

INVESTMENT MANAGEMENT REPORT

Report of the County Treasurer

All recommendations contained in this report are subject to confirmation by the Committee before taking effect.

Recommendations:

- (i) That the Investment Management Report be noted;
- (ii) That the Committee note compliance with the 2017/18 Treasury Management Strategy.
- (iii) That the County Treasurer in consultation with the Chairman be authorised to move up to £100m from UK passive equities to overseas passive equities (North America and Japan), if market conditions provide an opportunity and the appropriate trigger points are hit, and that the trigger points be reviewed at the next meeting of the Committee.
- (iv) That the Specialist Funds investment in the State Street Emerging Markets Fund be switched from the current equal country weighted fund to a fund tracking the MSCI Emerging Markets index.

1) FUND VALUE AND ASSET ALLOCATION

The table below shows the Fund value and the asset allocation for the Fund compared to the target asset allocation as at **30 June 2017**.

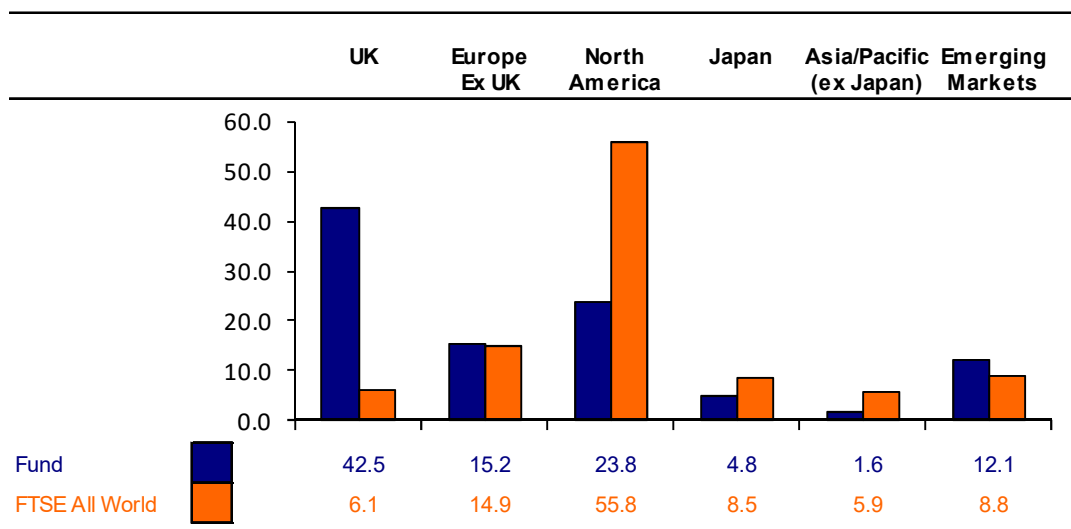
Fund Value and Asset Allocation

	Fund Value as at 30.06.17	Target allocation 2017/18	Fund asset allocation at 30.06.17	Variation from Target
	£m	%	%	%
Fixed Interest				
Global Bonds	217.1	6.0	5.5	
Multi-Sector Credit	216.4	6.0	5.4	
Cash	100.5	1.0	2.5	
	534.0	13.0	13.4	+0.4
Equities				
Passive Equities	1,739.8	43.0	43.6	
Active Global Equities	416.3	10.0	10.4	
Active Emerging Markets	182.0	5.0	4.6	
	2,338.1	58.0	58.6	+0.6
Alternatives/Other				
Diversified Growth Funds	593.3	15.0 *	14.9	
Property	368.7	10.0	9.2	
Infrastructure	155.0	4.0	3.9	
Private Debt	0.0	0.0 *	0.0	
	1,117.0	29.0	28.0	-1.0
Total Fund	3,989.1	100.0	100.0	

* Medium term allocation of 3% to Private Debt agreed, but this will be built up over time, funded from a decreased allocation to diversified growth funds

- The Fund value as at 30th June 2017 stood at £3,989.1 million, an increase of £60m over the quarter.
- The table shows the target asset allocation for 2017/18 as set out in the Investment Strategy Statement. With the exception of cash, the actual allocations are all within 1% of the target and no action is required to rebalance between asset classes. While the allocation to cash is higher than target, this will be reduced by the drawdown of the commitment made to private debt funds.
- The following table gives the geographical split of the Fund's equity allocations against the FTSE World geographical weightings:

Geographical Split of Equity Allocation compared to the FTSE All World Index

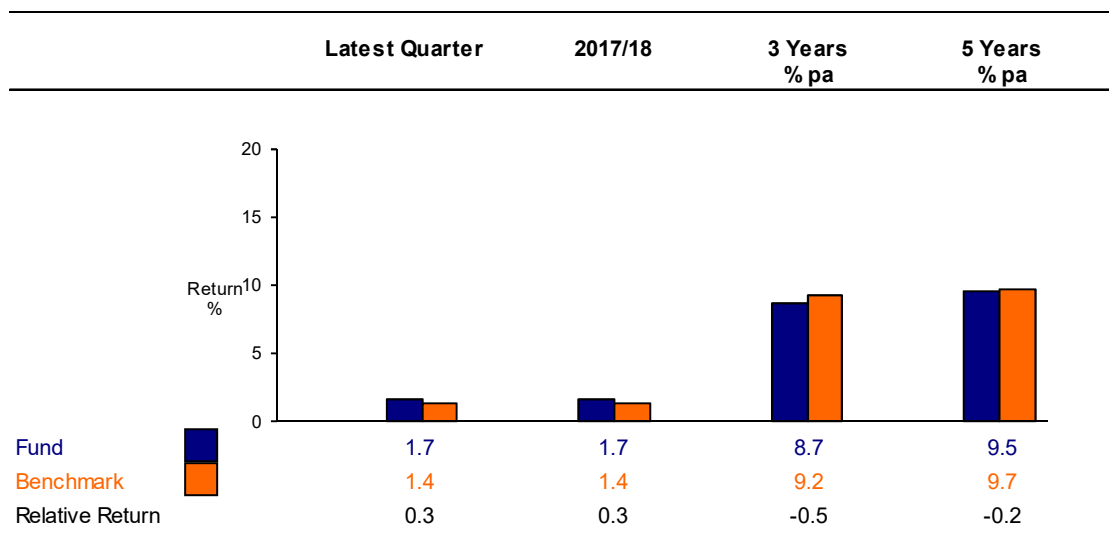


- The table shows that the Fund has an over-exposure to the UK and a significant under-exposure to North America compared to the world market. There is also a smaller under-exposure to Japan, while the exposure to Europe and the combined exposure to Asia/Pacific (ex Japan) and Emerging Markets is about right.
- It was agreed at the February committee that in principle, the Fund should look to reduce its overweight to UK equities by reallocating to overseas equities, predominantly to US equities with a small proportion to Japanese equities. It was agreed that the County Treasurer in consultation with the Chairman be authorised to move up to an initial £100m from UK passive equities to overseas passive equities, if market conditions provided an opportunity and appropriate trigger points were hit. Market conditions since February have not presented the appropriate opportunity and no action has been taken.
- It is proposed that the trigger points continue to be monitored over the period up to the next committee, and the County Treasurer retain the authorisation to move up to £100m, with the trigger points being applied to both the North America and Japan markets. However, there is a strong possibility that the agreed trigger points will not be hit for a significant period, and it is therefore proposed that officers review the trigger points with a view to recommending an alternative strategy for reducing the UK exposure and moving funds from the UK to overseas equities.

2) FUND PERFORMANCE

The performance of the Total Fund over the last quarter, the financial year, and on a rolling three and five year basis are shown in the following chart.

Longer Term Fund Performance Summary



The performance statistics quoted are net of fees for the current financial year and the last three years, but the five year figures shown combine gross performance up to 31 March 2014 and net of fees performance from 1 April 2014 onwards.

The last quarter has seen a return 0.3% above benchmark. The total absolute return for the year was +1.7%, ahead of the Fund benchmark of +1.4%. The longer term three and five year returns remain below benchmark.

A breakdown of the performance of the Total Fund for the quarter to 30 June 2017 and the comparative Index returns are shown in the table below:

Performance for the quarter to 30 June 2017

Sector	Fund Return	Benchmark	Benchmark Description
	%	%	
Global Bonds	1.0	0.3	BarCap Global Bonds
Multi-Sector Credit	2.0	1.7	MSC Bespoke *
Cash	0.2	0.0	GBP 7 Day LIBID
Passive Equities	1.5	1.6	Devon Bespoke Passive Index
Active Global Equities	2.7	0.5	FTSE World
Active Emerging Markets	1.6	2.3	MSCI Emerging Markets
Diversified Growth Funds	2.0	1.0	Devon Multi Asset Benchmark
Property	2.3	2.3	IPD UK PPF All Balanced Funds
Infrastructure	0.4	1.3	GBP 7 Day LIBID+5%
Private Debt	-	-	GBP 7 Day LIBID+5%

Total Fund	1.7	1.4	Devon Bespoke Index
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*Composed of 1/3 Bank of America Merrill Lynch Global High Yield Constrained Index; 1/3 JPMorgan Emerging Markets Bond Index Plus; 1/3 CSFB Bank Loan Index.

