Suffolk Pension Scheme
Manager meetings London: 29th January 2016

This report covers the face-to-face fund manager meetings held with seven of the fund managers employed by the Suffolk Pension Scheme. The meetings covered the fourth quarter of 2015, the year as a whole and some comments about the investment landscape for 2016. The meetings were held on the 29th of January and were hosted by Pantheon, who manage a number of private equity funds on behalf of Suffolk Pension Scheme. The overall impression was one of cautious optimism, albeit with the expectation of sustained volatility in markets throughout 2016. Given that markets have suffered their worse start to the year since the Great Depression, the overall mood was much better than we had expected.

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

First up were M&G Investments, who were represented by Andrew Swann (client director), Maria Stott (client service) and Richard Ryan (credit fund manager).

Andrew started the meeting by stating, “this is our time”. The difficult conditions seen in the credit markets in the seven months since the Suffolk Pension Fund made the first subscription have created a significant opportunity. When M&G were first appointed they were holding almost 30% of the fund in defensive assets including cash. They were waiting for a market set back in order to access value. As the risk appetite drained away from the market over the second half of the year, this is exactly what has occurred. The fund has halved its holding in defensive assets and expects to reduce this further as the managers continue to obtain oversold credits that are becoming available as investors panic and reduce risk.

This process is on going and M&G were keen to point out that they will have to enter the market to build positions, while prices are still falling and the bonds are available to buy from willing sellers. In the short term performance will suffer, however their firm belief is that in time buying good but out of favour credits when market risk appetite is low will deliver excess returns into the future.

Maria Stott briefly covered the performance since inception. Two subscriptions into the fund totalling £175m were made during May and June 2015. A gross return of -0.82% has been achieved up to the end of the year. This represents a relative underperformance of -1.16%, however this does include all the costs of entering the market as well as the weakness of the market itself.

The rest of the meeting was handled by fund manager Richard Ryan who expanded on the state of the credit markets and gave a number of examples of how M&G are hoping to benefit from these conditions. He confirmed that a major source of opportunity is the current evaporation of risk appetite. The more volatility is seen the more risk people think there is. Investors therefore have been indiscriminate in their selling, wanting to avoid market losses.

Unsurprisingly Richard does not know how long the bumpy ride will last, but looking at the portfolio his major concern is they don't have enough of the over sold bonds rather than holding too many. Credit spreads have widened sharply particularly in US Credit, which has about a 15% exposure in the fund. Monetary policy as well as risk appetite disappearing has driven prices lower. In Europe the ECB is doing the opposite of the US Federal Reserve, they want to push spreads and rates close to zero. This background has resulted in credit markets holding up much better in Europe overall. Only specific sectors have been weak, notably Mining and Oil but also Insurance where the new solvency II regulations are causing havoc, capital requirement for various risks still remain uncertain, spreads on household name insurance companies have widened sharply giving good opportunities for stock pickers such as M&G.

The final part of the meeting was taken up with a number of detailed examples of specific bonds held in the portfolio and the investment rationale that sits behind them. An interesting example was French company Areva. The company designs and builds nuclear power stations for EDF. A few delay issues on a major Finnish power station contract has lead to liabilities mounting up for Areva. Areva bonds went from a price of 90 to 75 resulting in 7-8% yield, on news of the problems in Finland. However the French state has now intervened and instructed EDF to step in and financially back Areva. Despite this clear state intervention (effectively removing the downside risk) the market was slow to respond to the change and M&G managed to build a useful position.

Overall it remains very early days for this fund and although the start has been disappointing it does seem as if M&G are now well positioned to take advantage of any upturn in global credit markets.

Blackrock : (active UK Equity and Global Bonds)

James Edwards (strategist, FIGO) Fred Wood (strategist) and Simon Betteley (client director) presented the report from Blackrock, which covered both the UK equity portfolio and the newly funded Global Fixed Income Fund (FIGO). The meeting started with a review of the equity portfolio.

UK Equity:
Equity markets recovered in Q4 2015, despite on going concerns over slowing growth in China and the much anticipated rate rise by the US Federal Reserve. All major equity markets showed positive returns. However the concerns that had been driving market nervousness for much of 2015 all came home to roost in the early weeks of 2016, with a very sharp sell off witnessed across the globe and the worst start to a year for markets since the great depression. It was noticeable that the Blackrock team remain fairly relaxed about the sell off. They do not see it as genuine panic or capitulation and point to the low volumes seen throughout January. Although much more volatility of this type is to be expected, these types of market do in fact throw up opportunities for active managers that can hold their nerve.

Fred Wood covered performance for the UK equity portfolio. Performance has been very strong in relative terms and although heartening the rewards for being under weight resources were described as 'outsized' compared to the risks taken, with one third of the entire portfolio outperformance coming from a modest underweight position. The rest of the outperformance comes from good companies who deliver earnings growth in a low growth environment.

