Suffolk Pension Scheme
Manager meetings London: 27th August 2015

This report covers the face-to-face fund manager meetings held with five of the managers employed by the Suffolk Pension Fund. The meetings covered the second quarter of 2015, the August market volatility, and the outlook for the year ahead. Blackrock were acting as hosts and we had the opportunity of meeting representatives from both the equity and bond teams.

Overall the second quarter of 2015 was a difficult time for markets, although the majority of our active managers delivered performance that was ahead of the benchmark, the returns were still negative in absolute terms. It was noted by a number of managers that the outlook remains a volatile one with attention likely to remain focused on the Chinese economic slowdown and the timing of the expected US interest rate rise. However, despite these concerns the divergence now being seen in terms of central bank policy is creating opportunities for active managers to deliver outperformance.

Schroders (multi manager property fund)

Representing Schroders were Geoff Day (Client Director) and Graeme Rutter (Head of Schroder Real Estate Capital Partners). This was the first meeting with Schroders since the departure of our previous fund manager Jennifer Murray who was made redundant. Although it was acknowledged that Jennifer had a good reputation with clients, we were informed that the redundancy decision was purely business related. In part, it reflected more efficient internal systems requiring only two instead of three senior managers', however it also opened up some better opportunities for younger members of the team, deemed important in order to keep them. Unfortunately, the situation has become somewhat more complicated. The day before our meeting the other remaining senior manager Tony Doherty had un-expectantly resigned to join Legal and General.

This now leaves the team under resourced and as the departure of Tony Doherty was so unexpected, and recent, no firm decision on how to respond had been made at the time of our meeting. Graeme will decide whether to bring in another experienced manager or use the opportunity to promote from within and accelerate the progress of the juniors. Graeme will remain the day-to-day manager of the Suffolk fund, however moving from three senior managers to one in a matter of weeks is clearly not ideal and it will be of interest to read what the Hymans research team conclude when they meet with Schroders shortly.

Moving onto the business update, Graeme emphasised the importance of scale and the ability to hold controlling stakes in the funds in which they invest. Schroders now have six "Schroder RECaP Partnerships" where they have complete control over the investment policy of the funds. They believe this is a major advantage, both in terms of gaining access to specialist opportunities (car show rooms were given as an example) but also in positioning the funds ahead of changes in the property investment cycle. At present the exposure to these wholly owned specialist funds make up about 15%-20%

of the Suffolk exposure however this is expected to continue to grow into the future. A regional office fund was mentioned as a possible new Schroder RECaP Partnership launch later this year. Assuming this does happen then it will form part of the Suffolk fund.

In terms of market overview, the commercial property sector remains strong. Property has outperformed both bonds and equities over the last one, three and five year periods. Central London offices and industrial property have been the strongest performers over this period. Rental growth remains healthy and is now spreading out beyond London into the regions. In terms of market drivers the outlook for commercial property continues to look positive with improving business confidence and continuing strong overseas buying power supporting the market. Retail space remains difficult and out of favour. Tactically Schroders are looking to reduce exposure to central London offices as prices have now exceeded the 2007 pre crash levels.

The returns Schroders have delivered have been ahead of benchmark over the longer term. Over three and five years they have beaten the benchmark by 0.9% and 0.3% per annum. Over the last twelve months performance has been very strong in absolute terms up 15% however this is 0.5% behind the benchmark. The cash held by Schroders has now been fully committed although not fully drawn and we remain in "commitment queues" for certain funds. Overall Graeme described the fund as being in good shape with no real problems. This does seem to be the case and given the long term nature of the asset class there is no need to panic about the staffing issues at this stage, however it will be important to monitor this situation to see how it develops.

