



DORSET COUNTY PENSION FUND

UK Equity Report for 3 months ending 30 June 2016

- Internal Managers Report
- Valuation Report
- Transaction Report

Dorset County Pension Fund Committee – 12 September 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 two active managers, AXA Framlington and Schroders as well as the internally managed passive fund. 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. Details of the combined portfolio (£622.5M at 30 June 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 30 June 2016, the FTSE All Share index was made up of 632 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £156.8 Billion) down to the smallest in the index, Hansa (market value £32.8 Million). Direct investment is made in the largest 350 companies, which comprises 96.9% by value of the index. Investment in the smallest companies which make up 3.1% 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 There was mixed performance from the UK Equity markets in the three months to 30 June 2016. The FTSE100 was the best performing index rising 5.3% (329 points), whilst the FTSE Small Cap ex Investment Trusts was the worst performing major UK index falling 4.1% (244 points). In comparison, there was also mixed performance from the major world indices. The Dow Jones was the best performer rising 1.4% (245 points), whilst the Nikkei225 was the worst performer falling 7.1% (1,183 points)

4.2 Over the twelve month period, all major UK equity markets fell. The FTSE100 was the best performing index falling 0.3% (17 points), whilst the FTSE250 fell 7.2% (1,260 points) over the same period. In comparison, there was mixed performance in all major world indices. The Dow Jones rose 1.8% (310 points), whilst the Shanghai Composite was the worst performer falling 31.5% (1,348 points) over the same period.

4.3 In June, global markets fell heavily after the UK voted to leave the European Union. The FTSE100 closed 3.2% or 199 points down at 6,138 the day after the result. Germany's Dax fell 6.8% and France's Cac40 fell 8%. In the US, the Dow Jones closed down 3.4% (610 points). Due to these falls the Bank of England intervened to provide £250Bn to support the markets. Days after the vote The FTSE100 rose strongly closing higher than it did on the day of the Referendum, whilst the FTSE 250 was still 6.1% lower closing at 16,271.1 whilst the Dow Jones had recovered nearly any losses, closing down 0.45% at 17,930.

Three Months to 30 June 2016

Country	Index	31/03/2016	30/06/2016	% Change
UK	FTSE100	6,174.9	6,504.3	5.3
UK	FTSE250	16,926.1	16,271.1	-3.9
UK	FTSE350	3,445.4	3,573.9	3.7
UK	Small Cap	6,264.8	6,226.1	-0.6
UK	Small Cap ex Investment Trusts	6,009.7	5,765.7	-4.1
UK	All Share	3,395.2	3,515.5	3.5
Japan	Nikkei225	16,758.7	15,575.9	-7.1
US	Dow Jones	17,685.1	17,930.0	1.4
Hong Kong	Hang Seng	20,776.7	20,794.4	0.1
France	Cac 40	4,385.1	4,237.5	-3.4
Germany	Dax	9,965.5	9,680.1	-2.9
China	Shanghai Composite	3,003.9	2,929.6	-2.5

Twelve Months to 30 June 2016

Country	Index	30/06/2015	30/06/2016	% Change
UK	FTSE100	6,521.0	6,504.3	-0.3
UK	FTSE250	17,531.5	16,271.1	-7.2
UK	FTSE350	3,626.3	3,573.9	-1.4
UK	Small Cap	6,322.7	6,226.1	-1.5
UK	Small Cap ex Investment Trusts	5,984.3	5,765.7	-3.7
UK	All Share	3,570.6	3,515.5	-1.5
Japan	Nikkei225	20,235.7	15,575.9	-23.0
US	Dow Jones	17,619.5	17,930.0	1.8
Hong Kong	Hang Seng	26,250.0	20,794.4	-20.8
France	Cac 40	4,790.2	4,237.5	-11.5
Germany	Dax	10,945.0	9,680.1	-11.6
China	Shanghai Composite	4,277.2	2,929.6	-31.5

5. **Performance**

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

Quarter to	Dorset %	Index %
30/06/2016	5.03	4.90
Financial Year to Date	<u>5.03</u>	<u>4.90</u>

The internally managed portfolio has outperformed the benchmark over the three month period to 30 June 2016 by 0.13% which is within the allowed tolerances.

5.2 THREE MONTHS TO 30 JUNE 2016

	Market Values		Performance	Benchmark	Benchmark
	31/03/2015	30/06/2016	%	%	Description
	£M	£M			
Internal	365.7	427.4	5.03	4.90	FTSE 350
AXA Framlington	108.0	159.6	-5.52	4.70	All-Share
Standard Life	71.9	0.0	0.00	0.00	
Schroders	38.6	35.5	-7.96	-4.06	Small Cap*
Total	584.2	622.5	1.19	4.33	

*FTSE Small Cap ex Investment Trusts

The figures for the whole UK equity portfolio show:

- The combined portfolio has underperformed its benchmark over the three month period by 3.14%.
- Both of the active UK managers underperformed their benchmarks with AXA Framlington underperforming by 10.22% and Schroders underperforming by 3.9%.

THREE AND FIVE YEAR ANNUALISED PERFORMANCE

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
	%	%	%	%
Internal	5.87	5.79	6.28	6.19
AXA Framlington	15.66	18.62	40.08	35.52
Schroders	9.69	9.39	10.34	11.16

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 0.08% and 0.09% respectively, within its agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 2.96% but outperformed its benchmark by 4.56% over five years.
- Schroders outperformed its benchmark over three years by 0.30% but underperformed its benchmark by 0.82% over five years.

5.3

The table below shows how the three UK Equity manager's valuations have changed over the financial year to 30 June 2016. This period saw the termination of the mandate with Standard Life in April 2016 and the subsequent allocation of additional funds to AXA Framlington of £60.8m and £47.7m to the Internal Managed Fund.

