SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **13 FEBRUARY 2015**

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

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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 Board, as well as manager investment performance.

RECOMMENDATIONS:

It is recommended that the Pension Fund Board:

1. Note the report.
2. Give consideration to multi asset credit as a future strategy for the Fund.
3. Delay the purchase of ill health insurance from Legal and General until the full implications of the revised price and new scheme rules have been fully evaluated.

REASON FOR RECOMMENDATIONS:

In order to achieve best possible performance alongside optimal risk.

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DETAILS:

1) Manager Issues during the Quarter

Manager	Issue	Status/Action Required
L&G	Possible Rebalancing	The asset allocation is within the Fund's policy control limits. The asset allocations at 31 December 2014 and 29 January 2015 are shown in Annex 1.
Mirabaud and Majedie	UK Equities Portfolio	At its meeting on 19 September 2014, the Board agreed to terminate Mirabaud's contract with immediate effect and temporarily move the 4% allocation from Mirabaud to a UK Equities passive portfolio with Legal & General. Officers immediately contacted Mirabaud to let them know of the Board's decision and make arrangements with both managers for the transfer of the funds. An in specie transfer with a net valuation of £98,437,899 from Mirabaud as at 8 October 2014 valuation date was placed into LGIM's N – UK Equity Index Passive Fund on 9 October 2014. At the Board meeting on 14 November 2014, Members agreed to transfer the allocation in its entirety to Majedie Asset Management. At the time of writing, this process is underway with a 9 February 2015 target transfer date. The ultimate gross of fees investment performance figures for the Mirabaud portfolio are shown below: *From Inception: p.a* Portfolio:9.62% vs Benchmark: 8.21% (+1.41%) *5 Years p.a* Portfolio 9.49% vs Benchmark 9.74% (-0.25%)
Capital Dynamics	Sale of Assets	The whole Capital Dynamic's US Solar Fund was sold to TerraForma Power Inc in December. The upfront cash sale was perceived to be a better value for investors than the expected return over the partnership lifetime. The fund received a distribution of $20.6m (equivalent to £13.2m) on 23 December 2014.
CBRE	Contract change	The Pension Fund Board resolved at the 19 September 2014 meeting to amend the wording in the CBRE contract to allow investment in global property. CBRE are currently working on this change, specifically the benchmark requirements for such a mandate. Officers will report to the 13 February 2015 meeting.
Franklin Templeton, Western, Baillie Gifford CBRE	Client meeting	Update of minutes of external fund manager meetings held on 11 February 2015 to be tabled at the meeting.

2) Freedom of Information Requests

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

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Date	Organisation	Request	Response
15/11/2014	Move your Money	A complete list of Pension Fund Investments with a breakdown of assets per council within the fund.	Full investment list as at 30 September 2014 and the valuation of each Council's assets as at the 2013 triennial Valuation
18/11/2014	Pitchbook	Private Equity Investment Data	Valuations and returns provided for each fund partnership as at the most recent valuation date.

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3) Future Pension Fund Board Meetings/Pension Fund AGM

The schedule of meetings for 2015 and 2016 is as follows:

- 13 February 2015: Board meeting hosted at County Hall.
- 15 May 2015: Board meeting hosted at County Hall.
- 11 September 2015: Board meeting hosted at County Hall.
- 13 November 2015: Board meeting hosted at County Hall.
- 20 November 2015: AGM hosted at County Hall
- 12 February 2016: Board meeting hosted at County Hall.
- 13 May 2016: Board meeting hosted at County Hall.
- 9 September 2016: Board meeting hosted at County Hall.
- 11 November 2016: Board meeting hosted at County Hall.
- 18 November 2016: AGM hosted at County Hall

4) Stock Lending

In the quarter to 31 December 2014, stock lending earned a net income for the Fund of £59k with an average value on loan equal to £95.8m

5) Ill Health Insurance

At the board meeting on 14 February 2014, it was agreed that an ill health insurance policy with Legal & General would be taken out in order to insure the fund and scheme employers against the potential cost of ill health retirement benefits.

The Council consulted with Procurement and Legal colleagues and, on 3 September 2014, published a voluntary ex ante transparency (VEAT) notice, advising the intention of the administering authority to enter into a contract with Legal & General.

Given the delay as a result of a protracted and delayed procurement process, it was necessary to resubmit fund data to Legal & General for a revised quotation. Legal & General have produced a quotation dated 28 January 2015, based on the same sum assured, but taking into account revised data and conditions in the ill health insurance market. The new quotation has an increase in premium from 0.63% to 0.88%.

This premium is based on a whole of fund basis. If scheme employers instead took insurance on an individual basis, the premium would further increased to 1.41%.

