Surrey Pension Fund Committee

16

Multi-Asset Credit and Gilts

February 2025

APEX

16

Attendees

Nick Harrison; Chair of the Pension Fund Committee

Neil Mason; Assistant Director – LGPS Senior Officer

Lloyd Whitworth; Head of Investment and Stewardship

Mel Butler; Deputy Head of Investment & Stewardship

George Cook; Investment and Stewardship Officer

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.

APEX

BCPP – Multi-Asset Credit fund (MAC)

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 2024, the value of Surrey's investment was £885.5 million.

16

Market background Calendar year 2024

After the strong performance in the fourth quarter of 2023, when the bond markets decided the US Fed was going to cut rates aggressively in 2024. The first quarter of 2024, saw higher than expected growth and stickier inflation, which undid all the optimism for US rate cuts. As can be seen in in Chart 1 below prices for UK gilts and index linked gilts fell. Through the middle part of the year government bonds did rather better as the rate of inflation fell slightly and central banks cut interest rates. Then in the fourth quarter the US bond markets began to worry about the Federal budget deficit implications of the new president, in particular Mr Trump. When he was duly elected, government bond yields surged higher (and prices fell sharply), so that yields finished the year at their highest levels since before the GFC nearly 20 years ago. As can be seen below, the prices of UK government bonds matched the US sell off with prices falling significantly. The orange line shows the price performance for UK Investment grade non-government bonds. It shows that these lower interest rate sensitive, higher yielding bonds, outperformed government bonds in all periods.

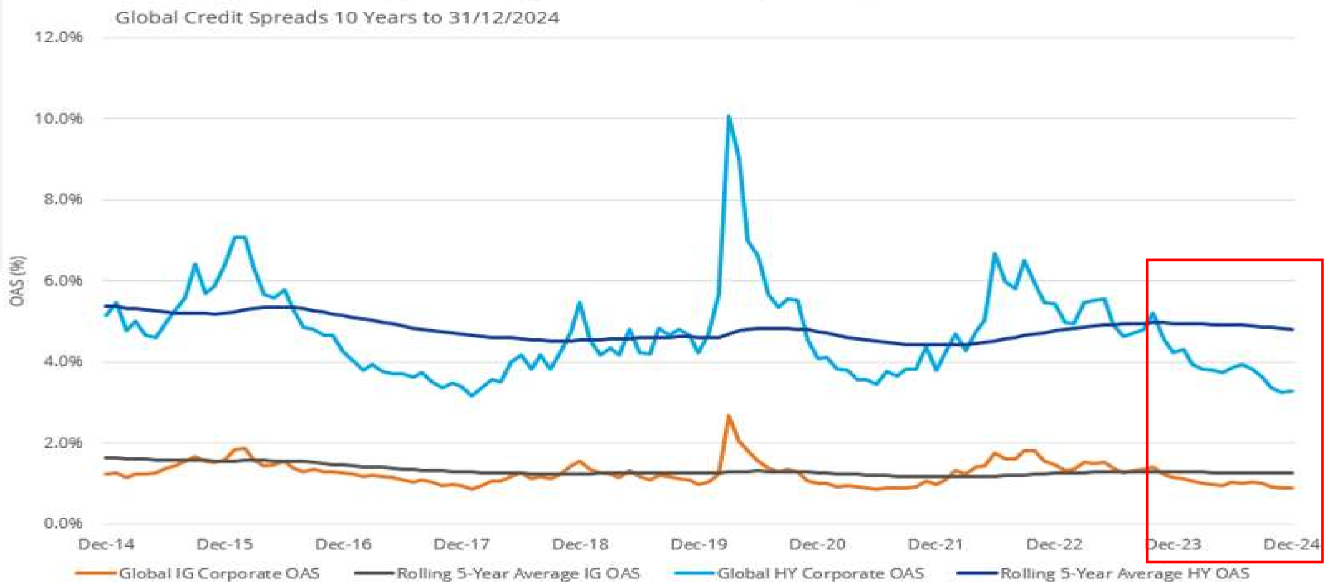
Chart 1: - UK Bond index returns, 12 months to 31st December 2024

