

**SURREY COUNTY COUNCIL****PENSION FUND COMMITTEE****DATE: 16 DECEMBER 2022****LEAD OFFICER: ANNA D'ALESSANDRO, DIRECTOR CORPORATE FINANCIAL & COMMERCIAL****SUBJECT: INVESTMENT MANAGER PERFORMANCE AND ASSET/LIABILITIES UPDATE****SUMMARY OF ISSUE:**

This report is a summary of manager issues for the attention of the Pension Fund Committee, as well as an update on investment performance and the values of assets and liabilities.

**RECOMMENDATIONS:**

It is recommended that the Pension Fund Committee:

- 1) Notes the main findings of the report in relation to the Fund's valuation and funding level, performance returns and asset allocation.

**REASON FOR RECOMMENDATIONS:**

To assess and acknowledge performance of the Fund's investment managers against the Fund's target returns, and whether it is meeting its Strategic Investment objective in line with the Business Plan.

**DETAILS:****Funding Level**

1. The funding level is derived as the ratio of the value of the Fund's assets to the value of its liabilities. The Fund's liabilities are the future benefit payments due to members in respect of their service accrued in the Fund. The Fund's assets are used to pay member benefits accrued to date.
2. Since the 2019 valuation we have reported the funding position each quarter using a static discount rate of 4.2%.
3. At the 2022 valuation, this discount rate was revised to 4.4%, which was higher than that set at the 2019 valuation due to an increase in investment return expectations. The 2022 valuation discount rate of 4.4% was set based on a 70% level of prudence ie based on market conditions as at 31 March 2022, there was a 70% likelihood that the Fund's assets would generate average returns of at least 4.4% over the following 20 years.
4. Return expectations as at 30 September 2022 were significantly higher than they were as at 31 March 2022. This is due, in part, to higher interest rates which are expected to increase returns on all other asset classes. The current discount rate of 6.3% is based on the same level of prudence as applied as at

31 March 2022 ie a 70% likelihood of achieving at least this level of return over the next 20 years.

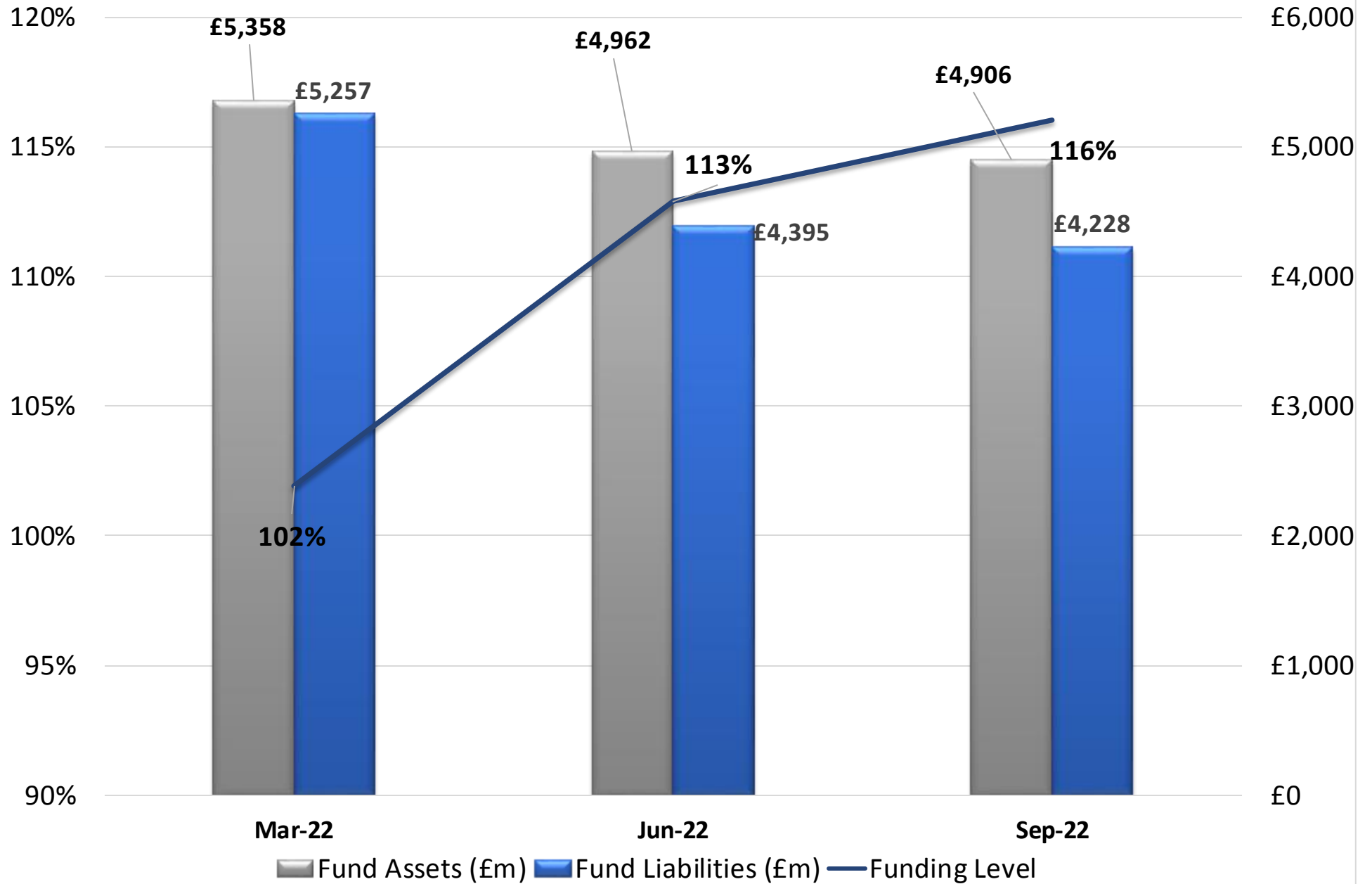
5. For the purpose of providing the quarterly funding updates following the 2022 valuation, it is appropriate (and the Fund Actuary's recommendation) that the 70% level of prudence remains fixed in the determination of the discount rate. This 'dynamic' discount rate each quarter-end would therefore reflect the change in investment return expectations since the 2022 valuation date.
6. Assessing the liabilities using the 'dynamic' discount rate also ensures that the factors leading to a change in asset values are being reflected in liability values. There is not a direct relationship (ie assets and liabilities do not react in the exact same way to changes in market conditions) but measuring the liabilities using the 'dynamic' discount rate means that the assets and liabilities are being measured on a consistent market basis over time.
7. Now is the right time to make this change, given the significant shift in market conditions (interest rates and short-term inflation) we have seen since the 2022 valuation date (31 March 2022). The world going forward may look quite different to the one where reporting on a fixed discount rate of 4.4% was appropriate, and there is a risk that continuing to report on a fixed discount rate may give a misleading picture of the emerging funding position.

