Pension Fund Committee

Dorset County Council

Date of Meeting	13 September 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 quarter to 30 June 2017. 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. The Independent Adviser’s report is contained at Appendix 1, and will be presented separately at the meeting. The report shows that overall the Fund returned 0.7% over the three months to 30 June 2017, underperforming its benchmark which returned 1.0%. Return seeking assets returned 1.1%, whilst the liability matching assets returned -2.1%.
Impact Assessment:	Equalities Impact Assessment: N/A
	Use of Evidence: N/A
	Budget: N/A

<table>
<tr><td rowspan="2"></td><td>Risk Assessment:
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.</td></tr>
<tr><td>Other Implications:
None</td></tr>
<tr><td>Recommendation</td><td>That the Committee :
i) Review and comment upon the activity and overall performance of the Fund.
ii) Notes the potential impact of the implementation of MiFID II from January 2018 on investment strategy, and approves officers to apply for the administering authority to opt up from retail client to elected professional client status with all relevant financial institutions.</td></tr>
<tr><td>Reason for Recommendation</td><td>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.</td></tr>
<tr><td>Appendices</td><td>Appendix 1: Report of the Independent Adviser
Appendix 2: New Money Forecast
Appendix 3: HSBC Manager Performance to 30 June 2017</td></tr>
<tr><td>Background Papers</td><td>HSBC Performance Statistics</td></tr>
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Email: d.wilkes@dorsetcc.gov.uk</td></tr>
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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. It is estimated that there will be a surplus of income over expenditure from these cash flows of approximately £25M in the 2017/18 financial year. The outturn cash-flows for 2016/17 and the anticipated cash flows for 2017/18 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 financial year to date.

Statement of cash-flow for the three months ended 30 June 2017

	£M	**£M**
Cash at 1 April 2017		**30.3**
Less:		
Infrastructure Drawdowns (net)	4.0	
UK Equity transactions (net)	0.5	
Property Transactions (net)	0.5	
		5.0
Plus:		
Private Equity (net)	4.0	
Liability Matching Bond (net)	20.0	
Currency Hedge (net)	5.5	
Increase in Cash	2.6	
		32.1
Cash at 30 June 2017		**57.4**

2.2 The cash flow above summarises the most significant transactions that have taken place for the three months to the end of June 2017. Since the end of June, the most significant transaction has been the purchase of the property at Park Plaza, Waterloo for £15.7M leaving cash balances of approximately £40.6M at the 31 July 2017.

