SURREY COUNTY COUNCIL

SURREY PENSION FUND COMMITTEE

DATE: **13 NOVEMBER 2015**

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 Surrey Pension Fund Committee, as well as manager investment performance.

RECOMMENDATIONS:

It is recommended that the Surrey Pension Fund Committee note the report.

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
L&G	Possible Rebalancing	The asset allocation is within the Fund's policy control limits. The asset allocations at 30 September 2015 and 27 October 2015 are shown in Annex 1.
Western	Multi Asset Credit	Update on implementation
Various	Client meeting	Verbal update from external fund manager meetings held on 9 November 2015 will accompany this item.

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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
09 September 2015	Pitchbook	Private equity investment information	Investment summary taken to previous meeting of Pension Fund Committee
25 September 2015	Dorking Advertiser	Investments held by the fund in the following sectors: Tobacco, Aerospace, Defence, Alcohol	A summary of directly held investments in each requested sector with the book and market value for each.

3) Future Surrey Pension Fund Committee Meetings/Pension Fund AGM

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

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

4) Local Pension Board

A meeting of the Local Pension Board was held on 12 October. A verbal summary of the meeting will be delivered to the Committee.

5) Stock Lending

In the quarter to 30 September 2015, stock lending earned a net income for the Fund of £78k with an average value on loan equal to £153m.

6) Internally Managed Cash

The internally managed cash balance of the Pension Fund was £37m as at 30 September 2015. As at 27 October 2015, the cash balance was £34m.

The current internally managed cash balance, driven by higher contributions compared to benefits paid and net income from private equity, is more than sufficient for liquidity purposes.

7) Liability Driven Investment (LDI) Framework

At its meeting on 13 February 2015, the Committee agreed to set the real yield trigger for future LDI leverage to 0.27% 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 that has been agreed.

Mercer has produced a simple one page document for this, shown as Annex 2. This will be shown produced at every future Committee meeting.

There will be element of ongoing training with this annex, with a regular reminder of the relationship between changes in yields (including the volatility in how these can move up and down) and the impact this has on the value placed on the liabilities.

8) Western Implementation Multi Asset Credit

At its meeting on 23 July 2015, the Pension Fund Board appointed Western Asset Management to run a Multi Asset Credit portfolio with funds from the LGIM investment grade bonds and the Western UK gilts. The establishment of regulatory approval for the pooled fund has taken longer than Western initially anticipated which has delayed the transfer of assets from LGIM and Western's gilt portfolio. The transfer is now scheduled to take place in mid November.

9) Employer Body Admission/Termination Guidance

At its meeting on 22 May 2015, the Surrey Pension Fund Committee agreed to the Fund establishing new guidance for scheme employers, which reflects a more structured and focused approach to risk assessment.

Officers have had further meetings with the Fund actuary to set out the scope of the project. This will include guidance to prospective new employers and established employers within the Fund.

The project develops a risk based approach to linking employer covenant strength to funding solutions.

The fund will consult with employers with a view to launching this new approach in line with the triennial valuation. Negotiations are taking place with the actuarial regarding the detail of the costs associated with the implementation.

10) The Impact of Markets in Financial Instruments Derivatives (MIFID II)

MIFID II is the European Union's second Markets in Financial Instruments Directive. There have been previous reported cases about poor investment decisions by local authorities in Europe and the new directive is intended to protect UK local authorities from future mis-selling. In order to achieve this, it is looking to reclassify all local authorities as retail clients from the current professional status.

This would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities in the same way as individuals and small businesses. That includes ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. That might be a welcome change, but it also involves a lot more administration for both the firm and the client in order to prove to the Financial Conduct Authority that all the necessary steps have been taken, and as evidence in case of alleged mis-selling. MIFID II does include an option for retail clients to opt for professional status.

MIFID II will not affect our current dealings with the fund managers with whom we already have arrangements. Under the “grandfathering” rules, our current service providers will continue to treat us as a professional client. However, when the Fund starts a new business relationship after 1 January 2017, we may well have a careful choice to make between categorisation as a retail investor or professional investor.

The Department for Communities and Local Government (DCLG), along with the Local Government Association (LGA) and the Pensions and Lifetime Savings Association (PLSA), formerly the National Association of Pension Funds, have invited the Surrey Fund (with six other LGPS funds) to have discussions with the FCA to put a case for keeping the LGPS as default professional. No date has been set for a meeting. Officers will keep the Committee updated when required.

11) Separation of the Pension Fund from the Host Authority

Each LGPS administering authority (as defined in Part 1 of Schedule 3 of the LGPS Regulations 2013) is responsible for managing and administering the LGPS for which it is the appropriate administering authority under the Regulations. The Administering Authority is responsible for maintaining and investing its own Fund for the LGPS.

