Suffolk Pension Fund
Manager meetings: London 5 August 2016

This report covers the face-to-face fund manager meetings held with seven of the managers employed by the Suffolk Pension Fund. Newton were acting as hosts on this occasion. The meeting covered the quarter to June 2016, which was a volatile period and included the results of the EU referendum. Most managers covered the immediate impact of the 'Brexit' result and gave opinions on the medium term outlook given the importance of the result for the future of the UK economy and beyond. An important factor related to 'Brexit', was the issue of currency exposure and hedging activity. Every manager was asked to briefly cover their policy on currency hedging and the extent to which this had been carried out during the recent volatility on currency markets.

KKR (Global Infrastructure)

The KKR report being presented by Guido Mitrani (principal, London) and Doug Watt (client team). The meeting started with an infrastructure team update and the announcement of the arrival of Tara Davies as a London based Managing Director of Infrastructure. Tara joined from Macquarie where she was Head of Infrastructure Mergers and Acquisitions. The report went on to highlight the latest performance figures and give an update on recent disposals from the fund.

In terms of performance to date, a summary of returns showed the portfolio marked at x1.3 MOIC (multiple on invested capital) net of fees. The fund has realised a 2.3% cash yield on an annualised basis over the first half of 2016, mainly driven by returns from solar power company, SunTap Energy and South Staffordshire Water. The portfolio is now 93% invested and the remaining capital is reserved for follow-on investments into existing holdings. This situation indicates that the fund is moving into its distribution phase where cash from both dividends and disposals will be returned back as the fund gradually liquidates.

The number of disposals within the fund continues to progress at a healthy rate and the market remains strong for sellers of infrastructure assets. Guido spent some time covering the upcoming sale of regional heating company Coriance. This has become a very profitable investment for the portfolio. The sale to First State Investments announced in June is expected to complete in September. On completion Coriance will deliver a gross multiple on invested capital of x2.5 with a gross IRR (internal rate of return) of 30% on a € basis. Coriance has exceeded expectations in both financial and operational performance. The new management team have won a number of new concessions and this combined with restructuring the company with cheaper debt; negotiating cheaper gas supply contracts and extending existing contracts has allowed the profitability of the company to double over the ownership period on dramatically improved margins. Adding to the realised investment return is the strong market for exits, where the multiple paid for these improved earnings has sharply increased, reflecting the dramatically improved margins and balance sheet strength.

The rest of the report covered general market conditions, which as mentioned remain very favourable for sellers. The refinancing markets also continue to show healthy liquidity. Other portfolio highlights included SABA the Spanish car parks business that is trading well and likely to be the next candidate for sale. T solar, which was the 'problem child' due to regulatory difficulties in Spain, is now refinanced and performing well. In terms of 'Brexit' no real affect is expected on the portfolio although for US$ investors South Staffordshire Water has suffered a reduction in value on translation.

The meeting concluded with a discussion on the cross-pool infrastructure group, which KKR are due to meet in the near future. This was a positive meeting and given the good progress with the fund, which is rapidly moving into the distribution phase, on current expectations this means 60-70% of the original investment cost will be returned by the end of the third quarter of 2016. Given this likelihood some thought might be appropriate as to whether there is an appetite to explore participating in any follow-on funds from KKR Infrastructure, in order to maintain the desired exposure to this asset class.

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

Blackrock attended the meeting with a team of four. James Macpherson (equity fund manager), Imran Sattar (equity fund manager), James Edwards (fixed income strategy) and Simon Betteley (client team). The meeting started by covering the news that James Macpherson has been promoted to Deputy CIO and that he will no longer be running the SPF UK equity portfolio. Imran Sattar who is part of the same team as James will be taking over on a day-to-day basis. Imran is very experienced and has been at Blackrock for a long time with an impressive track record of performance. In many ways I think there would have been less questioning and less time spent on this news if Blackrock had not provided a detailed slide on the relative performance of Imran in comparison to James. Although both records are highly impressive James did appear to have the edge over most periods and significantly so over three and ten year periods. I think by trying to be so transparent, Blackrock actually raised some concerns that might not otherwise have been there.

