Pension Fund Committee

Dorset County Council

Date of Meeting	1 March 2016
Officer	Pension 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 2015/16 Financial Year to 31 December 2015. The report also provides a commentary on the performance of the fund managers who are not considered elsewhere on the agenda and to address 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 -0.13% over the nine months to 31 December, outperforming its benchmark which returned -1.44%. Return seeking assets returned 0.68%, whilst the liability matching assets returned -5.73%. For the same period the WM Local Authority average returned -1.5%.
Impact Assessment:	Equalities Impact Assessment: N/A
	Use of Evidence: N/A
	Budget: N/A

	Risk Assessment: The Fund assesses the risks of its investments in detail, and considers them 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: None
Recommendation	That the Committee : i) Review and comment upon the activity and overall performance of the Fund. ii) Note the comments on future private equity allocations. iii) Agree to invest £35 Million in UK equities. iv) Agree to invest £15 Million with Insight subject to resolving the outstanding issues.
Reason for Recommendation	To ensure that the Fund has the appropriate management arrangements in place and are being monitored, and to keep the asset allocation in line with the strategic benchmark.
Appendices	Appendix 1: New Money Forecast Appendix 2: Report of the Independent Adviser Appendix 3: HSBC Manager Performance for the nine months to 31 December 2015
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. It is anticipated that there will be a surplus of income over expenditure from these cash flows of approximately £20M in the 2015-16 financial year. The anticipated cash flows for 2015/16 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. Cash flow

2.1 The table below summarises the main cash flows for the Fund for the nine months under review.

Statement of cash-flow for the 9 months ended 31 December 2015

	£M	**£M**
Cash at 1 April 2015		**33.1**
Less:		
UK Equity purchases (net)	0.8	
Infrastructure drawdowns (net)	1.4	
		2.2
Plus:		
Hedge Fund redemptions	5.6	
Private Equity distributions (net)	2.1	
Currency Hedge Gain	6.5	
Overseas Equities	29.5	
Increase in Cash	14.6	
		58.3
Cash at 31 December 2015		**89.2**

3. Fund Portfolio Distribution

3.1 The table below shows the position as at 31 December 2015. The target allocation shown is the strategy agreed at the September 2014 meeting of the Committee, due to the then concerns over the Barings mandate, and subsequent postponement of the search for an additional Diversified Growth Fund manager. Members will recall this search has been further delayed due to the pooling agenda.

Asset Class	Manager	31-Mar-15 £M	31-Mar-15 %	31-Dec-15 £M	31-Dec-15 %	Target Allocation £M	Target Allocation %
Bonds	(Several)	562.6	24.2%	537.6	23.5%	561.2	24.5%
UK Equities	(Several)	623.5	26.8%	598.9	26.1%	630.0	27.5%
Overseas Equities	(Several)	628.8	27.0%	616.9	26.9%	572.7	25.0%
Property	(CBREi)	228.8	9.8%	243.8	10.6%	229.1	10.0%
Absolute Return Funds	(Several)	8.3	0.4%	2.1	0.1%	-	0.0%
Infrastructure	(Several)	26.8	1.2%	28.1	1.2%	91.6	4.0%
Private Equity	(Several)	59.2	2.5%	65.5	2.9%	91.6	4.0%
Diversified Growth	(Barings)	111.6	4.8%	108.7	4.7%	114.5	5.0%
Cash	(Internal)	75.5	3.2%	89.2	3.9%	-	0.0%
Total		**2,325.0**	**100.0%**	**2,290.8**	**100.0%**	**2,290.8**	**100.0%**

3.2 The table above shows that in most asset classes the Fund's allocation is now close to or slightly above target, with the exception of Private Equity and Infrastructure which will take a number of months to fully drawdown.