The majority of Administering Authorities are local authorities and therefore operate in accordance with local government law requirements. However, some Administering Authorities are not local authorities, such as the Environment Agency, the London Pensions Fund Authority (LPFA) and the South Yorkshire Pensions Authority. Such bodies operate in accordance with their own legal constitutions.

There are diverse approaches to how each LGPS Fund operates. In some instances, two or more Administering Authorities may share their administration function, for example, through a shared service arrangement. However, where this happens, each local authority still retains its own individual Administering Authority status and therefore legal responsibility for its own Fund.

Work has been commissioned by the LGPS Scheme Advisory Board on options to improve the governance of pension funds by increasing the degree of separation between the scheme manager function (the management and administration of the scheme and the local fund) and the host authority. The following three options are being discussed.

Option One: This would entail a stronger role for a separate Section 151 Officer within a distinct entity of the local authority, separation of financial statements and audit arrangements and a pension fund specific annual governance statement. There would be a specific delegation that would require a senior officer to lead the function and group the responsibility for all LGPS related activities within one function.

Under this option each host authority would be required to group all LGPS related activities within one discrete organisational unit. Currently, the arrangement of how LGPS activities are managed is determined by individual administering authorities.

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Option Two: There would be a joint committee of two or more administering authorities, delegation of full scheme manager functions and all decision making to a section 102(5) joint committee. Employment of staff and contractual issues would be dealt with through the lead authority or wholly owned company. The ownership of assets would remain unchanged. Consideration could be given to enshrining the structure in legislation in the form of a combined authority.

Under this option, each of the LGPS administering authorities involved would delegate the function of scheme manager in its entirety to a joint committee under Section 102(5) of the Local Government Act 1972 (Part 2 paragraph 5). The joint committee would be responsible for all decisions relating to the management and administration of the scheme including asset allocation, manager selection, administering authority discretions, provision of administration services, appointment of advisors and procurement of related services (e.g. actuarial, legal and custodial).

The constitution of the joint committee would need to be contained in a formal agreement entered into by the authorities. The joint committee as constituted would not be a separate legal entity. Therefore it cannot own assets, have liabilities, raise taxes, enter into contracts or employ staff. The ownership of assets (administering authority) and responsibility for meeting liabilities (employers) would not change. Employment of staff, entering into contracts and other operational matters would be delivered via a lead authority using a Local Government Act 1972 Section 113 agreement or an arrangement under the Goods and Services Act 1970. Alternatively, the authorities could create a jointly owned and controlled company to perform this function.

Option Three: There would be a complete separation of the LGPS pension fund from the host authority with the DCLG or Treasury creating a single purpose pensions body and decision making removed from elected members. This option seeks to remove the potential for conflict of interest between the host authority and the pension fund by removing the fund and placing it in a separate body with its own duties and interests that are solely aligned with those of the beneficiaries.

Elected members of a current host authority may well be on the board of the new body but as employer representatives with no more or less say in the direction of investment policy than any other board member. This option aims to remove any possibility of the host authority from taking decisions on investments which prefer its interests over the interests of the members of the LGPS or other employers in the fund.

KPMG have been appointed by the LGPS Scheme Advisory Board to look into the above three options and come up with findings. KPMG have subsequently been working with various LGPS funds and reported as follows:

Option One: There would need to be a ring fencing of a new S151 officer for the Pension Fund, but this is recognised to be conflicted to the extent that the officer would still be part of the Local Authority. However, this could be managed through clear guidance, investment strategies, and a separate audit opinion for the Pension Fund. To facilitate this, changes to legislation would be needed.

Option Two: With joint committees, the optimal number of funds in a joint committee would need to be ascertained and size becomes an issue. In terms of the investment strategy, how that is ascertained would need to be decided in order to ensure no dictatorship by a dominant fund. However, there are fewer conflicts of interest as the Joint Committee would be separate to that of the participating Local Authorities.

Option Three: With full separation from the Local Authority and the Pension Fund, there would be clear separation and better transparency. This option is very much private sector so corporate practice to an extent would be followed. Further legislation would be needed with additional set-up costs involved.

It is important to note that, as part of their work, KPMG have not been asked to come up with a recommendation and, in the current climate of national asset pooling, there is no timeline in relation to when this is to be brought in.

11) National Asset Pooling

At the time of writing, we are still awaiting a consultation paper and nothing has been formally announced on timeframes. The latest expected timeline is set out below:

Government commissioned and received independent advice from “industry experts” to help set the “common criteria”.	Oct 2015
Consultation paper (and the backstop enforcement regulation) to be published.	Early Nov 2015
Consultation response from all stakeholders (expectation is for 12-week response period).	Early Feb 2016
Draft Regulations to be published.	March 2016
Effective date.	April 2016
Creation of national asset pools (to be phased in over three years).	April 2019
Transition of assets for those funds not meeting the ‘common criteria’.	Unknown

The November 2016 consultation paper will cover:

- Legislative changes circulated in draft to give the Secretary of State increased powers;
- Proposed changes in the investment regulations;
- Acceptable criteria for pooling;
- Back stop measures for recalcitrant schemes.

