Meeting: **Investment Subcommittee**

Date/Time: **Wednesday, 23 April 2014 at 10.00 am**

Location: **Goscote Committee Room, County Hall, Glenfield**

Contact: **Mr. S. Taft (Tel. 0116 305 6339)**

Email: **stephen.taft@leics.gov.uk**

Membership

Mr. G. A. Hart CC (Chairman)

Mr. J. B. Rhodes CC	Cllr. M. Graham
Mr. K. W. P. Lynch CC	Cllr. P. Kitterick
Mr. A. Stephens	Ms. L. Bateman

AGENDA

Item		Report by	
1.	Minutes of the meeting held on 26 March 2014.		(Pages 3-6)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Update on Multi Credit - Bank Replacement.	Investment Consultant	(Pages 7-13)
7.	Update on Multi Credit - Bank Replacement Investing.	Investment Consultant	(Pages 15-30)

8.	Emerging Market Debt - Presentation from Investment Consultant.	Investment Consultant	(Pages 31-36)
9.	Emerging Market Debt - Presentation from Investment Adviser.	Independent Investment Adviser	(Pages 37-46)
10.	Opportunities in Fixed Income - Presentation from Asset Manager.	Asset Manager	(Pages 47-78)
11.	Date of Next Meeting - Wednesday 25 June 2014.		
12.	Any other items which the Chairman has decided to take as urgent.		

Minutes of a meeting of the Investment Subcommittee held at County Hall, Glenfield on Wednesday, 26 March 2014.

PRESENT:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)
Mr. J. B. Rhodes CC
Mr. K. W. P. Lynch CC

Leicester City Council/District Council Representative

Cllr. P. Kitterick
Mr. A. Stephens
Cllr. M. Graham

Staff Representative

Mr. N. Booth

Independent Advisers and Managers

Mr. A. Green	Hymans Robertson
Mr. S. Jamieson	Independent Investment Adviser
Mr. A. Swan	M&G Investments
Mr. P. Taylor	M&G Investments
Mr. P. Clark	Kames Capital
Mr. D. Wise	Kames Capital
Mr. S. McWilliam	Kames Capital

25. Minutes of the meeting held on 16 October 2013

The minutes of the meeting held on 16 October 2013 were taken as read, confirmed and signed.

26. Questions

The Chief Executive reported that no questions had been received under Standing Order 35.

27. Questions asked by members

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

28. Urgent items

There were no urgent items for consideration.

29. Declarations of interest

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting.

No declarations were made.

30. Change to the order of business

With the consent of the Subcommittee, the Chairman agreed to vary the order of business from that set out on the meeting agenda.

31. Recommended Investment in M&G Debt Opportunities Fund II

The Subcommittee considered a report of the Director of Corporate Resources which provided information in respect of a recommended investment in the M&G Debt Opportunities Fund II. A copy of the report marked 'Item 6' is filed with these minutes.

Arising from the discussion, the following points emerged:

i) The proposed investment in M&G Debt Opportunities Fund II (DOF2) would be a continuation of the strategy used by the M&G Debt Opportunities Fund I (DOF1) in which the Pension Fund had an investment. The original fund was 90% drawn with the remaining 10% likely to be filled in June 2014, at which point DOF2 would be opened;

ii) The structure of DOF2 would be identical to that of the first fund, and was therefore classed as a closed-ended investment which was expected to mature by 2019;

iii) Investment opportunities would be carefully selected by M&G Investments in order to create a risk-averse portfolio;

iv) DOF1 had returned significant profit on the Pension Fund's original investment and it was expected that DOF2 would achieve similar results.

RESOLVED:

That the report be noted.

32. Exclusion of Press and Public

RESOLVED

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the following item of business on the grounds that it involves the likely disclosure of exempt information as defined in Part 1 of Schedule 12(A) of the Act:

Item	Exempt Under Paragraph:

Presentation by M&G Investments 3 and 10

[At this point representatives of M&G Investments joined the meeting.]

33. Supplementary Presentation on Recommended Investment in M&G Debt Opportunities Fund II

The Subcommittee received a presentation by M&G Investments outlining its reasoning for why the Pension Fund should invest in its proposed fund. The presentation was followed by questions from members. A copy of the presentation is filed with these minutes marked '10'. The presentation was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

[At this point representatives of M&G Investments withdrew from the meeting.]

Following the presentation, members of the Subcommittee discussed in private whether or not to invest in the proposed fund.

RESOLVED:

a) That the presentation be noted;
b) That a £40m commitment to invest in the M&G Debt Opportunities Fund II be approved.

[The meeting then reconvened into public session.]

34. Proposed Investment in Kames UK Active Value Property Unit Trust

The Subcommittee considered a report of the Director of Corporate Resources which provided information in respect of a recommended investment in the Kames UK Active Value Property Unit Trust. A copy of the report marked 'Item 7' is filed with these minutes.

Arising from the discussion, the following points were noted:

i) An investment in the Kames UK Active Value Property Unit Trust would be consistent with the 'opportunity pool' strategic asset allocation agreed at the Pension Fund Management Board's Strategy meeting in January;

ii) The Fund had already invested in real estate recovery through its Aviva Investors portfolio. An additional investment into the Kames Property Trust would allow the Fund to gain a more meaningful exposure in the secondary property market, which was performing well.

RESOLVED:

That the report be noted.

35. Exclusion of Press and Public

RESOLVED

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the following item of business on the grounds that it involves the likely disclosure of exempt information as defined in Part 1 of Schedule 12(A) of the Act:

Item	Exempt Under Paragraph:
Presentation by Kames Capital	3 and 10

[At this point representatives of Kames Capital joined the meeting.]

36. Supplementary Presentation on Proposed Investment in Kames UK Active Value Property Unit Trust

The Subcommittee received a presentation by Kames Capital outlining its reasoning for why the Pension Fund should invest in its proposed fund. The presentation was followed by questions from members. A copy of the presentation is filed with these minutes marked ‘11’. The presentation was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

[At this point representatives of Kames Capital withdrew from the meeting.]

Following the presentation, members of the Subcommittee discussed in private whether or not to invest in the proposed fund.

RESOLVED:

a) That the presentation be noted;
b) That a £25m commitment to invest in the Kames UK Active Value Property Unit Trust be approved.

[The meeting then reconvened into public session.]

37. Date of Next Meeting - 23 April 2014

It was noted that the next meeting would be held on 23 April 2014.

Wednesday, 26 March 2014
10.00 am - 11.40 am

CHAIRMAN

Multi-Credit: Bank Replacement

Addressee

This paper is addressed to the Investment Subcommittee of Leicestershire County Council Pension Fund ("the Fund"); it provides an extension of our Appendix 5 of our Asset Structure paper addressed to the Pension Fund Management Board of the Fund.

Summary of the Opportunity

- Incoming banking solvency requirements mean that banks will need to continue to reduce debt for an extended period.
- Banks play an important role in funding the economy. In Europe, close to two-thirds of financial intermediation (corporate lending) is serviced through banks. In the US, it is a much smaller figure at 25%.
- As the banking sector continues to shrink, it encourages new forms of capital market-based lending. Investment managers, both traditional and alternative, are now able to substitute banks in some areas of lending, and other more specialised areas of finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks.

Background

The level of debt in the world's developed economies grew steadily for more than a decade before the financial crisis in 2008. Although this leverage was prevalent across all sectors of the economy; it was the financial sector that was most exposed. Following the sub-prime mortgage market blow-up in the US in 2007 the systemic crisis that ensued led banks' expansion to suddenly reverse and a process of deleveraging began.

There are three ways a bank can reduce its leverage:

- they can either raise new equity, which can be costly;
- sell legacy assets held on their balance sheet, which could mean realising significant losses on impaired debt; or
- they can reduce their overall lending activity.

The third of these approaches has been the most economical and therefore the favoured approach taken by the banks to date.

This coupled with the reduction in the overall number of banks, as levels of bankruptcy and mergers increased post the financial crisis has resulted in a lending demand and supply imbalance.

Banks now face further deleveraging pressures with new regulation being the key driver. The Basel Committee of Banking Supervision (BCBS) has revised its existing capital adequacy guidelines and, with endorsement from the G20, is now implementing the Basel III framework. The key impacts of this are an increase in capital requirements for banks, changes to the way counterparty risk is assessed and the re-rating of certain risky assets. Basel III only began to be phased in early in 2013, with the implementation period expected to last five years to January 2018.

Higher capital requirements and liquidity constraints will lead to a multi-year process of deleveraging with central estimates ranging from $2 trillion to $10 trillion still to come off banks' balance sheets. Banks have already begun doing this via asset disposals and term funding, but need other options.

Opportunities for institutional investors

Banks play an important role in funding the economy. In Europe, close to two thirds of corporate lending is done by the banks. In the US, by comparison only about 25% of the economy is bank financed.

The supply of debt financing has a strong bearing on the wider economy. As bank disintermediation (the withdrawal of lending) takes hold and the banking sector continues to shrink, it encourages new forms of capital market-based lending. Investment managers, both traditional and alternative, are now able to substitute banks in some areas of lending, and other more specialised areas of finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks.

One may argue that capital markets participation in lending activities which were previously the domain of banks is not sustainable, and in fact reflects a search for yield in an environment when low risk assets offer little in the way of return. However in our view the bank retrenchment is resulting in a longer-term structural shift in the financial industry – especially in Europe – and going forward there will be an increase in demand for non-bank intermediaries to meet the credit needs of the economy. As long-term investors, pension funds are well placed to meet this need.

We have identified a number of asset classes and/or investment strategies that have the potential to exploit the global financial deleveraging. The major ones are summarised in the table below.

Asset Class/Strategy	Brief description	Expected return	Rating	Liquidity
Senior Secured Corporate Debt	Private or syndicated lending to sub-investment grade companies. Senior and secured on assets	LIBOR + 4.0 – 6.0% (syndicated); LIBOR + 4.5 -7.0% (private)	BB - CCC	Reasonably liquid (syndicated); 5 Years + (private)
Mezzanine Corporate Debt	Private lending to sub-investment grade companies. Subordinated to the senior debt often with an equity component	10% - 15% IRR	≤CCC	10 Years
Distressed Debt	Purchase of assets at stressed prices or securities of companies in financial or operating difficulties	15 - 20% IRR	≤CCC	5-7 Years
Senior Property Debt	Lending to property investors at the senior secured level. Properties can be either prime or high quality secondary	LIBOR + 2 - 6% although some debt defined as fixed rate	A	5-10 Years
Infrastructure Debt	Private lending to infrastructure projects at the senior, secured and subordinate lending	2.5 - 7% although some debt defined as fixed rate	Wide range	5-10+ Years
Asset-backed securities	Income payments from multiple underlying loans, which are then collateralised (or "backed") by a specified pool of underlying assets.	LIBOR + 0.5 - 4.0%+	AAA - unrated	Liquid, but can take time to build a portfolio as new stock limited
High Yield	Lending to large companies. Typically unsecured.	4% - 6%	BB - CCC	Reasonably liquid

Multi-Asset Credit Investing

The debt markets we have identified above provide a much wider range of higher yielding opportunities beyond traditional fixed interest investment grade bonds. These markets provide diversification by issuer and by bond type, and although correlated, markets do not necessarily move in parallel with one another.

Key attractions, given the withdrawal of bank lending and the level of current interest rates, are the additional yield that these markets can provide and the floating rate nature (i.e. coupons linked to LIBOR rather than fixed rates) of much of the opportunity set.

By using multi-asset credit mandates to access these debt markets rather than a number of discreet specialist managers, the manager can rotate assets over time to the opportunity set providing highest return per unit of risk, access to market can be faster, and the governance burden is limited to a single manager appointment.

A number of managers run Absolute Return credit portfolios that combine the above with more traditional active bond strategies, such as duration risk and currency management. The latter is not our focus, which is very much on allocating capital to attractive parts of the capital lending market in pursuit of stable and secure yield, rather than significant levels of active trading.

The benchmark for this type of mandate is normally set as a cash plus benchmark to avoid portfolio biases, e.g. LIBOR+4% p.a. net of fees.

Managers may be expected to include investment grade bonds as a “safe haven” if the price of the asset types listed above appears high. However, we are not targeting strategies that have a persistent holding in investment grade corporate bonds, as this will reduce the target level of return (as is the case for the current JPMorgan mandate).

Some managers may make small allocations to distressed debt to further enhance returns, although these are typically small as they are illiquid strategies. The Fund already has an allocation to distressed debt, but given it would form a small part of any multi-credit mandate and there would be a high level of stock specific diversification, we do not consider this to be of any concern.

Portfolios can be structured on a segregated basis or pooled arrangement.

A segregated mandate enables greater control around investment constraints (e.g. limit on overall rating quality) and additional flexibility (e.g. exposure to lower rated investments, Collateralised Loan Obligations (CLOs) and investment in peripheral European opportunities), thus allowing the investor to better define the target return and tailor the risk profile of the portfolio to that required.

However, pooled fund solutions provide easier implementation and on-going governance and would be less dependent upon a minimum level of investment. We are looking at a pooled fund solutions for this allocation.

Closed ended funds provide greater access to private/originated debt opportunities, whereas open ended funds typically focus solely on more liquid debt markets.

More details on some of the debt strategies are included in the Appendix.

Associated Risks

The risks associated with a multi-credit portfolio will vary by debt type, but also within each debt type there will be potential for variation in the terms of each bond. Key risks are as follows:

- Issuer or portfolio credit risk, i.e. risk of a down-grade and/or default;
- Prepayment risk, i.e. early repayment leading to a loss of the yield enhancement;
- Liquidity risk – some debt instruments are illiquid in nature (e.g. the direct lending markets, including corporate loans and real estate debt). Other elements of the market can become more illiquid under stress;
- Reinvestment risk – in the case of pooled funds, it may be that the yield benefit or discount to par price of existing investments becomes diluted if a pooled fund automatically reinvests proceeds into new bonds/loans, and where the yield on these is lower than on existing investments and, therefore, no longer sufficiently attractive. This is of particular relevance for single strategy pooled funds, where closed ended funds, such as the M&G DOF II, may be more appropriate.

Notes and Risk Warnings

The report should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the note is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the note may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix

Distressed Debt

The term 'distressed debt' encompasses a variety of instruments, including high yield and investment grade bonds, bank loans, private corporate lending, asset backed securities, real estate and infrastructure debt. Distressed managers target debt trading at a meaningful discount to its par value (>40%). Typically, the issuing entities are, or have been, in financial and/or operational difficulties.

In many instances investors look to gain profits by maximising recovery value post default, through undertaking a financial restructuring of the borrowing entity. Although we might expect there to be a degree of correlation with the high yield bond markets, the returns of distressed debt portfolios will be extremely security specific, depending on the success or otherwise of the managers' restructuring activities, etc.

Senior Secured Corporate Debt (Syndicated and direct)

Senior secured lending involves lending to US and / or European sub-investment grade companies. The lending can be either through bank origination and syndicating out to the primary market or through non-bank lenders privately negotiated deals direct with the borrowers. Typically privately negotiated deals which have a limited if any secondary market offers a liquidity premium over the syndicated market which has a functioning (to varying degrees) secondary market.

Current trends suggest that lenders to the private market can expect to be paid an illiquidity premium of 1- 2% over the more liquid syndicated loans market.

In general this involves lending to midsized companies as their size prohibits them raising finance through the public high yield bond markets. The purpose of the borrowing will typically be to finance company growth, acquisitions, mergers and private equity sponsored leveraged buy outs (LBOs). As the name suggests, senior secured loans sit senior (1st lien) within an issuer's capital structure and are secured against specific company assets. In the event of bankruptcy, senior debt will be repaid before other subordinated lenders. Historically, banks have been the dominant lender in this space. However, post Lehmans, regulation has forced banks to scale back their lending activities creating a demand for privately negotiated non-bank lenders.

Mezzanine Corporate Debt

Mezzanine debt is unsecured, subordinated, private lending to companies typically with an equity component. The debt sits subordinate to senior debt within a company's capital structure and will often have no specific asset backing. Exposure to mezzanine debt can be through specialist funds or multi direct lending funds which will combine exposures to mezzanine debt alongside senior secured lending.

Currently funds in the process of raising capital are targeting returns of between 10% and 15% per annum, depending on the expected level of mezzanine exposure. Clearly, this return target reflects a significant degree of asset risk and an illiquidity premium. Schemes looking for a medium-term strategic diversifier from equity risk, who are willing to give up liquidity for an extended period in order to achieve a significant yield premium, could consider mezzanine as an addition to the growth portfolio.

Senior Property Debt

Senior property debt involves lending to UK and / or European commercial property investors, either on a fixed or floating rate basis. Prior to the financial crisis banks were the main source of funding in this market. However, as with other direct lending opportunities now exist for non-bank lenders. Borrowers in this market include sovereign wealth funds, listed property companies and insurance companies. The term of lending is negotiable and can vary from 4 – 10 years. The market is private in nature, with no established secondary market (at this point). As such clients need to accept illiquidity during the loan term; typically around 10 years.

A key measure of quality is the loan-to-value ratio ("LTV"), the proportion of the value of the assets on which the loan is secured equivalent to the amount of the relevant lending plus any prior claims.

