Supplementary Agenda

Surrey Pension Fund Committee

Date & time	Place	Contact	Chief Executive
Friday, 2 June 2017 at 12.45 pm	Committee Room C, County Hall, Kingston upon Thames, Surrey KT1 2DN	Angela Guest Room 122, County Hall Tel 020 8541 9075	David McNulty

We're on Twitter: @SCCdemocracy

SUPLEMENTARY AGENDA

6 MANAGER ISSUES AND INVESTMENT PERFORMANCE (Pages 1 - 20)

These papers replace the report and annex 1 as previously published with the full agenda. The report has been separated into public and exempt information.

David McNulty
Chief Executive
Published: 25 May 2017

This page is intentionally left blank

SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: **2 JUNE 2017**

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

SUBJECT: **MANAGER ISSUES AND INVESTMENT PERFORMANCE**

SUMMARY OF ISSUE:

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

RECOMMENDATIONS:

It is recommended that the Pension Fund Committee:

1. Note the report.
2. Approve the Border to Coast side letter for inclusion in the final governance BCPP governance documents (see Annex 1).
3. Approve the £15m commitment to the Standard Life Secondary Opportunities III Fund (SOF III) agreed at the meeting on 10 February 2017 be denominated in US dollars in the sum of USD20m.
4. Approve a USD20m commitment to the BlackRock PEP VII (2016 Vintage)
5. Approve a USD20m allocation to the West Street Infrastructure Partners Fund III.
6. Note the item re asset pooling changes and to approve the Pool's revised approach to cost allocation.

REASON FOR RECOMMENDATIONS:

In order to achieve best possible performance alongside optimal risk.

DETAILS:

1) Manager Issues during the Quarter

Manager	Issue	Status/Action Required
All	Possible Rebalancing	The asset allocation is within the Fund's policy control limits. The asset allocations at 31 March 2017 is shown in Annex 2.
Various	Client meetings	Minutes from external fund manager meetings (Annex 3) held on 26 May 2017 will be tabled at the Pension Fund Committee meeting (to be tabled on the day).

2) Freedom of Information Requests

The table below summarises the Freedom of Information request responses provided by the Fund during the last quarter.

Date of Response	Organisation	Request	Response
13/02/2017	Pitchbook	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q3 2016/17
06/01/2017	Proxy Insight	Information concerning proxy voting records	Proxy voting records from June 2016 to November 2016.
17/03/2017	Bloomberg	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q3 2016/17

3) Future Pension Fund Committee Meetings/Pension Fund AGM

The schedule of meetings for 2016 is as follows:

- 15 September 2017: Committee meeting hosted at County Hall
- 10 November 2017: Committee meeting hosted at County Hall
- 17 November 2017: Pension Fund AGM hosted at County Hall

4) Investment Strategy Review

At its meeting on 10 February 2017, the Pension Fund Committee resolved to request that a specification paper for the strategic review of asset allocation by Mercer be circulated to all Members of the Pension Committee for approval. Delegated authority was given to the Strategic Manager Pension Fund & Treasury to arrange for Mercer to provide strategic review options.

Mercer's paper is provided shown as Annex 4. With input from officers, the Mercer representative and the independent advisor, committee members are invited to discuss the options available to the committee with regard to Mercer's strategic review brief.

5) Border to Coast Pensions Partnership (BCPP)

See Annex 1 (Part II Exempt)

6) Stock Lending

In the quarter to 31 March 2017, stock lending earned a net income for the Fund of £91,944.

7) Internally Managed Cash

The internally managed cash balance of the Fund was £68m as at 31 March 2017. As at 24 May 2017, the cash balance was £63.7m.

8) Liability Driven Investment (LDI) Framework

At its meeting on 13 February 2015, the Committee set the real yield trigger for future LDI leverage and this was incorporated into the mandate documentation with Legal & General (LGIM).

Now that the implementation for the leveraged gilt mandate has been completed, the Committee will regularly monitor movements in real yields and, specifically, the trigger point that has been agreed. Officers will report verbally to the meeting.

9) Standard Life Secondary Opportunities (SOF III)

The Pension Fund Committee approved a £15m commitment to the Standard Life Secondary Opportunities III Fund (SOF III) at its meeting on 10 February 2017. This fund is denominated in US dollars. At the current exchange rate of £1: USD1.29, this equates to a rounded up USD20m. It is requested that the commitment be ratified at USD20m and approved by the Committee.