There are no plans yet to formally consult on the criteria for pooling. It is thought that the criteria for pooling (all asset classes) are likely to be:

- Size (£30bn target);
- Cost Savings;
- Governance;
- Scope to invest in infrastructure.

There will be a further statement in the Chancellor's March 2016 Budget. The Government acknowledges that pooling could take over three years to implement.

Officers will report on the latest developments on national asset pooling at the meeting.

Report of the Strategic Finance Manager

Financial and Performance Report

1. Funding Level

Past Service Position	30 September 2015 £m
Past Service Liabilities	-4,255
Market Value of Assets	3,016
Deficit	-1,239
Funding Level	70.9%

The funding level at the latest formal valuation at 31 March 2013 was 72.3% and as at the end of September 15 it was calculated to be 70.9%, a drop of 4.7% compared to the end of June 2015. The previous quarter saw a decline in bond yields leading to a reduction in the discount rate; from 4.2% to 4.0% as well as a fall in the Fund market value.

This impact is shown in the below table which highlights amongst other factors a £79m increase in liabilities arising from changes to actuarial assumptions.

Quarterly Reconciliation	£m
Deficit at 30 June 2015	**-1,087**
Interest on deficit	-14
Excess return on assets	-73
Change in actuarial assumptions	-79
Contributions less benefits accruing	14
Deficit at 30 September 2015	**-1,239**

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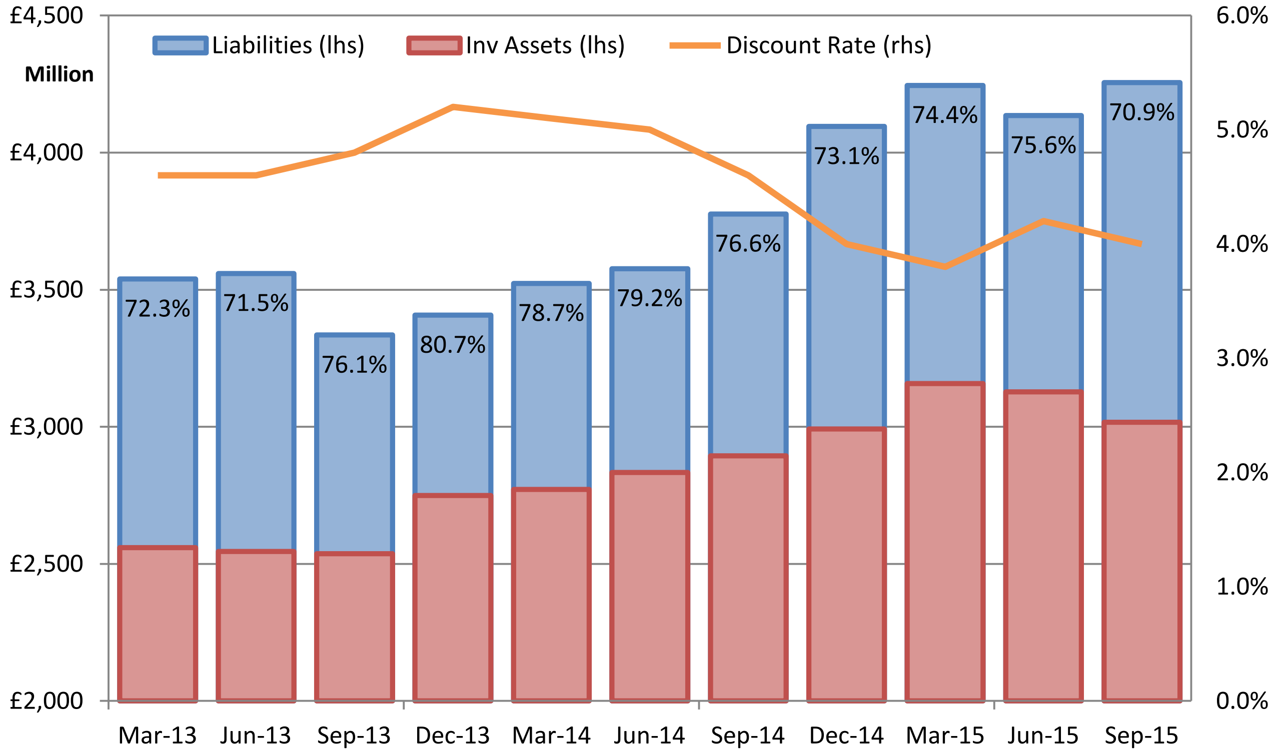
The period since the 2013 actuarial valuation has seen sizable movements in the discount rate, reaching 5.2% in December 2013 which corresponded to the funding level of 80.7%. The below graph sets out the value of liabilities and fund assets and the corresponding funding level along with the discount rate applied for each quarter



