East Sussex Pension Fund

Fixed Income Review of Current Holdings

May 2021

isio.

Document Classification Confidential

Contents

Introduction	Pg. 3
Current Portfolio	Pg. 5
Investment Managers	Pg 8
Initial Observations	Pg 11
M&G Considerations	Pg 14
Summary	Pg 19
Appendix	Pg 21

Introduction and Background

Addressee

- This report is addressed to the East Sussex County Council as Administering Authority of the East Sussex Pension Fund ("the Fund").

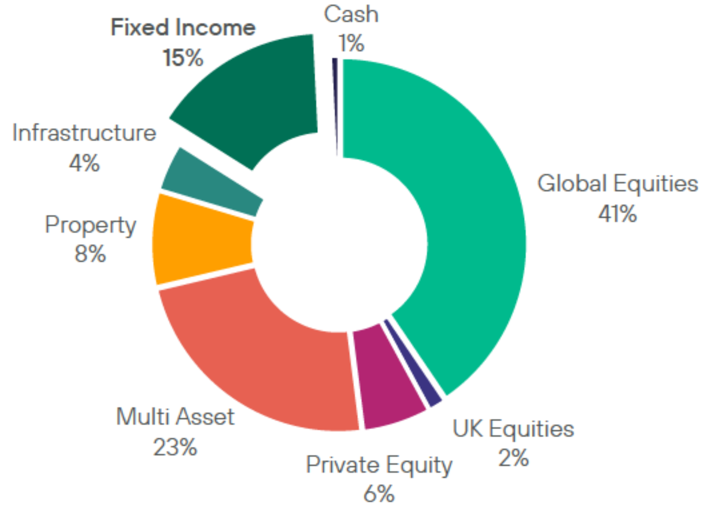
Background

- The Committee has instructed Isio to undertake a review of the current investment strategy which is due to be discussed at the July meeting. Ahead of this wider review, Isio has also been asked to provide some training for the Committee on fixed income as an asset class together with an overview of the current portfolio. The training material has been provided alongside this review.
- A detailed report will be presented to the September meeting. This will focus on the Fund's cashflow requirements and provide recommendations on evolving the bond portfolios.
- The Fund's current strategy includes a 16.5% strategic allocation (15% currently invested) to fixed income investments (i.e. a range of different bond based strategies). These include inflation linked government bonds (index linked gilts), corporate bonds, commercial real estate debt ("CRED") and diversified credit ("DCF"). DCF invests in a wide range of different bond markets at the managers discretion.

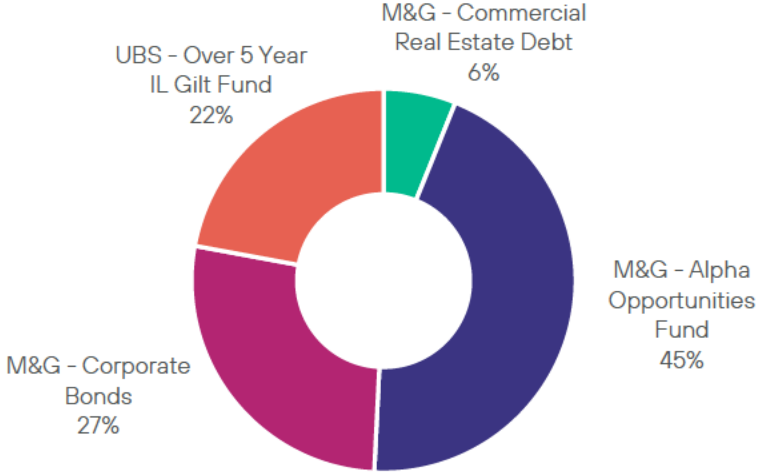
Scope of report

- The scope of this paper is to provide the following:
  - An overview of the Fund's current exposure to bond markets;
  - Analysis of the geographical, sector and credit quality of the portfolio;
  - Our views on the M&G Real Estate Debt Fund and the M&G Alpha Opportunities Fund, noting the recent significant departures from the M&G private debt teams. We have also included a high level summary of the manager's approach to environmental, social and governance (ESG) issues and comment on the exposure to fossil fuels.

