

SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: 11 NOVEMBER 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. Consider if there are any reviews as to the compliance of particular cases, projects or process that the Local Pension Board should undertake.
3. Approve a £20m commitment to the Darwin Property Fund II.
4. Approve the outlined Border to Coast project implementation methodology, the proposed resourcing and member oversight through the creation of three implementation sub groups, and the next stage budgetary commitment of £300k to enable the project to progress.

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 2016 and 27 October 2016 are shown in Annex 1.
Various	Client meetings	Minutes from external fund manager meetings held on 9 November to be tabled at the Pension Committee meeting.

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
07/07/2016	Proxy Insight	Information concerning the share voting records of the Fund	List of all votes cast by the Fund from April 2015 – May 2016.
06/09/2016	Individual	Information relating to the pension contributions made by Surrey County Council to the Pension Fund	A table of the amounts paid by Surrey to the Fund over a 5 year period.

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

The schedule of meetings for 2016 is as follows:

- 11 November 2016: Committee meeting hosted at County Hall
- 18 November 2016: Pension Fund AGM hosted at County Hall
- 10 February 2017: Committee meeting hosted at County Hall
- 2 June 2017: Committee meeting hosted at County Hall
- 8 September 2017: Committee meeting hosted at County Hall
- 10 November 2017: Committee meeting hosted at County Hall
- 17 November 2017: Pension Fund AGM hosted at County Hall

4) **Local Pension Board**

The last Local Pension Board meeting was on 19 October 2016. Included in the meeting was the approval for the inaugural Local Pension Board Annual Report (shown as Annex 2).

The Pensions Committee is asked to consider if there are any reviews as to the compliance of particular cases, projects or process that it would request that the Local Pension Board undertake.

The next meeting of the Local Pension Board is scheduled for March 2017.

5) **Stock Lending**

In the quarter to 30 September 2016, stock lending earned a net income for the Fund of £63k.

6) **Internally Managed Cash**

The internally managed cash balance of the Fund was £73m as at 30 September 2016. As at 27 October 2016, the cash balance was £77m.

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) Actuarial Update

The process of data transfer to the Fund's actuary for the triennial actuarial valuation as at 31 March 2016 is now complete. Officers have received an initial actuarial report that assessed the funding level at 31 March 2016 at 82.5%, up from 72.3% at 31 March 2013.

This is based on assets of £3.21bn and liabilities of £3.89bn and assumptions provisionally agreed as follows:

- Discount rate: 4.2%
- Salary increases: 2.4%
- Pension increases: 2.1%

The actuary will make a presentation of his initial findings at the Committee meeting on 11 November 2016. The actuary will also attend the Pension Fund Annual Meeting on 18 November 2016 with more detail on the background to the assumptions as set out above.

The Pension Fund and Treasury Manager has been in regular contact with the Surrey Treasurers Association to keep them apprised of progress. A meeting for the Surrey District and Borough Councils and Police Authority was hosted at County Hall on 4 November 2016 with the actuary in attendance.

The Pension Fund and Treasury Manager will officially report on the final actuarial results and report at the Pension Committee meeting of 10 February 2017.

9) Movement of assets from Marathon to Majedie and LGIM

An update will be provided at the meeting.

10) Investment Opportunity: Darwin Property Fund II

The Darwin Leisure Property Fund was established in 2008 and was the first fund of its kind to invest in the UK holiday park market.

Darwin identified that the UK holiday park market provided opportunities to generate long-term and stable investment returns for pension funds. Darwin acquires under-performing holiday parks and utilises management expertise, improved business models and economies of scale to increase the returns generated by each park in the portfolio. Where appropriate, planning opportunities are exploited to change the focus of park income, with many parks being completely redeveloped in order to generate significantly higher income streams.

The Fund aims to produce a total net return to investors of 8% to 12% per annum, and has generated an annualised three-year performance return of 11.2% as at 30 September 2016. Surrey Pension Fund's investment of £20m in 2013 has increased in value by 36.8% to £27.3m.

The Darwin Leisure Property Fund has now reached its optimum size and in order to protect the interests of existing investors, is subject to a soft close and is not accepting any new investments.

As still the only fund in this sector, Darwin has seen considerable demand from investors for a further fund as the market still offers untapped potential due to its highly fragmented nature. The Darwin Leisure Property Fund owns 19 parks out of 4,000 and the top four operators, including Darwin, still only control about 8% of the market by number. Consequently, Darwin is now launching a second fund, the Darwin Leisure Development Fund.

This new fund will follow a similar operating model to the Darwin Leisure Property Fund with two differences. Firstly, it will focus on parks with potential for redevelopment and sites which have planning permission that have not yet been implemented. Secondly, unlike the Darwin Leisure Property Fund, this fund will utilise modest gearing at a level of around 20% to help finance acquisitions and redevelopment.

The Darwin team has developed considerable expertise in identifying suitable acquisitions, managing complex redevelopment projects and operating a successful holiday park portfolio and this same team will be responsible for investment, acquisitions, developments and operational management of the new fund.

The Darwin Leisure Development Fund has a target return of 10 to 14%, net of charges, with capital growth rather than income as the main driver of return. The annual management charge is 0.75% for investments with a minimum 10-year lock-in and 0.85% for those without a lock-in. There are significant fee incentives for any investments made before 31 March 2017, with the annual management charges reduced to 0.50% and 0.60% respectively. The annual management charged is based on net asset value, rather than gross. The target size for the fund is £300m, at which point a soft close would also be implemented.

Subject to clarification and checking, the new investment opportunity is expected to be rated as an A by Mercer.

It is recommended that the Surrey Pension Fund make a £20m commitment to the Darwin Property Fund.

11) Border to Coast Pool: Update

The Border to Coast ambition is to establish a fully regulated asset management company that is ready to accept the transition of assets, as required by government. The working timeline is for completion by 1 April 2018.

Project Stages

Implementation of the BCPP asset pooling project is split into four stages:

Stage 1: Establishment of the founding partners and submission of the initial proposal to DCLG in February 2016. Now complete.

