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Surrey Pension Fund Committee

Bonds Manager Review Meeting Minutes

February 2024

Attendees

Nick Harrison; Chair Pension Fund Committee
Neil Mason; Assistant Director – LGPS Senior Officer
Lloyd Whitworth; Head of Investment and Stewardship
Anthony Fletcher; Independent Adviser

Background

The purpose of this report was to receive an update from BCPP on their Multi-Asset Credit Fund and to report on the portfolio of UK government bonds (Gilts) held as part of the Employer related strategies sub-portfolio managed by LGIM.

To the extent these minutes contain the views of the adviser those views are intended as strategic advice to inform discussions around the strategic asset allocation. They are not intended as investment advice nor should they be relied on as such.

BCPP – Multi-Asset Credit fund

Mandate summary

BCPP's investment return objective (primary benchmark) is stated as follows "The Fund aims to provide a total return which outperforms the total return of Sonia (cash) by at least 3-4% per annum over rolling five years periods (net of management fees)". The fund also has a secondary blended benchmark which can be used to assess the performance of the fund and each manager relative the asset class in which they invest.

At the end of December 2023, the value of Surrey's investment was £778.5 million. The Fund has been steadily increasing its exposure to MAC in order to bring the allocation up to 15% as stated in Surrey's strategic asset allocation. The performance of the MAC fund improved significantly as fixed income markets in general delivered better returns over the calendar year. This was especially true in the fourth quarter of 2023, when government yields and spreads of non-government bonds fell significantly in the expectation that the US Fed was to start cutting interest rates in the first quarter for 2024. Year to date in 2024 performance has been more mixed with government bonds delivering negative returns and credit markets doing generally better as spreads have continued to tighten.

Market background Calendar year 2023

The first nine months of 2023 were characterised by rising government bond yields; however, the negative performance wasn't as extreme as in 2022. As was the case in 2022, most of the negative outcome was the result of stronger than expected growth and inflation, and further increases in central bank interest rates. Government bonds are vulnerable to rising inflation and interest rates because of their low income yield and high interest rate sensitivity, this is especially true of UK government bonds (Gilts). The types of assets owned in a Multi-Asset Credit fund tend to have lower interest rate sensitivity but importantly their income yield is much higher and in some cases may be floating rather than fixed which means their income increases as interest rates increase. As a result, MAC funds broadly enjoyed a much better performance in the first nine months of the year. This can be seen in the MAC fund section of table 1 below and in the performance of global leveraged loans and global high yield bonds. For these credits, roughly half of the total return for the year was achieved in the first nine months whereas for government bond and investment grade credit nearly all the total return for the year was achieved in the fourth quarter only.

In the fourth quarter the landscape began to change, year over year headline inflation data fell sharply, outside of the US economic growth began to show signs of slowing and most importantly the US Fed, ECB and BoE stopped increasing interest rates. By November bond markets were expecting interest rate cuts as early as March 2024 and this optimism was fuelled by statements from Jerome Powell, governor of the US Fed that he could see the possibility of three 0.25% rate cuts in 2024. The fact that he and several other members of the FOMC said *"if inflation continues to fall and remain stable at lower levels"* was ignored by the government bond markets. This resulted in the very strong performance of interest rate sensitive, governnment bonds and investment grade credit in the last tree months of the year as noted on table 1 below.

Equity markets also performed strongly on the idea of lower interest rates, but also due to stronger than expected earnings and better profit margins and generally lower cost pressures from inflation and falling goods prices, even as labour markets remain tight. This helped spreads fall for the more economically sensitive credit markets as well, which benefitted the high yield bond and leveraged loans markets.