10) Private Equity Opportunity: BlackRock PEP VII (2016 Vintage)

BlackRock Private Equity Partners (PEP), a longstanding partner of the Surrey Fund, is currently raising assets for its latest global core commingled fund offering (PEP VII). The fund held its first close in March 2016 with Limited Partner (LP) commitments totalling USD 382m. As of March 2017, total LP commitments stood at USD 715m, with a high level continued commitments from existing investors. The Fund will close on 1 September 2017. PEP is targeting a fund size of USD 800m to 1bn, with investors

committing to the fund comprised of tier one Public Pensions, Private Pensions, Insurance Companies, Foundations and Endowments.

Founded in 1999 and with offices in London, Zurich, Princeton and Hong Kong, PEP is a team of 104 professionals, including 34 investment professionals, managing USD 23.5bn in LP commitments. As part of the world's largest asset manager, PEP benefits from BlackRock's global scale and deep resources to deliver a robust, durable private equity portfolio for investors. BlackRock offers:

- Global reach
- Strong focus on risk management and client solutions
- Access to superior and propriety deal flow
- Local expertise from many offices around the globe.

The foundations of PEP's investment strategy and approach are built upon best practices of leading pension fund and endowment private equity programmes over many market cycles. Senior members of the team have designed and successfully built some of the industry's oldest and most established institutional private equity programs. Managing Directors on PEP's investment team average 22 years of private markets investment experience.

Currently, PEP manages ten prior global core commingled fund offerings, overseeing USD 8bn in total investor commitments, generating strong absolute returns by investment type and vintage year, while significantly outperforming the global public equity markets. PEP VII targets 300 – 500 basis points gross Internal Rate of Return (IRR) outperformance of public markets, with significant downside protection.

As of 30 September 2016, PEP's global core commingled fund series track record generated 10.8% gross IRR and 1.51 x Total Value (TVPI). Compared with public equities (MSCI World), PEP's global core commingled fund series generated 510 basis points outperformance and had no capital loss in any given vintage year. The Surrey Fund has current private equity capital invested in DivPEP I (2000), II (2002) and III (2005).

As part of PEP's diversified investment strategy, the team has historically committed capital across primary funds, secondary transactions, and direct co-investments. Through PEP's investment in direct co-investments and the tactical purchase of secondaries, they have developed a thoughtful investment strategy aimed at reducing an early drag in fund performance, improving both IRR performance and the cash-flow profile to investors. This approach offers the potential for more attractive risk-adjusted return over and above that which would be obtained from a portfolio consisting only of primary funds.

The Fund's investment objective is to generate attractive capital appreciation through a diversified portfolio of investments in global private equity primary funds (up to 80% of the portfolio) across multiple vintage years combined with an up to 40% allocation to secondary transactions and direct co-investments.

The Fund will seek to invest;

- Up to 80% of the portfolio in buyouts, including growth investments (across small-cap, mid-cap and large-cap)
- Special Situations including turnaround (up to 30%)
- Venture capital (up to 10%).

Subject to market conditions and Fund size, PEP anticipates diversifying the Fund's assets by making between 25 and 35 commitments to superior, hard to access Primary Investments in the buyout and special situations space, supplemented with selective Venture Capital investments to top tier managers.

The Fund will seek exposure to private equity funds from well-established managers with long operating histories, stable and cohesive teams as well as proven track records. PEP believes that implementing the Fund's strategy of pursuing a well-diversified, multi-manager approach can significantly reduce volatility of the Fund and thus the downside risk of private equity investments over time.

PEP VII is already actively investing for over a year, and investors coming into the Fund will benefit from existing high quality investments and an accelerated portfolio ramp-up. As of 20 February 2017, the fund had already USD 247m approved or committed to investments in 25 primary funds, one secondary fund, and seven direct co-investments.

The management fee will be 0.70% on implemented commitments. Carried interest is 8%, subject to an 8% hurdle.

11) Private Equity Opportunity:

West Street Infrastructure Partners III ("WSIP III" or the "Fund") is a closed ended, private infrastructure fund, which will seek to make direct investments in infrastructure and infrastructure-related assets and companies. The Fund is managed by the Infrastructure Investment Group of Goldman Sachs (GS) Merchant Banking Division which has made 21 investments totalling USD 9.0bn across three funds since 2006. The Fund is the successor vehicle to GS Infrastructure Partners I & II which have achieved gross multiples on invested capital to date of 1.3x and 1.8x respectively. The investment team is made up of over 20 dedicated infrastructure professionals and the investment committee has an average tenure at Goldman Sachs of 20 years.

The Fund has a primary focus on existing infrastructure assets in the transportation, utilities and energy sectors in OECD markets, particularly Europe and North America. The investment team seeks to use Goldman Sachs' global network and its own relationships to self-source differentiated investment opportunities. The Fund prefers investments that have high margins and which are not over-leveraged to economic growth. Typically, the Fund looks for an investment size of USD 100m to 500m with target gross returns on a global, portfolio-wide basis of 10% to 15%. WSIP III's investment strategy is to seek attractive risk-adjusted valuations by pursuing proprietary

opportunities in defensive infrastructure assets and then actively driving value creation.

