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Surrey Pension Fund Committee

Manager Review Meeting Minutes

3rd May 2023

Attendees

Councillor Nick Harrison, Chairman of the Pension Fund Committee
Lloyd Whitworth, Head of Investment and Stewardship
Neil Mason, Assistant Director – LGPS Senior Officer
Anthony Fletcher, Independent Adviser

Background

The purpose of this meeting was to receive an update from Newton, Border to Coast Pension Partnership (BCPP) and LGIM, on performance and activity over the last year for the Surrey Pension Fund. The meetings were held at LGIM's offices in London.

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Newton Investment Management

Paul Markham – Portfolio Manager
David Moylett – Client Director

Mandate summary

An active global equity mandate seeking to outperform the MSCI All Country World index by 2% per annum (gross of fees) over rolling 3 year periods, Surrey appointed Newton in November 2007. It is intended that the Newton portfolio will be transitioned to BCPP when a suitable global equity investment solution becomes available.

Surrey's investment with Newton was valued at £489.5 million on the 31st March 2023.

Performance

In the three months to 31st March 2023 Newton returned +6.0% compared to the Index return of +4.4% and over twelve months the return was -0.3%, compared to -1.4% for the Index.

The key investment period for comparison to the benchmark and the target is gross annualised performance over three years, the fund's total return in this timeframe was +14.6% per annum (p.a.), compared to the benchmark return of +15.5% p.a. this outcome is -0.9% below the benchmark and -2.9% behind the target. The fund has outperformed the benchmark over longer timeframes delivering +1.3% p.a. extra over 5 and +0.6% p.a. over 10 years, but it has only outperformed the benchmark gross of fees by +0.2% p.a. since inception, which is -1.8% p.a. versus the performance target.

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The performance deviations in 2015/16 would suggest that the fund may have been carrying too much active risk because relative returns were +7.2% and -7.7% respectively. In 2017 changes were made to better manage the risks being taken to deliver the +2% performance objective. Since 2018 relative performance been less volatile despite the market's increased volatility, but gross performance while +1.3% p.a. ahead of benchmark remains -0.7% p.a. behind the performance target.

Positioning

Persistent inflation and the new geo-political reality has caused Newton to modify its long term broadly deflationary themes of Debt, Demographics, Disruption and Distortion, to Big Government, China influence, Financialisation and the Great power competition. With these themes as a guide, they are focusing their research and analysis on the following factors that could inform their stock selection decisions, corporate earnings, tighter liquidity, geopolitics, consumer strain, sticky inflation and the risk of a policy error. Over the last year with these factors in mind they have made 6 new purchases, increased exposure to 5 stocks; reduced exposure to 5 stocks and sold out completely from 5 others.

The fund consists of concentrated portfolio of 59 individual holdings up 5 from last year. At the sector level the largest overweight's are now financials, healthcare and information technology (IT) compared to IT, industrials and consumer discretionary last year. It could be that the fall in exposure to IT and consumer discretionary are the result of markets movements, Microsoft, Apple, Sony and Amazon's share price in particular had a difficult year, but Newton have added 2 new IT companies Nvidia and Roper Technologies. Industrials and consumer discretionary are now underweight, industrial exposure has been reduced by the sale of Norfolk Southern and Deutsche Post and a reduction in Trane Technologies.

The biggest swing was in the exposure to financials which was underweight last year but is now the biggest overweight. Newton stated last year that while they were cautious on banks, they saw opportunities in insurance and emerging markets and that the new resources the global team had it disposal could lead to more investment in these areas. They have reduced Swedbank and sold Chubb, but they have increased exposure to financials by adding to CME and Progressive the US insurance company, and by new positions in Hiscox the UK insurer and the Brazilian financial companies B3 and XP. At the meeting they also highlighted their exposure to south-east Asian insurers AIA and Ping An and the French underwriter Scor. The next largest overweight is healthcare, Newton have sold their holding in Novartis on continuing concerns about the direction of the company, but have added Danaher, the US life sciences and industrial conglomerate and topped on their exposure to Eli Lilly following the success of their new anti-obesity drug.

The fund remains underweight Energy, Materials and Real estate. The fund also remains overweight the UK and Europe and underweight the US, but these country level relative weights are more about where global companies are listed than the attractiveness of the domestic economies and companies.

In their presentation Newton also showed how ESG and RI is fully integrated into their investment process and demonstrated that their global equity fund's scope 1 and 2 net emissions exposure had fallen from 65% lower than the benchmark index last year to 76% lower this year. They also stated that the fund's WACI was this year 41% lower than the "typical" global low carbon index tracker fund compared to 40% lower last year. Newton actively engages with their portfolio companies on behalf of all investors. The examples they sited were Tesla on Governance issues, Amazon and Darling Ingredients on Social issues and Shell, Barclays and Darling ingredients on Environmental issues. They also mentioned GE's transformation to a strong ESG pure play through its involvement in green energy supply and transition.

