*Meeting:* **Investment Subcommittee**

*Date/Time:* **Wednesday, 29 April 2015 at 10.00 am**

*Location:* **Gartree 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 |
| Mr. J. Shuter | Cllr. M. Graham |

## AGENDA

| Item | | Report by | |
|---|---|---|---|
| 1. | Minutes of the meeting held on 15 October 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. | Recommended switch of investment with JPMorgan. | Director of Corporate Resources | (Pages 7 - 16) |
| 7. | Recommended investment in M & G Debt Opportunities Fund III. | Director of Corporate Resources | (Pages 17 - 24) |

8. Date of Next Meeting - 24 June 2015.

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. | Supplementary presentation on recommended investment in M & G Debt Opportunities Fund III. | Asset Manager | (Pages 25 – 52) |

**Minutes of a meeting of the Investment Subcommittee held at County Hall, Glenfield on Wednesday, 15 October 2014.**

**PRESENT:**

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)

Mr. K. W. P. Lynch CC

Leicester City Council/District Council Representative

Cllr. P. Kitterick
Cllr. M. Graham

University Representative

Mr. A. Stephens

Staff Representative

Mr. R. Bone

**61. Minutes of the meeting held on 25 June 2014.**

The minutes of the meeting held on 25 June 2014 were taken as read, confirmed and signed.

**62. Question Time.**

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

**63. Questions asked by members.**

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

**64. Urgent Items.**

There were no urgent items for consideration.

**65. 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.

**66. Emerging Market Debt - Report of the Investment Consultant.**

The Subcommittee received a briefing note on Emerging Market Debt prepared by Investment Consultants Hymans Robertson. A copy of the briefing note is filed with these minutes marked '6'.

It was noted that Investing in Emerging Market Debt was an attractive option for investors. Yields in the market had risen in recent months which had provided an ideal entry point for new investors. Leicestershire County Council's Pension Fund required a return of 4% per annum real, a figure which Emerging Market Debt investments were currently surpassing.

RESOLVED:

That the information provided be noted.

**67. Schedule of Future Meeting Dates.**

RESOLVED:

That it be noted that the dates of meetings in 2015, are as follows –

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

**68. Date of Next Meeting - 10 December 2014.**

RESOLVED:

That it be noted that the next meeting would be held on 10 December, 2014.

**69. Emerging Market Debt - Manager Interviews - Report of the Investment Consultant.**

The Board considered a report by the Investment Consultant, which provided members with background information relating to the Emerging Market Debt 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.

**70. Emerging Market Debt - 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 £70m commitment to invest in Ashmore’s Emerging Markets Blended Debt Strategy be approved.

Wednesday, 15 October 2014
10.00 am - 12.25 pm CHAIRMAN

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Leicestershire County Council

**INVESTMENT SUBCOMMITTEE – 29TH APRIL 2015**

**REPORT OF THE DIRECTOR OF CORPORATE RESOURCES**

**RECOMMENDED SWITCH OF INVESTMENT WITH JPMORGAN**

**Purpose of the Report**

1. To provide information in respect of a recommended switch between two credit funds managed by JPMorgan.

**Background**

2. The Fund's strategic benchmark includes a 5% weighting in credit, and this exposure is heavily biased towards private debt, a market which appears to offer considerably better future investment returns than those that will be available from liquid bonds (both government and corporate).

3. The Fund's exposure to private debt consists of a £35m investment in the Prudential/M & G UK Financing Fund and a £100m commitment (soon to be fully drawn) in the Partners Group 2014 Private Markets Strategy. Both of these investments are 'closed ended funds' where there is no ability to either add to the investment or to withdraw monies ahead of the natural mechanism built into the funds that will distribute cash as-and-when investments mature.

4. In combination these two investments will total about 4.4% of total assets, and the residual 0.6% is currently held in the JPM Strategic Bond Fund. This fund has been used as a source of funds for the Partners Group investment over the last 9 months.

5. Any target that is set as a percentage of total assets can drift away from the intended weighting simply as a result of divergent performance of different asset classes. For this reason it is considered preferable to maintain a small holding in an open credit fund (i.e. one into which subscriptions and redemptions can be made if necessary) as a 'float' to maintain the weighting at a level that is broadly equal to the strategic benchmark weighting.

6. The Prudential/M & G UK Financing Fund currently has 8 loans within it and the first one is due to mature in 2018, so there is no obvious reason why we should receive any meaningful amount of capital back within the foreseeable future. All of the borrowers, however, have the ability to repay the loans early (subject to certain penalties) if they wish and four of the original loans have previously been redeemed early. Maintaining a 'float' position gives a natural home to any early repayments and the ability to maintain the target weighting.

8. Attached as an appendix is a note from Hymans Robertson concerning the JPMorgan Multi Sector Credit Fund. Hymans view is that this fund is a better fit with

their investment views than the existing JPMorgan fund in which the Leicestershire Fund currently has invested in. As the Multi Sector Fund is relatively new and has only a small amount of assets invested within it, the manager is willing to offer a significant fee (and permanent) reduction for early investors. The fee for investment in the Multi Sector Credit Fund will, as a result, be lower than that paid on the current investment with JPMorgan despite the fact that this kind of fund would normally have a higher fee base. This fee reduction should not, in itself, be considered a reason to consider switching funds but in combination with the fact that the new fund is considered a preferable option to the existing investment, a switch is recommended.

9. Given the small size of the investment, a decision to switch (or not) is unlikely to have any material impact onto total fund performance. On balance, however, a switch is considered to be a better option than maintaining the status quo. The Multi Sector Credit fund has monthly dealing dates, as opposed to the daily dealing of the Strategic Bond Fund, and this is necessary as a result of the less liquid positions that it is likely to hold. Within the context of the Leicestershire Fund's likely activity in respect of purchasing and selling units within the fund, monthly dealing does not create any practical issues.

**Recommendation**

10. The Investment Subcommittee is recommended to approve a switch of investment from the JPMorgan Strategic Bond Fund to the JPMorgan Multi Sector Credit Fund.

**Equal Opportunities Implications**

None specific

**Background Papers**

None

**Appendix**

JP Morgan - Multi Sector Credit (MSC) Fund

**Officers to Contact**

Colin Pratt, Investments Manager
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Chris Tambini, Assistant Director Strategic Finance & Property
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# JP Morgan - Multi Sector Credit (MSC) Fund

## Addressee

This paper is addressed to the Investment Sub-Committee of the Leicestershire County Council Pension Fund ("the Fund"). It should not be released or otherwise disclosed to any third party without prior written consent except as required by law or regulatory obligation.

