Suffolk Pension Scheme
Manager meetings London: 6th May 2016

This report covers the face-to-face fund manager meetings held with six of the managers employed by the Suffolk Pension Fund, Pyrford were acting as hosts on this occasion. The six managers presented on seven separate strategies as a consequence of Blackrock covering both UK Equities and FIGO the global bond fund. The meeting covered the difficult and volatile first quarter of 2016 and the outlook for the year ahead.

The first quarter of 2016 proved to be a one of sharp contrasts for equity markets. The period up to mid February saw global markets suffer another severe set back, with falls of 20% or more from peak levels, a figure which is often seen as bear market territory. Once again anxiety over the Chinese economy weighed heavily, with growing concerns about the future management of the Chinese currency adding to the mix of slowing growth and the health of the banking system. January also witnessed another slump in oil prices with dramatic falls early in the month. From mid February onwards markets started to recover, the catalyst for this recovery was yet more central bank intervention coming from Europe, an economic stimulus package aimed at domestic demand in China and a softening in rhetoric from the Federal Reserve. All of which resulted in the quarter ending in slightly positive territory.

This sharp reversal in market and sector performance can be seen in the returns experienced by the active managers employed by the Suffolk Pension Scheme. Both Blackrock UK equity and Newton global equity had enjoyed a strong 2015. However with the mid February rebound benefiting previously out of favour sectors and markets, any portfolio that had done well over the recent past was destined to underperform during this period, and this was indeed that case for our managers. However the clear presentations heard over the day from all the managers were useful in putting the recent market volatility into perspective and showing how active management continues to seek opportunities in these difficult conditions.

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

Andrew Swan and Maria Stott (client service) presented the report from M&G. They were joined by Richard Ryan (senior credit fund manager) who is one of the fund managers on the Alpha Opportunities fund. Andrew Swan started the meeting by reiterating the aims and characteristics of the Alpha Opportunities Fund. As a reminder this is a multi asset credit fund with a performance target of 3%-5% above LIBOR over the credit cycle. The fund aims to incorporate some capital protection as part of the investment process. Suffolk Pension Scheme currently invests £172m in this fund.

Andrew then gave a quick overview of performance since inception of the Suffolk allocation, which was made during May 2015. During this period the return has been -0.31% which compares to a LIBOR benchmark return of 0.46%. This return is clearly disappointing but much of the rest of the meeting was spent examining the markets conditions that have resulted in this return and the active management decisions that have become possible in such a difficult and volatile markets. As is often the case, fund managers do like to give good news where possible and this was indeed the case here. It seems that the unaudited April numbers are showing a strong rebound in performance and a return of 2% is indicated. This would bring the since inception return up to around 1.74% above LIBOR, but of course nowhere near the target of +3%-5%. However is should be stressed that performance targets are predicated on a through cycle return and these remain very early days.

Richard Ryan then described the credit market background seen during the quarter. The first two months of year were described as being 'pretty brutal' with genuine panic seen in a number of areas. Some credit markets had almost completely seized as waves of fear surrounding China, the Euro zone and the collapse in oil investment took hold. Worried investors also began to look at US banks' exposure to the oil sector to such an extent that even extremely well capitalised banks such as Wells Fargo came under scrutiny. Richard pointed out that once an extreme shift in sentiment takes hold, it could turn into a vicious circle of fear and panic. An example being commentators predicting that oil would fall to $10 a barrel during this period, which in turn put more pressure on energy, related credits. Other areas of concern included 'Brexit', which impacted investor attitude towards UK Banks. European banks particularly in Italy and Portugal were also out of favour following a failed attempt at raising equity and the spectre of 'bail in' bonds coming to the fore. In terms of sectors Richard described how insurance sub-ordinated debt is now almost toxic, as other insurance companies cannot now hold these credits as new solvency rules forbid this. This has created good opportunities for M&G picking up spreads of around 4%, as opposed to the expected 1% which would be a fair price given the relatively low risk.

If I was to summarise the M&G approach it is to take advantage of this type of market dislocation and subsequent anomalies. Their stock picking approach involves buying while others want to sell, they will never (rarely) get the bottom. However they are confident that credits purchased during this recent turmoil will deliver good returns going forward (assuming no further panic sell off that is). The portfolios' defensive assets have now been deployed, these now stand at only around 7%, which contrasts to the near 35% when we first invested. The average credit rating now is BBB this was A- when we first invested so M&G are taking more risk, moving down the quality curve consciously as the spreads available warrant the increase in risk. Much of the rest of the meeting focused on these risks and also specific trading examples. Overall a good meeting from a team that always presents well. Given that they have executed the strategy as planned the hope now is for the performance to come through as expected. This will be the proof that the strategy is delivering as promised.