The assets backing the lending can be prime properties, such as long term fully occupied office building in the City of London, or can be what is termed secondary. Typically a secondary property will sit outside the prime City of London location and will have some ability for the purchases to add value, e.g. implement a business plan to increase occupancy levels to increase rental income. Currently the senior secondary market offers c3% premium over the prime senior lending market.

In addition to the senior property debt market, there is a mezzanine property debt market, which acts like the mezzanine corporate lending market, in terms of sitting between senior debt and equity, with a correspondingly higher yield than senior debt. This is a much smaller market than the senior real estate debt market.

Infrastructure Debt

The case for investing in infrastructure debt is very similar to that for property debt – scarcity of capital should result in higher income returns than has been available in the past. Initially banks continued to lend on core infrastructure assets since the cash flows are viewed as predictable and stable.

However, regulatory changes such as Basel III is reducing lending, in particular long term lending with short-term liabilities through increased capital charges. As a result, we have started to see a wave of infrastructure debt products launch which invest at both the senior and more junior levels. This market is in its infancy, although a relatively small number of fund managers have operated in the infrastructure debt arena for over 10 years (mainly in Australia).

There is little standardisation of products. One of the attractions highlighted by infrastructure debt proponents is the inflation-linkage characteristics of infrastructure assets. However, in reality, the debt funds are not distributing inflation-linked coupons, nor does the principal invested grow with inflation.

Asset backed securities (ABS)

Although not a directly affected by the bank deleveraging in the same way, ABS pricing suffered on the back of the financial crisis, and ABS bonds offer many of the same relative value attraction of the above, and would often be included in a multi-asset credit portfolio of bonds. Hence, we include some comment on them here for completeness.

ABS are bonds which are collateralised by a pool of underlying loans which generate the cash flows from which income and capital payments on the bond are made. The source or type of the loan pools can vary, e.g. residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS) and credit card loans. The loans are pooled in a special purpose vehicle (SPV), a company specifically set up to hold the loans and coordinate payments and which does nothing else. The SPV will usually issue a range of securities backed by the same pool of loans but carrying different levels of exposure to the risk of default in the underlying loans (and, as a consequence, different coupons). Typically bonds will be issued with maturities of between 2 and 10 years and will be floating rate over LIBOR.

The ABS universe offers a wide range of risk / return, ranging from prime RMBS (rated AAA by the public rating agencies) with current spreads over cash of less than 1% through to sub-investment grade paper offering high single digit spreads. RMBS form the bulk of most European ABS funds. The US market is of relatively limited interest in the current context. It is divided between agency RMBS, which is backed by the government and provides limited yield, and non-agency RMBS, which is mainly high-risk, sub-prime borrowing.

There are also some opportunities in European CMBS (where the diversification of underlying loans is much less than for RMBS) and ABS backed by other assets.

High Yield Bonds

These are corporate bonds, also referred to as ‘sub-investment grade’ bonds, as they are rated below BBB. The universe will included bonds which are rated sub-investment grade at issue and those which have been downgraded to sub-investment grade by the public rating agencies. Often the debt is unsecured, i.e. with no backing assets and sits below any senior secured debt. Typically the debt is issued with a fixed rate with terms of 5 years plus. The high yield bond market has a higher average loss from defaults than the investment grade credit market and as such pays higher coupons to compensate investors for this increased risk and the greater volatility in pricing.

The US market dominates in terms of market size (currently standing at circa $1. 2tr of outstanding debt). However, the European high yield debt market has been growing in recent years as banks have pulled away from sub-investment grade lending and currently stands at circa $350bn.

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Leicestershire County Council Investment Subcommittee

Multi-credit: Bank Replacement Investing

- Andy Green
- 23 April 2014

PUBLIC SECTOR

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Agenda

- Recap: the proposed mandates in the context of LCCPF
- What is multi-asset credit
- Why invest in it
- How to invest in it
- Outline of debt markets

16

HYMANS ROBERTSON

Structure - current

Equities (42% - 52%)

	Manager	Target %
UK	LGIM	12.0
Regional	LGIM	20.0
Equitised	Kames	1.5
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	6.0
	Capital	
	Delaware	
Private	Adams Street	4.0

Inflation Linked (12.5%)

	Manager	Target %
Ind-linked	Implemented	7.5
Infrastruct.	IFM	3.0
	KKR	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
FoFunds	Aviva	5.0
Direct	Colliers	5.0

Commodities (3%)

	Manager	Target %
	Investec	3.0

Alternative (22.5% - 32.5%)

	Manager	Target %
Targeted	Ruffer	7.4
	Pictet	5.3
	Aspect	3.5
	Aviva G7	1.3
Credit	JP Morgan	3.4
	M&G	1.6
Opp. pool		0-10

Overlay (0%)

	Manager	Target %
TAA	Kames	-
Currency	Millennium / Mellon	-

Return seeking
Real assets
Diversifying

HYMANS ROBERTSON

Required rate of return 4% p.a. real

An aggregate rate; not every mandate needs to deliver this return

	Weight (%)	Real Return (% p.a.)	Contribution to Return (%)
Equities (52%)			
Listed equity	46.5	4.3	2.00
Private equity	4	6.5	0.26
Real (25.5%)			
Inflation linked bonds	7.5	0.7	0.05
Infrastructure	3	3.8	0.11
Timber	2	3.3	0.07
Property	10	2.7	0.27
Commodities	3	2.0	0.06
Alternatives/Diversifiers (22.5%)			
Targeted return	17.5	(4.0) 3.0	0.52
Global Credit	5.0	(3.0) 2.0	0.10
Opportunity Pool	1.5	4.3	0.06
Currency overlay (Notional weight)	(26)	(1.0) 0.4	0.10
TOTAL	**100**		(4.0) **3.6**

18

Mandates to review

Pictet
JP Morgan

Mellon
Kames

Structure - proposed

19

Equities (50-52%)

	Manager	Target %
UK	LGIM	12.0
Regional	LGIM	22.5
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	5.5
	Capital	
	Delaware	
Private	Adams Street	4.0

Inflation Linked (12.5%)

	Manager	Target %
Ind-linked	Implemented	7.5
Infrastruct.	IFM	3.0
	KKR	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
Fund of Funds	Aviva	5.0
Direct	Colliers	5.0

Commodities (3%)

	Manager	Target %
	Investec	3.0

Alternative (22.5-24.5%)

	Manager	Target %
Targeted	Ruffer	7.5
	Aspect	3.5
Other opportunities		
EM Debt	To be decided	2.5
Credit Opps	Other credit incl. JPM	5.0
Other opp. pool	Incl. M&G at 2.5% and Kames Property at 1.0%	4.0-6.0

Overlay (0%)

	Manager	Target %
Currency	Millennium	-

Return seeking
Real assets
Diversifying

HYMANS ROBERTSON

Proposed strategy - forecast return

An aggregate rate, real return closer to 4.0%

	Weight (%)	Real Return (% p.a.)	Contribution to Return (%)
Equities (52%)			
Listed equity	48	4.3	2.06
Private equity	4	6.5	0.26
Real (25.5%)			
Inflation linked bonds	7.5	0.7	0.05
Infrastructure	3	3.8	0.11
Timber	2	3.3	0.07
Property	10	2.7	0.27
Commodities	3	2.0	0.06
Alternatives/Diversifiers (22.5%)			
Targeted return	11.0	4.0	0.44
Emerging Market Debt	2.5	3.0	0.08
Global Credit	5.0	4.0	0.20
Opportunity Pool	4.0	4.3	0.17
Currency overlay (Notional weight)	(13)	1.0	0.13
TOTAL	**100**		**3.9**

Proposed Mandates

EMD
Multi-credit
DOF II/Kames Property

HYMANS ROBERTSON

What is multi-asset credit?

- Multi-asset credit is an allocation to debt markets, where the manager has discretion to allocate between the different markets.
- Our particular focus is on higher yielding markets, typically sub-investment grade
- Hence, this should be viewed as a return seeking asset, typically with lower risk than equities
- Given a higher return target than investment grade credit mandates, managers will typically focus on:
  - High yield bonds
  - Secured Loans (public and private)
  - Asset Backed Securities (ABS)
  - Property & Infrastructure Debt (although often limited due to illiquidity)
- Other allocations may include convertible bonds & distressed debt
- Some managers will include EMD, but this normally requires a separate skill set/specialist team
- Managers may also include investment grade bonds as a “safe haven” if the price of the asset types listed above appears high
- It is not intended to include active currency or interest rate positioning

Why invest in multi-asset credit?

- The broad arguments for a strategic allocation to multi-asset credit:
  - Bond markets provide wider range of opportunities beyond traditional fixed interest investment grade bonds
  - These broader markets provide diversification by issuer and by bond type. In particular, not all credit markets move in parallel
  - By allocating to multi-asset credit rather than discreet fixed allocations, the manager can rotate assets over time to the opportunity set providing highest return per unit of risk
- The specific opportunity is based around Ex-banking lending:
  - Incoming banking solvency requirements mean that banks will need to continue to reduce debt for an extended period
  - As the banking sector continues to shrink, it encourages new forms of capital market-based lending. Investment managers are now able to substitute banks in some areas of lending and finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks
  - Key attractions are the additional yield that these portfolios can provide and the floating rate nature of many of these assets (linked to LIBOR) rather than fixed rate.

How to invest in multi-asset credit?

- A growing number of bond managers have broad enough skill set to manage multi-credit mandates
- These range from large global bond managers with teams specialising in each area of credit markets (potentially including EMD) through to specialist credit managers, with experience in securitised debt and originated corporate lending
- The target benchmark for this mandate, set to have a high enough return and to avoid portfolio biases, would be circa LIBOR+4% p.a. net of fees
- Mandates can be segregated or pooled; we are looking for a pooled solution
- Products may be open ended or closed ended funds. Those funds with a high focus on illiquid debt markets (typically originated debt) will use a closed ended fund structure. Either may be suitable for the Fund.

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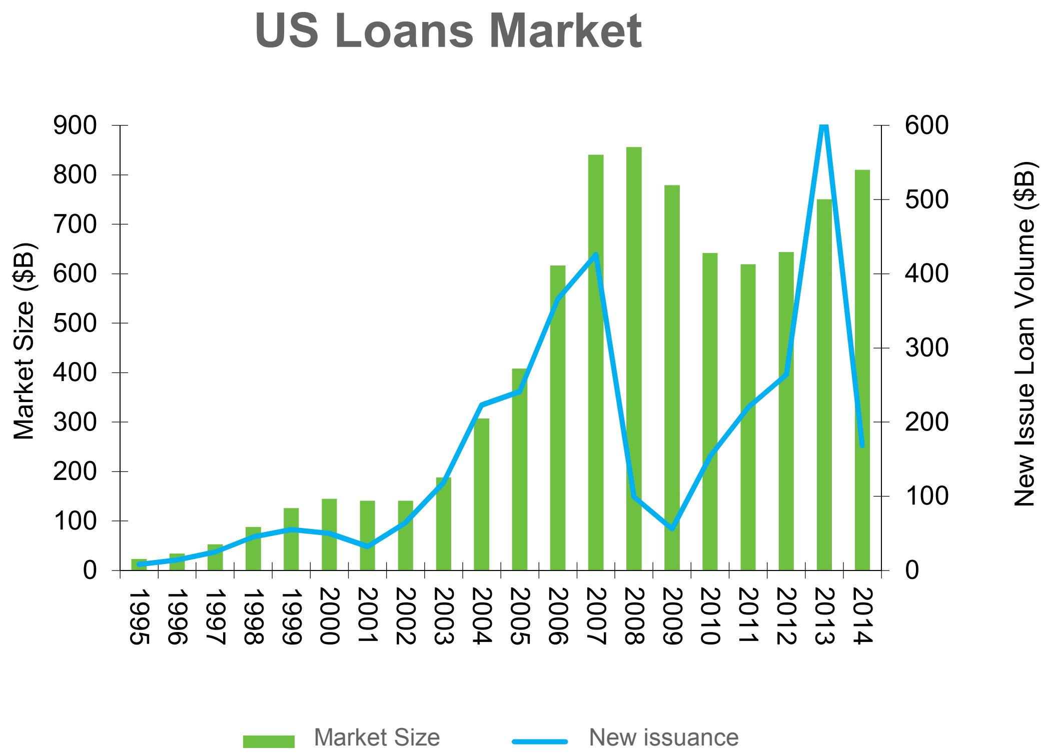
Summary of Opportunity Set

Asset Class/Strategy	Brief description	Expected return	Rating	Liquidity
Senior Secured Corporate Debt	Private or syndicated lending to sub-investment grade companies. Senior and secured on assets	LIBOR + 4.0 – 6.0% (syndicated); LIBOR + 4.5 -7.0% (private)	BB - CCC	Reasonably liquid (syndicated); 5 Years + (private)
Mezzanine Corporate Debt	Private lending to sub-investment grade companies. Subordinated to the senior debt often with an equity component	10% - 15% IRR	≤CCC	10 Years
Distressed Debt	Purchase of assets at stressed prices or securities of companies in financial or operating difficulties	15 - 20% IRR	≤CCC	5-7 Years
Senior Property Debt	Lending to property investors at the senior secured level. Properties can be either prime or high quality secondary	LIBOR + 2 - 6% although some debt defined as fixed rate	A - BB	5-10 Years
Infrastructure Debt	Private lending to infrastructure projects at the senior secured and subordinate level	2.5 - 7% although some debt defined as fixed rate	Wide range	5-10+ Years
Asset-backed securities	Income payments from multiple underlying loans, which are then collateralised (or "backed") by a specified pool of underlying assets.	LIBOR + 0.5 - 4.0%+	AAA - unrated	Liquid, but can take time to build a portfolio as new stock limited
High Yield	Lending to large companies. Typically unsecured.	4% - 6%	BB - CCC	Reasonably liquid

Senior Secured (Leveraged) Loans

- Debt issued by sub-investment grade companies with high levels of debt
- Senior in capital structure; secured on the issuing company's assets
- Floating rate notes, i.e. coupons based on LIBOR plus a spread
- Short to medium term, with pre-payment risk
- Private (illiquid) or public (primary and secondary) market traded
- Private debt should offer a premium over public debt for illiquidity
- US market comprises c.80%, remainder European



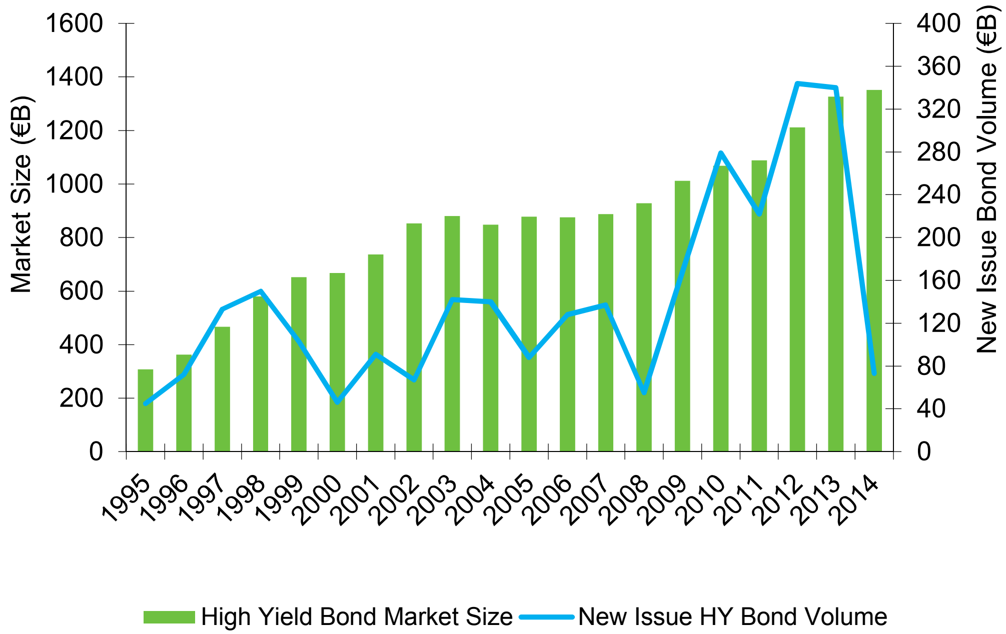
Source: Babson Capital

25

High yield bonds

- Corporate bonds issued by sub-investment grade companies
- Often unsecured debt (not backed by assets)
- Defined 'high yield' by rating agencies (<BBB for S&P)
- Universe includes downgraded investment grade bonds
- Historically higher average loss from defaults relative to investment grade credit
- Pay higher coupons to compensate investors for increased default risk
- Bank deleveraging has resulted in a growth in new issuance volume in the US and European
- US market dominates, accounting for c$1,200bn of outstanding debt

US High Yield Bond Market

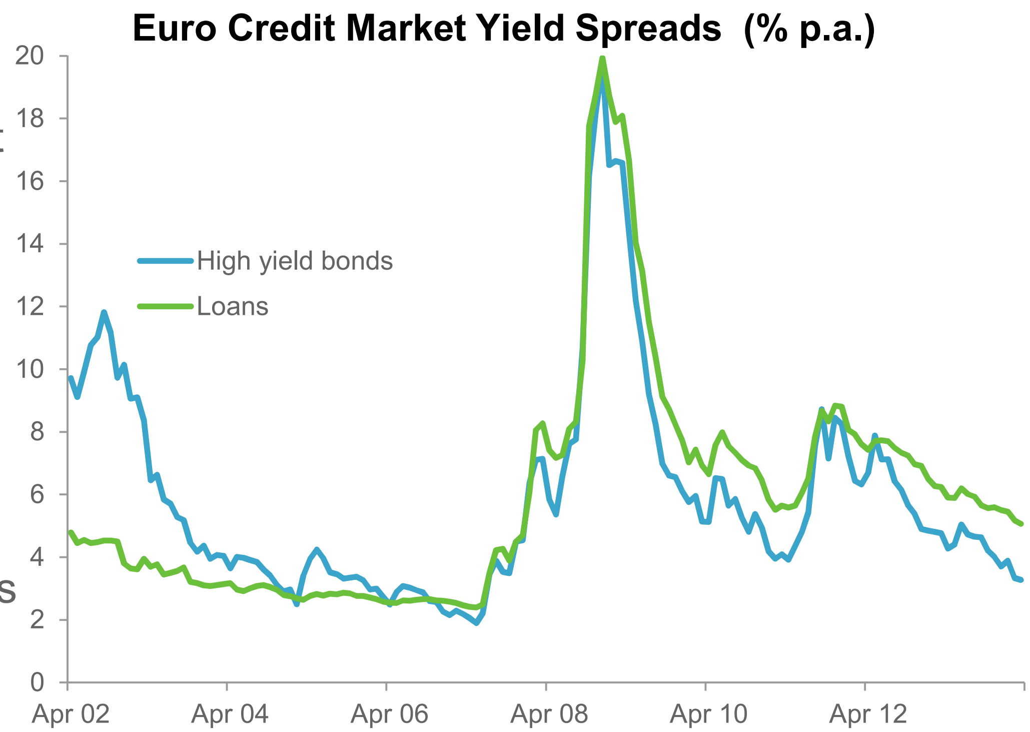


Source: Babson Capital

26

Current Credit Market Pricing
High Yield versus Loans

- Even since the spike and reversal of spreads in 2008/2009, high yield credit markets have experienced spread compression in the last couple of years.
- Bonds look expensive at the index level, particularly in Europe. However wide dispersion across ratings.
- For example, yields on single B new issuance in European High Yield bonds c2% higher than BB rated issuance.
- Spreads on loans have been less affected, and remain attractive on a relative basis, in particularly given the assets security.

