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 monthly reallocations from UK Passive to Global Passive be suspended, to be reviewed further later in the year.**
- **(iii) That the Committee note compliance with the 2018/19 Treasury Management Strategy.**

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 **31 December 2018**.

Fund Value and Asset Allocation

	Fund Value as at 31.12.18	Target allocation 2018/19	Fund asset allocation at 31.12.18	Variation from Target
	£m	%	%	%
Fixed Interest				
Global Bonds	222.6	6.0	5.5	
Multi-Sector Credit	215.7	6.0	5.3	
Cash	78.7	1.0	2.0	
	517.0	**13.0**	**12.8**	**-0.2**
Equities				
Passive Equities	1,737.0	43.0	43.1	
Active Global Equities	417.0	10.0	10.3	
Active Emerging Markets	173.0	5.0	4.3	
	2,327.0	**58.0**	**57.7**	**-0.3**
Alternatives/Other				
Diversified Growth Funds	571.8	13.0	14.2	
Property	402.0	10.0	10.0	
Infrastructure	161.5	4.0	4.0	
Private Debt	53.5	2.0	1.3	
	1,188.8	**29.0**	**29.5**	**+0.5**
Total Fund	**4,032.8**	**100.0**	**100.0**	

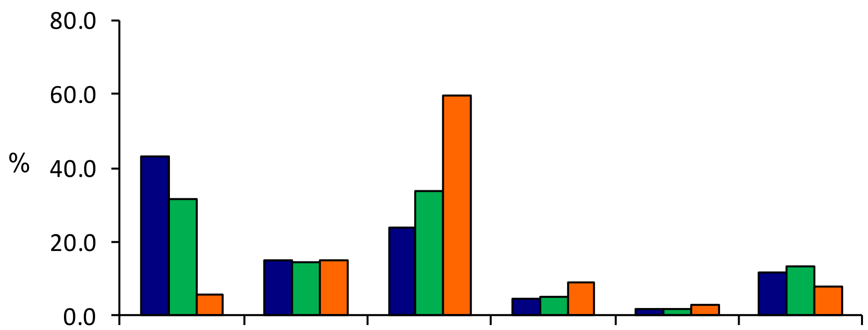
- The Fund value as at 31st December 2018 stood at £4,032.8 million, a decrease of £300m over the quarter, following significant market falls over the quarter. As a result, The Fund value at the end of December was around £50m lower than at 31st March 2018.

- For 2018/19 the strategic asset allocation has been amended, such that the allocation to diversified growth funds is reduced to 13% and the strategic allocation to private debt is shown as 2%. This reflects the likely drawdown during 2018/19 of the private debt commitments previously agreed by the Committee to be funded from the diversified growth fund allocation.
- At the November meeting, the Committee decided to allocate an initial £100 million to the Brunel Low Volatility Equities Portfolio, which would equate to an allocation of 2.5% of the Fund, to be funded by reducing the allocation to Passive Equities. This is not reflected in the table above, as the Brunel Low Volatility Equities Portfolio has not yet been made available for investment. The transition is currently expected to take place in mid-March.
- Drawdown requests were received over the quarter from Brunel for €6.7 million towards the £75 million infrastructure commitment, from Bluebay for £5.6 million and from Golub for $3.75 million of the private debt commitments. A further £7.2 million was requested by Bluebay and $9.375 million by Golub to be paid in early January after the quarter end. These were funded in part by available cash, but also by a redemption of £5 million from each of the Baillie Gifford and Barings diversified growth funds, as previously agreed.
- All asset classes were within the 2.5% threshold from their target weight as at 31st December.

<u>Geographical Weighting of Equity Allocation</u>

- The following table gives the geographical split of the Fund's equity allocations against the FTSE World geographical weightings.

<u>Geographical Split of Equity Allocation compared to the FTSE All World Index</u>