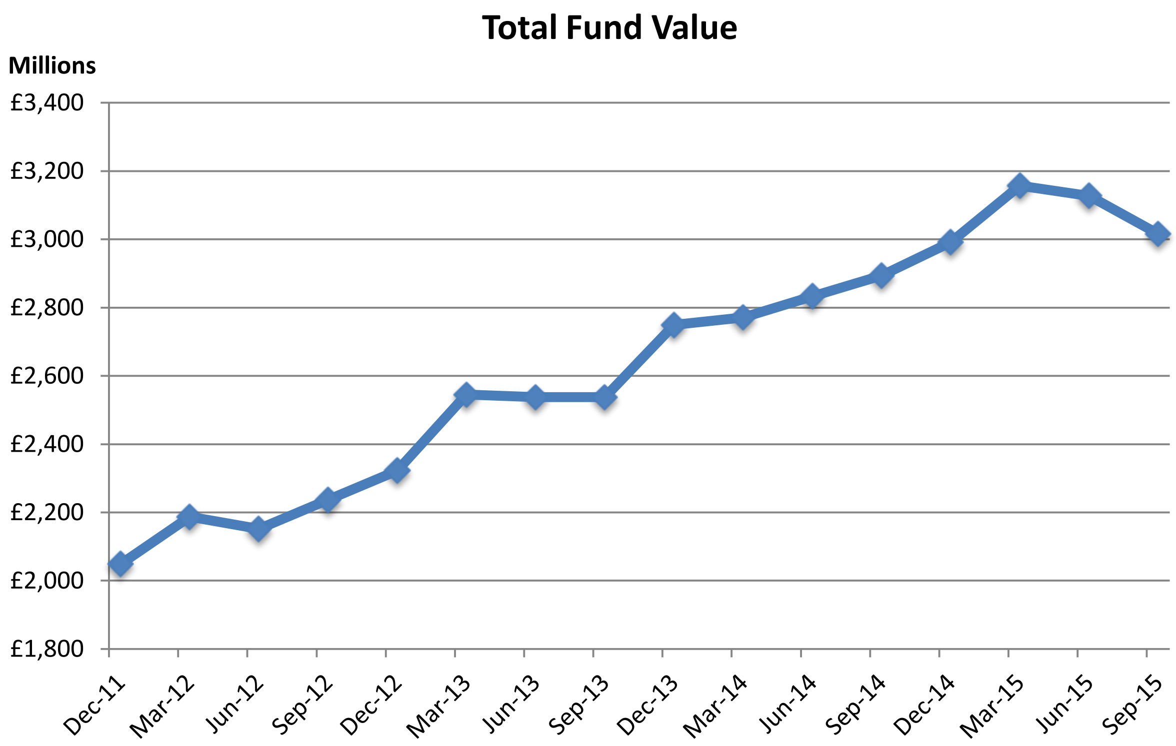
Valuation Period to date Reconciliation	£m
Deficit at 31 March 2013	**-980**
Interest on deficit	-130
Excess return on assets	72
Change in actuarial assumptions	-311
Contributions less benefits accruing	110
Deficit at 30 September 2015	**-1,239**

2. Market Value

The value of the Fund was £3,016.0 at 30 September 2015 compared with £3,127.2m at 30 June 2015. The investment performance for the period was -3.5%. The fund has managed to recover the losses incurred during the quarter in the following month with a market rally bringing the Fund back up to £3,139m on 28 October.

The change in market value is attributed as follows:

	£m
Market Value at 30/06/2015	**3,127.3**
Contributions less benefits and net transfer values	3.0
Investment income received	13.5
Investment expenses incurred	-3.2
Market movements	-124.6
Market Value at 30/09/2015	**3,016.0**
Market Value at 28/10/2015	**3,139.1**