#### 8. Results and assumptions

	31 March 2022	30 June 2022	30 September 2022
Assets (£m)	5,358	4,962	4,906
Past service liabilities (£m)	5,257	4,395	4,228
<b>Surplus/(Deficit) (£m)</b>	<b>101</b>	<b>567</b>	<b>678</b>
Funding level	102%	113%	116%
Discount Rate	4.4%	5.3%	6.3%
Salary Increases	3.7%	3.7%	3.6%
Pension Increases	2.7%	2.7%	2.6%
Likelihood of success	70%	70%	70%

- 9 For information, if a static discount rate of 4.4% were to apply (as applied at the 2022 valuation), our assessment is that the Fund's assets have a 87% likelihood of returning this level of return over the next 20 years. The reported funding level would therefore not be consistent with the level of prudence set at the 2022 valuation.
- 10 The graph below shows that funding level has reached 116% (102% as at 31 March 2022), updated for market conditions at 30 September 2022. The market value of assets is approximately £4.9bn and the value placed on the liabilities is £4.2bn.

# Surrey Pension Fund Quarterly Summary



11. Attitudes towards the evolving economic situation, and the resultant policy response from governments and central banks, fluctuated during the period. July saw optimism that inflation was peaking but August gave way to acceptance of more interest rate tightening ahead. This was compounded in September when the Federal Reserve surprised investors with higher interest rate projections. On the home front, the most important development during the quarter was the announcement of the Government's 'mini' budget. In response to the expected increase in Government borrowing, due to increased spending and unfunded tax cuts, sterling fell precipitously and gilt yields rocketed.

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Within this environment, global equities fell again in the quarter to 30 September 2022, as market participants reflected on high inflation, rising interest rates and a weakening economic outlook. Both developed and emerging market lost ground. European equity markets underperformed as the European Central Bank raised interest rates by 50bp in July and then 75bp in September. High gas prices are weighing heavily on industry and manufacturing on the continent, making a recession likely. Data points were also generally negative in the UK, although the unemployment rate fell to 3.6% in July, its lowest level since 1974. Japan outperformed as weakness in the yen is seen as supportive to exports and the Government announced plans to lift most travel restrictions relating to Covid. Emerging market equities underperformed, with China the key detractor.

Yields on global government bonds rose substantially over the period as central banks guided towards higher interest rates in a bid to combat inflation. As previously discussed, expectations of interest rate levels varied over the quarter, but the period ended with concerns over future increases after higher than predicted inflation announcements. European bond yields rose, with the 10-year German bund yield increasing from 1.4% to 2.1% and spreads widened on the Italian 10-year government bond. Government stimulus packages to aid consumers and businesses should support the economy to some extent, although increased borrowing, combined with economic contraction and rising inflation, could result in growing pressure on financial markets. In response to energy subsidies and the 'mini' budget, 10-year gilt yields rose dramatically from 2.2% to 4.1%, touching 4.5% in the last week of September. Yields fell back from this peak as the Bank of England intervened to contain further damage to the financial system by buying gilts. Yields on Japanese government bonds were relatively flat, as the Bank of Japan remains committed to maintaining its 10-year bond yield below 0.25% by purchasing an unlimited quantity of the bonds.

Credit spreads widened as investors feared negative impacts on growth and company finances against the backdrop of an already slowing global economy. The eurozone manufacturing PMI, at 48.4 in September, pointed to the biggest contraction in factory activity since June 2020. The consumer confidence indicator fell to its lowest level since the series began in 1985. Sterling credit underperformed due to local government policies on top of the general economic and market background.

The US dollar continued its rise against sterling, the euro and the yen over the quarter, as rising US interest rates applied further pressure to global economies and currencies amid weakening economic data. The euro ended the quarter below parity with the dollar.

12. Overall, the Fund returned -1.55% in Q2 2022/23 (Jul-Sep 2022), in comparison with the Fund's benchmark of -0.36%. The fall in absolute terms was the result of the factors discussed above, particularly highlighted by the performance of UK Gilts.

The relative underperformance was driven by three BCPP funds, namely Global Equity Alpha, Multi-Asset Credit and Listed Alternatives. BCPP Global Equity Alpha continued its disappointing run of performance this year, with half of the relative underperformance coming from currency exposure and half from the exposure to value managers. Relative to each individual market benchmark, the underlying funds within BCPP MAC underperformed by 0.4%, with 5 of the 6 managers underperforming. However, against the overall absolute return benchmark of SONIA +3.5%p.a., the Fund underperformed significantly more as yields across the market rose, as discussed above. BCPP Listed Alternatives underperformed its benchmark by 5.8% as some long duration/infrastructure positions had high correlation with the falling bond markets.

Offsets to this performance came from the Real Estate exposure, through CBRE, as well as the Private Markets positions. Valuations in both these asset classes tend to be less volatile and, compared to listed equities, tend to adjust more slowly to changing economic conditions. This can benefit relative performance on a short-term basis.