I do not believe at this point in time there is anything in this change of manager that should cause alarm and there is no reason to believe the team and process at Blackrock will remain anything but strong and robust into the future. It was pointed out that there is already a 76% commonality of holdings between the funds run by the two managers so although there will obviously be some stock specific changes to the portfolio, these should be limited. Although we were informed that Imran does prefer slightly larger stock positions than James, given the overall risk controls I would not expect this to introduce any significant levels of increased volatility at the portfolio level.

The meeting then went on to cover recent performance and market conditions. Overall the quarter to June was difficult and volatile. The portfolio was described as modestly positioned towards a 'remain' result in the referendum. A number of the more domestically orientated holdings fell sharply in the immediate aftermath but recovered as the quarter came to an end. Blackrock have recently reduced some risks in the portfolio particularly in the banks sector, which proved a good move given the interest rate reductions and introduction of more quantitative easing from the Bank of England.

In terms of performance, the portfolio after a very strong run did underperform in the quarter, up 4.0% against a benchmark of 4.7%. Despite this, the twelve-month figure is still 2.2% above benchmark. All other periods show outperformance against benchmark including the since inception figure which is now 2.6% p.a. over nine years. Overall a positive meeting and the departure of James from the day to day management of the portfolio although not ideal, should not cause any immediate concerns,

Blackrock: Fixed Interest (Global absolute return, FIGO)

The majority of the meeting was spent discussing the UK Equity portfolio and as such the FIGO presentation was shorter than usual. James Edwards who is a strategist on the fixed interest team began by giving a recap on FIGO. The performance target is to deliver 4-6% over cash with a low volatility of returns and without taking a view on the direction of interest rates while utilising a wide range of fixed interest instruments.

In terms of performance, the quarter showed an improvement with the fund generating a return of 1.2%. This in turn has boosted the year to date return into positive territory of 0.5%. The twelve months to June remain disappointing at 0.10%. Detailed attribution of the performance was provided in the report. The most significant negative was the fund being long Sterling going into the referendum vote, with the position taken mainly against the Euro. The team had taken the view that Sterling had been oversold into the referendum period, which they stressed tested, to understand the risks prior to taking on the position. They have now taken this risk down with the introduction of US treasuries, which have an attractive yield (relativity) and have performed well since the referendum particularly for sterling based investors. The good news is that post the quarter end, July has been very strong and at the time of the meeting the portfolio was now showing 2% up gross of fees year to date.

In terms of the outlook Blackrock are confident of making the performance target for this year giving the performance year to date and the yield in the portfolio which is now at 3.1% up from 2.7% in March. They are now running long UK Gilts after being short earlier in year on expected rate rises from the Bank of England, this has prospect has now vanished and a new programme of quantitative easing (QE) has been introduced. This new QE is a problem for bank equity (Newton make a similar point below), however bank debt is becoming more interesting as it has been excluded from the Bank of England corporate bond purchases (part of the latest QE) and is therefore now trading with 4% yields, which is now relatively attractive compared to other corporate bonds. Overall the good news with the results in July, has made the returns generated by FIGO much more in line with targets. Hopefully 2016 will not hold any negative surprises and after a tricky start the fund can deliver what was hoped for.

M&G Investments: Alpha Opportunities Fund (active credit), Debt Opportunities fund (distressed debt & restructuring)

Andrew Swan (client director) and Andrew Amos (director, fixed income) presented the report from M&G Investments. The main focus of the presentation was on the Debt Opportunities fund (DOF). Andrew Amos started by providing an update on DOF I where the fund is now fully invested and beginning to return cash as some early investments are liquidated. The fund is currently 80% invested in loans and 20% in high yield bonds. Eight investments have been realised all with returns in excess of the 15% IRR (internal rate of return target). The since inception return is 10.95% after fees and this is expected to rise close to 15% after the fund's major investment in Alliance Medical is liquidated, it was confirmed that post the restructuring that Alliance Medical continues to trade very strongly.

