Dorset County Pension Fund Committee 17 September 2018

UK Equity performance for the period ending 30 June 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 (£701.2M at 30 June 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 640 individual stocks ranging from Royal Dutch Shell Plc, the largest UK company (market value £222.5 Billion) down to the smallest in the index, The Lindsell Train Investment Trust Plc (market value £1.7 Million). Direct investment is made in the largest 350 companies, which comprises 96.5% by value of the index. Investment in the smallest companies which make up 3.5% 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 in the three months to 30 June 2018. The FTSE100 was the best performer rising 2.8% (581 points). The index achieved its best quarter in five years as worries over global trade eased. The FTSE Small Cap index was the worst performing UK index despite rising 5.1% (284 points) over the same period. In comparison, performance from major world indices were mixed with the Nikkei 225 rising 4.0% (850 points) whilst the Shanghai Composite fell 10.1% (322 points) over the same period. The Dow Jones rose 0.7% (168 points), down 1.8% since the start of the year, due to escalating trade tensions which affected the index more than others and left it vulnerable to further volatility.

4.2 Over the twelve month period, there were mixed performance from UK markets. The FTSE250 was the best performer rising 7.7% (1,491 points), whilst the FTSE350 was the worst performing index despite rising 5.0% (202 points). The FTSE100 rose 4.4% (324 points) over the same period. The Dow Jones was the best world index rising 13.7% (2,922 points), whilst the Shanghai Composite was the worst performing sector falling 10.8% (345 points) over the same period.

4.3 The FTSE100 reached a record high on 22 May 2018 closing at 7,859.2 due to an easing of trade tensions between the US and China and had boosted investors. The FTSE250 and the FTSE350 also reached records highs in May and June 2018 respectively.

4.4 The tables below show the performance of UK and World indices over the first quarter to June 2018.

Three months to 30 June 2018

Country	Index	31/03/2018	30/06/2018	% Change
UK	FTSE100	7,056.1	7,636.9	8.2
UK	FTSE250	19,460.5	20,831.0	7.0
UK	FTSE350	3,941.2	4,257.4	8.0
UK	Small Cap	5,593.1	5,876.8	5.1
UK	Small Cap ex Investment Trusts	7,354.9	7,873.2	7.0
UK	All Share	3,894.2	4,202.3	7.9
Japan	Nikkei225	21,454.3	22,304.5	4.0
US	Dow Jones	24,103.1	24,271.4	0.7
Hong Kong	Hang Seng	30,093.4	28,955.1	-3.8
France	Cac 40	5,167.3	5,323.5	3.0
Germany	Dax	12,096.7	12,306.0	1.7
China	Shanghai Composite	3,168.9	2,847.4	-10.1

Country	Index	30/06/2017	30/06/2018	% Change
UK	FTSE100	7,312.7	7,636.9	4.4
UK	FTSE250	19,340.2	20,831.0	7.7
UK	FTSE350	4,055.0	4,257.4	5.0
UK	Small Cap	5,585.0	5,876.8	5.2
UK	Small Cap ex Investment Trusts	7,402.6	7,873.2	6.4
UK	All Share	4,002.2	4,202.3	5.0
Japan	Nikkei225	20,033.4	22,304.5	11.3
US	Dow Jones	21,349.6	24,271.4	13.7
Hong Kong	Hang Seng	25,764.6	28,955.1	12.4
France	Cac 40	5,120.7	5,323.5	4.0
Germany	Dax	12,325.1	12,306.0	-0.2
China	Shanghai Composite	3,192.4	2,847.4	-10.8

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 30/06/2018	9.30%	9.30%	0.00%
12 months to 30/06/2018	9.50%	9.00%	0.50%
3 years to 30/06/2018 p.a.	9.70%	9.50%	0.20%
5 years to 30/06/2018 p.a.	8.90%	8.70%	0.20%

Financial Year To 30 June 2018

	Market Values £M		Performance	Benchmark	Benchmark Description
	31/03/2018	30/06/2018			
Internal	401.4	437.6	9.30%	9.30%	FTSE 350
AXA Framlington	190.7	205.5	7.70%	9.20%	All-Share
Schroders	55.1	58.1	5.40%	7.00%	Small Cap*
Total	647.2	701.2	8.51%	9.08%	

*FTSE Small Cap ex Investment Trusts

5.2 The figures for the whole UK equity portfolio show:

- The combined portfolio has underperformed its benchmark over the financial year to date by 0.57%.
- Schroders underperformed its benchmark by 1.60% and AXA Framlington underperformed its benchmark by 1.50%.

