Agenda Item:

11

Pension Fund Committee

Dorset County Council

Date of Meeting	1 July 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 fourth quarter of the 2015/16 Financial Year to 31 March 2016. 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 0.08% over the twelve months to 31 March 2016, outperforming its benchmark which returned -0.93%. Return seeking assets returned 2.04%, whilst the liability matching assets returned -13.89%. For the same period the WM Local Authority average returned 0.2%.
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) Make no additional changes to asset allocation at this time. iii) Agree that the Fund Administrator monitors the cash-flow and if required instructs the Corporate Bond and/or the Global Equity managers to return income to the Fund.
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 twelve months to 31 March 2016 Appendix 4: Summary of development proposal for Cambridge Science Park property
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. There has been a surplus of income over expenditure from these cash flows of approximately £24M in the 2015-16 financial year. This compares to the forecast of approximately £21M. The outturn cash-flows for 2015/16 and the anticipated cash flows for 2016/17 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 twelve months under review.

Statement of cash-flow for the twelve months ended 31 March 2016

	£M	**£M**
Cash at 1 April 2015		**33.1**
Less:		
Property transactions (net)	0.9	
UK Equity transactions (net)	3.4	
Currency Hedge (net loss)	4.3	
		8.6
Plus:		
Infrastructure transactions (net)	1.4	
Hedge Fund redemptions	5.7	
Private Equity transactions (net)	5.8	
Overseas Equities transition proceeds	30.4	
Increase in Cash	24.0	
		67.3
Cash at 31 March 2016		**91.8**

2.2 The cash flow above summarises the most significant transactions that have taken place for the twelve months to the end of March 2016. Since the end of March the most significant transactions have been the upfront payment of contributions by a number of employers (£26 Million inflow), the funding of the agreed changes to UK equity management arrangements (£35 Million net outflow), the first drawdown by IFM (£29 Million outflow), and the sale of Washford Mills retail warehouse, Redditch (£7 Million inflow), leaving cash balances of £61 Million at the end of May 2016.

3. Fund Portfolio Distribution

3.1 The table below shows the position as at 31 March 2016. The target allocation shown is the strategy as 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, amended by the decision made at the meeting 1 March 2016 to equalise the target allocations for UK Equities and Global Equities at 26.25% each.

		31-Mar-15		31-Mar-16		Target Allocation	
Asset Class	**Manager**	**£M**	**%**	**£M**	**%**	**£M**	**%**
Bonds	(Several)	562.6	24.2%	524.1	23.0%	557.6	24.50%
UK Equities	(Several)	623.5	26.8%	584.2	25.7%	597.4	26.25%
Overseas Equities	(Several)	628.8	27.0%	625.6	27.5%	597.4	26.25%
Property	(CBREi)	228.8	9.8%	246.3	10.8%	227.6	10.00%
Absolute Return Funds	(Several)	8.3	0.4%	1.8	0.1%	-	0.00%
Infrastructure	(Several)	26.8	1.2%	29.0	1.3%	91.0	4.00%
Private Equity	(Several)	59.2	2.5%	65.4	2.9%	91.0	4.00%
Diversified Growth	(Barings)	111.6	4.8%	107.6	4.7%	113.8	5.00%
Cash	(Internal)	75.5	3.2%	91.8	4.0%	-	0.00%
Total		**2,325.0**	**100.0%**	**2,275.8**	**100.0%**	**2,275.8**	**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 years to fully drawdown.

3.3 To show the impact of changes since the end of March, the table below shows the draft position as at the end of May.

		31-May-16		Target Allocation	
Asset Class	**Manager**	**£M**	**%**	**£M**	**%**
Bonds	(Several)	522.1	22.6%	564.9	24.50%
UK Equities	(Several)	627.1	27.2%	605.2	26.25%
Overseas Equities	(Several)	626.8	27.2%	605.2	26.25%
Property	(CBREi)	240.4	10.4%	230.6	10.00%
Absolute Return Funds	(Several)	0.9	0.0%	-	0.00%
Infrastructure	(Several)	57.7	2.5%	92.2	4.00%
Private Equity	(Several)	65.4	2.8%	92.2	4.00%
Diversified Growth	(Barings)	109.0	4.7%	115.3	5.00%
Cash	(Internal)	56.3	2.4%	-	0.00%
Total		**2,305.7**	**100.0%**	**2,305.7**	**100.0%**

3.4 The table shows that the decision taken at the last meeting to equalise the UK and Overseas equity exposures has proven successful. Although both are ahead of target weight, when the underweight in Private Equity is considered the position is broadly neutral.