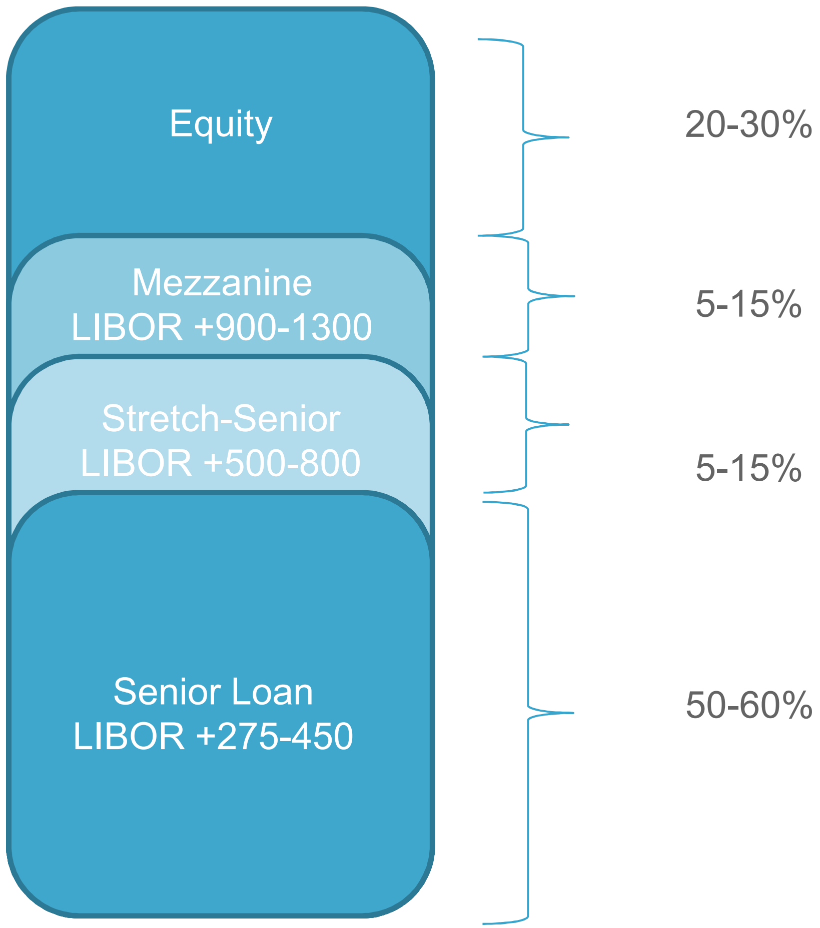


Source: Babson Capital

27

Property Debt

- Lending to commercial property investors with a focus on UK and European opportunities
- Borrowers include private equity sponsors and listed property companies raising capital to refinance or to fund new property development
- Fixed or floating rate debt with terms of lending varying from 4 to 10 years
- Senior or mezzanine available reflecting risk appetite
- Senior lenders have a priority, or ‘first lien’ claim on the property assets backing the loan in the event of a default
- Key measure of quality is the loan-to-value ratio (“LTV”). Senior property debt managers currently point to typical LTVs of up to 60%
- Spread compression has occurred on senior debt backed by prime London properties. However, senior debt on quality secondary still looks attractive.



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Additional Notes

Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Emerging Market Debt

Addressee

This paper is addressed to the Investment Subcommittee of Leicestershire County Council Pension Fund ("the Fund"); it provides an updated version of Appendix 6 of our Asset Structure paper addressed to the Pension Fund Management Board of the Fund.

Highlights

- Emerging Market Debt is issued as external debt (typically denominated in US$ or Euro, and referred to as hard currency debt) or local currency debt;
- The markets are substantial in size;
- The yield available on Emerging Market Debt has risen in recent months and may now provide an attractive entry point to these markets.

Background

Emerging Market Debt yield spreads over developed market bonds have widened in recent months. Whilst a number of the Emerging Debt markets warrant these higher yields (because of their higher risk), current yield levels present a potentially attractive entry point to these markets at a time when developed markets still offer little value.

Chart 1: Yield premium

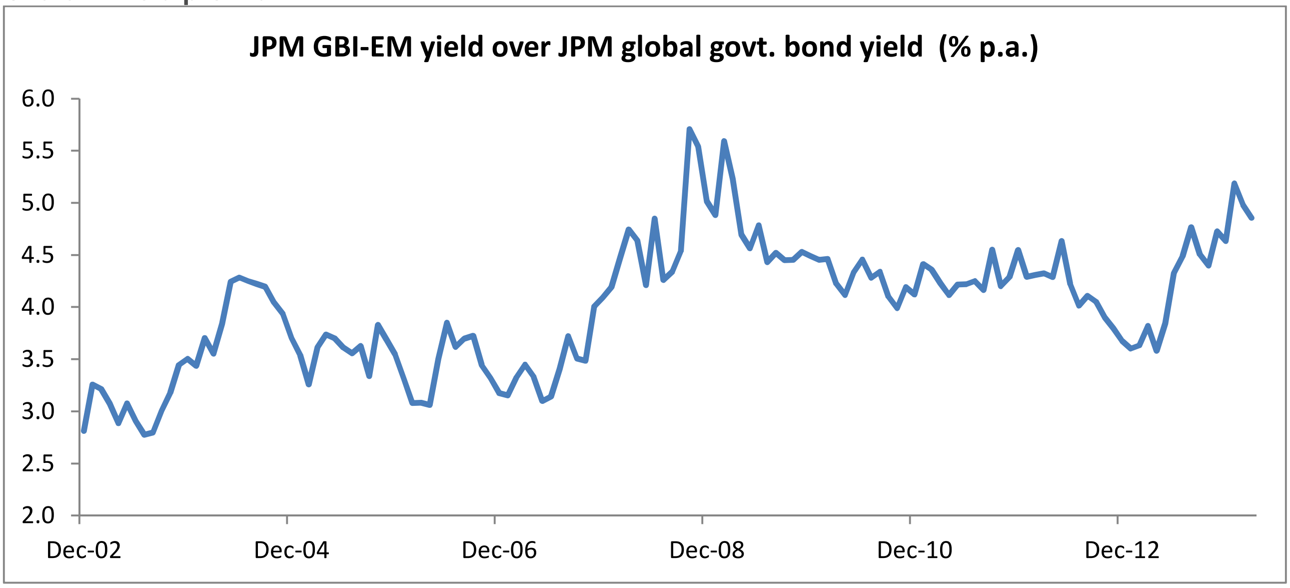


Chart 1 above shows that the yield on the **local** Emerging Market Debt index (JPM GBI-EM Diversified), which equates to an absolute yield of 6.8%, currently offers a 4.8% premium over the Global Government Bond index (JPM Global Govt. Bond).

In the context of the Fund's return requirement of at least 4% per annum real, this would appear to be a sufficiently attractive return; with expected volatility around 10% per annum, the risk adjusted returns are also attractive.

EMD can be considered as part of a broader allocation to higher yielding bonds, or as a stand-alone return generator. The Fund currently has some exposure to EMD within the JPMorgan mandate, although in practice, this has only ever been a small percentage of that mandate.

Development of EMD Markets

There have been four major phases in the development of the EMD market in the last 30 years;

- Prior to the late 1980's the majority of debt capital to Emerging Market (EM) countries was provided in loan format by commercial banks.
- The late 1980's through to the mid 1990's saw the transfer of this loan finance into the wider capital markets through tradable 'Brady bonds'. These bonds helped to form the basis of a more efficient, liquid market as it stands today.
- The mid 1990's onwards saw the growth of US dollar (hard currency) denominated EMD which was heavily skewed towards Latin America. The market went through a number of crises (e.g. the Asian financial crisis in 1997 and the 1998 Russian default). However, the improvement in fiscal and monetary policies in many EM countries has produced a steady increase in the credit quality.
- 2000 onwards has seen the rise of local rather than hard currency EMD. This now represents the majority of the market in terms of outstanding debt issuance.

Today's diverse EMD asset class is the result of fundamental changes in many EM countries. These countries now run disciplined fiscal and monetary policies which allay investors' concerns about the potential for inflation, currency devaluation or bond defaults.

In brief, the universe has evolved into both hard and local currency sovereign representation (including inflation-linked) and corporate bonds, a continual improvement in credit quality, and broader index representation from 5 continents and nearly 50 countries.

Evolution of the Emerging Markets Debt Universe.

Source: Russell Research

We comment below of the three categories of the current EMD universe:

- Hard currency - Sovereign and quasi-sovereign bonds denominated in major international currencies;
- Local currency - Sovereign and quasi-sovereign government bonds issued in each country's own currency;
- Corporate bonds - Debt instruments issued by public and private sector corporate issuers.

Hard Currency

Emerging Markets hard currency debt, also referred to as external debt, consists of dollar and euro denominated sovereign bonds. The asset class originally emerged out of the Brady Plan to restructure and standardise the market for EMD instruments in the 1980's and were named 'Brady bonds'

Hard currency debt is a USD1.4 trillion investment universe, which includes 54 countries and more than 325 securities. However, the investable universe (represented by the market's preferred index JPM EMBI Global Diversified) has a market capitalisation of approximately USD 330 bn.

The primary risk faced by investors in hard currency EMD is credit risk (the risk that the principal or coupon is not repaid, including changes in capital value due to the markets assessment of this risk).

Local Currency

Local currency bond markets are now the largest component of the EMD universe. This change has happened as EM government finances have improved, enabling longer debt maturity and allowing them to borrow in local currency at reduced cost.

The growth in the asset class has coincided with the establishment of pension funds across Emerging Markets over the past decade. Pension funds and other domestic financial institutions such as insurance companies and mutual funds have been buyers of this longer- dated debt. It is now an USD 6 trillion universe, but as is the case for hard currency debt, the investable universe (represented by the market's preferred index, the JPM GBI-EM Global Diversified) has as a market capitalisation of approximately USD 926bn.

Local currency debt gives an investor exposure to both rates and currencies across Asia, Latin America, Eastern Europe, and increasingly to frontier markets, such as Vietnam, Pakistan and Nigeria. These markets are influenced by the same domestic and international factors that influence developed sovereign bond markets.

The main risk and return factors faced by local currency EMD investors are interest rates and the appreciation or depreciation of the local currency.

The majority of EM local currency sovereign bonds are owned by domestic (local EM) investors; however the overseas institutional investor base has been growing. One of the important drivers of return from local currency EMD is the appreciation/depreciation of the currency. This has been an important driver of local currency EMD returns historically. EM currencies have become increasingly volatile since the 2008 financial crisis (e.g. in September 2011, May 2012) and are likely to remain an important driver of returns and volatility going forward.

Corporate Bonds

Global financial markets are today channelling more capital into the private sector in Emerging Markets than into the public sector. Since 2003 EM corporate debt issuance has been approximately twice that of sovereign debt issuance and EM corporate debt has rapidly developed into a significant asset class.

Many EM corporates are global-sized players who are among the world's lowest cost producers with leverage in both investment grade and high yield EM corporate debt materially lower than leverage in comparable developed market corporates. Approximately 70% of EM corporate debt stock is investment grade and includes issuers from around 70 countries.

The primary issuance is in **hard currency**. Corporate bonds now constitute the majority of outstanding EM hard currency debt. The investable universe is approximately $280bn.

Default rates have declined dramatically compared to a decade ago, as companies have reduced gearing and strengthened their balance sheets. However, 2009 was the year of high default rates, with a default rate for high yield EM corporate bonds of 6.1% (of which approximately 75% came from the Kazakhstan banking sector). This compares with, for example, 11.2% for US high yield corporate bonds.

Liquidity can be an issue with the smallest 300 (of 520 issuers) in the index accounting for less than 20% of the outstanding market value.

The Leading Benchmark Indices

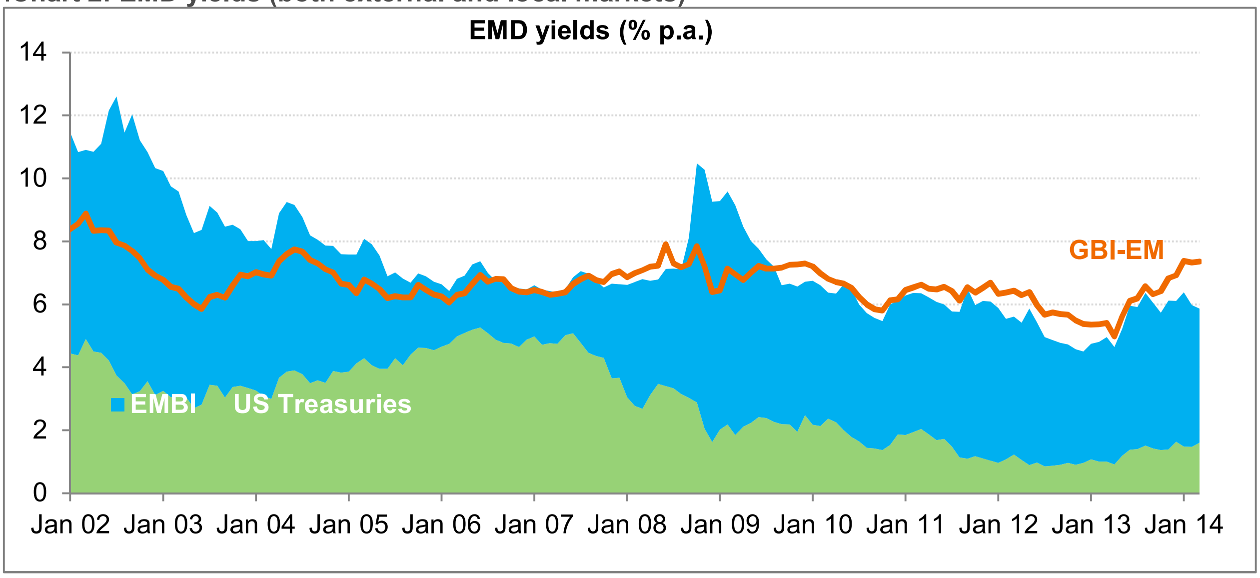
The J.P. Morgan range of indices is generally accepted as the market leader for both hard and local currency debt and for Emerging Market corporate bonds:

- **JPM EMBI Global Index**: External denominated Emerging Market sovereign debt, with USD denominated debt making up the largest component of the market (index).
- **JPM GBI-EM Diversified Index**: Local Emerging Market Government Bonds, the index excludes those countries with foreign investment constraints, including India and China and also limits any one country representing more than 10% of the overall index.
- **JPM CEMBI Diversified Index**: External denominated debt issued by corporate entities. Skewed towards Asia and Latin America (66% of the overall index).