The Blackrock UK portfolio ended up 6.8% over the year against a benchmark of 1.0%. Over the last quarter the portfolio returned 6.2% against a benchmark of 4.0%. As would be expected the recent very strong relative returns have strengthened the three year and since inception figures which now stand at a very credible +2.9% and +2.8% p.a. respectively. These are excellent figures but it is worth noting Fred's comment that recent returns have been disproportionately good when compared to the active risks being run, and hence we should not expect a repeat of this level of outperformance again this year. However Blackrock do see plenty of scope to continue the outperformance.

The meeting then turned to a number of specific stock ideas in the portfolio, including fast growing companies like Autotrader and Betfair. Changes to the portfolio including the sale of BHP Billiton and the slow reintroduction of Tesco were also covered. As the equity portion of the meeting concluded, Fred did point out that because they were lacking the truly defensive stocks they had lost 6% in January against a 5% market correction. However overall this remains a positive period for Blackrock and significant excess return has accrued to the Suffolk Pension Fund over the period of the relationship.

FIGO: (Fixed Income Global Opportunities)

James Edwards who works as a strategist on the fixed interest team gave some analysis on the market background. His view is that all markets are acting too negatively and too risk averse given the fundamentals. Oil demand is not low and therefore demand is not the issue. Strong supply is however, and this is not being reduced for many reasons including geo-political. There is nothing in the current data that implies China is collapsing. The US economy is still strong and continues to see very strong job creation, this is not a recession or crisis, just a slow down.

The Blackrock view is we entered 2016 expecting it to be a year of tightening but we have moved from this expected tightening bias to easing in just four weeks. The Federal Reserve has materially softened its outlook. The four rate rises expected for this year by markets now stands at one rise at most or even no rise at all, leaving the Federal Reserve effectively on hold. The Bank of Japan has introduced negative interest rates, The Bank of China introduces some form of loosening every time they meet. This is probably good for risk over next six months but markets are becoming more and more sceptical about central banks ability to underwrite risk.

James moved on to discuss the likely economic impact of the UK leaving the European Union so called 'Brexit'. This is an important topic and will have an impact on both the UK Equity and Bond markets. The Blackrock view is that there will be significant uncertainty in the run up to the referendum. They expect the UK to remain in, particularly if the campaigning centres on economics. However they see a real possibility that given the major issues on immigration the vote could be highly political and hence much more uncertain in outcome.

In terms of performance it remains early days in our relationship with FIGO, however in the approximately six months we have had an investment the fund has lost 0.82% (coincidently identical to M&G).

Partners: (Global Infrastructure)

Presenting the Partners report were James Larner (client team) and Marc Meier (portfolio manager based in Switzerland). The meeting started with a brief overview of the company, which now has $50bn under management and 800 employees. The infrastructure team now has a staff of 33 and should be 40 by year-end. When James was questioned on the reason for such significant staff build up he indicated that there has been a significant shift by Partners to become to more active in lead and joint lead investments both of which are labour intensive. Also given the competitive market good deals are increasingly harder to find and require more resources.

The market environment remains the same as at the last meeting. 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 in the 2008 crash particularly on large deals. They will continue to focus on the mid cap market (enter price full value $200m-1.5bn) and continue to seek opportunities away from the US and Europe.

The report then gave an update on the portfolio. As of November actual commitments have reached 67% of the total capital that was raised. This is up from 47% in December 2014. The amount of investment is now 55% up from 47% on the previous year. Interestingly the level of distributions back to investors now stands at 21%, which is ahead of expectations and reflects the very strong exit markets that have been present over the last year.

In terms of performance, the current net internal rate of return (IRR) stands at 9% and remains on target to deliver the targeted return, which is 8%-12%. In terms of the existing thirty-two investments in the fund none have issues, with approximately half 'on plan' and almost one third either 'above plan' or significantly ahead of expectations. So at this stage despite the frustrations at what appeared to be somewhat slow progress in getting the capital deployed, the fund now does appear well on track to deliver the expected returns; and given the amount of investments that appear above target it is possible we could see an uplift in the net IRR from current levels.

The rest of the meeting covered some interesting specific investments in the fund including an example of an early distribution. The Newcastle Coal Export terminal in Australia was sold earlier than expected into a strong market at 20% above par, realising a 1.66x money multiple and a net IRR of over 20.2%. This is a perfect example of how strong the exit market has become and also provides an illustration of why Partners have remained very cautious about overpaying as the portfolio builds out.

The meeting concluded with a brief discussion on LGPS pooling. Partners have contributed to the Hymans project pool initiative on infrastructure and have provided feedback to government on the feasibility of pooling the LGPS infrastructure resources.