The paper provides an overview of JP Morgan's relatively new Multi Sector Credit (MSC) Fund which is being considered as a replacement for the Fund's investment in the Global Strategic Bond Fund (GSB).

## Background and Proposal

In 2014 the Fund made a £100m commitment to Partners Group illiquid Multi Asset Credit fund. This is being funded from the JP Morgan GSB mandate. However, as noted in our strategy review, the allocation to the M&G Financing Fund and the Partners Group MAC is likely to be slightly lower than the 5% target allocation to credit strategies. Moreover, with drawdowns and returns of interest and capital there will likely always be an outstanding balance. We proposed that the balance at any time be retained in JP Morgan's GSB Fund subject to reviewing alternatives that may be considered more suitable. At no time is the balance in this fund expected to be material.

As an alternative to the GSB, this paper provides an overview of the MSC Fund, what we see as the key considerations for the Investment Sub-Committee and our overall view.

## The Fund

The MSC Fund was launched by JP Morgan in April 2014. The Fund is a "best ideas", benchmark agnostic strategy which dynamically allocates across higher yielding global credit markets including high yield bonds, US loans, global investment grade, convertible bonds and emerging market corporates. The Fund targets absolute returns of 3% - 7% per annum gross of fees over a credit market cycle. The Fund is currently yielding 4.6% and has an average credit rating of BB. Lisa Coleman, head of global credit and the lead portfolio manager (PM) for the Fund was instrumental in developing the Fund.

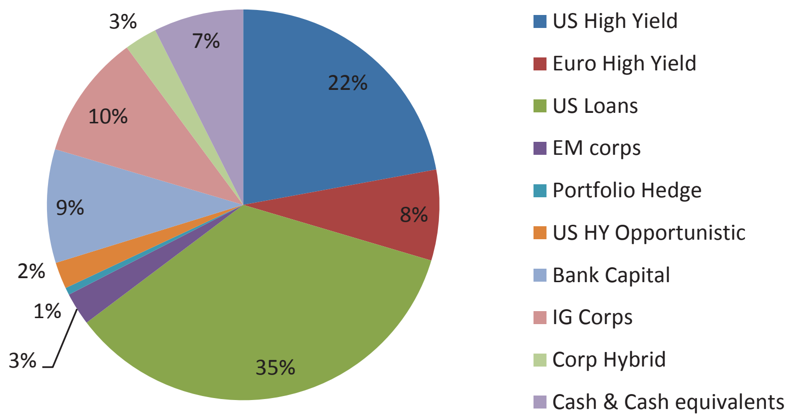
The key driver of returns is the Fund's long term exposure to global credit, in particular higher yielding markets, i.e. similar to the Partners Group fund, but focused on the more liquid enhanced yield markets. The Fund can take small exposure to more opportunistic idiosyncratic strategies - an example JPM gave was a long/short basket of CDS trades. However, such allocations will never be material in size.

The Fund can make defensive allocations to global investment grade credit, although unlike the current GSB, it is not expected that the Fund will have a large long term strategic allocation to this market. The Fund can also put hedges in place to dampen overall performance volatility (again such allocations will not be material).

The portfolio duration (a measure of the Fund's interest rate sensitivity) is expected to be significantly lower than that of more traditional bond strategies and is currently less than 3 years. Currency will not be part of the return/alpha source and all currency risk will be Sterling hedged for UK investors.

Below is a breakdown of the current MSC Fund asset allocation (as at 31st March 2015).

**Current asset allocation chart 1.**




One of the key differentiators of the MSC Fund, relative to a number of its competitors, is the wider opportunity set in which it can invest and includes emerging market corporates and convertible bonds.

### People

Lisa Coleman, global head of investment grade credit is the lead PM for the Fund. Lisa is supported by the senior PMs of the underlying specialist teams who are supported by their own dedicated team resource (figure in brackets). The team includes, Andreas Michalitsianos and Beate Muenstermann investment grade credit (plus16), Alex Sammarco US loans (plus 29), Peter Aspbury European High Yield (plus 5), Eduardo Alhadeff Emerging Market Corporates (plus 11) and Iain Stealey unconstrained fixed income strategies (plus 4). The team is also supported by the quant team.

### Philosophy

The Fund's investment philosophy is to generate returns of 3% - 7% per annum gross of fees over a credit market cycle through accessing the most attractive "best ideas" within global fixed income markets. The investment strategy team (IST), chaired by the fixed income CIO Bob Michele and attended by all the senior PMs across the sector teams, meets quarterly to discuss the key themes driving fixed income markets and sets the macro framework for the MSC Fund.

### Process

Lisa Coleman, the lead PM on the Fund has overall responsibility for the Fund's asset allocation and opportunistic exposure. Lisa works in conjunction with the other specialist PMs in the team to agree overall asset allocation. The process involves a formal weekly sector team meeting to assess relative value across fixed income markets. This process formalises the portfolio positing, given the macro framework set by the IST. Inputs into the process include both fundamental and quantitative. The quantitative inputs are used as an aid to decision making and do not drive investment decisions.

It is the responsibility of the specialist teams to make the individual security selections within the underlying asset sector sleeves. The strategy does not adopt a fund of fund approach and therefore it should only be the "best ideas" form each of the underlying teams which get into the portfolio. Risk management is firmly integrated into the investment process.

### Key considerations

We have detail below what we see as the key consideration for the Investment Sub-Committee to consider:

- **Investment approach** – the MSC Fund aims to achieve its return from allocating to higher yielding credit markets and some active management. The majority of the strategy's return is expected to be from gaining exposure to debt markets, which we favour, with the return from active management secondary, albeit not an immaterial component of risk.

- **Fund size** - the MSC Fund was initially seeded with $25m capital from JP Morgan Investment Bank. However, the introduction of the Volker rule in the US which governs investment banking activity (part of the Dodd-Frank regulation introduced in the aftermath of the 2008 financial crisis) has meant that the seed capital will be required to be returned to the bank sooner than the first anticipated, in June this year. This will leave one remaining investor in the Fund, $10m from a UK Pension Fund.

  JPM has said they are committed to promoting the MSC Fund. However, the Investment Sub-Committee needs to be made aware that there is a risk that JPM fails to raise sufficient assets for the Fund to remain a going concern and the MSC Fund is liquidated at some point in the future.