Expected Returns and Market Outlook

Returns from EMD have consistently outperformed other fixed income asset classes over the last ten years. The fundamentals of the issuers have significantly improved as emerging market countries economies have improved and they have grown at a faster pace than developed markets. The following chart summarises the long-term return and risk characteristics of EMD.

.Chart 2: EMD yields (both external and local markets)



Returns from hard currency EMD (JPM EMBI index) have been driven by coupon payments, spread compression and a fall in US treasury yields.

Returns in local currency EMD (GBI-EM Diversified index) have been driven by currency and interest rate movements. Price has been a relatively stable contributor to local currency returns. Yields have not necessarily improved markedly over the past five year period. Currencies have become increasingly volatile since 2008, and are likely to remain an important driver of returns and likely to be the key driver of volatility going forward.

For a given issuer, local currency debt is usually expected to have a higher yield than bonds denominated in hard currency. This arguably reflects the risk of holding emerging market currency (see Table 1 below).

Table 1: Risk/return profile over the last 10 years

Asset Class	Annualised Returns (%)	Annualised Volatility (%)	Yield (%)
EM Local Currency Debt	9.2	12.4	7.0
EM Hard Currency Debt	8.4	9.0	6.0
EM Corporate Debt	7.5	10.2	5.5
Global Bonds	4.8	5.8	2.3
Investment Grade Bonds (US)	4.8	3.6	2.7
High Yield Bonds (US)	8.6	10.4	6.0

Source: Bloomberg, returns and volatility from 29 February 2004 – 28 February 2014 in USD. Yield as at 28/02/14.

A few years ago, the major appeal of EMD as an asset class was its low correlation to other assets. More recently this diversification benefit has reduced, as the correlation of EMD with other asset classes has increased.

Table 2: Monthly correlations from January 2003 to February 2014 (excluding June 2008 – June 2009)

	JPM EMBI Global	JPM GBI-EM GD	S&P 500	US Treasury	US High Yield
JPM EMBI-Global	1	0.80	0.53	0.15	0.55
JPM GBI-EM GD	0.80	1	0.66	0.13	0.65

Source: JP Morgan, S&P, Bloomberg. Data as at 28 February 2014

Market Access

As the universe of issuers has become more diverse there is an argument that the broad long-term EMD premium has reduced and that the appeal of the asset class is therefore as much tactical as strategic. This view might suggest EMD exposure should be part of a broader return-seeking bond portfolio where allocation to different bond categories is actively managed. Within a broader bond portfolio, EMD can offer diversification benefits: sovereign rather that corporate risk, currency risk.

Our historic research suggests that passive management of EMD can be just as rewarding as active management, primarily due to the high fees of active management outweighing the excess returns. However, the a wide range of markets now included in the indices with economies at very different positions in their cycles currently argues for an active approach rather than passive. Therefore, we currently favour access within a higher yielding multi credit portfolio or via a specialist active manager.

The drivers of local currency and hard currency EMD returns can be quite different; local currency are dependent on a combination of currency moves and local interest rates, and hard currency on the 'spread' above US government bond yields. We tend to favour a combination of both local and hard currency EMD bonds, offering diversification across a range of countries and different instruments.

Allowing a skilled manager the freedom to allocate between the EMD asset classes in a 'blended' portfolio allows the potential for optimal returns from the EMD asset class.

Notes and Risk Warnings

The report should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the note is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the note may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

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Emerging market debt

April 2014

Scott Jamieson – Head of Multi-Asset Investing

KAMES CAPITAL

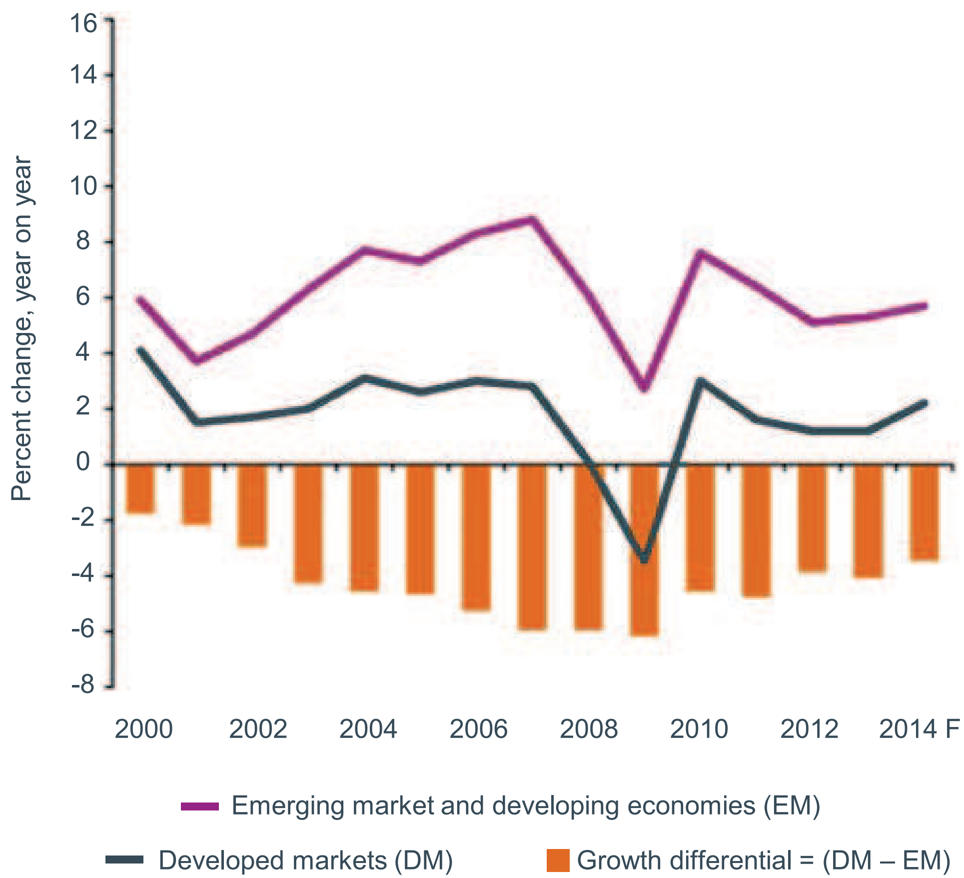
Big Picture

- **Favour able debt dynamics**
  - Certainly relative to the bloated economies of the developed world
- **Powerful demographics**
  - Growing populations and economies
  - Improving creditworthiness
- **Generally on dis-inflationary trend**
  - Unlike developed markets which is exploiting quantitative easing etc. to avoid deflation/generate inflation
- **Genuine contrast creates opportunities for selection**
  - Chile is not Argentina

Emerging Market is often a debt story, not an equity story

- **Where do corporate profits go?**
  - To the state (via. bloated state owned enterprise sectors eg. China, Brazil, Russia, India)
  - To the workforce (more socialist policies – note wage pressures in Brazil, South Africa, Chile, China, Turkey, Poland, South Korea).
  - These pressures have made emerging markets growth more sustainable by supporting higher domestic demand
- **Little left for equity holders**
  - favours external debt financing

Favourable real economic growth



- **Growth differential remains high at 4%**
  - has ‘moderated’ to longer-term sustainable average
- **Despite various headline crises, emerging markets continue to pace world economic growth**

40

Source: IMF

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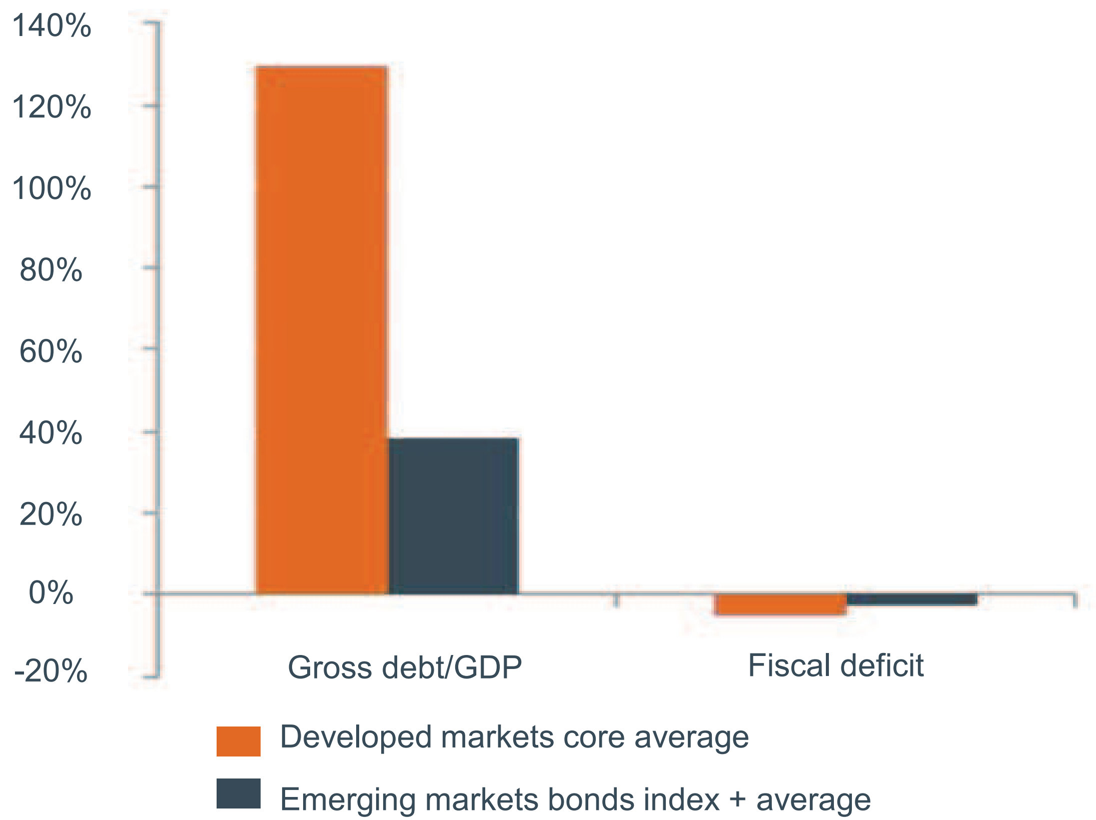
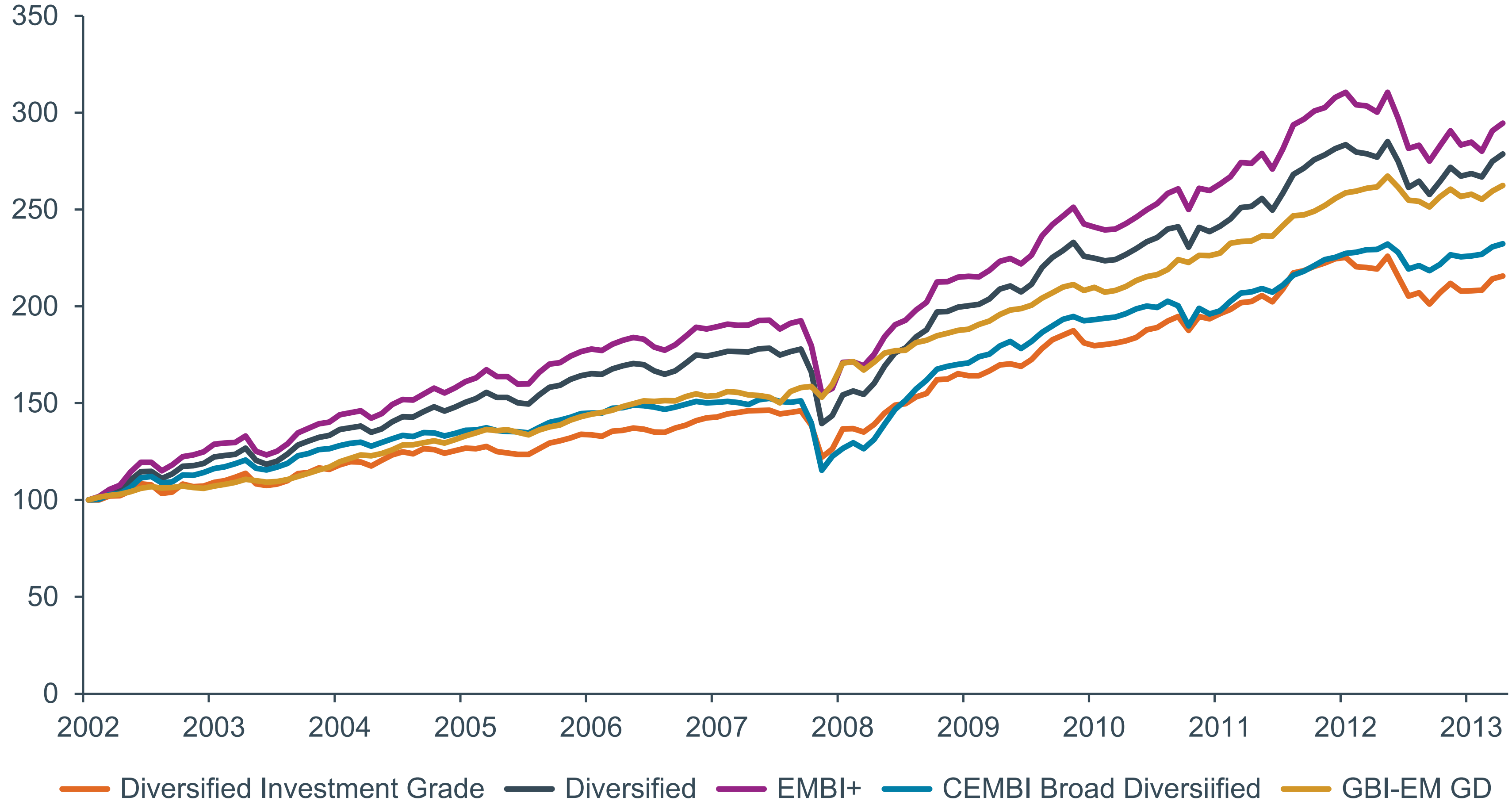
Emerging markets debt dynamics are much healthier than developed markets



41

A welter of indices (typically maintained by JP Morgan)

- **Diversified Investment Grade**
  - Hard currency; investment grade; sovereign and quasi-sovereign
- **Diversified**
  - Hard currency; investment grade and non-investment grade; sovereign and quasi-sovereign
- **Emerging Markets Bonds Index +**
  - Hard currency; sovereign, investment grade and non-investment grade
- **Corporate Emerging Markets Bonds Index (CEMBI) Broad Diversified**
  - Hard currency corporates; investment grade and non-investment grade
- **Government Bond Index- Emerging Markets Global Diversified (GBI-EM GD)**
  - Local currency; sovereign, investment grade and non-investment grade



Source: Bloomberg as at 31 March 2014

Constituents of Emerging market diversified index

	Weight	Average duration (yrs)	Rating	Yield (%)
Philippines	7.4	8.7	BBB-	3.9
Brazil	7.4	7.6	BBB	4.9
Mexico	7.1	9.4	BBB+	4.8
Turkey	7.1	7.6	BBB-	5.3
Indonesia	6.9	7.9	BB+	5.0
Russia	6.8	5.6	BBB	4.7
Colombia	5.9	8.8	BBB-	3.9
Poland	5.4	5.5	A-	3.4
China	5.2	7.2	A+	4.3
South Africa	5.0	6.6	BBB	5.2
Chile	4.8	8.3	A+	3.7
Peru	4.7	9.8	BBB+	4.6
Kazakhstan	4.5	6.9	BBB-	5.0
Panama	3.5	9.8	BBB	4.4
Malaysia	3.2	4.6	A	2.8
Lithuania	2.9	5.3	BBB-	5.0
Uruguay	2.9	10.2	BBB-	4.6
Romania	2.7	8.3	A-	3.4
Costa Rica	1.9	7.5	BBB-	3.9
Latvia	1.3	4.5	BBB-	5.0
Trinidad and Tobago	1.0	5.1	BBB	5.2
Morocco	1.0	9.4	BBB+	4.8
Slovak Republic	0.7	6.9	BBB	4.7
India	0.5	5.6	A+	4.1
Namibia	0.2	6.2	BBB+	4.8

Source: Bloomberg as at 31 March 2014

- **Wide range of countries to select from**
  - Most managers will avoid the minor weights
- **Weighted average yield of 4.5%**
  - c.f. US (2.7%), UK (2.7%),
- **Spain**
  - Yield of 3.2%
  - Credit rating BBB-
- **Portugal**
  - Yield of 3.8%
  - Credit rating BB-