3.5 The table also shows the increase in Infrastructure investment with the recent drawdown from IFM. The final point worth noting is the underweight position in the Bonds category. The make-up of this element of the portfolio needs to be de-constructed to analyse the position; the rlam Corporate Bond portfolio is valued at £291M or 12.6% of the Fund (against a target of 12.5%).

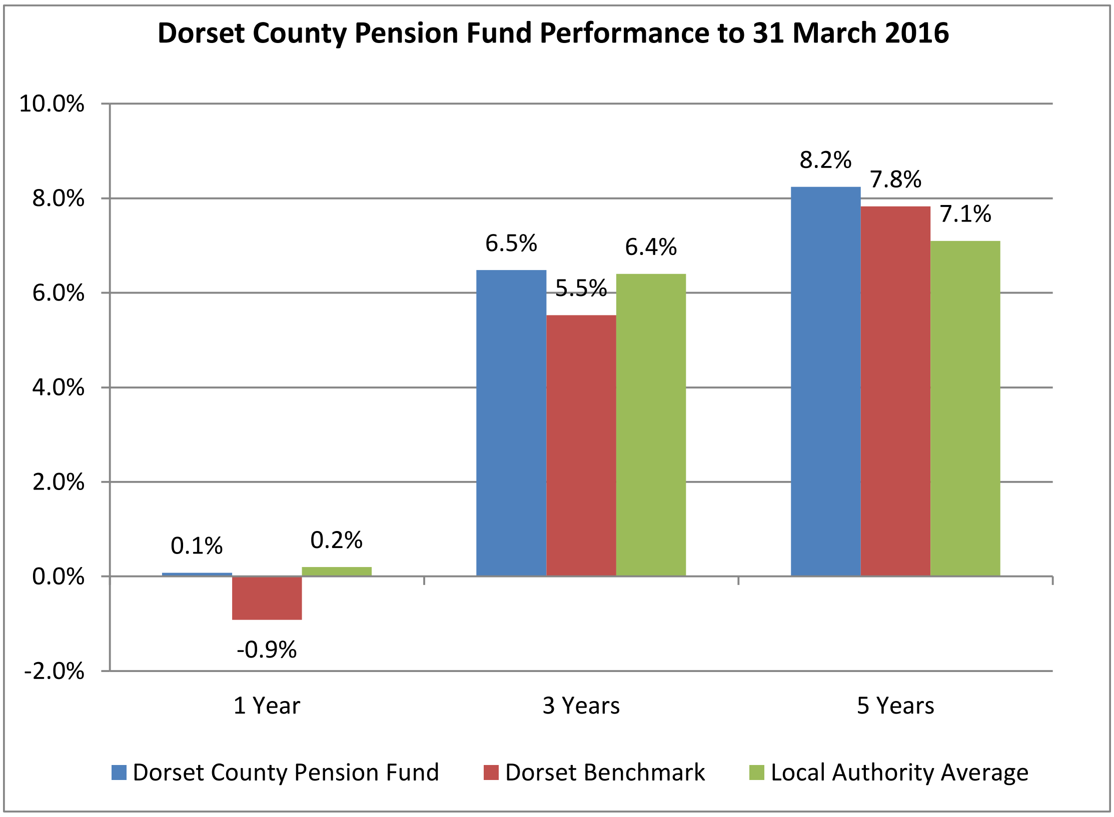
3.6 The Insight portfolio makes up the rest of the Bond portfolio and has fallen significantly in market value in the last 12 months. At the end of June 2015 it was valued at £291M and is now around £231M, or around 10% versus a target of 12%. Whilst the fall in value would not appear positive, in effect it means that the value of the Fund's liabilities have also fallen by a similar proportion. Given the very different role that the Insight portfolio plays in the overall Fund, it is not necessarily appropriate to rebalance to a target weight when the value falls or rises, this is more of a strategic decision around the proportion of the Fund to be hedged. It is therefore suggested that this should be reviewed as part of the overall strategic review the Fund undertakes after receiving the results of the Actuarial Valuation.

4. Overall Fund Performance

4.1 The performance of the Fund for the twelve months to 31 March 2016 shows an overall return of 0.08%, an outperformance of the benchmark of -0.93% by 1.01%.

4.2 The Fund has exceeded its benchmark over 3 years, returning an annualised 6.48% against the benchmark of 5.53%, and over 5 years, returning an annualised 8.24% against the benchmark of 7.83%.

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 twelve months to 31 March 2016, Return Seeking assets have returned 2.04% against the benchmark of 1.30%. The Liability Matching assets have returned -13.89% against the benchmark of -13.89%. 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.