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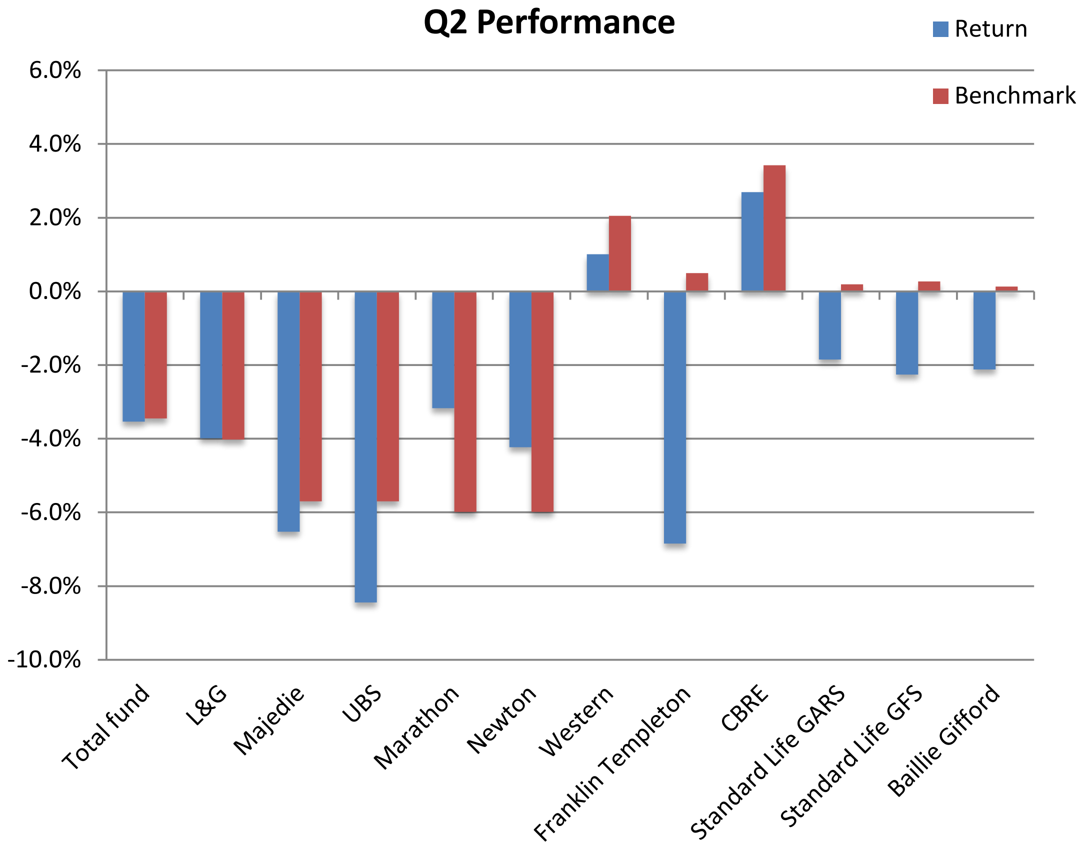
3. Fund Performance

Summary of Quarterly Results (gross of investment fees)

Overall, the Fund returned -3.5% in Q2 2015/16, in comparison with the Fund's customised benchmark of -3.4%.



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

Q2 2015/16 saw a very significant decline in investment market confidence as fears over the underlying causes of China's exchange rate policy shift and collapsing internal stock market led to substantial falls in global equity and commodity prices. The UK equity market benchmark, with a large proportion of the index comprising mining and oil companies suffered a decline of -5.7%, with both UK active managers returning greater losses of -6.5% and -8.4%.

Emerging market assets were hit particularly hard with many reliant on commodity industries and capital flows; with shifting capital flows putting pressure on emerging market currencies. Franklin Templeton's quarterly performance, of -6.9%, was primarily a result of significant detrimental currency movements in Asia and Latin America

The table below shows manager performance for 2015/16 Q2 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Performance %	Benchmark %	Relative %
Total fund	-3.5	-3.4	-0.1
L&G	-4.0	-4.0	0.0
Majedie	-6.5	-5.7	-0.8
UBS	-8.4	-5.7	-2.7
Marathon	-3.2	-6.0	2.8
Newton	-4.2	-6.0	1.8
Western	1.0	2.0	-1.0
Franklin Templeton	-6.9	0.5	-7.4
CBRE	2.7	3.4	-0.7
Standard Life GARS	-1.8	0.2	-2.0
Standard Life GFS	-2.3	0.3	-2.6
Baillie Gifford	-2.1	0.1	-2.2