MARKET VALUE OVER THREE MONTHS TO 30 JUNE 2016

Manager	Market Value		% of Total UK Equity as at	
	31/03/16	30/06/16	31/03/16	30/06/16
	£M	£M	%	%
Internal	365.7	427.4	62.6	68.7
AXA Framlington	108.0	159.6	18.5	25.6
Standard Life	71.9	0.0	12.3	0.0
Schroders	38.6	35.5	6.6	5.7
Total	584.2	622.5	100.0	100.0

5.4 Each external manager's commentary is summarised below:

AXA Framlington

1st Quarter 2016/17

Performance

During the first quarter, the fund returned -5.5% against the FTSE All Share return of 4.7%. For the twelve months to date the Fund returned -7.0% against its benchmark of 2.2%. It was a difficult quarter following the decision by the UK to leave the European Union. It was a poor absolute return and relative performance. There was significant outperformance of the FTSE100 compared to the FTSE250 and the FTSE Small Cap. Companies with overseas earnings, particularly with exposure to the resources sector and the US Dollar performed well. These included Hunting, BTG, Rotork and Weir. Being underweight in bank shares and financials was the largest contributor to relative returns. Negatives to performance were Essentra who performed poorly after a profit warning; in general, companies exposed to the UK economy, (particularly post EU referendum) performed poorly in anticipation of a deteriorating economic outlook. These include Paddy Power, Dixons Carphone, ITV and Rightmove. Trading still remains robust in each case; post EU referendum, in particular Consumer Services (i.e. media and retailers) which was the worst sector by relative contribution and also, being underweight in consumer goods, deemed to be "defensives", was a negative.

Activity

A new holding was bought in Smith & Nephew and Amryt Pharma over the quarter. Stocks added to included Experian, Worldpay and Redx Pharma. The holding in Inmarsat was sold. The sale of Steris shareholding (received following the takeover of Synergy Healthcare) was completed. Holdings were reduced included B&M, HSBC, Booker and St. James Place.

Outlook and Strategy

Market reaction to the UK leaving the EU was significantly negative. Those stocks with domestic UK earnings were punished more than those companies with overseas exposure. This resulted in the UK-exposed FTSE250 index underperforming the FTSE100. UK equities have performed well, albeit over a short time period, following an initial sell off. The Fund's underweight position in financials, particularly in banks, was positive. However, the underweight position in the FTSE100, particularly those in oil and gas, was detrimental, as was the underweight position in large consumer staple stocks, which showed resilience due to cash flows generated outside of the UK. Markets are trying to price in the impact of the EU referendum vote, however neither the political process nor economic impact can be predicted with any certainty. The heightened uncertainty could persist for some time and as a result, more volatility can be expected. Companies are already behaving cautiously and this is expected to continue, with investment decisions deferred further due to ongoing uncertainty. Confidence remains fragile and companies that disappoint on earnings will be punished. Inevitably, the stock market will overreact in certain instances and this will provide opportunities for stock pickers.

Schroders

1st Quarter 2016/17

Performance and Market Summary

During the 2nd quarter, the Fund returned -8.0% against the Small Cap benchmark of -4.1%. Over the twelve month period the Fund returned -4.5% against its benchmark of -3.6%. Over three years the Fund outperformed the benchmark by 0.3% but underperformed its benchmark by 0.8% over the five year period.

Activity

There were strong positive contributions from companies such as Safestore, Trifast and First Derivatives whilst Eco Animal Health and Advanced Medical Solutions

delivered solid results. Tribal's share price continued to recover as the new management team set about implementing a thorough and radical change in strategy. Detractors were mainly those stocks with a very high percentage of their sales in the UK. Concern about the impact of the EU referendum saw domestic stocks such as MJ Gleeson (housebuilder), Dart (travel agent and airline), Conviviality (on and off licence drinks distribution) and Polypipe Group (building products) all underperform. Servelec (healthcare software) reported a profit warning arising from procurement delays in both its Healthcare and Automation divisions. New holdings were bought in Wincanton, Blue Prism, Moses Club, Midwich and Finsbury Foods. Sales included the complete disposal of Severfield whilst partial disposals included Softcat, Dechra, Majestic Wine, Hill & Smith and Dart.

Outlook and Strategy

Currently, valuations within the FTSE Small Cap and FTSE250 discount a material weakening in earnings relative to consensus estimates. If, as anticipated, the slowdown in economic growth proves to be gradual rather than abrupt, and is relatively short lived, then it is reasonable to expect valuation multiples to recover towards levels seen before the EU referendum. Companies are using the environment of low interest rates to make acquisitions to supplement organic growth. This is being well received by the market and is a trend that will continue. Organic growth, pricing power, where possible and avoiding companies with too much debt will be sought because, in a deflationary environment, the latter can destroy the value of equity very quickly.

6 **Review of Activity**

6.1 The Internal managed portfolio had four corporate actions in the three month period to 30 June 2016:

- In May, Cable & Wireless were taken over by Liberty Global for £0.6M.
- In June, 3i Infrastructure had a Rights Issue of £0.1M.
- In June, Cobham had a Rights Issue of £0.1M.
- In June, Ball Corporation completed the acquisition of Rexam for £0.6M.

6.2 Following the sale of UK active manager Standard Life, the funds were distributed between AXA Framlington and the Internally Managed Fund. The transition was undertaken by LGIM. The total value of purchases and sales were £47.9M with a net purchase of £47.3M. There were 326 purchases (£47.4M) 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 30 June 2016 is £7,012. Net income for UK stock lending was £41,967 over the same period, giving a total of £48,979. This compares to the period to 30 June 2015 where overseas stock lending was £18,961 and the UK stock lending figure was £36,684 giving a total of £55,645.

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