DORSET COUNTY PENSION FUND

UK Equity
Report for 12 months ending 30 June 2017

- Internal Managers Report
- Valuation Report
- Transaction Report

Dorset County Pension Fund Committee – 13 September 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 (£702.4M at 30 June 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 30 June 2017, the FTSE All Share index was made up of 643 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £168.3 Billion) down to the smallest in the index, The Lindsell Train Investment Trust Plc (market value £1.3 Million). Direct investment is made in the largest 350 companies, which comprises 96.4% by value of the index. Investment in the smallest companies which make up 3.6% 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 June 2017 apart from the FTSE 100 which fell 0.1% (10 points). The Small Cap ex Investment Trusts was the best performing major UK index rising 2.9% (207 points). In comparison, performance from major world indices was equally strong with the Hang Seng the best performing index rising 6.8% (1,648 points). The exceptions were the CAC 40 which was flat and the Shanghai Composite which fell 0.9% (30 points).

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 28.4% (1,637 points), whilst the FTSE100 was the worst performing UK index rising 12.4% (808 points). The Nikkei 225 was the best performing world index rising 28.6% (4,458 points), whilst the Shanghai Composite was the worst performing index rising 9.0% (263 points). The Dow Jones rose 19.1% (3,420 points) over the same period.

4.3 On 26 May 2017 the FTSE100 closed at a new all-time high of 7,547.6, whilst sterling suffered its worst falls since January and opinion polls narrowed sharply ahead of the General Election. This record high was reached after five straight weeks of gains. With 60% of the FTSE100 revenues coming from outside the UK, a weaker pound supports export-oriented companies, while making shares cheaper for overseas investors. The FTSE250 also reached a record high of 20,024.9 on 26 May 2017.

4.4 On 19 June 2017 the Dow Jones closed at a record high of 21,529.0 as technology shares rebounded from a recent bout of falls to lead the market higher. Notable gainers included Apple Inc., Facebook Inc. and Amazon.com Inc. The S & P 500 also closed at a record high of 2,453.46 on 19 June 2017. This was partly due to the strengths in the overseas markets and benefitted from political news from Europe.

Three Months to 30 June 2017

Country	Index	31/03/2017	30/06/2017	% Change
UK	FTSE100	7,322.9	7,312.7	-0.1
UK	FTSE250	18,971.8	19,340.2	1.9
UK	FTSE350	4,046.6	4,055.0	0.2
UK	Small Cap	5,430.5	5,585.0	2.8
UK	Small Cap ex Investment Trusts	7,196.1	7,402.6	2.9
UK	All Share	3,990.0	4,002.2	0.3
Japan	Nikkei225	18,909.3	20,033.4	5.9
US	Dow Jones	20,663.2	21,349.6	3.3
Hong Kong	Hang Seng	24,116.6	25,764.6	6.8
France	Cac 40	5,122.5	5,120.7	0.0
Germany	Dax	12,312.9	12,325.1	0.1
China	Shanghai Composite	3,222.5	3,192.4	-0.9

Twelve Months to 30 June 2017

Country	Index	30/06/2016	30/06/2017	% Change
UK	FTSE100	6,504.3	7,312.7	12.4
UK	FTSE250	16,271.1	19,340.2	18.9
UK	FTSE350	3,573.9	4,055.0	13.5
UK	Small Cap	4,471.6	5,585.0	24.9
UK	Small Cap ex Investment Trusts	5,765.6	7,402.6	28.4
UK	All Share	3,515.5	4,002.2	13.8
Japan	Nikkei225	15,575.9	20,033.4	28.6
US	Dow Jones	17,930.0	21,349.6	19.1
Hong Kong	Hang Seng	20,794.4	25,764.6	23.9
France	Cac 40	4,237.5	5,120.7	20.8
Germany	Dax	9,680.1	12,325.1	27.3
China	Shanghai Composite	2,929.6	3,192.4	9.0

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:

Performance - Internally Managed

Period	Dorset %	Index %	Relative %
3 months to 30/06/2017	1.24	1.33	-0.09

The internally managed portfolio has underperformed the benchmark over the three month period to 30 June 2017 by 0.09% which is within the allowed tolerances of +/- 0.5%.

