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Notes from Meetings with Fund Managers: 2 February 2016

Hosted by Standard Life

Manager	Attending
Standard Life	Chris Nichols Nigel Cosgrove
CBRE	Ian Gleeson Alex Bignell DJ Dhanajani
Newton	Paul Markham David Moylett
Western	Andrew Belshaw Marian George

Standard Life

1. Met with Chris Nichols and Nigel Cosgrove.

2. Surrey has invested in two DGF mandates with Standard Life: £179m in Global Absolute Return Strategies Fund (GARS) and £78m in Global Focused Strategies Fund (GFS).

3. Both funds are intended to achieve long-term returns significantly above cash with much lower volatility than equities: GARS seeks to beat cash by 5% pa and GFS by 7.5% pa.

4. Success for DGFs is measured as much by their ability to dampen short-term volatility as by the long-term returns they generate. The sharp falls in equity markets in January 2016 therefore provide a test of the effectiveness of the approach.

5. While it is early to make any definitive judgments, GARS and GFS appear to have fared better than most DGFs in January 2016. Global equity market returns are likely to have been worse than -5%. By contrast, GARS will have returned about -2% and GFS will have returned about -1.5%.

6. Although the return was 3.7% in 2015, GARS has achieved its performance target over rolling three and rolling five-year periods (with an annualised return of 6.0% pa). Given the market falls in January 2016, it is likely that the rolling returns to end March 2016, while still positive, will be below the cash +5.0% pa target.

7. GFS was launched two years ago, so has yet to establish a full rolling three-year track record. In 2015 the return was above target at 9.7%.

8. In economic forecasts, they expect modest growth in US and UK economies and a soft landing in China.

9. The key investment views remain cautious on markets, so the scale of directional views (i.e., exposure to equity or bond markets) is well below peak levels.

10. They favour Relative Value positions that are less dependent on market direction. Examples include China consumers versus China manufacturers and US technology versus US small cap.

11. Currency views are usually Relative Value positions. They have been wary of SE Asian currencies relative to USD because of the slowdown in Chinese growth.

12. GARS is approaching £50bn (at end September 2015) with £1bn per month inflow. At some point, the firm will have to consider capacity management measures, but this is more likely to be in fee pricing than closing the fund.

13. Overseas clients pay much more than UK clients (US 1.15% pa, Europe 0.85% pa). There is no suggestion that Standard Life would change the discounted fee level agreed with Surrey, but it is highly unlikely that Standard Life would agree to this being offered to other participants in a collaborative venture.

14. The Multi-Asset Team increased its resources in 2015 from 46 to 60 staff. It has risen further in 2016. None of the key managers has left and additional personnel from Ignis have been integrated.

15. The Ignis team manages a successful global tactical asset allocation (GTAA) overlay for Phoenix. The firm is considering making this available more widely through a new product.

16. **Advisor view: GARS and GFS are both well designed DGF products that are performing well. I have two concerns about GARS in the longer term. The first is that it will eventually grow too big to access attractive opportunities. The second is that competitors will target the key decision makers when building their own DGF teams. There is no evidence that either concern has been relevant in 2015. The continuing strength of the product globally means it will be difficult to achieve fee savings as part of the LGPS collaboration exercise.**

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CBRE

1. Met with Ian Gleeson, Alex Bignell, DJ Dhanajani.

2. The Surrey mandate is valued at £197m and is close to fully invested.

3. Performance of the UK portfolio has been ahead of target over one, three and five years to end December 2015. The overall fund returned 13.0% in 2015 despite the drag associated with running down the legacy European holdings.

4. Undrawn commitments totalled £7m at end December 2015, with £3m expected to be drawn in Q1 2016. This includes drawdowns of the M&G Debt funds that are, at last, finding opportunities on attractive terms.

5. The key issue for this mandate in 2016 is whether the Committee approves the change in mandate to incorporate a 25% allocation to the Global Alpha Fund.

6. There has been no urgency to do this previously because the UK market has been performing strongly. CBRE expect UK returns to be less robust over the next three years, so there is a stronger case for diversifying outside the UK market.

7. Global Alpha is well diversified across the major developed markets with a small allocation to emerging markets (mostly in Chinese retail).

8. It is likely to take up to nine months to invest new cash allocations in the Global Alpha Fund. If the change of mandate requires reallocation from the existing assets, the drawdown period would be extended by up to a further three months.

9. **Advisor view: Property is a cyclical investment opportunity. The UK has performed well and may lag other real estate markets from here. It is sensible to change the mandate.**

Newton

1. Met with David Moylett and Paul Markham.

2. Surrey has £235m invested in a global equity mandate.

3. Performance in 2015 was very strong. The return of +10.5% was 7.2% ahead of benchmark. Relative performance over the rolling three-year was 3.6% pa ahead of benchmark. It has continued to outperform in January 2016.

