Agenda Item:

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Pension Fund Committee

Dorset County Council

Date of Meeting	4 March 2014
Officer	Report of the Fund Administrator
Subject of Report	Fund Administrator's report
Executive Summary	The purpose of this report is to update the Committee on the allocation of the assets and overall performance of the Fund as at the end of the third quarter of the 2013/14 Financial Year to 31December 2013. The report also provides a commentary on the performance of the fund managers who are not considered elsewhere on the agenda and addresses other topical issues for the Fund that do not require a separate report. The Independent Adviser's report is contained at Appendix 2, and will be presented separately at the meeting. The report shows that overall the Fund returned 6.39% for the financial year to date, and out-performed its benchmark which returned 5.19%. Return seeking assets added 8.31%, whilst the liability matching assets returned -9.09%.
Impact Assessment:	Equalities Impact Assessment: N/A
	Use of Evidence: N/A
	Budget: N/A
	Risk Assessment: The Pension Fund assesses the risks of its investments, which are considered as part of the strategic allocation. In

	addition risk analysis is provided alongside the quarterly performance monitoring when assessing and reviewing fund manager performance.
	Other Implications: N/A
Recommendation	1) Members consider and comment upon the activity and overall performance of the Fund.
Reason for Recommendation	To ensure that the appropriate management arrangements are in place and are being monitored, and to keep the asset allocation in line with the strategic benchmark.
Appendices	Appendix 1: Budget Monitoring and New Money Forecasts Appendix 2: Report of the Independent Adviser Appendix 3: HSBC Manager Performance and Risk analysis for the financial year to 31 December 2013
Background Papers	HSBC Performance Statistics
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1. Background

1.1 The Dorset County Pension Fund currently receives more money in contributions and investment income than it pays out as pensions and retirement grants. At the start of the financial year it was anticipated that there would be a surplusof income over expenditure from these cash flows of £33m in the 2013/14 financial year. The anticipated cash flows for 2013/14 along with the historic trends are illustrated in Appendix 1.

1.2 These‘new money’ levels are reviewed throughout the year, and Members are alerted if there is any significant variance from what is expected.

2. Fund Cash flow

2.1 Table 1 summarises the main cash flows for the Fund for the nine months to 31 December 2013.

Table 1 – Statement of Cash flows for the nine months to 31 December 2013

		£M	**£M**	
Cash at 1st April 2013			**52.4**	
Add:	New Money	28.6		
	Property Sales	3.9		
	Private Equity Redemptions	5.0		
	Hedge Fund Redemptions	0.5		
	Currency Hedge Gain	23.2		
			61.2	
Less:				
	Net UK Equity Purchases	3.1		
	Private Equity Purchases	3.6		
	Property Purchases	18.1		
			24.8	
Cash at 31st December 2013			**88.8**	*
* includes £1.3m of cash held in clearing accounts on 31/12/13				

2.2 The prediction for net new money into the Fund for 2013/14 was £33.2m at the start of the year. The actual amount of cash received to the end of December 2013 was £28.6m, which is significantly ahead of what was originally forecast.

2.3 Following a detailed budget monitoring exercise, it is expected that the Fund surplus for the year will be £36.3m; £2.9m more than budgeted. Pensions paid are expected to be £3.7m more than forecast, mainly due to a higher rate of increase in pensioners than expected. However, contributions from employers and employees is expected to be £4.8m higher than estimated, mainly because of the impact of auto enrolment, which has been implemented successfully at Dorset County Council. Transfer values, which are impossible to predict because they depend on the recruitment flows of individuals to and from scheme employers, have been higher than originally projected bringing in £1.5m more than anticipated. Finally, investment income is expected to be £0.3m more than forecast.

2.4 It was previously reported that there would be a special dividend from Vodafone following the sale of its stake in US company Verizon Mobile. Shareholders have the option to take the dividend in the form of special shares which will be immediately disposed of, meaning that it can be classed as a sale of asset rather than a dividend, thereby avoiding the dividend tax which is deducted at source.

2.5 Appendix 1 shows the budget monitoring for 2013/14 compared with the budget and the 2012/13 outturn, as well as graphs showing the historical trends of income and expenditure, and the net position of contributions less pensions paid.

