Dorset County Pension Fund Committee 21 June 2018

UK Equity performance for the period ending 31 March 2018

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 (£647.2M at 31 March 2018) 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 2018, the FTSE All Share index was made up of 638 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £187.9 Billion) down to the smallest in the index, Carpetright Plc (market value £20.1 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 negative performance from the UK markets in the three months to 31 March 2018. The FTSE100 was the worst performer during the quarter, falling 8.2% (631 points). The UK market had fallen out of favour with global investors, and the composition of the index had been detrimental to performance. The absence of large information technology companies in the UK and the dominance of "old world" industries such as financials, miners and energy companies in the index led to some of this underperformance against other indices. The relative strength of sterling was also a reason for performance during the quarter. The FTSE Small Cap was the best performing UK index despite falling 5.4% (319 points). In comparison, performance from major world indices also performed poorly with the Hang Seng the best performer rising 0.6% (174 points) whilst the Dow Jones fell 2.5% (616 points) over the same period. In the US, the weakest performance was in Telecoms and Consumer Staples, although most sectors fell. Technology and Consumer Discretionary stocks were the only positives over the quarter.

4.2 Over the twelve month period, there was mixed performance from UK markets. The FTSE Small Cap index was the best performer rising 3.0% (163 points), whilst the FTSE100 was the worst performing UK index falling 3.6% (266 points). The Hang Seng was the best performing world index rising 24.8% (5,982 points) over the twelve month period whilst the Dow Jones rose 16.6% (3,440 points) over the same period.

Three months to 31 March 2018

4.3

Country	Index	31/12/2017	31/03/2018	% Change
UK	FTSE100	7,687.8	7,056.6	-8.2
UK	FTSE250	20,726.3	19,460.5	-6.1
UK	FTSE350	4,277.0	3,941.2	-7.9
UK	Small Cap	5,911.9	5,593.1	-5.4
UK	Small Cap ex Investment Trusts	7,864.1	7,354.9	-6.5
UK	All Share	4,221.8	3,894.2	-7.8
Japan	Nikkei225	22,764.9	21,454.3	-5.8
US	Dow Jones	24,719.2	24,103.1	-2.5
Hong Kong	Hang Seng	29,919.2	30,093.4	0.6
France	Cac 40	5,312.6	5,167.3	-2.7
Germany	Dax	12,917.6	12,096.7	-6.4
China	Shanghai Composite	3,307.2	3,168.9	-4.2

Twelve months to 31 March 2018

Country	Index	31/03/2017	31/03/2018	% Change
UK	FTSE100	7,322.9	7,056.6	-3.6
UK	FTSE250	18,971.8	19,460.5	2.6
UK	FTSE350	4,046.6	3,941.2	-2.6
UK	Small Cap	5,430.5	5,593.1	3.0
UK	Small Cap ex Investment Trusts	7,196.1	7,354.9	2.2
UK	All Share	3,990.0	3,894.2	-2.4
Japan	Nikkei225	18,909.3	21,454.3	13.5
US	Dow Jones	20,663.2	24,103.1	16.6
Hong Kong	Hang Seng	24,111.6	30,093.4	24.8
France	Cac 40	5,122.5	5,167.3	0.9
Germany	Dax	12,312.9	12,096.7	-1.8
China	Shanghai Composite	3,222.5	3,168.9	-1.7

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 31/03/2018	-7.09%	-6.95%	-0.14%
12 months to 31/03/2018	1.26%	1.07%	0.19%
3 years to 31/03/2018 p.a.	5.84%	5.72%	0.12%
5 years to 31/03/2018 p.a.	6.59%	6.45%	0.14%

Financial Year To 31 March 2018

	Market Values £M		Performance	Benchmark	Benchmark Description
	31/03/2017	31/03/2018			
Internal	461.7	401.4	1.26%	1.07%	FTSE 350
AXA Framlington	185.4	190.7	2.88%	1.25%	All-Share
Schroders	47.6	55.1	16.19%	2.21%	Small Cap*
Total	694.7	647.2	3.01%	1.22%	

*FTSE Small Cap ex Investment Trusts

5.2 The figures for the whole UK equity portfolio show:

- The combined portfolio has outperformed its benchmark over the financial year to date by 1.79%.
- Schroders outperformed its benchmark by 13.98% and AXA Framlington outperformed its benchmark by 1.63%.

