Notice of Meeting

Surrey Pension Fund Board

Date & time	Place	Contact	Chief Executive
Friday, 19 September 2014 at 9.30 am	Ashcombe Suite, County Hall, Kingston upon Thames, Surrey KT1 2DN	Cheryl Hardman Room 122, County Hall Tel 020 8541 9075 cherylh@surreycc.gov.uk	David McNulty

If you would like a copy of this agenda or the attached papers in another format, eg large print or braille, or another language please either call 020 8541 9122, write to Democratic Services, Room 122, County Hall, Penrhyn Road, Kingston upon Thames, Surrey KT1 2DN, Minicom 020 8541 8914, fax 020 8541 9009, or email cherylh@surreycc.gov.uk.

This meeting will be held in public. If you would like to attend and you have any special requirements, please contact Cheryl Hardman on 020 8541 9075.

Elected Members

Ms Denise Le Gal (Chairman), Mr Nick Skellett CBE (Vice-Chairman), Mr W D Barker OBE, Mr Tim Evans, Mr John Orrick and Mr Stuart Selleck

Co-opted Members:

Mr Tony Elias (District Representative), Judith Glover (Borough/District Councils), Ian Perkin (Office of the Surrey Police and Crime Commissioner) and Philip Walker (Employees)

SUPPLEMENTARY AGENDA

6 INVESTMENT STRATEGY REVIEW (Pages 1 - 22)

Following the actuarial valuation, Mercer has advised the Board to establish a liability driven investment framework. As a first step in establishing this framework, the Pensions Fund Board's external advisor recommended that we consider investing in a leveraged gilt portfolio. Following training from four expert fund managers in this sector, this report seeks approval to invest £90m from our existing passive and index-linked gilt portfolios to a three times leveraged gilt portfolio with Legal and General Investment Management.

7 MANAGER ISSUES AND INVESTMENT PERFORMANCE (Pages 23 - 26)

This report is a summary of all manager issues that need to be brought to the attention of the Pension Fund Board, as well as manager investment performance.

David McNulty
Chief Executive
Published: 18 September 2014

MOBILE TECHNOLOGY AND FILMING – ACCEPTABLE USE

Those attending for the purpose of reporting on the meeting may use social media or mobile devices in silent mode to send electronic messages about the progress of the public parts of the meeting. To support this, County Hall has wifi available for visitors – please ask at reception for details.

Anyone is permitted to film, record or take photographs at council meetings. Please liaise with the council officer listed in the agenda prior to the start of the meeting so that those attending the meeting can be made aware of any filming taking place.

Use of mobile devices, including for the purpose of recording or filming a meeting, is subject to no interruptions, distractions or interference being caused to the PA or Induction Loop systems, or any general disturbance to proceedings. The Chairman may ask for mobile devices to be switched off in these circumstances.

It is requested that if you are not using your mobile device for any of the activities outlined above, it be switched off or placed in silent mode during the meeting to prevent interruptions and interference with PA and Induction Loop systems.

Thank you for your co-operation

6

SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **19 SEPTEMBER 2014**

LEAD OFFICER: **SHEILA LITTLE, DIRECTOR OF FINANCE**

SUBJECT: **INVESTMENT STRATEGY REVIEW: LIABILITY DRIVEN INVESTMENT**

SUMMARY OF ISSUE:

Following the actuarial valuation, Mercer has advised the Board to establish a liability driven investment framework. As a first step in establishing this framework, the Pensions Fund Board's external advisor recommended that we consider investing in a leveraged gilt portfolio. Following training from four expert fund managers in this sector, this report seeks approval to invest £90m from our existing passive and index-linked gilt portfolios to a three times leveraged gilt portfolio with Legal and General Investment Management.

RECOMMENDATIONS:

It is recommended that the Pension Fund Board approve:

1 the setting up a framework for a liability driven investment strategy (LDI) with the establishment of a leveraged gilt portfolio. It is recommended that this be funded by the existing passive and index-linked assets held with Legal & General, amounting to £90m.

