Room151 Roundtable
BONDS AND THE LGPS

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With interest rates rising at the fastest pace in more than a decade and inflation expected to stabilise, bonds are projected to make a comeback. LGPS pools have just completed their triennial valuation and are now reconsidering the role of fixed income in their strategic asset allocation.

Room 151 sat down at the Gherkin in London on 16 May with the CIO of West Yorkshire, the head of public markets for London CIV, four investors for LGPS funds and two bond fund managers for MFS Investment Management and Aegon Asset Management to discuss the outlook for bonds.

Room151

ATTENDEES

Tim Mpofu
head of pensions & treasury
Haringey Council

Nemashe Sivayogan
head of treasury of pensions
LB Merton

Nigel Mascarenhas
head of treasury & financial services
LB Camden

Rob Treich
head of public markets
London CIV

Leandros Kalisperas
CIO
West Yorkshire Pension Fund

Sandra Holdsworth
head of rates
Aegon Asset Management

Alexandra Ross
institutional relationship manager
Aegon Asset Management

Benoit Anne
managing director, investment solutions
MFS Investment Management

Kelly Tran
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ROOM151 ROUNDTABLE:
Bonds and the LGPS

Room151 got together the CIO at West Yorkshire pension fund, London CIV's head of public markets and investors for four of the pool's partner funds alongside two bond fund managers to discuss if bonds are making a comeback.

With interest rates rising at the fastest pace in more than a decade and inflation expected to stabilise, bonds are projected to make a comeback. LGPS pools have just completed their triennial valuation and are now in the process of reviewing their strategic asset allocation.

Room151 sat down with the CIO of an LGPS pool, a head of public markets, four investors for LGPS funds and two bond fund managers to discuss the role of bonds in LGPS investment strategies.

Peter Findlay: Why are investors looking at fixed income right now?

Benoit Anne: Fixed income is back as an attractive asset class and it can do a good job as a platform for integrating sustainable investment. The macro environment is now much more comfortable for fixed income. We are at the end of the journey of central bank policy tightening, which was extremely toxic for fixed income over the past few quarters, and we are finally seeing light at the end of the tunnel.

We are expecting perhaps one more hike from the Bank of England, and elsewhere most central banks have now completed the tightening cycle. This is a breath of fresh air for most fixed income investors because rate volatility was the big killer of fixed income investors last year. Not only that, the correlation between bonds and equities was also extremely high. Fixed income was in a very specific regime which we only see occasionally, and which I would characterise as 'fear of the Fed'.

Rate volatility is now going to subside or take a back seat. Inflation dynamics are improving in many places; in emerging markets we are well past the peak of inflation, and in the US as well. Maybe the laggards are the UK and the Eurozone but even there it is looking better.

Even if we are talking about potential recession risks, valuations have been greatly reset. And this provides a fantastic cushion going forward. Even if you factor in spreads widening in credits, you are still in a very good position, because this will be offset by some rate compression and the total return picture in fixed income is still looking very good.

Fixed income is also very well positioned against other asset classes. If I look at my strategic asset allocation, I would want to be overweight fixed income against equities. In equities, there are a few clouds on the horizon, including mixed earnings figures, which are probably skewed to the downside. I would argue that public fixed income is back as an attractive asset class against private credit. I no longer see the appeal for private credit.
MFS is a long-term investor, so sustainability makes total sense for us and fixed income is a great platform to express that sustainability focus. Why? When you want to have an impact, both in terms of returns and sustainability priorities, you do need that active long-term focus.

Peter Findlay: Investors still need to be making a decision about which type of fixed income to go for though?

Sandra Holdsworth: Absolutely, fixed income is a generic term for a whole range of asset classes, ranging from government, to emerging market, to corporate debt. They all fall under fixed income, but they all come with very

"We are at the end of the journey of central bank policy tightening, which was extremely toxic for fixed income over the past few quarters, and we are finally seeing light at the end of the tunnel"
Benoit Anne, MFS Investment Management

different risk-return attributes. And that is the beautiful but confusing part about fixed income. You really have to be aware of the risk you are taking when investing in fixed income so that it meets your needs.

For example, in government debt, you are probably just looking at interest rate risk, whether yields are going up or down. When you are looking at investment grade credit, you are also looking at credit risk: are those investment grade bonds going up or down in quality? This has an effect on the performance of those bonds. You then get political risk, which is particularly high in emerging markets and some might say in US treasuries right now.

You also have liquidity risk. We look at publicly traded markets and I would agree with Benoit that there is no sense in investing in private assets that are not very liquid. But even in public markets, liquidity risk can be a factor in the valuation. Certain types of fixed income, such as asset-backed or mortgage-backed securities, can have liquidity risks. Generally speaking, the more complex the security, the less liquid it is.

