Suffolk Pension Fund
Manager meetings: London 31st October 2016

This report covers the face-to-face fund manager meetings held with five of the managers employed by the Suffolk Pension Fund. Private equity manager Wilshire were due to present but weather issues resulted in their flight being cancelled and therefore they were unable to attend.

M&G were acting as hosts on this occasion and took the opportunity to introduce a number of new fund ideas in addition to providing an update on the Alpha Opportunities fund.

HSBC Security Services also presented on the performance measurement service they will be proving the fund following the decision by State Street to withdraw from this area of the business.

For the managers presenting on funds, the meetings mainly covered the eventful third quarter of 2016, which included the immediate aftermath of the EU referendum in the UK, the year to date returns and the immediate outlook for markets.

Although there is now an extension until January 2018 for compliance with the Markets in Financial Instruments Directive (MiFID II) clarification on the plans the schemes' fund managers are putting in place to deal with this legislation is relevant and the subject was raised with each manager in turn. Specifically, how they intend to classify the Suffolk Pension Scheme.

Winton (systemic hedge fund**)**

Jonathan Anayi (Head of UK clients) presented the report from Winton. He began the meeting by detailing the change in the organisation that had initially been flagged to us back in May by Alison Priestley who was covering for Jonathan. As a reminder of the changes, a decision has been taken to split research from investment management. Researchers will maintain a more academic focus away from short-term markets, whereas as the fund managers will focus on implementation of ideas. 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 different groups involved with the fund. We were given two examples of long-term research topics being looked at currently, which covered the areas of merger and acquisition activity by companies and issues surrounding corporate governance.

Winton have also looked at the important issue of succession planning for founder and Chief Executive, David Harding. It was recognised that, Matthew Beddlle who has been at Winton sixteen years and is currently the Chief Investment Officer would be the ideal choice and in recognition of the additional skills required to lead a company like Winton, he was sent on a nine month bespoke course on leadership at Stanford university.

The meeting then focused on the recent performance of the fund. Performance has been difficult for Winton over the last year. The fund has produced a negative return of 1.5% for the last twelve months. The third quarter of 2016 was also difficult with the fund down 1.1%. This has unfortunately resulted in the year to date return turning negative. The nine month to September return is now -0.8%. This recent poor performance has reduced the since inception returns which now stand at 5.7% on an annualised basis.

The main reason for the disappointing returns of the last year have been 'cash' equities (that is individual shares rather than index futures), these have fallen 4.7% over the year despite modest gains over the last quarter. Other detractors over this period have been precious metals and index futures. The most profitable strategies have been, currencies, interest rates and bonds. But good returns in these areas only partially offset the losses mentioned above. The significant impact of the cash equity strategy was especially disappointing given the relativity modest amount of the risk budget that they consumed over the period particularly in the last six months.

Overall this was a good update on the fund. It is unfortunate that Winton have not enjoyed an easy time in performance terms this year given the extra funds they received post the closure of BlueCrest to outside investors. Given the nature of the systematic investment approach it is sometimes difficult to really get below the surface and identify all the drivers of return. However as a company they continue to invest heavily in data and high ability staff, which should allow them to continue to deliver the healthy returns they have achieved over a significant period of time.

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

Peter Hunt new (relationship director) and Imran Sattar (UK portfolio manager) presented the report from Blackrock on the UK equity portfolio. Peter introduced himself as the replacement for Simon Betteley who has left Blackrock to pursue interests elsewhere. Peter has been involved with LGPS clients for around fifteen years and he reiterated the commitment Blackrock has to both the Suffolk Pension scheme and the LGPS in general. Given this was also Imran's first meeting as our new fund manager following the promotion of James Macpherson this was very much a new team presenting the equity report.

After the introduction, Peter opened by covering the market background. By way of background we were reminded that at the start of the year markets were primarily concerned about the economic situation in China and the risks around US interest rate rises and a feared 'policy error' by the Federal Reserve (the danger of raising rates too fast). However in the last quarter attention has focused on the implications of the 'Brexit' vote, currency movements and a looming US Election. Brexit in particular has made generating 'alpha' (outperformance) very hard in recent times according to Blackrock.

Imran covered the recent performance of the portfolio and explained the strong returns to the UK market over the last quarter resulted from the very high percentage of earnings in the FTSE 100 emanating from non Sterling currencies. Given the sharp fall in Sterling seen over the quarter the translation of these overseas revenues and earnings has resulted in strong UK market performance. Strong oil and commodity prices have also helped energy and mining stocks which both have significant weighting in the FTSE100 index.

