**Agenda Item:**

8

# Pension Fund Committee

**Dorset County Council**

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| Date of Meeting | 1 March 2017 |
| 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 two quarters of the 2016/17 Financial Year to 31 December 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 19.5% over the nine months to 31 December 2016, underperforming its benchmark which returned 19.1%. Return seeking assets returned 16.1%, whilst the liability matching assets returned 43.3%. |
| Impact Assessment: | Equalities Impact Assessment:<br><br>N/A |
| | Use of Evidence:<br><br>N/A |
| | Budget:<br>N/A |

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| | 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>None |
| Recommendation | That the Committee :<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.<br>iii) Consider a report from Mercer on the high level strategic asset allocation review.<br>iv) Approve the Investment Strategy Statement (ISS) March 2017. |
| 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: Report of the Independent Adviser<br>Appendix 2: New Money Forecast<br>Appendix 3: HSBC Manager Performance to 31 December 2016<br>Appendix 4: Strategic Asset Allocation Review (report from Mercer)<br>Appendix 5: Investment Strategy Statement (ISS) 2017/18<br><br>**The public should be excluded during consideration of Appendix 4 because its discussion in public would be likely to lead to the disclosure to members of the public present of exempt information as defined in the paragraph detailed below of Part 1 of Schedule 12A of the Local Government Act 1972 (as amended):**<br><br>**3. Information relating to the financial or business affairs of any particular person (including the authority holding that information)**<br><br>**and since it is considered that, in all the circumstances of the case, the public interest in maintaining the exemption outweighs the public interest in disclosing the information, in that disclosure at this time is likely to prejudice the final outcome of the strategic asset allocation review**. |
| Background Papers | HSBC Performance Statistics |

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| Report Originator and Contact | Name: David Wilkes<br>Tel: 01305 224119<br>Email: d.wilkes@dorsetcc.gov.uk |

## 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 £16M in 2016-17 to date, compared to the forecast of approximately £20M for the full year. The outturn cash-flows for 2015/16 and the anticipated cash flows for 2016/17 along with the historic trends are illustrated in Appendix 2.

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 nine months under review.

**Statement of cash-flow for the nine months ended 31 December 2016**

| | £M | £M |
|---|---|---|
| **Cash at 1 April 2016** | | **91.8** |
| **Less:** | | |
| Infrastructure Drawdowns (net) | 28.8 | |
| UK Equity transactions (net) | 32.7 | |
| Liability Matching Bond (net) | 45.0 | |
| Currency Hedge (net loss) | 32.7 | |
| Private Equity (net) | 1.4 | |
| | | **140.6** |
| **Plus:** | | |
| Upfront Payments of Employer Contributions* | 19.5 | |
| Property Transactions (net) | 4.7 | |
| Hedge Fund redemptions (net) | 1.4 | |
| Fixed Interest (net) | 9.6 | |
| Overseas Equities (net) | 55.0 | |
| Increase in Cash | 15.6 | |
| | | **105.8** |
| **Cash at 31 December 2016** | | **57.0** |

*£26M received as upfront contributions, of which 9/12ths represents cash in advance as at 31 December 2016.

2.2 The cash flow above summarises the most significant transactions that have taken place for the nine months to the end of December 2016. Since the end of December, the most significant transaction has been the second drawdown by IFM (£24M outflow), leaving cash balances of approximately £31M at the 3 February 2017.