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

James Macpherson (fund manager) and Simon Betteley (client director) presented the equities report for Blackrock. James started by mentioning the recent sharp market moves, that in part had been driven by concerns over slowing Chinese growth. James described the difficult transition that needs to take place in the Chinese economy as it transforms into a more 'Western' consumer spending led economy away from almost complete reliance on government fixed asset spending. This transition will increase volatility going forward and in terms of growth rates the consumer will need to increase spending by 15% this year in order to just replace the reduction in government spending. Hence the increased risks to the downside in terms of growth that lies behind much of the current market concerns.

Interestingly the recent volatility was seen as a good thing and an environment that could throw up opportunities for active managers. Even though the low liquidly of the summer months had exaggerated the price moves, in some ways the environment was a return to the more usual volatility seen in markets over time. The good news is that the portfolio has continued to outperform during this period. Blackrock have used the recent sell off to pick up some out of favour companies in the mining and oil & gas sectors. The thinking here is that the portfolio has made such good relative returns from being underweight in these areas that taking some of this risk away now is a sensible risk reward payoff.

With BHP Billiton and Rio Tinto now yielding 6.5% and 7% respectively purchases have been made to bring these stocks into a neutral position to the benchmark. James also spent some time talking through the continued weakness in the oil price pointing out that it could be a feature for sometime given that although shale gas has a high overall cost, marginal cost of production once up and running remains very low. So do not expect a significant slow down in shale gas production for a year or two. This "lower for longer" scenario for oil should benefit consumer spending assuming the windfall is spent and not used to pay down debt, which seems likely given recent consumer behaviour.

The meeting then moved onto performance. As Blackrock had just passed the eight year anniversary of being appointed by Suffolk Pension Fund a chart was produced showing the eight year cumulative return (albeit gross of fees) of the portfolio compared to the UK Index and RPI. The good performance and the power of compounding have combined to give the following eight-year cumulative returns. Blackrock Suffolk UK equities 61%, FTSE 31% and RPI 25%. Even taking onto account the need to deduct fees these are still impressive figures. The more traditional way to look at performance shows that over all periods Blackrock have outperformed the benchmark. 1.1% over the quarter to June, 5.3% over the last twelve months, 2.0% per annum over three years and since inception (which as mentioned is now eight years) +2.5% per annum which is above the target figure for performance. Overall a positive meeting with a manager and team that seem on top of their game at the moment, long may it continue.

Blackrock: Fixed Interest (Global absolute return)

The meeting continued with James leaving the room leaving Simon Betteley and another client director David Oelker who represented the team running the Fixed Interest Global Opportunities fund (FIGO) which Suffolk had recently made a £125m allocation to. David started the meeting by highlighting the different way credit managers see the world to equity managers. The volatility in recent weeks has also been seen in the credit world and opportunities have also become available. An example given contrasted nicely with James's mining example. While the equity team were buying up Rio Tinto as they believed it had been over sold, with a profit outlook higher than market expectations, the credit team had been looking at the bonds of another commodity stock Glencore. However what mattered to the credit team were not profit expectations, but the huge ($2.7bn) cut in capital expenditure this year followed by another $1bn next year. This may have consequences for future earnings and hence the equity may not be attractive, however by firmly stabilising the credit rating and underpinning the commodity trading business the bonds of Glencore now look very attractive and have been purchased by the team. I thought it was interesting to see how the teams looking at different parts of a company's balance sheet and see opportunities and risks in different places.

David went on the talk about the extent to which recent market nervousness had led to very sharp moves in the spreads of the various corporate credits they look at. As a reminder the 'spread' is simply the amount of extra yield a corporate bond will earn over and above a similar dated government bond. Low 'spreads' mean markets are more relaxed about risk, where as when risk aversion rises in a market then 'spreads' will tend to move higher as the underlying corporate bond fall in price more that the equivalent government bond.

Bond markets react to expectations of central bank policy even more than equity markets do and most of the rest of the meeting was focused on likely moves by the US Federal reserve, as well as moves by the ECB and Chinese central bank and how the credit markets are seeking to anticipate these. The FIGO portfolio uses top down macro views and combines these with sector and security bottom up views, to build a portfolio that is highly diversified both in terms of asset type and geography. The portfolio will also take active currency positions and the meeting ended with some detail on how the long USD position in the portfolio was being reduced and will be reduced further.

