Investec

London Borough of Tower Hamlets Pension Fund

Investec Funds Series iv, Target Return Fund

Investment report for the quarter ended 31 March 2015

Investec
Asset Management

Executive summary

Investment strategy

The London Borough of Tower Hamlets Pension Fund invests directly into the Investec Funds Series iv, Target Return Fund.

The Fund aims to produce a positive return over the long term regardless of market conditions by investing primarily in interest bearing assets and related derivatives.

The Fund aims to deliver steady gains over the long term through wide diversification of risk and a high level of investment flexibility.

The underlying principle of the Fund's strategy is that by taking a large number of small bets instead of a more limited number of larger bets it will be possible to generate an equivalent level of return, but with less short-term volatility.

Performance objective

To outperform the performance comparison index return by 2-3% per annum (gross of the base investment management fee) when measured over rolling three year periods.

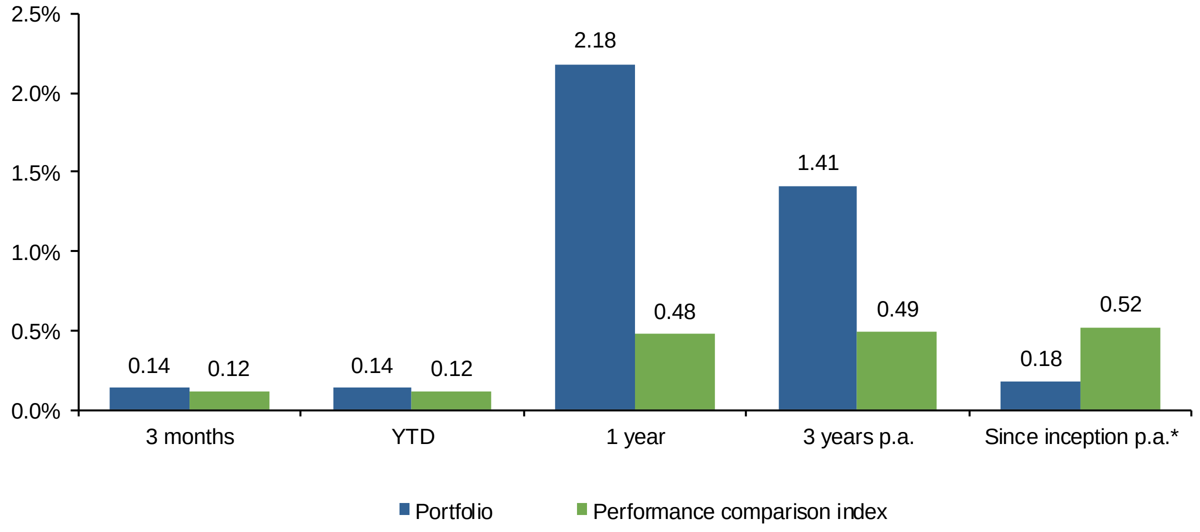
Performance commentary

The portfolio delivered a return of 0.14 % against a performance comparison index return of 0.12%. The main source of relative performance over the quarter was our exposure to corporate debt. Our broader credit market hedge position detracted after the rally in credit markets, which was most pronounced in European high yield markets. Meanwhile, within our currency exposure, our idiosyncratic, shorter-term positions were the primary detractors, although our strategic longer-term position helped mitigate the losses experienced here.

Our exposure to emerging market debt contributed to relative returns, while interest rate positioning also added. We managed to take full advantage of the rally in emerging market debt at the beginning of the year, while select exposure to high-quality country holdings proved beneficial within our interest rate exposure.

