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DORSET COUNTY PENSION FUND

UK Equity Report for 3 months ending 31 December 2016

- Internal Managers Report
- Valuation Report
- Transaction Report

Dorset County Pension Fund Committee – 1 March 2017

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 (£675.1M at 31 December 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 December 2016, the FTSE All Share index was made up of 635 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £186.2 Billion) down to the smallest in the index, The Lindsell Train Investment Trust Plc (market value £1.6 Million). Direct investment is made in the largest 350 companies, which comprises 96.7% by value of the index. Investment in the smallest companies which make up 3.3% 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 good performance from the UK markets in the three months to December 2016. The Small Cap ex Investment Trusts was the best performing index rising 4.6% (298 points), whilst the FTSE250 was the worst performing major UK index rising 1.2% (206 points). The FTSE100 rose 1.2% (244 points) over the same period. In comparison, there was mixed performance from major world indices. The Nikkei 225 was the best performer rising 16.2% (2,665 points), whilst the Hang Seng was the worst performer falling 5.6% (1,297 points).

4.2 Over the twelve month period, all major UK equity markets rose. The FTSE100 was the best performing index rising 14.4% (901 points), whilst the FTSE250 was the worst performing UK index rising 3.7% (648 points) over the same period. The Dow Jones rose 13.4% (2,338 points), whilst the Shanghai Composite fell 12.3% (436 points) over the same period.

4.3 At the end of October 2016 the FTSE100 closed higher for a fifth straight month, the first time since 2013, helped by a rally in banks and mining stocks and a weaker Sterling. Although the FTSE100 fell back in November it rose sharply again in December. The FTSE100 index reached its record high on 30 December at 7,142.8. This was mainly due to mining companies, with many gaining about 30% over the year. The FTSE100 benefitted from the fall in the pound since the EU Referendum

vote, because the many international companies whose shares are traded in the UK tend to benefit from it. Profits earned abroad by multinationals such as GlaxoSmithKline and major mining companies are worth more when converted into sterling. This makes a company's shares appear better value when compared with the higher profits it will make, prompting a revaluation of the stock.

- 4.4 The Dow Jones reached its record high on 20 December 2016 at 19,974.6 after it had recorded seven previous record highs since the US election on 8 November 2016. The Dow Jones has risen 1,430 points since the US election result as investors back Donald Trump's policies to boost the US economy. The technology heavy Nasdaq reached its record high on 27 December 2016 at 5,487.4 rising 1.3% (71 points) in the quarter and 7.5% (376 points) over the year. The broader S & P 500 index recorded its highest close on 13 December 2016 at 2,271.7 rising 3.2% (71 points) in the quarter and 9.5% (195 points) over the year.

Financial Year to 31 December 2016

Country	Index	31/03/2016	31/12/2016	% Change
UK	FTSE100	6,174.9	7,142.8	15.7
UK	FTSE250	16,926.1	18,077.3	6.8
UK	FTSE350	3,445.4	3,931.7	14.1
UK	Small Cap	4,542.8	5,143.2	13.2
UK	Small Cap ex Investment Trusts	6,009.7	6,802.3	13.2
UK	All Share	3,395.2	3,873.2	14.1
Japan	Nikkei225	16,758.7	19,114.4	14.1
US	Dow Jones	17,685.1	19,762.6	11.7
Hong Kong	Hang Seng	20,776.7	22,000.6	5.9
France	Cac 40	4,385.1	4,862.3	10.9
Germany	Dax	9,965.5	11,481.1	15.2
China	Shanghai Composite	3,003.9	3,103.6	3.3

Twelve Months to 31 December 2016

Country	Index	31/12/2015	31/12/2016	% Change
UK	FTSE100	6,242.3	7,142.8	14.4
UK	FTSE250	16,085.4	18,077.3	12.4
UK	FTSE350	3,494.5	3,931.7	12.5
UK	Small Cap	4,634.7	5,143.2	11.0
UK	Small Cap ex Investment Trusts	6,044.5	6,802.3	12.5
UK	All Share	3,444.3	3,873.2	12.5
Japan	Nikkei225	19,033.7	19,114.4	0.4
US	Dow Jones	17,425.0	19,762.6	13.4
Hong Kong	Hang Seng	21,914.4	22,000.6	0.4
France	Cac 40	4,637.1	4,862.3	4.9
Germany	Dax	10,743.0	11,481.1	6.9
China	Shanghai Composite	3,539.1	3,103.6	-12.3

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 summarise the performance of this portfolio:

