Record of the Pension Fund Investment Advisers Group (IAG)
9:45am 15 February 2013, Offices of UBS

Present

D Le Gal (Chair)

J Orrick
S Selleck (SS)
T Elias (TE)
D Josey (DJ)
M Few

S Little (SL)
P Triggs
J Evans
J Wilson

P Meredith (PM)
J Harrison

Representing Mercer
Steve Turner (ST)
Sanjay Mistry – Private debt training session

Representing Fund Managers
Steve Magill UBS
Digby Armstrong

Alex Bignall CBRE
DJ Dhananjai
Max Johnson

1. Apologies for absence were received from David Wood and Nick Harrison.

2. The Chair declared a personal interest to the IAG, due to her role as a Trustee Director of JP Morgan's UK Pension Fund. Paul Meredith also declared an interest as a UBS pensioner.

Item 1 – Notes of Meeting of 16 November 2012

3. After a couple of minor errors were pointed out, the minutes were noted.

4. MF wanted to follow up on the issues currently facing CBRE. ST stated Mercer have been reviewing the property portfolio and there are questions around the appropriateness of the multi-manager route. There have been problems with the European investments and issues with highly geared funds. They have been looking at what could be done to ensure CBRE are a good fit with the rest of the Surrey fund.

5. PM highlighted that when ING Real Estate were appointed in 2004, they were amongst the best in class managers and initially performed well. The European investments made in 2007 have proved disastrous and have been a drag on performance ever since.

6. How to get exposure to property is a big conundrum. The fund isn't big enough to invest directly, so the fund of funds route provides an opportunity to get exposure to an appropriately diversified portfolio. However, it does have drawbacks as there are two levels of fees and CBRE are one of the biggest players in the market holding 10 -20% of some funds, which makes the investments very illiquid. Change is very costly and you can be locked in to under-performing funds.

7. The problems faced by CBRE have been largely inherited from their takeover of ING Real Estate and it appears that the manager would like to restart the clock on performance measurement. The Group agreed to discuss the issue in more depth later in the meeting as CBRE are due to present to the group.

8. SS raised the issue of indemnities of members under the new Pension Board governance structure. PT agreed to check with the Legal team, but as the Board has committee status, he expects it to be the same indemnity cover as any other council committee.

Item 2 – Report of the Pension Fund & Treasury Manager

a) Matters arising since last meeting

9. UBS Triton Property Fund – The problems continue on the stricken fund. On the 31 January 2013, UBS issued a liquidation notice stating that with effect from 1 August 2013, the fund will be liquidated unless £150m of redemption requests are withdrawn by 30 April 2013. CBRE, who are managing the fund's investment, believe that liquidation with sales spread over 3-5 years is in the best interest of the fund and therefore do not want the redemption requests to fall by £150m. To help ensure this does not happen, CBRE will submit redemption requests on behalf of all their clients.

10. Majedie – The fund has submitted an application to be part of a class action against Hewlett Packard, a stock held by Majedie. The class action is the result of an $8bn write-off related to HP's takeover of Autonomy. The value of the fund's shares in HP has fallen by around $1m since the story came out. PM stated that, interestingly, Majedie originally held shares in Autonomy but got out very early due to concerns about their accounting practices.

11. Franklin Templeton – The transition into Franklin Templeton's Global Bond Fund took place as planned on 11 February 2013 at zero cost and with full market exposure maintained.

12. Freedom of Information Requests – There is still a lot of interest in tobacco investments, this time as the result of a (FoI) enquiry from The Times, questioning whether the fund had sought legal advice on the implications of responsibility for Public Health transferring to the local authorities on 1 April 2013. SL stated that the issue of tobacco investments had been raised recently at a meeting of the Society of County Treasurers (SCT). They agreed that the fiduciary duty of LGPS funds to obtain the best return possible is the overriding factor in investment decisions and the majority of funds will continue to invest in tobacco.

13. The same journalist at The Times also submitted FoIs into holdings in gambling and alcohol stocks. At the 31 January 2013, the Fund had £16.7m invested in alcohol companies and £3.7m in gambling companies.

14. Mirabuad's IMA has being updated so they can now invest up to 20% in global equities.

b) Private Equity

15. Hg Capital The Group approved the commitment of £15m to Hg Capital 7, subject to the outcome of a Mercer investment report on the fund.

16. ISIS invited the fund to be a key investor in their new growth fund. Last year the group approved a £15m commitment to the ISIS V fund but, due to the fund being heavily oversubscribed and issues around deadlines, the Surrey investment was not accepted. Surrey has been an important client to ISIS over the years and was one of their initial partners. ISIS wanted to keep the relationship going and therefore have offered the fund a position in the new ISIS growth fund.

