Pension Fund Committee
26 February 2015
Agenda Item 7

Suffolk Pension Scheme
Manager meetings London: 30th January 2104

This report covers the face-to-face fund manager meetings held with seven of the funds managers employed by the Suffolk Pension Fund. The meetings covered the fourth quarter of 2014, the year as a whole and some comments about the investment landscape for 2015. In addition to the regular fund manager briefings, newly appointed custodian HSBC gave an update and presentation of their services, while index manager LGIM provided an update on the transfer of Alliance Bernstein assets. Schroders were acting as hosts and consequently we got to meet Duncan Owen who is head of the entire Schroders property team for the first time, in addition to our normal contacts.

Overall, this was a set of informative and relatively positive meetings, the majority of our active managers who were presenting had encouraging performance. Particularly noteworthy in my view is the good returns we are now seeing from both Blackrock and Schroders relative to benchmark. Perhaps the only slight disappointment was the relatively slow progress of Partners Group in deploying the assets into their Infrastructure fund.

Newton: Actively managed global equity mandate

The regular team of Paul Markham (fund manager) and David Moylett (client director) presented the Q4 report from Newton. The meeting started on a fairly cautious note. Paul described the investment landscape as being very challenging and to expect another year of heightened volatility in markets. The major themes he identified were of a slowing Chinese economy leading to weakness in commodity prices; continued volatility in currency markets with particular mention made of the recent sharp move in the Swiss Franc, following the central banks decision to abandon the cap to the Euro and US $ strength with Yen weakness. In terms of the Oil price, Newton expect prices to remain low for the medium term with an expected $40-$65 range over the next three years. Lower Oil prices are expected to feed though to the benefit of the consumer and certain larger Oil importers such as Japan will benefit enormously. It was mentioned however that a low Oil price is not without some downside as Oil construction and Oil related jobs are significant in countries like the US. The very significant cut back in the Oil companies expenditure announced recently will have negative affects on what has until recently been a very buoyant part of the jobs market.

As has been the case for a number of meetings now Newton remain cautious on equity markets in general and the portfolio continues to be positioned defensively as a consequence of this caution. The team remain concerned that geopolitical aggression could act as a destabilising force for markets and highlighted Russia as an area of concern for Europe alongside concerns that the situation in Greece could cause future volatility in not only in European markets but also more widely.

Twice during the meeting Newton mentioned their intention to keep the portfolio concentrated and to only allow the very best ideas into the fund. By having this discipline they will avoid small stock positions, which are held but not really contributing meaningfully to performance. Having met with a number of Newton's competitors recently I believe this concentration of stock positions within global equity portfolios has become common industry practise. Paul reiterated the theme of high, free cash flow yielding stocks as being a major focus in the portfolio and one that has delivered strong returns in current market conditions. However, the challenge now is to find exciting re-investment opportunities when the decision is taken to take profits on stocks that have performed very strongly. This re-investment challenge is becoming more of an issue given the strong run from a number of equity markets in recent years.

In terms of performance the team focused on the year as a whole. They described performance as lacklustre in relative terms with the portfolio delivering a return of 10.9% against a benchmark of 10.6%. However given the strong relative returns in the previous two years the three year performance looks strong at 16.2% annualised against 14.0% for the benchmark. Given the disappointing 2011 return in particular, the five year portfolio performance is only in line with the benchmark.

Overall Newton continue to deliver reasonable above benchmark performance although as can be seen from the longer terms figures they are struggling to beat the benchmark by the target amount. One thing that I feel counts in their favour is the continuity of the team we meet, with our fund manager always willing to attend and consequently the message delivered is clear and consistent.

Blackrock: Active UK equity mandate (blended style growth orientation)

The usual team of Simon Betteley (client service) and Fred Wood (product specialist) presented the report from Blackrock. Blackrock began the presentation by handing out the 2015 outlook report, which has been produced by the Blackrock Institute. The report, which has the title "Dealing with Divergence" covers, what Blackrock see as the main investment themes likely to feature during 2015. Divergent economic growth and monetary policy will be a major theme this year with tightening financial conditions in both the US and UK. Blackrock see asset valuations and investor complacency as high which will most likely result in a burst of market volatility with bonds becoming less able to diversify given the ultra low yields currently available globally.

It is Blackrock's view that the US will surprise markets with a ¼% rate rise as early as June, Fred commented that they believe the Federal reserve wants to surprise investors. The UK was then expected to follow the US rise with a similar move later in the year (assuming no second UK election). For Blackrock the damaging affects of a rise in sterling would be mitigated by following the US move after a reasonable period of time. It is interesting to contrast this view on rates with Newton (which I forgot to include above) but the Newton view is that the economic data will not be strong enough this year for rate rises in either the US or the UK.

