Supplementary Agenda

Surrey Pension Fund Committee

Date & time	Place	Contact	Chief Executive
Friday, 23 September 2016 at 9.30 am	Members Conference Room	Angela Guest Room 122, County Hall Tel 020 8541 9075	David McNulty

We're on Twitter: @SCCdemocracy

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 .

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

Elected Members

Ms Denise Le Gal (Chairman), Mr Alan Young (Vice-Chairman), Mr W D Barker OBE, Mr Tim Evans, Mr Stuart Selleck and Mrs Hazel Watson

Co-opted Members:

Mr Tony Elias (Borough/District Representative), Ian Perkin (Office of the Surrey Police and Crime Commissioner), District Councillor Peter Stanyard (Borough/District representative) and Philip Walker (Employees)

AGENDA

6 **MANAGER ISSUES AND INVESTMENT PERFORMANCE – ANNEX 2** (Pages 1 - 8)

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

David McNulty
Chief Executive
Published: 21 September 2016

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

FIELD_TITLE

Item 06 - Annex 2

Surrey Pension Fund – Manager Review meeting on 15th Sept 2016

Representing Surrey
Elected Members: Alan Young, Bill Barker, Peter Stanyard, Hazel Watson
Officers/Advisors: Phil Triggs, John Harrison (Independent Investment Advisor)

Western Asset Management
Paul Shuttleworth (credit manager), Catherine Matthews (Multi Asset Credit product specialist), Marian George (client relationship manager)

Mandate: The existing mandate was changed in December 2015 to a benchmark that is wholly based on UK credit (Merrill Lynch £ Non-Gilt). The performance target is to outperform by 0.75% per annum before fees (currently 0.15% per annum) over rolling three-year periods. A new Multi Asset Credit (MAC) mandate was established with no formal benchmark but an expectation of delivering total returns of 5–7% per annum with a volatility of 5–7% and protection against large market falls.

*Portfolio values: A*t end of August 2016, the credit portfolio was valued at £183m and the MAC portfolio at £131m.

*Performance in 2016 (YTD): B*ond markets have delivered unusually high returns in the first eight months of 2016, especially in the UK, with the credit benchmark returning 15.2%. The credit portfolio was close to benchmark at 15.1% and the MAC delivered an above trend return of 8.8%.

Longer term performance: The change in the mandate has made the historic performance data less meaningful but, for completeness, the returns for periods to end August 2016 are:

1 year	Fund 15.6%	Benchmark 15.8%
3 years	Fund 9.5% pa	Benchmark 9.5% pa
5 years	Fund 8.6% pa	Benchmark 8.4% pa

Key issues

1. *Management changes:* There have been significant changes announced in the investment teams for both mandates. On the credit portfolio, Paul Shuttleworth is to retire on ill health grounds between now and early 2017. An external replacement has been identified, but the start date has yet to be finalised. Paul will remain until his replacement is fully on board to ensure a smooth transition. On MAC, the manager from launch in 2010, Chris Orndorff, has resigned to become chief investment officer (CIO) of the Paul Allen family office (of Microsoft fame). He has been replaced as portfolio manager by Mike Buchanan, Western's Deputy CIO. We have a meeting arranged when Mike is next in London in early October.

2. *Market background:* Credit market moves in 2016 to end August 2016 have been remarkable. Sharp falls in the first six weeks of the year have been reversed and all regions/sectors have delivered high total returns. UK assets have been the strongest performers. Assets perceived as safe e.g., UK utilities at 22.6% return, have performed better than those with more risk, e.g., UK high yield at 8.8% return. Sterling weakness has also enhanced returns from overseas bonds. The yield curve has fallen and flattened in all markets (general risk aversion), but has been most significant in the UK given the announced resumption of quantitative easing (QE) following the EU referendum. QE will also include some corporate bonds from end September, which has narrowed spreads in the bonds selected. The current level of bond yields globally is unprecedented. Some 25% of the global aggregate index (including sovereign and corporate bonds) currently stands on negative nominal yields, including 10% of the corporate bond market in Europe. Two European companies have even been able to issue new bonds on negative nominal yields. The manager believes this is unsustainable and reflects the distortion created by the European Central Bank's (ECB) QE buying of €7.5bn/month.

