# DORSET COUNTY PENSION FUND

## UK Equity
## Report for 12 months ending 31 March 2017

- Internal Managers Report
- Valuation Report
- Transaction Report

**Dorset County Pension Fund Committee – 21 June 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 (£694.7M at 31 March 2017) 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 March 2017, the FTSE All Share index was made up of 634 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £174.6 Billion) down to the smallest in the index, The Lindsell Train Investment Trust Plc (market value £1.4 Million). Direct investment is made in the largest 350 companies, which comprises 96.6% by value of the index. Investment in the smallest companies which make up 3.4% 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 positive performance from the UK markets in the three months to March 2017. The Small Cap ex Investment Trusts was the best performing index rising 5.8% (393 points), whilst the FTSE100 was the worst performing major UK index rising 2.5% (180 points). In comparison, performance from major world indices was equally strong with the exception of the Nikkei 225 which fell 1.1% (205 points). The Hang Seng was the best performing index rising 9.6% (2,111 points). The Dow Jones rose 4.6% (901 points) over the same period.

4.2 Over the twelve month period, all major UK equity markets rose. The Small Cap ex Investment Trusts was the best performing index rising 19.7% (1,186 points), whilst the FTSE250 was the worst performing UK index rising 12.1% (2,046 points). The FTSE100 rose 18.6% (1,148 points) over the same period. The Dax was the best performing world index rising 23.6% (2,347 points), whilst the Shanghai Composite was the worst performing index rising 7.3% (219 points). The Dow Jones rose 16.8% (2,978 points) over the same period.

4.3 On 20 March 2017 the FTSE100 recorded a record high for the third successive day at 7,429.8 as sterling weakened following news that the UK government would trigger Article 50, officially notifying the European Union of its decision to leave on 29 March

2017. The FTSE250 also closed on a record high on 20 March 2017 at 19,151.8 due mainly to Merger and Acquisitions and the rise in the pound.

4.4 On 1 March 2017 the Dow Jones reached a record high of 21,115.6, breaking the 21,000 barrier for the first time. This was due to renewed optimism over a huge economic stimulus in the US and hopes of a rate rise, as well as industrial and banking stocks performing well. The Dow Jones only took twenty five trading sessions to rise from 20,000 to 21,000 and was the fastest move between thousand point milestones since 1999. The technology heavy Nasdaq reached a record high of 5,914.3 on 30 March 2017 due mainly to financials as banks rose more than 2%.

**Three Months to 31 March 2017**

| Country | Index | 31/12/2016 | 31/03/2017 | % Change |
|---|---|---|---|---|
| UK | FTSE100 | 7,142.8 | 7,322.9 | 2.5 |
| UK | FTSE250 | 18,077.3 | 18,971.8 | 4.9 |
| UK | FTSE350 | 3,931.7 | 4,046.6 | 2.9 |
| UK | Small Cap | 5,143.2 | 5,430.5 | 5.6 |
| UK | Small Cap ex Investment Trusts | 6,802.3 | 7,196.1 | 5.8 |
| UK | All Share | 3,873.2 | 3,990.0 | 3.0 |
| Japan | Nikkei225 | 19,114.4 | 18,909.3 | -1.1 |
| US | Dow Jones | 19,762.6 | 20,663.2 | 4.6 |
| Hong Kong | Hang Seng | 22,000.6 | 24,111.6 | 9.6 |
| France | Cac 40 | 4,862.3 | 5,122.5 | 5.4 |
| Germany | Dax | 11,481.1 | 12,312.9 | 7.2 |
| China | Shanghai Composite | 3,103.6 | 3,222.5 | 3.8 |

## 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 |
| 3 months to 31/03/2017 | 3.71 | 3.95 | -0.24 |
| 12 months to 31/03/2017 | 22.29 | 21.91 | 0.38 |
| 3 years to 31/03/2017 | 7.71 | 7.61 | 0.10 |
| 5 years to 31/03/2017 | 9.58 | 9.54 | 0.04 |

The internally managed portfolio has underperformed the benchmark over the three month period to 31 March 2017 by 0.24% which is within the allowed tolerances of +/-0.5%. The performance of the internally managed portfolio was outside the agreed tolerance for the second quarter, but is still within its tolerance for the twelve months, three years and five years to date.

