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Surrey Pension Fund Committee

Bonds Manager Review Meeting Minutes

February 2023

Attendees

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

Background

The purpose of this meeting was to receive an update from BCPP on their Multi-Asset Credit Fund.

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.

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BCPP update

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 benchmark which can be used to assess the performance of each manager relative the asset class in which they invest.

At the end of December 2022, the value of Surrey's investment was £548.7 million, which was -£64.5 million or -10.5% lower than the value in December 2021. Prior to November 2021, the Multi-asset Credit mandate was managed by Western Asset.

Investment strategy and BCPP solution

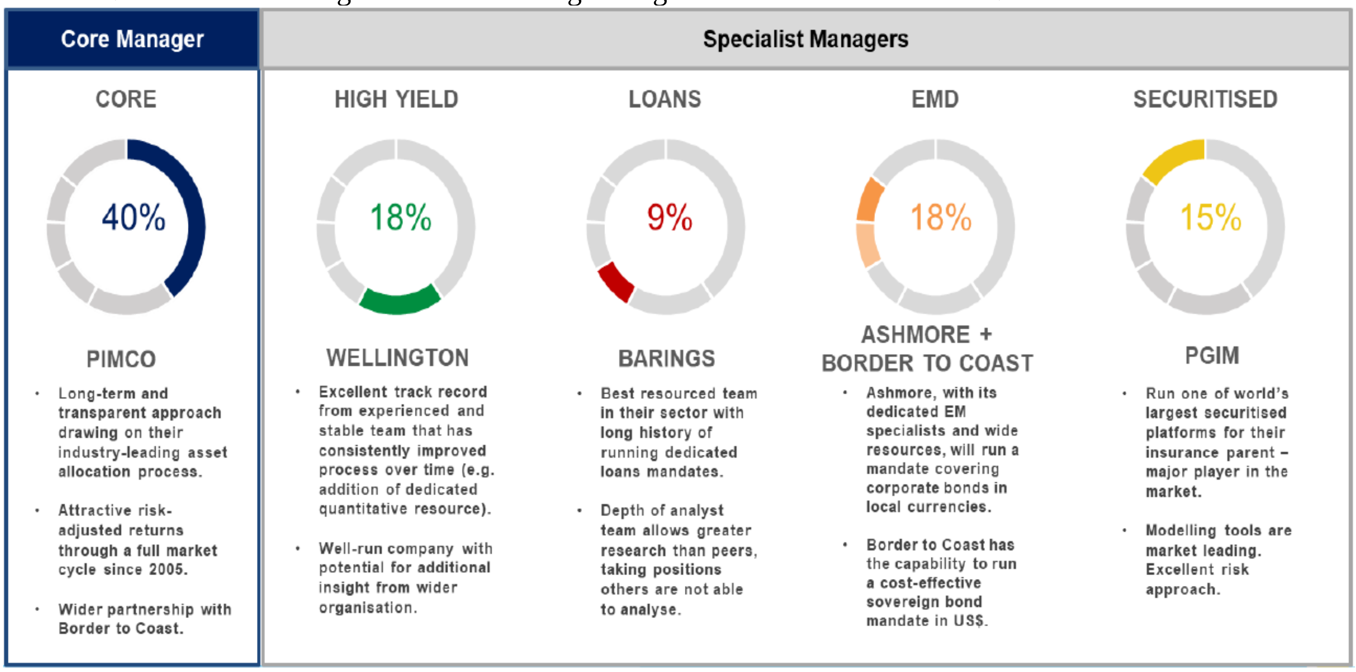
Multi-Asset Credit, or MAC for short covers a very large area of Bond or fixed income investment. Rather than focusing on the direction of interest rates, MAC strategies seek to exploit the drivers of return in the following areas: credit, structure, securitisation, emerging debt, sub-investment grade, frontier debt, un-rated, private debt, private loans and exploitation of the "illiquidity premium".