3.3 The table below summarises the draft valuation of the Fund as at 31 January 2016, and shows the impact that falls in global equity markets have had on the Fund:

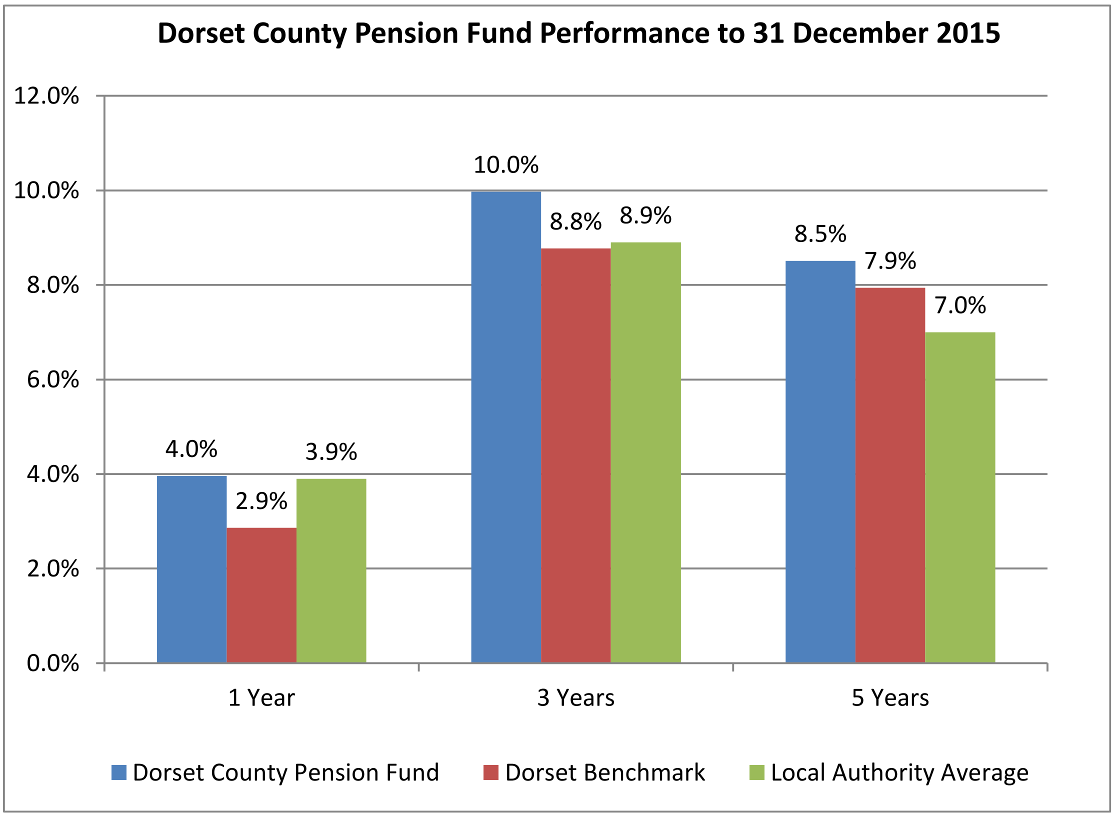
Asset Class	Manager	31-Jan-16 £M	31-Jan-16 %	Target Allocation £M	Target Allocation %
Bonds	(Several)	532.2	23.8%	547.1	24.5%
UK Equities	(Several)	563.7	25.2%	614.1	27.5%
Overseas Equities	(Several)	596.9	26.7%	558.3	25.0%
Property	(CBREi)	243.8	10.9%	223.3	10.0%
Absolute Return Funds	(Several)	2.1	0.1%	-	0.0%
Infrastructure	(Several)	28.1	1.3%	89.3	4.0%
Private Equity	(Several)	65.5	2.9%	89.3	4.0%
Diversified Growth	(Barings)	105.3	4.7%	111.7	5.0%
Cash	(Internal)	95.5	4.3%	-	0.0%
Total		**2,233.1**	**100.0%**	**2,233.1**	**100.0%**

4. Overall Fund Performance

4.1 The performance of the Fund for the nine months to 31 December 2015 shows an overall return of -0.13%, an outperformance of the benchmark of -1.44% by 1.31%. Over the 12 month period to 31 December 2015 the fund has returned 3.96% against the benchmark of 2.86%, an outperformance of 1.10%.

4.2 The Fund has exceeded its benchmark over 3 years, returning an annualised 9.97% against the benchmark of 8.77%, and over 5 years, returning an annualised 8.51% against the benchmark of 7.94%.

