Annual review of asset strategy and structure

Addressee

This paper is addressed to the Local Pension Committee (LPC) of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to provide the 2017 annual assessment of the Fund's investment strategy.

The note has not been prepared for use for any other purpose. It 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.

Executive Summary

Required return

The Fund's investment strategy is structured to deliver a blend of diversified return sources, with an emphasis on long-term investment and an element of inflation linkage. Our view of the expected real return over CPI is currently around 3.9% p.a.

Based upon the results of the 2016 valuation we estimate that the required return on Fund assets is between 3% to 3.5% p.a. above CPI inflation (after expenses) allowing for removing the deficit over a 20 year period and allowing for the difference between expected contributions and future service cost.

Hence, the expected return of the current strategy provides a small margin over the required return. This increases the chances of achieving the required return and we do not propose the need for any wholesale change in the target level of return.

Market Conditions

Our concerns remain that the level of future interest rates implied by long-dated gilt yields are too low, particularly relative to market implied RPI inflation, but equally that there is little expectation that UK rates are going to rise much more than they have in recent months (i.e. back to levels seen earlier in 2016) in the near-term. This applies equally to US treasury yields, which have risen faster than UK gilt yields, but still only to levels of 12 months' ago.

Over 2016 implied inflation pricing has also risen. Increases in short-term inflation can be expected both locally (Brexit) and globally (Trump policy). However, implied prices for longer-dated inflation have also risen.

2016 has been another strong year for equity market returns, which have been driven again by revaluation (i.e. a rise in Price/Earnings (P/E) ratio or how much investors are willing to pay for one year's profits) rather than earnings growth, which continues to flat-line globally, at least in local terms.

While US fiscal policy under Trump may evolve into a more persistent growth story for the US economy, it is not obvious that this will be to the benefit of wider global growth. As such forward looking expectations for global equities are caught between a rock and a hard place: either growth remains lacklustre, limiting future returns, or rates rise on the back of some more persistent growth, with the consequence of higher corporate borrowing costs and reducing the price to earnings investors should be willing to pay.

In this environment the outlook for both interest rates and equities remains uncertain. As a result we continue to consider the predictability of returns from shorter-dated debt and longer-dated secure real income assets provides relative attraction.

Recommendations

We do not see the need for any fundamental changes to the Fund's strategy at this time. The recommendations we make this year continue to be an evolution of the existing strategy.

As greater clarity emerges over the nature of the UK's exit from the EU and the policy direction of Trump it may be appropriate and opportune to adapt the Fund's strategy further, and therefore there may be a need to revisit the strategy ahead of 2018.

Based upon what we know today, we recommend the following:

Equities

- Given the dependency of equities on positive economic outcomes, coupled with comparatively strong returns over the last 3 years, **we recommend a 2.5% reduction in the strategic allocation to equities, which can be used to fund a higher allocation to private lending**. **We propose this reduction is applied broadly across the Fund's regional equity allocation**;
- As referred to last year, **we recommend the Fund consider the introduction of a global equity mandate with a growth bias to sit alongside the value bias of the passive RAFI mandate and the active income mandates**. This will give better diversification to sources of return in the equity portfolio than the current inherent factor biases. **However, we would expect that implementation be considered alongside proposals for equity investment in the Central pool rather than as a stand-alone exercise now**.

Income assets

- With market volatility and uncertainty over returns, we continue to favour the predictability of returns from relatively short-dated corporate lending. In particular we favour the characteristics of originated lending where the investor has more control over the terms of lending and where the expected return is not dissimilar to the expected return on global equities.
- We continue to prefer global managers such as Partners, who can tilt portfolios towards what they consider to be the most attractive markets. For example, through a combination of demand by European investors to lend capital coupled with better opportunities in the US, Partners are currently biasing their latest portfolio towards US lending, relative to their usual European bias.
- The Fund currently invests £100m in the Partners 2014 multi-credit private lending fund. **We recommend increasing the target allocation to private lending from 5.0% to 7.5% of Fund assets. To reach the higher recommended allocation we recommend splitting the capital required between Partners 2016 and 2017 multi-asset private lending fund programmes. Partners Group will present to the Committee at the meeting.**

Real Assets

- The Fund's strategic allocation to index-linked gilts is 7.5% of Fund assets, and the benchmark is the Over 15 year index, i.e. primarily ultra-long dated index-linked gilts.
- During the year the Fund's allocation to index-linked gilts was reduced tactically from 7.5% to 5.0%, reflecting the very strong returns that had been delivered by index-linked gilts, especially long-dated bonds. With yields having pulled back slightly from mid-year levels, this tactical positon has been favourable for the Fund. **We recommend closing the position and bringing the allocation back up to 7.5%, with the exact timing being dependent upon consultation between Officers, Investment Consultants and the manager (Kames Capital)**. This is not to say that index-linked gilts could not cheapen further, but is simply the application of disciplined portfolio management.

- With implied inflation having risen, yields on long-dated index-linked gilts look particularly low. Our preference is to use the additional 2.5% allocation to move the benchmark for the index-linked gilts from the Over 15 year index to a broader index. In particular, **we recommend using the Index-Linked Gilts All Stocks Index as the benchmark for the index-linked gilt allocation**.

Prepared by:-

Andy Green, Partner

January 2017, 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 investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

1. Fund asset allocation and required return

Current strategic asset allocation

The strategic asset allocation and implementation of the Fund is structured to accommodate the need for both the long-term return requirements (primarily equities and alternatives) and a degree of inflation linked returns, given the nature of the liabilities.

Details of the current target allocation are shown in the table below:

Equities (50.5-52.5%)

	Manager	Target %
Listed		
UK	LGIM	8.5
Regional	LGIM	26.0
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	6.0
	Delaware	
Private		
	Adams Street	4.0

1. Actual allocation to Pictet is 2.6% due to underweight in Opportunity pool.

Real Income Assets (24.5%)

Inflation Linked (14.5%)

	Manager	Target %
Index-linked	Implemented	7.5
Infrastructure	IFM	5.0
	KKR	
	JPMorgan	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
Fund of Funds	Aviva	10.0
Smaller lots, active value	Kames	
Direct	Colliers	

Alternative (23-25%)

	Manager	Target %
Targeted		
	Ruffer	7.0
	Aspect	4.0
	Pictet	0.5[1]
Overlay	Millennium	-
Other opportunities		
EM Debt	Ashmore	2.5
Credit Opps	JPM	5.0
	UK Financing Fund	
	Partners	
Other opp. pool	M&G	4.0-6.0
	Markham Rae	

Under the current strategic allocation, the lower end of the equity range (50.5%) will only be reached if the opportunity pool investments reach the full weighting of 6% and until the opportunity pool investments exceed 4%, the strategic equity weighting to equities will be 52.5%.