## 3. Fund Portfolio Distribution

3.1 The table below shows the position as at 31 December 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-16 | | 31-Dec-16 | | Target Allocation | |
|---|---|---|---|---|---|---|---|
| **Asset Class** | **Manager** | **£M** | **%** | **£M** | **%** | **£M** | **%** |
| Bonds | RLAM | 286.1 | 12.6% | 304.3 | 11.5% | 332.0 | 12.50% |
| UK Equities | Several | 584.2 | 25.7% | 675.1 | 25.4% | 697.1 | 26.25% |
| Overseas Equities | Several | 625.6 | 27.5% | 719.6 | 27.1% | 697.1 | 26.25% |
| Property | CBRE | 246.3 | 10.8% | 239.2 | 9.0% | 265.6 | 10.00% |
| Absolute Return Funds | Several | 1.8 | 0.1% | 0.4 | 0.0% | - | 0.00% |
| Infrastructure | Several | 29.0 | 1.3% | 65.7 | 2.5% | 106.2 | 4.00% |
| Private Equity | Several | 65.4 | 2.9% | 80.2 | 3.0% | 106.2 | 4.00% |
| Diversified Growth | Barings | 107.6 | 4.7% | 115.2 | 4.3% | 132.8 | 5.00% |
| Cash | Internal | 91.8 | 4.0% | 57.1 | 2.2% | - | 0.00% |
| **Total Return Seeking Assets** | | **2,037.8** | **89.5%** | **2,256.8** | **85.0%** | **2,337.1** | **88.0%** |
| Liability Matching Assets | Insight | 238.0 | 10.5% | 399.0 | 15.0% | 318.7 | 12.00% |
| **Total Asset Valuation** | | **2,275.8** | **100.0%** | **2,655.8** | **100.0%** | **2,655.8** | **100.0%** |

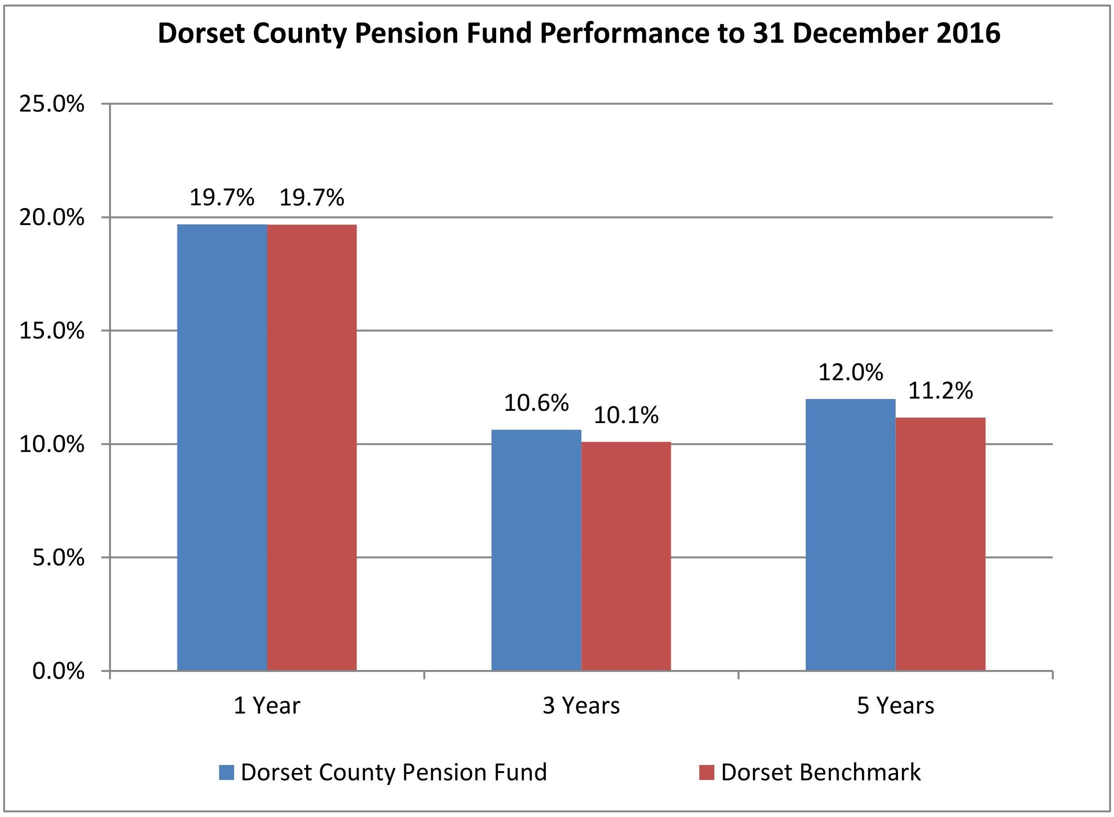
3.2 The table above shows that in most asset classes the Fund's allocation is now close to or slightly above target, with the exception of Private Equity and Infrastructure which will take a number of years to fully drawdown. Since 31 December 2016, there has been a drawdown of approximately £24M against the commitment with IFM, one of the Fund's two Infrastructure managers, which will bring the Fund's allocation to this asset class closer to target.

