CT/16/104
Investment & Pension Fund Committee
2 December 2016

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 action taken to rebalance the asset allocation to within the target ranges be noted;

(ii) That the County Treasurer, in consultation with the chairman, be authorised to put in place additional currency hedging strategies, as outlined in section 3 of the report.

(iii) That the Committee note compliance with the 2016/17 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 **30 September 2016**.

Fund Value and Asset Allocation

	Fund Value as at 30.9.16	Target allocation	Fund asset allocation at 30.9.16	Variation from Target
	£m	%	%	%
Fixed Interest				
Bonds	426.4	14.0	11.6	
Cash	51.0	2.0	1.4	
	477.4	**16.0**	**13.0**	**-3.0**
Equities				
Passive Equities	1,612.0	40.0	43.7	
Active Equities	558.3	15.0	15.1	
	2,170.3	**55.0**	**58.8**	**+3.8**
Diversified Growth Funds	**518.3**	**15.0**	**14.1**	**-0.9**
Alternatives				
Property	372.5	10.0	10.1	
Infrastructure	148.9	4.0	4.0	
	521.4	**14.0**	**14.1**	**+0.1**

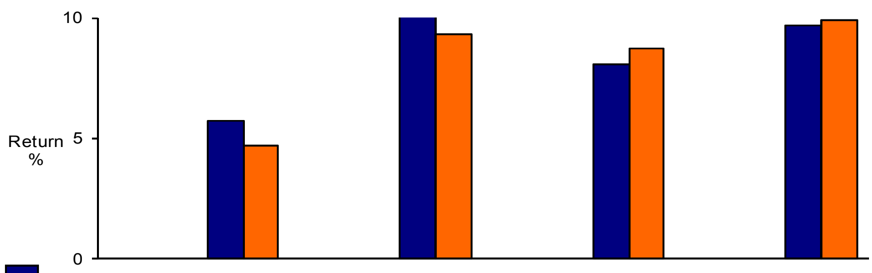
Total Fund	**3,687.4**	**100.0**	**100.0**

- The Fund value as at 30th September 2016 stood at £3,687.4 million, an increase of £190m over the quarter, and an increase of £350m since 1st April.
- As a result of the rise in equity markets, assisted by currency gains as a result of the fall in value of Sterling, the allocation to equities was 3.8% above target at the end of September. In accordance with the Fund’s rebalancing policy, agreed by the Investment and Pension Fund Committee in June 2013, if an asset class is more than 2.5% above or below the target allocation, this should prompt a decision by officers, in discussion with the Fund’s adviser, as to whether any action is required to rebalance the fund back to its target allocations. Following discussion it was concluded that now would be a good point at which to take some profit from the increase in equity values, and £50m was redeemed from the passive mandates managed by SSgA, which brought equities back to within the 2.5% threshold.
- The decision was taken to reinvest the £50m redeemed from the passive equities allocation by increasing the allocation to Diversified Growth Funds by £40 million and to cash by £10 million. This would have the effect of bringing the allocation to Diversified Growth Funds back up to the 15% target.
- The fixed interest allocation was 3% below target at the quarter end, mostly as a result of the global bonds mandates managed by Lazard and Wellington being below their target allocation. A reallocation to global bonds was therefore also considered, but it was concluded that low current yields on fixed interest made them a less attractive asset class for additional investment. The Committee had previously agreed to maintain the allocation to fixed interest below its target level at the meeting in May 2014.

2) FUND PERFORMANCE

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

Longer Term Fund Performance Summary



	Latest Quarter	From 31/3/16	3 Years % pa	5 Years % pa
Fund	5.7	10.6	8.1	9.7
Benchmark	4.7	9.3	8.7	9.9
Relative Return	1.0	1.3	-0.6	-0.2

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

The six months to 30 September 2016 has seen an absolute return of +10.6%. This is ahead of the Fund benchmark of +9.3%.

