SURREY COUNTY COUNCIL

SURREY PENSION FUND COMMITTEE

DATE: **13 MAY 2016**

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 a £24m commitment to Capital Dynamics LGPS Collective Private Equity Vehicle.

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 31 March 2016 and 30 April 2016 are shown in Annex 1.
Various	Client meetings	A verbal update from external fund manager meetings held on 5 May 2016 will accompany this item. Minutes from the meetings will be provided on the day of the meeting as Annex 2

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
11 March 2016	Bloomberg	Private equity and venture capital partnership data	List of private equity investments as at 31 December 2016
11 March 2016	Pitchbook	Private equity and venture capital partnership data	List of private equity investments as at 31 December 2016

3) Future Pension Fund Committee Meetings/Pension Fund AGM

The schedule of meetings for 2016 is as follows:

- 13 May 2016: Committee meeting hosted at County Hall.
- 11 July 2016: Extraordinary 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: Pension Fund AGM hosted at County Hall

4) Local Pension Board

The last Local Pension Board meeting was on 9 March 2016. Minutes of this meeting are shown as Annex 3.

The next meeting of the Local Pension Board is scheduled for 4 July 2016.

5) Stock Lending

In the quarter to 31 March 2016, stock lending earned a net income for the Fund of £120k with a value on loan equal to £129m.

6) Internally Managed Cash

The internally managed cash balance of the Fund was £64m as at 31 March 2016. As at 30 April 2016, the cash balance was £63m.

7) 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.

8) Considerations when setting academy contribution rates

As part of the 2016 formal valuation, employers will be categorised into different risk groups to allow appropriate contribution rates to be set that are consistent with the risks that different employer pose to the Fund.

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All academies benefit from a Department for Education (DfE) guarantee. In the event of an academy failing, the guarantee would meet any existing debt unrecovered from the academy due to the Fund. This provides some protection. However, the guarantee is time limited, with about four years remaining, and has a ceiling. We are unaware of any claim being made on this guarantee to date.

The Fund is currently not in favour of a universal pooling of academy contribution rates and funding levels. The reasons for this are as follows:

- Contribution rates will be based on the average experience of all the academies in the pool. In effect, academies with positive member experience will subsidise the academies with poorer experience.
- Accumulated deficits will be difficult to track and apply to each employer, possibly resulting in complications if one academy fails or opts to leave the pool.
- There would be a sharing of the impact of pay awards. This could be a drawback for academies whose pay awards are lower than the average for the pool.
- Outside of a pool, the academy has more control over its pension contributions and can reduce them by exercising discipline in pay awards.

Most academies have joined together to form multi-academy trusts (MATs). Membership of a MAT normally means that a standard set of terms and conditions are employed, including pay awards and sharing of resources and expenses.

In the 2016 valuation, academies within MATs will be offered the opportunity to fully pool contributions and funding levels. The benefits of this approach are as follows:

- Pooling reduces the volatility of contribution rates (for smaller academies in particular) arising because of experience. Small employers will benefit from the protection the pool provides from uncertain and unpredictable events such as pensioner members enjoying unexpectedly and unusually long periods in retirement. Having a single contribution rate across the MAT will provide a significant budgeting and administration benefit, especially as school staff are often shared across sites within the MAT.

- MATs will have a single accounting report. This will provide clear efficiencies in administration for the academies and the Fund. This is likely to be of increased relevance due to the proposed proliferation of school to academy conversions.

- Pooling allows academies in the MAT to share pool risks. In the event of one academy in the MAT failing, the remaining academies in the MAT would share any debt. This provides additional protection for the Fund.

In order for a MAT pool to be created, all academies within the MAT will need to opt in and sign a legally enforceable undertaking committing them to share the risk of academies failing within the MAT pool.

The impact of the improved covenant of MAT pools will have an impact on the Fund's risk categorisation of academies. When setting the contribution rate at the formal valuation, the Fund will take into account whether an academy is a member of a MAT pool or otherwise. In line with the new risk based approach for calculating employer contributions for the 2016 valuation, academies within a MAT pool will be allowed a greater risk tolerance for their contribution rates than academies outside of a MAT pool.

9) Internal Audit - Pension Fund Investments

The internal audit for the pension fund investments was completed in February 2016, with the final report taken to the Audit and Governance Committee in April. The opinion was 'Effective' with no recommendations. A copy of the report is shown as Annex 4.