Imran again pointed out the alpha had been difficult to find. However, despite this, the portfolio returned 8.4% over the quarter, 0.6% above the index. Over the last twelve months the portfolio has returned 18.3% against 16.8% and is now 3.0% per annum ahead over the last three years and remains very strong over all periods since inception. As has been mentioned before by me, a very credible set of returns, which does strengthen the case for active management.

The report showed detailed attribution by stock of the last three months with a notable winner being ARM holdings the technology stock which was taken over by Japanese company Softbank for a substantial premium to the prevailing market price. Being underweight miners detracted from performance and banks also underweight had a good quarter and detracted from relative returns. However overweight positions in information technology and support services both contributed to another strong quarter.

Imran gave a quick run through of some recent purchases including Grainger, a residential property company with tenants on long term regulated tenancy agreements. When the tenant leaves (I was not sure if this was normally from moving or dying) the company makes a return on gaining vacant possession and creating value uplift after refurbishment and onward sale. Blackrock believe there is substantial value in the stock.

Imran concluded with a brief overview of what he is looking for in a company given the macro conditions. We remain in a low growth, low interest rate and low inflation world. Blackrock continue to look for companies that can grow profits and reinvest these, compounding returns. They also look for companies that are exposed to structural growth via technical innovation and require little in the way of capital expenditure to grow.

In summary this was a good meeting. Imran who presented very well in his first full meeting, highlighted that the market remains very tough to make money, with investors not as focused on individual companies but more on macro events, which is difficult for stock pickers. Despite this issue, which has been the feature of markets for a while now Blackrock have performed well, so hopefully this will continue.

Blackrock Fixed Interest (Global absolute return, FIGO)

The meeting concluded with James Edwards (fixed interest strategist) introducing the FIGO portion of the report with a very quick reminder of how the fund operates. The fund is trying to generate consistent returns without relying on duration (changes in interest rates). The team seek to build very a diversified portfolio with volatility between 2-4%. The current yield of the fund is 3.1%, which should result in a gross return of 4% for the year as a whole.

James introduced a slide detailing the risk allocation between the various fixed income, rates and currencies held by the portfolio and the changes over the quarter. The major change is the reduction in US treasury exposure. Blackrock took this risk as a migrator ahead of 'Brexit' and have now closed the position. They have increased exposure to investment grade bonds and high yield bonds particularly via energy stocks where they see value given the more favourable conditions emerging for the sector.

In investment grade, which has lagged behind, they have added financials as they look cheap in credit terms, in direct contrast to the equity in financials. They like UBS and Credit Suisse. Even Banca Intesa in Italy, which from an equity standpoint looks a poor investment. There remains plenty of activity in the corporate bond space with 2016 likely to be a record year for US companies issuing debt.

James moved onto another slide that showed the duration breakdown by currency and country. The team have taken steps to neutralise risk to US rates as they expect a December move from the Federal Reserve, assuming this does occur they will add risk in this area again. We were told they currently like 'TIPS' (US inflation linked bonds) on the view that the Federal Reserve is happy to allow inflation to run a little 'hotter' over the near term which would be good for inflation linked bonds.

They think the market in general is underestimating the outlook for inflation, both in the US and elsewhere, in fact only in the UK is the index linked market price reflecting inflation at the target central bank level. Steeping yield curves could be a theme for next year, given the amount of government fiscal response expected everywhere accept EU. However even in Europe the type of purchases from the latest ECB quantitative easing could lead to a slightly steepening curve as well.

Performance was quickly covered and there was a slide on attribution over the past three months, where most asset classes made a positive contribution (except CLO's, collateralised loan obligations). Over three months the portfolio has done well, up 1.96% gross of fees giving a return of 2.78% over one year and a since inception figure of 1.34%. This is an improvement on the performance since being invested in the fund and hope this continues as FIGO has not quite delivered the expected returns so far.

M&G (Alpha Opportunities, fixed income**)**

As M&G were acting as hosts for the day they took the opportunity to introduce some other members of the fixed interest team managing other products that M&G considered might be of interest to the Suffolk Pension scheme. As well as the usual team of Andrew Swan (director fixed income) Maria Stott (client director) and

Richard Ryan (senior fund manager), we were introduced to Andrew Matthews who is a director in the greenfield infrastructure fund and Martin Limpenny manager of the debt solution fund.