The meeting concluded with subject of pooling being discussed. M&G informed us that there are two other funds in the ACCESS group that are investors in the Alpha Opportunities fund. The current plan is to offer a new share class to the pool that will be available with a lower TER (total expense ratio) and they provided a slide to illustrate this.

Winton: Systematic Hedge Fund

Alison Priestley (client service) presented the report from Winton as our usual contact Jonathan Anayi (Head of UK clients) was away on business. This was not the first time we had met Alison as she had presented the Winton report a year ago also when covering for Jonathan. It was noted that this was the first meeting we have had with Winton following the decision to invest funds returned from BlueCrest with them.

The meeting started with an update on Winton as a firm. A decision has been taken to split research from investment management. This does not affect in any way the management of the Futures Fund where the Suffolk Pension scheme invests. It does however better reflect the differences between the roles of the investment management group, who are primarily involved with the implementation and coding up of the investment signals, from the research and data team who are hunting for and testing the signals. As risk control was a theme that occurred throughout the day it was noted that the Winton chief risk officer is not on the board. However the newly created role does report directly into David Harding the founder and CEO.

After a general run through of the market returns and the performance of various hedge fund strategies (index returns not Winton per se) over the last year there was a brief discussion on 'Brexit' and the ability of the Winton algorithms to interpret this potentially unique event. Alison remained confident that the trends that emerge even during a one off event such as 'Brexit' will still conform to a standard pattern over time and therefore will not cause any concern.

In terms of performance the last quarter has delivered flat performance which has fed through to a -3.3% return over the last twelve months. However over the longer term performance has held up reasonable well. Even after the recent negative returns the since inception return is 6.8% annualised which results in a 26% return on the invested money since inception. In terms of what drove returns over the difficult Q1 2016 Winton were long bonds and rates, which were the best performers, the cash equity strategies have been the worst with a very poor momentum signal doing the damage. The report detailed performance by sector over the previous twelve months with, Energy, Interest rates and bonds contributing the most to returns. Cash equities (individual shares) currencies and indices (equity) the largest detractors from returns.

Although Winton run an entirely systematic investment process the volatility affecting the tradition active mangers still affects this quantitative process. Alison pointed out that lots of positions in the fund (long and short) are in the process of reducing as trends reverse. On-going changes included moving from short to long in gold and looking likely to switch positions in a number of currencies including Sterling, Euro and the Swiss Franc.

The rest of the meeting focused on risk controls and measurement. Partly this was a theme that ran throughout the day, with a number of managers asked to give more detail on risk controls, but in the case of Winton the recent allocation of additional funds and the somewhat limited information they provide in the report proved a catalyst for some detailed questioning. It was agreed that in future Winton would try and provide some more information on risk controls and measurement for future meetings.

Blackrock: Fixed Interest (Global absolute return, FIGO)

On this occasion the team from Blackrock consisted of James Edwards (strategist, FIGO) Fred Wood (client director) and Simon Betteley (client director) who were joined for the first time by Leila Mahoney (fixed income strategist) who has recently joined the FIGO team reporting to James. They presented the report from Blackrock, which covered both the UK equity portfolio and the global fixed income fund (FIGO). In our previous meeting with the team the review of the equity portfolio was first up and took the lion share of the available time so on this occasion it was decided to present FIGO first.

James Edwards introduced the FIGO portion of the report with a very quick reminder of how the fund operates. Suffolk Pension Scheme have now been invested in this product for eleven months, it has a LIBOR +4%-6% performance target with a 2%-4% volatility target. It seeks to achieve this via a very diversified investment approach utilising a wide duration band -2 to +7 years (as a reminder duration is a measure of how sensitive a bond is to a given change in interest rates). As the fund has a low correlation to bond indices it should help diversify other portfolio assets including bonds. The aim of capital preservation plays a part in the investment process.

Since the investment was made performance of the FIGO fund has not been strong. The since inception return for the GBP share class is -1.37%. In terms of a monthly profile a slide in the presentation showed of the ten months since the investment was made there have been two positive, six negative and two flat months for returns. There did not seem any clear indication that Blackrock had enjoyed the strong April that M&G appears to have done and therefore as we move close to the one year mark returns might struggle to show even a LIBOR level of return.