Source: - Bloomberg, 31st December 2024

APEX

Chart 2 shows the extra yield in terms of spread over governments that investment grade and high yield bonds attract. As can be seen in the red box these spreads fell over 2024, this spread compression, the higher yield and lower interest rate sensitivity means these asset classes both delivered better total returns, see Table 1 below. Also shown on Table 1, Leveraged Loans outperformed, because loans and securitised assets usually have floating coupons and the pace of rate cuts was slower than expected. Emerging market debt also had a better year that government bonds.

Chart 2: - Credit spreads, extra yield over government bonds, last 10 years.



Source: - Bloomberg, 31st December 2024

16

In January 2025 government bond yields continued to rise on US fiscal concerns until lower December inflation data and the equity market volatility caused by Chinese AI company DeepSeek caused yields to fall sharply. In February government yields have started to rise again as the US Fed left rates unchanged and January's Inflation data jumped sharply. Meanwhile non-government bonds have continued to outperform.

With spreads now at their narrowest level since the GFC and arguably with the aggregate credit quality of the market in lower than it was back then. Non-government bonds, now look expensive, especially Investment grade credit, where the extra spread is almost insufficient to provide a yield cushion against normal market spread volatility.

I would not be surprised to see bond market volatility continue throughout 2025 as markets see what Mr Trump actually does, rather than what he says. US growth is widely expected to be stronger in 2025, and inflation stickier, which means the US Fed is less likely to need/want to cut rates. 10 year government yields at around their current level are about correctly priced for one or two US rate cuts this year. So it maybe a year to "clip the coupon", which would favour the higher yield available for non-government bonds provided defaults and downgrades can be avoided. As I find it harder to see further spread compression leading to outperformance amusingly 'yield could trump spread'. On the other hand government bond yields do not have to fall much to outperform because of their higher interest rate sensitivity.

Table 1: - % Total returns, period end 31st December 2024		
Indices	**3 months**	**12 months**
Global equity FTSE All-World	+5.9	+19.8
Government bond		
UK Gilts – Fixed Interest Gilts >15y	-7.2	-10.7
UK Gilts - Index Linked Gilts >15y	-10.1	-15.6
Overseas Government bonds*	-1.7	+1.6
Non- Government bond		
UK Investment grade corporate bonds	-0.4	+1.9
Global investment grade corporates*	-1.5	+3.6
Global High yield corporates*	+0.5	+8.9
Emerging market Government bonds*	-1.7	+5.5
US Leveraged loans*	+2.3	+8.7
Cash - Sterling 3 month deposit	+1.2	+5.3
MAC Funds**		
BCPP Multi-Asset Credit Fund	**-0.1**	**+7.2**
Neuberger	-0.1	7.4
CQS	+2.3	+11.7
Oaktree	+1.4	+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.