WSIP III has already made a convertible preferred equity investment in EnLink, an integrated energy midstream company based in Dallas, Texas. EnLink has a contracted business model with minimum volume commitments and limited direct commodity price exposure.

WSIP III also plans to commit to a second investment that is an opportunity to invest alongside Delta Air Lines in Empire State Terminal Group. This is an entity to be established to construct and operate an upgraded Delta terminal at LaGuardia Airport in New York. The potential benefits of this investment can be summarised as:

- Proprietary transaction: Negotiated transaction on a rare US airport opportunity with a long-standing client of the firm
- Leading partner: Leading airline with an extensive New York presence and in-house terminal construction and operating capabilities
- Core infrastructure asset: Sizeable and critical core infrastructure asset with significant scarcity value and a strong catchment area
- Long-term contracted cash flow: Contracted fixed-rent model with cost pass-throughs, which insulate WSIP from traffic cyclicality

Goldman Sachs will aggregate all investments from LGPS into the Fund to allow the collective allocation from LGPS to benefit from the same economic terms as other investors of the same size. Goldman Sachs will also provide knowledge transfer to assist the LGPS in the development of a successful co-investment and co-underwriting programme.
A number of their institutional clients have evolved their infrastructure investment programmes from fund investments to co-investments and then to co-underwritings, and they are happy to assist us in a similar development programme.

The fee is 1.5% for commitments less than $100 million, 1.25% for commitments equal to or greater than $100 million and less than $250 million, 1.00% for commitments equal to or greater than $250 million and less than $500 million. Carried interest is 10%, subject to an 8% hurdle.

Goldman Sachs will be aggregating all LGPS investments to get the best fee deal. At this stage total LGPS commitments are less than $100 million.

The Committee is asked to approve a USD20m allocation.

Report of the Strategic Finance Manager

Financial and Performance Report

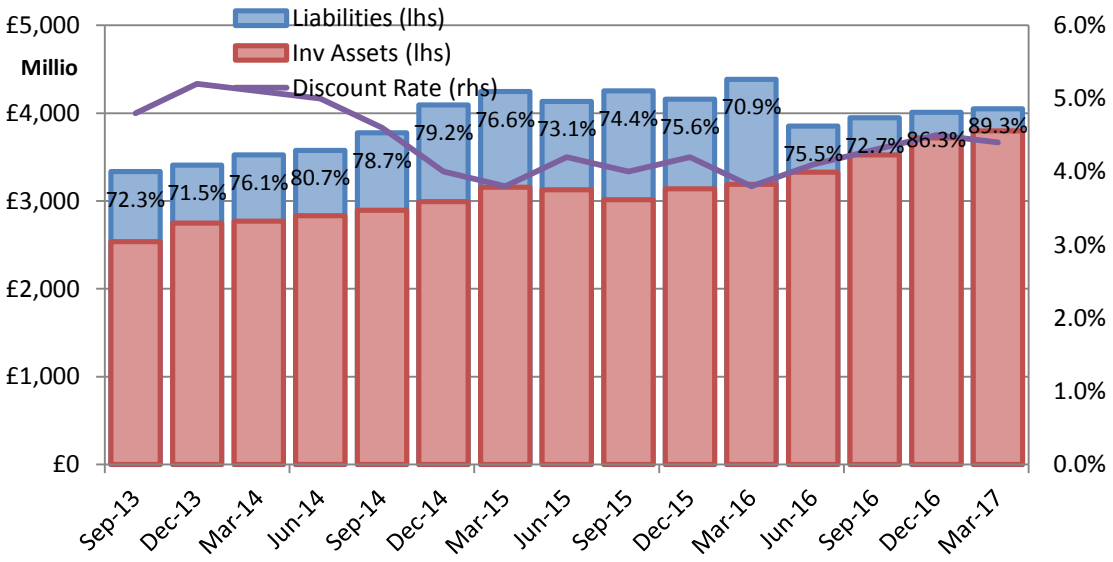
1. Funding Level

The actuary has been consulted and has set out an approximate funding position and the assumptions used for the funding position as at 31 March 2017.

The funding level has increased to 93.8% as at 31 March 2017 (82.5% as at 31 March 2016) and is based on the formal valuation results, updated for market conditions at 31 March 2017 and actual fund returns to that date.