Current asset allocation



Current fixed income allocation breakdown



Note: Asset allocations as at 31 December 2020
Source: Investment managers, Isio calculations

Current portfolio

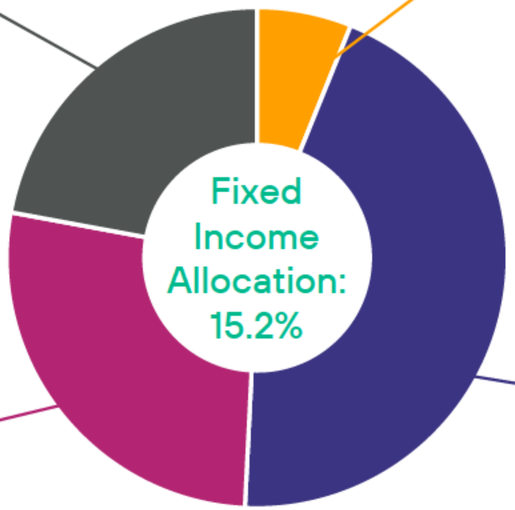
Current Fixed Income Holdings

UBS Index-Linked Gilts: (3%)

- Liquid bonds issued by the UK government, which provide regular inflation linked coupon payments, and a return of principal adjusted for inflation at maturity.
- Passively managed
- Current yield: Inflation minus 2.2%

M&G Commercial Real Estate Debt: (1%)

- Privately originated loans made to finance the purchase / refinancing of buildings.
- The returns come primarily in the form of interest payments, and origination fees at the outset of the loan.
- Actively managed
- Current yield: 3.8%



M&G Diversified Credit: (7%)

- Diversified portfolio comprised of a range of underlying liquid credit assets.
- Provides access to a global pool of credit opportunities via a single relatively cost and governance efficient mandate.
- Actively managed
- Current yield: 2.9%

M&G Corporate Bonds: (4%)

- Higher quality liquid bonds issued by corporates which provide regular fixed coupon payments, and a return of principal at maturity.
- Actively managed
- Current yield: 1.7%

Source: Investment managers at 31 December 2020

Asset Class Summary

Fixed Income Holdings

Index-Linked Gilts ('ILG')

Index-linked gilts are government bonds whose coupons and principal rise in line with RPI inflation. ILG are popular instruments for pension scheme investors, because of the liability matching qualities, diversification and downside protection properties they provide. They also one of the only assets to provide exposure to uncapped rises in inflation expectations, and are one of the most simple and effective ways of inflation hedging.

ILG funds typically invest in bonds of a specific maturity range, depending on the overall parameters of the product.

Expected net return p.a.	Gilts
Volatility p.a.	11%
Liquidity	Daily
Inflation linkage	100%

Corporate Bonds

Corporate bonds are debt instruments issued by companies which typically pay periodic interest coupons until the principal amount is repaid at maturity. Investment Grade ("IG") bonds are issued by companies considered to be relatively lower risk and the bonds are rated from AAA to BBB. High yield bonds are issued by companies deemed to be lower down the credit spectrum.

Corporate bond investments by pension schemes play a dual role in the portfolio: to serve as a proxy matching asset class and to provide a source of growth returns.

Expected net return p.a.	Gilts + 0.8%
Volatility p.a.	9%
Liquidity	Daily
Inflation linkage	Low

Diversified Credit ('DCF')

DCF portfolios consist of primarily Investment Grade, High Yield and Emerging Market Debt, but managers have discretion to access other areas within credit markets such as Bank Loans and Asset/Mortgage backed securities.

Diversified Credit Funds seek to generate the majority of the returns from credit risk, and to a lesser extent from other risks like duration, political and currency risks. Similar to other credit funds, outperformance relative to benchmark is usually from asset allocation and stock selection, both of which are dependent on manager skill.

Expected net return p.a.	Gilts + 2.5%
Volatility p.a.	11%
Liquidity	Monthly
Inflation linkage	Low

Commercial Real Estate Debt ('CRED')

CRED funds are comprised of a concentrated portfolio of loans, backed by commercial real estate.

Unlike traditional property investments, which rely heavily on capital appreciation for returns, the returns on CRED funds primarily come in the form of coupon payments and origination/prepayment fees. This increases the certainty of returns and reduces reliance on property valuations.