## Fund Performance - Summary of Quarterly Results

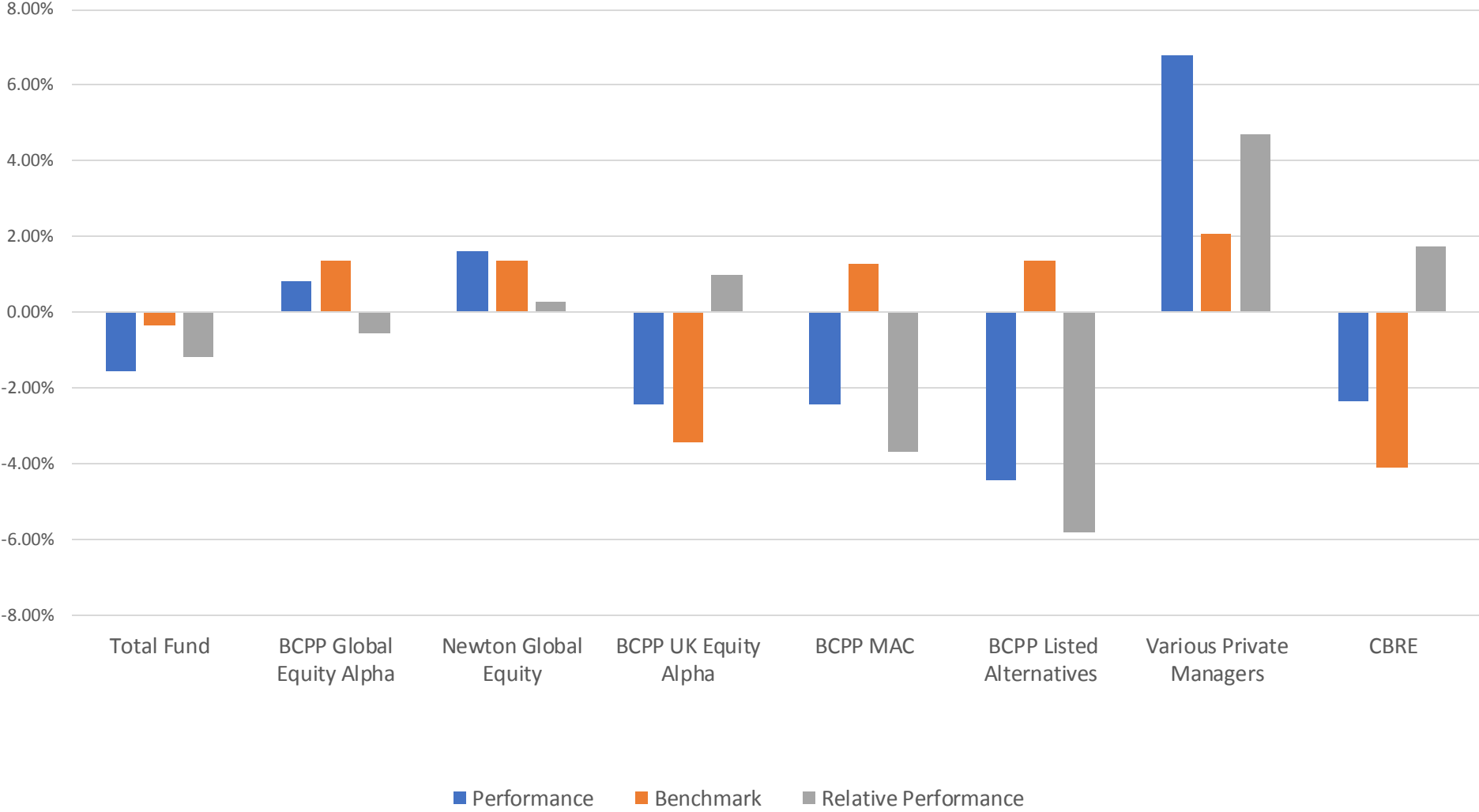
The table below shows manager performance for Q2 2022/23 (July – September 2022), net of investment manager fees, against manager specific benchmarks using Northern Trust data.

As at 30 Sep 2022		3M				1Y				3Y		
Asset Class	£m	Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance
<b>Total Fund</b>	<b>4,908.47</b>	-1.55%	-0.36%	-1.19%		-7.68%	-3.84%	-3.84%		2.19%	3.17%	-0.98%
<b>Active Global Equity</b>	<b>1,116.3</b>											
BCPP Global Equity Alpha	659.1	0.82%	1.37%	-0.55%		-7.82%	-4.17%	-3.65%		5.85%	7.22%	-1.37%
Newton Global Equity	457.2	1.63%	1.37%	0.26%		-5.32%	-4.17%	-1.15%		7.43%	7.22%	0.21%
<b>Active Regional Equity</b>	<b>452.3</b>											
BCPP UK Equity Alpha	452.3	-2.45%	-3.45%	1.00%		-15.88%	-4.00%	-11.88%		-0.62%	0.80%	-1.42%
<b>Passive Global Equity</b>	<b>866.7</b>											
LGIM - Future World Global	866.7	1.17%	1.22%	-0.05%								
<b>Passive Regional Equity</b>	<b>381.7</b>											
LGIM - Europe Ex-UK	42.5	-2.39%	-2.43%	0.04%		-13.12%	-13.61%	0.48%				
LGIM Emerging Markets	284.4	-2.34%	-2.39%	0.06%		-8.76%	-8.84%	0.08%				
LGIM - Japan	14.3	0.94%	0.77%	0.17%		-13.65%	-13.98%	0.34%				
LGIM - Asia Pacific ex-Japan	40.6	-2.98%	-2.97%	0.00%		-9.17%	-9.16%	-0.01%				
<b>Fixed Income</b>	<b>649.1</b>											
BCPP MAC	524.1	-2.42%	1.26%	-3.68%								
LGIM Gilts *	125.0	-12.44%	-12.44%	0.00%		-23.93%	-23.93%	0.00%		-12.28%	-12.28%	0.00%
<b>Private Markets Proxy</b>	<b>348.7</b>											
BCPP Listed Alternatives	348.7	-4.44%	1.37%	-5.81%								
<b>Private Markets</b>	<b>712.2</b>											
Various Private Managers	712.2	6.77%	2.06%	4.71%		21.67%	-2.93%	24.60%		10.13%	8.06%	2.07%
<b>Real Estate</b>	<b>350.5</b>											
CBRE	350.5	-2.36%	-4.10%	1.75%		14.50%	13.05%	1.45%		6.63%	7.76%	-1.14%
<b>L&amp;G Currency Overlay</b>	<b>- 47.0</b>											
<b>Total Cash &amp; Equivalents</b>	<b>77.8</b>											