The asset allocation outlined above contains a diversified range of sources of return. Across the strategies, the Fund has exposure to the following sources of return and risk:

- Corporate growth
- Government risk
- Interest rates
- Inflation
- Active management
- Illiquidity premium
- Complexity premium

Required rate of return on assets

The value placed on the Fund's liabilities is determined by measuring the discounted value of the benefits to be paid in the future for accrued benefits. The initial results of the 31 March 2016 actuarial valuation show an improvement in the funding level from 72% to 76% since 2013.

	31 March 2013 £m	31 March 2016 £m
Liabilities	3,652	4,153
Assets	2,628	3,164
Shortfall	(1,024)	(989)
Funding level	72%	76%

During the three year period the liabilities have grown by 13.7% and the assets by 20.3%, resulting in the improvement in funding.

The discount rate used to calculate the value of the 2016 liabilities in the above table is 4.0% p.a., which reflects an asset outperformance over gilts of 1.8% p.a. or a real return over CPI of 1.9% p.a. This means that if the Fund assets were equal to the value of the liabilities, then the Fund would only need to earn a return of 1.9% over CPI (assuming that contributions were sufficient to meet the cost of benefits accruing). However, the Fund assets are less that the value of the liabilities, so the Fund will need to earn a return on the assets higher than the discount rate, i.e. more than 1.9% over CPI, in order to remove the underfunding.

The extent of the excess return required will depend upon the time horizon over which the deficit is to be made good. Ignoring any difference between the value of contributions and the cost of benefits accruing, the required return to restore the funding level to 100% over 20 years is approximately 3.3% p.a. over CPI. This increases to 4.7% p.a. over CPI if looking to restore the funding over 10 years. In practice there will be other external factors such as movements in real yields that influence the discount rate used to value the liabilities and to determine future service costs.

Setting a strategic asset allocation with an expected return of 3.3% p.a. over CPI will by definition only give a 50% chance of achieving required level of return. By targeting a higher expected return, the Fund can increase the proportion of outcomes that deliver 3.3% over CPI or more. The downside is of course that by targeting a much higher expected return, there is likely to be greater variation in outcomes and hence more potential downside. Hence, there is a balance to be struck.

Targeting a real return over CPI of 3.9% provides some headroom over the minimum required return to restore funding – we estimate around a 60% likelihood[1] of achieving the required real return over 20 years. We also estimate that around 90%[1] of outcomes would be better than if the Fund adopted a strategy with an expected return of 3.3% over CPI. Hence, we do not propose the need for any wholesale change in the target level of return. (Note 1: estimated using a simplified model, and to be treated more as illustrative rather than based upon detailed modelling).

Strategic forecast return

As noted in previous reports, this real return target applies at the aggregate Fund level. It does not require every asset and mandate held by the Fund to deliver returns at this level, and the investment policy should reflect a combination of return sources that balance the need to generate return with the benefit of diversification of returns. In the table below we set out the target contribution from each component of the strategy to the overall objective.

	Benchmark weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (52.5%)			
Listed equity	48.5	4.3	2.1
Private equity	4	6.5	0.3
Real (24.5%)			
Inflation linked bonds	7.5	0.3	0.0
Infrastructure	5	3.8	0.2
Timber	2	3.3	0.1
Property	10	2.7	0.3
Alternatives/Diversifiers (23%)			
Targeted return	11.5	4.0	0.5
EMD	2.5	3.0	0.1
Global Credit	5	4.0	0.2
Opportunity Pool	4	4.3	0.2
Currency overlay (Notional weight)	(c10)	1.0	0.1
TOTAL	**100**		**3.9**

Although this is based on our subjective views of long-term strategic returns, it highlights the main source of return is listed equities, with much more limited contributions from other strategies.

In principle, we would prefer a more diversified contribution to the overall expected return, particularly if this increases the predictability of returns. However, this has to be offset against the relatively cheap cost of investing in listed equities.

LGPS Pooling

While the Fund has agreed to become part of a group of eight funds forming LGPS Central, investments will not be managed on a joined basis until April 2018. The approach that LGPS Central adopts for pooling assets is likely to differ from one asset class to another, and there may be different timelines for moving assets to a pooled basis.

Even once LGPS Central pool is fully operational, it will be the responsibility of the Local Pension Committee to set strategy for the Fund. However, during this interim period the Investment Subcommittee will also continue to be responsible for implementing the strategy.

Recognising that there will be a transition of assets into the LGPS Central pool at some point, we do not expect there to be substantial changes to the strategy or its implementation. Hence, as in previous years, the recommendations in this report are relatively modest.

2. Market Commentary

2016 is likely to be remembered as a year of political rather than economic upheaval. Following the US Presidential election, investors quickly put aside earlier doubts and chose instead to focus on certain aspects of the Trump agenda – infrastructure spending, corporate tax cuts – and, to some extent, have taken their implementation as a fait accompli. Implementation may prove more difficult of course, whether it is selling increased spending to Congressional Republicans or lower corporate tax to voters. These aspects chimed with bond investors' pre-election mood - US yields had been drifting higher since the middle of the year, as a pick-up in economic growth made an interest rate rise more likely. After a weak first half of 2016, the US bounced back in the third quarter with the fastest growth for two years and the pace in the fourth quarter seems to be similar.

Elsewhere, further threats to EU stability from Italy and France have not derailed an admittedly subdued recovery. Recession had seemed an imminent threat in Japan, but PMI survey data have picked up – recent yen weakness may have helped.

In the UK, November's Inflation Report from the Bank of England had a more sanguine assessment of near-term growth, although it remained downbeat about the prospects for later in 2017. Thoughts of a further rate cut may have been abandoned for the moment, and market-implied forward rates suggest that it will be two years before interest rates are back to pre-referendum levels.

Government bonds, and interest rates and inflation

Gilt yields continued their climb back from the depths of August – at the end of 2016 10-year gilt yields are 1.4% p.a., i.e. well above the lows of 0.6% p.a. In practice this has only taken them back to pre-EU referendum levels and the gilt yield curve still implies that interest rates will peak below 3%. All of this still suggests a pretty gloomy economic outlook for the next generation, but in reality the outlook from here is very uncertain - there is plenty of scope for the outcome to be a bit better with the result that gilt yields would be more likely to rise further. However, any setback could see yields revert to the low levels of mid-2016.

Inflation risk would seem to be equally uncertain, with signs of investors paying up for inflation protection. The price that investors are willing to pay for inflation protection, referred to as implied inflation, is the difference between the yield on fixed interest or conventional gilts and the yield on equivalent index-linked gilts. The increase in the long-dated implied inflation has risen 0.5% p.a. over 2016 (25-year gilt implied inflation is now 3.7% p.a. compared to 3.2% p.a. at the beginning of 2016) and looks unattractive. A similar picture can be seen in the US - breakeven inflation has risen but, in contrast to the UK, US 10 and 30 year implied inflation ended the years around 2.0% p.a., i.e. in line with the Fed's long-term target.