	Whole Loan
Expected net return p.a.	Gilts + 3.5%
Volatility p.a.	8-10%
Liquidity	Very low – closed ended funds
Inflation linkage	Low

Notes: Corporate bonds expected return based on over active over 15yr funds.

Investment Managers

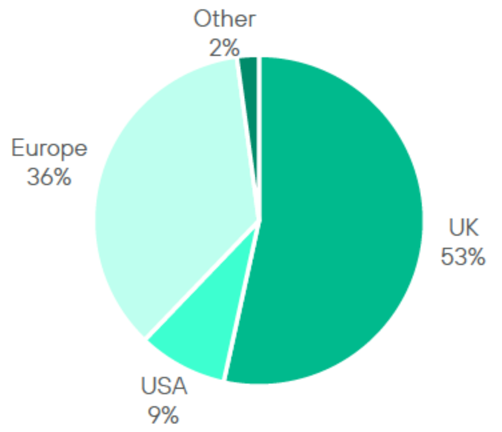
Current Manager Overview

	UBS	M&G		
Name of Fund	Over 5 Year IL Gilt Fund	LF Access Sterling Corporate Bond Fund	Alpha Opportunities Fund	Real Estate Debt Fund VI
Asset Class	Index-Linked Gilts	Corporate Bonds	Diversified Credit	Commercial Real Estate Debt (CRED')
Fund Size	£3bn	£170m[2]	£10bn	REDF IV: £971m[4] REDF V: £474m[4] **REDF VI: £838m[4]**
Holding Size (% Weight)	£138m (3%)	£170m (4%)	£280m (7%)	£38m (1%)
Strategic Weight	3%	4%	7%	3%
Target Return	To match benchmark[1]	Composite Return[3] + 0.5% p.a. (net of fees)	LIBOR + 2.6% to 4.6% p.a. over an investment cycle (net of fees)	REDF IV: 2.7%[5] REDF V: 7.6%[5] **REDF VI: 4.5%[5]**
Active/Passive	Passive	Active	Active	Active
Open/Closed Ended	Open	Open	Open	Closed (Scheduled maturity date: 20 December 2027)
Liquidity	Daily	Daily	Monthly	N/A (closed-ended)
Target Credit Quality	Investment grade credit only (AA rating given for the British Government)	Investment grade average with maximum of 10% permitted in sub-investment grade	No set target but the Fund will retain an average rating of investment grade quality	No set target however REDF VI splits investments between REDFIV and REDFV which invest in investment grade and sub-investment grade debt respectively
Current Duration	23.8 years	12.5 years	0.2 years	N/A
% Inflation Linkage	100%	-	-	-

Notes: Data as at 31 December 2020 unless otherwise stated. [1] Benchmark is the FTSE Index-Linked Gilts Over 5 Years index. [2] Total fund size is equal to East Sussex holdings as this is a segregated mandate. [3] Composite return is iBoxx Sterling Over 15 Year Non-Gilts Index (50%) and the iBoxx Sterling Non-Gilts Index (50%) over any three year period. [4] Total commitments shown. [5] Net projected IRR shown.
Source: investment managers, Isio calculations.

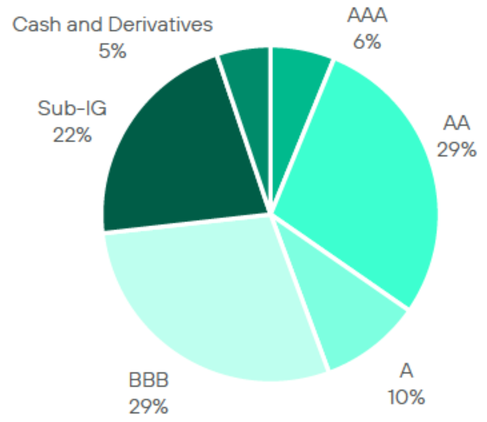
Look Through Exposure

Geographic Exposure



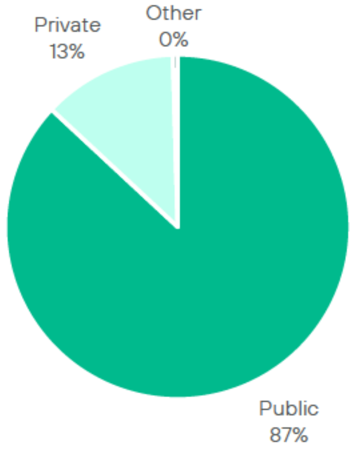
- Significant UK bias – driven by CRED, Corporate Bonds, and Gilts
- Lack of US exposure relative to market, across all mandates – M&G has a European focus
- Scope to further diversify geographic exposure.