2 the appointment of Legal and General Investment Management with the intention of eventually implementing an LDI strategy. This will serve as a platform for future strategy requirements as the Fund approaches full funding. The appointment should be subject to final full diligence being completed in terms of the legality of the LGIM solution within the LGPS Regulations.

3 the level of liability protection to be increased as the funding level moves further towards 100% with triggers set for consideration of these future decisions, and further Board training to be provided.

REASON FOR RECOMMENDATIONS:

The Pension Fund will eventually be fully funded. In preparation for this event, the Pension Fund Board must adapt and monitor its investment strategy according to its liability profile in a changing market environment. Adopting a liability driven investment framework and, as a first step, a leveraged gilt portfolio will help reduce deficit volatility through better protection against adverse changes in long-term interest rates and inflation.

DETAILS:

Background to Liability Driven Investment

1 At the Board meeting of 15 May 2014, the Board agreed to consider the introduction of a liability driven investment framework. This would further enhance the Fund's approach to risk management and reduce the inherent volatility of the funding level that results from changes in long-term interest rates and inflation expectations. At the meeting, the Pension Fund Board agreed to put the platform in first with a view to building up the allocation over time, as the funding level improves and also as real yields increase.

2 The Pension Fund Board's external advisor has suggested that the Fund introduce LDI, with a framework in place, thus enabling future dynamic changes to be achieved efficiently. It will be important to ensure that the initial structure of the new framework is both robust and flexible in the near and longer term. There are a number of implementation considerations that are important to bear in mind when setting up a LDI framework for the Fund, as set out below.

Implementation Considerations

3 One of the foremost considerations for the LDI framework will be the structure of the solution. Special attention needs to be paid here due to the nature of the regulatory environment, namely, the LGPS Investment Regulations 2009. A pooled fund solution will fall within the LGPS Regulations.

4 Such a solution can come in the form of investing in standard pooled funds offered by an investment manager (structured in a way that is specific to the Fund). Pooled funds can be structured in a number of ways, including:

- Qualified Investor Funds (QIFs);
- Sociedad de Inversión de Capital Variable (SICAVs); and
- Insurance policies.

5 The Pension Fund's officers have taken advice in determining from a legal perspective the suitability of the available structures of pooled funds. The Pension Fund's officers appointed Sackers (specialists in LGPS law) in order to take advice on the legal issues of the new mandate.

6 The Fund has sought clarification from Sackers concerning permissible structures, and Sackers' advice is that a liability hedging mandate can be implemented with one of the above structures. The Sackers advice is attached as Annex 1 (in a separate Part 2 paper).

7 The most common solution amongst the preferred fund managers is the QIF. Based on past legal discussions relating to other LGPS funds, it is understood that a QIF structure may fall under the definition of an "unlisted" asset, which would be subject to a 10% investment limit under the relevant investment regulations quoted above.

8 Given that the Pension Fund currently has a target 5% allocation to unlisted assets in the form of Private Equity holdings, a QIF structure on its own is not likely to provide sufficient flexibility for future investment, given that the level of liability hedging will need to increase over time. A potential solution to the 10% cap on unlisted assets is to “wrap” a QIF in a unit trust (which has an upper investment limit of 35%). This would ensure that the solution would be future-proof, but would involve a greater level of complexity at the initial implementation stage, should a QIF solution be selected.

9 As part of the selection process, fund managers attended a training meeting of the Pension Fund Board on 12 September 2014 to discuss leveraged gilts. The manager list was derived from Mercer’s liability hedging “Preferred Provider” list and takes into account other specific considerations for the Fund.

10 Managers were assessed according to the following criteria:

- (1) Manager capability
- (2) Value for money (fees)
- (3) Dynamic Instrument Selection
- (4) Ease of compliance with LGPS Regulations

11 The Pension Fund Board’s external advisor had previously assessed the shortlisted four managers with LGIM scoring highest in criteria (1), (2) and (4). LGIM’s managers also presented very well at the 12 September 2014 meeting, in terms of presenting a competent solution and having a very good understanding of the liability structure of the Surrey Fund and how the proposed solution would meet the risks pertaining to it.

