SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: 10 MARCH 2023

LEAD OFFICER: ANNA D'ALESSANDRO, DIRECTOR CORPORATE FINANCIAL & COMMERCIAL

SUBJECT: INVESTMENT MANAGER PERFORMANCE AND ASSET/LIABILITIES UPDATE

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SUMMARY OF ISSUE:

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

RECOMMENDATIONS:

It is recommended that the 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. 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.

3. 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.

4. Results and assumptions

	31 March 2022	30 September 2022	31 December 2022
Assets (£m)	5,358	4,906	5,074
Past service liabilities (£m)	5,257	4,228	4,080
Surplus (£m)	**101**	**678**	**994**
Funding level	102%	116%	124%
Discount Rate	4.4%	6.3%	6.2%
Salary Increases	3.7%	3.6%	3.2%
Pension Increases	2.7%	2.6%	2.2%
Likelihood of success	70%	70%	70%

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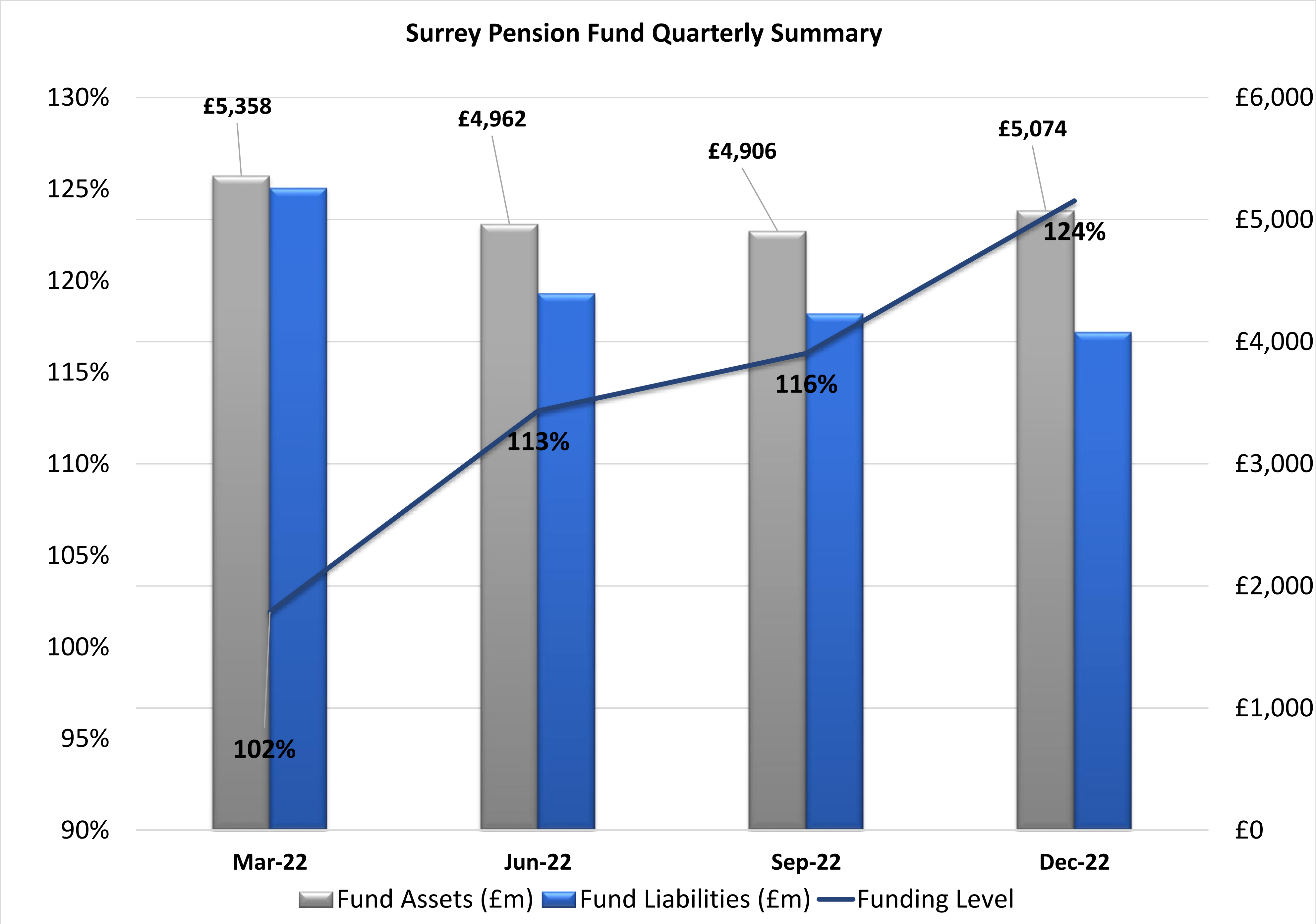
5. The discount rate assumptions at each date are based on the return expected from the Fund's assets with a 70% likelihood, ie based on our asset return expectations as at 31 December 2022, there is an 70% likelihood that the Fund's assets will generate returns over the next 20 years at the level of at least 6.2% per annum.

6. The increase in the discount rate (6.2%) as at 31 December 2022 compared to 31 March 2022 (4.4%) is due to an increase in asset return expectations since the 2022 valuation which has been driven in part, by a significant increase in long dated gilt yields since then. Asset return expectations have reduced slightly since the previous funding update as at 30 September 2022.