4.3 The chart below shows the overall performance for 1, 3 and 5 years against the Fund's bespoke benchmark, and the Local Authority average performance.



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 For the nine months to 31 December 2015, Return Seeking assets have returned 0.68% against the benchmark of -0.91%. The Liability Matching assets have returned -5.73% against the benchmark of -5.73%. 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 cannot 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. The table below shows the overall performance of the Fund, but makes the distinction between the return seeking assets and the liability matching assets.

		9 Months to 31 December 2015		
Asset Category	**Manager**	**Dorset %**	**Benchmark %**	**Over/(Under) %**
Overall Fund Performance	**All**	**-0.13**	**-1.44**	**1.31**
Total Return Seeking Assets	**Various**	**0.68**	**-0.91**	**1.59**
UK Equities	(Various)	-1.81	-3.15	1.34
Overseas Equities	(Various)	-1.44	-3.29	1.85
Bonds	(RLAM)	-3.28	-3.76	0.48
Property	(CBREi)	10.36	10.05	0.31
Private Equity	(Various)	17.06	-3.52	20.58
Diversified Growth	(Barings)	-2.61	3.45	-6.06
Infrastructure	(Various)	7.34	7.41	-0.07
Total Liability Matching Assets		**-5.73**	**-5.73**	**0.00**
Bonds	(Insight)	-5.73	-5.73	0.00

4.6 It is pleasing to note that in relative terms each asset class has outperformed its own benchmark over the nine month period with the only exceptions being Diversified Growth and Infrastructure. It is a positive sign that, despite the negative absolute returns in a number of asset classes, the Dorset fund managers have been successful in "riding the storm". Whilst the Diversified Growth Fund manager has suffered, it is to be expected in an asset class that is benchmarked against cash, in times of falling global markets.

4.7 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.

4.8 The HSBC performance report, contained at Appendix 3, gives an attribution analysis of the performance for the year to date on pages 6 and 7. This analysis shows that the market contribution had a positive effect of 88bps against the benchmark and stock selection was positive by 43bps. Return seeking assets had an overall positive contribution of 139bps mainly driven by UK equities (36bps), overseas equities (27bps) and private equity (55bps).

5. Manager Progress

Diversified Growth

5.1 The Diversified Growth allocation was mandated to Barings on 30 March 2012. Diversified Growth Funds are designed to give fund managers total discretion over how and where they invest which means that the portfolio holds a wide range of investments against a diverse range of asset classes. The Barings fund seeks to achieve out performance against a cash benchmark by focussing on asset allocation decisions. This fund targets equity like returns with about 70% of the equity risk.

5.2 The performance for Barings for the nine months and twelve months to 31 December 2015 is summarised below.

Market Value at 1 April 2015	Market Value at 31 Dec 2015	9 months to 31 Dec 2015		12 months to 31 Dec 2015	
£000s	£000s	Performance %	Benchmark %	Performance %	Benchmark %
111,640	108,721	-2.61	3.45	1.10	4.60

5.3 Over the nine months the Barings fund delivered a 2.61% negative return, against the benchmark of 3.45% but in the third quarter the fund returned 3.96% against its benchmark of 1.14%. The fund manager comments that the fund is focused on Europe and Japan. Within Europe the focus is on domestic areas whilst Japan presents opportunities as government reform efforts and tax changes continue and valuations remain attractive. The emphasis of the Fund is towards growth and defensive positions.