The impact of this revised premium is detailed in the following table:

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Financial Year Ending	Total Payroll	Annual Premium @ 0.88%	Difference in quotation provided to the Board 15/11/2013	Total Tier 1 and 2 strain	Strain and Premium Difference	Equivalent premium rate of Tier 1 and Tier 2 strain
31/03/2013	£489m	£4.30m	+ £1.22 m	£2.30 m	- £2.00 m	0.47%
31/03/2012	£465m	£4.09m	+ £1.16 m	£3.79 m	- £0.30 m	0.82%
31/03/2011	£460m	£4.04m	+ £1.06 m	£2.98 m	- £1.06 m	0.65%
31/03/2010	£495m	£4.36m	+ £1.24 m	£1.38 m	- £2.98 m	0.28%
31/03/2009	£468m	£4.12m	+ £1.17 m	£1.72 m	- £2.40 m	0.37%
Total	£2,377m	£20.91m	+ £5.85 m	£12.17 m	- £8.74 m	0.51%

The justification for this increase in premium is that it fully takes in to account the changes in accrual rate from 1/60th to 1/49th applicable from 1 April 2014 and the increase in state pension age, both of which have increased the costs of ill health retirements in the LGPS. Annual data from the pension service will be available from the pension service after the scheme year end of 31 March 2015, which indicates the material impact of the new scheme rules on the costs of ill health retirement.

Due to the increase in the premium quoted by Legal & General, it is recommended that the Pension Fund Board does not approve the purchase of ill health retirement insurance until such time that it has been possible to assess the impact of the new scheme rules on the costs of ill health retirement to the pension fund and the associated value for money of the Legal & General offer.

6) Private Equity

The following table shows the estimated value of all cash distributions and drawdowns for the existing private equity partnerships, and the impact that the estimated level of cash flows would have upon the asset allocation to private equity using current market values.

	Year 1 2015/16 £m	**Years 1 – 3 2015/18 £m**
Estimated Distributions	-16.6	-76.8
Estimated Drawdowns	15.5	57.5
Net Distribution	**-1.1**	**-19.3**
Revised Private Equity Allocation £m	131.2	113.0
Revised Private Equity Allocation %	4.4%	3.8%

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7) Internally Managed Cash

The internally managed cash balance of the Pension Fund was £12.4m as at 31 December 2014.

8) Liability Driven Investment Framework

The Board meeting of 19 September 2014 recommended the setting up of a framework for a liability driven investment (LDI) strategy with the establishment of a leveraged gilt portfolio to be run by Legal & General Investment Management. This will be funded by the existing passive and index-linked gilts held with Legal & General, amounting to a maximum of £90m.

The contracts that have been signed only relate to the restructuring of the physical gilts. It should be noted that no investment will be taking place yet in the leveraged gilt structure. The switch into the leveraged gilt structure will take place based on yield triggers, set at 0%, at the Board meeting of 14 November 2014. The Liability Driven Investment framework by means of the Fund's existing assets of £90m was set up on 3 November 2014.

Mercer have since published advice relating to the implementation of the leveraged fund and this is included as Annex 2. The working assumption is that leveraging will be based on a yield trigger, when the yield on the 2035 Index-Linked Gilt reaches 0%. This will be subject to regular reviews, given that there is no guarantee that this will happen in the short/medium term.

With regard to the current position regarding gilt yields and the record lows that the market has produced since the last meeting, AXA Investment Managers produced the paper shown as Annex 3 in December 2014 about the supply and demand dynamics for index-linked gilts (ILGs) and the impact this has on real yields. Mercer has previously talked about the massive supply and demand imbalance for ILGs. The annex is attached in order to help the Board understand why a very large and sustained increase in real yields is unlikely, and this will help with the trigger discussion at future meetings.

9) Internal Audit Report: Investment Function

The Internal Audit Team recently completed a report on the investment function. The completed report is shown as Annex 4 for discussion.

10) Multi Asset Credit

It is proposed that Mercer hold a training session within the meeting on multi-asset credit from an investment strategy perspective: the case for multi asset credit, expected benefits, potential risks and how to implement. Papers on this training session will be sent out prior to the meeting.

It is recommended that members give consideration to the asset class as a future strategy for the Fund.

11) Governance Strategies and Policies

A report is included on the 13 February agenda reference the revised voting policy following the Financial Reporting Council's (FRC's) review of changes to the UK Corporate Governance Code.

12) Marathon Asset Management: Emerging Markets

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For some time, Marathon has been urging fund officers to open custodian accounts with regard to exposures in India, Chile, Egypt and United Arab Emirates. The Fund has existing exposure to most countries around the globe, but some (including the list above) are highly bureaucratic, requiring much paperwork, as well as the mandatory appointment of tax advisors and other consultants within the country in question.

As an alternative means of gaining exposure to these markets, the Board is invited to consider the Marathon Emerging Markets Fund. This is offered by Marathon, specifically for clients that cannot access the emerging markets directly, or are not in a position to cope with the level of bureaucracy imposed by particular countries. It will be far easier to invest via this pooled fund than to open and manage the various accounts on behalf of the Surrey Fund itself. The fund is daily dealing to facilitate investment from Marathon's segregated clients. There is no additional fee for the Surrey Fund and, by accessing the Fund, it will gain exposure to the full suite of emerging markets.

