SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: **10 FEBRUARY 2017**

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 a £15m commitment to Hg Capital 8 Fund

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
All	Possible Rebalancing	The asset allocation is within the Fund's policy control limits. The asset allocations at 31 December 2016 and 26 January 2017 are shown in Annex 1.
Various	Client meetings	Minutes from external fund manager meetings (Annex 2) held on 6 February 2017 will be tabled at the Pension Fund 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
05/10/2016	Pitchbook	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q1 2016/17
05/10/2016	Preqin	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q1 2016/17
16/12/2016	Bloomberg	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q2 2016/17
16/12/2016	Peimedia	Information concerning the private equity investments of the pension fund	An investment summary of active private equity partnerships as at end of Q2 2016/17

3) Future Pension Fund Committee Meetings/Pension Fund AGM

The schedule of meetings for 2016 is as follows:

- 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 most recent Local Pension Board meeting was on 25 January 2017.

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

The next meeting of the Local Pension Board is scheduled for 15 March 2017.

5) Stock Lending

In the quarter to 31 December 2017, stock lending earned a net income for the Fund of £63k.

6) Internally Managed Cash

The internally managed cash balance of the Fund was £98m as at 31 December 2016. As at 27 January 2017, the cash balance was £99m.

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) 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) Private Equity Opportunity: Hg Capital 8 Fund (2017 Vintage)

Hg Capital is currently in the market with its eighth Northern European, mid-market Fund, known as Hg Capital 8. Hg Capital 8 will reach its hard cap of £2.5bn in its second and final closing in February 2017 (representing the fastest fund raising in Hg Capital's history). The fund is three times over-subscribed in terms of overall investor demand. Hg Capital 8 held a first closing in December 2016 on commitments of circa £1.9bn, with investors committing to the fund including the BBC Pension Fund, Goldman Sachs, Allianz, the University of Cambridge and California State Teachers.

Hg Capital is a blue chip and well established sector-focused European private equity house, having completed 125 investments since 1990. Since 2000, it has delivered a 2.5 x cost and 37% gross IRR across investments in its current sectors: TMT, Services and Industrials. Hg Capital's aim is to generate at least 2.0 x net across market cycles, as demonstrated through its 2001, 2002 and 2006 Funds. Its 2009 and 2013 vintage Funds are also on track to deliver comparable returns. The Surrey Fund has current private equity capital invested in Hg Capital Funds 3 (2001), 4 (2002), 5 (2006), 6 (2009) and 7 (2013).

Hg Capital targets this performance through a consistent and well-defined investment strategy, investing behind distinctive business model characteristics across sub-sectors it knows well and over a period of many years. Examples of sub-sectors that Hg Capital has invested in include tax accountancy software, payroll software, regulatory driven/compliance services, asset leasing, and tech-enabled industrial components. The firm seeks to invest across Northern Europe with the UK, Germany, Nordic and Benelux regions representing the greatest focus historically. The clarity of its investment strategy typically results in Hg Capital tracking investment opportunities for an average of around four years prior to investing, which can extend advantages in both due diligence and outcompeting potential competition.

The Fund seeks to invest in majority or control buyouts, investing at least £100m of equity per investment, often with additional investment for follow-on acquisitions. As an investor in mid-market and growing businesses, over 90% of returns historically have been delivered through revenue and profit growth. The current portfolio (Hg Capital 7) is currently growing revenue and profits at 10% and 17% respectively (as at November 2016). Critically, the Hg Capital portfolio has delivered growth every year through the economic cycle, delivering positive profit growth through 2009 and the broader financial crisis. Hg Capital has also driven organic employment growth in its portfolio by an average of around 5% over the last two years, at the same time as delivering this level of financial growth.

Growth is typically sought through building and growing sustainable books of businesses and profitable expansion in the companies' customer bases, investing heavily in management team capability and business infrastructure to ensure strong platforms for future growth, and repositioning of the business

with a view to achieving strategic premia at exit. Historically, Hg Capital has achieved an average uplift to pre-exit value of around 40% since 1990.

The firm is led and owned by an experienced and well-tenured senior team of 15 Partners, who have worked together for an average of 12 years. The firm's 112 employees are based across two offices in London and Munich, who work collaboratively across sector-oriented teams to deliver the firm's strategy.