Key issues over the quarter include:

- The active equity and fixed interest managers have had a good quarter, performing above benchmark, with the exception of the emerging markets equities mandate which underperformed.
- Currency issues have again had an impact, with a weakening dollar reducing the value of the Fund's unhedged US exposure. This has had an adverse impact on the infrastructure return, and on the dynamic currency hedged passive US exposure. However the increase in the static hedged portion of the passive portfolio from 50% to 100% has protected the Fund to some extent. Conversely the strengthening Euro has means that the additional Euro hedges put in place have had a negative impact on both equity and infrastructure returns.
- The diversified growth funds (DGFs) have outperformed their cash plus benchmarks at a time of modest positive returns in equity and bond markets.
- Property has also seen a modest positive return in line with the benchmark.

3) SPECIALIST FUNDS – STATE STREET EMERGING MARKETS FUND

- (a) The Specialist Equity Funds mandate, to which 5% of the fund is allocated, includes an investment in the State Street equal country weighted fund, which has been held since 1995. The fund allocates an equal weight to each of the countries included within the MSCI Emerging Markets index. This means, for example, that there is an equal amount allocated to Peru and Hungary as there is to South Korea, India and Brazil. This contrasts with the main MSCI Emerging Markets Index which will have higher allocations to the latter countries reflecting the size of their economies.
- (b) The impact of this is that if smaller countries perform better than the larger countries then the Devon investment will do better than the index, whereas if the larger countries perform better, then the Devon fund will do worse than the index. The original strategy was put in place in the 1990s to exploit emerging market volatility in a systematic way and for many years did so successfully. Over the 22 years this investment has been held the annualised return has been 9.6%, compared with the MSCI Emerging Markets index return of 8.0%, i.e. outperformance of 1.6% per year. However, the outperformance was generated in the early years of the investment and more recently the relative returns have been less good. These are summarised in the table below:

State Street Equal Country Weighted Fund Performance – Periods to 30 June 2017

	1 Year %	3 Years %	5 Years %	10 Years %
Total Return	+20.0	+6.5	+5.0	+6.1
MSCI Emerging Markets Index	+27.4	+10.8	+8.2	+6.7
Difference	-7.4	-4.3	-3.2	-0.6

- (c) The features of the emerging markets universe in the 1990s were rather different to today. All the markets (including China) were small, often under-researched and de-synchronised with large swings driven by perceived political and financial risks. The opportunities to exploit investor behavioural biases were high and the quarterly re-balancing process enabled what was essentially a value style to work well (and at very low cost).
- (d) The current emerging market universe has much larger size variance, broader research coverage and higher levels of inter-dependency (therefore synchronicity). This makes the equal weighted approach less appropriate. In particular it will inevitably overweight smaller markets, which may be small because of persistent economic/political failure rather than investor behaviour. There is also more risk involved in allocating larger amounts to smaller countries, as there are liable to be fewer companies in the indexes of those countries. For

example, while there are 111 companies in the South Korea index and 78 in India, there are only three in each of Peru, Hungary and Egypt, so the average allocation to an Egyptian company is 37 times as much as to the average Korean company.

- (e) Therefore, in view of the recent poor results from this strategy, and to reduce the level of risk involved, it is proposed to change the investment such that it tracks the main MSCI Emerging Markets index, rather than the equal country weighted index, which can be achieved through the funds that State Street offers. This will maintain the allocation to emerging markets until the move across to Brunel, but remove the potential for underperformance (or outperformance) compared to the index.

4) BUDGET FORECAST MONITORING AND CASH MANAGEMENT

- (a) Appendix 1 shows the actual to date and revised forecast for 2017/18 against the original budget forecast. There was a deficit of £5.4m between contributions received and pension benefits paid out during the quarter.
- (b) The income received as cash reflects the income from the property mandate, distributions from infrastructure investments and interest on internally managed cash. This income was sufficient to cover the gap between pension benefits payments paid and the contributions received over the quarter. The remaining income is from the Fund's segregated equity and bond mandates and is reinvested by the fund managers.
- (c) Pension administration costs for the first quarter reflect the payment of the annual charge for IT support during the quarter. The updated forecast for the year is still in line with the original forecast. The actual expenditure to date for investment management and oversight and governance are generally low as payments are made in arrears. The high expenditure on actuarial services reflects costs over the quarter that will be recharged to employers, which will then reduce the net expenditure.
- (d) At 31 August 2017 the unallocated cash on deposit amounted to **£46.6m**. This is summarised in the following table. The cash held is being maintained at a lower level than in the past, with a target level of only 1% of the Fund, and it is therefore necessary to ensure its liquidity for cashflow purposes. However, the return of capital from one of the specialist funds has resulted in £10m being placed in a 6 month notice account. The additional cash is being held to meet future cashflow requirements, including providing for the drawdown of investment commitments.

