Appendix 6

Allenbridge
Part of MJ Hudson

Review of Fixed Interest Portfolios

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MJ HUDSON

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Recommendations

I am uncomfortable with the Fund's overweight against its Strategic Benchmark in Equities given my current market outlook. This is a 2-5 year view. Over this period I also expect the Fund's Fixed Interest portfolios to deliver low returns, potentially of no more than the current yield of around 2% per annum.

I would like the committee to consider selling the 1.1% of the Fund currently held in Blackrock's Enhanced Alpha Global Equity Fund. This would reduce the Equity Exposure from 63.4% to 62.3% and the overweight in Equities from +3.4% to +2.3% against the Strategic benchmark. The Committee could decide to reduce Equities back down to the Strategic Benchmark level of 60%, this would require selling part of one of the two main Equity mandates, Baillie Gifford or MFS. I would suggest Baillie Gifford because their Equity Portfolio accounts for over 40% of the Fund and is one of the main determinants of the Fund's future performance against its Benchmark. I retain a high level of conviction in their ability in this mandate but value diversification of risk above this.

The Fund is currently 1.3% underweight in its Multi Asset Income mandates. The Blackrock money could be reinvested in one of the Multi Asset Income (MAI) Funds reducing the Fund's underweight against its Strategic Benchmark in this area. My preference would be the Fidelity MAI Fund as I have a slightly higher conviction in the manager's ability over the Schroder MAI fund.

I am not in favour of investing new money into either of the Fund's existing Fixed Interest mandates. The benchmark for both mandates currently yields around 2% which is a good indication of the future return potential of these portfolios.

If the committee does decide to reduce the Fund's equity exposure down to 60% as per the Strategic Benchmark I would recommend reinvesting the money by building a holding in the Fidelity Multi Asset Credit Fund. This would be a new area for the Fund although both of the Fund's Multi Asset Income portfolios do have around one third of their assets exposed to Multi Asset Credit.

The Fidelity Multi Asset Credit Fund currently yields 6%, it invests globally into a wide variety of bonds but, importantly, can hold 100% of the Fund in Investment Grade Bonds and Sovereign Bonds if the manager is concerned about market levels and wishes to position the portfolio defensively. It targets a 5% return across a full market cycle rather than targeting a benchmark.

My suggestion would be to initially move 2% from the existing Fidelity mandate to the new fund as well as 2% from the Baillie Gifford global Equity mandate. This would leave the Fund with 10% in the existing two bond mandates and 4% in

an Absolute Return Bond Fund targeting a 5% return over a full market cycle. This could be seen as the first step in moving all of Fidelity's current mandate across to their Absolute Return mandate in due course.

Background

Current Fund exposure to Fixed Interest

Manager	AuM (31/3/19)	Weighting (31/3/19)	Benchmark Index Composition	Inception
Fidelity	£78.6M	7.6%	50% Iboxx Sterling Non Gilt Index; 50% Iboxx Sterling Gilts	1/5/99
Baillie Gifford	£59.1m	5.7%	44% FTSE Actuaries All Stocks; 44% Merrill Lynch Sterling Non Gilt; 6% JP Morgan GBI-Emerging Market Global Diversified; 6% Barclays Global Credit.	1/12/13

- The Fund is underweight Fixed Interest against its Strategic benchmark with a weighting of 13.3% against 15.0% as at 31/3/19. This will not have changed much during April.
- The two Fixed Interest portfolios have different benchmarks with Baillie Gifford able to take slightly more credit risk through exposure to Emerging Market and High Yield Bonds with each area having a 6% weighting in Baillie Gifford's composite benchmark. It also takes greater currency risk with a higher percentage of the holdings in overseas bonds. The main aspects of the two benchmarks invest in Government and Investment Grade bonds.
- Both benchmarks currently show a yield of around 2% per annum.
- Bonds as an asset class have performed well over the long term (20 years plus) as inflation has fallen across the developed world. Since inception in 1998, the Fidelity Bond benchmark has returned 5.8% per annum. More recently Bond yields have been pushed down further by central banks adopting Quantitative Easing (QE) as an approach to stimulate the global economy post the Global Financial Crisis in 2008/9. Over 5 years the Fidelity Bond benchmark has returned 5.6% p.a.
- Of the two portfolios Fidelity has shown a consistent ability to add value against their benchmark through positioning the portfolio to make the best of market conditions. Over 20 years there have been enough periods of market stress to challenge any portfolio manager and Fidelity's ability to achieve their performance target (Benchmark +0.75% p.a.) over a 20 year period is impressive.
- Baillie Gifford have matched their benchmark in performance terms since inception in December 2013. The portfolio performed poorly last year which has undermined their 5 year track record. The Baillie Gifford portfolio seems to be consistently long of credit risk against its benchmark, this means it will do well in stable or positive market conditions but will underperform when there is a flight to quality and increasing concern about credit risk as was the case towards the end of 2018.