Then there is inflation risk, which is key. It could be an asset for you or erode the value of the bond. You can buy inflation-linked debt. There is currency risk, too. Currency in general is a highly volatile asset class and the impact of currency risk may dwarf your returns in fixed income.

Lastly, you may want active or passive management when it comes to fixed income portfolios. Particularly when it comes to portfolios where you have a high degree of credit risk, it may not be a good idea to have passive portfolio because you've then got exposure to all the worst companies who carry on increasing their debt and you do not have exposure to all the good companies.
All these considerations need to be taken into account and each asset class will have a combination of those risks. So, for example, investment grade credit will have interest rate risk embedded into its structure and credit risk.

"The key to looking at fixed income is firstly to understand the asset classes and then understand your needs, what you actually want it to do, and then a portfolio can be constructed around this"
Sandra Holdsworth, Aegon Asset Management

"We would agree that the downside risks on interest rates has dissipated, but with a lot of noise and volatility around that"
Rob Treich, London CIV

And inflation linked bonds were the disaster asset class last year, which may be somewhat surprising given that inflation was so high, but this is because they had interest rate risks embedded into their structure as well.

The key to looking at your fixed income allocation is to look closely at what you want it to do. You may want to hold fixed income as diversification against other asset classes. Fixed income can act like that in a certain time period but, again, there may be a difference between sub-investment grade portfolios and government debt portfolios. They don't always move in the same direction at the same time. From our point of view, the key to looking at fixed income is firstly to understand the asset classes and then understand your needs, what you actually want it to do, and then a portfolio can be constructed around this.

Rob Treich: In a paper which we published in November 2022 called 'Corporate credit, is the glass half full?' we concluded that, looking at yield curves and spreads combined, it was an opportune time to revisit fixed income as a relevant source of income. However, I did say that we should expect to see ripples along the way because of the volatility of changes in interest and inflation expectations, and the risks to corporate earnings. And since then, it is safe to say that the ripples were actually waves, and quite big waves, not least the LDI crisis.

Liquidity risks worry us. LDI illustrated again what we saw in March 2020: the fragility of liquidity, particularly in the credit markets as you get into sub investment grade and structured products, for example. That is something we always want our investors to be very cognisant of.

Today, I'd say the cup is probably a little bit more than half full. We would agree that the downside risks on interest rates has dissipated, but with a lot of noise and volatility around that. We are a bit less convinced that spreads offer great value. We think they offer reasonably fair value in the context of an uncertain environment for earnings. We have seen the first cracks in the system in the US banking sector, which is probably not where we expected it. But corporate earnings have been more robust than expected. We accept that some rate stability and compression could also set some widening of spreads but we would be quite cautious, particularly in the lower rated segments of the market.

So by and large we are positive, and we would encourage clients to have a closer look at their fixed income allocations. We are trying to broaden our offering and to make that relevant to the client funds. It can be quite challenging to find a product which resonates with the largest proportion of our client funds, but we do need to expand the range.

On the broader point of sustainability, I am really encouraged by what is going on from a responsible investment perspective in the fixed income market. In discussions with our managers, the depth and quality of the ESG work that they bring into the debate has improved a lot, the quality of data is much better, the quality of carbon metrics in credit portfolios, subject of course to the limitations of the variety of the composition of the universe, is much stronger than it was. Where we would want to press is on engagement and impact and the tracking of that impact to follow through that it matters. We would also want to take a closer look at the sustainable bond market, which is now a substantial proportion of our global bond fund, and that market is growing at a rate of knots.

Peter Findlay: Leandros, downside risk has largely dissipated as Rob just said and public fixed income is looking more attractive at the moment than private credit. Where do you stand on that?

Leandros Kalisperas: At West Yorkshire Pension Fund, we have been pretty equity facing for many years, going back to the past decades. I would describe our portfolio as 80/20 rather than the traditional 60/40 which would have obviously accommodated a lot more fixed income as a baseline than we have. That has served the pension fund well in terms of long-term risk premium. But one must take seriously what has happened over the past two years and work out what that means for us. The triennial valuation has just been done; the SAA review that results from that is something I am working on.

Has the inflation risk premium returned? And if it has, where does that tail risk get hedged? It is often said that equities is the best form of inflation hedge in the long run, but with earnings under pressure and equities having outperformed GDP for many years, is equity the best hedge over the shorter term? We are strategic investors, but we have to be cognisant of the macro and tactical

environment. One of the questions I am now asking myself is whether inflation linkage, specifically, contractual and clear is something we need to take more of when rebalancing the asset allocation.

