie Gifford and Standard Life. Funding for these two mandates came from a reduction in the equity assets managed by Fidelity.

The second and largest phase was to reorganise the regionalised equity portion of the fund into three separate global equity investment mandates enabling the fund to benefit from manager investment styles across a range of markets. This phase was concluded in December 2013 with the appointment of Baillie Gifford, BlackRock and MFS investment Management. Funding for these new mandates came from the remaining Fidelity equity assets, and a reduction in the equity assets held by Baillie Gifford.

At the end of the second phase, the fund had completed 80% of its reorganisation and had increased the number of investment managers from two to five, and the number of separate mandates from four (two each at Fidelity and Baillie Gifford) to seven.

Two DGF mandates
Three global equity mandates
Two fixed income mandates

Phase 3 Fixed Income

Whilst this final phase was originally looking to invest in global bond funds, the manager responses to an initial search in 2013/14 found very few managers with global reach and some that focussed on one sub asset class such as “global emerging market” or “global high yield”, yet described themselves as “global fixed income”. It was agreed in the first quarter of 2014 that the brief should be widened to include fixed income assets which had an “illiquidity premium” such as capital release bonds, infrastructure/renewable energy investments and social housing. At the May 2014 meeting of the PISC, it was agreed that, whilst an illiquidity premium had its attractions, further review was needed.

PISC 2 December 2014

At the meeting on 2 December 2014, members considered propositions for investment in illiquid assets and felt that the Committee needed more information before making any firm commitment in either asset class or amount.

It was agreed, however, that AllenbridgeEpic should consider alternative ways in which to improve investment returns whilst maintaining liquidity and transparency and present them at the next meeting of the PISC to be held on 24 February 2015.

Current fixed income Structure

L B Bromley Pension Fund is currently holding approx. £115.1m or approx. 17% of the total fund in fixed income assets (31 December 2014), split as follows:

Baillie Gifford

The original portfolio (comprising regional equities and fixed income) had an inception date of 30 November 1999. The reorganisation of the equity portfolio into a separate global equity mandate was completed on *31 December 2013* and the fixed income mandate changes were completed on *15 April 2014*

Fixed income value £50.2m as at 31 December 2014

The fixed income target is to outperform (before fees) a composite benchmark comprising 50% FTSE Actuaries UK Conventional Gilts All Stocks index, and 50% Bank of America Merrill Lynch Non-Gilt Index over rolling three year periods

Fidelity

Original inception (regional equities and fixed income) 30 April 1998

Value of fixed income fund £64.9m at 31 December 2014

The target is to achieve 0.75%pa over the iBoxx Composite Index (50% Gilts and 50% Non- Gilts) over rolling three year periods

Overall Fund

Based on current values and targets, the fixed income portfolio is set an aggregated return target of 1.0%pa (0.97% pa at current value split) over rolling three years (gross of fees).

As previously noted, investment in illiquid assets, infrastructure, social housing, property, long lease contracts, capital release bonds, etc, should provide an enhanced source of return because of the "illiquidity factor", but would have very limited market liquidity pending repayment at maturity. It is this lack of liquidity which concerns the members. My understanding of the discussions at the 2 December 2014 meeting, is that the Sub-Committee would rather be invested in liquid fixed income assets, in a more broadly based fund than is currently in place and which carries a higher out-performance target. We, (AllenbridgeEpic), have again looked at the market and considered various funds which purport to operate in the unconstrained global fixed income space and have found that very little change has taken place since we last looked in depth with several products invested in just one fixed income class or a mix of corporate and high yield, both of which are vulnerable to shifts in interest rates and economic change.

However, in discussion with Paul Harris (Fidelity), he mentioned a Fidelity product (Fidelity Fixed Income Diversified Alpha) ("FIDA") which might be of interest. As a result, I met with Peter Khan, (Portfolio Manager FIDA, who also manages the Fidelity High Yield and Fidelity Global Income Fund) and Rob Marsden (Investment Director) on 14 January 2015, who walked me through a 90 minute presentation on FIDA.

In some respects, FIDA is similar to the Standard Life "GARS" Fund in which the L B Bromley Pension Fund has been successfully invested since December 2013, albeit GARS invests across a significant number of different asset classes and products rather than just one broad asset class.

FIDA takes an active absolute return approach to fixed income investing with a target return of 1.5% to 3.0% over cash (one month EURIBOR), gross of fees which would be in the 40/50 bps range. FIDA is broadly market neutral and seeks to generate alpha (at least 10bps) from each high conviction idea from eleven different diverse sources, whilst maintaining volatility between 2 and 5.0% per annum and operates a very conservative and focussed buy/sell risk measurement process.

Its three key themes are:

- Attractive risk adjusted returns
- Strong capital preservation
- Low volatility

This volatility target is slightly below that of Baillie Gifford (4.7%) and GARS (4.3%) as at year end. FIDA is currently relatively small (around 50m), but has additional current investor interest which Fidelity hopes will be converted into additional aum. This is one of the reasons I recommend a "drip feed" methodology. It is true to say that an investment of this size is unlikely to have a visible impact on the overall fund return, however, it provides a broad based allocation of funds at a time when single asset class funds are struggling to find positive returns over inflation.

The L B Bromley Pension Fund has two fixed income managers who have delivered positive results for many years, Baillie Gifford has only recently reorganised its fixed interest portfolio, whilst the Fidelity portfolio has been in situ since April 1998. It is possible that a further search could identify another manager(s) with a good track record although completion and funding would probably take at least three months (under a non OJEU process), would incur transition costs and would add an additional manager to the existing list, with additional governance implications.

We consider this Fidelity product to be one of the better offerings for several reasons:

- Fidelity is well known to the Pension Fund
- Consistent delivery of positive returns to benchmark with the existing mandate
- Fidelity is a significant investment manager in the Local Authority market
- Minimal new documentation needs
- No need for an external manager search
- Lower all round costs to the fund and a very speedy implementation process

Because FIDA is within the Fidelity Investment Management Group, the Pension Fund could simply appoint Fidelity to run this new fund alongside its existing UK Aggregate Fund and drip feed funds across. There is no need for the Fund to effect an open market search for a new product and as such, this process, which would be" documentation-lite" could be completed in a matter of days and at very low cost.

Recommendation:

That the L B Bromley Pension Fund consider investing in FIDA with an initial investment of £5.0m, funded from the existing Fidelity UK Aggregate Bond Fund, followed by quarterly transfers (amounts to be confirmed on a quarterly basis and dependent on investment performance and additional investors joining the fund).