Overall this was an interesting introduction to the FIGO fund and process. It was decided that as this is a new type of fund for the Suffolk scheme it would be useful to see Blackrock every quarter in the short term.

M&G Investments: Alpha Opportunities Fund (active credit)

This was the first meeting with M&G since the allocation of £175m into their global credit fund. Presenting the report from M&G were Maria Stott (client director) who we had met before and David Fancourt (senior fund manager) who we had not. As this was the first meeting since appointing M&G the meeting started with an overview of both the company and the investment approach used in the fund. Alpha Opportunities has a performance target of LIBOR +3%-5%. It is described as having a bottom up benchmark unconstrained approach, investing in a broad range of credit assets with the performance coming from exposure to credit risk premium while simultaneously seeking to minimise interest rate risk. The current yield of the fund is 3% and it makes quarterly distributions. This is a large fund (£4bn) and maintains a very diversified portfolio of holdings, which currently stands at 389. M&G have a very large credit team, researching individual credits, and looking for mispriced assets is the core of the investment approach as is the discipline to 'stand aside' when the market is not paying adequately for risk.

One aspect of this approach that raised a few questions was the extent to which M&G hold what they referred to as 'defensive assets', (cash and near cash) in the portfolio in order to keep their 'powder dry' if markets were to experience a sell off. Currently the fund holds 21% in these defensive assets of which 10% is in cash. This has been as high as 35% of the fund as recently as August 2014. We asked for a chart of the longer term weighting in the portfolio of cash and near cash and it does appear that the weighting rarely falls below 20%, although it does move around substantially having been as low as 3% and as high as 40% over the last 5 years.

In terms of the outlook M&G expect more volatile times ahead with yields around fair value in terms of the premium (spread) over gilts. The US market is currently seen as best value as the supply of corporate bonds hitting the market ahead of the expected rate rise, has softened prices pushing rates higher. Overall M&G think that the recent volatility in global markets will continue and will provide plenty of opportunities for well resourced stock pickers like themselves to make active returns. They remain cautious on the European high yield market, as despite spreads appearing attractive, when historic default rates are factored in they are in fact expensive compared to history. It is an advantage of the "benchmark agnostic approach" that there is no compulsion to invest in expensive or poor value areas simply to remain close to the benchmark weighting.

Overall this was a slightly disappointing meeting, with not as much insight or clarity in terms of their approach or the market landscape as we had hoped. This was doubly disappointing being the very first meeting where we were trying to get up to speed with a new type of fund for the Suffolk scheme. I have since been informed that M&G were aware the meeting was a bit flat and have agreed that Richard Ryan (who was the manager who made the successful pitch to the committee earlier in the year) attend the next meeting in October, hopefully we can get a bit more of an insight next time.

Partners Group: Global Infrastructure fund

The presenting team from Partners was Brandon Praton (co-head of Infrastructure), Sarah Brewer (investor relations) and Marc Meier (fund manager Swiss office). 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. This was the first meeting with Partners since January a meeting where we were somewhat disappointed about the slow progress of the fund in terms of deploying capital. At the January meeting Brandon had assured us that H1 2015 would be a very busy period and that we would be seeing real progress at the next meeting.

There has been some progress and the fund now has thirty investments, which represents just less than 50% of the total commitment by investors. Partners have recently made commitments to projects that would bring this figure up to around 60%. However as of the date of the meeting only 32% of these total commitments had been drawn down from ourselves. This slow rate of progress has resulted in a one-year extension to the investment period, which now runs up until 2018. It should also be remembered that fees are being paid on the full committed amount. We were for the first time given an indication of the performance of the investments made to date, with a return of 7.7% net annualised as of end June 2015. The target remains in the 8%-12% and Partners still expect to be able to achieve this level