Looking Forward

The current yield on the two Bond benchmarks is close to 2%. This will equate to the per annum return in the future if the portfolios were held until each Bond holding reached maturity and was redeemed. For returns to be higher than this Bond yields would have to fall further creating a capital gain to add to the yield. This could happen in two ways, firstly, inflation could continue to fall over the medium term pushing bond yields lower, this would require a further economic slowdown and falling interest rates; secondly, markets could become destabilised by an event which causes a rush to safe haven assets such as Government Bonds. This would be a more transitory event unless it undermined the

outlook for the global economy. In the UK we have the added dimension of Brexit which is likely to continue to affect UK Government Gilt yields in the (hopefully) short term.

Simplistically, for bonds yields to fall further the fear of a global recession needs to increase. Given that we are 10 years into the current economic expansion this has to be seen as a reasonable probability over the next 3-5 years with some commentators expecting a US recession in 2020/21.

Against this is the already low level of bond yields which have undoubtedly been pushed down by the Quantitative Easing (QE) adopted by many central Bbanks as a response to the global economic slowdown post the Financial Crisis in 2008/9.

More controversially, my personal view is that we are approaching the nadir of long term anti-inflationary pressures. The more isolationist policies being pursued by the US and copied elsewhere is reducing the globalisation of trade; the backlash against fiscal prudence/austerity, which has been the main economic policy globally post the Global Financial Crisis, is leading governments to pacify the electorate by promising increased spending; the desire for increasing standards of living post a decade of stagnation is forcing political parties to focus more on short term promises rather than longer term sound economic management; these are all straws in this argument, the question is when do they become relevant? We know the US Central Bank (the Fed) will allow inflation to rise above its 2% target for a period of time until it is convinced that disinflationary pressures have passed. Whilst I do not expect bond yields to rise back to the levels of 10 years ago I do believe there is reason to be cautious. If inflation does start to rise then interest rates and bond yields will follow, this would lead to a capital loss in the Fund's Fixed Interest holdings. Because both the benchmarks for the two existing Bond portfolios have a duration of nearly 10 years, a 1% increase in bond yields would lead to a 10% fall in the value of the each Bond portfolio.

A possible solution to this risk is to invest in a Bond portfolio with shorter duration, which lowers the sensitivity to interest rate moves, and higher yield which should boost returns. This requires taking higher credit risk to capture the higher yield.

The problem is that credit spreads tend to be correlated to equities.

A bonds' credit spread is the amount of extra yield an investor demands in order to invest in a bond of similar maturity that is backed by a sovereign government. The Government Bond is seen as risk free because most governments can always print more money if they cannot afford to pay a bond back at maturity. Therefore, the yield on a Government bond is seen as the risk free rate and any other bond issued by someone with a lower credit rating should yield a premium to the Government Bond to reflect the higher risk of default and of the investor not getting their capital back.

When equities fall it is due to investors' concern about future profits and dividends. This usually means a deteriorating economic environment and hence a deteriorating credit outlook. Baillie Gifford produced the table below showing the correlation of different bonds to global equities. A score of 0 means the bond price will move independently of equities, (uncorrelated); a negative number means that bond prices move in the opposite direction to equities (negatively correlated). As can be seen below, all types of bonds have some positive correlation to equities over both the short and longer term. The lower the credit quality the greater the correlation to equities. However, the correlations between asset classes are not stable. There have been periods of time when the correlation between Equities and Government Bonds has been negative.