10) Private Equity Opportunity – Capital Dynamics LGPS Collective Private Equity Vehicle 2016/2017

Capital Dynamics has developed a Collective Private Equity Vehicle specifically designed for LGPS investors (LGPS CPEV) in response to the ongoing quest to reduce investment management fees via collaboration. The vehicle is sterling denominated and provides an opportunity for LGPS investors to gain access to an optimally balanced portfolio of private equity strategies including access restricted opportunities.

The portfolio will be globally diversified with an optimal combination of strategies to mitigate the J-Curve effect. No less than 65% will be invested in primary investments, of which approximately 40% will be in the US, 40% in the EU and 20% in Asia and the Emerging Markets. Up to 20% will be invested in Capital Dynamics own private equity funds with no double layering of fees, (i.e. secondaries and co-investment). Up to a further 15% will be invested in secondaries on an opportunistic basis. The secondary and co-investment proportion of the portfolio will have global diversification.

The portfolio has been designed to minimise risk, whilst preserving attractive target returns of between 12% and 15% net internal rate of return (IRR), (1.5x to 1.8x net multiple of cost). The Capital Dynamics track record over the same strategies (including immature funds in their respective J-curves) is 19.2% net.

LGPS CPEV 2016/2017 will invest 20% of the vehicle in Capital Dynamics's Global Secondaries IV Fund and the Capital Dynamics Mid-Market Direct Fund IV (the current co-investment fund) with no additional layer of fees. The investment period will be two years from the first close of each vehicle.

The discounted management fee of 21.6bps is for LGPS investors who can commit to three annual programmes in advance. Fees will only commence as each Fund commences. Each pooled vehicle is close-ended, with a ten-year life. The performance fee of 7.5%, is payable after all capital invested has been returned to investors in cash plus a compounded 8% hurdle. Once this has been achieved, Limited Partners receive 92.5% of profits and Capital Dynamics receive 7.5%.

12 Capital Dynamics is an independent global private equity and infrastructure asset manager with over 140 staff across ten offices worldwide. They have been investing in private equity for more than 25 years and their senior investment professionals have an average of over 20 years of investing experience and due diligence expertise. Capital Dynamics currently has 16 LGPS clients included in its investor base.