17. Members raised concerns that the level of investment would be 20% of the total fund value. In the past, 10% was used as a general rule of thumb. However, the ISIS track record and the relatively small fund size were considered and it was felt this helped to offset the risk. The Group approved the commitment of £10m to ISIS Growth Fund.

18. More generally in terms of private equity performance monitoring, it was felt that a consistent definition of Internal Rate of Return (IRR) should be used to monitor performance. Currently managers provide their own performance measures and it is unknown if the calculation of IRR is consistent across the managers in the portfolio.

19. PM stated that private equity has always been excluded from the performance monitoring of the fund and really should be included in total portfolio performance measuring.

c) Internally Managed Cash

20. The Group felt the build up of cash should be used to rebalance, and additional funds should be allocated to the diversified growth managers to bring them up to their benchmark allocations, as the actual allocations had slipped a bit over the last year due to the strong performance of equities.

21. The group also discussed what it should do with the 2% benchmark allocation made to the Majedie global fund. This investment will no longer take place so it should be reallocated. As the allocation was to global equities, the Group considered an additional allocation to Newton but were put off by concerns over their long term performance. Marathon were also considered but it was agreed that their allocation is already high at around 12% and there are questions about what effect the recent organisational changes will have on performance.

22. Majedie are slightly over their benchmark allocation to UK Equities so it was agreed that should be increased from 6% to 7%, with the remaining 1% to be allocated to global equities with Legal & General.

d) Financial & performance report

23. The value of the fund increased from £2,236.9m at 30 September 2012 to £2,322.4m at 31 December 2012. The estimated fund value at 13 February 2013 is £2,427.0m.

24. The quarterly performance of +3.3% was greater than the customised benchmark of +2.9% (+0.4%).

25. In absolute terms the best performing managers was Majedie, with a return of +7.3%, compared to a benchmark of +3.8% (+3.5%).

26. In relative terms the best performing manager was also Majedie with their ourperformance of +3.5%.

27. Newton underperformed with a return of +0.5% compared to a benchmark of +2.2% (-1.7%). CBRE and Mirabaud also slightly underperformed with a relative return of -0.3% and -0.2% respectively.

28. The total Fund returned +12.4% over 12 months, which was above the benchmark return of +10.7% (+1.7%)

29. In absolute terms the best performing manager was Marathon with a return of +18.8% compared to benchmark return of +10.7% (+8.1%). In relative terms the best performing manager was also Marathon with their outperformance of +8.1%.

30. Marathon (+8.1%), UBS (+5.4%), Majedie (+3.9%) Newton (+3.5%) and Western (1.7%) all achieved their outperformance target for the year.

31. CBRE (-0.3%) and Mirabaud (-0.4%) failed to beat the benchmark for the year.

e) Public services pensions bill and proposed governance arrangements

32. PT updated members on the current positions. The Bill is currently with the House of Lords and will receive its third reading on 26 February before going back to the Commons and, as things stand, is likely to receive Royal Assent in time for the 2013 valuation.

33. Auto-Enrolment will be implemented by the County Council with effect from 1 April 2013. This is where staff who are currently not members of the pension fund are auto-enrolled and have to opt out if they don't want to remain a member. The Pensions Admin team at SCC is managing the process and estimate that 90% of those auto-enrolled will opt out again. However, early indications from organisations that have already implemented auto-enrolment show that it might only be around 75%.

34. Members requested that an update is provided at the next meeting covering how the process went and the number of opt outs.

f) Actuarial Valuation

35. The next valuation will be as at 31 March 2013. A briefing note on the basis for the assumptions to be used such as discount rate and inflation is due to be released by the actuary shortly. This is an important document as the assumptions used will have a large role in determining the funding levels and therefore the contribution rates of each employer.

36. The stabilisation policy will continue for the large, long-term employers such as the local authorities in the fund. This is where their contribution rates remain consistent over a number of valuation cycles in the expectation that the employers underpay in the bad times and overpay in the good. The contribution rates may have to be

adjusted as a result of the 2013 valuation if the results are outside of the accepted parameters of the stabilisation policy, which is a distinct possibility this time round.

Item 3 – Manager Meetings

37. PT, PM and JE met with Marathon, Newton, Majedie, L&G and Mirabaud on 29 January.

38. Newton. The Group focused the discussion on Newton. Mercer rates Newton highly for their income and multi-asset return strategies, but only average for benchmark strategies. The portfolio of stocks they have is relatively defensive which explains their recent underperformance.

39. PM highlighted they did actually outperform +3% over the last 12 months, but agreed the December quarter had been relatively poor at -1.7%. The reason for the underperformance in the quarter was due to being underweight in financials which had performed well. Over the long term Newton's performance has suffered due to not holding Apple, but this had actually increased performance over the quarter.

