Leicestershire County Council

INVESTMENT SUB COMMITTEE – 14 OCTOBER 2020

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

MULTI ASSET CREDIT (MAC) UPDATE

Purpose of the Report

1. The purpose of this report is to update the Committee on the development of the LGPS Central multi asset credit (MAC) sub fund.

Background

2. MAC funds can invest across a range of credit asset classes. Investment managers have a wide universe of 'products' available to them and their approach to their use within each mandate can be wide ranging.

3. Assets classes such as cash, emerging market debt including government and corporate company debt instruments are common. These instruments can be global or defined to specific regions or classes e.g. Europe or US and Developed or emerging markets and can cover both commercial and sovereign debt. The inclusion of commercial (company) debt opens up a vast pool of options such as high yield bonds (junk bonds), asset backed loans (loans with asset securing) and more opaque instruments such as Collateralised Loan Obligations (CLO). CLOs are loans that are ranked below investment grade and are initially sold to a CLO manager who bundles multiple loans together. The manager sells stakes in the CLO to outside investors in a structure called tranches. Each tranche is a piece of the CLO, and it dictates who will be paid out first when the underlying loan payments are made. In addition, the mandates can limit the use of the above by weighting limits and further stipulate the use or limit the quality of debt used as rated by the major ratings agencies.

4. The Fund has limited exposure to this asset class via a minor holding totalling 0.5% of the total Fund's value, through JP Morgan's Global Credit fund (c.£28m).

5. The annual asset allocation review approved in January 2020 advised that the Fund should increase the allocation to this class from 0.5% to 4.0%. It is deemed to be attractive for a number of reasons.

    a. It provides exposure to multi-asset classes through a single investment strategy.

    b. Managers have the flexibility to move opportunistically between asset sectors, which should allow managers to create excess return by allocating to attractive asset classes. Significant divergence can occur between individual asset class returns and an effective manager will allocate dynamically between asset classes to add value.

c. MAC strategies can provide yield enhancement compared to traditional fixed income strategies. This is attractive to investors who may need income streams to meet liabilities in a low interest rate environment

6. The Fund took the opportunity in May 2020 to review with its advisor the Selection Questionnaire (SQ) and advert including the general fund mandate before it was sent to the market. The review allowed the Fund to address areas that would not meet its objectives. Central have now received the responses to the SQ which have now been marked.

<u>Multi Asset Credit (MAC) mandate</u>

7. The allowable characteristics of the mandate are listed below. The Fund already has an allocation to investment grade credit and emerging market debt and so the Fund engaged Hymans with the view to designing a product that would fit the Fund. As such the current mandate has less than 10% weightings to investment grade corporate bonds and less than 10% weighting to emerging market debt.

- The portfolios will be actively managed
- The portfolios will be well-diversified across global, multi-asset credit sectors
- The portfolios may invest in liquid global fixed and floating rate instruments in markets including but not limited to Government, Investment Grade, High Yield, Emerging Market Debt and Loans
- The portfolios may use derivative instruments for efficient portfolio management and hedging purposes
- At least 90% of the portfolio will be hedged back to GBP

8. The limits and risk management parameters are described below.

- < 10% exposure to Emerging Market Debt (includes both Hard Currency and Local Currency)
- < 15% exposure to Government Bonds (UK Gilts/US Treasury)
- < 10% exposure to Investment Grade Corporate Bonds
- All other sectors will be limited to a maximum of 30% of the portfolio (to include but not limited to: High Yield Securities, Loans, Asset-backed Securities, Convertibles, CLO’s, Covered Bonds, Coco’s, Hybrids)
- No single investment above 5% of the active portfolio
- No single investment to be more than 5% of the issue
- < 10% non-GBP currency exposure

9. Compared to the recently invested in Investment Grade Corporate Bond product this product is able to invest in a wider pool of securities and therefore has an overall higher risk and expected return. This fund is currently targeted to return 4% net over the benchmark which is 3 month GBP LIBOR (London interbank overnight rate) . At present the LIBOR rate is c0.05%.

<u>Next steps</u>

10. Responses to the request for proposal have been received and Central are due to inform a maximum of six managers of the next stage where they will enter into competitive due diligence. Post scoring of these a maximum of three managers will

be selected to run the mandate. Central have advised ideally they would wish to appoint two managers and only in the event a third manager adds diversification that the others cannot would a third manager be considered. The competitive due diligence is due to take place in October.

11. Central are estimating a finalised product to have FCA approval in December 2020 and a transition date and handover to finalised managers of the new fund in spring 2021.

12. The Leicestershire Fund under the current strategic asset allocation have c£150m to invest to reach the target weight with the allocation being taken from the Fund's current targeted return allocation.

13. Once the managers have been finalised officers will instruct Hymans to conduct due diligence and bring a proposal to Committee for approval.

Recommendation

14. It is recommended that the Investment Subcommittee notes the report.

Equality and Human Rights Implications

15. None.

Background Papers

None

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