**Agenda Item:**

**10**

# Pension Fund Committee

**Dorset County Council**

| | |
|---|---|
| Date of Meeting | 12 September 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 first quarter of the 2016/17 Financial Year to 30 June 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.<br><br>The Independent Adviser's report is contained at Appendix 2, and will be presented separately at the meeting.<br><br>The report shows that overall the Fund returned 4.85% over the three months to 30 June 2016, underperforming its benchmark which returned 5.65%. Return seeking assets returned 4.41%, whilst the liability matching assets returned 8.80%. |
| Impact Assessment: | Equalities Impact Assessment:<br><br>N/A |
| | Use of Evidence:<br><br>N/A |
| | Budget:<br>N/A |

| | |
|---|---|
| | Risk Assessment:<br>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:<br><br>None |
| Recommendation | That the Committee :<br><br>i) Review and comment upon the activity and overall performance of the Fund.<br>ii) Make no additional changes to asset allocation at this time. |
| 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<br>Appendix 2: Report of the Independent Adviser<br>Appendix 3: HSBC Manager Performance for the three months to 30 June 2016 |
| 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 £26M in the 2016-17 financial year. This compares to the forecast of approximately £24M. The outturn cash-flows for 2016/17 and the anticipated cash flows for 2017/18 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 three months under review.

**Statement of cash-flow for the three months ended 30 June 2016**

| | £M | £M |
|---|---|---|
| **Cash at 1 April 2016** | | **91.8** |
| **Less:** | | |
| Infrastructure Drawdowns (net) | 28.0 | |
| UK Equity transactions (net) | 36.2 | |
| Currency Hedge (net loss) | 19.0 | |
| | | **83.2** |
| **Plus:** | | |
| Upfront Payments of Employer Contributions* | 19.5 | |
| Property Transactions (net) | 5.0 | |
| Hedge Fund redemptions (net) | 0.9 | |
| Private Equity (net) | 1.1 | |
| Increase in Cash | 3.8 | |
| | | **30.3** |
| **Cash at 30 June 2016** | | **38.9** |

*£26M received as upfront contributions, of which 9/12ths represents cash in advance as at 30 June 2016.

2.2 The cash flow above summarises the most significant transactions that have taken place for the three months to the end of June 2016. Since the end of June, the most significant transactions have been the agreed redemptions to improve cash resilience of £75M and the further investment of £45M with Insight leaving cash balances of approximately £69M at the end of August 2016.

## 3. Fund Portfolio Distribution

3.1 The table below shows the position as at 30 June 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.

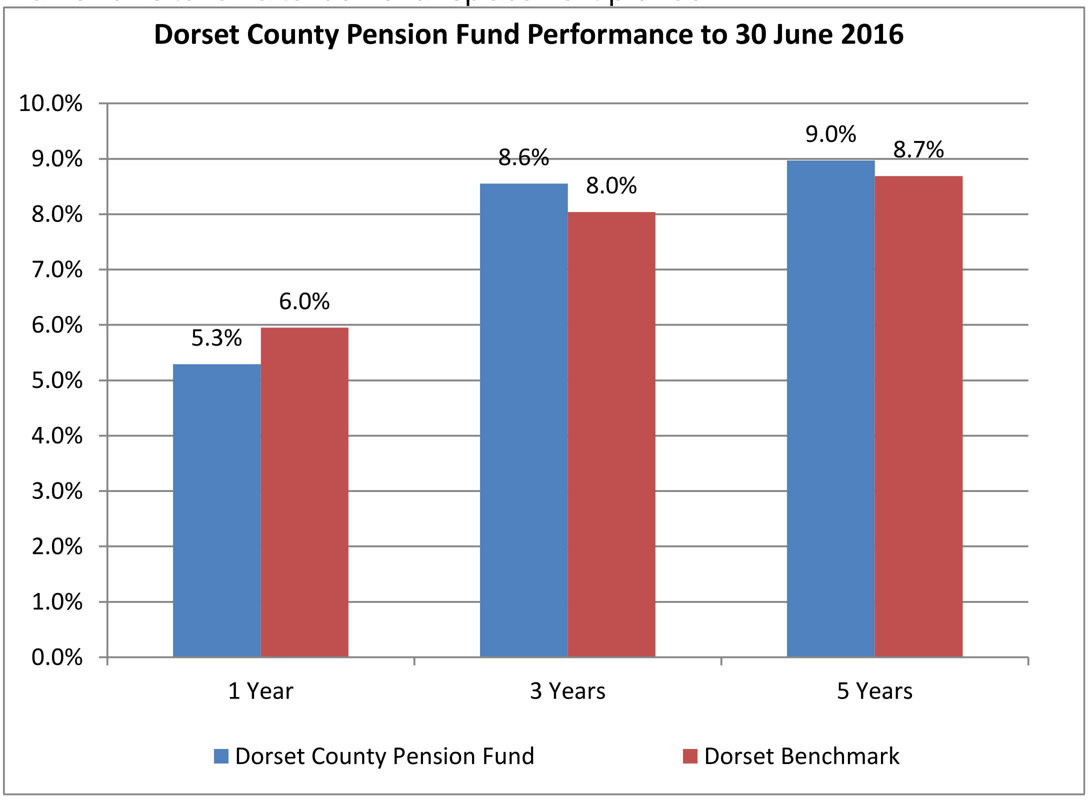
| Asset Class | Manager | 31-Mar-15 £M | 31-Mar-15 % | 30-Jun-16 £M | 30-Jun-16 % | Target Allocation £M | Target Allocation % |
|---|---|---|---|---|---|---|---|
| Bonds | (Several) | 524.1 | 23.0% | 560.0 | 23.6% | 581.4 | 24.50% |
| UK Equities | (Several) | 584.2 | 25.7% | 622.5 | 26.2% | 622.9 | 26.25% |
| Overseas Equities | (Several) | 625.6 | 27.5% | 669.4 | 28.2% | 622.9 | 26.25% |
| Property | (CBREi) | 246.3 | 10.8% | 242.1 | 10.2% | 237.3 | 10.00% |
| Absolute Return Funds | (Several) | 1.8 | 0.1% | 0.7 | 0.0% | - | 0.00% |
| Infrastructure | (Several) | 29.0 | 1.3% | 60.4 | 2.5% | 94.9 | 4.00% |
| Private Equity | (Several) | 65.4 | 2.9% | 68.6 | 2.9% | 94.9 | 4.00% |
| Diversified Growth | (Barings) | 107.6 | 4.7% | 110.4 | 4.7% | 118.7 | 5.00% |
| Cash | (Internal) | 91.8 | 4.0% | 38.9 | 1.6% | - | 0.00% |
| **Total** | | **2,275.8** | **100.0%** | **2,373.0** | **100.0%** | **2,373.0** | **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.