40. Their investment themes and staff are generally good, but PM feels the organisation does lack a bit of guts in decision making. They base decisions on solid evidence which, whilst being a sound investment strategy, does mean they often miss real turnaround opportunities to drive performance.

41. Over the last 5 years, they are 1% behind benchmark. Prior to that their record was very good. At the time Newton were appointed, the other managers who pitched such as Alliance Bernstein have performed disastrously.

42. Overall, WM say to not to make manager changes unless you are absolutely convinced and at the moment there is not a fundamental loss of confidence amongst the board.

43. JH stated that Newton have a very good reputation from absolute return strategies but in global equities they are somewhat lacking. It is not a bad place to have money and overall the insights that the organisation can provide should manifest in performance.

44. ST recommended that Newton should be asked what effect reducing the number of stocks in the portfolio has had on performance compared to if they kept it the same.

Item 4 – Business Plan

45. JE took the Group through the main tasks of the business plan and the activities that the Pension Fund and Pension Admin teams will have to complete over the coming 2013/14 financial year.

46. The plan is split into 6 main areas:

- Administration
- Communication
- Actuarial/Funding

- Surrey Pension Board
- Financial Risk Management
- Investment

47. Over the coming financial year, the key tasks will be around the implementation of the new Surrey Pension Fund Board to replace the IAG and also the actuarial valuation due to take place as at 31 March 2013.

48. The Group agreed with the areas of priority and approved the business plan for 2013/14.

Item 5 – Risk Register

49. JE took the group through the risk register for 2013/14. The register is based on the previously approved register for 2012/13 which had then been updated for 13/14.

50. The risks are grouped as follows:

    - Investment
    - Financial
    - Funding
    - Operational
    - Governance

51. Each risk is then scored based on the potential impact on each of the fund, employers and reputation. The likelihood of the event occurring is then rated and these figures are used to give an overall risk score. The risks are then ranked in order and colour coded based on the potential severity.

52. New risks included 'transition from IAG to Pension Board creates operational difficulties due to increased membership and remit' ''inappropriate long-term investment strategy', 'fall in equity market leading to decreased funding'.

53. Members debated the new risks to determine whether or not they were actually covered by existing entries.

54. Members approved the risk register for 2013/14.

Item 6 – Presentations by fund managers

55. CBRE opened with a review of the UK economy. The market in the UK is still in a relatively poor state. The economic growth outlook for the UK has deteriorated and all four rating agencies have the UK on negative watch.

56. In terms of the UK property market, weak performance continues in the direct market with expected return of 3% during 2012. Capital values on all property has been declining since November 2011. London continues to buck the trend, mainly driven by overseas buyers.

57. There is a large polarisation in the performance of property in prime locations compared to other property, for example, returns from Q2 2009 to Q3 2012 are +27% for prime shops and -9% for secondary/tertiary shops.

58. CBRE predict that capital values will continue to decline in 2013 and will not start to increase on an annual basis until 2015.

59. The strategy CBRE will follow focus on the following core themes:

- Long and secure income streams.
- Acquiring core specialist fund at attractive discounts to NAV.
- Prime shopping centres
- Industrial property in SE England
- Student housing in leading university towns

Opportunistic Themes

- Take advantage of bank distress
  - Acquisitions from bank driven disposals
  - Provision of mezzanine finance
- Development finance in certain markets where demand is high
- Mispriced high yield property

60. CBRE intend to increase the portfolio allocation to debt to 10% which will be implemented over the next two years. A new manager has been selected and CBRE are currently negotiating terms.

61. Performance in the quarter was -0.3% and +0.7%, +5.3%, -5.9% & +2.1% in the 1 year, 3 years, 5 years, & since inception respectively.

62. The sector allocation compared to benchmark currently has the most overweight positions as +17.4% to European property, +7.7% to other commercial which is mainly student accommodation. The most underweight are offices in the rest of the UK -9.4% and unit shops -6.7%.

63. The largest contributors to performance over the last 12 months were the M&G Secured Property Income Fund (+0.8%) and West End of London Property Unit Trust (+0.7%). The largest detractors were UBS Triton Property Unit Trust (-0.7%) and CBRE Strategic Partners Europe Fund III (-0.6%).

64. CBRE feel that the liquidation of the UBS Triton fund is the best way forward. It will mean that the sales period can be extended to three to five years and therefore it can be done in a controlled manner which will maximise value. CBRE are willing to take a pragmatic view of the situation and, if another option is presented such as a fund merger, they would encourage UBS to fully assess the potential of such a proposal.