Stage 2: Confirmation by the founding partners of their intention to join BCPP and submission of the detailed proposal (including resource requirements, regulated operating model and governance structures) to DCLG in July 2016. Now complete.

Stage 3: Formal confirmation by each Partner Fund to join BCPP and creation of the BCPP Asset Management Company as a separate FCA regulated legal entity, which is ready to receive assets by 1 April 2018. It is proposed this be split into two phases.

The first phase will be from now until January 2017 with the finalisation of a detailed project plan, approval of the next stage budget (£300k per Partner Fund), set up of shell company, and drafting, evaluation and award of tenders for all required advisory services. All Partner Funds should secure Full Council approval to proceed with the creation of the Joint Committee and the acquisition of a partnership shareholding which will include finalisation of the detailed articles of association, shareholder reserved matters. The Member Steering Group will also appoint the senior company executives and non-executive directors.

The second phase will be from January 2017 to April 2018 with the election of a Chair to the Joint Committee, the sourcing of premises, acquisition and installation of asset servicing (depository, custodian, etc.), procurement of ICT systems, attainment of FCA registration (including completion of all procedures and policies), finalisation of the investment sub-group offering (to include tax and transition work), and the implementation of the full personnel structure, TUPE staff transfer and recruitment to vacant posts, etc.

Stage 4: Formal creation of the company and receipt of all required FCA approvals scheduled for April 2018 onwards. Transition of assets from the partner funds into the asset management company. Bedding down will include continual review of member oversight and governance frameworks through the Joint Committee and investment monitoring.

Member Sub Groups

The Member Steering Group approved the immediate creation of three member sub groups set out below.

- 1) Operating Model Sub Group: Oversight of the setup of the Operating Model, asset servicing and ICT systems sourcing and implementation, FCA compliance, and asset structuring.
- 2) People Sub Group: Oversight of all activities relating to setting senior executive remuneration and conditions, TUPE transfer of existing staff and recruitment of the senior company officers, and the securing of suitable premises.
- 3) Governance and Monitoring Sub Group: Oversight of all activities relating to the governance and monitoring model that will be required to enable the funds to hold the BCPP asset management company to account. This work stream also includes coordinating the final approvals through the individual partner funds governance structures to approve the creation of the Joint Committee and final commitment by each Partner Fund to the acquisition of an equal voting shareholding in BCPP (including the associated reserved matters).

The sub group set up will provide for appropriate partner fund member oversight of the project throughout the set up stage of the project. Additionally, it overcomes the practicalities of twelve partner funds meeting to the frequency that will be required to oversee a project of this scale and ensure delivery to the demanding timelines that are being set by government.

Dedicated Resourcing

The implementation management continues to be resourced and coordinated by partner fund officers, but dedicated time will be identified for the officers undertaking this work on a part time basis. Time will be reimbursed to the funds on the basis of basic pay plus employee oncosts (NI and pension).

The dedicated resourcing proposed is:

Fiona Miller (Cumbria): Implementation coordination manager

Steve Halford (Cumbria): Project management support

Mark Lyon (East Riding) and Jo Ray (Lincolnshire): Operating model work stream

Nick Orton (Durham) and Ian Bainbridge (Tyne & Wear): People work stream and executive search and remuneration work

David Hayward (Tyne & Wear), Phil Triggs (Surrey) and Nick Orton (Durham): Governance and monitoring work stream leads in consultation with the S151 officers of the 12 administering authorities.

The creation of these sub groups will allow for operational member oversight and alleviate the need for the full Member Steering Group to meet more than every three months. Strategic oversight and direction will remain within the full Member Steering Group. At each full meeting of the Member Steering Group, any matters requiring support by all partner funds will be addressed and, once a decision is reached, then implementation of that outcome will be delegated to officers within that work stream with member support and oversight being provided the by sub group.

Establishment of a Company and Joint Committee

The establishment of a BCPP shell company for the asset management aspect will enable BCPP to become a contracting entity. In order to advance this, it will require approval through each Fund's internal governance structures (full council) for the creation of a joint committee and acquisition of a shareholding in the BCPP asset management company. The committee process and timelines by which this will be established have yet to be agreed and formalised.

The Member Steering Group has agreed to progress through their individual funds appropriate authority (from full council via a change in constitution) to establish governance structures and secure commitment to the next delivery phase in the forming of an asset management company and a joint committee.

Tender Process for Appointment of Advisors

Work is currently being undertaken for the setting up and running of the asset management company and the process required to monitor and govern the company once it is established via the joint committee. Due to the conflict of interest between the functioning of a company shareholder board and a joint committee, two separate legal firms will be appointed to advise on each via a tender process.

One firm will advise on behalf of the asset management company (investment company setup and asset/tax structuring), whilst the second will be a joint procurement for all the individual partner funds with expertise required in local government governance arrangements (setting up and running of a joint committee, ownership and governance of a Teckal company, and contracts between the funds and BCPP).

Budget Approval

The move forward will require the further commitment of £300k per Fund as set out in the pooling submission to Government by Border to Coast dated 15 July 2016 (shown as Annex 3). This sum is on top of the £50k previously agreed by the committee. Commitments by each administering authority in the Border to Coast pool are equal amongst the twelve administering authorities.

New Investment Regulations

The Local Government Pension Scheme (Management and Investment of Funds) regulations 2016 (SI 2016 No 946) came into force on 1 November 2016. However, an annulment Early Day Motion was tabled in the House against these regulations but no resolution was passed for the matter to be debated. Despite the Early Day Motion, and the remote possibility of a successful annulment debate, these regulations came into force on 1 November 2016.

Any action taken under them from 1 November 2016 will be lawful and will remain so up to the date of any successful annulment debate. Successful annulment debates are very rare but, in that unlikely event, the Government will need to decide what action to take in terms of reintroducing the regulations. Officers will update members at the meeting.