With regard to the implementation of the switch into the Emerging Markets Equity Fund, as would be expected, the majority of the current emerging markets holdings would be transferred in specie into the Fund. For these markets there would be no transaction costs incurred. However, a number of markets are non-transferrable and would have to be sold and repurchased (Brazil, Korea, Malaysia, Philippines and Taiwan), and for these countries there would be some trading costs.

India is the only country that exists in the pooled fund, but not in the existing Surrey portfolio and currently makes up around 6% of the total Fund allocation. There would be some transaction costs associated with the purchase of these assets.

	Transaction Costs ($USD)
Non-Transferrable Markets	89,067
New Markets	7,340
Total	**96,407**

It is worth noting that the costs associated with the investment in new markets would be incurred regardless of the investment into the pooled fund. The costs associated with the non-transferrable markets are additional costs that would not otherwise be incurred. The expected transaction costs are minimal in terms of the total portfolio (around 0.02%). Mercer is supportive of an investment into the Marathon Emerging Markets Equity Fund, within Surrey's segregated portfolio.

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13) Members' Knowledge Assessment

This will be tabled at the 13 February 2015 meeting in order to allow sufficient time for Members to complete the necessary outstanding paperwork and assessments and for officers to collate the results.

14) Fund Manager Meetings of 11 February 2015

Notes of the fund manager meetings of 11 February 2015 will be tabled at the Board meeting on 13 February.

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Report of the Strategic Finance Manager

Financial and Performance Report

1. Funding Level

Past Service Position	31 December 2014 £m
Past Service Liabilities	4,095
Market Value of Assets	2,992
Deficit	(1,103)
Funding Level	73.1%

The funding level at the latest formal valuation at 31 March 2013 was 72.3%. As at 30 December 2014 the funding level stands at 73.1%, a slight improvement from March 2013, but a decline from highs of 79.8% as at 30 June 2014. This is despite investment performance outperforming the actuarial assumptions over recent years.

The following table shows the impact of differing factors upon the Fund deficit

	£m
Deficit at 31 March 2013	**-980**
Interest on deficit	-88
Excess return on assets	166
Change in actuarial assumptions	-271
Contributions less benefits accruing	70
Deficit at 31 December 2014	**-1,103**

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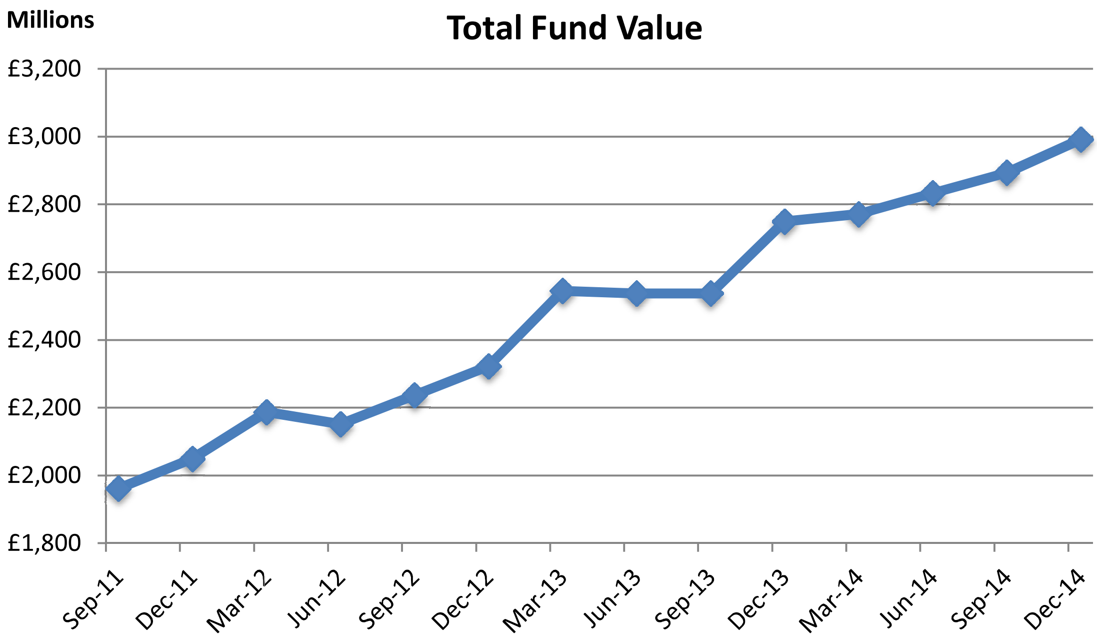
2. Market Value

The value of the Fund was £2,991.7m at 31 December 2014 compared with £2,893.8m at 30 September 2014. Investment performance for the period was +2.9%.

The increase is attributed as follows:

	£m
Market Value at 30/09/2014	**2,893.8**
Contributions less benefits and net transfer values	20.3
Investment income received	11.2
Investment expenses paid	-5.3
Market movements	71.7
Market Value at 31/12/2014	**2,991.7**
Market Value at 29/01/2015	**3,058.9**



3. Fund Performance

Summary of Quarterly Results (gross of investment fees)

Overall, the total fund returned +2.9% in Q3 2014/15, in comparison with the Fund's customised benchmark of +2.4%.