Performance

Periods ended 31 March 2015



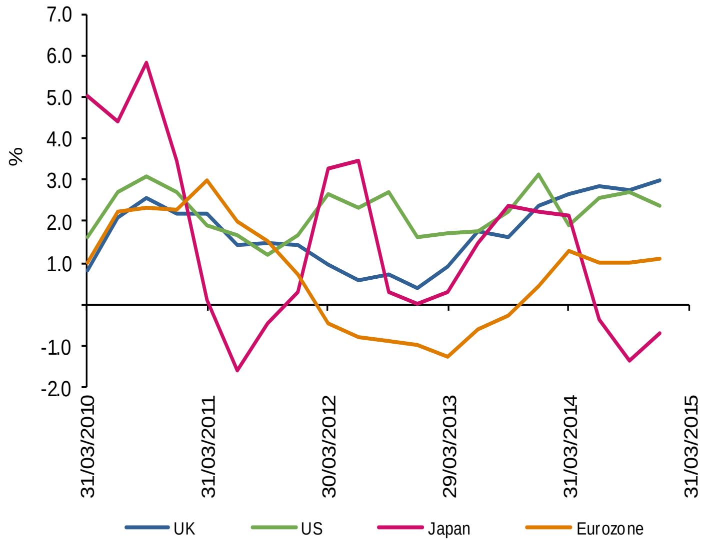
Market value : GBP 99,629,864.34

Source: Investec Asset Management. Returns are stated gross of fees. Periods above 12 months are annualised.
Performance comparison index: Overnight GBP LIBOR Rate.
*Inception date: 26 April 2010

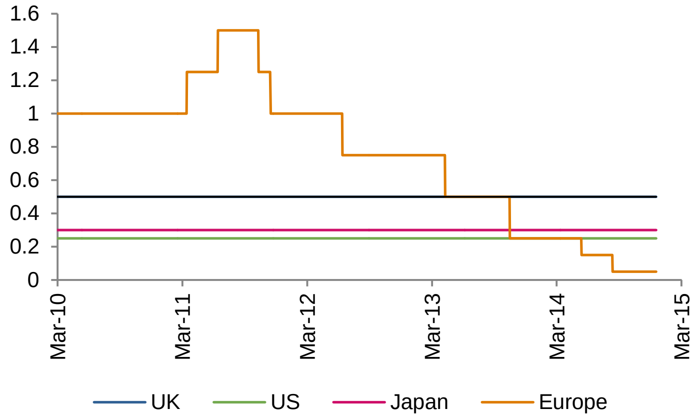
Economic and market review

Global economy – quarter ended 31 March 2015

GBP trend (annualised)



Key official interest rates



Growth

While economic data from the US undershot expectations, forecasts of global economic growth edged higher. The period was something of a contrast to previous quarters after euro-zone data was stronger and US data stuttered. Data in Japan continued to disappoint, while political rhetoric started to take centre stage in the UK in the run up to the May General Election.

After successive months of buoyant US economic data, the beginning of 2015 marked something of a slowdown, in spite of the effective 'tax cut' from lower oil prices. This manifested itself through an increasingly 'data-dependent' US Federal Reserve (Fed) in the context of interest rate hikes.

In the euro zone, deflationary pressure has eased slightly, while economic data has improved. Exports, in particular, have grown against a backdrop of a weaker euro following the European Central Bank's (ECB) quantitative easing (QE) programme.

Meanwhile, one year after the April 2014 consumption tax hike in Japan, the economy has struggled with falling inflation and a real economy (production of actual goods and services) which has failed to show material signs of improving, despite domestic financial asset prices rising strongly.

Monetary Policy

The first quarter of 2015 was particularly eventful across global markets. Underpinned by the slump in oil prices in 2014, the period will chiefly be remembered for the extent of extraordinary monetary policy actions taken by various central banks. Falling global inflation – primarily driven by plummeting oil prices – prompted 36 central banks to cut interest rates across the globe in a bid to maintain currency competitiveness.

In Europe, the ECB finally introduced sovereign bond QE, while the Swiss National Bank (SNB) surprised markets by scrapping the Swiss franc/euro cap after both the chairman and vice-chairman of the SNB had previously confirmed their support.

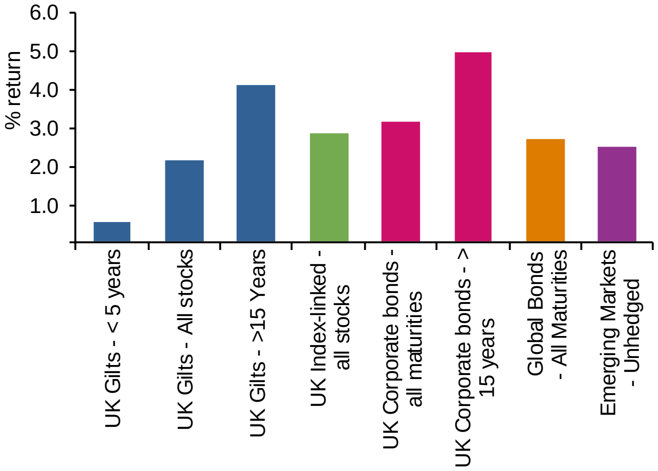
The Fed once again drew significant attention as market participants looked for clues on the intentions of the timing, and subsequent path, of future interest rate hikes. The term "patient" was dropped for the first rate hike, although this was widely expected. Indeed, market perceptions were relatively more dovish as the Fed signalled higher data dependence amid weaker inflation and mixed data.