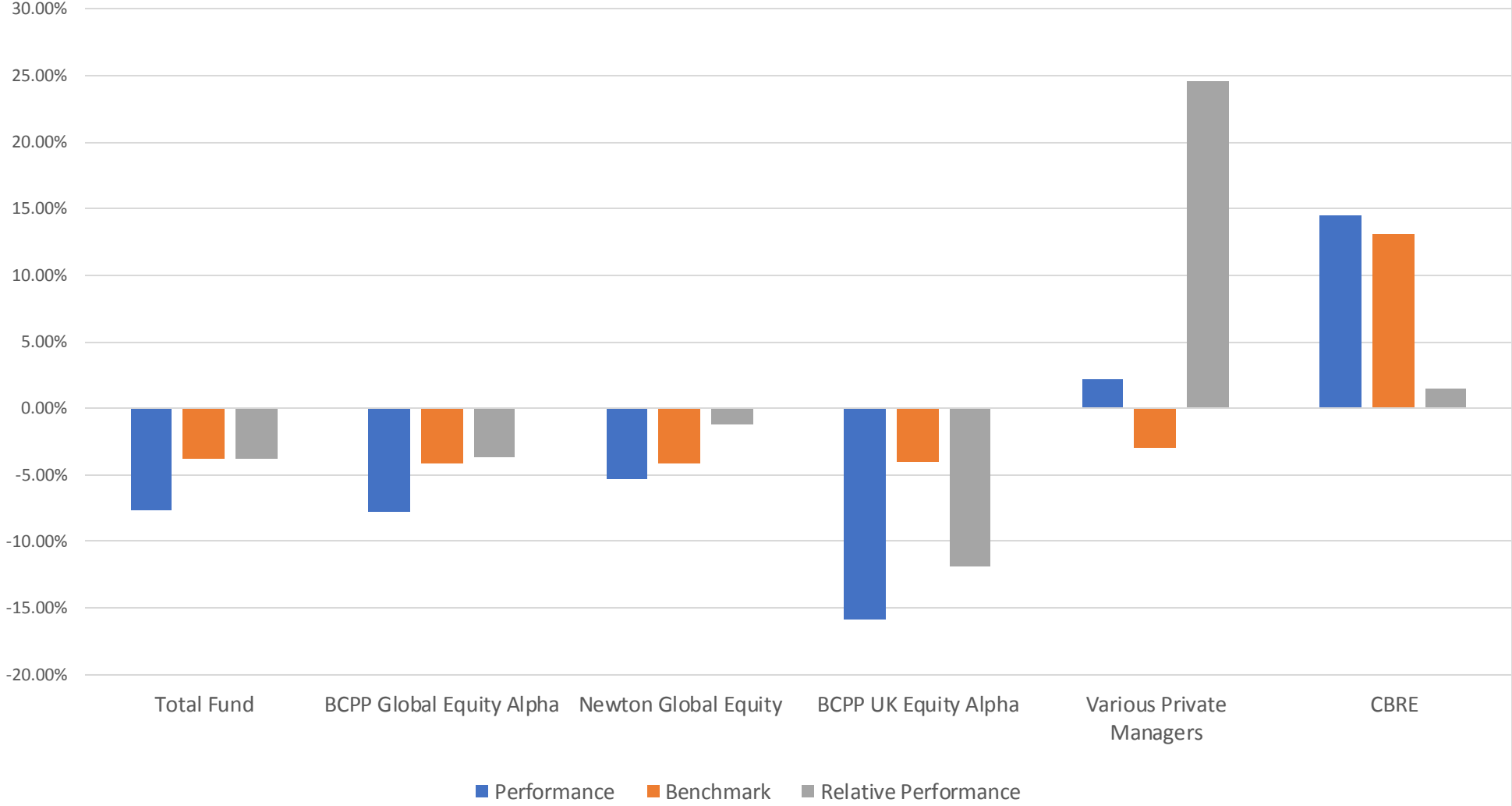
\* Performance figures represent total Bespoke Fund (3M Gilt Return -18.1%, Liquidity Return 0.41%)