3. *Portfolio performance:* The UK credit portfolio encompasses non-UK bonds, so will always be underweight in the UK relative to the 100% in the benchmark. The current portfolio has 15.8% outside the UK, mostly in the US (8.5%) and Europe (4.7%). Given the strength of UK bonds so far this year, the country allocation has been a negative contributor of about 0.4% to returns. This was largely offset by positive sector selection. Since end August 2016, credit markets have been more volatile and the relative performance has been modestly positive.

4. *Credit portfolio positioning:* In the setback in Jan/Feb 2016, the manager increased risk exposures, particularly in consumer related stocks. The subsequent rally has been dramatic and valuations are stretched in many sectors. In late August 2016, the risk profile was cut back and a short duration position adopted for the first time in three years. While there are few 'cheap' sectors, there are some relative value opportunities. Financials have been left behind and spreads between US and UK issues have widened. The portfolio has an above benchmark yield (2.3% versus 1.9%) and shorter duration (8.4 years versus 8.7 years). It is 18% underweight in the highest rated issues (AAA and AA), but does hold some index-linked gilts (2%) and overseas government bonds (5%).

5. *MAC portfolio positioning:* The portfolio is globally invested and has 59% in US, 14% in Europe, 11% in Americas ex US, 8% in Asia and 8% in cash. The manager seeks to keep the yield high at 5 to 7% per annum, which entails holding a significant proportion in bonds below investment grade (currently 52.4%) and using broad strategic diversification to minimise the impact of defaults (on average at about 1% per annum since the fund was launched in 2010). The current yield is 5.6% and the average duration is 5.6 years.

Advisor view: The credit market environment has been truly extraordinary and is almost certainly distorted by price insensitive, rules based central bank buying. Western has done well to keep pace with the credit market with a portfolio that offers better strategic diversification and a higher yield than the benchmark. While it is still early days to assess the new bond strategy, the changes in fund managers on both mandates are significant, and we will need to assess the impact carefully over the next 12 months. Meetings with Mike Buchanan and Paul Shuttleworth's replacement are priorities.

Majedie
Chris Field (portfolio manager), Simon Hazlitt (client relationship manager)

Mandate: The main UK equity portfolio seeks to outperform the All-Share index by 2.5% pa before fees over rolling three-year periods. The smaller Tortoise fund also invests in UK equities but with an objective of generating positive absolute rather than relative returns.

Portfolio values: At end August 2016, the main portfolio was valued at £307m and the Tortoise portfolio at £14m.

Performance: The main fund returned 10.6% in 2016 to end August 2016, which was marginally ahead of the benchmark return of 10.5%. The Tortoise fund returned 16.8%. Longer term returns for the main fund have been exceptionally good, although the last 12 month period has been more challenging than most.

% pa	1 year	3 years	5 years	10 years	Inception*
Main Fund	7.6	7.7	12.8	10.0	13.8
All-Share	11.7	6.4	9.5	5.8	9.3
Relative	**- 4.2**	**1.3**	**3.3**	**4.2**	**4.5**
Tortoise Fund	11.1	5.7	7.9	n/a	11.6

** Main Fund since Sept 2003; Tortoise Fund since Sept 2009*

Key issues

1. *Management:* The main portfolio continues to be managed in four different manager sleeves split between Chris Field (30%), James de Uphaugh (30%), Matthew Smith (30%) and Richard Staveley (10%, small cap bias). Each has complete autonomy and they have differing individual styles, with Matthew Smith the most value oriented and Chris Field the most likely to retain growth stocks with positive momentum. The correlation between managers is monitored to ensure they do not suffer ‘group think’. The business closed for new assets in 2006 and has operated on a replacement basis ever since. Mandate terminations as corporate pension clients de-risk out of equities are replaced by new investors. All clients pay performance fees so performance achieved is more important to profitability than asset growth. Fees have averaged about 0.9% per annum including performance fees.