7. The assumptions for Pension Increases (CPI) reflects the central projection of CPI from the Hymans ESS model (as at the effective date).

   a. The CPI assumption set at the 2022 valuation (31 March 2022) recognises a one-year spike in inflation of c. 8%.
   b. Since then, the change in CPI over the 12 months to September 2022 has been confirmed to be 10.1% and this is the expected 2023 Pension Increase order. This has been allowed for in the value of the liabilities as at 31 December 2022 (and 30 September 2022).

8. The graph below shows that funding level has reached 124% (102% as at 31 March 2022), updated for market conditions at 31 December 2022. The market value of assets is approximately £5.1bn and the value placed on the liabilities is £4,1bn.


Surrey Pension Fund Quarterly Summary
130%
125%
120%
115%
110%
105%
100%
95%
90%
£6,000
£5,000
£4,000
£3,000
£2,000
£1,000
£0
£5,358
£4,962
£4,906
£5,074
102%
113%
116%
124%
Mar-22
Jun-22
Sep-22
Dec-22
Fund Assets (£m)
Fund Liabilities (£m)
Funding Level

9. Global equities rose over the fourth quarter amid increasing optimism about inflation moderating in 2023. Europe was the best performer as warmer-than-average weather sent European gas prices lower and risks of severe recession appeared to lessen. The Asia Pacific region also outperformed, with China’s sudden relaxation of many of its COVID-19 restrictions surprising the market and expected to boost economic activity. While an increase in COVID infections could hamper recovery somewhat, investors remain optimistic about the prospects for the Chinese economy in 2023.

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The US Federal Reserve (Fed) went ahead with two interest rate hikes over the quarter, the second of which was for 50 basis points (bps) rather than the 75bps enacted in previous meetings. US inflation slowed for the fifth consecutive month in November, to 7.1% and Euro area inflation declined for the first time since June 2021, from 10.6% to 10.1%. The US labour market remained tight but showed signs of normalising, reminding the market of the possibility of recession this year if the labour market cools too much.

It was a mixed picture for global government bonds over the fourth quarter of 2022, with the 10-year US Treasury yield roughly flat, German and Japanese yields rising and UK gilt yields falling.

European bond yields rose, with the German 10-year bund yield rising from 2.11% to 2.56%. The European Central Bank (ECB) raised interest rates twice over the quarter, by 75bps in October and a further 50bps in December. Central bank guidance indicated that rates would continue to rise “significantly” to get eurozone inflation back down from November’s 10.1% to the bank’s 2.0% target.

UK gilt yields fell over the fourth quarter, from 4.10% to 3.67%. Yields spiked in late September and early October after the ‘mini-budget’, but with the new government focusing on balancing the books, gilt yields trended down before rising again in December. The Bank of England raised interest rates twice over the quarter, by 75bps and 50bps.

Japanese government bond yields rose suddenly on 20 December when the Bank of Japan (BoJ) unexpectedly announced that it had raised its target on the 10-year bond yield from +/- 0.25% to +/- 0.5%. Yields on 10-year bonds ended the quarter at 0.41%. The central bank now owns more than half the country’s outstanding bonds.

Yields on global credit fell in the fourth quarter, and credit spreads tightened. With consumer price indices indicating slowing inflation rates, and speculation over a possible US Federal Reserve (Fed) pause in rate hikes, some investors began to feel that bad news was already priced in.

The US dollar fell against sterling, the euro and the Japanese yen in the fourth quarter of 2022. While the dollar’s rise earlier in the year drove global currencies to near historic lows versus the US currency, this began to revert in the fourth quarter. Economies proved more resilient than some had feared. Meanwhile, the UK and eurozone continued to narrow the gap between US and European interest rates. Sterling rose against the dollar but weakened slightly against the euro and the yen.

10. Overall, the Fund returned +3.48% in Q3 2022/23 (Oct-Dec 2022), in comparison with the benchmark of +1.31%. As well as a return to an absolute increase in value, the Fund also outperformed the benchmark by 2.17%.

    The best absolute performance came from the exposure to European, UK and Asia Pacific equities, for the reasons previously discussed. However, there was positive absolute performance from all funds and asset classes except for real estate and a marginal fall for the Gilts exposure. The real estate sector is going through a period of re-pricing reflecting rising interest rates and the availability of income elsewhere. There is also pressure in terms of capital flow out of real estate funds, partly driven by asset allocation decisions following the LDI debacle.

    Whilst the absolute value of the Fund's real estate investment fell, the performance was better than the benchmark. There were also better relative performances over the period for BCPP Global Equity Alpha, driven by strong performance by the value managers, and BCPP MAC, where there was some recovery at the end of the year from lower levels.

