Dorset County Pension Fund Committee – 28 February 2018

UK Equity performance for the period ending 31 December 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 (£744.9M at 31 December 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 December 2017, the FTSE All Share index was made up of 641 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £206.6 Billion) down to the smallest in the index, Up Global Sourcing Holdings Plc (market value £31.0 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 three months to 31 December 2017. The FTSE100, the FTSE250 and the FTSE350 were the best performing major UK indices rising 4.3%. In comparison, performance from major world indices were mixed with the Nikkei225 the best performer rising 11.8% (2,409 points), whilst the Shanghai Composite was the worst performer falling 1.2% (42 points) over the same period. The Dow Jones rose 10.3% (2,314 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 15.6% (1,062 points), whilst the FTSE100 was the worst performing UK index rising 7.6% (545 points). The Nikkei225 was the best performing world index rising 36.0% (3,651 points), whilst the Shanghai Composite was the worst performing index rising 6.6% (204 points). The Dow Jones rose 25.1% (4,957 points) over the same period.

4.3 The FTSE100 ended 2017 at a new record high of 7,687.8 boosted once again by strong mining stocks and the weak pound. The index has risen 3.9% since the beginning of December 2017 and was up 7.6% over the calendar year. Housebuilders Berkeley Group and Persimmon were among the best performing companies on the FTSE100 in 2017. The FTSE250, which is mainly comprised of UK focused companies, closed at an all-time high of 20,726.3 on 29 December 2017, a 14.7% rise over the calendar year.

4.4 In the US, the Dow Jones, the S&P 500 and the Nasdaq all recorded record highs in 2017. The Dow Jones rose 25.1% over the year to reach its record high of 24,837.5 on 28 December 2017. This was due to a tax package which would boost company profits with cuts to corporate taxes and the positive global economic growth. The S&P500 rose to 2,690.2 on 18 December 2017, a rise of 19.4% over the calendar year, with the information technology the best performing sector. The Nasdaq rose 28.2% to its record high of 6,994.8 on 18 December 2017 over the calendar year with large stocks like Facebook, Amazon and Netflix performing well. In the Eurozone Germany's Dax index also reached a record high of 13,478.9 in November 2017, a rise of 12.5% over the calendar year.

Three months to 31 December 2017

Country	Index	30/09/2017	31/12/2017	% Change
UK	FTSE100	7,372.8	7,687.8	4.3
UK	FTSE250	19,874.8	20,726.3	4.3
UK	FTSE350	4,101.7	4,277.0	4.3
UK	Small Cap	5,712.4	5,911.9	3.5
UK	Small Cap ex Investment Trusts	7,659.9	7,864.1	2.7
UK	All Share	4,049.9	4,221.8	4.2
Japan	Nikkei225	20,356.3	22,764.9	11.8
US	Dow Jones	22,405.1	24,719.2	10.3
Hong Kong	Hang Seng	27,554.3	29,919.2	8.6
France	Cac 40	5,329.8	5,312.6	-0.3
Germany	Dax	12,828.9	12,917.6	0.7
China	Shanghai Composite	3,348.9	3,307.2	-1.2

Twelve months to 31 December 2017

Country	Index	31/12/2016	31/12/2017	% Change
UK	FTSE100	7,142.8	7,687.8	7.6
UK	FTSE250	18,077.3	20,726.3	14.7
UK	FTSE350	3,931.7	4,277.0	8.8
UK	Small Cap	5,143.2	5,911.9	14.9
UK	Small Cap ex Investment Trusts	6,802.3	7,864.1	15.6
UK	All Share	3,873.2	4,221.8	9.0
Japan	Nikkei225	19,114.4	22,764.9	19.1
US	Dow Jones	19,762.6	24,719.2	25.1
Hong Kong	Hang Seng	22,000.6	29,919.2	36.0
France	Cac 40	4,862.3	5,312.6	9.3
Germany	Dax	11,481.1	12,917.6	12.5
China	Shanghai Composite	3,103.6	3,307.2	6.6

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 31/12/2017	4.88%	4.99%	-0.11%
12 months to 31/12/2017	13.04%	12.91%	0.13%
3 years to 31/12/2017 p.a.	9.99%	9.93%	0.06%
5 years to 31/12/2017 p.a.	10.25%	10.13%	0.12%