\*\* Includes £8.3m of money market funds

### 3 Months to 30 Sep 2022 Active Manager Performance Relative to Benchmark

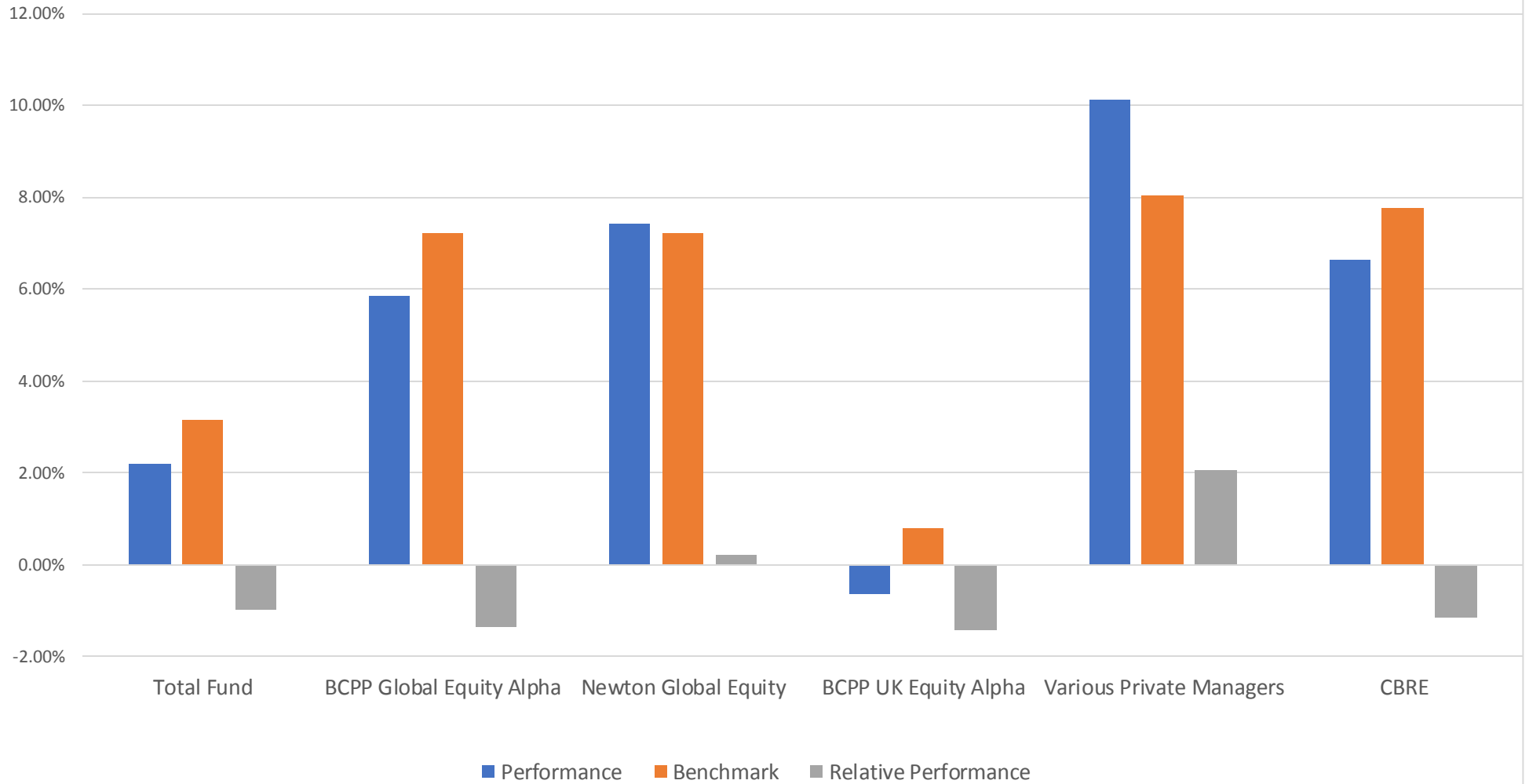


### 1 Year to 30 Sep 2022 Active Manager Performance Relative to Benchmark





### 3 Years to 30 Sep 2022 Performance Relative to Benchmark



## Recent Transactions

13. In October 2021 the Fund purchased units in the BCPP Multi-Asset Credit Fund to a value of £613.5m. This was funded from the disposal of units in the Western Multi-Asset Credit Fund and units in the Templeton Global Total Return Fund.
14. In October 2021 the Fund purchased units in the LGIM Future World Global Equity Index Fund to a value of £996m. This was funded from the disposal of units in the LGIM RAFI Multi-Factor Developed Index Fund and units in the LGIM MSCI World Low Carbon Target Index Fund.
15. In February 2022 the Fund purchased units in the BCPP Listed Alternatives Fund to a value of £386.5m. This was funded from the disposal of units in the Baillie Gifford Diversified Growth Fund, units in the Aviva Investors Multi-Strategy Target Return Fund, and units in the Ruffer Absolute Return Fund.
16. During the second half of 2022 the Fund has used BCPP Listed Alternatives, BCPP UK Equity Alpha and LGIM Liquidity Fund as a source of funds for private market capital calls.