Adviser view

This was another very good meeting with Newton once again I was impressed by the level of energy and enthusiasm demonstrated in the meeting and the quality of the reporting package.

I am satisfied that Newton is sticking to their investment themes and processes and encouraged that while their fund does not have a primarily "sustainable" or "ESG" driven investment approach, its scores on these metrics are very strong. The introduction of more robust risk controls following the highly volatile relative performance in 2015 and 2016 seems to be working as the returns since 2018 show. But it is disappointing that the longer term returns are only
11 just ahead of benchmark on a gross basis, having said that, I am happy that Surrey Pension Fund can remain invested with Newton until BCPP have a replacement investment strategy the Fund can subscribe to.

BCPP

Graham Long – Head of the External Investment Team
Milo Kerr – Head of Client Relationship Management

Mandate summary

Surrey has transitioned all of its UK active and a significant portion of its Global active equity assets into two funds designed by BCPP in conjunction with the other Partner Funds. Namely the UK Equity Alpha fund and the Global Equity Alpha fund.

UK Equity Alpha fund

The UK Equity Alpha fund is designed to outperform the FTSE All Share index by 2% net of fees. At the end of March 2023 Surrey had just over £499.5 million invested in the fund. The inception date for the fund was 18th December 2018.

Performance

Over the quarter to 31st March 2023, the UK Equity Alpha fund has returned +5.5% compared to +3.1% for the benchmark and over 12 months -0.1% versus +2.9%. Over rolling 3 years the fund returned +14.1% p.a. and the benchmark returned of +13.8% p.a.

Since inception the fund has given back all of its outperformance and is now behind benchmark with a fund return of +5.7% p.a. compared to the benchmark return of +6.2% p.a. According to the most recent attribution data while the combination of managers added +1.0% through their stock selection decisions, BCPP's manager selection decisions have detracted -1.6% p.a. from total fund performance since inception. 11

At the end of March 2023, the fund had 4 underlying managers each with a distinctive investment style. Redwheel and Lindsell Train replaced UBS during the 2nd quarter of 2022 and have been responsible for their performance since the 9th May 2022 when the transition was complete. As part of the transition the strategic weight to each of the managers in the strategy has been modified; the neutral allocation to Baillie Gifford (growth) has been reduced from 35% to 30%, and Janus Henderson (small cap) from 15% to 12.5%. The neutral allocation to Redwheel's value style is 30%, and Lindsell Train's UK Quality style is 27.5%.

Over the year both Ballie Gifford and Janus Henderson underperformed the FTSE All share but Baillie Gifford outperformed its peer group benchmark. Over 3 years UBS must have delivered some of the outperformance as both Baillie Gifford and Janus Henderson underperformed. Since May last year and in the 3 months to the end of March the new managers, Redwheel and Lindsell Train, have delivered the majority of the positive contribution to returns, although Baillie Gifford did outperform the FTSE All share over the quarter.

Positioning

The replacement of UBS by Redwheel and Lindsell Train has changed the stock selection but interestingly the relative sector level allocation of the fund, is similar. The combined manager relative overweight allocations remain Technology followed by Consumer discretionary and Industrials the fund remains underweight Basic materials, Energy and healthcare. The individual managers have different sector weightings; however, they are all overweight consumer discretionary and industrials, only Redwheel is neutral technology with Baillie Gifford the largest overweight. Of the underweight sectors Redwheel has the largest overweight in Energy and Ballie Gifford the only overweight in healthcare.

Despite the restructure of the fund, Ballie Gifford still dominates the risk budget, and is responsible for about half the risk taken on an ex-ante and ex-post measurement basis, even after their neutral allocation was reduced. It also appears from the analysis that the largest drawdowns in performance occur when Baillie Gifford's ex-ante risk is rising or contributing the most. The analysis also shows that total fund ex-ante risk peaked at over 8 on the inclusion of the new managers and has remained greater than the 2 to 6 (95% of the time) guidance range given by BCPP and above what is the maximum industry expectation for fund with a 2% outperformance objective.

At the manager level BCPP periodically rebalances the manager allocations based on their longer term views of market developments and how relative performance has taken manager exposures away from their neutral weights in the strategy. The most recent of these BCPP manager selection decisions have moved Baillie Gifford's allocation to +1.5%, and Janus Henderson to +1.0% overweight, and Lindsell Train to -1.0% and Redwheel -1.5% underweight relative to the neutral strategic exposure.

Manager update

In the last 12 months due to very poor performance, team and portfolio construction changes, Baillie Gifford was placed on "watch" with a full review conducted in August 2022. The result of the review gave BCPP sufficient confidence to retain Ballie Gifford, and at the end of December 2022 BCPP decided to take them off "watch" but they continue to closely monitor developments.

