Meeting: **Investment Subcommittee**

Date/Time: **Wednesday, 15 October 2014 at 10.00 am**

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

Contact: **Mr. M. Hand (Tel. 0116 305 6038)**

Email: **matthew.hand@leics.gov.uk**

Membership

Mr. G. A. Hart CC (Chairman)

Cllr. P. Kitterick	Mr. J. B. Rhodes CC
Mr. K. W. P. Lynch CC	Mr. R. Bone
Cllr. M. Graham	Mr. A. Stephens

AGENDA

Item		Report by	
1.	Minutes of the meeting held on 25 June 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.	Emerging Market Debt - Report of the Investment Consultant.	Investment Consultant	(Pages 7 - 14)

The Chairman will be asked to consider items 10 and 11 on the agenda at this stage of the meeting, which will involve the likely exclusion of the public.

7. Schedule of Future Meeting Dates.

   Members are asked to note the meeting dates below following consultation with the Chairman:

   18 March
   29 April
   24 June
   22 July
   19 August
   14 October
   9 December

8. Date of Next Meeting - 10 December 2014.

9. Any other items which the Chairman has decided to take as urgent.

   Exclusion of the Press and Public.
   The public are likely to be excluded during consideration of the following items in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information):

10.	Emerging Market Debt - Manager Interviews - Report of the Investment Consultant.	Investment Consultant	(Pages 15 - 26)

   Exempt under Paragraphs 3 and 10 of Schedule 12A.

11. Emerging Market Debt - Manager Interviews.

   Exempt under Paragraphs 3 and 10 of Schedule 12A.

Leicestershire County Council

Minutes of a meeting of the Investment Subcommittee held at County Hall, Glenfield on Wednesday, 25 June 2014.

PRESENT:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman) Mr. J. B. Rhodes CC

Leicester City Council/District Council Representative

Cllr. M. Graham
Cllr. P. Kitterick

Staff Representative

Mr. R. Bone

Independent Advisers and Managers

Mr. S. Jamieson	Independent Investment Adviser
Mr A. Green	Hymans Robertson
Ms. C. Ballantyne	Hymans Robertson

50. Election of Chairman

It was proposed, seconded and resolved that Mr. G.A Hart CC be appointed Chairman of the Investment Subcommittee for the period ending with the date of the Annual Council meeting in May 2015.

Mr. G.A Hart CC – In the Chair

51. Minutes.

That the minutes of the meeting held on 23 April 2014 were taken as read, confirmed and signed.

52. Question Time.

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

53. Questions asked by members.

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

54. Urgent Items.

The Chairman agreed that Investment Subcommittee should consider one urgent item, a report of the Director of Corporate Resources concerning the outcome of negotiations with two Investment Managers on their fee levels.

The matter was considered urgent in light of the fact that the next Pension Fund Management Board meeting was scheduled for 5 September 2014, and if a decision was delayed until then a considerable amount of potential savings would be lost.

55. 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.

56. Multi Credit: Bank Replacement.

The Subcommittee received a briefing note on Multi Credit Bank Replacement prepared by Investment Consultants Hymans Robertson. A copy of the briefing note is filed with these minutes marked ‘7’.

Arising from the discussion, the following points were noted:

- That it had been agreed at the Pension Fund Management Board Strategy meeting on January 24 2014 that funds would be drawn down from within the JP Morgan Fund and reinvested into other credit opportunities, including Bank Replacement Lending;

- It was recognised that as banks withdrawal of lending continued, there would be an increase in demand for non-bank intermediaries, such as multi asset credit funds, to meet the credit needs of the economy;

- A 4% real asset return was required in order for the Fund to remain healthy. It was expected that an investment in Multi Credit Bank Replacement would be able to provide this value of return.

RESOLVED:

That the information provided be noted.

57. Date of Next Meeting - 23 July 2014.

RESOLVED:

That it be noted that:

a) the next meeting of the Subcommittee is scheduled to be held on 23 July, 2014;

b) the meetings scheduled for 23 July and 13 August 2014 are likely to be cancelled due to a lack of business to be transacted, Members to be contacted by officers to confirm matters nearer the time.

[Subsequently to the meeting, the 23 July 2014 meeting was confirmed as cancelled].

