Annex 2

Notes from Meetings with Fund Managers: 5 May 2016

Hosted by Marathon

Manager	Attending
Franklin Templeton	Chris Orr Stuart Lingard
Marathon	Graeme Neuff Lindy du Plessis Bill Arah
UBS	Steve Magill Digby Armstrong
Baillie Gifford	Anthony Dickson James Squires

Notes from Meetings with Fund Managers: 10 May 2016

Manager	Attending
Standard Life	Ross Campbell

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Franklin Templeton: Chris Orr, Stuart Lingard

- It has been a poor last 12 months for performance, with a return of -6.2% net of fees. This means the mandate has now returned -1.0% per annum since inception in February 2013. The benchmark return (Barclays Multiverse in USD) was +4.4% and +0.7% per annum respectively.

- The 10% shortfall relative to benchmark in the last 12 months was largely attributable to currency, which contributed -9.8%. This reflected the fund's positioning long of the US dollar and short of both the Yen and the Euro.

- Franklin Templeton's core views remain intact. They favour the US dollar (+109%) relative to the Yen (-36%) and the Euro (-52%). There have been some changes in positioning in recent weeks, but mainly to adjust the risk allocations. The exposure to South Korean bonds has been retained, but the exposure to the Won has been removed. Similarly, they have hedged out the exposure to the Hungarian Forint. Outside the major currency blocks, the largest currency exposures are to the Mexican Peso (+19%), the Malaysian Ringgit (+18%) and the Brazilian Real (+10%).

- FT's central expectation is that economic growth will be better than the implied market consensus. They believe improving consumer spending and wage pressure will cause US inflation to pick up over the next few months. They also expect the slowdown in China to be a continued soft landing. If growth is worse than consensus or there is a financial crisis in China, the portfolio would continue to perform poorly.

- The fund takes positions that are hugely different from a global credit benchmark. Duration has been largely removed through an interest rate swap in the US, so overall duration is just 0.02 years (versus the benchmark over 6.5 years).

- There is virtually no investment in the major global bonds markets. The US, Japan, UK and Euro bond markets account for well over 80% of global bonds, but the aggregate exposure in this fund is less than 5%, and that is mostly in Portugal. The portfolio instead focuses on a broad range of mainly short dated emerging market bonds, with roughly one third currently below investment grade.

- We discussed liquidity and default risks. Liquidity is monitored carefully, particularly in smaller emerging markets. The only positions which would take more than a day to unwind currently are in Ukraine and Uruguay. Default experience has also been very limited. There have been no defaults since the Ivory Coast some years ago. The only material de-rating was Ukraine following the dispute with Russia.

- The portfolio has a huge yield premium to the benchmark: the yield to maturity is 7.3% versus a benchmark below 1.8%.

- ***Adviser view: We expected Franklin Templeton to take significant views different from the global bond market and, in particular, to have far less reliance on duration to generate returns. Had poor performance been due to a further leg in the sovereign bond bubble, I would say that was to be expected given the mandate we gave FT. However, I am disappointed that a narrow range of currency views have been so influential in the performance achieved in the last 12 months. We did not appoint FT to be just a currency manager. While it may be rational to expect the US dollar to strengthen relative to the QE driven Yen and Euro, I am not comfortable having this as the dominant view, particularly when there are a number of swing factors that FT have little or no insight on, such as the outlook for China or the possibility of a President Trump.***

Marathon: Graeme Neuff, Lindy du Plessis, Bill Arah

- Another cracking period for Marathon, with a return for the 12 months of +3.5% net of fees versus a benchmark of -1.2%. This means the relative performance before fees has been +1.9% per annum over 3 years, +3.2% per annum over 5 years, +3.5% per annum over 10 years and +3.4% per annum since inception.

- The bulk of the discussion was with Bill Arah talking about the outlook in Japan. The Japan equity sleeve has been one of the few areas where Marathon has struggled.

- Bill is an unequivocal bull of Japanese equities in the long term. He believes there is a cultural change well underway in which managements are starting to focus on return generation rather than maintaining employment. Marathon has just appointed Masanaga Kono as an analyst to lead their corporate governance efforts in Japan.