Peter Findlay: Do you see yourself rebalancing from the 80/20 split you currently have?

Leandros Kalisperas: It is always a function of where the pension fund is in terms of its cashflow position, its maturity and its membership profile, so that in itself is a slow moving piece. But the way the pension fund is structured has a degree of autonomy that allows it to move away from that strategic asset allocation over an interim period. As Rob has said, I wouldn't be surprised if we took a little bit of equity risk off the table and took on a bit of fixed income and credit risk.

One thing we haven't explored yet is domestic versus global. Clearly, our liabilities are domestic, but mandates typically have the ability to move between domestic and global assets. How has the global picture changed? To throw a provocative phrase in there, let's look at 'monetary nationalism'. Just look at what has happened in Turkey over the last few years, look at what the US is doing in terms of the Inflation Reduction Act. These are quite significant trends and something we need to think of for our own fixed income strategy.

Peter Findlay: Tim, are you embarking on a review of your strategic asset allocation and if so, could you share that journey with us?

Tim Mpofu: Yes. We finished our triennial valuation alongside the other funds at the end of this year. Two things emerged from that. One is that the contribution rates reduced a bit. At the same time, the inflation uplift has increased and the membership has more or less remained the same so effectively, the cashflow pressure has increased. Haringey is quite a diverse pension fund. We have about 47.5% in equities and the rest is in alternatives and fixed income. In fixed income we have two buckets; we have a 7.5% allocation to index linked gilts which last year have not performed as imagined, that has been quite a painful part of our portfolio. But alongside that, we have 10% invested in multi-asset credit through London CIV which invests across the spectrum. Those two funds have a very different purpose in the fund and they are

Kelly Tran, MFS
Investment Management

all allocated at different times as we have gone through different valuations.

What is the primary driver for our fund to allocate more into fixed income? The first thing is diversification. Over the last few years, it seems like diversification hasn't been available and we had to get it from elsewhere in the portfolio, primarily in alternatives. The second thing is inflation protection. That is why historically we had index linked gilts in our portfolio. In a period where inflation is increasing and rates are increasing that is not always a good holding, which is why we are reviewing our portfolio and considering whether to stay with the allocation or to get rid of it, but I wouldn't want to get completely rid of it. The final thing is income generation, which is now an emerging risk in our portfolio, whether we have enough cash on a mark-to-market basis and we are doing some cashflow modelling. This is still preliminary work but our understanding is that the gap is going to be quite meaningful, which means that we have to move the portfolio around and find out how to generate income.

Peter Findlay: Nemashe, is your asset allocation review underway and where does fixed income feature in your thinking at the moment?

Nemashe Sivayogan: We have slightly increased our allocation to fixed income. On the credit side, I do have multi-asset credit and also private debt. The private credit and multi asset credit investments have been added for diversification purposes, but we couldn't rely on them for cashflow because they have different types of capital calls and as a fund, Merton is a mature fund: we have more pensioners than deferred members. To start with, we receive less contributions and, with the 10% pension increase from April, we need the cash to fill that gap. For us, an increased bond allocation will be a secure way to ensure the cashflow, so we have increased this allocation and we wanted to make this stable so that it would secure sufficient cash, which is exactly what we needed to fill the gap.

This also means that we can leave the growth assets in the portfolio and we don't have to be exiting at the wrong time.

On the treasury side, we need more income and currently bond rates are good, so we are buying bonds that give us stable income and help us balance the budgets.

Nigel Mascarenhas: My starting point is our triennial valuation and we had quite pleasing results, we were over 90% funded about six years ago, and we are now over 130% funded. We're in a very strong funding position; it's about how to protect that. To Sandra's point, we're holding bonds for all three reasons you mentioned – less so yield, it's more the matching and the diversification. It would be difficult to do this with equities. If you look at the PIRC stats, most of the around 60 equity funds assessed underperformed significantly.

In bond markets, like most markets, it helps to work with managers who can move in and out of certain sectors. It is a wide field and if you don't have the expertise in-house you need to have a manager that can move in and out of certain sub-classes easily. I know that private credit has been strong recently but that may not be so going forward. For example, 50% of private credit titles are not large cap, and after Credit Suisse and the AT1s, you need a manager that can avoid the 5% of defaults you have currently got in the US. If equities have a difficult time, I think the bond market has its own traps that we need to be aware of. So be careful chasing those so called 'golden asset classes'.

Socially responsible investment (SRI) is incredibly important to my members and having asset classes that behave responsibly and allow you to evaluate the underlying investments in a way that fits with our investor beliefs is really important to us and to our members. I think that is probably true across London.