Credit Rating Breakdown



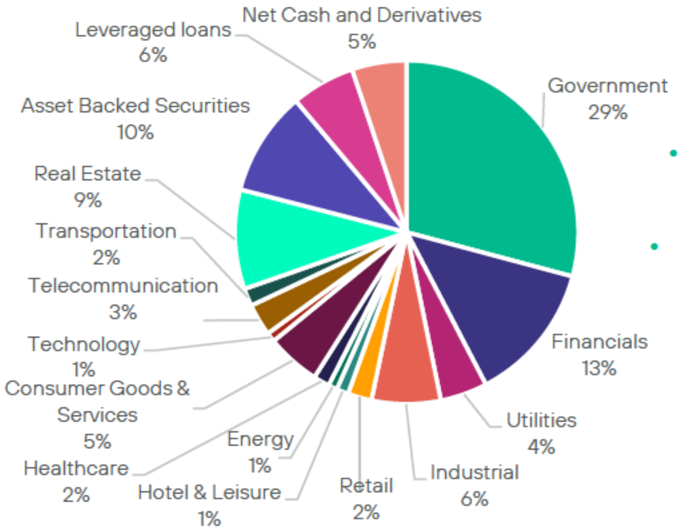
- Diversified across the credit spectrum, with an average investment grade credit rating
- Higher returning credit mandates, CRED largely focussed on below investment grade ratings.

Public vs Private Asset Exposure



- Majority of fixed income exposure in public markets, with CRED the only sole private exposure
- There is scope to introduce further private credit exposure, providing greater scope to harvest an 'illiquidity premium'

Sector Breakdown



- Well diversified across underlying sectors
- Some limited exposure to sectors such as retail and leisure.

Note: Information as at 31 December 2020
Source: Investment managers, Isio calculations.

Initial observations

isio.

Strategic Perspective

Index linked gilts

- A significant rise in inflation remains one of the Fund's most significant risks – all of the benefit payments are inflation linked and rising inflation will lead to a higher value of liabilities.
- We believe there is strong strategic rationale for the allocation to index-linked gilts, due to the direct inflation protection offered by this asset class. However, yields remain extremely low (inflation minus 2.2% p.a.).
- We are supportive of this allocation, but alongside this believe the Committee should continue to explore any other investments which provide an element of direct inflation protection with a higher yield (e.g. long lease property, infrastructure).

Corporate bonds

- We believe there is limited strategic rationale for this allocation. The current mandate provides limited prospective return, given how low credit spreads are, whilst the risk reduction characteristics are also somewhat limited given that corporate bonds offer no inflation protection (and limited sensitivity to changing interest rates vs government bonds)
- We believe this capital could be better deployed elsewhere.

Diversified credit

- We believe diversified credit plays a useful role within your portfolio, providing diversification, stability and downside protection. The mandate should also provide an element of stability in an environment where interest rates are rising given it is not directly exposed to falling bond prices if interest rates do rise.
- We believe there is a strong rationale to retain a diversified credit mandate. The existing approach has a bias towards European markets which could be diversified more broadly.

Real estate debt

- We believe there is strong strategic rationale for the allocation to private market credit and to commercial real estate debt within this.
- This asset class offers contractual returns and scope , and believe it offers attractive risk diversification at the portfolio level. The Fund's allocation to the asset class, and private debt in general, is currently relatively low, and could be increased.
- We believe that whole loan CRED offers a more attractive risk/return profile than standalone junior or senior deals. By investing in the entire debt portion of a real estate deal, managers can achieve a premium in terms of return per unit of risk. This is achieved primarily due to the the governance efficiencies available to borrowers.

Manager Perspective

Index linked gilts

- UBS has proven to be capable at tracking the index-linked gilt benchmark. The fees paid on the mandate are also attractive.
- UBS is currently the passive manager employed by the Access pool and also provides wider passive investments for the Fund. We do not have any specific concerns around this mandate.