- Bill noted that in every decade since 1945, Japan households have been net sellers of domestic equities, so levels of ownership are extremely low relative to most major markets. Households have cash balances in excess of U$10 trillion, with an equity market valued at just U$4 trillion. Unemployment is also very low at 3.1%, making Japan one of the tightest labour markets in the world.

- The biggest change is in corporate behaviour. Japan companies have historically sought to pay down debt, so leverage is typically very low. The Government is also encouraging businesses to focus on return generation.

- Overall, Bill believes Japan is the only major market in the world with scope both to increase payouts based on current earnings and to increase earnings materially as well.

- ***Adviser view: Marathon continues to impress both in the performance delivered and, more importantly, in the quality of their research output. This remains a core mandate for the Pension Fund.***

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UBS: Steve Magill and Digby Armstrong

- UBS have performed better than expected in the latest quarter but were still well below the index over the year, with a return of -6.0% versus -3.9%. Various 'value indices', such as S&P and MSCI, saw much larger shortfalls, with underperformance of between 5% and 8% over the year. The longer term performance of the UBS mandate is ahead of index over both 3 and 5 years (by about 1.6% per annum) which, again, is in marked contrast with the value indices which have lagged.

- The portfolio is skewed towards cyclical industries (mining, energy, banking) rather than utilities, healthcare and consumer goods on valuation grounds. While consumer stocks have less volatile earnings, valuations are expensive having been driven by falling bond yields. Cyclical industries, by contrast, are having to focus on management actions to improve profitability. Examples include strategic reviews at Anglo American and Barclays.

- We asked about the appointment of a new Head of Dealing at UBS, Lynn Challenger. Our concern was that merging equity trading desks for the traditional and the hedge fund businesses might disadvantage the Value team. They do not expect any change in their dedicated dealing team, but said they would alert us if that were to change.

- We also asked about client flows. The Mercer 'buy' rating has not resulted in any new mandates – mainly because there are very few if any active UK equity mandates available. The largest client (GMPF) has stated it remains committed to the Value product and there have been additional flows in from 2 other LGPS clients as part of rebalancing asset allocation. The Value product currently manages £3.9bn.

- ***Adviser view: The transition from Richard West to Steve Magill has been handled very smoothly as was the previous transition from Mark Powers to Richard West. The new team has performed well in a difficult period for the value style. The team remains committed to the value style and appears to retain the support of the firm. In the longer term, there is a risk that changes in the LGPS will disrupt the viability of the product, but there is no sign of that at present.***

Baillie Gifford: Anthony Dickson and James Squires

- This has been a difficult market environment for DGFs in general, but Baillie Gifford has coped better than many, including Standard Life. The portfolio is a diversified basket of long exposures to markets and active strategies. Unlike GARS or GFS, it does not have net short positions other than in major sovereign bonds. It therefore is expected to deliver negative returns when 'risk assets' generally perform poorly as they have in the last 12 months.

- The return in the year to 31 March 2016 was -1.9% net of fees, which is clearly well below the target of 3.5% per annum ahead of cash (or 4.0% for the year). A fairer assessment is over the rolling 5-year period, where the return has been +4.4% per annum net of fees. For the Surrey Fund, the return achieved since inception in May 2012 is +4.9% per annum net of fees versus a benchmark of +4.0% per annum.

- In the last 12 months, the detractors have been listed equities and related asset types, such as high yield, private equity and commodities. Other diversifiers, such as insurance linked, infrastructure and property were positive contributors.

- BG's central expectation is for decent growth, especially as the lagged benefits of lower oil prices and easy monetary policy continue to feed through.

- They are expecting a pickup in US inflation and have taken out a new position on US break-even inflation. The other new position taken is in Greek bonds where they expect a better outcome from creditor negotiations than is currently priced into markets.

- The existing DGF portfolio is closed to new investors, but a new fund is being launched with a slightly narrower range of asset classes (for example, it will not invest in insurance linked) and a lower fee.