While many of these opportunities imply higher credit risk and lower liquidity than traditional investment grade government or non-government sectors, they tend to have lower duration which means they have less interest rate risk and sensitivity, combined with a much higher yield that aims to compensate the investor for the lower liquidity and 10
higher credit risk. The asset class might be expected to provide ideal diversification characteristics for an investor looking for higher fixed income returns particularly in a low or rising government bond yield environment.

The BCPP MAC Fund in which Surrey is now invested seeks to exploit all these opportunities. The fund they have designed uses a core and satellite approach. The core manager is PIMCO who run a generalist MAC fund which operates right across the whole non-government bond universe, investing in both Investment grade and sub-investment grade debt. PIMCO have full discretion to tactically allocate wherever they see the opportunity and are expected to be dynamic in their decision making.

Around the core manager BCPP have selected five specialist asset managers (see exhibit 1 below) who each solely manage one sector of the bond market. In the satellites it is BCPP who will be responsible for the tactical allocation between managers. The wavelength of these asset allocation decisions is expected to be longer than PIMCO's partly due to the cost of making the allocation change but also because the decision is designed to be more long term in nature. BCPP's decision making will be based on market intelligence provided by PIMCO and each of the specialist managers and then assessed through the lens of the whole in-house investment team at BCPP.

Exhibit 1: - Shows the managers and their strategic weights in the BCPP MAC Fund.



Market background Calendar year 2022

Over twelve months all sectors of global bond markets delivered huge negative returns, much larger than the negative returns delivered by equity markets, with the highest duration government bond markets delivering the worst returns. 2022 was truly an “annus horribilis” for bond investors especially in the UK with possibly the worst returns for a lifetime. Stability was only restored to the UK government bond (Gilt) market in October 2022 by the intervention of the Bank of England and with the replacement of Liz Truss and Kwasi Kwarteng by the more fiscally prudent Rishi Sunak and Jeremy Hunt. As the Table 1 and Chart 1, below show the negative performance was broad based. The key drivers being much higher and more persistent inflation and more aggressive increases in central bank interest rates than had been expected. While it was long duration (interest rate sensitive) government bond markets that experienced the worst returns all bonds are subject to changes in value when interest rates and inflation increase. The capital value of non-government bonds is also vulnerable to falling equity markets and the vulnerability is higher for lower credit rated sectors.

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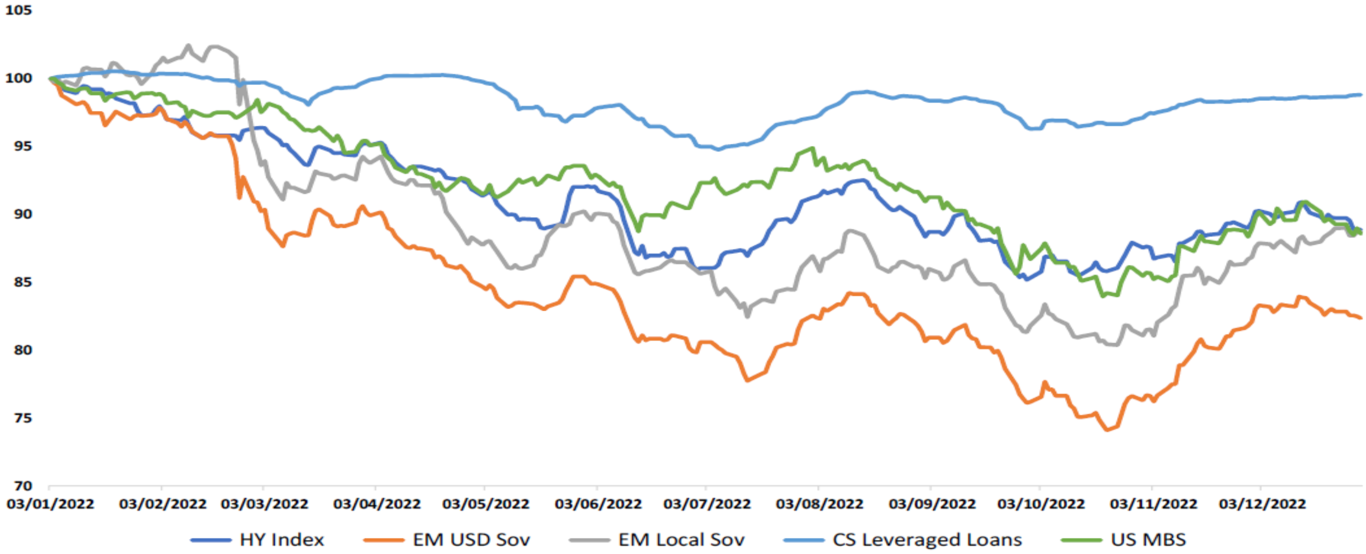
Table 1: - % Total return Period end 31st December 2022