Report of the Strategic Finance Manager

Financial and Performance Report

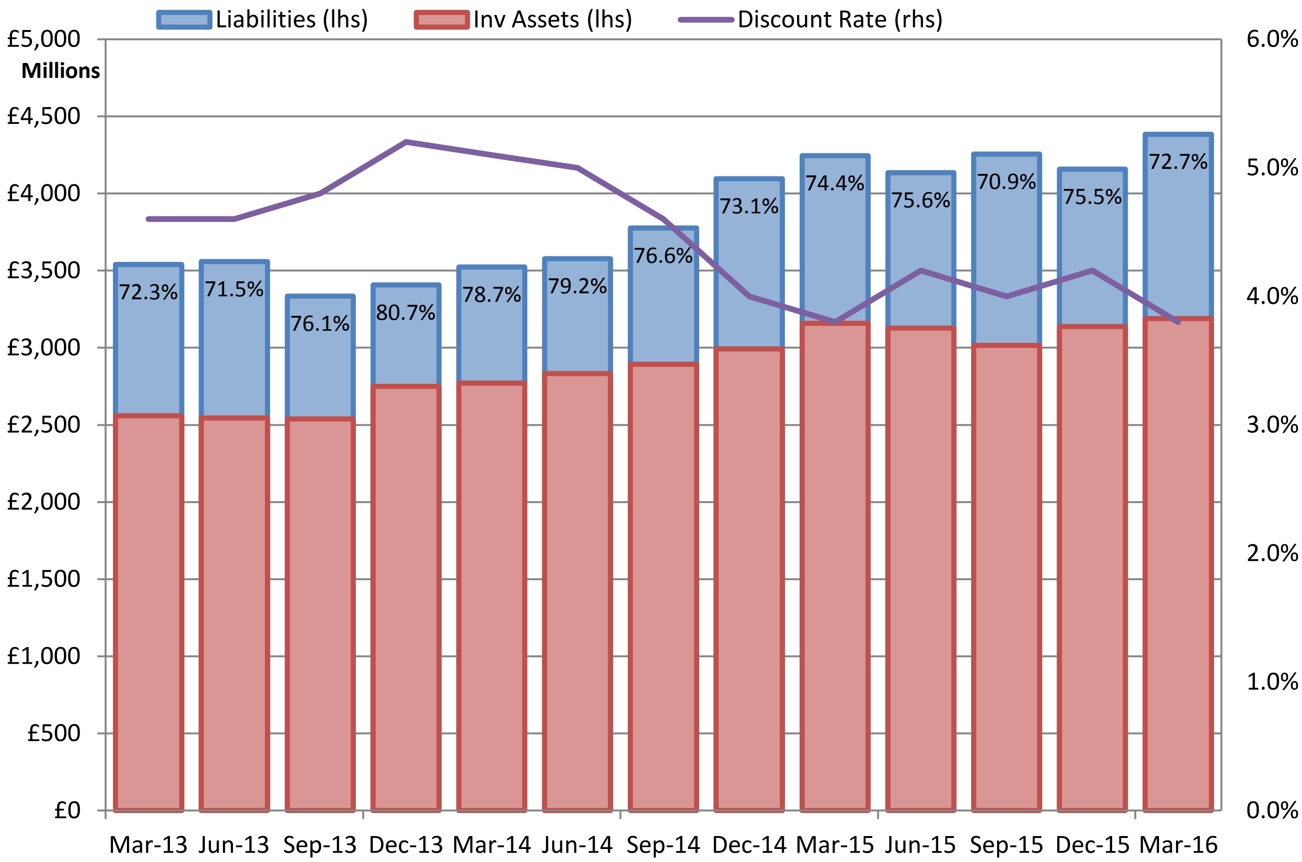
1. Funding Level

Past Service Position	**31 March 2016 £m**
Past Service Liabilities	4,384
Market Value of Assets	3,188
Deficit	1,195
Funding Level	**72.7%**

If this calculation was performed using the valuation assumptions proposed for the 2016 valuation, e.g., a higher asset outperformance assumption of 2.0% rather than 1.6% and reduced salary and inflation assumptions, the result would be a funding level of 79.7% with a deficit of just under £800m.

Quarterly Reconciliation	**£m**
Deficit at 31 December 2015	**-1,019**
Interest on deficit	-14
Excess return on assets	10
Change in actuarial assumptions	-186
Contributions less benefits accruing	14
Deficit at 31 March 2016	**-1,195**

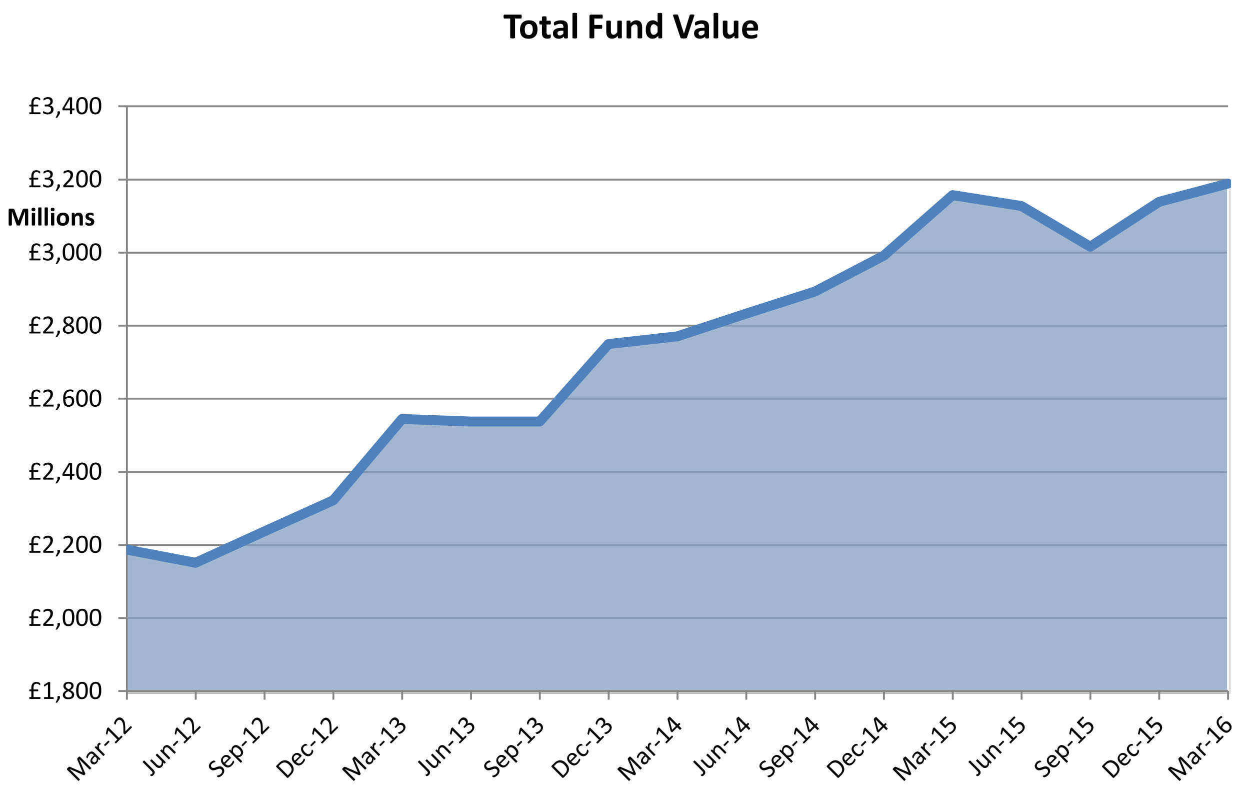
The period since the 2013 actuarial valuation has seen sizable and volatile movements in the funding level. The graph below sets out the value of liabilities and fund assets and the corresponding funding level along with the relevant discount rate applied for each quarter