Other bond markets

In the US dollar high yield bond market, yield spreads edged a little higher in the run-up to the election but have contracted since. In absolute terms, yields remain largely flat over the final quarter because of the rise in risk-free yields, but are now c200bps lower than at the start of the year.

Our general view on high yield credit remains that it retains appeal as a diversifier from equities and is less dependent upon the extent of positive outcomes required to justify equities continuing to move higher. In the case of higher quality issues, absolute returns are likely to be low in the medium term reflecting low underlying Government yields.

Equities and currency

The immediate impact of the US Presidential election on global equity markets has been mixed. It has been unequivocally good for US equities, which have reached new highs despite another disappointing quarterly earnings season. In aggregate, earnings are well ahead of last year's numbers, but still lower than two years ago and short of pre-season expectations. Investors' enthusiasm reflects hopes of a fiscal boost in the US, the prospect of lower corporate taxes and the assumption of an "America first" tilt to trade policy.

Our main concern is that in an environment of growing economic optimism, global equities could be vulnerable to devaluation if bond yields start to rise. In terms of both high current valuations and the momentum of bond yields, the US appears particularly exposed.

In practice, we are slightly sceptical that the Trump economic agenda can be delivered quite as easily as the market seems to discount. Even if it is, the potential rise in protectionism that may be part of the same package could pose a risk to global growth. A post-election fall in emerging market equities is consistent with increased trade risk, although it does no more than unwind relative strength earlier in the year. While we would not ignore the risks that protectionism might bring to emerging markets, valuations here provide a better cushion than in most developed markets and we would not be looking to reduce exposure. Other developed markets were seemingly unaffected by trade concerns and have risen since the election; the main winner has been Japan, where a sharp downturn in the yen provided a potential boost to economic growth.

From a UK perspective, sterling had fallen another 5% in trade-weighted terms at the start of October, but recovered to finish only slightly lower over the quarter as a whole. Sterling weakness has boosted the return to global equities in every quarter of 2016, implying a return enhancement to unhedged sterling investors of nearly 20% p.a. over 2016.

A further currency boost to equity returns over the medium term might suggest that the UK was finding things tough outside the EU. If the longer-term economic impact of Brexit is limited (or even positive), it might be hedged investors whose returns are boosted in the future – on some measures sterling looks very cheap relative to history, particularly against the US dollar. We would hesitate to suggest that currency strategy should be determined by a favoured economic view but, given the scale of sterling's decline, the timing of a review of hedging policy is sensible to ensure it remains appropriate in the context of the overall management of risk and return.

Property

The disruption to the UK property market in the wake of the referendum vote proved to be short-lived. Across the market as a whole, as reflected in the IPD Monthly Index, capital values edged up in October and November. The correction from the peak earlier in the year has been modest and does little to allay our underlying concerns that prices are not cheap and rental growth will be hard to come by, but relative to other assets property provides attractive income yield and has a considerable buffer over Government bonds.

3. Credit Allocation

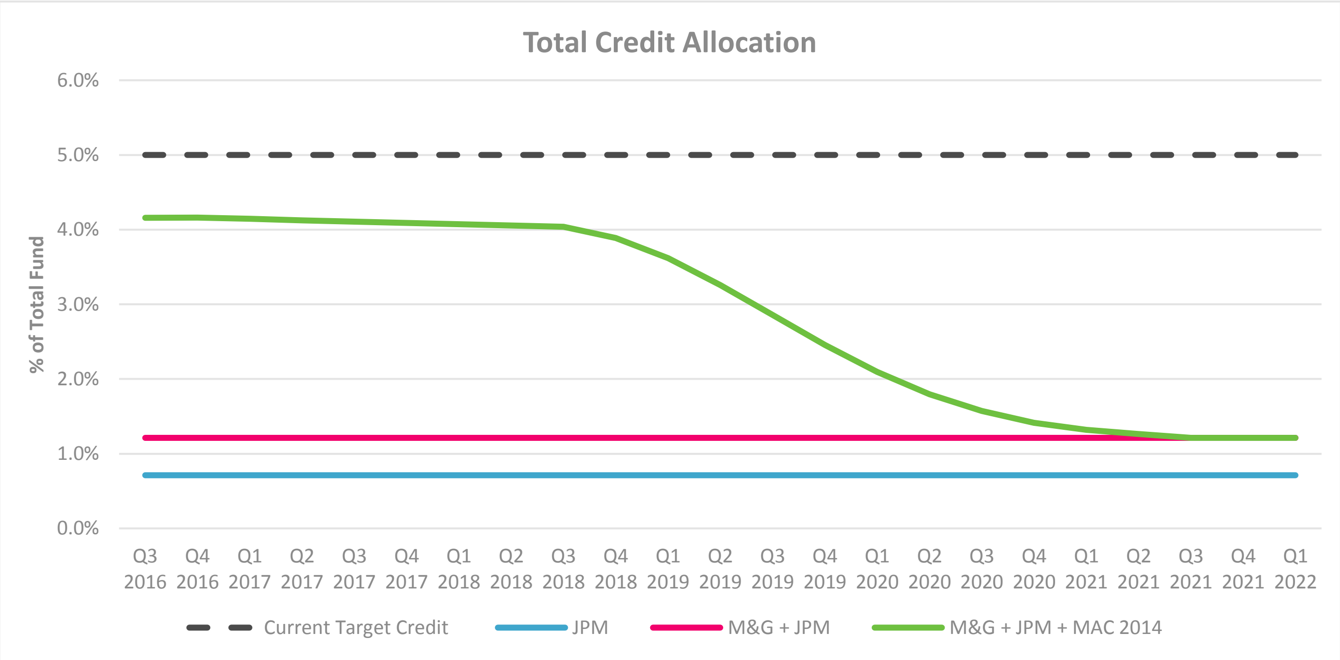
The Fund's global credit allocation is currently split as follows:

	Holding (£m)	Weight (%)
Partners Multi Credit 2014 Fund (originated private lending)	106.3	3.0%
M&G UK Financing Fund	18.3	0.5%
JPMorgan	25.5	0.7%
Total	**154.4**	**4.2**
Target		**5.0**

Although the Partners allocation is fully invested, distributions from the M&G UK Financing Fund mean that the allocation to credit is below target, and with further distributions from Partners MAC 2014, the actual allocation will continue to fall, all else being equal.

The return on Partners MAC 2014 fund has been 6.3% net, and we remain confident that the fund will continue to deliver returns in line with initial expectations of LIBOR + 4% p.a. net of fees.

Money will start to be distributed back from MAC 2014 in terms of income from loans and redemption proceeds when loans are repaid. This is expected to start in 2017, but accelerate into 2018 and beyond. The chart below illustrates the current projection of the Fund's allocation to credit using the projected distribution profile for MAC 2014 expected by Partners and assuming the allocation to JPM and M&G (or equivalent) is maintained.



With market volatility and uncertainty sitting over the return prospects of equity markets, we continue to favour relatively short-dated corporate lending, which offers greater predictability of returns.

