Suffolk County Council

Agenda Item 8

Suffolk Pension Fund Committee, 3 June 2015

Information Bulletin

The Information Bulletin is a document that is made available to the public with the published agenda papers. It can include update information requested by the Committee as well as information that a service considers should be made known to the Committee.

This Information Bulletin covers the following items:

1. Independent Investment Advisors Report

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1. Investment Manager Meetings – 1 May 2015

This report covers the face-to-face fund manager meetings held with seven of the managers employed by the Suffolk Pension Fund. The meetings covered the first quarter of 2015 and the outlook for the year ahead. M&G were acting as hosts and consequently in addition to meeting with Andrew Swan and Paul Taylor our usual contacts on the Debt Opportunities Fund, Maria Stott a member of the team that manages the Alpha Opportunities fund which Suffolk Pension fund had recently made an allocation to sat in on the meeting and gave an update on progress. Overall the first quarter of 2015 was a positive start to the year, the majority of our active managers presented encouraging performance. However it was noted that a number of managers said that April has been a more difficult month, with Newton and Winton in particular experiencing negative returns.

Newton: Actively managed global equity mandate

The regular team of Paul Markham (fund manager) and David Moylett (client director) presented the Q1 report from Newton. The meeting started with David highlighting the wide divergence of returns at both a regional and sector level. The environment remains challenging but it also remains a good environment for active management, given the divergence in economic growth and central bank policy that now exists across the globe. Newton once again demonstrated with a chart the fact that all the performance that has been seen in the global equity market since 2011 has been the result of investors paying higher multiples (of earnings) rather than any real increases in underlying earnings. In terms of the drivers for the last quarter the best performing sectors were Healthcare and Consumer Discretionary. Over the last year it has been Japan and more recently Continental Europe that have been the strongest performers. Both of these markets have been boosted by their respective central banks undertaking quantitative easing. It was also mentioned that in addition to the quantitative easing the Japanese equity market has been helped by government initiatives to encourage companies to operate with better standards of corporate governance and to pay higher dividends.

Newton ran through a number of stock examples as a way of explaining the themes that run through the portfolio. The largest single positive contribution to performance over the quarter was from US food company, Kraft Group that was taken over by fellow food group Heinz at a significant premium to its trading share price. As mentioned above a feature of the first quarter was the strong performance of the Japanese equity market, this resulted in five of the ten best performing stocks in the portfolio coming from Japan. The department store Don Quijote delivered a very strong set of results with same store sales up 5% over the last year. Sugi Holdings which was described by Paul as the Japanese equivalent of Boots, also performed strongly as the sales of generic drugs continues to rise in response to a government policy to encourage the use of generics by the aging population of Japan. On the negative side Microsoft was the largest single detractor from performance having in the previous quarter delivered a disappointing set of results. Interestingly the latest set of results released just after the quarter end are much stronger with the company benefitting from the uptake of monthly billing for many of its major products including Microsoft Office which is now increasingly delivered and updated online via the ‘cloud’. Newton is still confident that Microsoft will perform well going forward.

In terms of performance the first quarter was a good one for Newton with the fund returning 9.4% against a benchmark of 7.5%. This has resulted in a fairly impressive one-year outperformance of 2.4% above the benchmark. The three-year outperformance is now a very healthy 3.2% per annum. Despite some early issues with performance the recent strong returns have led to a 0.7% per annum outperformance since inception, which was July 2007. Although no details were provided Newton did mention that the second quarter has not got off to a good start and some relative performance has been lost. We will have to see whether over the balance of the quarter performance can be recovered.