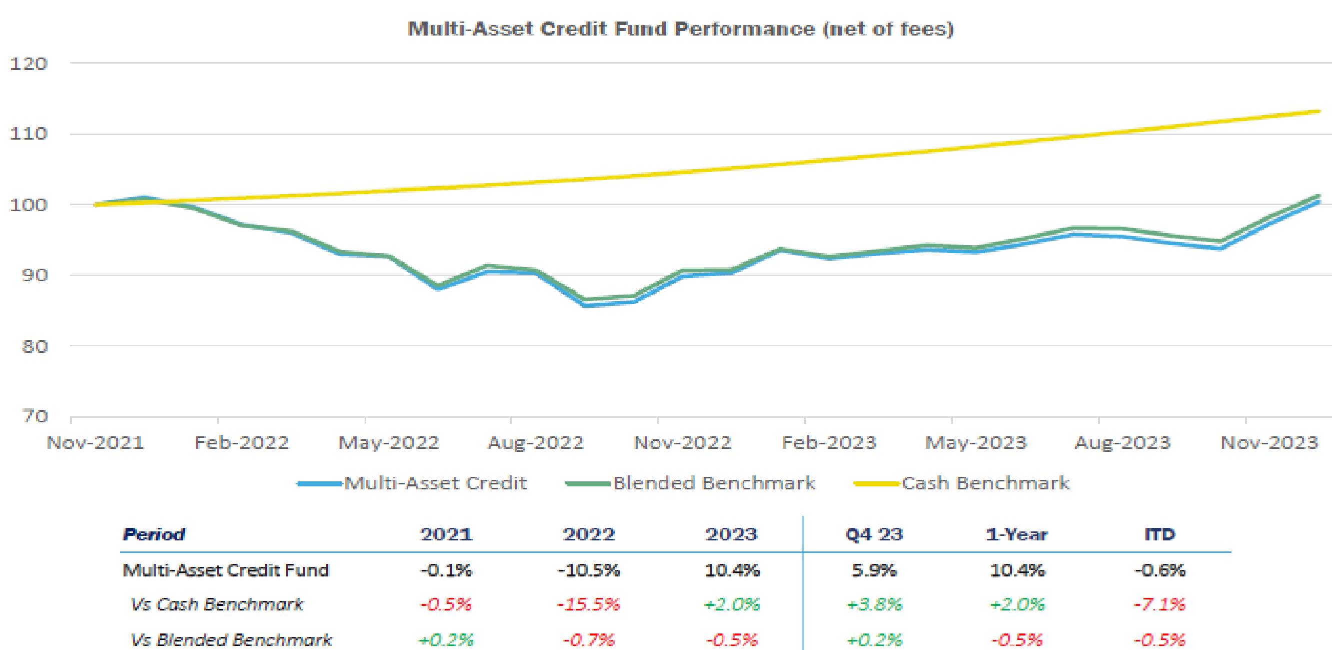
Year to date in 2024, much of this optimism in the government bonds markets has evaporated with the yield of US and UK 10 year government bonds higher, reversing nearly all their gains in the fourth quarter of 2023. Credit markets have outperformed due to their higher income and have continued to deliver positive returns. The yield of credit markets is slightly higher and remains attractive as a source of income. However, credit spreads have continued to narrow to government bonds, making non-government bonds now look relatively more expensive.

I expect this volatility to continue throughout 2024 as inflation data and optimism on rate cuts ebbs and flows. The amplitude of changes in yields and spreads could also increase as we get closer to the US presidential election campaign. I expect central banks to cut rates this year led by the US Fed, but not as early, or by the amount expected by the market because I believe growth could be stronger than expected and inflation, especially core inflation, could remain sticky.

Table 1: - % Total return Period end 31st December 2023		
Indices	**3 months**	**12 months**
Global equity FTSE All-World	+6.3	+15.3
UK Gilts – Fixed Interest Gilts >15y	+14.3	+2.0
UK Gilts - Index Linked Gilts >15y	+13.8	-3.4
Overseas Government bonds*	+8.4	+9.7
Sterling 7 day SONIA	+1.4	+5.0
UK Investment grade corporate bonds	+8.3	+9.8
Global investment grade corporates*	+7.0	+7.8
Global High yield corporates*	+6.4	+12.0
Emerging market Government bonds*	+9.1	+9.3
Global Leveraged loans*	+6.0	+12.0
MAC Funds**		
BCPP Multi-Asset Credit Fund	**+5.9**	**+10.5**
Another Pool's MAC fund	+5.4	+12.4
CQS Credit Multi-Asset fund	+4.2	+12.4
Western Asset Multi-Asset Credit fund	+6.6	+10.6

Index returns provided by ICE Indices are unhedged in Sterling terms except when noted, *Currency hedged. ** MAC Fund returns provided by the Manager. The funds chosen are similar to BCPP's in terms of asset mix and cash plus total return objective. The other pool's fund is combination of 3 different MAC fund managers. CQS and Western each manage a stone alone MAC fund.