In particular we favour the characteristics of originated lending where the investor has more control over the terms of lending and where the expected return is not dissimilar to the expected return on global equities.

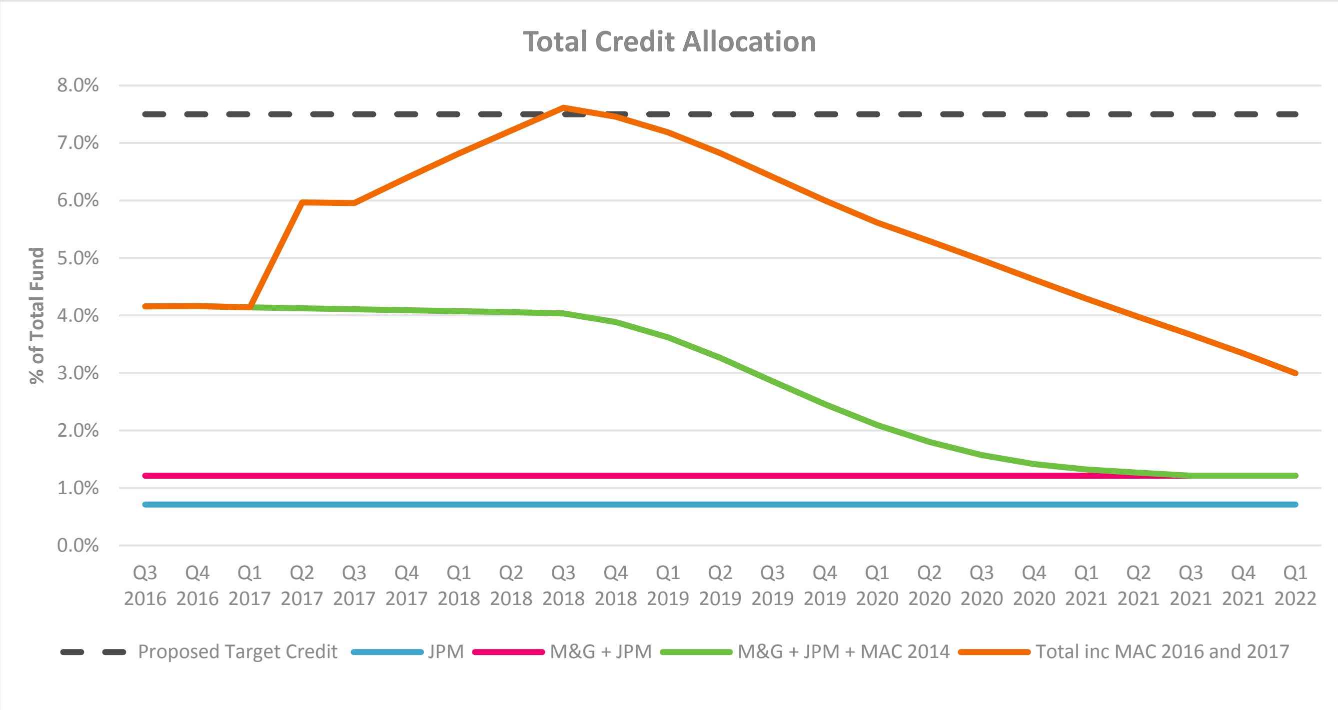
Reflecting this relative predictability we recommend increasing the allocation to corporate lending from 5.0% to 7.5% of the Fund's assets, and to target additional investment in Partners' multi credit strategies to fund this additional allocation.

Partners raise annual funds and are currently in the final stages of investing MAC 2016. The final close takes place in April 2017 when outstanding commitments will be drawn. This fund has already originated 12 loans, with more expected to be completed shortly.

Partners will then begin raising commitments for MAC 2017, which will be drawn in four equal instalments from July 2017 to April 2018.

In the appendix to this paper we provide more details on the Partners MAC 2014 and 2016 funds.

To reach the proposed 7.5% allocation to corporate lending, we recommend that the LPC commit £70m to MAC 2016 and a further £70m to MAC 2017. The chart below illustrates the projected investment assuming 2017 follows a similar profile to 2016.



We note that there is a subscription charge for being a late investor into the MAC 2016 fund. This is to protect earlier investors from any dilution caused by later investors coming into the fund. For an allocation of £70m the required charge would amount to £1.2m. Paying this amount simply puts the Fund in the same position as it would have been had it invested in MAC 2016 fund from the start, i.e. the Fund would benefit from its share of the returns on MAC 2016 since inception of the fund and would not be disadvantaged in any way relative to other investors.

4. Equities

The Fund's benchmark equity allocation is largely invested in listed equity markets (48.5%) with a further 4% of the Fund invested in private equity. The listed equity allocation comprises:

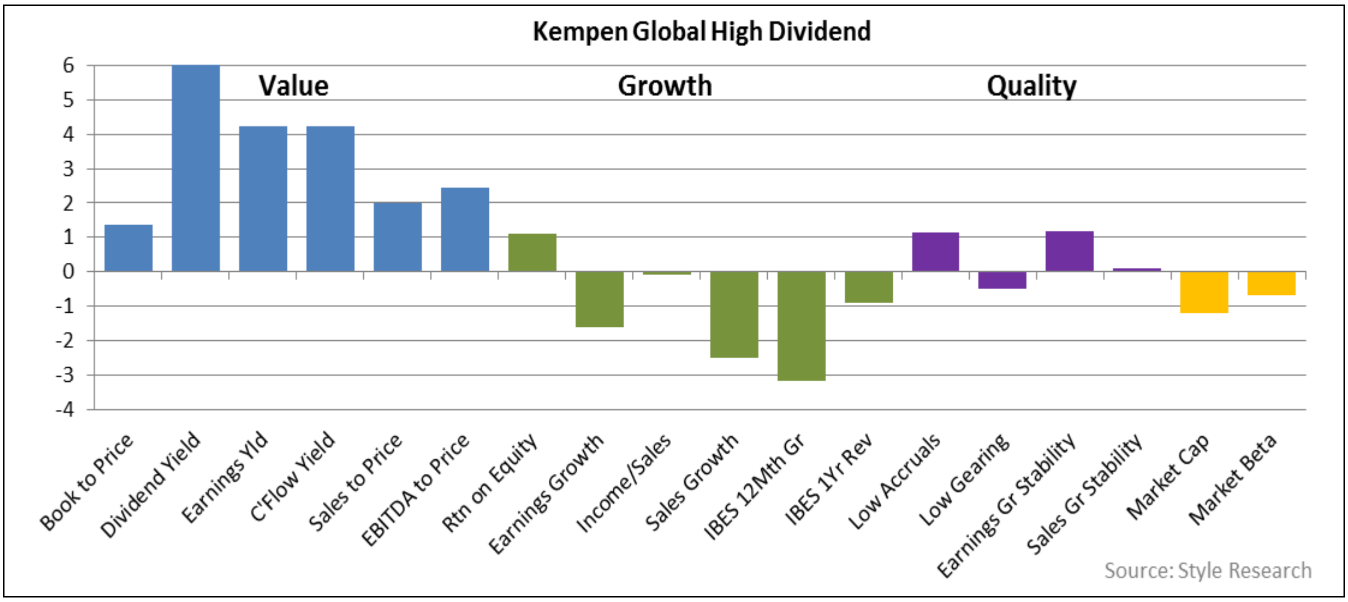
- a passive regional allocation;
- an allocation to passively managed fundamental indexation (i.e. valuation based) indices in US and Europe;
- 2 active global income managers;
- an active emerging markets manager.