Period	Dorset	Index	Relative
	%	%	%
3 months to 30/06/2016	5.03	4.90	0.13
3 months to 30/09/2016	8.15	7.63	0.52
3 months to 31/12/2016	3.81	3.88	-0.07
9 months to 31/12/2016	17.92	17.29	0.63
12 months to 31/12/2016	16.87	16.81	0.06
3 years to 31/12/2016	6.10	5.98	0.12
5 years to 31/12/2016	10.04	9.94	0.10

The internally managed portfolio has underperformed the benchmark over the three month period to 31 December 2016 by 0.07% which is within the allowed tolerances of +/-0.5%. The performance of the internally managed portfolio is outside the agreed tolerance for the financial year to date due to the second quarter's figure, but still within its tolerance for the twelve months, three years and five years to date.

5.2 FINANCIAL YEAR TO 31 DECEMBER 2016

	Market Values		Performance	Benchmark	Benchmark Description
	31/03/2016	31/12/2016	%	%	
	£M	£M			
Internal	365.7	448.6	17.9	17.3	FTSE 350
AXA Framlington	108.0	182.8	8.2	17.2	All-Share
Standard Life	71.9	0.0	-	-	All-Share
Schroders	38.6	43.7	13.7	13.2	Small Cap*
Total	584.2	675.1	15.0	16.2	

*FTSE Small Cap ex Investment Trusts

The figures for the whole UK equity portfolio show:

- The combined portfolio has underperformed its benchmark over the financial year to date by 1.2%.
- Schroders outperformed its benchmark by 0.5% whilst AXA Framlington underperformed its benchmark by 9.0%.

THREE AND FIVE YEAR ANNUALISED PERFORMANCE

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
	%	%	%	%
Internal	6.1	6.0	10.0	9.9
AXA Framlington	4.7	6.1	10.7	10.1
Schroders	10.7	7.4	18.8	19.4

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 0.1%, within the agreed tolerance.

- AXA Framlington underperformed their benchmark over the three year period by 1.4% but outperformed its benchmark by 0.6% over five years.
- Schroders outperformed its benchmark over three years by 3.3% but underperformed its benchmark by 0.6% over five years.

5.3

The table below shows how the three UK Equity manager's valuations have changed over the financial year to 31 December 2016.

MARKET VALUE OVER FINANCIAL YEAR TO 31 DECEMBER 2016

<u>Manager</u>	<u>Market Value</u>		<u>% of Total UK Equity as at</u>	
	<u>31/03/16</u>	<u>31/12/16</u>	<u>31/03/16</u>	<u>31/12/16</u>
	<u>£M</u>	<u>£M</u>	<u>%</u>	<u>%</u>
Internal	365.7	448.6	62.6	66.4
AXA Framlington	108.0	182.8	18.5	27.1
Standard Life	71.9	0.0	12.3	0.0
Schroders	38.6	43.7	6.6	6.5
Total	584.2	675.1	100.0	100.0

5.4 Each external manager's commentary is summarised below:

AXA Framlington

3rd Quarter 2016/17

Performance

During the third quarter, the fund underperformed the FTSE All Share with a return of 3.8% against the benchmark of 3.9%. For the twelve months to date the Fund returned 4.2% against its benchmark of 16.7%. Over the three years, the fund underperformed its benchmark by 1.3% but outperformed by 0.6% over the five year period. Growth stocks continued to rally helped by the election result in the USA. Recovery in the quarter continued and a good relative and absolute return, especially in the six months where the fund outperformed the index by 3.0%. However, political uncertainty continues to plague markets.

Activity

RPC, the largest holding in the portfolio was again the biggest contributor to relative performance with a return of 11.5% and a relative contribution of 0.5%. Elementis shares recovered after better trading results with a return of 27.2% and a relative contribution rate of 0.5%. Not owning British American Tobacco was a relative positive. The best relative performing sector was industrials and being underweight in consumer goods was a positive to performance. The biggest negative contributor to performance was being underweight in Royal Dutch which performed strongly with a return of 19.9% and a relative contribution rate of -0.75%. The worst relative performing sector was consumer services whilst financials continued to perform as the holding remained underweight. No new holdings were established in the quarter, but stocks added to were Breedon, Ascential and Johnson Matthey. The holding is B&M European Value Retail S.A. were sold and holdings were sold in BT Plc, Travis Perkins Plc and AstraZeneca Plc. Part of RPC was sold, as it had, through success, become too large a holding to be in the fund.