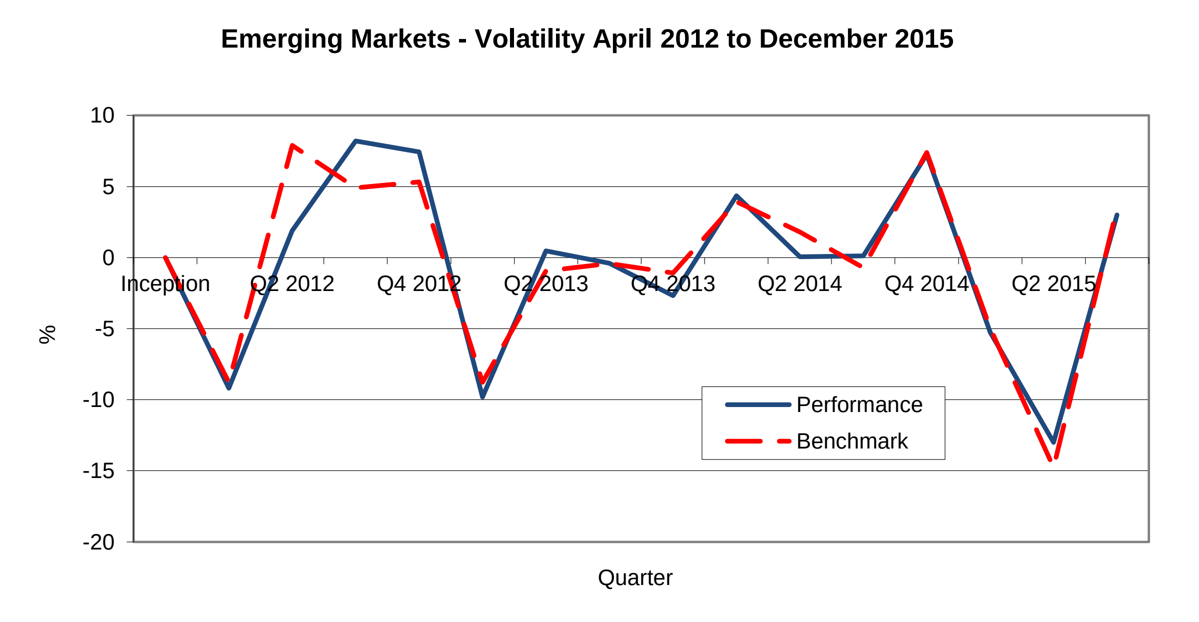
Emerging Market Equity

5.4 The performance of JP Morgan for the nine months and twelve months to 31 December 2015 is summarised below.

Value at 1 April 2015	Market Value at 31 Dec 2015	9 months to 31 Dec 2015		12 months to 31 Dec 2015	
(£000's)	(£000's)	Performance %	Benchmark %	Performance %	Benchmark %
71,205	60,448	-15.11	-15.90	-8.95	-9.65

5.5 The return of -8.95% for the 12 months to 31 December 2015 was above the benchmark of -9.65% by 0.70%. The fund manager comments that emerging markets witnessed the fifth worst year for the asset class since 1988, sparked by an intensification of worries about the Chinese economy and the possible spill-over into other emerging and developed markets.

5.6 Emerging market equities are seen as the asset class which will offer the most growth over the medium term, albeit with high levels of volatility. The chart below shows the differences in quarterly performance since inception and highlights the volatility of the performance to date alongside the benchmark.



Private Equity

5.7 The 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 2015.

5.8 The table shows the commitment Dorset has made to each fund in Euros and US Dollars, the draw-downs 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 2015 and the total gains or losses, which includes the distribution plus the latest valuation.

Manager / Fund	Commitment	Drawn down	% of Commit-ment	Distribution	Valuation	Gain / (Loss)
	€m	€m		€m	€m	€m
HV Partnership V	12.000	11.280	94%	10.335	6.529	5.584
HV Direct V	3.000	2.880	96%	2.768	1.230	1.118
SL 2006	22.000	19.719	90%	14.624	11.358	6.263
SL 2008	17.000	13.349	79%	4.739	11.638	3.028
	$m	$m		$m	$m	$m
HV Venture VIII	15.200	14.744	97%	10.981	13.966	10.203
HV Buyout VIII	22.800	20.748	91%	17.948	13.827	11.027
HV Buyout IX	15.000	7.388	49%	1.642	7.381	1.635
HV Partnership VII (AIF)	20.000	3.100	16%	0.000	3.344	0.244
HV Venture IX	10.000	6.600	66%	1.083	7.749	2.232
SL SOF I	16.000	8.648	54%	0.332	9.375	1.059
SL SOF II	20.000	5.377	27%	0.000	6.325	0.948
Harbourvest Partners X AIF	10.000	0.250	3%	0.000	0.239	-0.011
Harbourvest Partners X AIF	5.000	0.175	4%	0.000	0.158	-0.017

5.9 For the 9 months to 31 December 2015 total drawdowns have been £12.2M and total distributions £14.3M. In order to meet the target allocation, there is a requirement to keep committing to Private Equity funds, and officers are in regular discussions with HarbourVest and SL Capital to identify further opportunities.