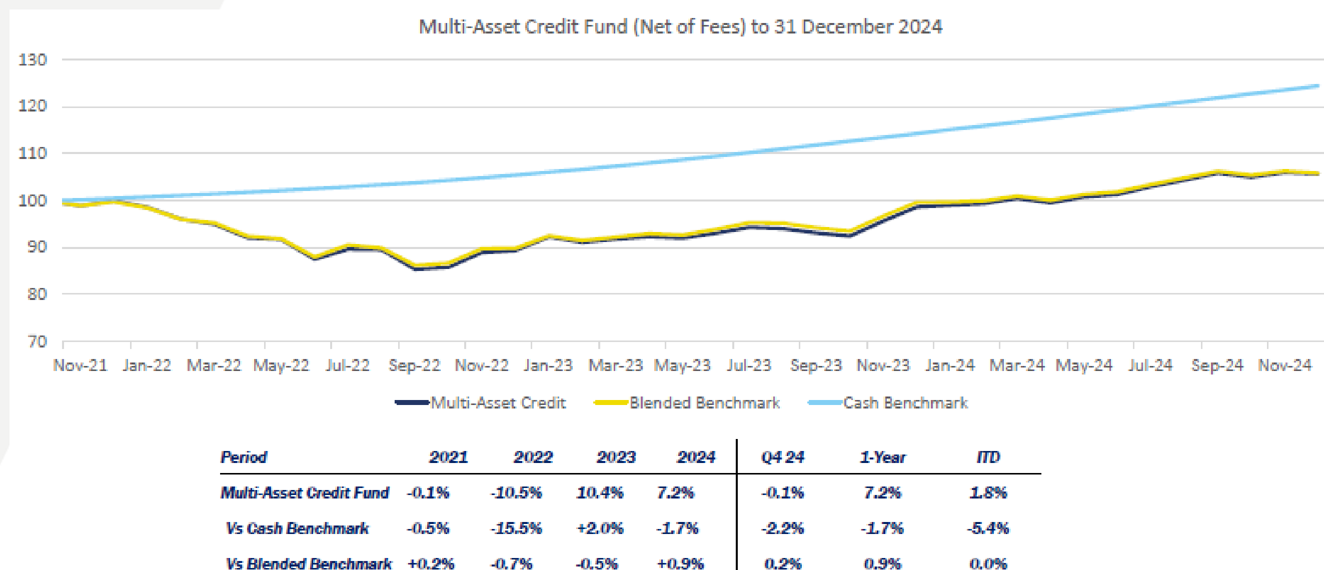
Performance update

The BCPP MAC fund delivered 7.2% net of fees in 2024, -1.7% below the fund's cash +3% to +4% primary Benchmark. However the result was +0.9% better than the blended asset class performance. Since Inception, just over three years, the fund is -5.4% per annum behind the primary cash benchmark but in line with the blended asset class performance, see chart 3 below.

Over the year none of the managers outperformed the cash plus benchmark and overall fund performance was -1.7% below the cash plus benchmark return of +8.9%. The attribution analysis provided by BCPP for calendar year 2024 uses the market comparators. This shows the fund outperformed the blended market comparator with +1.1% coming from stock selection, 0.94% coming from PIMCO and 0.27% from PGIM. All the other managers delivered almost negligible stock selection contributions, except BCPP EM debt that

delivered -0.08%. Asset allocation decisions were also negligible at the manager level but at the combined portfolio level summed to -0.08%.