Administering authorities will need to have regard to best practice, government guidance and the potential provision for the Secretary of State to intervene in the investment function, although seemingly not in an investment pool itself. Members of the Committee were previously advised that the creation of Financial Conduct Authority (FCA) registered entities would result in only approved persons being qualified to engage in manager selection. This continues to be the case that the Border to Coast entity will consist of an FCA approved operator and FCA approved Authorised Contractual Scheme. However, it should be noted that other proposed pooling solutions adopted by England and Wales pools have not necessarily chosen this route and approaches vary. The outcome of the Government's assessment process is still forthcoming as to the satisfaction of the Government's original criteria and the best fit of all the solutions presented.

Further Meeting with the Minister

The final submission also detailed the legal and governance frameworks that BCPP intends to implement in order to pool and meet the criteria as set by government, and the anticipated resources required in setting up and running the entity. These proposals are currently being evaluated by government and a meeting between Border to Coast representatives and the minister, Marcus Jones MP, will take place on 16 November 2016. Cllr Le Gal and Sheila Little in their capacities as Chairman and S151 officer respectively, will represent Surrey and Border to Coast at this meeting.

With the Regulations already laid, once ministerial support is received, all funds will be required to progress and legally commit to a pooling arrangement, or face the possibility of intervention.

In order to ensure the project can progress at the required pace if approval is received, members are requested to approve the outlined implementation methodology, the proposed resourcing and member oversight through the creation of three implementation sub groups. Members are also asked to approve the next stage budgetary commitment of £300k to enable the project to progress.

12) Investment Strategy Statement (ISS)

The new Investment Regulations will dispense with the current, explicit limits on specified types of investment and, instead, charge administering authorities with determining the appropriate mix of investments for their funds. In exchange for more freedom in the formulation of investment strategies is an obligation upon administering authorities to adhere to official guidance and the imposition of broad powers allowing the Government to intervene if they do not.

Administering authorities until 1 April 2017 to publish their first Investment Strategy Statement (ISS) in accordance with the new rules. Work is already underway in the drafting of this document. The Regulations oblige each administering authority to formulate an investment strategy, having first obtained suitable advice and consulted appropriately. The strategy will have to include:

- a requirement to invest in a wide variety of investments (the Regulations' definition of an 'investment' is broad but explicit reference to derivatives, thereby removing an ambiguity which had prevailed for some time;
- an assessment of the suitability of particular investments and investment types (it must also state the maximum proportion of its fund that it will invest in particular investments or investment classes);
- the authority's attitude to risk, and how it will be assessed and managed;
- its approach to investment pooling;

- how it takes account of social, environmental and corporate governance factors;
- its policy on exercising voting and other rights attached to investments.

An administering authority will have to publish the first such ISS by 1 April 2017, and maintain it with reviews taking place at least triennially. A draft statement will be brought to the committee on 10 February 2017.