3. Fund Portfolio Distribution

3.1 The last strategic review in June 2011 changed the asset allocations and at the February 2013 meeting Members agreed further distributions to JP Morgan and Barings to bring the allocations into better alignment with the target allocation. Table 2 illustrates the current position and the comparative figures as at 1st April 2013

Table 2 – Dorset Fund Market Values – Comparative Figures

		Dorset Fund Market Values						
		Actual at 1 April 2013		**Actual at 31 Dec 2013**		**Target Allocation**		**Flexi-bility + / -**
Asset Class	**Manager**	**£M**	**%**	**£M**	**%**	**£M**	**%**	**%**
Bonds	(Several)	402.3	20.9	385.1	18.8	409.6	20.0	2.5
UK Equities	(Several)	536.1	27.8	593.8	29.0	573.5	28.0	5.0
Overseas Equities	(Several)	536.9	27.9	561.9	27.4	553.0	27.0	5.0
Property	(CBREi)	162.1	8.4	185.7	9.1	204.8	10.0	2.5
Absolute Return Funds	(Several)	89.9	4.7	88.8	4.3	122.9	6.0	-
Private Equity	(Several)	53.2	2.8	52.1	2.5	81.9	4.0	-
Diversified Growth	(Barings)	91.2	4.7	93.2	4.6	102.4	5.0	-
Cash	(Internal)	54.1	2.8	87.6	4.3	-	-	-
		1,925.8	**100.0**	**2,048.2**	**100.0**	**2,048.2**	**100.0**	

3.2 The figures show that against the target allocation, the Fund is currently underweight in Bonds. These include the Insight Inflation Hedging mandate, which has seen a reduction in its value since the start of the year, compared to the majority of the Fund which has increased in valuetherefore changing the relative weighting in the portfolio.

3.3 UK and Overseas equities continue to be overweight as their relative performance has been better than the rest of the Fund. Overseas equities now include the cash held by Pictet on a tactical basis as this best reflects the resources allocated to the area. The cash holding is a tactical decision by the fund manager and could be invested if deemed appropriate.

3.4 The Fund continues to be underweight in the alternative fields of Absolute Returns, Private Equity and Diversified Growth. The proposals from the strategic review of assets, reported on this agenda will seek to address this and propose a rebalancing of the portfolio in line with a revised strategy.

3.5 The Property portfolio remains underweight due to the tactical sales of Howard House, Bristol and the industrial units in Hertford at the end of the last financial year. During the year to date there have been purchases of £18.1m on two properties in Cambridge for £9.3m and £3m and a property in Leeds (£5.6m), as well as capital works of £0.2m at the Cathedral Retail Park in Norwich. These purchases have increased the weighting to 9.1%, which is 0.9% below the strategic allocation. CBRE, the fund manager, are actively seeking new properties and are considering bids on an office building in Aberdeen, a hotel premises in Stratford on Avon, and a supermarket in South Shields.

3.6 The Fund held £88.8m of cash (4.3%) which is being held for cash flow purposes, to allow the necessary investments in property and private equity as they arise, as well as to provide liquidity for any foreign exchange losses that might occur at the end of each quarter.Cash balances are also being held pending the asset allocation review, reported elsewhere on this agenda, and due to the transfer of Probation Pensions to the Greater Manchester Pension Fund, as part of the restructure of the National Probation Services. It is estimated that the Dorset Probation Trust's share of the assets is around £30m.

4. Overall Fund Performance

4.1 The performance of the Fund during the first nine monthsshows an overall return of 6.39%compared to the benchmark of 5.19%, an overall out performance of 1.20%. Over a 12 month period the Fund has returned 17.32% against the benchmark of 15.71%, an out-performance of 161basis points.

4.2 Over the last 3 years returns now outperform the benchmark and averaged 9.89% per annum compared to the benchmark return of 9.66%. Over the previous 5 years the out performance was 118 basis points with the Fund returning 12.79% per annum. Table 3 illustrates the performance over the last 3 months, year to date, 1 year, 3 year, 5 years and 10 years.

Table 3 – Overall Fund Performance

Performance as at	3 Months	1 Year	3 Years	5 Years	10 Years
Actual	4.28	17.32	9.89	12.79	7.75
Benchmark	3.72	15.71	9.66	11.61	8.21
(Under)/Out Performance	**0.56**	**1.61**	**0.23**	**1.18**	**(0.46)**

4.3 Members will recall that the Fund suffered significant falls in value during 2008 which has now fallen out of the 5 year performance figures. It must also be noted that the benchmark set by Dorset represents a challenging target and is higher than the Local Authority average returns over these time periods.