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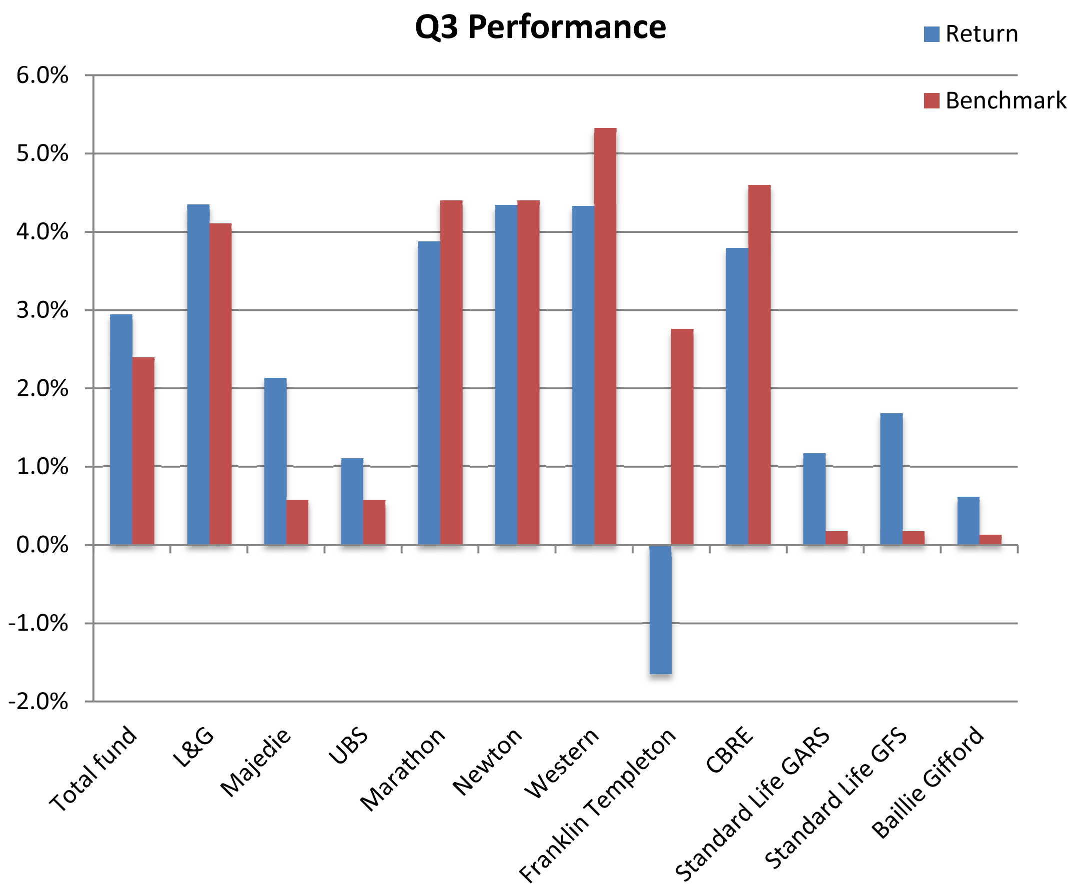

Both Baillie Gifford and Standard Life are absolute return funds with a benchmark based upon short term cash holdings.

Overseas Equity had another strong quarter with a benchmark return of +4.4%, with Newton reporting +4.3% and Marathon slightly below with +3.9%. Both UK equity managers outperformed a fairly flat benchmark performance for the quarter, with Majedie outperforming by +1.5%.

Continued downward pressure on bond yields had a positive impact upon the bond portfolio with western reporting +4.3%; an underperformance of 1.0% versus benchmark.

The table below shows manager performance for 2014/15 Q3 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

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Manager	**Performance %**	**Benchmark %**	**Relative %**
Total fund	2.9	2.4	0.5
L&G	4.3	4.1	0.2
Majedie	2.1	0.6	1.5
UBS	1.1	0.6	0.5
Marathon	3.9	4.4	-0.5
Newton	4.3	4.4	-0.1
Western	4.3	5.3	-1.0
Franklin Templeton	-1.7	2.8	-4.5
CBRE	3.8	4.6	-0.8
Standard Life GARS	1.2	0.2	1.0
Standard Life GFS	1.7	0.2	1.5
Baillie Gifford	0.6	0.1	0.5

Franklin Templeton is measured against a US Dollar denominated benchmark which is then converted back to Sterling. This can cause a disparity between performance and benchmark in the event of large currency movements.

Both Baillie Gifford and Standard Life are absolute return funds with a benchmark based upon short term cash holdings.

Summary of Full Year Results (gross of investment fees)

During the course of the previous 12 months to 30 December 2014, the Fund returned +7.9% overall, an outperformance of 1.0% against the customised benchmark of +6.9%.

