Leicestershire County Council Investment Subcommittee

Multi-credit: Bank Replacement Investing

- Andy Green
- 23 April 2014

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Agenda Item 7

Agenda

- Recap: the proposed mandates in the context of LCCPF
- What is multi-asset credit
- Why invest in it
- How to invest in it
- Outline of debt markets

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Structure - current

Equities (42% - 52%)

	Manager	Target %
UK	LGIM	12.0
Regional	LGIM	20.0
Equitised	Kames	1.5
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	6.0
	Capital	
	Delaware	
Private	Adams Street	4.0

Inflation Linked (12.5%)

	Manager	Target %
Ind-linked	Implemented	7.5
Infrastruct.	IFM	3.0
	KKR	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
FoFunds	Aviva	5.0
Direct	Colliers	5.0

Commodities (3%)

	Manager	Target %
	Investec	3.0

Alternative (22.5% - 32.5%)

	Manager	Target %
Targeted	Ruffer	7.4
	Pictet	5.3
	Aspect	3.5
	Aviva G7	1.3
Credit	JP Morgan	3.4
	M&G	1.6
Opp. pool		0-10

Overlay (0%)

	Manager	Target %
TAA	Kames	-
Currency	Millennium / Mellon	-

Return seeking
Real assets
Diversifying

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Required rate of return 4% p.a. real

An aggregate rate; not every mandate needs to deliver this return

	Weight (%)	Real Return (% p.a.)	Contribution to Return (%)
Equities (52%)			
Listed equity	46.5	4.3	2.00
Private equity	4	6.5	0.26
Real (25.5%)			
Inflation linked bonds	7.5	0.7	0.05
Infrastructure	3	3.8	0.11
Timber	2	3.3	0.07
Property	10	2.7	0.27
Commodities	3	2.0	0.06
Alternatives/Diversifiers (22.5%)			
Targeted return	17.5	(4.0) 3.0	0.52
Global Credit	5.0	(3.0) 2.0	0.10
Opportunity Pool	1.5	4.3	0.06
Currency overlay (Notional weight)	(26)	(1.0) 0.4	0.10
TOTAL	**100**		(4.0) **3.6**

Mandates to review

Pictet
JP Morgan

Mellon
Kames

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Structure - proposed

Equities (50-52%)

	Manager	Target %
UK	LGIM	12.0
Regional	LGIM	22.5
Global	Kempen	4.0
	Kleinwort Benson	4.0
Emerging	LGIM	5.5
	Capital	
	Delaware	
Private	Adams Street	4.0

Inflation Linked (12.5%)

	Manager	Target %
Ind-linked	Implemented	7.5
Infrastruct.	IFM	3.0
	KKR	
Timberland	Stafford	2.0

Property (10%)

	Manager	Target %
Fund of Funds	Aviva	5.0
Direct	Colliers	5.0

Commodities (3%)

	Manager	Target %
	Investec	3.0

Alternative (22.5-24.5%)

	Manager	Target %
Targeted	Ruffer	7.5
	Aspect	3.5
Other opportunities		
EM Debt	To be decided	2.5
Credit Opps	Other credit incl. JPM	5.0
Other opp. pool	Incl. M&G at 2.5% and Kames Property at 1.0%	4.0-6.0

Overlay (0%)

	Manager	Target %
Currency	Millennium	-

Return seeking
Real assets
Diversifying

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Proposed strategy - forecast return

An aggregate rate, real return closer to 4.0%

	Weight (%)	Real Return (% p.a.)	Contribution to Return (%)
Equities (52%)			
Listed equity	48	4.3	2.06
Private equity	4	6.5	0.26
Real (25.5%)			
Inflation linked bonds	7.5	0.7	0.05
Infrastructure	3	3.8	0.11
Timber	2	3.3	0.07
Property	10	2.7	0.27
Commodities	3	2.0	0.06
Alternatives/Diversifiers (22.5%)			
Targeted return	11.0	4.0	0.44
Emerging Market Debt	2.5	3.0	0.08
Global Credit	5.0	4.0	0.20
Opportunity Pool	4.0	4.3	0.17
Currency overlay (Notional weight)	(13)	1.0	0.13
TOTAL	**100**		**3.9**

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Proposed Mandates

EMD
Multi-credit
DOF II/Kames Property

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What is multi-asset credit?