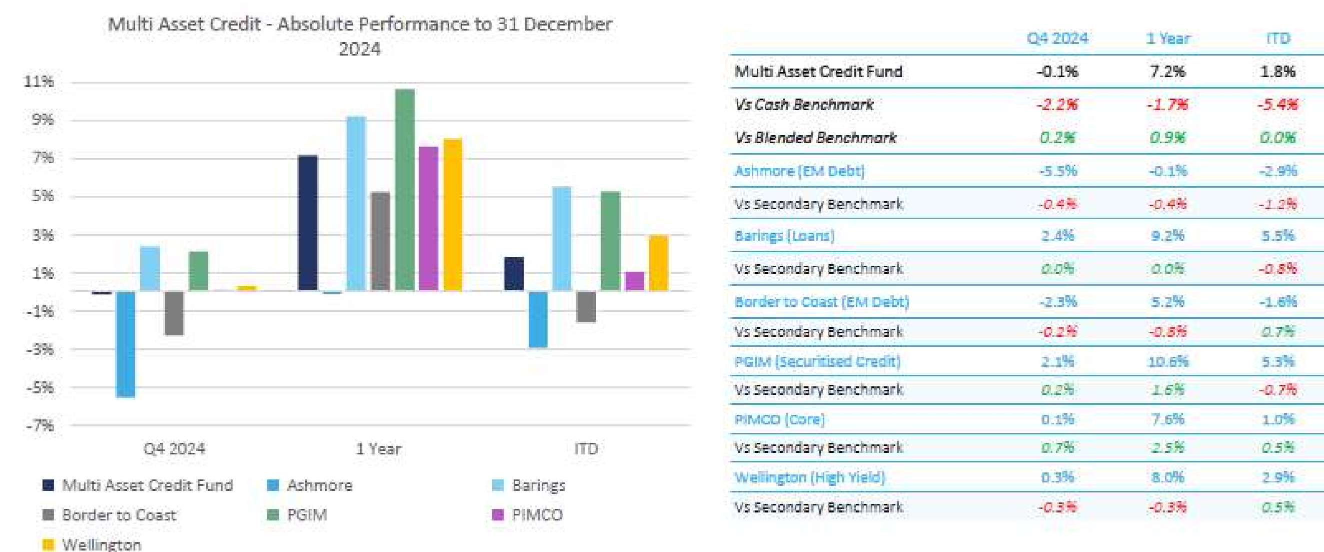
Chart 3: - BCPP performance



Period	2021	2022	2023	2024	Q4 24	1-Year	ITD
Multi-Asset Credit Fund	-0.1%	-10.5%	10.4%	7.2%	-0.1%	7.2%	1.8%
Vs Cash Benchmark	-0.5%	-15.5%	+2.0%	-1.7%	-2.2%	-1.7%	-5.4%
Vs Blended Benchmark	+0.2%	-0.7%	-0.5%	+0.9%	0.2%	0.9%	0.0%

As shown in the table on Chart 4, since inception Barings, PIMCO, PGIM and Wellington have each delivered a positive absolute returns and the emerging debt managers, BCPP and Ashmore a negative absolute returns, none of the managers outperformed the cash plus benchmark. Relative to their chosen market comparator (secondary benchmarks), only BCPP, PIMCO and Wellington have outperformed and all the other managers have underperformed.

Chart 4: - Fund performance versus Primary benchmark and blended asset class performance and Manager returns versus their market index.



	Q4 2024	1 Year	ITD
Multi Asset Credit Fund	-0.1%	7.2%	1.8%
Vs Cash Benchmark	-2.2%	-1.7%	-5.4%
Vs Blended Benchmark	0.2%	0.9%	0.0%
Ashmore (EM Debt)	-5.5%	-0.1%	-2.9%
Vs Secondary Benchmark	-0.4%	-0.4%	-1.2%
Barings (Loans)	2.4%	9.2%	5.5%
Vs Secondary Benchmark	0.0%	0.0%	-0.8%
Border to Coast (EM Debt)	-2.3%	5.2%	-1.6%
Vs Secondary Benchmark	-0.2%	-0.8%	0.7%
PGIM (Securitised Credit)	2.1%	10.6%	5.3%
Vs Secondary Benchmark	0.2%	1.6%	-0.7%
PIMCO (Core)	0.1%	7.6%	1.0%
Vs Secondary Benchmark	0.7%	2.5%	0.5%
Wellington (High Yield)	0.3%	8.0%	2.9%
Vs Secondary Benchmark	-0.3%	-0.3%	0.5%

Source for both charts; Border to Coast Pensions Partnership – Surrey MAC Review

APEX

16

Current positioning

Table 2 below shows relative weights of each manager in the fund at the beginning and end of 2024, as decided by BCPP compared to the Fund's strategic asset allocation. At the start of the year BCPP positioned the fund to be:-

- Higher credit quality - due to their ongoing concerns about credit and default risk.
- Higher (Duration) interest rate sensitivity - because they believed that central banks would continue to cut rates.
- Underweight high yield credit and overweight relatively cheaper securitised credit.

To achieve this, they reduced the fund's exposure to Barings (leveraged loans) and Wellington (high yield debt) and increased the exposure to higher duration emerging market debt with both Ashmore and BCPP and securitised credit with PGIM.