3. Asset Valuation and Target Allocation

3.1 The table below shows the position as at 30 June 2017. 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.

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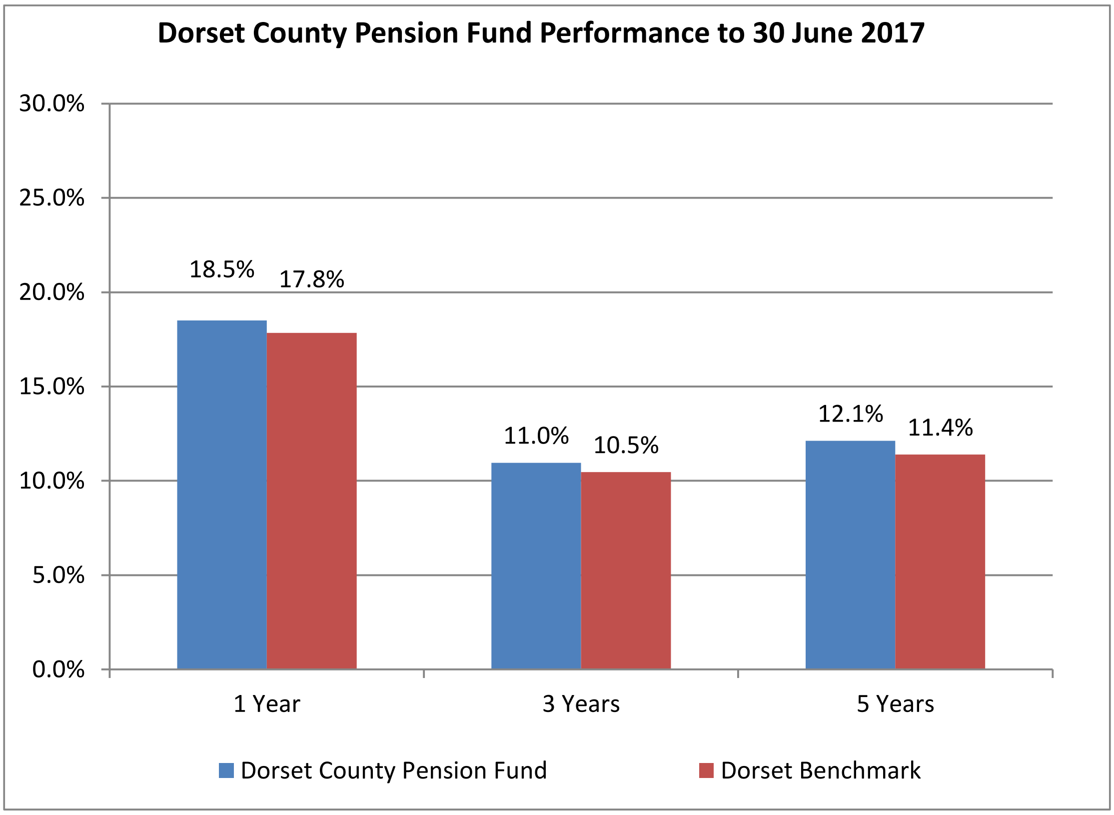
Asset Class	Manager	31-Mar-17 £M	31-Mar-17 %	30-Jun-17 £M	30-Jun-17 %	Target Allocation £M	Target Allocation %
Bonds	RLAM	313.5	11.45%	317.1	11.48%	345.2	12.50%
UK Equities	Several	694.7	25.38%	702.4	25.43%	724.9	26.25%
Overseas Equities	Several	763.0	27.88%	766.5	27.75%	724.9	26.25%
Property	CBRE	241.1	8.81%	246.4	8.92%	276.2	10.00%
Absolute Return Funds	Several	0.4	0.01%	-	0.00%	-	0.00%
Infrastructure	Several	98.0	3.58%	102.7	3.72%	110.5	4.00%
Private Equity	Several	77.0	2.81%	75.1	2.72%	110.5	4.00%
Diversified Growth	Barings	119.1	4.35%	121.6	4.40%	138.1	5.00%
Cash	Internal	30.3	1.11%	57.4	2.08%	-	0.00%
Total Return Seeking Assets		**2,337.1**	**85.39%**	**2,389.2**	**86.51%**	**2,430.3**	**88.0%**
Liability Matching Assets	Insight	399.8	14.61%	372.5	13.49%	331.4	12.00%
Total Asset Valuation		**2,736.9**	**100.00%**	**2,761.7**	**100.00%**	**2,761.7**	**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 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 2017 shows an overall return of 0.65%, an under-performance of the benchmark of 0.96% by 0.31%.

4.2 Over the longer term, the Fund has exceeded its benchmark over 3 years, returning an annualised 11.0% against the benchmark of 10.5%, and over 5 years, returning an annualised 12.1% against the benchmark of 11.4%. The chart below shows the overall performance for 1, 3 and 5 years against the Fund's bespoke benchmark.



4.3 When considering the overall performance it is important to distinguish between 'return seeking' and '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.

4.4 For the three months to 30 June 2017, return seeking assets have returned 1.07% against the benchmark of 1.34%, and the liability matching assets have returned 2.12% against the benchmark of -2.04%. This strategy is intended to hedge against the impact of increasing pensions liabilities which are linked to the Consumer Prices Index (CPI). CPI cannot currently be hedged as there is not a sufficiently developed futures market, so the Fund's 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 return seeking and liability matching assets.

		3 Months to 30 June 2017		
Asset Category	**Manager**	**Dorset %**	**Benchmark %**	**Over/(Under) %**
Overall Fund Performance	**All**	**0.65**	**0.96**	**-0.31**
Total Return Seeking Assets	**Various**	**1.07**	**1.34**	**-0.27**
UK Equities	(Various)	1.92	1.44	0.48
Overseas Equities	(Various)	0.38	1.00	-0.62
Bonds	(RLAM)	1.11	0.59	0.52
Property	(CBRE)	3.29	2.35	0.94
Private Equity	(Various)	-0.16	1.42	-1.58
Diversified Growth	(Barings)	2.15	1.06	1.09
Infrastructure	(Various)	0.91	2.41	-1.50
Total Liability Matching Assets		**-2.12**	**-2.04**	**-0.08**
Liability Driven Investment	(Insight)	-2.12	-2.04	-0.08

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 - the asset allocation (market contribution) of the Fund and within those allocations the stock selection (selection contribution) choices that have been made. Market contribution reflects the effect of decisions to change the weighting of the different asset classes within the Fund, and selection contribution is a measure of a fund manager's ability to outperform their benchmark.

4.7 The HSBC performance report, contained at Appendix 3, gives an attribution analysis of the performance for the year to date on pages 7 to 8. This analysis shows that the market contribution had a negative effect of 132bps against the benchmark and stock selection was positive by 12 bps.