- Multi-asset credit is an allocation to debt markets, where the manager has discretion to allocate between the different markets.
- Our particular focus is on higher yielding markets, typically sub-investment grade
- Hence, this should be viewed as a return seeking asset, typically with lower risk than equities
- Given a higher return target than investment grade credit mandates, managers will typically focus on:
  - High yield bonds
  - Secured Loans (public and private)
  - Asset Backed Securities (ABS)
  - Property & Infrastructure Debt (although often limited due to illiquidity)
- Other allocations may include convertible bonds & distressed debt
- Some managers will include EMD, but this normally requires a separate skill set/specialist team
- Managers may also include investment grade bonds as a “safe haven” if the price of the asset types listed above appears high
- It is not intended to include active currency or interest rate positioning

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Why invest in multi-asset credit?

- The broad arguments for a strategic allocation to multi-asset credit:
  - Bond markets provide wider range of opportunities beyond traditional fixed interest investment grade bonds
  - These broader markets provide diversification by issuer and by bond type. In particular, not all credit markets move in parallel
  - By allocating to multi-asset credit rather than discreet fixed allocations, the manager can rotate assets over time to the opportunity set providing highest return per unit of risk
- The specific opportunity is based around Ex-banking lending:
  - Incoming banking solvency requirements mean that banks will need to continue to reduce debt for an extended period
  - As the banking sector continues to shrink, it encourages new forms of capital market-based lending. Investment managers are now able to substitute banks in some areas of lending and finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks
  - Key attractions are the additional yield that these portfolios can provide and the floating rate nature of many of these assets (linked to LIBOR) rather than fixed rate.

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How to invest in multi-asset credit?

- A growing number of bond managers have broad enough skill set to manage multi-credit mandates
- These range from large global bond managers with teams specialising in each area of credit markets (potentially including EMD) through to specialist credit managers, with experience in securitised debt and originated corporate lending
- The target benchmark for this mandate, set to have a high enough return and to avoid portfolio biases, would be circa LIBOR+4% p.a. net of fees
- Mandates can be segregated or pooled; we are looking for a pooled solution
- Products may be open ended or closed ended funds. Those funds with a high focus on illiquid debt markets (typically originated debt) will use a closed ended fund structure. Either may be suitable for the Fund.