12 The Pensions Fund Board’s external advisor has advised of the high level of capability within the LGIM team and the competiveness of the fee quote, as well as the lack of any complications associated with the solution (an insurance policy) in terms of the LGPS regulations, and LGIM being a significant market player. This solution overrides the concerns associated with a QIF solution.

13 It is recommended that LGIM be appointed to implement a leveraged gilt portfolio, using the Fund’s existing passive and index-linked gilts with LGIM, thus preparing a platform for the future strategy requirements. It is recommended that the mandate would be funded by restructuring the existing entire passive gilts portfolio and a proportion of the index-linked gilt portfolio held with Legal & General, amounting to £90m.

CONSULTATION:

14 The Chairman of the Pension Fund has been consulted on the establishment of a leveraged gilt portfolio and, subject to Board members’ agreement is in full support of the recommendations.

RISK MANAGEMENT AND IMPLICATIONS:

15 The risk related issues are addressed in the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

16 The financial and value for money implications are addressed within the report.

DIRECTOR OF FINANCE COMMENTARY

17 The Director of Finance is satisfied that the adoption of a leveraged gilt strategy will address the risks associated with interest rates and inflation to the pension fund. The Director of Finance notes that a final due diligence will be completed, ensuring that that all legal, material, financial and business issues have been considered and addressed, prior to the implementation of the recommendations within this report.

LEGAL IMPLICATIONS – MONITORING OFFICER

18 The Monitoring Officer notes that specialist advice has been obtained from external lawyers in this matter. Given the specialist nature of the legal context and the very recent referral to the Monitoring Officer of this matter, she is not in a position to offer any additional advice. The Board will need to consider the advice that Sackers have provided but should also be aware that Sackers have indicated that:

"This is an area where views diverge widely between different lawyers. There is currently no authority (that we are aware of) to determine the matter one way or another. It would, in our view, be reasonable for the Council to rely on our interpretation, but this is a regrettably an area where there is considerable uncertainty."

EQUALITIES AND DIVERSITY

19 The adoption of a leveraged gilt portfolio will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

20 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

21 The following next steps are planned:

- Decision on implementing the recommendations within the report.
- Further training provided to Board members at future meetings.
- Further reports to the Board at future meetings.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Pension Fund Board Chairman

Annexes:
None

Sources/background papers:
None

This page is intentionally left blank

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

This page is intentionally left blank

Summary of Meetings with Fund Managers

Held on 17 September 2014

Present:

Denise Le Gal, Stewart Selleck, Ian Perkin, Phil Triggs and John Harrison

Newton

David Moylett and Jeff Munroe

As a house, Newton holds concerns on global banking and is cautious on the aftermath of the global financial crisis.

They see the investment backdrop as low growth, low return amidst a volatile environment. Opposing dynamics will mean that further volatility is expected.

They regard equities as still being the performing asset class.

All in all, they are bearish and highly selective, and feel that there is some adjustment to make to a new liquidity setting.

Newton has set the portfolio to overweight in Healthcare and underweight in Financials and regard the banks as now being in a deleveraging phase that is not good for banking stocks. IT, Telecoms and Consumer Staples are also favoured.

They also regard emerging markets as not being cheap and therefore have pitched underweight in this category. Newton notes the current geo-political risks and the somewhat relaxed stance taken by the markets with regard to these risks.

From previously having numerous themes in the portfolio, Jeff Munro confirmed that some of these have been clipped back. As a house, they are cautious and keen to build in downside protection.

Notwithstanding the bearish stance, Newton see encouraging signs with UK and US employment continuing to improve, Japan remaining on track, and no collapse in China. Newton continues to favour companies with strong balance sheets, clarity of earnings and cash generation.

Mirabaud

Philip Watson and David Kneale

7

Mirabaud have stuck to the Castle/Moat/Goldmine principle, aiming to invest within the best businesses and high quality companies in the UK over the long term. They confirmed their research style is more akin to a forensic accountant than a market trader with pressure applied to company finance directors via this research.

Mirabaud note the Bank of England's current stance with regard to interest rates, the soft measures slowing the housing market, the lack of any wage growth and regard interest rates as likely to rise slowly over a long period of time.