5.2 **FINANCIAL YEAR TO 30 JUNE 2017**

	Market Values		Performance	Benchmark	Benchmark
	31/03/2017	**30/06/2017**	**%**	**%**	**Description**
	£M	£M			
Internal	461.7	461.0	1.2	1.3	FTSE 350
AXA Framlington	185.4	190.0	2.5	1.4	All-Share
Schroders	47.6	51.4	8.1	2.9	Small Cap*
Total	694.7	702.4	2.1	1.3	

*FTSE Small Cap ex Investment Trusts

The figures for the whole UK equity portfolio show:

- The combined portfolio has outperformed its benchmark over the financial year to date by 0.8%.
- Schroders outperformed its benchmark by 5.2% and AXA Framlington outperformed its benchmark by 1.1%.

THREE AND FIVE YEAR ANNUALISED PERFORMANCE

	Three Years		Five Years	
	Performance	**Benchmark**	**Performance**	**Benchmark**
	%	**%**	**%**	**%**
Internal	7.3	7.3	10.4	10.4
AXA Framlington	6.4	7.4	10.7	10.6
Schroders	16.3	10.3	19.7	18.4

The figures for the whole UK equity portfolio show:

- Over both the three and five year period the Internally Managed Fund has matched its benchmark, within the agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 1.0% but outperformed its benchmark by 0.1% over five years.
- Schroders outperformed its benchmark over three years by 6.0% and by 1.3% 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 TO 30 JUNE 2017

	Market Value		% of Total UK Equity as at	
	31/03/17	30/06/17	31/03/16	31/12/16
Manager	£M	£M	%	%
Internal	461.7	461.0	66.4	65.6
AXA Framlington	185.4	190.0	26.7	27.1
Schroders	47.6	51.4	6.9	7.3
Total	**694.7**	**702.4**	**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 – 1st Quarter 2017/18

Performance: During the quarter, the fund outperformed the FTSE All Share with a return of 2.5% against the benchmark of 1.4%. Over the three years, the fund underperformed its benchmark by 1.0% and outperformed by 0.1% over the five year period. The general election result in the quarter was unsettling to UK equities whilst Brexit confusion creates ongoing uncertainty.

Activity: BTG, who licence, develop and commercialise pharmaceuticals had good results in the quarter and was the biggest contributor to relative performance. London Stock Exchange shares were the second best contributor to relative returns post the collapse of their merger with Deutsche Borse. Sector allocation was positive and being overweight in industrials was the most positive contributor to relative returns. ITV was the worst negative influence on relative returns as worries persist on a decline in UK advertising. Being underweight in financials was the biggest negative influence on relative returns. There were no new holdings initiated, but stocks added to included BP, Royal Dutch Shell, Bodycote, Rentokil and Severn Trent. The final balance of the BT holding was sold. Exposure to the automotive sector was reduced with part sales of GKN and Auto Trader. Exposure was reduced to the UK consumer by part sales of holdings in ITV, Rightmove, Paddy Power Betfair and Dixons Carphone.

Outlook and Strategy: The UK General Election result in June caused volatility and uncertainty at the end of the quarter. UK domestic stocks are still under pressure regarding the outlook for consumption pre Brexit and will continue to underperform due to wage inflation and rising costs. The uncertainty created by the nature of the negotiations is unhelpful for confidence and is causing much volatility. Interest rate rises are being deferred due to the fragile economic outlook with falling global inflation. The US Federal Reserve appear to have deferred interest rate rises for the moment. Better growth in Europe and some recovery in Asia Pacific is helping sentiment regarding global growth. The weak dollar appears to be a reflection on the Trump Presidency.

Schroders – 1st Quarter 2017/18

Performance and Market Summary: During the quarter, the fund returned 8.1% against the Small Cap benchmark of 2.9%. Over the twelve month period the Fund returned 45.6% against its benchmark of 28.4%. Over three years the Fund outperformed the benchmark by 6.0% and outperformed by 1.3% over the five year period.

Activity: It was an eventful quarter for the UK equity market amid uncertainty over the economic outlook, the political backdrop at home and abroad, and the future path of monetary policy to be taken by the world's central banks. UK equities on the whole performed well in May, led by the FTSE100 which rallied as sterling weakened as the polls narrowed ahead of the UK General Election, and amid a rotation back towards defensive sectors and away from cyclicals.

