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Notes from the Pension Fund Board 31 May 2013 (afternoon training session)

Hosted by Standard Life Investments at 30 St Mary Axe, London.

Manager	Attending
Baillie Gifford	Paul Morrison James Squires
Standard Life	Roger Sadewsky Dale MacLennan

Internal Cash and Asset Allocation

1. The Board discussed potential changes to the pension fund's asset allocation.

2. The internally managed cash levels surpassed minimum levels required for day-to- day liquidity, allowing £25m to be assigned to the externally managed portfolios.

3. Strong market movements in equities had lead to the fund's actual asset allocation differing from the target policy allocation. This difference was most marked in the allocation to global equities with a target of 34.0% against an actual allocation of 39.4% as at 14 May 2013.

4. The actual asset allocation to property was 5.2%, significantly underweight the 7% target.

5. Mercer, represented by Steve Turner (ST), brought to the Board a report analysing the potential to change CBRE's investment mandate, specifically the benchmark outperformance target. ST proposed that the current outperformance target for CBRE of 1.0% above the benchmark was forcing CBRE's investment strategy to be overly aggressive, seeking ambitious capital appreciation from a greater allocation to higher risk funds.

6. CBRE were overweight in a number of poorly performing European funds which were a drag on the overall portfolio's performance. CBRE had proposed two options that would allow them to de-risk the portfolio to allow a greater focus on income generation, thus not relying on capital appreciation to achieve the out-performance target.

7. Option A would allow for a reduction in the outperformance target from 1.0% to 0.5%. Option B would reduce the target to 0.5% but would also involve a capital contribution from internal cash of £25m to allow the portfolio to become more balanced

8. The Board felt that option B was the preferred choice and the surplus internal cash balance of £25m would be assigned to CBRE.

9. In terms of the Fund's overall asset allocation, the Board sought to clarify the agreed +/-3.0% control range on the broad target asset allocation categories as shown in the newly approved Statement of Investment Principles (SIP). It was suggested that a breach in the control range of greater than +/-3.0% would not stipulate that steps be taken immediately to restore parity, but that this breach should necessitate discussion.

10. As such the Board discussed the 5.4% overweight position in global equity. It was felt that
whilst global equity has performed especially strongly over the last period, the fund should
seek to ensure a diverse portfolio of assets to mitigate risk and volatility of returns and that
5 such an overweight position in global equity was not consistent with that approach.

11. John Harrison recommended that the passive global equity mandate, managed by LGIM, would be the best source of funds to rebalance the portfolio, given the strength of the current two active global equity managers. The global equities element of LGIM was overweight 3.1% against the target of 14%. This disparity was equal to £75m. The Board debated whether, to balance the portfolio, £75m should be removed from LGIM's passive mandate.

12. The £75m would be split between two different managers: £25m to be assigned to the diversified growth manager Baillie Gifford to align the allocations to each of the two current diversified growth funds.

13. The remaining £50m would be held for the release of a new diversified growth fund, also managed by Standard Life, but along different lines to the existing GARS fund. Following questioning about the differences between the existing GARS and the new version, Dale MacLennan from standard Life explained that the fund targeted a higher absolute return and that, out of a total of 35-40 investment themes, the new GARS funds only shared four with the former, indicating a diversity of approach and asset type.

Baillie Gifford (BG)

1. Paul Morrison and James Squires presented.

2. The Board were informed that the Baillie Gifford diversified growth fund was closed to new entrants with total fund size of £3.4bn at 31 March 2013. The allocation to Surrey was worth £97.3m as at 28 May 2013.

3. The aim of the portfolio is to deliver strong absolute returns, comparable with equity type returns, but with much reduced volatility of less than 10% per annum. Since inception in December 2008, BG reported annualised growth of 14.2% and volatility of 6.9%.

4. BG invests in a broad range of asset classes with an overriding focus upon managing risk. This is maintained through managing a number of disparate investment strategies with positions held as a hedge against the performance of other strategies. One example was insurance backed securities, the performance of which is linked to the occurrence of natural disasters, with a strong divergence from the performance of other assets.