5.10 Members will recall that at the meeting in June 2014, the Fund agreed to commit £50Million to Private Equity over the forthcoming two year period. Officers have identified opportunities with the Fund's two Private Equity managers over the intervening period, and the final tranche of the £50 Million has recently been committed to the SL Capital Special Opportunities Fund (SOF) III. This Fund will hold a first close in the first quarter of 2016, and will replicate the successful strategies of SOF I and SOF II in which Dorset invests.

5.10 Private Equity is a long term investment and as such the performance should be reviewed over the longer term. Private Equity benchmarks are not readily available and so the asset class is benchmarked against listed equity; the FTSE All Share index. The table below shows the performance over 3 and 5 years against the benchmark.

Private Equity Overall Performance

	3 Years to 31 Dec 2015		5 Years to 31 Dec	
Manager	**Dorset**	**Benchmark**	**Dorset**	**Benchmark**
	%	**%**	**%**	**%**
HarbourVest	20.00	7.27	16.53	6.00
Standard Life	6.81	7.27	4.97	6.00

6. Treasury Management

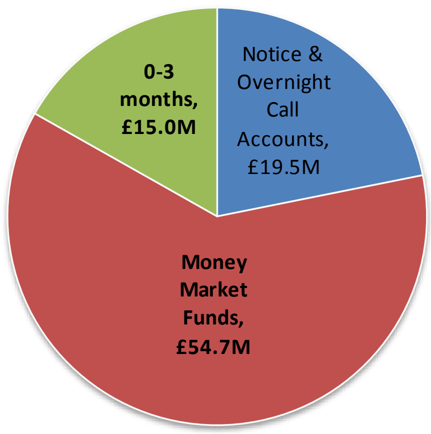
6.1 The Fund generates cash flows throughout the year which need to be managed. The Fund therefore holds a proportion of cash that is invested in call accounts, money market funds and fixed term deposits. A breakdown of the balances held internally as at 31 December 2015 is shown in the table below. This includes relatively small amounts of cash held with the custodian bank account at HSBC and in a property rent collection account, where a float is required to be held for working capital purposes.

6.2 Since the financial crisis of 2008-09, 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, Capita, have advised that cash balances can be invested for more than 3 months in the big four UK banking groups – Barclays Plc, HSBC Plc, Lloyds Banking Group and the Royal Bank of Scotland. 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. Internally managed cash returned 0.42% over the nine months, which is ahead of the benchmark, as measured by the 7 day LIBID, at 0.28% for the same period. These low market rates have broadly been caused by the funding for lending scheme and Bank of England restrictions on how banks have to treat liquid deposits.

Lender/Borrower	Amount £000s	Rate %
Fixed Term Deposits		
Lloyds Banking Group	5,000	0.57%
Smitomo Mitsui Corp	10,000	0.59%
Total Loans	15,000	0.58%
Call Accounts		
National Westminster Bank	359	0.25%
Svenska Handelsbanken	6,600	0.45%
Santander UK Plc 120 Day Notice	5,000	1.05%
Santander UK Plc 180 Day Notice	5,000	1.15%
Total Call Accounts	16,959	0.83%
Money Market Funds		
Standard Life	15,000	0.49%
Deutsche	9,700	0.48%
BNP Paribas	15,000	0.56%
Federated Prime Rate	15,000	0.50%
Total Money Market Funds	54,700	0.51%
Holding Accounts		
HSBC Custodian Account	1,055	0.00%
Property Client Account	1,473	0.00%
Total Holding Accounts	2,528	0.00%
Total Cash / Average Return	**89,187**	**0.57%**

Duration of Investments



7. Global Equity Managers

7.1 At the previous meetings of the Committee members approved the new Global Equity management arrangements. At the meeting in November it was reported that Legal and General Investment Management (LGIM) had been appointed to manage the transition of arrangements.