## Stock Lending

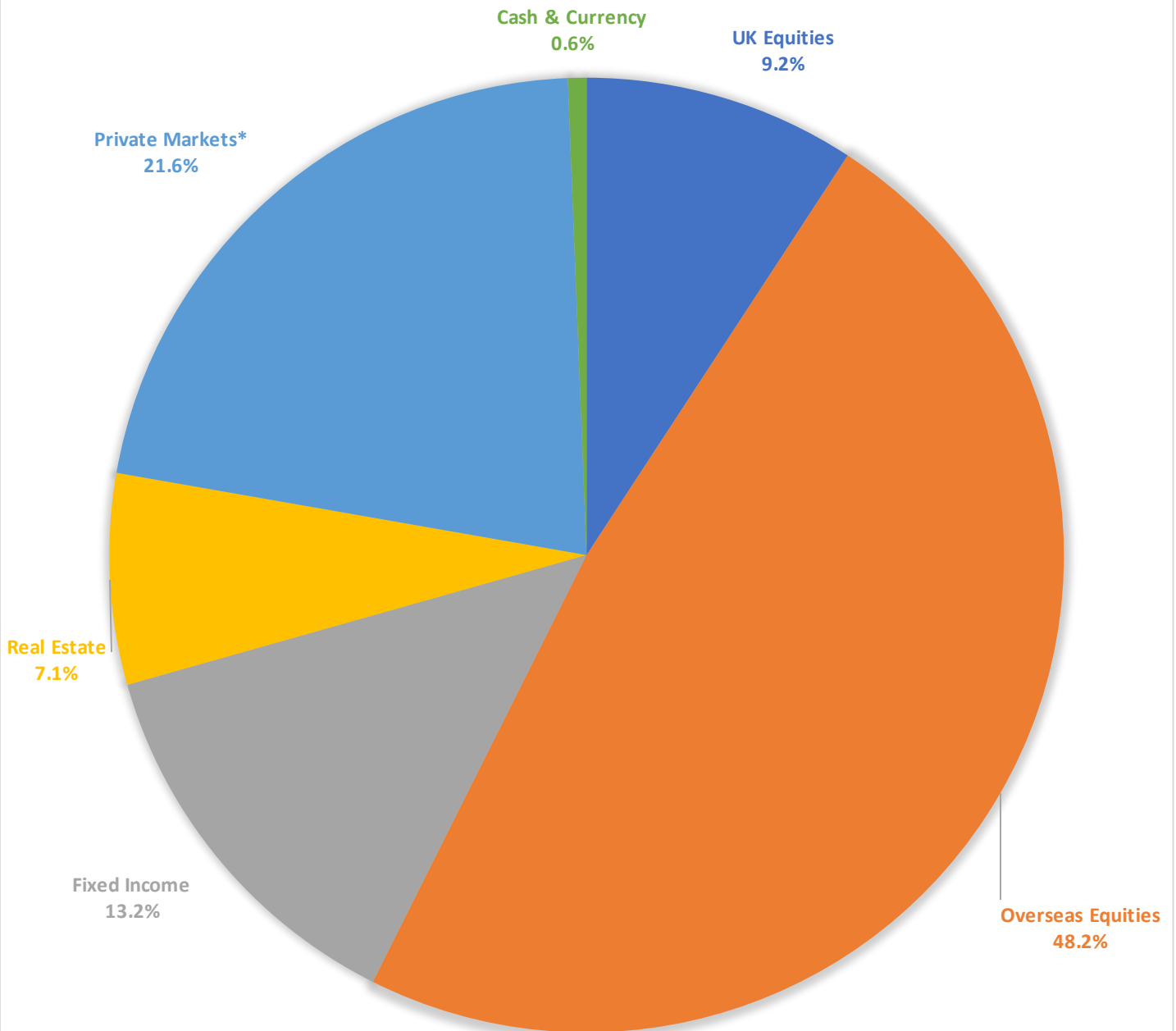
17. In the quarter to 30 September 2022, stock lending earned a net income for the Fund of £2,939 compared with £8,784 for the quarter ended 30 June 2022.
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## Asset allocation

18. The table and the graph below show the target and actual asset allocations for the quarter ending 30 September 2022. These allocations were agreed by the Pension Fund Committee in the December 2021 meeting.

Asset class	Total Fund (£M)	Actual (%)	Target (%)	Advisory ranges %	Role(s) within the strategy
<b>Listed Equities</b>		<b>57.4%</b>	<b>54.8</b>	<b>51.8 – 57.8</b>	Generate returns in excess of inflation, through exposure to the shares of domestic and overseas companies.
UK	452.3	9.2%	12		
Global Market Cap	1,116.3	22.7%	13		
Global Regional	97.3	2.0%	10		
Emerging Markets	284.4	5.8%	3.8		
Global Sustainable	866.7	17.7%	16		
<b>Alternatives</b>		<b>28.8%</b>	<b>27.6</b>	<b>22.6-32.6</b>	Generate returns in excess of inflation, through exposure to illiquid assets that are not publicly traded, whilst providing some diversification away from listed equities and bonds.
Private Markets	712.2	14.5%	17	7.0-25.0	
Listed Alternatives	348.7	7.1%	3	0.0-6.0	
Real Estate	350.5	7.1%	7.6	4.6–10.6	
<b>Multi Asset Credit</b>		<b>10.7%</b>	<b>12.1</b>	<b>9.1-15.1</b>	Offer diversified exposure to global credit markets to capture both income and capital appreciation of underlying bonds.
Multi Asset Credit	524.1	10.7%	12.1		
<b>Fixed Interest Gilts</b>				<b>2.5-8.5</b>	Low risk income stream
Fixed Interest Gilts	125.0	2.5%	5.5		
<b>Cash &amp; Currency Overlay</b>		<b>0.6%</b>			
Cash & Currency Overlay	30.8				
<b>Total</b>	<b>4,908.5</b>		<b>100</b>		