The terms of the Hg Capital 8 Fund are largely unchanged versus the Hg Capital 7 Fund, with market standard management fee and carried interest provisions for a fund of its size and type.

The management fee will be 1.75% on committed capital (1.5% post the investment period with 20% carried interest, subject to a net 8% hurdle.

12) Border to Coast Pool: Asset Pooling

A separate report on the Border to Coast Pool is included in the meeting agenda.

Report of the Strategic Finance Manager

Financial and Performance Report

1. Funding Level

The actuary has been consulted and has set out an approximate funding position and the assumptions used for the funding position as at 31 December 2016.

The funding level has increased to 91.0% as at 31 December 2016 (82.5% as at 31 March 2016) and is based on the formal valuation results, updated for market conditions at 31 December 2016 and actual fund returns to that date.

These are as follows:

- A discount rate of 4.5%
- Pension payments increases of 2.4%
- Salary CPI inflation of 2.7%
- Actual fund returns for the period 1 April 2016 to 31 December 2016 of 15.1%
- Assumes contributions and benefit payments are broadly similar

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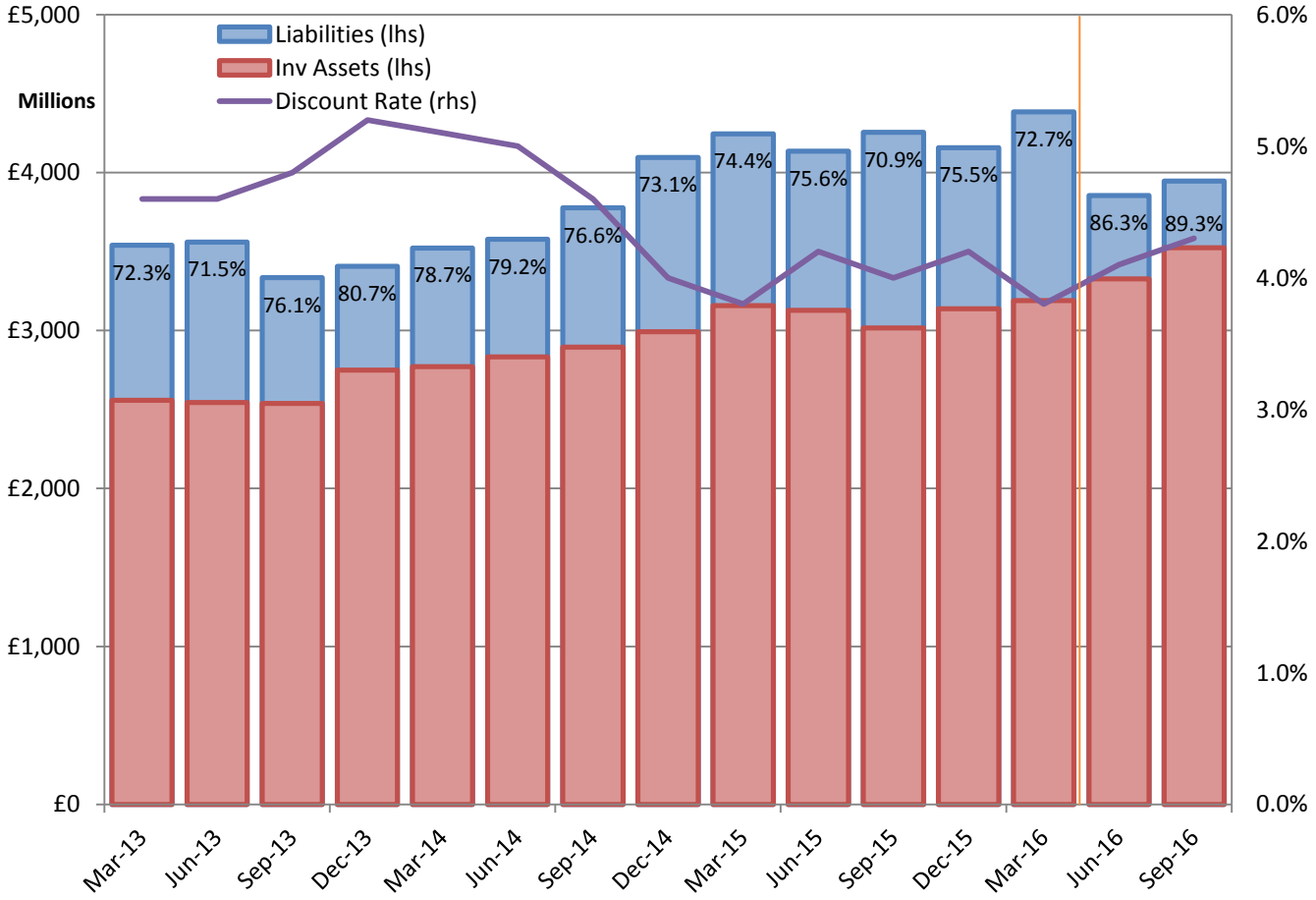
£5,000
£4,000
£3,000
£2,000
£1,000
£0
Millions
Liabilities (lhs)
Inv Assets (lhs)
Discount Rate (rhs)
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
72.3%
71.5%
76.1%
80.7%
78.7%
79.2%
76.6%
73.1%
74.4%
75.6%
70.9%
75.5%
72.7%
86.3%
89.3%
Mar-13
Jun-13
Sep-13
Dec-13
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Dec-14
Mar-15
Jun-15
Sep-15
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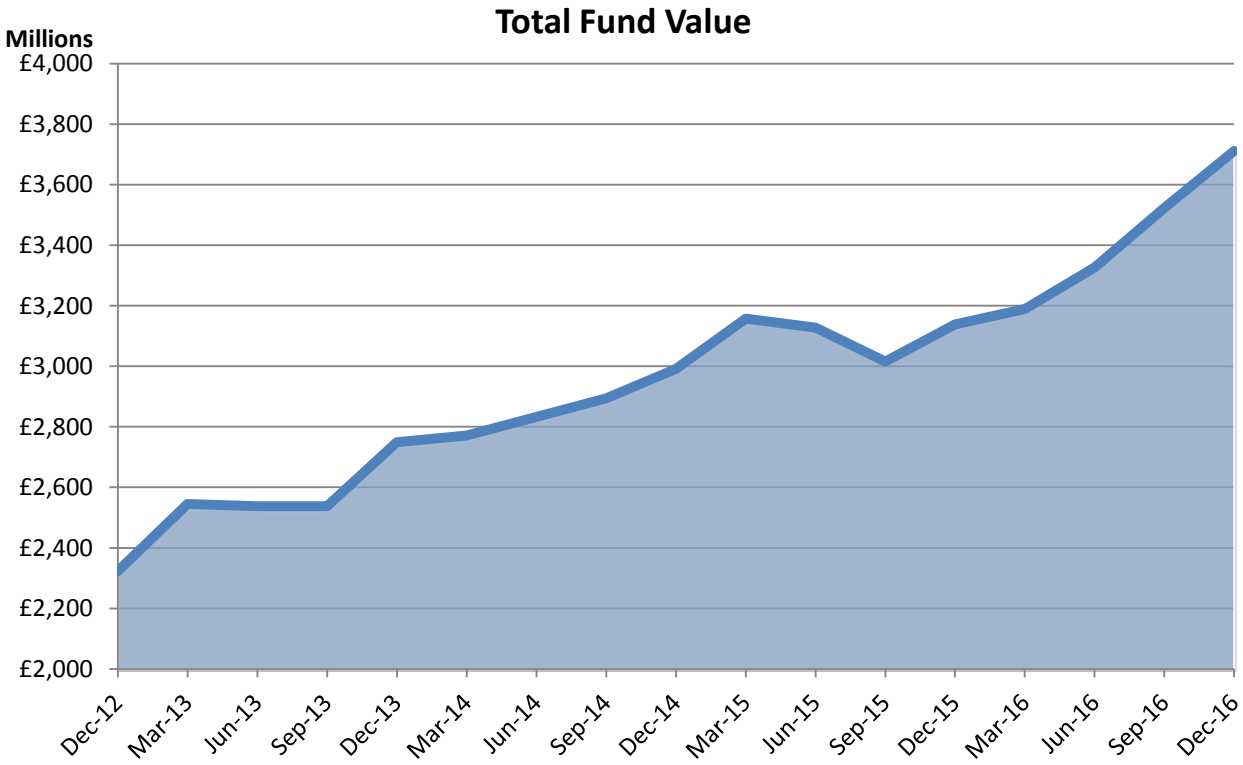
Sep-16