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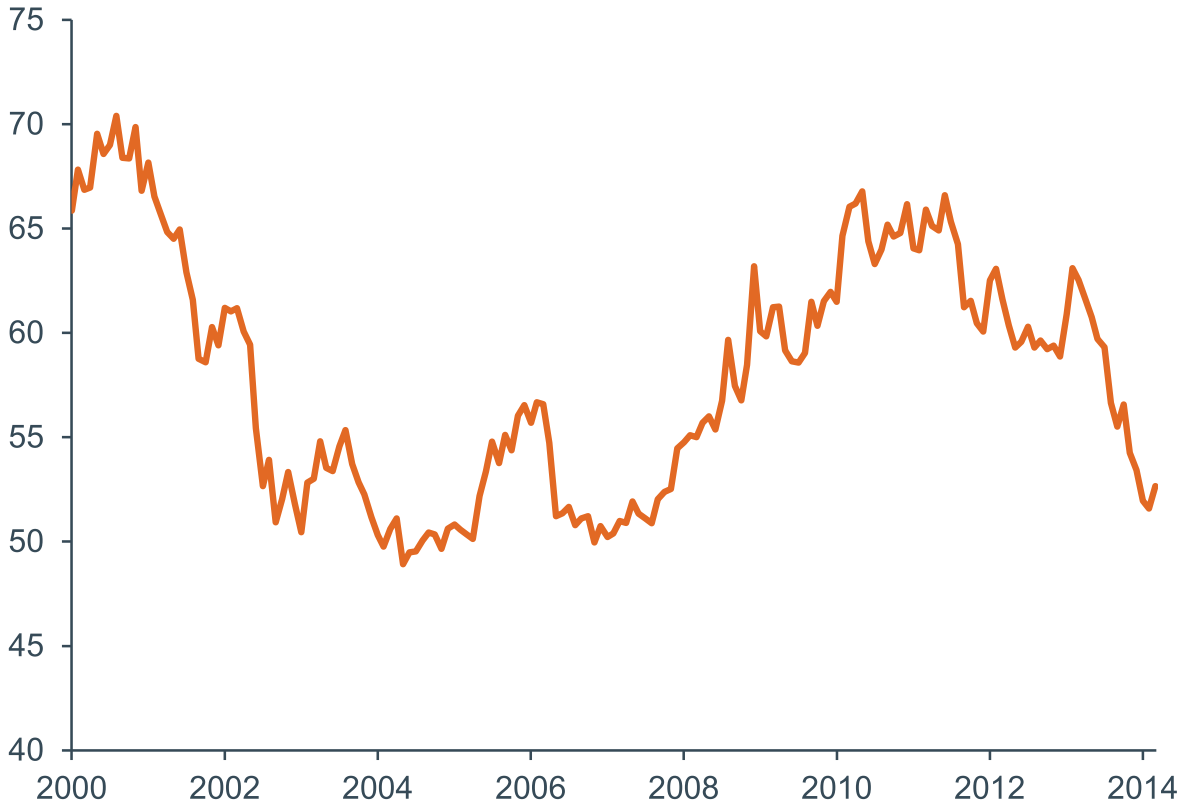
The currency dimension

Emerging market foreign exchange vs GBP



Source: Bloomberg as at 31 March 2014

- **The main currency reference point is US$**
  - Hard currency debt usually raised in US$
- **Emerging market foreign exchange has been hit hard of late**
  - Everything cycles

45

Important information

This document is not intended for retail distribution and is directed only at investment professionals. It should not be distributed to, or relied upon by, private investors.

All data in this presentation is sourced to Kames Capital unless otherwise stated.

The views expressed in this document represent our understanding of the current and historical positions of the market. They should not be interpreted as a recommendation or advice.

Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and is not guaranteed.

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FPID: 2014/CS2190

JP Morgan Asset Management

Opportunities in Fixed Income

Leicestershire County Council

23 April 2014

Your presenters

Peter Cazalet, *managing director,* is a client advisor in the UK institutional marketing and relationship management team. An employee since 1995, Peter was previously a fund director, principally for UK balanced funds. Prior to joining the firm, he was a director of UK equity sales at S G Warburg Securities. Before S G Warburg, Peter worked as a director in UK equity sales at Hoare Govett. Peter obtained a B.Sc. in Biological Sciences from Exeter University.

Charles McKenzie, *managing director*, is the head of EMEA Fixed Income Client Portfolio Management (CPM) in the Global Fixed Income, Currency & Commodities (GFICC) group. Based in London, Charles oversees the teams responsible for the retention of clients, the acquisition of new fixed income and currency business and product development and management. Prior to joining the firm in 2012, Charles was Deputy Head of Fixed Income at Aberdeen Asset Management. Previously, he spent twelve years at Deutsche Asset Management holding various roles including head of UK Fixed Income and head of Specialist Fixed Income. Charles holds a degree in economics from Southampton University and an M.B.A. in finance from London City University Business School.

Agenda

Where are the opportunities in fixed income?

- High yield
- Loans
- Securitised products – Mortgages
- Emerging market debt
- Unconstrained strategies

High Yield

J.P.Morgan Asset Management

High yield market characteristics

Euro High Yield

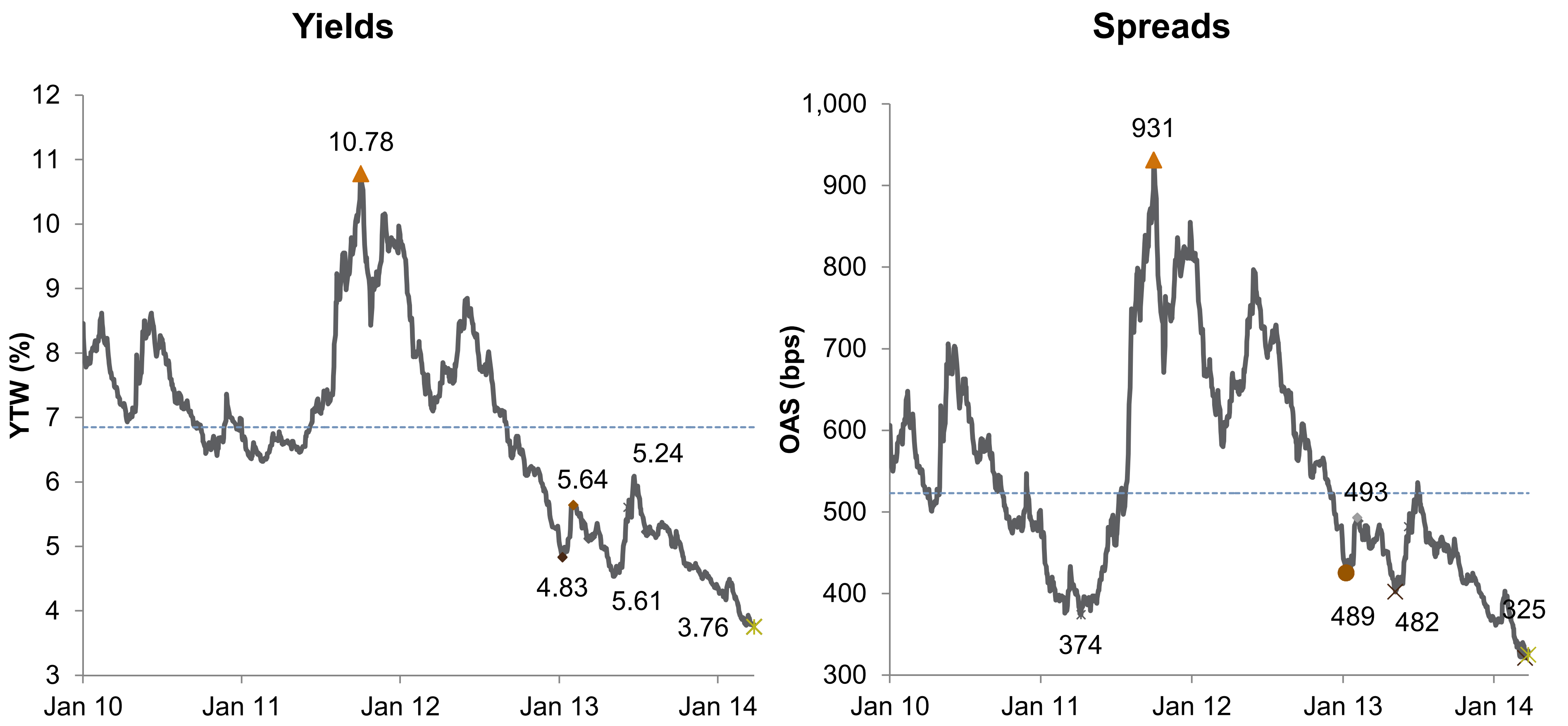
	As of 28-Mar-14
Size of market	USD 429bn
YTD performance	2.34%
2013 performance	8.84%
Yield	3.75%
Spread	325bps
Duration	3.78yrs
Maturity	4.64yrs
Rating	BB3

USD High yield

	As of 28-Mar-14
Size of market	USD 1,253bn
YTD performance	2.67%
2013 performance	7.41%
Yield	5.27%
Spread	373bps
Duration	4.84yrs
Maturity	6.52yrs
Rating	B1

Source: J.P. Morgan Asset Management, data as of 28 March 2014. HY – high yield. Yield is yield to worst. Spread is option-adjusted spread.

European high yield: recent history

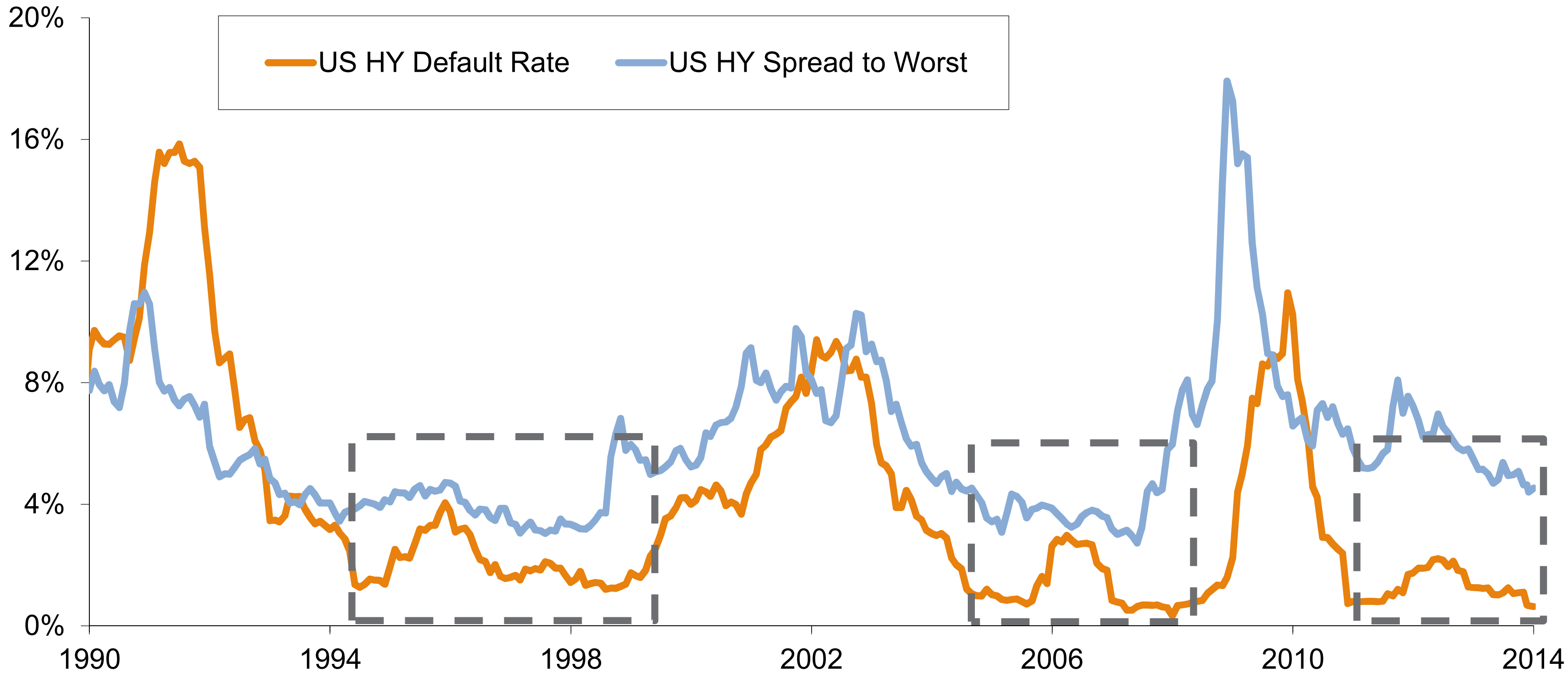


Source: J.P. Morgan Asset Management, data as of 28 March 2014. HY – high yield. Yield is yield to worst. Spread is option-adjusted spread.

J.P.Morgan
Asset Management

High Yield: fundamentals

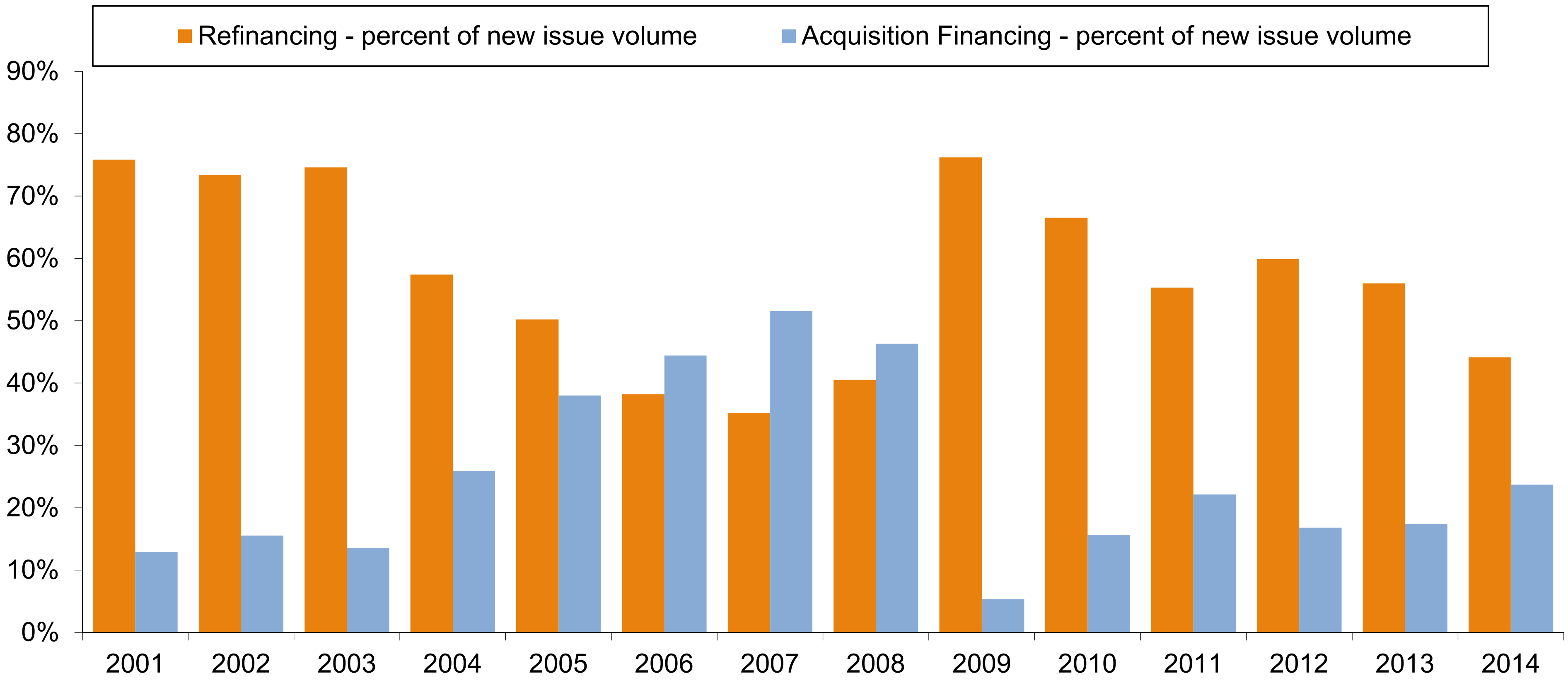
Spreads



Source: J.P. Morgan Asset Management, data as of February 2014. HY – high yield

High Yield: technicals

Percent of issuance used for refinancing or acquisition financing



Source: J.P. Morgan Asset Management, data as of 28 February 2014.