In terms of why performance had been disappointing James explained that the FIGO positioning for the last year or so was predicted on running a low risk portfolio because there was a strong indication that the Federal Reserve was about to enter into a rate tightening cycle. As a consequence, Blackrock ran low levels of duration counterbalanced by some selective higher risk credits, the timing and extent of the rate hikes in the US proved less than the market had predicted and this had an impact on returns.

Other issues that detracted from performance included the holdings they had in European finance credit. Blackrock took the view that the regulatory environment was positive for these banks, in the event the introduction of negative rates by the ECB raised worries about European banks profitability and hence the bonds suffered. The issues surrounding ‘bail in’ bonds attached to Portuguese banks also affected risk appetite in financial bonds and Blackrock were slow to realise this, which detracted from performance.

FIGO also lost money by being long on emerging market currency basket five months too early, which was held against the USD, and detracted from returns during the period. However this basket has now started to perform along with Gold which the fund holds via an ETF (exchange traded fund) this lost money last year but is now performing well and acts as a tail risk hedge against the ability of central banks to control monetary policy.

The meeting focused on risk for a while following some questioning. James explained how they look at tail risk, by looking at each bond without any diversification i.e. how much risk is taken in each bond individually in a worse case environment (using various stress tests). They believe their propriety risk system (which is a profit centre in its own right apparently) is unique in the market place and gives them an edge in this area. After some discussions on risk measurement the meeting moved onto future policy.

Leila the newest member of the team concluded the meeting with a brief run through of the current views, they had been running low levels of risk so far this year, but with oil price stabilisation and Chinese growth bottoming they are now looking to add to risk by adding duration in US rates (treasury) on a relative value basis, compared to Germany on the long end of the curve in particular, (that is bonds with a long time to expiry). They are also adding to inflation sensitive positions as the outlook for inflation is set to tick higher by buying inflation-linked bonds. This was an informative meeting on a fund with lots of moving parts, performance has been disappointing but its very early days and the fund has plenty of tools to utilise in order to generate the expected returns.

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

Fred Wood who is the UK equity strategist was very pressed for time given the lengthy FIGO presentation, but nevertheless gave a quick run through of the UK Equity portfolio. In terms of performance Q1 2016 proved difficult given the sharp reversals in sector trends, any portfolio that had been performing well in the recent past would be expected to struggle, and this was indeed the case. The Q1 return was -1.2% compared to a benchmark of -0.4%. However over more meaningful periods the performance remains strong. Over the twelve months to March the portfolio outperformed by 3.8%, over three years 2.6%p.a. and since inception in July 2007 2.7% p.a.

Fred highlighted the sharp rotation that has been seen in equity markets year to date. Last year proved a good year for companies showing structural growth i.e. auto traders, and ‘disruptor’ companies such as Right Move and Just Eat. The year had also been very poor for resources companies in oil and mining. This year so far has been the complete opposite, without a great deal of supporting evidence from macro data the out of favour stocks from last year have begun to perform. It remains unclear whether there is a sustainable change as the data showing slow downs in the rate of decline in certain commodities might not in fact be reliable.

In response to these changing conditions and also as a risk reduction exercise (risk reduction against the index that is), Blackrock have closed the large underweight position in the oil sector increasing the weight up to neutral mainly by purchasing Shell. There are no plans to move to overweight at this stage because Blackrock believe Iran remains a block on OPEC being able to achieve meaningful production cuts. Despite what we have seen over the second half of the quarter they believe the commodity rebound will be short lived. The Blackrock view is still firmly that the commodity super cycle is over. They are however being wary of the commodity rebounds, which is why they have modified risk. They still believe that high levels of personal and government debt will result in continued low growth and low inflation. Therefore cash flow generation will remain key for stock selection going forward.

Overall a solid meeting with evidence that FIGO can start to deliver the expected returns the key concern at the moment. The equity portfolio looks set to resume its good performance as the market begins again to factor in the longer term underlying fundamentals.

Pyrford: Absolute return fund using traditional equities and bonds

Pyrford who were acting as our hosts for the day and were represented by Felim Glynn (client contact) and Tony Cousins (Chief Executive & CIO). Felim introduced the report by confirming that there had been no changes to the team since our last meeting six months ago, the new analyst that had been mentioned then as an imminent arrival, is now on board. The only other corporate news was that Pyrford have started to work with the London CIV (collective investment vehicle) where they will have five clients up and running from June. Needless to say Pyrford are keen to work with the ACCESS pool where they have one other client in addition to the Suffolk Pension Fund.