Indices	**3 months**	**12 months**
Global equity FTSE All-World	+2.2	-7.3
UK Gilts - Conventional All Stocks	+1.7	-23.8
UK Gilts - Index Linked All Stocks	-6.0	-33.6
Overseas Government bonds*	-0.4	-12.2
Sterling 7 day SONIA	+0.7	+1.4
UK Investment grade corporate bonds	+7.2	-19.5
Global investment grade corporates*	+2.7	-15.1
Global High yield corporates*	+4.8	-12.6
Emerging market Government bonds*	+7.0	-18.7
Credit Suisse Leverage loans*	+2.2	-1.3
MAC Funds**		
BCPP	**+4.7**	**-10.5**
Another Pool’s MAC fund	+3.7	-8.5
CQS Credit Multi-Asset fund	+2.6	-8.8
Western Asset Multi-Asset Credit fund	+2.8	-12.4

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: - Credit asset class index returns provided by BCPP, indexed to 100, on 1st January 2022.



The sectors of the bond market that MAC funds are invested in are shorter duration and some sectors like loans have floating rather than fixed rate coupons, which means they are less sensitive to changes in interest rates. They also have coupons that are higher than government bonds which over time means the extra income will cushion the impact of falling capital values, driven by rising interest rates. However, the returns of these sectors are also influenced by credit risk, and like equities they have some economic / corporate sensitivity, so they will also tend to sell off when equity prices fall. Credit risk is usually the dominant factor driving their performance because weaker credits tend to be more likely to default. In the event of a default the capital loss will usually far outweigh the higher yield of the investment hence the managers will concentrate their research on trying to buy or avoid buying credits that are mis-priced for the risk of default.

By mitigating the risk of default, MAC managers should be able to deliver a higher level of return from the market sectors in which they invest. In addition, by tactically changing the weight of each asset class for instance in a rising rate environment, increasing the allocation to Loans and reducing the allocation to Hard currency emerging market debt, they should also be able deliver higher returns.

Current position

At inception BCPP positioned the MAC fund with some strategic tilts to reflect their relative value views. Relative to the funds neutral strategic allocations these tilts were +2% overweight Ashmore EM local currency and +1% overweight Barings Leveraged Loans versus -2% underweight Wellington High yield and -1% BCPP underweight EM hard currency. They were neutrally allocated to PIMCO the core manager and PGIM the securitised credit manager. They have made no changes to these strategic relative value tilts in 2022. 10

BCPP presented evidence to suggest that over calendar 2022 the fund had delivered a total return of -10.5% compared to the Public Market Equivalent (secondary benchmark) of -9.9% and suggested that their strategic relative value tilts had made a positive contribution to overall fund performance of +0.2% whereas the performance of the combined managers had made negative contribution to overall performance of -0.8%.

In table 2 below, BCPP have presented the total return of the individual managers and the MAC fund against the primary and secondary benchmarks. It shows that each manager has delivered a negative absolute return since inception, which is substantially behind the primary benchmark. with only Wellington and BCPP delivering a positive relative return when compared to the secondary benchmark. Over 4q22 all the managers delivered positive absolute returns in excess of the primary benchmark and with only PGIM significantly behind their secondary benchmark.