2. *Portfolio performance:* Investor risk aversion has driven defensive stocks to ever higher ratings, so it is now difficult to find businesses with low exposure to weak European growth on reasonable ratings. The last 12 months have been challenging for relative performance because expensive defensives have become even more expensive while everything else has been volatile. Majedie were too early into commodities, although better economic data from China has prompted a recovery more recently. The biggest ‘hits’ came from overweight positions in financials (RBS and Barclays) and underweight positions in tobacco (BAT).

3. *Outlook:* Majedie believe that the current market environment is unusual, with defensive stocks now on unsustainably high ratings. Consumer staples businesses have been pushing margins too far and are allowing competitors (including own brand) to undercut them. They also are wary of domestic cyclicals given potential economic risks in the UK during Brexit negotiations. They prefer sectors such as mining and food retailing, where new management is adopting a more disciplined approach to capital investment, which augers well for future returns improving from depressed levels. Commodities businesses, such as Anglo American and BP, are also embarked on cultural change to reduce costs. Banks are favoured because they are lowly rated than previously despite improved balance sheets. They may also benefit from a recent change in Bank of Japan policy to focus QE on short maturity bonds which, if followed elsewhere, may steepen the yield curve. This will benefit banks.

4. *Portfolio positioning:* The largest overweight positions in the main fund are in banks (+5.7%), fixed line telecom (+5.6%), food retailers (+5.2%), oil and gas (+4.3%) and support services (+4.2%). The largest underweight positions in the portfolio are in tobacco (-5.3%), beverages (-4.6%), pharmaceuticals (-3.6%) and household goods (-3.3%). The fund has 10% invested outside the UK, particularly in European telecoms (Orange and Telecom Italia). The active risk is 4.4%. The Tortoise fund takes both long and short positions. The fund is mostly long in commodities and telecoms and mostly short in consumer goods, industrials and financials (insurance companies rather than banks).

Advisor view: While the last 12 month period has been a rare period of poor relative performance, the long term track record is exceptional and the rationale for the portfolio positioning continues to be well researched and well argued. Majedie remains a core active manager for our Pension Fund.

Baillie Gifford
Scott Lothian (portfolio manager), Paul Morrison (client relationship manager)

Mandate: The Diversified Growth Fund (DGF) mandate dates back to May 2012 and seeks to achieve a return of 3.5% per annum (after fees) above UK base rates over rolling five-year periods with a volatility below 10%.

Portfolio value: At end August 2016, the DGF portfolio was valued at £136m.

Performance: Between May 2012 and June 2016, the fund achieved a return of 4.8% pa (net of fees) with an average volatility in the last five years of 4.5%, so it has exceeded its stated objectives. However, in the last 12 months, the net of fees return was -0.1%. Positive contributions from active currency (+0.9%), infrastructure (+0.8%) and commodities (+0.5%) were largely offset by negative returns from listed equities in Europe and Japan (-1.5%) and structured finance (-0.5%).

Key issues

1. *Management:* The team has been stable over the last year following the departure of Mike Brooks to Aberdeen. The portfolio management team is now five strong with Felix Amoaka having been promoted from analyst and Scott Lothian joining from Schroders in 2015. The fund was closed at £5.9bn, but a new less liquidity constrained version was launched in 2015 and has grown to £250m.

2. *Portfolio performance:* While there is an active currency component outsourced to a specialist team within Baillie Gifford, the fund's default is to hedge all other currency positions back to Sterling to dampen volatility. This meant they were exposed to poor local currency returns from listed equities in Europe and Japan, even though they chose to hedge less than the default position ahead of the EU referendum. They also suffered from having short positions in sovereign bonds against long positions in credit and emerging market debt.

3. *Outlook:* They continue to expect modest economic growth and supportive central bank policy. The rest of 2016 may be dominated by political risk, but it is not clear how to hedge a Trump presidency, so the investment options are not the same as for Brexit. Their long term return expectations from most asset classes are below their target relative to cash, so they believe they will have to be more active in asset allocation in future.

4. *Portfolio positioning:* Listed equities remain the largest risk allocation at about a third of the gross risk (before diversification), although this picks up the equity risk embedded in other assets types, such as property REITS. The allocation to listed equities has been reduced from 22% to about 17% in the current quarter. Within bonds, the fund has 16% in high yield, 5% in investment grade bonds, 9% in emerging market bonds and is 8% short in sovereign issues. The rest of the portfolio is broadly diversified with meaningful exposures to structured finance (9%), infrastructure (8%), absolute return (8%), property (7%), insurance linked (4%) and commodities (4%).