5. BG were questioned about the exposure to insurance backed securities and the liquidity of these assets, especially the liquidity in the face of a forced sale due to fund withdrawals. BG responded that the liquidity of the assets in which they invest is very important and has a significant impact upon their strategy. Insurance assets are less liquid than some other portfolio assets as the total market is relatively small, but that fund exposure to these assets is limited and monitored regularly.

6. BG had set internal investment restrictions to ensure liquidity, 90% of holdings must be open to exit within one day.

7. A key performance driver to the fund's performance was an average 4.9% holding in private equity which returned 28% over the past 12 months. BG explained that a significant number of private equity funds were trading at large discounts to their net asset value so were very attractive. Whilst discounts to NAV had shortened in recent months, BG still 5 considered some private equity funds to be attractive.

8. The relatively weak performance of the asset category listed equities was queried with a return over the previous year of 1.1%. BG explained that the allocation to listed equities included a variety of derivative assets which would have performed strongly had the equity markets pulled back or stagnated.

9. BG were overweight in emerging market bonds, which provided the greatest absolute return within the portfolio. Another aspect of emerging market bonds to which BG were optimistic is the exposure to emerging market currency through this asset class. BG did not hedge the emerging market currency exposure.

10. BG's economic outlook was confident, with the prospect of a major collapse in asset prices lessening. In light of this, BG's recent adjustments in the portfolio included an increase in listed equity and emerging market bonds with a reduction in defensive cash holdings.

11. BG were questioned about the potential withdrawal of central bank support via commitment to quantitative easing (QE). The withdrawal of QE was very much at the forefront of BG's strategy themes, with a distinction between how well the central banks will manage the withdrawal as the impact of a disorderly exit would be markedly different.

12. The issue of Europe was raised. BG maintained that whilst Europe was a very problematic area there were areas attractive for investment. One such area was dividend futures. Companies are very unwilling to reduce the dividend levels even if profitability falls so BG considered this a defensive exposure to Europe.

Standard Life Investments (SLI)

1. Roger Sadewsky and Dale MacLennan from Standard Life Investments (SLI) presented.

2. Dale provided a summary of the objective of the SLI Global Absolute Return Strategies (GARS) Fund. The objective is to achieve an absolute return of cash + 5.0% per annum over rolling three-year periods with an expected volatility between 4.0% to 8.0%.

3. The GARS fund only invests in highly liquid instruments with significant market depth to ensure that the fund has daily liquid access with limited price impact.

4. Investment strategies and ideas are designed to cover a two to five year duration which allows SLI to take a long term view on an investment issue, reducing the timing pressure.

5. The example offered of this was SLI's position on Japan. Japan was operating under a number of high profile economic problems including high debt to GDP, ageing demographics and restrictive labour market. SLI believed that it was likely that in the medium term some action would be taken, enabling a long US Dollar versus Yen position, which came to fruition following the recent Bank of Japan monetary expansion.

6. SLI were underweight on South Korean and Taiwanese equities following increased pressure from other manufacturing hubs and the decline in the relative value of the Yen.

7. SLI had recently taken an overweight position in Chinese equities. Fears surrounding a slowdown in China's growth rate had brought asset prices in line with valuation. SLI were of the opinion that a long position in the Chinese equity market had a limited downside risk.

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8. SLI were confident in the US economy: the banking sector was in much better shape than Europe and US companies were sat upon very strong balance sheets with the recent low levels of capital expenditure likely to be reversed in the near future. However, concerns regarding the unwinding of US QE led to SLI taking steps to lessen US exposure through futures and options.

9. Improvements in the US economy will have significant impact on Mexico. SLI was overweight in Mexican government bonds with a low debt to GDP of 30% and recent credit upgrades, as well as positive exposure to the Mexican Peso.

10. In response to questioning regarding Europe, SLI were of the opinion that the risk premium in Europe had reduced to an extent that the market was less attractive, especially in France, where French equities had recently outperformed German equities, indicating a mispricing of risk.

11. SLI made reference to developing strategies based on where there is suspicion of strong structural improvements in a country, but that will not necessarily be evident in the short term. The extended investment duration allows SLI to develop long term strategies based on such assertions. One such strategy was a long Indian Rupee versus the Singapore Dollar position based upon perceived strengths of the Indian economy.

12. SLI were also interested in exposure to income generating property through REITS, excluding Australian and Canadian property due to perceived currency overvaluations.