Valuation Period to date Reconciliation	£m
Deficit at 31 March 2013	**-980**
Interest on deficit	-158
Excess return on assets	162
Change in actuarial assumptions	-357
Contributions less benefits accruing	138
Deficit at 31 March 2016	**-1,195**

2. Market Value

The value of the Fund was £3,188.9 at 31 March 2016 compared with £3,138.4 at 31 December 2015. The investment performance for the period was +1.1%.



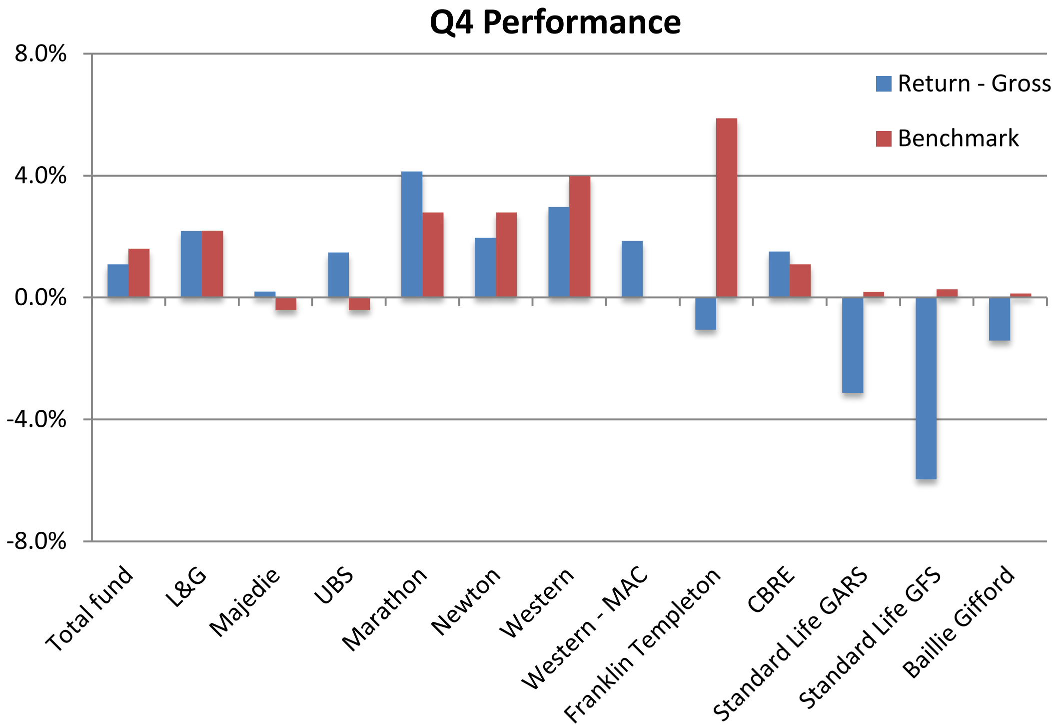
The change in market value is attributed as follows:

Quarterly Market Value Reconciliation	**£m**
Market Value at 31/12/2015	**3,138.4**
Contributions less benefits and net transfer values	14.8
Investment income received	11.0
Investment expenses incurred	-2.7
Market movements	27.4
Market Value at 31/03/2016	**3,188.9**
Market Value at 30/04/2016	**3,190.3**

3. Fund Performance

Summary of Quarterly Results (gross of investment fees)

Overall, the Fund returned +1.1% in Q4 2015/16, in comparison with the Fund's customised benchmark of +1.6%.