Newton has had a very good three years in terms of performance and even over the longer timeframe the numbers are beginning to look good. It remains to be seen if the set back that was mentioned for April leads to a change in their fortunes. It does seem reasonable that given the issues that the global market will face over the medium term, Newton’s continued defensive approach and focus on companies with strong market positions and strong cash flow generation will stand them in good stead even if market conditions deteriorate

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

The Blackrock report was presented by Simon Betteley (client service) who was joined on this occasion by our fund manager James Macpherson (fund manager) who had not presented to us in a while. James began by describing the investment landscape and the economic backdrop. The Global economy was described as being back on track, with growth occurring and inflation firmly under control. The recent slow-down in both the US and UK economies is temporary although this has pushed back the date for rate rises in both countries. James described how the portfolio had benefitted from a number of corporate actions over the last year, including two bids involving Astra Zeneca and Shire Pharmaceutical. Although neither bid was successfully completed both companies were subsequently re valued by the market. In fact some clever active management generated additional good returns for the portfolio. Shire was held at the time of the bid, sold into the rally and then repurchased at a discount as the bid failed and then held in the subsequent 20% re rating rally. More merger and acquisition activity is expected in the UK market during 2015.

James went on to explain that overall market volatility is now very low, and at levels not seen since the 1950's and 60's. This has led to the apparent level of active risk in the portfolio (that is risk against the benchmark) appearing to be very low, in fact seemingly too low to generate the outperformance targets. In order to achieve the level of risk that would normally be required to make the performance target, holdings would have to reduce down to around twenty stocks from the current thirty-five. This is not considered a viable option as the market has changed dramatically in terms of liquidity over the recent past. With the sharp increase in index funds and ETF's (exchange traded funds) over the last decade, liquidity has drained from the market for active managers looking to buy and sell large blocks of shares. James mentioned that where as in the past he could deal in 30% of the average daily volume (ADV) of a stock without moving the share price, this has now dropped to around 10% of ADV. Consequently holding a portfolio as concentrated, as twenty stocks would not be sensible and prove difficult to trade. James then talked through a number of stock examples held in the portfolio including Kingfisher and IMI both beneficiaries of a cyclical recovery in Europe. He also explained that he was now looking at Tesco following the recent fall in share price and the new management team taking significant restructuring activity.

In terms of performance the recent good run continues. In Q1 2015 the Blackrock portfolio returned 5.7% against a benchmark return of 4.7%. This strong result means that over the last twelve months the portfolio has risen 9.5% a very credible 2.9% ahead of the index. The three-year rolling return is 12.3%, which is 1.7% per annum ahead of the benchmark, just slightly below the target return of 2%. Blackrock were appointed in July 2007 and it is to their credit that since that inception date the portfolio has delivered a return 2.5% ahead of the benchmark per annum.

The meeting concluded with a very bullish and somewhat non-consensus view on the outlook for equities. The view centred on the fact that the relationship between the cost of equity and the cost of debt has changed given that debt is now so cheap. Cash generative companies are able to pay down debt fast and then re leverage or buy in shares easily and at a rate rarely seen before. Retailer Next was given as a prime example of a company able to do this and hence the spectacular returns seen from the shares over many years. Given that a number of companies can use almost zero debt-funding costs to drive returns on equity combined with the fact that pension schemes cannot fund pensions on 1% (or lower) bond yields, therefore, equity is the place to go. I think this was an interesting non-consensus view from Blackrock and certainly provided an interesting counterpoint to the ultra-pessimistic view adopted by Pyrford.

Pyrford: Absolute return fund using traditional equities and bonds

Pyrford were represented by Felim Glynn (client contact) who was joined on this occasion by Paul Simons (Fund Manager Asia) who has presented to us before. After the normal introductions Felim informed the meeting that founder and current investment chairmen Bruce Campbell would be undergoing the next stage of what was described as his gradual retirement. Bruce will be stepping down from his current position and will be relocating to Australia where he has family. He will still have some input into the Pyrford process and will take on the title of Strategic Investment Adviser, however it is clear his day-to-day influence will be greatly reduced. When we met with Bruce in September last year he was an extremely compelling presenter and in many ways put to rest some of the concerns about the underlying investment approach of Pyrford that understandably had surfaced in the face of continued underperformance. Undoubtedly he will be missed given the relatively small team that Pyrford have. However as this was part of a planned process, it is unlikely to cause any disruption to the management of the fund. Felim concluded by mentioning that two graduate hires had recently been made and will train as stock analysts.