Chart 1: - BCPP performance and attribution



Period	2021	2022	2023	Q4 23	1-Year	ITD
Multi-Asset Credit Fund	-0.1%	-10.5%	10.4%	5.9%	10.4%	-0.6%
Vs Cash Benchmark	*-0.5%*	*-15.5%*	*+2.0%*	*+3.8%*	*+2.0%*	*-7.1%*
Vs Blended Benchmark	*+0.2%*	*-0.7%*	*-0.5%*	*+0.2%*	*-0.5%*	*-0.5%*

Source: - BCPP

The BCPP MAC fund delivered 10.4% net of fees in 2023, slightly behind the blended asset class benchmark but +2% ahead of the Sonia+3 - 4% cash benchmark, helped by a strong fourth quarter. Inception to date, only just over two years, the fund is also slightly behind the blended benchmark and -7.1% annualised behind the cash benchmark.

The attribution analysis for calendar year 2023 provided by BCPP shows very small negative contributions to performance from Ashmore (local ccy EM debt), Barings (Loans) and BCPP (hard ccy EM debt). With the largest positive contribution to performance coming from Wellington, the high yield bond manager, who have consistently outperformed by their security selection. The largest negative contributions to returns came from PIMCO (Core MAC) and PGIM (Securitised). While much of the difference arising from PGIM's performance has been attributed to the benchmark. It would appear that PIMCO were on the wrong side of the duration and credit spread movements

throughout the year.

Since inception Barings, PGIM and Wellington have each delivered a positive absolute return and BCPP, Ashmore and PIMCO a negative absolute return, none of the managers outperformed the cash plus benchmark. Relative to their chosen market comparison benchmarks, only BCPP and Wellington have outperformed and all the other managers have underperformed.

Current positioning

Table 2 below shows relative weights of each manager in the fund as decided by BCPP compared to the Fund's strategic asset allocation. The underweight allocation to PIMCO can be explained by performance drift rather than any active decisions taken by BCPP. At the start of the year BCPP set out to have a higher credit quality portfolio due to their ongoing concerns about credit and default risk. They wanted to increase the (Duration) interest rate sensitivity of the fund because they also believed that central banks were coming to the end of the interest rate hiking cycle. To achieve this, they started to reduce the fund's exposure to Loans and High yield debt and increase the exposure to Hard currency emerging market debt (EMD) and Securitised assets.

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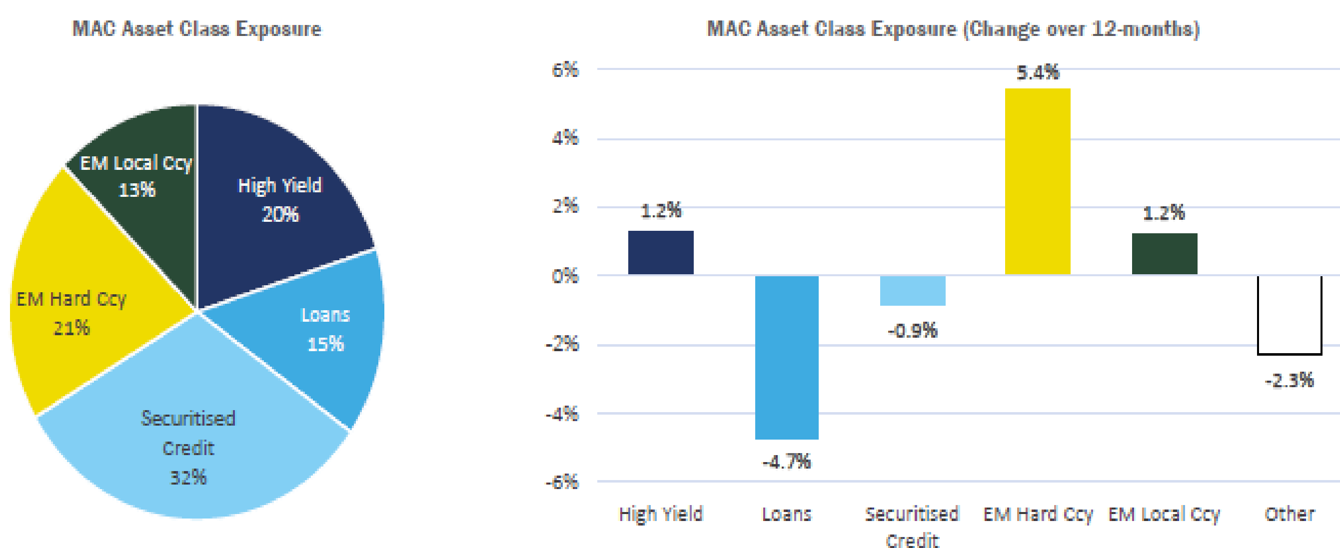
Table 2: - Strategic and BCPP active tactical manager allocations 31st December 2023.

