APPENDIX 1

REPORT PREPARED FOR

London Borough of Bromley Pension Fund

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

The Committee has already been provided with detailed papers on the completion of Phases 1 and 2, and certain interim papers on Phase 3: Reorganisation of the fixed income assets.

Fixed Income Summary to date

Phase 3 Fixed Income

Whilst this final phase originally considered investing in global bond funds, the manager responses to an initial search in 2013/14 found very few managers with global reach, and found some who 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 expressed concern over the illiquidity aspects. It was agreed that he 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.

PISC 24 February 2015

The Sub-Committee received a short presentation from AllenbridgeEpic which highlighted an investment opportunity from Fidelity Investment Management. This opportunity provided for an absolute return strategy, funded from the existing UK Aggregate Bond Fund which focussed on eleven key investment themes primarily using derivative based contracts. From a return perspective the fund sought to generate 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.

Whilst not dismissing this product out of hand, the Committee agreed that they would have preferred to measure the FIDA opportunity against another product offering, which perhaps included more physical investments.

Current fixed income Structure

L B Bromley Pension Fund is currently holding £118.2m (15.9%) of the total fund in fixed income assets (31 March 2015), split between Baillie Gifford £51.6m (6.9%) and Fidelity £66.6m (9.0%) in pooled funds, both of which have moderate outperformance targets over their respective benchmarks.

Members should note that the long term strategic allocation to fixed income is 20%. The underweight has primarily been caused, not by poor performance by the managers, but by

central bank actions on interest rates and quantitative easing keeping rates at minimal levels, this, coupled with strong equity performances (also a product of low interest rates), has forced the overall percentage holding in fixed income, at the total fund level, to fall to 15.9% (31 March 2015) from 16.6% as at 31 March 2014.

17 May 2015 Pension Investment sub Committee meeting

In response to the request from the PISC at their last regular meeting on 24 February 2015, Baillie Gifford and Fidelity were asked to consider how they could refine their respective current investment mandates in order to broaden their investment opportunity set, but at the same time retaining liquidity. Recommendations, in the form of short written papers, as to how they would manage this increased flexibility are attached in Appendix A. In addition, both managers will be in attendance at the meeting on 19 May 2015 to present their recommendations and to respond to questions.

Alick Stevenson
AllenbridgeEpic Investment Advisers

APPENDIX A

Baillie Gifford

Potential Amendments to LB of Bromley Bond Mandate

Background

This paper explores the effect of potential changes to the share of London Borough of Bromley's bond portfolio managed by Baillie Gifford.

Current investments

Your existing bond portfolio is invested in the Baillie Gifford Sterling Aggregate Plus Fund. This fund is managed against a benchmark made up of 50% UK government bonds (gilts) and 50% sterling investment grade non-gilts.

This benchmark is quite typical for the bond investments of UK pension funds with similar characteristics and objectives to those of Bromley. The underlying assets are liquid and mainstream and denominated entirely in sterling. Because the non-gilts are all investment grade bonds, they are highly correlated with gilts.

The risk framework of the mandate gives Baillie Gifford the scope to invest opportunistically in attractive bonds outside this narrow benchmark. For example, we have recently benefited from having around 5% in high yield bonds. We believe that there are sufficient degrees of freedom for us to add value relative to the benchmark over the investment cycle of around 1.5% per annum.

However, we have now reached the point at which the yield on the 50:50 aggregate bond index has fallen to close to 2%, driven by lower gilt yields. We can infer from this that future returns from this market are likely to be low, our ability to out-perform our benchmark notwithstanding.

This extreme market situation has led many clients to ask how their bond investments might be improved. In answer, we see scope for potential improvements in three directions:

- Increasing expected returns
- Reducing the volatility of the bond portfolio's returns
- Widening the scope of the manager to add value over the benchmark

In this paper we analyse the effect that two amendments to Bromley's existing portfolio would have on these factors. It should be noted that none of the material in the paper constitutes advice, that actual outcomes may differ significantly from our projections and that the analysis is not specific to your liabilities or other investment factors.