J.P.Morgan Asset Management

Loans

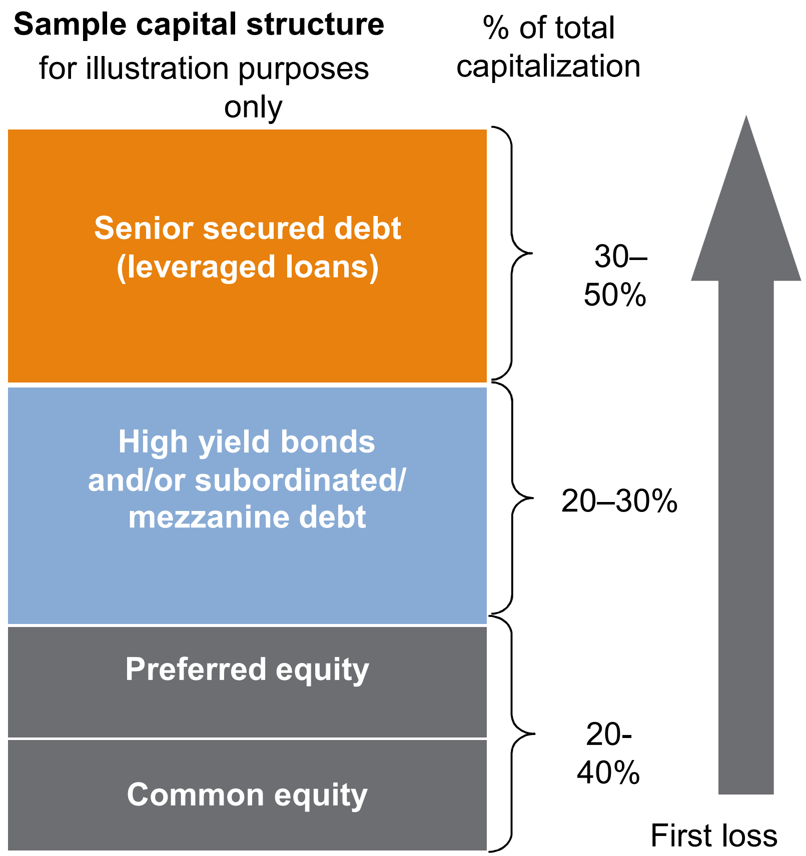
Attributes of Leveraged Loans and High Yield Bonds

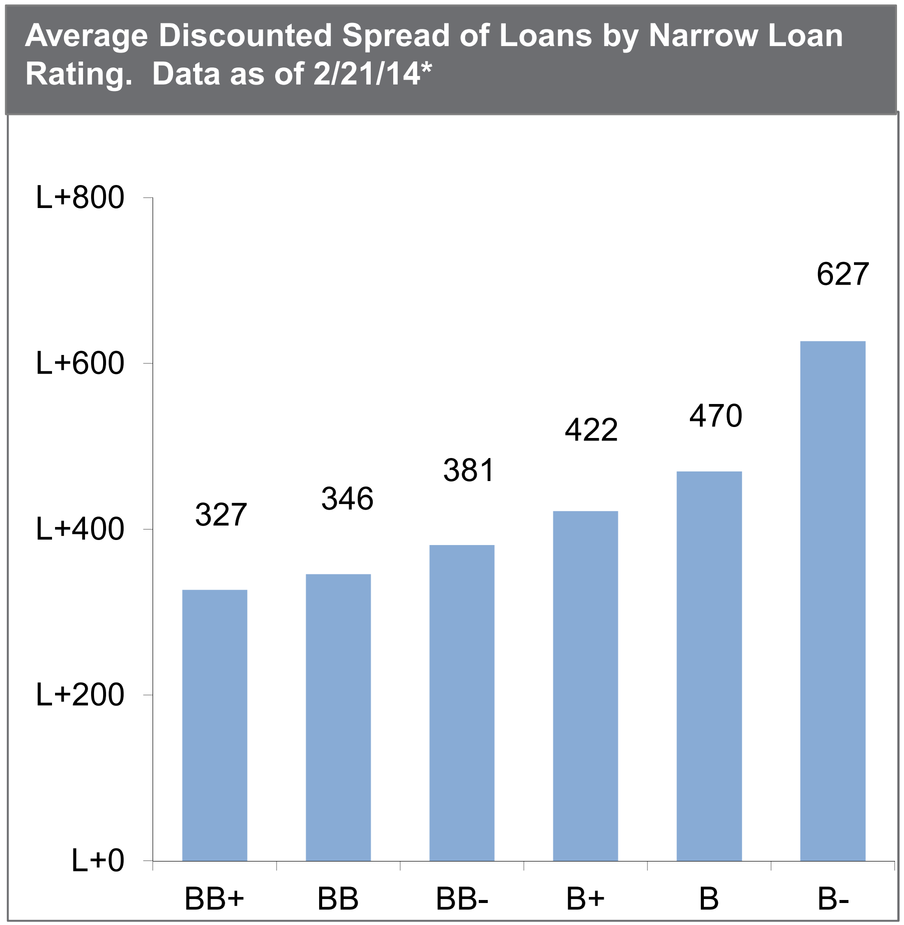
	Leveraged loans 1st lien	High yield bonds	Equities
Ranking	Yes–1st ranking	Generally none	None
Security	Senior secured	Generally senior unsecured or lower	Junior
Covenants	More comprehensive, often with maintenance as well as incurrence- based	Less restrictive; incurrence limitations	None
Term	5-8 years	7–10 years	Open ended
Income	Cash pay–floating (LIBOR based), quarterly	Cash pay–fixed, semi-annual	Dividends– uncertain, usually cash pay
Interest rate duration	Limited	Moderate	N/A

*Refers to protection against the borrower repaying the debt prior to when it is due. When a borrower has discretion to repay debt before it is due, it causes reinvestment risk for the lender. In addition, if the debt is repaid before it is due it may diminish/enhance the return, depending on whether the investment was purchased at a premium/discount.
Source: J.P. Morgan Investment Management Inc.

J.P.Morgan Asset Management

Leveraged Loan Overview





Sources: J.P. Morgan, Credit Suisse. Data as of February 28, 2014 unless otherwise stated.
*Source: Standard and Poor's LCD & S&P/LST Leveraged Loan Index. Assumes discount from par is amortized evenly over a three-year life.

Leveraged Credit Market Remains Healthy

Fundamentals

- Companies' balance sheets are mostly stable and leverage remains at reasonable levels
- Companies have refinanced at lower rates, reducing costs
- Underwriting standards generally remain credit positive

solid

Technicals

- HY bond new-issue volume totaled $16.6 billion for February, while loan issuance volume remained strong at $63 billion.
- Flows in high yield and leveraged loan funds were $2.2 billion and $1.82 billion respectively.

mixed

Valuations

- Global issuer default rate finished February at 2.4%
- The prospect of continued liquidity helped drive positive flows
- Treasuries remained well bid amid tepid economic data which helped to support fixed income prices

supportive

* Data as of February 28, 2014
Sources: J.P. Morgan Asset Management, Barclays, High Yield 2% Index Credit Suisse Leveraged Loan Index, Moody's data
Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they can be met.

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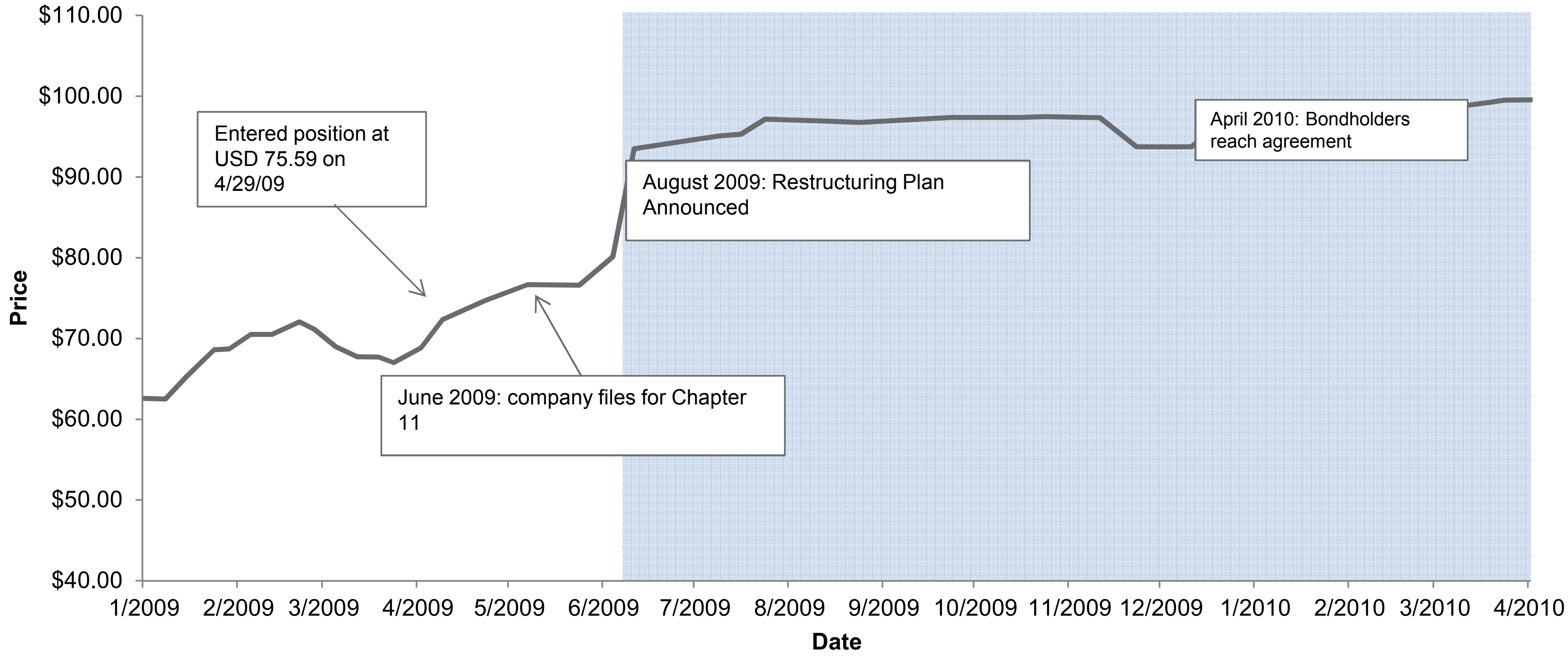
Investment Example – Price of Six Flags Term Loan



Source: J.P. Morgan, priced by Markit.

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Securitised products – Mortgages

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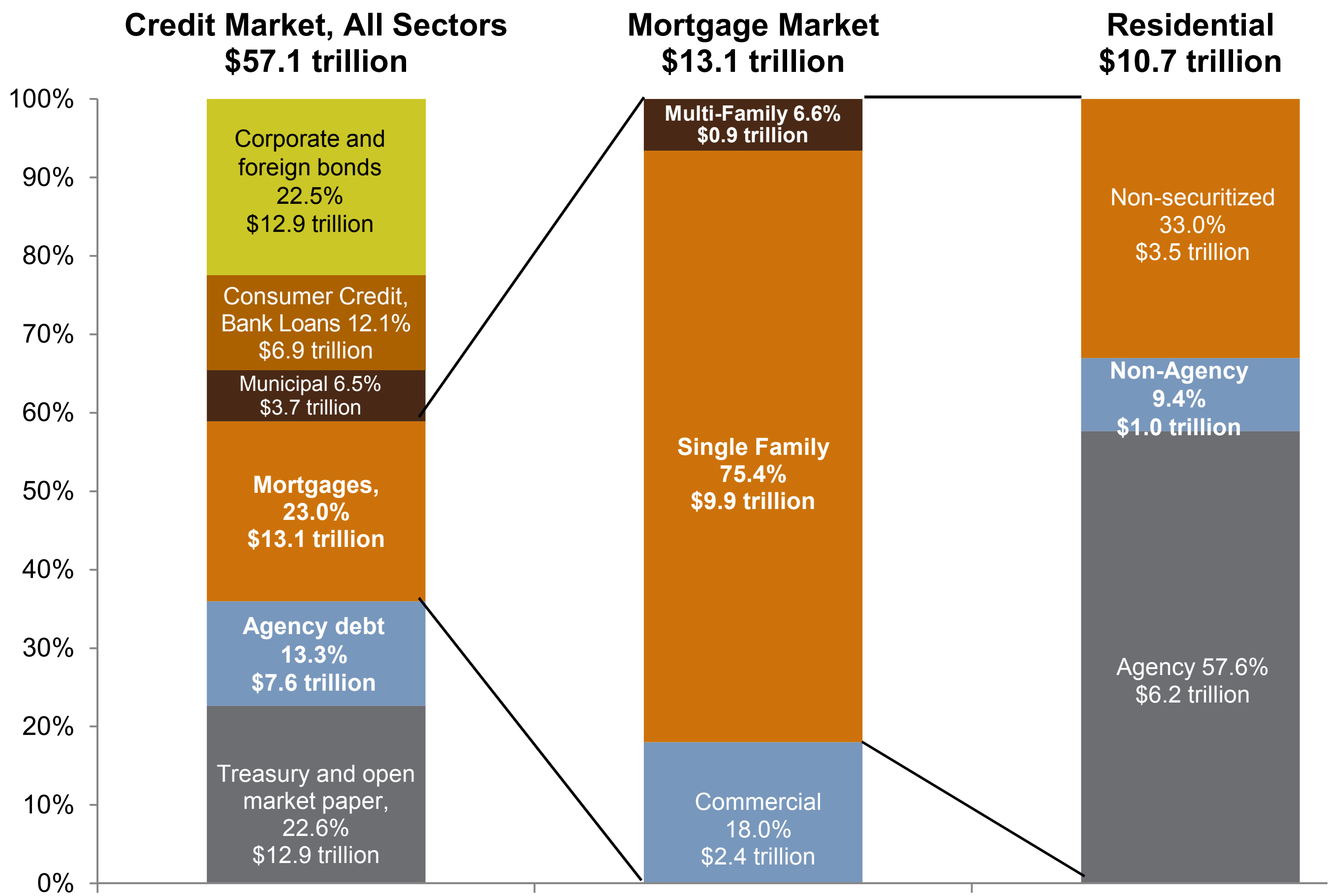
The U.S. mortgage sector is the largest component of the U.S. fixed income market with USD 13 trillion outstanding



Source: Federal Reserve Flow, of Funds, First Quarter, 2013 Results, JPM Securities.

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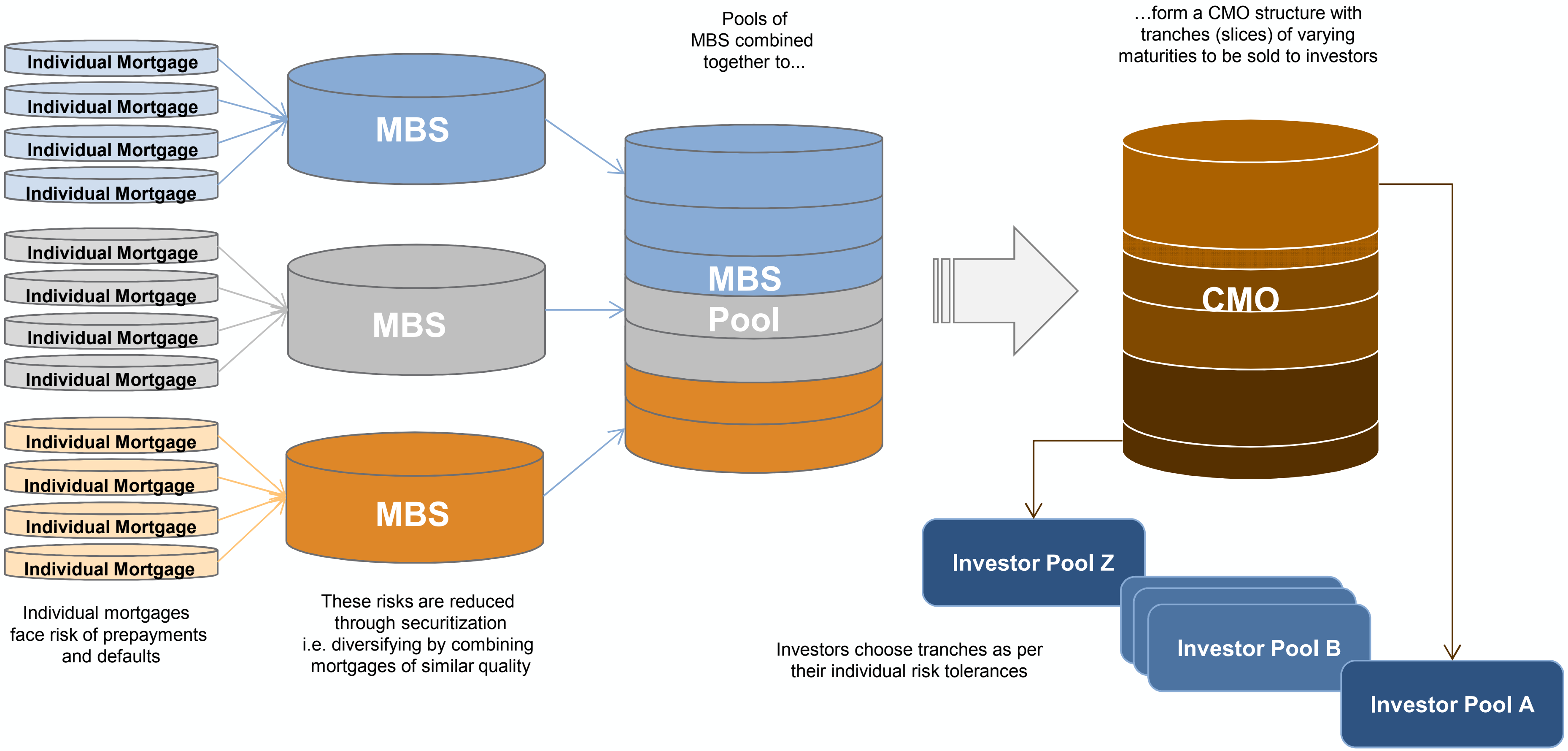
Securitization of Mortgages

Securitization Explained



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Mortgage-Backed Securities Composite

All data as of February 28, 2014

Discretionary assets: $3.79 billion

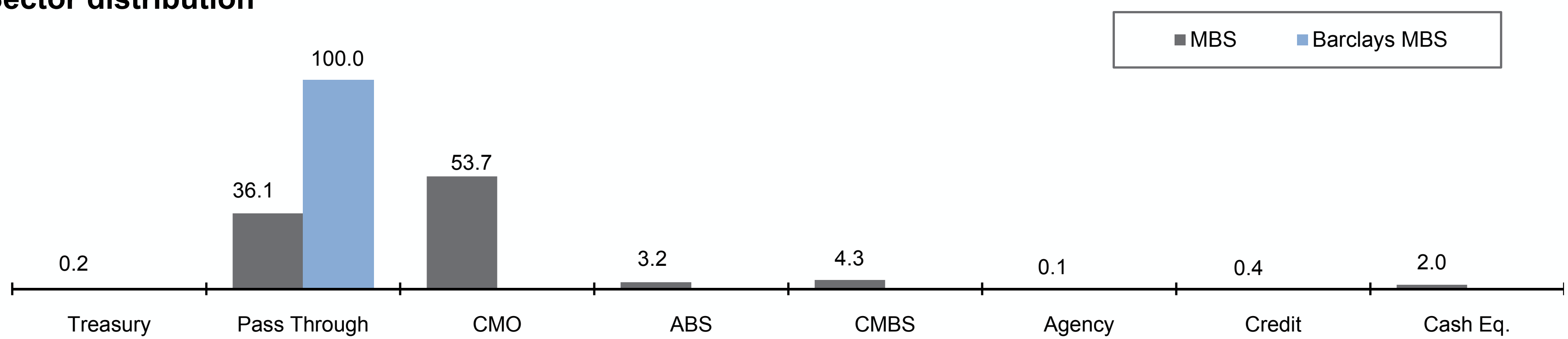
Portfolio statistics

	MBS	Barclays MBS
Yield to Maturity	2.62%	2.54%
OAS (bps)	108	24
Weighted Avg. Life (yrs)	5.19 yrs	6.87 yrs
Duration	3.74	4.78
Average Quality	AA	AAA
Number of holdings	683	769

Quality Distribution*

	MBS	Barclays MBS
AAA	80.4%	100.0%
AA	2.1%	0.0%
A	3.0%	0.0%
BBB	4.1%	0.0%
BB and below incl. NR	10.4%	0.0%
Total	100.0%	100.0%

Sector distribution[1]



*See Appendix Disclosure Page regarding the quality rating methodology used above.