4.4 When considering the overall performance it is important to note the split between the "Return seeking assets" and the "Liability matching assets". Since the implementation of the strategic review in 2012, the Fund has held a proportion of the assets in an Inflation Hedging Strategy, managed by Insight.

These assets are not held to add growth, but to match the movements in the Fund's liabilities. It is therefore important to consider that in normal circumstances, the benchmark movement of these assets is a proxy for the Fund's liabilities.

4.5 The Liability Matching strategy, conducted by Insight has returned 14.63% since its inception on 1st July 2012. For the nine months to 31 December 2013Return seeking assets have returned 8.31% against the benchmark of 7.00%. The Liability Matching assets have returned -9.09% against the benchmark of-10.04%. This strategy is intended to hedge against the impact of increasing pensions liabilities which are linked to, amongst other things, the consumer prices index (CPI). CPI can not currently be hedged as there is not a sufficiently developed futures market, so the Dorset strategy targets the retail prices index (RPI) swaps market to act as a proxy for CPI which tends to be lower than RPI. Table 4 shows the overall performance of the Fund, but makes the distinction between the return seeking assets and the liability matching assets.

Table 4 Summary Fund Performance by Asset Class -9 months to 31December 2013

		9 Months to 31 December 2013		
Asset Category	Manager	Dorset	Bench-mark	Over/ (Under)
		%	%	%
Overall Fund Performance	**All**	**6.39**	**5.19**	**1.20**
Total Return Seeking Assets	**Various**	**8.31**	**7.00**	**1.31**
UK Equities	(Various)	8.98	8.32	0.66
Overseas Equities	(Various)	5.12	6.42	-1.30
Bonds	(RLAM)	1.09	-1.52	2.61
Property	(CBREi)	8.52	9.73	-1.21
Hedge Funds	(Various)	4.77	5.08	-0.31
Private Equity	(Various)	6.05	9.53	-3.48
Diversified Growth	(Barings)	2.16	3.42	-1.26
Cash	(Various)	0.59	0.29	0.30
Total Liability Matching Assets		**-9.09**	**-10.04**	**0.95**
Bonds	(Insight)	-9.09	-10.04	0.95

4.6 In considering the performance of the Fund as a whole, there are two main areas that explain where the performance is being generated. These are the asset allocation (market contribution) of the Fund and within those allocations the stock selection (selection contribution) choices that have been made. The stock selection element is a measure of the fund managers' ability to outperform their benchmark. The asset allocation is the effect of decisions to change the weighting of the different asset classes within the Fund.

4.7 The HSBC performance report, contained at Appendix 3, gives an attribution analysis of the performance for the quarter on pages 5 and 6. This analysis shows thatthe market contribution had a positive effect against the benchmark of 110bps whilst stock selection detracted by 33 bps. Return seeking assets contributed 118bps mainly driven by equities (UK and Overseas) of 16 bps, hedge funds of 28 bps and currency hedging 92 bps. The stock selection contribution was hit by the poor performance of overseas equities, especially in Emerging Markets, with a total negative contribution of 93 bps, which offset the strong contribution from UK equities of 60 bps, which was mainly driven by the stock selection decisions of Standard Life and AxaFramlington. Stock selection also acted as a drag for hedge funds by 25 bps.

5. Manager Progress (excluding UK equities)

Active US Equity

5.1 The performance of Intech for the 9 months to 31 December 2013is illustrated in Table 5.

Table 5 – Performance of Intech – US Equity

	USD $				GBP £			
	Market Value 1 April 2013 ($000's)	Market Value 31 Dec 2013 ($000's)	Perfor mance %	Bench mark %	Market Value 1 April 2013 (£000's)	Market Value 31 Dec 2013 (£000's)	Perfor-mance %	Bench-mark %
Intech	151,112	181,405	20.05	19.69	99,514	109,524	10.06	9.74

5.2 The Intechfund actively manages US equity stocks using disciplined mathematical processes to outperform the benchmark at the same level of risk. During the nine months to December the fund made positive returns of 20.05% against a benchmark of 19.69%, an improvement on the six month position where it was lagging the benchmark when measured in US Dollars. The appreciation of Sterling over the year means the Sterling performance is lower at 10.06% against a benchmark of 9.74%. By following their disciplined trading model Intech expect to make returns above the benchmark over the medium term. Returns over the 3 and 5 year period have been consistent, with the three years to 31 December 2013, returning 14.64% per annum. Over five years the fund has returned 14.89% per annum against the benchmark of 14.65%