Potential additions

Two new strategies are evaluated: Global Credit and Local Currency Emerging Market Bonds. The assumption is that additions of up to 5% is made in each, funded from the existing bond portfolio.

Global Credit

Credit, or non-government bonds, is already 50% of your bond benchmark. This is a well-established market sector with good liquidity and depth. It is viewed as an attractive part of clients' portfolios because, over time, the extra yield in this type of bond compared to gilts has more than compensated for the higher risk of default.

Global Credit differs from your current investment in credit in two ways. First, it invests in corporate bonds across all developed market currencies rather than predominantly sterling. Secondly, it invests more in bonds with lower credit ratings. These differences are partly a reflection of its benchmark, the Barclays Global Credit index and partly because the strategy has been designed to have fewer investment constraints than your existing strategy.

One important point to make, however, is that our policy in Global Credit is to hedge the currency risk that arises from its global investments back to sterling. Thus no direct currency exposure would arise from investing in this Fund.

The change in overall investment characteristics which these two factors bring your portfolio brings is as follows:

1. More High Yield

Global Credit's benchmark has 18% in sub-investment grade (high yield') bonds. However we concentrate on improving BB-rated bonds at the higher quality end of this spectrum and do not expect to have significant investments at lower ratings i.e. B and, in particular CCC. We believe that these higher quality BB bonds are part of an investment 'sweet spot' where we can find the most attractive bonds on a risk-return basis and so we have given the strategy latitude to take significant over-weights in this area. So, at the end of last month we had a 24% overweight in BB-rated bonds by money weight as opposed to a 4% under-weight in B and CCC.

High yield is, in our view, an attractive asset class over the economic cycle. Investors have been systematically over-compensated for the risk of default over a sustained period. While the market volatility is greater than your existing investments, investors with longer investment horizons can reasonably choose to look through this in the interests of better returns.

Importantly, high yield has historically been only loosely correlated with investment grade bonds. This means that its higher volatility will have less of an effect when twinned with an investment grade portfolio. This helps explain why the Global Credit benchmark has exhibited similar volatility to the purely investment grade all-non gilt index. The reason for its low correlation is that high yield issuers usually benefit from economic upswings because their earnings improve, helping improve their credit status. Conversely, strong economic conditions tend to hurt investment grade bonds because gilt yields rise and this market sector is closely tied to gilts.
Greater international diversity

The other prominent difference in Global Credit is that its issuer base is more international. This, we believe, is beneficial for two reasons. First, it makes the index less prone to domestic economic factors. This makes for better economic diversity. Secondly, it gives our investment team a broader opportunity set with around 13,000 issues in the index. This greater choice is one of the factors behind our decision to target a more ambitious performance target in this strategy.

Taken together, on the basis of past experience, a modest allocation to Global Credit can boost expected returns without greatly increasing volatility.

Emerging Market Bonds

Many of our clients are being advised to add emerging market (EM) bonds to their portfolio mix. The economic case is that the average emerging economy has less debt and better growth than the UK and their bond markets have significantly higher yields. EM bonds have cheapened recently – particularly in sterling terms as currencies weakened - in contrast to the trend in developed market bonds. With a different economic cycle, EM bond returns are less correlated with gilts and sterling corporate bonds than most other bond types.

The asset class is not without its risks and recent events in Russia (a 4.2% weight in the strategy's benchmark index, the JP Morgan GBI-EM Global Diversified) underscore this. Inflation remains higher than in developed markets and so one has to 'aim off' from the high headline yield. Nevertheless, the positive longer term economic fundamentals underpin the case for investment.

We have chosen to invest in so-called 'local currency' bonds in our Fund rather than 'hard' currency (i.e. mainly dollars, as well as sterling, euro and yen to a lesser extent). We did so because we believed that clients would prefer the greater diversification benefit that other currencies bring and also because there is a clear trend towards emerging countries choosing to issue in their own currencies. Hard currency bonds are more akin to corporate bonds and hence less of a diversifier.