Andrew went onto detail a number of the successful realised exits to date and explained the various drivers of the returns that have been generated. During the meeting a slide was presented showing the expected realisation timetable over the next eighteen months. The current expectation is that 65% of the funds positions by value will be exited within twelve months. This is in line with the five year life span of the fund. SPF can also expect a £27m dividend to be paid in early August as the DOF I moves into its distribution period where quarterly dividends will be paid out.

There was a very brief update on DOF II this is now fully drawn and committed with seventeen investments in twelve sectors and seven countries. There will be some top up investment including Alliance Medical and for the Irish residential property investment requiring the remaining additional capital. Returns to date are a little behind what would be expected with a since inception return of 8%. This is mainly because of a Czech coal business, which has underperformed, however, the 12-13% target return is still expected to be delivered post Alliance Medical sale. The reinvestment period will last until mid 2018 for this fund at which time is will start to deliver the dividends and returns of capital in the same way DOF I is now doing.

The rest of the meeting concentred on two new funds the teams are marketing the Debt Solutions fund, which will carry out direct lending in complex situations where other providers don't have the resources or capital freedom to get involved. The fund will look to support good business through a transition phase when banks won't help in countries outside UK, Germany and France, for instance Italy and Greece They will be looking at good quality low risk companies with low leverage. But companies that nether the less have complexity. The aim of the fund will be to provide a running yield of around 6% with a 6% equity kicker.

The other fund called Folios III is a partnership with a Dublin based housing developer, which is a company that originally was restructured in the DOF I portfolio. Overall an interesting meeting with the returns to both DOF I an II on track and significant cash being returned to SPF over the next few years.

Newton: actively managed global equity

David Moylett (client director) and Paul Markham (fund manager) presented the report from Newton. The meeting started with David giving an overview of the global market conditions seen during the quarter. Global markets had been characterised by high levels of uncertainty and by a sharp rotation in the sectors that have driven returns. All regions of the global equity market delivered positive returns to an un-hedged Sterling investor during the quarter, however to a large extent this performance was driven by the weakness in Sterling. The strongest region over the quarter was the US with emerging markets enjoying a sharp recovery towards the end of the quarter.

In terms of sectors, the energy sector was the strongest, up almost 18% in three months on hopes that the slight recovery in oil prices had further to go. The worst performer was consumer discretionary stocks, up only 3.6%. However, it was the disappointing return to information technology up 5.8%, which had the more significant impact on the returns to the Newton global portfolio. The portfolio had greatly benefited from being overweight IT and underweight energy stocks in the recent past, however as the relative returns to these sectors reversed over the quarter the portfolio underperformed.

In terms of performance, Newton delivered 8.2% against a benchmark of 8.6%. However, despite the recent change in market leadership highlighted above, the positioning of the Newton fund has been favourable for a considerable period of time. The one year return of 16% is 2.7% ahead of benchmark, as are all other periods including the since inception numbers. Paul Markham went through in some detail on a number of stock specific influences both positive and negative over the quarter. The rest of the meeting covered some of the investment themes that help drive the Newton investment process.

Particular attention was drawn to the issue of state / central bank intervention on interest rates. It was pointed out that zero and negative rates are 'toxic' for the financials sector as they undermine lending revenues while destroying deposit and investment income. Overall this global rate situation is making it almost impossible for financials to create value to shareholders (a point also made by Blackrock above) and this is a prime reason for remaining underweight the sector.

The meeting concluded with a discussion on the 'Brexit' vote and putting this in context with other global themes. Although the direct portfolio impact of Brexit is limited for a global portfolio, it is an important decision in that it is the culmination of many longer terms forces that do impact on stock selection and are likely to continue to do so in the future. Overall a good meeting with plenty of two-way conversations and a report that highlighted the extent to which Newton continue to invest thematically and with a medium to longer-term investment horizon.