Given the importance of the Oil sector to the UK market the team spent some time talking through the implications of the major fall in Oil prices that had started earlier in 2014 but really came to investors attention later in the year when the Oil futures price (that is the long term price of Oil) fell dramatically. It was this fall in the futures that Blackrock described as a 'game changer'. Apparently, up to that point the weakness in the Oil price had been expected to be more of a short-term issue. The Blackrock view is that overall the outlook for Oil production is likely to remain stronger for longer, given that changes in the technology of shale oil, recovery has significantly reduced costs. This has resulted in some shale producers being able to deal with Oil prices as low as $45. Given this and the large fall in shale oil production some commentators have forecast, has been overdone and therefore low oil prices will be a feature for some time. In terms of the economic impact Blackrock described the positive impact that will be felt globally and in particular for the US consumer. We were shown a chart that illustrated that in 2008 the average American could buy 4.4 gallons of fuel per hour work whereas today this figure is 8.1 gallons. A reduction in household costs of this magnitude was described as on a scale with the Bush tax cuts. Although Oil shares have fallen the UK markets largest Oil stocks Royal Dutch Shell and BP have both announced major cut backs in expenditure and as Blackrock explained these are integrated Oil companies and actually make more money "downstream" (that is in refining when) Oil prices are falling.

Before moving onto performance Simon reminded us of the major changes to the team and process that had occurred two years ago (I seem to recall that they were specifically not referred to as major changes at the time). A greater focus on research and getting that research into the portfolios has worked well. The work that the team carried out with an outside consultant to get more value from company meetings has also helped at the margin. This combined with market conditions where a high dispersion of stock returns has become a feature is really helping active managers such as Blackrock, so with this as a backdrop the meeting turned to performance.

In terms of performance the picture is a healthy one. In the final quarter of 2014 the portfolio delivered 2.2% against a benchmark of 0.6%. This resulted in a performance of 2.4% ahead of benchmark for the year as a whole. This recent strong relative performance has helped the three-year returns, which now beat the benchmark by an annualised 1.2%. As highlighted in my previous report what is particularly impressive about Blackrock now is the since inception returns, which stretch back over eight years and have delivered 2.5% above the benchmark on an annual basis. Which is a very impressive achievement in my opinion.

Pyrford: Absolute return fund using traditional equities and bonds

Pyrford were represented by Felim Glynn (client contact) who was joined on this occasion by Tony Cousins (Chief Executive and CIO) who has presented to us before. After the normal introductions and confirmation that there had been no changes to the team, Pyrford turned to Q4 performance. The portfolio returned 2.09% against a benchmark return of 1.19%. This relatively good return has helped the 2014 figures slightly with the portfolio delivering 4.74% against the benchmark of 6.69%. The benchmark for Pyrford is RPI +5% not a standard equity or bond benchmarks. Given their extremely defensive positioning in both equities and bonds it is not surprising that they have failed to achieve the agreed returns in any calendar year, or since inception. The drivers of the good performance in Q4 2014 was US$ strength which helped the overseas bonds and a good relative return from UK equities which outperformed the UK market by over 3%.

In terms of individual positions the largest contributors were the aforementioned US bonds, United Utilities and Legal & General. On the negative side BP was the largest detractor. Pyrford hold BP for its dividend paying potential and although they have reduced the weighting they retain the stock. It is their view that the large reduction in capital expenditure announced at the results (-$15bn) and the strength of the balance sheet will protect the dividend paying capacity of BP over the medium term. The rest of the meeting was taken up with Tony explaining why the negative stance they are taking is in no danger of changing. He reiterated the Pyrford view (reported here many times) that the UK economy is built on a housing bubble. Unsustainable consumer spending is being fuelled by this housing wealth and is unsupported by wage growth. Our over leveraged society is holding in the main floating rate loans which make us particularly vulnerable to even smallest interest rate rise. Real economic growth will be hard to come by and without this the already expensive equity market will struggle to make progress.

In this environment and until the correction (they see as inevitable) occurs, Pyrford will continue holding only the dullest shares (their phrase) with good dividends and strong cash flow. These defensive equities are combined with very short dated bonds as; they see bonds as being at least as over priced as equities. It was certainly interesting to hear that its not just the UK on the brink of a financial precipice. Tony described the Bank of Japan's balance sheet as "turning parabolic" and Europe with the ECB now engaging in quantitative easing as another disaster in the offering with or without Greece. I have to say that meeting with Pyrford is a bit like encountering one of those strange folk on Oxford Street walking up and down with a placard saying "the end is nigh". I always get a slight unnerving feeling; what if they are right? What do they know I don't, what happens next? I have that same, slightly concerned feeling every time I meet the very persuasive Pyrford. Anyway moving on.