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

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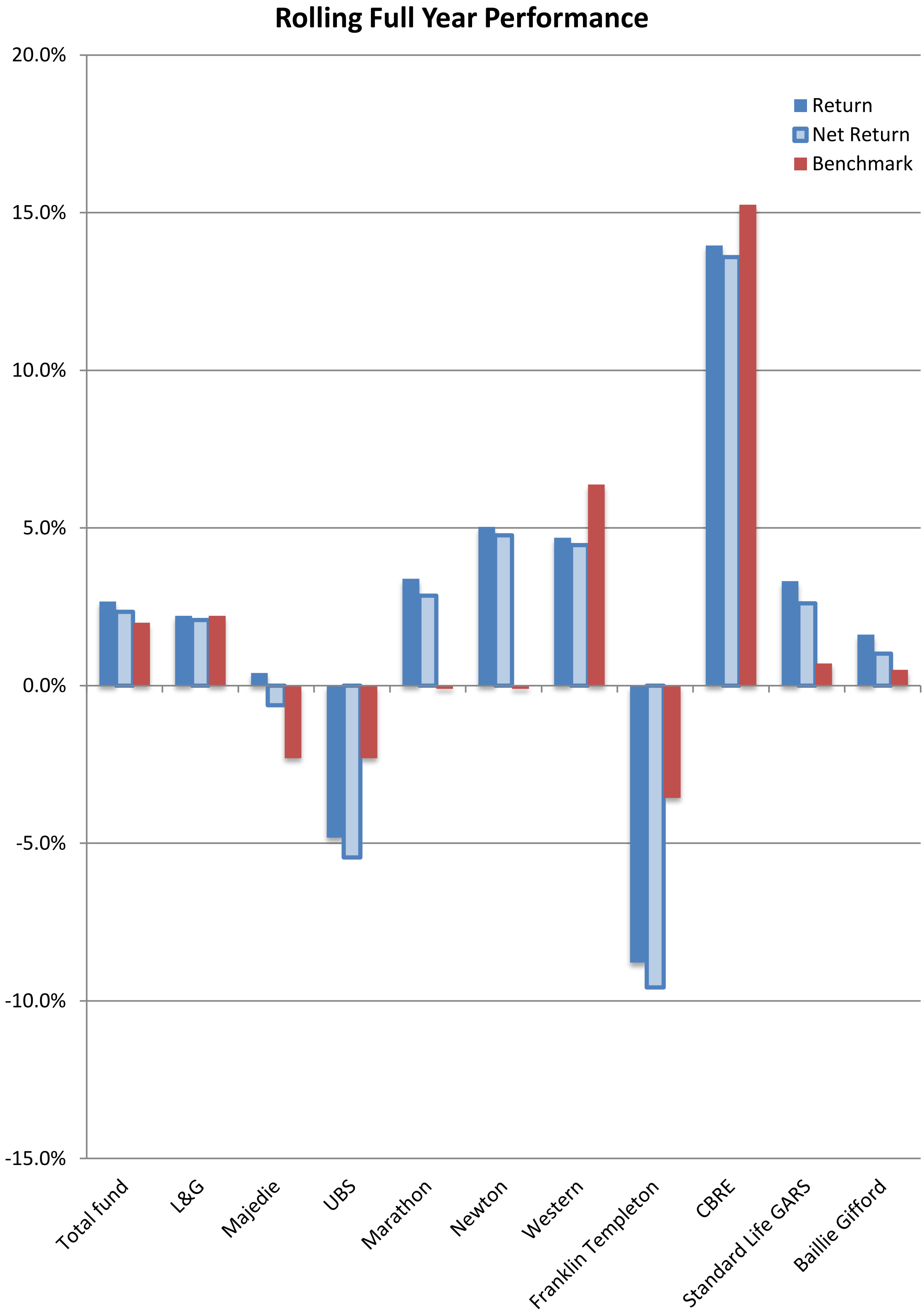
Summary of Full Year Results

During the course of the previous 12 months to 30 September 2015, the Fund returned +2.7% gross of investment fees against the customised benchmark of +2.0%.



Manager	Gross of Fees Performance %	Benchmark %	Relative %	Net of Fees Performance %
Total fund	2.7	2.0	0.7	2.3
L&G	2.2	2.2	0.0	2.1
Majedie	0.4	-2.3	2.7	-0.6
UBS	-4.8	-2.3	-2.5	-5.4
Marathon	3.4	-0.1	3.5	2.8
Newton	5.0	-0.1	5.1	4.8
Western	4.7	6.4	-1.7	4.5
Franklin Templeton	-8.8	-3.6	-5.2	-9.6
CBRE	14.0	15.3	-1.3	13.6
Standard Life GARS	3.3	0.7	2.6	2.6
Baillie Gifford	1.6	0.5	1.1	1.0

