Surrey Pension Fund – Manager Review Meeting on 26th May 2017
Attended by Phil Triggs and John Harrison

Majedie: UK Equities
Chris Field (Portfolio Manager) and James Mowat (Client Relationship)

Adviser view: no issues
Another excellent year from the Majedie team. They have consistently anticipated changes in market direction and positioned the portfolio accordingly. The move from a cyclical bias to a more defensive portfolio appears sensible. There are no immediate issues with this mandate.

In the longer term, the main challenge for the business will be succession management. The founders established the business in 2003 and are of similar age to Simon Hazlett, who has now retired. There is no indication that any of the main investors (James de Uphaugh, Chris Field and Matthew Smith) are planning to leave soon, but this is an issue to monitor.

Mandates
- UK Equity (£368m) long only portfolio seeking index +2.5% pa (inception Sept 2004)
- Tortoise (£15m) long/short global equity portfolio seeking positive absolute returns (inception Sept 2009)

Performance

	Q1 2017 %	12 months %	3 years % pa	Since inception % pa
UK Equity Fund	1.7	25.7	8.4	12.2
FTA All Share index	4.0	22.0	7.7	8.3
Relative	**- 2.3**	**+ 3.7**	**+ 0.7**	**+ 3.9**
Tortoise Fund	**- 2.1**	**+ 14.1**	**+ 4.5**	**+ 5.3**

The rolling three-year returns are above benchmark but a little below our target. However, Majedie's long-term performance remains impressive. They have rarely been behind the index for more than a few months and have far exceeded our targets since inception.

Points covered
- Simon Hazlett has retired and James Mowat has replaced him as Client Relationship Director. James was previously with Baillie Gifford.
- Majedie remains focused on equity mandates and closed to new asset flow in 2006. Subsequent asset growth has been through market movement and outperformance. Pension fund de-risking has led to a steady recycling of clients from corporate schemes to other investors – DB pension schemes now account for less than 50% of the business, with more than half of this represented by their 9 LGPS clients. They have this week joined the options available on the London CIV.
- LGPS pooling may be a challenge given capacity constraints. The capacity available to the London CIV is about £1bn, of which about £500m is for existing clients.
- Relative performance benefited from market movements post-Brexit. In particular, mining stocks recovered strongly, with Anglo American, BHP Billiton and KAZ Minerals the largest individual contributors over the year to March 2017. Banks also performed well.
- They have around 10% invested in non-UK equities, mostly in Europe.
- They are becoming more cautious, with the economic cycle already relatively prolonged and US interest rates likely to rise. Fiscal measures are stalling, inflation pressures are building and there is growing uncertainty about how to unwind QE. They expect the US to face headwinds but Europe to see improved economic growth.
- They have reduced cyclical exposure by trimming weightings in banks and miners, but regard traditional defensives (utilities and consumer staples) as too expensive. They prefer European telecoms (BT, Orange, Telecom Italia), food retailers (Tesco, Morrison) and support services (Rentokil). They also have over 3% in gold miners.
- One recurrent theme is 'Darwinian winners' – businesses which are squeezing weaker players out. Examples include Ryanair and Card Factory.

Western Asset Management: Bonds
Annabel Rudebeck (Portfolio Manager) and Marian George (Client Relationship)

Adviser view: no issues
Performance has been steady and broadly based on both portfolios.

Mandates
- UK Credit (£181m) seeking index +0.75% pa (inception Dec 2015)
- Multi-asset Credit (£135m) unconstrained portfolio seeking positive absolute returns (inception Dec 2016)

Performance

	Q1 2017 %	12 months %	3 years % pa	Since inception % pa
UK Credit Fund	2.2	10.8		10.6
Benchmark	1.8	9.7		9.6
Relative	**+ 0.4**	**+ 1.1**		**+ 1.0**
MAC	**+ 3.1**	**+ 9.0**		**+ 9.1**

It is still early days for mandates that should be measured over rolling 3-year periods or longer. To date performance has been good.

Points covered
- Annabel Rudebeck has taken over from Paul Shuttleworth who has now retired. Annabel was previously with Rogge and before that JP Morgan. She is responsible for non-US investment grade credit and sits on the Global Investment Strategy and Global Credit Committees.
- Political events have had a big influence on both markets and policy makers. The £10bn corporate bond programme by the Bank of England in the wake of the UK referendum result has now ended but had a meaningful impact. Markets have also been reacting to the Trump result and to concerns about elections this year in France, Italy and Germany. This has provided opportunities.
- Performance attribution for the year to March shows that they gained from sector allocation, security selection and US duration views. The only negative was the underweight position in UK duration (long gilts).
- They have a sanguine view of markets. They believe defaults will remain low, so US high yield is not expensive despite a yield below 6%. They are also relaxed about some perceived global economic risks, such as a hard landing in China – the debt concerns are well known, largely domestic and mostly in government backed banks.
- There are areas of concern. For example, Italian banks have 16% NPLs.
- Electoral surprises could also prompt volatility, although they would regard sterling weakness following a hung parliament as a buying opportunity.
- The UK credit portfolio yields 2.7% (0.5% above the benchmark) and a similar duration. The MAC portfolio yields 6.1% with a duration of 4.9 years.
- We asked for more information about the longer-term default experience in the US high yield portfolio used within the MAC mandate. Marian will provide this.

Newton: Global Equities
Paul Markham (Portfolio Manager) and David Moylett (Client Relationship)

Adviser view: close attention required
The last 12 months have been very poor and raise questions about the role Newton should have in the Fund in the longer term. While I have some sympathy for their cautious outlook, the portfolio construction disciplines have not been impressive. Following such a strong cyclical run, markets could well become more fearful, which ought to align better to Newton's approach. If they are to retain/regain our confidence, it will be important that they deliver much stronger relative returns if markets stumble.