Schroders (Multi Manager indirect property)

The report from Schroders was presented by Geoff Day (client director), Graeme Rutter (head of real estate) and Naomi Green (property fund manager). This was our first chance to meet with Schroders following the rebuilding of the team after the departures and redundancies of the previous year. Graeme Rutter who continues to look after the SPF investments on a day-to-day basis is now joined by Naomi Green acting as his alternate. Naomi joined Schroders in April; from Electra she has a lot of previous experience dealing with specialist property funds. With the arrival of Naomi the Schroders team is once again fully formed.

After an update on the team Graeme gave a run through of the property market. In many ways it has been the property market that appears to have been most affected, in the short term by the 'Brexit' vote. It was therefore unsurprising that much of the market overview focused on the possible implications of 'Brexit' for property. The key massage from Schroders was that since the vote, a high degree of uncertainty about the 2017 UK GDP and inflation has entered the market. The range of forecasts is now huge particularly for GDP and because there is such a strong relationship between GDP and rental growth this uncertainty has large ramifications for pricing in the property market in general but for Central London offices in particular given specific concerns over 'Brexit' that sit on top of GDP uncertainty.

Graeme confirmed that it remains very difficult to accurately forecast what 'Brexit' will mean for Central London offices, however it is widely agreed that it is this segment of the property market that is most vulnerable given the importance of financial services. There have been some estimates of up to 50,000 jobs losses in the City (this of course could be completely inaccurate), which at 100sq ft per person is 5m sq. ft. of prime office space demand lost to the market, which would be significant, even with the prospect of some schemes being postponed which would create some offset.

We were shown a chart of net additions against forecast net absorptions for central London office space that indicated a vacancy rate moving from 6% to 15% in London over next 2 years. However, beyond London the picture looks much brighter, the shortage of grade A space in the twenty largest cities outside London is acute and this gives plenty of opportunity for property managers to add value through refurbishment

Naomi concluded the meeting with a run through of the portfolio. The portfolio is currently sitting on 2.2% cash but this has now been committed. In terms of performance the three months to June delivered flat performance in line with the benchmark. Over a year the portfolio is up 6.7% against a benchmark of 7.2%. Both these valuations were impacted by 'fair value' adjustments that were imposed following 'Brexit' by Legal & General and Standard Life. Both managers reduced the value funds by 5% following the vote to reflect 'perceived' changes in the value of properties. However it was pointed out that these adjustments were made without any transactional evidence. These adjustments remain under review. Over the longer term Schroders remain marginally ahead of benchmark and have added 0.4% p.a. over ten years.

In terms of the outlook Schroders are looking to actively reduce central London property and have already post quarter end, made reductions in industrial property with the aim of building cash to 5% and subsequently to look for opportunities from distressed sellers if the market does undergo a post 'Brexit' correction. Overall a reassuring meeting from Schroders who have re built the team and now seem on the front foot in terms of maximising the post 'Brexit' investment environment

Partners Group (Global Infrastructure)

The report from Partners Group was presented by Sarah Brewer (senior vice president) and James Larner (vice president), both from the Investment Solutions group. James started the meeting with a quick update on the firm. Assets under management have now grown to $50bn, the Denver office is now fully open and was described as being set up to create a campus environment suited for idea generation. James mentioned that the infrastructure group that is responsible for the fund where SPF has an interest is now 41 people strong.

The report then went on to cover the market environment in global infrastructure investment. The Partners view is that there has been no real change in the environment since we last met six month ago. As a reminder very large sums have been raised from investors for European core infrastructure assets which has lead to prices being driven up and value becoming very hard to find. As overpaying for assets is a killer for infrastructure returns Partners have emphasised many times the advantages of having a global reach. The team continue to search for opportunities in the less crowded and obvious places where they anticipate better returns will be available. We were given as an example that in the current environment there are much better returns available in Japanese renewables than in either the US and European markets which is where Partners are concentrating their efforts in renewables.