7.2 The transition from Pictet Asset Management and Janus Intech was completed 17 December 2015, and the market values for the three new managers as at 31 December 2015 were Allianz £222m, Investec £167m and Wellington £167m. The support of the LGIM team throughout the process was invaluable and through the effective and efficient management of the trading process was able to save the Dorset Fund a significant amount, as well as limiting the risk of "out of market exposure".

8. LGPS reform

8.1 At the special meeting of the Committee in January members agreed the proposed response to the Government's pooling agenda. This proposal was also agreed by each of the respective Committees of the other 9 members of Project Brunel, and was submitted as a joint response by the deadline of 19 February.

8.2 A couple of weeks ahead of the deadline representatives of Project Brunel met with officials from HM Treasury and the DCLG to present the proposals and seek their views as to its acceptability. The response was generally positive, and also identified areas in which the proposal will need strengthening ahead of the second deadline for more detailed proposals in July 2016.

8.3 It is hoped that a response to the proposals will be received within a few weeks of the 19 February deadline to enable officers to start work on the next stage of the work plan. Officers will update the Committee verbally if anything emerges prior to the meeting on 1 March.

8.4 Members will recall that 19 February is also the deadline for responding to the Government's consultation on revoking and replacing the LGPS Investment regulations. Officers emailed a copy of the proposed response to the Committee and a number of comments were received which were included in the final response which was circulated to by email. We await the Government's response to this consultation.

9. Asset Allocation

9.1 A separate report on today's agenda addresses the issue of UK Equity and makes a recommendation as to a course of action. This report contains commercially sensitive information and is therefore treated as exempt. The recommendation contained within the report will not affect the overall asset allocation of the Fund (shown at paragraph 3).

9.2 The asset allocation shown in paragraph 3 highlights the cash balances that have accrued within the Fund over the year, and partly as a result of taking some cash from the Global Equity portfolio at the time of transition. It is appropriate to consider whether it is appropriate to invest a proportion of this cash in the portfolio.

9.3 In considering allocating cash it is important to look at any predicted inflow/outflows of cash over the next 3/6 months, to ensure that the appropriate balance is maintained. Through conversations with the Fund's infrastructure managers it has been identified that it is likely that around £50 Million will be drawn down by the end of September and therefore the Fund will need to maintain appropriate balances to fund this.

9.4 A handful of the Fund's employers have opted to pay the employers element of their monthly contributions up front on 1 April, and have received a small discount in the contribution rate for doing so. At the time of writing the exact amount has not been calculated but it will be in the region of £25 Million - £30 Million. It is important that this is not held in cash but invested in line with strategy.

9.5 The table in paragraph 3.3 shows UK equities has an underweight position of around £50 Million, whilst Global equities are overweight by around £38 Million. Private Equity is also showing an underweight position, as highlighted previously, of £23 Million. In total equities are therefore around £35 Million underweight. It would not be appropriate to divest from Global equities at this time, as most of their gain in value will be due to weakness in Sterling and this may well revert over time. However it would be sensible to allocate £35 Million to UK equities, partly as a proxy for the illiquid Private Equity, to bring the net position back in line with the target weight. The balance of this allocation across the UK equity managers is addressed in the report referred to in paragraph 8.1.

9.6 In addition to the allocation to UK equities it is also appropriate to invest a further £15 Million with Insight, the Fund's inflation hedging manager. Officers and advisers have been in conversation with Insight over a couple of issues that need to be addressed before this allocation can be made, but it is recommended that subject to resolving these issues a further £15 Million is allocated to Insight from cash on or around 1 April.

9.7 Paragraph 3 also highlighted an under-allocation to Private Equity and Infrastructure, due mainly to the time taken for each asset class to draw down committed funds, and also the relative movements in value against other asset classes. The Fund has now allocated the £50M agreed in June 2004 in an attempt to address this; however it is clear that more needs to be done. This level of additional commitment is unlikely to see the Fund reach its strategic target weight, and therefore in addition to fulfilling this allocation, further allocations will be required. A report with proposals in this respect will be tabled to the Committee in 2016.

Richard Bates
Pension Fund Administrator
February 2016