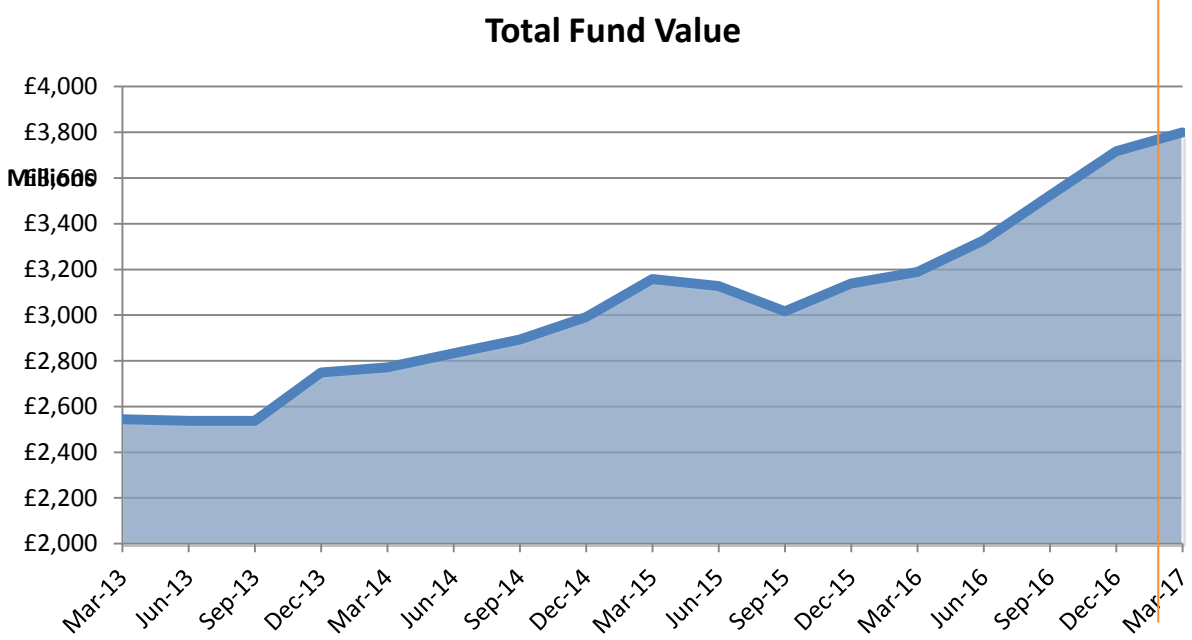
These are as follows:

- A discount rate of 4.4%
- Pension payments increases of 2.4%
- Salary CPI inflation of 2.4%
- Actual fund returns for the period 1 April 2016 to 31 March 2017 of 18.9%



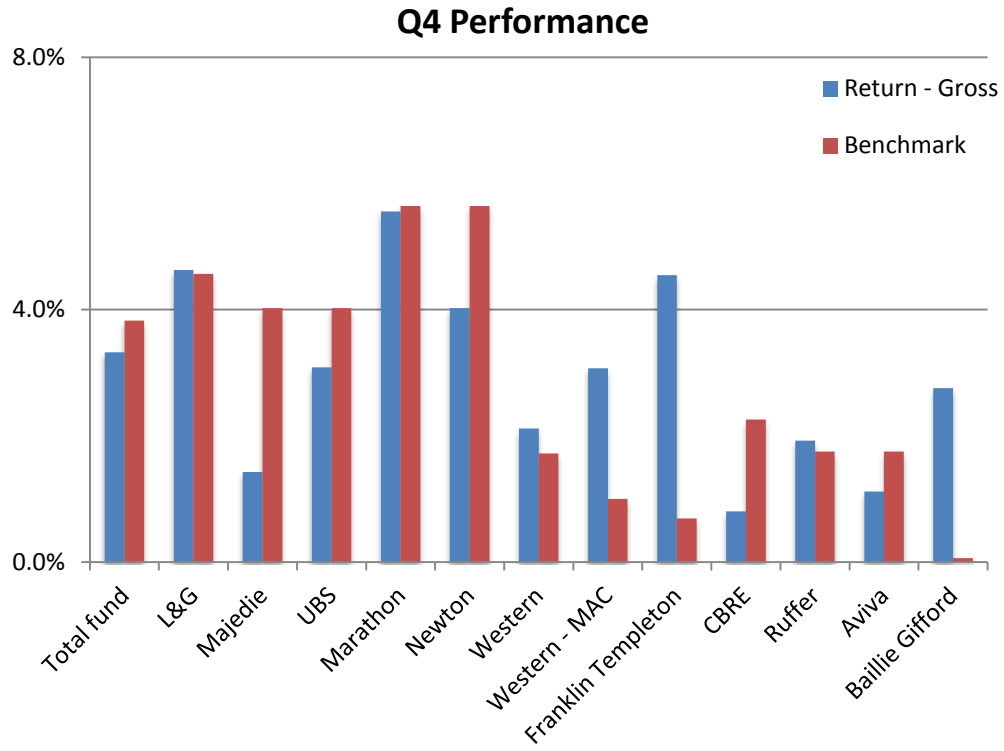
Market Value

The value of the Fund was £3,798.9m at 31 March 2017 compared with £3,717.5m at 31 December 2016. The investment performance for the period was +3.3%.



