DORSET COUNTY PENSION FUND

UK Equity
Report for 6 months ending 31 March 2016

- Internal Managers Report
- Valuation Report
- Transaction Report

Dorset County Pension Fund Committee – 1 July 2016

UK Equity Report

Report of the Internal Manager

1. **Purpose of the Report**

1.1 To review the management of the UK equity portfolio.

2. **Recommendations**

2.1 That the report and performance be noted.

3. **Background**

3.1 The UK Equity portfolio has three active managers, AXA Framlington, Standard Life and Schroders as well as the internally managed passive fund. This was reduced to two active managers after the Standard Life mandate was terminated in April 2016. This combination of managers and styles is designed to give the opportunity of outperformance against the FTSE All Share index and has a two thirds passive and one third active mix, which is maintained after the April 2016 change. Details of the combined portfolio (£584.2M at 31 March 2016) are shown in the table at paragraph 5.2.

3.2 The internally managed passive fund aims to track as closely as possible the FTSE 350 index which measures the progress of the majority of the UK equity market. At 31 March 2016, the FTSE All Share index was made up of 642 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £134.6 Billion) down to the smallest in the index, Hansa Trust Plc (market value £29.4 Million). Direct investment is made in the largest 350 companies, which comprises 96.6% by value of the index. Investment in the smallest companies which make up 3.4% of the index is achieved by a holding in the Schroders Institutional UK Smaller Companies Fund which is managed on an active basis.

4. **Market Background**

4.1 All major UK Equity markets rose in the six months to 31 March 2016. The best performing index was the FTSE Small Cap index which rose 2.6% (160 points), whilst the FTSE250 was the worst performing major UK index rising 1.5% (243 points). The FTSE100 rose 1.9% (113 points) over the same period. In comparison, there was mixed performance from the major world indices. The Dow Jones was the best performer rising 8.6% (1,400 points) whilst the Nikkei225 was the worst performer falling 3.6% (630 points).

4.2 Over the twelve month period, there was mixed performance from the major UK Equity markets. The FTSE Small Cap ex IT was the best performing index rising 5.9% (333 points) whilst the FTSE100 was the worst performing major UK index falling 8.8% (598 points). In comparison, all major world indices fell. The Dow Jones fell 0.5% (91 points) whilst the Shanghai Composite was the worst performer falling 19.9% (744 points) over the same period.

4.3 The FTSE100 reached a 2016 calendar year high on 30 March 2016 at 6,203.2, with help from the mining sector which rose 5.6% and confirmation that US rates would be raised more cautiously. On 11 February 2016 the FTSE100 was at its lowest level since 11 January 2010 amid continuing concerns about the slowdown in China's growth, while banking stocks were impacted by losses of Italian financial stocks. In February 2016, the Dow Jones closed at a six month low of 15,660.2. This was 16.9%

(2,652 points) lower than the all-time high on 19 May 2015 of 18,312.4.

Six Months to 31 March 2016

Country	Index	30/09/2015	31/03/2016	% Change
UK	FTSE100	6,061.6	6,174.9	1.9
UK	FTSE250	16,683.0	16,926.1	1.5
UK	FTSE350	3,384.7	3,445.4	1.8
UK	Small Cap	6,105.2	6,264.8	2.6
UK	Small Cap ex Investment Trusts	5,885.5	6,009.7	2.1
UK	All Share	3,335.9	3,395.2	1.8
Japan	Nikkei225	17,388.2	16,758.7	-3.6
US	Dow Jones	16,284.7	17,685.1	8.6
Hong Kong	Hang Seng	20,846.3	20,776.7	-0.3
France	Cac 40	4,455.3	4,385.1	-1.6
Germany	Dax	9,660.4	9,965.5	3.2
China	Shanghai Composite	3,052.8	3,003.9	-1.6