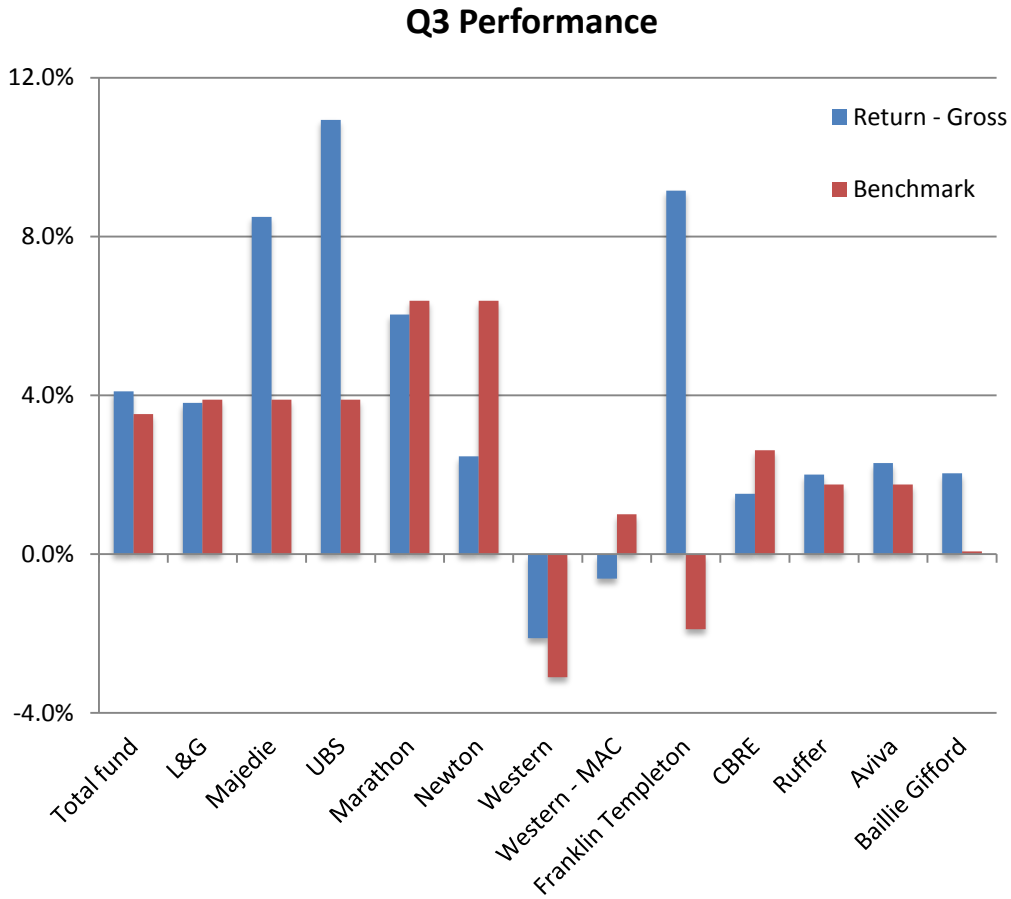
2. Market Value

The value of the Fund was £3,717.5 at 31 December 2016 compared with £3,523.7 at 30 September 2016. The investment performance for the period was +4.1%.



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

Overall, the Fund returned +4.1% in Q3 2016/17, in comparison with the Fund's customised benchmark of +3.5%.