- **Fees** - JPM is offering a significantly discounted annual management charge (AMC) for the Fund (given the removal of the seed capital). The original headline fee is 50 basis points (bps) annual management charge (AMC) plus 11 bps administration and operational charge, giving a total expense ratio (TER) of 61 bps per annum (p.a.).

  JPM has reduced the AMC to 25bps p.a. The administration costs will remain at 11 bps; giving a TER of 36bps p.a. We have asked if JPM would consider offering a flat fee to Leicestershire of 25bps p.a., which would be the total annual cost for the Fund. In principle they may be supportive of this fee but are required to seek legal counsel before confirming.

- **Transaction costs** – by matching investment with the return of seed money, JPM has agreed to waive any transactions costs associated with funding the allocation to the MSC Fund. There would still be disinvestment costs associated with coming out of the GSB Fund and we have asked JPM to confirm these costs.

- **Liquidity** – an allocation to the MSC Fund needs to be sufficiently liquid to be used as a float to back the Fund's allocation to the illiquid multi-credit mandate managed by Partners Group. JPM has said that they can provide monthly liquidity for the Fund.

  By nature of the main markets to which this strategy is exposed, the liquidity can disappear when markets are under stress, such as was the case around the financial credit crisis.

- **Performance** – it is relatively early days in terms of accessing the overall performance of the MSC Fund. Since inception (April 2014) the Fund's Sterling share class has returned 3.6% with less volatility than the high yield bond market and broadly equal to the average return of investing in high yield and syndicated loans.  We have provided performance on an absolute and relative basis for a number of the underlying strategies, since inception, in the appendix. In general performed has been inline or better than the individual strategy's benchmark performance.

### Our overall view:

We are supportive of transferring the Fund's allocation from the GSB Fund to the MSC Fund. Albeit, this is with the caveat that the MSC Fund may struggle to reach critical mass and could be liquidated at some future date. Our view is based on a number of factors and includes:

- The fee on the MSC Fund compares favourably with other similar funds in the market and is the same as the current fee the Fund is paying for the GSB Fund (which is 30bps AMC plus an additional 6bps administration costs, giving at total expense ratio of 36bps). And indeed will be less if JPM agrees to the flat fee of 25bps which we have requested.

- Leicestershire already has exposure to many of the underlying strategies through its allocation to the GSB Fund. And it is the same investment resource and philosophy used to managed both the GSB Fund and the MSC Fund. However, the MSC Fund will provide a greater strategic long term allocation to higher yielding global liquid credit markets and is therefore more likely to provide the higher returns required. We also like that the investable universe is wider than many of the competitor Funds and includes emerging market corporates and convertible bonds.

- We believe monthly liquidity is sufficient for the MSC Fund to be used as a float to support the illiquid allocation to the Partners Group mandate.

Prepared by:-

Claire Ballantyne, Bond Research Consultant

Andy Green, Partner

April 2015

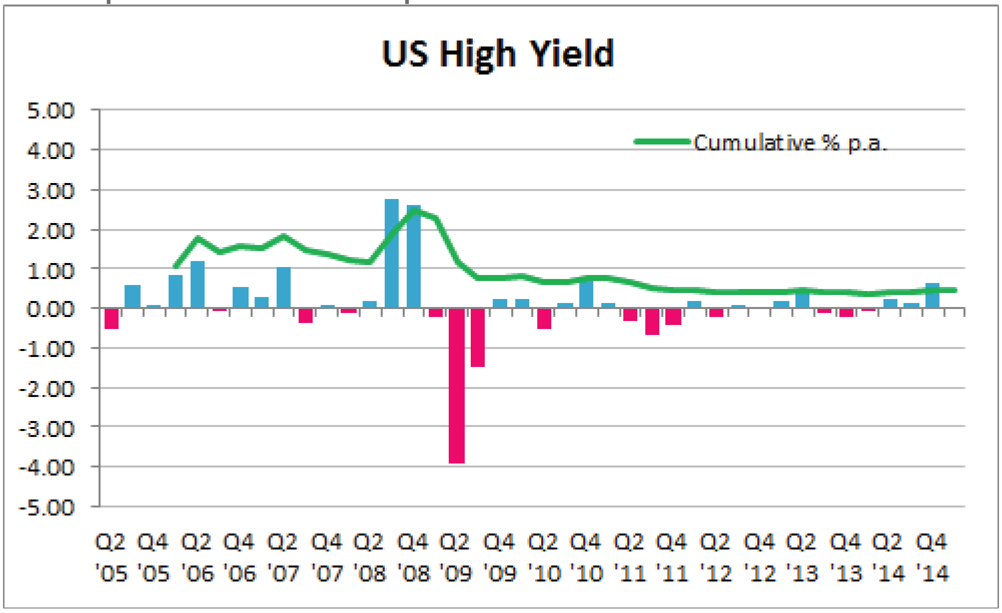
For and on behalf of Hymans Robertson LLP

### 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.

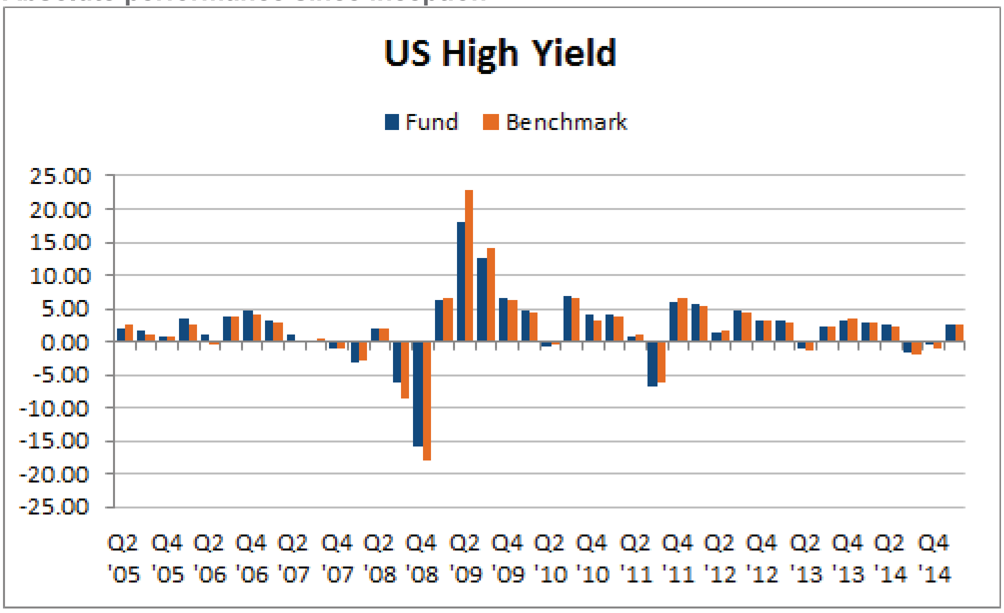
# Appendix - Performance of underlying strategies