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 2017 is summarised below.

	Market Value 01-Apr-17	Market Value 30-Jun-17	3 months to 30 June 2017	
	£000s	£000s	Performance %	Benchmark %
Barings	119,069	121,628	2.15	1.06

5.3 The return of 2.15% for the three months to 30 June 2017 was above the benchmark of 1.06% by 1.09%. The fund manager comments that the portfolio has benefited by keeping exposures to markets such as Japan and Europe, where the economic recovery has until recently been hidden by political concerns. The preference is to focus more on the corporate earnings potential of Japanese companies and so far this has worked and delivered healthy gains for the fund.

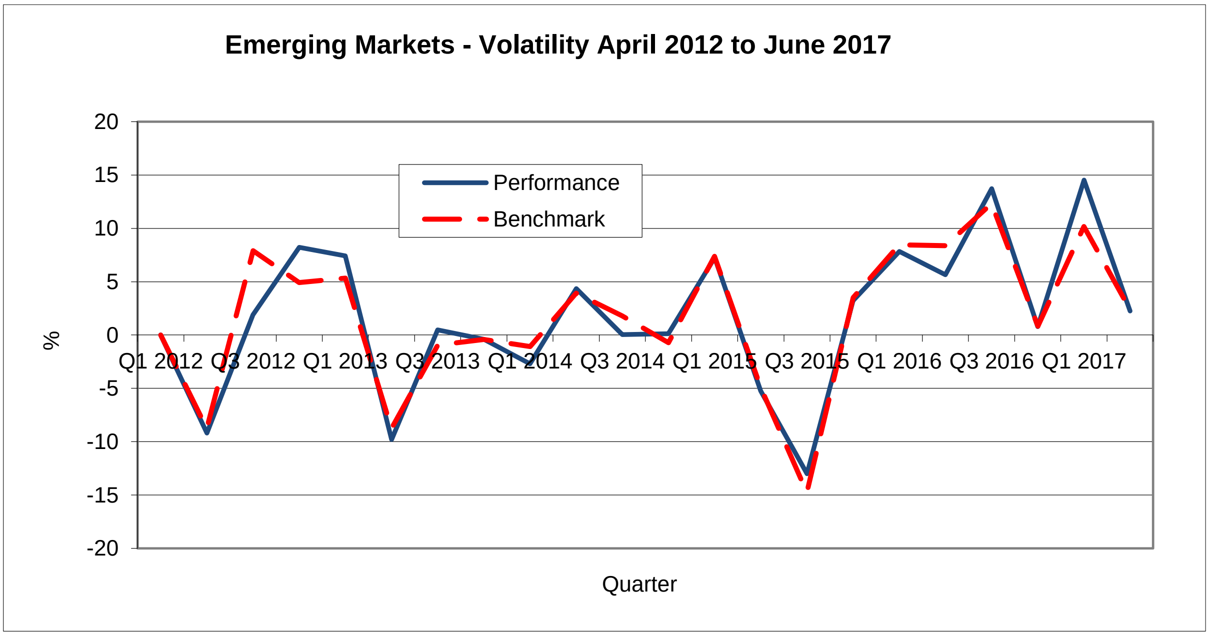
Emerging Market Equity

5.4 The performance of JP Morgan for the three months to 30 June 2017is summarised below.

	Market Value 01-Apr-17	Market Value 30-Jun-17	3 months to 30 June 2017	
	(£000's)	(£000's)	Performance %	Benchmark %
JPM	91,232	93,289	2.25	2.40

5.5 The return of 2.25% for the three months to 30 June 2017 was marginally below the benchmark of 2.40% by 0.15%. The fund manager comments that technology, Turkey and China were the largest contributors to performance, while Russia was the biggest negative as falling oil prices put pressure on this market. With the likelihood of rising inflation it has been sought to limit the impact on the portfolio from lower growth by reducing underweight holdings in classic growth stocks like Tencent, Alibaba and JD.com, which outperform when growth is scarce. This risk management helped during the quarter.

5.6 Emerging market equities are seen as the asset class which is likely to 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 30 June 2017.