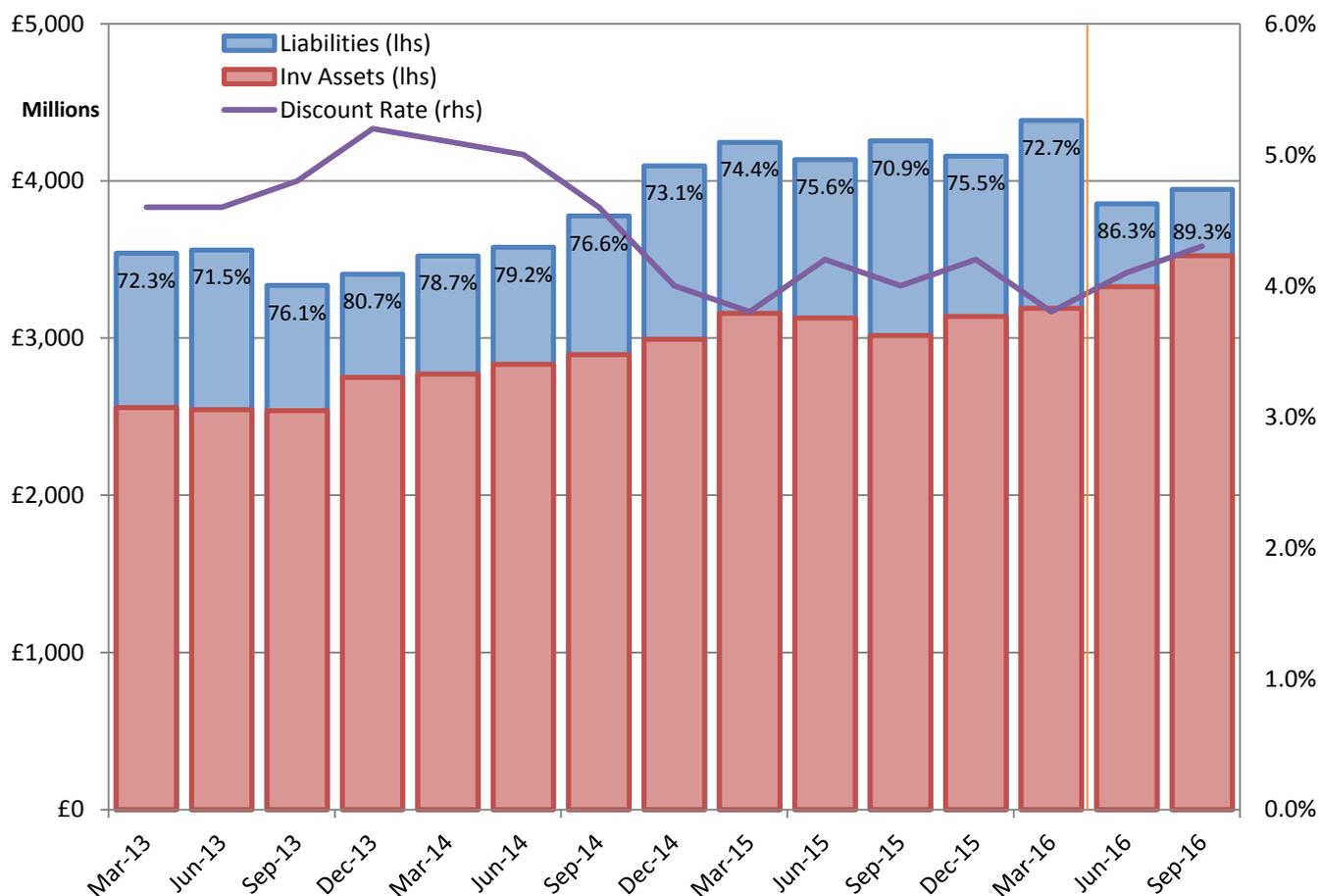
Report of the Strategic Finance Manager

Financial and Performance Report

1. Funding Level

Past Service Position	30 September 2016 £m
Past Service Liabilities	-3,946
Market Value of Assets	3,524
Deficit	-422
Funding Level	89.3%

Quarterly Reconciliation	£m
Deficit at 31 March 2016*	-527
Interest on deficit	-15
Excess return on assets	153
Change in actuarial assumptions	-47
Contributions less benefits accruing	14
Deficit at 30 June 2016	-422

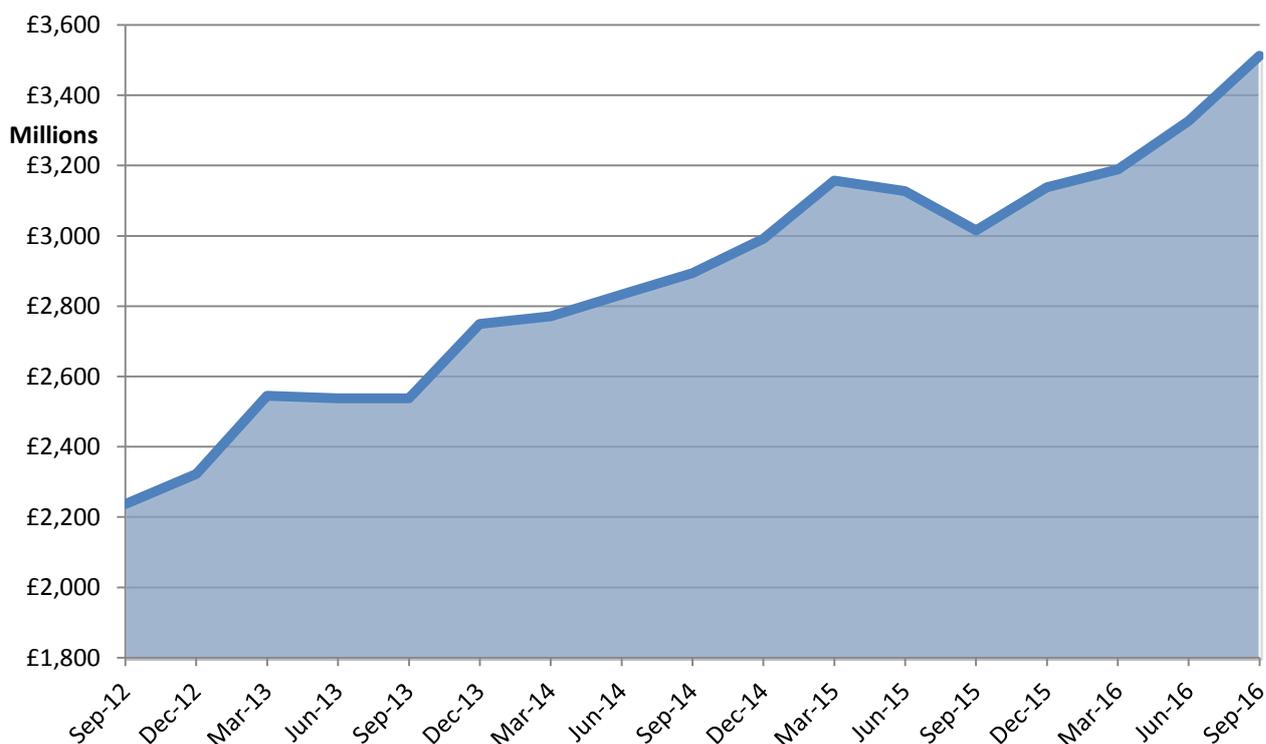


Valuation Period to date Reconciliation	£m
Deficit at 31 March 2013	-980
Interest on deficit	-187
Excess return on assets	412
Change in actuarial assumptions	166
Contributions less benefits accruing	167
Deficit at 30 June 2016	-422

2. Market Value

The value of the Fund was £3,523.7 at 30 September 2016 compared with £3,327.0 at 30 June 2016. The investment performance for the period was +6.3%.

Total Fund Value



The change in market value is attributed as follows:

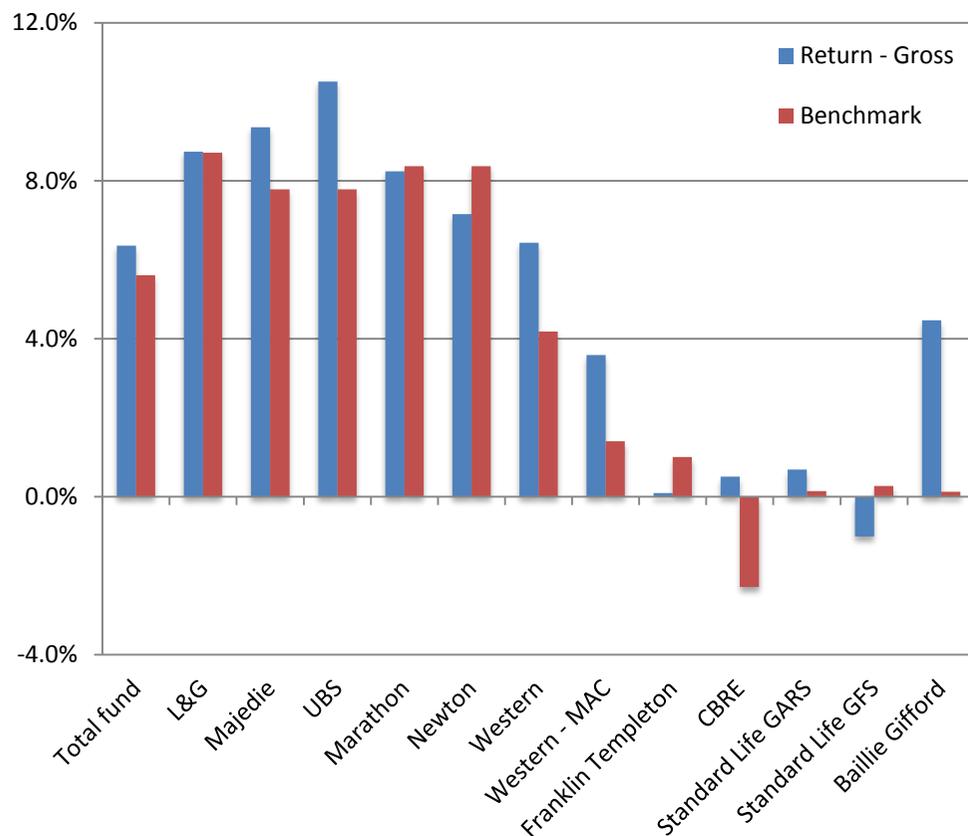
Quarterly Market Value Reconciliation	£m
Market Value at 30/06/2016	3,327.0
Contributions less benefits and net transfer values	12.4
Investment income received	14.3
Investment expenses incurred	-2.9
Market movements	172.9
Market Value at 30/09/2016	3,523.7
Market Value at 27/10/2016	3,593.2

3. Fund Performance - Summary of Quarterly Results (gross of investment fees)

Overall, the Fund returned +6.3% in Q2 2016/17, in comparison with the Fund's customised benchmark of +5.6%.

The table below shows manager performance for 2016/17 Q2 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Q2 Performance

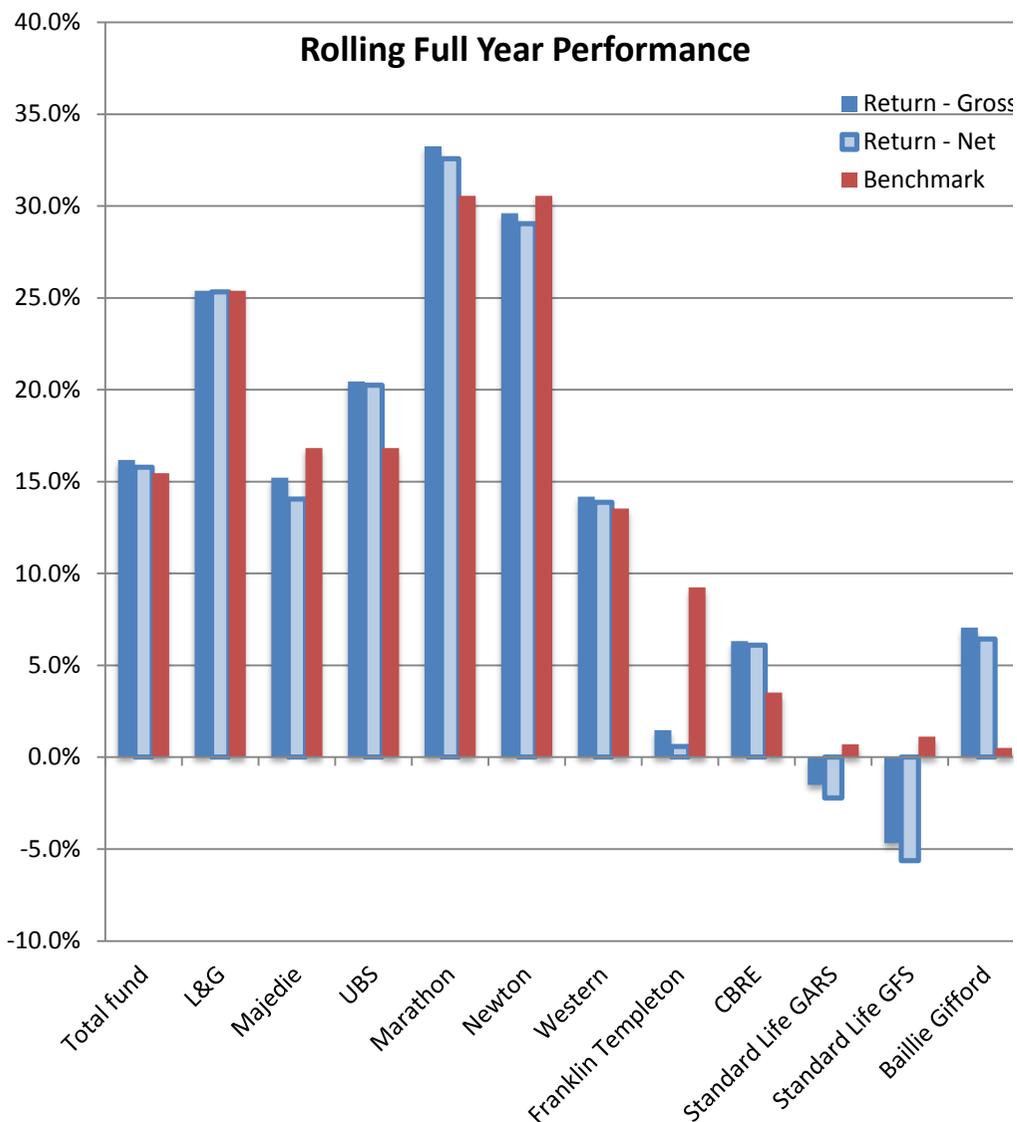


Manager	Gross of Fees Performance %	Benchmark %	Gross Performance Relative to Benchmark %
Total fund	6.3	5.6	0.7
L&G	8.7	8.7	0.0
Majedie	9.3	7.8	1.5
UBS	10.5	7.8	2.7
Marathon	8.2	8.4	-0.2
Newton	7.1	8.4	-1.3
Western	6.4	4.2	2.2
Western - MAC	3.6	1.4	2.2
Franklin Templeton	0.1	1.0	-0.9
CBRE	0.5	-2.3	2.8
Standard Life GARS	0.7	0.1	0.6
Standard Life GFS	-1.0	0.3	-1.3
Baillie Gifford	4.5	0.1	4.4

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

Summary of Full Year Investment Results (Gross and net of fees)

During the course of the previous 12 months to 30 September 2016, the Fund returned +15.8% net of investment fees against the customised fund benchmark of +15.3%.