58. Urgent Item - Investment Fund Management Fees Paid By The Pension Fund.

The Subcommittee received an urgent report by the Director of Corporate Resources in respect of fee negotiations with two Investment Managers, the Chairman having decided that it was of an urgent nature in light of the fact that the next Pension Fund Management Board meeting was scheduled for 5 September 2014, and if a decision was delayed until then a considerable amount of potential savings would be lost. The report having been circulated at the meeting is filed with these minutes.

It was noted that following the decision by The Pension Fund Management Board on 22 May 2014, officers were asked to seek the reduction of fees paid to the Boards Investment managers whose recent poor performance had caused concern. Those discussions had now taken place and had been concluded.

RESOLVED:

a) That the offers of reduced management fees as detailed in paragraphs 6-9 of the report, be approved;

b) That the decision of the Subcommittee be reported back to the September meeting of the Pension Fund Management Board for its consideration.

59. Supplementary Information informing the Multi - Credit - Bank Replacement Manager Interviews.

The Board considered a report by the Investment Consultant, which provided members with background information relating to the Investment Manager interviews to be held as part of item 11 on the agenda . A copy of the report is filed with these minutes marked ‘10’. The report was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

That the information provided be noted.

60. Multi - Credit - Bank Replacement Manager Interviews.

The Subcommittee received presentations by representatives from three Investment Managers which were followed by questions from members. A copy of the presentations are filed with these minutes marked ‘11a’, ‘11b’ and ’11c’. The presentations were not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

a) That the presentations delivered on behalf of the three Investment Managers be noted;

b) That a £100m commitment to invest in the Partners Group Multi Asset Credit Fund 2014 be approved.

Wednesday, 25 June 2014
10.00 am - 12.40 pm CHAIRMAN

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

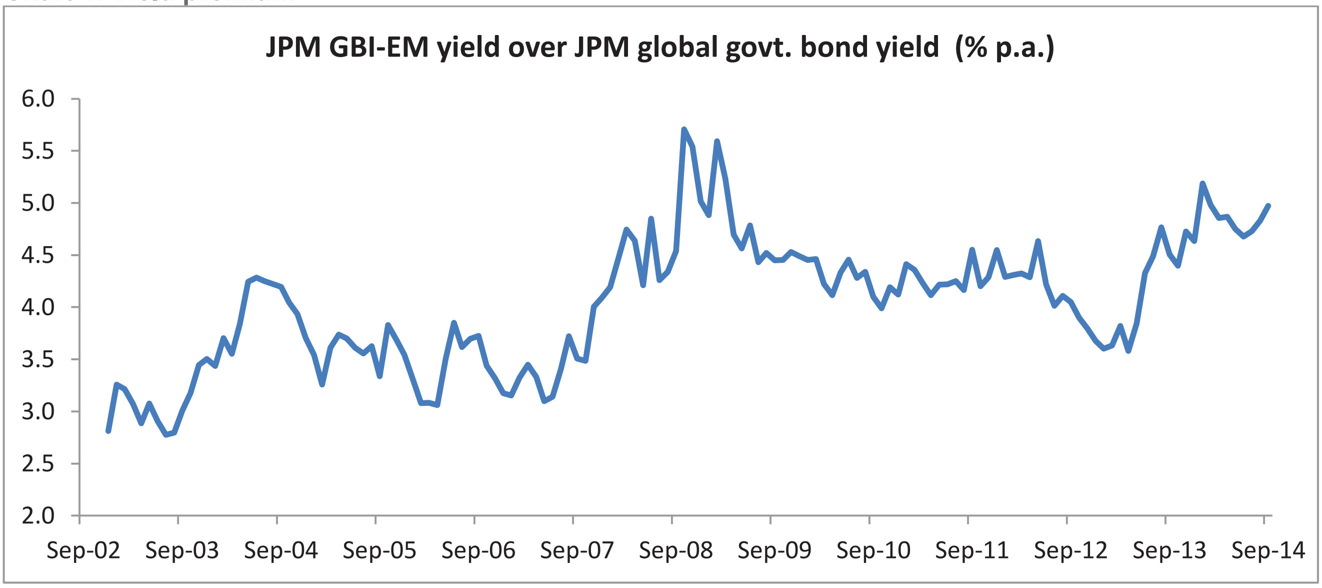


Chart 1 above shows that the yield on the **local** Emerging Market Debt index (JPM GBI-EM Diversified), which equates to an absolute yield of 6.7%, currently offers a 5.0% premium over the Global Government Bond index (JPM Global Govt. Bond).