Advisor view: BG's DGF key strength has been its exposure to a broad range of often illiquid asset types rather than a reliance on tactical asset allocation, so it was not encouraging to hear that they think they will need to be more active in asset allocation in future to achieve the target returns. This may simply have been a below par presentation from the Baillie Gifford team, but it is possible that idea generation has suffered from the loss of Mike Brooks. This is something to watch out for in the next few months. In the meantime, the BG DGF remains one of the most strategically diversified and it is not alone in having delivered lacklustre returns in the last 12 months.

CBRE
DJ Dhananjai (portfolio manager), Max Johnson (client relationship manager)

Mandate and history: The mandate was originally awarded to the ING property team in April 2004, but the ING business was acquired by CBRE in 2011 and the current investment team has been managing the portfolio since then. The mandate they inherited incorporated a substantial allocation to highly leveraged European property funds that have performed poorly and proved difficult to sell. The legacy holdings have now largely been disposed of, but have been a material drag on performance relative to the UK based benchmark.

The fund currently seeks to achieve a return 0.5% pa (gross of fees) above the All Balanced Property Fund Index over rolling three-year periods. Earlier this year, the Pension Fund Committee agreed to broaden the property exposure to include global investments via CBRE's Global Alpha fund, a conservatively managed pooled vehicle with a bias to quality assets. A further £30m was allocated to the fund to enable this to be achieved cost effectively. It is expected to take between six and 12 months before the Fund's allocation is invested.

Portfolio value: At end June 2016, the property portfolio was valued at £207m, with a further £38m of undrawn client commitments.

Performance: The fund returns shown below cover the periods to end June 2016. They show the overall fund return and the return on the UK assets, excluding the European legacy holdings. The UK assets have exceeded the return objective consistently.

% pa	1 year	3 years	5 years
Overall fund return	9.4	12.3	8.0
UK assets only	9.6	14.0	10.0
Return objective	7.7	13.0	8.9

Key issues

1. *Management:* There have been no significant changes to the investment team. The portfolio has been actively managed with £46m of new commitments (£5m of which has been drawn), £4m of secondary market purchases, £4m of secondary market sales and £2m of redemptions.

2. *Portfolio performance:* The largest positive contributors in the 12 month period to end June 2016 were WELPUT (+2.1%), Schroder UK Real Estate (+1.5%), Unite UK Student Accommodation (+1.1%) and Industrial Property (+1.1%). Only two funds delivered negative returns: the Strategic Partners Europe Fund III (-0.6%) and the Standard Life UK Retail Parks (-0.1%). The WELPUT holding is being reduced on a phased basis.

3. *Outlook:* CBRE expects capital returns in the UK to be negative in the period 2016 to 2018, with Brexit uncertainty exacerbating an already maturing market cycle. London office is most exposed to a reduction in demand. Against this, Brexit may mean monetary policy is lower for longer, which would highlight the yield advantage of property, and the fall in Sterling may make UK property more attractive to overseas investors. They have not changed the portfolio themes with a focus still on higher quality and lower vacancy assets.

4. *Portfolio positioning:* The key themes remain prime logistics, income security and defensive alternatives, such as student housing, leisure and healthcare. They also favour regional diversification in major UK cities. The UK fund has a quality bias, with a below benchmark yield of 3.4% and modest leverage (about 17%). The themes in the Global Alpha fund are similar, but they expect stronger rental growth than in the UK and also favour cyclical offices in the US and Australia. The Global Alpha fund currently has 34% in America, 38% in Europe and 28% in Asia. It has a higher yield at 4.9% and its leverage (at 31%) is lower than most global funds.

Advisor view: – Property is an illiquid asset in every sense and the making of changes is both expensive and slow. The CBRE team has done a good job in managing the UK assets and in unwinding the mistakes of the past. The gradual move into global property still makes sense, given the maturity of the UK property cycle.

This page is intentionally left blank