Twelve Months to 31 March 2016

Country	Index	31/03/2015	31/03/2016	% Change
UK	FTSE100	6,773.0	6,174.9	-8.8
UK	FTSE250	17,090.6	16,926.1	-1.0
UK	FTSE350	3,726.4	3,445.4	-7.5
UK	Small Cap	6,165.0	6,264.8	1.6
UK	Small Cap ex Investment Trusts	5,676.9	6,009.7	5.9
UK	All Share	3,663.6	3,395.2	-7.3
Japan	Nikkei225	19,207.0	16,758.7	-12.7
US	Dow Jones	17,776.1	17,685.1	-0.5
Hong Kong	Hang Seng	24,900.9	20,776.7	-16.6
France	Cac 40	5,033.6	4,385.1	-12.9
Germany	Dax	11,966.2	9,965.5	-16.7
China	Shanghai Composite	3,747.9	3,003.9	-19.9

5. **Performance**

5.1 The internally managed passive portfolio is modelled to track the index with a tolerance of $^{+}$/.0.5% pa allowing for the costs of rebalancing. The figures shown below are for this part of the Fund only.

Quarter To	Dorset %	Index %
30/06/15	-1.56	-1.72
30/09/15	-5.70	-5.79
31/12/15	3.87	4.00
31/03/16	-0.72	-0.38
Annual Total	-4.23	-4.11

Notes:

- The Dorset Fund has underperformed the benchmark over the twelve month period to 31 March 2016 by 0.12% which is within the allowed tolerances.

5.2 **TWELVE MONTHS TO 31 MARCH 2016**

	Market Values 31/03/2015 £M	31/03/2016 £M	Performance %	Benchmark %	Benchmark Description
Internal	401.4	365.7	-4.23	-4.11	FTSE 350
AXA Framlington	108.7	108.0	-0.66	-3.91	All-Share
Standard Life	78.5	71.9	-7.71	-3.91	All-Share
Schroders	34.9	38.6	11.26	5.85	Small Cap*
Total	623.5	584.2	-2.93	4.61	

*FTSE Small Cap ex Investment Trusts

The figures for the whole UK equity portfolio show:

- The combined portfolio has outperformed its benchmark over the twelve month period by 0.19%.
- Two of the three active UK managers outperformed their benchmarks. Schroders and AXA Framlington outperformed their benchmarks by 5.41% and 3.25% respectively, whilst Standard Life underperformed its benchmark by 3.80% in the twelve month period to 31 March 2016.

THREE AND FIVE YEAR ANNUALISED PERFORMANCE

Manager	Three Years Performance %	Three Years Benchmark %	Five Years Performance %	Five Years Benchmark %
Internal	3.57	3.52	5.62	5.58
AXA Framlington	6.93	3.67	8.92	5.69
Standard Life	3.42	3.67	4.86	5.69
Schroders	14.10	12.31	13.52	12.61

The figures for the whole UK equity portfolio show:

- Over both the three and five year period the Internally Managed Fund has outperformed its benchmarks by 0.05% and 0.04% respectively, within its agreed tolerance.
- AXA Framlington outperformed their benchmark for both three and five years by 3.26% and 3.23% respectively. Standard Life underperformed both their benchmarks for the three year period by 0.25% and by 0.83% over the five year period. Schroders outperformed its benchmark over three years by 1.79% and 0.91% over five years.

5.3 The table below shows how the four UK Equity manager's valuations have changed over the year to 31 March 2016. All UK Managers valuations, with the exception of Standard Life have increased over the period to 31 March 2016.

MARKET VALUE OVER TWELVE MONTHS TO 31 MARCH 2016

Manager	Market Value 31/03/15	Market Value 31/03/16	Total % of UK Equity As At 31/03/15	Total % of UK Equity As At 31/03/16
	£M	£M	%	%
Internal	401.4	365.7	64.4	62.6
AXA Framlington	108.7	108.0	17.4	18.5
Standard Life	78.5	71.9	12.6	12.3
Schroders	34.9	38.6	5.6	6.6
Total	**623.5**	**584.2**	**100.0**	**100.0**