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

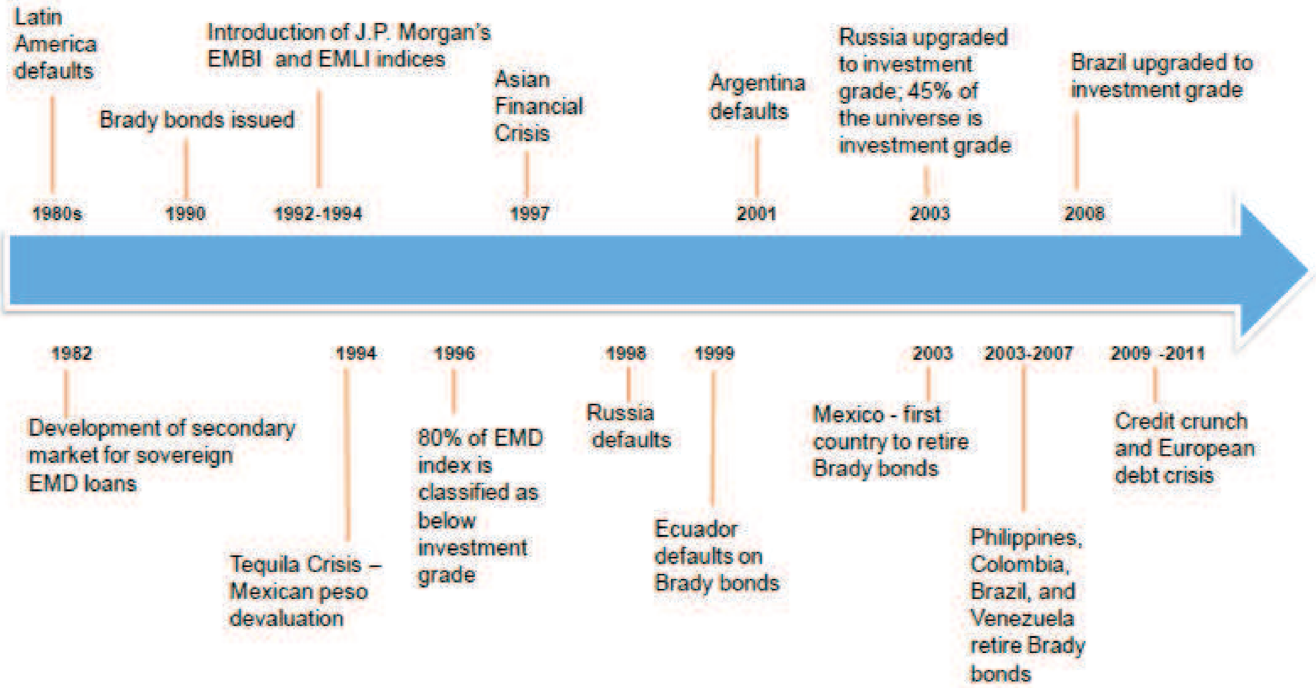
There have been four major phases in the development of the EMD market in the last 30 years;

- 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 61 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, however 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. The JPM GBI-EM index of local currency government bond issuers includes 16 countries (compared to the 61 countries represented in the hard currency index).

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 Emerging Market hard and local currency debt and for Emerging Market corporate bonds:

- **JPM EMBI Global Index (hard currency)**: the EMBI Global tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. Global indices exclude countries with capital controls, in other words, they are more reflective of the investable universe.

- **JPM GBI-EM Diversified Index (local currency)**: The GBI-EM is the first comprehensive, global local currency Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Diversified indices cap single countries to a given percentage, in this case 10%. This avoids skewing the benchmark towards outlying large countries or conversely the weaker countries receive a fair representation. Global indices exclude countries with capital controls, in other words, they are more reflective of the investable universe.

- **JPM CEMBI Diversified Index (hard currency)**: The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. The index is skewed towards Asia and Latin America which account for approximately 60% of the overall market.