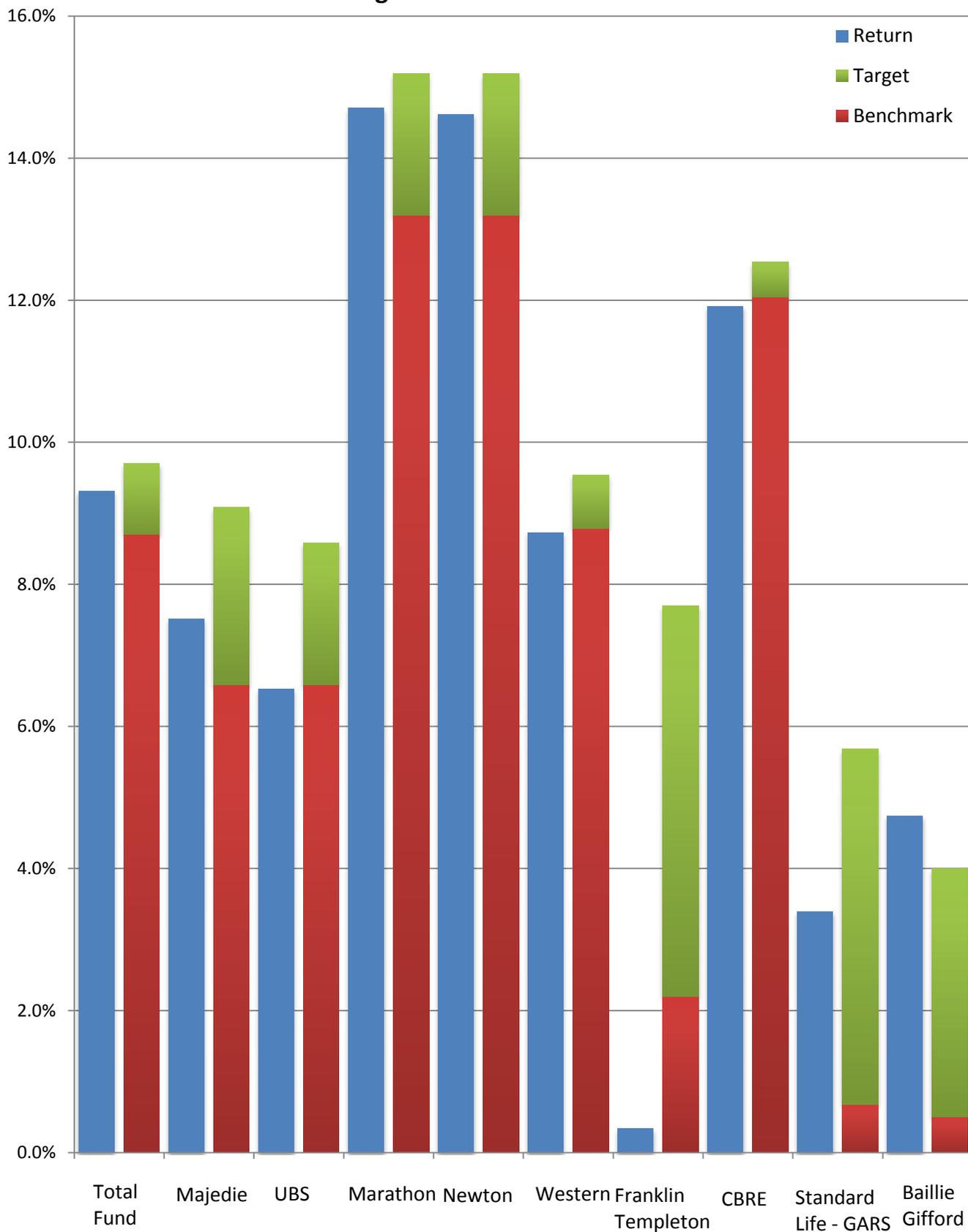
The table below shows manager performance for 2016/17 Q2 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Net of Fees Performance %	Benchmark %	Net Performance Relative to Benchmark %	Gross of Fees Performance %
Total fund	15.8	15.3	0.5	16.2
L&G	25.3	25.4	-0.1	25.4
Majedie	14.1	16.8	-2.7	15.2
UBS	20.3	16.8	3.5	20.4
Marathon	32.6	30.6	2.0	33.2
Newton	29.0	30.6	-1.6	29.6
Western	13.9	13.5	0.4	14.2
Franklin Templeton	0.6	9.2	-8.6	1.5
CBRE	6.1	3.5	2.6	6.3
Standard Life GARS	-2.2	0.7	-2.9	-1.5
Standard Life GFS	-5.6	1.1	-6.7	-4.7
Baillie Gifford	6.4	0.5	5.9	7.0

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 (3year TBC)