65. CBRE refused to be drawn into how much of the fund they own but admitted they would be in the top two investors.

66. DLG quizzed CBRE on how the fund can avoid perception that there needs to be a fire sale of assets. CBRE think that the three to five year timeframe provides enough time to ensure there is competition for each asset and therefore realistic values are achieved.

67. Mercer previously initiated discussions with CBRE about changing their benchmark from the current +1% IPD UK All Balanced Property Funds Index. CBRE agreed that the +1% is at the top end of target performance. They believe they have the ability to achieve it, but it does mean taking an increased level of risk.

68. After CBRE had left, the Group discussed the potential change of the mandate. The Group felt that, whatever changes are made, the performance record needs to remain. The Group noted that making any changes to the property portfolio could potentially be expensive and take time.

69. The Group agreed to ask CRBE to produce a report on the impact and changes they would make if the target was reduced to +0.5% and how they would do it in the most cost effective way. Mercer will present report at next meeting.

70. The Group also briefly discussed making a direct allocation to a property income fund outside of the CBRE remit. The fund is currently underweight in property and this method could be used to bring the allocation up to the benchmark.

71. UBS Digby Armstrong and Steve Magill attended the meeting to discuss the recent performance of UBS. Over the quarter, they had outperformed +3.0% and over the year +5.6%, 3 years +0.3%, 5 years +0.6% but underperformed -0.8% since inception.

72. In the quarter, the largest contributors to performance were Lloyds +1.0% and Dixons +0.9%. These firms were also the two largest contributors to performance over the last year with +2.4% and +2.1% respectively. These are two of the stocks that UBS have been saying for the last 18 months or so that they have a lot of conviction in, so they were pleased that their assumptions have proved correct so far.

73. Lloyds Group shares are currently worth 52p and UBS have fair value as being 70p. The stock current makes up 2% of the index and 7% of the portfolio. The bank is currently reducing costs by running down non-core services and is also improving the balance sheet position. Questions remain about possible further bad debt write downs and potential fines for any role played in the LIBOR scandal.

74. BP was highlighted as another key stock, current price is 453p and UBS thinks fair value is around 580p. The portfolio is currently 5% overweight in BP and it makes up 4% of the index. BP has lost $70bn market cap since the Macondo disaster (£2 per share), with net costs of around $30bn (£1 per share). UBS expect the BP share price to recover the lost £1 when the US Department of Justice settlement occurs. UBS regards the resolution of the Russian investments as a positive step and believe this hasn’t been reflected by the market yet.

75. UBS highlighted that the value style of investing has generally performed poorly over the last five years. The S&P Value Index is about 10% below the FTSE All Share for the period. UBS now feel that market conditions are starting to improve and value investing performance will improve. A number of merger and acquisitions have already taken place in early 2013 and they believe this is set to increase which will help drive performance.

76. UBS aren’t reliant on the market to generate returns and instead focus on individual companies rather than macro-economic factors. They do believe there is

more confidence being shown by investors in equities and the trend of increasing allocations to bonds rather than equities is starting to reverse.

77. The outlook for 2013 is to keep the overweight positions in BP, Lloyds and Dixons as UBS think there is still a lot of potential upside in these companies until they meet fair value.

78. UBS think performance over the last year has been good and feel that a number of companies in the portfolio still look cheap which means there is a good chance that positive performance will continue. However, their overriding worry is finding enough cheap companies to fill the portfolio.

Item 7 – Member Training – Private Debt

79. Sanjay Mistry from the Alternatives Boutiques team at Mercer attended the meeting to give members a training session on private debt.

80. Private debt refers to an investment in privately negotiated debt. It can involve investing in senior bank debt, leveraged loans, mezzanine and subordinated debt within the capital structures of corporate entities.

81. In 1999 banks made up 88% of the loan market but the financial crisis has led to a large reduction in bank lending. In 2012 only 51% of the loan market was made by banks and this has created a number of opportunities for institutional investors.

82. Private debt is a broad term which covers a number of different products with different risk/return profiles. Property and infrastructure senior debt is seen as low risk with returns of between 3 - 5%, right up to corporate mezzanine debt with returns of 12 -15%.

83. Private debt has similar characteristics to private equity in terms of cash flows. Funds often have limited fund raising periods and commitments are drawn down over 2 - 5 years. The J-curve is less pronounced than for private equity investments.

84. Each deal has a negatively skewed risk/return profile in that the upside is largely capped, but downside is not. To mitigate this, investors need to invest in well diversified funds.

85. Management fees are high at around 1 to 2% pa and 10 – 20% performance fees (with a 6 – 8% hurdle) are the norm.

Additional Item – Treasury Strategy

86. Members were informed that the county council had approved its treasury strategy for 2013/14. Members agreed that the fund's treasury strategy should again mirror the county council for 2013/14.

Meeting concluded 3:30pm

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