Janus Henderson was also placed on "watch" due to Board level management changes, including a change in CEO, the retirement of the CIO and a couple of highly experienced fund managers. These changes were considered and it was decided that they had no impact of the UK smaller companies team. The review also determined that the recent poor performance can be attributed to shorter term changes in the macro-economic environment and the increase in interest rates and not the long term philosophy or investment approach of the team.

<u>Global Equity Alpha fund</u>

11 The Global Equity Alpha fund is designed to outperform the MSCI World Index by 2% net of fees. At the end of March 2023 Surrey had £739.4 million invested in the fund. The inception date of the fund was 24th October 2019.

Performance

Over three months to 31st March 2023, the Global Equity Alpha fund returned +6.5% compared to +4.4% for the benchmark, over the year the fund returned +3.7% versus -1.4% for the benchmark. Over three years the fund outperformed the benchmark and performance objective by +2.9%, and +0.9% respectively delivering +18.3% p.a. relative to the benchmark return of +15.5% p.a. Since inception the fund has delivered a total return of +9.5% p.a. compared to the benchmark return of +9.1% p.a.

The fund has 5 managers each with distinctive styles: -

Manager	Investment style	Neutral weight
Loomis Sayles	Growth	25%
Ninety One – Franchise	Quality	20%
Ninety One – Value	Value	20%
Harris	Value	25%
Lindsell Train	Quality	10%

In the last year there has been a lot of discussion about whether the benchmark index should include emerging markets and China in particular, for more details about this see the positioning section below. In December 2022 GSAM and FountainCap were added to the manager line up to increase the potential emerging market exposure of the opportunity set.

A rolling three year period is a reasonable timeframe to measure investment performance, although longer periods of delivering consistent risk adjusted outperformance are more highly sought after by pension fund investors. Over three years it is the value managers that have delivered the outperformance, and the quality managers that have consistently underperformed and Loomis Sayles the growth manager has performed more like a market neutral manager i.e. never too far away from the benchmark. Over the slightly longer period since inception of the fund in October 2019, Lindsell Train has consistently underperformed whereas the other quality manager 91franchise is in line with benchmark and 91value has underperformed.

According to the latest performance attribution analysis provided by BCPP on an annualised basis since inception their manager selection decisions have added +1.8% p.a. whereas the security selection decisions of the combined individual mangers have detracted -1.4% p.a.

Positioning

When the partner funds were going through the design process for the Global Equity Alpha (GEA) fund there was a lot of discussion around should the benchmark index include emerging markets or not and the conclusion was the allocation to emerging markets was a sovereign decision of the partner funds and not BCPP, because many of the partner funds already had separate strategic allocations to emerging markets. Hence the performance benchmark for GEA was set as MSCI World (Developed Markets) Index, but the managers were allowed to take "off benchmark" stock selection decisions to invest in emerging markets if they chose to.

Over the last year in consultation with partner funds BCPP have decided that the GEA should be benchmarked against the MSCI All Country World Index. i.e. including China and some other emerging countries as part of the index. In order the facilitate this since December 2022 the fund has allocated a 3% strategic exposure to Emerging market equities excluding China, to be managed by GSAM and a 1% exposure to Chinese equities to be managed by FountainCap.

At the end of March 2023, the aggregate fund sector exposure was most overweight consumer discretionary, consumer staples and financials and underweight real estate, energy and utilities. At the manager level, Harris, 91Value and Loomis Sayles had their biggest positions in consumer discretionary and financials, Lindsell Train in consumer staples and 91Franchise in consumer staples and financials. In terms of the underweights only 91Value and Harris had an overweight to Energy.

In terms of the contribution to risk as measured by ex-ante tracking error, total risk is within the range expected for a fund trying to deliver outperformance of an index by 2% per annum. The largest contributors to risk remain Harris and 91Value. 11

Manager update

Loomis Sayles, was placed on "watch" due to resignations from their dedicated analyst team. BCPP have engaged with the CEO, CIO and the investment team at Loomis and have calls scheduled to discuss the matter further and will keep Partner Funds abreast of any pertinent developments.

91Franchise, Simon Brazier (co-Head of the Quality Team) has departed Ninety One. Simon was focused on the UK funds and although he shared leadership responsibilities with Clyde Rossouw (PM on Global Quality), he had no material input on the BCPP strategy and his responsibilities are being picked up by senior UK focused individuals.