## 4. Overall Fund Performance

4.1 The performance of the Fund for the three months to 30 June 2016 shows an overall return of 4.85%, an underperformance of the benchmark of 5.65% by 0.80%. The Fund has exceeded its benchmark over 3 years, returning an annualised 8.55% against the benchmark of 8.04%, and over 5 years, returning an annualised 8.97% against the benchmark of 8.69%.

4.2 The chart below shows the overall performance for 1, 3 and 5 years against the Fund's bespoke benchmark. Following State Street's decision to discontinue providing performance measurement services to third party UK clients after Q1 2016, we are not currently able to provide a comparison with the LGPS average performance. However, the Cross Pool group have asked LGPS National Frameworks to run a tender for a replacement provider.



4.3 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.

4.4 For the three months to 30 June 2016, Return Seeking assets have returned 4.41% against the benchmark of 5.18%. The Liability Matching assets have returned -8.80% against the benchmark of 8.80%. 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.

| | | 3 Months to 30 June 2016 | | |
|---|---|---|---|---|
| **Asset Category** | **Manager** | **Dorset %** | **Benchmark %** | **Over/(Under) %** |
| **Overall Fund Performance** | **All** | **4.85** | **5.65** | **-0.80** |
| **Total Return Seeking Assets** | **Various** | **4.41** | **5.18** | **-0.77** |
| UK Equities | (Various) | 1.19 | 4.33 | -3.14 |
| Overseas Equities | (Various) | 6.65 | 8.68 | -2.03 |
| Bonds | (RLAM) | 5.05 | 5.62 | -0.57 |
| Property | (CBREi) | 1.40 | 1.45 | -0.05 |
| Private Equity | (Various) | 5.29 | 4.70 | 0.59 |
| Diversified Growth | (Barings) | 2.62 | 1.13 | 1.49 |
| Infrastructure | (Various) | 3.48 | 2.41 | 1.07 |
| **Total Liability Matching Assets** | | **8.80** | **8.80** | **0.00** |
| Bonds | (Insight) | 8.80 | 8.80 | 0.00 |

4.5 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.

4.6 The HSBC performance report, contained at Appendix 3, gives an attribution analysis of the performance for the year to date on pages 7 to 9. This analysis shows that the market contribution had a positive effect of 11bps against the benchmark and stock selection was negative by 75bps.

## 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 three months to 30 June 2016 is summarised below.

| | Market Value at 1 April 2015 | Market Value at 30 June 2016 | 3 months to 30 June 2016 | |
|---|---|---|---|---|
| | £000s | £000s | Performance % | Benchmark % |
| Barings | 107,588 | 110,411 | 2.62 | 1.13 |

5.3 Over the three months the Fund delivered a 2.62% return, against the benchmark of 1.13%. The fund manager comments that the UK referendum on EU membership was the focal point for markets. The surprise "leave" vote resulted in market volatility with the largest moves felt in currency markets. In this context the Fund produced a positive return. The return was ahead of both the performance compactor and global equities.