Emerging Markets Equity

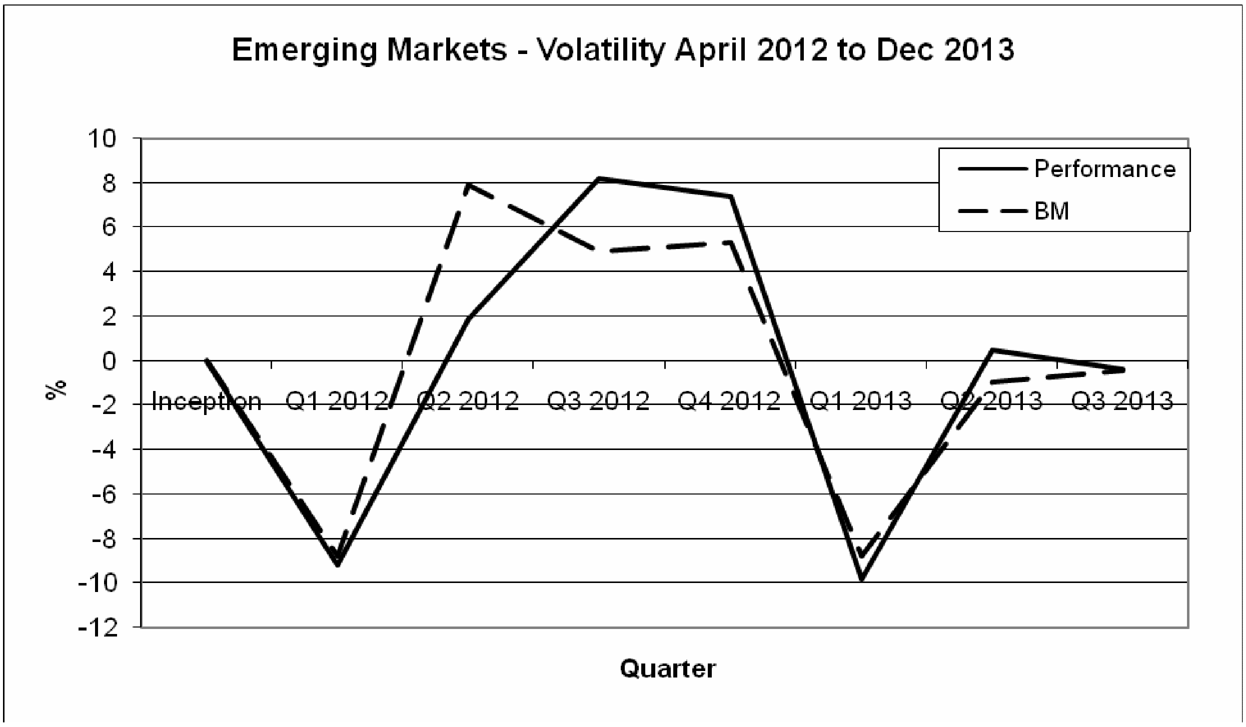
5.3 The JP Morgan mandate started on 5th April 2012. The performance of the fund for the nine months to 31December 2013 is shown in Table 6.

Table 6 – JP Morgan Emerging Markets Performance for the 9 months to December 2013

	Value at 1 April 2013 (£000's)	**Market Value at 31 Dec 2013 (£000's)**	**Performance over 9 months**		**Performance Since Inception**	
			Performance %	Benchmark %	Performance %	Benchmark %
JP Morgan	72,324	65,283	-9.74	-9.24	-1.67	-1.50

5.4 Emerging markets have faced a difficult 12 months, being affected during the first quarter of 2013/14 by the Federal Reserve's tapering comments, which started a general market panic before consolidating itself on the emerging markets with investors seeking to repatriate their capital back to the US, which had a big impact on emerging market debt and currencies in particular. There was also public unrest in Turkey and Brazil which had a short term impact on market sentiments. The second and third quarter's performance was broadly flat with most of the losses happening in May and June 2013. JP Morgan operate a strategy with multiple drivers of country sector and stock (top down approach) alongside the fundamental and qualitative analysis (bottom up), and they believe that Emerging markets are now in a valuation 'territory' that is typically reserved for crisis periods and they feel it is the time to invest.