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

The final quarter of the financial year saw significant volatility with equity markets falling significantly in the first half of the year arising largely from worrying news flow and economic data from China. This market decline had largely reversed by the end of the quarter following more encouraging economic news from the US, particularly surrounding consumer spending and employment, as well as moves to negative interest rates from the Bank of Japan and the European Central Bank.

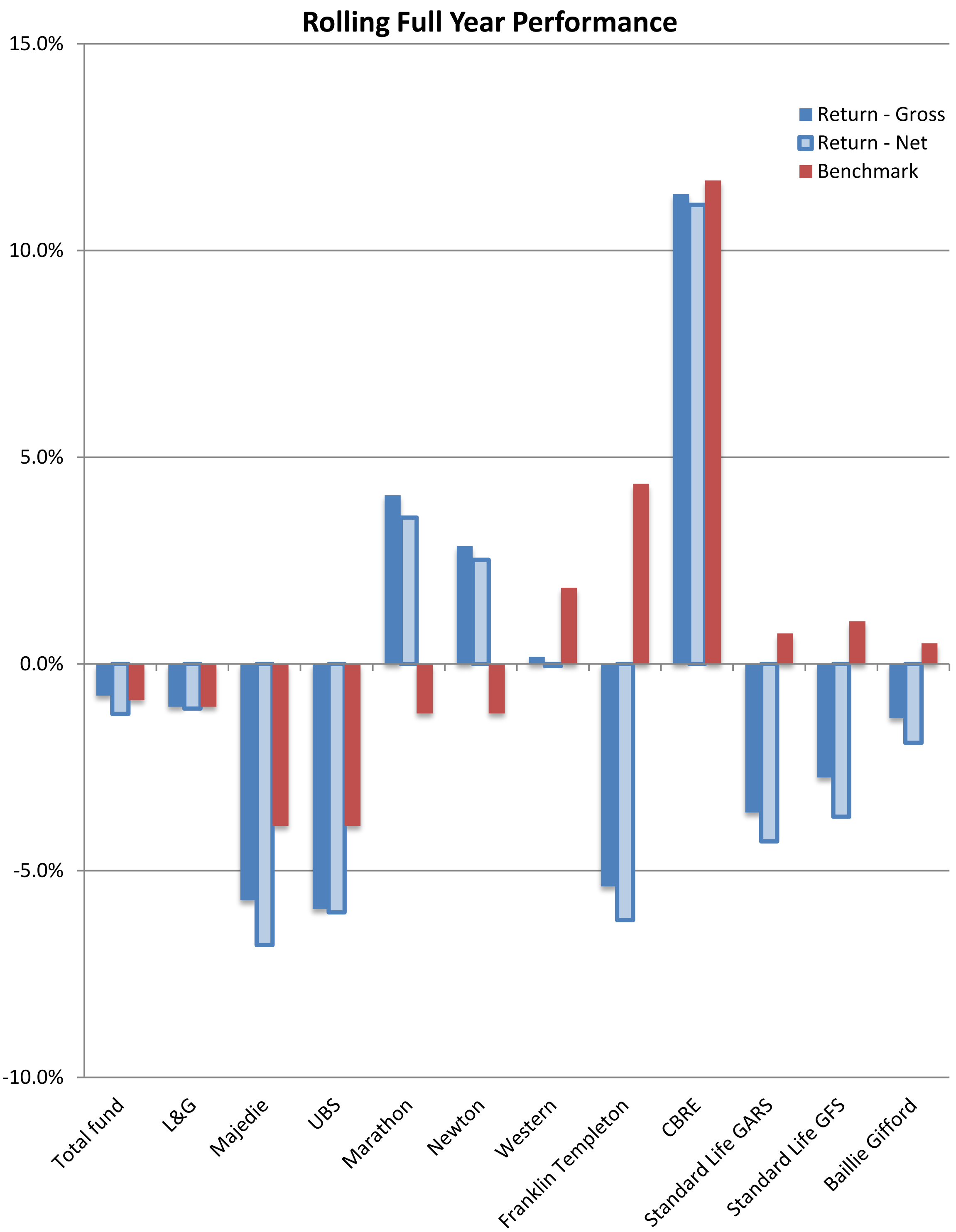
The table below shows manager performance for 2015/16 Q4 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Performance %	Benchmark %	Relative %
Total fund	1.1	1.6	-0.5
L&G	2.2	2.2	0.0
Majedie	0.2	-0.4	0.6
UBS	1.5	-0.4	1.9
Marathon	4.1	2.8	1.3
Newton	2.0	2.8	-0.8
Western	3.0	4.0	-1.0
Western - MAC	1.9	0.0	1.9
Franklin Templeton	-1.1	5.9	-7.0
CBRE	1.5	1.1	0.4
Standard Life GARS	-3.1	0.2	-3.3
Standard Life GFS	-6.0	0.3	-6.3
Baillie Gifford	-1.4	0.1	-1.5