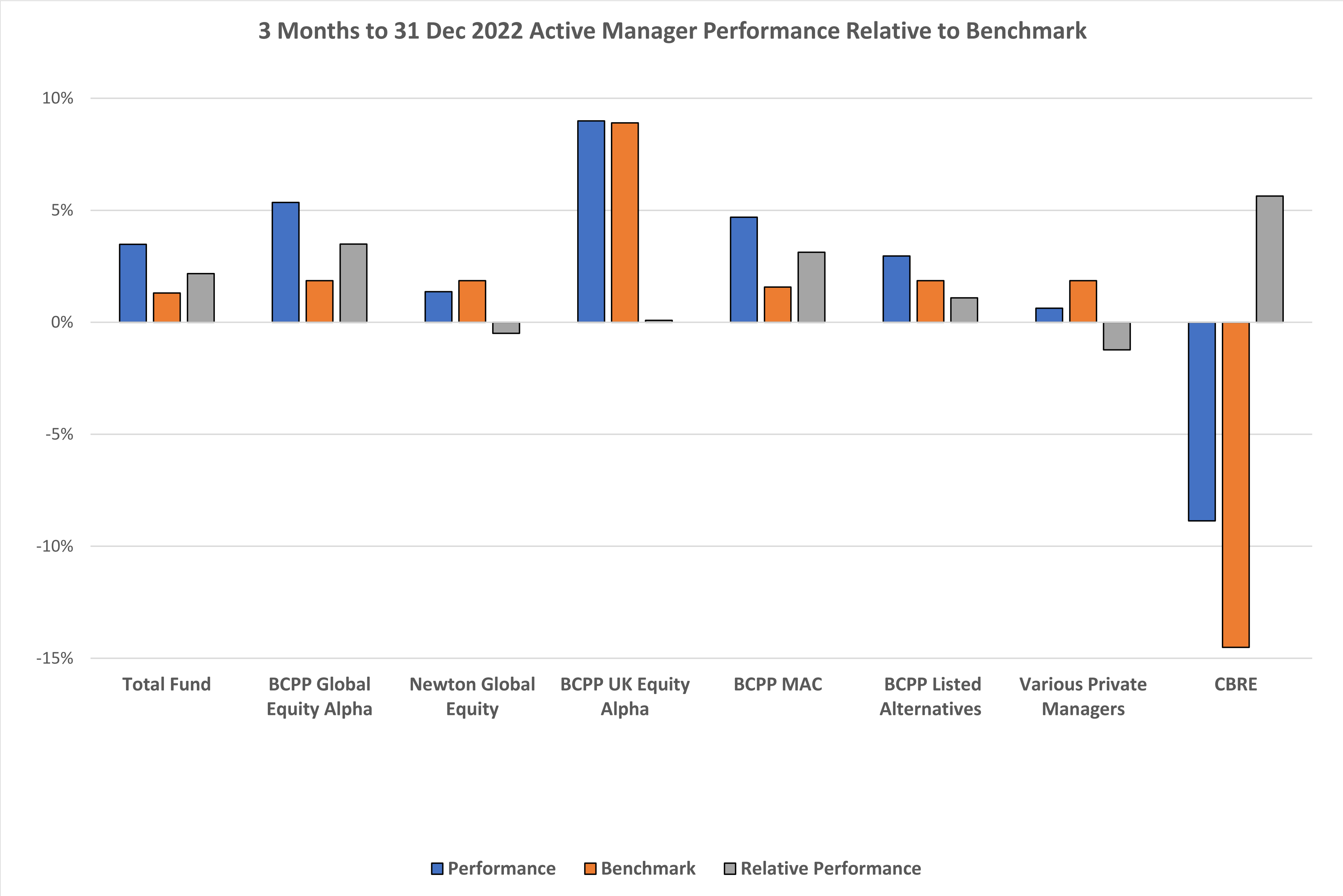
Fund Performance - Summary of Quarterly Results

The table below shows manager performance for Q3 2022/23 (October – December 2022), net of investment manager fees, against manager specific benchmarks using Northern Trust data.