Adviser view

This year's annual equity reporting package from BCPP was slightly better but overall, the papers they produced were still not specific to the Surrey pension funds' investments, unlike the papers produced by Newton and LGIM, even to the extent that they did not give Surrey's AUM in each BCPP fund. Overall, it was good to see the recent improvement in the performance of the UK and Global equity alpha funds. However, the explanation of excess ex-ante tracking error/risk management in the UK fund was unsatisfactory, if this strategy was being managed on the old model outside of pooling, I would be recommending that Surrey put BCPP UK Equity Alpha fund on watch for possible replacement if risk management does not improve.

I am also unhappy with the change to Global Equity Alpha fund's benchmark from MSCI World to the MSCI All Country World Index, in other words to include emerging market equities in the benchmark index. The decision to invest in global equity and emerging market equity has always been a sovereign decision of the partner funds. This decision by BCPP in my view decreases the flexibility of each fund to choose its most appropriate strategic asset allocation to global equity markets.

Legal & General Investment Management

James Sparshott – Head of Local Authorities
Robert Dowling – Fund Manager, Index Funds
Jeannette Andrews – Senior Global ESG Manager
Tom Simpson – Client Manager

Mandate summary

The mix of Index driven (passive) strategies managed by LGIM for Surrey has not changed significantly over the last twelve months. At the 31st March 2023 the value of assets managed by LGIM on Surrey's behalf was £1,510,784,741. The asset allocation is set out in the table below.

Investment fund	**£ value 31st March 2023**	**%**
Europe (ex-UK) Equity Index	51,590,722	3.41
Japan Equity Index	15,454659	1.02
Asia Pac (ex-Japan) Developed Index	44,048,643	2.92
World Emerging Markets Equity Index	275,655,870	18.25
Future World Emerging Markets Equity Index	11,073,595	0.73
Future World Global Equity Index	925,746,141	61.28
Bespoke Fund*	187,215,113	12.39
Total	**1,510,784,741**	**100**

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*The Bespoke Fund consists of Fixed Interest Gilts valued at £126,200,782 (67.4%) and a Sterling liquidity fund valued at £61,047,318 (32.6%).

LGIM are also responsible for maintaining Surrey's currency hedging strategy in co-ordination with Newton and BCPP. The strategy reduces the overseas currency exposure of the equity holdings by 50% to dampen the volatility caused by currency movements, it is re-balanced and rolled over on a quarterly basis.

Performance

As expected, these funds have performed in line with the underlying performance benchmarks, with only slight variations based on the cost of rebalancing or paying for the benchmark index data.

Surrey has taken the active decision to make ESG, decarbonisation and the transition to net zero part of its investment strategy. To not adopt this approach with its index driven investment strategies would mean that Surrey passively accepts that investment will be made into companies based solely on their market cap weight in the index and this could include companies that may not have any ESG, decarbonisation or transition to net zero policies.

It is important to note however that the Future World Global Equity Fund uses a bespoke index designed by Solactive, which because of exclusions and LGIM's ESG factor score re-balancing, will not track a full market cap weight global index. This fund also has a decarbonisation policy aimed at aligning the investment strategy with a net zero future, which means that over time the funds index could move further away from a full market cap weighted index.

Over twelve months, the Future World Global Equity Index Fund has returned -1.02% compared to the Solactive benchmark index return of -1.22%, whereas the FTSE All World (full market cap) index returned -0.93%. Since the inception of Surrey's investment on the 1st October 2021, the fund has returned +0.99% p.a. versus +0.81% p.a. for the benchmark and the FTSE All World index +1.74% p.a. The FTSE All World index has a higher weight to energy companies which have significantly outperformed since the Russian invasion of Ukraine.

Most of the rest of the meeting was taken up with a detailed explanation of LGIM's net zero approach, the methodology and developments behind the Future World Index Funds range and an update on LGIM's Responsible Investment Strategy. From May 2023 LGIM's Environmental modelling will include scope 3 value chain emissions intensity, and they will be broadening their nature based scoring methodology to include Deforestation and Water Management and adding Lobbying Activities to their Governance score modelling. This increases the number of factors considered in their Environmental, Social, Governance and Transparency modelling to 34.

Adviser view

I remain impressed by the obvious skill and depth of knowledge LGIM employ to deliver cost effective index based investment solutions for clients. They have clearly thought carefully about how they can help clients achieve their ESG, decarbonisation and net zero objectives and were able to demonstrate the likely trade off between desired returns and increased tracking error, for index based strategies. I also believe their "engagement with consequences" approach is a model that can be applied not just to index (passive) investment strategies but also could be used as part of an engagement and alignment strategy for active management and even applied to the whole pension fund and asset management industry.

Surrey Pension Fund has made the active decision to invest in the "passive" Future World Global Equity Index fund that is consistent with its philosophy, investment beliefs, and long term commitments to the inclusion of ESG factors and the goals of the SDGs in its investment processes and its plans for net zero by 2050 or sooner.

Anthony Fletcher – Independent Adviser to the Surrey Pension Fund

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