Three And Five Year Annualised Performance

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
Internal	5.8%	5.7%	6.6%	6.5%
AXA Framlington	6.1%	5.9%	8.0%	6.6%
Schroders	17.0%	9.0%	16.4%	11.6%

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%, within the agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 0.2% but outperformed its benchmark by 1.4% over five years.
- Schroders outperformed its benchmark over three years by 8.0% and by 4.8% over five years.

The table below shows how the three UK Equity manager's valuations have changed over the financial year to 31 March 2018.

Market Value 31 March 2017 to 31 March 2018

	Market Value		% of Total UK Equity as at	
	31/03/17	31/03/18	31/03/17	31/12/17
Manager	£M	£M	%	%
Internal	461.7	401.4	66.5	62.0
AXA Framlington	185.4	190.7	26.7	29.5
Schroders	47.6	55.1	6.9	8.5
Total	**694.7**	**647.2**	**100.0**	**100.0**

The commentaries for the quarter from AXA Framlington and Schroders are summarised below:

5.3 **AXA Framlington – 4th Quarter 2017/18**

Performance: During the quarter, the fund outperformed the FTSE All Share with a return of -5.5% against the benchmark of -6.9%. For twelve months, the fund returned 2.8% against a benchmark of 1.3%. Over the three years, the fund underperformed its benchmark by 0.2% but outperformed the index over the five year period by 1.4%.

Activity: With the takeover bid for GKN by Melrose GKN was the biggest contributor to relative returns. On a stock level not owning British American Tobacco was beneficial to relative returns. Sector allocation was positive; being overweight in Industrials was the most positive contributor and being underweight in Consumer Goods was a positive influence on sector relative returns. IMI, which did not meet expectations when reporting full year results, was the biggest detractor to relative returns. Coats Group Plc and Eddie Stobart Logistics Plc was added to. A new holding in Stirling Industries was established. Stirling's management team were previously at Melrose Plc and have raised capital through an Initial Public Offering (IPO) to acquire industrial companies. No holding was sold outright. Part holdings were sold in RPC Group Plc, Paddy Power Betfair Plc, Rightmove Plc, St James's Place Plc and Essentra Plc.

Outlook and Strategy: Brexit news continues to weaken UK consumer confidence. Rising bond yields are undermining confidence in equities. US economic data leads to expectations of further quantitative tightening.

5.4 **Schroders – 4th Quarter 2017/18**

Performance and Market Summary: During the quarter, the fund returned -3.8% against the Small Cap benchmark of -6.5%. Over the twelve month period the Fund returned 16.2% against its benchmark of 2.2%. Over three years the Fund outperformed the benchmark by 8.0% and by 4.8% over the five year period.

Activity: The Fund significantly outperformed its FTSE Small Cap (ex-investment companies) benchmark over the three month period to March 2018. Corporate broker K3 Capital was the top contributor over the period on the back of a well-received year end trading update. A globally diversified retailer of proprietary audio recording devices Focusrite performed very well following a strong interim trading update. The update revealed that growth has remained robust, with sales expanding more than 25% during the first six months of the new financial year helped by increased demand over the Christmas period. Travel and logistics group Dart continued its very good run as it unveiled a highly encouraging year-end trading update. The company said it expects underlying profit before tax in 2018 to be materially ahead of market expectations and reported solid volume and pricing trends for 2019, driven by its award-winning leisure travel business. Medical enterprise software supplier Craneware also delivered double-digit share price returns following robust interim results and news of further significant contract wins with US hospital providers. Further positives included not owning the following: Debenhams (post-Christmas profit warning due to difficult seasonal trading), McBride, manufacturer of own-label consumer goods (profit warning, partly due to rising input cost inflation) and flooring distributor Headlam (full-year results suggested a challenging outlook for its UK residential business).