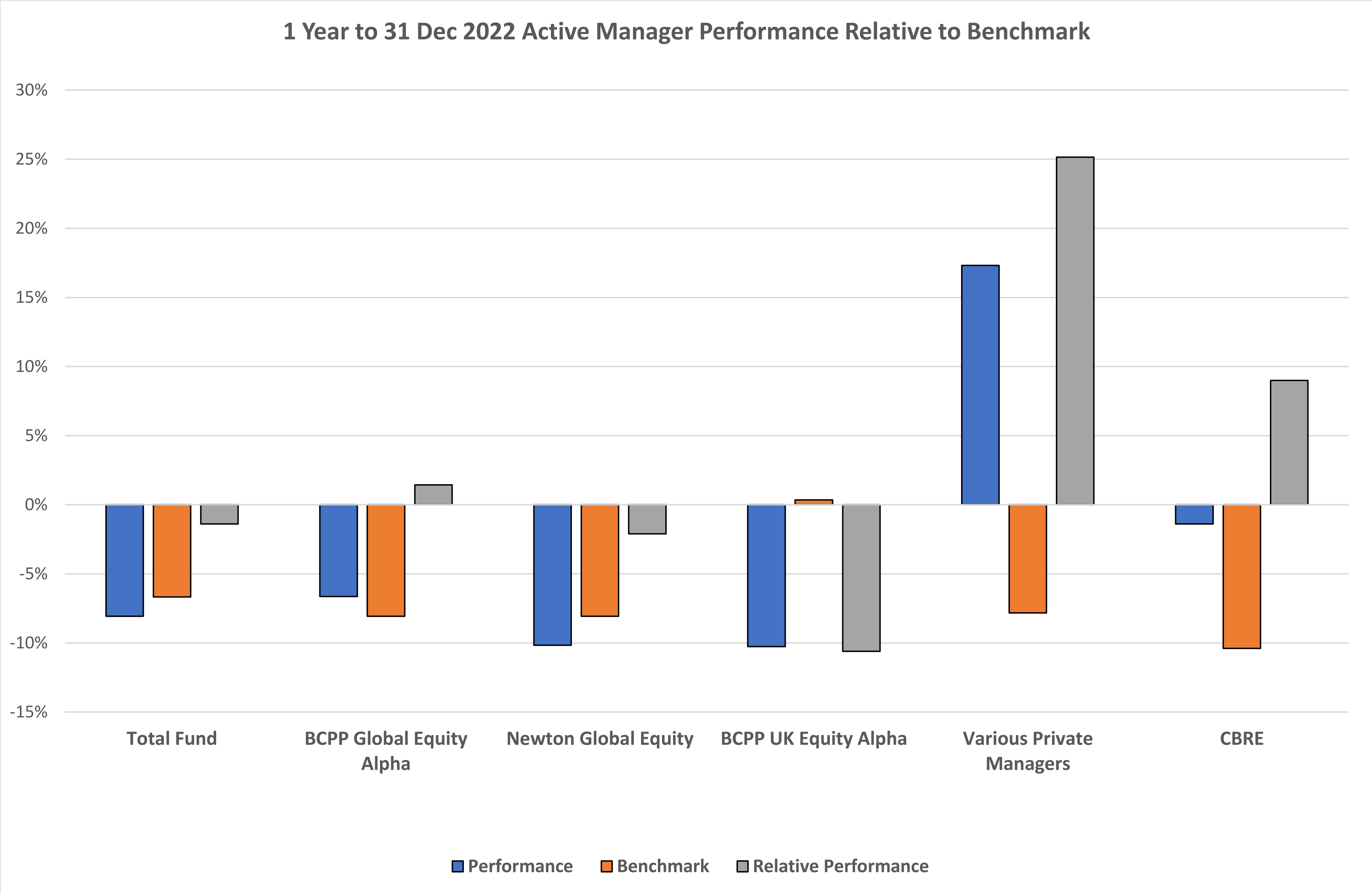
As at 31 Dec 2022		3M				1Y				3Y		
Asset Class	£m	Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance
Total Fund	**5,076.7***	3.48%	1.31%	2.17%		-8.07%	-6.68%	-1.39%		3.06%	3.81%	-0.74%
Active Global Equity	**1,157.9**											
BCPP Global Equity Alpha	694.3	5.35%	1.86%	3.49%		-6.65%	-8.08%	1.43%		6.87%	7.40%	-0.53%
Newton Global Equity	463.6	1.37%	1.86%	-0.49%		-10.17%	-8.08%	-2.10%		7.55%	7.40%	0.14%
Active Regional Equity	**473.5**											
BCPP UK Equity Alpha	473.5	8.99%	8.90%	0.09%		-10.27%	0.34%	-10.61%		-0.25%	2.30%	-2.56%
Passive Global Equity	**894.5**											
LGIM - Future World Global	894.5	1.84%	1.86%	-0.02%		-9.19%	-8.91%	-0.28%				
Passive Regional Equity	**393.2**											
LGIM - Europe Ex-UK	48.1	11.66%	11.65%	0.02%		-7.74%	-8.20%	0.46%				
LGIM Emerging Markets	286.1	0.59%	0.69%	-0.11%		-6.90%	-6.84%	-0.05%		1.56%	1.53%	0.03%
LGIM - Japan	15.2	4.84%	4.81%	0.03%		-4.81%	-5.19%	0.38%				
LGIM - Asia Pacific ex-Japan	43.9	8.06%	8.04%	0.02%		-1.58%	-1.61%	0.03%				
Fixed Income	**672.3**											
BCPP MAC	548.7	4.69%	1.57%	3.13%		-10.53%	4.96%	-15.49%				
LGIM Gilts **	123.6	-0.30%				-26.61%				-6.28%		
Private Markets Proxy	**291.2**											
BCPP Listed Alternatives	291.2	2.96%	1.86%	1.09%								
Private Markets	**785.4**											
Various Private Managers	785.4	0.63%	1.86%	-1.23%		17.32%	-7.83%	25.15%		11.49%	8.37%	3.12%
Real Estate	**319.4**											
CBRE	319.4	-8.87%	-14.51%	5.64%		-1.39%	-10.39%	9.00%		3.79%	2.17%	1.63%
L&G Currency Overlay	- 12.5											
Total Cash & Equivalents	101.8											