Diversified credit

- We rate M&G highly in this space. However given the size of the mandate and some of the biases in the existing exposure, we believe there could be merit in considering diversifying the manager-specific risk by introducing a second provider.
- We note the Committee has expressed concern in relation to the fund's fossil fuel exposure and this is explore further in the next section of this report.

Corporate bonds

- M&G is a very credible investment grade bond manager. However, from a strategic point of view, we believe this capital could be better deployed elsewhere.

Real Estate Debt

- The Fund's exposure is currently a blend of senior real estate debt and subordinated real estate debt with M&G. This is a relatively unusual structure.
- We previously rated M&G highly (green on a traffic light scale), but in the light of very significant departures from the team, we have downgraded this proposition to amber. We consider this in more further in the next section of this report.

M&G Considerations

M&G Alpha Opportunities - Fossil Fuel Exposure (1)

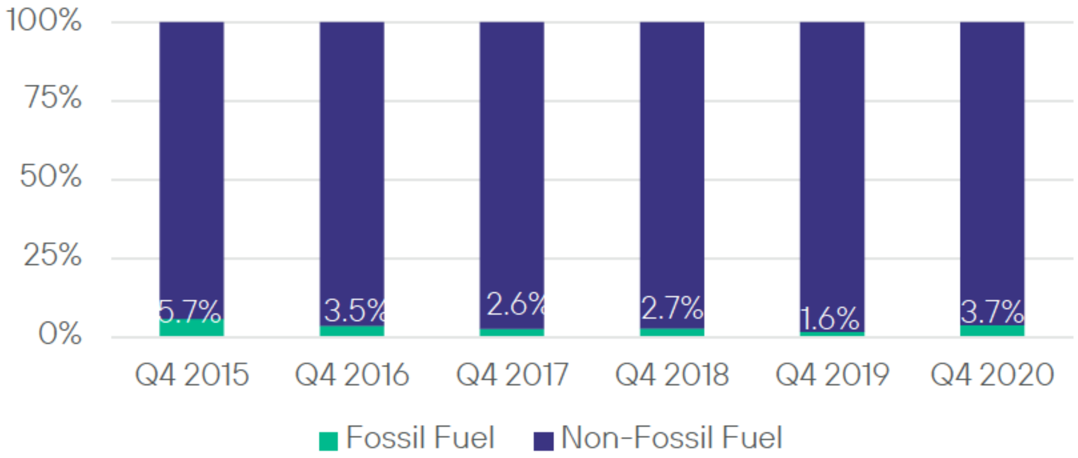
Overview

- M&G do not view fossil fuel exposure at a top-down level, instead any exposure is derived based on bottom-up, issuer by issuer assessment. Exposure over time has not meaningfully changed.
- Engagement and active ownership are preferred to exclusion as they are seen as particularly attractive opportunities to drive positive change and generate positive performance, whilst having a minimal impact on the portfolio's risk and return .
- A sustainable version of the Alpha Opportunities Fund is launching in Q3, with a 'Net Zero by 2050' target amongst other sustainability driven exclusions and goals.

Portfolio level

- Fossil fuel exposure in the portfolio is built from the bottom-up and is based upon the manager's view on the compensation (i.e. the incremental yield) relative to the risk being run.
- The Fund's exposure to fossil fuels was 2.0% of total portfolio value as at 31 March 2021. The change over time is consistent with M&G's bottom-up approach and the current level of exposure within the Fund is significantly lower than a comparable index. We note that, in comparison, the M&G Corporate Bond Fund has an exposure of c.8.0% to fossil fuels (slightly below the comparative benchmark allocation of 9.0%).
- M&G believe being invested and engaging is more beneficial than divesting and the implications of increasing a company's cost of capital. It is noted financing is required in order to pursue sustainable projects. By remaining invested M&G can engage and encourage investee companies to pursue these.