On the negative side, not owning engineering group Fenner and electronic components maker Laird contracted from performance. The companies respectively recommended bids from French tyre manufacturer Michelin and US private equity group Advent International. Mobile advertising platform provider Taptica International fell sharply amid concerns over the possible regulatory implications for data-driven media models

following revelations around the misuse of personal information obtained from Facebook. The shares performed poorly, despite Taptica publishing very strong full-year results. Other key detractors included consumer goods group UP Global Sourcing which had a significant UK exposure and UK men's tailoring specialist Moss Bros whose problems are stock specific and largely self-inflicted.
Following strong performances Charter Court Financial Services, a specialist lender serving the UK residential mortgage market; Victoria, floor coverings supplier; Finsbury Food, baked goods manufacturer and 10-pin bowling provider Hollywood Bowl were all sold. An IPO of leading financial administration services provider JTC was participated in, which is set to benefit from strong global in back office demand. A new position was purchased in OnTheMarket's IPO, an estate-agent owned online property portal which is poised to emulate the success of sector leader Rightmove.

Outlook and Strategy: If sentiment towards UK equities has continued to plumb new depths, the same can't be said of the currency which has staged a recovery since the Autumn of 2017. Sterling has rebounded against a backdrop of better-than-expected macroeconomic data, the decision by the Bank of England in November to reverse its 25 basis point post-referendum rate cut, and progress with Brexit negotiations. Should sterling hold onto its gains there might be some light at the end of the tunnel for the UK consumer, which has had to contend with a foreign-exchange driven inflation spike. It may be that this spike peaked at the end of last year and, against the backdrop of a buoyant jobs market (and more recently some signs that wages are picking up) the rate of generalised price increases in the economy may begin to more closely resemble wage inflation during 2018.

Some consumer micro markets are showing a marked improvement in revenue and margin trends, and the recent "surprising positive" statement from sofa retailer DFS Furniture, for example, may be testament to this. The chief executive officer of Next has also given the impression of pressures easing in the consumer market.

The outlook for the corporate sector seems less clear, and investors may wish to focus on the companies which have the power to pass on rising costs by increasing prices to end customers, without impacting volumes. It would be sensible to also avoid those with too much debt. If some of these very challenged companies do surpass lowly expectations, the rewards could be great, but so too could the risks of failure as underlined by some pretty major share price performances.

6. Summary of Trading Activity

6.1 There was five corporate actions relating to the internally managed portfolio in the quarter to 31 March 2018:

- In January 2018, Worldpay Inc was taken over by Worldpay Inc Class A for £1.6M.
- In March 2018, Booker Group Plc was taken over by Tesco Plc for £0.3M.
- In March 2018, Aldermore Group was taken over by FirstStrand Ltd for £0.2M.
- In March 2018, Ladbrokes/Coral Group Plc was taken over by GVC Plc for £0.5M.
- In March 2018, Great Portland had a Return of Capital for £0.1M.

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

- 26 January 2018: 3 purchases (£0.9M) and 4 sells (£0.9M), for a net nil trade. This was required to realign the passive fund with the index.
- 14 February 2018: 3 purchases (£0.1M) and 209 sells (£44.3M), with a net sell of £44.2M. This was undertaken to reduce the target allocation of UK equities and invest £50M into the Diversified Growth Fund Manager Baring Asset Management Limited. The shortfall in cash was taken from Internally Managed Cash (£5.8M).

- 20 March 2018: 1 purchase (£0.1M) and 62 sells (£1.6M), with a net sell of £1.5M. This was required to realign the passive fund with the index.

7. **Stock Lending**

Stock lending of equities was managed in the UK by HSBC, and on global equities by each manager up to the end of December 2017. In January 2018, responsibility for all the Fund's stock lending passed to State Street, the common custodian for all funds in the Brunel Pension Partnership. For the financial year to 31 March 2018, net income from stock lending was £187,605.

David Wilkes
Finance Manager (Treasury and Investments)
June 2018