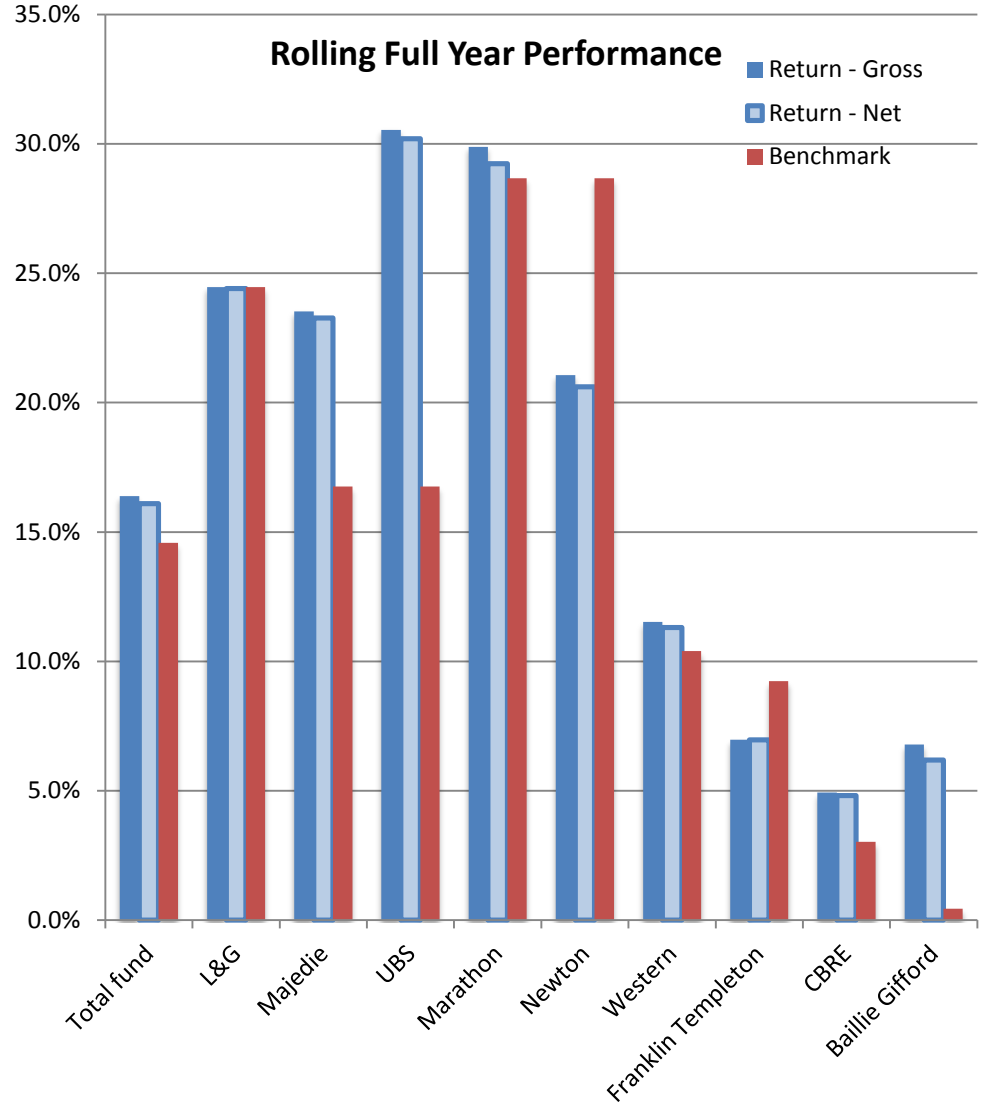
Baillie Gifford diversified growth funds is an absolute return fund with a benchmark based upon short term cash holdings.

The table below shows manager performance for 2016/17 Q3 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data. TO BE ROUNDED

Manager	Gross of Fees Performance %	Benchmark %	Gross Performance Relative to Benchmark %
Total fund	4.1%	3.5%	0.6%
L&G	3.8%	3.9%	-0.1%
Majedie	8.5%	3.9%	4.6%
UBS	10.9%	3.9%	7.0%
Marathon	6.0%	6.4%	-0.4%
Newton	2.5%	6.4%	-3.9%
Western	-2.1%	-3.1%	1.0%
Western - MAC	-0.6%	1.0%	-1.6%
Franklin Templeton	9.2%	-1.9%	11.1%
CBRE	1.5%	2.6%	-1.1%
Standard Life GARS	2.0%	1.8%	0.2%
Standard Life GFS	2.3%	1.8%	0.5%
Baillie Gifford	2.0%	0.1%	1.9%

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

During the course of the previous 12 months to 31 December 2016, the Fund returned +16.4% net of investment fees against the customised fund benchmark of +14.6%.