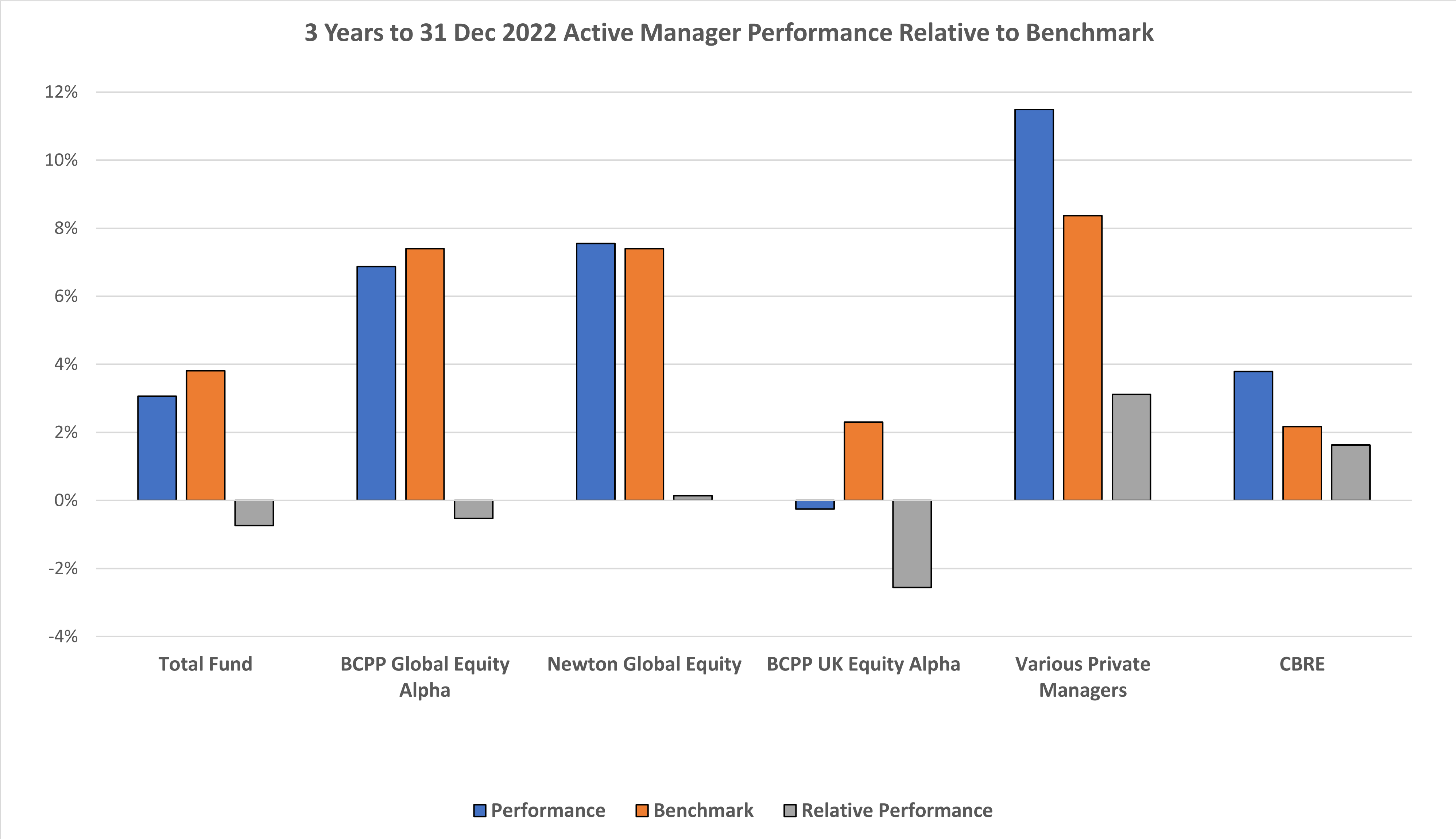
* Includes £7.55m of money market funds

** Performance figures represent total Bespoke Fund (3M Gilt Return -0.41%, Liquidity Return 0.68%)



3 Months to 31 Dec 2022 Active Manager Performance Relative to Benchmark
10%
5%
0%
-5%
-10%
-15%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
BCPP MAC
BCPP Listed Alternatives
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance


1 Year to 31 Dec 2022 Active Manager Performance Relative to Benchmark
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance


3 Years to 31 Dec 2022 Active Manager Performance Relative to Benchmark
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance

Recent Transactions

11. 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.

12. 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.

13. 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
7 Return Fund.

14. 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

15. In the quarter to 31 December 2022, stock lending earned a net income for the Fund of £3,634 compared with £2,939 for the quarter ended 30 September 2022.

Mandate Change

16. Since the period end, the investment management agreement with CBRE has been amended. As discussed in the Committee meeting of 16 December 2022, CBRE will now cease to re-invest returns of income and instead pay that income out to the Fund. Given the potential launch and Fund investment in the new BCPP real estate funds, and the potential lack of liquidity of some real estate investments, new investment commitments by CBRE will solely be made to (i) open ended funds, or (ii) funds with at least an annual redemption window.

Asset allocation

17. The table and the graph below show the target and actual asset allocations for the quarter ending 31 December 2022. These allocations were agreed by the Pension Fund Committee in the December 2022 meeting.

Asset class	Total Fund (£M)	Actual (%)	Target (%)	Advisory ranges %	Role(s) within the strategy
Listed Equities		**57.5%**	**54.8**	**51.8 – 57.8**	Generate returns in excess of inflation, through exposure to the shares of domestic and overseas companies.
UK	473.5	9.3%	6.6		
Global Market Cap	1,157.9	22.8%	21.4		
Global Regional	107.1	2.1%	2.2		
Emerging Markets	286.1	5.6%	5.5		
Global Sustainable	894.5	17.6%	19.1		
Alternatives		**27.5%**	**27.6**	**22.6-32.6**	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	785.4	15.5%	17	7.0-25.0	
Listed Alternatives	291.2	5.7%	3	0.0-6.0	
Real Estate	319.4	6.3%	7.6	4.6–10.6	
Multi Asset Credit		**10.8%**	**12.1**	**9.1-15.1**	Offer diversified exposure to global credit markets to capture both income and capital appreciation of underlying bonds.
Multi Asset Credit	548.7	10.8%	12.1		
Fixed Interest Gilts				**2.5-8.5**	Low risk income stream
Fixed Interest Gilts	123.6	2.4%	5.5		
Cash & Currency Overlay	89.3	**1.8%**			
Total	**5,076.7**		**100**		