[1]Measurements in percents. Index statistics compiled by running Barclays constituents through Yield Book models. Please see performance disclosures which accompany this presentation. Actual account characteristics may differ.

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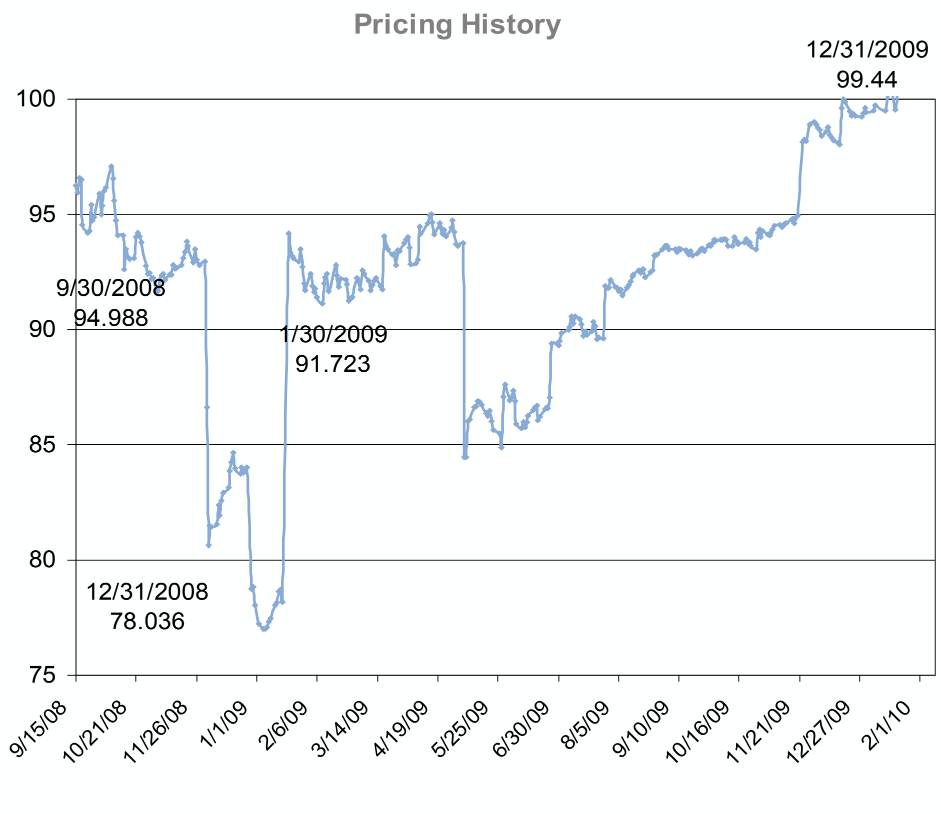
Non-Agency MBS Example

Deal Name	BAC Funding Corp 2003-3 1A33
Purchase date	12/2006
S&P Rating	AAA
Current Credit Support	5.27%
Vintage	2003
Loan Type	99.7% 30 Year Fixed Rate
Occupancy Status	97.4% Owner Occupied
Loan Size	Primary Jumbo at Issue
30 Day Delinquencies	0.88%
60 Day Delinquencies	0.14%
90 Day Delinquencies	0.14%
Bankruptcy	0.00%
Foreclosure	0.00%

FICO Score	
601-650	1.4%
651-700	12.4%
701-750	34.8%
751-800	48.3%
801-850	3.1%
Average FICO Score	746



Source: Bloomberg, Loan Performance and JPMorgan Asset Management
For Illustrative purposes only.

Last data point: 02/10/10

65

Emerging market debt

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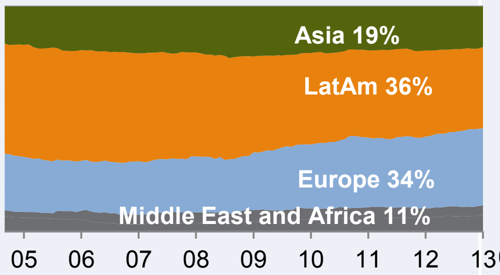
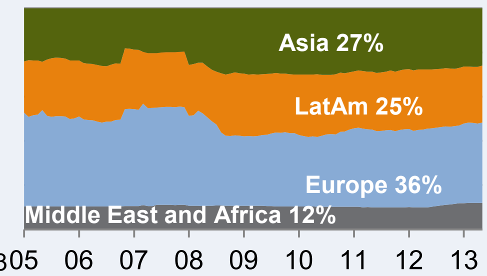
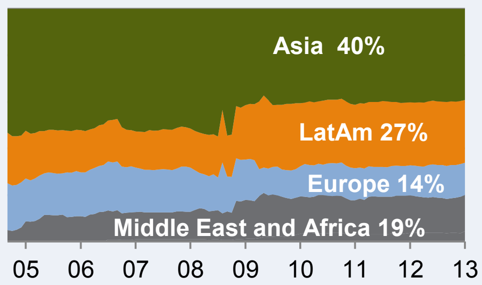
Emerging market debt – sector composition

Sector Strategy	Sovereign Debt	Local Currency Debt	Corporate Debt
Currency	USD	Local Currency	USD
Credit Quality (Moody's/S&P/Fitch)	Baa3/BBB-/BBB	Baa2/BBB+/BBB+	Baa2/BBB/BBB
Duration	6.49 years	4.56 years	4.72 years
Yield	6.06%	7.20%	5.19%
Market Value	USD 326 Billion	USD 896 Billion	USD 276 Billion
Historical Regional Distribution (%MV) Current values labeled			
Top 5 Countries (%MV)	Russia 5% Brazil 5% Philippines 5% Mexico 5% Turkey 5%	Brazil 10% Malaysia 10% Mexico 10% Poland 10% Russia 10%	Hong Kong 6% Russia 6% Mexico 6% Korea 6% India 5%

Source: J.P. Morgan Asset Management. As at 31/12/2013.

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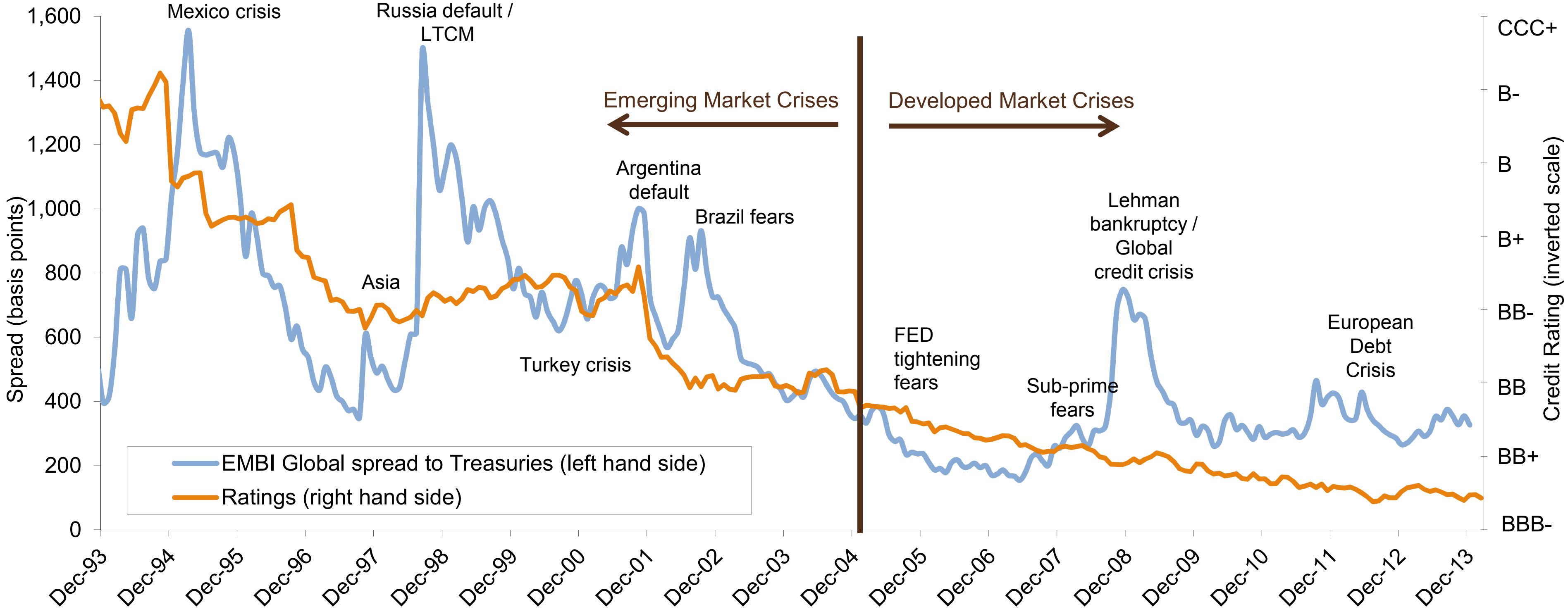
Spreads have widened out while ratings remain steady

As of 28 February 2014

EM External debt spreads and average credit ratings (inverted scale)



Source: J.P. Morgan Asset Management.
Note: The J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) is representative of the sovereign debt market.

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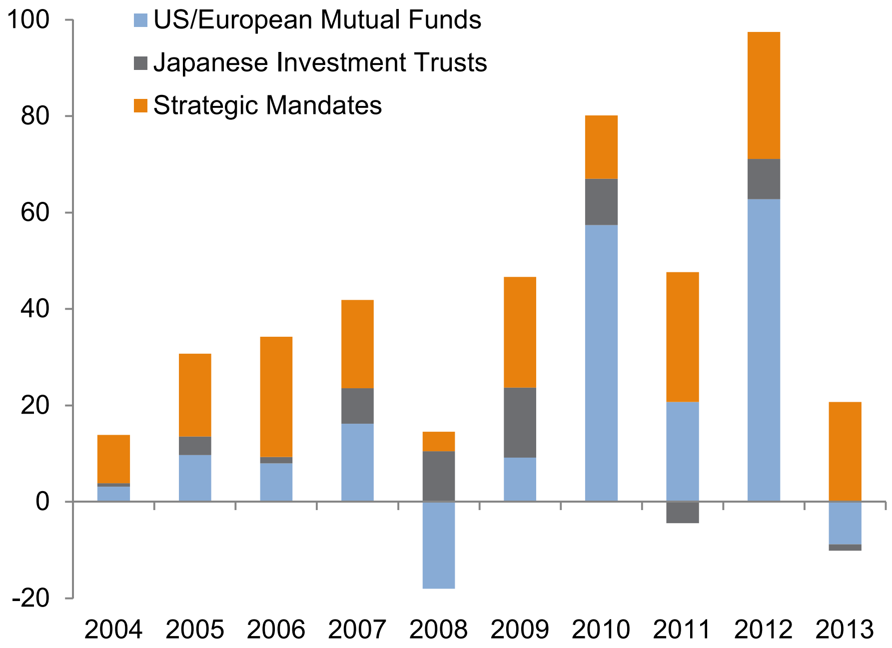
Strategic institutional investors continue to support the asset class

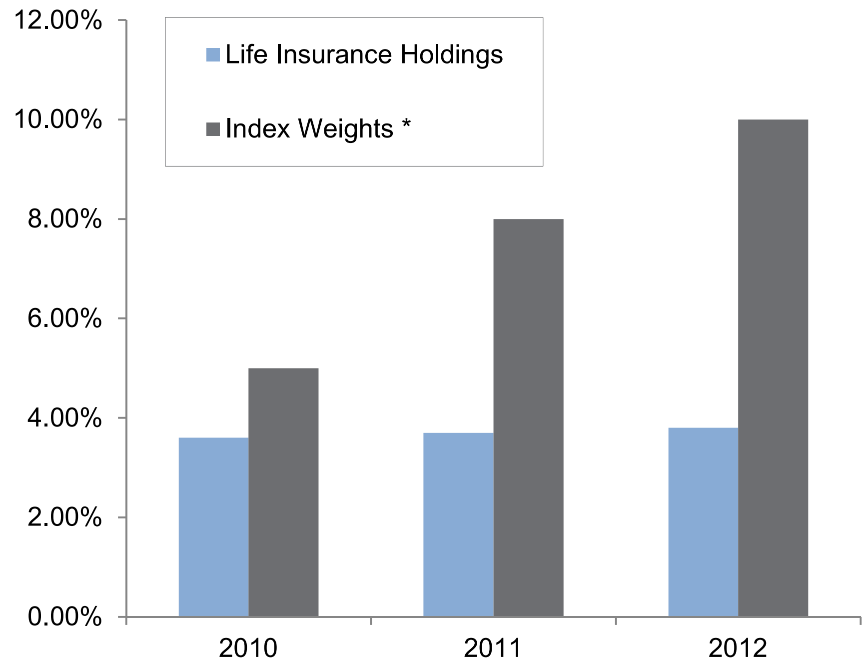
Strategic inflows remain supportive

USD billion cumulative, yearly



Source: EPFR, JPMorgan, SNL. As of Nov. 23

US Life Insurers' allocation to EM Corporates Remain Low



Source: J.P. Morgan Securities and SNL . * Share of EM Corporate Bonds in the combined US High Grade and US High Yield Indices. Insurers could use benchmarks with a lower EM allocation than JPM Indices. As at 31st December 2013

