



TALENT • HEALTH • RETIREMENT • INVESTMENTS

SURREY PENSION FUND
RISK MANAGEMENT UPDATE

NOVEMBER 2014



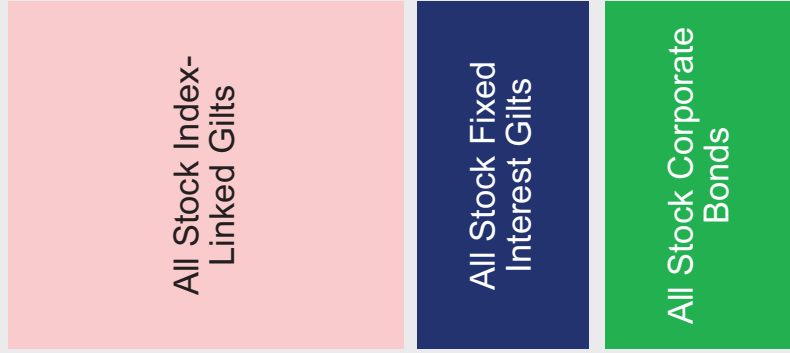
STEVE TURNER



RESTRUCTURING L&G GILT PORTFOLIO OVERVIEW OF THE IMPLEMENTATION PLAN

We have been working with L&G to develop an implementation plan which is illustrated below. We have provided advice on Step 1 and L&G implemented this trade on 3 November 2014. The next step will be to structure the initial LDI portfolio and to agree the details of the proposed yield trigger.

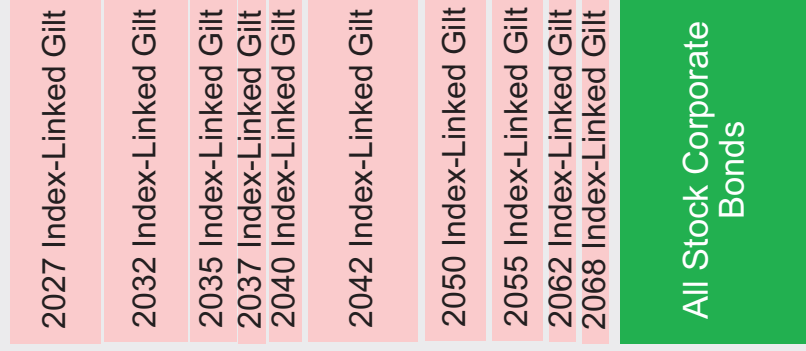
Starting position



Index-linked gilts transferred into a portfolio of single stock funds in order to make the portfolio "LDI ready"

Fixed interest gilts also transferred into single stock funds to "add" inflation at an affordable price