Three And Five Year Annualised Performance

	Three Years		Five Years	
	Performance	Benchmark	Performance	Benchmark
Internal	9.7%	9.5%	8.9%	8.7%
AXA Framlington	6.2%	9.6%	8.3%	8.8%
Schroders	16.4%	9.6%	16.9%	12.3%

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%, within the agreed tolerance.
- AXA Framlington underperformed their benchmark over the three year period by 3.4% and by 0.5% over five years.
- Schroders outperformed its benchmark over three years by 6.8% and by 4.6% over five years.

The table below shows how the three UK Equity manager's valuations have changed over the financial year to 30 June 2018.

Market Value to 30 June 2018

	Market Value		% of Total UK Equity as at	
	31/03/18	30/06/18	31/03/18	30/06/18
Manager	£M	£M	%	%
Internal	401.4	437.6	62.0	62.4
AXA Framlington	190.7	205.5	29.5	29.3
Schroders	55.1	58.1	8.5	8.3
Total	**647.2**	**701.2**	**100.0**	**100.0**

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

5.3 **AXA Framlington – 1st Quarter 2018/19**

Performance: During the quarter, the fund underperformed the FTSE All Share with a return of 7.7% against the benchmark of 9.2%. For twelve months, the fund returned

8.2% against a benchmark of 9.0%. Over the three years, the fund underperformed its benchmark by 3.4% and by 0.5% over the five year period.

Activity: The portfolio underperformed the benchmark in the quarter. The biggest contributor to relative returns held in the portfolio was Rentokil Initial. Not owning British American Tobacco was very beneficial to performance. Sector allocation was positive. Being overweight in industrials was the most positive contributor to relative returns, whilst being underweight in financials, especially banks, was a positive influence on sector relative returns. BTG and Elementis had disappointing results and were the biggest detractors from relative returns. There were no new holdings added in the quarter but holdings of Weir Group and Eddie Stobart Logistics were added to. The holding of Paddy Power Betfair and St James Place were finally sold. Holdings where exposure was reduced, included Elementis, Dunelm, BTG, Auto Trader, Vodafone and Lloyds Banking Group.

Outlook and Strategy: Brexit continues to weaken UK consumer confidence, whilst the US economy remains strong. Merger and Acquisition activity remains prevalent.

5.4 **Schroders – 1st Quarter 2018/19**

Performance and Market Summary: During the quarter, the fund returned 5.4% against the Small Cap benchmark of 7.0%. Over the twelve month period the Fund returned 13.5% against its benchmark of 6.4%. Over three years the Fund outperformed the benchmark by 6.8% and by 4.6% over the five year period.

Activity: The fund underperformed its FTSE Small Cap (ex-investment companies) benchmark over the three month period to June 2018. Miniatures manufacturer Games Workshop was the top individual contributor on the back of earnings upgrades for the 2018 financial year. This globally diversified business is reaping the rewards of getting creativity, manufacturing and distribution right. Since the beginning of 2016 the share price has risen by more than 5x resulting in the company being promoted into the FTSE250 just prior to the period under review. First Derivatives, a world-leading provider of “Big Data” analytics technology, was another top contributor on the back of robust full-year results. Growth at the group’s financial technology (FinTech) artificial intelligent business remains strong and the company is also capitalising on Big Data opportunities outside of FinTech and marketing technology (the other core segment). There were benefits from not holding estate agent group Countrywide or oil exploration and production business Nostrum Oil & Gas, which both warned on profits in the period.