Sarah Brewer then provided an update on the fund in terms of commitments and returns. Previously a characteristic causing some concern with the Partners fund has been the impression of slow progress in getting assets into the portfolio (particularly in comparison to KKR). The good news is that there does appear to be some real progress now being made. The latest figures we were shown were up to the end of May 2016 and these showed a commitment level (that is investments agreed as a % of money raised in the fund) now at 73% up from 62% a year ago. The amount actually invested is 60% up from 48%. As would be expected the returns are also improving as time moves on, with a net multiple on money invested now x 1.17 (x1.11 in 2015). The annualised net return since inception is now 9.4% (7.7% 2015)

Importantly the portfolio assessment showed that of the thirty-four investments in the fund only one is categorised as “with issues” this is a US gas fired power station that was unexpectedly closed for urgent maintenance in December for almost a month as repairs took much longer than expected. However the portfolio looks in good shape with ten assets above plan and twenty-three either on plan currently or expected to be after the first assessments are made. The report also contained a slide indicating that the fund will complete in terms of commitments this year. There has been significant progress even since May with four major deals being closed subsequent to the figures shown in the report. With the market so strong for sales we were told to expect further partial exits over the rest of the year. It does look now as if Partners will be returning cash back to SPF in much the same way KKR will be doing and hence keeping the desired exposure to the Infrastructure market will need some thought over the next few years from the committee.

Giving the sharp moves in Sterling since the ‘Brexit’ vote some time was spent explaining how the fund hedges its currency exposures. The currency hedging for the fund on a look through basis, was shown on a slide along with the changes in the sterling hedging pre and post ‘Brexit’. Sterling exposure moved from 8.5% un-hedged one week before the vote to just 3.5% over the result period. Its worth noting that this fund is in fact a € denominated fund. This was a positive meeting will real progress now being made and the returns that were hoped for beginning to materialise, the decision in my view as with KKR is what to put in place to replace this infrastructure exposure as distributions from exited assets are returned to SPF .

Pantheon (Private Equity programme)

The team from Pantheon presenting the report consisted of Rob Barr (Partner), Mike Mellody (Analyst) and Helen Steers (Partner). It was the first time we had met Helen although she has been at Pantheon for twelve years. Helen leads the Pantheon European primary investment activity as well as chairing he European investment committee. The meeting started with a run through of the private equity market conditions.

In terms of new deal activity this remains at good levels but has not recovered to the very high levels of activity seen prior to 2008 and there has been some slow down in European deal flow during the current year. Exit activity remains very strong with another record year in terms of distributions (a feature also seen in infrastructure see KKR and Partners). Ultra low interest rates continue to fuel the market for buy outs and the availability of debt remains strong although deals are still not being structured with as much leverage as prior to 2008. Importantly for performance the earnings being seen in the private equity space are significantly out pacing those seen in public equity markets. An example Pantheon gave for this year showed European private equity revenue is up 8% with earnings up 10% with public market comparisons of -3% and -3% respectively. However this healthy environment is making the price of entry for many private equity assets expensive in terms of multiples and therefore great care needs to be taken not to over pay for assets.

In terms of performance across the thirteen funds that make up the SPF private equity exposure to Pantheon the current valuation shows a multiple on invested money of x1.45 and a net IRR of 10.5% (9.8% in 2015) this shows an outperformance of public markets (in this case MSCI World) of 1.75%. This is below what would be expected given the illiquidity premium of this asset when compared to public markets. However Pantheon remain confident that over the life of the programme the returns will strengthen from here and with public markets unlikely to continue their recent strong run over the medium term the expected 3-5% outperformance of public markets is entirely realistic .

The rest of the meeting covered the permanent capital private equity investment trust run by Pantheon where SPF has an interest. Here performance in both share price and NAV terms continues to outpace the FTA All Share index. The final slides covered the new investments made by SPF this year in the Pantheon Access 2016, which is a customised account of primary investments into a global portfolio consisting of between 30-35 leading private equity firms, which appear to be on target in terms of timing.

Mark Stevens August 2016