We have got 12% in fixed income and we are looking to increase that and take some risk off the table at our next strategic asset allocation review. That journey can be very difficult, you see some funds at the top of the league table and then the next year they are not doing so well. And that's not really where we want to be. And I don't think that is where our section 151 officer wants to be. What they want is stability.

Peter Findlay: Nemashe, do you have to see things through a sustainability lens before allocating to fixed income?

Nemashe Sivayogan: Definitely. But we have a slightly different approach. We didn't set a target for our pension fund by which date we


Alexandra Ross, Aegon Asset Management

want to be net zero. We told our members that we are on a journey; the LGPS is a long-term investor and has a responsibility to pay members' benefits. So as part of this, we started to measure our carbon footprint in 2018. We started with equities and to measure our scope 1 and 2 footprint and the results were good. Then we started with scope 3 and the results were encouraging. This is the first time we will also be looking at private credit and private markets. Our members are on board, we are on a journey, and any new investment we will make we will look for their ESG screening and a low carbon footprint. If it is not good, we will not invest in it.

Benoit Anne: To protect the portfolio against inflation risks makes total sense. But I am not sure if inflation linkers are the best tool to do so. If I had to say whether inflation risks are underpriced or overpriced right now, I would probably be in the camp saying inflation risks are overpriced. Therefore, I would rather have a diversified portfolio with some linkers but also nominal bond exposure. And that would probably be doing a good job over the long term. I would not be full on inflation linkers. Eighteen months ago, maybe yes, but not anymore, I think that wheel has turned.

To address a few other points, the good news is that fixed income has become an attractive de-risking asset class. I think it is attractive not

"Whether or not central banks are independent, governments have become big actors and Covid has accelerated that trend globally"
Leandros Kalisperas, West Yorkshire Pension Fund

because of the spread levels, but the total yield is high enough to provide a bit of cushion even if you happen to face a bit of spread widening. My total returns forecast would be positive, even if you may face increased credit risk. I agree that it needs to be assessed by an active manager with a fundamental research process.

That leads me to monetary nationalism, as Leandros remarked. If you have a global portfolio of opportunities, you can play the relative value angle and play into the distortions created by this phenomenon. When you talk about domestic versus global assets, I'd say there is a bit of value that can be extracted by looking at the global level and picking up on the trend that markets are not synchronised.

Sandra Holdsworth: The thing about global markets, sitting here in the UK, especially if you look at investment grade credit, or sub-investment grade credit, you are going to have access to a much bigger pool of companies that you can access the credit from. Your portfolio can have a much bigger diversification, and you are not forced into issuers that might have a lot of debt that you don't really want because you are just restricting yourself to one market. With an active manager, it is a good idea to think that way because they can pick what they think is best from an investment analysis point of view. And they can take into account all the considerations you want on credit metrics or specific needs on the sustainability side.

But what are you going to do about the currency risk? You probably have a portfolio manager who hedges it back into Sterling. But I presume that within your equity portfolio, you are invested in equities on an un-hedged basis, so you want to navigate currency risk here as well. But with fixed income, the currency return can dwarf fixed income returns so it may be appropriate to have a portfolio manager who fully takes that into account. So there is either a cost or a benefit in hedging foreign currencies. Investing in a country with higher interest rates and cash rates than the UK will have an impact. Right now, investing in Japanese currency bonds on a hedged basis is quite profitable whereas investing in Mexican debt can be quite costly. These are all things that your manager should be take into account.

On the point of monetary nationalism, it is a constant worry, but we tend to think of it as tail risk scenarios. Generally, in modern democracies there are checks and balances. In fixed income, where returns are often governed

by central bank policies, if the central bank is independent, it is usually fine.

Rob Treich: In a decoupled world of global opportunities, what about duration risk? Do you manage duration across the different currencies going forward?

Sandra Holdsworth: Yes, I think that is going to be a feature over the next few years, if you sit back and look through the decade after the global financial crisis. Interest rates were synchronised and if they went down, they all went down together. Looking forward, it is a much more volatile landscape and there is evidence of cycles decoupling a bit and that does give you an opportunity set for active managers.

Rob Treich: We would encourage that and build that flexibility into the mandates, but we also do think there are ways around that in terms of reporting of performance if we created too much flexibility and it becomes rather difficult to disentangle the returns.

Leandros Kalisperas: Whether or not central banks are independent, governments have become big actors and Covid has accelerated that trend globally. There are issues that governments either rightly or wrongly are deemed to be best to address. That plays a part in the understanding of fixed income because effectively governments, fiscal deficits and the interplay between rates and foreign exchange is going to be significant around the world.