This does mean that investing in this strategy brings foreign currency exposure. We manage this investment aspect actively, and often see a currency over-weight as the best means to exploit an improving economic trend or, conversely, under-weight a currency where there is a deterioration in store. Our expectation is that many emerging nations will see their currencies strengthen against sterling in time as they narrow the productivity gap with developed economies. However, this will probably not be a smooth journey and one can reasonably anticipate volatility periodically.

In time, we anticipate that many emerging markets will see their currencies appreciate versus those of developed markets owing to their greater potential improvement in productivity. We have witnessed this in the past in countries like Japan and Korea. In the meantime, there is additional volatility, albeit rewarded with higher interest rates. This is one reason that most advisors suggest relatively low weights in the asset class at this stage.

We believe that emerging market bonds, as a nascent asset class, are quite inefficient. In other words, bond and currency values can fail to reflect economic fundamentals for an extended period. This inefficiency gives us the potential to outperform its benchmark in time as active investors.

Making a modest allocation to EM bonds will add somewhat to overall volatility but is likely to add to expected returns and increase portfolio diversity.

Other considerations

1. Interest rate sensitivity

Making investments in these areas would reduce the sterling interest rate sensitivity of your portfolio. This might be seen as a disadvantage if the Fund took a 'matching' or 'liability-driven' approach which generally involves buying long maturity bonds or proxies for these instruments. However, the recent strategic review did not advise this investment approach at this stage. Instead, it advocated making assets 'work harder' in order to improve returns. This proposal fits well with boosting returns.

Buying more long dated bonds at today's low yields is unlikely to result in good returns.

2. Credit ratings

Many clients have concerns about lower credit quality bonds. We see a marked increase in risk in corporate bonds rated B or below and do not anticipate significant investments in this area. BB and BBB rated bonds are viewed as lying in an investment 'sweet spot' in which there is a balance between value and the potential for us to find improving credits. For this reason, you can anticipate Global Credit having over-weights in this bans rather than very low ratings.

Currently, the benchmark index used by our EM bond fund does not have any bond rated lower than BB and its average credit rating is BBB. While we may make some opportunistic investments in lower rated bonds, this will not be a significant part of the portfolio (currently 2.3%).

Conclusion

Overall, we believe Global Credit and EM bonds could help Bromley to diversify its bond exposure and raise the performance target of its portfolio. In this respect, there are clear parallels with the decision previously made to adopt a global approach to investing in Equities.

While yields in Global Credit have fallen, the inclusion of high yield bonds provides a meaningful cushion over the yield obtainable in the existing portfolio. This is not without risks, but high yield is an asset class that has well established attractive risk-return characteristics.

Emerging countries have superior economic characteristics to the UK in many respects and their bond yields have been less distorted by quantitative easing. Most commentators expect growth to be better than in the West both in the short and long-term. Nevertheless, economic and political institutions are underdeveloped and corruption is a continuing problem. We anticipate EM bonds to be higher returning than gilts over the longer term but to remain more volatile for some time. A modest investment is nonetheless merited.

We see both Global Credit and EM bonds as fruitful areas for active investment. Both areas are, in our opinion, inefficient and lend themselves to fundamental research. Our Funds both have higher performance targets than your existing mandate and we believe this is justified by the potential for active management.

The scale of potential investment, as we understand it, is up to 10% of your existing portfolio into the new strategies. Clearly, this will not be transformational but would boost the overall yield on your bonds by around 0.25% while reducing duration (interest rate sensitivity) by about 0.4 years.

So we see genuine benefits in diversification for Bromley through extending in either of these directions. The additional volatility of the additional strategies should be dampened by diversification effects. While the most obvious benefit will be the boost to yield, we also believe that both fields are attractive arenas for active management, hence our higher performance targets.

We look forward to discussing these potential changes with you in due course.

Baillie Gifford & Co
April 2015

Fidelity Investment Management

London Borough of Bromley: Fixed Income Proposal

The Current Fidelity Mandate

The existing fixed income mandate of £66.6m is managed relative to a market benchmark (the IBOX Composite) which is made up of 50% UK Government and 50% UK Non-Government Fixed Income Securities. Our target is to outperform this benchmark by 0.75% p.a. over rolling 3-year periods.