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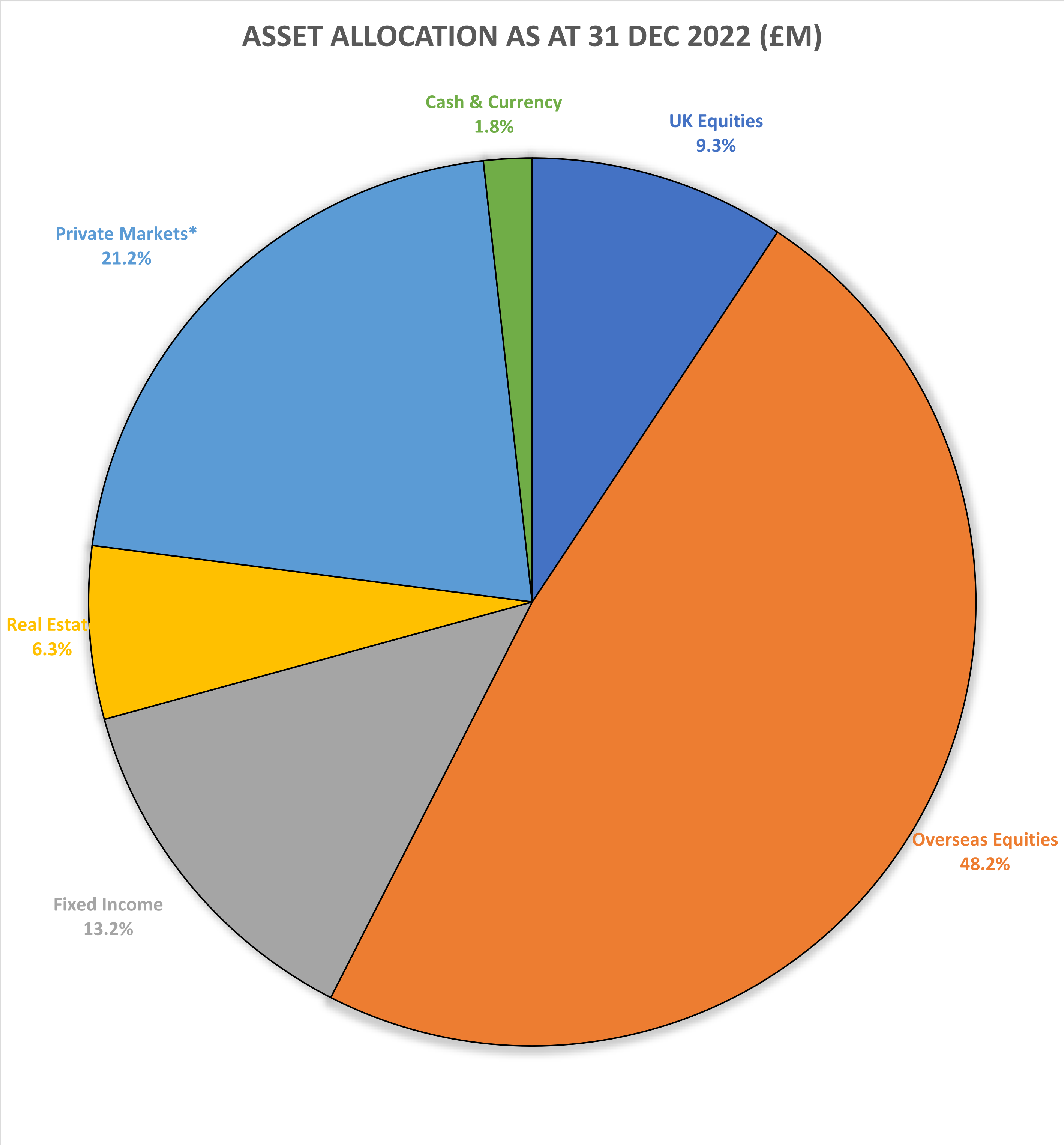
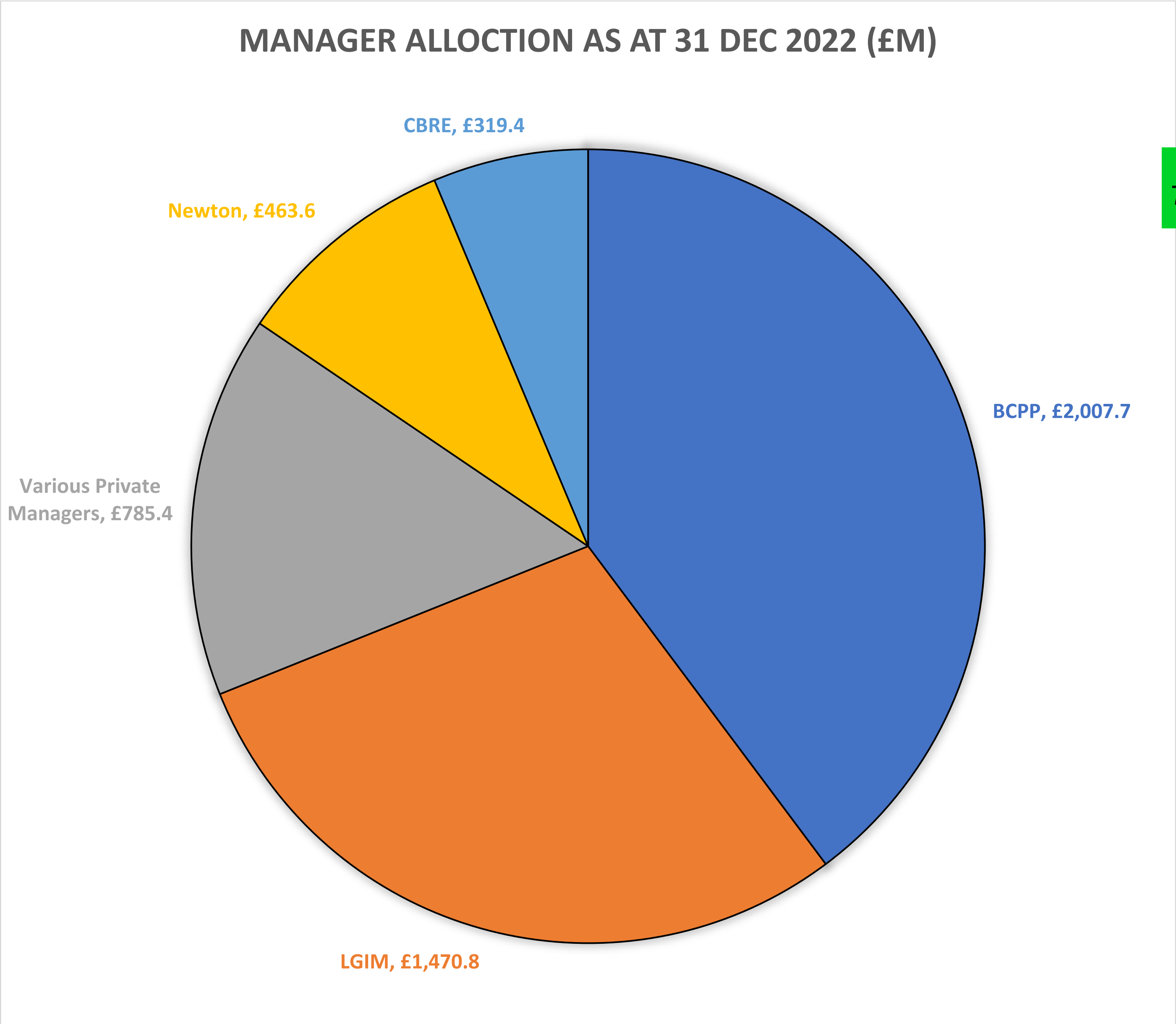