Step 1 - complete

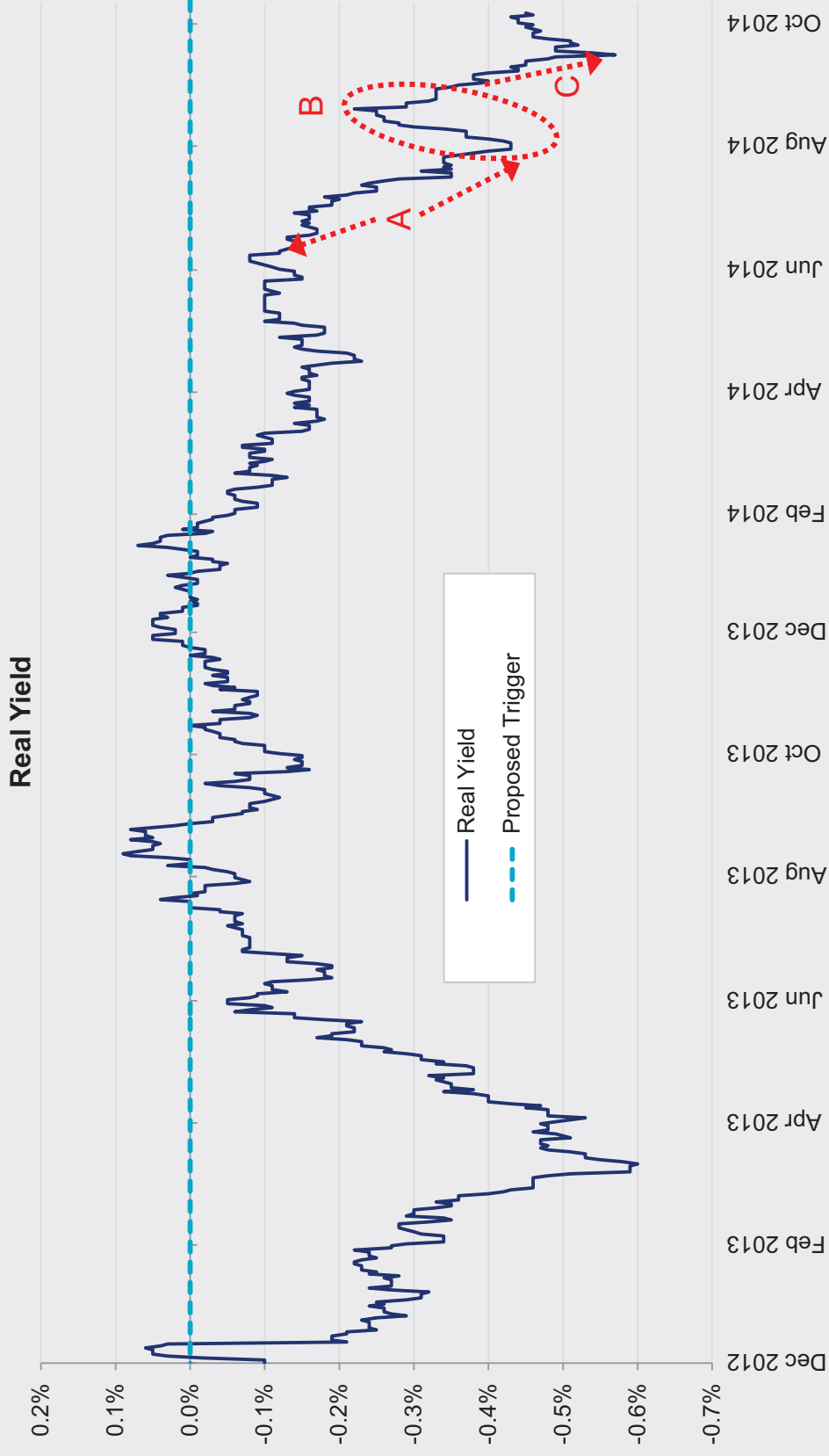


Max of £90m to be transferred should index-linked yields reach 0% p.a.

Step 2 – to do



MOVING TO LEVERAGED GILT STRUCTURE PROPOSED GILT TRIGGER



A – ECB set the deposit rate to -0.1% in June. This resulted in a flee to UK Government Bonds which has led to yields falling.

B – Around the Scottish referendum there was further volatility, with some respite once it became apparent that the “no vote” would win.

C – Towards the end of September, there was a sell-off in return seeking assets as economic data and forecast deteriorated. As such, investors displayed a ‘flight to quality’ which led to a further fall in yields.

RESTRUCTURING THE L&G GILT PORTFOLIO REVIEW OF THE TRANSITION

L&G Fund	Previous allocation (Date: 22 nd October 2014)		New allocation (Date: 3 November 2014)	
	£m	%	£m	%
All Stocks Fixed Interest Gilts	43.8	30.2	-	-
All Stocks Index-Linked Gilts	101.5	69.8	-	-
2027 Index Linked Gilts	-	-	26.2	18.2
2032 Index-Linked Gilt	-	-	22.6	15.7
2035 Index-Linked Gilt	-	-	11.6	8.1
2037 Index-Linked Gilt	-	-	7.2	5.0
2040 Index-Linked Gilt	-	-	8.2	5.7
2042 Index-Linked Gilt	-	-	28.0	19.5
2050 Index-Linked Gilt	-	-	15.4	10.7
2055 Index-Linked Gilt	-	-	13.1	9.1
2062 Index-Linked Gilt	-	-	6.9	4.8
2068 Index-Linked Gilt	-	-	4.6	3.2
Total L&G gilts	£145.3m	100%	£143.8m	100%
Interest rate hedge ratio	-	5%	-	6%
Inflation hedge ratio	-	4%	-	6%

Source: L&G (asset values), Mercer (hedge ratios).

REVISED FEE BASIS

L&G Passive Funds	Previous fee basis		Revised fee basis	
	% p.a.	Estimated fee p.a.	% p.a.	Estimated fee p.a.
UK equity	0.0425%	£115,000	0.04%	£110,000
Global equity	0.11%	£375,000	0.08%	£270,000
Emerging Market equity	0.25%	£100,000	0.175%	£70,000
Corporate bonds	0.08%	£40,000	0.08%	£40,000
Gilts	0.04%	£60,000	0.0275%	£40,000
Estimated total	0.08%	£690,000	0.06%	£530,000

Source: L&G (fee basis), Mercer (estimated fee based on an total L&G assets of £840m)
 Note: Fee estimates have been rounded for illustration

- ✓ The new fee basis leads to a material reduction in on-going fees
- ✓ Estimated saving of £140,000 p.a. on the passive equity exposure
- ✓ Estimated saving of £20,000 p.a. on the passive gilt holdings (further discount from L&G)
- ✓ Total estimated saving of £160,000 p.a. (before implementing the pooled leveraged gilt strategy)

SUMMARY & NEXT STEPS

Summary

- ✓ The gilt portfolio has now been restructured and is “LDI ready”.
- ✓ The revised L&G fee basis has led to an estimated reduction in investment manager fees of £160,000 per annum.
- ✓ The current bond portfolio provides a 6% interest rate hedge ratio and a 6% inflation hedge ratio (and the “shape” of this exposure now better matches the liabilities).