**Relative performance since inception**



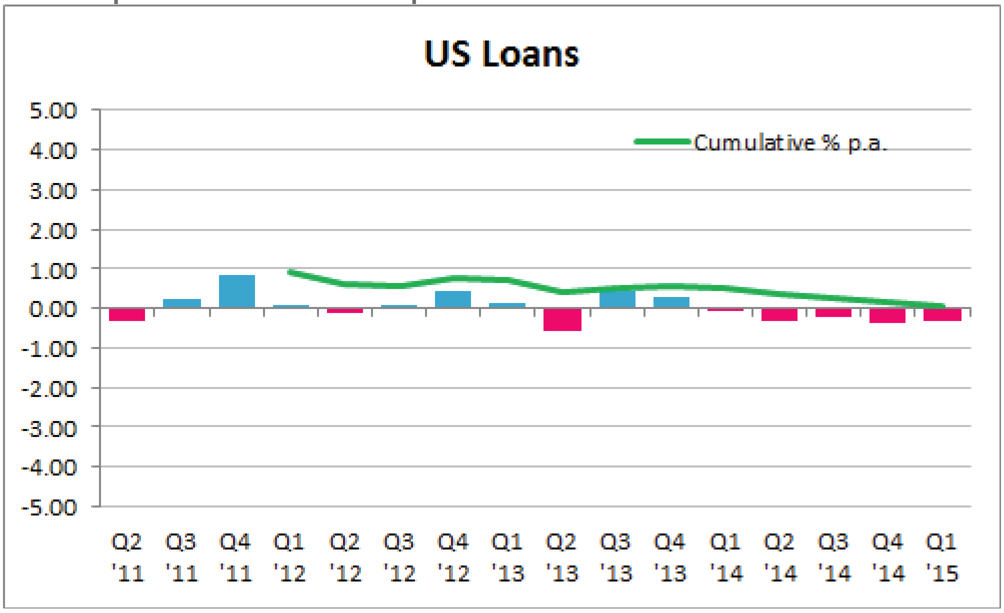

Fund source: JP Morgan, Benchmark source: JP Morgan - Barclays Capital High Yield 2% Issuer Capped Index

**Absolute performance since inception**



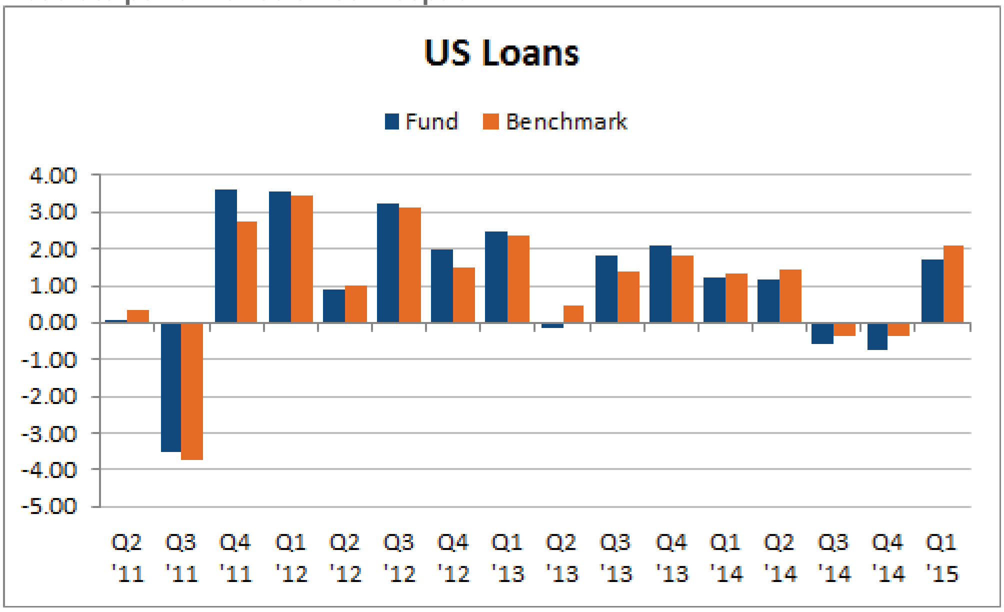

Fund source: JP Morgan, Benchmark source: JP Morgan - Barclays Capital High Yield 2% Issuer Capped Index