## ASSET ALLOCATION AS AT 30 SEP 2022 (£M)

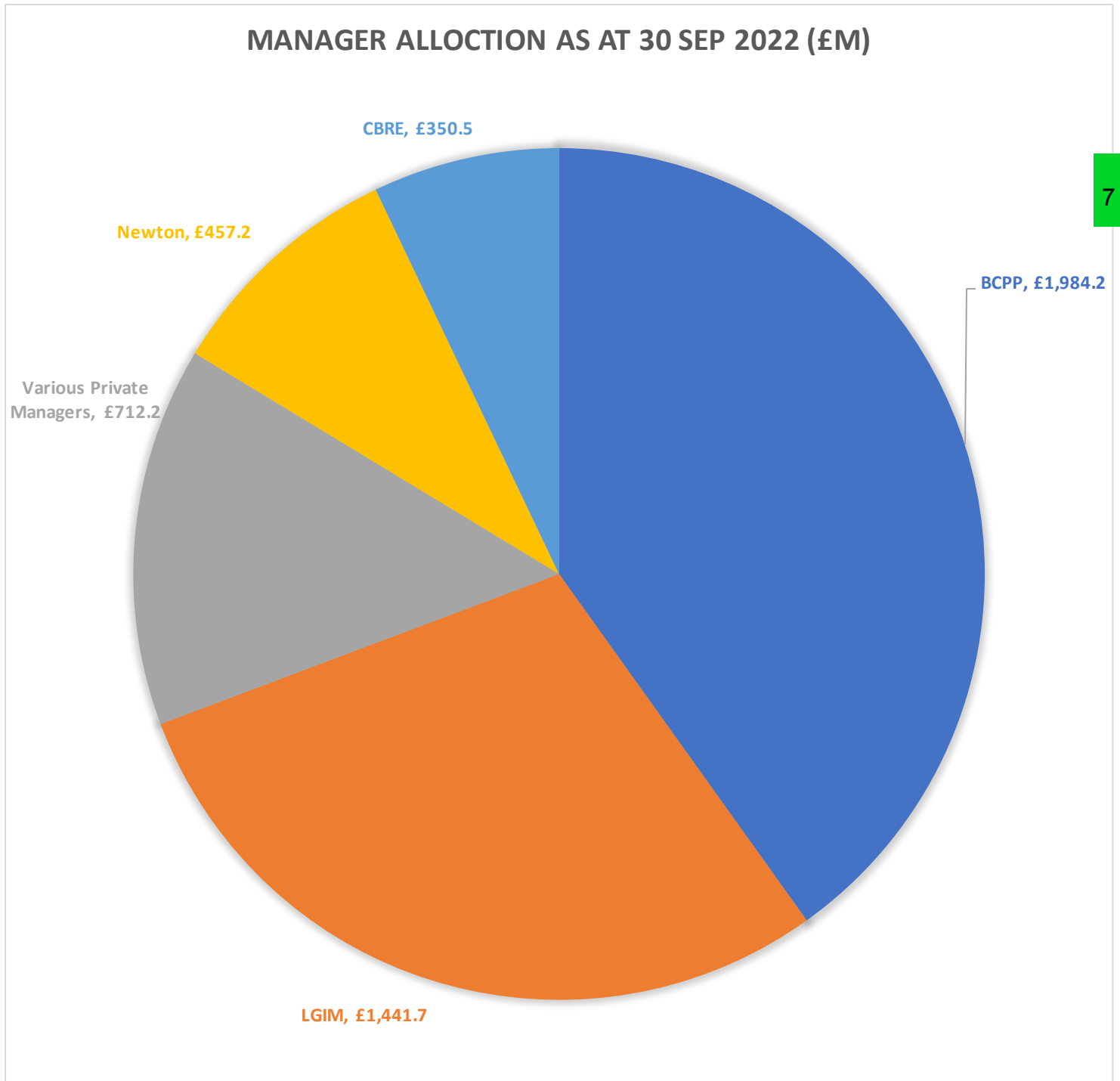


\*Includes Listed Alternatives

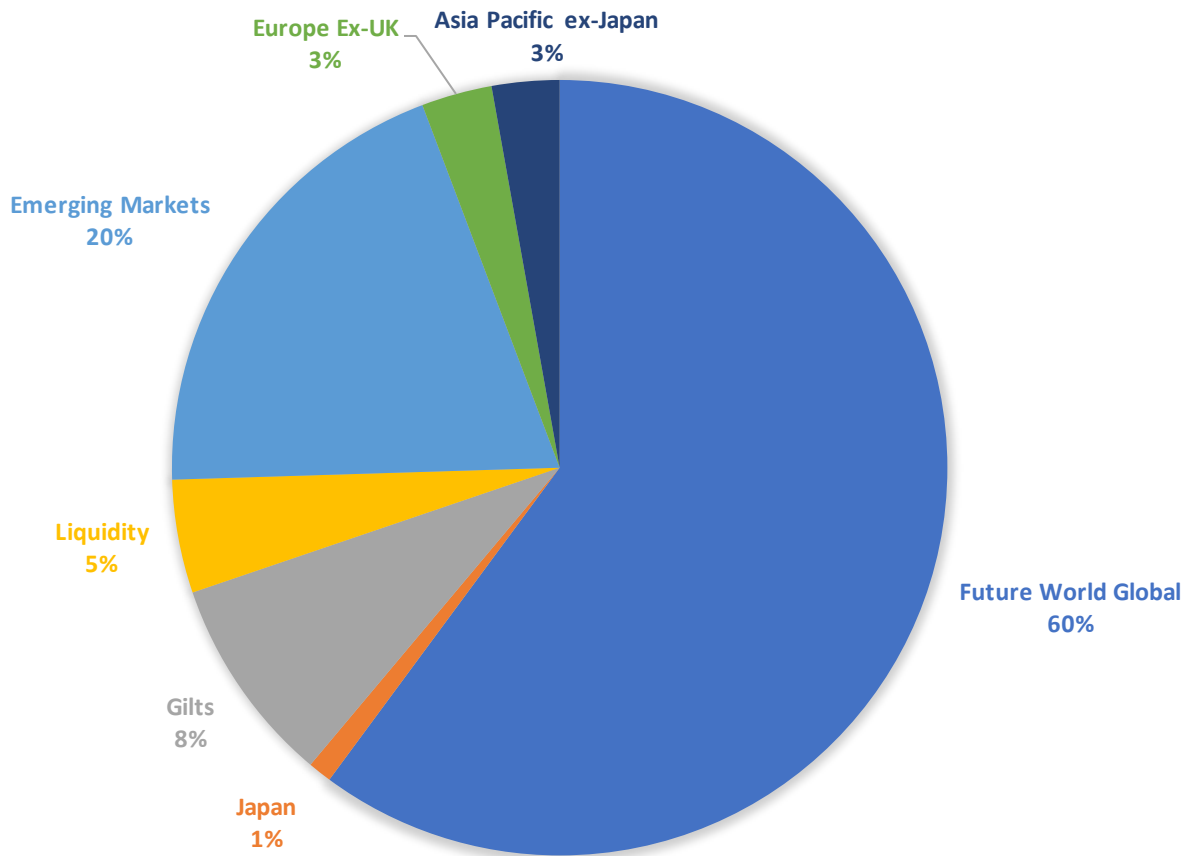
## Manager Allocation

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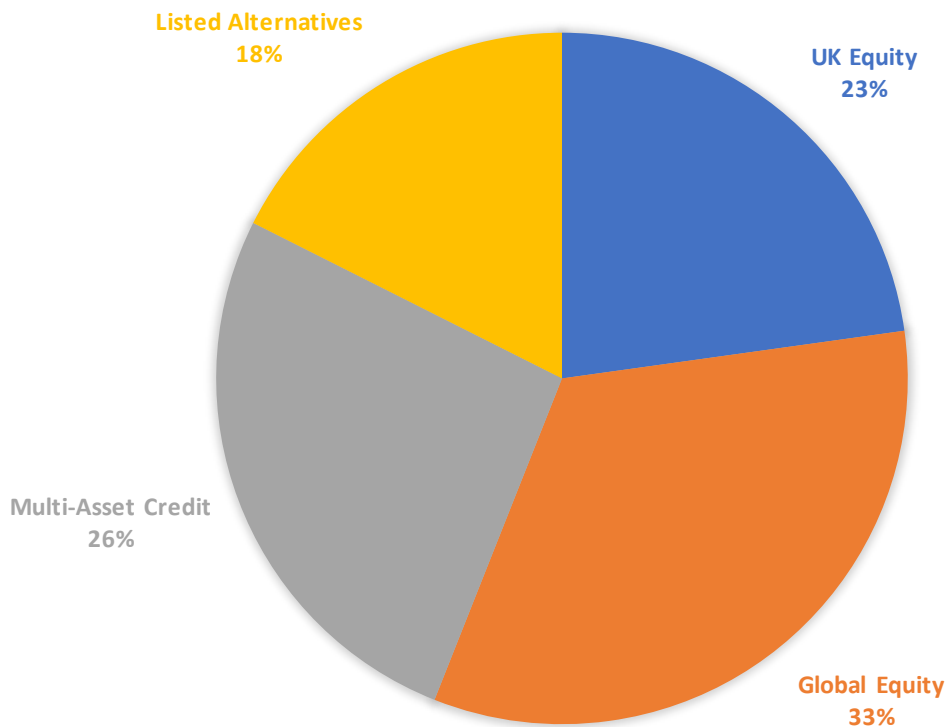
The graph below shows the manager allocation for the quarter ending 30 September 2022.



## LGIM ALLOCATION DETAIL AS AT 30 SEP 2022



## BORDER TO COAST LISTED ALLOCATION AS AT 30 SEP 2022



## Cashflow

19. Pensions Funds have a positive cash-flow when their contribution inflows exceed pension benefits paid.
20. Contributions are derived from employers and employees. Pension benefits are derived from pensions and lump sum benefits paid to retired members and benefits paid to employees on leaving the Fund.
21. Any positive cash-flow is invested in accordance with the Fund's cash management plan.
22. We are reviewing cashflow information and in due course will review the prospective cashflow requirements taking account of likely pension increases and the new schedule of employer contributions following the actuarial valuation.

£m Period	Total contributions received	Total pension benefits paid	Net cash-flow
Quarter One 2022/23  (1 Apr 2022 – 30 Jun 2022)	54.8	51.2*	3.6
Quarter Two 2022/23  (1 Jul 2022 – 30 Sep 2022)	56.3	48.6	7.7

\*This figure is inflated due to an increase in Transfers Out during the quarter

23. An indication of the current membership trends is shown by movements in membership over quarters four and one. Member data listed below.

Period	Active members	Deferred members	Pension members	Total members
Quarter One 2022/23  (1 Apr 2022 – 30 Jun 2022)	35,394	43,085	29,917	108,396
Quarter Two 2022/23  (1 Jul 2022 – 30 Sep 2022)	35,010	43,728	30,264	109,002

## Fund Manager Benchmarks

Fund	Portfolio	Benchmark Index	Performance Target relative to Benchmark
Surrey Pension Fund	Total Portfolio	Weighted across fund	+1.0%

Manager	Portfolio	Benchmark Index	Performance Target relative to Benchmark
BCPP	UK Equities Alpha	FTSE All Share	+2.0%
BCPP	Global Equities Alpha	MSCI ACWI	+2.0%
BCPP	MAC	SONIA + 3.5%	