		12 Months to 31 March 2016		
Asset Category	**Manager**	**Dorset %**	**Benchmark %**	**Over/(Under) %**
Overall Fund Performance	**All**	**0.08**	**-0.93**	**1.01**
Total Return Seeking Assets	**Various**	**2.04**	**1.30**	**0.74**
UK Equities	(Various)	-2.93	-3.12	0.19
Overseas Equities	(Various)	-0.45	1.86	-2.31
Bonds	(RLAM)	-0.11	0.05	-0.16
Property	(CBREi)	12.44	11.27	1.17
Private Equity	(Various)	23.22	-2.39	25.61
Diversified Growth	(Barings)	-3.62	4.61	-8.23
Infrastructure	(Various)	12.78	9.98	2.80
Total Liability Matching Assets		**-13.89**	**-13.89**	**0.00**
Bonds	(Insight)	-13.89	-13.89	0.00

4.6 In relative terms each asset class has outperformed its own benchmark over the twelve month period with the only exceptions being Diversified Growth, Bonds and Overseas Equities. 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, however it is a little disappointing that it has also underperformed equities.

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 negative effect of 163bps against the benchmark and stock selection was positive by 14bps. Return seeking assets had an overall positive contribution of 112bps mainly driven by UK equities (12bps), total cash (27bps) and private equity (71bps).

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 twelve months to 31 March 2016 is summarised below.

	Market Value at 1 April 2015	Market Value at 31 March 2016	12 months to 31 March 2016	
	£000s	£000s	Performance %	Benchmark %
Barings	111,640	107,588	-3.62	4.61

5.3 Over the twelve months the Fund delivered a 3.62% negative return, against the benchmark of 4.61%. The fund manager comments that in general, equity markets were the source of losses for the portfolio. While our allocations had little direct exposure to the banking system, thus avoiding the main source of losses, exposures to both Europe and Japan affected performance. As mentioned earlier in the report and underperformance against a cash benchmark is not surprising, but a small underperformance against equities is a little disappointing.

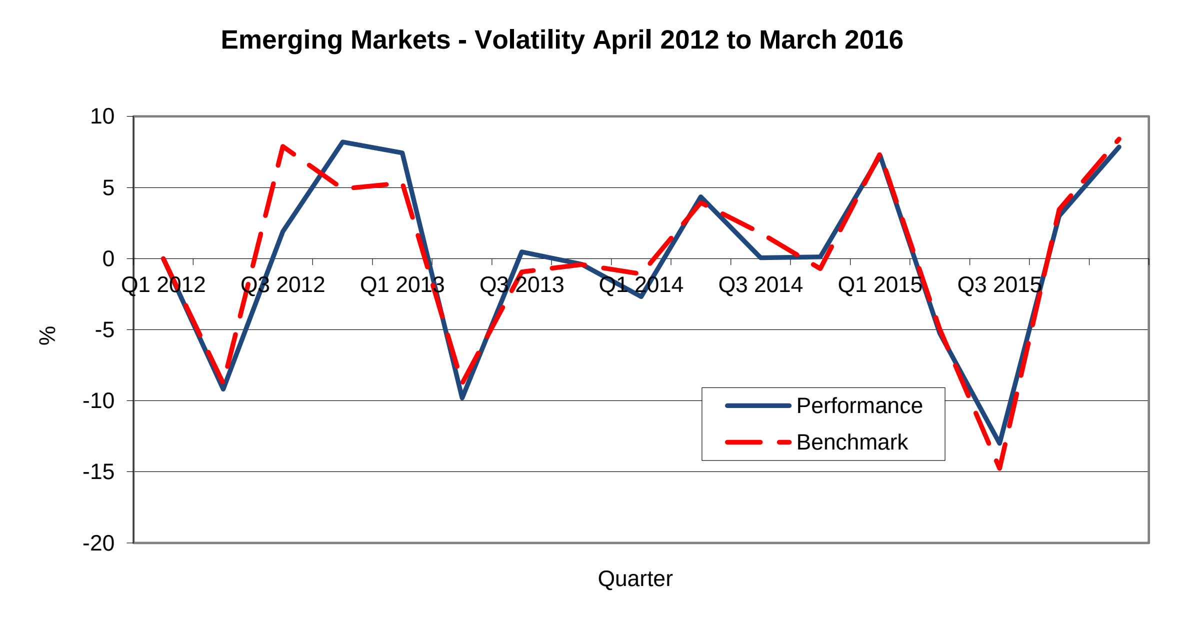
<u>Emerging Market Equity</u>

5.4 The performance of JP Morgan is summarised below.

	Value at 1 April 2015	Market Value at 31 March 2016	12 months to 31 March 2016	
	£000s	£000s	Performance %	Benchmark %
JPM	71,205	65,186	-8.44	-8.78