Schroders

Schroders were acting as our hosts for the day and as such the normal team of Geoff Day (client director) and Jennifer Murray (property fund manager) were joined for a while by Duncan Owen who heads up the entire property team at Schroders. The meeting started with Duncan giving an overview of the Schroders property business with a brief description of the various business lines. Duncan joined the firm about three years ago and now heads a business with assets of £15bn spread across 15 distinct funds. After the overview Duncan outlined his view of the UK property market. This was described as polarized with 'winning' cities and towns emerging where all sectors of the property market are doing well regardless of type. In these areas there has been the rise of multi-use sites where commercial and retail co exist on the same site and even residential plays a role. However the UK market remains bifurcated with some parts of the market up 20% in 2014 with other parts completely flat. Given this, caution is needed as certain prime assets have become overpriced.

One encouraging sign is that the property market is moving from an investor lead market with the search for yield driving up prices into a more balanced rent driven market. Rents are rising in a number of sectors and this is supporting capital growth. Although both office and industrial rents are heading upwards they still remain relatively cheap compared to history. However caution was expressed about retail rents, which Schroders still considered expensive in real terms.

Jennifer and Geoff continued with a round up of performance of the multi manger fund that the Suffolk scheme has invested in. Last year proved a very strong one for property returns. The Schroder fund delivered 18.1% against a benchmark of 17.2%. This means the fund has now beat the benchmark over 1, 3 5 and 10 years. The relative performance over ten years net of fees now stands at 0.6% per annum. This for a 'core' diversified fund is a very credible return and precisely the type of consistent moderate outperformance that is desirable for a long term LGPS fund. To round up the meeting Jennifer went through some of the specific areas where interesting opportunities were now occurring. We went though a number of slides on e-tailing (on line retail distribution sites) motor showrooms and high-street sites for the Tesco Metro/Sainsbury Local type of store. All these sites are showing good demand at attractive yields. Overall a positive meeting and we were left with confidence that the new capital that Schroders has been given by the scheme would be well deployed and that property as an asset class would continue to enjoy positive returns over the medium term.

KKR: Global Infrastructure.

James Marsh (investor relations) and Guido Mitrani (Infrastructure team) presented the report from KKR, who we had last seen in September. As a reminder The Global Infrastructure fund I was launched in 2010 and has a life of twelve years with the option of three one-year extensions, depending on market conditions. Over the life of the fund a return of 12% net is targeted with approximately half this return coming by way of dividends paid from the assets acquired. The fund has been fully invested since late last year with 10% of the capital reserved for expected top up commitments to existing holdings. The fund managed to deliver a yield of 4.8% last year, which is expected to grow slightly to 5% this year. This cash yield is on target and will eventually form half of the expected return.

The majority of the meeting was taken up with Guido and James giving a detailed run through of the infrastructure investments that are in the fund. Saba the car park operator and one of the earliest investments continues to perform well. The cost efficiency plan which was introduced last year is on track and despite still being in an expansion phase the business is generating a 2.5% distributable yield. With the underlying business performing ahead of plan and exit markets looking favourable, KKR mentioned that an early exit from this business is a possibility.

Coriance which is a contracted district heating supplier in France, has won a number of new concessions and has almost doubled its operating profits from €17m to €30 since its acquisition. KKR has made a part realisation of Bayonne Water where they had acquired a 40-year concession to supply water and process wastewater for the city of Bayonne. The sale of 49% of the KKR stake to Middleton water was made at x2.6 the original price. Guido remarked that despite the sale the contract was performing very well and the remaining 51% remains a value asset for the fund.

ELL, the European locomotive leasing platform started from scratch by KKR (see previous report for details) is running ahead of plan with 50 locomotives already leased and a further 27 contracted awaiting delivery. 2015 is looking like another good year with the original plan to lease 30 units now expected to be 45. The original investment thesis, that of an undersupplied European market does appear to have been the correct one and genuine value has been created here. The rest of the meeting covered the energy assets where the fund has multiple investments, mainly in solar energy. Of note was the underperformance of SSM Solar in Canada where heavy snow fall (the worst in 50 years) and a falling Canadian dollar have reduced returns. Mention was also made of Acciona Energy, one of the last investments to have been put into the fund. This asset contains wind as well as solar assets in the US, Europe and Latin America and therefore provides diversification by both county and generation type. KKR made particular mention of some Greek assets that sit within the Acciona portfolio, regulatory issues related to the economic situation in Greece need to be resolved before the final price for the assets can be agreed, until such time the assets are affectively held outside the portfolio.

Overall another positive meeting with KKR who reported the follow up fund, GIF II has now closed to new investors after hitting its target $3bn. Investor appetite was such that the second fund was significantly over subscribed. KKR at this stage seem to be running slightly ahead of the original timescale and targets, which is in contrast to Partners Group who were next to represent.