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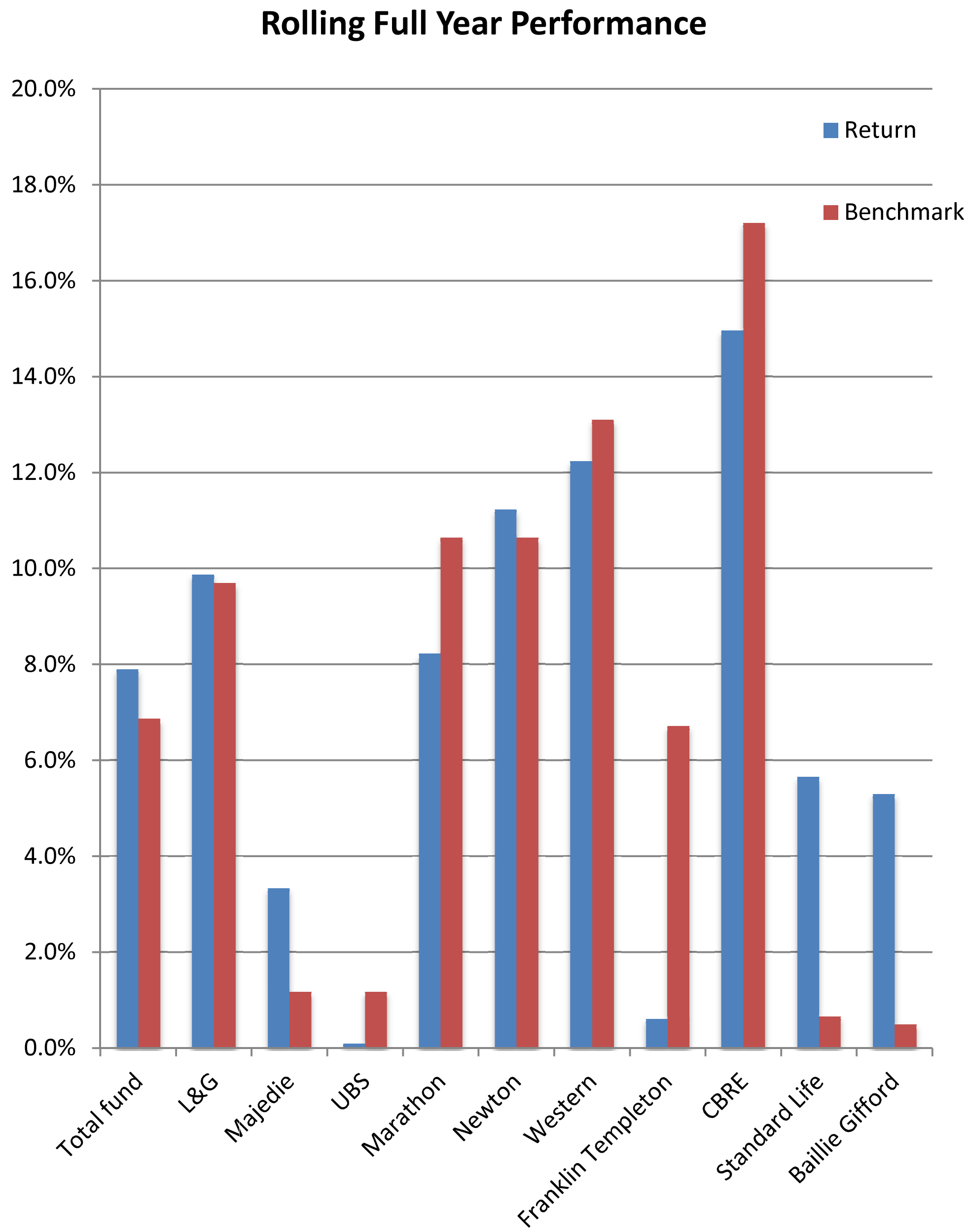

Property has again provided by far and away the largest absolute return for the fund over the preceding 12 months with CBRE reporting +15.0% but below the benchmark of +17.2%.

Active bond manager Western reported a double digit return of +12.2% against a benchmark of +13.1%. The return attributable to currency hedging as part of the total fund return for the previous year is -0.2%.

