

Dorset County Pension Fund Committee – 23 November 2017

UK Equity performance for the period ending 30 September 2017

1. Purpose of the Report

1.1 To review the performance 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 (£716.1M at 30 September 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 September 2017, the FTSE All Share index was made up of 642 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £186.6 Billion) down to the smallest in the index, HSS Hire Group Plc (market value £22.8 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 positive performance from the UK markets in the six months to September 2017 apart from the FTSE 100 which fell 0.7% (50 points). The Small Cap ex Investment Trusts was the best performing major UK index rising 6.5% (464 points). In comparison, performance from major world indices was stronger with the Nikkei 225 the best performing index rising 17.8% (1,156 points), whilst the Shanghai Composite was the worst performer rising 3.9% (126 points). The Dow Jones rose 8.4% (1,175 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 17.8% (1,156 points), whilst the FTSE 100 was the worst performing UK index rising 6.9% (474 points). The Nikkei 225 was the best performing world index rising 23.8% (3,907 points), whilst the Shanghai Composite was the worst performing index rising 11.5% (344 points). The Dow Jones rose 22.4% (4,097 points) over the same period.

4.3 In September, The Dow Jones reached a record high of 22,412.6, mainly due to improving corporate earnings, a strong labour market and an environment marked by both low interest rates and low inflation. In Europe, the Dax reached a record high of 12,828.9 in September 2017 as relatively attractive valuations and optimism about global economic growth continued to appeal to investors. Both the Dow Jones rising 13.4% and the Dax rising 11.7% both outperformed the FTSE 100 which only rose 3.2% over the same period.

Six months to 30 September 2017

Country	Index	31/03/2017	30/09/2017	% Change
UK	FTSE100	7,322.9	7,372.8	0.7
UK	FTSE250	18,971.8	19,874.8	4.8
UK	FTSE350	4,046.6	4,101.7	1.4
UK	Small Cap	5,430.5	5,712.4	5.2
UK	Small Cap ex Investment Trusts	7,196.1	7,659.9	6.4
UK	All Share	3,990.0	4,049.9	1.5
Japan	Nikkei225	18,909.3	20,356.3	7.7
US	Dow Jones	20,663.2	22,405.1	8.4
Hong Kong	Hang Seng	24,116.6	27,554.3	14.3
France	Cac 40	5,122.5	5,329.8	4.0
Germany	Dax	12,312.9	12,828.9	4.2
China	Shanghai Composite	3,222.5	3,348.9	3.9

Twelve Months to 30 September 2017

Country	Index	30/09/2016	30/09/2017	% Change
UK	FTSE100	6,899.3	7,372.8	6.9
UK	FTSE250	17,871.4	19,874.8	11.2
UK	FTSE350	3,812.4	4,101.7	7.6
UK	Small Cap	4,974.9	5,712.4	14.8
UK	Small Cap ex Investment Trusts	6,503.9	7,659.9	17.8
UK	All Share	3,755.3	4,049.9	7.8
Japan	Nikkei225	16,449.8	20,356.3	23.7
US	Dow Jones	18,308.2	22,405.1	22.4
Hong Kong	Hang Seng	23,297.2	27,554.3	18.3
France	Cac 40	4,448.3	5,329.8	19.8
Germany	Dax	10,511.0	12,858.9	22.3
China	Shanghai Composite	3,004.7	3,348.9	11.5

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
6 months to 30/09/2017	3.92%	3.46%	0.46%
12 months to 30/09/2017	11.88%	11.72%	0.16%
3 years to 30/09/2017 p.a.	8.56%	8.37%	0.19%
5 years to 30/09/2017 p.a.	10.00%	9.87%	0.13%

5.2 FINANCIAL YEAR TO 30 SEPTEMBER 2017

	Market Values		Performance	Benchmark	Benchmark
	31/03/2017	30/09/2017	%	%	Description
	£M	£M			
Internal	461.7	466.3	3.9	3.5	FTSE 350
AXA Framlington	185.4	196.1	5.7	3.6	All-Share
Schroders	47.6	53.7	13.1	6.4	Small Cap*
Total	694.7	716.1	5.1	3.2	

*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 1.9%.
- Schroders outperformed its benchmark by 6.7% and AXA Framlington outperformed its benchmark by 2.1%.

THREE AND FIVE YEAR ANNUALISED PERFORMANCE

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
	%	%	%	%
Internal	8.6	8.4	10.0	9.9
AXA Framlington	7.4	8.5	10.1	10.0
Schroders	18.7	12.4	19.2	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 benchmark by 0.2% and 0.1% over three and five years respectively, within the agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 1.1% but outperformed its benchmark by 0.1% over five years.
- Schroders outperformed its benchmark over three years by 6.3% and by 2.4% 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 SEPTEMBER 2017

<u>Manager</u>	<u>Market Value</u>		<u>% of Total UK Equity as at</u>	
	<u>31/03/17</u>	<u>30/09/17</u>	<u>31/03/17</u>	<u>30/09/17</u>
	<u>£M</u>	<u>£M</u>	<u>%</u>	<u>%</u>
Internal	461.7	466.3	66.5	65.1
AXA Framlington	185.4	196.1	26.7	27.4
Schroders	47.6	53.7	6.9	7.5
Total	694.7	716.1	100.0	100.0

5.4 The external manager's commentary for both AXA Framlington and Schroders is summarised below:

AXA Framlington – 2nd Quarter 2017/18

Performance: During the quarter, the fund outperformed the FTSE All Share with a return of 3.3% against the benchmark of 2.1%. Over the three years, the fund underperformed its benchmark by 1.1% and matched the index over the five year period.