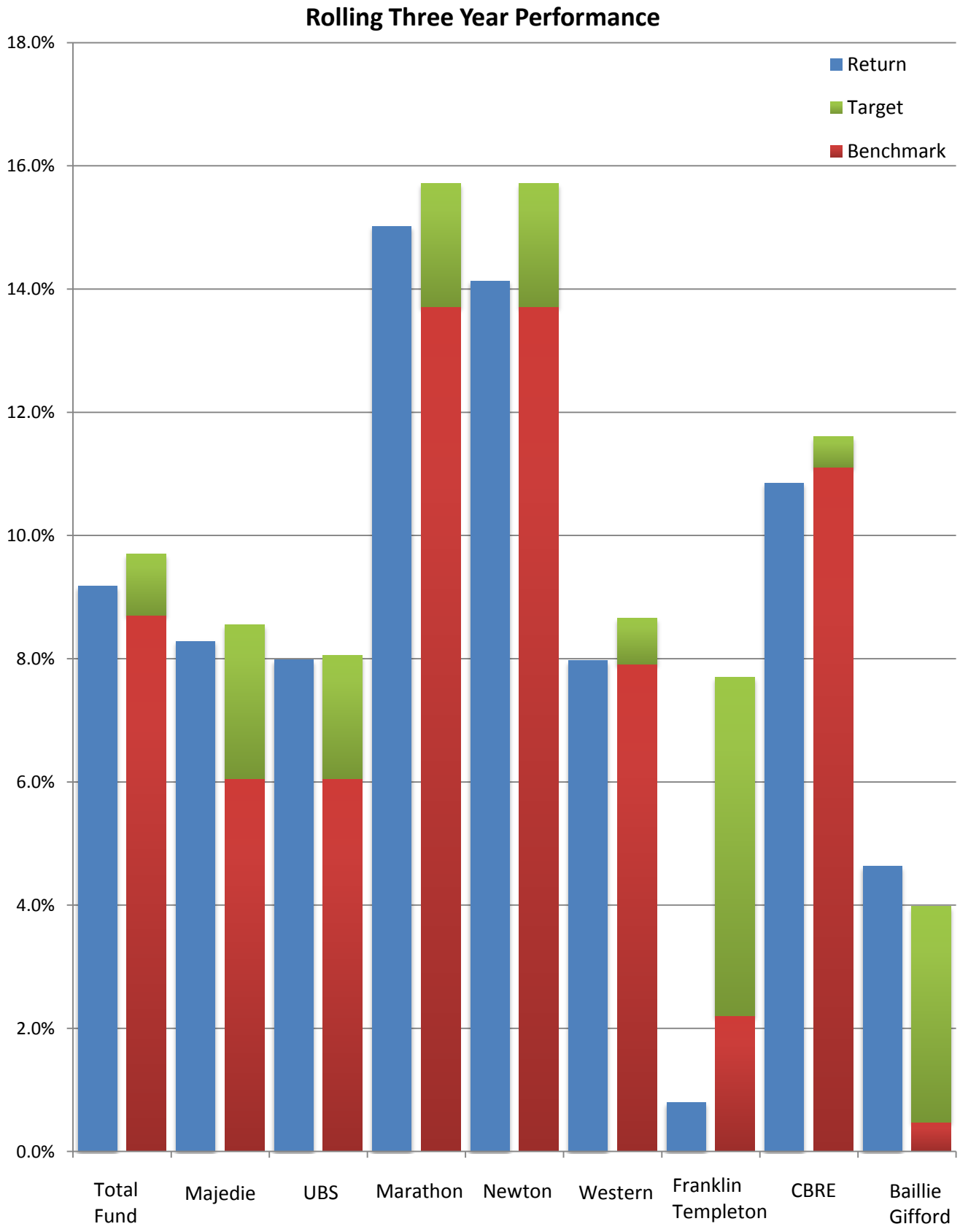


The table below shows manager performance for the year at 2016/17 Q3 (gross of investment manager fees) against manager specific benchmarks using Northern Trust data.