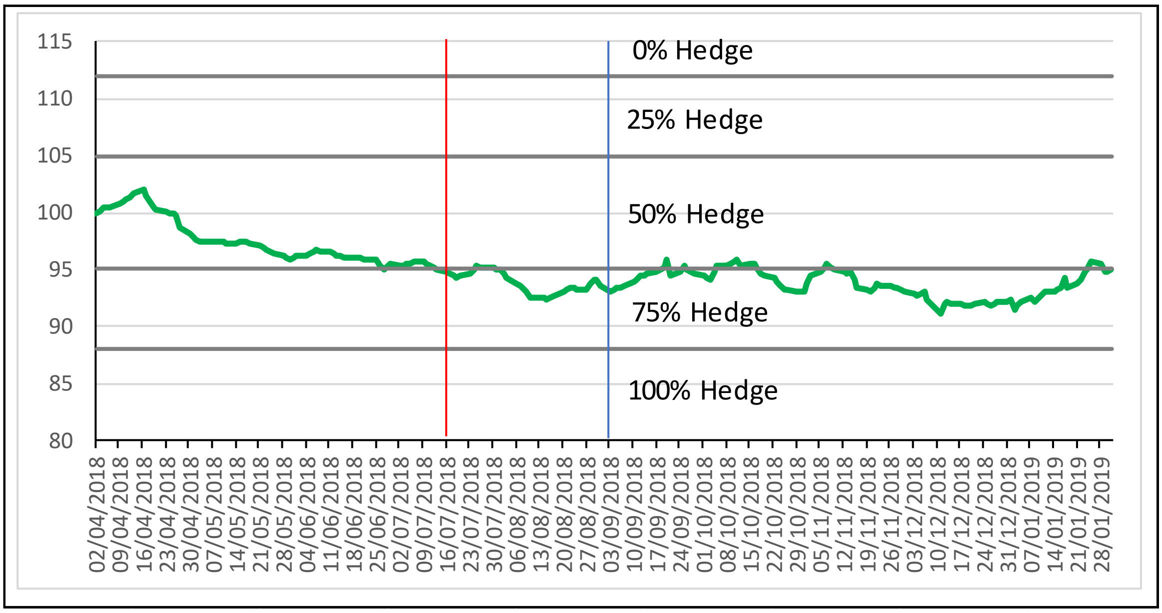
	UK	Europe Ex UK	North America	Japan	Asia/Pacific (ex Japan)	Emerging Markets
Fund as at March 2017	42.8	15.0	23.9	4.6	1.7	12.0
Fund as at Dec 2018	31.3	14.4	33.7	5.2	1.9	13.6
FTSE All World	5.9	15.1	59.5	8.9	2.9	7.7

- The Committee have previously agreed that in principle, the Fund should look to reduce its overweight to UK equities by reallocating to overseas equities on a phased basis. A total of £236 million had been moved by the end of December 2018, comprising the minimum monthly sum agreed, plus additional amounts transferred when the agreed trigger points were hit. A further £20 million has been transferred since the end of December.
- The graph shows the progress that has been made since March 2017 in reducing the overweight to the UK and the underweight to North America. While this continues to be the right thing to do in the longer term, there is continuing concern that US share prices have reached inflated levels, despite the market falls during the last quarter. It is suggested that it would now be appropriate to suspend the monthly reallocations and to review the position again later in the year.

Currency Hedging

- The following table shows the value of Sterling against a weighted average of the other major currencies.

Value of Sterling v. Weighted Average of US Dollar, Euro and Yen

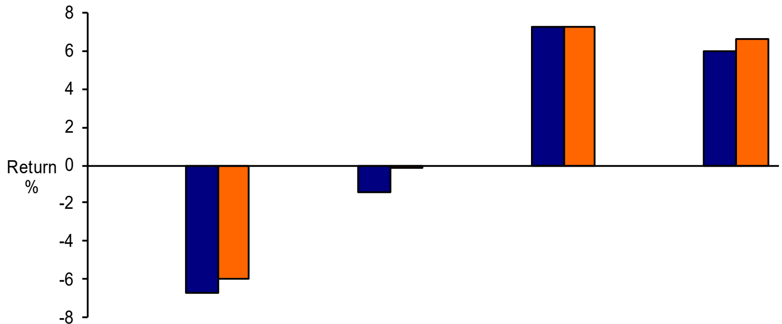


- As agreed by the Committee the allocation to Brunel's passive developed world equity portfolio was initially 50% hedged to Sterling. The transition point to Brunel is shown by the red line on the graph. However, in accordance with the currency hedging policy agreed at the June meeting of the Committee, as a result of further weakness in the value of the pound the trigger was hit to increase the hedge ratio to 75%. This is illustrated in the following chart which shows the value of Sterling against a weighted average of the US Dollar, Euro and Yen since 1st April 2018. The value of Sterling reduced from $1.40 against the pound at the beginning of April to below $1.30 at the end of August. The increase in the hedge ratio was implemented on 4th September, as shown by the blue line on the graph. The value of Sterling has fluctuated around the trigger point for moves between 75% and 50% during September and October, and again at the end of January, but the hedge has been maintained at 75%.