5.2 **FINANCIAL YEAR TO 31 MARCH 2017**

| | Market Values | | Performance | Benchmark | Benchmark |
|---|---|---|---|---|---|
| | **31/03/2016** | **31/03/2017** | **%** | **%** | **Description** |
| | £M | £M | | | |
| Internal | 365.7 | 461.7 | 22.3 | 21.9 | FTSE 350 |
| AXA Framlington | 108.0 | 185.4 | 9.8 | 22.0 | All-Share |
| Standard Life | 71.9 | - | - | - | All-Share |
| Schroders | 38.6 | 47.6 | 23.9 | 19.7 | Small Cap* |
| **Total** | 584.2 | 694.7 | 19.1 | 21.8 | |

*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 2.7%.
- Schroders outperformed its benchmark by 4.2% whilst AXA Framlington underperformed its benchmark by 12.2%.

**THREE AND FIVE YEAR ANNUALISED PERFORMANCE**

| | Three Years | | Five Years | |
|---|---|---|---|---|
| | **Performance** | **Benchmark** | **Performance** | **Benchmark** |
| | **%** | **%** | **%** | **%** |
| Internal | 7.7 | 7.6 | 9.6 | 9.5 |
| AXA Framlington | 4.9 | 7.7 | 9.1 | 9.7 |
| Schroders | 13.2 | 8.7 | 18.0 | 16.8 |

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 2.8% and also underperformed its benchmark by 0.6% over five years.
- Schroders outperformed its benchmark over three years by 4.5% and by 1.2% 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 March 2017.

**MARKET VALUE OVER FINANCIAL YEAR TO 31 MARCH 2017**

| | Market Value | | % of Total UK Equity as at | |
|---|---|---|---|---|
| | 31/03/16 | 31/03/17 | 31/03/16 | 31/03/17 |
| Manager | £M | £M | % | % |
| Internal | 365.7 | 461.7 | 62.6 | 66.5 |
| AXA Framlington | 108.0 | 185.4 | 18.5 | 26.7 |
| Standard Life | 71.9 | 0.0 | 12.3 | 0.0 |
| Schroders | 38.6 | 47.6 | 6.6 | 6.9 |
| **Total** | **584.2** | **694.7** | **100.0** | **100.0** |

5.4 Officers met with the fund managers for both AXA Framlington and Schroders in May, and each external manager's commentary is summarised below:

**AXA Framlington - 4th Quarter 2016/17**

Performance: During the quarter, the fund underperformed the FTSE All Share with a return of 1.5% against the benchmark of 4.0%. For the twelve months to date the Fund returned 9.8% against its benchmark of 22.0%. Over the three years, the fund underperformed its benchmark by 2.8% and also underperformed by 0.6% over the five year period. It was a poor relative return in the quarter, mainly stock specific. Growth stocks continued to rise helped by the election of a US president perceived to be business friendly, whilst political uncertainty continued to plague markets.

Activity: This was a difficult quarter for the Fund where Brexit fears continued to influence markets. RPC, the second largest holding, had a 1 for 4 rights issue to fund an acquisition and this accounted for -1.48% of the relative underperformance and was the biggest negative contributor to relative performance.

Other negatives to performance included not owning British American Tobacco which was the second biggest negative to relative return at -0.49%; being underweight in consumer goods which was the biggest negative contributor to relative returns and consumer services was also negative. Positives to performance included being underweight in Royal Dutch Shell and BP which were the greatest performers to relative return of 0.49% and 0.42% respectively, whilst the best relative contributing sectors were being underweight in oil and gas and being overweight in industrials.

There were three new holdings purchased in Rentokil, Bodycote and Severn Trent. Holdings added to included Clinigen, Lloyds Banking Group Plc, Ashtead, Ascential and Johnson Matthey. The exposure to telecoms of BT and Vodafone were reduced. Following the bid for Booker from Tesco, the holding in Booker was reduced. Premier Oil was sold following their dilutive re-financing and part holdings were sold in RPC, Hunting, Dixons Carphone, Rightmove and ITV.

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. The US presidential election result has led to a further rally in global equities and expectations that corporate taxes will be reduced in the USA. US monetary tightening occurred and more is expected in 2017.

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. There is much political uncertainty affecting capital markets. Fragile global economic growth is causing many companies to downgrade expectations, compounded by the EU Referendum. Monetary tightening in the USA is occurring, but the new president will hopefully be business friendly and cut corporate taxes.