Source: Factset

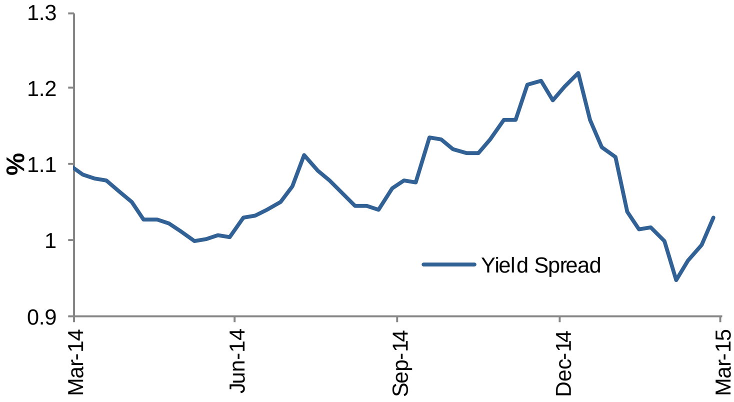
Economic and market review

Markets – quarter ended 31 March 2015

3 month £ returns



Spread between £ all maturities gilt and corporate bond yields



Returns

Yields on 10-year government bonds fell to 1.92% in the US and 1.58% in the UK, while rising to 0.40% in Japan.

Core bond market yields have continued to fall with a low inflation environment globally and pervasive accommodative monetary policy, most notably from the ECB and its QE programme.

Each of the UK, Germany and Japan 10-year bonds reached a record low yield at some point during the quarter. Falling inflation has left real yields attractive in an environment where the 'search for yield' is far reaching. Easy monetary conditions and the prospect of steady, but not spectacular, growth has kept yields lower.

Credit spreads narrowed modestly across the developed market space with high yield bonds reversing some of the prior quarter's widening. European high yield credit, in particular, benefited from the positive sentiment post the ECB QE announcement.

Emerging market local currency bonds were once again adversely impacted by the strengthening US dollar, while emerging market hard currency bonds achieved a modest gain as investors sought out higher yielding dollar assets.

Valuation and behavioural aspects

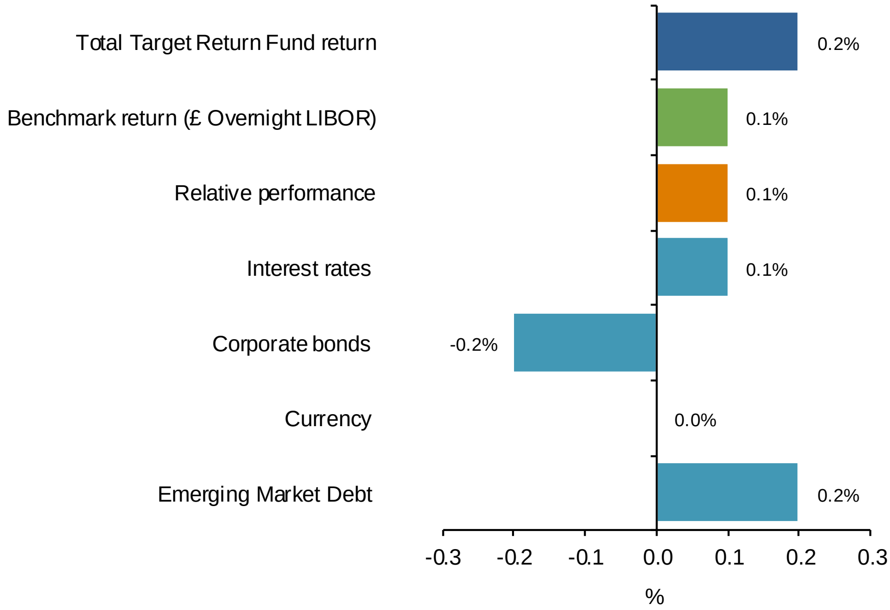
There is increasing dispersion in global bond markets which widely coincides with a higher level of both developed market and emerging market currency volatility. Much of this relates to differing prospects for monetary policy, especially with the US increasingly primed to start hiking interest rates. More importantly, this is an environment where valuation appears expensive in both absolute and relative value propositions, across global macro markets.