Mandate
Global equities (£305m) seeking index +2% pa (inception Nov 2007)

Performance

	Q1 2017 %	12 months %	3 years % pa	Since inception % pa
Fund	4.0	23.5	15.4	8.4
Benchmark	5.6	32.2	15.6	8.9
Relative	**- 1.6**	**- 8.7**	**- 0.2**	**- 0.5**

Performance has been very poor in the last year, undermining the outperformance seen in the previous four years. Newton are keen to position the shortfall as having been too defensive in a 'mad and unsustainable' market. While this has undoubtedly been a factor, attribution (see below) suggests analytical failures were equally responsible.

Points raised

- Performance had been well ahead of target in three of the previous four years, benefiting from a defensive bias during a period of economic uncertainty. The last 12 months have seen a significant swing back to cyclicals as markets have anticipated fiscal reflation following the election of President Trump – materials and financials have been the strongest performers, with consumer staples and utilities lagging. Newton did not believe fiscal reflation would be deliverable and continue to distrust bank balance sheets, so they maintained a defensive bias and suffered significantly in the year to March. Investor excitement has waned since March and they believe they are 1.5% ahead of the index in the current quarter.
- Attribution of underperformance in individual stocks, however, suggests a number of losses from poor analysis.
- The largest hit was from Teva Pharmaceuticals, which is 1.6% of the portfolio and cost 1.12% in relative return. Teva is a generics drug company domiciled in Israel, which has a large US business. It should have benefited from a drive to spend less on branded drugs. However, long delays in gaining regulatory approval for its acquisition of a business from Allergan, high debt costs relative to cash flow and the resignation of the CEO (and potentially the CFO) have undermined the share price. The biggest concern is that Newton's largest position in the stock was below 2%, implying they continued to buy the shares into the decline despite deteriorating news flow.
- Other disappointments include TripAdvisor (the new business model was unproven and has failed), Japan Tobacco (slow to migrate to e-cigarettes) and AB Foods (valuation highly dependent on Primark where poor like-for-like sales seen). These four negative contributors account for a shortfall of over 3% in the year.
- They remain cautious on market valuations. In particular, price/sales ratios in the US are at all-time highs – other measures are also high but distorted by above average profitability. They think demographics and technology are deflationary and this might be exacerbated by the prolonged period of zero interest rates. They see parallels between the US today and Japan in the 1990s where businesses that should go bust continue because they can still pay debt costs. They also see car loans, with the average tenure now over 6 years, as similar to the sub-prime crisis.
- They are less pessimistic about Europe, although they find it harder to gain a 'pure' exposure without owning banks.

- Recent purchases are Bangkok Bank (low valuation) and Sony (low valuation and operational improvements). Recent sales are stocks that had performed well (Bridgestone, BAT and Toyota). They also sold Dun & Bradstreet because they believe the quality of earnings has declined.
- Most of the portfolio reflects the team's global model. The main stocks owned that reflect Paul's individual view are Don Quijote (well-managed discount food retailer), Blue Buffalo (pet food) and Fanuc (industrial automation).

Aviva: Diversified Growth
Peter Fitzgerald (Portfolio Manager) and Matthew Graham (Client Relationship)

Adviser view: no issues
The Pension Fund has diversified its Diversified Growth Fund exposure through three managers with very different approaches. The Aviva fund is the closest to a hedge fund. It uses a wide range of relative market positions (long versus short) and has a strong emphasis on risk control through diversification. The fund's track record has been broadly consistent with other such funds.

The performance of DGFs generally has been lacklustre since 2015, which has caused some to question whether it would be better to invest in a simpler combination of bonds and equities. I do not share this view. Equities and bonds have both had a strong run and now stand on valuations that are demanding from a historical perspective. It seems likely that the next few years will be more challenging, which would provide opportunities for diversification to be a benefit rather than a cost.

Mandate
DGF (£305m) seeking cash +5% pa (inception Oct 2016)

Performance
In Q1 the fund returned -1.26%, but it is far too early to judge this absolute return mandate.

Points raised
- The market environment for DGFs have been less favourable recently, but the Aviva product has continued to attract new business – in the UK, about half has come from GARS. The AIMS OEIC is currently £4.9bn, with a total of £8.6bn in the strategy as a whole.
- Performance since inception for Surrey (7 months) is close to target, with less than a third of the volatility of equities.
- We discussed managing volatility through periods of election uncertainty. They contrasted elections that are close (e.g. the UK referendum and US President) with those that are not (e.g. France). They sought protection through currency positions for the close elections (short sterling for UK, short Mexico peso for US) but did not for France.
- They do have a long-term allocation to volatility protection, but do not use the Vix because the holding cost is too high. They prefer to use relative volatility between markets (e.g. Hong Kong versus US).
- Their central expectation is for growth in US to moderate, China to stabilise and inflation pressures to build. They believe 10-year break-even inflation at 1.8% pa in the US is too low.
- They key risks to this central case are US interest rates rising too quickly, a hard landing in China, debt deleveraging and nationalism prompting trade wars. None is a large enough probability to drive asset allocation nor a small enough probability to ignore.
- In equities, the favoured areas are Europe and small companies in Emerging Markets.
- In bonds, they are long in the US and short in the UK. They expect US rates to steepen and have a local currency position in short-dated Indonesian bonds.
- In currencies, they have a short Korean Won versus US dollar position as a hedge against a China slowdown.
- The risk profile of the underlying positions would total close to 15% in isolation, but this falls to about 5% taking into account diversification.

John Harrison
31st May 2017

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