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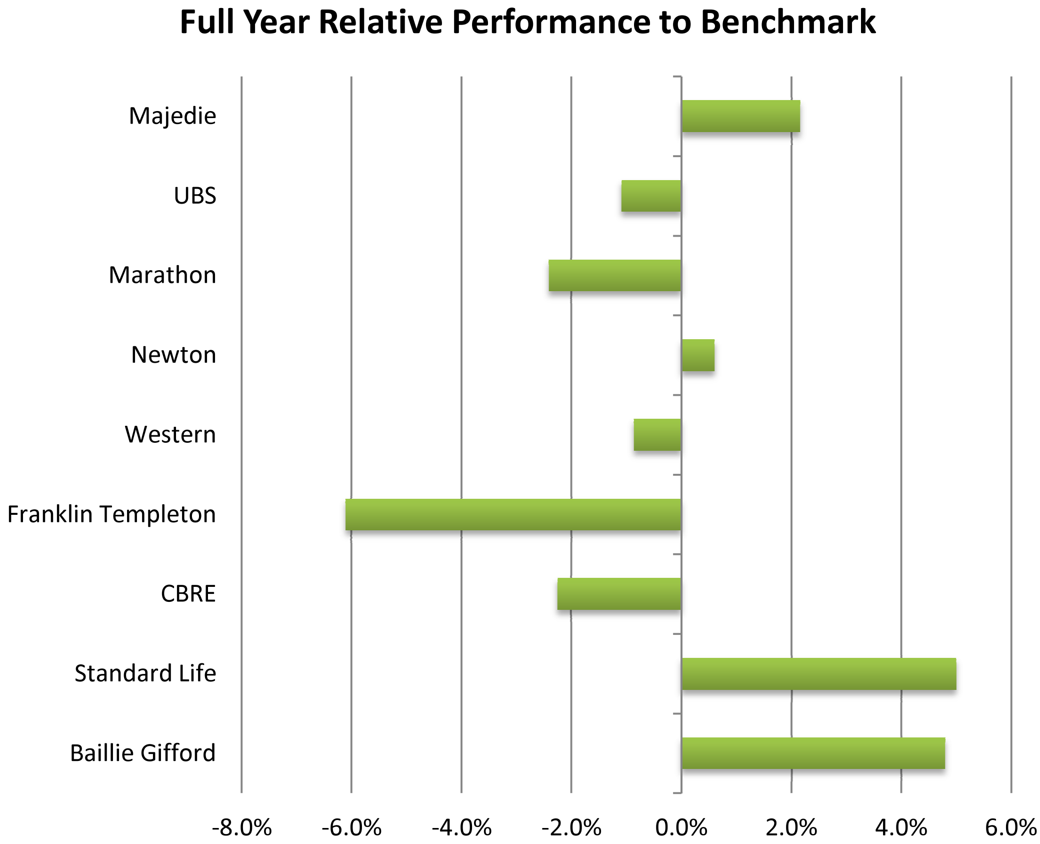


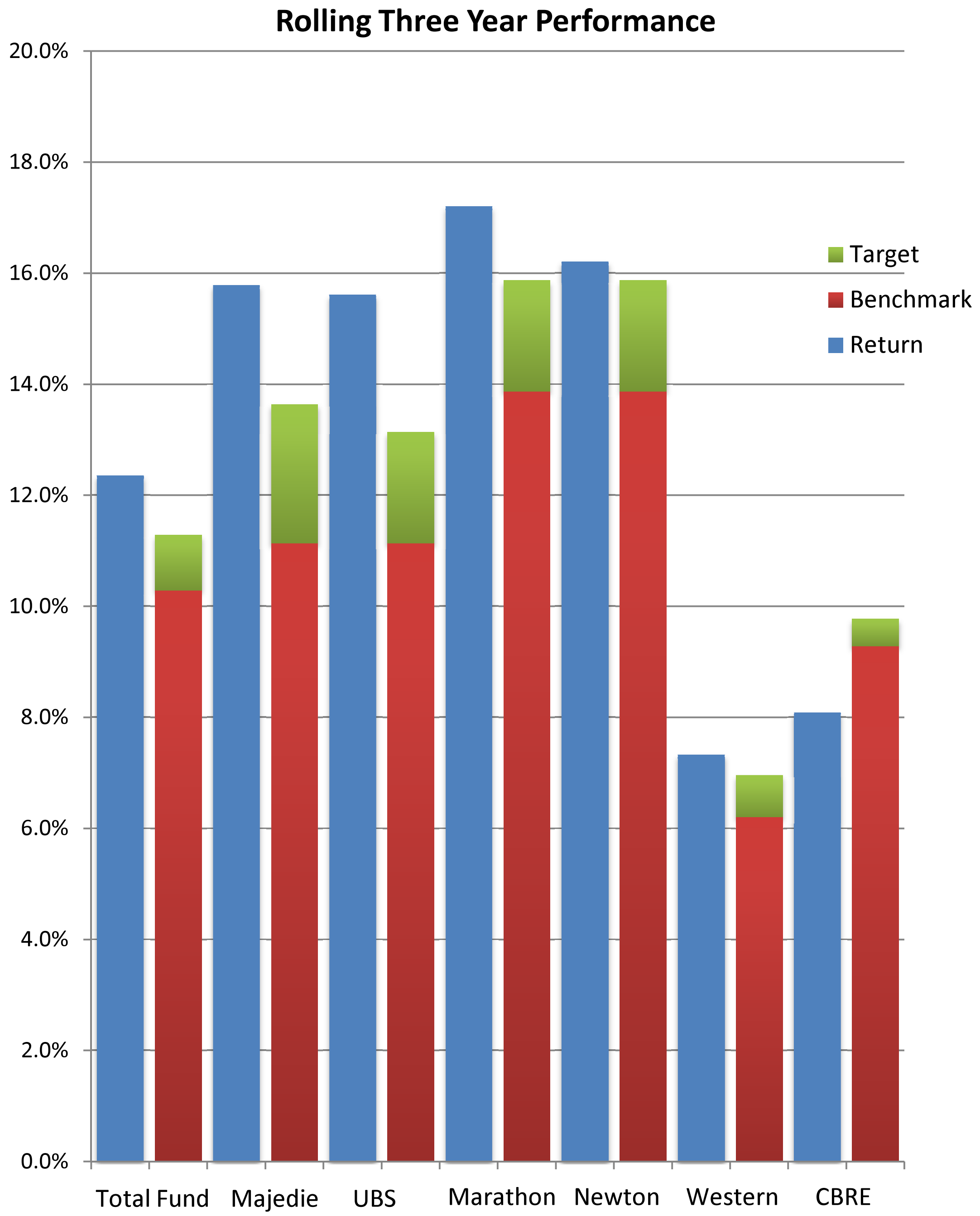
The table below shows manager performance for the year to 30 December 2014 against manager specific benchmarks using custodian data.