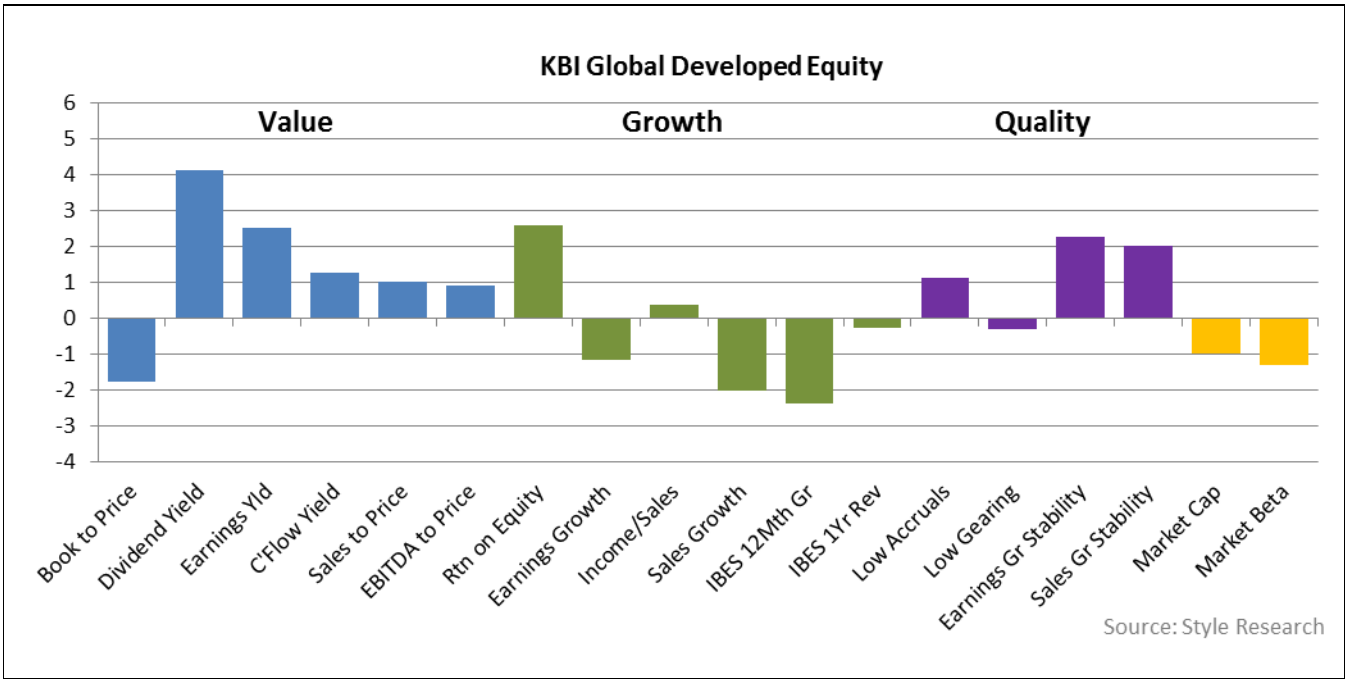
The two income managers have continued to deliver reasonable relative returns in strong markets (KBI are 1.3% ahead over the 12 months to 30 September, while Kempen are in line with the world index) and Delaware have materially outperformed in Emerging markets (+17.9% relative over the year to 30 September 2016).

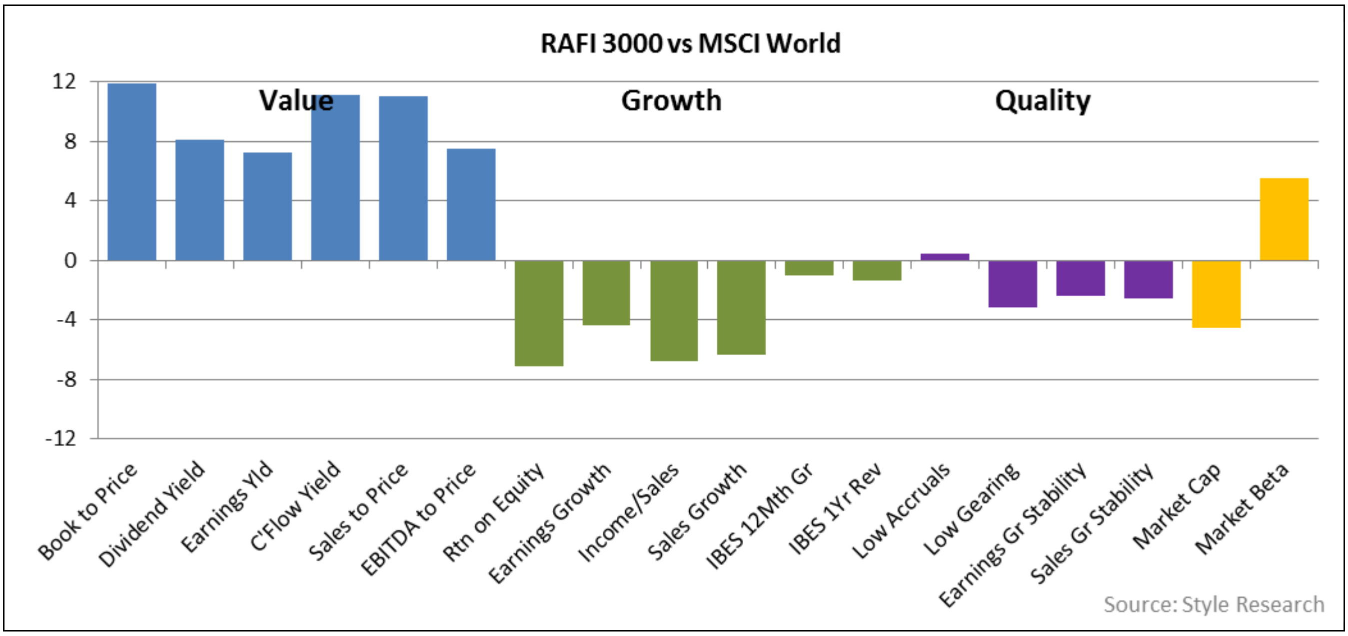
After underperforming in 2015, Fundamental Indices are also beginning to outperform broader markets as value stocks beginning to recover.