- ***Adviser view: BG has done a good job in a volatile and unhelpful market environment.***

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Standard Life: Ross Campbell

- SL cited many themes dominating the first quarter: concerns on Chinese economic growth, a weak commodity sector, low oil prices and the possibility of rising stress in the credit markets. That resulted in market volatility and global equities and other risky assets started the year poorly. From the middle of February, riskier assets rebounded somewhat as US data proved more resilient and less likely to slide into a recessionary environment.

- SL saw Government bonds have a good quarter. Despite generally expensive valuations, safe haven sovereign bonds posted positive returns. The strong performance was driven by increased demand from safe haven seeking investors, amid waning investor risk appetite.

- SL regards the following as its best strategies in the quarter: US relative interest rates, US real versus US nominal, Australian Duration and US Large Cap versus Small Cap. Conversely, the following strategies detracted from performance: Short US Duration, US Equity, Banks versus Consumer Staples, US dollar versus Singapore Dollar & Euro, Japanese & European Equity, and US Equity Tech versus Small Cap.

- GARS performance was negative because the market's behaviour in the early part 2016 was consistent with an outlook that was very different from SL's central case. The market feared recession, but SL's view of the global economy is more progressive. SL cites that GARS is taking longer term views rather than trying to chase the vagaries of market sentiment.

- SL expects the global economy to continue to expand, but at a fairly unimpressive rate. It expects the US to slow compared with last year, but not by as much as recent market moves appear to discount. In Europe, the economy has been surprisingly resilient over the past year. And it expects China to continue to slow. It sees a number of world economies that are undergoing structural change, including China, where the authorities are trying to manage a move towards a more consumer-oriented economy and Australia where the focus is on reducing the dependence on the resources sector.

- SL says that GARS is currently positioned to reflect the above views. For example, the long equity positions are focused on Europe and Japan, where valuations are lower and there is more scope for an earnings surprise. Both of these underperformed over Q1 despite a rebound in equity markets since mid February. The banking sector suffered losses on the back of subdued confidence in global markets. In addition, receding expectations of further increases in the US interest rates and worsening credit market conditions also weighed on the banking stocks in the US and Europe. Consequently, the GARS strategy of US Equity Banks versus Consumer Staples relative value strategy contributed negatively.

- SL points to the key element of GARS portfolio construction involving the testing of resilience to a variety of extreme scenarios that could potentially disrupt markets globally. Currently, managers interpret market behaviour as increased fear of an imminent global downturn, being very similar to one of the scenarios tested; that of a severe slowdown in the Chinese economy. In this respect, the SL points to the portfolio performing as expected. SL points to the extensive scenario testing in gaining assurance that the portfolio will retain sufficient diversity to weather periods of turmoil.

- Broad market themes were similar for the GFS portfolio and some of the impacts from GARS apply to GFS. Other detractors specifically for GFS included the UK equity House Builders versus Retailers: this was one of the best performers in 2015 and SL still has confidence on a longer term view. However in Q1, the spectre of the Brexit vote was enough to spook foreign investors and house builders sold off. Another specific strategy was the Japanese Capital Equity strategy whereby the portfolio is looking to benefit from a renewed drive at corporate governance, which is encouraging buy backs from cash rich companies benefitting underlying shareholders. This was dented in Q1 as a strengthening Yen was unhelpful.

- ***Adviser view: I am reluctant to draw too many conclusions from one poor quarter or year, especially for a product that has consistently achieved its return target in the longer term. Having said that, the performance of both GARS and GFS in Q1 is disappointing given they are designed to be resilient in difficult market environments. Investors have two concerns about GARS. The first is whether the loss of key investors to other firms in recent years has undermined the team's investment flair. The second is whether the enormous size of the GARS capabilities will constrain the team's ability to find enough investment opportunities. This quarter has done nothing to allay these fears. The structural resilience of GARS comes from having a broad range (30 or so) of investment positions that are well diversified. In Q1 some of these positions were more correlated than expected as well as being detractors, notably in sector relative value (a bigger component of GFS than GARS). I think it would be wrong to take action based on one poor quarter, but we will need to keep a closer eye on Standard Life in the year ahead.***

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