5.5 The return of -8.44% for the twelve months to 31 March 2016 was above the benchmark of -8.78% by 0.34%. The fund manager comments that the performance was positive in the quarter, but this bellies a significant amount of volatility, with asset class witnessing a double digit fall in the first three weeks of the quarter, before rallying sharply through March. After an awful start to the year driven by concerns of falling global economic activity, the Federal Reserve tightening amid a slowing US economy, the Chinese renminbi decline and further collapse in oil prices led to policy makers starting to acknowledge the economic slowdown and the possibility of more monetary easing.

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 Harbour Vest 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 March 2016.

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 March 2016 and the total gains or losses, which includes the distribution plus the latest valuation.

Manager/Fund	Commitment	Drawdown	% of Commitment	Distribution	Valuation	Gain/(Loss)
	€m	€m		€m	€m	€m
HV Partnership V	12.000	11.400	95%	10.830	6.130	5.560
HV Direct V	3.000	2.880	96%	3.081	0.996	1.197
SL 2006	22.000	19.809	90%	17.276	9.043	6.511
SL 2008	17.000	13.652	80%	5.295	11.558	3.201
	$m	$m		$m	$m	$m
HV Venture VIII	15.200	14.820	98%	11.761	13.227	10.169
HV Buyout VIII	22.800	20.862	92%	18.522	13.316	10.976
HV Buyout IX	15.000	7.988	53%	1.909	7.677	1.598
HV Partnership VII (AIF)	20.000	3.950	20%	0.295	3.810	0.156
HV Venture IX	10.000	7.350	74%	1.604	8.561	2.816
SL SOF I	16.000	8.473	53%	0.580	9.085	1.192
SL SOF II	20.000	5.187	26%	0.000	6.383	1.195
HV X AIF	10.000	0.250	3%	0.000	0.235	-0.015
HV X AIF	5.000	0.175	4%	0.000	0.156	-0.019

5.9 For the twelve months to 31 March 2016 total drawdowns have been £13.9M and total distributions £19.7M. 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 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. The table below shows the performance over 3 and 5 years against the benchmark. Both managers are showing strong performance over both periods, which is pleasing. The difference between the two sets of performance is largely due to HarbourVest investing mainly in US dollars and Standard Life mainly in Euros.

Private Equity Overall Performance

	3 Years to 31 Mar 2016		5 Years to 31 Mar 2016	
Manager	**Dorset**	**Benchmark**	**Dorset**	**Benchmark**
	%	**%**	**%**	**%**
HarbourVest	16.57	3.67	16.12	5.69
Standard Life	11.75	3.67	11.31	5.69

6. Treasury Management

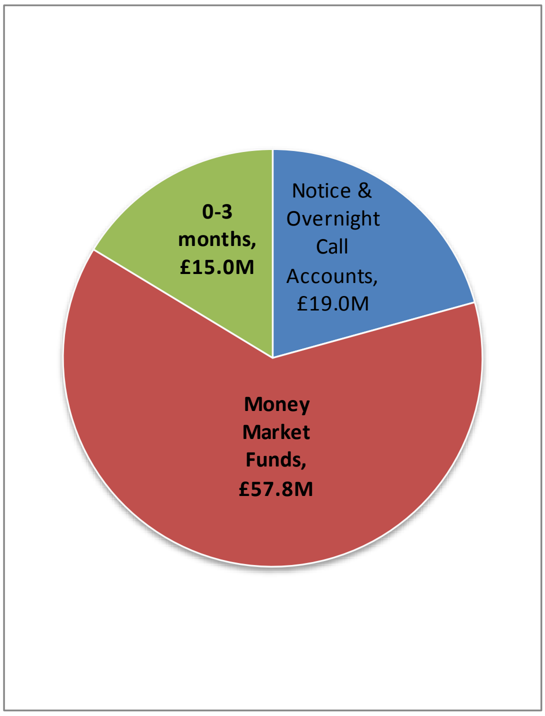
6.1 The Fund generates cash flows throughout the year which need to be managed. The Fund therefore holds a proportion of cash that is invested in call accounts, money market funds and fixed term deposits. A breakdown of the balances held internally as at 31 March 2016 is shown in the table below. Relatively small cash balances are also held in the custodian bank account at HSBC and in a property rent collection account where a float is required 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, HSBC, Lloyds and RBS. 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. For further details, please see the annual Treasury Management report on this agenda.