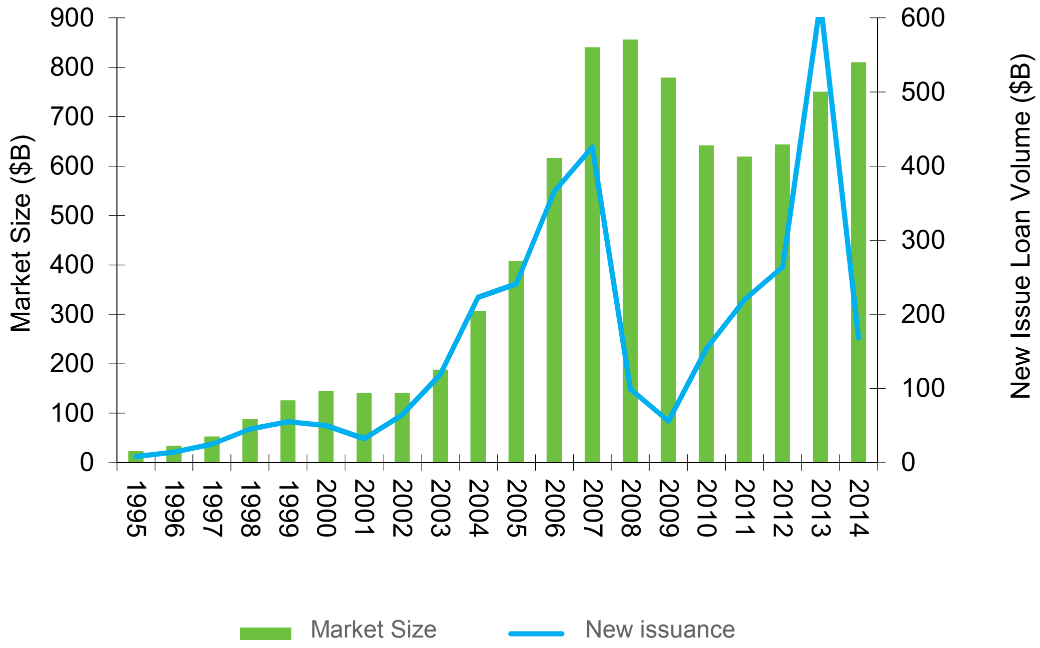
Summary of Opportunity Set

Asset Class/Strategy	Brief description	Expected return	Rating	Liquidity
Senior Secured Corporate Debt	Private or syndicated lending to sub-investment grade companies. Senior and secured on assets	LIBOR + 4.0 – 6.0% (syndicated); LIBOR + 4.5 -7.0% (private)	BB - CCC	Reasonably liquid (syndicated); 5 Years + (private)
Mezzanine Corporate Debt	Private lending to sub-investment grade companies. Subordinated to the senior debt often with an equity component	10% - 15% IRR	≤CCC	10 Years
Distressed Debt	Purchase of assets at stressed prices or securities of companies in financial or operating difficulties	15 - 20% IRR	≤CCC	5-7 Years
Senior Property Debt	Lending to property investors at the senior secured level. Properties can be either prime or high quality secondary	LIBOR + 2 - 6% although some debt defined as fixed rate	A - BB	5-10 Years
Infrastructure Debt	Private lending to infrastructure projects at the senior secured and subordinate level	2.5 - 7% although some debt defined as fixed rate	Wide range	5-10+ Years
Asset-backed securities	Income payments from multiple underlying loans, which are then collateralised (or "backed") by a specified pool of underlying assets.	LIBOR + 0.5 - 4.0%+	AAA - unrated	Liquid, but can take time to build a portfolio as new stock limited
High Yield	Lending to large companies. Typically unsecured.	4% - 6%	BB - CCC	Reasonably liquid

Senior Secured (Leveraged) Loans

- Debt issued by sub-investment grade companies with high levels of debt
- Senior in capital structure; secured on the issuing company's assets
- Floating rate notes, i.e. coupons based on LIBOR plus a spread
- Short to medium term, with pre-payment risk
- Private (illiquid) or public (primary and secondary) market traded
- Private debt should offer a premium over public debt for illiquidity
- US market comprises c.80%, remainder European