3. Fund Performance - Summary of Quarterly Results (gross of investment fees)

Overall, the Fund returned +3.3% in Q4 2016/17, in comparison with the Fund's customised benchmark of +3.5%.



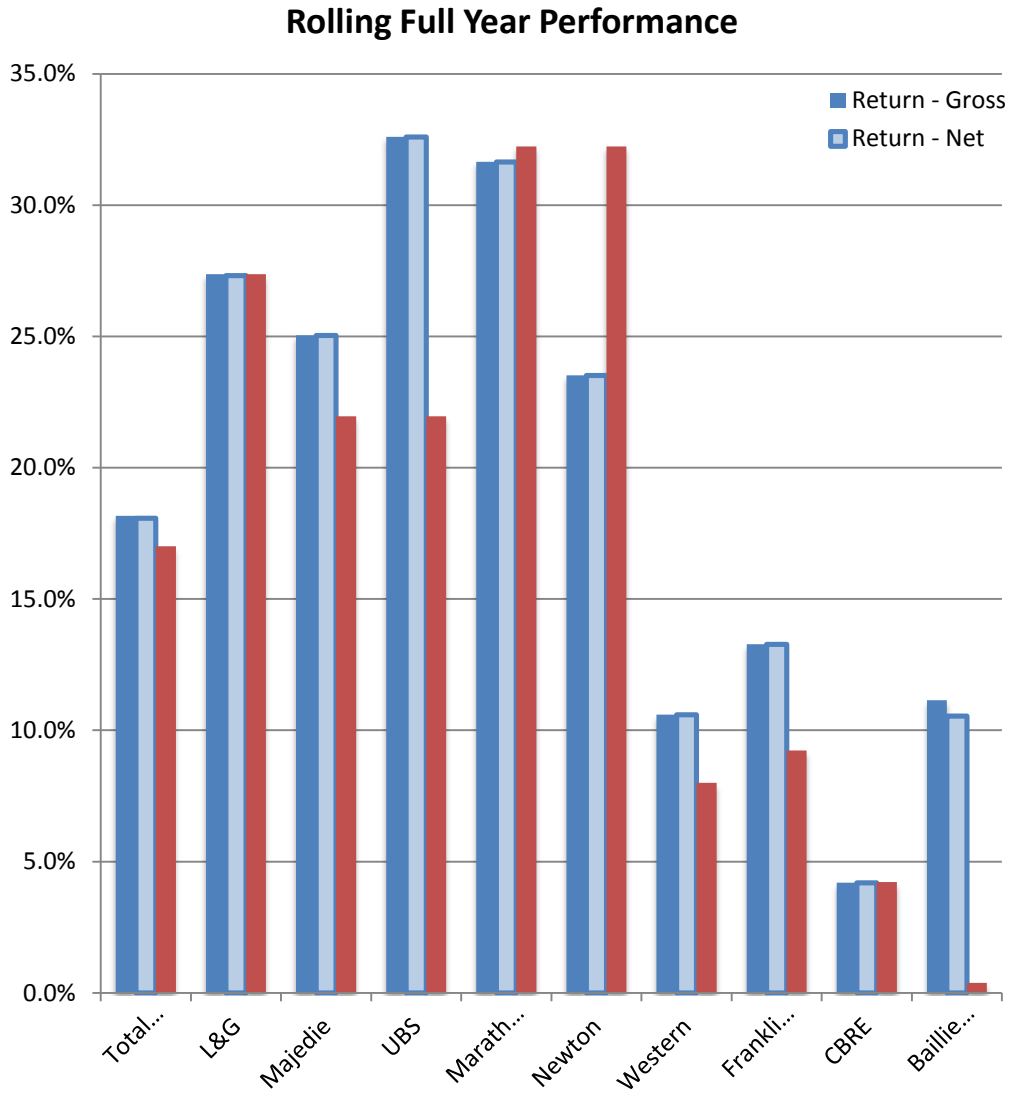
Baillie Gifford diversified growth funds is an absolute return fund with a benchmark based upon short term cash holdings.