Looking forward into 2025 as the narrative in the 2 righthand columns shows on table 2, the BCPP team plan to reduce emerging debt exposure, maintain the underweights in high yield and leveraged loans and maintain their overweight in securitised credit and strongly overweight the core manager PIMCO.

Table 2: - Dynamic Manager asset allocation decisions taken by BCPP

Manager	31 Dec 23 Weight	31 Dec 24 Weight	Strategic Weight	Forwards Looking DAA View	Rationale
Ashmore *EM Local & Corps*	10.1%	8.6%	9%	Underweight	US political developments creating a challenging environment for EM FX. Potential tariffs, greater inflationary pressures/uncertainty. Central banks have capacity to cut. **Proposed watchlist inclusion, further diligence to be conducted. Some concerns with culture, and risk management.*
Barings *Leveraged Loans*	8.6%	8.6%	9%	Underweight	Cycle approaching later stage. Loans are lower quality with cyclical spread widening risk. Supportive refinancing activity has pushed maturities out to 2027. Discounting from short end of the curve and large relative spread allows for attractive carry.
PGIM *Securitised Cred.*	15.8%	16.7%	15%	Overweight	Low duration asset class but carries well due to curve inversion (discounts off short end). High quality portfolio providing diversification benefits in the event of volatility spike/slowing economic growth/spread expansion. Spreads have tightened but valuations remain relatively attractive. Strong absolute return driven by carry.
PIMCO *Core*	39.8%	40.4%	40%	Strong Overweight	Tactical asset allocation flexibility desirable in uncertain/volatile markets. Diversification benefits of high quality, balanced spread sensitivity, with moderate duration.
Wellington *High Yield*	16.0%	15.5%	18%	Underweight	Valuations are rich, we can access more attractive spread elsewhere (Sec Cr). Refinancing has gone well. Fundamentals are solid and quality has improved over recent years, and growth is supportive.
BTC *EM Hard*	9.7%	10.2%	9%	Underweight	Concerns over the impact of new political regime in the US and policy impact on the long end of the yield curve. Spread valuations tight.