The meeting began with a brief update on the Alpha Opportunities fund where the Suffolk Pension Fund has been invested since May 2015. The fund has a benchmark unconstrained approach with a performance target of LIBOR +3-5% achieved by accessing credit risk premium. After a difficult start the fund has begun to deliver the expected returns. Over the year to date, Alpha Opportunities is up 5.1% and is up over 6.2% over twelve months. This very strong performance has driven up the since inception returns to 3.6% over cash. This is a very satisfying outcome given the volatility that has been seen in credit markets over this period.

The last time we met M&G just after Q1, they explained how the 'dry powder' they had built up in defensive assets had been put to work, buying into a falling and risk averse credit market. As they predicted at the time, markets began to recover from fears over weak emerging markets, weak commodities and a general risk aversion. The credits they had been buying in a falling market began to perform strongly.

During this period, they focused on miners which were very out of favour, however, given the very strong rebound they have now taken profits in many of these names. I think this illustrates the extent to which M&G can be shown to actively manage this fund and stick to the principle of buying into out of favour areas, but also being willing to sell when price targets are met. The bonds of insurance companies which they were also buying during this period are still held.

Although the defensive assets were reduced dramatically during the first quarter, falling as low as 6-7% of fund value, they have now climbed back up to 25% as profits have been taken on credits that have recovered after the early year sell off. Despite this recovery, the team still wants to be exposed to areas of the credit market where there is still value. They want to avoid the central bank manipulated areas of the market, for instance the areas of the corporate bond market where the ECB and BoE are buying under the latest quantitative easing programmes.

Richard concluded this part of the meeting with some interesting stock examples including Glencore and Freeport McMoran on the commodities side. The final slides on the fund covered risk analysis, some thoughts on the implications for the upcoming elections in the US, the German and French elections next year and included the Italian referendum. Overall a very positive meeting with the active management of the fund really shining through and beginning to deliver the returns that had been hoped for

As M&G were acting as the host for the day they had been given the opportunity to introduce a number of other products that might be of interest to the Suffolk Pension fund. Some brief highlights are listed below.

M&G Debt solution fund

Martin Limpenny (fund manager) introduced the Debt Solutions fund which has a target of 8%+ IRR pa, from secured loans in under serviced markets. These loans will be into more complex situations in jurisdictions poorly serviced by the banking sector. However these loans are less complex and do not require the company restructuring that a loan in the DOF (debt opportunities fund) would. Suffolk Pension scheme has investments in DOF I and II.

M&G Infracapital (Greenfield Infrastructure fund**)**

Andrew Matthews who is a director in the Greenfield infrastructure fund introduced the opportunity. M&G are raising £1bn for a later stage development and construction infrastructure fund, with a target to earn mid to high teen returns and to develop long term cash flow yielding assets. This is a potentially interesting fund for long term investors and is being marketed to a number of LGPS funds. The targeted returns benefit from involvement in later stage development and construction. By developing and holding a portfolio of operational brownfield assets, the long term cash flow yield remains attractive to long term pension fund investors.

M&G Illiquid Credit fund

This is a partnership with RBS in the private lending area with loan sizes around £15-25m with each loan going through the M&G credit process.

Pyrford (Absolute return fund using traditional equities and bonds)

Tony Cousins (Chief Executive and CIO) and Felim Glynn (client director) presented the report from Pyrford. The meeting began with reference to a slide in the pack quoting (unattributed) something I had written in a previous report comparing Pyrford to a placard carrying 'end of the world' doomsayer. Albeit one with compelling logic underpinning the view I of course meant this as both a humorous comment and in fact a compliment to the conviction investing which I think Pyrford carry out well. Tony was very keen to point out that although they do continue to think almost all assets remain expensive they are not 'perma-bears'. They did buy into equities in the panic sell off seen in February this year which was the first time they had done so since 2009. This decision was reversed in August, following a rise in prices resulting from yet more central bank action leading to the value that emerged in February disappearing. In fact, the equity weighting is now back to the lows of 2007.

Performance has been good recently. Against the agreed RPI+5% benchmark the fund has delivered 2.49% v 1.92% over quarter three 2016. Over one year the fund has returned 12.39% v 7.13% for the benchmark. This has helped Pyrford move ahead of the benchmark over a two-year period. Longer timeframes still show a lag in performance compared to the target.