Manager	Performance %	Benchmark %	Relative %
Total fund	7.9	6.9	1.0
L&G	9.9	9.7	0.2
Majedie	3.3	1.2	2.1
UBS	0.1	1.2	-1.1
Marathon	8.2	10.6	-2.4
Newton	11.2	10.6	0.6
Western	12.2	13.1	-0.9
Franklin Templeton	0.6	6.7	-6.1
CBRE	15.0	17.2	-2.2
Standard Life GARS	5.7	0.7	5.0
Baillie Gifford	5.3	0.5	4.8

Franklin Templeton is measured against a US Dollar denominated benchmark which is then converted back to Sterling. This can cause a disparity between performance and benchmark given large currency movements.

Both Baillie Gifford and Standard Life are absolute return funds with a benchmark based upon short term cash holdings.

Summary of Rolling Three Year Performance (gross of investment fees)



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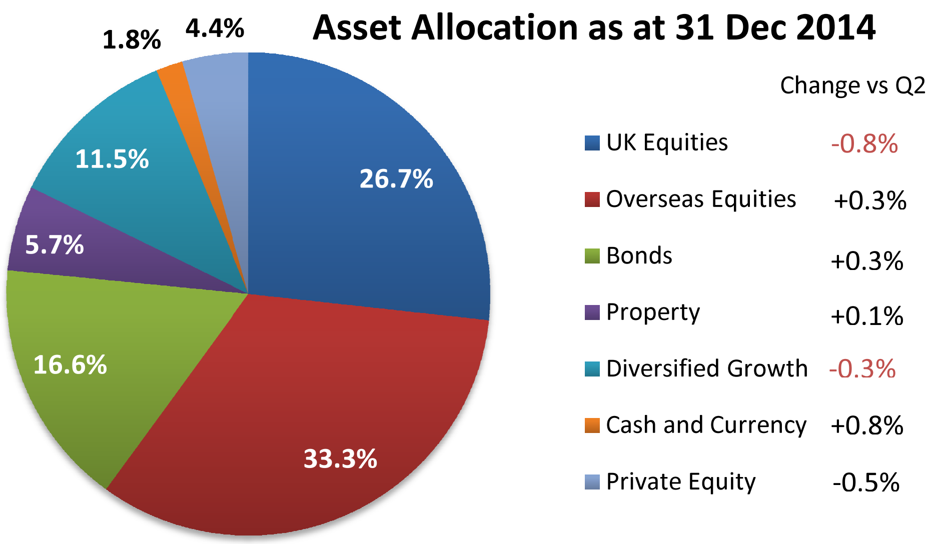
The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target %	Relative %
Total fund	12.4	10.3	11.3	1.1
L&G	11.8	11.8	11.8	0.0
Majedie	15.8	11.1	13.6	2.2
UBS	15.6	11.1	13.1	2.5
Marathon	17.2	13.9	15.9	1.3
Newton	16.2	13.9	15.9	0.3
Western	7.3	6.2	7.0	0.3
CBRE	8.1	9.3	9.8	-1.7

4. Asset Allocation

The graph and table below summarise the asset allocation of the fund as at the 31 December 2014.