Fossil fuel exposure changes



Source: M&G

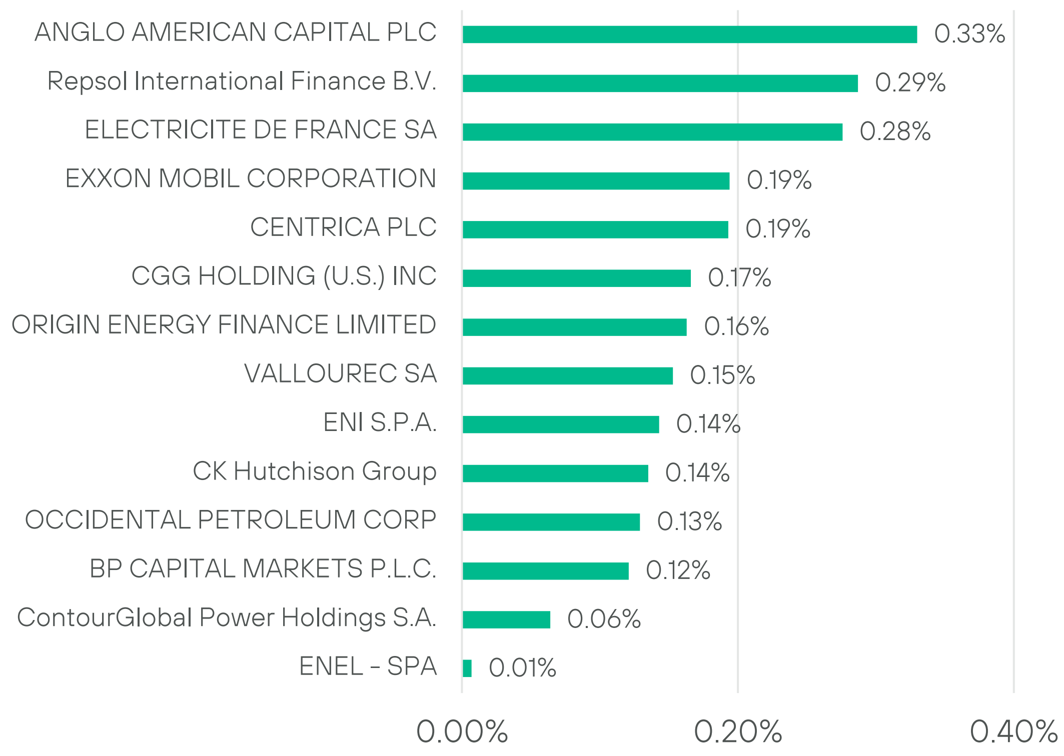
Note: M&G use the MSCI factor definition which considers any companies with an industry tie to fossil fuels (thermal coal, oil and gas) in particular reserve ownership, related revenues and power generation. This definition does not count companies who provide evidence of owning metallurgical coal reserves.

M&G Alpha Opportunities - Fossil Fuel Exposure (2)

Issuer level

- M&G believe that ESG factors can impact on long-term investment outcomes. M&G's bottom-up approach selects securities based on the value offered and the perceived risk in holding that security. Exposure to fossil fuels is typically justified by environmental commitments that are at least in line with market norms, whereby the risk is assessed as being adequately compensated.
- Examples of exposures in the portfolio and their commitments:
  - **Repsol:** A Spanish petrochemicals company that became the first major oil company to commit to Net Zero by 2050, in 2019.
  - **Anglo American:** A multinational mining organisation that has an objective of exiting thermal coal activity in the next three years.