## 4. Overall Fund Performance

4.1 The performance of the Fund for the nine months to 31 December 2016 shows an overall return of 19.46%, a marginal over-performance of the benchmark of 19.10% by 0.36%. This high level of short term returns by the Fund and its benchmark have been driven largely by the impact of sterling's depreciation, following the result of the EU referendum, on the asset classes the Fund is invested in, rather than relative outperformance of the markets by the Fund's managers.

4.2 Over the longer term, the Fund has exceeded its benchmark over 3 years, returning an annualised 10.63% against the benchmark of 10.09%, and over 5 years, returning an annualised 11.98% against the benchmark of 11.17%.

4.3 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.




4.4 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 Investments. 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 nine months to 31 December 2016, Return Seeking assets have returned 16.14% against the benchmark of 15.45%, and the Liability Matching assets have returned 43.28% against the benchmark of 43.93%. 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.

| | | 9 Months to 31 December 2016 | | |
|---|---|---|---|---|
| **Asset Category** | **Manager** | **Dorset %** | **Benchmark %** | **Over/(Under) %** |
| **Overall Fund Performance** | **All** | **19.46** | **19.10** | **0.36** |
| **Total Return Seeking Assets** | **Various** | **16.14** | **15.45** | **0.69** |
| UK Equities | (Various) | 13.67 | 17.07 | -3.40 |
| Overseas Equities | (Various) | 29.55 | 25.93 | 3.62 |
| Bonds | (RLAM) | 9.46 | 9.19 | 0.27 |
| Property | (CBRE) | 2.50 | 2.39 | 0.11 |
| Private Equity | (Various) | 18.98 | 17.24 | 1.74 |
| Diversified Growth | (Barings) | 7.12 | 3.36 | 3.76 |
| Infrastructure | (Various) | 12.53 | 7.41 | 5.12 |
| **Total Liability Matching Assets** | | **43.28** | **43.93** | **-0.65** |
| Liability Driven Investment | (Insight) | 43.28 | 43.93 | -0.65 |

4.6 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.

4.7 The HSBC performance report, contained at Appendix 3, gives an attribution analysis of the performance for the year to date on pages 8 to 10. This analysis shows that the market contribution had a positive effect of 29bps against the benchmark and stock selection was negative by 1bps.

## 5. Manager Progress

<u>Diversified Growth</u>

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 nine months to 31 December 2016 is summarised below.

| | Market Value 01-Apr-16 | Market Value 31-Dec-16 | 9 months to 31 December 2016 | |
|---|---|---|---|---|
| | £000s | £000s | Performance % | Benchmark % |
| Barings | 107,588 | 115,248 | 7.12 | 3.36 |

5.3 The return of 7.12% for the nine months to 31 December 2016 was above the benchmark of 3.36% by 3.76%. The fund manager comments that their position in Japanese equities was a positive contributor to performance, whilst their holding in the FTSE100 was a mild positive due to its large proportion of multinational companies that benefitted from their overseas earnings. The return was ahead of both the performance compactor and global equities.