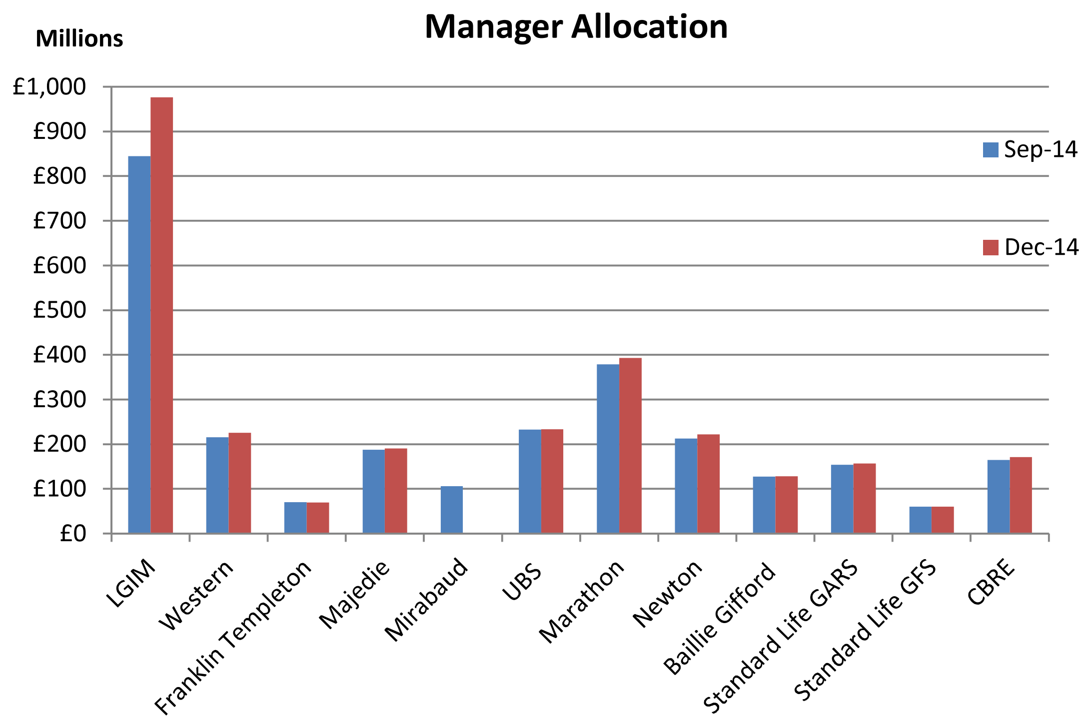


The table below compares the actual asset allocation as at 31 December 2014 against target asset weightings.

	TOTAL FUND	Actual	Target	Last Quarter	
	£m	%	%	£m	%
Fixed Interest					
UK Government	67.4	2.3	2.6	108.7	3.8
UK Non-Government	130.7	4.4	7.1	125.2	4.3
Overseas	72.5	2.4	0.0	62.6	2.2
Total Return	69.3	2.3	2.4	70.4	2.4
Index Linked	155.5	5.2	5.5	104.1	3.6
Equities					
UK	800.0	26.7	27.5	795.6	27.5
Overseas	995.3	33.3	32.3	953.1	32.9
Property Unit Trusts	170.6	5.7	6.2	162.9	5.6
Diversified growth	345.0	11.5	11.4	341.4	11.8
Cash	55.9	1.9	0.0	33.4	1.2
Currency hedge	-2.7	-0.1	0.0	-5.0	-0.2
Private Equity	132.3	4.4	5.0	141.4	4.9
TOTAL	**2,991.7**	**100.0**	**100.0**	**2,893.8**	**100.0**

5. Manager Allocation

The graph below shows the current manager allocation.



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The table below includes the actual and target manager allocation weightings for those investments managed through the custodian Northern Trust as at 31 December 2014. This excludes internal cash and private equity portfolio.

Investment Manager	Asset Class	Market Value £m	Actual Allocation %	Target Allocation %
L&G	Multi-Asset	976.5	34.6	34.7
Western	Bonds	225.4	8.0	8.3
Franklin Templeton	Bonds	69.3	2.5	2.6
Majedie	UK Equity	190.1	6.6	7.0
UBS	UK Equity	233.4	8.3	8.0
Marathon	Global Equity	393.1	13.9	12.0
Newton	Global Equity	222.1	7.9	8.0
Baillie Gifford	Diversified Growth	128.2	4.5	4.0
Standard Life GARS	Diversified Growth	156.5	5.5	8.0
Standard Life GFS	Diversified Growth	60.3	2.1	
CBRE	Property	170.9	6.0	6.5
TOTAL		**2,825.8**	**100.0**	**100.0**

6. Fees

The following table shows a breakdown of fees paid during Q3 2014/15

Manager	Market Value 31/12/2014 £m	Manager Fee Q3 £	Annualised Average Fee
L&G	976.5	175,657	0.07%
Western	225.4	120,918	0.21%
Franklin Templeton*	69.3	121,454	0.70%
Majedie**	190.1	1,511,191	3.18%
UBS**	233.4	1,430,926	2.45%
Marathon	393.1	426,921	0.43%
Newton	222.1	142,677	0.26%
Baillie Gifford*	128.2	203,171	0.63%
Standard Life GARS	156.5	257,865	0.66%
Standard Life GFS	60.3	150,777	1.00%
CBRE	170.9	172,314	0.40%
Manager Fees Total		**£4,713,872**	**0.67%**
Mirabaud transfer expense		238,062	
Tax witheld		143,263	
Other investment expenses		106,455	
Total Investment Expenses		**£5,251,652**	

*Estimated
** Includes performance fee and UBS performance claw back fee

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CONSULTATION:

7 The Chairman of the Pension Fund Board 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.

DIRECTOR OF FINANCE COMMENTARY

10 The Director of Finance is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed.

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 the initiative is not a 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 Board Chairman

Annexes:
1. Asset Allocation Policy and Actual as at 31 December 2014 and 30 January 2015
2. Mercer: LDI Paper
3. AXA Discussion Paper: Gilt Yields
4. Internal Audit Report: Investment Function

Sources/background papers:
None

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