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

Summary of Full Year Results

During the course of the previous 12 months to 31 March 2016, the Fund returned -0.8% gross of investment fees against the customised fund benchmark of -0.9%



Manager	Gross of Fees Performance %	Benchmark %	Performance Relative to Benchmark %	Net of Fees Performance %
Total fund	-0.8%	-0.9%	0.1%	-1.2%
L&G	-1.0%	-1.0%	0.0%	-1.1%
Majedie	-5.7%	-3.9%	-1.8%	-6.8%
UBS	-5.9%	-3.9%	-2.0%	-6.0%
Marathon	4.1%	-1.2%	5.3%	3.5%
Newton	2.8%	-1.2%	4.0%	2.5%
Western	0.2%	1.8%	-1.6%	-0.1%
Franklin Templeton	-5.4%	4.4%	-9.8%	-6.2%
CBRE	11.4%	11.7%	-0.3%	11.1%
Standard Life GARS	-3.6%	0.7%	-4.3%	-4.3%
Standard Life GFS	-2.7%	1.0%	-3.7%	-3.7%
Baillie Gifford	-1.3%	0.5%	-1.8%	-1.9%

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

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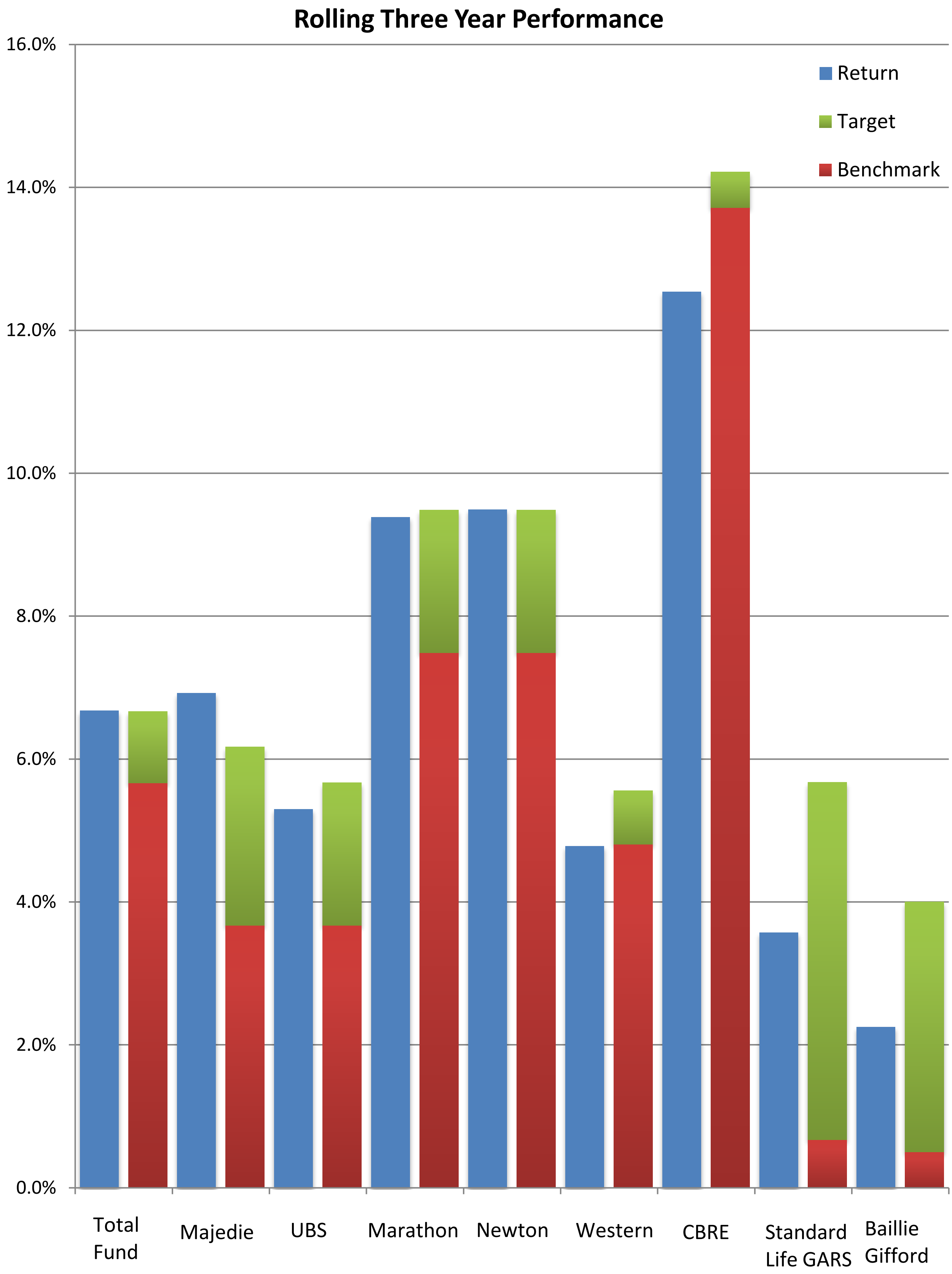
Summary of Rolling Three Year Performance