Outlook and Strategy

The UK domestic stocks are still under pressure regarding the outlook for consumption post the EU Referendum. The uncertainty created by the nature of the negotiations is unhelpful for confidence and causing some volatility. Weak economic global growth will lead to further lowering of earnings expectations except those UK overseas earners who are benefitting from the weaker pound sterling. The fragile global economic growth is causing many companies to downgrade expectations,

compounded by the EU Referendum. Monetary tightening in the USA is occurring and a new President will hopefully be business friendly.

Schroders

3rd Quarter 2016/17

Performance and Market Summary

During the third quarter, the Fund returned 6.7% against the Small Cap benchmark of 4.6%. Over the twelve month period the Fund returned 13.5% against its benchmark of 12.5%. Over three years the Fund outperformed the benchmark by 3.3% but underperformed by 0.6% over the five year period.

Activity

Over the three month period to December 2016 the fund delivered a return 2.1% points ahead of its benchmark. Notable contributions to outperformance came from Trifast and Blue prism, as well as MP Evans which received an unsolicited bid approach which was declined later in the quarter. The most significant detractor to performance came from NAHL Group. In September 2016, NAHL Group commenced the trial of a small proportion of enquiries through different commercial and structural arrangements, playing a more proactive role in the entire conduct and financing of personal injury cases. In December 2016, the Board decided to accelerate investment in these cases. To position the group for this different approach to funding and processing enquiries, an exceptional investment of £1.7M is anticipated by the end of the 2017 financial year, with around £0.5M of this by the end of the 2016 financial year. This will fund investment in the National Accident Helpline brand and the creation of these alternative business structures. This new approach will see a deferment of operating profit of approximately £4M in the 2017 financial year with a reduction in cash conversion to about 60% from the assumed 65% in the second half of the 2016 financial year. It is anticipated that cases put through the approach will settle within two years when the cashflow will be received and the remaining revenue and operating profit recognised. This chain of events saw the shares marked down aggressively. With regards to disposals, profits were taken in a number of names over the period. Additionally, the holding in NCC were sold, a significant proportion of which was before that company's profit warning. Stakes in Kainos and Mears were sold because of being increasingly concerned about rising constraints on UK government expenditure. The proceeds of these divestments were invested in a number of new names as well as adding to existing holdings where there is still some value to be exploited. A couple of additions were flotations, namely Luceco and Warpaint, the former being a manufacturer and distributor of electrical fittings and LED luminaires whilst the latter manufactures and designs cosmetics. AB Dynamics, Redt Energy and Futura Medical were also new purchases. Tracsis, Gresham Technologies and Carclo were added to the existing holdings. There were partial sales in Sanne, Fisher (James), Dart and Polypipe.

Outlook and Strategy

For the UK equity market overall, the 12 month price/earnings ratio has increased from 9.5x in 2011 to today's 14x. The increase in the market's valuation multiple has been notably driven by a number of defensive sectors such as beverages, tobacco and pharmaceuticals, which have witnessed historically high valuations. Multiples for oil producers have increased further more recently, as earning estimates have been further revised downwards whilst the share price has grown. The key as always is investing in those companies that can maintain their competitive advantage as the relentless pressure on profitability continues across the market. This can be seen in the recent warnings from Pearson and BT, two large constituents of the FTSE 100 index. Companies, using the environment of low interest rates, looks set to continue for some time to make acquisitions to supplement organic growth. This is being well received by the market and it is a trend that is expected to continue. Organic growth and pricing power and where possible avoiding companies with too much debt are sought. There should be opportunities for Mergers and Acquisitions activities, particularly with the recent weakness in sterling.

6 **Review of Activity**

6.1 The Internal managed portfolio had six corporate actions in the three month period to 31 December 2016:

- In October, SABMiller was taken over by Anheuser-Busch Inbev for £8.9M.
- In October, there were two corporate actions. These were Informa Rights Issue (£0.1M) and Phoenix Rights Issue (£0.2M).
- In November, there was a demerger between esure Group Plc and Gocompare.com for £0.2M
- In December, there were two corporate actions. There was a merger between NEX and ICAP for £0.3M and a merger between Tullett Prebon and ICAP for £0.1M.

6.2

- In October, the UK Equity Internally Managed Passive Fund was rebalanced. The total value of purchases and sales were £4.1M with a net purchase of £0.7M. There were 25 purchases (£2.4M) and 68 sales (£1.7M).

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 December 2016 is £22,320. Net income for UK stock lending was £124,530 over the same period, giving a total of £146,850.

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