Rolling Three Year Performance

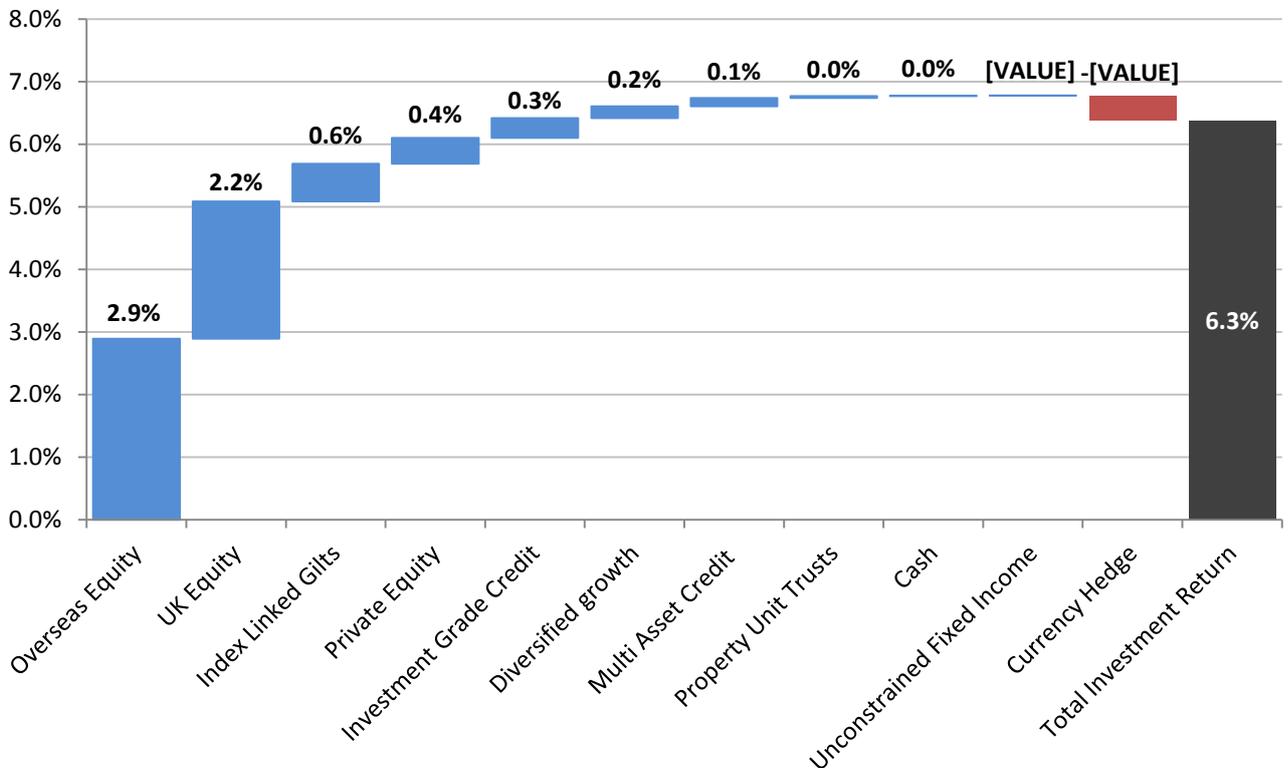


The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target Above Benchmark %	Relative to target %
Total Fund	9.3	8.7	9.7	-0.4
Majedie	7.5	6.6	9.1	-1.6
UBS	6.5	6.6	8.6	-2.1
Marathon	14.7	13.2	15.2	-0.5
Newton	14.6	13.2	15.2	-0.6
Western	8.7	8.8	9.5	-0.8
Franklin Templeton*	0.3	2.2	8.3	-8.0
CBRE	11.9	12.0	12.5	-0.6
Standard Life GARS	3.4	0.7	5.7	-2.3
Baillie Gifford	4.7	0.5	4.0	0.7

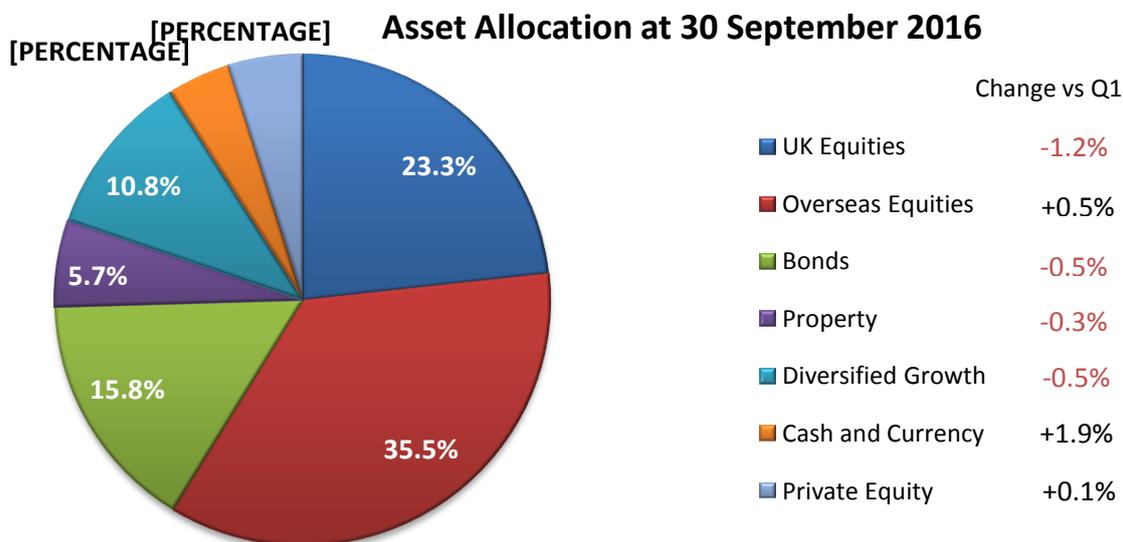
Quarterly Investment Attribution

The below chart sets out the overall investment return attributable to the whole fund from each asset class during Q2 2016/17. The significant fall in the value of sterling following the referendum led to the loss on the currency hedge having a large impact upon the investment performance for the quarter.



4. Asset Allocation

The graph and table below summarise the asset allocation of the fund as at 30 September 2016.