**Relative performance since inception**



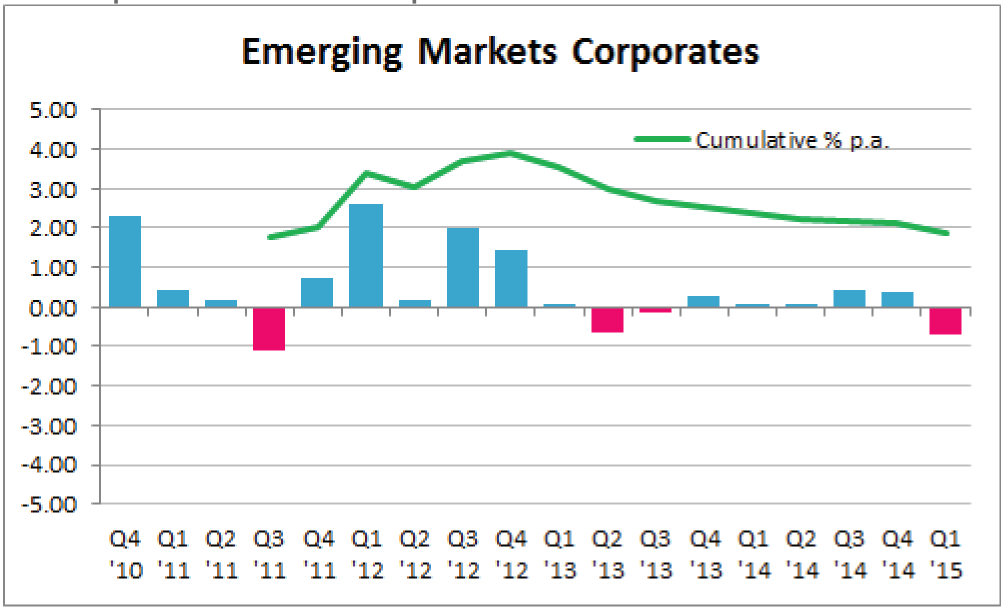

Fund source: JP Morgan, Benchmark source: Credit Suisse Leveraged Loans Index

**Absolute performance since inception**



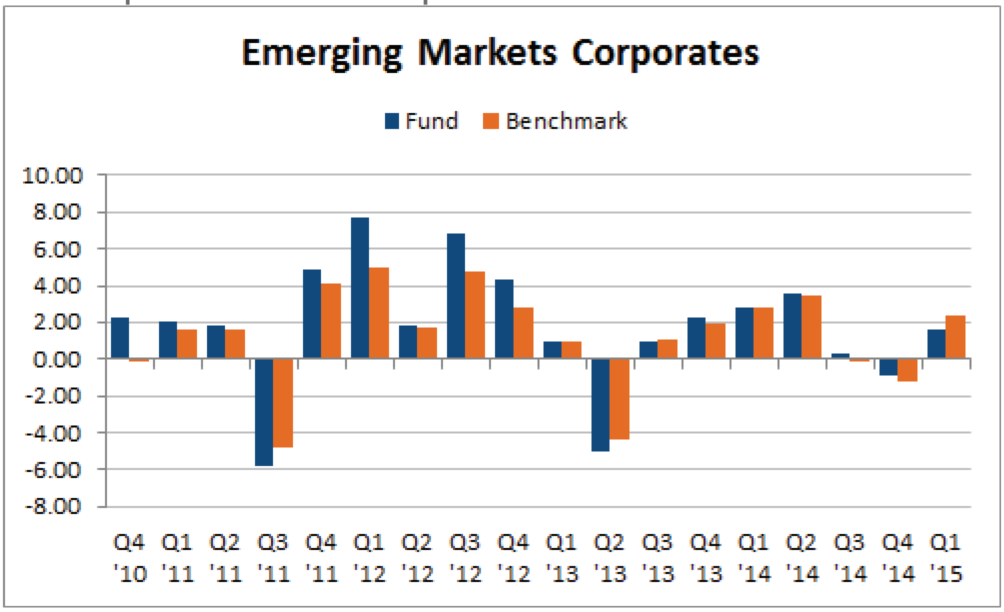

Fund source: JP Morgan, Benchmark source: Credit Suisse Leveraged Loans Index

**Relative performance since inception**



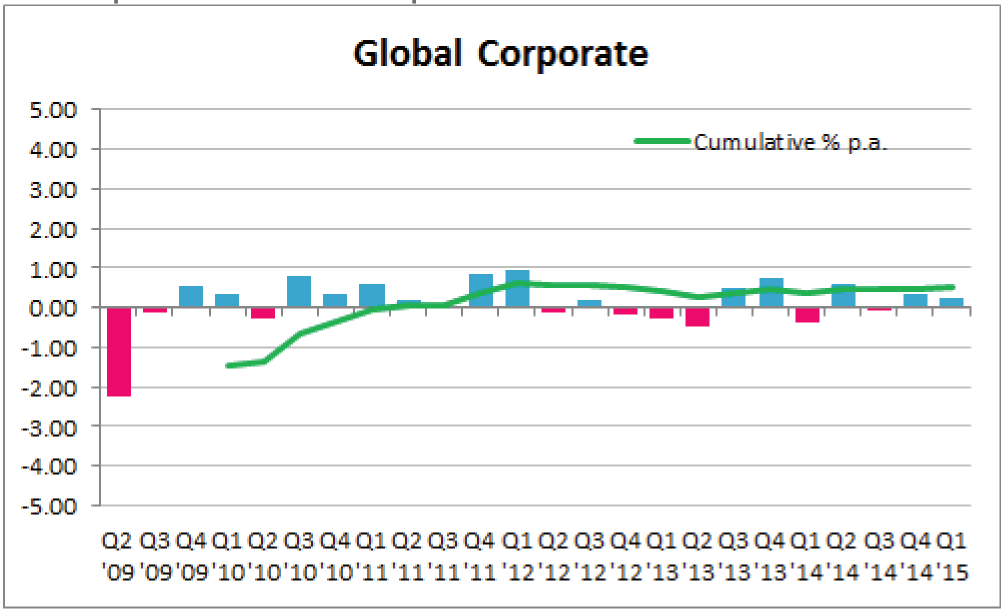

Fund source: JP Morgan, Benchmark source: JP Morgan CEMBI Broad Diversified Index

**Absolute performance since inception**



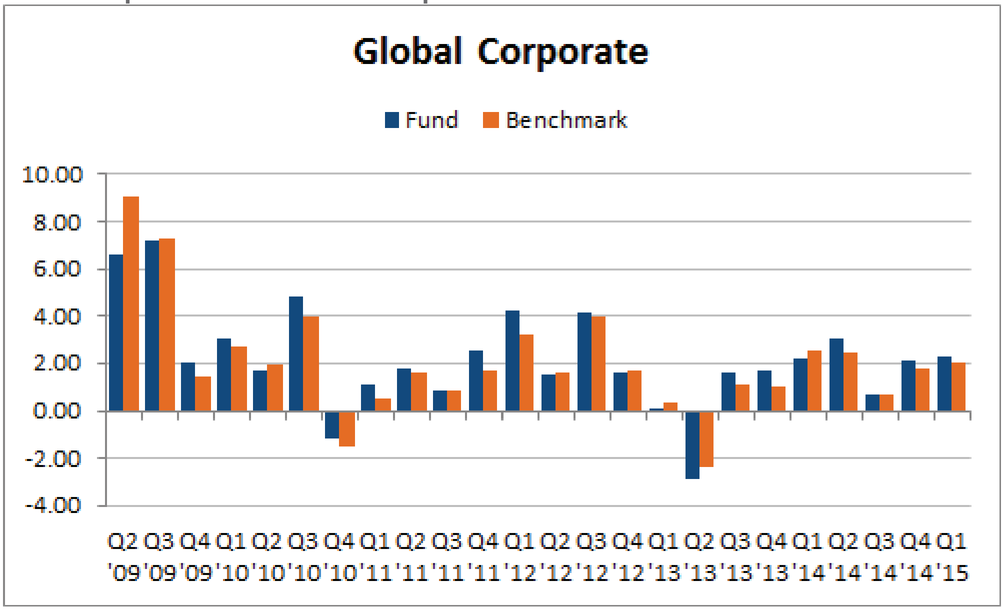

Fund source: JP Morgan, Benchmark source: JP Morgan CEMBI Broad Diversified Index