5.5 Emerging market equities are seen as the asset class which will offer the most growth over the medium term, albeit with the high levels of volatility that we have seen since making the investment. The chart below shows the differences in quarterly performance since inception and highlights the volatility of the performance to date alongside the benchmark. The chart shows that it is typical to see growth and losses of 8% per quarter.



Private Equity

5.6 The Pension Fund has committed to investing with HarbourVest and Standard Life in their Private Equity Fund of Funds. Private Equity is an area that takes several years for commitments to be fully invested, and the table below shows the position as at 31 December 2013.

5.7 Table 7shows the commitment Dorset has made to each fund in Euros and US Dollars, the drawdowns that have taken place to date and the percentage of the total drawdown against Dorset's commitment. It also shows the funds that have been returned to the Dorset Fund, the valuation as at 31 December 2013 and the total gains or losses, which includes the distribution plus the latest valuation. So far all but one of the funds have performed positively and are showing net gains overall.

Table 7 Private Equity Commitments, Drawdowns and Valuations as at 31 December2013

Manager	Commit ment	Drawn down	% of Commit -ment	Distribu tion	Value	Gain / (Loss)
	€m	€m		€m	€m	€m
HV Partnership V	12.000	10.380	87%	2.720	9.919	2.259
HV Direct V	3.000	2.880	96%	0.593	2.267	-0.020
SL 2006	22.000	18.663	85%	4.600	15.607	1.544
SL 2008	17.000	8.022	47%	0.580	7.705	0.263
	$m	$m		$m	$m	$m
HV Venture VIII	15.200	12.844	85%	2.961	13.277	3.394
HV Buyout VIII	22.800	17.214	76%	4.686	16.739	4.211
HV Buyout IX	15.000	2.213	15%	0.000	2.279	0.067
HVVenture IX	10.000	1.700	17%	0.000	1.789	0.089

HV = HarbourVest
SL = Standard Life

5.8 Private Equity is a long term investment and as such the performance should be reviewed over the longer term. The benchmark used for this fund is the FTSE All Share index.Table 8 shows the performance over 3 and 5 years against the benchmark, with both funds performing well over a three year period. Members will recall from the June meeting that there has been a significant jump in the 5 year benchmark. It was 2.4% in March, 10.70% in September and 14.31% as at December, which reflects the stock market recovery since the lows in 2008. Over the medium to long term the annualised performance is therefore positive. During the last quarter, distributions have been greater than the drawdown's, which has contributed in the continued underweight position in the private equity portfolio. This will be partially addressed by the Committee's decision to allocate a further £10m to the Standard Life Secondary's Fund at the November 2013 meeting. The strategic review will also seek to address this.

Table 8 Private Equity Performance 3 and 5 years

Manager	3 Years to 31December 2013		5 Years to 31December 2013	
	Dorset %	Benchmark %	Dorset %	Benchmark %
HarbourVest	12.67	9.41	9.41	14.31
Standard Life	14.58	9.41	4.79	14.31

Hedge Fund (Absolute Returns) Managers

5.9 The Pension Fund has active investments with two Fund of Hedge Fund managers; International Asset Management (IAM), and Gottex. There are also investments in delayed redemption funds with the previous manager, Pioneer. Whilst a notice of redemption was given to Pioneer as at 1 April 2009, there remains about £1.7m held in illiquid investments pending sales, following a recent redemption in September for £0.5m.Table 9 shows the current portfolio and performance for the nine months to 31December 2013 alongside the performance over 5 years.

Table 9 Hedge Fund Performance for the nine months to 31December 2013 and 5 Years

Manager	Value at 1 April 2013	Market Value 31 December 2013	9 Month Performance %	9 Month Benchmark %	5 Year Performance %	5 Year Benchmark %
Gottex (£000's)	30,280	31,489	3.99	4.23	6.11	5.90
Pioneer (£000's)	2,340	1,789	-2.98	5.94	6.04	6.82
IAM (£000's)	57,277	55,493	-3.11	5.50	3.08	7.40
IAM ($000's)	86,976	91,914	5.49	5.50	n/a	n/a

5.10 The performance of Gottexhas lagged behind the benchmark during the first nine months of the year, although it has made positive returns. The 5 year performance is better showing an outperformance of 0.21 basis points. However, members will recall that the losses incurred in the autumn of 2008 were significant and this has now dropped out of the 5 year performance figures. Since inception the Gottex fund has returned on average -1.52% per annum.