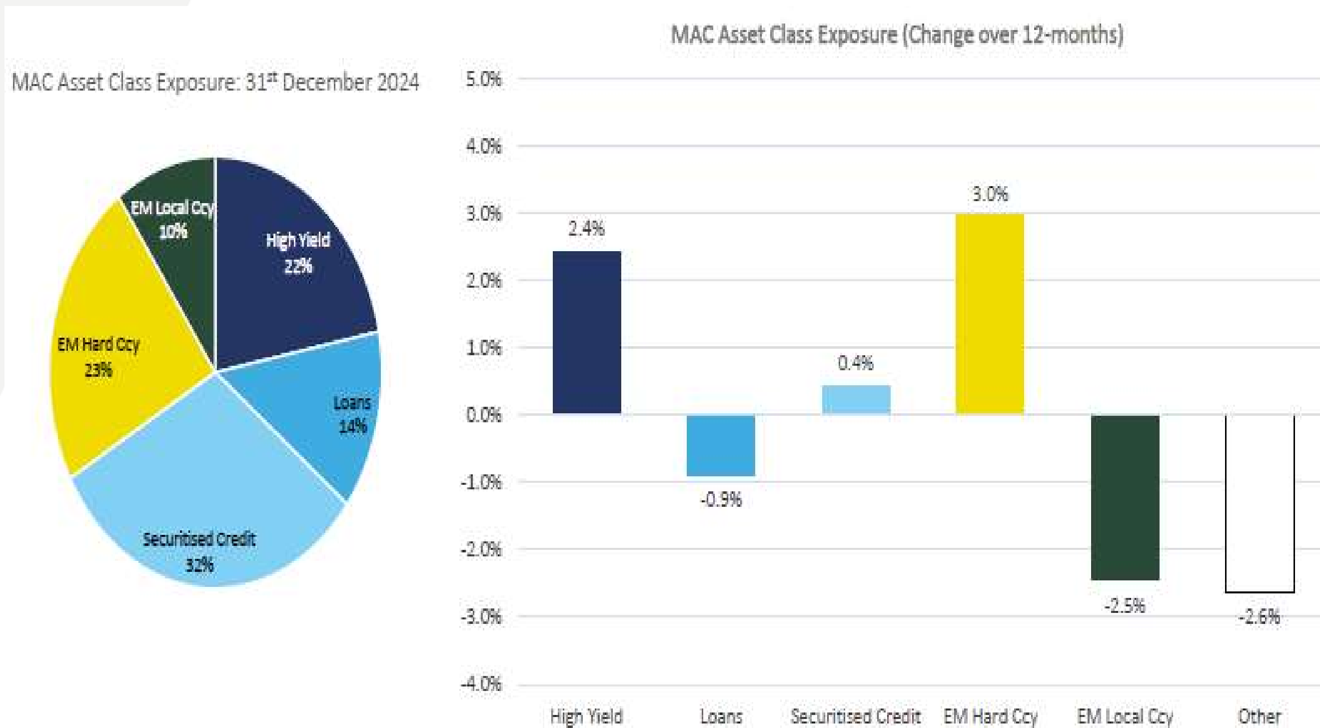
Key – Absolute Mandate Deviations

Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
<-3%	-3% to 0%	-1.5% to +1.5%	0% to +3%	>+3%

Source; Border to Coast Pensions Partnership – Surrey MAC Review

Chart 5 shows the 31st December 2024 resulting look through positions of both the BCPP dynamic manager asset allocation decisions and the decisions taken by the Core manager PIMCO.

Chart 5: - "Look through" resulting active asset class allocations 31st December 2024



Source; Border to Coast Pensions Partnership – Surrey MAC Review

From Table 3 below it can be seen that the combined allocation decisions of BCPP and PIMCO appear to have both amplified and negated the decisions taken by the BCPP team to implement their dynamic asset allocation process.

As a result over 2024 the fund appears to have had, possibly the following un-intended asset allocation positions : -

- A much larger duration and EMD exposure.
- A much lower exposure to Leveraged loans.
- Underweight exposure to securitised credit rather than overweight.
- Overweight high yield debt instead of underweight.

APEX

Table 3 : -BCPP Manager level intended Dynamic Asset Allocations vs actual look through fund positioning in %.

Date		31st December 2023			31st December 2024		
Strategic weight	Manager	DAA	Look through	Summary result	DAA	Look through	Summary result
9	Ashmore EMD local ccy	+1.0	+1.2	Neutral	-0.4	-2.5	Larger underweight
9	Barings Leveraged Loans	-0.4	-4.7	Much larger underweight	-0.4	-0.9	Underweight
15	PGIM Securitised Credit	+0.8	-0.8	Opposite underweight	+1.7	+0.4	Less overweight
40	PIMCO Core Manager	-0.2	-0.2	Neutral	+0.4	+0.4	Neutral
18	Wellington High yield bonds	-2.0	+1.2	Opposite overweight	-2.5	+2.4	Opposite larger overweight
9	BCPP US$ EMD	+0.7	+5.4	Much larger overweight	+1.2	+3.0	Larger overweight

Source; Border to Coast Pensions Partnership – Surrey MAC Review 2024 and 2025.

16

Adviser view

In the last couple of years I have given BCPP the "benefit of the doubt" on the MAC fund and their explanations for relative performance versus the cash benchmark and the blended market comparator. Despite often unsatisfactory answers to questions about their understanding of the risks they were taking and my concerns on portfolio construction and manager benchmarking. Partly because in 2022 all bond markets had experienced an "Annus horribilis" caused by the war in Ukraine, rapidly rising inflation and interest rates and a reset to historically normal levels of interest rates and bond yields. After years of central bank repression and ZIRP following the GFC. I also believed they had been "unlucky" to be launching their new fund into that environment.