**Relative performance since inception**




Fund source: JP Morgan, Benchmark source: Barclays Global Aggregate Corporate Bond hedged USD

**Absolute performance since inception**




Fund source: JP Morgan, Benchmark source: Barclays Global Aggregate Corporate Bond hedged USD

Leicestershire County Council

**INVESTMENT SUBCOMMITTEE – 29TH APRIL 2015**

**REPORT OF THE DIRECTOR OF CORPORATE RESOURCES**

# RECOMMENDED INVESTMENT IN M & G DEBT OPPORTUNITIES FUND III

## Purpose of the Report

1. To provide information in respect of a recommended investment in the M & G Debt Opportunities Fund III (DOF III).

## Background

2. As part of the Fund's 'Opportunity Pool' allocation, investments have been made into the two previous M & G Debt Opportunities Funds - £35m into the original fund and £40m into DOF II.

3. The intention was that the two existing DOF investments would total 2.5% of Fund assets and it was always thought probable that the original fund would start to return capital before DOF II had been fully drawn. At the time of agreeing the investment in DOF II the total commitment to the two funds was nearly 3% of Fund assets.

4. The original DOF fund became fully drawn in April 2014 (having started to draw capital in September 2012), and DOF II is currently 64% drawn (the first drawdown was July 2014) and is expected to be fully drawn within the next 3 – 4 months.

5. The first DOF fund is now at a stage of maturity that all of the capital and income that it generates is likely to be paid out to investors, and the first distribution (of nearly £5.5m) occurred in February 2015. M & G will provide a presentation to the Investment Subcommittee at today's meeting which will give details about the performance and activity within both of the existing DOF funds, and these have been sufficiently good to suggest that the investment rationale behind the opportunity has been sound and that the manager has the required skills to identify and realise the opportunities that exist. Investors committed to all three Funds are protected against undue risk concentration at a co-mingled level by risk concentration limits set and maintained by M & G.

6. The Debt Opportunity Fund III is almost identical in structure to the previous DOF funds. The investment manager is of the opinion that there remain ample opportunities available to raise another fund with a target return of 15% p.a. and the Pension Fund's investment advisors considers that it remains an attractive investment opportunity. A paper provided by Hymans Robertson is attached as an appendix to this report.

7. The Fund's investments in the previous DOF funds sit within the 'Opportunity Pool' allocation of the strategic asset allocation. Given the expectation that the first fund will be distributing significant sums back to investors over the next two years, and given the success of the strategy, it is considered sensible to commit to DOF III in order to maintain the Fund's intended 2.5% weighting to the strategy. A sum of £40m should be sufficient to maintain the weighting, and the new commitment should be considered as a 'recycling' of the capital being generated from the first fund. Based on the current fund size an investment of £40m is 1.3% of total assets.

8. The Fund's asset allocation to the opportunity pool has been agreed at 4% - 6%, so there is still significant scope to add other investments into the pool. The opportunity pool currently consists of the two DOF investments and a specialist property fund, and other opportunities that are considered attractive will be brought to the ISC when they are identified. The first source of funds for any new opportunities will be the residual c.£30m investment still held with Pictet, so further opportunities will not unduly impact onto the Fund's other portfolios and general cash flows remain sufficiently strong that these are likely to be of use in funding any further opportunity pool investments.

9. **Supplementary Information Informing the Recommendation to approve a £40m commitment to invest in the M & G Debt Opportunities Fund III**

An exempt presentation by M & G informing the proposed investment, which is of a sensitive nature, is included as item 10 on the agenda.

**Recommendation**

10. The Investment Subcommittee is recommended to approve a £40m commitment to invest in the M & G Debt Opportunities Fund III.

**Equal Opportunities Implications**

None specific

**Background Papers**

Investment Subcommittee – 26 March 2014 – Recommended Investment in M & G Debt Opportunities Fun II
http://politics.leics.gov.uk/Published/C00000919/M00004024/AI00037705/$Item6InvestmentinMGDebtOppsfinal.docA.ps.pdf

**Appendix**

M&G Debt Opportunities Fund III

**Officers to Contact**

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Chris Tambini, Assistant Director Strategic Finance & Property
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# M&G Debt Opportunities fund III

## Addressee

This note has been prepared by Hymans Robertson for the Investment Sub-Committee of Leicestershire County Council Pension Fund (LCCPF).

## Introduction and Proposal

M&G are in the process of launching their third distressed debt fund, the Debt Opportunities Fund (III). This note is designed to provide a detailed overview of the key characteristics for the Fund. This paper should not be released or otherwise disclosed to any other third party, except as required by law, or without our prior written consent. We accept no liability where the paper is used by, or released or otherwise disclosed to a third party unless we have expressly accepted such liability in writing.

LCCPF has already made an allocation of £35m to M&G's first Debt Opportunities Fund (DOFI) and a further £40m allocation to the manager's second Fund, DOFII. DOFI is fully invested with DOFII 64% drawn.

In order to maintain a rolling commitment to M&G's management of assets in this sector of the debt markets as DOFI begins to pay down, we suggest a commitment of £35m to £40m to DOF III would be appropriate.

Funding for DOFIII would come from DOFI distributions and the reduction in the Fund's commodity exposure (assuming any disinvestment occurs ahead of funding). To the extent this is insufficient to meet calls for cash, strategic funding should be from equities, which acts as the strategic balance to variation in the LCCPF Opportunity Pool allocation.

## Firm Background

M&G investment management is a wholly owned subsidiary of the listed financial services group, Prudential. Fixed income is a vital part of firm's business, both externally and for the management of internal insurance assets and represent the vast majority of the assets under management. The firm's UK heritage has led to its success in managing assets for UK institutional clients. M&G employs one of the largest credit resources in the city across both the public and private debt markets. The debt restructuring team sits within the wider debt resource. Paul Taylor, head of the team, launched the first Debt Opportunities Fund in 2012, and the second in 2013.

## Overview of the strategy

The launch of the Debt Opportunities Fund (III) follows the success of DOF I & II.