As noted last year the combination of the two income mangers and the Fundamental Index allocation provides a bias to value factors in the equity portfolio relative to the global market index (as shown by the positive blue bars in the charts below) and away from the largest companies (as shown by the first negative yellow bar). The KBI mandate also applies some sustainability or quality features in their portfolio. Over time we would expect these tilts to be rewarding. However, all three portfolios are also tilted away from growth factors (the green bars).

Last year we recommended the LPC consider the introduction of a global equity mandate with a growth bias to sit alongside the biases of the RAFI mandates and the income mandates. We would expect exposure to be achieved through active management rather than a passive index, where growth biased solutions are limited. However, given decisions over the choice of equity managers is likely to sit within the LGPS Central pool in the relatively near future, we suggested that it would be sensible to consider this again as part of the restructuring of assets within LGPS Central or when there is greater visibility around what this will look like.







Recommendation

Reflecting the unpredictability of equity returns in the medium term, coupled with equities currently being the main source of expected return in the Fund's overall strategy, we propose that the 2.5% additional allocation to private lending is funded from listed equities. This has little impact on the overall return, but at the margin moves a proportion of the Fund from assets that are very dependent upon positive growth outcomes to assets with more predictable returns irrespective of economic conditions.

The private lending strategy is likely to be split equally between US and Europe, with a bias to the UK within Europe. This would suggest funding the additional allocation from a mix of UK, European and US equities. However, given UK, European and US equities form the majority of the listed equities, we propose disinvesting the 2.5% on a pro-rata basis across the regional equity portfolio, including UK equities.

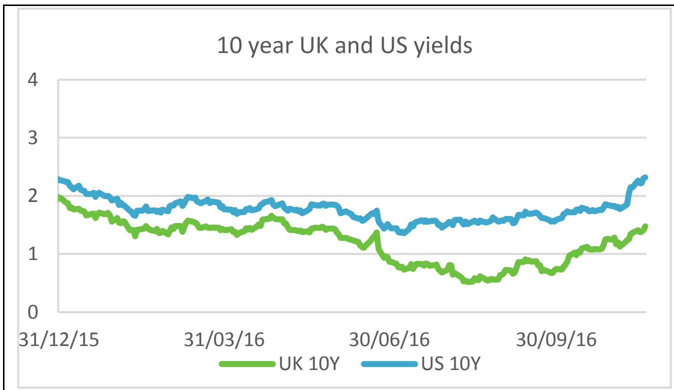
5. Inflation protection assets

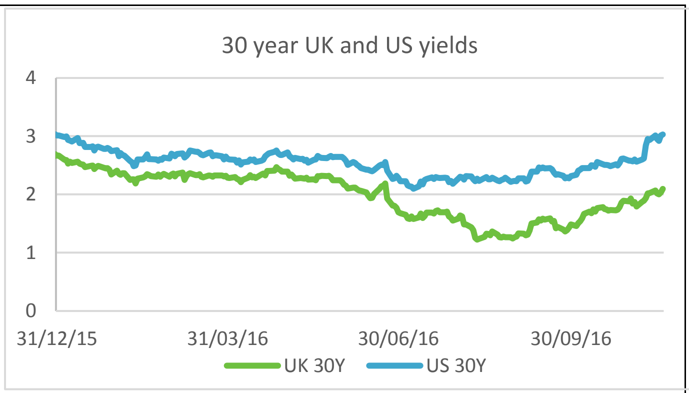
During the year the Fund increased the allocation to infrastructure from 3% to 5% by investing $90m in the JPMorgan Infrastructure fund.

In addition the Fund committed a further £25m to Kames active value property and re-categorised the Kames allocation into the core property allocation, rather than considering it as part of the Opportunity Pool.

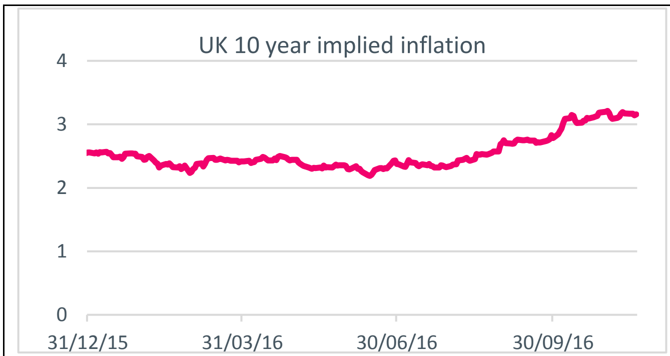
The strategic allocation to index-linked gilts is 7.5%, which represents one-third of the real asset allocation of the Fund. Following an action taken under the delegated powers available to the Director of Corporate Resources, the Fund's allocation to the index-linked gilt mandate was tactically reduced to 5% in August through sales of £65m, crystalizing a material profit on the mandate.

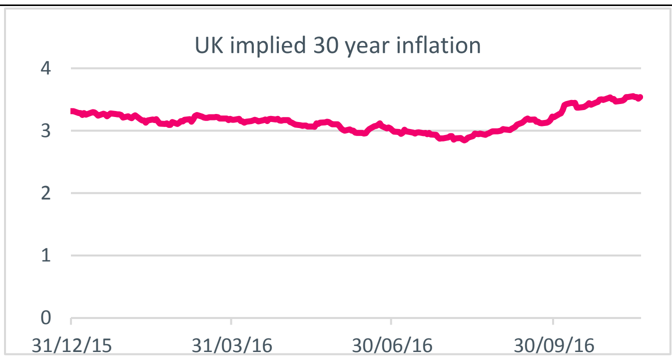
Since August, Government bond yields have risen reflecting higher interest rate expectations in the UK, and more recently in the US.





Real rates on index-linked gilts also rose, but the extent of the rise has been tempered by a continued rise in inflation expectations – real rates have risen by 0.3% and they remain persistently negative.





There are structural reasons why short-term inflation pricing has risen following the UK's vote to leave the EU and Trump's victory in the US Presidential election.

However, very long-term inflation pricing has also risen, and since 1 July 2016 implied inflation beyond 25 years has risen more than implied inflation between 15 and 25 years. In our view, this rise in longer term inflation pricing is more a reflection of investors paying a higher premium for long-term inflation protection than any significant rise in central expectations for long-term inflation levels.

Reflecting the rise in real yields, we propose removing the tactical underweight by bringing the allocation to index-linked gilts back up to the strategic allocation of 7.5%.

However, rather than reinstating the 7.5% allocation using the current Over 15 year index, we recommend the LPC adopt the All Stocks Index-Linked Gilt index as the strategic benchmark, i.e. a broader index which is less focused on the longest dated gilts, where we consider pricing to be relatively expensive.