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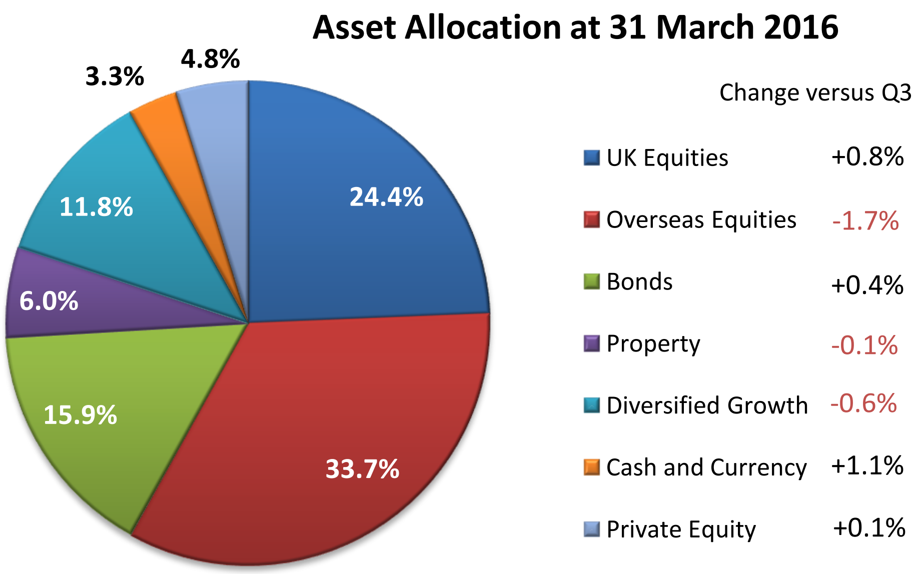
The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target Above Benchmark %	Relative %
Total Fund	6.7	5.7	1.0	0.0
Majedie	6.9	3.7	2.5	0.8
UBS	5.3	3.7	2.0	-0.4
Marathon	9.4	7.5	2.0	-0.1
Newton	9.5	7.5	2.0	0.0
Western	4.8	4.8	0.75	-0.75
CBRE	12.5	13.7	0.5	-1.7
Standard Life GARS	3.6	0.7	5.0	-2.1
Baillie Gifford	2.2	0.5	3.5	-1.8