*Includes Listed Alternatives

Manager Allocation

The graph below shows the manager allocation for the quarter ending 31 December 2022.



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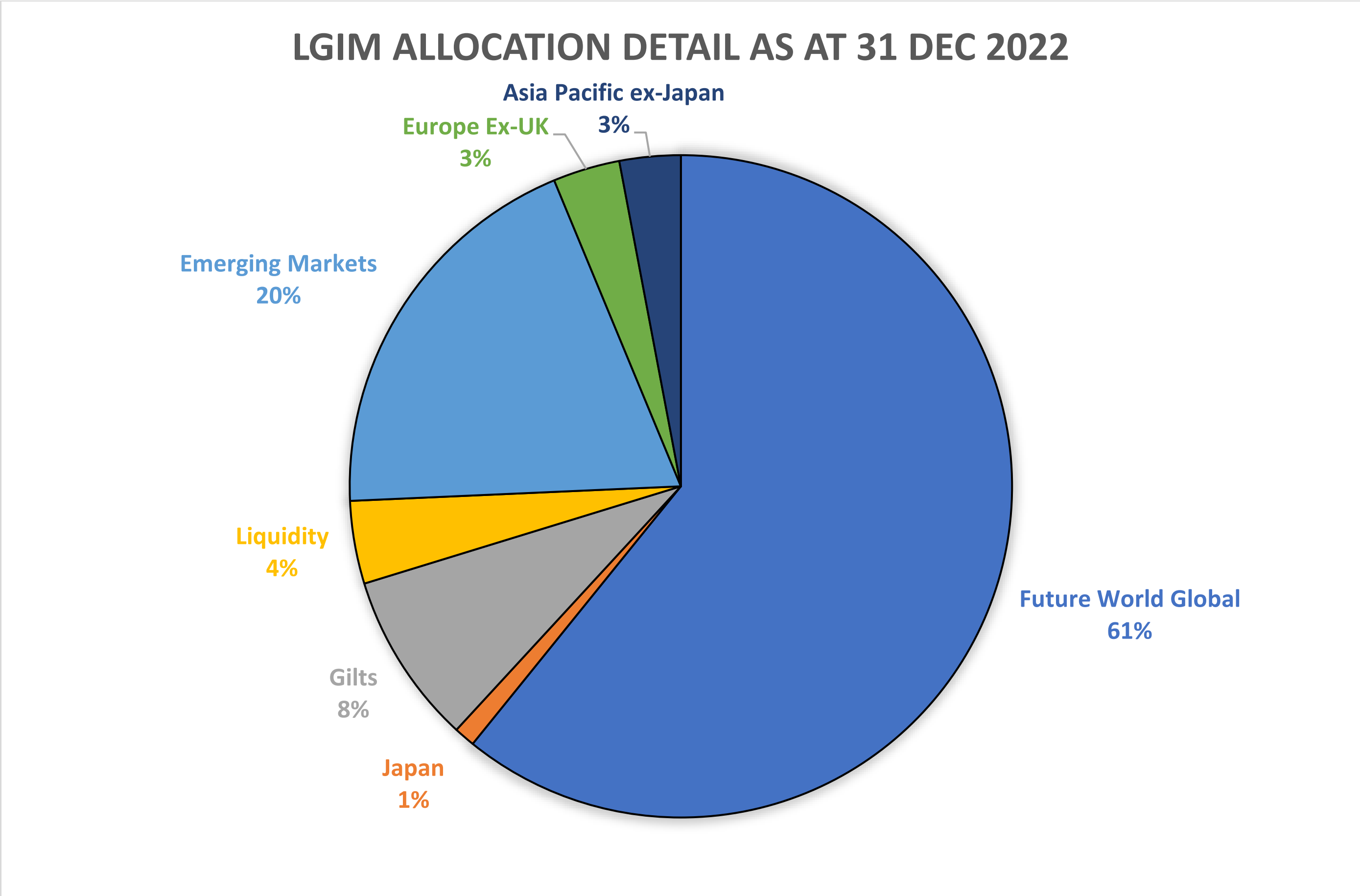
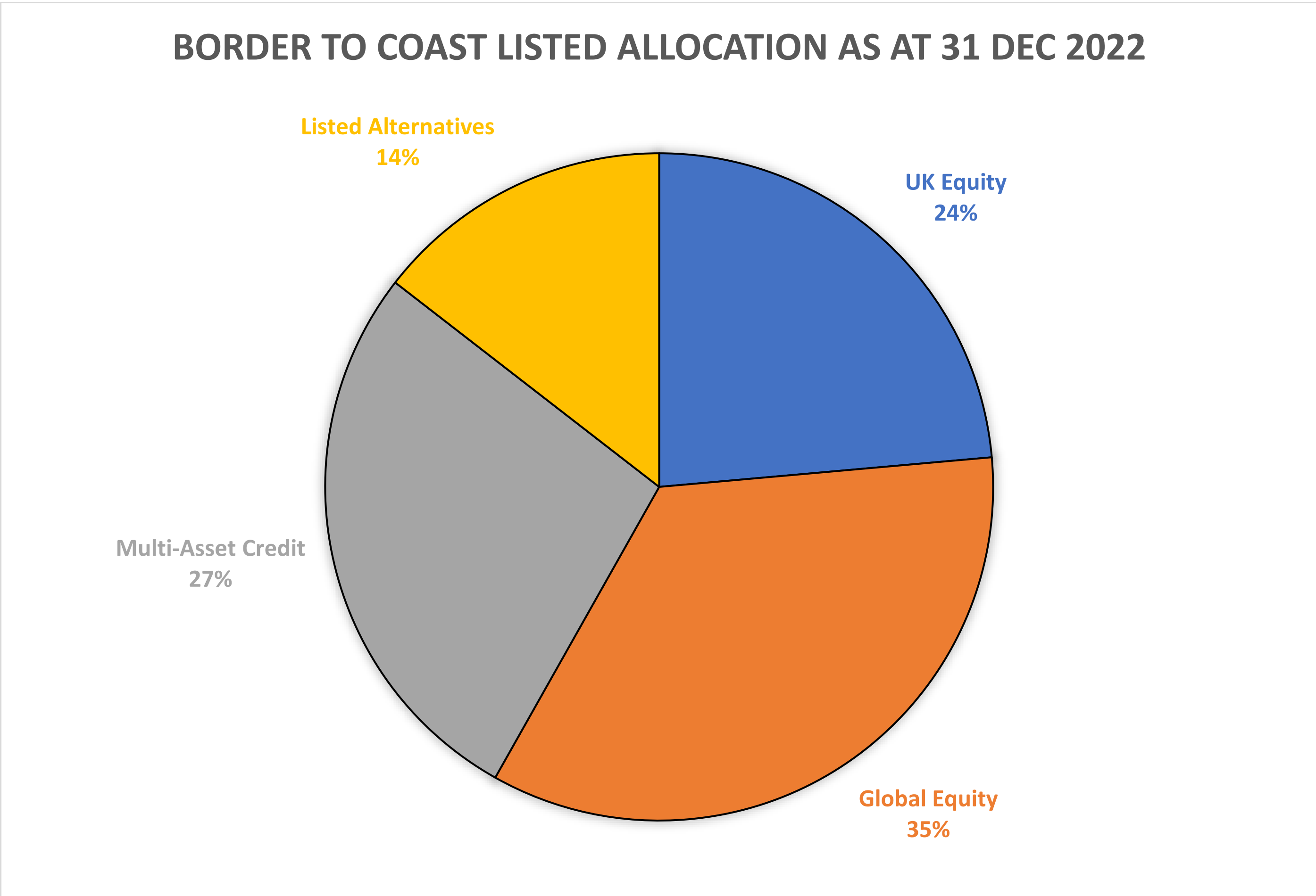