With regard to sub benchmark performance over the last three years, Mirabaud acknowledged that they had been too cautious about equity markets in 2012, and should have taken on more risk within the portfolio at that time. With regard to current opportunities, they saw limited liquidity over the summer resulting in significant share price movements.

They regard the payment of dividends as absolutely critical within the generation of investment returns, and emphasised their ruthlessness with regard to stock selection, avoiding companies that are not currently paying a dividend. This has come from a changing philosophy. Mirabaud has sold out of GlaxoSmithKline and Tesco recently as a result of this, with Tesco recently cutting its dividend by 75%. Supermarkets are not currently favoured in asset allocation, their gross margins having reduced drastically in recent years.

Mirabaud currently favours house builders within the portfolio, having seen the number of independent house building firms diminish in recent years, and thus reduce the competition for the big players.

Mirabaud is seeing the PPI refunds regime coming to an end, but notes that retailers didn't see much of this extra tax free disposable cash.

Mirabaud favours sensible company valuations, with solid cash flow, dividend payment and high barriers to entry. They pointed to some 'big bets' within the portfolio, notably Aveva and Telecity (both Technology sector). There is a degree of concern with Aveva, which is being addressed this week with company management.

With regard to their own principle, they regard the market as having a different perspective, with the market currently viewing and valuing shares differently from the Mirabaud castle/moat style. In tandem, a few of their large bet stock selection disappointments are being treated savagely by markets.

7

Western

Paul Shuttleworth and Bernhard Speiser

Western are conscious of the lower UK inflation outlook (1.5%) and the Eurozone (0.3%), accompanied by positive UK growth of 3.2%. Despite this, there is no evidence of any increase in UK disposable income.

They are conscious of the Bank of England's hints at early interest rate hikes, possibly just after Christmas.

Western reported positive returns in all major government bond markets with global corporate, high yield and emerging market spread narrowing.

As at 31 August 2014, 90% of the portfolio is UK, 5% is Eurozone and minor amounts in the US, Brazil, Mexico and cash.

Average yield for the portfolio is 2.9% with average duration at 8.6 years and average rating A+.

A conversation took place as to the normalisation of the economic/investment backdrop, and the answer from Western was that normal is not normal any more. The central bank will remain accommodative, inflation will average out at 2% and long term gilts will revert to mean over the long term.

UK GDP and house prices retain a strong correlation, thus the UK economic recovery is seen to be led by domestic household consumption.

Western pointed out that Vodafone recently issued a corporate 6-year bond with a 1.1% yield, pointing out that the equity path will offer a better risk-adjusted return.

CBRE

7

Max Johnson and D. Dhananjai

CBRE saw an under-performance for the year, experiencing a European drag on overall performance. This has been held back by (a) the adverse impact of the European holdings inherited from the previous manager and (b) the dilutive effect of investing cash into a rising market.

The underlying UK portfolio has exceeded the target versus benchmark over the quarter, year, three years and five years, but the total portfolio has fallen below the target over each period. Over three years, the underlying UK assets achieved 8.1% pa versus a target of 7.1% pa while the total portfolio achieved 5.6%. CBRE will provide an attribution of the shortfall between European holdings and cash dilution but expect the European holding will account for over 2.0% per annum.

The European performance issue should cease to be a drag from 2015, with the three main European PUT holdings in wind up. The winding up process is crystalising large losses on asset disposals, but CBRE has already written down NAVs significantly and do not expect further substantial write downs.

The investment of additional cash in well under way. CBRE has committed all but £1.9m of the cash, although £20m is still undrawn by the underlying funds. The main undrawn commitments are in Palmer Capital (expected to be invested or returned by early 2015), M&G Debt funds (expecting to be drawn over the next 2 years) and CBRE UK Property fund (expecting to be drawn by mid 2015).

There was a discussion about the relative attractiveness of UK and non-UK property. CBRE remains optimistic about total returns in the UK over the period to 2016, so see no pressing need to take the additional risk of investing overseas. In the long term, there is a case for allowing investment in global property, although this would require a change in the Surrey mandate. CBRE will circulate a paper on the case for global property investment

18 September 2014