5.4 Each external manager's commentary is summarised below:

Schroders
4th Quarter 2015/16
Performance and Market Summary
During the 4th quarter, the Fund returned -0.2% against the Small Cap benchmark of -0.6%. Over the twelve month period the Fund returned 11.3% against its benchmark of 5.9%.The Small Cap indices underperformed the wider market as they lagged the sharp rise in mining and oil shares as these two sectors have a much higher weighting in the FTSE100. Dart Group was the main contributor as the company announced that it was trading ahead of expectations, while Internetq received a cash bid at a substantial premium to the current price. Dechra Pharmaceuticals, Photo-Me International and MJ Gleeson all announced positive results with double digit dividend increases. The main negatives to performance came from Avon Rubber over concerns about a slowdown in its index, while companies with domestic exposure such as Ted Baker and CLS Holding suffered concerns about whether Brexit may become a reality after the referendum.
Activity
New holdings included Imagination Technology Group, Bioventix, Sinclair Pharma, Blue Prism, Harwood Wealth and Tracsis. The holding is SDL was added to as were Conviviality and MP Evans. The total holding in Chesnara were sold whilst there were partial sales in Tyman and Rathbone Brothers.
Outlook and Strategy
The sharp increase in commodity share prices has seen them recover far faster than the underlying commodities but this area is expected to come under pressure in the next quarter. The introduction of the National Living Wage is going to be inflationary and companies are looking at increasing capital expenditure to compensate. Where these costs cannot be passed on, then profits are going to come under pressure. Concerns over the Brexit vote are leading to increased volatility in the market, especially in domestic focused stocks. Companies are being sought using the environment of low interest rates to make acquisitions to supplement organic growth. This is being well received in the market and it is a trend that is expected to continue. Organic growth will continue to be sought along with pricing power where possible and avoiding companies with too much debt because, in a deflationary environment, the latter can destroy the value of equity very quickly.

Standard Life
4th Quarter 2015/16
Performance
During the quarter, the Fund returned -0.2% against the FTSE All Share Index return of -0.4%. Over the year to 31 March 2016, the Fund returned -7.7% against the index return of -3.9%. A major positive for relative performance came from exposure to a number of commodity-related stocks, which recovered strongly over the quarter. The long held view was that the commodity sell off discounted the importance of basic and industrial materials in a still growing world. As a result, holdings in Glencore, Anglo

American, First Quantum, Hochschild and Lonmin all performed well as commodity prices staged a revival later in the quarter. Meanwhile, Mergers and Acquisitions activity proved positive for holdings in Premier Foods. McCormick, the owner of the Schwartz brand, bid for the owner of the Bisto and Mr Kipling brands. Nissin, the Japanese noodle producer, has also built a stake in the company. On the downside, positions in Royal Bank of Scotland and Barclays struggled as the cost of regulatory compliance, internal restructuring and lower-for-longer interest rates weighed on growth and profitability. Airline operators Flybe and IAG (the owner of the British Airways and Iberia brands) were weak given heightened security concerns following the terrorist attacks in Brussels. Despite this, summer booking profiles look to be robust. Finally, Trinity Mirror was weak as investors doubted the potential for its new publication "New Day" as investors would have preferred to see regional consolidation.

Activity

Purchases over the quarter included Standard Chartered. A meeting with the new CEO gave reassurance that the company is capable of delivering on the base case return-on-equity target. The belief is that the trading environment is no more difficult than consensus expects, but also appreciates that because balance sheet pressure is easing, management will have greater ability to drive growth. This makes the valuation look particularly compelling. An improved set of results prompted the purchase of GlaxoSmithkline. The results proved the company is on the right track, with earnings ahead of expectations, discipline on costs and strong growth from vaccines and consumer, particularly HIV, drugs. It also reiterated its guidance for double-digit growth in 2016. The view is that the market is being too conservative on future profitability, which gives management scope to beat expectations. Centrica was purchased as it continued to leverage its ability to take out costs, focus on cash generation and commit to growing the dividend. The risks from low oil and gas prices are well understood by the management and should meet their targets under various stress scenarios. Furthermore, the Competition & Markets Authority's conclusions were more positive than expected. Other purchases included Sports Direct, Ophir and Sthree. Sales over the period included Tullow Oil which had performed well despite the weak oil price. The previously significant discount to NAV has closed somewhat on the back of this. Likewise, BP had also held up relatively well in the face of the falling oil price but evidence from company results suggest it is not cutting capital expenditure and costs quite as quickly as some global peers. This gave grounds for concern and therefore reduced the holding. Elsewhere, the holding in HSBC was reduced. While Asian growth remains a concern, management are understanding the cost base and redeploying capital into growth opportunities. The shares look fairly priced relative to book value. Finally, after a phenomenal run of performance, the holding in Darty was reduced as they were in talks about its potential acquisition.