A key driver for the good returns in the recent past has been currency. Both overseas bonds and equities which are un-hedged in the portfolio delivered strong returns as sterling fell following the 'Brexit vote'. Pyrford had believed that sterling was an overvalued currency before 'Brexit', giving and the referendum result simply accelerated the fall.

Following the sharp fall in sterling, Pyrford have adjusted an element of their non-sterling exposure with some US$ assets sold and Australian dollar now hedged. In fact, they now see they US$ as overvalued when compared to Sterling, which is very cheap. Tony commented that if sterling gets down to parity (which some commentators have predicted) it would be staggeringly cheap.

The report showed a number of economic charts covering central bank balance sheet expansion, commercial banks assets and gross public debt. These are all macro concerns that inform Pyrford's defensive stance. There was a new slide included, showing the stock selection performance of just the UK equity portion of the fund. Tony expanded on their investment philosophy of buying high ROE (return on equity) companies, which facilitates compounding of returns and a high dividend yield, as this often provides more than half of the total return of equity. As total returns are dividends plus sustainable growth combined, the higher the dividend the less growth there needs to be to make the return.

At the end of the meeting as with all the managers they were asked about MiFID II. The Pyrford fund as with M&G Alpha Ops is a UCITS fund and they expect to treat Suffolk Pension fund as professional investors. Overall a very informative meeting with a consistent and well-argued investment philosophy, which always provides food for thought.

Newton (actively managed global equity)

David Moylett (client director) and Paul Markham (fund manager) presented the Quarter 3 2016 report from Newton. The meeting started with David giving an overview of the global market conditions seen during the third quarter and the year to date. With global equity markets remaining strong this year the Suffolk Pension Scheme mandate with Newton now stands at over £400m. David highlighted that although quarter three had been positive to markets, it had also been a volatile period. Emerging markets continued their recent good run which given Newton's underweight position detracted from relative performance.

The presentation contained a slide showing the three-month return at the sector level. Information technology was the best performing sector helping the portfolio given Newton's overweight stance. However, both materials (in response to higher steel and iron ore prices) and financials also enjoyed above market returns and both these sectors are underweight in the portfolio and hence acted as a drag on returns both over the quarter and as David pointed out over the year as a whole.

The year to date has been one of rising oil prices which have increased 31% up to the end of September. Iron ore and steel prices have also rallied significantly, along with emerging markets. None of these moves have helped the Newton portfolio but they still see a real possibility of a reversal in these trends and highlighted the recent rise in Chinese iron ore inventories and the on-going rise in the private debt levels in China as possible catalysts. The recent falls in sterling have however boosted returns to un-hedged sterling investors and the portfolio has been a beneficiary in absolute terms.

The meeting moved onto recent performance which given the environment described above was negative in relative terms although very significant gains have been seen in absolute terms. The fund returned 7.2% for the quarter and 29.6% for the year compared to 8.4% and 29.6% for the benchmark. Newton remain ahead of benchmark on an annualised basis over every over time period from two years to inception.

The recent underperformance is driven by the more defensive and less cyclical nature of the portfolio, characteristics that have recently been lagging in performance terms but had previously been the positive driver of relative returns. The outperformance of many of the more inflation sensitive stocks driven by what has become know as the 'reflation' trade has been a feature of markets in recent months.

The report detailed both detractors and positive contributors to returns at the stock level and Paul gave brief descriptions of many of the underlying reasons for why particular stocks had made an appearance in either list. One sector that seems to have suffered recently was healthcare, where Newton remain both overweight and positive. As Hilary Clinton appeared to move ahead in the polls concerns of future pricing controls weighed on the sector.

Paul moved onto a slide that showed recent transactions and highlighted the underlying investment reasons for these, which gave a good feel for the underlying thought processes that underpins the management of the portfolio.

The portfolio was now down to sixty five stocks which is towards the lower end of what we have come to expect. Post the quarter three period, markets have again been strong, up around 5% in sterling terms with sterling falling further. In terms of short term issues, both the upcoming US election and the expected rise in US rates towards the end of the year were mentioned as potential triggers that could disrupt the strong momentum in emerging market stocks, that has been in place throughout most of 2016.

The meeting ended with a brief discussion on MiFID II with Newton confirming that it is their intention to categorise the Suffolk Pension scheme as professional investors, which given Newton are not set up to deal with retail clients would seem the only course of action available. Overall as has become the norm with Newton a clear, informative and detailed overview of both drivers for world equity markets but also how these forces are interacting with the specific stocks held in the fund.

Mark Stevens Nov 2016