The index-linked gilts with a term up to 15 years represent approximately one-third of the broad index. Hence, by adopting this broader index, the additional 2.5% allocation can be used to buy shorter dated index-linked gilts rather than buying more Over 15 year index-linked gilts. In practice, the manager will apply their discretion to purchase assets where they consider there to be most value.

6. Targeted Return

The current allocation to targeted return comprises the Ruffer, Aspect and Pictet portfolios.

Manager	Target	Actual (30 Sept 2016)
Ruffer	7.0%	6.6%
Aspect	4.0%	3.7%
Pictet	0.5%	2.6%
	11.5%	**12.9%**

Although the allocation to Pictet may be reduced over time, assuming investment in the Opportunity pool increases from the current allocation (c2.7% as at 30 September), it is not anticipated that this will occur in the near future, especially as the equity allocation is currently over 53%, i.e. above its target range, and provides another source of assets.

Due to relative returns, the allocation to Ruffer and Aspect are below target.

Hence, at a benchmark level we propose reducing the Ruffer and Aspect targets by 0.5% each, and increasing the Pictet benchmark allocation to 1.5%. No change to the actual allocation is proposed.

When the actual Opportunity pool allocation nears the lower end of its range (4.0%), the allocation between these three managers can be reviewed again.

7. Summary of recommendations

The table below sets out our higher level strategic recommendations. The changes are highlighted in red.

	Current Benchmark weight (%)	Proposed Benchmark Weight (%)	Long-term Real Return (% p.a.)	Contribution to Strategic Return (% p.a.)
Equities (48.0 – 50.0%, proposed)				
Listed equity	46.5-48.5	44.0 – 46.0	4.3	2.0
Private equity	4	4	6.5	0.3
Real (24.5%)				
Inflation linked bonds	7.5	7.5	0.3	0.0
Infrastructure	5	5	3.8	0.2
Timber	2	2	3.3	0.1
Property	10	10	2.7	0.3
Alternatives/Diversifiers (25.5 - 27.5%, proposed)				
Targeted return	11.5	11.5	4.0	0.5
EMD	2.5	2.5	3.0	0.1
Global Credit	5	7.5	4.0	0.3
Opportunity Pool	4-6	4 - 6	4.3	0.2
Currency overlay (Notional weight)	(c.10)	(c.10)	1.0	0.1
TOTAL	**100**	**100**		**3.9**

The main strategic change we propose is to reallocate 2.5% of Fund assets from equities to global credit. This has no material impact on the expected return but, at the margin, provides greater predictability to returns and further diversifies the portfolio’s sources of return at a time when market direction is uncertain.

During the year the Fund’s allocation to index-linked gilts was reduced tactically from 7.5% to 5.0%, reflecting the very strong returns that had been delivered by index-linked gilts, especially long-dated bonds. We recommend closing the position and bringing the allocation back up to the strategic allocation of 7.5%, but moving benchmark to the All Stocks Index-linked Gilt Index instead of the Over 15 year index.

At a benchmark level, we also propose increasing the target weight to Pictet by 1.0% to 1.5%, with a corresponding reduction of 0.5% in the target weight to each of Ruffer and Aspect, although this more closely reflects the actual allocation and so does not mean moving any assets.

Additional information

Appendix 1 – Partners 2016 MAC Fund

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Appendix 1 Partners Multi Asset Credit

Corporate capabilities

Partners Group was formed in 1996 by former Goldman Sachs investors and has grown rapidly to become one of the largest private market investment firms globally. It has over 800 employees, based in 18 locations. Partners Group employees remain the largest shareholders through an equity ownership programme. The firm manages some €42bn in a range of vehicles including private equity, private debt, real estate debt and infrastructure debt and has invested over $8.7bn in more than 350 private credits across markets since 2003.

People

Partners Group employs one of the largest private markets teams, including 120 experienced professionals dedicated to credit investing across corporate debt, private real estate, private infrastructure, distressed and public markets. Scott Essex and Rene Biner co-head the private debt team and are members of the investment committee responsible for the Fund, other members of the investment committee include Christopher Bone, head of private debt Europe, Christian Ebert, Alexander Ott, private debt Europe, Christopher Hardison, private debt Americas, Robin Thywissen, private debt Europe and Edward Tong, head of private debt Asia. The Fund will have the oversight of the Relative Value Committee, which is made up of the firm's CIO and co-founder, Marcel Erni as well as the firm's other co-founders and Chief economist. This group is responsible for taking a top-down view across regions, sectors and asset classes to determine the relative attractiveness of each providing focus for the research and sourcing teams. The manager also employs work-out expertise which the investment team can work with in the event of a loan defaulting.

Philosophy

Partners Group believes it can leverage its extensive network and knowledge of private equity markets in the equivalent debt markets. It employs a fully integrated way of working - there is no "silo mentality" at the firm. Further, incentives for investment professionals are structured in a way that enhances co-operation and communication across teams. All employees are expected to contribute to sourcing transactions, understanding underlying portfolios of potential acquisitions etc, and every employee is compensated based on the success of the whole company, not individual teams.

Process

Partners Group is flexible in how it deploys capital, allowing investors to exploit the entire credit opportunity set. Investments will be diversified across asset classes, instruments, sectors and geographies and typically include strong financial covenants, with a focus on floating-rate senior secured debt offering strong principal protection, with investments focused on capital preservation. On each investment the team works alongside members of the eight industry teams and has access to 60 senior external industry advisors as part of the due diligence process. In addition, the in-house tax, legal and structuring teams work closely on potential investments including advising on legal documentation.

MAC Program

The manager is in the process of raising capital for its third Multi-Asset Credit (MAC), MAC 2016. The fund will be managed in the same way as the other two funds in the MAC program range. MAC 2016 is targeting a final close in April 2017 after which the manager will begin raising capital for its MAC 2017 fund, targeting a first close in July 2017.

The MAC programs can invest across the private debt markets including corporate, real estate and infrastructure debt and on an opportunistic basis high yield debt and distressed. The target regional split is 30-70% Europe, 20-50% US and 0-30% Asia Pac. The targets asset split is 65-100% senior secured debt, 0-35% subordinated debt and 0-5% equity. The return target is 4% to 6% p.a. over LIBOR net of all fees with an expected running cash yield of 5% p.a. once fully invested.