Pyrford then turned to Q1 performance. On a gross of fees basis the portfolio returned 3.05% against a benchmark return of 1.07%. This relatively good return has helped the twelve month figure slightly with the portfolio delivering 7.53% against the benchmark of 6.75%. Over a two-year period and since inception the portfolio remains below benchmark. As a reminder the benchmark for Pyrford is RPI +5% not a standard equity or bond index. A request was made for future reports to provide performance net of fees as well, in order for a more accurate view of returns actually delivered to the Suffolk scheme.

Given their extremely defensive positioning in both equities and bonds it is not surprising that they have struggled to achieve the agreed returns in any calendar year, or since inception although the current twelve-month figure does beat the benchmark. The driver of the good performance in Q1 2015 was once against 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 helped by currency, Legal & General where a dividend increase had pleased investors and GlaxoSmithKline helped by an asset swap with Novartis. . On the negative side Southern Scottish Energy and National Grid were the largest detractors, both responding to a proposed energy price cap if the Labour Party gain power at the forthcoming general election. There is not much else to report in terms of the underlying portfolio, as there had been no changes to the underlying positions since the last meeting. The meeting concluded with Paul Simons briefly repeating the Pyrford investment view, which I have covered many times before. But for the record it remains, European issues including Greece that are likely to come to head soon, US overvaluation, money printing, lack of investment and unsustainable public and private debt levels. All of which means both equities and bonds are expensive and therefore Pyrford will remain positioned ultra-defensively in order to be able to react when the sharp market correction occurs.

M&G Investments: UK and European distressed debt: Debt Opportunities fund (DOF)

M&G were hosting the day's meetings and were represented by Andrew Swan (client director) and Paul Taylor (Fund Manager & Head of Restructuring) we were also joined by Maria Stott who works on the fixed income desk that run the Alpha Opportunities fund. Paul began by reiterating the M&G approach to distressed debt emphasising their risk-averse approach, which is focused and analysis lead. M&G seek out good companies with bad balance sheets that are in some form of debt distress and provide lending solutions into these situations. At the outset a clear exit strategy is in place before any investment is made. Paul again explained that M&G did not use a 'market' approach to finding investments but rather used a 'rifle' shot (his words) approach into very specific situations that fulfilled an exacting set of criteria. The presentation contained a slide of the various checklists that are used to assess each opportunity. Two of the more interesting hurdles that need to be cleared are ability for M&G to join the creditor committee and influence directly the restructuring process and a prior strategy for defeating any spoiling tactics of other creditors or shareholders. The conversation then turned to the M&G restructuring team itself, which has now grown to ten strong with another about to arrive. This was described as probably the largest and most experienced debt restructuring team in Europe and has more than doubled in size since the launch of DOF I.

The rest of the meeting consisted of an update on the two funds where Suffolk has an interest. The funds have a five-year life span. As a direct result of this 17% of the original fund Debt Opportunities I (DOF I) has now been returned to investors. This return of capital is the result of investments maturing but with insufficient time left on the fund to reinvest this capital elsewhere and still keep to the funds five year timeframe. M&G wanted to emphasise this timing issue and also highlight that there were still very many investment opportunities they were seeing in the market. DOF I has delivered a 10.9% return over the last twelve months. Six investments have been realised early, at internal rates of return (a measure of performance) ranging from 22% to 109%. The main distribution period will commence in 15 months' time.

We were also shown a number of detailed case studies of investments held in DOF I, as a way to further explain how M&G achieve returns.

There was not as much detail offered on DOF II, presumably as this is still in the early stages of capital deployment. However nine months in the fund is now 64% drawn with new commitments expected this quarter. Although early days, everything is looking good with thirteen investments made across public high yield bonds and private loans and six investments already successfully restructured. DOF II is expected to be fully invested ahead of the two-year time frame, which ends in June 2016.

As the meeting was closing Andrew mentioned that they were in the early stages of raising money for a third fund, the imaginatively named Debt Opportunities Fund III (DOF III). This is expected to raise €750m which is more than twice the size of the first two funds and reflects an environment that M&G sees as increasingly fertile for restructuring in Europe. Deflation, the introduction of Basel III banking regulations and continued geo-political tension in Russia, Ukraine and problems in Greece are all seen as opportunities. Paul commented that many of the highly leveraged deals completed only last year are already looking unsustainable. Given the timing of cash coming back from DOF I, it does not seem likely that Suffolk could commit to DOF III without increasing the target allocation to this asset class temporarily. However I would not bet against a DOF IV being launched in 2016 and that might be something to consider assuming market conditions continued to look interesting.