Cash on Deposit

Type of Deposit	Maturity period	Actual as at 31/03/17 £m	Average Interest Rate %	Current as at 31/08/17 £m	Average Interest Rate %
Call and Notice Accounts	Immediate	10.1	0.29	36.6	0.38
	6 Month Notice	10.0	0.80	10.0	0.80
Term Deposits	<30 Days	10.0	0.45	0.0	
	>30 Days	20.0	0.60	0.0	
TOTAL (at 31st August 2017)		50.1	0.55	46.6	0.47

- (e) The weighted average rate being earned on cash deposits, as at 31 August 2017, was **0.47%**. This reflects the current low interest rate environment and the need to ensure liquidity as a result of the low level of cash being maintained.

- (f) The deposits in place during the year to date have fully complied with the Fund's Treasury Management and Investment Strategy for 2017/18.

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Local Government Act 1972

List of Background Papers Nil

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Devon County Council Pension Fund Budget / Forecast 2017/18

	Actual 2016/17 £'000	Original Forecast 2017/18 £'000	Actual to June 17 £'000	Revised Forecast 2017/18 £'000	Variance from Original Forecast £'000
Contributions					
Employers	(123,163)	(127,000)	(29,484)	(127,000)	0
Members	(36,709)	(37,000)	(8,875)	(37,000)	0
Transfers in from other pension funds:	(8,205)	(6,000)	(2,014)	(6,000)	0
	<u>(168,077)</u>	<u>(170,000)</u>	<u>(40,372)</u>	<u>(170,000)</u>	<u>0</u>
Benefits					
Pensions	136,549	142,000	35,075	142,000	0
Commutation and lump sum retirement benefits	27,716	30,000	8,992	30,000	0
Lump sum death benefits	3,751	4,000	934	4,000	0
Payments to and on account of leavers	719	500	120	500	0
Payments for members joining state scheme	5,684	6,000	693	6,000	0
	<u>174,419</u>	<u>182,500</u>	<u>45,813</u>	<u>182,500</u>	<u>0</u>
Net Withdrawals from dealings with fund members	6,342	12,500	5,441	12,500	0
Investment Income					
Received as Cash	(23,276)	(24,000)	(5,272)	(24,000)	0
Reinvested by Fund Manager	(16,576)	(17,000)	(5,358)	(17,000)	0
	<u>(39,852)</u>	<u>(41,000)</u>	<u>(10,630)</u>	<u>(41,000)</u>	<u>0</u>
Administrative costs					
Peninsula Pensions	2,059	2,000	744	2,000	0
	<u>2,059</u>	<u>2,000</u>	<u>744</u>	<u>2,000</u>	<u>0</u>
Investment management expenses					
External investment management fees - invoiced	6,182	6,900	821	6,900	0
External investment management fees - not invoiced	4,343	4,400	726	4,400	0
Custody fees	107	115	25	115	0
Transaction costs	1,370	1,500	377	1,500	0
Reversal of accrual	(2,471)	0	0	0	0
Stock lending income & commission recapture	(109)	(100)	(18)	(100)	0
Other investment management expenses	50	50	0	50	0
	<u>9,472</u>	<u>12,865</u>	<u>1,931</u>	<u>12,865</u>	<u>0</u>
Oversight and governance costs					
Investment & Pension Fund Committee Support	92	95	14	95	0
Pension Board	26	27	6	27	0
Investment Oversight and Accounting	281	285	50	285	0
Brunel Pension Partnership	146	440	(7)	440	0
Legal Support	34	30	0	30	0
Actuarial Services	69	40	106	40	0
Investment Performance Measurement	38	0	0	0	0
Subscriptions	19	20	13	20	0
Internal Audit fees	22	14	0	14	0
External Audit fees	29	29	0	29	0
	<u>755</u>	<u>980</u>	<u>181</u>	<u>980</u>	<u>0</u>
Total Management Expenses	12,286	15,845	2,855	15,845	0