Fixed income markets have delivered strong returns in recent years against a backdrop of benign inflation and low interest rates, and we have added additional value over and above the market gains. Over the last 3 and 5 years the fund has returned +8.4% pa and +9.0% pa respectively, comfortably beating the benchmark returns of +7.2% pa and +7.8% pa by +1.2% pa over both time frames.

Moving Forward

The key question for the future is what will happen when the current ultra-low interest rate environment ends and interest rates rise to more normal levels. Much will depend on the speed and magnitude of future rate rises, which in turn depend on the strength of economic growth and inflation and it is possible that interest rates will remain lower for longer than many people expect. However, we have looked at various scenarios and it seems clear that if interest rates 'normalise', conventional market based fixed income portfolios are likely to see capital values fall. If interest rates rise only slowly then there will be a lesser negative impact on conventional bond portfolios, but the scope to earn the sort of returns seen in the last few years is much reduced.

We believe that the solution is to start to introduce an absolute return portfolio alongside the traditional long only approach which we have followed to date. This would provide scope to preserve capital value and to exploit a wider set of investment opportunities.

An absolute return strategy would eliminate market exposure and remain broadly market neutral over the full market cycle. In other words, the portfolio would have zero years 'duration' (compared, for example to your existing portfolio duration of 9 years) and so offer downside protection as interest rates rise.

Our Recommendation: Fidelity Fixed Income Diversified Alpha (FIDA) Fund

The Fixed Income Diversified Alpha (FIDA) Fund employs an absolute return strategy unconstrained by traditional, benchmark-bound performance objectives to offer investors returns relative to cash. The strategy blends a global macroeconomic outlook with Fidelity's bottom up approach to investing; optimising a best ideas approach to security selection within a global opportunity set to deliver attractive risk adjusted returns.

We believe that the quality and depth of fundamental research produced by the Fidelity Fixed Income Team allows this philosophy to be successfully implemented to deliver superior risk-adjusted returns compared to a long only, benchmark constrained strategy.

Fidelity FIDA

The FIDA strategy combines diverse sources of alpha, preventing any single position from dominating portfolio risk. Ideas are usually implemented through "pair trades", combining a long and a short position.

Each position is categorised into one of 11 different types of alpha strategy and appropriately sized based upon level of conviction, volatility and correlation criteria.

Key Benefits

Low Volatility & Attractive Risk-Adjusted Returns: The fund aims to deliver cash + 150–300 bps* with a target volatility of 2-5%. FIDA limits the risk of capital losses.

Diversification: Recent years have seen a broad trend towards a more flexible approach to investing, unconstrained by a benchmark. FIDA is broadly market neutral; it may invest in any sector or asset class in Emerging and Developed market debt.

Strong Capital Preservation: The strategy is ideal for investors looking to diversify a growth portfolio with a stabilising vehicle.

A competitive edge: co-management structure

Within our investment teams, we combine home grown talent with experience. Our equity and Fixed Income research teams are two of the largest on the buy-side. Peter Khan and Tim Foster are the portfolio managers and their respective trading and quantitative backgrounds combine to provide the broad base of knowledge and experience necessary for the successful management of the FIDA strategy.

Our process is entirely transparent, integrated and collegiate. Research from the Credit, Quantitative, Trading and Product teams is made available to the entire Fixed Income team, so that every decision is taken with a holistic view.

Conclusion

After a long and successful period for conventional market referenced fixed income investors, there are growing concerns that capital will be at risk as bond yields eventually rise from their historic lows.

We believe that investors should consider moving towards a more broadly based, largely market neutral approach and propose the Fidelity FIDA, initially as a complement to the existing mandate.

We think that a sensible first step might be to consider an allocation of, say, 10% to FIDA to sit alongside the existing portfolio. The initial allocation might then be increased as discussions with your advisors and the economic environment evolve.