Agenda Item 12

Leicestershire County Council

LOCAL PENSION COMMITTEE – 26TH FEBRUARY 2021

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED INVESTMENT: AEGON SHORT DATED INVESTMENT GRADE BOND FUND

Purpose of the Report

1. The purpose of this report is to provide information in order to facilitate a decision for the Pension Fund to invest in the Aegon short dated investment grade bond fund (SD Fund). This report will be accompanied by a presentation from Aegon Asset Management delivered during a private session.

Background

2. As at January 2021 the Pension Committee approved the 2021 strategic asset allocation (SAA). This included a 3.0% allocation to investment grade credit.

3. The Fund made an investment to LGPS Central's investment grade bond fund in 2020. The Fund is currently underweight to this target and as such the SAA stated that pending a review of the SD Fund an allocation of 0.5% (c.£25million) be proposed.

4. Currently the Fund holds more cash than is needed for day to day expenses, calls for private investments such as private equity and infrastructure and for emergencies arising from collateral calls relating to the currency hedge.

5. At present given the positive cashflow nature of our Fund (the Fund collects more from employer employee contributions and pension investment income than it pays out in pensions), the Fund will be consistently needing to invest.

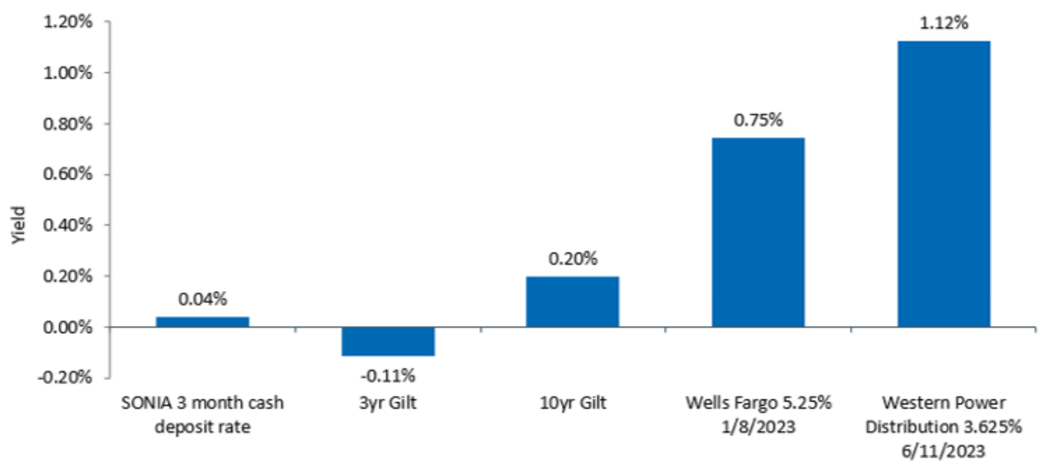
Why short dated investment grade investments

6. Short dated bonds are defined within this mandate as having less than four years to maturity, the point at which the capital is returned. The investment grade element relates to the issuers credit rating (these are issued by one of the big three agencies, S&P, Moody's and Fitch), with a rating better than BBB (on the S&P scale) meaning the issuer is of investment grade.

7. Short dated bonds have stronger capital preservation characteristics than longer dated bonds all other things being equal and the Fund has recognised the need for a short dated product within the 2021 SAA. The Fund does not currently invest in a bond product returning between cash (currently less than 5 basis points or 0.05% pa) and LGPS Central's investment grade product which targets a total return of +0.8% over a blended benchmark of sterling and global bonds.

8. The Aegon product with a shorter ‘modified duration’ (all other risks equal) will have a lower price volatility than the LGPS Central Investment Grade bond fund. Simply, as maturity time of a bond increases so does duration and the bond becomes more volatile. The average duration to maturity within the Aegon portfolio will be less than three years with no bond holding maturing at more than four years.

9. Investors are facing negative real returns (accounting for inflation on the nominal yield). Short dated corporate bonds offer an attractive yield for low duration. See yields for varying instruments below for comparison taken as at 31st December 2020 from Bloomberg. The two issues on the far right are considered short dated and investment grade.



Duration	3 months	2.8 years	9.8 years	2.7 years	2.9 years
Rating	AAA	AAA	AAA	A-	BBB

10. Central do not offer a similar product nor do they have one in their pipeline given there has been no appetite to create a product from the partner funds.

<u>Aegon SD fund management background</u>

11. The fund will be managed by two managers who have a long track record. They are supported by an investment grade portfolio management team in Edinburgh. Of particular note is the 33 credit analysts responsible for bottom up credit research with an average industry experience of 17 years.

12. Officers discussed with management the process of selection which included research process, management’s ability to invest in new issues from new companies who had not previously issued bonds, credit research & ESG scoring of issuers. A Responsible Investment presentation is included within the appendices.

<u>Current Aegon Short Dated mandates</u>

13. Aegon have managed short dated investment grade portfolios since 2011 and a range of dedicated segregated short dated mandates since 2017. At present the AUM totals £995 million under the various mandates described below.

14. Aegon have provided details of four portfolios that they manage. A table below summarises the performance over various timeframes.

    Portfolio A: short dated investment grade corporate bond module within the Aegon Absolute Return Bond Fund, bonds have two years or less to final legal maturity and invest in global investment grade bonds only.

    Portfolio B: a segregated buy and maintain short dated investment grade mandate for a UK Local Authority Pension Scheme. Initial mandate initiated with five years or less to final legal maturity. Sterling-only bonds at request of client are held. Investment grade mandate with flexibility to hold high-yield and non-rated bonds up to 20%.