I raise this just to entertain the idea that government activism is part of the story. In some ways, that tempers my enthusiasm for fixed income. Because the unknowns in equity markets are fairly clear whereas some of the issues in fixed income are perhaps unknown in terms of how central banks act and in terms of how the commercial banking system operates. Although we talked about the fact that valuations have taken away some of the risks in fixed income, at a theoretical and philosophical level, fixed income has quite a lot of risks that are not yet well understood.

Kelly Tran: Do factors such as diversification, liquidity needs and sustainability conflict and therefore have to be prioritised?

Rob Treich: Wherever we are and whatever is happening, there is always that pull in different directions. Perhaps it is about trying to create that dynamism and flexibility within the allocation as opposed to trying to do it outside the allocation, but it is very much a challenge. You can only do your best in terms of empirical analysis. Run the numbers and models and apply a bit of judgement around that and give yourself the best odds in terms of achieving these objectives, which are sometimes in conflict.

Nigel Mascarenhas: We are a smaller fund and we can't have the same number of fund managers that some of the larger funds have. We realise there are trade-offs, to the point that we are not achieving the targets we set for our managers, but what we need to hold on to is that we are achieving our actuarially assessed objectives. That is really important for the LGPS; that is ultimately what pays the pensions. We do realise it's a balance and our members have big RoI expectations.

Tim Mpofu: I would agree with Nigel, the primary goal is to meet that discount rate target. Essentially we want to make sure that our funding base is as stable as it can be. But we are also very interested in sustainability products. We have just allocated to an impact fund and we want all our managers to be able to provide us with that information.

From my perspective, this is really about getting a better understanding of where the opportunities lie. We are looking at where our requirements are and what out liquidity needs are. There are opportunities in public fixed income markets but it will be important to pick up on the risks that have been discussed.

Nigel Mascarenhas: The starting point has to be, what do you want from the asset class? I am looking forward to seeing how our allocation may grow. It is nice to see a previously somewhat unloved asset class reporting higher returns and enjoying positive headlines.

Benoit Anne: I am enthusiastic and comforted with the general sentiment around fixed income right now and it confirms my earlier comments that fixed income is back and makes sense as part of a strategic asset allocation. There has been a lot of progress in terms of integrating ESG in sustainable strategies. In terms of engagement, it is complicated because you can't vote, but there is a lot of discussion on measuring the impact of engagement. We have partnered with the University of Oxford in a study on measuring the impact of engagement.

Sandra Holdsworth: We certainly hope that fixed income is back. The last few years have been a rollercoaster and the movement of rates has ramifications which are still ongoing. The corporate sector has been relatively ok so far, but there will be more cracks to come.

IS ENGAGEMENT MORE POWERFUL THAN EXCLUSION?

Benoit Anne from MFS Investment Management explains why engagement is more powerful than exclusion as a way to encourage long-term value creation and economic growth

It could be argued that building a portfolio comprising only 'good' companies with strong ESG credentials and excluding everything else is not a bad way to generate investment returns. It seems logical to us that companies addressing real social and environmental needs should, all else being equal, have better long-term prospects than companies causing harm to either people or planet.

But all else does need to be equal. For example, ask yourself these questions:

1 What if a company 'doing good' is unable to deliver durable profit growth because it has no enduring competitive advantage?

2 Even if a company does have a lasting competitive advantage, what if your entry point is at such a high valuation that returns are likely to be disappointing?

In these cases, we believe exclusion is unlikely to prove a good investment approach. We view exclusion in this context as an abdication of responsibility, not the exercise of it. That's because in public markets, excluding companies passes the issues on to other investors rather than seeking to positively influence the companies we are invested in.

Engagement as a force for change

What can sustainability-minded investors do? We believe they should engage as proactive stewards of capital and use the power of the capital markets as the point of leverage on which we can move the world.

We need to know our limits — we should not delude ourselves that we understand our companies better than the people managing

them. However, as long-term investors, we should make it clear where our priorities lie:

- We would like companies to be managed for long-term value creation, not short-term profit maximisation.
- We think that good management teams will generally pay due care and attention to social and environmental externalities that could lead to a material financial cost at some point down the line.
- If engagement bears no fruit, we will exercise our voting powers to force the issue.

Engagement and proxy voting are meant to work in tandem. Proxy votes, unlike engagement alone, can provide a measurable snapshot of investor sentiment and can force the adoption of binding resolutions on companies not cooperating with investors.