Source: Factset

Performance analysis

What helped and hurt – quarter ended 31 March 2015

Contribution to performance for the quarter



Interest rates

The positive relative performance from our interest rate exposure was predominantly due to our holdings of smaller, higher-quality government bonds, such as Israeli and Australian, where both central banks struck a more dovish tone in one form or another. However, our short exposure to US Treasuries was a drag on relative returns after US government bond markets continued to rally amid a more dovish interpretation of US Federal Reserve (Fed) comments.

Corporate bonds

Our corporate credit exposure detracted from relative returns over the period. The bulk of this underperformance came in March, when broader credit market hedge positions detracted after a strong rally in high yield credit markets, particularly in Europe following the announcement of quantitative easing (QE) from the European Central Bank.

Currency

Our currency exposure made a flat contribution to returns, reflecting how negative performance from our idiosyncratic, shorter-term positions was offset by our core, longer-term holdings, such as our strategic bias towards the US dollar. Indeed, several of our idiosyncratic trades did not evolve as we had expected, although each of these were managed carefully.

Emerging market debt

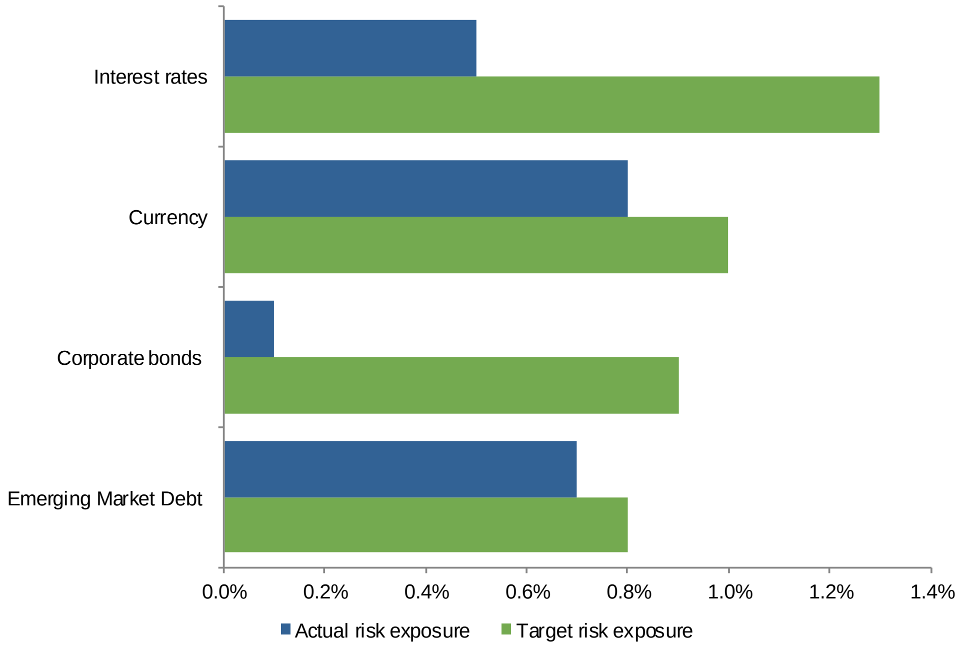
Our emerging market debt exposure added to relative returns over the period. This was predominantly due to us being able to take full advantage of the strength in emerging market bonds at the beginning of the year. However, broad-based weakness towards the end of the quarter proved difficult to escape from and dampened the positive relative returns modestly.