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 0.57% over the twelve months, which is ahead of the benchmark, as measured by the 7 day LIBID, at 0.37% 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		
Smitomo Mitsui Corp	10,000	0.73%
Smitomo Mitsui Corp	5,000	0.73%
Total Loans	15,000	0.73%
Call Accounts		
National Westminster Bank	807	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	17,407	0.81%
Money Market Funds		
Standard Life	12,800	0.50%
Deutsche	15,000	0.51%
BNP Paribas	15,000	0.52%
Federated Prime Rate	15,000	0.53%
Total Money Market Funds	57,800	0.52%
Holding Accounts		
HSBC Custodian Account	680	0.00%
Property Client Account	942	0.00%
Total Holding Accounts	1,622	0.00%
Total Cash / Average Return	**91,829**	**0.60%**

Duration of Investments



7. Property investment – Cambridge Science Park

7.1 At previous meetings of the Committee the potential to redevelop the property at Cambridge Science Park was discussed and it was agreed that CBREi could progress with the project and seek to gain the necessary planning permission. All planning permissions have now been granted and CBREi have recommended that the Fund undertakes the development.

7.2 To enable the development to proceed promptly it was not possible to wait for this meeting to reach a decision so a detailed paper was circulated to all Committee members by email, together with a short summary of the proposals. A summary is attached at Appendix 4.

7.3 Members approval was sought to commence on the development project that will take around 18 months to complete, and will cost around £14M. The proposal explained the risks of the transaction, and how the Fund could mitigate these. One of the biggest risks would be the potential to let the newly developed building, however this is removed with a tenant already in place.

7.4 An additional issue that was considered was the proportion that Property makes up of the total Fund. The table at paragraph 3.3 shows that Property is currently 10.4%, or around £10M over target. By the end of the construction, this is likely to rise, dependent on values of other elements of the Fund; on current values it would be around 11%. Whilst this higher than target it is not a significant concern, particularly in light of the potential return against other asset classes. It should, however be kept under review.

7.5 After consideration of the issues members of the Committee unanimously agreed to the proposals, and CBREi have been instructed to proceed.

8. Asset Allocation

8.1 At the meeting of the committee 1 March 2016 it was agreed to terminate the UK Equities mandate with Standard Life, and to reinvest the proceeds, together with a further £35 Million from cash balances, with AXA and the internally managed portfolio. Legal and General Investment Management (LGIM) were appointed to manage the transition which was successfully concluded 29 April 2016.

8.2 It was also agreed to invest a further £15 Million with Insight, the Fund's inflation hedging manager, subject to resolving a couple of outstanding issues. These issues have now been resolved and therefore the allocation to Insight will be made shortly from cash balances.

8.3 At the last meeting, members were informed that a number of the Fund's employers opted to pay the employer's element of their monthly contributions for 2016/17 up front on 1 April 2016, receiving a small discount in the contribution rate for doing so, as agreed by the Fund's actuary. The total upfront payments were £26 Million, which have been invested in line with strategy early in April. However, the counterpoint to this is that the cash-flows will be reduced during the year.

8.4 As mentioned in paragraph 2.2 the infrastructure investment managed by IFM issued a drawdown notice for £29M on 1st April, this was the first amount to be called by IFM and is nearly 60% of the total commitment.

8.5 After the transactions that have taken place in the last couple of months, when 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 £35 Million will be drawn down by the end of September and therefore the Fund will need to maintain appropriate balances to fund this. The construction costs of £14 Million for Cambridge Science Park over the next 18 months also need to be allowed for.

8.6 Given the issues highlighted above the current cash-flow projections are showing that the Fund may well need additional income later in 2016/17. It is therefore appropriate to consider how the Fund may boost its cash-flow. The simplest way would be to instruct the Corporate Bond and Global Equity managers to start returning dividend income to the Fund, rather than the current practice of re-investing it. In total these investments currently generate around £20 - £25 Million per annum, which would easily cover any potential shortfall.

8.7 Each of the managers concerned has been consulted and it is a solution that could be initiated quite simply, and quickly. Given that the Actuarial Valuation results are due in the next 6 months, and these will drive Employers' contributions for the 3 years commencing 1 April 2017, it would not be sensible to put in place a long term solution without knowing the impact of these. It is worth remembering that there was always a chance that this position would arise when it was agreed that the employers' could pay their deficit contributions for three years up-front in April 2014.

8.8 It is therefore proposed that the Fund Administrator and the internal team monitor the cash-flow for the remainder of the calendar year, and implement the proposed return of income from the fund managers if it becomes necessary.

Richard Bates
Pension Fund Administrator
June 2016