BlueCrest: Multi Strategy Hedge Fund

Stephen William (consultant relations) Eleanor Robb (investor relations) once again presented for BlueCrest. The meeting started with an update from Eleanor on the corporate changes that had been mentioned at the last meeting. The quantitative team headed by Leda Braga has now formally spun off into a new company called Systematica. BlueCrest retain a stake in the company and have a seat on the board. Importantly BlueCrest retain visibility into the on-going research programme for Blue Trend which is the main fund managed by Systematica to which the AllBlue product allocates. It seems from what we were told that this separation has happened smoothly and there were no issues of concern for the AllBlue fund. There was no other significant news concerning the corporate side of BlueCrest apart from the possible separation of the mortgage team into a separate company at a future point. No further detail was given about this but it did occur to me that BlueCrest seem to be facing a bit of cultural pressure, with successful teams wanting to further monetise their success by forming their own companies. This is something that we might need to explore further at subsequent meetings

The rest of the meeting was taken up with a fairly detailed overview of performance in the six months since the last meeting. In terms of changes to allocation the most significant has been a large reduction in the weighting of BlueCrest Capital

International. This strategy is described as global macro with a strong fixed income focus, which takes views on expected central bank activity. Unfortunately it was the unexpected lifting of the peg on the Swiss Franc by the Swiss central bank in January, which caused performance problems for the strategy. The subsequent sharp rise of the Franc against the Euro triggered a loss of 5% in January for Capital International and in turn has led to a number of investors redeeming the fund. As AllBlue is a multi-strategy fund it had only 16% of it its capital invested in Capital international at the time and given good performance from other strategies such as Credit and Trend Following equities, the overall fund finished January up 1.1%. This provides a good example of diversification by strategy reducing risk for investors. In terms of yearly performance AllBlue finished 2014 up 6.6% which was not spectacular however a better showing than 2013 where the strategy only managed 1.8%. In Q1 2015 it has delivered 2.5% after fees with all three months showing positive returns. Of the eight independent strategies that combine to form AllBlue, seven of them are positive year to date with all the equity strategies doing particularly well, including BlueCrest Equity Strategies the latest addition to the fund which has been covered in previous reports.

The final part of the meeting consisted of a run through of the global economic situation. The rise in US interest rates is now more likely to occur at the back end of the year rather than mid-year. With the expected rise in UK rates set back even further given the recent slow-down in the economy. Given this meeting took place just over a week prior to the UK election Stephen reiterated that there were real risks associated with an uncertain outcome (these presumably have faded given the election result). In terms of Europe it is the BlueCrest view that any volatility surrounding Greek default will be short lived and that there will be a classic “fudge” negotiated at the eleventh hour for rescheduled payments. In terms of outlook this looks positive for the strategy. The Equity trend following is enjoying some of the best market conditions ever experienced and even the out of favour Capital International macro strategy is now looking more interesting and the team may well look to rebuild some of the weighting that was removed in Q1.

Winton: Systematic Hedge Fund

Alison Priestly (client team) presented the report from Winton. Alison was covering for Jonathan Anayi (client team) who replaced Andrew Fraser at the last meeting but is currently working in the US. Alison started the meeting by giving an update on the performance of the fund. At 31 March, the Suffolk Pension Fund had £44.6m invested with Winton. The return over the last twelve months has been a very strong 20.1%, this figure includes the strong Q4 2014 where Winton benefitted greatly from the sharply lower Oil price and a good start to the year. In Q1 2015 the fund is up another 5%. The main performance drivers for the first quarter came from currencies where a short position in the Euro against the dollar paid off, as did a position on European interest rates, where falling rates also made profits. The portfolio was also positioned to take advantage of rising equity markets and the strong equity returns seen over the quarter also contributed to good performance.