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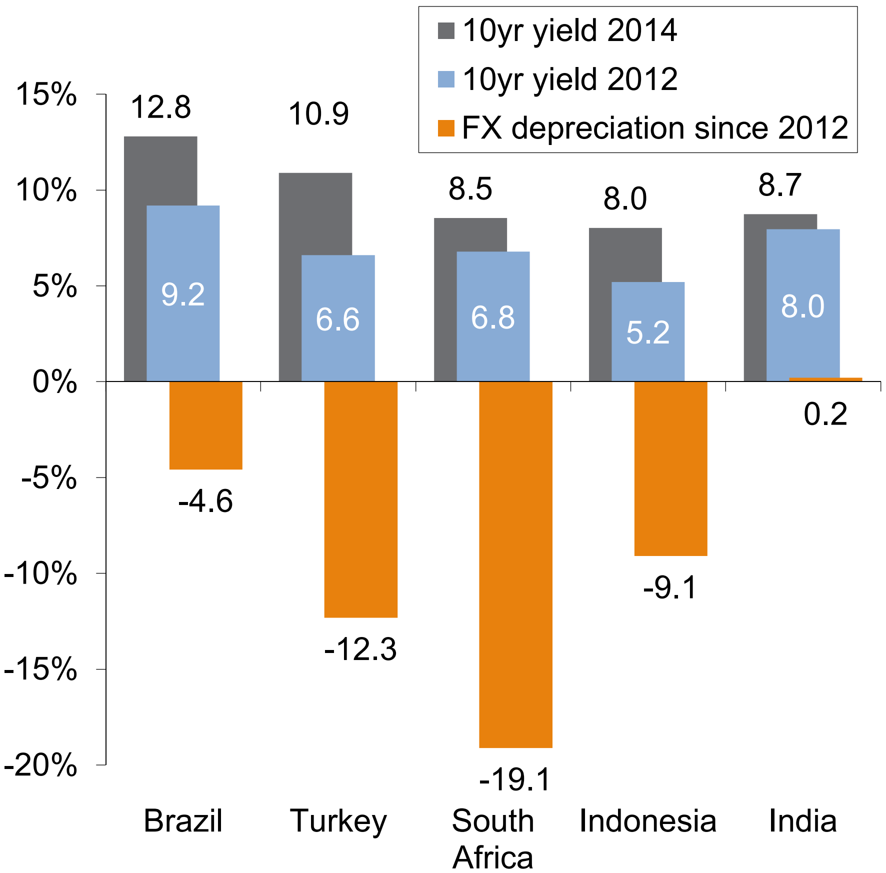
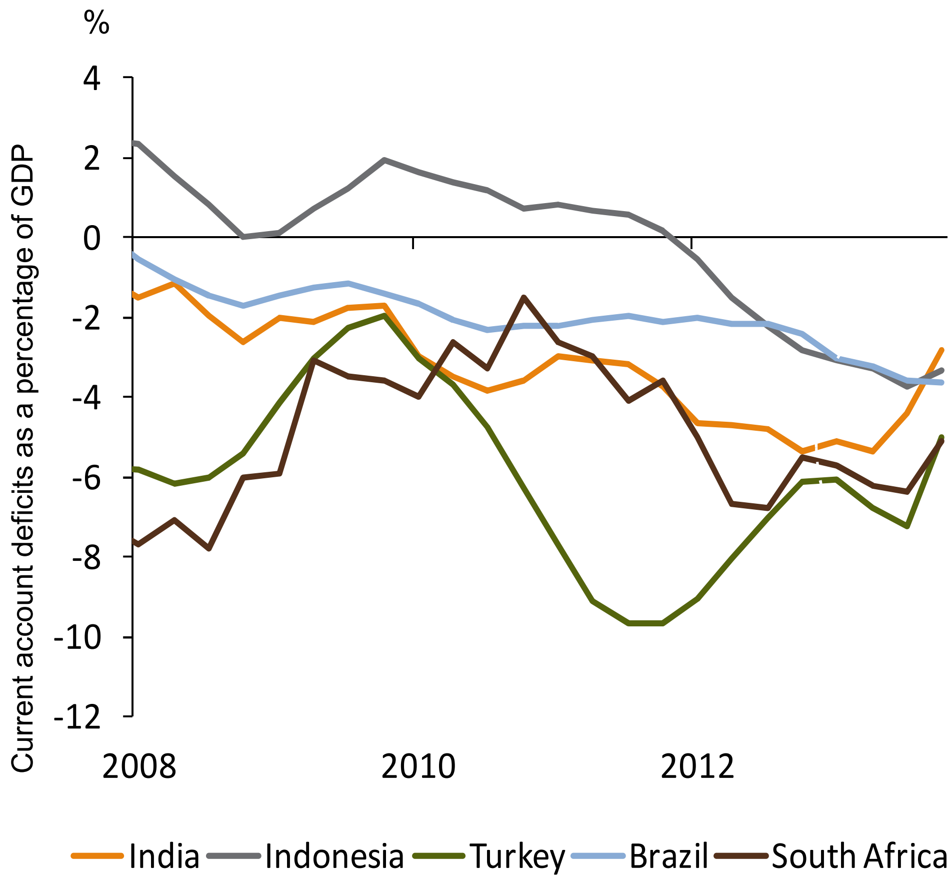
EMD: A fragile opportunity?

Valuations



Fundamentals



Source: J.P. Morgan Asset Management, Bloomberg. Data as of March 2014.

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Key Opportunities and Challenges for EMD in 2014

Opportunities

- Very attractive valuations
- Fundamental turnaround stories (Indonesia, India etc)
- Strategic Inflows will provide support

Challenges

- US Treasury rates volatility
- Commodities prices softening
- Capital flow vulnerability may persist

Source: J.P. Morgan Asset Management

71

Unconstrained fixed income

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Bond Benchmarks: Counterintuitive

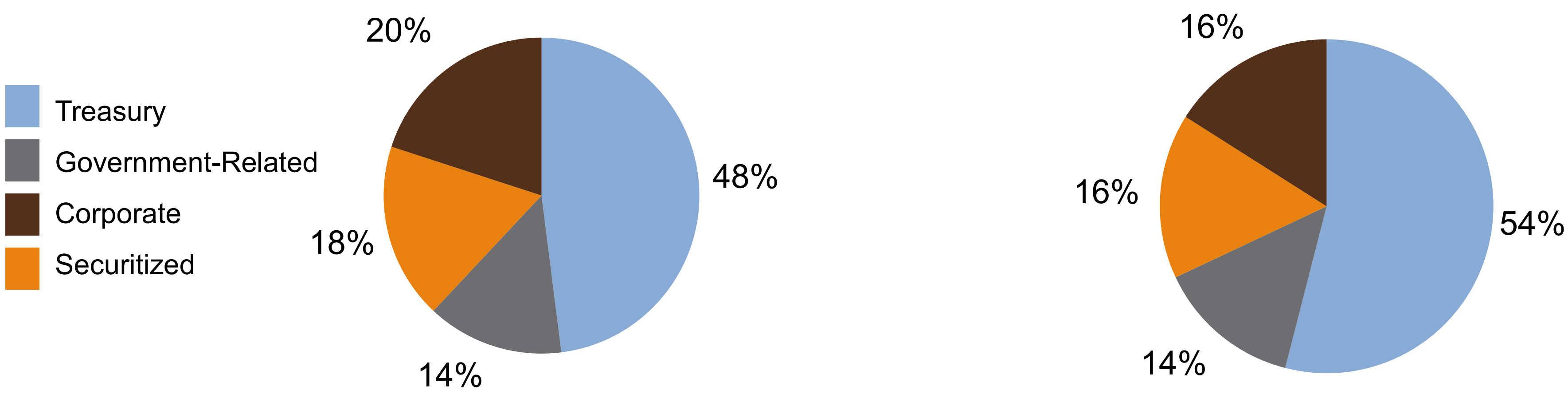
Barclays Global Aggregate today and 10 years ago

2004

- Duration: 4.9 years
- Yield: 3.32
- Sector breakdown:

2014

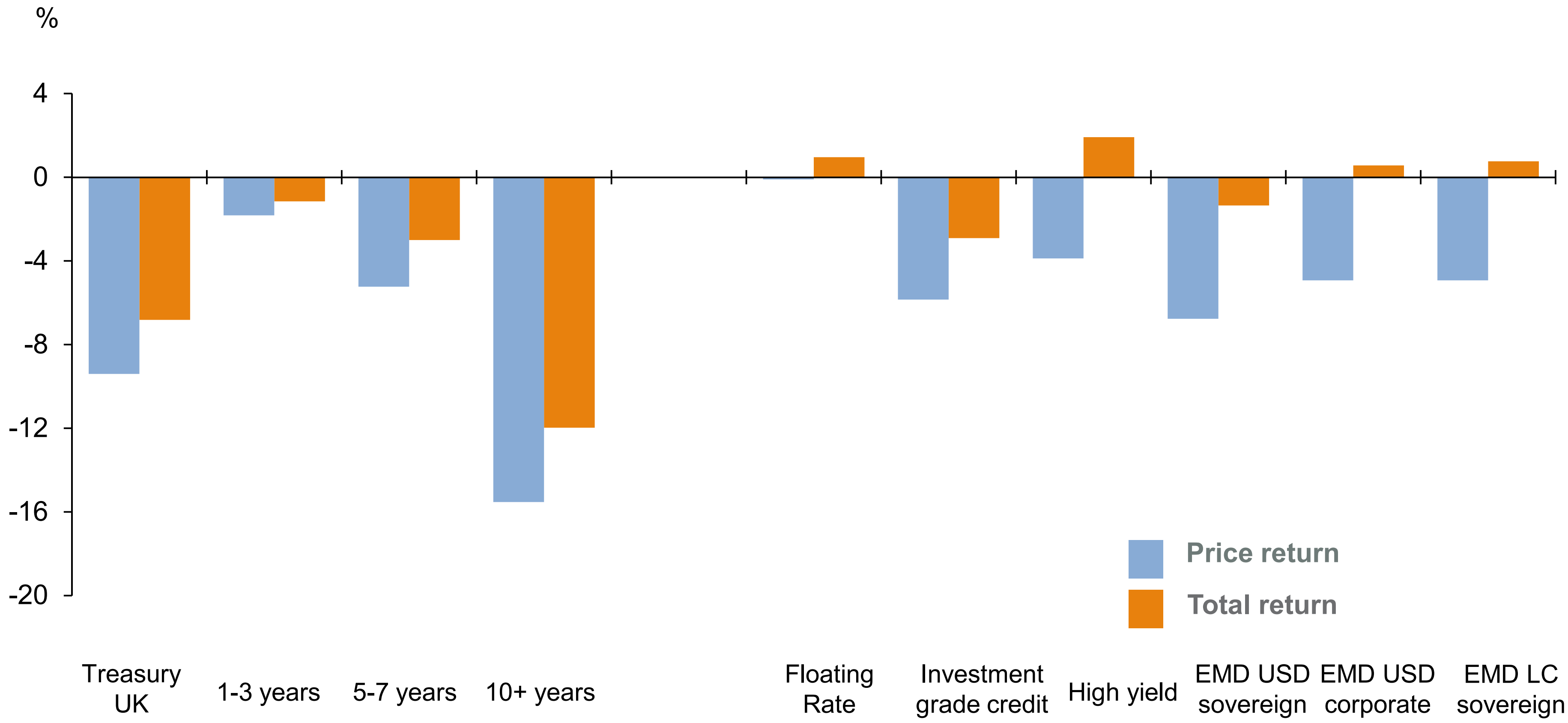
- Duration: 6.2 years
- Yield: 1.94
- Sector breakdown:



Source: Bloomberg, data as of January 2014 and January 2004. Duration is modified adjusted duration: Yield is yield to worst.

Government bonds aren't safe investments when rates rise

Estimated price impact of a 1% rise in local interest rates on selected indices



73

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Importance of dynamically diversifying across fixed income sectors

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	Ten-yr Ann.
£ Local*	8.5% Linkers 8.5%	25.1% EM Debt 11.9%	2.9% Linkers 2.9%	8.5% Linkers 8.5%	45.1% Global Agg 5.6%	44.5% High Yield 60.9%	17.1% High Yield 14.9%	19.9% Linkers 19.9%	15.8% UK Corp 15.8%	7.1% High Yield 8.1%	3.2% Linkers 3.2%	9.8% High Yield 8.8%
	6.8% UK Corp 6.8%	13.3% High Yield 2.9%	0.9% UK Corp 0.9%	7.6% Global Agg 5.3%	26.5% Global IG -5.1%	15.4% UK Corp 15.4%	15.3% EM Debt 11.8%	16.8% UK Gilts 16.8%	13.4% High Yield 18.0%	1.8% UK Corp 1.8%	2.8% EM Debt 3.5%	9.1% EM Debt 8.3%
	6.6% UK Gilts 6.6%	11.5% Portfolio 7.3%	0.2% UK Gilts 0.2%	5.1% UK Gilts 5.1%	25.0% EM Debt -9.7%	12.1% EM Debt 25.9%	10.6% Portfolio 9.5%	11.3% Portfolio 11.1%	12.9% EM Debt 18.0%	0.5% Linkers 0.5%	2.5% UK Corp 2.5%	7.0% Portfolio 6.7%
	5.5% Portfolio 8.1%	9.0% Linkers 9.0%	-1.2% Portfolio 4.1%	4.9% Global IG 3.2%	13.6% UK Gilts 13.6%	11.2% Portfolio 17.3%	9.2% Global IG 7.2%	10.0% EM Debt 9.2%	7.4% Portfolio 9.6%	-1.5% Global IG 0.1%	2.5% Portfolio 2.8%	6.8% Linkers 6.8%
	4.8% High Yield 11.4%	8.5% UK Corp 8.5%	-1.6% High Yield 10.5%	4.7% EM Debt 6.5%	12.1% Portfolio -2.0%	6.4% Linkers 6.4%	8.9% Linkers 8.9%	6.4% Global Agg 5.4%	6.3% Global IG 10.9%	-1.9% Portfolio -1.2%	2.4% UK Gilts 2.4%	5.8% Global IG 4.9%
	4.2% EM Debt 11.8%	8.1% UK Gilts 8.1%	-3.1% EM Debt 10.5%	4.4% Portfolio 4.4%	3.7% Linkers 3.7%	6.1% Global IG 16.6%	8.9% Global Agg 4.6%	5.9% UK Corp 5.9%	2.6% UK Gilts 2.6%	-4.2% UK Gilts -4.2%	2.4% High Yield 3.0%	5.4% UK Gilts 5.4%
	2.1% Global IG 5.5%	7.9% Global IG 3.5%	-5.9% Global IG 3.6%	1.6% High Yield 2.0%	0.9% High Yield -26.4%	-1.0% UK Gilts -1.0%	8.8% UK Corp 8.8%	5.1% Global IG 4.8%	0.6% Linkers 0.6%	-4.4% Global Agg -0.1%	1.9% Global IG 2.6%	5.3% UK Corp 5.3%
	1.9% Global Agg 4.9%	6.8% Global Agg 4.3%	-6.5% Global Agg 3.6%	0.6% UK Corp 0.6%	-9.1% UK Corp -9.1%	-4.8% Global Agg 5.1%	7.5% UK Gilts 7.5%	4.0% High Yield 3.7%	-0.3% Global Agg 5.7%	-10.0% EM Debt -8.3%	1.7% Global Agg 2.0%	5.3% Global Agg 4.4%

Source: Barclays Capital, BoA/Merrill Lynch, J.P. Morgan, FTSE, J.P. Morgan Asset Management. *Returns are calculated in the currency of the underlying asset class if it is a single currency index otherwise they are hedged ('local currency') if the index contains assets in denominated in different currencies. Annualised return covers period 2004 to 2013. Linkers: FTSE UK Gilts Indexed Linked Government; UK Gilts: JP Morgan UK Global Bond, EM debt: JP Morgan EMBI+; Hight yield: BoA/Merrill Lynch Developed Markets High Yield Constrained, UK corp: Merrill Lynch Sterling Corporates; Global Agg: Barclays Global Aggregate; Global IG: Barclays Global Aggregate – Corporates. Portfolio weights; 35% Gilts, 15% EM debt, 15% high yield,10% index linked, 10% UK corporate, and 15% global investment grade bonds. "Guide to the Markets - UK". Data as at 31 March 2014.

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Unconstrained fixed income strategies

- Gaining popularity with institutional investors
- Avoid the tyranny of benchmark
- Attractiveness of total return strategies
- Best ideas, unconstrained approach to fixed income

Appendix

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GFICC Scenario probabilities and investment expectations: 2Q14

Expansion

Base Case (60% - unchanged):
- **Sub Trend Recovery continues into 2015**
  - GDP 2-4%; Inflation 0-2%

Global economy is still recovering, not yet expanding
- Economic recovery in US is broadening (excluding weather impact); Europe is stable
- Optimism offset by deteriorating trade surplus in Japan and tighter credit conditions in China
- Sufficient labor market slack will keep inflation at low levels
- US unemployment could reasonably be 1.5% higher than the reported data*
- Inflation risks are to the downside, as deflation is still a very real threat in peripheral Europe, and Japan exporting disinflation to the US
- Central Banks will remain accommodative until deleveraging occurs or inflation is evident
  - Foreign Direct Investment (FDI) inflows do not indicate pressures building

Strategy Implications:
- Yield and carry remain attractive
- European bank hybrid securities
- US reperforming/non-performing residential mortgage market
- Bank leveraged loans

Above trend growth (35% - unchanged)
- GDP >4%; Inflation >2%

- Accelerating US recovery leads to stronger EM as exports pickup
- Europe experiences real growth
- Increase in Japanese consumption is more than simply front running VAT hike
- Energy should recede with the Spring thaw, leading to stronger discretionary spending and less pressure on central banks to battle commodity price inflation
- Market volatility rises from abnormally low levels
- Market anticipates central banks normalizing rates

Strategy Implications:
- Short duration
- Floating rate credit
- Convertible bonds
- Short positioning in securities with negative convexity (agency MBS) and short volatility will be good hedges

Contraction

Crisis (5% - unchanged):
- **Disorderly movement in markets causes systemic impact and tail risk**

- Ukraine could destabilize both the emerging and developed markets as politics could escalate into global conflict
  - Our expectation is that US and EU will work with Russia to avoid escalation and disorderly and collapsing markets
- The Fragile Five (Brazil, Indonesia, India, South Africa, Turkey) represent risk, if credit conditions tighten, as they need to import capital
- A hard landing in China is a distant threat – PBOC is managing down credit fueled growth

Strategy Implications:
- Long position in G4 government bonds
- Short position in EMD

Recession (0% - unchanged)
- GDP <2%; Inflation <0%

- Overall expansionary policy of Central Banks makes the risk of recession over the next 3-6 months unreasonable
- Japan is at greatest risk of recession, where fiscal drag could offset trend growth

*Using the Yellen/Williams adjustment to the participation rate.

Source: GFICC Investment Strategy Team. As of March 13, 2014. Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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