Pension Fund Committee

Minutes of the meeting held at County Hall, Colliton Park, Dorchester, Dorset, DT1 1XJ on Thursday, 22 November 2018

Present:
John Beesley (Chairman)
Andy Canning, May Haines, John Lofts, Mark Roberts, Peter Wharf and Andrew Turner

Officer Attendance: Richard Bates (Chief Financial Officer) and David Wilkes (Senior Finance Manager - Treasury and Investments).

Manager and Advisor Attendance
Soraya Chabarek, CQS
Alan Saunders, Independent Advisor
Craig Scordellis, CQS

(Notes:These minutes have been prepared by officers as a record of the meeting and of any decisions reached. They are to be considered and confirmed at the next meeting of the Pension Fund Committee to be held on **Wednesday, 27 February 2019**.)

Apologies for Absence

44 Apologies for absence were received from Spencer Flower and Colin Jamieson.

Code of Conduct

45 There were no declarations by members of disclosable pecuniary interests under the Code of Conduct.

Minutes

46 The minutes of the meeting held on 17 September 2018 were confirmed and signed.

Public Participation

47 Public Speaking

There were no public questions received at the meeting in accordance with Standing Order 21(1).

There were no public questions received at the meeting in accordance with Standing Order 21(2).

Petitions

There were no petitions received at the meeting in accordance with the County Council's Petition Scheme.

Manager Presentation from CQS

48 The Committee received a presentation from Soraya Chabarek and Craig Scordellis, CQS, the Fund's Multi Asset Credit (MAC) manager. The presentation covered the performance and outlook for Dorset County Pension Fund's investment in the CQS Multi Asset Credit Fund.

CQS were a credit specialist and didn't do anything else. Their fund was positioned defensively, and looked to lend to good businesses and to avoid defaults. Over the last six years there had been three defaults, but with very high recovery rates.

The objective of the CQS fund was to return cash plus 4-5% over a business cycle. Since inception in December 2017, Dorset's investment had performed below this target, but it had performed well against the market.

It was a very challenging environment for credit markets, as economies moved from a sustained period of Quantitative Easing (QE) to Quantitative Tightening (QT). CQS did not believe there was a systemic banking or default crisis as there had been in 2008, when many companies only just covered their interest costs with 'free cash'. This left them exposed to the risk of being unable to service their debt should interest rates increase and/or earnings growth decrease.

Whilst the level of defaults was expected to increase, CQS believed their process was designed to avoid lending to businesses that would default. Their fund was positioned to minimise the exposure to interest rate rises and to take advantage of opportunities in floating rate debt. It was a diversified fund with a maximum 1.2% exposure to any one company.

The CQS fund's highest exposure was to Senior Secured Loans, near the top of their allowable maximum exposure of 60%. These were loans to companies with credit ratings below BBB-. Such loans were higher up the capital repayment structure than other debt, so therefore had higher recovery rates in the event of default. They had floating rates of interest, so were less exposed to the risk of increases in interest rates.

The CQS fund's second highest exposure was to Asset Backed Securities (ABS), near the top of the allowable maximum exposure of 25%. This was lending to a securitised structure, where the investment was secured against physical assets such as property. Exposure to corporate bonds was relatively low, with the exposure to High Yield Bonds at an all-time low, as the presence of many retail investors in these markets had added volatility.

The Independent Advisor noted that the defensive positioning of the fund was one of the reasons for the selection of the manager in this asset class.

The Vice-Chairman asked how CQS could achieve their target over the longer term. CQS had been able to invest at low prices, therefore the cash returns from their holdings should be sufficient to meet their target, if markets stabilised. Capital preservation was the priority in current market conditions, and the key to long term performance was to avoid defaults. Since inception CQS had not met the target but they had made a positive return unlike most index tracker funds in credit markets.

In response to questions from members, it was confirmed that all debt was bought through banks not directly from companies, and that the allocation to Europe was higher than to the Americas because borrowing in Europe had been more conservative than in the US.
The Independent Advisor asked if the Committee should be concerned about the fall in lender protections from the rise of 'convenant-lite' and 'side-car' debt arrangements. CQS replied that loan market documentation had moved towards that for bonds, and this emphasised the need for detailed analysis of default risk and recovery rates. Awareness of how loan defaults in different jurisdictions could be treated was also a very important consideration.

Noted

Governance Compliance Update

49 The Committee received the annual update on governance compliance from the Governance Advisor. He was satisfied that since his last report in November 2017 governance standards had been maintained and improved upon.

The Local Pension Board (LPB) was operating effectively and in line with its responsibilities but there was pressure from the Pensions Regulator for quarterly meetings as a minimum. It was suggested that greater reference to the LPB could be incorporated into the Fund's risk register.

The Governance Adviser confirmed that the training received by LPB members was satisfactory. The Chairman re-iterated the invitation to LPB members to attend Committee meetings and training sessions.

The Fund's annual report for 2017-18 was compliant with the regulatory requirements and reflected good practice, although it was noted that the disclosure of compliance with Myners' principles was no longer a requirement. The Finance Manager added that CIPFA were consulting on changes to the guidance for preparing the annual report so some changes to the report for 2018-19 were expected.