Whilst many activist investors are aggressive in their engagement strategies, the rise of collective engagement organisations has been driven by some of the largest asset managers and asset owners. Taking part in collective engagement gives both larger and smaller shareholders a powerful voice for communicating and a forum for influencing change.

We believe working together allows for a more efficient engagement process and encourages productive discussions on the issues at hand. Overall, in our view, collective engagement can lead to more effective, reasonable engagements that have the power to drive change in the real economy.

Aligning with clients on value creation

Most investors share a common goal: to seek to generate strong, durable risk-adjusted returns. It is our obligation and fiduciary duty as investment managers to behave as long-term owners when we invest our clients' assets.

To us, exclusionary policies limit our effectiveness and do not help us achieve this goal for our clients. We believe thoughtful engagement and proxy voting practices are vital to encouraging long-term value creation and economic growth.

Turn the page for two case studies of how we engage in fixed income.

European electronic systems and device manufacturer

As the Russian invasion of Ukraine gathered momentum in early April, one of our analysts reassessed our credit recommendations on a European electronic systems and device manufacturer for the defense sector alongside documenting a more nuanced longer-dated view on ESG within the sector.

From an ESG standpoint, the company took steps to improve its credentials, especially given longstanding governance concerns over boardroom appointments, quantified objectives and long-term targets. Bonds performed well in 2022, with a backdrop of war supplemented by a deleveraging of balance sheet (via disposals) and an eventual credit rating upgrade.

The company has delivered on important ESG milestones and appointments, including the appointment of a new chief sustainability officer and two new board members focusing on corporate development and social responsibility along with the implementation of new anticorruption practices.

We believe management will help mitigate governance deficiencies, which, combined with strategic clarity, will improve decision making, so the company is no longer a concern from an ESG standpoint. Given the economic changes for defense companies and ESG improvements, we think the company can potentially perform well over the mid- to long-term.

ESG factors in packaged foods

During the year, members of our equity and fixed income teams collaborated on researching ESG factors relating to packaged food. Discussions centered around the prominent issues. Some examples are outlined in the table, *right.*

A key component of these discussions included devising a set of engagement questions to ask companies to use in future joint engagements. Broadly, the questions are designed to gather more detail on the topics listed above, although they are intended to serve as a guiding framework for discussion, not a rigid checklist.

The team also looked across a variety of companies held in our portfolios to identify potentially notable information to help deepen the team's research and engagement efforts, including:

- An overview of the carbon emissions intensity of meat production companies in comparison to pure play snacks, cereals and confectionary and other products
- The companies that have set or commitment to SBTi targets
- The water reduction programs of these companies
- Examples of RepRisk reports for select companies that highlight the types of differences in geographic exposure and base input commodities that can cause controversies

EXAMPLES OF ESG CONSIDERATIONS IN PACKAGED FOODS

Environmental
• Water usage • Waste generation • Energy & carbon intensity of process • Plastics and packaging costs & reputational risk
Social
• Product quality & safety • Supply chain risks • Human capital consideration • Cybersecurity
Governance
• Board management • Business ethics • Emerging regulation

The purpose of this collaboration between our equity and fixed income teams was to deepen the team's understanding of ESG issues in this industry and to strengthen research and engagement efforts from both an equity and fixed income perspective. The team will continue to collaborate on this topic in the coming years.

■ ***Benoit Anne** is managing director, investment solutions at MFS Investment Management.*

For more information about MFS Fixed Income capabilities, please contact **Kelly Tran**, managing director – institutional, via ktran@mfs.com.

DELIVERING ROBUST INCOME FOR LOCAL GOVERNMENT PENSIONS

Jordan Irvine from Aegon Asset Management analyses the growing importance of cashflow management for LGPS investors.

Climate change, inflation and regulatory changes have been, and will continue to be, high on LGPS agendas. However, an area that is likely to gain more attention this year is cashflow management and how to deal with the increasing number of funds that are (or soon to become) cashflow negative.

The accelerating trend towards cashflow negativity

A cashflow negative pension scheme simply means that the benefits being paid out exceed the income from contributions and investments.

The surge in inflation has accelerated this trend among LGPS. This is because there has been a material increase in benefit payments on the back of the inflation readings. At the same time, inflationary pay increases have been lower, so the income from contributions has failed to keep pace with benefit outgoings.

One of the main risks of cashflow negativity is the risk of being a forced seller of assets to meet cashflow needs. This becomes particularly problematic during periods of market stress, as pension schemes are forced to sell assets after market falls, therefore crystallising losses.