LGIM ALLOCATION DETAIL AS AT 31 DEC 2022
Asia Pacific ex-Japan
3%
Europe Ex-UK
3%
Emerging Markets
20%
Liquidity
4%
Gilts
8%
Japan
1%
Future World Global
61%


BORDER TO COAST LISTED ALLOCATION AS AT 31 DEC 2022
Listed Alternatives
14%
UK Equity
24%
Multi-Asset Credit
27%
Global Equity
35%

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Cashflow

18. Pensions Funds have a positive cash-flow when their contribution inflows exceed pension benefits paid.

19. 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.

20. Any positive cash-flow is invested in accordance with the Fund's cash management plan.

21. 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. 7

£m Period	Total contributions received	Total pension benefits paid	Net cash-flow
Quarter Two 2022/23 (1 Jul 2022 – 30 Sep 2022)	56.3	48.6	7.7
Quarter Three 2022/23 (1 Oct 2022 – 31 Dec 2022)	53.6	46.9	6.7

22. An indication of the current membership trends is shown by movements in membership over quarters two and three. Member data listed below.

Period	Active members	Deferred members	Pension members	Total members
Quarter Two 2022/23 (1 Jun 2022 – 30 Sep 2022)	35,010	43,728	30,264	109,002
Quarter Three 2022/23 (1 Oct 2022 – 31 Dec 2022)	35,473	43,744	30,482	109,699

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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:

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

RISK MANAGEMENT AND IMPLICATIONS:

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

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

25. Financial and value for money implications are discussed within the report. 7

DIRECTOR CORPORATE FINANCIAL & COMMERCIAL COMMENTARY

26. 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

27. There are no legal implications or legislative requirements.

EQUALITIES AND DIVERSITY

28. 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

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

WHAT HAPPENS NEXT

30. The following next steps are planned:

- Implement equity asset allocation restructure as agreed in the Committee meeting in December 2022.
- Continue to monitor performance and asset allocation.

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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