In terms of performance, Pyrford enjoyed a strong Q1 2016, returning 2.7%, which was ahead of the FTSE All share, which fell 0.4% and their actual RPI +5% benchmark, which was 1.4% over the same period. The defensive nature of the portfolio has been a benefit in terms of performance, particularly against a UK equity benchmark where Pyrford have delivered 2.3% and 4.7% annualised returns over one and two years against an index return of -3.9% and 1.2% respectively. However, the Pyrford portfolio holds some overseas equity and both UK and overseas bonds and is managed with an absolute benchmark of RPI +5% as the target. Against this benchmark the portfolio has done less well. Despite a strong last six months which is ahead. Over one, two and three years and since inception Pyrford are behind this RPI +5% target.

The strong performance over the recent past and the underperformance over the longer term can both be seen in the same light. Pyrford are running a very defensively positioned portfolio, both in terms of the equities held but also in the types of bonds, which are short duration and therefore less exposed to the large moves that have been seen in the longer duration bonds, which in recent times have delivered strong returns.

CEO Tony Cousins reiterated the Pyrford's approach to long-term investment. He rejects 'tracking error' as a meaningful measure of risk control. There is no safety in numbers; markets can fall very quickly and sharply. The ability to remove/limit investment risk is key for Pyrford. Avoiding the sharp falls so prevalent in markets is important to their approach, with Tony pointing out that a market down 39% then up 30% is still down 9% overall ! If nothing else Pyrford have a number of senior staff that paints a compelling if somewhat scary view of global investment conditions and Tony is no exception.

The rest of the meeting was a whirlwind tour around recent market behaviour and some of the longer-term underlying issues that continue to influence this behaviour. In an entertaining run through Tony covered European banks, which were 'crushed' during Q1 2016. Needless to say Pyrford hold no European banks. The 'bail in' regime in Italy and Portugal started the route with owners of junior bonds bailed into equity which then risks becoming worthless, really damaging sentiment (see M&G/Blackrock above on the same issue). Tony's view was that, what made this development even worse was that certain investors did not know they held bonds that had these 'bail in' characteristics (this sounds somewhat negligent to me if true).

Pyrford as a firm also have concerns about the ECB's measure of bank balance sheet riskiness which was described as 'smoke and mirrors'. However given the sharp sell off, the team never shy of being contrarian have started to look at some European banks. Warming to his theme Tony moved onto central banks behaviour. We were shown a number of graphs depicting 'absurdly' low bond yields caused by money printing, Pyrford (and others) have a firmly held opinion that real economic growth is not created by printing money, but rather by sales and productivity growth. All that matters thematically is that these factors are absent at the moment, the asset price inflation we have seen since 2009 is a red herring in this sense. As an example of where policy might be running into serious issues the presentation moved onto Japan. Here the central bank liabilities to GDP curve is turning parabolic, itself very worrying but when combined to the 220% debt to GDP and 8% deficit level it is not a pretty picture. With government bonds equal to 130% of issuance being bought by the Bank of Japan, and negative interest rates introduced the behaviour of the Yen (i.e. strengthening) appears totally perverse. We live in strange (worrying) times was the message I took from this part of the presentation.

In fact the sharp market sell off seen in the period up to mid February saw Pyrford buy equity for the first time since 2009, with some equity markets down 20% from the highs and yields in the broader market (total market UK from DataStream is the universe they look at) hitting 4% the allocation to equity was increased by 5%. They still believe the fair value number for the UK market is 5% div yields, if the market were to hit this level then the team would be looking to buy more aggressively than the 5% tranches they did in 2009. The reason is that the return on bonds now is so low compared with 2009 that equity would be significantly more compelling in comparison if it did fall to these levels. Overall another thought provoking run through from Pyrford, who if nothing else are consistent in their message and articulate their worldview powerfully.

Newton: actively managed global equity

David Moylett (client director) and Paul Markham (fund manager) presented the Q1 2016 report from Newton. The meeting started with David giving an overview of the global market conditions seen during first quarter. Unsurprisingly this was described as remaining very challenging. At our last meeting in January Newton had commented that the roller-coaster ride seen in the final quarter of the year (2015) is simply becoming the norm now for markets, this it turns out was a prescient comment. Investors witnessed not only a very sharp sell off in equity markets from the beginning of the year until a sharp reversal from mid February, but also performance rotation in terms of sectors and regions. Japan which had been a strong performer during the previous period fell sharply due to concerns over the effectiveness of central bank policy. The Bank of Japan introduced negative deposit rates for banks in a move aimed at stimulating lending and weakening the Yen, in the event, the Yen strengthened which in turn worried investors. In contrast Emerging Markets, which had been amongst the worst performing regions in the medium term, bounced strongly on a modest rally in commodity prices and a weaker dollar.