5.2 **Financial Year To 31 December 2017**

	Market Values £M		Performance	Benchmark	Benchmark Description
	31/03/2017	31/12/2017			
Internal	461.7	485.7	8.99%	8.63%	FTSE 350
AXA Framlington	185.4	201.9	8.80%	8.72%	All-Share
Schroders	47.6	57.3	20.76%	9.28%	Small Cap*
Total	694.7	744.9	9.84%	7.99%	

The figures for the whole UK equity portfolio show:

- The combined portfolio has outperformed its benchmark over the financial year to date by 1.85%.
- Schroders outperformed its benchmark by 11.48% and AXA Framlington outperformed its benchmark by 0.08%.

Three And Five Year Annualised Performance

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
Internal	10.0%	9.9%	10.3%	10.1%
AXA Framlington	7.9%	10.1%	10.5%	10.3%
Schroders	21.3%	13.7%	19.8%	15.5%

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 0.1% and 0.2% over three and five years respectively, within the agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 2.2% but outperformed its benchmark by 0.2% over five years.
- Schroders outperformed its benchmark over three years by 7.6% and by 4.3% 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 31 March 2017 to 31 December 2017

	Market Value		% of Total UK Equity as at	
	31/03/17	31/12/17	31/03/17	31/12/17
Manager	£M	£M	%	%
Internal	461.7	485.7	66.5	65.2
AXA Framlington	185.4	201.9	26.7	27.1
Schroders	47.6	57.3	6.9	7.7
Total	**694.7**	**744.9**	**100.0**	**100.0**

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

AXA Framlington – 3rd Quarter 2017/18

Performance: During the quarter, the fund underperformed the FTSE All Share with a return of 2.9% against the benchmark of 5.0%. For twelve months, the fund returned 10.4% against a benchmark of 13.1%. Over the three years, the fund underperformed its benchmark by 2.2% but outperformed the index over the five year period by 0.2%.

Activity: Paddy Power Betfair was the biggest contributor to relative returns in the quarter. BBA Aviation Plc benefitted from tax cuts and a stronger economy in the USA and was a positive to the fund. Being underweight in Utilities was the biggest positive influence on sector relative returns. A negative to performance were RPC, a design and engineering company who were de-rated and was the biggest negative contributor to relative returns. Sector allocation was a negative and being overweight in industrials was the biggest negative contributor to relative returns. A new holding in Coats Group was established. Coats is the global leader in industrial threads with greater than 20% world market share and three times larger than its nearest competitor. The final tranche of Severn Trent was sold. Others holdings sold included RPC, Paddy Power Betfair, Rightmove, Hunting and Essentra.

Outlook and Strategy: Brexit negotiations continue to affect UK consumer confidence, especially witnessed in high price items such as automobiles and household furniture. US tax changes are leading to upward earnings expectations in many sectors. Dividend growth is still very positive in the UK. There is good accelerating global GDP growth, but because of Brexit influences, the UK is lagging behind.

Schroders – 3rd Quarter 2017/18

Performance and Market Summary: During the quarter, the fund returned 6.8% against the Small Cap benchmark of 2.7%. Over the twelve month period the Fund returned 31.6% against its benchmark of 15.6%. Over three years the Fund outperformed the benchmark by 7.6% and by 4.2% over the five year period.