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



	Latest Quarter	2018/19	3 Years % pa	5 Years % pa
Fund	-6.7	-1.4	7.3	6.0
Benchmark	-6.0	-0.1	7.3	6.6
Relative Return	-0.7	-1.3	0.0	-0.6

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 of -6.7%, which was 0.7% below benchmark, resulting in a return of -1.4% for the financial year to date, 1.3% below the Fund's strategic benchmark. A breakdown of the performance of the Total Fund for the nine months **to 31 December 2018** and the comparative Index returns are shown in the following table:

Performance for the nine months to 31 December 2018

Sector	Fund Return %	Benchmark %	Benchmark Description
Global Bonds	3.5	3.9	BarCap Global Bonds
Multi-Sector Credit	-2.8	-3.3	MSC Bespoke *
Cash	-0.6	0.4	GBP 7 Day LIBID
Passive Equities	-2.4	-2.5	Devon Bespoke Passive Index
Active Global Equities	-2.5	1.4	FTSE World
Active Emerging Markets	-5.4	-6.9	MSCI Emerging Markets
Diversified Growth Funds	-4.8	3.4	Devon Multi Asset Benchmark
Property	5.0	4.5	IPD UK PPF All Balanced Funds
Infrastructure	8.0	4.2	GBP 7 Day LIBID+5%
Private Debt	10.7	4.2	GBP 7 Day LIBID+5%
Total Fund	**-1.4**	**-0.1**	**Devon Bespoke Index**

*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 six months include:

- During a quarter when equity markets fell by 10%, the negative returns suffered by the diversified growth funds (DGFs), against their cash plus targets resulted in the below benchmark performance. The DGFs have performed poorly over the year to date.
- The active global equity allocation has also under-performed over the year to date. The emerging markets equities mandate enjoyed better relative performance over the last

quarter and is now ahead of benchmark for the year to date, albeit delivering a negative absolute return.

- Global bonds produced a positive 3.5% return just below the benchmark, while the multi-sector credit has only delivered a -2.8% return during a period where riskier assets have suffered, albeit above the reference benchmark.
- The private market returns (property, infrastructure and private debt) have all delivered good positive returns, demonstrating their diversification benefits during periods when equity markets fall. The private debt return was boosted by significant currency gains on the US investment during a period of Sterling weakness.

Returns on equity markets during January have been stronger, and will have reversed some of the losses, but considerable uncertainty remains, fuelled by world trade concerns, inflated share prices and Brexit.

3) FUNDING LEVEL

The most recent triennial valuation, as at 31 March 2016, carried out by the Fund Actuary, Barnett Waddingham, determined that the Devon Pension Fund had a funding level of 84%.

The Fund Actuary provides a quarterly update, using the approach of rolling forward the data from the 2016 valuation, and updating it for subsequent investment returns, pension and salary increases. While it is not possible to assess the accuracy of the estimated liability as at 31 December 2018 without completing a full valuation, the results will be indicative of the underlying position.

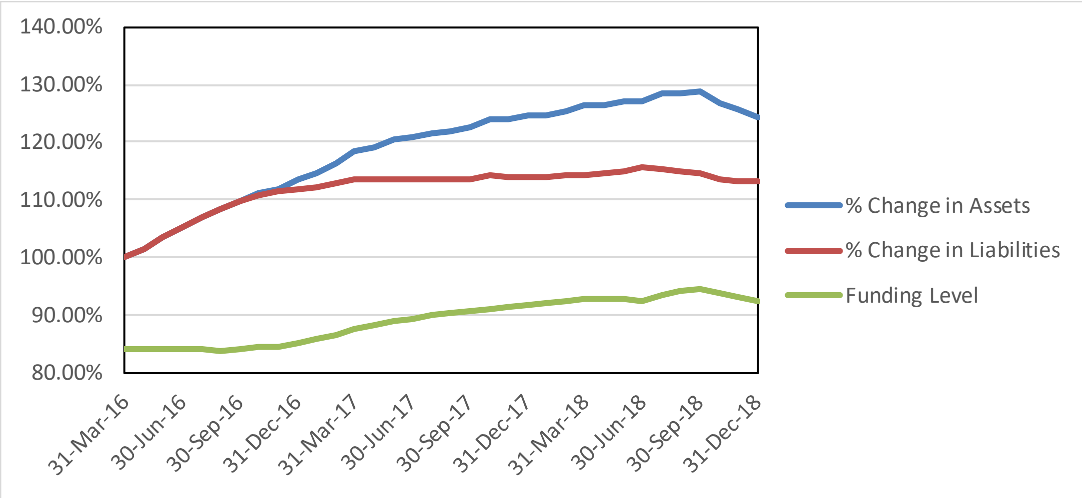
- Over the period since the 2016 Triennial Valuation, returns have been ahead of the required rate, although the annualised return over that period has fallen from 11.1% to 7.3% as a result of the market falls during the last quarter. Returns since the last Valuation are shown in the following table:

<u>Investment Returns since 2016 Triennial Actuarial Valuation</u>

	Actuarial Assumption	Actual Return
2016/17	5.5%	18.0%
2017/18	5.5%	4.3%
2018/19 to date	4.1%	-1.4%
Return since 31/3/16 (annualised)	**5.5%**	**7.3%**

- Both the assets and liabilities have increased, although the assets have increased at a faster rate than the liabilities and there has therefore been an improvement in the funding level over the period, although this has also dipped over the last quarter. The movement in assets, liabilities and funding level is shown in the following graph.

Movement of Assets, Liabilities and Funding Level March 2016 to September 2018



- Using the ongoing basis, the Actuary has estimated a funding level of **92.3%** as at 31 December 2018, compared with the 84% funding level at the 2016 Triennial Valuation.
- However, HM Treasury has recently reviewed the discount rates it proposes to use for the unfunded public sector pension schemes. It has reduced the SCAPE rate (Superannuation Contributions Adjusted for Past Experience, from 2.8% above the Consumer Prices Index (CPI) to 2.4% above CPI. It is thought likely that the review of the LGPS 2019 Valuation undertaken by the Government Actuary's Department under Section 13 of the Public Services Pension Act 2012 will use the SCAPE rate to assess whether LGPS funds meet solvency and long term efficiency requirements. The Actuary is therefore likely to adopt a higher level of prudence in setting the discount rate for the 2019 Valuation, which is likely to bring the funding level back down to nearer the funding level at the 2016 Valuation.
- Since the quarter end, markets have bounced back during January to recover some of the losses of the previous quarter. The performance of the Fund's assets over the current quarter will have an impact on the position at the 2019 Valuation.

4) BUDGET FORECAST MONITORING AND CASH MANAGEMENT

(a) Appendix 1 shows the income and expenditure for 2018/19 against the original budget forecast.

(b) There was a deficit of **£9.8m** between contributions received and pension benefits paid out over the nine months to 31 December. It is now forecast that individual transfers out of the fund will now be £2.5m more than originally forecast.

(c) The income received as cash reflects the income from the property mandate, distributions from infrastructure investments and interest on internally managed cash. This income has been sufficient to cover both the gap between pension benefits payments paid and the contributions received and the management costs for the quarter. The remaining income is from the Fund's segregated equity and bond mandates and is reinvested by the fund managers.

(d) Following the transition of passive equities to Brunel, the passive fees will no longer be invoiced, but will be deducted from the fund value. As a result, the invoiced fees are now anticipated to be below the original forecast for the year. The forecast for external management fees not invoiced will be impacted by the level of performance fees charged on some of the specialist equity, infrastructure and private debt funds, which is difficult to estimate at this point of the year, and the forecast is therefore shown as unchanged. The transactions costs to date appear low, but this is pending receipt of an updated report from State Street.

(e) Brunel company costs invoiced to the Fund are now shown under investment manager fees, but there is still a residual spend under oversight and governance costs where the Client Group receives external support for the administration of meetings etc. and provision of legal advice. This heading now shows a forecast spend of £20,000 for the year. It should be noted that a number of the governance and oversight headings will include annual invoices or recharges levied near year end, hence expenditure to date appears low in comparison with the annual forecast.

(f) The following table shows that the unallocated cash on deposit as at 31 January 2019, was **£25.5m**, plus **$5.1m** in US Dollars. 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. The level of cash has reduced since the beginning of the financial year as a result of the drawdown of investment commitments.

Cash on Deposit

Type of Deposit	Maturity period	Actual as at 31/03/18	Average Interest Rate	Current as at 31/10/18	Average Interest Rate
GBP Deposits		**£m**	**%**	**£m**	**%**
Call and Notice Accounts	Immediate	12.2	0.43	15.5	0.78
	6 Month Notice	10.0	0.97	10.0	0.97
Term Deposits	<30 Days	15.0	0.49	0.0	
	>30 Days	15.0	0.72	0.0	
TOTAL GBP		**52.2**	**0.64**	**25.5**	**0.86**
USD Deposits		**$m**	**%**	**$m**	**%**
Call and Notice Accounts	Immediate	12.6	1.55	5.1	2.48

(g) The weighted average rate being earned on GBP cash deposits, as at 31 January 2019, was **0.86%.** 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. However, there has been an increase in the rates achievable from money market funds following the Bank of England's decision to raise the base rate to 0.75%, and this is reflected in the higher average rate compared with 31 March. A higher rate is achievable on the US Dollars investment, but the return will also be impacted by changes in the exchange rate.