The Governance Advisor observed that the new investment pooling arrangements appeared to have proceeded well but continued to represent challenges in establishing a workable governance structure for the future that integrated the responsibilities of the Committee, the LPB and Brunel Ltd.

The Vice-Chairman asked about the detailed governance issues to be resolved in relation to the investment pooling arrangements. The Finance Manager replied that whilst the overall governance framework for Brunel was in place, primarily through the Brunel Oversight Board and the Client Group, the detailed process for holding Brunel to account for the performance of their investment portfolios needed to be finalised.

A member asked about the impact of local government reorganisation in Dorset on the membership of the Committee. The Fund Administrator confirmed that Dorset Council would become the administering authority for the Fund. The draft constitution for Dorset Council would be produced shortly and this would include details of the membership of all committees, including the Pension Fund Committee.

Resolved

That officers provide an update on how the performance of Brunel portfolios will be monitored.

Independent Adviser's Report

50 The Committee considered a report by the Independent Advisor that gave his views on the economic background to the Fund's investments, and the outlook for the different asset classes. He highlighted the key risks for markets and concluded that it continued to be a time for a more cautious approach to investment decisions.

In the US, the Federal Reserve had acted a little slower in tightening monetary policy than previously expected, despite a tight labour market, and inflation predicted to rise. In the UK, the fiscal stimulus in the October 2018 budget had been received positively by markets but there was continued uncertainty about the outcomes of the Brexit process.

Equity markets had performed poorly since the end of September 2018. The consensus view was that corrections to valuations would be seen in 2020, but there was uncertainty over the timing and the degree by which markets would discount

prices in advance. There were also risks in credit markets from deterioration in the quality of loans and an increased incidence of corporate failures.

It was recommended that the Fund should continue to de-risk by taking 1-2% out of equities back towards target allocation and allow cash balances to build-up in the short term. The Fund should also consider increasing its inflation hedging ratio to 50% but should pause there and not commit further collateral beyond that.

Noted

Fund Administrator's Report

51 The Committee considered a report by the Pension Fund Administrator on, and the asset allocation, valuation and performance of the Fund's assets up to 30 September 2018, and the latest indicative funding position. The value of the Fund's assets had briefly exceeded £3 billion at the end of September 2018, but the subsequent market correction meant that this had fallen back to £2.9 billion by the end of October 2018.

The funding update showed an improvement in the funding position from 83.2% at the last triennial valuation as at 31 March 2016 to an estimated 92.91% as at 30 September 2018. This was due to higher than expected increases in asset values in the intervening period.

The Independent Advisor noted the improved funding position for the Fund and the LGPS more widely. If the funding position in a corporate scheme exceeded 100% then that scheme would look to de-risk. He felt there needed to be more discussion and guidance about what the 'end-game' should be for LGPS funds.

The total return on investments was slightly ahead of the combined benchmark for the quarter, and broadly in line with the benchmark over all longer periods reported. Returns in the quarter were driven by gains in equities in overseas developed markets and private equities, with UK and emerging markets flat or negative.

The Fund was overweight in listed equities with 50.1% of assets by value at the end of September 2018 compared to the target of 45%. Officers would continue to sell equities back towards target. This would lead to higher cash balances in the short term until there were opportunities to invest in the more illiquid asset classes where the Fund was below target, namely property, private equity and infrastructure.

Performance by asset class and by manager was discussed. The underperformance since inception of Investec, one of the Fund's global equities managers, was highlighted. The performance over the last 12 months of JP Morgan, the Fund's emerging markets equities manager was also a concern. The Independent Advisor suggested that an additional comparison of Smart Beta performance against a passive Global Equities mandate would be useful.

The performance of CBRE was below benchmark for the quarter and year to date due to a change in treatment by the valuers of the 'old' Cambridge Science Park holdings. It was anticipated that this would be offset by an expected uplift in valuation of the 'new' Cambridge Science Park holdings when the development was complete. The Chairman highlighted that this investment in a development project was an exception to the Fund's general approach to property investment.

The Independent Adviser said that there were two ways of measuring the performance of CQS, the Fund's Multi Asset Credit (MAC) manager. Their performance was below target but better than the universe of their competitors.

Re-negotiations with Insight Investments, the Fund's Liability Driven Investment (LDI)

manager, had resulted in a reduction in base fees, an improved performance fee mechanism and an updated benchmark. Significant improvements to reporting had also been made but some further changes were sought. A training session for the Committee with Insight would be arranged for 2019.

Officers agreed to amend the performance by asset class section of the report to include the value of Assets Under Management (AUM) for each investment manager.

The Chairman thanked officers for their organisation of the training days.

Resolved
1. That the activity and overall performance of the Fund be noted.
2. That the progress in implementing the new strategic asset allocation be noted.
3. That the returns from the Smart Beta portfolio be compared to investment in a passive global equities mandate.
4. That future reports show the value of Assets Under Management (AUM) for each investment manager in the performance by asset class section.