Cashflow negativity is not a new phenomenon for pension schemes. Private sector schemes have faced similar challenges over the past decade and have evolved their investment strategies to manage these challenges, including:

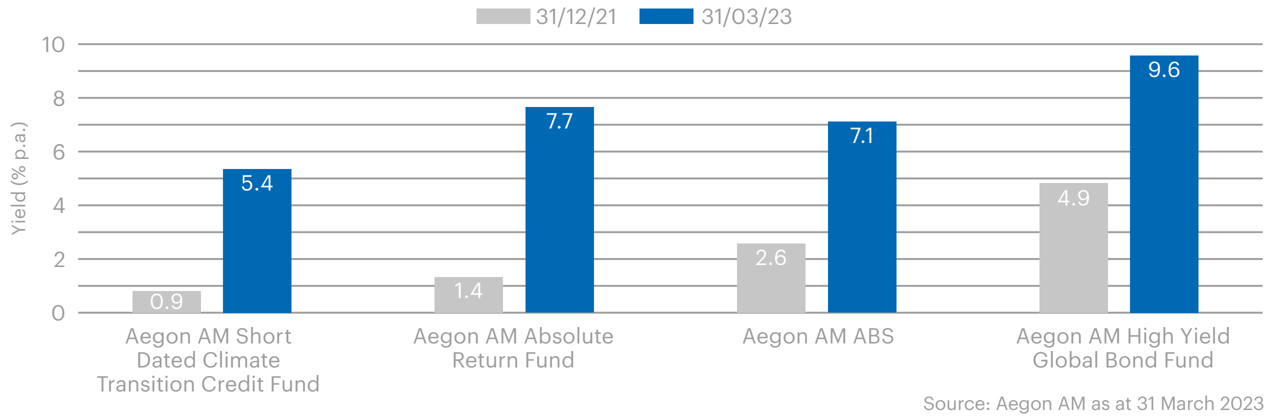
1. Increasing allocations to income-generating assets to provide pension funds a natural source of contractual income.
2. Considering income options within growth allocations and switching to income distributing strategies.

Increasing the allocation to income-generating assets

Compelling valuations

2022's 'perfect storm' has created attractive opportunities for investors looking to make allocations to fixed income strategies. Chart 1 highlights the yields on offer across Aegon AM fixed income strategies compared to the end of 2021 when yields were towards their lower

CHART 1: YIELD-TO-MATURITY FOR AEGON AM FIXED INCOME STRATEGIES



Source: Aegon AM as at 31 March 2023

points. The yield-to-maturity (YTM) represents the annualised percentage total return anticipated if the bond is held to maturity, assuming no defaults.

The strategic rationale

Each fixed income strategy offers a different risk/return profile to help meet the differing needs of investors, although each share characteristics which are likely to be appealing to LGPS:

- An enhanced income relative to cash and government bonds, which becomes particularly desirable in a high inflation environment.
- A strong record of managing defaults through different economic cycles.
- Short duration means that these strategies are less sensitive to interest rate changes, which has been compelling to many investors in a rising rate environment.
- Shorter maturity (than the average bond) means there is a high frequency of maturing bonds generating a steady income stream. This also means that the strategies benefit from a powerful 'pull-to-par' effect.

Consider income options within growth allocations

A simple step for an LGPS looking for extra income is to consider switching to income-distributing strategies. This would mean that the income from these strategies would be distributed back to the LGPS in the form of cash, rather than being reinvested. This is best achieved if the strategy itself is specifically designed with an income focus.

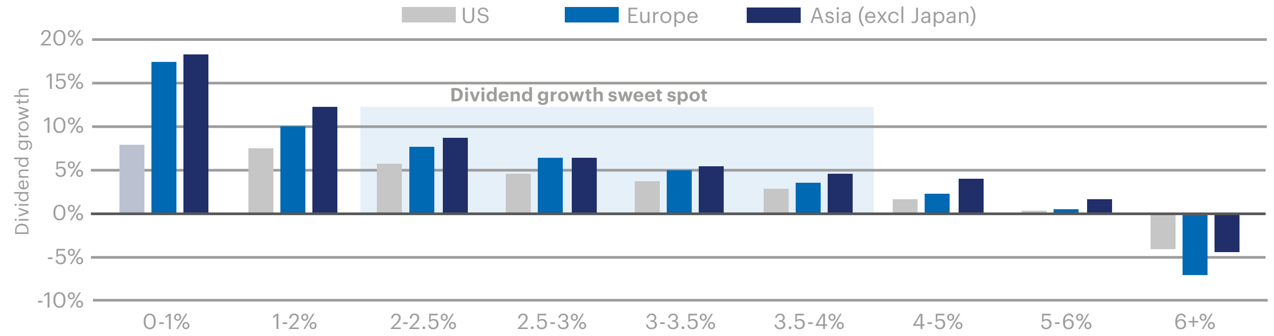
Two income focused Aegon AM strategies that have been particularly well received by LGPS are the Global Equity Income Fund and the Global Diversified Monthly Income Fund. The table below summarises both strategies.