%	Strategic weight	Tactical weight		BCPP Active decision		Comments
		31-12-22	31-12-23	31-12-22	31-12-23	
Ashmore (local ccy EMD)	9	11	10.1	+2	+1.1	
Barings (Loans)	9	10	8.6	+1	-0.4	Reduced from +1% to increase duration of the fund
BCPP (Hard ccy EMD)	9	8	9.7	-1	+0.7	Increased from -1% to increase duration of the fund
PGIM (Securitised)	15	15	15.8	0	+0.8	Increased to +1% to improve overall Quality of the fund
PIMCO (Core)	40	40	39.8	0	-0.2	Performance drift
Wellington (High yield bonds)	18	16	16	-2	-2	Maintained at -2% underweight due to concerns about credit risk

Chart 2 shows the resulting positions of both the BCPP tactical manager asset allocation decisions and the decisions taken by each manager in their asset class. The decisions by the individual managers have amplified the interest rate sensitivity decision, so that the fund is nearly 5% underweight Loans which are predominantly linked to floating rates and over 5% overweight Hard currency EMD which are linked to fixed coupons and much higher duration. Despite BCPP's efforts to reduce credit risk, the fund remains overweight High yield and underweight Securitised assets. Other consists of FX positioning and other derivatives used by some of the managers to dampen market volatility.

Chart 2: - "Look through" resulting active asset class allocations 31st December 2023



Source: - BCPP

Specialist manager comments

Ashmore: - Local currency EMD

Ashmore are recognised as being a high conviction manager confident to take large positions. Their performance benchmark / market comparator is made up of 2/3 local currency EMD and 1/3 EM corporate bonds. This can be advantageous, but most EM corporate debt is denominated in hard currencies rather than local currency. In the last year while Ashmore delivered a positive contribution to performance from the decisions in local currency EMD this was more than offset by the negative contribution from their corporate bond decisions.

Barings: - Leveraged Loans

Are so large in this area that their performance will always be very close to that of the index. Relative to the index they are likely to be low risk which should be good for the Fund in times of poor loan performance because of the high quality of their credit analysis, but it also means they are unlikely to outperform when times are good.

BCPP: - Hard currency EMD

The universe of issuers in this asset class is relatively narrow and well researched. They tend to be high credit quality and long duration. Given these characteristics and BCPP having a low cost in-house capability it was reasonable to appoint BCPP to manage this allocation. The MAC team have placed BCPP on watch because one of the lead fund managers is leaving the team.

PGIM: - Securitised Credit

Have a very conservative approach and a large well respected team of analysts and like Barings they are a large player in the asset class. How much of their underperformance is driven by their conservative approach and market position is difficult to assess because the selected performance benchmark would appear to be inconsistent with how the fund is allocated. They also use derivatives to dampen the market volatility of the fund, this means they are often paying for insurance their clients do not need.