Source: Investec Asset Management, Returns are stated gross of management fees

Performance analysis

Portfolio strategy for the Strategic Bond Fund as at 31 March 2015

Model risk exposure (%) – Proposed allocation of risk between strategies



Strategy

Overall interest rate exposure was essentially unchanged over the quarter, although the mix was adjusted somewhat. We increased our net short exposure held in US Treasuries, while reducing our strategic short position in Japanese government bonds. We also closed our modest long position in German Bunds and ended the quarter with slight short exposure.

Within the portfolio's currency exposure, our long-held strategic long in the US dollar was reduced meaningfully over the quarter, back to around neutral levels. This corresponded with the existing overweight in sterling being added to, alongside a further reduction in the euro underweight.

Our corporate credit exposure was largely unchanged with a small reduction in lower rated bonds and investment grade bonds added to.

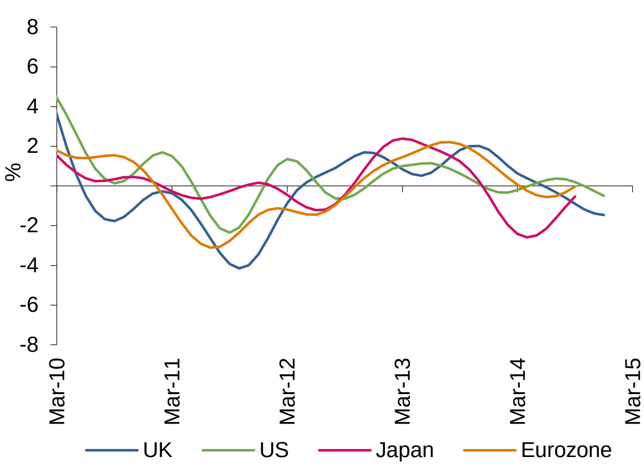
Our emerging market debt remains significantly higher than our average exposure during 2014. Aggregate duration exposure across emerging market bonds was held constant.

Source: Investec Asset Management.

Economic and market review

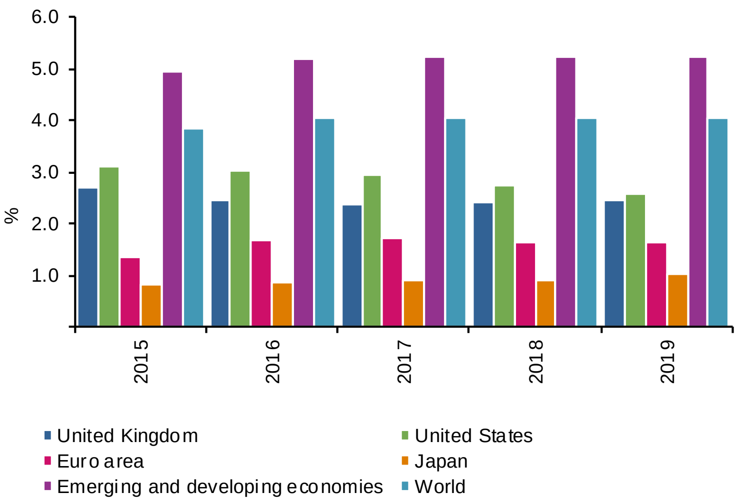
Global economy – quarter ended 31 March 2015

OECD lead indicators



Source: Factset

GDP outlook (year on year % change)



Source: International Monetary Fund (IMF) October 2014

Economic growth prospects

Underpinned by the tailwind of lower oil prices, global growth appears likely to surprise to the upside later this year.

Easier monetary conditions and relatively expansionary fiscal policy should provide an additional boost to the global economy.

The economies of the euro zone and Japan are both benefiting from weaker currencies, although growth might still be held back by structural drags.

The outlook for the US is still optimistic, despite weaker global growth and a strong US dollar weighing on the domestic economy.

Inflation

The inflationary backdrop remains benign across both developed and emerging market economies. Inflation expectations, which have been remarkably resilient, are also beginning to slide lower. A sustained output gap and lower commodity prices mean disinflationary forces are dominating.

Entrenched lower inflation is proving a challenge to policy makers and resulted in a wave of unconventional monetary measures globally.

In the US, while headline inflation registered a fall of 0.1% in the 12 months to March 2015, core inflation – which strip out volatile items such as food and energy – actually rose 1.8% for the same period. Clearly, the falling oil price appears the primary culprit. A similar, although somewhat less pronounced impact, is also evident in the UK where headline and core inflation registered readings of 0% and 1.0% in the 12 months to March 2015, respectively.