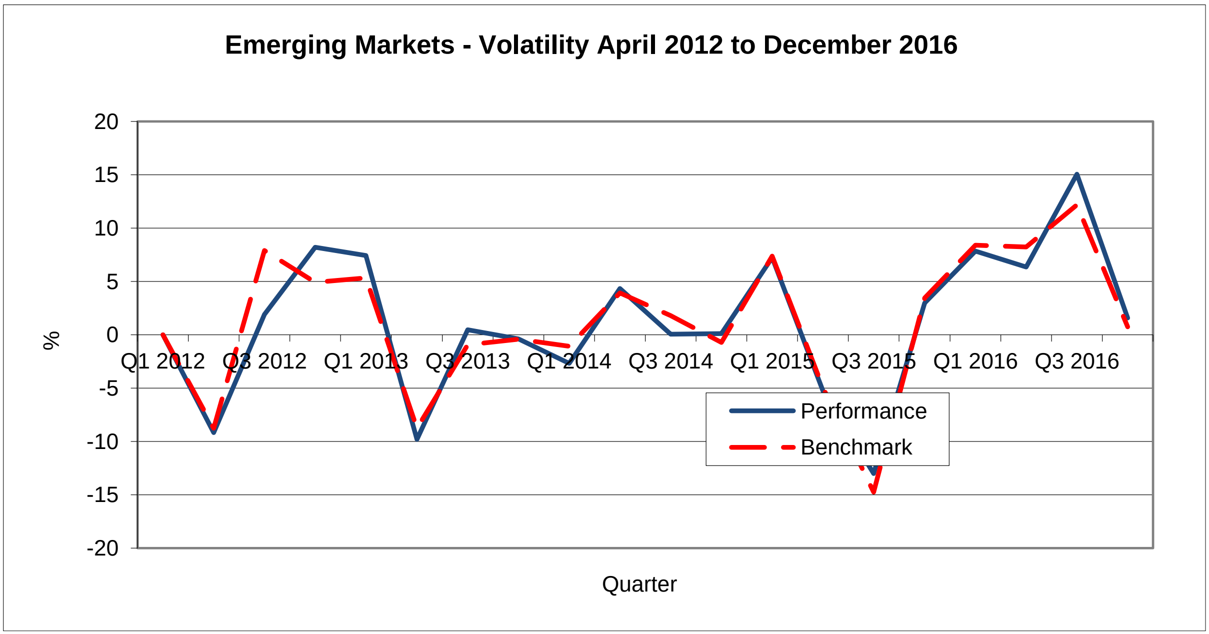
Emerging Market Equity

5.4 The performance of JP Morgan is summarised below.

| | Market Value 01-Apr-16 | Market Value 31-Dec-16 | 9 months to 31 December 2016 | |
|---|---|---|---|---|
| | (£000's) | (£000's) | Performance % | Benchmark % |
| JPM | 65,186 | 81,025 | 24.30 | 22.75 |

5.5 The return of 24.30% for the nine months to 31 December 2016 was above the benchmark of 22.75% by 1.55%. The fund manager comments that the outperformance benefitted from the commodity exposure in Russia which was the largest country overweight and being overweight in North Asia and Eastern Europe, which shows the best combinations of attractive valuations and positive trends in earnings. Turkey detracted from performance which reflected US strength and political challenges such as external financing needs and a weakening in the country's credit fundamentals as economic growth slows.

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

**Private Equity Commitments, Drawdowns and Valuations**

| Manager / Fund | Commitment | Drawdown | % of Commitment | Distribution | Valuation | Gain / (Loss) |
|---|---|---|---|---|---|---|
| | €m | €m | | €m | €m | €m |
| HV Partnership V | 12.000 | 11.400 | 95% | 12.517 | 5.175 | 6.292 |
| HV Direct V | 3.000 | 2.880 | 96% | 3.337 | 0.667 | 1.124 |
| **HarbourVest Total €m** | 15.000 | 14.280 | | 15.853 | 5.842 | 7.415 |
| SL 2006 | 22.000 | 19.937 | 91% | 19.651 | 7.178 | 6.893 |
| SL 2008 | 17.000 | 14.736 | 87% | 7.012 | 11.677 | 3.954 |
| **Standard Life Total €m** | 39.000 | 34.673 | | 26.664 | 18.856 | 10.847 |
| **Overall Total €m** | **54.000** | **48.953** | | **42.517** | **24.698** | **18.262** |
| | $m | $m | | $m | $m | $m |
| HV Venture VIII | 15.200 | 14.896 | 98% | 13.322 | 11.668 | 10.094 |
| HV Buyout VIII | 22.800 | 21.432 | 94% | 21.369 | 12.290 | 12.227 |
| HV Buyout IX | 15.000 | 9.038 | 60% | 2.513 | 9.161 | 2.637 |
| HV Partnership VII (AIF) | 20.000 | 6.550 | 33% | 0.295 | 6.506 | 0.252 |
| HV Venture IX | 10.000 | 8.250 | 83% | 2.048 | 9.330 | 3.128 |
| Harbourvest Partners X AIF | 10.000 | 0.850 | 9% | 0.000 | 0.868 | 0.018 |
| Harbourvest Partners X AIF | 5.000 | 0.475 | 10% | 0.000 | 0.465 | -0.010 |
| **HarbourVest Total $m** | 98.000 | 61.491 | | 39.547 | 50.288 | 28.344 |
| SL SOF I | 16.000 | 11.433 | 71% | 4.039 | 12.103 | 4.709 |
| SL SOF II | 20.000 | 11.230 | 56% | 2.159 | 10.655 | 1.584 |
| SL SOF III | 20.000 | | 0% | | | 0.000 |
| **Standard Life Total $m** | 56.000 | 22.663 | | 6.198 | 22.758 | 6.293 |
| **Overall Total $m** | **154.000** | **84.153** | | **45.745** | **73.045** | **34.637** |