- The first fund which closed in June 2012 with €280m of commitments had a 2 year drawdown period. To date 100% of the committed capital has been drawn with 19 investments made in Europe. This month it is making its first distribution of capital to investors of €50m. The first fund's current performance, based on five realised investments and the expected return on current portfolio holdings, is well in excess of the 15% return target.

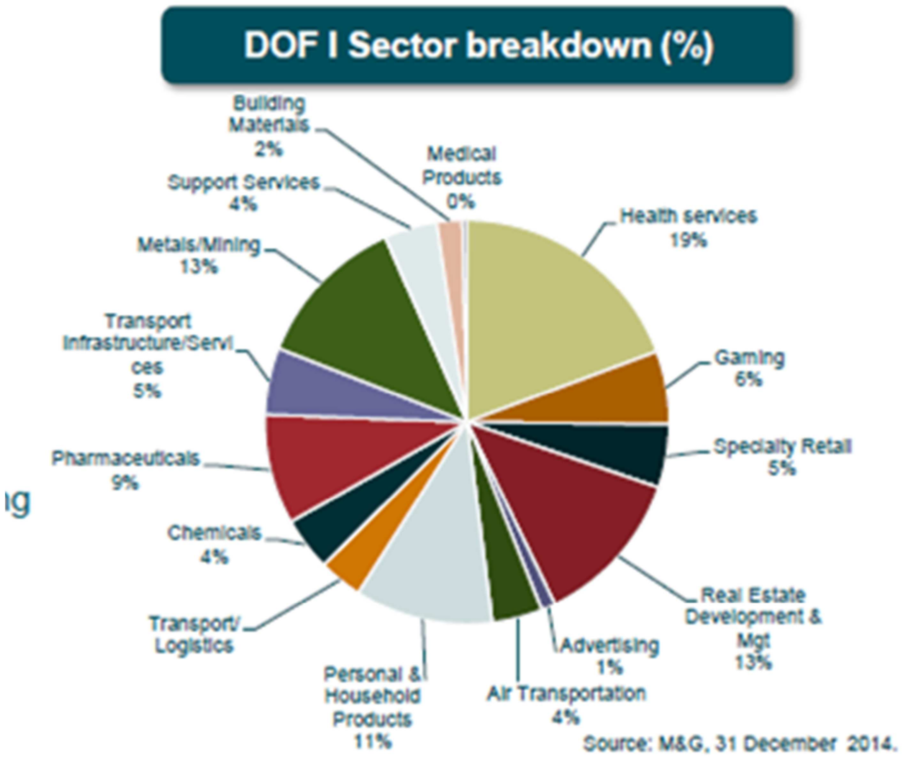
  The €50m distribution reflects the repayment or sale of 3 assets in the Fund. Two loans are being repaid early with internal rates of return of 22% and 109% gross of fees and charges. The third loan is being sold in the secondary market at an internal rate of return of 53% gross of fees and charges.

- The second fund closed in June 2014 with €300m of commitments and also has a 2 year drawdown period. 50% of commitments were drawn in the second half of 2014, and the fund is now 64% drawn.

**Table 1: Snapshot of investments in Debt Opportunities Fund (I)**

| Company | Seller | Reason for Sale | Exit strategy | Target IRR |
|---|---|---|---|---|
| **Alliance medical** | Dubai International Capital | Forced sellers – due to lack of refinancing | Restructuring and sale of business | 15% |
| **Irish House Builder** | Banks | Banks were forced sellers | Recapitalisation and restructuring of business | Current IRR 30% |
| **Ground rent securitisation** | Banks | Banks were forced sellers | Sold in secondary market | Returned 14.3% |

**Chart 1: Distribution of investments in Debt Opportunities Fund (I) (source M&G)**




DOFIII will follow the same investment philosophy, investing in a concentrated portfolio of European distressed debt opportunities. Although there is no standard definition of what constitutes 'distressed' debt, it typically starts with the price. Distressed debt managers target bonds, loans and other financial claims which offer high levels of yield (>10%), often trading at a meaningful discount to their par value (>40%).

This discount might exist for numerous reasons. These include deterioration in the credit-worthiness of the borrower, perhaps due to its underlying business suffering, or uncertainty regarding a future requirement for re-financing or restructuring of the debt. Some might already be in reorganisation proceedings under bankruptcy law, with others perceived to be at material risk of being so. In these instances, investors rightly expect higher rates of return and running yields to compensate them for the elevated risks they face.

M&G's approach to distressed debt is value-driven. The team seek to identify and analyse companies where they believe - based on the valuation of the company and or its assets - the market is overly discounting the value of the debt.

The team do not consider themselves as activist investors (per se) in this space, but will get involved in the restructuring of companies, sitting on creditor boards and appointing interim new management where appropriate.

### Key drivers for the strategy

The market environment for distressed debt is driven by a number of factors, most notable being:

- **Supply.** In contrast to most risk asset classes and strategies, distressed debt managers can find that difficult financial and economic conditions act in their favour, through increasing the supply and breadth of potential investments (of which only a very small proportion will ever be attractive) and the likelihood that current owners of this debt are willing to sell at heavily discounted prices. This potential for counter cyclicality is one of the most attractive aspects of the asset class.
- **Basel III implementation.** The key impacts of this regulation is an increase in capital requirements for banks, changes to the way counterparty risk is assessed and the re-rating of certain risk assets. All of which have added further pressure on European banks that have been deleveraging since the 2008 financial crisis.

  One of the resulting opportunities is the ability to purchase assets from banks at discounted prices (although this has been much slower to transpire than many initially though at the end of the financial crisis). It has also led to tighter credit conditions making it harder for companies to access financing which can lead to financial difficulties and as such investment opportunities.
- **Corporate balance sheet and working capital efficiency.** This has a much wider impact on corporates at this stage of the credit cycle compared to 2008-2009, when distressed opportunities where largely driven by overleveraged LBO companies

### European focus

The uncertainty regarding the current macro-economic situation in the Eurozone might superficially draw into question the legitimacy of focusing on an investment in this region (rather than, for example, the US, or globally). However, we are comfortable with the Fund's European focus for three reasons.

Firstly, the investment is so security specific such that its outcome is unlikely to be primarily driven by broad economic outcomes, but rather the resolution of each specific debt situation. Some of the businesses involved are also likely to have meaningful business interests / revenue streams outside of Europe anyway.

Secondly, we regard the key to success in this fund as being the expertise brought by the investment manager and its knowledge of the underlying companies – M&G's European focus fits well here.