The reason for the slow progress remains the same as it did at the January meeting; market valuations in infrastructure remain high. In certain areas, valuations and transactions are at levels as high as in 2007, just prior to the crash. One of the issues is the huge amount of capital chasing quality infrastructure projects which results in aggressive pricing, Partners mentioned recent transactions of private equity buyers paying x28 EBITDA for an Australian toll road company and closer to home AB Ports being purchased at x24 EBITDA. Partners expressed the view that it would be impossible to make acceptable returns after over paying to this extent. Their approach is to look in areas of the Infrastructure market that are less crowded in terms of available capital. With 80% of Infrastructure funds raised in the US and Europe, Partners are looking outside these areas. Examples of projects they are bidding for included a light rail project in Canberra Australia, a Solar power project in Japan and Partners have signed a contract on a project to install an undersea fibre optic cable from New York to Sao Paulo in Brazil.

Overall progress is still slower than we would have liked, but where investments have been made they seem to be delivering the expected returns however the fund still is at such an early stage much is still to be done before we can make a full assessment. It will be a few years before the full picture on this fund becomes clear. It also seems unlikely that the market for finding infrastructure projects at a reasonable price in Europe and the US will get easier for Partners in the short term. It makes the performance and progress of our other Infrastructure manager KKR seem all the more impressive, it will be interesting to see if this remains the case when we next meet them.

Newton: actively managed global equity

The regular team of Paul Markham (fund manager) and David Moylett (client director) presented the Q2 report from Newton. The style of the slides had changed from the last time we met with more emphasis on linking stocks ideas to the underlying themes that drive the Newton investment process. As expected the meeting started with some comments about the recent market turmoil. The Newton view is that this is really a continuation of what has been the underlying situation for some time, that of a low growth, low return environment prone to bouts of volatility. David pointed out that the global equity market is now negative over twelve months. They expected more of this type of environment for the next few years. Interestingly the Newton view is that some of the really difficult fiscal decisions forced on Greece in the recent past will in fact be required in other countries in the medium term.

Paul took up the theme by pointing out that the structural issues in China had been around for some time now with the authorities trying to deal with the credit issues that have built up in the economy while at the same time trying to rebalance the economy more towards the consumer. A worrying new development has been the extent to which other Asian economies have started to competitively devalue their currencies, a situation worsened by the recent surprise devaluation of the Chinese Yuan.

All these issues now make it extremely unlikely the US Federal reserve will move to raise rates in September. Delaying into December or even into next year now seems more likely. However as mentioned in previous meetings the Newton view is that the Fed remain extremely aware of the need to raise rates and return to a more normal rate environment in order to have some headroom ahead of the next serious downturn. In fact the waning power of central banks globally to influence events remains a real concern for Newton.

Against this backdrop the portfolio has continued to outperform. Newton had positioned the portfolio defensively ahead of the recent turmoil. In terms of recent performance the portfolio fell 4.0% against a market fall of 5.3% over the second quarter. This continues a trend of outperformance that now stands at 4.2% ahead of the index over twelve months and 2.5% per annum ahead over the last three years which is the target. This recent strong performance has resulted in the since inception figure (which like Blackrock is now eight years) to stand at 0.8% per annum ahead of benchmark.

The rest of the meeting was taken up with a number of attribution examples in terms of both stocks and sectors. Newton remain cautious of emerging markets and will remain underweight as the shake out is not over yet in their view. They remain very keen on the IT sector, which is the best contributing sector in recent times for the portfolio. Paul has increased exposure to Google after the quarter end and that has proved a good purchase. As mentioned above the slides now contain more information of the types of theme Newton are keen to gain exposure to in the portfolio. These include companies benefiting from exposure to demographics, online spending and increased demand for health products. Overall the cautious defensive approach Newton has been adopted in the recent past continues to benefit performance. The impression given at the meeting is that we can expect more of the same in terms of the global economy and therefore the recent good run for Newton in relative terms could well continue.

Mark Stevens

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