PIMCO: - Core MAC

Have a very well-resourced business in fixed income and their MAC team is well supported by this infrastructure. The analysis presented by BCPP showed that they have been active in terms of asset class positioning, duration and overall credit risk exposures. But it would appear their over-arching macro-economic call may not have been ideal for how the market performed, resulting in them being “whipsawed” by the market.

Wellington: - High yield bonds

Have stuck to their knitting over the last year and delivered another outperformance of the market comparator benchmark. The analysis presented by BCPP shows that they were directionally overweight credit risk when spreads were attractive and reduced this as markets became expensive and they seem to have been diligent in their credit work. High yield managers have to pick up the “nickels and dimes” presented by the market because the carry of the index is usually +0.6% per month even when spreads are narrow.

Adviser view

It remains the case that it is too early to judge the performance of the BCPP MAC fund compared to the primary benchmark of cash +3% to +4% over rolling 5 year years. Whereas compared to the blended market benchmark of how the underlying markets have performed the BCPP MAC fund had another reasonable year. Overall contributions to return were not helped by the active decisions taken by BCPP to move away from the strategic asset allocation and some of the individual managers also struggled, most notably PIMCO who have the largest portion of the fund.

Now that the fund has been running for more than 2 years, I believe it reasonable to re-visit the investment universe and market comparator benchmarks of each of the managers. I believe this should start with Ashmore, they have been

appointed predominantly for their skills in local currency EMD which they seem to be good at, but they also have benchmark allocation to EM corporates, maybe this should be an off-index opportunity? I also believe BCPP should re-visit the performance benchmark for PGIM, the fund's asset allocation bares almost no relationship to the AAA, CLO benchmark. I also do not like the use of derivatives to dampen market volatility as this rarely offsets the magnitude of the volatility when needed and as a result needlessly pays away hard won income, it also demonstrates a lack of conviction by the manager.

While BCPP have improved the reporting package for the fund it remains well below industry standard, let alone best practice.

LGIM – Over 15year Gilt fund

Mandate summary

Legal & General Investment Management (LGIM) manage a portfolio of UK government bonds (Gilts), with a maturity of over 15 years in order to match the liabilities of the Fund's employer strategies. The inception date for this investment was 1st November 2023 and the amount invested was £111.4 million.

The LGIM fund is passively matched to the weight of Gilts in issue with a maturity of more than 15 years, defined as being a constituent of the "FTSE Actuaries UK Conventional Gilts Over 15 Years Index". When the time to redemption of a holding falls below 15 years it will automatically be sold and the money redistributed to other Gilts with a maturity of greater than 15 years. Equally if the government issues a new Gilt with a maturity of more than 15 years it will automatically be purchased by selling the appropriate amount of the existing Gilts in the Fund. No active decisions are taken by LGIM in managing this fund, the purpose is at times to match the characteristics of Fixed Interest Gilts with a maturity of greater than 15 years.

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Performance

As would be expected the fund has performed in line with the movements of the over 15year Gilt index. In the last few months of 2023 as noted above in the market background section and can be seen in table 1 government bonds delivered strong positive returns. Surrey's investment between the beginning of November and the end of December delivered a return of around +14%. However, year to date in 2024 (to 14th February 2024) returns have been negative which has bought down the holding period return to around +8%.

As noted in table 1 above inflation linked gilts have delivered a lower return than fixed interest gilts, over the same period as the real yield has increased. Over the last 2 years the real yield of over 15 year Index Linked Gilts has increased from the extremely over valued level of -2.1% in February 2022. At the end of February 2024 the real yield had increased to +1.2%.

As noted by the Officers in their report if the real yield of over 15 year Linkers continues to rise to a level where the necessary conditions are met, the Fund's employers strategy will automatically switch from Fixed Interest Gilts to Index Linked Gilts.

Adviser view

LGIM are highly skilled and extremely well resourced to manage this strategy on behalf of the Surrey Pension Fund. They are one of the leaders in providing this kind of investment approach and their scale and systems enable them to do it at an extremely low cost, much lower than how the strategy was being implemented before and below the cost of similar solution available from BCPP.

Anthony Fletcher – Independent Adviser to the Surrey Pension Fund

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