**Schroders - 4th Quarter 2016/17**

Performance and Market Summary: During the quarter, the fund returned 9.0% against the Small Cap benchmark of 5.8%. Over the twelve month period the Fund returned 23.9% against its benchmark of 19.7%. Over three years the Fund outperformed the benchmark by 4.5% and outperformed by 1.3% over the five year period.

Activity: Over the three month period to 31 March 2017 the fund outperformed its benchmark by 3.2%. The main contributors to performance were mainly from technology or engineering stocks. The most significant contributor was Microgen which announced results ahead of expectations and has started to use its surplus cash to make small acquisitions. Taptica continued its run of upgrades during the quarter, having delivered five upgrades over the past twelve months. Despite that performance, the shares still only trade on a p/e ratio of eleven times. Taptica has recently opened new offices in Japan and the UK. Games Workshop released an upbeat trading statement on 6th March to which the shares responded commensurately.

The fund benefited from being underweight in NCC which saw the departure of its Chief Executive following weak trading and poor integration of acquisitions. In early February, RM announced good results in addition to the acquisition of the Education and Care business of Connect Group for £56.5m in cash. Negatives to performance included Colefax who reported weak results towards the end of January, arising from weakness in the US. Autins, a manufacturer of automotive insulation products, suffered delays at its largest customer. SQS also experienced what its management team reckon to be a hiatus in demand from several of its automotive customers for its software testing products. In a February trading update, Tracsis indicated that revenues would be weighted more to the second half than has been the case historically thanks to longer sales cycles with the UK's Department of Transport. The management also pointed to pricing pressure in its Traffic and Data services division. Tracsis' shares were marked down accordingly.

There was an energetic approach to recycling capital in successful investments over the course of the quarter. With regards to disposals, profits were taken in a number of names over the period. Additionally, Amino Technologies was completely disposed of at a good profit. Similarly, profits were taken in other names such as Anpario, Gateley and Luceco where the risk-reward profile was not as attractive as it had once been.

Similarly, profits were taken in several positions but still left the fund with meaningful positions in those names. This approach was taken across the market cap range. The proceeds of these divestments were invested in a number of new names as well as topping up existing holdings where there is still some value to be exploited. A couple of additions were floatations, namely Medica and UP Global Sourcing, the former providing teleradiology services in the UK, whilst the latter provides merchandising, sourcing and distribution of kitchenware products.

Outlook and Strategy: This quarter has seen a strong start by small companies as investors reflect the level of earning and dividend growth being delivered. To a degree, there has also been some catch up following the strong currency induced performance of the FTSE100 last year. In the UK, economic growth has continued to surpass the expectations of most forecasters who expected a significant slowdown. Consumer spending has remained robust even if the traditional bricks and mortar retailers faced incessant margin pressure from lower cost internet competitors. Employment remains high but wage growth has started to slow and is now only matching inflation. The weakness of sterling has started to see higher costs being passed on to the consumer and it will be seen whether companies will be able to make these increases stick or will have to reverse them due to falling demand.

Companies, are using the environment of low interest rates, which 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 expect to continue for some time. The trend will continue in seeking organic growth and pricing power where possible and avoiding companies with too much debt. There is an expectancy for a

Merger and Acquisition activity pick up, particularly with the recent weakness of sterling.

## 6 Review of Activity

6.1 The Internal managed portfolio had two corporate actions in the three month period to 31 March 2017:

- In February, there was a RPC Rights Issue for £0.1M
- In March, there was a Segro Rights Issue for £0.1M.

6.2

- In January, the UK Equity Internally Managed Passive Fund was rebalanced. The total value of purchases and sales were £2.0M with a net purchase of £0.5M. There were 8 purchases (£1.2M) and 10 sales (£0.7M).
- In February, the UK Equity Internally Managed Passive Fund was rebalanced. The total value of purchases and sales were £1.9M with a net sale of £1.1M. There were 15 purchases (£0.4M) and 74 sales (£1.5M).

## 7 Stock Lending

7.1 Stock lending of equities is managed in the UK on an agency basis by HSBC, and on global equities by Allianz, Investec and Wellington.

7.2 For the year to 31 March 2017, net income from UK stock lending was £169,000 and overseas stock lending income was £28,000, giving a total of £197,000.

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**Finance Manager (Treasury and Investments)**
**June 2017**