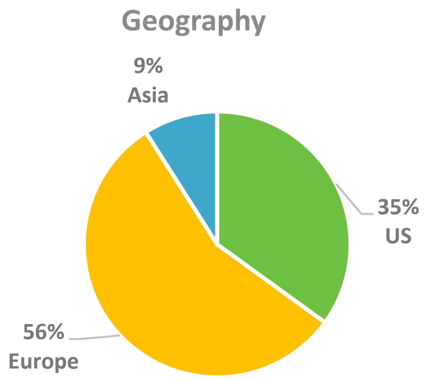
Partners Group is one of only a few managers who has the required resource, credentials and infrastructure to manage this type of MAC strategy on a global basis, allowing them to take advantage of increasing relative value opportunities in the US alongside opportunities in Europe, where deal terms have remained relatively static. The manager's approach also allows form the to make relative value allocation across asset classes, including corporate lending, real estate debt and infrastructure debt, although the manager expects

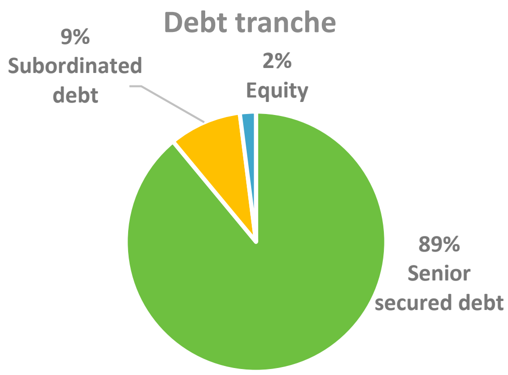
There is also an ease on governance requirements for Fund in appointing Partners for subsequent mandates, given the Investment Committee is familiar with the manager and have had a positive experience to date investing in the 2014 MAC fund.

The success of the MAC programs illustrate that the manager can get money invested in a timely way and that they can access a significant pipeline of investment opportunities.

MAC 2014 Program

The MAC 2014 fund has made 46 direct investments, diversified by geography, industry sectors and is focused on senior secured debt, split 80% corporate debt and 20% real estate and infrastructure debt (the majority in real estate debt). The fund was fully invested in July 2015 and is in harvest mode, making its first distribution in December 2015 and a further distribution in June 2016. Further distributions are expected to be on the 31st December 2016 and 30th June 2017. To date the fund has delivered in line with its objectives. The fund has experienced one credit event to date, however the credit represents less than 2% of the fund's holding and it is expected recovery will be over 80%, representing less than 50 basis point loss, which has already been covered by the income from the loan, i.e. the fund should not experience any capital loss from the event.





MAC 2014 Program	Program characteristics
Fund size	£255.3 m
Investments	46
Value creation	£25.9m
Distribution	£12.8m
NAV	£268.5m

	Portfolio statistics
Net IRR	6.3%
Net multiple	1.10x
Cash yield 1	3.76%
Gross running yield 2	7.3%
Equity cushion	48.0%
EBITDA margin 3	27.8%

1 The cash yield refers to the distributions made to investors and is calculated since inception.

2 The gross running yield is what the portfolio generates based on its current portfolio (i.e. when fully invested).

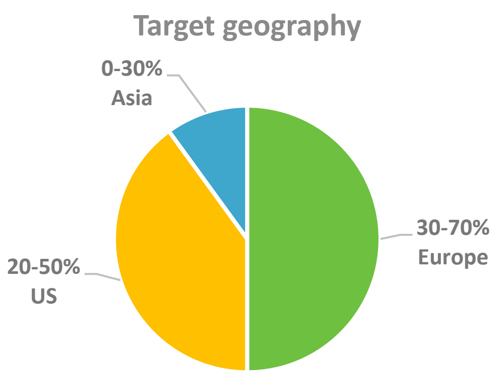
3 Weighted average adjusted EBITD margin.

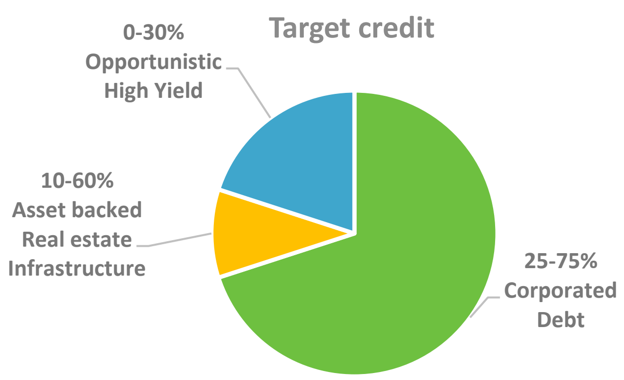
MAC 2016 Program

The manager is at the latter stages of raising capital for its MAC 2016 fund. The fund target size is up to £500m and currently the manager has £200m in fund commitments. The expected final close for the fund is in April 2017, however the manager has asked that investors need to confirm in January 2017 if they wish to come into the fund at the final close.

The MAC 2016 will be managed in line with the MAC 2014 and 2015 funds and is expected to invest predominately in senior secured corporate direct lending in Europe and the US, with a small allocation to Asia. As of the end of October 2016 the fund has originated 12 transaction and funded 6.

The manager is seeing increasing opportunities in the US market as a result of stricter regulatory requirements, including new lending guidelines reducing further banks' involvement in the leveraged lending market. This coupled with the risk retention rules which come into play in the US at the end of this year have reduced the demand for syndicated loans via Collateralised Loan Obligations (CLOs), creating a lending gap where larger companies have in the past financed through the syndicate market and are now looking to manager like Partners for financing. Partners expect the 2016 fund's exposure to the US market to be at the upper end of the (20 – 50%) range. Below we provided further details on the fund:





Program 2016	
Structure	Public Limited Liability company
Manager	Partners Group (Guernsey) Limited
Target Fund size	£500m (£200m capital committed)
Closing	1st close – July 2016, next close January 2017, final close April 2017 (manager has said they will need to know by January 2017 if investors wish to come in at final close)
Term	1-year build-up plus 5-year duration with 1-year wind-down period

	Fees
HR fee discount	Establishment charge on-off 0.30% (0.15% rebate) Management fee: year 1 0.425%, thereafter 0.85% p.a. until the 5th anniversary of the program and thereafter 0.85% p.a. on cost Average fee: 0.75% p.a. (0.05% discount).
Performance fee	7.5% of profits, subject to a 4% preferred return p.a. to investors with catch-up

Background: bank replacement lending opportunity

Historically banks have played an important role in funding the economy. In particular in Europe, where prior to the 2008 financial crisis close to 80% of corporate lending was done by banks. The reverse is the case in the US given its more developed non-bank lending market.

As a consequence of new bank legislation in the fallout of the financial crisis banks have been less active in the lending market. This new legislation is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage and has resulted in a significant increase in financing by non-bank lenders. In 2015, it was estimated that non-bank lending in the US and in Europe reached over 60% and 80% respectively. This coincides with a significant demand for financing from Private Equity sponsors which is keeping transaction terms at attractive levels relative to the traded leverage markets in both the US and Europe. Another dynamic in the US which is positively influencing pricing for non-bank lenders is the risk retention rule, requiring CLO managers to “keep skin in the game” which comes into force by the end of the year. This is reducing the formation of CLOs, which in turn is decreasing demand for syndicated loans. This is making banks less willing to do syndications, forcing larger leveraged companies, often arguably more robust than mid-cap companies, to target companies like Partners for financing.

We see this bank disintermediation (the withdrawal of lending) resulting in a longer-term structural shift in the financial industry which will continue to provided attractive risk adjusted return for longer term investors for a period of time.