A breakdown of the performance of the Total Fund for the **six months to 30 September 2016** and the comparative Index returns are shown in the table below:

Performance for the six months to 30 September 2016

Sector	Fund Return	Benchmark	Benchmark Description
	%	%	
Global Fixed Interest	8.3	8.8	BarCap Global Bonds / MSC
Cash (inc Foreign Currency)	0.4	0.1	GBP 7 Day LIBID
Passive Equities	13.1	13.1	Devon Bespoke Passive Index
Active Equities	19.3	18.0	FTSE World
Diversified Growth Funds	6.7	2.1	Devon Multi Asset Benchmark
Infrastructure	8.0	0.1	GBP 7 Day LIBID
Property	0.0	-0.6	IPD UK PPF All Balanced Funds
Total Fund	**10.6**	**9.3**	**Devon Bespoke Index**

Key issues over the quarter include:

- Following the outcome of the referendum and the decision to leave the European Union, a major casualty of the result was a significant fall in the value of Sterling. This has had a positive effect of increasing the value of the Fund's overseas assets in Sterling terms and pushing up the value of UK shares where companies benefit from overseas earnings. Bond values have also risen as a flight to quality and fears about growth and inflation have compressed yields yet further.
- Returns would have been higher but for the impact of the partial currency hedging in place on the Fund's overseas passive equities and global bonds mandates. The currency hedges in place reduced the returns during a period when it would have been better to have been unhedged.
- The diversified growth funds (DGFs) outperformed their cash plus benchmarks at a time of positive returns in equity and bond markets.
- Property has seen reductions in capital values as a result of uncertainty following the referendum result, but the income yield has resulted in an overall flat return over the 6 months, while the benchmark has been negative.

3) CURRENCY HEDGING

(a) A significant factor in the positive returns over the period since the EU Referendum has been the fall in the value of Sterling. This has had the effect of increasing the value of the Fund's overseas assets. Forecasting currency movement is always difficult, and it appears likely that the value of Sterling could remain low for some time to come, and could still go lower. However, it may be that the majority of the impact of the vote to leave the EU on the value of Sterling has now been factored into its value and that any further fall in value will be significantly less than that experienced over the last four months.

(b) The biggest currency risk to the Fund, therefore, would be that if Sterling begins to rise in value against the US Dollar and the Euro, the currency gains that have been made over the last four months could be reversed. The precise currency exposure of the total fund is difficult to calculate, as most of the managers have some discretion to vary currencies, and the currency exposure of DGFs or multi asset funds like Baillie Gifford, Barings and Wellington can vary. But a rough approximation, based on a transparent look-through analysis of underlying assets, suggests a total unhedged overseas currency exposure of around 30-35%

of the assets of the Fund. It would therefore be sensible to consider managing that risk by increasing the extent of the currency hedging in place on the Fund's overseas assets. The risks associated with currency will be considered as part of the upcoming strategy review, but it is likely to be several months before any changes resulting from the review will be implemented.

(c) There are two areas of potential focus for increased currency hedging. Firstly the overseas passive funds managed by State Street. Currently there is a dynamic hedge in place over half the assets in each of North America, Europe and Japan. The dynamic hedge is actively managed and the level of hedge will be varied by State Street according to whether their model perceives Sterling to be under or overvalued. There is a static 50% hedge in place over the remaining half of the assets, and it would be possible to increase the hedge from 50% up to 75% or 100% on this part of the portfolio. There would be a small additional cost, but it would reduce the risk of a rise in Sterling having a negative impact on the value of the assets.

(d) The other area where additional currency hedging could be beneficial would be in relation to the Specialist Funds. The RWC European Focus Fund and the First State European Diversified Infrastructure Fund are both denominated in Euros, and while the Montanaro Smaller Companies Fund has a Sterling share class, the underlying investments have significant exposure to the Euro. These three funds between them have a value of around £140m and it would be possible to put in place a currency overlay to reduce the impact of currency moves on the Sterling valuation of these funds. While two of the other specialist funds (the UBS International Infrastructure Fund and the FPP Emerging Markets Fund) are both denominated in USD they are of lower value and have significant underlying exposure to other currencies, so a hedge on these funds would be less effective.

(e) The remainder of the Fund's other overseas assets would be more difficult to hedge. Both the Aberdeen Asset Management mandates have global holdings in a variety of currencies. Aberdeen have indicated that trying to put a hedge in place would be extremely costly due to the wide variety of currencies. The global bonds funds managed by Wellington and Lazard already have a 50% hedge in place, and the remaining currency risk is actively managed. The Baillie Gifford and Barings diversified growth funds both already make extensive use of currency hedging to manage risk.

(f) It is therefore proposed that the County Treasurer, in consultation with the chairman, be authorised to put in place the additional currency hedging strategies, as outlined in paragraphs (c) and (d), as and when market conditions seem appropriate. This would have the effect of reducing the unhedged overseas currency exposure from around 30-35% to around 25%.

4) BUDGET FORECAST MONITORING AND CASH MANAGEMENT

(a) Appendix 1 shows the actual to date and revised forecast for 2016/17 against the original budget forecast. This shows a deficit of £13.1m between contributions received and benefits paid out in the first half of the year. In addition £5.9m in management expenses has been incurred over the six months. This is offset by the receipt of £11.6m investment income from property and infrastructure, with a further £7.9m being reinvested by the Fund's investment managers.