BCPP	Listed Alternatives	MSCI AC World Index	
Newton	Global Equities	MSCI AC World Index	+2.0%
Various	Private Equity	MSCI World Index	+5.0%
CBRE	Real Estate	MSCI/AREF UK QPFI All Balanced Property Fund Index (for UK Assets)  Global Alpha Fund Absolute Return 9-11%	+0.5%
LGIM	Europe ex-UK Equities  Future World Global Equity Index  Japan Equity  Asia Pacific ex-Japan Development Equity  World Emerging Markets Equity  LGIM Bespoke & Cash	FTSE Developed Europe ex-UK Net  Solactive L&G ESG Global Markets Net  FTSE Japan Net  FTSE Developed Asia Pacific ex-Japan Net  FTSE Emerging Net  Fund return	To track the performance of the respective indices within a lower level of tracking deviation (gross of fees) over rolling 3-year periods



## **CONSULTATION:**

24. The Chair of the Pension Fund Committee has been consulted on this report

## **RISK MANAGEMENT AND IMPLICATIONS:**

25. Risk related issues have been discussed and are contained within the report.

## **FINANCIAL AND VALUE FOR MONEY IMPLICATIONS**

26. Financial and value for money implications are discussed within the report.

## **DIRECTOR CORPORATE FINANCIAL & COMMERCIAL COMMENTARY**

27. The Director Corporate Financial & Commercial is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed.

## **LEGAL IMPLICATIONS – MONITORING OFFICER**

28. There are no legal implications or legislative requirements.

## **EQUALITIES AND DIVERSITY**

29. 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**

30. There are no potential implications for council priorities and policy areas.

## **WHAT HAPPENS NEXT**

31. The following next steps are planned:

- Analyse asset allocation relative to any agreed changes resulting from Investment Strategy Review.
- Continue to monitor performance and enhance risk adjusted returns

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### **Contact Officer:**

Lloyd Whitworth, Head of Investment & Stewardship

### **Consulted:**

Pension Fund Committee Chair

### **Annexes:**

Annexe 1 - Manager Fee Rates (Part 2)

### **Sources/background papers:**

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