5.11 The IAM fund has underperformed their benchmark by 432 basis points per annum over the past 5 years. During the nine months to 31 December 2013 IAM has under-performed following a positive first quarter, when hedged into Sterling. Against the dollar benchmark performance is in line over the nine months. IAM believe that performance will improve as the markets begin to normalise again after the financial crisis.

5.12 Alternative assets as a whole, and especially hedge funds,are central to the strategic review that is being reported elsewhere on this agenda.

6. Treasury Management

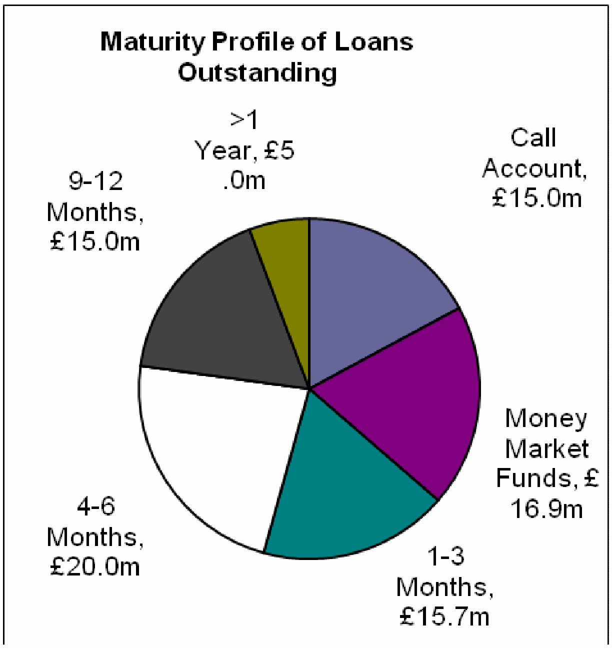
6.1 The Pension Fund generates cash flows throughout the year which need to be managed. The Fund therefore holds a proportion of cash that is invested in call accounts, money market funds and fixed term deposits. A breakdown of the balances held internally as at 31 December 2013 is shown in Table 10.

6.2 Since the credit crunch, there has been a significant reduction in the number of countries and financial institutions that are deemed safe for investments. The Council's treasury management advisers have recently advised that cash balances can be invested for more than 3 months in the big four UK banking groups. The majority of cash continues to be lent for less than 3 months in UK institutions to ensure that the money is both secure and liquid, and so it is available for distribution.

6.3 In terms of performance, the weighted average yield continues to reduce as, higher return investments mature and have to be replaced with lower rate ones. The determination of the Bank of England to keep interest rates low, coupled with new banking regulations have resulted in banks' reducing the amount they pay on instant access and short notice accounts. Interest rates on the main call account used by the Pension Fund have reduced from 0.8% to 0.3%. Internally managed cash returned 0.59% over the nine months to December 2013, which is almost twice that of the benchmark at 0.29%.The overall weighted average annual return of the cash invested as at 31December 2013 was 0.68%.

Table 10 – Analysis of Cash Balances Held as at 31 December 2013

Lender/ Borrower	Amount £'000	Rate %
Loans		
Lloyds TSB Bank	5,000	1.10
Barclays Bank	10,000	0.53
NatWest	15,000	0.60
Lloyds Bank Plc	5,000	1.00
Lloyds Bank Plc	10,000	0.89
Lloyds Bank Plc	5,000	0.98
Lloyds Bank Plc	5,000	0.75
Call Accounts		
National Westminster Bank	733	0.40
SvenskaHandelsbanken	15,000	0.65
Money Market Funds		
PF Ignis MMF	14,850	0.44
PF Federated Prime Rate MMF	2,000	0.42
Total Managed Cash	**87,583**	**0.68**
Holding Accounts		
HSBC	518	0.01
CBRE Rent Account	692	0.01
Total	**88,793**	



7. Audit of the 2013/14 Pension Fund Accounts

7.1 Officers have met with KPMG, who will undertake the external audit of the Pension Fund accounts, to discuss the audit plan. There has been a change in the personnel who are carrying out the audit, but they do not envisage any major new risks or changes to the audit process. An interim audit will take place the week commencing 14 April, with the final audit commencing on the 7 July 2014 for three weeks. They will present their findings to the September meeting of this Committee.

8. Asset Allocation

8.1 There has been a review of the strategic asset allocation of the Fund, which has looked at the risk and return structure of the Fund and identified a few areas where improvement can be made. The outcome of this review is being reported elsewhere on this agenda.

Paul Kent
Fund Administrator
February 2014