It should be noted that the funds primary benchmark objective is to deliver an absolute return over the investment cycle of Cash + 3.5%, and that each specialist manager has been selected because they have the skill to deliver a return in excess of their chosen secondary benchmark.

Table 2: - Absolute and relative performance of the BCPP MAC Fund and its constituent managers.

	Q4 2022			Since Inception (November 2021)		
	Portfolio	Secondary Benchmark	Relative	Portfolio	Secondary Benchmark	Relative
Ashmore *EM Debt (Local & Corp)*	8.1%	6.7%	*1.4%*	(15.2%)	(12.7%)	*(2.5%)*
Barings *Leveraged Loans*	2.1%	2.2%	*(0.1%)*	(3.2%)	(1.3%)	*(1.8%)*
PGIM *Securitised Credit*	1.78%	3.7%	*(1.9%)*	(3.2%)	(2.1%)	*(1.1%)*
PIMCO *Core Manager*	5.1%	3.6%	*1.4%*	(10.4%)	(10%)	*(0.4%)*
Wellington *High Yield*	4.9%	3.9%	*1%*	(9.5%)	(10.4%)	*0.9%*
Border to Coast *EM Debt (Hard)*	8.2%	7.6%	*0.6%*	(15.7%)	(17.9%)	*2.2%*
Multi-Asset Credit Fund	*4.7%*	*4.2%*	*0.5%*	(9.4%)	(9%)	*(0.4%)*
Primary Benchmark (Cash plus 3.5% p.a.)	4.7%	1.6%	*3.1%*	(9.4%)	4.8%	*(14.1%)*

Adviser view

In my last report on the MAC fund, I said it was 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. After 15 to 16 months this is still the case, but each manager was also selected on their ability to outperform their chosen secondary benchmark and BCPP accepted responsibility for their tactical relative value tilts. At the time I agreed and this is still the case, with BCPP's medium term tilts towards loans and local currency emerging market debt and away from high yield bonds and hard currency emerging market debt. Loans because they have floating rate coupons which re-fix higher as interest rates rise. I also expected increased equity market volatility that could impact high yield bonds despite their low interest rate sensitivity, and because hard currency emerging market debt tends to be more interest rate and dollar sensitive.

I accept that the last year has probably been the worst in living memory for returns from all fixed income markets and especially longer duration government and investment grade non-government bonds as shown in table 1 above. The global reset to more normal levels of interest rates post the emergency level markets have become habituated to since the Global Financial Crisis and extended by the covid pandemic was always going to be painful for bond and equity markets.

However, I am disappointed by is the lack of transparency and inconsistency of the information provided by BCPP. The failure to present a coherent narrative supported by appropriate risk and return data to explain decisions taken by the respective managers and the decisions taken by BCPP around tactical asset allocation decisions has reduced my confidence in their ability to manage what is a fairly complex core / satellite approach to Multi-Asset Credit fund management. In future I would like to see a proper presentation from BCPP of the quality we might expect from an
10 asset management company, that is clear and coherent, showing what they did and why, for the period under examination. If they can do this it will go a long way to improving my confidence in their ability. What I am especially frustrated by is at the current level of bond yields and credit spreads, I believe investing in a good quality MAC strategy represents a significant opportunity for long term investors.

In my last report, I said: - *"Each manager has responsibility to deliver outperformance relative to their own specialist investment strategy. BCPP are responsible for asset allocation decisions and will provide performance attribution for each manager relative to their asset class and performance attribution of their tactical asset allocation decisions. BCPP have no track record of delivery in MAC Tactical Asset Allocation, but I believe with the support of the market intelligence they will be getting from PIMCO and the other managers they have a reasonable chance of delivery, time will tell whether they can add sufficient value to generate the target return."*.

Thus far I am as mentioned above more disappointed with the presentation of; individual asset manager risk and return data; the reasons for the decisions taken at the manager level, and at the fund level; than I am with the performance of the fund. As table 1 shows few MAC managers or individual asset class strategies produced a better return over the calendar year 2022.

Anthony Fletcher – Independent Adviser to the Surrey Pension Fund