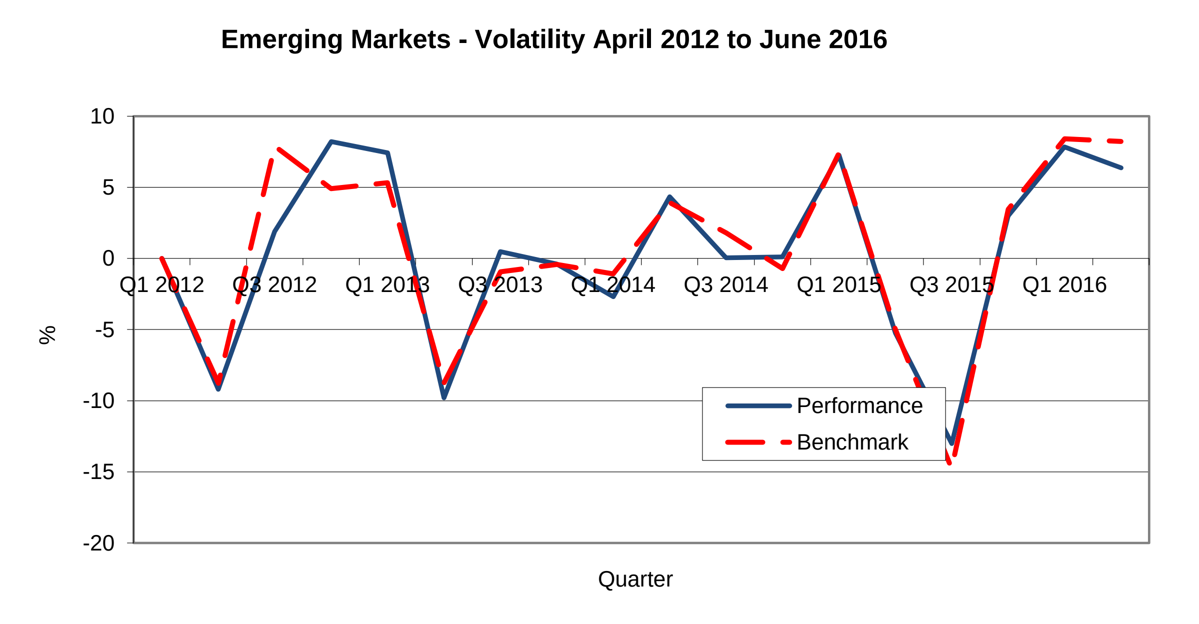
<u>Emerging Market Equity</u>

5.4 The performance of JP Morgan is summarised below.

| | Value at 1 April 2016 | Market Value at 30 June 2016 | 3 months to 30 June 2016 | |
|---|---|---|---|---|
| | £000s | £000s | Performance % | Benchmark % |
| JPM | 65,186 | 69,331 | 6.36 | 8.23 |

5.5 The return of 6.36% for the three months to 30 June 2016 was below the benchmark of 8.23% by 1.87%. The fund manager comments that it was a challenging quarter as strong stock selection in China and their longstanding overweight in highly ranked Russia was offset by holdings in Turkey and by not owning commodity stocks in Brazil. The impact of the EU referendum was felt through a small number of businesses they have holdings in that have exposure to the UK economy or sterling, and through positions in Hungary and Poland who benefit from European integration. However, they view the EU result as a temporary "risk-off" event for emerging markets and have not changed their positioning as a result.

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 30 June 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 30 June 2016 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 | 11.400 | 95% | 11.345 | 5.841 | 5.786 |
| **HV Direct V** | 3.000 | 2.880 | 96% | 3.249 | 0.736 | 1.105 |
| **SL 2006** | 22.000 | 19.844 | 90% | 18.278 | 8.068 | 6.503 |
| **SL 2008** | 17.000 | 13.913 | 82% | 5.723 | 11.566 | 3.376 |
| | $m | $m | | $m | $m | $m |
| **HV Venture VIII** | 15.200 | 14.820 | 98% | 12.160 | 12.008 | 9.348 |
| **HV Buyout VIII** | 22.800 | 21.090 | 93% | 19.258 | 12.881 | 11.050 |
| **HV Buyout IX** | 15.000 | 8.363 | 56% | 1.909 | 8.158 | 1.704 |
| **HV Partnership VII (AIF)** | 20.000 | 4.950 | 25% | 0.295 | 5.005 | 0.350 |
| **HV Venture IX** | 10.000 | 7.700 | 77% | 1.691 | 8.595 | 2.587 |
| **SL SOF I** | 16.000 | 8.217 | 51% | 2.572 | 8.896 | 3.250 |
| **SL SOF II** | 20.000 | 5.025 | 25% | 1.984 | 6.257 | 3.216 |
| **Harbourvest Partners X AIF** | 10.000 | 0.500 | 3% | 0.000 | 0.501 | 0.001 |
| **Harbourvest Partners X AIF** | 5.000 | 0.325 | 4% | 0.000 | 0.289 | -0.017 |