The euro zone fell into deflationary territory although there are optimistic signs after a reading of -0.1% in the 12 months to March 2015 – in stark contrast to the same figure for January 2015 of -0.6%.

GDP outlook

The IMF has stated global economic growth will be “moderate and uneven” in 2015. Falling oil prices means the economy is set to expand 3.5% and 3.8% for 2015 and 2016, respectively. The 2016 figure represents an upward revision from its January prediction. That said, the IMF’s warning of “uneven” growth alludes to a higher chance of negative shocks than positive shocks.

Despite more recent data from the US being relatively mixed, the US economy is likely to continue to act as the engine of global growth, while the euro zone and Japan will continue to look to a weaker currency to help boost both growth and inflation. Elsewhere, the Chinese economy continues to rebalance to a lower growth path with emerging markets, more broadly, adversely impacted by lower commodity prices.

The first rate hike from the Fed appears most likely to be in September of this year – slightly later than consensus forecasts of June at the end of 2014. However, a June rate hike very much remains a possibility.

Global market outlook

Quarter ended 31 March 2015

Tactical and strategic asset class views

BONDS	→	CURRENCIES	
US & UK government	→	USD	↗
EU & Japan government	↘	EUR	↘
Inflation linked	→	GBP	→
Investment grade	↘	JPY	→
High yield	↘	EM	↘
EMD	→		

Views of Investec Asset Management's Multi-Asset team and reflect relative preferences within respective asset class. Directional views for bonds reflect projected price movements. As at 31 March 2015.

→ Neutral ↑ Strongly up ↓ Sharply down ↗ Trending up ↘ Trending down

Bonds

It is clear that we are in a period of increasing divergence in policy responses between the US and other economies. The debate in the US is centred on the timing of rate hikes, while other economies are still in the midst of cutting rates. This calls for flexibility and selectivity with owning developed government bonds. We do not rule out US Treasuries as a potential investment though, and as with UK, Canada and Australian government bonds, they offer a relatively attractive yield to other markets such as Germany and Japan. Our preference for these markets is on investing further out along the yield curve and/or to position for changes in the shape of the curve.

Corporate bonds

We remain cautious about credit markets, for both investment grade and high yield bonds, due to the scale and quality of issuance, increased leverage levels and the extent of investor crowding in these markets. However, we recognise that the accommodative monetary policy in the global system provides a strong backdrop for these markets, and so believe there is potential for modest returns.

Emerging markets

Emerging market local currency debt appears to offer a decent risk premium for investors. These markets should also be supported by soft inflation and reasonable economic growth. However, selectivity is crucial and the country-specific balance of payment situations should determine the relative winners and losers. We believe emerging market local bonds offer better value than hard currency bonds, and this view has been strengthened given the recent divergent performance between the two markets.

Currency

We continue to remain positive on the US dollar as we believe the fundamentals of the economy are robust and the US is most likely to return to policy normalisation sooner than the other major economies. The direction of travel for the euro seems clear over the long term, with a further depreciation likely to take it to parity and beyond relative to the dollar. The strengthening dollar may have the biggest impact on emerging market currencies. That said, there are selective buying opportunities available.

Inflation-linked bonds

Collapsing expectations around inflation has seen break-even rates continue to fall globally. However, this presents select opportunities where valuation appears most compelling. US longer-term break-even rates are an example where the inflation expectations being priced in perhaps appear too low, presenting an attractive opportunity.

Source: Investec Asset Management

Risk

We have a dedicated in-house risk analysis team, who prepare regular portfolio analyses for your fund manager.

These reports detail forecast and actual tracking error for the portfolio, and show the major sources of potential risk relative to the benchmark and enable your fund manager to access and manage risk so that it is consistent with the mandate you have set.

The table below shows the current forecast ('ex ante') tracking error for your portfolio.

Statistical analysis	Ex ante (p.a.)
Fund Tracking Error	1.22%

Source: Investec Asset Management / EMA.

Investec
Asset Management

Your client management team

Please contact a member of your Investec Asset Management team if you have any questions regarding this report.

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