5.8 The table shows the commitment the Fund 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 the Fund’s commitment. It also shows the distributions that have been returned to the Fund, the valuation as at 30 June 2017 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%	13.577	4.315	6.493
HV Direct V	3.000	2.880	96%	3.472	0.682	1.274
HarbourVest Total €m	15.000	14.280	95%	17.049	4.997	7.766
SL 2006	22.000	20.018	91%	20.795	6.886	7.662
SL 2008	17.000	15.095	89%	8.116	12.111	5.132
Standard Life Total €m	39.000	35.113	90%	28.910	18.997	12.794
Overall Total €m	**54.000**	**49.393**	**91%**	**45.959**	**23.994**	**20.560**
	$m	$m		$m	$m	$m
HV Venture VIII	15.200	14.896	98%	14.321	10.594	10.019
HV Buyout VIII	22.800	21.432	94%	23.236	11.207	13.011
HV Buyout IX	15.000	9.488	63%	3.656	9.252	3.421
HV Partnership VII (AIF)	20.000	7.750	39%	0.431	8.159	0.840
HV Venture IX	10.000	8.500	85%	2.569	9.244	3.313
Harbourvest Partners X AIF	10.000	1.050	11%	0.081	1.116	0.147
Harbourvest Partners X AIF	5.000	0.613	12%	0.038	0.614	0.039
HarbourVest Total $m	98.000	63.728	65%	44.330	50.187	30.789
SL SOF I	16.000	10.885	68%	6.024	10.460	5.599
SL SOF II	20.000	7.643	38%	3.649	9.493	5.499
SL SOF III	20.000	0.000	0%	0.000	0.000	0.000
Standard Life Total $m	56.000	18.528	33%	9.672	19.954	11.098
Overall Total $m	**154.000**	**82.256**	**53%**	**54.002**	**70.140**	**41.887**

5.9 For the three months to 30 June 2017 total drawdowns have been £1.4M and total distributions £5.6M. 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.

Private Equity Overall Performance

Manager	3 Years to 30 Jun 2017		5 Years to 30 Jun 2017	
	Dorset %	Benchmark %	Dorset %	Benchmark %
HarbourVest	23.16	7.40	18.77	10.57
Standard Life	10.47	7.40	10.69	10.57

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 2017 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.

	Amount £000s	Rate %
Call Accounts		
National Westminster Bank	3,155	0.01%
Total Call Accounts	3,155	0.01%
Money Market Funds		
Standard Life	14,300	0.24%
BNP Paribas	11,800	0.28%
Federated Prime Rate	12,500	0.24%
Deutsche	12,450	0.22%
Total Money Market Funds	51,050	0.24%
Holding Accounts		
HSBC Custodian Account	2,582	0.00%
Property Client Account	592	0.00%
Total Holding Accounts	3,174	0.00%
Total Cash / Average Return	**57,379**	**0.22%**

7. Markets in Financial Instruments Directive (MiFID) II

7.1 Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non-MiFID scope business and are categorised as 'per se professional' clients for MiFID scope business if they satisfy the MiFID large undertakings test or if they fulfil certain 'opt-up criteria'. Dorset County Council, as administering authority for the Fund, is currently categorised as a 'per se professional' client by all our investment managers and other relevant financial institutions.

7.2 Following the introduction of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, financial institutions will no longer be able to categorise a local authority as a 'per se professional client'. Instead, all local authorities must be classified as 'retail clients' unless they are opted up by each institution to 'elective professional client' status.

7.3 A move to retail client status would mean that all financial services providers like banks, brokers, advisers and fund managers will have to treat local authorities the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. This provides a higher standard of protection for the client but it also involves more work and potential cost for both the firm and the client, for the purpose of proving to the regulator that all such requirements have been met.

7.4 Even if the institution secures the ability to deal with retail clients, the range of instruments it can make available to the client will be limited to those defined under Financial Conduct Authority (FCA) rules as 'non-complex' which would exclude many of the asset classes currently included in LGPS fund portfolios. In many cases managers will no longer be able to even discuss certain asset classes and vehicles with the authority as a retail client.

7.5 However, MiFID II does allow retail clients which meet certain conditions to elect to be treated as professional clients (to ‘opt up’), subject to a quantitative and a qualitative test assessment by the financial institution. The election to professional status must be completed with all financial institutions prior to 3 January 2018. Failure to do so by local authorities would result in the financial institution having to take ‘appropriate action’ which could include a termination of the relationship at a significant financial risk to the authority.

7.6 Authorities are not required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status, for example, if the membership of the Committee changed significantly resulting in a loss of experience, or if the relationship with the authority’s investment advisor was terminated.

7.7 LGPS pools will be professional investors in their own right so will not need to opt up with the external institutions they use. Local authorities will however need to opt up with their LGPS pool in order to access the full range of services and sub-funds on offer.

7.8 Therefore, in order to continue to implement the Fund’s investment strategy after 3 January 2018, applications for election to be treated as a professional clients need to be submitted to all financial institutions with whom there is an existing or potential relationship in relation to the investments of the Fund as soon as possible.

Richard Bates
Pension Fund Administrator
September 2017