The Brunel Pension Partnership - Project Progress Report

52 The Committee considered a report by the Fund Administrator on the progress to date in implementation of the Full Business Case (FBC) for the Brunel Pension Partnership, as approved by the Committee at its meeting on 9 January 2017.

The Fund's internally managed UK equities' portfolio and the Fund's global equities under the management of Allianz successfully transitioned to Brunel portfolios in July 2018. The Fund's allocation to active UK equities would transition to Brunel from the management of AXA Framlington before the end of November 2018.

In total, approximately £900 million of investments would then have transferred to Brunel's management in the first eight months of operation, representing 30% of the Fund's total assets. Fee savings to Dorset from the three transitions to end of November 2018 were estimated to be approximately £1.3m in a full year.

Emerging Markets equities was the next portfolio to be developed by Brunel. The Fund had a 3% (£90m) allocation to emerging markets under the management of JP Morgan. The expectation was that this would transition in full to Brunel, but with transition not expected to complete until September 2019.

In private markets, Brunel was still at the market research stage for Private Equity, but there had been good progress in Secured Income with two thirds of Dorset's allocation of 2% (£60m) committed to underlying funds. However, it was expected that it would be some time before these commitments were drawn down due to the nature of the asset class.

The FBC assumed that substantially all the new Brunel portfolios would be ready for investment within the first two years of operation. From the experience of the first transitions it was felt that this timetable was unrealistic. The level of resources needed by Brunel was also underestimated, with concerns from the clients that piecemeal increases to budgets were being sought by Brunel. Therefore, a full review of the FBC was required.

As a result of this review, the transition plan had been stretched to three years and it was proposed to increase Brunel's budget from £7.8m this year to £10.4m in 2018/19, with Dorset's share up from approximately £800k to £1m. Clients should now have a much greater level of certainty in the transition plan and funding requirements. Client priorities were also taken into consideration in the revised transition plan.

The Vice-Chairman asked for confirmation of the impact of extending the transition plan on the break-even point for Dorset from the pooling project, and that representatives from Brunel be invited to the next meeting of the Committee. The Chairman asked that minutes of the meeting of the Brunel Oversight Board on 1 November 2018 be circulated to members of the Committee as soon as they were available.

Resolved
1. That the progress in implementing the project be noted.
2. That officers provide a summary of fee savings achieved and transition costs incurred for the transitions to date.
3. That officers confirm the impact of extending the transition plan on the break-even point from the pooling project for the Fund.
4. That representatives from Brunel be invited to the next meeting of the Committee.
5. That the minutes of the meeting of the Brunel Oversight Board on 1 November 2018 be circulated to members of the Committee as soon as they were available.

Pension Fund Administration

53 The Committee considered a report by the Pension Fund Administrator on the administration of the Fund.

The Ministry for Housing, Communities and Local Government (MHCLG) were consulting on three technical amendments to the LGPS regulations – (1) survivor benefits, (2) power to issue statutory guidance and (3) early access to benefits for deferred members of the 1995 scheme. Officers sought approval to respond with full agreement to all three proposed areas of change.

The 2018 data quality report showed that the quality of data tested was generally of a high standard and had improved since the 2017 report. A data improvement plan had been produced to address those areas where there were still some concerns. The Vice-Chairman asked that the Pensions Manager, and her team, be thanked for the good work that had been undertaken to improve the quality of the Fund's data.

The gradual reduction to the Annual Allowance and the introduction of the Tapered Annual Allowance had led to increased complexities and an increase in the number of members affected. As a result, Barnett Waddingham, the Fund's actuary, had been commissioned to produce a simple guide to completion of the self-assessment tax return for members affected.

Resolved
1. That the update on the administration of the Fund be noted.
2. That the proposed response to the consultation on technical amendments to the LGPS regulations be approved.
3. That the Data Improvement Plan be approved.
4. That the Pensions Manager and her team be thanked for the good work that had been undertaken to improve the Fund's data quality.

Date of Next Meeting

54 **Resolved**
That a meeting be held on the following date:

27 February 2019 County Hall, Dorchester.

Questions

55 No questions were asked by members under Standing Order 20(2).

Exempt Business

Exclusion of the Public
Resolved
That under Section 100A(4) of the Local Government Act 1972, the public be excluded from the meeting for the business specified in minute 56 because it was likely that if members of the public were present there would be disclosure to them of exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Act and the public interest in withholding the information outweighs the public interest in disclosing that information.

Request of Employer to Exit the Local Government Pension Scheme (Paragraph 3)

56 The Committee considered a request from an employer to exit the Local Government Pension Scheme. The Scheme Member Representative asked if an Equalities Impact Assessment by the administering authority was required, and officers agreed to take internal legal advice on this point.

Resolved
That the Committee support the proposal from the employer to cease membership of the LGPS and agree a phased repayment of the deficit, subject to (1) certification by the Fund Actuary, (2) a legally binding agreement being in place, and (3) obtaining legal advice regarding the requirement for an Equalities Impact Assessment by the administering authority.

Meeting Duration: 10.00 am - 1.00 pm