In terms of how all this volatility has affected returns, Newton rather unsurprisingly had their first negative (relative to benchmark) quarter of the recent past. The portfolio returned 1.8% against a benchmark of 2.8%. However after such a recent strong run, all other periods from one year to inception are comfortably ahead of benchmark. As an example the three-year return is 2.1% p.a. ahead and the five year 1.8% ahead p.a.

Paul went on to describe in detail the various drivers of performance over the latest quarter. In general terms the underperformance of value stocks has not helped them. At the sector level the fall back in healthcare, which is one of the main overweight's in the portfolio, also detracted from performance. This appears in part due to concerns over a potential Hilary Clinton presidency, as she is expected to look for price regulation in healthcare industry if elected. The bounce in emerging markets was also a negative as Newton has been (correctly) underweight emerging markets for some time. Emerging markets are an area where Newton are looking to explore further. The sustained underperformance to developed markets makes them now more interesting and although a number of issues remain, including over leverage of foreign currency debt and the general slow down in the global economy, there are genuine areas of value emerging and if prices were to fall further we can expect Newton to begin to increase positions.

The rest of the meeting was a run through of the various trades that have been carried out over the quarter and the reasons behind these trades. These included purchasing international drinks company Diageo, partly because of its very strong Indian business where, particularly in high end whiskey it is growing sales very strongly. In the UK the holding in Vodafone was increased as it had fallen to a level where it was trading on a 5.5% yield and had hit the bottom of a fairly well established trading range

Overall a friendly and informative meeting with the issues surrounding the first quarter well explained. Although the sharp change in market leadership did no favours to Newton over the quarter they remain confident that their style of active management will continue to add value in a world where the difficult financial conditions and low growth rates are expected to continue.

Legal & General Investment Management: Passive Equity and Bonds

James Sparshott (head of local authority relationships) and Adam Willis (head of index distribution) presented the report from LGIM. They had produced a report that summarised the asset management relationship they enjoy with the Suffolk Pension Scheme. This consists of c.£729m in assets invested in a number of low cost index tracking funds that cover all major developed equity markets, global emerging markets and the RAFI all world index. In addition LGIM managed index tracking funds covering over 15 year Gilts and emerging market bonds. The report highlights that all funds have performed in line or have exceeded their benchmark since inception and are now enjoying a reduced fee of 0.13%.

The meeting quickly focused in on the performance and characteristics of the RAFI portion of the passive portfolio. As a reminder RAFI stands for Research Associates Fundamental Indices. These indices in contrast to the more usually quoted capitalisation weighted indices (for example FTSE100) break the link between price and index weight, they instead attach weight to a series of balance sheet fundamentals for example book value, sales, cash flow and dividends. Whereas in a capitalisation weighted index the more expensive a company becomes the higher its weight this is not the case for RAFI. One possible way to view the difference is to think of RAFI as a mean reversion construction and capitalisation weighted indices as a momentum construction.

RAFI indices tend to exhibit a value tilt because of the construction methodology. When mean reversion in stocks occurs this will help RAFI returns (relative to cap weighting) but this revision has not happened recently, leaving value out of favour. Adam noted that global stocks are trading at a 43% valuation discount compared to market capitalisation and that these levels historically have resulted in subsequent RAFI outperformance of capitalisation weighted indices over the subsequent five years . The 2009 RAFI rebalance, which drove extremely good subsequent returns, was the subject of a lot of investor nervousness and some redemptions. It was known that the rebalance was going to deliver a big trade into Financials. Investors relying on instinct redeemed ahead of this (the inference was they switched into cap weighted benchmarks once more) and subsequently lost between 15-20% of the next years bounce in markets which was captured by the newly re-weighted RAFI indices benefitting from a sharp mean reversion in financial stocks.

Over all this was an informative meeting and it will be worth monitoring how the various passive strategies perform over the medium term, which with the previous allocations to just the capitalisation weighted passive portfolio was not previously of interest.

Mark Stevens (May 2016)