Pantheon: (Private Equity Programme 2002-2010 and 2014-2015)

Pantheon who were our hosts for the day were represented by Rob Barr (partner), Alex Scott (partner), Mike Mellody (client service). As a reminder the Suffolk Pension Fund had committed a total of £37.1m across ten separate Pantheon funds with vintage dates (that is the year where the fund started to invest) between 2002 and 2010. The ten private equity funds in which Suffolk Pension Fund has an interest are invested across the globe with separate funds targeting Asia, the US and Europe. In aggregate of the £37.1m that has been committed Pantheon have now drawn down £32.0 for investments. As of September 2015 £30.0m has been returned in distributions with £18.6m left as the net asset value of the remaining investments.

The report contained estimated aggregate performance for the ten funds as at the end of December 2015. At this date the overall internal rate of return was shown as 9.8% (internal rate of return is the usual way private equity funds show performance as it captures the various cash flows and timescales inherent in private equity investment) and with a multiple made on the money invested of x 1.51. These returns represent a slight improvement over the figures that were presented at the last meeting, which was a year ago. It is worth noting that these are the aggregate figures with individual funds delivering significantly different returns both in absolute terms and also when compared to public markets. Detail was provided on a number of the individual funds.

These investments are now mature and are returning cash back to the Suffolk Pension Fund as would be expected for private equity investments which are a self liquidating asset class. Rob Barr covered the current private equity investment landscape. This can be summarised as strong for exits and company earnings. The ability to raise debt also remains strong but valuations are now quite stretched for new deals in certain areas and the flow of new deals is not as strong as in the recent past with turmoil in Asian markets the most noticeable.

The meeting concluded with an update on the new commitments to the three new Pantheon funds during the second half of 2015. The commitments into Pantheon Global Secondary Fund V, Global Co-investment Fund III and the Multi-strategy programme amount to a total of £80m. It is anticipated that a further £20m will be committed during the first quarter of 2016 into the 2016 Multi strategy programme.

Although it is very early in the life of all these funds the report did cover a number of the early investments that have been made and the indications are that these have gone well. It will certainly be informative to monitor this new set of commitments as they deploy capital given that this is the first new commitment to private equity for many years for the Suffolk Pension Fund and in terms of size represents a larger exposure than in the past to Pantheon.

KKR: (Infrastructure)

Alex Fletcher (Managing Director) and Guido Mitrani (Infrastructure team) presented the report from KKR, who we had last seen six months ago. 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.

Guido began the meeting by reiterating that the market for infrastructure remains very competitive with the search for yield if anything still increasing. In terms of the portfolio it is currently marked at x1.2 money multiple and a net IRR of 7.6%. The fund is still 90% deployed with 10% held for add on investments, this remains unchanged from the previous meeting. KKR are using the continuing strong exit market to look for ways to crystallise value by full or partial exits. It was mentioned there are two further sales under way with exits expected to generate strong returns. As the portfolio matures the realised yield is expected to rise. This yield now stands at 5.2% and is expected to grow to 6% by year end, which is on target for 50% of the total 12% target return. It was confirmed that all investments are now delivering a cash dividend.

The rest of the meeting covered various specific investments. One challenging investment that has not met expectations and has been exited below cost is Canada solar company SSM Solar. The weak Canadian dollar (which was not hedged) and heavy snow fall (the worst in 50 years) lead to the investment being sold at only 0.7%x money multiple. A disappointing result but not one that has damaged the overall return expectations.

The team went on to cover two success stories. ELL the European locomotive leasing platform started from scratch by KKR and focused in Germany and Austria has now deployed all its original capital with 50 locomotives acquired. With demand still strong the company is looking to take this inventory up to 80 locomotives. This will require some of the portfolio’s 10% reserve to get there. ELL continues to operate above expectations.

The final investment covered in detail was Saba the car park operator and one of the earliest investments. It continues to perform well, with the cost of restructuring having been a success. The company is close to divesting all its remaining logistics business which if successful may allow an early exit.

The meeting finished with thoughts on pooling and UK infrastructure. KKR have been involved with previous agreements proposed by NAPF. They stressed that any arrangement would need to stack up economically for both the manager and the pooled investors. One area that would need very careful planning was Greenfield infrastructure investment, where the pension funds need for income earning assets might be at odds with the return profile typical of green field infrastructure projects. Overall a good meeting with the fund delivering returns reasonable if not spectacular at this stage of the investment.

Newton: (active Global Equity)

The regular team of Paul Markham (fund manager) and David Moylett (client director) presented the report from Newton. The meeting started with David highlighting that the market environment remains very challenging; the roller-coaster ride seen in the final quarter of the year is simply becoming the norm now for markets. The high level of debt both private and public remain, low growth and low returns will continue for the foreseeable future with equity indices making little net progress overall but with significant volatility quarter to quarter. But even despite these challenges overall this remains a good environment for active management, given the divergence in economic growth and central bank policy that now exists across the globe the markets will continue to throw up good opportunities for stock pickers.