The table below shows manager performance for 2016/17 Q4 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Gross of Fees Performance %	Benchmark %	Gross Performance Relative to Benchmark %
Total fund	3.3%	3.5%	-0.5%
L&G	4.6%	3.9%	0.1%
Majedie	1.4%	3.9%	-2.6%
UBS	3.1%	3.9%	-0.9%
Marathon	5.6%	6.4%	-0.1%
Newton	4.0%	6.4%	-1.6%
Western	2.1%	-3.1%	0.4%
Western - MAC	3.1%	1.0%	2.1%
Franklin Templeton	4.5%	-1.9%	3.9%
CBRE	0.8%	2.6%	-1.5%
Ruffer	1.9%	1.8%	0.2%
Aviva	1.1%	1.8%	-0.6%
Baillie Gifford	2.8%	0.1%	2.7%

Summary of Full Year Investment Results (Gross and net of fees)

During the course of the previous 12 months to 31 March 2017, the Fund returned +18.2% net of investment fees against the customised fund benchmark of +17.0%.

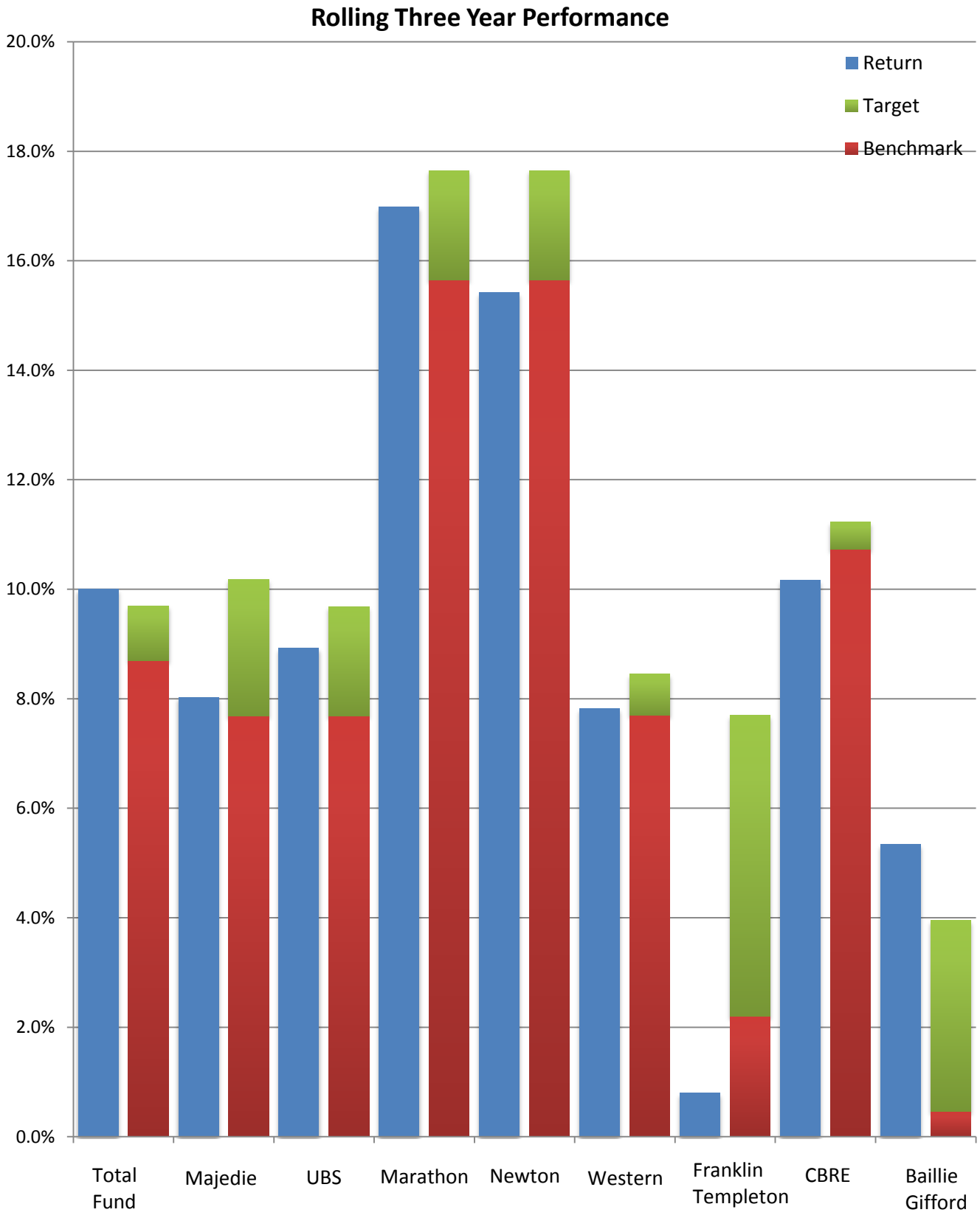


The table below shows manager performance for the year at 2016/17 Q4 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Net of Fees Performance %	Benchmark %	Net Performance Relative to Benchmark %	Gross of Fees Performance %
