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.

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 March 2017**.

Fund Value and Asset Allocation

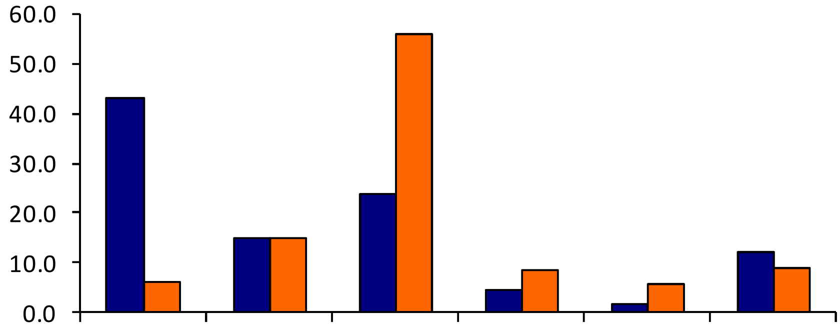
	Fund Value as at 31.03.17	**Target allocation 2016/17**	**Target allocation 2017/18**	**Fund asset allocation at 31.03.17**	**Variation from 2017/18 Target**
	£m	**%**	**%**	**%**	**%**
Fixed Interest					
Bonds	429.7	14.0	12.0	11.0	
Cash	86.9	2.0	1.0	2.2	
	516.6	**16.0**	**13.0**	**13.2**	**+0.2**
Equities					
Passive Equities	1,713.1	40.0	43.0	43.6	
Active Equities	597.5	15.0	15.0	15.2	
	2,310.6	**55.0**	**58.0**	**58.8**	**+0.8**
Diversified Growth Funds	**581.1**	**15.0**	**15.0**	**14.8**	**-0.2**
Alternatives					
Property	363.0	10.0	10.0	9.2	
Infrastructure	157.5	4.0	4.0	4.0	
	520.5	**14.0**	**14.0**	**13.2**	**-0.8**

Total Fund	**3,928.8**	**100.0**	**100.0**	**100.0**

- The Fund value as at 31st March 2017 stood at £3,928.8 million, an increase of £150m over the quarter, and a total increase of £593m over the financial year.

- The table shows the target allocation for 2016/17, and the revised target allocation for 2017/18 as set out in the Investment Strategy Statement approved at the February committee meeting, following the strategic asset allocation review undertaken by Mercer. Following the revision of the target allocations, the actual allocations are all within 1% of the target and no action is required to rebalance between asset classes.
- 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>



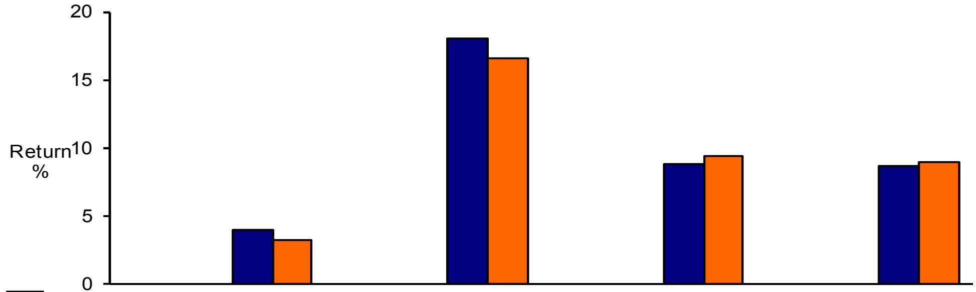
	UK	Europe Ex UK	North America	Japan	Asia/Pacific (ex Japan)	Emerging Markets
Fund	42.8	15.0	23.9	4.6	1.7	12.0
FTSE All World	6.1	14.9	55.8	8.5	5.9	8.8

- 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 over the last four months 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.

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	2016/17	3 Years % pa	5 Years % pa
Fund	4.0	18.0	8.9	8.7
Benchmark	3.2	16.6	9.4	9.0
Relative Return	0.8	1.4	-0.5	-0.3

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 0.8% above benchmark. The total absolute return for the year was +18.0%, ahead of the Fund benchmark of +16.6%. The longer term three and five year returns remain below benchmark.