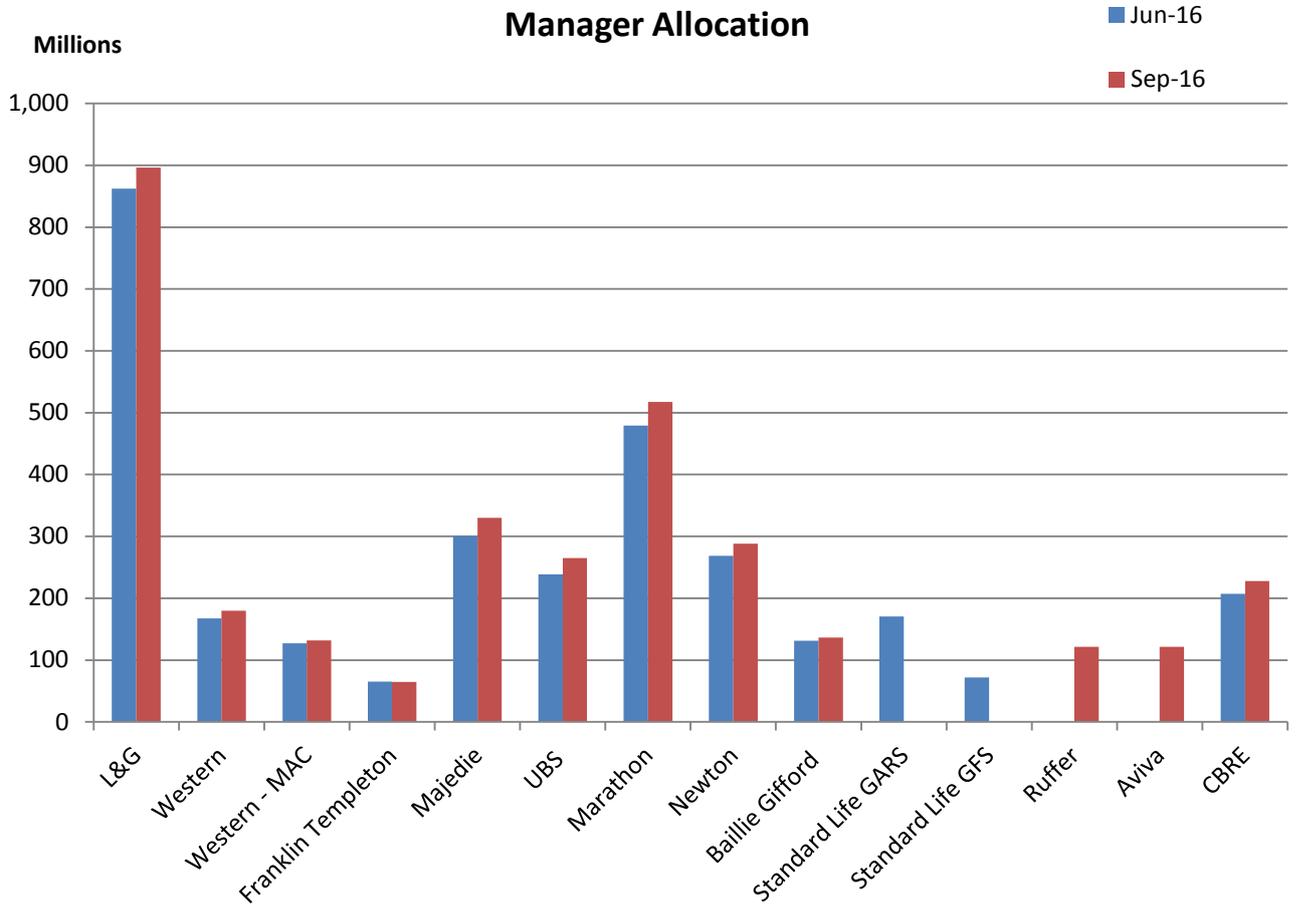


The table below compares the actual asset allocation as at 30 September 2016 against target asset weightings.

	TOTAL FUND	Actual	Target
	£m	%	%
Bonds			
Multi Asset Credit	131.7	3.7	4.4
Investment Grade Credit	175.3	5.0	5.3
Index Linked Gilts	184.7	5.2	5.5
Unconstrained	64.5	1.8	2.4
Equities			
UK	819.6	23.3	27.5
Overseas	1,250.9	35.5	32.3
Property Unit Trusts	201.1	5.7	6.2
Diversified growth	379.2	10.8	11.4
Cash	145.8	4.2	0.0
Currency hedge	1.5	0.0	0.0
Private Equity	169.4	4.8	5.0
TOTAL	3,523.7	100.0	100.0

5. Manager Allocation

The graph below shows the manager allocation as at the 30 September and 30 June 2016.



6. Fees

The following table shows a breakdown of fees paid during Q2 2016/17

Manager	Market Value 30/09/2016 £m	Manager Fees Q2 £000	Annualised Average Fee
L&G	896.1	32	0.01
Western	179.6	102	0.23
Western - MAC*	131.7	115	0.35
Franklin Templeton*	64.5	83	0.51
Majedie	329.9	332	0.40
UBS	264.7	162	0.24
Marathon	517.3	504	0.39
Newton*	288.2	176	0.24
Baillie Gifford*	136.3	212	0.62
Standard Life GARS*	0.0	281	0.66
Standard Life GFS*	0.0	162	0.90
Ruffer	121.4	n/a	n/a
Aviva	121.4	n/a	n/a
CBRE	227.7	110	0.19
Manager Fees Total		2,272	0.26
Tax withheld		175	
Other investment and administration expenses**		736	
Total Management Expenses		3,183	

* Estimated, to exclude transaction fees

** Primarily transaction costs, property fund expenses and administration 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. With regard to investment pooling the S151 officer will continue to work closely with other officers to ensure effective governance and assurance of administering authority responsibilities under any new pooled arrangements.

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 30 September 2016 and 27 October 2016

Annex 2: 2015/16 Annual Report of the Local Pension Board

Annex 3: Funding requirement within BCPP pooling submission for the next stage.

Sources/background papers:

None

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