Total fund	18.2%	17.0%	1.2%	18.1%
L&G	27.4%	27.4%	0.0%	27.3%
Majedie	25.0%	22.0%	3.1%	25.0%
UBS	32.6%	22.0%	10.6%	32.6%
Marathon	31.6%	32.2%	-0.6%	31.6%
Newton	23.5%	32.2%	-8.7%	23.5%
Western	10.6%	8.0%	2.6%	10.6%
Franklin Templeton	13.3%	9.2%	4.0%	13.3%
CBRE	4.2%	4.2%	0.0%	4.2%
Baillie Gifford	11.1%	0.4%	10.8%	10.5%

Both Baillie Gifford is an absolute return fund with a benchmark based upon short term cash holdings.

Summary of Rolling Three Year Performance



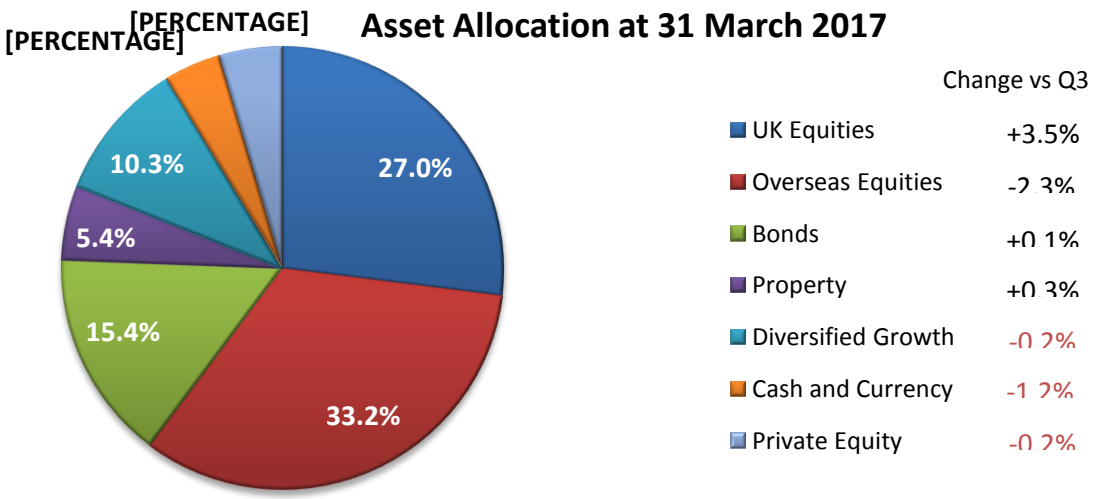
6

The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target Above Benchmark %	Relative to target %
Total Fund	10.0%	8.7%	9.7%	0.3%
Majedie	8.0%	7.7%	10.2%	-2.2%
UBS	8.9%	7.7%	9.7%	-0.8%
Marathon	17.0%	15.6%	17.6%	-0.7%
Newton	15.4%	15.6%	17.6%	-2.2%
Western	7.8%	7.7%	8.5%	-0.6%
Franklin Templeton*	0.8%	2.2%	7.7%	-6.9%
CBRE	10.2%	10.7%	11.2%	-1.1%
Baillie Gifford	5.3%	0.5%	4.0%	1.4%

4. Asset Allocation

The graph and table below summarise the asset allocation of the fund as at 31 December 2016.