Next steps

The key next steps are to agree the detailed asset allocation for the LDI strategy and the associated yield trigger. Discussions with L&G are well underway and we will report back to the Board with our advice in due course.

I look forward to discussing the contents of this report with the Board.

Steve Turner
Mercer Limited

APPENDIX



INTRODUCTION TO SOME IMPORTANT TERMINOLOGY

Jargon	What it means	Change in market conditions	Impact on liabilities
Interest rates	Discount rate	↔	→
		→	←
Inflation	Increase in pension payments	↔	←
		→	→

IMPORTANT TERMINOLOGY

Nominal interest rates: the yield on fixed-interest gilts that represent the change in interest rates.

Real interest rates: the yield on index-linked gilts that represent the change in interest rates and inflation

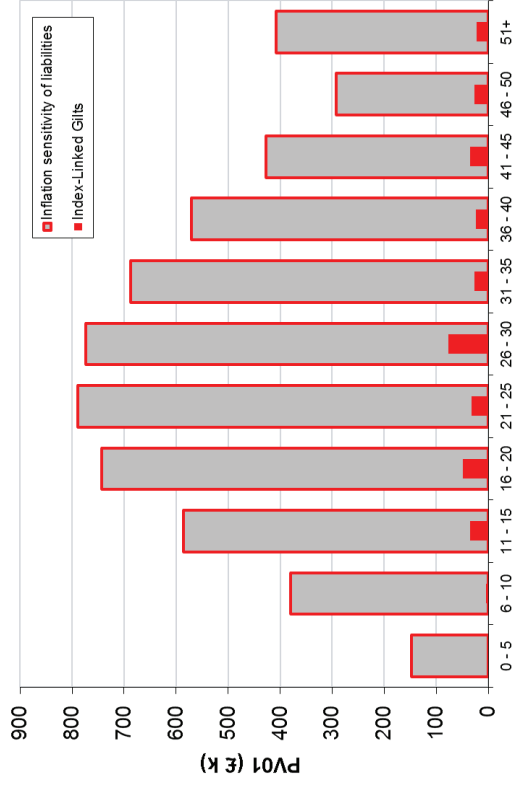
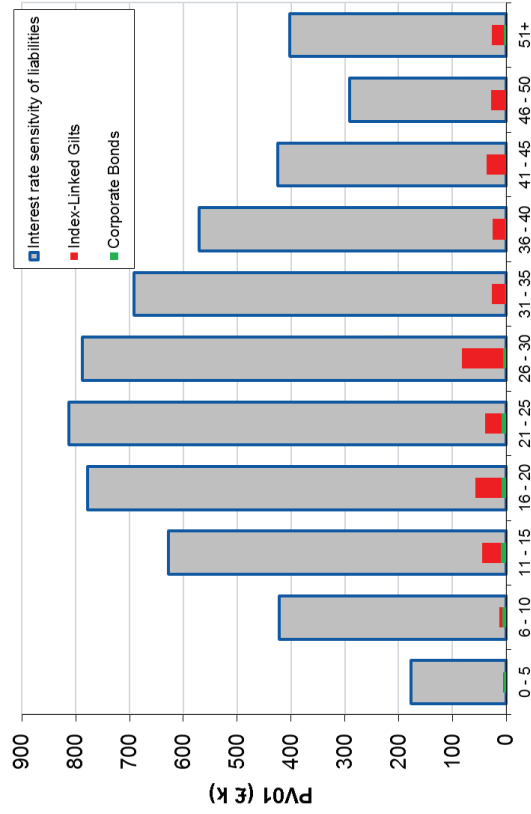
Duration: a term used to describe how sensitive the present value of a liability, or an asset, is to changes in the interest rate

- Duration is expressed in years. The higher the duration the greater the sensitivity to changes in interest rates
- For example a duration of 20 years means that for every 1% p.a. change in interest rate, the value of the asset / liability will change by approximately 20%.

PV01: the value change in the assets or liabilities as a result of a 0.01% uniform change in long term interest rates

IE01: the value change in the assets or liabilities as a result of a 0.01% uniform change in inflation expectations

RESTRUCTURING THE BOND PORTFOLIO UPDATED HEDGING POSITION



Total Interest Rate

Assets	PV01 (£'000) - A	386
Liabilities	PV01 (£'000) - L	5,984
Hedge ratio (of liabilities)	A/L	6%

Total Inflation

		331
		5,805
		6%

Note: The hedge ratio is expressed on an estimated value of the liabilities on the current funding basis. The analysis above indicates that if interest rates were to fall/rise by 0.01% then the deficit would rise/fall by c.£5.6m. Similarly, the analysis shows that if inflation were to fall/rise by 0.01% then the deficit would also fall/rise by c.£5.5m. **The overall hedge ratio is estimated to be 6%.**

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© 2014 Mercer LLC. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualized investment advice.

This does not contain regulated investment advice in respect of actions you should take. No investment decision should be made based on this information without obtaining prior specific, professional advice relating to your own circumstances.

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.



This page is intentionally left blank