Emerging markets debt benchmark information

Aggregate	EMBI Global % (hard currency)	GBI-EM % (local currency)	CEMBI BD % (hard currency)
By sub-region	**100.0**	**100.0**	**100.0**
Asia	19.1	24.7	37.4
Europe	31.8	36.4	13.1
Latin America	41.1	27.2	28.7
Middle East/Africa	8.0	11.7	20.8
Number of countries	61	16	45
Ratings	**100.0**	**100.0**	**100.0**
AAA			0.2
AA	2.3	0.1	7.4
A	21.0	38.5	22.8
BBB	49.1	54.3	40.2
<BBB	27.6	7.1	29.4
Yield	5.0%	6.4%	4.5%

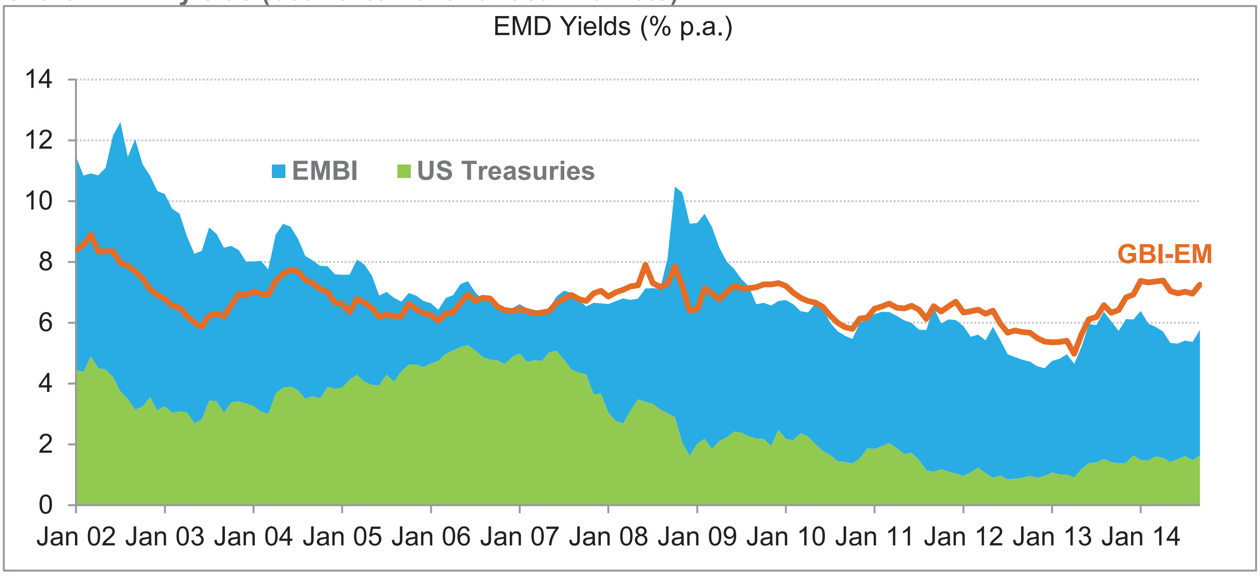
Source: JPMorgan and Barclays Capital as at 30/06/14

Ratings based on the higher of S&P, Moody's and Fitch

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	9.7	12.5	6.5
EM Hard Currency Debt	8.8	8.7	5.4
EM Corporate Debt	7.7	10.1	5.1
Global Bonds	5.0	5.7	2.0
Investment Grade Bonds (US)	5.0	3.5	2.6
High Yield Bonds (US)	8.6	10.4	5.5

Source: Bloomberg, data as at 31/08/14 in USD. *Yield as at 30/06/14.

All emerging market debt asset classes recorded positive returns in Q2 2014, supported by better than expected economic activity and reduced external financing risks.

Inflation remains subdued in general. With most major developed market central banks likely to maintain accommodative monetary policy for the time being, we expect most emerging market central banks to also refrain from raising real interest rates.

Emerging market debt continues to offer value compared with developed markets.

Market Access

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 use of local and hard currency benchmarks and the wide range of countries now included in the indices with economies at very different positions in their cycles argues for a more active approach rather than passive. Therefore, we currently favour access via active management. This can be within a higher yielding multi credit portfolio or via a specialist active manager. In practice there are very few managers who incorporate EMD within higher yielding multi-credit mandates, and therefore a diversified EMD mandate provides the most suitable route to market.

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.

Prepared by:-

Allison Galbraith, Research Consultant

Andy Green, Partner

October 2014

For and behalf of Hymans Robertson LLP

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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