5.9 For the three months to 30 June 2016 total drawdowns have been £2.2M and total distributions £3.3M. 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 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 30 Jun 2016** | | **5 Years to 30 June 2016** | |
|---|---|---|---|---|
| **Manager** | **Dorset** | **Benchmark** | **Dorset** | **Benchmark** |
| | **%** | **%** | **%** | **%** |
| HarbourVest | 18.23 | 5.86 | 16.80 | 6.26 |
| Standard Life | 12.30 | 5.86 | 10.58 | 6.26 |

## 6. Treasury Management

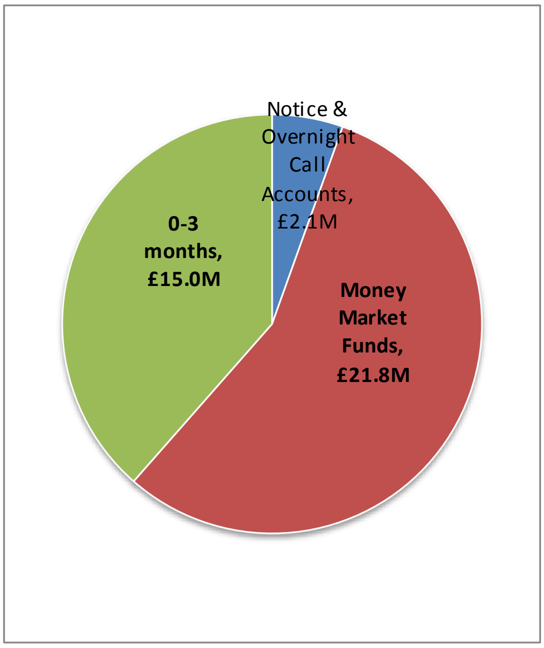
6.1 The Fund generates cash flows throughout the year which need to be managed. The Fund therefore holds a proportion of cash that is invested in call accounts, money market funds and fixed term deposits. A breakdown of the balances held internally as at 30 June 2016 is shown in the table below. Relatively 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 0.58% over the three months, which is ahead of the benchmark, as measured by the 7 day LIBID, at 0.32% 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** | | |
| Sumitomo Mitsui Corp | 10,000 | 0.73% |
| Smitomo Mitsui Corp | 5,000 | 0.73% |
| Total Loans | 15,000 | 0.73% |
| **Call Accounts** | | |
| National Westminster Bank | 492 | 0.25% |
| Svenska Handelsbanken | - | 0.45% |
| Santander UK Plc 120 Day Notice | - | 1.05% |
| Total Call Accounts | 492 | 0.25% |
| **Money Market Funds** | | |
| Standard Life | 750 | 0.50% |
| BNP Paribas | 15,000 | 0.52% |
| Federated Prime Rate | 6,050 | 0.53% |
| Total Money Market Funds | 21,800 | 0.52% |
| **Holding Accounts** | | |
| HSBC Custodian Account | 940 | 0.00% |
| Property Client Account | 696 | 0.00% |
| Total Holding Accounts | 1,636 | 0.00% |
| **Total Cash / Average Return** | **38,928** | **0.58%** |

**Duration of Investments**




## 7. Asset Allocation

7.1 At the last meeting of the Committee in July, the Chief Treasury and Pensions Manager highlighted the possible demands on the Fund's cash over the remainder of the financial year, including further potential currency hedging payments, calls for additional collateral for the inflation hedging mandate and drawdowns of commitments to infrastructure investments. It was agreed that options for meeting cash demands would be discussed by the Pension Fund Administrator, the Chief Treasury and Pensions Manager and the Independent adviser and that authority to agree officers' subsequent proposals would be delegated to the Chairman and Vice-Chairman.

7.2 It was subsequently agreed to redeem £20M from Allianz, £20M from Investec, £15M from Wellington, £10M from RLAM and £10M from Internally Managed UK Equities, and to invest a further £30M with Insight to improve the collateral position on the inflation hedging mandate. All of these changes have now been actioned. The Fund Administrator and the internal team will continue to monitor the cash-flow on an on-going basis, and will make further recommendations for change as and when the need arises.

**Richard Bates**
**Pension Fund Administrator**
September 2016