5.9 For the nine months to 31 December 2016 total drawdowns have been £12.2M and total distributions £10.8M. 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. For example, the Interim Chief Treasury and Pensions Manager and the Independent Adviser recently met with HarbourVest to discuss a potential further investment.

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**

| Manager | 3 Years to 31 Dec 2016 | | 5 Years to 31 Dec 2016 | |
|---|---|---|---|---|
| | Dorset % | Benchmark % | Dorset % | Benchmark % |
| HarbourVest | 22.82 | 6.05 | 19.12 | 10.10 |
| Standard Life | 13.89 | 6.05 | 13.51 | 10.10 |

## 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 September 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   over the six months, which is ahead of the benchmark, as measured by the 7 day LIBID, at 0.21% 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.

| | **Amount £000s** | **Rate %** |
|---|---|---|
| **Fixed Term Deposits** | | |
| Total Fixed Term Deposits | - | - |
| **Call Accounts** | | |
| National Westminster Bank | 1,979 | 0.01% |
| Total Call Accounts | 1,979 | 0.01% |
| **Money Market Funds** | | |
| Standard Life | 15,000 | 0.30% |
| BNP Paribas | 15,000 | 0.33% |
| Federated Prime Rate | 15,000 | 0.31% |
| Deutsche | 8,000 | 0.30% |
| Total Money Market Funds | 53,000 | 0.31% |
| **Holding Accounts** | | |
| HSBC Custodian Account | 1,352 | 0.00% |
| Property Client Account | 725 | 0.00% |
| Total Holding Accounts | 2,077 | 0.00% |
| **Total Cash / Average Return** | **57,056** | **0.29%** |

## 7. Review of Strategic Asset Allocation

7.1 Following the results of the latest triennial actuarial valuation, investment consultants Mercer have been commissioned to review the Fund's current strategic asset allocation. Mercer's initial high level findings are included in Appendix 4 for consideration by the Committee. It is proposed that a final report will be prepared for the June 2017 meeting of the Committee to agree any changes to the existing strategic asset allocation.

**8. Investment Strategy Statement (ISS)**

8.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require administering authorities to formulate and to publish an Investment Strategy Statement (ISS), in accordance with guidance issued by the Department for Communities and Local Government (CLG) in September 2016.

8.2 The ISS replaces the requirement for administering authorities to formulate and publish a Statement of Investment Principles (SIP). The aim of the new investment regulations is to transfer investment decisions and their consideration more fully to administering authorities, with less central prescription than before. The ISS must also detail the Fund's approach to pooling, including its commitment to "a suitable pool" that meets the criteria published by CLG in November 2015.

8.2 The ISS must be published by 1 April 2017, then kept under review and revised from time to time, but at least every three years. It may be necessary to amend the ISS following the final outcome of the review of the strategic asset allocation described in paragraph 7 above.

**Richard Bates**
**Pension Fund Administrator**
February 2017