M&G AOF - Top 10 exposures to fossil fuel

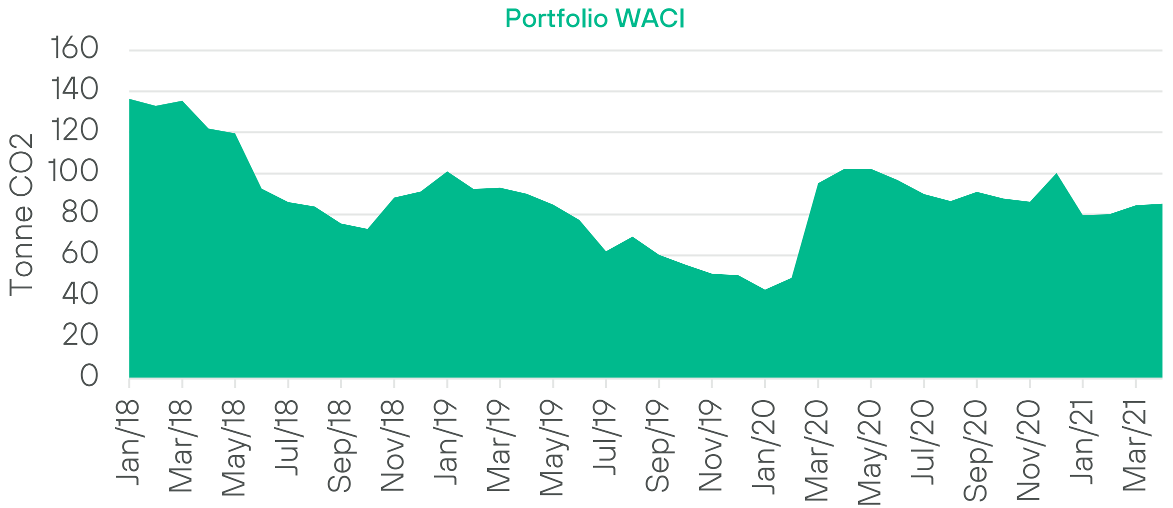


Source: M&G. As at 31 March 2021.

M&G Alpha Opportunities - Fossil Fuel Exposure (3)

Weighted average carbon intensity ('WACI')

- This metric allows comparison of a portfolio's carbon emissions (scope 1 + 2, relative to sales) to a comparable benchmark.
- The Fund's WACI as at 31 March 2021 was 90.2 tonne CO2 equivalent, which is significantly lower than the broad universe of 304.8.
- Availability and quality of data in carbon metrics remains a problem for the industry as coverage is inadequate and the data often misrepresents 'actual' figures.
- As with fossil fuel related issuers, M&G aim to engage with those issuers with a greater WACI and consider their climate risk objectives. For example:
  - **OCI (largest WACI contributor):** Chemical company developing sustainable alternatives which have a 60% GHG saving.



Engagement rather than Exclusion

- M&G's scale provides them the opportunity to engagement and develop relationships with investee companies, beyond the traditional engagement point at issuance.
- Engagement is conducted through the SASB Framework, allowing material risks to be identified and acted upon accordingly.
- M&G encourage issuers to commit to reducing carbon intensity. In areas such as fossil fuels/coal, where engagement is not achieving the desired outcome, exclusion is used.
- Within the constraints of fixed income engagement, M&G demonstrate strong credentials (e.g. 404 meetings with 332 issuers in 2019) and have provided examples of both investee companies and where they rejected the investment opportunity.

Examples:

LyondellBasel

- This chemicals based company who does not have a Net Zero 2050 commitment. M&G have recently utilised their position in 'Climate Action 100+' requesting related items were added to the AGM agenda.

Carnival Corporation (Cruise Ships)

- Engaged in late 2019 to address water pollution, sulphur fuel usage and a capsizing event. A failure to acknowledge or address the issues resulted in M&G not participating in a new issue.

Note: Broad universe used is 50% Barclays Global Aggregate Investment Grade / 50 Barclays Global High Yield.

M&G Team Changes

Overview

- M&G recently announced a number of significant senior team changes within their private debt teams. This is directly relevant to the Fund's investment in the Real Estate Debt Fund and weakens the proposition in our view. We outline the changes for each of the various functions below and share some more detailed thoughts on the real estate debt team in our due diligence not in the appendix.
- The changes do not directly impact the Corporate Bond or Alpha Opportunities teams and we retain our Green rating of Alpha Opportunities. **However, there is a direct impact on the real estate debt fund and we have downgraded our rating of this (from green to amber) reflecting the significant departures.**

Fund specific: Real Estate Debt

- The most significant of the reported team changes, M&G announced that four senior members of the Real Estate Finance team had handed in their resignation.
- As three of those resigning formed the entirety of the team's investment committee, M&G will be undertaking a process to identify and select a new investment committee. Key man clauses in the fund documentation relating to those resigning will pause the deployment of any further capital until the new investment committee is approved by >50% of investors.
- The team remains large relative to other real estate debt teams in the industry with an established 17 member team continuing to operate across origination, asset management, investor relations and operations. Two existing members of the Real Estate Finance team, Duncan Batty and Dan Riches have been promoted to co-head the team.