(b) The revised forecast shows an increased forecast for transfers in from other pension funds, where the original forecast has already been achieved. The same is true for payments to and on account of leavers. The Investment Oversight and Accounting heading includes an additional £50,000 Brunel costs.

(c) At 14 November 2016 the unallocated cash on deposit amounted to £43.6m. The cash held is being maintained at a lower level than in the past, and it is therefore necessary to ensure its liquidity for cashflow purposes. Hence the majority of cash is held in money market funds or call accounts with immediate or short term access. The cash figure includes an additional £10m as a result of the rebalancing outlined in section 1 of the report, and this has been placed into a longer term 6 months deposit.

Cash on Deposit

Type of Deposit	Maturity period	Actual as at 31/03/16	Average Interest Rate	Current as at 14/11/16	Average Interest Rate
		£m	%	£m	%
Call and Notice Accounts	Immediate	39.2	0.41	12.6	0.33
	2 Day Notice			21.0	0.48
Term Deposits	<30 Days	0.0		0.0	
	>30 Days	0.0		10.0	0.60
TOTAL (at 14th November 2016)		**39.2**	**0.41**	**43.6**	**0.47**

(d) The weighted average rate being earned on cash deposits, as at 14 November 2016, 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. The rates available have fallen further following the Bank of England's decision to reduce the base rate to 0.25%. However this has been offset to a certain extent by the use of a money market fund with a 2 day notice period for the withdrawal of cash that offers a better rate, and the use of a six month term deposit.

(e) The deposits in place during the year fully complied with the Fund's Treasury Management and Investment Strategy for 2016/17.

Mary Davis

Local Government Act 1972
List of Background Papers Nil

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Appendix 1

Devon County Council Pension Fund Budget / Forecast 2016/17

	Actual 2015/16 £'000	Original Forecast 2016/17 £'000	Actual to Sept 16 £'000	Revised Forecast 2016/17 £'000	Variance from Original Forecast £'000
Contributions					
Employers	(117,079)	(117,000)	(53,247)	(117,000)	0
Members	(36,201)	(36,000)	(17,794)	(36,000)	0
Transfers in from other pension funds:	(4,766)	(3,000)	(3,310)	(4,500)	(1,500)
	(158,046)	(156,000)	(74,351)	(157,500)	(1,500)
Benefits					
Pensions	132,435	135,000	67,805	135,000	0
Commutation and lump sum retirement benefits	30,035	32,000	14,975	32,000	0
Lump sum death benefits	3,777	4,000	2,067	4,000	0
Payments to and on account of leavers	443	200	288	400	200
Payments for members joining state scheme	6,986	6,000	2,321	6,000	0
	173,676	177,200	87,457	177,400	200
Net Withdrawals from dealings with fund members	**15,630**	**21,200**	**13,105**	**19,900**	**(1,300)**
Investment Income					
Received as Cash	(19,021)	(19,100)	(11,645)	(19,100)	0
Reinvested by Fund Manager	(16,722)	(14,300)	(7,921)	(14,300)	0
	(35,743)	**(33,400)**	**(19,566)**	**(33,400)**	**0**
Administrative costs					
Peninsula Pensions	1,523	1,713	718	1,713	0
	1,523	**1,713**	**718**	**1,713**	**0**
Investment management expenses					
External investment management fees - invoiced	5,242	5,950	2,070	5,950	0
External investment management fees - not invoiced	2,994	3,000	1,442	3,000	0
Custody fees	140	115	25	115	0
Transaction costs	3,508	3,510	1,354	3,510	0
Stock lending income & commission recapture	(94)	(85)	(52)	(85)	0
Other investment management expenses	50	25	11	25	0
	11,840	**12,515**	**4,849**	**12,515**	**0**
Oversight and governance costs					
Investment & Pension Fund Committee Support	85	92	48	92	0
Pension Board	21	27	15	26	(1)
Investment Oversight and Accounting	288	333	241	383	50
Legal Support	43	43	(7)	43	0
Actuarial Services	41	60	67	60	0
Investment Performance Measurement	24	42	8	42	0
Subscriptions	38	41	11	41	0
Internal Audit fees	13	14	0	14	0
External Audit fees	29	29	0	29	0
	582	**681**	**383**	**730**	**49**
Total Management Expenses	**13,945**	**14,909**	**5,950**	**14,958**	**49**