Manager	Net of Fees Performance %	Benchmark %	Net Performance Relative to Benchmark %	Gross of Fees Performance %
Total fund	16.1%	14.6%	1.5%	16.4%
L&G	24.4%	24.5%	-0.1%	24.5%
Majedie	23.3%	16.8%	6.5%	23.5%
UBS	30.2%	16.8%	13.4%	30.5%
Marathon	29.2%	28.7%	0.5%	29.9%
Newton	20.6%	28.7%	-8.1%	21.1%
Western	11.3%	10.4%	0.9%	11.5%
Franklin Templeton	7.0%	9.2%	-2.2%	7.0%
CBRE	4.8%	3.0%	1.8%	4.9%
Baillie Gifford	6.2%	0.4%	5.8%	6.8%

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



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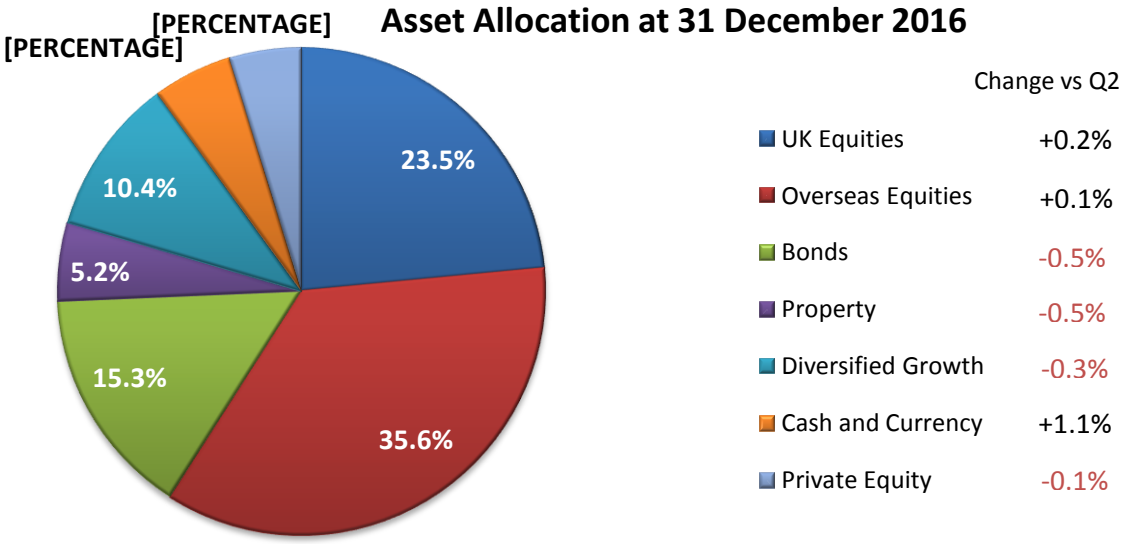
The below table shows the annualised performance by manager for the previous three years.

Manager	Performance %	Benchmark %	Target Above Benchmark %	Relative to target %
Total Fund	9.2%	8.7%	9.7%	-0.5%
Majedie	8.3%	6.1%	8.6%	-0.3%
UBS	8.0%	6.1%	8.1%	-0.1%
Marathon	15.0%	13.7%	15.7%	-0.7%
Newton	14.1%	13.7%	15.7%	-1.6%
Western	8.0%	7.9%	8.7%	-0.7%
Franklin Templeton*	0.8%	2.2%	7.7%	-6.9%
CBRE	10.9%	11.1%	11.6%	-0.8%
Baillie Gifford	4.6%	0.5%	4.0%	0.7%