US Loans Market



Source: Babson Capital

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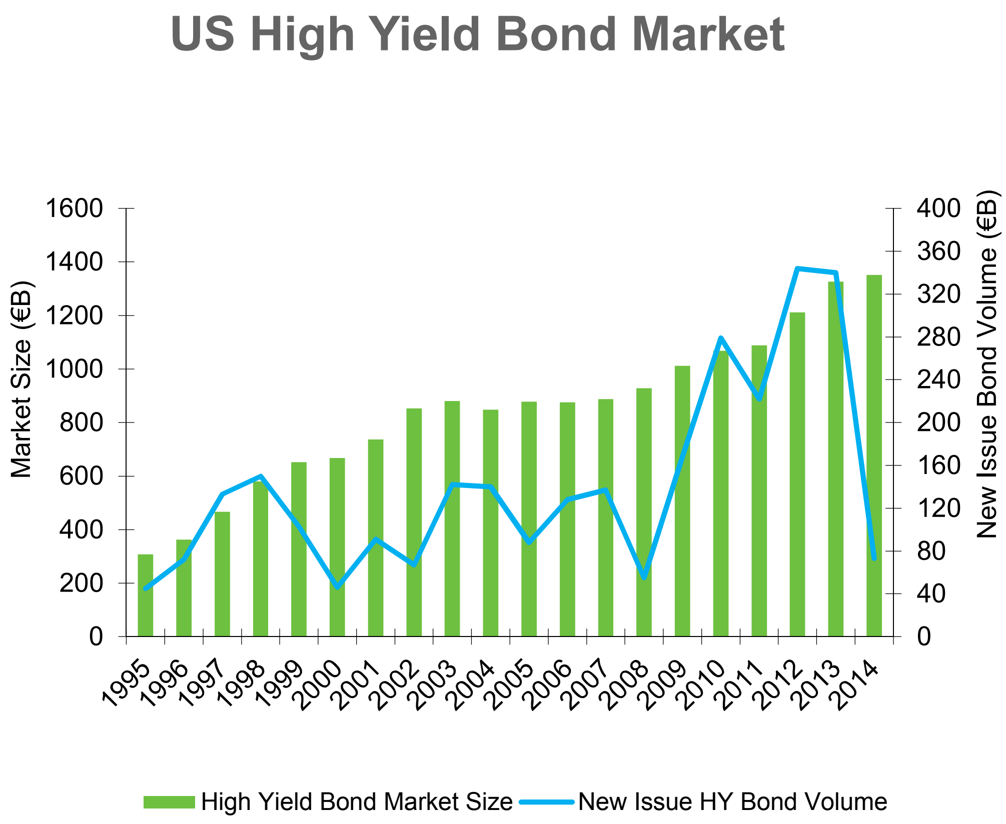
High yield bonds

- Corporate bonds issued by sub-investment grade companies
- Often unsecured debt (not backed by assets)
- Defined ‘high yield’ by rating agencies (<BBB for S&P)
- Universe includes downgraded investment grade bonds
- Historically higher average loss from defaults relative to investment grade credit
- Pay higher coupons to compensate investors for increased default risk
- Bank deleveraging has resulted in a growth in new issuance volume in the US and European
- US market dominates, accounting for c$1,200bn of outstanding debt



Source: Babson Capital

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Current Credit Market Pricing
High Yield versus Loans

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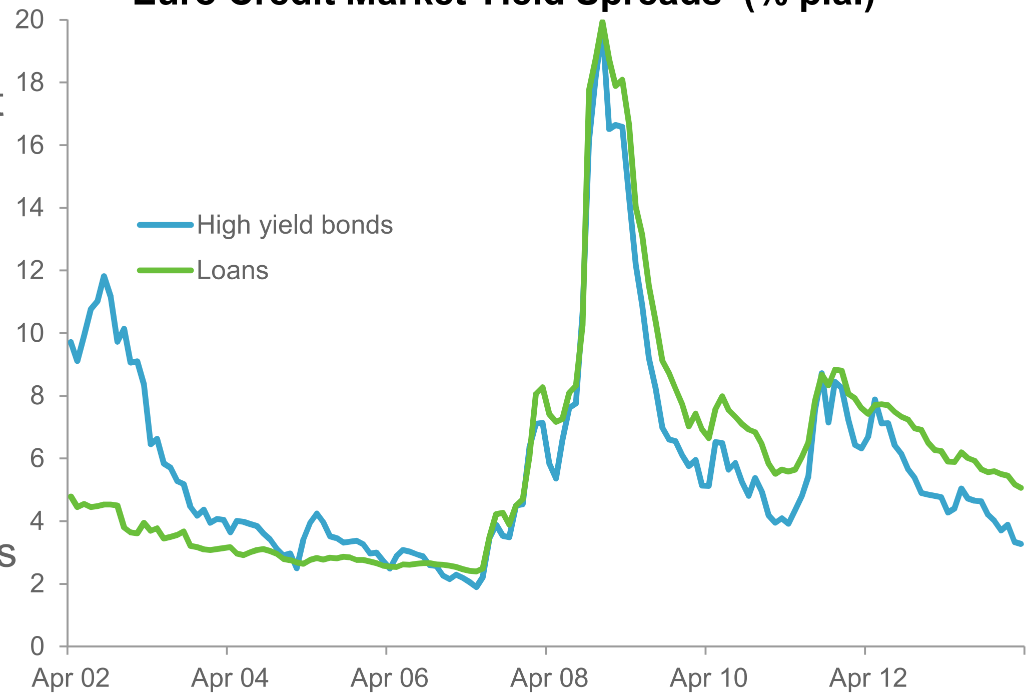
- Even since the spike and reversal of spreads in 2008/2009, high yield credit markets have experienced spread compression in the last couple of years.
- Bonds look expensive at the index level, particularly in Europe. However wide dispersion across ratings.
- For example, yields on single B new issuance in European High Yield bonds c2% higher than BB rated issuance.
- Spreads on loans have been less affected, and remain attractive on a relative basis, in particularly given the assets security.