4. Newton's defensive bias was helpful in 2015 and continues today. The fund remains underweight in emerging markets and commodities (energy and mining).

5. Market behaviour is a concern, with increasingly narrow leadership, particularly in the US. Only 15 of the top 300 companies outperformed in 2015 with 4 stocks dominating: Facebook, Apple, Netflix and Google (the so-called FANG).

6. Valuation has been less important than earnings trend. There is starting to be valuation discrepancies between similar stocks in the US and Europe (for example, in banks).

7. The long-term trend to greater globalisation is under pressure both from growing protectionism and from geographical differences in the cost of capital.

8. The biggest risk to future relative performance would probably be a sustained improvement in economic growth expectations. The fund is defensively biased and is underweight in cyclical sectors, such as mining.

9. In 2015 the Surrey portfolio performed 0.3% better than the average for the global equity team. It has higher exposure to some winners (Alphabet, Altria, Sugi).

10. Other stocks discussed include Suntory (unlisted parent), CA Technologies (rival in mainframes to Microsoft with strong cashflow and good dividend), Glaxo (vulnerable dividend given patent expiries and tight free cashflow), Sun Art Retail (China supermarkets) and Citigroup (is price/book low enough given exposure to EM and bonds?)

11. **Advisor view: A great year for Newton that has boosted their confidence in applying the thematic approach. The global equity process is more focused following the changes implemented by Jeff Munroe three years ago.**

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Western Asset Management

1. Met with Paul Shuttleworth and Marion George.

2. Surrey's UK credit mandate is valued at £159m with a further £121m invested in a new multi asset credit (MAC) mandate.

3. John Harrison met the US based manager of the MAC fund, Chris Orndorff, when he was in London in January. Additional comments on this meeting are shown below.

4. Implementation of the new investment in MAC and transition of the UK mandate to 100% UK credit was delayed by changes to the Irish regulatory regime. This delayed approval of the new MAC fund. The mandate changes were implemented on 21 December 2015.

5. Performance of the UK mandate was below benchmark in 2015. The portfolio was more exposed to credit risk and less to gilts. Performance remains ahead of benchmark over the rolling three years, but has not achieved its performance objective.

6. Credit markets have become very pessimistic, with yield spreads widening significantly. Big falls in commodity prices and concerns about growth in China have weighed heavily on sentiment.

7. January 2016 was the worst ever January for credit relative to gilts. Yield spreads have widened further and now stand at the highest level for any period other than in the 2008/9 financial crisis. This suggests investors are discounting a severe recession.

8. Corporate balance sheets have deteriorated, with higher debt issuance, share buy-backs and increased M&A activity. However, spreads are far higher than realised or expected default rates.

9. Western are expecting lacklustre economic growth in UK and US and a soft landing in China. They believe investor risk aversion has gone too far and that credit spreads are attractive.

10. They have specific concerns about the UK economy for two reasons. Firstly, the risk of Brexit adds to investor uncertainty, given a vote to leave would be perceived very badly by markets. Secondly, the UK economy is overly dependent on housing.

11. The UK credit portfolio has 12% allocated outside the UK. It has a bias away from the higher credit ratings (AAA and AA) in favour of lower credit ratings (BBB and below).

12. **Advisor view: Recent market movements have been difficult for credit managers, given that macroeconomic concerns have dominated security assessment. The changes in the structure of the mandate have also been a slight drag. Western now have a more stable mandate focused on UK credit mandate, so we would not want to see further shortfalls in relative performance from here**.

Western Asset Management: MAC mandate

13. Comment on John Harrison's meeting with Chris Orndorff on 28th January 2016.

14. The investment approach places emphasis on income generation and seeks to avoid persistent biases to individual asset categories. There is no 'neutral' asset allocation and no explicit income target to constrain the process.

15. The three portfolio managers are experienced investors who understand both the benefits and the limitations of risk models.

16. The expected volatility is 5 to 7%, with significant downside protection. The predicted volatility implied by their risk model has been below 5% for most of the period since the fund launch in 2010 and realised volatility has been just over 4%. The managers believe risk models currently understate prospective risk.

17. The portfolio has an income generating core portfolio with relatively low turnover (20% pa). This is supplemented by risk management overlays with higher turnover. Within the risk budget, 40-50bps is allocated to tail risk protection through derivatives.

18. Their biggest fears currently are a China banking crisis or a liquidity squeeze in bond ETFs. Neither is believed to be likely. The duration contribution to risk is higher than previously, but this reflects increased credit quality rather than a view on interest rates – lower quality credits have proportionately less duration risk and proportionately more default risk. They are wary of EM corporates (a value trap) and bank loans (poor liquidity).

19. Overall they perceive the opportunity set for active bond managers to be larger than normal because volatility has been low and is likely to rise.