(h) The deposits in place during 2018/19 to date have fully complied with the Fund's Treasury Management and Investment Strategy.

5) ENGAGEMENT ACTIVITY

(a) As a responsible investor, the Fund should report regularly on its engagement activity. Voting and engagement are largely delegated to the Fund's external investment managers. The voting records of the Fund's principal equity managers at company meetings held over the last quarter is summarised in the following table.

<u>Votes Cast at Company Meetings in the quarter to 31 December 2018</u>

Manager	Number of Meetings	Number of Resolutions	Votes against managemt recommnd'n
Brunel (LGIM)	422	3,444	583
Aberdeen Asset Management	8	73	4
Specialist Funds (combined)	32	312	5

The Brunel passive allocation will include all the companies in the relevant indices, both UK and across the developed world, hence there are many more meetings voted at than for the active managers. More detail on the resolutions that the managers have voted on, together with their engagement activity, is available in the managers' quarterly investment reports, distributed separately to the Committee.

(b) The Fund is also a member of the Local Authority Pension Fund Forum (LAPFF), who undertake engagement activity on behalf of their member funds. Where significant issues arise on the agendas of company meetings, for example on remuneration policies or shareholder resolutions on climate change related issues, LAPFF will issue a voting alert to its members, including a recommendation on how to vote. However, there were no voting alerts issues during the quarter to December.

(c) The LAPFF quarterly engagement report for the quarter to 31 December is not yet available, but will be circulated to the Committee when it has been published.

Mary Davis

<u>Local Government Act 1972</u>
List of Background Papers Nil
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Appendix 1

Devon County Council Pension Fund Budget / Forecast 2018/19

	Actual 2017/18 £'000	Original Forecast 2018/19 £'000	Actual to Dec 18 £'000	Revised Forecast 2018/19 £'000	Variance from Original Forecast £'000
Contributions					
Employers	(131,149)	(134,000)	(100,198)	(134,000)	0
Members	(37,659)	(37,000)	(28,646)	(37,000)	0
Transfers in from other pension funds:	(6,481)	(6,000)	(3,911)	(6,000)	0
	(175,289)	(177,000)	(132,755)	(177,000)	0
Benefits					
Pensions	142,191	148,000	111,762	148,000	0
Commutation and lump sum retirement benefits	28,225	30,000	21,062	30,000	0
Lump sum death benefits	3,357	4,000	3,098	4,000	0
Payments to and on account of leavers	445	500	480	500	0
Individual Transfers	5,410	6,000	6,175	8,500	2,500
	179,628	188,500	142,578	191,000	2,500
Net Withdrawals from dealings with fund members	**4,339**	**11,500**	**9,823**	**14,000**	**2,500**
Investment Income					
Received as Cash	(28,441)	(29,000)	(19,766)	(29,000)	0
Reinvested by Fund Manager	(16,137)	(17,000)	(12,613)	(17,000)	0
	(44,578)	**(46,000)**	**(32,379)**	**(46,000)**	**0**
Administrative costs					
Peninsula Pensions	2,037	2,241	1,688	2,241	0
	2,037	**2,241**	**1,688**	**2,241**	**0**
Investment management expenses					
External investment management fees - invoiced	7,698	8,800	5,416	8,400	(400)
External investment management fees - not invoiced	6,242	5,500	2,918	5,500	0
Custody fees	160	160	93	160	0
Transaction costs	1,510	1,500	560	1,500	0
Reversal of accrual	0	0	0	0	0
Stock lending income & commission recapture	(77)	(100)	(17)	(100)	0
Other investment management expenses	30	50	0	50	0
	15,563	**15,910**	**8,970**	**15,510**	**(400)**
Oversight and governance costs					
Investment & Pension Fund Committee Support	93	100	62	100	0
Pension Board	29	31	16	31	0
Investment Oversight and Accounting	280	300	186	300	0
Brunel Pension Partnership	(94)	0	10	20	20
Legal Support	30	30	0	30	0
Actuarial Services	28	30	30	30	0
Investment Performance Measurement	60	60	0	60	0
Subscriptions	23	25	19	25	0
Internal Audit fees	13	24	0	24	0
External Audit fees	24	30	6	30	0
	486	**630**	**329**	**650**	**20**
Total Management Expenses	**18,086**	**18,781**	**10,986**	**18,401**	**(380)**