	Correlation to Global Equity (1Y)	Correlation to Global Equity (10Y)
DM Govt	0.07	0.06
Inv Grade	0.37	0.20
High Yield	0.65	0.51
Structured Finance	0.22	0.18
EM hard currency	0.65	0.63
EM Local currency	0.38	0.41

(DM-Developed Market; EM-Emerging Market)

The table shows that it is High Yield Bonds and Emerging Market Bonds which have had the highest correlation to Equities. That is because these are the bonds with a higher credit risk, yet they are also the bonds with a higher yield which the Fund would need to hold to bolster current yields in the two Bond portfolios.

Question: Do we want to increase the credit risk within the Fund at the current time. Doing so would increase the yield on the Fixed Interest portfolio of the Fund but this may not translate into better performance if the global economy moves towards a recession. In a recession, whilst Government Bond yields would fall, credit spreads would widen and so higher yielding, lower credit quality bonds may not outperform their Government Bond counterparts until the fear of a recession has passed.

A potential solution to this is to invest with a manager who actively manages their credit exposure and has the ability to make the portfolio defensive if they fear a recession or feel bond markets have got ahead of themselves. These tend to be Absolute Return style bond portfolios with fairly wide mandates to invest in a variety of bonds including all those the Fund is currently invested in within the two existing Fixed Interest portfolios.

Both Baillie Gifford and Fidelity can manage such portfolios. Fidelity has existing mandates in this area, Baillie Gifford is currently discussing setting up such a fund with a potential launch date of autumn this year.

Product Offering at Baillie Gifford and Fidelity

I have spoken to both Baillie Gifford and Fidelity about potentially increasing the yield on the existing bond mandate they each manage for the Fund. Both managers can alter the existing mandate to take more credit risk by increasing the exposure to Emerging Market Debt and High Yield Bonds. I am not in favour of this approach for the reasons discussed above.

Alternatively, both managers can offer an Absolute Return Bond fund or portfolio albeit Baillie Gifford will not be launching their fund until the autumn. This allows the manager a more flexible approach as the benchmark is of the 'cash + x' absolute return style rather than driven by a benchmark.

I have greater conviction in the Fidelity product partly because the manager has shown more ability to add value in the portfolio they have managed for the Fund for over 20 years and partly because they have an existing fund in this area already with a track record.

Looking at the Fidelity offering in particular, this fund would seem to have some attractions. The manager has been active at the asset allocation level in the past, holding higher levels of cash through periods of market stress e.g. 2008/9. Investment Grade Bonds, similar to those held in the existing portfolios, has ranged from 30-50% of the portfolio over the last two years again showing an active asset allocation. The maximum allocation to Government debt is 100% of the fund so the portfolio can be very defensively positioned if the manager believes this will add value. The portfolio is currently cautious focusing on short duration, high quality bonds.

Comparing the existing mandate with the Fidelity Multi Asset Credit mandate:

Existing UK Aggregate Bond Fund	Multi-Asset Credit Fund
Tight Focus on UK Government Gilts and investment grade corporate bonds	Wider flexibility to invest dynamically into different types of bond with different credit risk
Performance relative to a benchmark	Total return target
Returns heavily influenced by the benchmark	Volatility reduced through diversification of holdings
Moderate to high sensitivity to interest rates	Flexible management of interest rate exposure
Return target benchmark +0.75%	5% per annum over the market cycle

The Fidelity multi-Asset Credit fund has an AuM of only $140m at the current time but counts Greenwich LGPS Fund as one of its investors. Given the smaller size of the fund at present much of the investments are made through other Fidelity funds e.g. into high yield bonds and emerging market debt funds; but this would change as the fund grows with more being made directly into physical holdings. Fees are not charged on holdings in other Fidelity products but the overall fee would be slightly higher than for the existing mandate.

Conclusion

At a minimum I would recommend the Committee sells the £10m remaining in the Blackrock Enhanced Global Alpha Equity Fund and reinvests this money into the Fidelity Multi-Asset Income fund. I would also be supportive of divesting 2% of the Funds AuM (Approximately £40m in total) from both the Baillie Gifford Global Alpha Fund and the Fidelity Fixed Interest portfolios and reinvesting the money into a new holding in the Fidelity Multi Asset Credit Fund.

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