Aegon AM strategy	Why might it appeal to LGPS?
Global Equity Income Fund The strategy aims to deliver yield around 130% of the MSCI ACWI index on a rolling 12-month period as well as long-term capital growth, by investing in a high conviction portfolio of 30-50 companies.	✔ Premium income stream of 30% more than the MSCI AC World Index ✔ Defensive exposure to global equities through a lower beta approach ✔ A high conviction portfolio focussed on quality companies that pay reliable and growing income
Global Diversified Monthly Income Fund Invests in a diversified range of income assets including fixed income, equities, listed real estate, and specialist income.	✔ A monthly distribution of natural income, targeting 5% p.a. ✔ Medium term capital growth, while offering half to two-thirds of the volatility of global equities ✔ A highly diversified actively managed portfolio

Aegon Global Equity Income Fund - finding the sweet-spot for dividend growth

Dividend income has proven to be an important component of long-term total equity returns. To put into perspective, in the US, dividends have contributed to 36% of the total return on the S&P 500 since 1940.

CHART 2: FINDING THE DIVIDEND GROWTH SWEET SPOT



Source: SG Cross Asset Research/Equity Quant, June 2021.

Our strategy is premium yielding rather than high yielding. This means we want to deliver income that is stable and growing, rather than the highest out there, which helps to protect downside risk. We achieve this by focussing on quality companies (not deep value) with strong balance sheets, high return-on-equity, and well-covered dividends.

History shows that once stocks have a dividend yield over 4% the dividend growth slows materially. Above 5% and the growth becomes negligible, while above 6% and the dividends typically decline.

The importance of equity income strategies was easy to overlook in the latter part of the 2010s, when markets were driven by growth. However, the backdrop has changed and the current environment of high inflation, rising interest rates, and global growth slowing favours a quality income style. It is in these conditions that equity income strategies tend to perform well.

Aegon Diversified Monthly Income Fund

The strategy invests in a diversified range of income assets including fixed income, equities, listed real estate, and specialist income. In the current environment an active multi-asset approach offers significant flexibility to take advantage of opportunities within markets. Chart 3 illustrates the degree of asset allocation flexibility within the Aegon Diversified Income Fund, dating back to inception in 2016.

This flexibility is important in delivering consistent income, with the strategy targeting an income distribution of 5% p.a., distributed monthly using natural income. We note that the 12-month historic yield at 31 March 2023 was sitting at 5.7% p.a.

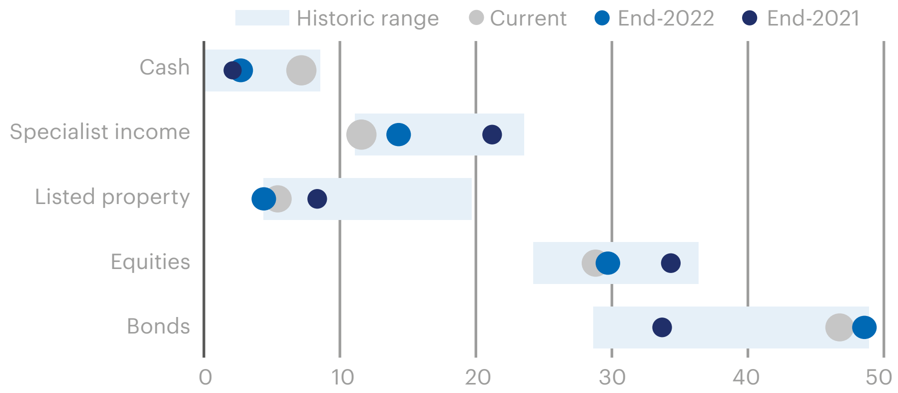
Conclusions

Delivering a robust income stream will be a priority for many LGPS looking to manage the challenges of being cashflow negative. Of course, good governance will be key. Knowing how much and how quickly cash will be needed then allows individual funds to make plans and consider key questions, such as where to source the assets.

A key focus, however, should be to try and deliver income naturally to avoid being a forced seller of assets in volatile times. .

■ ***Jordan Irvine** is client relationship director UK institutional at Aegon Asset Management.*

CHART 3: ASSET ALLOCATION RANGES SINCE INCEPTION



Source: Aegon Asset Management. Allocation as at 31 March 2023. Asset allocation ranges shown for Aegon Diversified Monthly Income Fund since fund launch 25 February 2014