Activity: First Derivatives, a world leading provider of "Big Data" analytics technology, was the top contributor. Growth at the group's financial technology (finTech) artificial intelligence (AI) remains robust, with software sales up 31%. First Derivative is a high quality business which is simultaneously making good progress at driving future growth. The company signed contracts with multiple new sectors in 2017, capitalising on Big Data opportunities outside of FinTech and marketing technology, (the group's other core segment. It has also launched a range of initiatives to enhance machine learning capabilities, which is rapidly growing area of AI. Floor covering specialists Victoria performed very well as the company reported robust interim results. The market also welcomed two acquisitions in the hard flooring market, further enhancing the company's global growth prospects. Victoria has a good track record of acquisitive led growth and is also benefiting from a number of self-help initiatives at its UK business. Travel and logistics group Dart was another top contributor as strong interim results reflected the success of its compelling mass market travel offering to a financially stretched UK consumer. The company began operating out of Birmingham and London Stansted this year, expanding away from its North of England bases which helped drive a 41% increase in the number Jet2holidays packages to 1.81 million. Sentiment towards the shares was further supported following the collapse of competitor Monarch Airlines and by Ryanair being forced to cancel flights due to staffing issues. Shares in miniatures manufacturer Games Workshop recaptured their very strong momentum as a half-year trading update revealed the recent positive trends are continuing into 2018. This globally diversified business is reaping the rewards of getting creativity, manufacturing and distribution right. Not owning heavily indebted outsourcing group Carillion was a benefit. The company unveiled its third profit warning in five months and cautioned that it would breach its banking term. Carillion has subsequently collapsed after failing to reach an agreement with its lenders. On the negative side, LED lighting products manufacturer Dialight performed poorly after warning that short term production issues would dampen profits. Defence and security business Cohort was another negative despite reporting good interim results. The company has a strong offering in cyber and submarine technology, being two priority areas in NATO defence planning. Following a very strong performance the holding in software robotics specialist Blue Prism was sold. The shares have risen substantially since the holding was bought at the time of the initial public offering (IPO) in March 2016. The holding in ten-pin bowling specialist Hollywood Bowl was reduced which was another very successful investment made at the time of the IPO in September 2016. Advantage was taken of favourable IPO valuation to add Sumo Group to the portfolio, a provider of creative and development services to the video games and entertainment industries. A position in fellow Sheffield based technology company ITM Power was bought, which specialises in clean fuels. Its hydrogen cell systems will benefit from good adoption levels in public transport. The IPO for Alpha Financial Markets Consulting was participated in. This specialist provider of consultancy services to the asset and wealth management industry has a good track record of delivering consistent growth and high margins.

<u>Outlook and Strategy</u>: UK equity returns have averaged around 12% per annum since the economy emerged from recession in 2009. This is broadly similar to the pre-recession average but lower than the corresponding return from the S&P 500, which has averaged around 15% per annum over the same period. As policy interest rates have remained well below pre-crisis levels, long term interest rates have also naturally remained lower than normal. With US economic growth expected to be higher than in the UK over the next 2-3 years, and policy interest rates in the US have increased relative to the UK, the spread between US and UK yields has widened over the past 12-18 months.

Summary of Trading Activity

6.1 There was five corporate actions relating to the internally managed portfolio in the quarter to 31 December 2017:

- In October 2017, Land Securities had a Return of Capital for £0.1M.
- In October 2017, Amec Foster Wheeler were taken over by John Wood Group Plc for £0.4M.
- In October 2017, Kennedy Wilson Europe Real Estate Plc was sold for £0.1M.
- In December 2017, Paysafe Plc were taken over by PI UK Bidco Ltd for £0.6M.

- In December 2017, Kennedy Wilson Holdings Inc. (US) for £0.1M.

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

- 16 October 2017: 16 purchases (£1.7M) and 28 sells (£1.3M), with a net purchase of £0.4M. The FTSE UK Index Quarterly Review September 2017 affected this trade with three new stocks entering the index and three stocks being deleted.
- 27 November 2017: 6 purchases (£0.8) and 15 sells (£0.3M), with a net purchase of £0.5M. This was required to realign the passive fund with the index.
- 19 December 2017: 5 purchases (£0.9M) and 5 sells (£0.5M), with a net purchase of £0.4M. This was required to realign the passive fund with the index.

7 Stock Lending

7.1 Stock lending of equities was managed in the UK by HSBC, and on global equities by each manager up to the end of November 2017. In November 2017, The Brunel Pension Partnership started using State Street as its third party administrator and custodian. During the change of custodian stock lending was stopped so the transition of stocks could be transferred from HSBC to State Street. Due to this no stock lending income was received in December 2017. Stock lending started again with State Street in late January 2018. For the financial year to 31 December 2017, net income from UK stock lending was £131,745 and was £32,378 from overseas giving a total of £164,123.

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