Partners Group: Global Infrastructure

The presenting team from Partners was Brandon Praton (co-head of Infrastructure), Sergio Jovele and Sarah Brewer (investor relations). Suffolk Pension Fund has made a €54.0m commitment to this global infrastructure fund, which completed its final close at around €1bn. in Q3 2014, two years after commitments were first made. The meeting began with a run through of the new members of staff recruited into the infrastructure team, with three senior hires in Asia the US and Europe. Partners reported that the significant hires were a positive sign of the increasing opportunities and deal flow they were seeing, and not a sign that they had failed to staff sufficiently at the outset of the fund raising two years ago (as I rather cynically suggested).

Partners reiterated their view that many infrastructure markets were crowded and expensive. Despite seeing lots of deal flow, pricing was often not acceptable and in many ways some European and US infrastructure markets were looking as overvalued as they had ahead of the 2008 crash. Even the banking sector that had withdrawn to lick wounds post crisis was now back in strength and willing to support infrastructure project bids. Given this crowed situation in the US and Europe, Partners continue to look elsewhere for good opportunities and in addition to Australia which they have mentioned to us before, Japan was mentioned as interesting particularly in energy generation, given that 40% of the base generating load was removed following the Fukushima disaster. It was mentioned that the strengthening of the Asian experience in the team with new hires, was to make better use of these opportunities in less crowed markets.

It is not surprising that given Partners overall caution on markets that they have been extremely cautious on deploying capital. As of January the level of commitments had reached 50% across 28 investments, which is up from 36% across 26 investments when we last met in September. Of the investments made so far the majority are either on plan or to early to say. Despite the slow progress to date the early part of 2015 is expected to be very busy and show real progress with a further €150m committed during the quarter. At the meeting we were informed that a deal to buy Toronto City Airport had just been signed, with at least three more significant commitments expected during the quarter.

Overall as previously mentioned the rate of progress is frustratingly slow albeit for apparently good reasons. Committing capital at the early stages of the fund raising has exacerbated the feeling of delay. However the meeting ended with an upbeat assessment of the progress to be made over the short term. Partners expect to be able to report meaningful progress next time we meet, which is scheduled for October I believe. I hope to be able to report on both good progress and give some proper detail about the success (or otherwise) of the underlying assets following that meeting.

For completeness I will mention two further meetings that took place over the day:

Legal & General Investment Management: Index Mandates equities and bonds

LGIM were represented by James Sparshott (head of local authorities) Rachel Gibben (assistant manager, Strategy Implementation) and Martin Earle (senior manager, allocation strategy). James started the meeting by highlighting the assets the Suffolk scheme has with LGIM and the various benchmarks and weightings. He also gave an update on the allocation of the assets that had been transferred in from Alliance Bernstein and where these were currently invested. James also provided an illustration of the revised benchmark that LGIM would be implementing when the various changes agreed had been fully implemented. Following on from this Rachel, who has been closely involved with the transfer of the Bernstein assets gave a more detailed update. It seems the transfer went very smoothly will all the stocks held by Bernstein transferred 'in specie' without additional costs. The only exception was a single illiquid Israeli stock that had to be treated separately and will incur a separate charge. LGIM are experts at this type of transfer and it showed in the efficiency of their processes.

The meeting concluded with an overview of the allocation strategy capability team from Martin Earle. This team has the ability to rebalance automatically back to a pre determined benchmark responding to market moves from all of a schemes various managers. There is a great deal of flexibly in how to set up such a 'swing mandate' as it is known and this presentation was an attempt to demonstrate how this could be of use to Suffolk if were given the LGIM mandate to control the overall exposure between gilts and equities across the whole scheme. With this in place, LGIM would rebalance back to the benchmark given a predetermined set of rules. What should have been a fairly straight forward presentation seemed to get lost somehow and instead of the process becoming clearer it became more opaque. To be fair to LGIM, part of the problem was that it is not clear exactly what type of 'swing' mandate would be suitable (if any) however it was still disappointing that Martin muddied rather then cleared the waters. Still more work needed on this one I feel.

HSBC Security Services: Custody and stock lending

Given that HSBC is the newly appointed custodian to the scheme it was considered sensible to bring them in for an update and give them a chance to highlight some of the other custodian services they offer. Pat Sherman (head of relationship management) and Adrian Bailey (pension relationship manager) represented HSBC. After a high level run through of what a global custodian actually does from Pat, Adrian went into more details about the services HSBC currently provide for the scheme and finished by exploring other services HSBC offered. These included performance measurement, compliance monitoring and possibly of most interest; involvement/monitoring of global class actions where the Suffolk scheme might have a beneficial interest. Overall this was an interesting and informative meeting.

Mark Stevens
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