Specialist provider of consultancy services to the asset and wealth management industry Alpha Financial Markets Consulting performed very well on the back of robust full-year results. Since their IPO in October last year Alpha has largely remained under the radar, despite having excellent exposures to secular growth trends in the asset management industry. Cosmetics supplier Warpaint London announced solid full-year results and a reassuring trading update for the new financial year, which revealed that the integration of the Retra business is on track. Sumo Group, a provider of creative and development services to the video games and entertainment industries and leading financial administration services specialist JTC generated double-digit share price returns over the period. The ongoing robust debut performances of these two recent IPOs underline the vibrancy of the new issues market. Medical enterprise software supplier Craneware was another top contributor as it benefited from increased order wins in the US healthcare market.

On the negative side, not owning UK roadside group AA was a key detractor after the shares bounced back markedly (rising more than 70% over the quarter) from what had been a materially oversold state. AA performed very poorly prior to the period under review (falling more than 50% in the previous quarter) after warning on profits and cutting the dividend, culminating in the company's demotion from the FTSE250 into the FTSE Small Cap index. The shares seemed oversold at the time, so a brief rally was likely but a position was not taken up mindful of AA's highly leveraged balance sheet. The extreme share price volatility experienced by AA has become increasingly common in the UK equity market and can have pronounced negative impact on fund performance over short time periods. In a similar vein, not owning highly financially geared oil and gas exploration and production business Premier Oil detracted from performance after it bounced back (shares rose more than 60% over the quarter) as crude oil prices recovered.

Looking through this share price volatility the holdings have continued to report resilient trading. This is certainly true of travel and logistics group Dart, which was another large detractor in the quarter. Since the period end Dart's positive share price momentum has resumed, the shares rising more than 30% in one day alone on revealing that its pre-tax profits would "substantially exceed" market expectations. A notable exception to the above-mentioned trends is Photo-Me International which fell sharply in response to a profit warning. While the photobooth operator revealed that trading for 2018 had been in-line with expectations, it also guided profit forecasts lower in 2019 as a result of overcapacity in Japan. The number of booths in Japan has increased significantly following the introduction by the government of new photo ID cards. However, the new cards (which are not compulsory) have not driven a pick-up in demand for ID photography to the degree anticipated by the industry.

New positions were established in cash equities trading venue Aquis Exchange and law firm Rosenblatt. The holding in On the Beach, a specialist retailer of budget overseas holidays online were sold following a change in EU regulations relating to package holidays which threatens one of its key competitive advantages.

Outlook and Strategy: As sterling has recovered from the lows it hit in the wake of the EU referendum, CPI inflation has fallen back and UK real wage growth has returned to positive territory. Sterling has been volatile recently following a raft of disappointing macro-economic data (most likely driven by the very cold weather in February and March) and fresh uncertainty around Brexit. However, should the currency hold onto its gains there might be better news for the UK consumer. Against the backdrop of a very low UK unemployment rate, wage growth has picked up. Consumer spending is growing year on year and should enjoy a good quarter as a result of the warm weather and England's success at reaching the semi-finals of the World Cup. For consumer facing sectors the key challenge will be to identify the beneficiaries of the increased spending, especially given that the structural changes impacting the UK high street now seems to be accelerating. The aim is to continue to seek out high-quality companies, those with organic growth, pricing power and strong management teams and avoid those with too much debt to support their business model.

6. Summary of Trading Activity

6.1 The decision was made for no trading activity in the quarter due to the ongoing transition of the Internally Managed Fund to LGIM in July 2018.

6.2 There were nine corporate actions relating to the internally managed portfolio in the quarter to 30 June 2018:

- In April 2018, Provident Financial Plc had a Rights Issue for £0.1M.
- In May 2018, GKN Plc was taken over by Melrose Plc for £0.3M.
- In May 2018, Capita Plc had a Rights Issue for £0.1M.
- In May 2018, Aveva Plc had a Return of Capital for £0.1M.
- In June 2018, Fenner Plc was taken over by Michelin for £0.2M.
- In June 2018, Glencore Plc had a Return of Capital for £0.2M.

- In June 2018, UBM Plc was taken over by Informa Plc for £0.5M.
- In June 2018, Old Mutual announced a restructuring for £1.3M.
- In June 2018, Fidessa Plc was taken over by Ion Trading for £0.3M.

7. **Stock Lending**

The total stock lending for the period ending 30 June 2018 was £37,339.

David Wilkes
Finance Manager (Treasury and Investments)
September 2018