A breakdown of the performance of the Total Fund for the **year to 31 March 2017** and the comparative Index returns are shown in the table below:

Performance for the year to 31 March 2017

Sector	Fund Return	Benchmark	Benchmark Description
	%	%	
Global Fixed Interest	8.3	8.0	BarCap Global Bonds / MSC
Cash (inc Foreign Currency)	1.3	0.2	GBP 7 Day LIBID
Passive Equities	23.9	24.4	Devon Bespoke Passive Index
Active Equities	30.1	33.1	FTSE World
Diversified Growth Funds	10.8	4.2	Devon Multi Asset Benchmark
Infrastructure	14.2	0.2	GBP 7 Day LIBID
Property	4.0	3.7	IPD UK PPF All Balanced Funds
Total Fund	**18.0**	**16.6**	**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 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 also rose as a flight to quality and fears about growth and inflation compressed yields yet further, although this has partly reversed over the last six months.
- As agreed at the December meeting of the Committee, additional currency hedging has been put in place. The passively hedged North America, Europe and Japan funds managed by State Street have been changed from a 50% static hedge to a 100% static hedge. The

dynamically hedged funds remain unchanged. In addition forward currency contracts have been put in place to hedge the currency risk in respect of the Montanaro European Smaller Companies Fund, the RWC European Focus Fund and the First State European Diversified Infrastructure Fund, all of which have significant exposure to the Euro. The additional currency hedging will safeguard the gains made from the fall in the value of Sterling should it strengthen over the coming months, but will reduce the opportunity of further gains should Sterling weaken further. Given the significant fall in Sterling over 2016, the most significant risk to the fund would be a strengthening of Sterling against the Euro and US Dollar.

- Equities delivered a strong absolute return. However the active equity managers have collectively performed below the FTSE World benchmark. This is partly a result of the underweight exposure to the US market which rallied strongly following the election of Donald Trump.
- The diversified growth funds (DGFs) have outperformed their cash plus benchmarks at a time of positive returns in equity and bond markets.
- The infrastructure investments have performed well over the year, also aided by the currency movements, and have also provided significant income distributions to the Fund.
- 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 positive return over the year.

3) BUDGET FORECAST MONITORING 2016/17 AND 2017/18

Appendix 1 shows the outturn position for 2016/17 against the original budget forecast and the forecast for 2017/18.

(a) **Contributions and Benefits**

- There was a deficit of £6.3m between contributions received and benefits paid out during 2016/17. This was a lower deficit than forecast, partly as a result of some of the Fund's employers deciding to pay in additional contributions in 2016/17 to reduce their deficit and thereby reduce the deficit contributions that will be needed in future years. There was also an increase in transfers in from other pension funds, which is a difficult area to predict.
- The forecast for 2017/18 shows an increase in the employer contributions expected as a result of the new contribution levels set by the triennial Actuarial Valuation. The forecast expenditure on pensions also shows an increase in line with the trend over recent years. The forecast deficit for the year is £12.5m.

(b) **Investment Income**

- Investment income was higher than anticipated. The income received as cash reflects the income from the property mandate, distributions from infrastructure investments and interest on internally managed cash. The growth in income reflects growing distributions from the infrastructure investments and good yields on property. This income is retained to cover the gap between pension benefits payments and the contributions received and also to pay management expenses. The remaining income is from the Fund's segregated equity and bond mandates and is reinvested by the fund managers.
- The forecast for 2017/18 assumes a similar level of income to that achieved in 2016/17.

(c) **Management Expenses**

This heading comprises pension administration costs, investment management expenses and oversight and governance costs.

- The pension administration costs for 2016/17 were slightly higher than anticipated in the budget. There were two main reasons for this. Firstly, additional system costs were required in order to reconcile the Guaranteed Minimum Pension figures with those held by HMRC. Secondly, costs anticipated to occur in 2015/16 slipped into 2016/17.
- Invoiced investment management fees were broadly in line with the forecast, with the increase reflecting the growing value of the Fund over the year. Fee reductions were negotiated with three managers during the year. The increase in the management fees not invoiced largely reflected higher performance fees taken by the infrastructure fund managers, which reflected a positive investment performance. In November it was identified that in 2015/16 an asset purchase of £2.471m had been incorrectly treated as a transaction cost and as a result the transaction costs for that year were overstated. This has been corrected in 2016/17 and has been shown as a separate entry, which has reduced the total investment management costs from that forecast.
- Oversight and governance costs were broadly as forecast with the exception of the cost of the Brunel pooling project, where the legal and consultancy costs were higher than originally allowed for.
- The forecast management costs for 2017/18 show an increase from the costs in 2016/17. For the most part these reflect inflation and the growing value of the Fund. The significant increase in the forecast cost of the Brunel Pension Partnership of £440,000 reflects the fact that the company will be setting up its office, recruiting directors and staff and appointing an administrator during the year as it starts to become fully operational.