Finally, it will arguably be some of the Eurozone stresses (i.e. contraction in lending from Banks caused by ongoing deleveraging pressures) that will drive the scale of the opportunity set and their potential returns.

### Overview of risk

The Fund faces the idiosyncratic and operational risks associated with individual securities, which are selected by the fund manager, Paul Taylor and his team. Security selection is vital to the success of the Fund, in particular, given the expected concentration of portfolio holding (between 10 – 20 securities). The high level of income and returns sought will provide little protection against outright loss form one or two poor decisions.

To mitigate losses the team adopts a risk averse, credit driven and disciplined approach to security selection. Each investment decision must meet a number of set criteria at both the financial and legal level.

The set criteria (checklist) include; ensuring the underlying business is sound, the supporting assets underpin a recovery, financial diligence confirms value, legal diligence confirms a clear path through restructuring, the ability for M&G to join the creditor committee or otherwise influence restructuring, a clear strategy for managing spoiling tactics from equity holders and other creditors, debt yield to maturity must be over 15% and finally there must be multiple ways to exit the position and unlock value.

We would note that success in security selection is not necessarily dependent on the overall macro-economic environment, good or bad. However, we would expect that widespread recovery in the coming years would act as a tailwind to the fund (to the extent that this had not reduced prospective returns through occurring during and / or prior to the investment period).

### Strategic rationale

As a recap, we include in the Appendix to this note the strategic rationale for investing in the M&G Debt Opportunity Fund range.

In brief, we consider the M&G Debt Opportunities Funds an attractive diversifying growth strategy for those clients willing to withstand the illiquidity (5-7years).

It can be considered alongside other forms of higher risk lending, such as high yield bonds and loans. Although we might expect there to be a degree of correlation with the high yield bond and loan markets, the returns of distressed debt portfolios will be extremely security specific.

This is not an approach based simply on earning coupons / yield and avoiding default. Instead, successful investing is heavily reliant on having debt restructuring expertise, which may involve some level of activism, and understanding different European jurisdiction is critical.

### Key features of the proposed investment

Key features of this fund are similar to previous funds, namely:

- The fund invests in the debt of underperforming, stressed or distressed UK and European issuers
- Target return; minimum of 15% p.a. net of all fees
- No leverage will be used in the fund
- The fund has a 5 year term (with options to extend to 7 years)
- Drawdowns will be spread over the initial investment period of up to 2 years
- Investments; 10-20 names (max 15% of commitments to a single name)
- Size of Fund: Target fund size is €750m
- Should be viewed as illiquid for the entire term

### Our overall view

We think there is a strong case for employing M&G as a distressed debt manager and support an investment in the managers Debt Opportunities Fund (III). This recommendation is based on both the manager's ability in distressed debt investing on a standalone basis and its competitive position over alternative investors.

On a standalone basis, the team has provided reasonable evidence of demonstrable experience and track record in dealing with similar investments in the past, initially investing for its own Life book of assets, before launching an external fund in 2012. It has also shown sufficient due diligence resource, with a team of credible restructuring specialists and large private and public credit research teams.

In terms of its competitors, M&G's position as a leading debt investor (both for external investors and its own Life Fund) provides it with a competitive edge in this area.

Firstly, the exposure and information gained on underlying borrowers by M&G through its current debt and/or equity investments (e.g. within its Life Funds) will be critical in identifying opportunities.

Secondly, M&G's ownership of debt outside of the Debt Opportunity Fund's assets is important in establishing control during any restructuring (in many instances, M&G will, in aggregate, own 25% or more of the debt capital / instrument involved).

Finally, subject to appropriate arrangements as to equal treatment of the different investors, we regard the common ownership of M&G with the Fund as being attractive in terms of aligning interests.

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For and on behalf of Hymans Robertson

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**General Risk Warning**

This Briefing Note is general in nature and it does not provide a definitive analysis of the subject matter covered and may be subject to change. It is not specific to the circumstances of any particular employer or pension scheme. The information contained herein is general in nature, not to be construed as advice and should not be considered a substitute for specific advice in relation to individual circumstances. Where the subject of this note refers to legal issues please not that Hymans Robertson LLP is not legally qualified to give legal opinions therefore you may wish to obtain legal advice. Hymans Robertson LLP accepts no liability for errors or omissions.

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

## Strategic rationale for investing in M&G Diversified Opportunity Funds

We consider the M&G Debt Opportunities Fund III as an attractive diversifying growth strategy for those clients willing to withstand the illiquidity (5-7years).

- It could be considered alongside other forms of higher risk lending, such as high yield bonds and loans. Although we might expect there to be a degree of correlation with the high yield bond and loan markets, the returns of distressed debt portfolios will be extremely security specific, depending on the success or otherwise of the managers' sourcing, due diligence and restructuring activities, etc. This is not an approach based simply on earning coupons / yield and avoiding default. Instead, successful investing is heavily reliant on having debt restructuring expertise, which may involve some level of activism.
- Distressed debt remains a 'niche' strategy, accessed by only a small proportion of the institutional investor market. Whilst the number of market participants is growing, investments are often made through private transactions and therefore not widely available to the broader investment management industry.
- There is a valid investment thesis for the distressed debt opportunity set, particularly in Europe. Increasingly stringent regulatory requirements will continue to place pressure on banks to de-lever combined with difficult economic conditions which should increase the supply and breadth of potential investments (of which only a very small proportion will ever be attractive). Despite the increased ECB support, the sluggish economic recovery in Europe will challenge poorly capitalised corporates.
- Given the often private nature of distressed investing there tends to be a restricted (if any) secondary market. Therefore, the timing of exit or sale of the underlying securities can be an important determinant of total returns. Clients face the risk that the macro-environment during any 1-2 year window is not conducive to selling risky assets. However, we are comfortable with this risk given the strategy is not heavily reliant on the existence of a secondary market to exit positions. But rather clients' capital will be returned through the debt maturing and / or through the restructuring process resulting in the debt being repaid prior to maturity.
- Perhaps the greatest hurdle to demand from potential investors in this market is transparency and governance. Investors must rely on the skill of the investment manager in accessing deals and in the market environment being such that enough attractive opportunities are available. We believe that M&G has a proven track-record investing in this market and will continue to find attractive investment opportunities though out credit cycles through a combination of the firm's extensive knowledge of the market and its reputations of being one of the largest credit managers for both its internal and external client base.

By virtue of paragraph(s) 3, 10 of Part 1 of Schedule 12A
of the Local Government Act 1972.

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