Euro Credit Market Yield Spreads (% p.a.)



Source: Babson Capital

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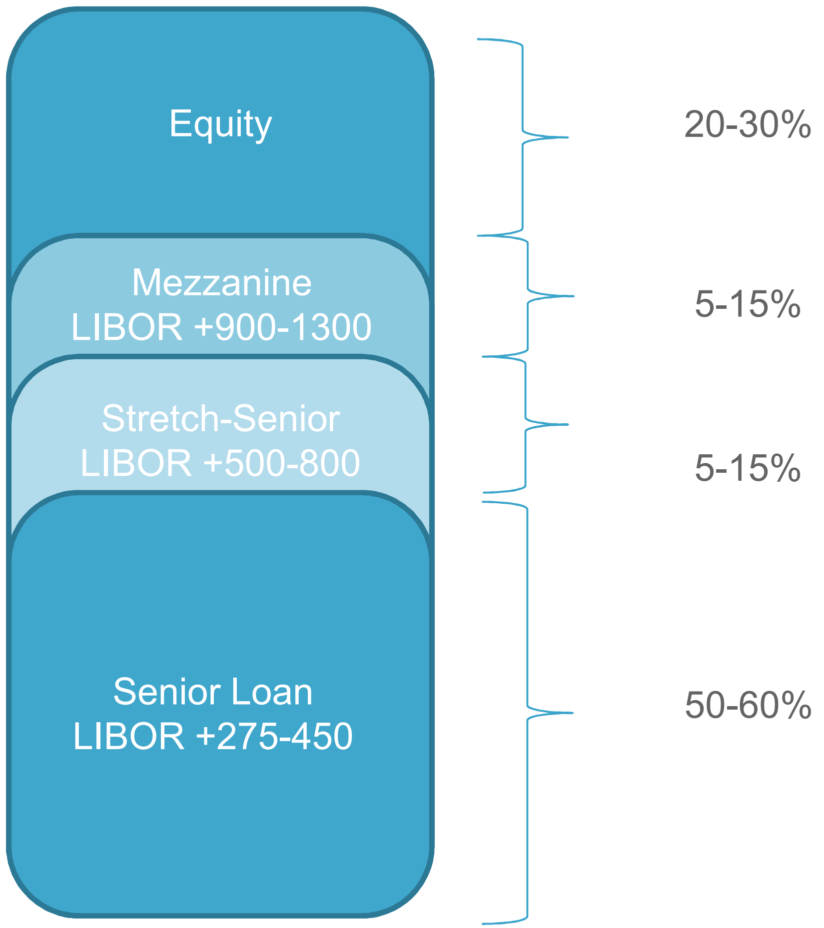
Property Debt

- Lending to commercial property investors with a focus on UK and European opportunities
- Borrowers include private equity sponsors and listed property companies raising capital to refinance or to fund new property development
- Fixed or floating rate debt with terms of lending varying from 4 to 10 years
- Senior or mezzanine available reflecting risk appetite
- Senior lenders have a priority, or 'first lien' claim on the property assets backing the loan in the event of a default
- Key measure of quality is the loan-to-value ratio ("LTV"). Senior property debt managers currently point to typical LTVs of up to 60%
- Spread compression has occurred on senior debt backed by prime London properties. However, senior debt on quality secondary still looks attractive.



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Additional Notes

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.