4) TREASURY MANAGEMENT STEWARDSHIP 2016/17

(a) At the February 2016 Committee, members approved a Treasury Management and Investment Strategy for 2016/17. This section of the report provides a review of the unallocated cash managed by the Assistant County Treasurer and his team during 2016/17.

(b) Interest rates continue to be very low and the Bank of England base rate was reduced from 0.5% to 0.25% following the result of the EU referendum. The rates available from the banks for call accounts and short term deposits have reduced during the year, largely as a result of regulatory issues designed to ensure the safety of bank deposits.

(c) The Pension Fund maintains a very prudent approach to cash investments. Cash is now being maintained at a low level, and therefore ensuring liquidity of the Fund’s cash is a key requirement. Putting safety and liquidity before yield does however impact on the income being generated from these investments but is a necessary position to maintain.

(d) At 31 March 2017 the unallocated cash on deposit amounted to **£50.1m**. This is summarised in the following table. 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. However, the return of capital from one of the specialist funds has resulted in £20m being placed into longer 6 month deposits and a further 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 31/03/16	Average Interest Rate	Current as at 31/03/17	Average Interest Rate
		£m	%	£m	%
Call and Notice Accounts	Immediate	39.2	0.41	10.1	0.29
	6 Month Notice	0.0		10.0	0.80
Term Deposits	<30 Days	0.0		10.0	0.60
	>30 Days	0.0		20.0	0.45
TOTAL (at 31st March 2017)		**39.2**	**0.41**	**50.1**	**0.55**

(e) The weighted average rate being earned on cash deposits, as at 31 March 2017, was **0.55%.** 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 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 and Forecast 2017/18

	Actual 2015/16 £'000	Original Forecast 2016/17 £'000	Actual 2016/17 £'000	Variance from Original Forecast £'000	Forecast 2017/18 £'000
Contributions					
Employers	(117,079)	(117,000)	(123,163)	(6,163)	(127,000)
Members	(36,201)	(36,000)	(36,709)	(709)	(37,000)
Transfers in from other pension funds:	(4,766)	(3,000)	(8,205)	(5,205)	(6,000)
	(158,046)	(156,000)	(168,077)	(12,077)	(170,000)
Benefits					
Pensions	132,435	135,000	136,549	1,549	142,000
Commutation and lump sum retirement benefits	30,035	32,000	27,716	(4,284)	30,000
Lump sum death benefits	3,777	4,000	3,751	(249)	4,000
Payments to and on account of leavers	443	200	719	519	500
Payments for members joining state scheme	6,986	6,000	5,684	(316)	6,000
	173,676	177,200	174,419	(2,781)	182,500
Net Withdrawals from dealings with fund members	**15,630**	**21,200**	**6,342**	**(14,858)**	**12,500**
Investment Income					
Received as Cash	(19,021)	(19,100)	(23,276)	(4,176)	(24,000)
Reinvested by Fund Manager	(16,722)	(14,300)	(16,576)	(2,276)	(17,000)
	(35,743)	**(33,400)**	**(39,852)**	**(6,452)**	**(41,000)**
Administrative costs					
Peninsula Pensions	1,523	1,713	2,059	346	2,000
	1,523	**1,713**	**2,059**	**346**	**2,000**
Investment management expenses					
External investment management fees - invoiced	5,242	5,950	6,182	232	6,900
External investment management fees - not invoiced	2,994	3,000	4,343	1,343	4,400
Custody fees	140	115	107	(8)	115
Transaction costs	3,508	3,510	1,370	(2,140)	1,500
Reversal of accrual			(2,471)	(2,471)	0
Stock lending income & commission recapture	(94)	(85)	(109)	(24)	(100)
Other investment management expenses	50	25	50	25	50
	11,840	**12,515**	**9,472**	**(3,043)**	**12,865**
Oversight and governance costs					
Investment & Pension Fund Committee Support	85	92	92	(0)	95
Pension Board	21	27	26	(1)	27
Investment Oversight and Accounting	288	283	281	(2)	285
Brunel Pension Partnership		50	146	96	440
Legal Support	43	43	34	(9)	30
Actuarial Services	41	60	69	9	40
Investment Performance Measurement	24	42	38	(4)	0
Subscriptions	38	41	19	(22)	20
Internal Audit fees	13	14	22	8	14
External Audit fees	29	29	29	(0)	29
	582	**681**	**755**	**74**	**980**
Total Management Expenses	**13,945**	**14,909**	**12,286**	**(2,623)**	**15,845**