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

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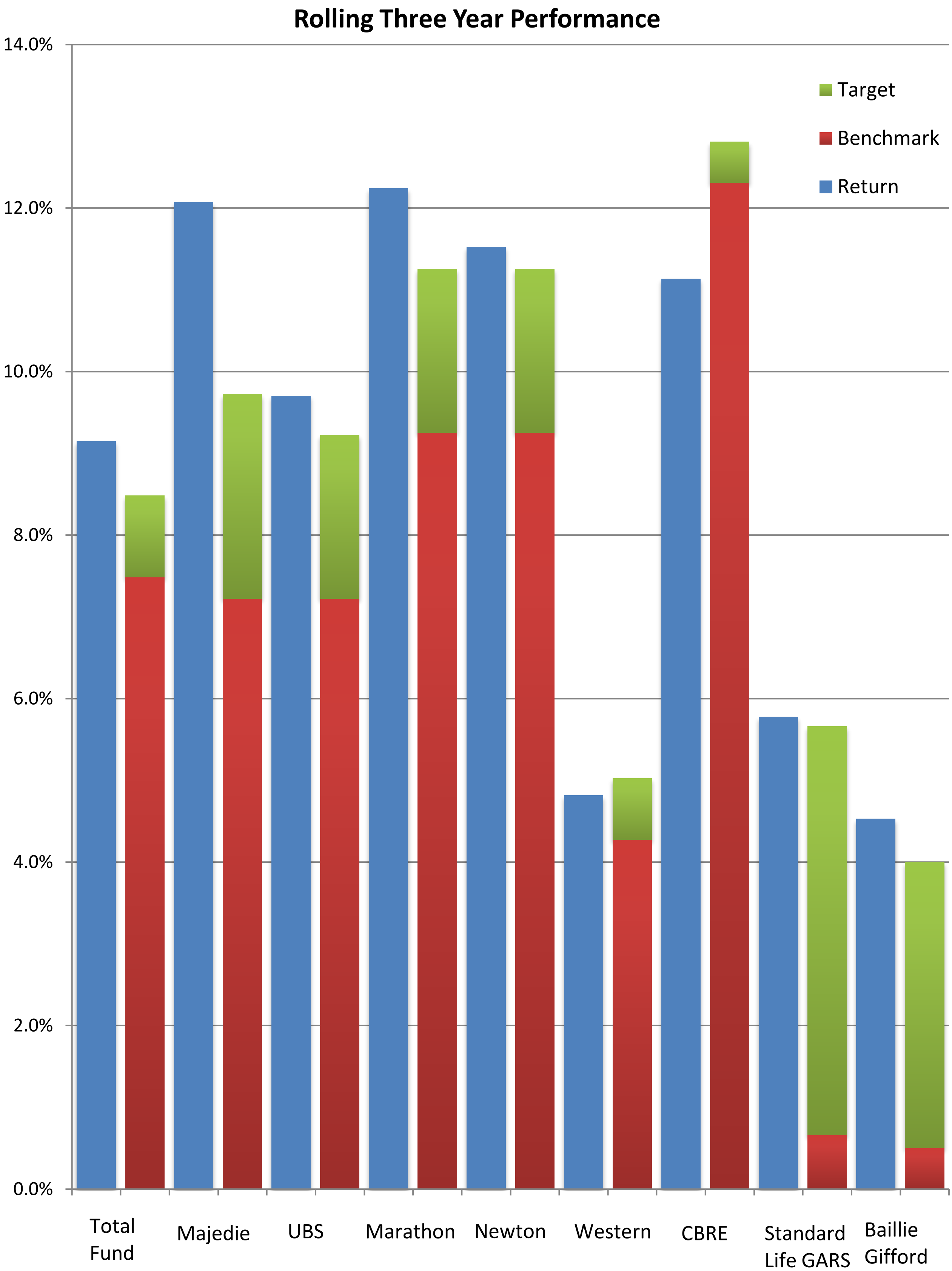
Summary of Rolling Three Year Performance

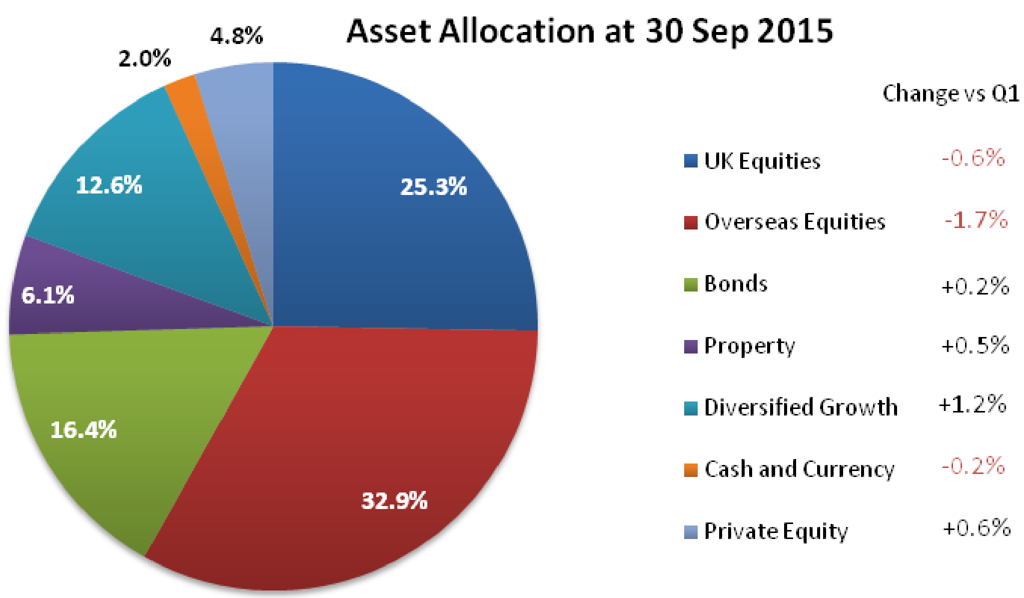


The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target %	Relative %
Total fund	9.1	7.5	8.5	0.7
Majedie	12.1	7.2	9.7	2.3
UBS	9.7	7.2	9.2	0.5
Marathon	12.2	9.3	11.3	1.0
Newton	11.5	9.3	11.3	0.3
Western	4.8	4.3	5.0	-0.2
CBRE	11.1	12.3	12.8	-1.7
Standard Life GARS	5.8	0.7	5.7	0.1
Baillie Gifford	4.5	0.5	4.0	0.5

4. Asset Allocation

The graph and table below summarise the asset allocation of the fund as at the 30 September 2015.