Other business areas: Debt Opportunities

- Co-Head of the restructuring team, Rafael Cerezo, resigned to undertake a career break and travel with his family. Rafael's responsibilities remain with Andrew Amos (previously Co-Head) who now solely leads the team and has been a fund manager since 2012. Andrew had been part of the team managing the Debt Opportunities strategies since inception. Rafael's assets had been moved to other members of the DOF team since he became co-head and co-fund manager in June 2020. We are comfortable in the structure and expertise of the existing team following Rafael's departure.

Other business areas: Specialty Finance

- Vaibhav Piplapure, who co-founded the Specialty Finance team in 2017, advised that he would be resigning and taking up a new role at KKR. Jerome Henrion, who co-founded the team with Vaibhav in 2017 will remain as the fund manager for the fund and continue as head of the team.
- Asim Zaman, who has 11 years' experience in structuring, trading and rating structured finance transactions, (most recently at Barclays), has been hired in Vaibhav's place.
- The existing team is well experienced and supported. M&G advised that two further individuals have been identified and will be joining the team in the upcoming months.

Summary

Summary

Current holdings

- The Fund's current strategic weight to fixed income is 16.5% of total Fund assets with the current allocation 15%. This allocation is spread across a variety of fixed income investments. These include index linked gilts, corporate bonds, commercial real estate debt, and diversified credit.
- The intention is that the overall allocation to fixed income is reviewed at the upcoming strategy in July and subsequently the composition and strategic direction of the fixed income portfolio is reviewed in September.
- We have identified some areas for consideration in relation to the mandates within the portfolio. The Trustees should consider the strategic direction of the fixed income portfolio and how this could be enhanced to meet the Fund's objectives. We have summarised our initial observations and recommendations on this page.

Strategic thought

- We are comfortable with the Fund's allocation to index-linked gilts and real estate debt as there is strong strategic rationale for these mandates within the portfolio. We believe there is scope to seek additional yield through assets that are directly linked to inflation but higher yielding than government bonds, and scope to increase the overall allocation to illiquid credit.
- The Fund's allocation to diversified credit plays a useful role within your portfolio, providing diversification, stability and downside protection. However due to M&G's bias towards European markets we believe there could be merit in introducing a second provider within the diversified credit space.
- We believe there is limited strategic rationale for the Fund's allocation to corporate bonds and the Trustees should considering deploying this capital elsewhere.

Manager thoughts

- We have mixed views on the Fund's current fixed income managers.
- UBS have proven to be a capable and cost effective manager government bond manager and we have no specific concerns surrounding this allocation.
- The significant team changes within the M&G private debt team is an area that we will continue to monitor in the light of recent downgrade to 'Partially Meets Criteria'. The loss of experience within the team is concerning and negatively impacts our view on the Fund's allocation to CRED with M&G.
- In relation to the diversified credit holdings, we believe M&G are credible in this space and have demonstrated their ability to perform well. We have no concerns with this mandate currently. M&G are also a credible corporate bond manager. however, as noted we believe this capital could be better deployed elsewhere from a strategic standpoint..

M&G AOF fossil fuel exposure

- Over time M&G's exposure to fossil fuels has not meaningfully changed (currently 2.0% of the fund), and remains materially lower than the comparative benchmark. M&G build their exposure (including fossil fuel exposure) from the bottom up and appear to have sound justification for holding the fossil fuel related names from an ESG point of view.
- There is a sustainable version of the Alpha Opportunities Fund is launching in Q3 2021, with a 'Net Zero by 2050' target amongst other sustainability driven exclusions and goals. This could be an opportunity for the Fund to maintain it's diversified credit exposure with M&G in a more ESG conscious manner.

Appendix

isio.

Contacts

David O'Hara
Partner
Investment Advisory
+44 (0) 141 739 9133
David.Ohara@isio.com

Andrew Singh
Principal Consultant
Investment Advisory
+44 (0) 131 202 3916
Andrew.Singh@isio.com

Douglas Sayers
Executive Consultant
Investment Advisory
+44 (0) 141 739 9139
Douglas.Sayers@isio.com

Aimee Hunter
Assistant Consultant
Investment Advisory
+44 (0) 141 739 9125
Aimee.Hunter@isio.com

isio.