Despite the strong rebound in the market and fund performance in 2023 my concerns about their understanding of the funds risk and return dynamics remained and while I had raised these directly with BCPP, I only lightly touched on them in my report last year.

This year in discussions it has emerged that there is a fundamental disconnect between what the funds benchmark is set to achieve and how the individual managers have been tasked to deliver their returns. Furthermore there has been no modification to the manager line up nor does it appear concern or guidance

from BCPP to the managers on the importance of the cash plus benchmark. Hence they have carried on managing their asset classes unchanged.

Apart from the disconnect on fund objectives and the manager objectives mentioned above, this year for me there are two extra and fairly key observations. First 2024 was almost a perfect year for the MAC fund to re-coup a significant portion of the cash plus benchmark underperformance accrued since inception. Because spreads have narrowed significantly presenting all MAC sub asset class managers with the opportunity to outperform on credit market security selection. Which should be the primary driver of returns from this strategy. To be fair they may not recouped all the underperformance, but the last year does not come round very often and the fund has not sufficiently benefitted from the opportunity.

16

Secondly, as table 3 above shows the fund has not been actually been positioned how BCPP believed they had positioned it and they have done little to address the differences over the year. In simple terms the fund has had much more interest rate sensitivity (duration), much more high yield credit risk and emerging market risk and much less loan and securitised credit exposure than they intended when setting as their strategy.

While some of this should have helped performance such as the unintended high yield overweight. This has probably been more than offset by the unintended overweight duration, emerging markets exposure and unintended underweight exposure to floating rate leveraged loans and securitised credit.

As a result I believe Surrey needs to engage with the CIO and manager selection team at BCPP to review the performance objectives of the fund. BCPP should also conduct a fundamental review of the strategy, portfolio construction and policies of how the BCPP MAC fund is run. This review should also include an assessment of the Dynamic Asset Allocation approach, the individual managers and their ability to deliver the required level of return, individually and in combination.

APEX

LGIM – Over 15year Gilt fund

Mandate summary

Surrey have invested in a pooled index tracking fund with Legal & General Investment Management (LGIM) designed to match the positioning and performance of the over 15 year UK government bonds (Gilts). 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.

16

There is also a condition that if the real yield of over 15 year Index Linked Gilts rises 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.

Performance update

As would be expected the fund has performed exactly in line with the movements of the over 15year Gilt index. At the end of December 2024, the value of Surrey's investment was £115.4 million. Most of this increase was achieved in the fourth quarter of 2023 when as I reported last year yields fell sharply, although the bonds will have also delivered some income throughout the year. Over the year the absolute total return of the fund was -10.63% exactly the same as the index. The over 15 year Fixed Interest Gilts Index delivered a significant negative absolute return as yields increased by almost 1.0% to finish the year at a new high since before the GFC of 5.06%

Over the year the real yield of the over 15 year Index Linked Gilt index has increased by 0.9% to +1.75% the highest level in more than 20 years.

Adviser view

LGIM are highly skilled and extremely well resourced to manage this kind of strategy on behalf of the Surrey Pension Fund. They are one of the world leaders in providing this kind of investment approach and their scale and systems enable them to do so at an extremely low cost, lower than the cost the active solution available from BCPP using the same index.

Anthony Fletcher – Independent Adviser to the Surrey Pension Fund

This document is directed only at the person(s) identified on the front cover of this document and is governed by the associated agreements we have with that person. No liability is admitted to any other user of this report and if you are not the named recipient you should not seek to rely upon it.

This document is issued by Apex Investment Advisers Limited (no. 4533331) is a limited company registered in England & Wales. Registered Office: 4th Floor, 140 Aldersgate Street, London, EC1A 4HY. Apex Investment Advisers Limited (FRN 539747) is an Appointed Representatives of Apex Group Fiduciary Services (UK) Limited (FRN 448301) which is Authorised and Regulated by the Financial Conduct Authority.