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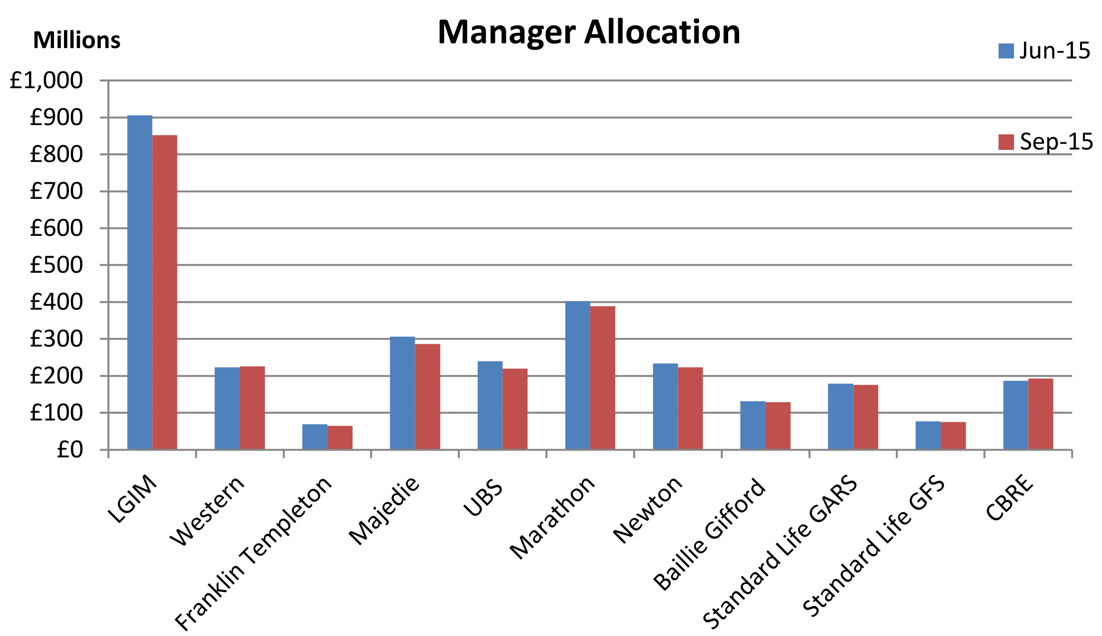
The table below compares the actual asset allocation as at 30 September 2015 against target asset weightings.

	TOTAL FUND	Actual	Target	Last Quarter	
	£m	%	%	£m	%
Fixed Interest					
UK Government	64.5	2.1	2.6	62.8	2.0
UK Non-Government	131.2	4.3	7.1	130.9	4.2
Overseas	74.6	2.5	0.0	75.0	2.4
Total Return	64.2	2.1	2.4	69.0	2.2
Index Linked	159.3	5.3	5.5	155.7	5.0
Equities					
UK	762.1	25.3	27.5	779.7	24.9
Overseas	991.6	32.9	32.3	1,068.6	34.2
Property Unit Trusts	183.6	6.1	6.2	187.4	6.0
Diversified growth	379.7	12.6	11.4	387.4	12.4
Cash	75.7	2.5	0.0	62.1	2.0
Currency hedge	-16.2	-0.5	0.0	5.0	0.1
Private Equity	145.8	4.8	5.0	143.6	4.6
TOTAL	**3,016.1**		**100.0**	**3,127.2**	**100.0**

5. Manager Allocation

The graph below shows the current manager allocation.



6. Fees

The following table shows a breakdown of fees paid during Q2 2015/16

Manager	Market Value 30/09/2015 £m	Manager Fees Q2 £000	Annualised Average Fee
L&G	852.2	166	0.08%
Western	225.4	131	0.23%
Franklin Templeton*	64.2	134	0.83%
Majedie	286.3	763	1.07%
UBS	219.8	145	0.26%
Marathon	388.7	465	0.48%
Newton	222.9	303	0.54%
Baillie Gifford*	128.7	172	0.53%
Standard Life GARS*	175.7	291	0.66%
Standard Life GFS*	75.3	188	1.00%
CBRE**	193.2	0	
Manager Fees Total		**2,758**	**0.28%**
Tax withheld		151	
Other investment expenses***		300	
Total Investment Expenses		**3,209**	

*Estimated, to exclude transaction fees
** Invoiced after end of quarter
*** Primarily transaction costs & property fund expenses

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.

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 Committee Chairman

Annexes:
1. Asset Allocation Policy and Actual as at 30 September 2015 and 27 October 2015
2. Monitoring statement re movements in real yields reference the LDI Strategy

Sources/background papers:
None