    Portfolio C: a short dated investment grade segregated mandate for UK corporate pension scheme. A three year mandate designed to match cash flow requirements for the pension scheme, sterling-focused, but with flexibility to own non-sterling bonds up to 30%,

    Portfolio D: another short dated investment grade segregated mandate for UK corporate pension scheme. Core portfolio of GBP investment-grade corporate bonds with maximum final maturity of four years. Capped exposure to high-yield, callable and non-rated bonds and limited flexibility to invest in USD and EUR bonds, hedged to GBP.

%	1 year	2 years p.a.	3 years p.a.	5 years p.a.	Since launch p.a.
Portfolio A 2 year maturity	2.25	2.16	1.69	1.64	1.86
Portfolio B 5 year maturity	1.96	2.52	1.81	-	1.85
Portfolio C 3 year maturity	2.33	2.77	-	-	2.73
Portfolio D 4 year maturity	2.64	-	-	-	2.68

Figs: provided by Aegon to Dec 2020.

<u>Fund characteristics and benchmark</u>

15. This is a new fund which has been back tested. Aegon are currently running a shadow portfolio in order to demonstrate the historic performance and expected holdings.

16. The performance objective of the fund is to return +1.25% over cash per annum over a rolling three year basis, gross of fees.

17. Other fund characteristics are described in the table below

	Aegon SD Fund (as at 31/1/21)
Investment universe	• Core of portfolio in investment grade corporate bonds with less than four years to expected maturity • Capped exposure to asset backed securities, high yield, callable and non-rated bonds • Global exposure hedged back to £ - no active currency risk • Derivatives for efficient portfolio management allowed
Guidelines	• 100% invested in bonds with less than four years to expected maturity • 20% maximum investment in high yield, non-rated and callable bonds • 20% maximum investment in asset backed securities • Duration ≤ 3 years • Maximum 70% holding in BBB rated debt
Leverage	• None allowed
Liquidity / pricing	• Daily pricing and dealing
Performance target	• +1.25% over cash (overnight SONIA) per annum over a rolling three year basis, gross of fees.
Benchmark	Cash (SONIA) + 1.25%
Structure / share class	Accumulation or quarterly income distribution. GBP.
Holdings	78
Max issuer exposure	1.75%
Average credit quality	A-
Yield to maturity	0.89%
% in A rated / B rated / cash	51.5% / 46.25% / 2.25%
Modified duration	2.6 years

<u>Risks</u>

18. Three main risks exist for bond products, liquidity, interest rate and credit risk.

    a. Liquidity: The product aims to invest in large and liquid issuers of bonds and this demonstrated as such within the shadow portfolio which currently holds over 70 issues with the top 25 amounting to around 43% of the total value of the fund.
    There are over $4 trillion equivalent of eligible bonds highlighting the large and liquid nature of the global universe, this covers over 1200 unique issuers over 18 industry sectors highlighting the scale of the available universe.
    Aegon intimate that the transaction costs (represented by the bid offer prices) are slightly lower than the benchmark given this fund would be investing in the larger and more liquid global issuers and therefore estimate this to be c20 bps rather than the benchmark c25bps. This is of course subject to market conditions at the time of investment and or redemption.

b. Interest rate: by definition the short dated space is less sensitive to rises in interest rates which would otherwise reduce the value of the bonds. This product cannot invest in bonds with an expected maturity date (when the bond is redeemed) of more than 4 years. In addition, the mandate requires the overall duration of the bond to be sub 3 years. Many commentators expect interest rates to stay lower for longer and as such bonds maturing in a number of years should have lower interest rate risk. As these bonds mature however they could be reinvested into higher yielding issues if inflation were to pick up.

c. Credit risk: this is the risk of issuers defaulting on their bonds. The ability of the team in understanding the risk and mitigation is key here. Aegon's team, as described earlier has 33 global credit analysts, the two managers for the fund have a combined 42 years experience in fixed income and are supported by 3 professionals in Edinburgh with a combined 80 years' experience.

Environmental, social and governance

19. Aegon aim to construct the portfolio with a low carbon intensity. The model portfolio (as at Feb 2021) has 67% lower carbon intensity than the comparable short dated index. Aegon are able to draw upon their team of 14 dedicated global responsible investment team to allow ESG factors are built into decisions.

20. A research example is included within Appendix A which incorporates comments on the management structure, controversy scores, event risk potential and if engagement with the company is recommended. It is worth noting that Aegon have a A+ rating from the PRI (principles of responsible investing) for strategy and governance of responsible investing activities as at 2020, in addition their RI programme is ranked 6th from 75 among global asset managers according to a survey by ShareAction undertaken in 2020 and 1st within managers for fixed income.

Summary

21. Aegon are offering a lower risk product that aims to return +1.25% over cash per annum measured over a rolling three year period. They have managed similar mandates for a number of years and have a team in place. One of their larger segregated mandates is with another local authority defined benefit scheme (performance included in the paper), Aegon have managed that portfolio for four years now.

22. Aegon have experienced no credit defaults across the short dated portfolios since the inception of the strategies detailed earlier in the paper. The product bridges a gap identified in the 2021 SAA and gives the Fund a low cost entry into am appropriate product.

23. Their fee structure is attractive.

24. It is worth noting that the Hymans 2021 SAA proposed officers are delegated discretion to use the Aegon fund or any alternative fund reviewed and considered

by the ISC as a short term alternative to holding cash. Officers will therefore consider this in light of the current cash holding and act accordingly.

Supplementary Information

25. An exempt paper which is of a sensitive nature is included elsewhere on the agenda which contains supplementary information on the potential investment into Aegon's short dated investment grade fund.

Recommendation

26. The Committee is recommended to consider an investment into the short dated investment grade fund.

Equality and Human Rights Implications

27. None

Appendices

28. Appendix A – Aegon short dated investment grade fund presentation
Appendix B – Responsible investment presentation

Background Papers

29. None

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