Newton continues to do well in this environment. The portfolio has been overweight in Information Technology and Healthcare and underweight in both Materials and Utilities which has been a benefit to performance, over the last twelve months both stock and sector selection has been positive. Returns over the past year have been exceptionally strong. Newton delivered a return of 10.7% for 2015 compared to a market return of 3.3%. This has fed through to three-year figures 3.5%p.a. above the market and five-year returns 1.9% above benchmark. Overall, a very credible performance.

The rest of the meeting covered stock changes over the last quarter with Paul highlighting particular areas of interest. These included Japanese soft drink and food company Suntory which is a new purchase. The stock looks very expensive on Japanese GAAP which is what most investors will be focusing on. However digging below the surface Suntory looks very good value when viewed on the basis of international account standards (IAS). This is a company, which is strong on innovation and free cash flow. Suntory have indicated they will only report on IAS going forward and on this basis they will look very good value when compared with similar companies in contrast to the present situation where they look expensive.

Other portfolio changes Paul talked through included adding to Altria (tobacco) because of a strong dollar, and taking profits on Kraft Heinz as the merger benefits have become overstated and the stock offers little upside from present values. The meeting concluded with the introduction of two new themes, which will help drive investment ideas going forward.

The first theme has been labelled "Mind the gaps" and explores the development of an increasingly divergent economy which to an extent is masked by the overall GDP figures in many economies. The gaps that are appearing in various areas of the global economy are not only dispersion in growth but also inflation, which is becoming increasingly divergent across economic sectors. Newton sees these growing gaps as both a potential trap for investors but also a source of potential returns.

The second theme that has been introduced is one of Abundance. This is also a two edged theme with both risk and opportunities for investors. The Newton view is there is too much capacity in manufacturing and other high fixed cost industries. This abundance makes pricing difficult, even between countries and as the internet democratises pricing globally this is bad for high fixed cost businesses. However, the abundance of connectivity and to an extent capital does provide for opportunities for companies set up to provide enabling technologies and services.

We will wait with interest how these new themes are played out in the portfolio. Overall another good meeting with Newton who are enjoying a very good run of performance, in what are difficult market conditions. Long may this run continue because as seems likely global markets are going to remain challenging for the foreseeable future.

Schroders: (Multi Manager Property)

Geoff Day (client director) and Graeme Rutter (head of real estate) presented the report from Schroders. The meeting started with an update on the various changes within the property team. The last meeting had taken place against a background of redundancy of our long time contact Jennifer Murray and then the unexpected resignation of the senior manager who was expected to cover some of her clients. It does seem as if the staffing issues are in the process of being addressed, a new fund analyst has joined the team, one of the senior experienced analysts has moved into a more fund management role. Grahame also confirmed that another outside hire would be joining the team in a property fund management role. So it looks as if the worst of the disruption is now behind Schroders, it is too early to tell how the new look team will perform but given the slow moving nature of the property market there seems no need for concern at this time.

The meeting then turned to market background and performance. The property market in 2015 continued its recent very strong run. Property is now the best performing asset class over 1,3 and 5 years. In terms of the various segments of the property market central London remains very strong but has become volatile and looks fully valued, because of this Schroders have reduced down the benchmark weighting for central London offices and might reduce it further in the future.

Outside London, strong occupier demand is lifting both office and industrial rents across the UK. Rental growth is now being seen in all areas of the market although retail continues to be the weakest area and this is expected to continue for some time. In terms of the overall market Schroders see property values as fairly full compared to history and expect a period ahead where rents catch-up with capital values. It was highlighted that there is not as much speculative development (particularly outside London) as in previous cycles and this should reduce any negative affects of a slowdown.

The City of London office market is the exception and looks toppy in terms of speculative development and hence vulnerable to a set back. Interestingly, Schroders are not seeing much drag from the emerging market turmoil or sovereign wealth funds and at the moment both areas remain very important for the London market. This speculative area has been key in previous downturns hence why this is important to monitor closely.

This part of the meeting concluded with a brief discussion on 'Brexit'. Rather unsurprisingly the Schroders view is that 'Brexit' would be bad for the London office market mainly because of the possible damage caused to the financial services industry, and possible weakness in sterling. One thing that does seem certain is that the London property market will slowdown until the vote.

The meeting concluded with a review of the performance of the Schroders fund. Over the long term the portfolio beats the property index by around 0.5% p.a. this is a fairly consistent figure over 3,5 and 10 years. The last twelve months have lagged the index by about 0.8%, the under performance can be attributed to cash drag and transactions costs as the portfolio seeks to invest new funds into a strong market. Overall Schroders remain solid if not spectacular and assuming the new elements settle into the team then this solid performance should continue.

Mark Stevens (February 2016)