Winton run a fully systematic investment process that seeks to generate returns by investing in a wide range of asset classes. Although this is a dynamic process approximately 25% of the risk is taken in each of four areas; equities, bonds, commodities and currencies. Single stock equities now make up the majority of equity risk, which is a departure from the past where Winton tended to trade only in equity indices. Much of the rest of the presentation and the report is taken up with a detailed overview of the scientific process that Winton use to generate the strategies used on the fund. Research is the core activity of the firm and research staff now number 135 including 50 PhD's up from a total of 9 in 2000. Alison briefly reiterated the various strategies that have been developed for the Futures programme in which Suffolk Pension Fund invests. These include more mainstream techniques such as momentum and fundamental approaches but also more esoteric research programmes such as weather satellite data and agricultural seasonality. By using a wide range of techniques and employing these across multiple asset classes Winton seek to outperform in most market conditions and there were a number of slides in the presentation detailing how the fund has performed in various market conditions, including during times of financial crisis. The end result is only two down years since 1997 and a better risk adjusted return than any of the underlying markets that the fund invests in.

This was an informative presentation on what is a highly technical fund; recent performance has been exceptional and unlikely to continue at the same level. However at this point Winton are delivering very credible returns that are uncorrelated to the other mangers that are employed by Suffolk and are therefore delivering exactly what was intended by their appointment

Wilshire Private Markets: Private Equity

William Van Eesteren and IIona Brom the managing directors of the Wilshire European office flew in from Amsterdam to present an update on the Wilshire Private Equity funds that the Suffolk Scheme has invested in. As a reminder, the Suffolk Pension Fund is invested in nine separate Wilshire funds with starting dates for investment in 2003, 2005, 2006 and 2007. The major portion of the exposure is to funds focused on the US and European private equity markets, however there is a single smaller investment in the 2007 Wilshire Asia fund VII. In total over the nine funds Suffolk Pension scheme has committed just over £57m. At the end of March, Wilshire had called 90% of this commitment for investments (up from 86% at last meeting in September). Over the entire period just over £41m has been received back as the earlier funds begin to return capital in line with the expected life cycle of these types of investments, this is £3m more than at the previous meeting.

The report, which Wilshire presented, provided details on the performance and maturity of each of the nine funds where Suffolk has an interest. In terms of net internal rate of return (a measure of investment performance) the lowest is the 2006 European Fund VII, which has only delivered a net return of 3.9% to date. The best performing fund is the 2003 vintage US fund V, which has a net rate of return of 13.2%. Overall Wilshire have delivered solid if not spectacular returns when compared with public equity markets with seven of the nine funds delivering returns ahead of the nearest equivalent public market index. Given that the Suffolk Pension Fund exposure to this asset class will gradually reduce as the portfolios continue to mature and return cash back to the scheme, Wilshire will be visiting the committee to highlight why private equity exposure is worth maintaining in a long term fund. With this visit to the committee in mind the format and presentation of the report was raised as an issue at the meeting. Although undoubtedly Wilshire presented a detailed comprehensive report, it was full of investment jargon and measures of performance that where specific to the world of private equity. Many of the terms used would not be familiar to the non-specialist and with no glossary provided in the report it was not clear how a non-specialist reader was meant to find out. It was ‘politely’ suggested that when Wilshire present to the committee later this year, that it would benefit all concerned if the presentation was re drafted such that it was comprehensible to the non-private equity specialist.

In terms of market outlook both the US and European markets were described as expensive with lots of liquidity being available and banks again willing to lend. This has driven up competition for assets and lead to deals becoming expensive, particularly of the larger end of the market. It is for this reason that Wilshire does not want to operate in this part of the private equity market but rather in the smaller and mid-market range. They also look for complex niche deals where companies are in need of significant management input. Wilshire are looking for companies that can be purchased at a discount but also offer genuine potential to grow in response to management action. They are looking to add value to these companies rather than simply strip assets and reduce costs. They are also careful to structure deals that avoid taking on significant levels of debt despite this being readily available in the current market. It will be interesting to see them in Ipswich later this year and we can hope that they come to educate, rather than bamboozle us with Net IRR, Net PIC, Net TVPI , DPI ‘s etc.

Mark Stevens

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For further information please contact: Paul Finbow Corporate Finance Specialist; Email: paul.finbow@suffolk.gov.uk, Telephone: 01473 265288.

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