Activity: It was a good quarter, outperforming the All Share Index. RPC, a design and engineering company, had good results in the quarter and was the biggest contributor to relative returns. Not owning British American Tobacco was the second most positive influence on relative returns. Being underweight in consumer goods was the biggest positive influence on relative returns. Negatives to performance included Paddy Power Betfair which was the worst negative influence on relative returns whilst sector allocation was also a very small negative. Being underweight in oil and gas was the most negative contributor to relative returns. There were no new holdings initiated in the quarter, but stocks added to included Bodycote, Diageo, Smith and Nephew and Applegreen. The final tranche of Dixons Carphone was sold. Sales included holdings in ITV, Rightmove, Paddy Power Betfair, St. James Place, Autotrader and RPC.

Outlook and Strategy: Brexit negotiations continue to affect UK consumer confidence, especially witnessed in high ticket items such as automobiles and household furniture. Interest rates are expected to rise in the USA and UK, but slowly. UK dividend growth of 7% per annum is expected in the UK in 2017 helps underpin share valuation.

Schroders – 2nd Quarter 2017/18

Performance and Market Summary: During the quarter, the fund returned 4.6% against the Small Cap benchmark of 3.5%. Over the twelve month period the Fund returned 31.5% against its benchmark of 17.8%. Over three years the Fund outperformed the benchmark by 6.4% and outperformed by 2.5% over the five year period.

Activity: Over the twelve months to 30 September 2017, the fund outperformed its benchmark by 13.8%, whilst over the quarter, the fund outperformed its benchmark by 1.1%. The most significant contributor was Microgen which in its very strong interim results in July 2017, disclosed organic revenue growth of 39% on a constant currency basis with group adjusted operating profit increasing by 42%. IQE again performed well as it continued to report very strong demand for its laser technology for use in smartphones but also commented that interest in its technology to change the colour of laser light for use in fibre optic telecommunications was robust. Over the course of the period, Games Workshop had two strong trading statements which delivered meaningful upgrades and the shares were marked up. Blue Prism performed well again as demand for the company's software robots remained strong. Detractors to performance was in the UK consumer sector due to the uncertainty caused by the UK General Election and its aftermath led to profit warnings from UP Global Sourcing, Epwin and Warpaint. Both Dart and Focusrite's share price fell whilst Impellam was another weak performer and was affected by the NHS freezing spending on recruitment. With regard to disposals, profits were taken in a number of names over the period and the total holdings of Blue Prism and iomart were sold. Profits were also taken in Dart and Medica but holdings were still left in both stocks. The proceeds of these divestments were invested in a number of new names as well as topping up existing holdings where there was still profit to be had. Two additions were flotations, Charter Court, a UK challenger bank specialising in buy-to-let space. The other was Quiz, a fast fashion retailer specialising in targeting females in the 18-25 year age bracket. Having established a traditional and online presence in major metropolitan areas of the UK, the group is now seeking to expand internationally. REDT Energy was added to the portfolio as the age of distributed power generation using intermittent

technologies such as solar and wind is stimulating interest and demand for the group's unique power storage technology.

Outlook and Strategy: Over the course of the year, the momentum in mid-sized companies has continued to be strong, based on the results which the companies have been reporting. There has also been double digit increases in dividends. In the UK, economic growth has remained positive but concerns exist that as a country the reliant on the consumer spending is too reliant. Against this, employment continues to increase and it looks as though the real wage trend is much better than that measured by the ONS. If, as expected, inflation begins to fall towards the year end, this should also help to ease pressure on UK households. As the recovery in economic activity has become fully established and growth has been maintained at a higher rate than had generally been 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 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, pricing power where possible and avoiding companies with too much debt will continue. Merger and Acquisitions will remain high, particularly in light of continued sterling weakness.

Summary of Trading Activity (see Annex 1)

- 6.1 There was four corporate actions relating to the internally managed portfolio in the quarter to 30 September 2017:
- In July 2017, WS Atkins were taken over by SNC-Lavalin Group Inc for £0.4M.
 - In July 2017, Shawbrook Group Plc were taken over by Martin Bidco for £0.1M.
 - In September 2017, Berendsen Plc was taken over by Elis FP for £0.4M.
 - In September 2017, Micro Focus had a Return of Capital for £0.1M.
- 6.2 Trading activity on the internally managed portfolio took place twice in the quarter:
- 24 July 2017: 9 purchases (£2.9M) and 12 sells (£2.1M), with a net purchase of £0.8M. This was due mainly to the UK Government selling its remaining stake in Lloyds Banking Group, necessitating in a purchase of this stock for £0.5M. The FTSE UK Index Quarterly Review June 2017 affected trading where six new stocks entered the index and six stocks were deleted.
 - 14 August 2017: 25 purchases (£5.4M) and 177 sells (£6.1M), with a net sale of £0.7M. This trade was mainly due to a large purchase of British American Tobacco shares (£4.0M) after the company completed its acquisition of Reynolds American Inc. In order to balance the portfolio a large number of stocks were needed to be sold.
- 7 **Stock Lending**
- 7.1 Stock lending of equities is managed in the UK by HSBC, and on global equities by each manager. For the financial year to 30 September 2017, net income from UK stock lending was £101,613 and was £14,171 from overseas giving a total of £115,784

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November 2017