# Pensions CIV Sectoral Joint Committee

Item no: 7

## Fixed Income: Addressing the Challenge


| | | | |
|---|---|---|---|
| **Report by:** | Julian Pendock | **Job title:** | Investment Oversight Director, London LGPS CIV Ltd. |
| **Date:** | 10 February 2016 | | |
| **Contact Officer:** | | | |
| **Telephone:** | 020 7934 9887 | **Email:** | Julian.pendock@londonciv.org.uk |



**Summary**

The Local Government Pension Schemes, in common with many pension funds across the globe, require structurally higher cashflows than in the past. This secular change will require a structural re-weighting towards fixed income products, at a time when traditional fixed income products can no longer deliver the returns and outcomes that the pension funds require. Collaboration through the CIV will increase the chance of meeting the cashflow requirements, as the scale of assets will enable the CIV to seek bespoke structured solutions which would likely not be economic for the boroughs on a stand-alone basis.


**Recommendations**

The committee is recommended to:

i. Note the work and findings of the Investment Advisory Committee (IAC) and the CIV officers; and

ii. Approve further work by the IAC and CIV officers to explore more fully the concept of a bespoke CIV product (or range of products) as one possible solution in the quest to secure the required cashflows.

# Fixed Income: Addressing the Challenge

## Introduction

1. Pension funds globally require structurally higher cashflows, as the pension schemes mature. This process has been accelerated in Local Government by cost-cutting measures, which has resulted in a material drop in active members. Moreover, strategic asset allocations will likely be affected by the fact that many risk assets are facing secular headwinds from the confluence of a variety of complex factors, which is also generating demand for products which are not reliant on the appreciation of public market valuations, such as tapping into the illiquidity premium which "patient capital" can access.
2. Traditional fixed income products can no longer be relied upon to deliver the required cashflows, as Central Banks' policies have bid up the price of low-risk bonds, thus crushing the yield (which has an inverse correlation with price).
3. Research and analysis has shown that there is little in the way of commonality and quantum in the London Boroughs' fixed income allocations, and also little in the way of conviction. This is in no way a reflection on the skill sets and diligence of the boroughs' pension officers; rather, this is a reflection of how the structural changes in the fixed income markets have rendered many previously-profitable mandates obsolete, as Central Banks' policies have resulted in many low-volatility, high yield strategies morphing into low-yield and high-volatility mandates.

## The challenges which investors in fixed income currently face

4. The structural changes in the broader fixed income (FI) markets, brought about by Central Banks (CB) "unconventional" policies, have rendered the fixed income asset class far more heterogenous and complex than was previously the case. These changes have brought with them potentially additional reward for FI investors, as well as risk. Investors now more than ever, need to be aware of their required returns as well as their level of risk tolerances in their quest to achieve their required level of cashflow yield. In common with other asset classes, many investors have taken on risks that perhaps are not well understood in the ubiquitous "reach for yield". Some of these fixed income products are akin to picking up pennies in front of the proverbial steamroller; i.e. a strategy which works very well until it comes to a rather abrupt and unhappy end.

## The traditional role of FI asset allocations

5. The first consideration which investors must address is the role of FI in their portfolios. Traditionally, FI exhibited three attributes: safety, income and diversification. Equities were employed as call options on global economic growth and hence generated capital growth, whilst fixed income allocations generated sufficient cashflow to cover the day to day cashflow requirements of pension funds.

## The risks which investors must now navigate

6. Investors must navigate a sobering list of inter-connected issues when considering fixed income, which include the following:
   - Credit Cycle Risk (i.e. near the end of a long economic cycle, hence Default Risk)

- Balance Sheet Risk (Investment Grade credit)
- Duration Risk
- Illiquidity Risk
- Interest Rate Cycle Risk
- Inflation Risk

**The Way Ahead**

7. The selection of FI mandates which can deliver the required solutions for the boroughs will require creative thinking. It is likely that an illiquidity premium will be required in order to attain the required cashflow returns. This in turn means a holistic approach is required; for example, if infrastructure investments deliver the required cashflows, then arguably it is of less importance whether the product is put in the infrastructure "bucket" or fixed income; it is the forecast cashflow returns and risk which matter.
8. The prospect of pooling assets enables CIV officers to approach suitable FI managers and request them to draw the outlines of a bespoke CIV product which would deliver the cashflow required by each borough. The concept has been floated on an informal basis with fund managers who have the resources to deliver a structured product solution.
9. The collation of data in the triennial valuation in 2016 should provide a valuable starting point for the formal process of going to the market. Whilst this means that formal work cannot immediately commence on this project, the following points should be taken into account:
    - Fixed income products have high transaction costs, as the bid-ask spreads have structurally widened, largely as a result of Basel III banking regulations. This means that it would be economically suboptimal to transition funds into and out of an interim solution.
    - It is mission critical to assess and project as accurately as possible the boroughs' cashflow requirements, and this necessitates awaiting the data from the triennial valuation.
    - Tapping an illiquidity premium means great care must be taken in constructing the FI solution, as by definition boroughs would find that exiting the investment would be costly. The extra due diligence required means that more time / resource will be needed.
    - The CIV is currently resource-constrained, and this strictly limits the amount of work which can be conducted on this project given the tight timetables and ambitious pipeline of funds which are slated to be transitioned in 2016.

**IAC Fixed Income Group Analysis and Progress**

10. The IAC Fixed Income sub-group reported to the IAC the findings in the data collected by London CIV from the boroughs on their current fixed income exposure.
11. The boroughs collectively have £4.1bn in fixed income with 28% passively managed (predominately Index linked gilts.) Two boroughs (City of London and Kensington &

Chelsea) have no current direct FI investments (both manage their exposure through a number of multi-asset strategies.)

12. Commonality was found in one viable area (over 5 year Inflation Linked Gilts (ILGs)) specifically with one manager (Legal and General.) The remainder of the investments, as expected, are extremely varied in terms of their place in borough's strategic allocation, and the selection of duration, strategy and manager. Borough’s responses to the data gathering exercise were varied in their depth and detail. A number of themes stood out at first glance, including the number of mandates that have been in place since before 2005.

13. It was suggested that whilst laying the groundwork for an effective long-term solution would take time, the CIV could transition the Legal and General ILG mandate (which currently demonstrates commonality), subject to the agreement of the current borough investors. This would allow the participating boroughs to benefit from some immediate fee savings as well as increasing the AUM of the CIV. A further avenue to explore is the appetite for Multi-Asset Credit (MAC) / Multi Sector Credit (FI products which deploy tactical asset allocation).

**Conclusion**

14. The boroughs are likely to require a structurally greater increase in cashflows in order to meet the evolving demands from maturing pension schemes. Accessing these cashflows will likely require a more creative approach than has previously been required when making allocations to the FI space. Through collaboration, the CIV can help by working with FI managers to create a bespoke, holistic structured product solution. This will require the data from the triennial valuation as the building blocks for the product. In the meantime, with the agreement of the relevant boroughs, the CIV can migrate the relevant ILG mandates onto the CIV, and explore the appointment of MAC managers.

**Recommendations**

15. The committee is recommended to:
    i. Note the work and findings of the Investment Advisory Committee (IAC) and London CIV officers; and
    ii. Approve further work by the IAC and London CIV officers to explore more fully the concept of a bespoke CIV product (or range of products) as one possible solution in the quest to secure the required cashflows.

**Financial Implications**

16. The financial implications are addressed in the report

**Legal implications**

17. There are no legal implications.

**Equalities implications**

18. There are no equalities implications.