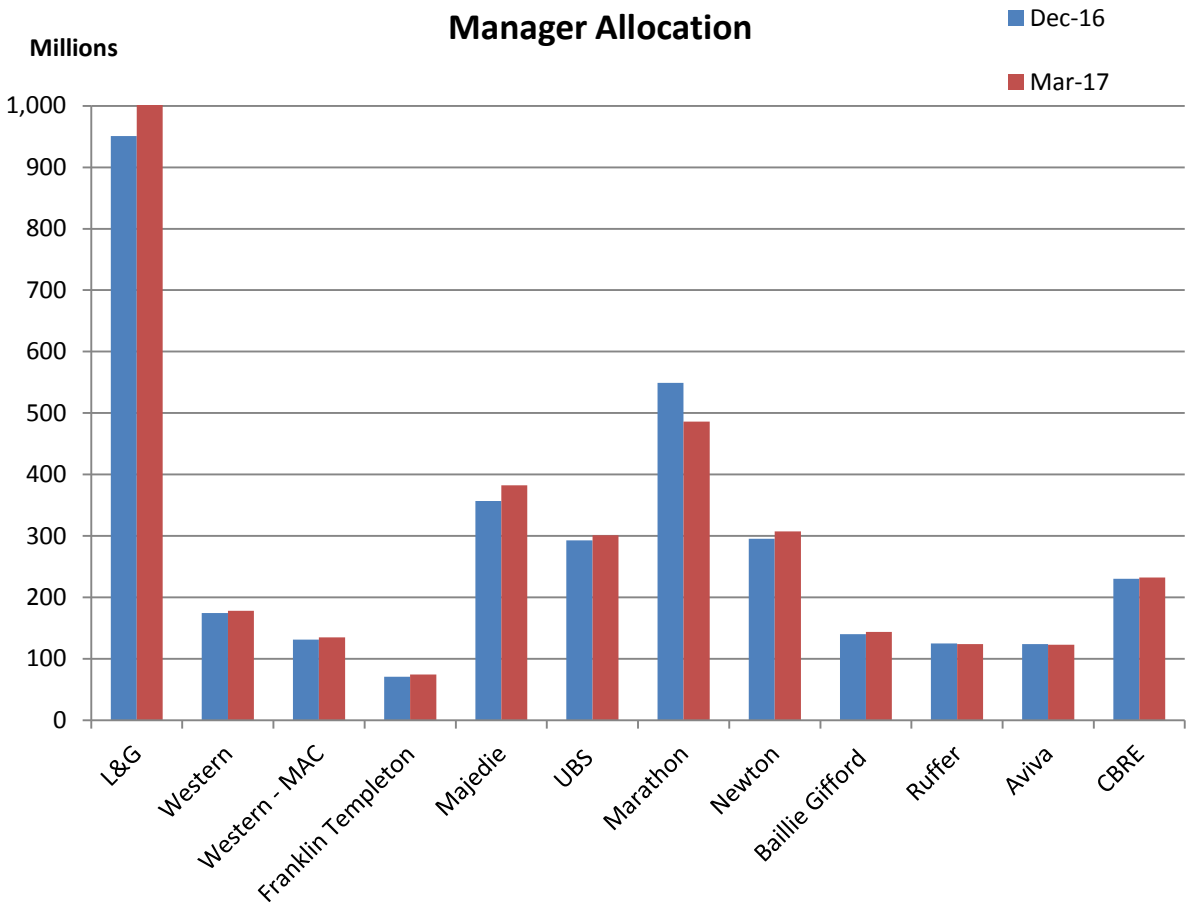


The table below compares the actual asset allocation as at 31 March 2017 against target asset weightings.

	TOTAL FUND	Actual	Target
	£m	%	%
Bonds			
Multi Asset Credit	134.9	3.6%	4.4
Investment Grade Credit	175.0	4.6%	5.3
Index Linked Gilts	199.4	5.2%	5.5
Unconstrained	74.1	1.9%	2.4
Equities			
UK	1025.1	27.0%	27.5
Overseas	1263.0	33.2%	32.3
Property Unit Trusts	206.5	5.4%	6.2
Diversified growth	390.3	10.3%	11.4
Cash	156.8	4.1%	0.0
Currency hedge	-0.2	0.0%	0.0
Private Equity	174.1	4.6%	5.0
TOTAL	3798.9	**100.0**	**100.0**

5. Manager Allocation

The graph below shows the manager allocation as at the 31 March 2017 and 31 December 2016.



CONSULTATION:

7 The Chairman of the Pension Fund Committee has been consulted on this report.

RISK MANAGEMENT AND IMPLICATIONS:

8 Risk related issues have been discussed and are contained within the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

9 Financial and value for money implications are discussed within the report.

SECTION 151 OFFICER (DIRECTOR OF FINANCE) COMMENTARY

10 The Section 151 Officer (Director of Finance) is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed. With regard to investment pooling the S151 officer will continue to work closely with other officers to ensure effective governance and assurance of administering authority responsibilities under any new pooled arrangements.

LEGAL IMPLICATIONS – MONITORING OFFICER

11 There are no legal implications or legislative requirements.

EQUALITIES AND DIVERSITY

12 The approval of the various options will not require an equality analysis, as there is no major policy, project or function being created or changed.

OTHER IMPLICATIONS

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

WHAT HAPPENS NEXT

14 The following next steps are planned:

- Implementation of the various recommendation approvals.

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

Consulted:
Pension Fund Committee Chairman

Annexes:
Annex 1: BCPP side letter
Annex 2: Asset Allocation Policy and Actual as at 31 March 2017
Annex 3: Minutes from external fund manager meetings held on 26 May 2017 (to be tabled on the day)
Annex 4: Mercer Scope for Investment Strategy Review

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.

6

Document is Restricted

This page is intentionally left blank