4. Asset Allocation

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

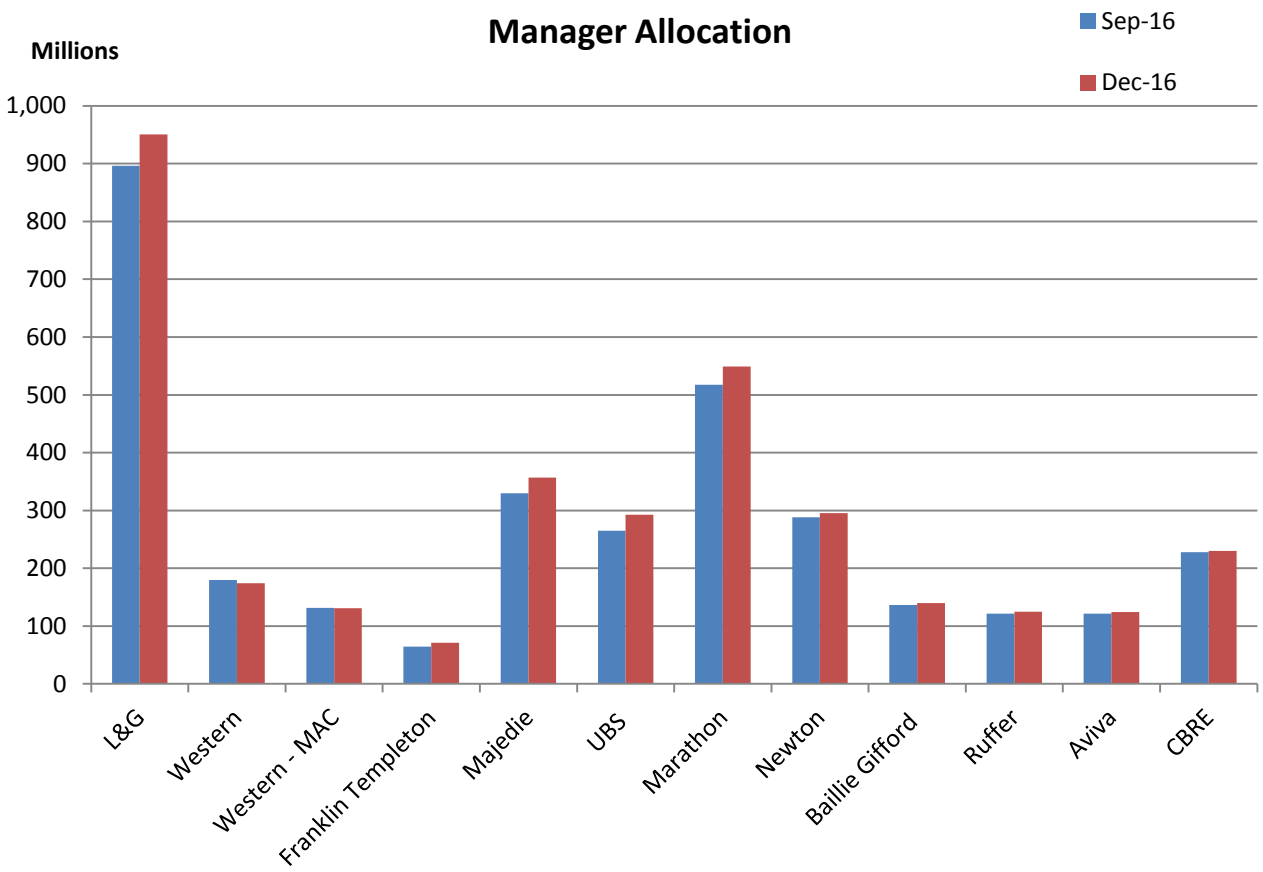


The table below compares the actual asset allocation as at 31 December 2016 against target asset weightings.

	TOTAL FUND	Actual	Target
	£m	%	%
Bonds			
Multi Asset Credit	130.9	3.5%	4.4
Investment Grade Credit	170.8	4.6%	5.3
Index Linked Gilts	195.6	5.3%	5.5
Unconstrained	70.8	1.9%	2.4
Equities			
UK	873.3	23.5%	27.5
Overseas	1,321.8	35.6%	32.3
Property Unit Trusts	192.8	5.2%	6.2
Diversified growth	388.4	10.4%	11.4
Cash	192.5	5.2%	0.0
Currency hedge	4.6	0.1%	0.0
Private Equity	176.0	4.7%	5.0
TOTAL	**3,717.5**	**100.0**	**100.0**

5. Manager Allocation

The graph below shows the manager allocation as at the 31 December 2016 and 30 September 2016.



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 26 January 2017
Annex 2: Minutes from external fund manager meetings held on 6 February 2017

Sources/background papers:
None

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