Outlook and Strategy

Investors are nervous of recessionary risks, and while these risks have generally risen the view is that global growth will continue to remain positive, albeit somewhat reduced and relatively modest compared with longer-term trends. A growth environment will be supportive for UK equities, and attractive stock specific opportunities continue to be identified. Uncertainty and concern around the growth outlook for the Chinese economy, monetary policy in the US, and geo political tensions as well as Brexit will act to increase volatility.

AXA Framlington

4th Quarter 2015/16

Performance

During the fourth quarter, the fund returned -3.7% against the FTSE All Share return of -0.4%. For the twelve months to date the Fund returned -0.7% against its benchmark of -3.9%. The three and five year's performance outperformed its benchmarks by 3.2% over both periods. It was a difficult quarter with a poor absolute return and relative performance although there was good long term performance. Prior to the merger and admission to the FTSE100 of the merged Paddy Power Betfair, Betfair was the biggest contributor to relative performance. RPC continued to perform well whilst being underweight in banks and financials shares was the largest contributor to relative returns. Negatives to performance were Paddy Power Betfair after the merger date and was the worst performer. Also, Consumer services; media and retailers was the worst sector by relative contribution and also being underweight in consumer goods was a negative.

Activity

No new holdings were established in the quarter. Stocks added to included Experian, Wordpay, Eco Animal Health and GlaxoSmithkline. The holdings in Next were sold at the beginning of the quarter. Following the takeover of Synergy Healthcare by US corporation Steris, the shares in Steris were sold, which were issued and US listed. Holdings also reduced included B&M, HSBC, Booker, St. James Place and Wolseley.

Outlook and Strategy

Global growth expectations continue to fall and bring with it uncertainty and volatility. The UK referendum on EU membership creates more uncertainty. Commodity prices rallied, the US dollar weakened and China growth did not disappoint. Confidence is however fragile and expectations for Company earnings are punished when they disappoint. There has been a rise in commodity prices and a stronger Chinese economy, whilst the US dollar weakened. Global growth expectations are still weak.

6 Review of Activity

6.1 The Internal managed portfolio had eight corporate action in the three month period to 31 March 2016, and include:

- In January, there was a Rights Issue for RPC Group Plc for £0.1M
- In January bwin Interactive Entertainment AG was taken over by GVC Holdings Plc for £0.4M
- In January, Telecity Group Plc was acquired by Equinix Inc for £0.2M.
- In February, Amlin Plc was taken over by MS&AD Insurance Group for £0.6M
- In February, BG's merger with Royal Dutch Shell received £2.5M in cash. However, as part of the merger extra Royal Dutch shares were received for a value of £4.7M making the overall total of the merger to be £7.2M.

6.2 The UK Equity Internally Passive Fund was rebalanced once in the three month period to 31 March 2016.

- In January 2016 the total value of purchases and sales were £3.8M with a net purchase of £0.2M. There were 19 purchases (£2.0M) and 74 sales (£1.8M).

6.3 After the decision at the last Committee to invest monies to the Internal Managed Fund this was undertaken in April 2016.The total value of purchases and sales were £47.8M with a net purchase of £47.3M. There were 326 purchases (£47.5M) and 4 sales (£0.2M).

7 Stock Lending

7.1 Stock lending is managed in the UK on an agency basis by HSBC, and overseas on the same basis by Pictet.

7.2 Total overseas stock lending income for the year to 31 March 2016 is £45,690. Net income for UK stock lending was £145,351 over the same period, giving a total of £191,041. This compares to the period to 31 March 2015 where overseas stock lending was £76,162 and the UK stock lending figure was £145,167, giving a total of £221,329.

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