Many of the gains in April and May were undone in June. UK domestic cyclicals reversed as sterling weakened further as the reality of a hung parliament materialised. An increasingly uncertain outlook for consumer spending also weighed on UK-focused sectors. Meanwhile, the defensive sector fell back as long-dated government bond yields in developed markets recovered on the back of comments from European Central Bank Governor Mario Draghi and Bank of England Governor Mark Carney.

These comments were taken to signal a shift towards tighter monetary policy, while the US Federal Reserve raised base rates by a further 25 basis points.

Over the three months to 30 June 2017, the fund outperformed its benchmark by 5.2%. The most significant contributor was Blue Prism which announced a series of upgrades to its revenue expectations over the next two years. Warpaint delivered a strong set of results and upgrades to earnings forecasts at the start of May. Dart Group continued to perform well as the market warmed to its expansion plans to Stansted outside of its northern homeland of Leeds, Manchester, Edinburgh and Glasgow. Focusrite, a global music and audio production company, continued to successfully go about its business and was accordingly rewarded in the market.

With respect to detractors, the two most significant contributors were marked down for their exposure to the UK consumer, in the form of clothing trading retailer Ted Baker and affordable homes for MJ Gleeson. Another weak performer was Impellam, as the market worried that a period of economic uncertainty would hinder growth at this recruitment company. Lamprell continued to struggle as the market continued to take a determinedly sceptical view of the company’s prospects, despite it announcing a joint venture with Aramco and Hyundai, proving it with a point of entry into the Saudi Arabian market.

A more energetic approach to recycling capital in successful investments were continued over the course of the quarter. With regard to disposals, profits were taken in a number of names over the period such as Cohort, Blue Prism, iomart, Microgen and Taptica. 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. One addition was a flotation, namely K3 Capital, providing business transfer, brokerage and corporate finance services. EKF Diagnostics came under new management which promptly refocused the group on where it made the best return on its capital and sold or closed those part of its business which were impairing cash flow generation. New shares were bought upon this new strategy being declared. IQE was purchased as its ability to consistently manufacture miniature lasers for use in smartphone facial recognition technology means it is well placed to grow rapidly over the next couple of years.

Outlook and Strategy: UK equity returns were positive over the second quarter of 2017 but markedly less than those in the first quarter. This was largely a result of the combined impact of lower oil prices, a moderately higher exchange rate versus the dollar and heightened political risk after the surprise result of the General Election. Consensus aggregate earnings dipped marginally during the second quarter but still showed earnings increasing by approximately 20% in 2017. As the impact of higher oil prices unwinds, aggregate earnings growth is forecast to drop in 2018.

As the recovery in economic activity has become fully established, and growth has been maintained at a higher rate than had generally expected in the aftermath of the EU referendum, the bias in monetary policy is naturally starting to shift towards reversing some of the easing in policy conditions implemented after the referendum.

Companies are continuing to use 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 is expected to continue. Seeking organic growth will continue, pricing power where possible and avoiding companies with too much debt. Merger and

Acquisitions activity is expected to continue, particularly in light of continued sterling weakness.

Review of Activity

6.1 There was one corporate action relating to the internally managed portfolio in the quarter to 30 June 2017:

- In June 2017, the merger of Henderson Group and Janus Capital was announced. The combined entity, called Janus Henderson, was delisted from the London Stock Exchange and will continue to trade on the New York and Australian markets. Proceeds of the merger were £0.6M.

6.2 Trading activity on the internally managed portfolio took place three times in the quarter:

- 19 April 2017: 8 purchases (£1.3M) and 3 sells (£0.4M), with a net purchase of £0.9M.
- 27 April 2017: 13 purchases (£0.4M) and 75 sells (£1.6M), with a net sale of £1.2M.
- 19 May 2017: 2 purchases (£0.5M) and 2 sells (£0.1M), with a net purchase of £0.4M.

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 financial year to 30 June 2017, net income from UK stock lending was £50,994 and overseas stock lending income was £13,876, giving a total of £64,870.

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September 2017