4. Asset Allocation

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



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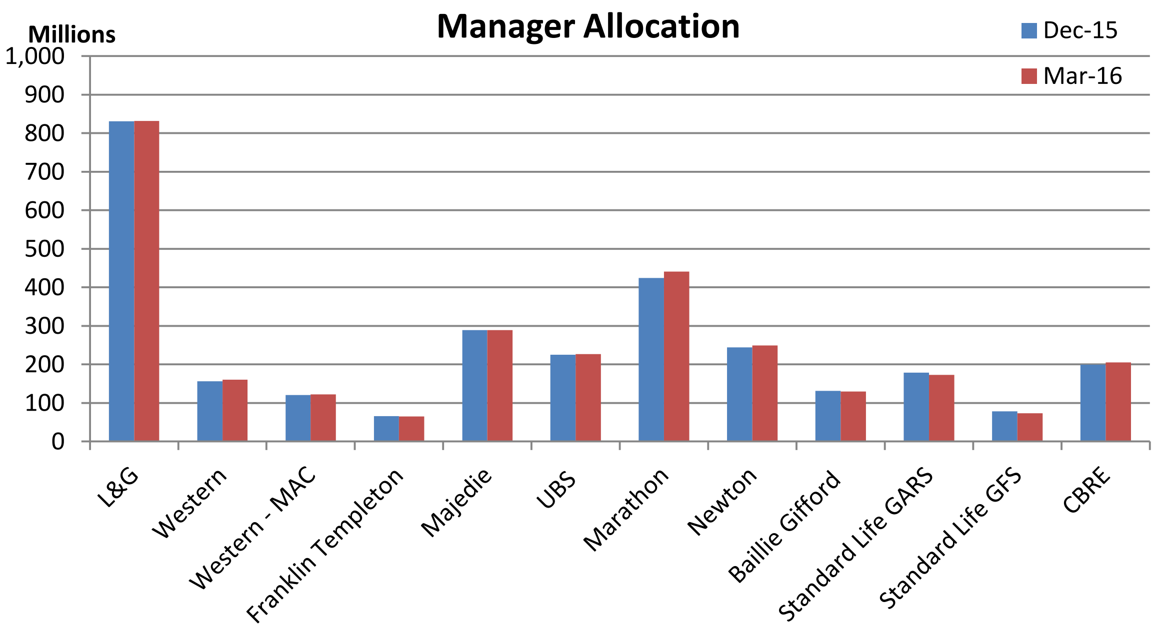
The table below compares the actual asset allocation as at 31 March 2016 against target asset weightings.

	TOTAL FUND	Actual	Target
	£m	**%**	**%**
Bonds			
Multi Asset Credit	120.6	3.8	4.4
Investment Grade Credit	151.3	5.0	5.3
Index Linked Gilts	153.8	5.1	5.5
Unconstrained	66.1	2.0	2.4
Equities			
UK	740.7	24.4	27.5
Overseas	1,109.6	33.7	32.3
Property Unit Trusts	190.6	6.0	6.2
Diversified growth	388.7	11.8	11.4
Cash	86.7	3.5	0.0
Currency hedge	-17.9	-0.2	0.0
Private Equity	148.2	4.8	5.0
TOTAL	**3,138.4**	**100.0**	**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 Q4 2015/16

Manager	Market Value 31/03/2016 £m	Manager Fees Q3 £000	Annualised Average Fee
L&G	831.7	163	0.08%
Western	160.9	125	0.31%
Western - MAC**	122.7	18	0.30%
Franklin Templeton*	65.3	131	0.81%
Majedie	289.5	294	0.41%
UBS	227.3	134	0.24%
Marathon	440.7	473	0.43%
Newton	249.0	162	0.26%
Baillie Gifford*	129.8	173	0.53%
Standard Life GARS*	173.1	289	0.67%
Standard Life GFS*	73.7	179	0.97%
CBRE	205.5	110	0.21%
Manager Fees Total		**2,251**	**0.28%**
Tax withheld		280	
Other investment expenses***		139	
Total Investment Expenses		**2,670**	

* Estimated, to exclude transaction fees
**MAC expense only from mid December.
*** 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 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: Asset Allocation Policy and Actual as at 31 March 2016 and 30 April 2016
Annex 2: Minutes from meetings with fund managers on 05 May 2016
Annex 3: Minutes from the Local Pension Board Meeting held on 9 March 2016.
Annex 4: Pension Fund Investments Internal Audit Report 2016

Sources/background papers:
None